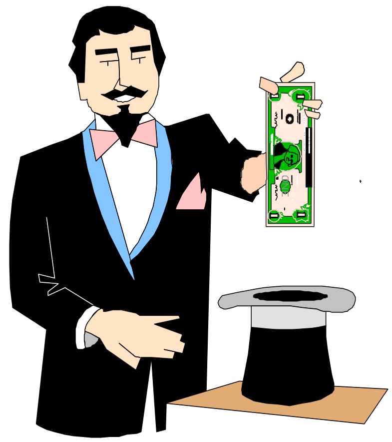
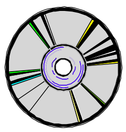
UNIT 17

HOW BANKS CREATE MONEY





We all know that the central bank of your country has the sole responsibility for creating money. It prints and coins as much as the government feels necessary. But, do you know that banks also create money by themselves? This is done by lending out the larger portion of the money they have on deposit and keeping only a fraction. Whether this fraction is 1/10th, 1/50th, 1/100th depends on the banking regulations in your country. This process of lending out money and keeping a small amount in reserve - **the fractional reserve** - is the basis of modern banking. In order to illustrate this point, let us say that the ratio is one to a hundred, which means that the bank must hold 1% out of every 100 dollars it has. Then 1 to 100 is the fractional reserve requirement.

Basically, here is how it works:

1. **Person A deposits 100 dollars into the first bank.**
2. **The bank keeps 1% ($1) in reserve and lends out 99% ($99) to person B.**
3. **After that, person B deposits the $99 into the second bank.**
4. **The second bank also keeps 1% of the money and lends out $98.1 to person C.**
5. **C deposits the money into another bank.**
6. **This process continues until all the money is used up.**

<u>Try this</u>.

Can you calculate the total amount of money that can be created in this way?

(See diagram next page)

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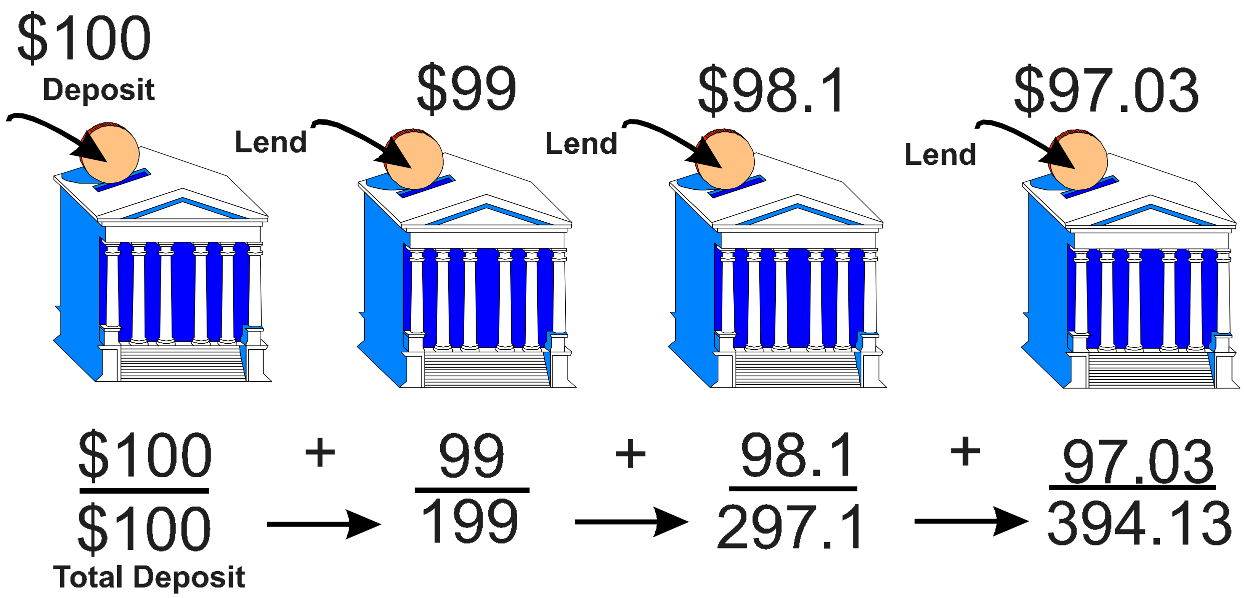
Now the total deposits of the first and second banks add up to $199 (see diagram below). Add the third bank and the total is $297.1. The money keeps on increasing. If this procedure continues until all the money is used up, the grand total amount of money that can be created is a staggering **$9,900!** Not bad, unless the banks go under (fail). What happens is that the last bank in the series fails and this sets off a chain reaction of failures in all the banks way back down the line. Then, you could have a total collapse of the system - a nightmare for the economy, which bankers will do anything to avoid.



The central bank will avoid this catastrophe by arranging a bail out (help out) package with other banks in the system in the form of special loans. Depositors will be safe up to a certain limit set by government insurance, which guarantees they will not lose more than a certain amount. If that is not enough, it can always print more money and pass it around. This will seem good at first, but, of course, creates inflation which results in higher prices in the end. As mentioned before, "the last man standing" is always the ordinary worker who gets paid in the inflated currency.

Discussion.

1) In your country, how much insurance is there on bank deposits?
2) Should this amount be raised, lowered or left unchanged?
3) Are banks as careful with their depositors' money when they know insurance will cover their losses as when it will not?
4) Is there a "moral hazard" associated with insurance; that is, people engage in more risky behavior because someone else will pay for their losses?
5) Do you know any stories of banks making bad loans?

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COMPREHENSION

Write **T** for true or **F** for false in the box next to each statement.

	Banks print money by themselves.
	Banks borrow money from other banks.
	Banks cannot lend out money they do not have.
	In an emergency, banks always have enough money on hand in case depositors run in to get their cash.
	Banks create the illusion of money through credit.
	As long as a bank operates on the fractional reserve system, it can never go broke.

TALK IT OVER

1. Are you a borrower or a lender?
2. What do you think should be the fractional reserve ratio for banks in your country?
3. Should government get involved in the stock market; that is, prop it up (support it)?

DEBATE

The issue: **Government should subsidize large companies and banks when they cry bankruptcy.**

1. First, choose a side: FOR or AGAINST.
2. Next, list your reasons below. Write ideas for both FOR and AGAINST sides, because they could be used against you. Be prepared to write them on the board.
3. Then, debate with other classmates.

FOR	AGAINST

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CREDIT. Think and discuss.

1) Are you the kind of person who likes to pay in cash, or by credit? Why?
2) What do you like and dislike about the credit card culture?
3) Why is the interest charge for late payments on credit card bills so high per month? Could a bank charge you that high a rate on a loan?
4) What is the difference between a banks loan and a credit card bill?
5) Look up the word "usury." Can you think of examples?
6) Is it possible to borrow on one credit card to pay off another?
7) If you owed a lot of money on a credit card and could not pay it back, how would the bank get its money back?
8) When you buy on credit, does real money ever change hands?
9) Is it possible to live in a "cashless society," that is, one in which "real" money never changes hands? What would be the advantages and disadvantages?
10) Money is the medium of exchange. We do not trade our labor and goods directly, but use money instead. Can creating more money alone, therefore, really boost the economy?