A Loophole Allows Banks – But Not Other Companies – to Create Money Out of Thin Air

One of the Main Causes of Our Economic Problems

By Washington's Blog

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The central banks of the United States, England, and German – as well as 2 Nobel-prize winning economists – have all shown that banks create money out of thin air … even if they have no deposits on hand.

The failure of most governments and most mainstream economists to understand this fact – they instead believe the myth that people make deposits at their bank, and these deposits are then lent out to new borrowers – is the main cause of our rampant inequality and economic problems.

But how do banks actually make loans before they have sufficient deposits on hand?

Economics professor Richard Werner – the creator of quantitative easing – noted in September that the field of economics has been lost in the woods for an entire century because it has failed to understand how banks actually create money.

Professor wrote an academic paper in 2014 concluding:

> What banks do is to simply reclassify their accounts payable items arising from the act of lending as 'customer deposits', and the general public, when receiving payment in the form of a transfer of bank deposits, believes that a form of money had been paid into the bank.
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> The 'lending' bank records a new 'customer deposit' and informs the 'borrower' that funds have been'deposited' in the borrower's account. Since neither the borrower nor the bank actually made a deposit at the bank—nor, in connection with this transaction, anyone else for that matter, it remains necessary to analyse the legal aspects of bank operations. In particular, the legality of the act of reclassifying bank liabilities (accounts payable) as fictitious customer deposits requires further, separate analysis. This is all the more so, since no law, statute or bank regulation actually grants banks the right (usually considered a sovereign prerogative) to create and allocate the money supply. Further, the regulation that allows only banks to conduct such creative accounting (namely the exemption from the Client Money Rules) is potentially being abused through the act of'renaming' the bank's own accounts payable liabilities as 'customer deposits' when no deposits had been made, since this is also not explicitly referred to in the banks' exemption from the Client Money Rules, or in any other statutes, laws or regulations, for that matter.

Professor Werner explained:

> Although the implementation of banking services relies heavily on accounting, hardly any scholarly literature exists that explains in detail the accounting mechanics of bank credit creation and precisely how bank accounting differs from corporate accounting of non-bank firms.
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> It can be deduced that this ability of banks is likely derived from the operational, that is, accounting conventions and regulations of banking. These either differ from those of non-banks, so that only banks are able to create money, or else non-banks have missed out on the significant opportunities money creation may afford.
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> In order to identify the difference in accounting treatment of the lending operation by banks, we adopt a comparative accounting analysis perspective.
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> When the non-financial corporation, such as a manufacturer, grants a loan to another firm, the loan contract is shown as an increase in assets: the firm now has an additional claim on debtors — this is the borrower's promise to repay the loan. The lender purchases the loan contract, treated as a promissory note. Meanwhile, when the firm disburses the loan (and hence discharges its obligation to make the money available to the borrower), it is drawing down its cash reserves or monetary deposits with its banks. As a result, one gross asset increase is matched by an equally-sized gross asset decrease, leaving net total assets unchanged.
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> In the second case, of a non-bank financial institution, such as a stock broker engaging in margin lending, the loan contract is the claim on the borrower that is added as an asset to the balance sheet, while the disbursement of the loan – for instance by transferring it to the client or the stock exchange to settle the margin trade conducted by its client – reduces the firm's monetary balances (likely held with a bank). As a result, total assets and total liabilities remain unchanged.
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> While the balance sheet total is not affected by the granting and disbursement of the loan in the case of firms other than banks, the picture looks very different in the case of a bank. While the loan contract shows up as an increase in assets with all types of corporations, in the case of a bank the disbursement of the loan … appears as a positive entry on the liability side of the balance sheet, as opposed to being a negative entry on the asset side, as in the case of non-banks. As a result, it does not counter-balance the increased gross assets. Instead, both assets and liabilities expand. The bank's balance sheet lengthens on both sides by the amount of the loan (see the empirical evidence in Werner, 2014a and Werner, 2014c). Thus it is clear that banks conduct their accounting operations differently from others, even differently from their near-relatives, the non-bank financial institutions.
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> Surprisingly, we find that unlike the other firms whose balance sheets shrank back in Step 2, the bank's accounts seem in standstill, unchanged from Step 1. The total balance sheet remains lengthened. No balance is drawn down to make a payment to the borrower.
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> So how is it that the borrower feels that the bank's obligation to make funds

available are being met? (If indeed they are being met). This is done through the one, small but crucial accounting change that does take place on the liability side of the bank balance sheet in Step 2: the bank reduces its ‘account payable’ item by the loan amount, acting as if the money had been disbursed to the customer, and at the same time it presents the customer with a statement that identifies this same obligation of the bank to the borrower, but now simply re-classified as a ‘customer deposit’ of the borrower with the bank.

The bank, having ‘disbursed’ the loan, remains in a position where it still owes the money. In other words, the bank does not actually make any money available to the borrower: No transfer of funds from anywhere to the customer or indeed the customer’s account takes place. There is no equal reduction in the balance of another account to defray the borrower. Instead, the bank simply re-classified its liabilities, changing the ‘accounts payable’ obligation arising from the bank loan contract to another liability category called ‘customer deposits’.

While the borrower is given the impression that the bank had transferred money from its capital, reserves or other accounts to the borrower’s account (as indeed major theories of banking, the financial intermediation and fractional reserve theories, erroneously claim), in reality this is not the case. Neither the bank nor the customer deposited any money, nor were any funds from anywhere outside the bank utilised to make the deposit in the borrower’s account. Indeed, there was no depositing of any funds.

In Step 1 the bank had a liability — an obligation to pay someone. How can it discharge this liability? A law dictionary states:

> “The most common way to be discharged from liability … is through payment.” [1]

And yet, no payment takes place in Step 2 (and hence in the entire ‘lending’ process), which is why the bank’s balance sheet in total remains stuck in Step 1, when all lenders still owe the money to their respective borrowers. The bank’s liability is simply re-named a ‘bank deposit’. However, bank deposits are defined by central banks as being part of the official money supply (as measured in such official ‘money supply’ aggregates as M1, M2, M3 or M4). This confirms that banks create money when they grant a loan: they invent a fictitious customer deposit, which the central bank and all users of our monetary system, consider to be ‘money’, indistinguishable from ‘real’ deposits not newly invented by the banks. Thus banks do not just grant credit, they create credit, and simultaneously they create money.

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Instead of discharging their liability to pay out loans, the banks merely reclassify their liabilities originating from loan contracts from what should be an ‘accounts payable’ item to ‘customer deposit’ (in practise of course skipping Step 1 entirely and thus neglecting to record the accounts payable item). The bank issues a statement of its liability to the borrower, which records its liability as a ‘deposit’ of the borrower at the bank.

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What enables banks to create credit and hence money is their exemption from the Client Money Rules. Thanks to this exemption they are allowed to keep customer deposits on their own balance sheet. This means that depositors who deposit their money with a bank are no longer the legal owners of this money. Instead, they are just one of the general creditors of the bank whom it owes money to. It also means that the bank is able to access the records of the customer deposits held with it and invent a new 'customer deposit' that had not actually been paid in, but instead is a re-classified accounts payable liability of the bank arising from a loan contract.

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What makes banks unique and explains the combination of lending and deposit-taking under one roof is the more fundamental fact that they do not have to segregate client accounts, and thus are able to engage in an exercise of 're-labelling' and mixing different liabilities, specifically by re-assigning their accounts payable liabilities incurred when entering into loan agreements, to another category of liability called 'customer deposits'.

What distinguishes banks from non-banks is their ability to create credit and money through lending, which is accomplished by booking what actually are accounts payable liabilities as imaginary customer deposits, and this is in turn made possible by a particular regulation that renders banks unique: their exemption from the Client Money Rules. [Werner gives a concrete example on British law for banking and non-banking institutions.]

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It would appear that those who argue that bank regulations should be liberalised in order to create a level playing field with non-banks have neglected to demand that the banks' unique exemption from the Client Money Rules – a regulation benefitting only banks – needs to be deregulated as well, so that banks must also conform to the Client Money Rules.

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Alternatively, one could argue that it would level the playing field, if the banks' current exemption from the Client Money Rules was also granted to all other firms — in other words, if the Client Money Rules themselves were abolished. This would allow all firms to also engage in the kind of creative accounting that has become an established practise among banks. It would certainly ensure that competition between banks and non-bank financial institutions would become more meaningful, since the exemption from the Client Money Rules, together with the banks' deployment of this exemption for the purpose of re-labelling their liabilities, has given significant competitive advantages to banks over all other types of firms: banks have been able to create and allocate money – virtually the entire money supply in the economy – while no other firm is able to do the same.

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Basel rules were doomed to failure, since they consider banks as financial intermediaries, when in actual fact they are the creators of the money supply. Since banks invent money as fictitious deposits, it can be readily shown that capital adequacy based bank regulation does not have to restrict bank activity: banks can create money and hence can arrange for money to be made available to purchase newly issued shares that increase their bank capital. In other words, banks could simply invent the money that is then used to increase their capital. This is what Barclays Bank did in 2008, in order to avoid the use of tax money to shore up the bank's capital: Barclays 'raised' £5.8 bn in new equity from Gulf sovereign wealth investors — by, it has transpired, lending them the money! As is explained in Werner (2014a), Barclays implemented a standard loan operation, thus inventing the £5.8 bn deposit

> ‘lent’ to the investor. This deposit was then used to ‘purchase’ the newly issued Barclays shares. Thus in this case the bank liability originating from the bank loan to the Gulf investor transmuted from (1) an accounts payable liability to (2) a customer deposit liability, to finally end up as (3) equity — another category on the liability side of the bank’s balance sheet. Effectively, Barclays invented its own capital. This certainly was cheaper for the UK tax payer than using tax money. As publicly listed companies in general are not allowed to lend money to firms for the purpose of buying their stocks, it was not in conformity with the Companies Act 2006 (Section 678, Prohibition of assistance for acquisition of shares in public company). But regulators were willing to overlook this. As Werner (2014b) argues, using central bank or bank credit creation is in principle the most cost-effective way to clean up the banking system and ensure that bank credit growth recovers quickly. The Barclays case is however evidence that stricter capital requirements do not necessary prevent banks from expanding credit and money creation, since their creation of deposits generates more purchasing power with which increased bank capital can also be funded.

In other words, banks have been granted a loophole – not available to other businesses – to use a fiction that the banks’ liabilities are really assets -which has given them a huge competitive advantage over everyone else.

No wonder banks now literally own the country … including the entire political system.

But why don’t mainstream economists understand how banks actually create money?

Economics professor Steve Keen explained last week in Forbes:

> In any genuine science, empirical data like this would have forced the orthodoxy to rethink its position. But in economics, the profession has sailed on, blithely unaware of how their model of “banks as intermediaries between savers and investors” is seriously wrong, and now blinds them to the remedy for the crisis as it previously blinded them to the possibility of a crisis occurring.
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> A wit once defined an economist as someone who, when shown that something works in practice, replies “Ah! But does it work in theory?”

Mainstream economic models are fundamentally wrong. The theories taught in economics programs are riddled with errors. For example, they don’t take into account such basic factors as private debt.

That’s why the 2008 crash happened … and that’s why the economy is heading south now.

So things are going to get worse and worse until they’re fixed to account for how banks actually create money.

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