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LECTURE 32: HOW BANKS WORK

I. Fractional reserve system

a. Banks are *financial intermediaries*: they connect savers with borrowers. They make money by turning their liabilities (debts) into assets, such as lending out a deposit.

   i. *Reserve ratio* is the portion of deposits banks hold either in their vaults or at the Federal Reserve. Anything they don't hold onto, they lend out.[1]

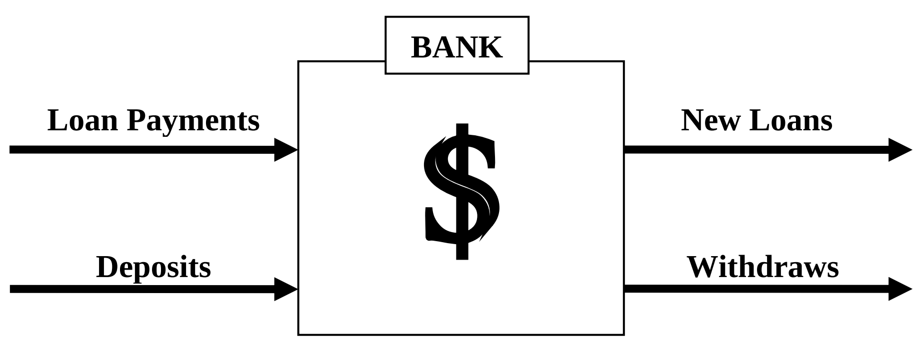
   ii. This system is called the *fractional reserve system*; banks keep a fraction of what's deposited and the rest is lent out.

b. A house of cards?

   i. So banks get money from depositors and then lend most of it out to others. But you can still stake a claim 100% of the money you deposited. How? It's not there anymore!!!

   ii. If you close your bank account, you'll be taking other people's deposits. This isn't a big deal—these individuals still have a claim to their money. People only want a fraction of the money in their checking account at any one time.

   iii. Every day, the bank brings in money from people paying back loans and from new deposits in accounts. Every day, money flows out in the form of loans and withdraws. Running a bank is all about doing what you can to manage those inflows and outflows.



[1] There's also this thing called the reserve requirement, or the percent of reserves that banks have to hold onto to cover withdraws. This is a regulatory requirement but even when the reserve requirement is zero, banks still have an incentive to keep cash on hand. No one wants to put money in bank and then not be able to get it back!

iv. The problem occurs when people take more out than what is there. This is called a bank run and when it happens, it becomes a disaster very quickly.

c. FDIC
   i. Stopping a bank run is very hard. The more people try to take money out, the more urgent it is to withdraw money. In emergencies, the government might declare a "holiday" and close the banks, but that doesn't really solve the problem.
   ii. The Federal Deposit Insurance Corporation insures all deposits under $250,000. If the bank fails, you'll still get your money. Just make sure your bank is a member of FDIC (it's a really shady bank if it's not).

d. Money creation
   i. If a bank gets new deposits, most of that money is lent out; that's the point of the system.
   ii. But that means that a single dollar is counted twice as part of the money supply. Once as deposit—fulfilling the role as an asset of the depositor—and once as a loan—fulfilling the role as an asset of the bank.
   iii. Resist the temptation to freak out. Unlike GDP, where we hate counting things twice, this isn't a big deal. The money *should* be counted twice; the same dollar is doing two things; it's just like the velocity of money. The same money is involved in multiple transactions.
   iv. Though no money was printed, this is money creation. Loans count as money. When banks fail or don't give out loans, that's money destruction.