If you want to borrow money to start a taco stand, I go to the goldsmith and I say, “I need some gold so that I can pay the works. The goldsmith can also make money by taking the gold that is in the vault and lending it to other people. Think about how pieces of gold. Now, the goldsmith can charge me a fee for this service because he is doing me a favor, but the goldsmith later. So if I put ten pieces of gold into the vault, the goldsmith is going to give me a receipt for ten pieces of gold. Now, the goldsmith can charge me a fee for this service because he is doing me a favor, but the goldsmith can also make money by taking the gold that is in the vault and lending it to other people. Think about how this works.

So I want to borrow money to start a taco stand, I go to the goldsmith and I say, “I need some gold so that I can pay the people that are building my factory.” He says, “Okay, I will lend you some gold right now, but you have got to bring it back to me later with interest.” So since more gold goes back into the vault than came out, the goldsmith can take part of it as his profit. So the goldsmith can make money by lending gold to others. Now, a problem can arise here, of course, if the goldsmith starts lending out money, and then everybody comes back and there is no gold there. That is called a run on the bank, but one thing that makes that relatively unlikely is called synchronization. That is, think about the way people behave as far as deposits and withdrawals are concerned. People deposit and withdraw from the bank in a kind of predictable fashion. If I go to the goldsmith on a particular day and I want to withdraw some of my gold, chances are that somebody came by earlier that day or maybe the previous day and deposited gold. So the goldsmith, rather than digging in and finding the coins that I actually put in, can give me the gold that the guy left there the day before.

So as long as deposits are well synchronized with withdrawals, the goldsmith can take the bulk of this gold and lend it out keeping a relatively small amount on hand if people want to come in and withdraw, then, in the meantime, rely on synchronization. That is, gold flows in and out in some predictable way.

Let us think more about what the goldsmith could do, because rather than actually lend out the gold coins, the goldsmith has another strategy. That strategy arises because this receipt that I got for gold may actually begin to circulate as money itself. Think about this. If everybody knows that the goldsmith is reliable and if these receipts cannot be counterfeited easily, that is, that they would have to have the goldsmith’s thumb print on them or something like that, then whenever I want to buy something, I do not actually have to go get my gold out of the vault at all. I can just give you the receipt. Now, you are entitled to go make the withdrawal yourself whenever you want. So, the goldsmith’s receipts begin to circulate as money. They become a medium of exchange. The gold here that is in the vault is the commodity, but the receipt is representative. Because it is representative, people will accept it. That means that the goldsmith does not have to lend out gold at all. What he can do is if you want to borrow money from the goldsmith, the goldsmith can just give you a receipt directly so that you can go out and spend it like money. You give the goldsmith an IOU, which shows up in his vault, and he gives you a receipt, which you go out and spend. Now, anybody who wants to can take this receipt, bring it into the goldsmith, and cash it in for gold. So, the goldsmith now has to be careful how many of these receipts that he issues, because if he should get overstretched, that is, if the goldsmith starts issuing lots more receipts than he has in gold, he is now vulnerable to a run on his bank. That is, “I
hear the goldsmith is issuing a lot of receipts. We are seeing a lot of receipts out there. I do not think that he has the gold.” Then everybody is going to bring their receipts at once come to the goldsmith, take all of his gold, and break the bank. That is the end of the goldsmith.

So you see the problem. This problem helps us understand the basic concept in the financial system. That is the concept of fractional reserve banking. Money circulates whether in the form of receipts for gold or whether in the modern world in the form of checking accounts and currency, but if there are not reserves to back those, and, in particular, in the case of checking accounts, if the bank is creating a lot of checking accounts because it wants to be issuing loans so that it can earn interest; if the bank is creating checking accounts and it does not have dollar bills to back it, then they are subject to the same kind of problems that the over-eager goldsmith is once he has issued all of these receipts.

Now, this raises an interesting question. That is, what is a dollar bill backed by? I have dollar bills right here in my wallet. What is it that determines their value? Can I take this and cash it in for gold? Absolutely not. The Federal Reserve that issued this currency will no longer trade it for gold. In fact, private households haven’t been able to get gold from the Fed since the great depression. What is it that determines the value of a dollar? The value of the dollar, because it is not based on anything that is actually backing it, depends on other people’s willingness to accept it, and ultimately, that value is grounded in two things. First of all, the government requires that you hold it to pay taxes, and second, it is legal tender. That is, if I pay a debt with it, then you cannot sue me in court for nonpayment. It all goes back, the basic idea of the way the banking system works, and all goes back to the goldsmith. The goldsmith starts with safekeeping, then begins making loans, then finds himself the custodian of the community’s money supply because his receipts begin to circulate as money. That puts him in the position of wanting to issue enough of the receipts that he makes full profit off of his lending activities, but not so much that he makes people afraid that he cannot actually back his receipts with gold. This is the basic idea behind the modern banking system, a fractional reserve system where checking accounts have to be backed with reserves. We are going to see shortly how that fractional reserve banking system works in the modern financial system.