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Fractional Reserve Banking Is Fraudulent and Ruinous

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ABSTRACT: Fractional reserve banking is a banking system where commercial banks are required to maintain only a fraction of deposits as cash reserves for withdrawal while also having the ability to create money through lending. This has been a topic of heated debate in economics. Both camps have presented arguments that have not conclusively disproved the opposing viewpoint, resulting in a decades-long stalemate on this complex and contentious subject. This article demonstrates that fractional reserve banking is fraudulent and ruinous, asserting that it is fraudulent when banks use funds from non-interest-bearing accounts to issue loans or make investments, as this practice constitutes an infringement of property ownership rights. It is further fraudulent when commercial banks create money by lending it into existence. Additionally, fractional reserve banking is ruinous because it leads to crises and other detrimental consequences. The article is structured in four parts: the first discusses ethics, fraud, and human nature; the second outlines the definition of fractional reserve banking; the third explains the doubly fraudulent nature of this model; and the fourth examines its ruinous consequences.

KEYWORDS: commercial banking, fractional reserve banking, bank credit, central banking, monetary systems, ethics, social philosophy, economics, Africonomics, social sciences.

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INTRODUCTION

The legitimacy and desirability of fractional reserve banking have always been a topic of contentious debate in economics. For the past decades, the debate primarily involves two camps within free-market economics. Socialist and other statist fields of economics, including contemporary mainstream economics, have not addressed their position on this complex and contentious subject, which is a fundamental aspect of existing banking and monetary systems. This lack of engagement in such a crucial scholarly debate suggests that mainstream/statist economics is indifferent to or supportive of fractional reserve banking. Indeed, the absence of challenge to fractional reserve banking from economists outside the free market sphere indicates a general acceptance and tacit endorsement of this banking model by contemporary mainstream economics.

Fractional reserve banking faces rebuttal and defense from two opposing camps within free-market economics. One side argues that it is fraudulent and illegitimate, while the other defends its legitimacy and desirability. Both camps have presented arguments over the years, but none have conclusively disproved the opposing viewpoint, resulting in a decades-long stalemate on this intricate and controversial economic matter. This article asserts that fractional reserve banking is a fraudulent banking model with detrimental consequences for the stability of the financial system and the economy. It is worth noting that despite his fierce criticism of this banking model, Professor Murray Rothbard was among many thinkers who opposed fractional reserve banking.

The list of thinkers who rejected fractional reserve banking on varying grounds is compelling. In his article, *100% Banking and Its Advocates: A Brief History*, Edward Fuller lists philosophers, economists, and even political figures who have

objected to this banking model. Fuller starts his historical overview with Aristotle, Thomas Aquinas, and the Spanish scholastics before moving to cover thinkers like David Hume and David Ricardo and finally to more recent economists like Irving Fisher, Ludwig von Mises, and others. Fuller (2019) remarks:

The 100% plan is often dismissed as a radical proposal. But many of history's most celebrated monetary theorists have advocated 100% reserves, including Azpilcueta, Hume, Say, Ricardo, Fisher, and Mises [Hazlitt, and others]. Furthermore, the fathers of modern banking theory – Pennington, Torrens, and Joplin – were 100% bankers. 100% reserve banking is not radical. In reality, it is far more conservative than fractional reserve banking.

Friedrich Hayek endorsed 100% banking. Following Mises, Hayek argued that fractional reserve banking is the cause of the business cycle. Consequently, 100% banking is the way to abolish destructive booms and busts. Hayek wrote in 1925: "The problem of the prevention of crises would have received a radical solution if the basic concept of Peel's act had been consistently developed into the prescription of 100 percent gold cover for bank deposits as well as notes."

Fuller (2019) also notes:

In 1933, a group of economists at the University of Chicago produced the Chicago Plan for 100% banking. The Chicago Plan proposed "the outright abolition of deposit banking on the fractional-reserve principle." The proposal was signed by Henry C. Simons, Frank Knight, Lloyd Mints, Aaron Director, Henry Schultz, Paul H. Douglas, Garfield V. Cox, and Albert G. Hart. In this way, the Chicago school of economics was born out of the 100% reserve banking movement.

The purpose of this article is neither to defend one camp nor attack the other. This article aims to contribute to understanding fractional reserve banking and assert the Africonomics position on this contentious yet crucially important monetary subject. This article clarifies the issue, ending the decades-long stalemate by demonstrating that fractional reserve banking is unethical and fraudulent because

this model results in a commercial banking system that recurrently or continuously violates property ownership rights when banks use funds from non-interest-bearing accounts, mainly but not exclusively checking accounts, to issue loans or make investments.

More egregiously, fractional reserve banking is further fraudulent because it enables a few members of society (i.e., banking institutions) to create money out of nothing by lending it into existence. This conjured-up money is then used to purchase goods, services, or assets in the marketplace, which were produced through time, capital, and effort of other market participants. This model of nothing to something grants a tremendous and unjust advantage to a select few who can create money and their associates. Moreover, fractional reserve banking undermines trust in the banking system and breeds financial instability, leading to more frequent crises, bank runs, and other adverse economic and societal consequences. In other words, fractional reserve banking is ruinous and doubly fraudulent.

ETHICS, FRAUD, AND HUMAN NATURE

Morality and the ability to make ethical decisions are unique qualities that distinguish humankind from other living species. While humans share essential functions like eating, drinking, sleeping, and breathing with animals, they possess higher cognitive abilities such as logical reasoning, complex analysis, and knowledge accumulation. Unlike other creatures, humankind has innate morality and ethical discernment capacity. This capacity allows humans to distinguish right from wrong, ethical from unethical, and good from evil. This shared understanding of moral principles and ethical discernment constitutes a universal standard for justice in

human relations and coexistence, setting humans apart from animals and other life forms on Earth.

Although they can perform acts of kindness and compassion, like humans, animals are guided by their instincts and do not consider justice, injustice, or right and wrong in their actions. This underscores the fact that animals cannot make ethical judgments or have moral obligations towards each other. For example, when a leopard captures and consumes an alligator by the riverbank, it is not committing the unethical act of murder. It is simply behaving as a leopard does. In contrast, humans possess ethical standards and moral obligations towards each other. Notice that humankind's abysmal track record of ethical and just behavior with one another does not invalidate the fact that humans have an inherent sense of morality and ethical discernment capacity. These remain a fundamental characteristic that distinguishes humans from other living species.

Consider, for instance, that it is established across cultures, countries, and continents that lying, deceiving, defrauding, stealing, and oppressing are unethical practices. Unlike animals, humans have shared universal ethical standards and moral obligations in their actions and interactions. Therefore, theories that lack ethical grounding and whose policy implications result in fraudulent, confiscatory, and oppressive practices can be considered primitive, animalistic, and uncivilized. Such models are pseudoscientific, even if lauded for their apparent scientific rigor. Economics and other social sciences should not be so-called "value-free" sciences, meaning they should not rely solely on utilitarian and positivist frameworks, as they deal with human beings, their natural rights, and relations.

The lack of ethical guardrails in these fields has resulted in the prevalence of flawed and politically motivated models that prioritize state interests over justice.

This has led to the normalization of coercive, fraudulent, confiscatory, and oppressive policies, severely harming the economy, society, and human civilization. To achieve optimal outcomes, jurisprudence, economics, and other social sciences must be rooted in natural law ethics to prioritize justice, minimize injustice, and foster peaceful human relations. As the sciences of humans and their actions, economics, and other social sciences need ethical foundations based on the universal ethical principles and moral obligations humanity shares. This approach is essential for establishing a more prosperous and genuinely civilized world.

As the social philosopher and economist Manuel Tacanho (2023) notes:

Western economics is in disarray, marked by much confusion and distortion. The fundamental issue with Western economics and other social sciences is that they rest on a materialistic-mechanistic worldview and are dominated by utilitarian and positivist frameworks. This lack of ethical grounding has led to confusion and distortion, resulting in garbled economic models with coercive, fraudulent, confiscatory, and repressive policy implications. Socialist and other statist models are pseudoscientific, even as they are justified and promoted as strictly scientific.

Human societies have well-established ethical and legal standards against which to assess whether an action or model is fraudulent. If an economic theory or policy involves fraud, it is unethical, morally unacceptable, and should be rejected as illegitimate in a civilized society. Before going any further, it is pertinent to clarify the definition of fraud and fraudulent acts. According to Law.com, a legal dictionary (Hill and Hill 2005), fraud is “the intentional use of deceit, a trick or some dishonest means to deprive another of his/her/its money, property or a legal right.” The Free Dictionary (Collins Dictionary of Law) states that fraud is “a false representation of a matter of fact—whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed—that deceives and is

intended to deceive another so that the individual will act upon it to her or his legal injury.”

The law website Justia defines *fraud* as “a deliberate scheme to obtain financial or similar gain by using false statements, misrepresentations, concealment of important information, or deceptive conduct is known as fraud.” This definition is particularly applicable to fractional reserve banking. The Association of Certified Fraud Examiners (ACFE) observes that fraud is “any activity that relies on deception in order to achieve a gain. Fraud becomes a crime when it is a “knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment” (Black’s Law Dictionary).” Lastly, Investopedia (Chen, 2022) asserts that “fraud is an intentionally deceptive action designed to provide the perpetrator with an unlawful gain or to deny a right to a victim. Fraud involves the false representation of facts, whether by intentionally withholding important information or providing false statements to another party for the specific purpose of gaining something that may not have been provided without the deception.”

Deception lies at the core of fraudulent acts. Terms like deceit, concealment of fact, misrepresentation, and false statements consistently appear when defining fraud and fraudulent activity. For this analysis, *fraud* is defined as a deliberate and duplicitous act committed by an individual or institution that involves deception or other dishonest practices such as concealing information, misrepresenting facts, omission of truth to deceive for financial gain, or acquiring property illegitimately. This definition, with its emphasis on deception and illegitimate acquisition of property, should be kept in mind going forward.

DEFINING FRACTIONAL RESERVE BANKING

Fractional reserve banking is a commercial banking model where banks keep a fraction of deposits as cash reserves (i.e., vault cash) for withdrawals and lend or invest most of the funds entrusted. Under this banking model, commercial banks also create non-currency money, also known as credit money, by lending it into existence. In contemporary economies, most of the money supply, measured by M2 or M3, is created by the commercial banking system rather than central banks. As a result, this banking model leads to an exponential increase in the money supply relative to the monetary base. Base money, or the monetary base, is defined as the total currency (central bank notes and coins) circulating in the economy, plus currency in the vaults of commercial banks and reserves held with the central bank. Note that the specific definitions and classifications of base money and other monetary aggregates vary slightly from country to country.

Historically, reserve requirements in the United States and other countries have been around ten percent, a figure often cited in economic literature. However, the reality is that the actual reserve requirements are now much lower. For instance, in March 2020, the Federal Reserve, the United States central bank, made a significant move by reducing the reserve ratio to zero percent, thereby eliminating reserve requirements in the United States for all depository institutions. This policy shift means that banks are no longer required to meet reserve requirements, signaling that they are not obligated to maintain sufficient available reserves to meet customer withdrawals. This approach encourages excessive risk-taking among financial institutions and other market participants and imprudent lending practices that carry harmful consequences, as demonstrated by the 2008 subprime mortgage crisis and similar events. In the Eurosystem, the European Central Bank (ECB) has

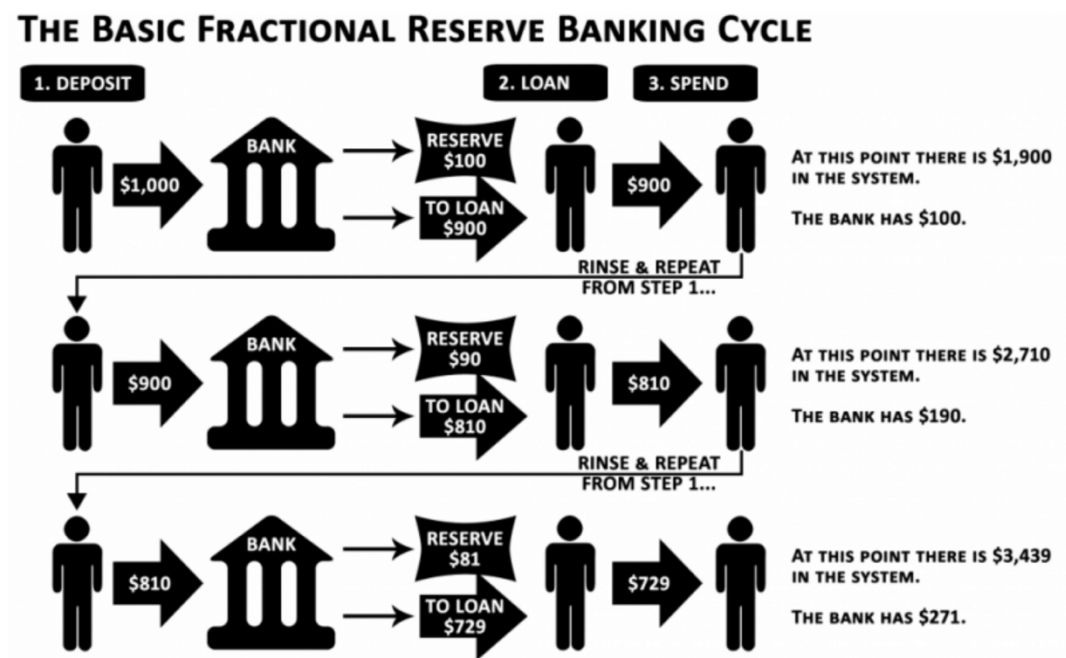
maintained a uniform minimum reserve requirement ratio of 1 percent since January 2012. Before that, from its establishment in January 1999 until 2012, the reserve requirement ratio for the eurozone was 2 percent. As of September 2023, the reserve requirement has been zero percent. Imposing such artificially low reserve ratios weakens the commercial banking system and increases the likelihood of future banking crises and bank failures.

Consider the following example. Under a reserve ratio of 1 percent, if Person A deposits €1,000 in their checking account at BankX, the bank is legally permitted to lend or invest €990 of those funds (usually without the depositor's knowledge or explicit consent) while keeping the remaining €10 available for withdrawal on demand. According to the Money Multiplier formula of mainstream economics, $\text{Total Money Created} = \text{Initial Deposit} \times (1 / \text{Reserve Requirement})$, a €1,000 deposit can add up to €100,000 to the money supply through lending (of funds that are not legitimately the bank's property to begin with). Moreover, under fractional reserve banking, commercial banks create (credit) money by lending it into existence, artificially expanding the economy's money supply by many multiples of the monetary base. As indicated above, the monetary base is a fraction of the total money supply in contemporary fractional reserve commercial banking economies.

Exact numbers are hardly available, but for the Eurozone, the monetary base, also known as "narrow money" or M1, which includes the total currency in circulation (euro notes and coins) and overnight deposits, is reported to be a mere 5 percent of the total money supply, meaning that up to 95 percent of the Eurosystem's money supply is "broad money" (M2 and M3) mainly created in the commercial banking system through lending activity. The distinction between central bank money (mostly the monetary base) and commercial bank money (credit

or non-currency money) is described by different M metrics known as monetary aggregates, depending on the country. In the United States, the monetary base is reported to account for about 5 to 10 percent of the total money supply. Such is the relevance of the commercial banking sector to the stability and financial soundness of existing economies, which also highlights the detrimental effects in case of trouble.

Figure 1: An illustration of a fractional reserve banking process.



The Basic Fractional Reserve Banking Cycle Sources: <http://cynic.me>

In his book *Understanding Money Mechanics*, Robert P. Murphy (2021, 62) writes:

Our current monetary system is based on fiat money; there is nothing “backing up” the US dollar. The ability of the federal government/Federal Reserve to create new money simply by printing up green pieces of paper—or nowadays just through electronic activities that don't even involve physical currency—might lead some people to believe that it is only in a fiat money system that this type of money creation “out of thin air” is possible. However, if they maintain less than 100 percent reserves on their checking accounts (demand deposits), commercial banks also have the ability to create money through their lending decisions.

Explaining how Canada's banking system functions, Stuckey et al. (2021) observe:

Private commercial banks also create money when they purchase newly issued government securities as primary dealers at auctions. They do so by making digital accounting entries on their own balance sheets: the asset side is augmented to reflect the purchase of new securities, and the liability side is augmented to reflect a new deposit in the federal government's account with the bank. However, it is important to note that the majority of money in the Canadian economy is created within the private banking system every time banks extend new loans like mortgages, consumer loans and business loans. Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.

Similarly, a paper by the Bank of England's Monetary Analysis Directorate (McLeay et al., 2014) remarks:

Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. **At that moment, new money is created** [emphasis original]. For this reason, some economists have referred to bank deposits as ‘fountain pen money’, created at the stroke of bankers' pens when they approve loans.

It is astonishing how banks have the privilege to create money, which represents purchasing power, out of nothing and charge interest on it. Meanwhile, everyone else in society must work to earn their purchasing power through time and effort. Closing this part, fractional reserve banking is a commercial banking system where banks are required to keep only a fraction of deposits as cash reserves for withdrawals and can lend or invest most of the entrusted funds. In this model, commercial banks also create non-currency money by lending it into existence to the extent that most of the economy's total money supply originates from the commercial banking sector, which is reported to be about 90 percent in the United States and other more developed countries.

FRACTIONAL RESERVE BANKING IS FRAUDULENT

Recall that earlier in this article, it was explained that unlike animals, who live according to their instincts and have no ethical discernment capacity or moral obligations in their actions, humans share universal principles to assess whether an action or policy is ethical or unethical, right or wrong, good or evil. Humankind possesses innate morality, ethical discernment, and a universal standard for justice. In other words, humans and human societies are bound by moral principles and obligations, which require avoiding fraud and aggression, among other unethical practices. This is a fundamental characteristic that sets humans apart from other living species. To reiterate, *fraud* is a deliberate and duplicitous act committed by an individual or institution that involves deception or other dishonest practices such as concealing information, misrepresenting facts, omission of truth to deceive for financial gain, or acquiring property illegitimately. Fractional reserve banking is fraudulent for the following reasons.

1. Property Rights Infringement

Fractional reserve banking results in a commercial banking system that violates property ownership rights, as banks recurrently or continuously use (seize) funds from non-interest-bearing accounts to issue loans, make investments, or deposit them at an interest-paying central bank facility. It is ethical, legal, and customary when banks use funds from interest-bearing instruments, such as a term deposit, to grant loans or make investments. Such is standard procedure in banking. However, it is an infringement of property ownership rights and, hence, fraudulent when banks use funds from non-interest-bearing accounts (i.e., mainly but not exclusively checking accounts) as depositors are neither made (explicitly) aware of such banking practice nor, more crucially, have depositors (knowingly) consented to this arrangement. Notice that despite being more than 30 years into the Internet age, most people, even in so-called developed economies, are unaware of the nature and implications of fractional reserve banking, a crucial part of existing banking and monetary systems.

Only a few decades ago, the phrase “payable to the bearer on demand” was removed from U.S. dollar notes. Just over 50 years since the last connection to the gold standard was severed, many national currencies, notably the British pound, still enunciate, “I promise to pay the bearer on demand.” This highlights an established and consequential feature of banking and the nature of non-interest-bearing accounts, where funds must be available for withdrawal on demand, especially checking accounts. However, this is rarely the case in contemporary fractional reserve commercial banking systems, where banks use entrusted funds as they see fit, including funds from non-interest-bearing accounts. Moreover, reserve requirements are artificially ultra-low and, in some cases, such as in the United

States and the Eurosystem, abolished altogether, giving banks complete discretion over the use of customers' deposits.

As economist Jonathan Newman (2023) remarks:

The debates over the sustainability and ethics of fractional reserve banking suffer from poorly defined terms. If a deposit is defined as “redeemable at par on demand,” then that constitutes a promise by the bank to have the funds available *at par on demand*, meaning no loans are purchased with those funds. If a contract stipulates that the bank will offer accounts for which deposits are defined as such but then uses the funds to provide loans [or make investments], then the bank is in breach of contract [i.e., it is committing fraud]. If, however, the bank and the customer agree on a looser definition of the term “deposit,” such that deposits are not always redeemable at par, or are redeemable at par but sometimes with a delay, then that is their prerogative.

Another issue that occurs in fractional reserve commercial banking systems is that “fractional-reserve banking creates a legal impossibility: through bank lending, the borrower and the depositor become owners of the same money [property]. Fractional-reserve banking leads to contractual obligations that cannot be fulfilled from the outset” (Polleit, 2010). When depositors put their funds in the bank, it could be unreasonably argued that the funds cease to be their property and become the bank's property. This might be true for savings accounts with timed deposits or other interest-bearing instruments. However, it would be fraudulent to apply the same principle to checking account funds or funds from other non-interest-bearing accounts without the explicit consent of the depositor, who is the rightful owner of the funds.

Commercial banking systems that operate on a fractional reserve basis have, historically and currently, yet to be transparent or forthright with depositors about their practices. This lack of transparency has resulted in banking systems that

recurrently or systematically violate property ownership rights. For most depositors, if not all, a deposit is a bailment rather than a transfer of property ownership to the bank. A bailment refers to rendering property, such as funds, to a bailee, trustee, or custodian (in this case, a commercial bank) for safekeeping or other purposes without transferring ownership. Bank deposits have historically been and still are considered bailments, even if present-day banking laws and practices do not treat them as such. It is crucial to note that legality and conventional practice do not necessarily imply an errorless model or a sound and just policy.

Furthermore, if current legal frameworks allow commercial banks to use funds deposited with them without distinguishing between checking and savings accounts, in other words, without regard for whether funds are from interest-bearing or non-interest-bearing accounts, as long as banks comply with the central bank's set reserve requirements of, say, 10, 5, or 0 percent, then this practice would constitute a more institutionalized violation of property rights and therefore more blatantly fraudulent. Depositors have yet to explicitly consent to such a banking model, where funds from non-interest-bearing accounts cease being their property once deposited in the bank.

The history of fractional reserve banking is problematic and dishonorable rather than transparent and honest. It is marked by deception, corruption, fraud, crisis, and other detrimental issues. Fractional reserve banking originated centuries ago when goldsmiths noticed that depositors rarely asked for their coins back all at once. Consequently, they began issuing unbacked deposit certificates and loans, which amounted to monetary dishonesty and cheating. This unethical and fraudulent practice became more widespread as more promissory notes (unbacked or partially backed) were issued and circulated alongside legitimate depository

notes. This was possible because the community did not know of the trickery occurring and thus still trusted that circulating deposit certificates and loan notes merely represented silver or gold storage with a goldsmith. This eventually led to bank runs and other problems.

The goldsmiths made illegitimate profits from this unethical and fraudulent practice, like modern-day commercial banks, by keeping interest payments from unbacked or partially backed loans. They could also use unbacked certificates of deposit to buy goods, services, or assets. As Stuckey et al. (2021) note, “Commercial banks also create money when they purchase newly issued government securities as primary dealers at auctions.” Fractional reserve banking enables banks and other institutions to gain property and financial profits illegitimately. Unfortunately, the dishonest practices that gave rise to fractional reserve banking continue, with existing commercial banks legally authorized to create money by lending it into existence at interest, creating a fraudulent and unjust banking system on a much larger scale than the goldsmiths.

In his book *100% Money*, Irving Fisher (1936, 18-19) observes:

The 100% proposal is the opposite of radical. What it asks, in principle, is a return from the present extraordinary and ruinous system of lending the same money 8 or 10 times over, to the conservative safety-deposit system of the old goldsmiths, before they began lending out improperly what was entrusted to them for safekeeping. It was this abuse of trust which, after being accepted as standard practice, evolved into modern [fractional reserve] deposit banking. From the standpoint of public policy it is still an abuse, no longer an abuse of trust but an abuse of the loan and deposit functions.

Additionally, there is the issue of bail-ins, which lead to further violation of property rights and more injustice. Richard Best (2023) observes:

Bail-ins and bailouts are designed to prevent the complete collapse of a failing bank. The difference between the two lies primarily in who bears the financial burden of rescuing the bank. With bailouts, the government injects capital into banks, enabling them to continue their operations. During the financial crisis of 2007-2008, the government injected \$700 billion into companies like Bank of America, Citigroup, and American International Group (AIG) using taxpayer dollars. Bail-ins provide immediate relief when banks use money from their unsecured creditors, including depositors and bondholders, to restructure their capital. Banks can convert their debt into equity to increase their capital requirements. Although depositors run the risk of losing some of their deposits, banks can only use deposits over the \$250,000 protection provided by the Federal Deposit Insurance Corporation (FDIC).

Fractional reserve banking, combined with central banking and government intervention, has created overleveraged, increasingly centralized, and fragile commercial banking systems, often resulting in financial crises and other detrimental consequences. The most recent crisis occurred in the first half of 2023, with the collapse of several banks, most notably Silicon Valley Bank, Signature Bank, and First Republic Bank. Adding to the problem, current banking regulations allow failing banks to use their customers' deposits to rescue themselves in case of trouble, constituting a blatant infringement on property ownership rights.

Following the 2008 global financial crisis, many European countries began to experience economic stagnation; some fell into debt-related financial crises and economic recession, known as the Eurozone debt crisis. Cyprus was severely affected, and by 2012–2013, the Cypriot economy was in a severe banking and economic crisis that sent shockwaves across the Eurosystem. At the heart of the crisis were the country's two largest commercial banks, Bank of Cyprus and the now-defunct Laiki Bank, despite rescue efforts. This is where the bail-in resolution, a plan devised by the Eurogroup, the European Commission, the European Central Bank, and the International Monetary Fund (IMF), was implemented in Cyprus to rescue

a failing banking sector. Since January 2016, the bail-in system, as it is officially labeled, has been part of the Eurozone's Bank Recovery and Resolution Directive. In other words, bail-ins are an official policy in the eurozone, regardless of ethical and economic considerations. Panicos Demetriades (2018), a professor of financial economics and the Governor of the Central Bank of Cyprus at the time of the crisis, remarks:

The findings of Brown et al. are drawn from a survey of 800 Cypriot households in 2013-14. The respondents were clients of the two banks that were resolved – Bank of Cyprus and Laiki – and/or clients of other financial institutions. Importantly, households with deposits above the insurance threshold (€100,000) were over-sampled: 49% had at least one bank deposit over this threshold. Within their sample, 55% of households incurred a direct financial loss, 28% experienced a bail-in of uninsured deposits, 16% experienced a bail-in of bonds, and 44% suffered a loss of bank equity. Of the sampled households, 30% incurred a loss from two sources and 10% from all three.

The bail-in system is a coercive and confiscatory model. Depositors, bondholders, and equity holders were not consulted, nor was their consent requested. Instead, their property was seized swiftly and without their approval. According to Michalis Stylianou (2022), Head of the Resolution Department at the Central Bank of Cyprus, the “bail-in amount reached 3.8 billion euros of deposits (around 25% of total deposits) and affected around 20,000 depositors.” In response to these measures, The Guardian (2013) described the bail-in resolution as “draconian terms aimed at keeping Cyprus in the eurozone include closure of second-largest bank and big losses for wealthy savers.”

Figure 2: A candid description of the bail-in resolution.

Cyprus bailout deal with EU closes bank and seizes large deposits

Draconian terms aimed at keeping Cyprus in eurozone include closure of second-largest bank and big losses for wealthy savers

Draconian or despotic? Undeniably. Fraudulent and confiscatory? Certainly. A significant number of those affected were so defrauded that they collectively filed a petition for compensation with the European Union court, as reported by Reuters (2018):

An EU court has rejected a petition for compensation by bank depositors whose funds were confiscated in Cyprus's financial crisis in 2013, in a process which would become a European template for banks in trouble. Depositors in two Cypriot banks lost billions when savings were confiscated to protect the island's banking system in 2013, in a process known as a bail-in. The move was a condition sought by international creditors for a 10 billion euro (\$11.62 billion) bailout to the east Mediterranean island. "The Court concludes that the individuals and companies which initiated the actions have not succeeded in demonstrating an infringement of the right to property, of the principle of protection of legitimate expectations, or of the principle of equal treatment," the General Court of the European Union, a division which addresses complaints against EU institutions, said in a news release [see General Court of the European Union Press Release No 108/18 for full statement].

The request for compensation was unsurprisingly rejected. The bail-in mechanism, a confiscatory model, has been a part of the Eurosystem's Bank Recovery and Resolution Directive since January 2016. The bail-in program

implemented in Cyprus set a fraudulent and confiscatory precedent that could be used on a larger scale in the event of another, more significant banking crisis. The full implications of this precedent are not yet widely understood. It also demonstrated that banks may not necessarily be the safest place to keep funds in many jurisdictions, particularly considering that existing fractional reserve commercial banking systems appear increasingly troubled in Western and other economies. In the United States, another crisis, perhaps like the 2023 banking crisis, remains likely as many small and regional banks face increased stress and heightened risks of failure.

The bail-in mechanism illustrates that banks are not only legally allowed to use funds from non-interest-bearing accounts and create money by lending it into existence, but depositors' funds can also be *seized* to help rescue a failing bank operating on a fractional-reserve system. It is crucial to note that the bail-in mechanism may be applicable in the United States and other countries. Best (2023) states that "the provision for bank bail-ins in the Dodd-Frank Act was largely mirrored after the cross-border framework and requirements outlined in Basel III International Reforms 2 for the banking system of the European Union."

2. Conjured-up Purchasing Power

More egregiously, fractional reserve banking is further fraudulent because it enables banking institutions to create money out of nothing by lending it into existence. This conjured-up money is then used to purchase goods, services, or assets in the marketplace, which were produced through time, capital, and effort of other market participants. This model of nothing to something grants a tremendous and unjust advantage to a select few who can create money and their associates.

Money is the fundamental good in the economy as it represents purchasing power and intermediates economic transactions. As a national currency, money is an indispensable tool that functions as a medium of exchange, an instrument of account, and a store of purchasing power. Therefore, a nation's monetary systems must be as honest and sound as possible.

Allowing a select few to conjure up money is fraudulent and confiscatory. Therefore, it is morally wrong and unacceptable to an enlightened and civilized society. When a society's legal framework allows a select few to create purchasing power, it legitimizes structural fraud and injustice. It leads to a significant disadvantage for the majority and harmful consequences for society. Those who create money can easily obtain goods, services, or assets, leaving the rest of society, who must work as entrepreneurs or employees—in many professions, it may include sweat, blood, or risk of death—in a constant struggle to earn their purchasing power. Fractional reserve banking is fraudulent because it enables a select few to create purchasing power, exacerbating this imbalance. This banking model constitutes a tremendous and systemic injustice in society, significantly aggravating income and wealth inequality issues, among other adverse effects.

Consider the following case. Fraudster Frank creates a counterfeit \$100 note and places it on a frame beside an authentic \$100 bill to showcase his superb counterfeiting skills to family and friends. Although this act is already considered a crime under U.S. counterfeiting laws, it is yet to be fraudulent because nobody has been deceived and defrauded by the counterfeit note. No one knows about its existence except Frank himself. However, the act becomes fraudulent when Fraudster Frank goes to the market and uses his fake but seemingly authentic \$100 note to acquire a good, service, or asset (e.g., shares of a company stock). At this

point, Frank has defrauded the seller (directly) and the community (indirectly). He has exchanged nothing for something. Something of value that has taken labor, capital, and effort to produce. Frank's action is undeniably unethical and fraudulent.

The same principle applies to any other member of society who conjures purchasing power, whether commercial banks or the central bank. For instance, when a commercial bank issues a loan, let us say a mortgage, and the loan is partially or fully covered with money created digitally by simply marking the borrower's account with the lent amount; the borrower will, of course, use the money to acquire a house, and the bank will profit off the interest paid overtime on conjured-up (credit) money. Building a house requires significant time, labor, and many other inputs from those involved in the house construction supply chain, except for the banker, whose part was effectively created out of nothing. Like Frank's action, banks creating money by lending it into existence is unethical, fraudulent, and unjust.

This detrimental situation raises some pertinent questions. Why are banks allowed to create money within existing legal frameworks? Is it because this economic model allows for government debt monetization, thereby significantly increasing its (deficit) spending capacity? Governments determine what is lawful and unlawful based on the prevailing positivist approach to jurisprudence. However, legality does not necessarily equate to just policy. It is essential to recognize that natural law precedes and is superior to government law and legal frameworks based on legal positivism. Natural law provides an ethical and more dependable foundation for developing sound principles in jurisprudence and economics. Approaching economics and jurisprudence with natural-moral law philosophy will foster justice, prosperity, and peaceful socioeconomic systems by minimizing or eliminating coercive, fraudulent, confiscatory, and oppressive policies. This approach is also

essential for creating a more peaceful and genuinely civilized world. Should banks have the power to create purchasing power while everyone else must earn it legitimately through time and effort? The answer is a clear no, as this arrangement is fraudulent, confiscatory, and constitutes a structural injustice.

Banks are granted the tremendous privilege of creating money, which is the fundamental good in the economy as it represents purchasing power and intermediates economic transactions. In this case, for justice and consistency, bakers, for instance, should also be given the capacity to create bread or some bread inputs out of nothing. Gold miners should have the power to create gold, essentially a gold printing machine. Shoemakers and other producers should be able to create shoes, steel, fuel, and other products out of nothing, as banks do. Why should only banks have this privilege? Workers, too, should have access to purchasing power with little to no work provided. This way, everyone would have access to purchasing power with similarly minimal effort. This elucidates that under a just legal framework, no member of society, not even the central bank, should be privileged to create money. Money must be produced and earned legitimately, not conjured up.

Fractional reserve banking is a *doubly* fraudulent commercial banking model. It is fraudulent when banks use funds from non-interest-bearing accounts to issue loans, make investments, or deposit them at an interest-paying central bank facility, as this practice constitutes an infringement of property ownership rights. It is more egregiously fraudulent when commercial banks create (non-currency) money, meaning they conjure up purchasing power by lending it into existence. Therefore, the interest payments gained over the loan's duration are partially or entirely fraudulent. Accordingly, a society with a fractional reserve commercial banking system and a central bank has a *triply* fraudulent monetary system. A monetary

system that constitutes a confiscatory structural injustice and leads to ruinous consequences.

FRACTIONAL RESERVE BANKING IS RUINOUS

Even if fractional reserve banking were to pass the ethical test, which it does not, and considerations of justice and civilization were to be put aside, which they must not, and fractional reserve banking were to be analyzed through a utilitarian-positivist lens, it would still be an unsound model because it carries destabilizing and ruinous consequences for the financial system, the economy, and society. Let us examine this banking model from an amoral, empirical standpoint. Historical evidence and the troubled, crisis-ridden state of current commercial banking systems indicate that fractional reserve banking is an undesirable model as it results in or significantly contributes to several adverse outcomes. Detrimental consequences include moral hazard, asset price inflation, exacerbation of income and wealth inequality, centralization and financialization of the economy, excessive risk-taking, and overindulgent household, corporate, and government debt accumulation.

Also, fractional reserve banking, with its dubious practices, is central to speculative financial engineering, bubbles, crises, and bank failures. This model is a principal contributor to economic cycles, which are characterized by artificially induced booms that eventually become pernicious busts in the form of a recession or economic depression. Boom-bust cycles debilitate the economy and impoverish society, leading to instability and social disharmony. While fractional reserve banking is not the sole cause, it plays a principal and consequential role. Central

banking and government intervention are central in distorting markets and the economy, causing these and other issues afflicting contemporary statist economies. Let us examine some problems associated with fractional reserve commercial banking.

1. Moral Hazard

A moral hazard occurs when one party is encouraged to take on more risk or make imprudent decisions because another party will bear some or all the costs or negative consequences of those actions. In a specific banking context where certain practices like money creation are facilitated, banks will overuse this facility if it leads to faster and more significant profits. The pervasive moral hazard associated with fractional reserve banking is underscored by this model originating from the deceptive practices of goldsmiths who engaged in fraudulent banking. In contemporary times, banks are similarly prone to take and use deposited funds without the depositors' knowledge, especially considering that legal frameworks effectively allow them to do so. Banks are likely to do so excessively, given the power to create money, because it benefits them and their associates. This is a significant and tempting privilege that fractional reserve commercial banking systems have, leading to a systemic moral hazard and a troubled banking system.

The central bank's guarantees, acting as a "lender of last resort," liquidity provider, and rescuer, significantly exacerbate the moral hazard issue embedded in existing financial and other sectors, particularly the government/political sector. By permitting fractional reserve banking, establishing minimal to no reserve requirements, and maintaining artificially low benchmark rates, central banks incentivize commercial banks to generate substantial amounts of credit money,

leading to an influx of debt in the economy. As noted earlier, this model crucially facilitates government debt monetization and, therefore, its spending capacity. This monetary regime fuels speculative investments, malinvestment, wasteful resource allocation, excessive risk-taking, and imprudent lending, fostering an environment with a heightened appetite for risky and over-leveraged activities. Market participants consequently engage in speculation involving risky instruments such as Collateralized Debt Obligation (CDOs), Collateralized Debt Obligation Squared (CDO-squared), and other speculative activities. As illustrated by the 2008 subprime mortgage crisis and other similar events, these activities typically lead to ruinous consequences.

The 2007/8 subprime mortgage bubble burst is a noteworthy example of the dangers of fractional reserve commercial banking combined with accommodative central bank policies. The collapse of the CDO market in 2007 was the main trigger for the subprime mortgage bubble bursting, leading to a severe global financial crisis and the 2007-2009 Great Recession. The adverse effects of the Great Recession are still felt today, and many economies, such as the United Kingdom, are yet to recover fully. Accessible credit, excessive debt, high-risk investments, and debt-fueled speculation led to the crisis. The economic bubble's ruinous consequences, which continue to affect people and economies today, were primarily caused by a fractional reserve commercial banking system and years of accommodating central bank policies, often called the "Greenspan put." The Greenspan put seems to have evolved into a permanent central bank put. Meanwhile, banking and economic conditions continue to deteriorate.

Professor Jörg Guido Hülsmann (2021) observes:

All contemporary monetary systems are based on such legal tender privileges. Paper money—as well as electronic money ("central-bank liquidity")—does not compete with other monetary products on the free market, but is imposed by special privilege. It is therefore called fiat paper money. This institution is of great interest from the point of view of the theory of moral hazard. In fact it entails moral hazard on the greatest imaginable scale, again, both on the side of its producer and on the side of its users.

Fiat paper money creates moral hazard for the producer because he has the possibility of creating virtually any amount of money and, thus, to buy virtually any amount of goods and services for sale. The only limit to this capacity is the hyperinflation that invariably results in the case of a great inflation of the money supply.

But fiat paper money also creates moral hazard on the side of the money users—the citizens, the banks, and the governments—because they sooner or later come to realize that the masters of the printing press have the power to bail out virtually any bankrupt firm or government. Thus they engage in more or less reckless financial planning, expecting that the monetary authorities will not allow a great mass of reckless planners to go bankrupt. This speculation has been borne out by the last thirty years. Public and private debts are at record heights all over the world.

Further compounding moral hazard and incentives for commercial banks to engage in risky and detrimental practices are deposit insurance programs. As Steve Dewey, a former federal financial regulator, points out:

The unprecedented bailout of \$231 billion in uninsured deposits at two large regional banks, plus a new Federal Reserve emergency bank lending program [Bank Term Funding Program (BTFP)] with weak collateral requirements, will lead to yet more moral hazard in an American financial system already accustomed to being bailed out by the federal government. It also throws out the much-heralded objective of the 2010 Dodd-Frank Act to eliminate "Too Big To Fail" government bailouts in the U.S. financial system.

Lawrence McQuillan of the Independent Institute similarly remarks:

Deposit guarantees generate moral hazard—riskier behavior in the banking sector. Federal deposit insurance does not guarantee bank profits, but it does incentivize executives to take socially excessive risks knowing that depositor losses will be backstopped to the limit established by the federal government. After seeing regulators' responses to the collapse of Silicon Valley Bank and Signature Bank, it would be understandable to conclude that, effectively, there is no upper coverage limit anymore. Riskier investment decisions by bank executives often fuel more severe boom-and-bust business cycles, with risks building over time as deposit coverage limits have been increased.

The ease with which fractional-reserve banks can create money and (mis)use entrusted funds produces a systemic moral hazard of excessive debt, among other harmful consequences, resulting in a debt-based and over-indebted economy. A debt-based economy is more prone to credit crises and economic instability, which can have serious consequences. Over time, high debt levels and other issues that plague contemporary fractional reserve banking systems significantly weigh down the economy, with risks and troubles of such an arrangement becoming increasingly evident. This is the current situation in many economies, including the United States, where household, business, and government debt levels are becoming worrisome and unsustainable. Such a system cannot be sound, stable, and lasting.

Figure 3: U.S. student debt has grown dramatically, contributing to high university tuition fees. LendingTree (Schulz, 2023) reports that “Americans own \$1.77 trillion in federal and private student loan debt as of the second quarter of 2023.” The United States is currently embroiled in a student debt crisis, with the Biden administration seeking to “forgive” some of the debt.

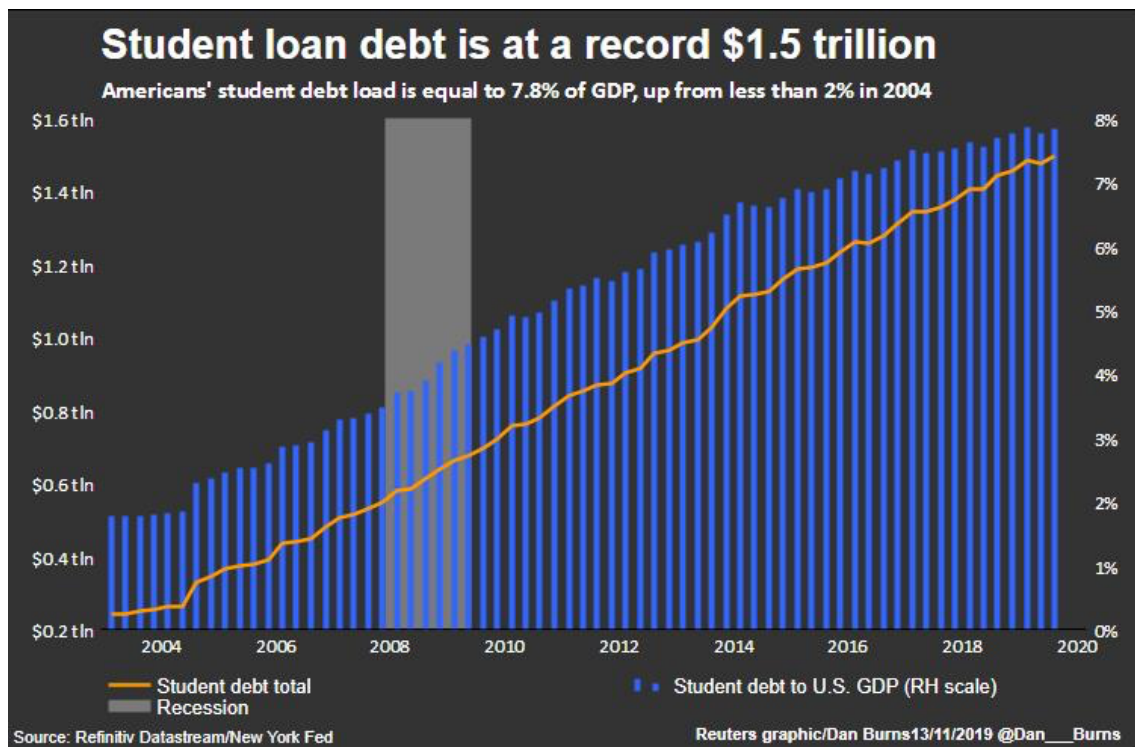


Figure 4: The Federal Reserve Bank of New York’s Center for Microeconomic Data notes in its latest Quarterly Report on Household Debt and Credit that debt has increased by \$228 billion (1.3%) in the third quarter of 2023, to a total of \$17.3 trillion, mainly driven by mortgage, credit card, and student loan debt. Many U.S.

households are highly indebted and increasingly reliant on additional debt, mainly through credit cards, to meet necessities.

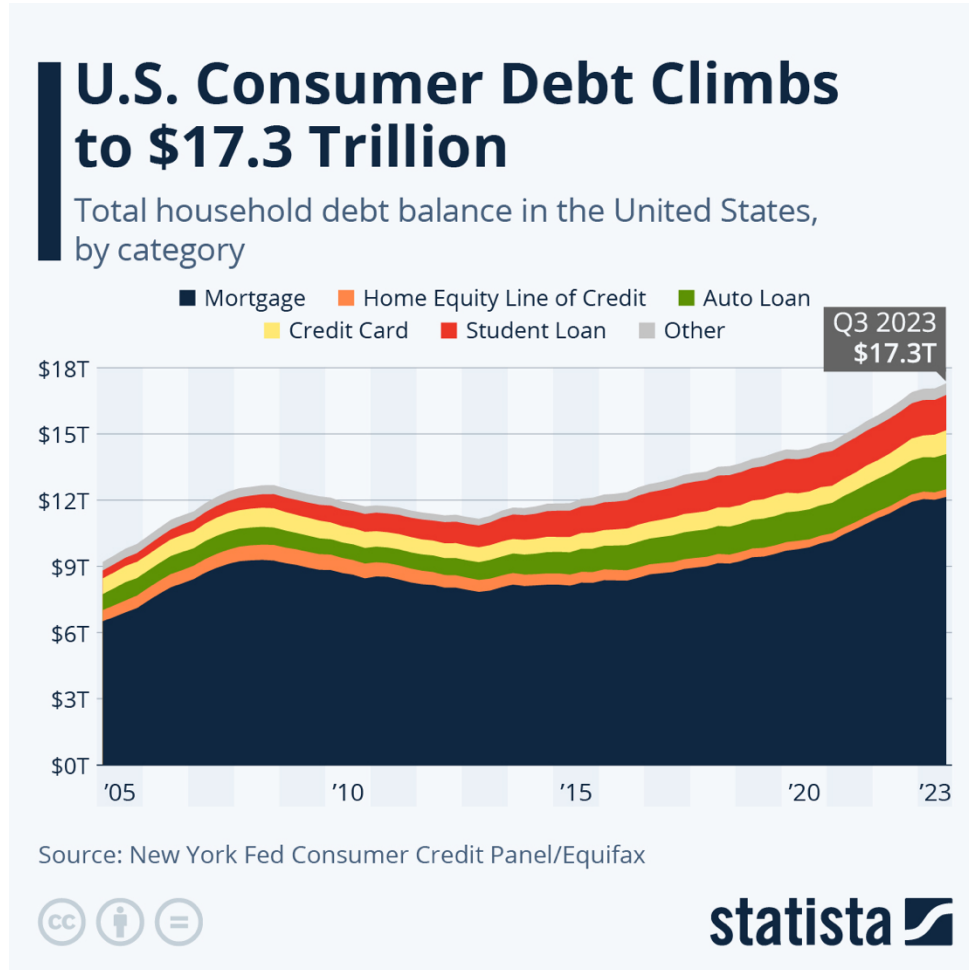


Figure 5: U.S. corporate debt continues to reach new highs. Statista (2022) notes that “from almost 19.6 trillion U.S. dollars in Q1 2018, by Q2 2022, this value had climbed to approximately 23.9 trillion U.S. dollars. Of this latter total, 16.3 trillion U.S. dollars was debt issued by financial corporations.” Unsurprisingly, the bulk of

corporate debt is due to financial corporations, considering the nature of existing banking systems.

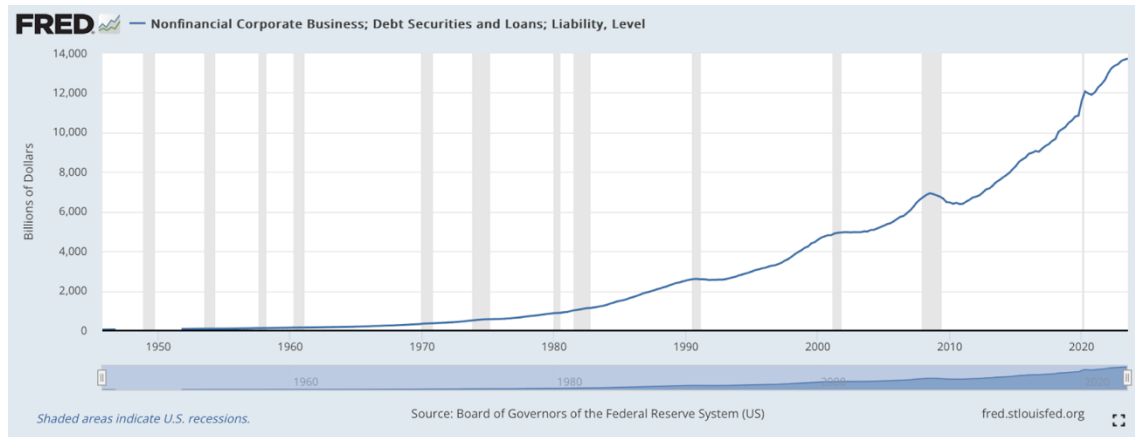


Figure 6: Global corporate debt continues to rise, underscoring its unsustainability. The corporate debt bubble is the second largest bubble within the overall enormous debt bubble that has formed over the past decades. Government debt is the largest of the bubbles. These bubbles were fostered by central bank policies and crucially facilitated by fractional reserve commercial banking. Recall that the bulk of the money supply is created in the commercial banking system through credit activity.

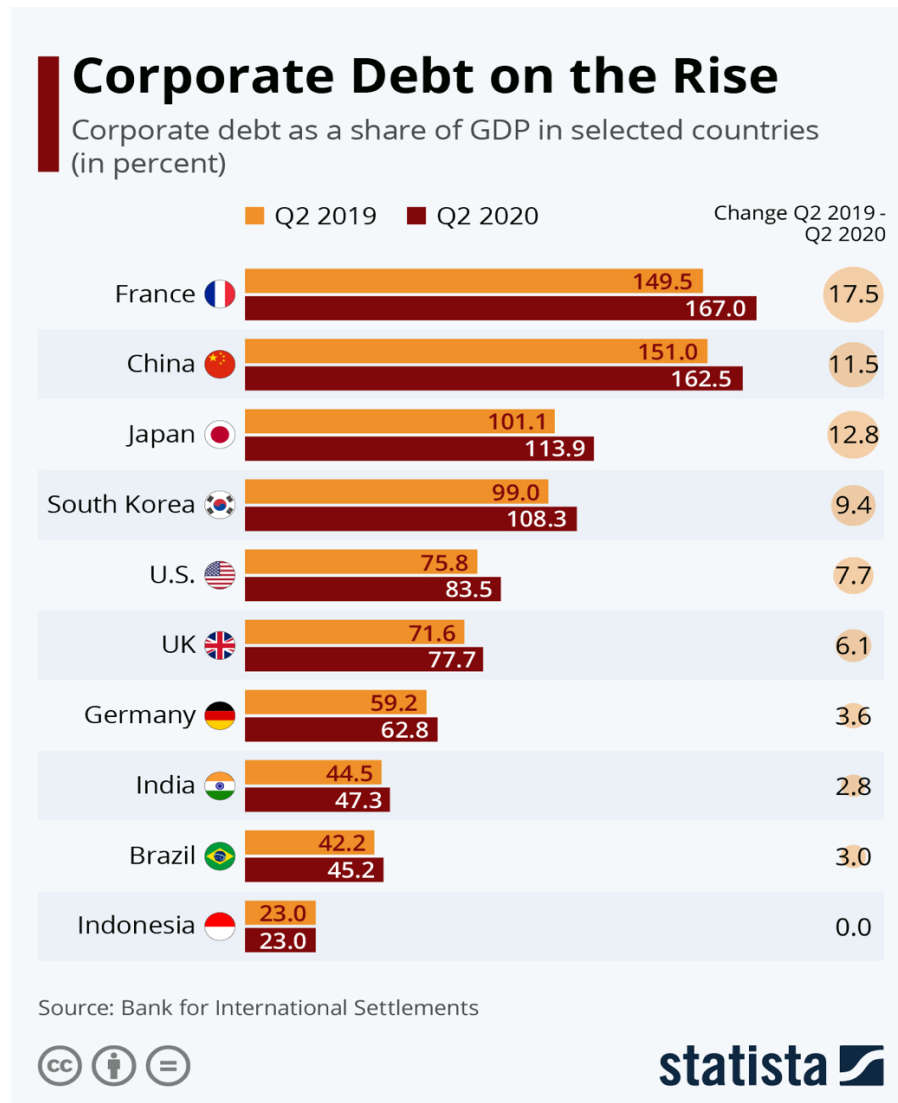
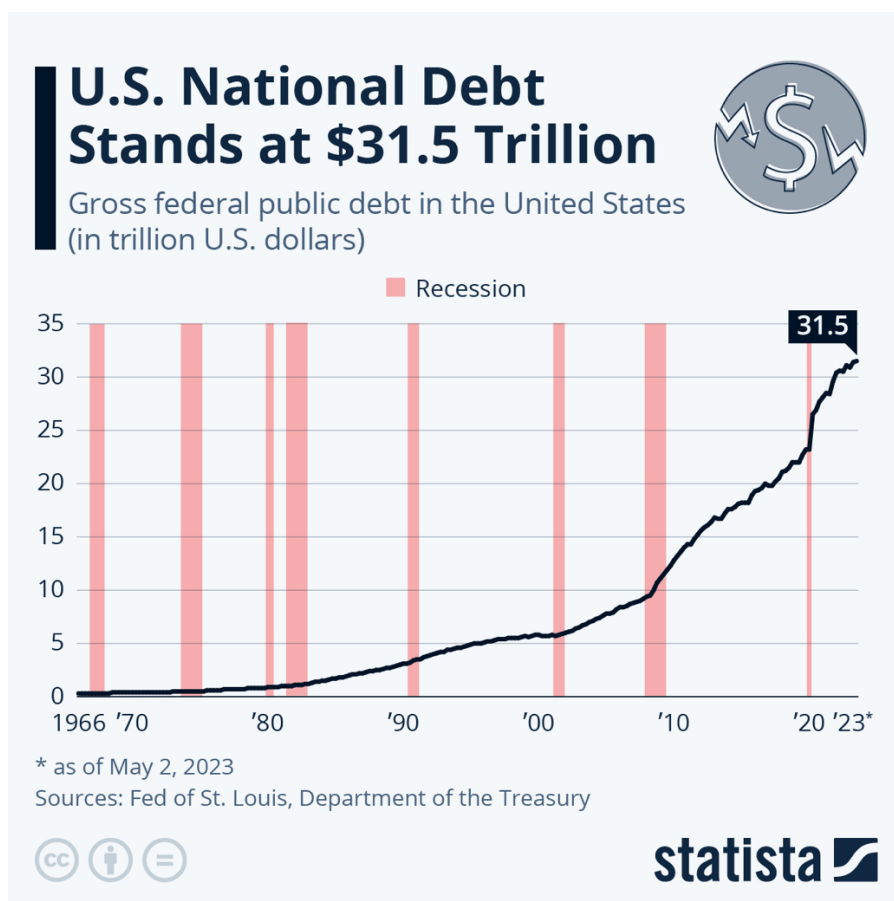


Figure 7: U.S. government debt has reached \$34 trillion as of January 2024 and counting. The current fiscal and economic data suggest that the government's fiscal position will continue to deteriorate, leading to a further increase in debt levels. The situation is alarming, considering that 52 percent of all outstanding U.S. government debt will mature in the next three years amid higher debt servicing costs and persistent inflation pressures. 31 percent of the debt maturing in 12 months. Such a

short-term maturity profile will require substantial debt rollovers. Even if the central bank were to lower interest rates and make government borrowing and debt servicing costs less burdensome, the United States may still be heading toward a sovereign debt crisis. Dire as the United States' fiscal outlook may be, it becomes direr still when one accounts for the nearly \$85 trillion in unfunded obligations required to maintain the many federal government programs and commitments.

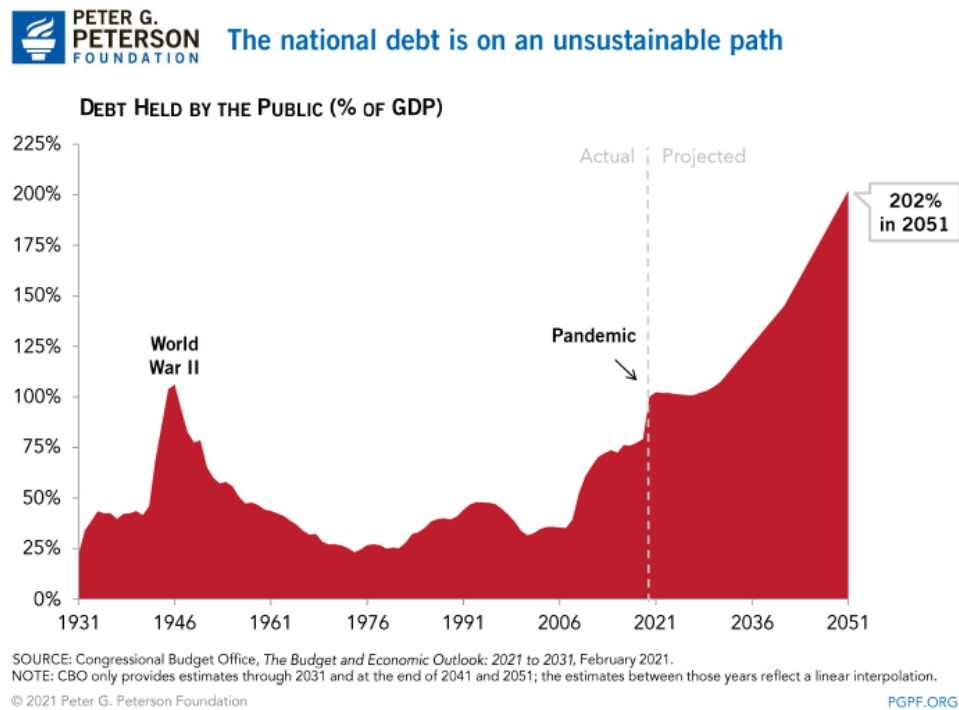


As economist Peter Earle (2024) points out:

The time taken to surpass successive \$10 trillion milestones has dropped. After crossing the \$1 trillion dollar mark for the first time in 1981, the Federal debt didn't surpass \$10 trillion

until 2008, 27 years later. It only took nine years to surpass \$20 trillion (2017), then a mere five years to eclipse \$30 trillion (2022). Now, 22 months after that, the US is almost halfway to the \$40 trillion point. (It's difficult to imagine that the US Federal debt was, well within many of our lifetimes, less than one-third the current market capitalization of Apple, Inc., but that is indeed the case.)

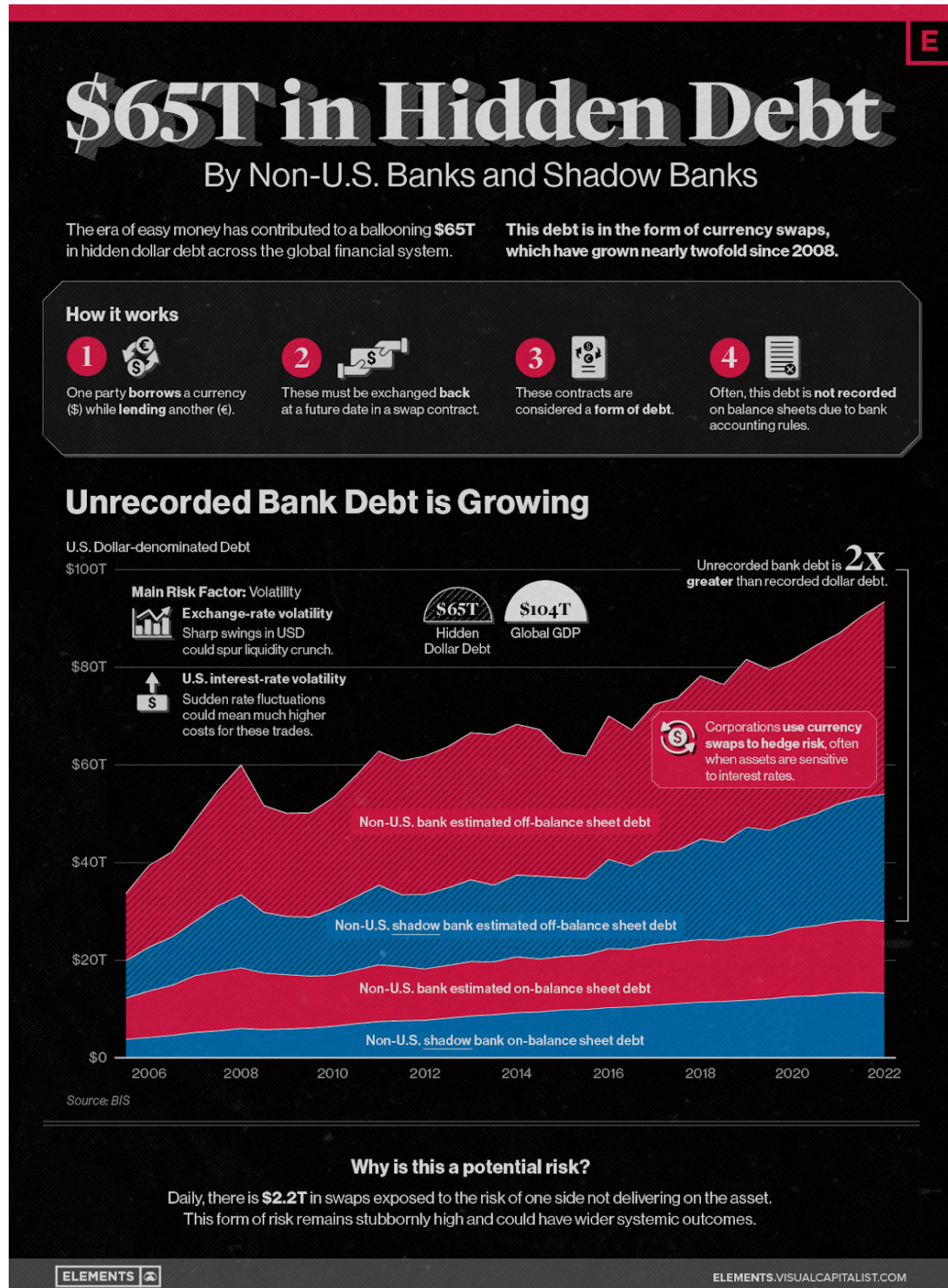
Figure 8: Projected increase in U.S. government debt.



The issue of excessive debt, stemming from fractional reserve commercial banking and central banking, is much more significant than official figures suggest. Fraudulent and deceptive practices have been prevalent in this banking model for centuries. The actual debt levels are higher than reported, making the current banking systems more fragile and troubled than they appear. For instance, a recent

paper by the Bank for International Settlements titled *Dollar Debt in FX Swaps and Forwards: Huge, Missing and Growing* (2022) reveals that there is over \$65 trillion in unrecorded, off-balance sheet dollar-denominated debt by non-U.S. banks and shadow banks, also known as the Eurodollar system. This vast amount of debt, which is more than half of the current global GDP of \$104.5 trillion, mainly exists in the form of currency derivatives and has increased significantly since the Great Recession (2007-09) as market participants sought higher yields amid monetary easing and ultra-low interest rate policies set by central banks. It is pertinent to underline that attempts to “solve” the problems of the global financial crisis caused by prior interventions led to further problems, inflated other bubbles, and weakened the financial system, undermining economic stability, prosperity, and social harmony.

Figure 9: Over \$65 trillion in unrecorded, off-balance sheet dollar-denominated debt by non-U.S. banks and shadow banks in the global financial system.



A fractional reserve commercial banking system combined with central banking invariably leads to several adverse outcomes. These include over-indebtedness and debt dependency, excessive risk-taking and speculative activities, severe market distortions, bubbles, misallocation of resources, crises, and recessions with detrimental effects on the economy and society. This model creates a fundamentally unsound, increasingly unstable, and unsustainable system. Further, the current monetary systems of fractional reserve commercial banking combined with deposit insurance programs, among other central bank and government guarantees, create another, more sociological, moral hazard problem. It encourages a culture of financial imprudence, irresponsibility, consumerism, and profligacy in households, corporations, and governments. This statist system represses and undermines a culture of savings, thrift, personal responsibility, prudence, and autonomy, creating an infantilized society that is increasingly dependent on government programs.

2. Asset Price Inflation

The original definition of *inflation* is the artificial expansion of the supply of money and credit. Fractional reserve commercial and central banking are inherently inflationary as these models involve artificially (and systematically) expanding the supply of money and credit. This process of artificially expanding the pool of money and credit (*monetary inflation*) and the central bank's manipulation of interest rates resulted in several ruinous effects. Although there seems to be little evidence of a direct correlation between commercial bank credit expansion and *consumer price inflation*, what is undeniable is that fractional reserve commercial banking does inflate the money supply exponentially relative to the monetary base, contributing

more directly to *asset price inflation* and more indirectly to currency debasement—the erosion of the currency’s purchasing power, which insidiously contributes to higher consumer prices to a meaningful degree over time. Asset price inflation caused by a fractional reserve commercial banking system combined with and fostered by central bank policies has had significant and far-reaching harmful effects on the economy besides exacerbating income and wealth inequality. This monetary arrangement resulted in several economic distortions, such as pricing many out of homeownership.

As William L. Scott (2022) writes:

Asset price inflation has been an underrated problem in the U.S. economy for as long as 40 years. An excess of lendable funds developed following 1980, leading to secularly falling interest rates. In result, financial values increased much more than the real economy and jobs. The outcome was a significant increase in income inequality. Moreover, the excess of lendable funds encouraged subprime lending that brought on the financial crisis and Great Recession. Now, we find that asset price inflation is reflected in the Consumer Price Index. Owing to rising mortgage values, residential home prices have increased substantially. The outcome is rising homeowner costs that contributed almost 60% to recent increases in the CPI.

Figure 10: The current fiat monetary system's ability to drive up asset prices and inflate a sense of economic growth and prosperity should not be underestimated. This is well-recognized and appreciated in the government/political sector.



A noticeable correlation exists between the artificial expansion of the money and credit supply, accommodative central bank policies, and the inflation of financial asset prices. A fractional reserve commercial banking system, combined with central banking, has been the principal factor driving financial markets, asset price inflation, and fueling bubbles for the past decades. Economist Brian Barnier's analysis, as reported by Yahoo Finance (2016), provides an excellent description of this phenomenon:

The period between the mid-to late-1990s until 2000 was, of course, marked by the tech bubble. While stocks took much of the headline, that time also saw heightened activity in the

commercial paper market. Startups and young companies sought cash beyond their stratospheric share values to fund their operations. Barnier's regression analysis shows commercial paper increases could explain as much as 97% of the tech bubble.

Shortly after the tech bubble burst, a housing bubble began, once more in the form of mortgages and other debt. That drove 94% of the market's move for the first several years of the current century. As the financial crisis reached a fevered pitch in 2008, the Federal Reserve took to flooding the financial market with dollars by buying up bonds. Simultaneously, interest rates fell dramatically, as bond yields move in the opposite direction of bond prices. Barnier sees the Fed [in conjunction with a fractional reserve commercial banking system] as responsible for over 93% of the market from the start of QE until today.

Figure 11: Total assets held by leading central banks and the U.S. stock market represented by the S&P 500 Index.

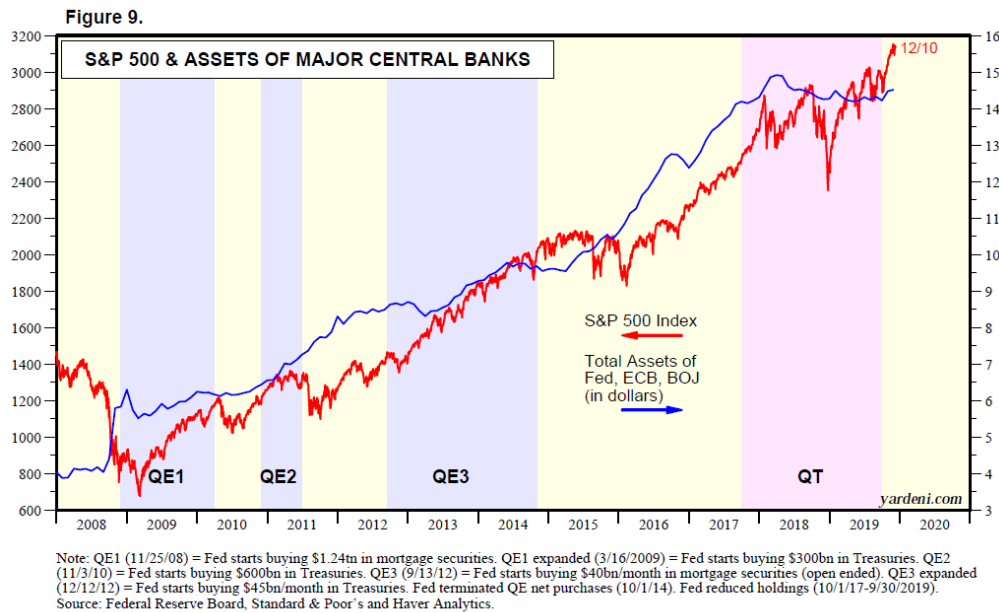
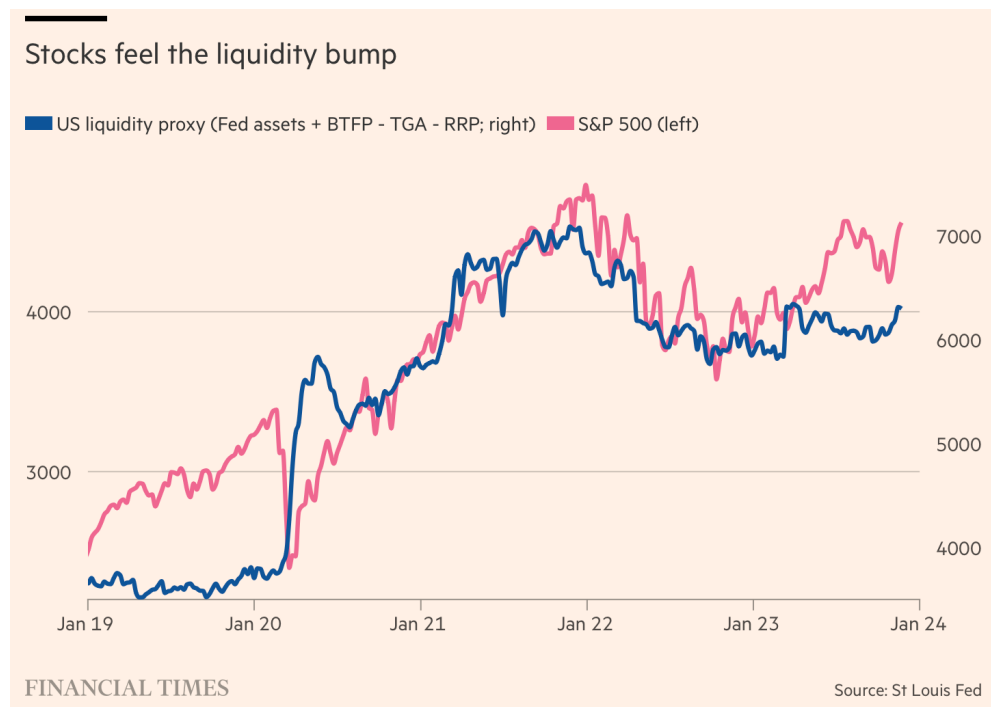


Figure 12: The proxy for U.S. liquidity and the stock market.



3. Income-Wealth Inequality

The current monetary system of fractional reserve commercial banking and central banking exacerbate income and wealth inequality issues for several reasons:

1. A privileged few, including financial institutions, institutional investors, and others with collateral or influential connections, have easier access to capital for their ventures than the majority. This disparity becomes even more apparent when one considers that institutional investors such as investment funds can easily obtain loans from commercial banks to acquire more assets and engage in financial market speculation, often leading to significant financial gains. In contrast, without such access or facilities, the average person faces

increasing economic distress amid policy-created rampant inflation and a cost-of-living crisis.

2. The artificial suppression of interest rates has been an ongoing issue with adverse consequences. It harms the majority, especially savers while benefiting those who can borrow large amounts of capital more easily and cheaply. This disparity has been particularly pronounced in the past four decades (1981 to 2021), a period of declining interest rates and increasing financialization of the economy. This has significantly boosted the wealth of financial asset holders, handsomely benefiting the top few. The majority, who own only a tiny portion of the total pool of financial assets, have been marginalized and, in many cases, priced out. In her book *Engine of Inequality: The Fed and the Future of Wealth in America*, Karen Petrou (2021, 272) notes:

Ultra-low rates fundamentally eviscerated the ability of all but the wealthy to gain an economic toehold; instead they lead investors to drive up equity and other asset prices to achieve their return ... but average Americans hold little, if any, stock or investment instruments. Instead, they save what they can in bank accounts. The rates on these have been so low for so long that these thrifty, prudent households have in fact set themselves back with each dollar they save. Pension funds are just as hard-hit meaning not only that average Americans can't save for the future, but also that the instruments on which they count for additional security are unlikely to meet their needs.

3. The current monetary system consistently devalues the currency, leading to a gradual decrease in its purchasing power. Unfortunately, this process disproportionately hurts the majority, who are not well-versed in financial matters and cannot safeguard their savings from the

persistent erosion of purchasing power due to the prevailing policy of currency debasement. However, while detrimental to the majority, the continuous artificial expansion of the money supply, that is, monetary inflation, benefits a select few. As Mark Thornton (2022) points out regarding the Cantillon Effects:

Mainstream economists typically limit the discussion of Cantillon effects to the redistribution of wealth that accompanies an increase in the money supply. The first recipients of the money experience an increase in wealth, while those who do not receive it experience a decrease in wealth. Rouanet provides extensive empirical evidence of the Cantillon effect in terms of changing the distribution of income. However, this redistribution of wealth is only the first step in Cantillon's much deeper analysis of the effects of an increase in money.

Artificially low interest rates and accessible credit boost asset prices, benefiting the few who own most financial assets while adversely impacting the majority who do not benefit from such asset price increases. This policy exacerbates income and wealth inequality issues. While it benefits the holders of financial assets, the current monetary system further pressures the majority into a difficult situation by providing low returns on their hard-earned savings, typically failing to keep up with consumer price inflation. Recall that, meanwhile, the currency is being debased, thereby eroding the majority's purchasing power and aggravating the injustice. The current monetary system of fractional reserve commercial banking and central banking allows the wealthy to become wealthier while insidiously expropriating and hurting the majority through currency debasement, price inflation, and artificially low interest on their savings. This pricing out of wealth-building assets and the continued erosion of the currency's purchasing power make it difficult for most people to establish or maintain a stable financial base.

The current fiat monetary systems operate in a way that subtly and unnoticeably transfers purchasing power from the majority to the state and those associated with it, as well as large, established corporate interests favored by it. This process significantly contributes to a greater concentration of wealth and economic power in the hands of a few elites. It is facilitated by a fractional reserve commercial banking system, which is the main component of the monetary system and is where most lending activity and artificial credit expansion occur.

The existing monetary system insidiously hinders real economic growth in several ways, such as through programs like the interest rate on reserve balances (IORB). In March 2020, reserve requirements were altogether eliminated by the Federal Reserve. In July of the same year, the interest rate on excess reserves (IOER) and the interest rate on required reserves (IORR) were replaced with a single rate, the IORB. Programs like interest on reserves encourage banks to deposit 'their' funds with the central bank, as it is a risk-free investment with a reasonable rate of return. This reduces lending to individuals, small businesses, and medium enterprises for productive purposes. These groups, who make up the majority, usually lack sufficient collateral. They are now left with higher interest rates while competing with the central bank and other prominent financial players, such as institutional investors, for access to capital.

Economist Russ McCullough (2023) remarks:

I think the average American does not know that the US Federal Reserve currently pays 4.90% interest to banks on people's checking and savings deposits—this includes the cash in the drawer. I just checked my personal savings account and I am currently getting .01% on my savings account. My hard-earned money is earning my bank 4.89% interest—this is not right.

Additionally, did you know that your deposits no longer get loaned out to small businesses and consumers the way they used to? It is true, part of your deposits at the bank partially fund government deficit spending rather than going to private loans for small businesses and individuals. Americans are partially funding government spending with their checking and savings deposits. Customer checking account deposits are mostly interest free, but the Federal Reserve pays banks interest on a fraction of those deposits. For example, if you have \$1,000 in your checking account earning 0%, the bank may have \$600 of your deposit on deposit with the Fed earning 4.9% as of April 2023.

Dan Sanchez (2018) similarly writes:

It is for reasons such as these that Ludwig von Mises said that, “inflationary policy is the most radical revolutionary institution in the world.” Every day it generates new money, the Federal Reserve [in conjunction with a fractional reserve commercial banking system] effects an ongoing aristocratic economic revolution, quietly siphoning wealth from the people, like Daniel Plainview with his long milkshake straw, and pumping it into the vats of a privileged elite. Moreover, this makes us all poorer in an indirect fashion as well, by rewarding government beneficiaries at the expense of efficient producers, and by perpetuating the economically destructive business cycle.

4. Financialization and Centralization

The distinction between the real economy and the financial economy has become a common practice and topic of discussion among economists and non-economists. This distinction, which results from the significant distortion and financialization of the United States and other advanced economies over the past decades, is not a natural state of the economy. In a sound, undistorted economy, there would be no need to differentiate between the real and financial economies. The existing distinction, therefore, reflects a reality of financialized economies. In a sound economic system, the more prominent real economy should drive the financial

sector, and capital markets reflect the dynamics of the real economy. However, in today's manipulated and financialized economies, this order has been severely inverted: the financial economy has become so prominent in monetary terms that it has become the dominating force. The real economy has become subordinate, driven by factors such as central bank policy, financial engineering, and excessive debt.

In a natural, undistorted economy, such as a free enterprise system with a sound currency, savings, investment, entrepreneurship, and the production of goods and services are driven by market forces. This decentralized and self-regulating nature of a free enterprise system is a key feature that sets it apart from the current financialized statist systems, where these aspects are subject to centralized manipulation and technocratic management. In an undistorted economy, there would be no need to differentiate between the real and financial economies, as the economy would not be centralized and financialized as it currently is. The financial sector would not be inflated to the point where financial markets dominate the economy, and interest rates, money and credit supply, and capital markets would accurately reflect economic activity and reality. It is worth noting that financialization and economic centralization have long been pervasive trends in the United States and many other economies, even as economic conditions continue to deteriorate. This is evidenced by increasing volatility, stagnating growth, weakening economic fundamentals, social tensions, and other issues.

The financialization of the U.S. economy began with the establishment of the current U.S. central bank, the Federal Reserve, more than a century ago in 1913. However, financialization has dominated the United States, other leading economies, and the world over the past four decades. Over this period, interest rates have steadily and artificially gone from historical highs to extreme lows, and

monetary inflation and instability have become more rampant. Central bank manipulations and government intervention have led to structural distortions and the financialization of the U.S. and other economies. Accommodative monetary policy, rampant financial engineering, bubbles, hidden, off-balance-sheet debt amounting to tens of trillions of dollars, proliferation of derivative financial products, and other detrimental issues have all emerged during this period. Fractional reserve commercial banking systems have played a crucial role in this process.

In an article discussing how the U.S. economy became financialized, Ryan McMaken (2020) observes:

To read or watch the news in today's world is to be confronted with a wide array of stories about financial organizations and financial institutions. News about central banks, interest rates, and debt appear to be everywhere. But it was not always the case that the financial sector and financial institutions were considered so important. Public policy in general was not always designed with a focus toward propping up banks, keeping interest rates low, and ensuring an ever greater flow of cheap and easy loans. Reporting on the minutiae of central banks—with the assumption that these changes directly impact nearly every facet of our lives—wasn't always the norm. But that is where we are now.

The change is real and it's a thing called "financialization." It has arisen from an economy that is increasingly focused on the financial sector at the expense of other areas of the economy. And it's relatively new. Scholars have suggested many causes for financialization, but they often end up just blaming markets. In fact, the true cause is decades of government and central bank policy devoted to inflating asset prices in financial markets and bailing out the financial sector again and again.

Over the past decades, monetary policies have led to financialization and other adverse economic, societal, and cultural effects. These policies have increased asset prices, exacerbated income and wealth inequality, and created systemic moral hazards in the political and private sectors. Moreover, the current monetary system

has been the primary force behind the centralization of the financial industry and the concentration of economic power in the hands of a few entities, including the central bank and a small number of large commercial banks and other financial institutions.

In their paper, *The State and Fate of Community Banking*, Marshall Lux and Robert Greene (2015) note:

Our assessment of Federal Deposit Insurance Corporation data finds that community banks service a disproportionately large amount of key segments of the U.S. commercial bank lending market – specifically, agricultural, residential mortgage, and small business loans. However, community banks' share of U.S. banking assets and lending markets has fallen from over 40 percent in 1994 to around 20 percent today. Interestingly, we find that community banks emerged from the financial crisis with a market share 6 percent lower, but since the second quarter of 2010 – around the time of the passage of the Dodd-Frank Act – their share of U.S. commercial banking assets has declined at a rate almost double that between the second quarters of 2006 and 2010. Particularly troubling is community banks' declining market share in several key lending markets, their decline in small business lending volume, and the disproportionate losses being realized by particularly small community banks.

Similarly, economist Peter Jacobsen (2023) writes:

Over the last 40 years, there has been a clear trend of bigger banks taking over the industry. Several metrics point to this fact. If you look at the number of FDIC-insured banks, the industry remained relatively close to 14,000 banks from 1935 to 1985. However, in 1985, that number steadily declined to a little over 4,000 at the end of 2022. But it's not just the number of banks that reflects this trend. To a certain extent there may be technological changes driving banks to consolidate, but many suspect banking regulations are a major culprit.

As banking regulations increase in number and complexity, large banks with pre-existing teams of accountants, lawyers, and lobbyists are more able to handle regulatory compliance. Furthermore, when the government creates banking industry regulations, it brings large

banks to the table. This gives them an advantage in crafting regulations which suit them. Economists call this concept regulatory capture, and whistleblower Carmen Segarra's tapes all but prove this is an issue.

The trend of centralizing the financial system and consolidating economic power continues without any signs of slowing down. Last year, four relatively large regional banks in the United States—Silvergate Bank, Silicon Valley Bank, Signature Bank, and First Republic Bank (acquired by JPMorgan Chase)—failed, marking the 2023 U.S. banking crisis. Credit Suisse, a once globally recognized banking giant, also experienced a similar fate in Europe. Its long-time rival UBS acquired it in a government and central bank 'brokered' deal. More banking crises, bank failures, bailouts, and takeover of smaller banks by larger ones will likely continue to occur.

5. Economic Zombification

The contemporary statist socioeconomic systems of fractional reserve commercial banking, central banking, and government intervention, mislabeled as free-market capitalism or market economies, have caused numerous problems within and between nations. One of these issues is economic zombification, a concept that emerged with the financialization of the United States and other more developed economies over the past few decades. This concept originated from studying Japan's long-term stagnation and "lost decade" after its economic bubble burst in the early 1990s. Zombie firms are generally struggling companies that generate enough income but cannot pay off their debt. They usually rely on debt and have earnings before interest and taxes equal to or less than their total debt obligations. While the definition of what constitutes a zombie firm varies, what is certain is that the number of zombie companies has significantly increased over the

last decades. For example, a recent IMF working paper (Albuquerque and Iyer, 2023) notes this trend in the United States:

The share of zombie firms for both listed and private firms has been steadily increasing over the last 20 years, especially after the GFC [2008 global financial crisis]. Low interest rates, ample liquidity, and search for yield may have been related to this upward trend. This phenomenon is particularly evident for listed firms, with zombie firms accounting for over 10 percent of all listed firms in the sample in 2021 [as of 2023, zombie companies make-up 11.5 percent of U.S. listed companies (Wiltermuth, 2023)], which compares with 6 percent in 2000. For private firms the rise has been from 1 percent in 1997 to 5.3 percent in 2020. We find that upticks in the share of zombie firms tend to occur in the wake of economic downturns, such as in the early-2000s, and after the GFC. After the temporary downward trend from 2016 to 2019, the share of listed zombie firms started to rise again during the Covid-19 pandemic, potentially reflecting the unprecedented policy support and easy financing conditions. This support, which was initially largely untargeted, may have helped unviable firms stay afloat.

A paper by the Bank for International Settlements (Banerjee and Hofmann, 2018) likewise notes:

The rising number of so-called zombie firms, defined as firms that are unable to cover debt servicing costs from current profits over an extended period, has attracted increasing attention in both academic and policy circles. Using firm-level data on listed firms in 14 advanced economies, we document a ratcheting-up in the prevalence of zombies since the late 1980s. Our analysis suggests that this increase is linked to reduced financial pressure, which in turn seems to reflect in part the effects of [artificially] lower interest rates [and accommodative credit conditions]. We further find that zombies weigh on economic performance because they are less productive and because their presence lowers investment in and employment at more productive firms.

The economic zombification phenomenon is not limited to the private sector or ‘the developed world.’ It is prevalent across economies and regions, affecting

listed, private, and state-owned enterprises. State-owned enterprises typically rely on government subsidies and other state-granted assistance to stay operational. This highlights another issue: most governments have high debt levels and run permanent deficits. The prevalence of unbalanced government budgets and deficit spending indicates that most governments are economically zombie-like despite their ability to impose heavier taxation and print currency.

Economics professor Daniel Fernández (2021) remarks:

Until now, the 21st century could be called the century of debt, and if things continue the way they are, it could well be called the century of the great debt default. At the beginning of the century, extremely low interest rates promoted by central banks in practically the entire developed world caused a frenzy of private credit creation and a gigantic financial and real estate bubble that exploded in 2008 with dire consequences for the world economy. Global debt reached \$200 trillion at the beginning of 2011, while global GDP was \$74 trillion (275 percent debt/GDP). In the second quarter of 2021, global debt reached almost \$300 trillion with a global GDP of \$83.9 trillion (330 percent debt/GDP).

6. Crises and Bank Runs

Lastly, a fractional reserve commercial banking system is prone to recurring crises and bank runs. A bank run occurs when many depositors lose trust in their bank due to insolvency, credibility, and other issues that may cause them to fail and rush to withdraw their funds. The 2023 U.S. banking crisis, marked by the failure of several banks, including Silicon Valley Bank, was the most recent case of a banking crisis accompanied by a bank run. The history of bank runs dates to when goldsmiths started issuing promissory notes beyond gold or silver deposits to back them. Bank runs are relatively rare, but they do occur. When they happen, they highlight the

inherently problematic nature of fractional reserve commercial banking, as banks are often unable to meet withdrawal demands in the event of a banking panic due to maturity mismatch or similar issues. This scenario worsens the crisis and potentially leads to bank failure or a more systemic crisis. After the 2008 global financial crisis, marked by the failure of several banks and a severe global recession, the 2023 U.S. banking crisis has reignited concerns about the troublesome and detrimental nature of the current monetary arrangement.

Figure 13: A visual representation of a bank run process.



Banking crises can have severe and widespread consequences. For instance, during the Great Depression in March 1933, the U.S. government implemented a national bank holiday that lasted a week. This prevented individuals and businesses from accessing their funds and banking services, aiming to stop bank runs, prevent further bank failures, and restore stability to the banking system after month-long bank runs. Given the increasingly precarious state of banking systems in the United States and other economies, a national holiday could occur again. In some instances, banking crises can lead to violence, as seen recently in Lebanon, where armed depositors raided banks in frustration and demand for their funds during the height of the recent hyperinflationary collapse of the Lebanese economy.

As Doug Ashburn (2023) points out:

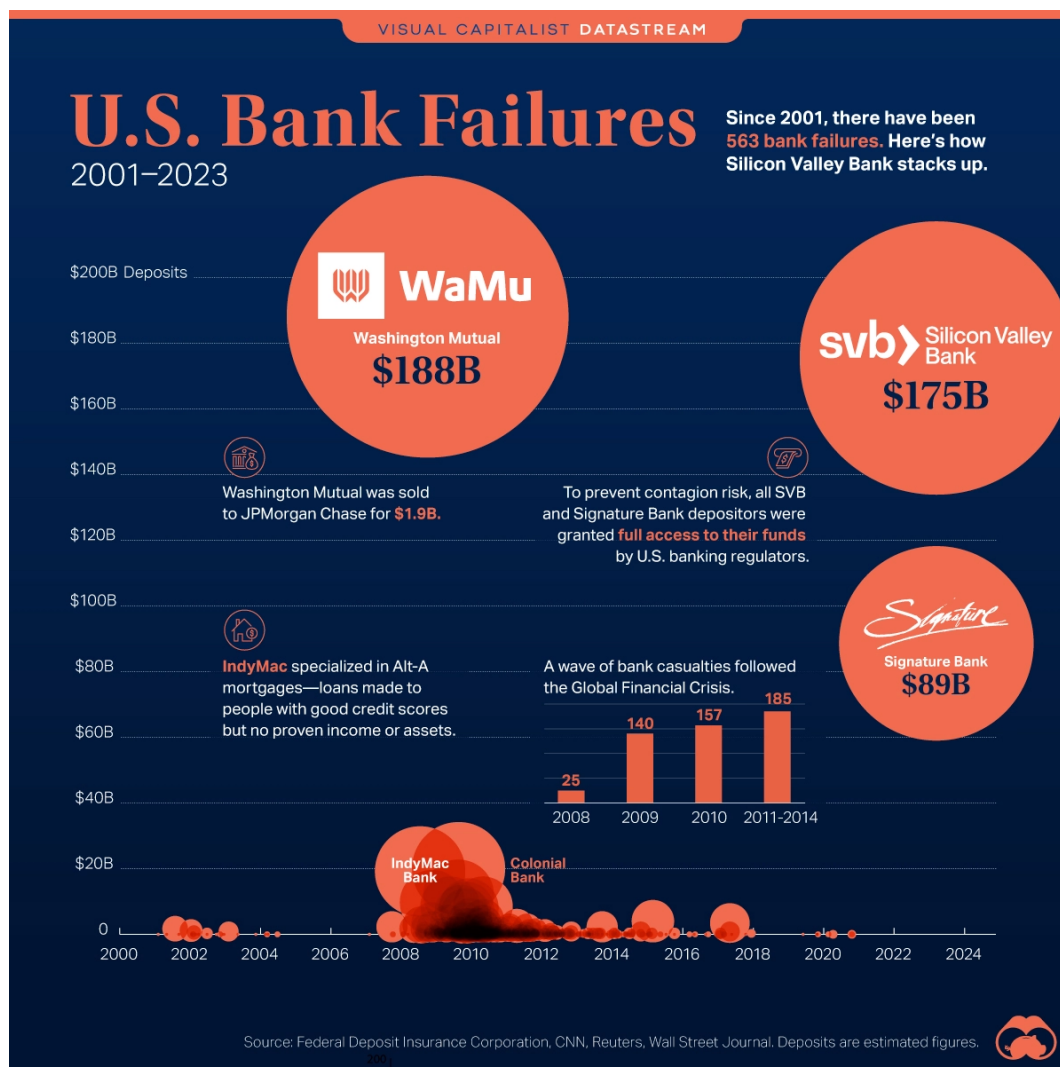
Your money is safe ... except when it isn't. That's why, despite a myriad of protections built into the U.S. and other banking systems throughout the world, bank runs—when hordes of depositors sense danger and clamor to remove their money from banks—still happen. In March 2023—15 years after the near-collapse of the U.S. banking system that led to the Great Recession—Silicon Valley Bank (SVB), a key banking institution for start-ups and venture capital firms, was shut down by state regulators amid a bank run. After other regional banks, such as Silvergate Bank and Signature Bank, also collapsed, the Federal Deposit Insurance Corporation, along with the Federal Reserve, Treasury Department, and other financial regulators, stepped in to back depositors and make funds available to prevent a systemic failure.

Despite deposit insurance programs, extensive regulations, and other state measures, banking systems in the U.S. and other countries seem increasingly unstable and troubled. The elitist and ruinous nature of the current fractional reserve commercial banking and central banking monetary system is highlighted by the fact that banking crises and bank failures continue to result in the centralization of the financial system and the concentration of economic power in the hands of a few

entities in the U.S. and elsewhere. Since March 2023, midsize and regional U.S. banks have experienced deposit outflows to more prominent national banks. This benefits the large banks that receive such deposits but puts midsize and regional banks under additional stress, worsening their situation and raising the risk of bank runs and subsequent failures. In turn, more banking crises and bank failures will further centralize the financial system and consolidate power in the hands of the central bank and other leading players. Karl Evers-Hillstrom (2023) observes:

Perhaps the most imminent threat facing the banking system is the outflow of funds from midsize and regional banks, which are a key part of the U.S. financial system. Wealthy depositors moved their funds from these banks to larger institutions over fears of additional bank runs. San Francisco's First Republic Bank [acquired by JPMorgan Chase] lost around \$70 billion in deposits within weeks of SVB's collapse, prompting large banks to throw the lender a lifeline. While the FDIC only insures deposits up to \$250,000, federal regulators used an exception to insure all deposits at SVB and Signature Bank to boost confidence in the banking system.

Figure 14: Visualizing U.S. bank failures from 2001 to 2022.



Bank failures in the United States have been increasingly common over the past forty years, as financialization accelerated since the termination of the remaining link to the gold standard in 1971. According to data from the Federal Deposit Insurance Corporation (FDIC), there have been 563 bank failures in the United States since 2001. This high number of bank failures within twenty years is concerning even for an economy as large as the United States. The number of U.S. banks has steadily

declined since the 1980s, dropping from about 14,000 in the early 1980s to just over 4,000 by the end of 2022 (Jacobsen, 2023). While it is true that bank failures may still occur in a free-market capitalist system with a sound monetary foundation, the substantial decrease in the number of banks in the United States over the past few decades is concerning, as it is revealing. This situation demonstrates that the current fractional reserve commercial banking and central banking monetary system is ruinous, with its adverse effects being harmful to the banking system, the financial system, the economy, and society.

CONCLUSION

Fractional reserve banking is a banking system where commercial banks are required to maintain only a fraction of deposits as cash reserves for withdrawal while having the ability to create money through lending. This model has long been a source of debate in economics, with one camp arguing that it is fraudulent and illegitimate while the other has defended its legitimacy and desirability. Both camps have presented arguments over the years, but none have conclusively disproved the opposing viewpoint, resulting in a decades-long stalemate on this complex and contentious subject, a crucial part of existing banking and monetary systems. This article has brought much-needed clarity, ending the longstanding stalemate by demonstrating that fractional reserve banking is ruinous and doubly fraudulent.

Fractional reserve banking is a *doubly* fraudulent commercial banking model. It is fraudulent when banks use funds from non-interest-bearing accounts to issue loans, make investments, or deposit them at an interest-paying central bank facility, as this practice constitutes an infringement of property ownership rights. It is more

egregiously fraudulent when commercial banks create (non-currency) money, meaning they conjure up purchasing power by lending it into existence. Therefore, the interest payments gained over the loan's duration are partially or entirely fraudulent. Accordingly, a society with a fractional reserve commercial banking system and a central bank has a *triply* fraudulent monetary system. A monetary system that constitutes a confiscatory structural injustice and leads to ruinous consequences.

Humankind has inherent morality and ethical discernment capacity, which guide and regulate human actions, relations, and coexistence. This shared understanding of ethical or unethical, right or wrong, and good or evil constitutes a universal standard for justice, providing the soundest foundation for legal and economic frameworks for structuring society and fostering peaceful relations. Morality and ethical discernment are fundamental traits that set humans apart from animals. Unlike animals, humans have shared universal ethical principles and moral obligations in their actions and interactions. The essence of fraud or fraudulent action is deception. Historically and presently, fractional reserve banking systems have been mired in deceptive, fraudulent, and dishonest practices. Similar to Fraudster Frank, banks creating money by lending it into existence is unethical and fraudulent. Thus, a legal framework that allows some members of society to conjure up purchasing power (i.e., printing currency physically and digitally) is morally wrong and unacceptable to a civilized society, as it legalizes a fraudulent model and perpetuates a confiscatory structural injustice.

Additionally, fractional reserve banking is ruinous. Combined with central bank and other government policies, this model leads to systemic moral hazards, banking crises, bank runs, and failures. It contributes to mispricing risk and capital,

which leads to malinvestment, misallocation, and wastefulness of resources. Fractional reserve commercial banking plays a principal role in artificial monetary expansion, which is at the core of the boom-bust cycle. Artificial booms turn into busts, causing ruinous recessions or depressions. The current monetary system of fractional reserve commercial banking and central banking inflates the money supply, debases the currency, and drives up asset prices, exacerbating income and wealth inequality, among other detrimental consequences. This process of currency debasement is confiscatory, a hidden wealth transfer that benefits the state and those associated with it at the expense of the majority.

The existing monetary system has led to a distorted, unstable, and financialized economy. It centralizes the financial system, concentrating economic power in the hands of a few, and results in an overleveraged and debt-dependent economy. This system is characterized by excessive household, business, and government debt, and its many adverse effects must be more comprehensively studied. Given the fraudulent, confiscatory, and ruinous nature of the current fractional reserve commercial banking and central banking monetary system, African policymakers are encouraged to adopt the nilar. This gold-based monetary system, designed specifically for African nations, offers a sound and effective solution. By implementing the nilar, Africa can break free from the longstanding economic woes caused by Western models and create a new reality of integrated, stable, and prosperous African economies.

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