The Banking Secret, Which Makes the Fatcats Richer, While Destroying the Real Economy

That Neither Economists nor Laypeople Know…

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Private Banks – Not the Government or Central Banks – Create 97 Percent of All Money

Who creates money?

Most people assume that money is created by *governments* … or perhaps central banks.

In reality – as noted by the Bank of England, Britain's central bank – 97% of all money in circulation is created by *private* banks.

Bank Loans = Creating Money Out of Thin Air

But *how* do private banks create money?

We've all been taught that banks first take in deposits, and then they loan out those deposits to folks who want to borrow.

But this is a myth …

The Bank of England the German central bank have explained that loans are extended *before* deposits exist … and that the loans *create* deposits:

The above is from an official video released by the Bank of England.

The Bank of England explains:

> Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.
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> The reality of how money is created today differs from the description found in some economics textbooks:
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> - Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.
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> One common misconception is that banks act simply as intermediaries, lending out the deposits that savers place with them. In this view deposits are typically 'created' by the saving decisions of households, and banks then 'lend out' those existing deposits to borrowers, for example to companies looking to

> finance investment or individuals wanting to purchase houses.
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> In reality in the modern economy, commercial banks are the creators of deposit money …. Rather than banks lending out deposits that are placed with them, the act of lending creates deposits — the reverse of the sequence typically described in textbooks.
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> Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created. For this reason, some economists have referred to bank deposits as 'fountain pen money', created at the stroke of bankers' pens when they approve loans.
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> This description of money creation contrasts with the notion that banks can only lend out pre-existing money, outlined in the previous section. Bank deposits are simply a record of how much the bank itself owes its customers. So they are a liability of the bank, not an asset that could be lent out.

Similarly, the Federal Reserve Bank of Chicago published a booklet called "Modern Money Mechanics" in the 1960s stating:

> [Banks] do not really pay out loans from the money they receive as deposits. If they did this, no additional money would be created. What they do when they make loans is to accept promissory notes in exchange for credits to the borrowers' transaction accounts.

Monetary expert and economics professor Randall Wray explained to Washington's Blog that:

> Bank deposits are bank IOUs.

Economics professor Richard Werner – who obtained his PhD in economics from Oxford, was the first Shimomura Fellow at the Research Institute for Capital Formation at the Development Bank of Japan, Visiting Researcher at the Institute for Monetary and Economic Studies at the Bank of Japan, Visiting Scholar at the Institute for Monetary and Fiscal Studies at the Ministry of Finance, and chief economist of Jardine Fleming – was granted access to study a bank's books, and confirmed that private banks create money when they simply create fictitious deposits into a borrower's account.

Werner explains:

> 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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> No balance is drawn down to make a payment to the borrower.
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> 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'.
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> 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.
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> The bank's liability is simply re-named a 'bank deposit'.
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> 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' ….

How Can Banks DO This?

Professor Werner explains the reason that banks – but no one else – can create money out of thin air is that they are the *only* institution exempted from normal accounting rules.

Specifically, every other company would be busted for fraudulent accounting if they conjured new money out of thin air by reclassifying a liability (i.e. an accounts payable) as an asset (i.e. a deposit).

But the banks have pushed through exemptions so that they don't have to follow normal accounting rules:

> 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'.
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> 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.]

Sound fraudulent? Professor Werner thinks so, also:

But he also makes some more important points …

What Does It All Mean? The Implications of Money Creation By Private Banks

Mainstream economists believe that private debt doesn't even "*exist*" as a force that acts on the economy. For example, Ben Bernanke and Paul Krugman assume that huge levels of household debt don't hurt the economy because more debt among households just means that savers have loaned them money … i.e. that it is a *net wash* to the economy. To make this assumption, they rely on the myth debunked above … that banks can only loan as much money out as they have in deposits. In reality, 143 years of history shows that excessive private debt – in and of itself – can *cause depressions*.

Moreover, Professor Werner points out that attempts to shore up the banking system with capital requirements (such as the Basel accords) are doomed to failure, since they don't recognize that banks create money at will:

> 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.

Moreover, Werner points out that banks *create* the boom-bust cycle by lending too much for speculative, non-productive purposes:

By failing to take into account the fact that banks create money, economists and governments are sowing the seeds for future crashes.

But the economics field is very resistant to change …

Economics professor Steve Keen notes 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?"

And a 2016 IMF paper notes:

> Around [the 1960s] banks began to completely disappear from most macroeconomic models of how the economy works.
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> This helps explain why, when faced with the Great Recession in 2008, macroeconomics was initially unprepared to contribute much to the analysis of the interaction of banks with the macro economy. Today there is a sizable body of research on this topic, but the literature still has many difficulties.
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> Virtually all recent mainstream neoclassical economic research is based on the highly misleading "intermediation of loanable funds" description of banking …
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> In modern neoclassical intermediation of loanable funds theories, banks are seen as intermediating real savings. Lending, in this narrative, starts with banks collecting deposits of previously saved real resources (perishable consumer goods, consumer durables, machines and equipment, etc.) from

> savers and ends with the lending of those same real resources to borrowers. But such institutions simply do not exist in the real world. There are no loanable funds of real resources that bankers can collect and then lend out. Banks do of course collect checks or similar financial instruments, but because such instruments—to have any value—must be drawn on funds from elsewhere in the financial system, they cannot be deposits of new funds from outside the financial system. New funds are produced only with new bank loans (or when banks purchase additional financial or real assets), through book entries made by keystrokes on the banker's keyboard at the time of disbursement. This means that the funds do not exist before the loan and that they are in the form of electronic entries—or, historically, paper ledger entries—rather than real resources.
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> This "financing through money creation" function of banks has been repeatedly described in publications of the world's leading central banks—see McLeay, Radia, and Thomas (2014a, 2014b) for excellent summaries. What has been much more challenging, however, is the incorporation of these insights into macroeconomic models [how true].

What's the Solution?

We've seen the problems created by failing to take into account the fact that private banks create money.

But there are solutions …

Initially, Professor Werner notes that preventing banks from creating *new* money to loan for speculation and mere personal consumption would prevent booms and busts:

Werner says that the "Asian Miracle" happened for exactly this reason:

Additionally, allowing small community banks to grow would cause the real economy to flourish … since small banks loan to small businesses (which create most of the jobs), while big banks only loan to giant companies and speculators:

Indeed, big banks are virtually out of the business of traditional lending … and small banks are the only ones funding Main Street.

Werner says this is the secret of Germany's economic success:

Postscript: Due to their unique money-printing powers, banks now literally own the world … including the entire political system.

There's a war raging in connection with banking. Remember that the giant banks tried to kill off community banking through the Trans Pacific Partnership. And as Professor Werner points out, the European Central Bank is currently in a war to destroy community banks:

One of key battles for prosperity and democracy today is decentralization of the banking system.

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