ECN 1B—The Money Multiplier

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Step 1. Suppose you sell a bond to the Federal Reserve for \$1,000. Since that \$1,000 is no longer being held by the Federal Reserve, it is now in circulation, and therefore the money supply has increased by \$1,000.

Step 2. You deposit the \$1,000 in your savings account. Your bank faces a reserve requirement of $R = 10\% = 0.10$. This means they have to keep $\$1,000 \times 0.10 = \$100$ of your deposit at the bank at all times. The remaining $1 - R = 90\% = 0.90$ of your deposit, however, they can loan out. So they'll loan $\$1,000 \times 0.90 = \$900$.

The \$1,000 you deposited is still your money. But Person A, who borrows the \$900 from the bank, has currency *that did not exist before.* So when you deposited your \$1,000 in the bank, it had the effect of creating \$900. So now, overall, the money supply has increased by

$$\begin{aligned} &\$1,000 + \$900 \\ &= \$1,000 + \$1,000(0.90) \\ &= \$1,000 + \$1,000(1 - R). \end{aligned}$$

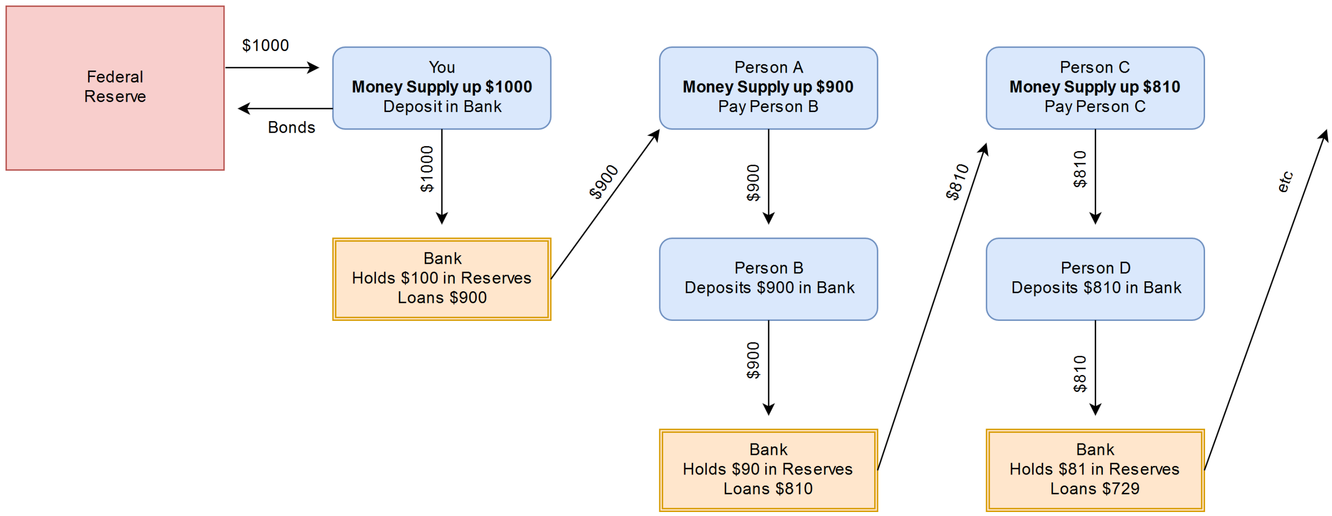
Step 3. Person A borrowed the \$900 presumably because she wanted to spend it on something. So she spends it at Person B's shop. Person B takes the \$900 and deposits it at his bank.

The story is the same as before: his bank faces a reserve requirement of $R = 10\% = 0.10$. This means they have to keep $\$900 \times 0.10 = \$90$ of his deposit at the bank at all times. The remaining $1 - R = 90\% = 0.90$ of his deposit, however, they can to loan out. So they'll loan $\$900 \times 0.90 = \$810$.

The \$900 he deposited is still his money. But Person C, who borrows the \$810 from the bank, has currency *that did not exist before.* So when Person B deposited his \$900 in the bank, it had the effect of creating \$810. So now, overall, the money supply has increased by

$$\begin{aligned} &\$1,000 + \$900 + \$810 \\ &= \$1,000 + \$1,000(0.90) + \$1,000(0.90)^2 \\ &= \$1,000 + \$1,000(1 - R) + \$1,000(1 - R)^2. \end{aligned}$$

Step ∞. This process will repeat itself indefinitely.



The pattern that emerges is that, ultimately, the money supply will increase by

$$\begin{aligned}
&\$1,000+ \quad \$900+ \quad \$810+ \quad \$729+ \quad \$656.10+ \quad \dots \\
=\ &\$1,000+ \quad \$1,000(0.90)+ \quad \$1,000(0.90)^2+ \quad \$1,000(0.90)^3+ \quad \$1,000(0.90)^4+ \quad \dots \\
=\ &\$1,000+ \quad \$1,000(1-R)+ \quad \$1,000(1-R)^2+ \quad \$1,000(1-R)^3+ \quad \$1,000(1-R)^4+ \quad \dots
\end{aligned}$$

Since $0 < R \leq 1$, we can actually evaluate this sum, even though it has infinitely many terms added. It turns out that the money supply will ultimately increase by

$$\$1,000 \times \frac{1}{R} = \$1,000 \times \frac{1}{0.10} = \$1,000 \times 10 = \$10,000.$$

The term $1/R$ is called the **money multiplier**.

Appendix: Deriving the Money Multiplier. This is optional and is a little bit mathematical, but it explains where the money multiplier comes from. As shown above, when the reserve requirement is R, the money supply will increase by

$$S = \$1,000 + \$1,000(1-R) + \$1,000(1-R)^2 + \$1,000(1-R)^3 + \dots$$

Multiply everything by $(1-R)$ and we have

$$\begin{array}{rccccc} S = & \$1,000+ & \$1,000(1-R)+ & \$1,000(1-R)^2+ & \$1,000(1-R)^3+ & \dots \\ S(1-R) = & \$1,000(1-R)+ & \$1,000(1-R)^2+ & \$1,000(1-R)^3+ & \$1,000(1-R)^4+ & \dots \end{array}$$

Notice that because S is an infinite sum, every term in $S(1-R)$ is also found in S. So if we take $S - S(1-R)$, the only thing that won't cancel out will be the \$1,000 term. Therefore

$$S - S(1-R) = \$1,000.$$

But $S - S(1-R)$ simplifies into $S - S + SR = SR$. Therefore

$$SR = \$1,000 \quad \Longrightarrow \quad S = \$1,000 \times \frac{1}{R}.$$