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The role of fractional reserve banking in amplifying credit booms: evidence from panel data

I use panel data on 20 countries to analyze links between savings (defined as time deposits and savings accounts) and credit extended by banks. Credit growth is not related to prior changes in savings, at least not in the short-run. This result indicates that the intuition behind the loanable funds theory does not work well to explain macroeconomic dynamics. I also find that the share of savings in total deposits is positively affected by cyclical upswings in GDP, which is consistent with the permanent income hypothesis. Most interestingly, however, the share of savings decreases during credit booms. The existence of such effect is predicted by the Austrian theory of the business cycle. Based on above results, I infer that an important disadvantage of fractional reserve banking is tendency for the market interest rate to diverge from the natural interest rate. In this paper, I also propose a new method of credit booms identification that captures the timing of booms more adequately than procedures commonly used in the literature.