Money & Banks: some poorly understood fundamentals

Josh Ryan-Collins

nef (the new economics foundation)

Just Banking Conference

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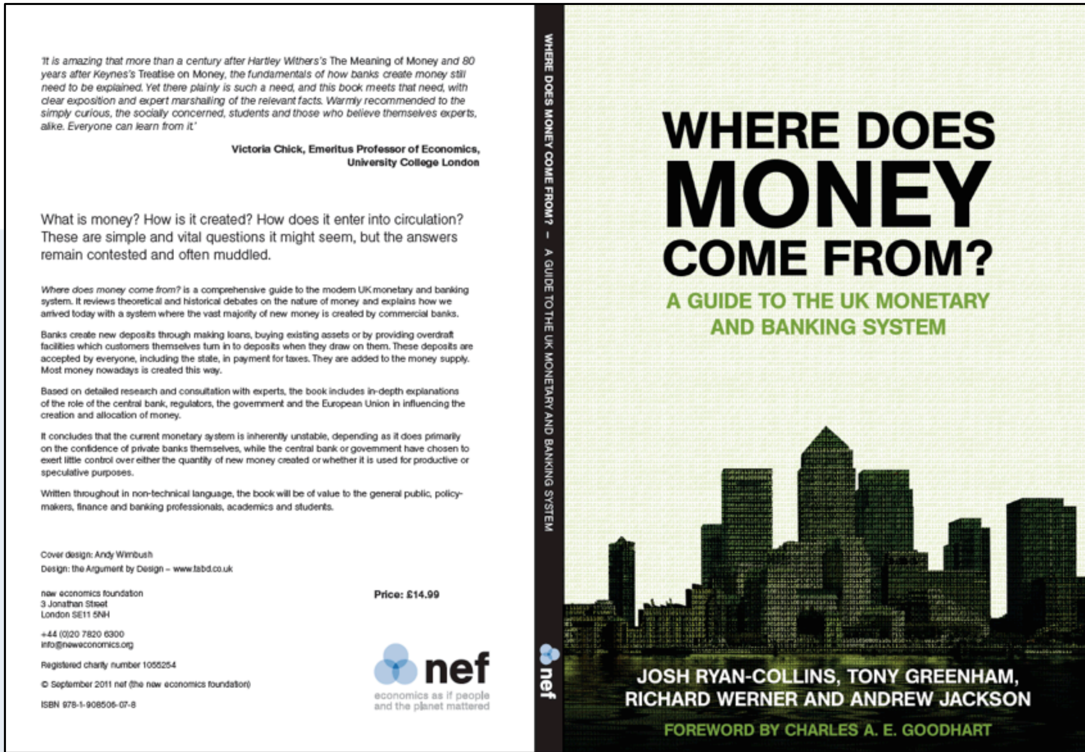

'It is amazing that more than a century after Hartley Withers's *The Meaning of Money* and 80 years after Keynes's *Treatise on Money*, the fundamentals of how banks create money still need to be explained. Yet there plainly is such a need, and this book meets that need, with clear exposition and expert marshalling of the relevant facts. Warmly recommended to the simply curious, the socially concerned, students and those who believe themselves experts, alike. Everyone can learn from it'

Victoria Chick, Emeritus Professor of Economics, University College London

What is money? How is it created? How does it enter into circulation? These are simple and vital questions it might seem, but the answers remain contested and often muddled.

Where does money come from? is a comprehensive guide to the modern UK monetary and banking system. It reviews theoretical and historical debates on the nature of money and explains how we arrived today with a system where the vast majority of new money is created by commercial banks.

Banks create new deposits through making loans, buying existing assets or by providing overdraft facilities which customers themselves turn in to deposits when they draw on them. These deposits are accepted by everyone, including the state, in payment for taxes. They are added to the money supply. Most money nowadays is created this way.

Based on detailed research and consultation with experts, the book includes in-depth explanations of the role of the central bank, regulators, the government and the European Union in influencing the creation and allocation of money.

It concludes that the current monetary system is inherently unstable, depending as it does primarily on the confidence of private banks themselves, while the central bank or government have chosen to exert little control over either the quantity of new money created or whether it is used for productive or speculative purposes.

Written throughout in non-technical language, the book will be of value to the general public, policy-makers, finance and banking professionals, academics and students.

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WHERE DOES MONEY COME FROM? – A GUIDE TO THE UK MONETARY AND BANKING SYSTEM

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WHERE DOES MONEY COME FROM?

A GUIDE TO THE UK MONETARY AND BANKING SYSTEM

JOSH RYAN-COLLINS, TONY GREENHAM, RICHARD WERNER AND ANDREW JACKSON

FOREWORD BY CHARLES A. E. GOODHART

www.neweconomics.org/publications/where-does-money-come-from

A few questions of minor importance

1. What is money?
2. What do bank's do?
3. Who decides how much money gets in to the economy?
4. Who decides where it goes?

What is money?

What do banks do?

Banks *create new money* whenever they expand their balance sheets (aka make 'loans')

Figure 9: Loan by Barclays Bank.

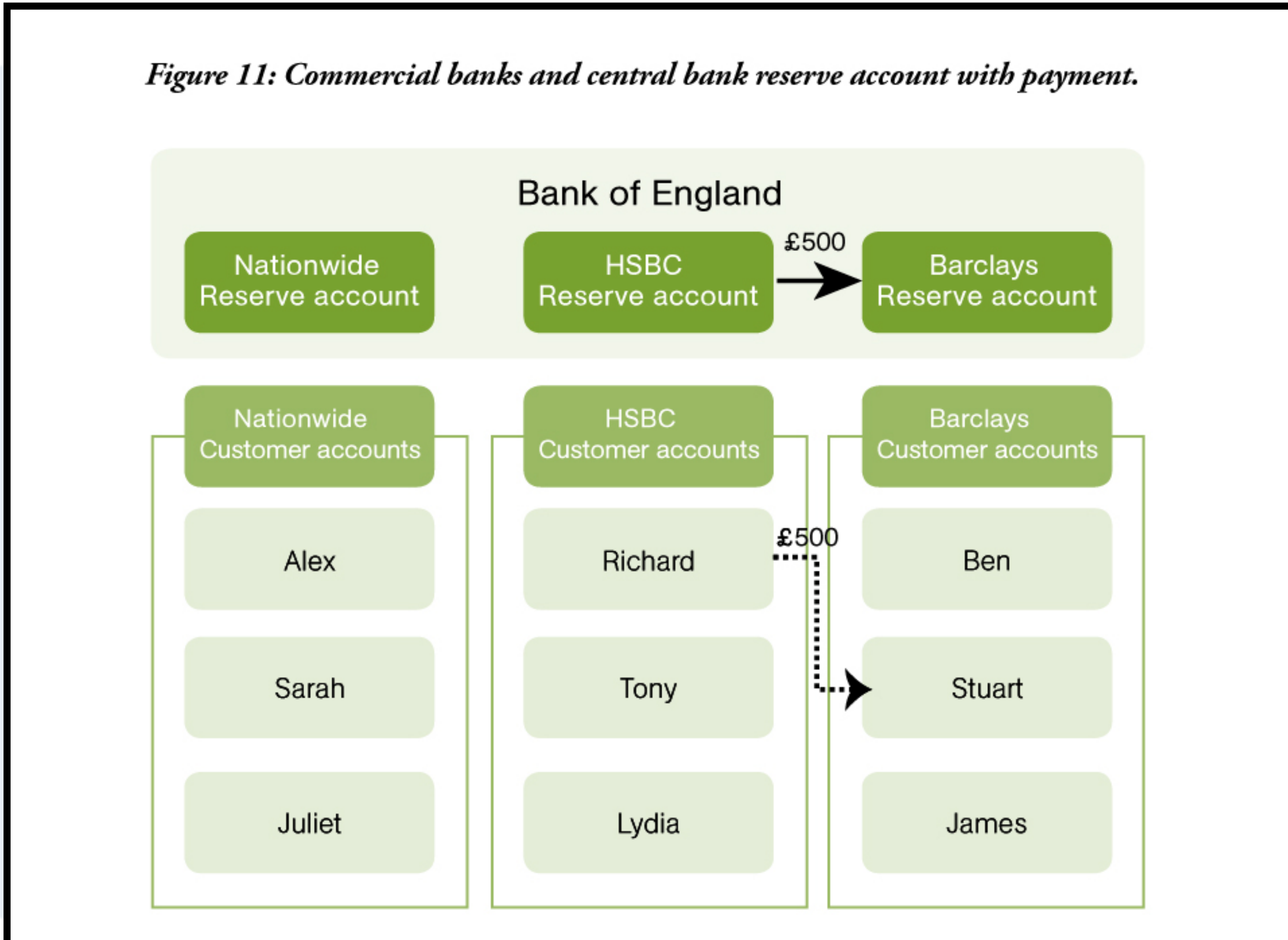
BARCLAYS BANK BALANCE SHEET (Step 1)	
Assets (What the borrowers owe to bank + bank's money)	**Liabilities** (What the bank owes to the depositors + bank's net worth)
Loan to Robert: £10,000	

Figure 10: Bank simultaneously creates a loan (asset) and a deposit (liability).

BARCLAYS BANK BALANCE SHEET (Step 2)	
Assets (What the borrowers owe to bank + bank's money)	**Liabilities** (What the bank owes to the depositors + bank's net worth)
Loan to Robert: £10,000	Robert's new account: £10,000

Source: Ryan-Collins et al. (2011) *Where does Money Come From?*, **nef** (the new economics foundation), p56

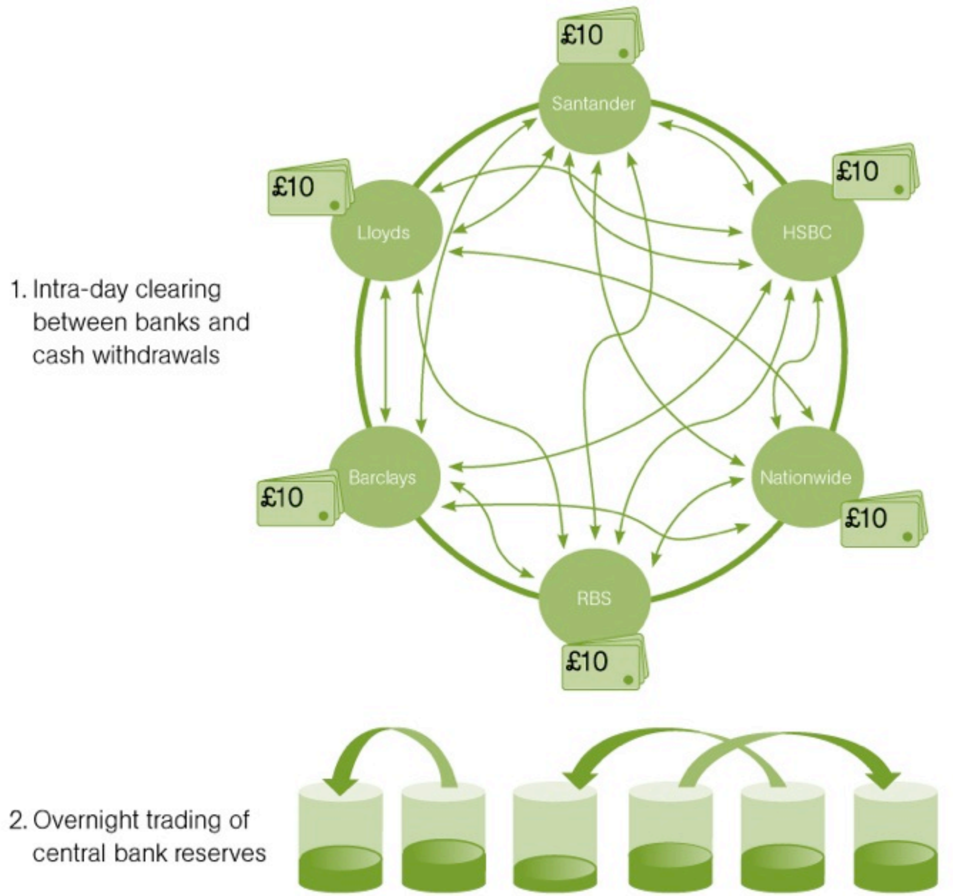
Payment of £500 from Richard to Stuart



Source: Ryan-Collins et al. (2011) *Where does Money Come From?*, **nef** (the new economics foundation), p59

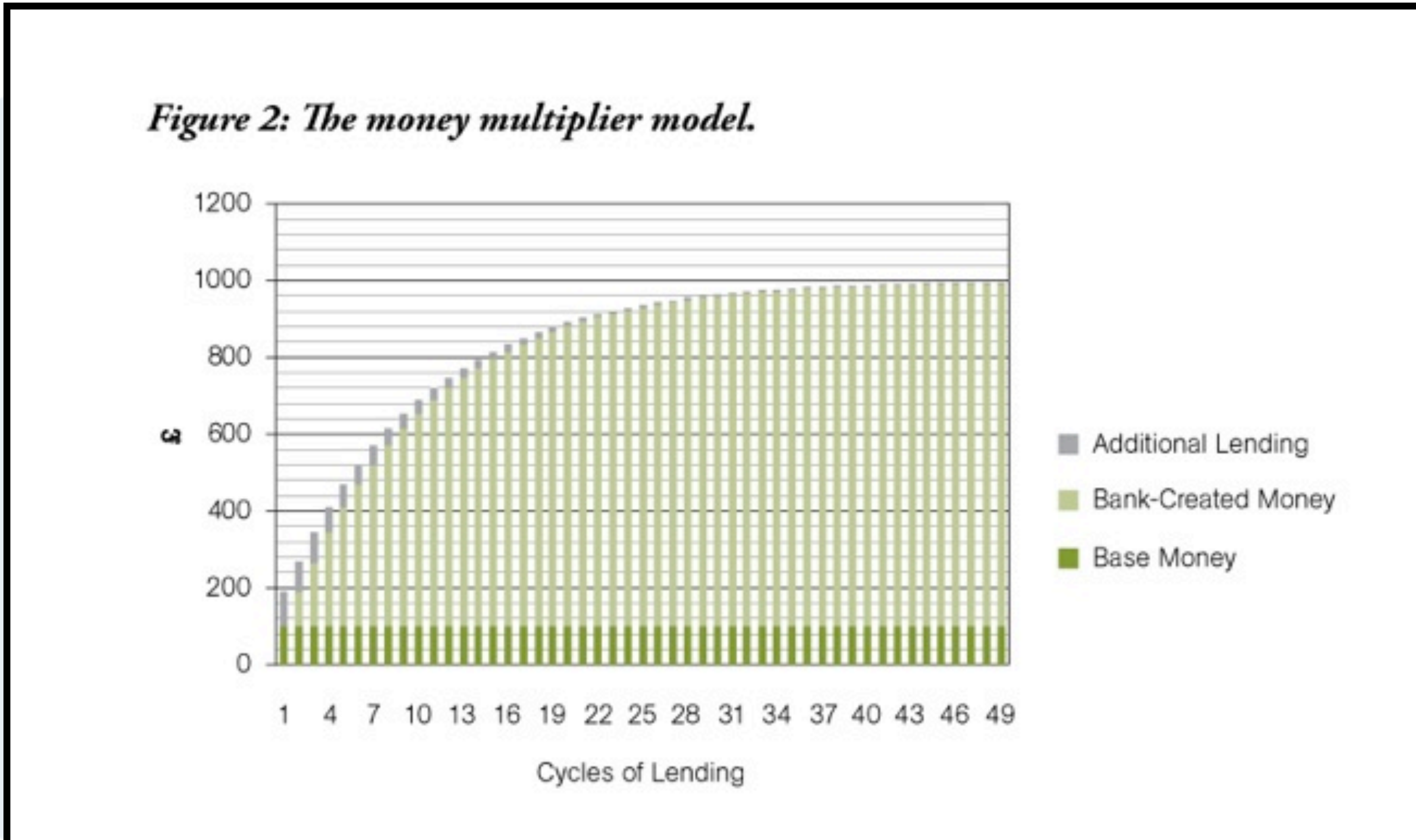
Intra-day clearing & overnight settlement

Figure 13: Simplified diagram of intra-day clearing and overnight trading of central bank reserves between six commercial banks.



Source: Ryan-Collins et al. (2011) *Where does Money Come From?*, **nef** (the new economics foundation), p63

The myth of the reserve-multiplier



Source: Ryan-Collins et al. (2011) *Where does Money Come From?*, **nef** (the new economics foundation), p20-21

Breakdown of relationship between base money and bank money

Source: Bank of England, Interactive Database, data series LPQAUYM (M4), LPQVQKT (notes and coins), YWMB43D (Central bank reserves).

The tail wags the dog

Figure 4: 'Balloon' of commercial bank money.

Source: Ryan-Collins et al. (2011) *Where does Money Come From?*, **nef** (the new economics foundation), p23

'In the real world, banks extend credit, creating deposits in the process, and look for the reserves later.'

Alan R. Holmes, Federal Reserve Bank of New York (1969)

'In reality the sequence works more in the opposite direction with banks taking first their credit decisions and then looking for the necessary funding and reserves of central bank money.'

Vitor Constancio, vice president of the European Central Bank (2011)

Banks need our deposits to ‘balance the books’

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BALANCE SHEET FOR COMMERCIAL BANK		
Assets £	**Liabilities £**	
Loans to customers	Customers deposits	
Reserves at the BoE		
Cash		
Financial assets (e.g. government securities)	Loans from other financial institutions	
Other assets (e.g. buildings, investments)	Capital	Equity capital: • share capital • retained profits
		Provisions
		Subordinated debt (liability to bondholders)
TOTAL LIABILITIES = TOTAL ASSETS		

Source: Ryan-Collins et al. (2011) *Where does Money Come From?*, **nef** (the new economics foundation), p75

Banks decide where money goes

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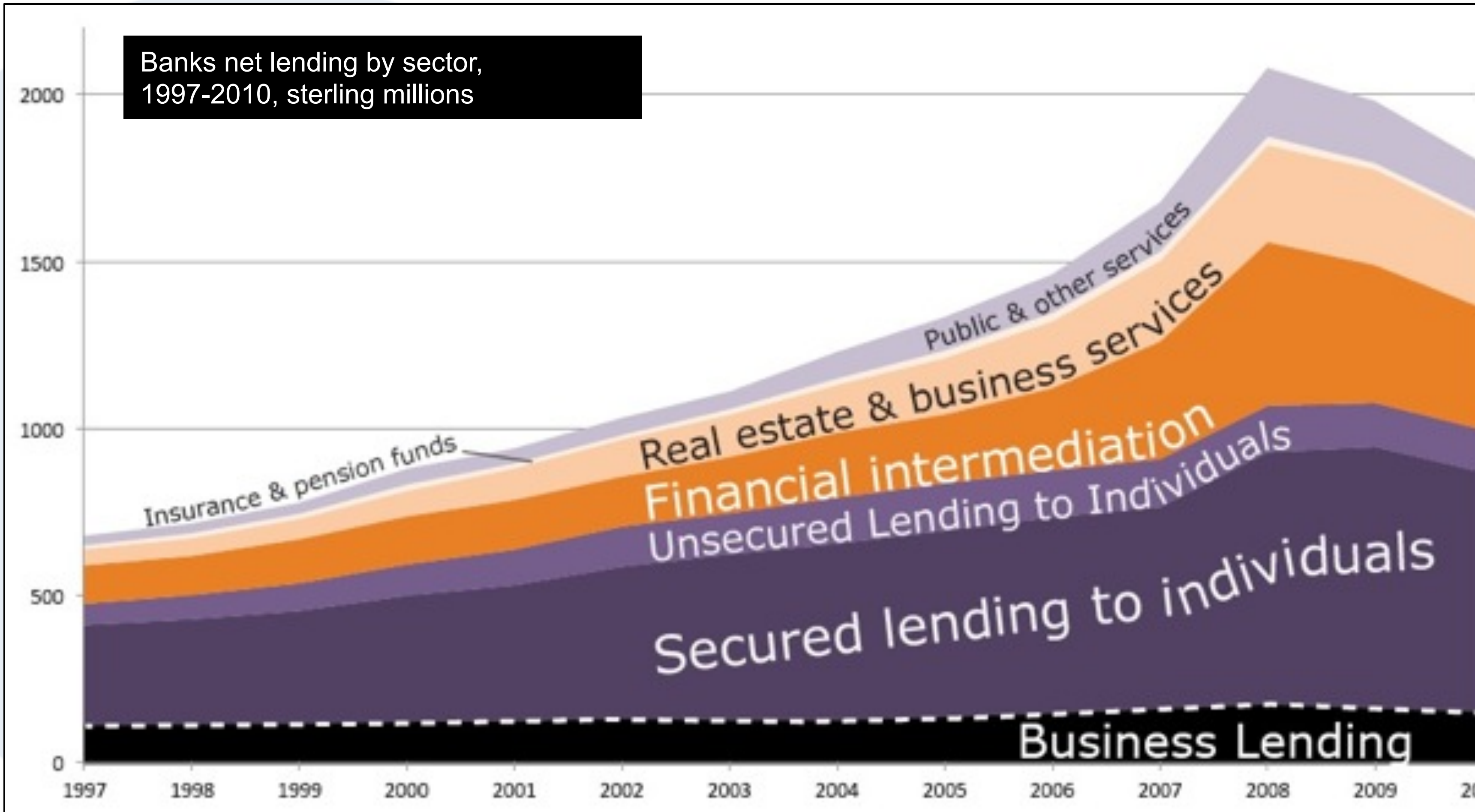
'Both [households and companies] are, to a greater or lesser degree, rationed in their access to credit, given that borrowers know a great deal more about their conditions and prospects than do risk-averse lenders, and that lenders face obstacles in ensuring that borrowers honor their contracts.'

Paul Tucker, Deputy Governor, Bank of England, 2010, 'Money and credit: banking and the macro-economy', Bank of England, Quarterly Bulletin, Q1, p97

Bank lending is driven by confidence and profit



Source: Bank of England Statistical Database and Positive Money

More information

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