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# The role of banks in money creation

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*Introduction*

The phrase “banks create money” forms part of popular discourse, but it conveys an erroneous message of the banks' role in the money creation process. The topic is particularly relevant today because the notion that banks can create money out of nothing has generated public anger and recent publications by the BoE fuel the misunderstanding. Without clarity, the misguided belief that banks create money out of nothing will continue to influence models of the financial sector and monetary policy interventions.

*How does bank money creation happen?*

Modern money consists primarily of two types of monetary instruments: cash money and bank money. The modern banking system transforms heterogeneous privately issued debt-credit instruments into homogeneous debt-credit instruments – bank money. The creation of this type of money has been understood to be the result of an inter-temporal exchange transaction between parties since the earliest influential discussions on modern bank money, yet it is conspicuously absent in contemporary explanations.

*Debt-credit based money creation in the absence of banks*

The traditional view adopted in the money supply debate is that banks create bank money by creating debt and granting loans. This explanation is then extended to suggest that banks thereby create money out of nothing. However, this is an inadequate caricature of the process of bank money creation. We illustrate this using a simple narrative of Mr B(uyer) who wishes to buy residential property (because residential mortgage loans are at the heart of explanations of the recent financial crisis) without the aid of banking institutions. Mr B enters into an agreement with Ms S(eller) who owns a house and wishes to sell it. The price of the house is R1m. Mr B does not have the R1m in cash money available and therefore must come to some debtor arrangement with Ms S. The debt-credit agreement is the counter exchange to the exchange of the residential property and it is a form of monetary instrument that was, in the absence of banking institutions, commonly used. The debt-credit agreement was created as a result of the underlying transaction, it derives its value from the exchange, and its value is underpinned by the obligation of Mr B to make future payment.

*Modern Banking*

In modern banking, the seller will put the property on the market subject to the condition that the buyer obtain financing from a bank. Banks emerge because, as intermediaries, they reduce a broad spectrum of associated transaction costs. For the seller the liquidity, solvency and default risks with respect to the buyer have been resolved by the involvement of the bank. The bank records a deposit entry in the name of the seller thereby recording the value of bank money created by the underlying transaction. To an outside observer, by recording a deposit entry, the bank has created money out of nothing; this is the illusion of the bank creating money but this is only the *prima faci*e appearance and not the truth of the matter. The R1m bank money was not created directly by the bank, nor was it created out of nothing. The money was created and derived its value as a result of the underlying exchange transaction. The outside observer has neglected to acknowledge that the deposit value records the value-for-value exchange conducted through an underlying transaction. In reality, the seller no longer has a house and the buyer now has a house.

*The timing of money creation*

The moment bank money creation is *recorded,* may however, differ from the time it is actually *created*. Take a cheque for example. Money is created at the moment the cheque is written and used to pay for a transaction, however, the act of money creation is not recorded until the seller deposits the cheque at the bank. Alternatively if a bank chooses to directly credit a customer's account with the value of a personal loan for example, the bank is recording the value of an exchange that is yet to occur, this deposit entry is an accounting formality recognising a future obligation, no value has yet been realised. The case of the cheque is a lag in the timing of the money creation, and the personal loan is a case of the cart leading the horse. In none of the cases does the bank directly create money, nor is money created out of nothing.

*Policy implications*

Failure to acknowledge the bank's role as intermediary between buyer and seller obscures the need to consider the requirements of sellers and the demand side factors of buyers when investigating money supply dynamics. Current explanations of the bank money creation process ignore the underlying transaction relationship and so undermine these aspects. Policy formulation can therefore be enriched by increased attention to underlying capital demand factors, working capital management practice, and the financing of exchange between buyer and seller.