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Banks? Ponzi Game!

Even wonder how a bank works? Ever wonder why banks build marble palaces and ornate temples instead of low cost, high efficiency offices like any sensible business would do? Ever wonder why the money changers of ancient times did their work at the temple designed to serve god?

Banks are places where you take your money to keep it safe from thieves. The bank takes your money and puts it in a vault under lock, key and armed guard. This is OK but inconvenient, every time you need to pay someone for something you first have to go to the bank and get some of your money out of the vault. So you make a deal with the banker, he gives you a little book full of slips of paper that say: "Please give Mr. So and So so many of my dollars. Thank you." The merchant takes this slip of paper, and he "checks" with the banker to see if he will honor it. If the merchant gets an affirmative answer, he will give you the merchandise and the check is born. Now the merchant has to go to the bank to retrieve the money. It is still inconvenient for someone but at least you managed to pass the inconvenience to someone else. Of course, the merchant is liable to charge a little more to make up for the extra effort that it takes to run the business. The merchant and the baker are now meeting on a daily basis and the banker finally convinces the merchant to leave his money in the bank as well, safe from thieves and, as an added convenience, that will save him lots of time and trips to the bank.

That is basically how banks got their start. Banks need a sturdy "safe" box but, up to now, there is no justification for the marble temples. The banker, like Donald Duck's uncle, visits the vault every night and, finally, it dawns on him that only a small part of the money is ever moved in and out of the vault. Well over 99% just sits there on the proper shelf year after year.

In questions of money there is always someone in need: a king might need some money to buy uniforms and weapons for his army; a merchant might need some money to finance a purchasing expedition to the Far East; an industrialist might need some money build a new factory. All three go to the banker knowing full well that he has a vault full of money, just the thing they need. The merchant and the industrialist promise to pay back not only the money but some little extra from their profit and this profit sharing causes the banker to take an "interest" in their dealings. With the king things get a little bit more difficult because there is little likelihood that he will ever return the money but then, he has these huge bodyguards and well, for ones safety and all that.... I guess I'll just charge the industrialist and the merchant a bit more "interest" to make it up.

Everyone is happy but few notice the banker's dealings. If all the depositors were to go to the bank at the same time, there would not be enough money in the vaults to pay everyone off. Some of the money is now in the Far East, some is being used to build a factory and some is being wasted in some silly war. As long as they don't all go to the bank at the same time, each depositor thinks that he still has the original sum of money he deposited in the bank and the three borrowers know that they also have some money they did not have before. There is more money in "circulation" than the amount originally deposited at the bank. Miracle of miracles, banks can create money by lending out what is not theirs. This sounds suspiciously like shorts selling stocks that don't belong to them.

Bankers are very good a figuring. After a while they notice that the total sum of money that they need to move in and out of the vault each day is less than one percent of all the money in the vault. To save wear and tear, they decide to keep that one percent in the cashier's drawers and the vault is hardly ever opened again. The banker figures that he could lend out all the money in the vault and no one would be the wiser. He realizes that things don't always go smoothly and he decides that to lend it all out is too risky so decides to lend, say 80% of it, and now the probablity of enough depositors coming all at the same time for their money is low enough to make the risk bearable. In effect, he "reserves" 20% for a rainy day.

Merchants are no different that the rich people who originally deposited their money in the bank. They take out loans but there is no need for them to physically take the money out of the bank. They just open an account with the money they just borrowed. The money itself still sits in the bank vault. But now the banker has the original 100 dollar account plus the 80 dollar account with the merchant. The banker can now lend out 80% of the merchant's new account, another 64 dollars! This is what it looks like after a while:

Reserve	10%	**20%**	30%	40%
Deposit	100	**100**	100	100
First loan	90	**80**	70	60
Second loan	81	**64**	49	36
Third loan	73	**51**	34	22
Fourth loan	66	**41**	24	13
Fifth loan	59	**33**	17	8
Total all loans	900	**400**	233	150
Original deposit	100	**100**	100	100
Money in "circulation"	1,000	**500**	333	250

This is the miracle of banking, pure and simple. That's all there is to it. All the high sounding talk is just a veil to hide in secrecy this very simple Ponzi Game. Greenspeak is designed to hide this dirty little secret.

Why do we need a lender of last resort? Because sometimes the bankers go overboard with their Ponzi game and then they use taxpayer money to bail themselves out to protect us, the depositor and taxpayer. Something smells fishy here!

What does the FED do? They play two games, both of which raise or lower the effective bank reserves thereby changing the amount of money in circulation. As most money people now know, when the quantity of money in circulation is high in relation to the amount of goods and services made available by the economy, prices rise and we call that inflation. When there is not enough money in circulation, prices drop and we have deflation.

The first game the Federal Reserve plays is called: Open-Market Operations. The Fed buys or sells government securities to the banks thereby increasing or decreasing the amount of loanable money that they have in their vaults.

The second game the Fed plays is to change the interest rate that they charge banks. When the interest rate rises, money for the banks becomes more expensive and they are less likely to borrow from the Fed and lend to their customers. When the rates fall, money is cheaper, bankers borrow more from the

Fed and lend more to their customers. Again, it is a way to increase or decrease the amount of money in circulation.

Money. Whence it Came, Where it Went by John Kenneth Galbraith is an excellent work for those who want to understand the simplicity of money. Two excepts:

"Few phrases have ever been endowed with such mystery as open-market operations, the bank rate, the discount rate. This is because economists and bankers have been proud of their access to knowledge that even the most percipient of other citizens believe beyond their intelligence. Open-market operations are the sale of securities just mentioned by the central bank which removes the loanable cash or reserves from the commercial or ordinary banks. The bank rate and the discount rate are the same; they are what prevents the banks from too painlessly recouping their cash by borrowing from the central bank. This is it."

"Much discussion of money involves a heavy overlay of priestly incantation. Some of this is deliberate. Those who talk of money and teach about it and make their living by it gain prestige, esteem and pecuniary return, as does a doctor or a witch doctor, from cultivating the belief that they are in a privileged association with the occult -- that they have insights that are not available to the ordinary person. Though professionally rewarding and on occasion personally profitable, this too is a well established form of fraud. .... The study of money, above all other fields in economics, is the one in which complexity is used to disguise the truth, not to reveal it. Most things in life -- automobiles, mistresses, cancer -- are important principally to those who have them. Money, in contrast, is equally important to those who have it and to those who don't. Both, accordingly, have a concern for understanding it. Both should proceed in the full confidence that they can."

Now back to the question: Ever wonder why banks build marble palaces and ornate temples instead of low cost, high efficiency offices like any sensible business would do? Because, just like religion, banking is built on nothing but faith. Faith cannot be proven, it must be demonstrated by lavish architecture. Why people confuse lavish architecture for sound foundations is beyond me to explain.

Later...

There is no reason why a system based on faith, with the proper safeguards, cannot work very well. After all, we basically trust our neighbors and do it on faith. English common law is based on faith when it states that we are innocent until proven guilty. Innocence is presumed.

The banking system has served us well since it was invented in Italy over 500 years ago. I think the major change that is taking place is that people are taking their savings out of banks and putting them in the stock market but never before did people have so much saved up. Banks will continue to serve business and business will continue depositing funds in banks. Karun Philip was talking about "securitizing" loans but I prefer to buy "real" securities of companies I know and trust thereby cutting out the middleman (the bank and the mutual fund). Securitizing is nothing new, Fannie Mae and Freddie Mac do it with home mortgages but the mortgages are backed by real property. I don't see how an unsecured loan can be securitized and made safer if all that backs it is the faith in the borrower and not real assets.

Actually, my piece was aimed more against the Fed than against banks even though I have no great love for them either ;-(. But to understand how the Fed works you first have to understand how banking works. What is happening is that the government is taking a business institution (banks) and it is trying to use it as in instrument of policy. Not only does it not work well, it screws up business at the same time. My contention is that the Fed should be abolished. Some kind of government commission, like the SEC, should supervise the banks so that we have safeguards but it should not otherwise interfere with the operation of banks.

The biggest objection to the elimination of the Fed seems to be that it is "the lender of last resort." In other words, it saves badly run banks, but only if they are really big (does Continental Illinois ring a bell?). I think that banks should buy private insurance just like brokerages do, after all the function of insurance is to transfer risk. I'm sure Warren Buffett would be more than happy to insure banks if the rate is right. There really is no reason why the government should interfere with business beyond making sure that the little guy does not get ripped off. And that's what courts are for.

Stepping off the soap box....

Denny
"Demand creates queues. Supply gets rid of them."