Funding the Future

Where does money come from?

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The subject of money is being much discussed on this blog at present - and common misunderstandings and misrepresentations as to its true nature are flowing, as is usual when this subject is discussed. As such can I recommend Where Does Money Come From? , published by the New Economics Foundation? They say of this:

This book argues that the process of money creation, and how new money is allocated within the economy, is widely misunderstood by economists and policymakers, and yet needs to be reformed if future financial crises are avoided.

* **The UK's money supply is created by commercial banks when they extend or create credit,** giving such institutions vast power over our economic destiny

* **This system over-expands the money supply during booms, causing credit bubbles, and reinforces monetary contraction during the bust, causing longer and deeper recession**

* **Quantitative easing (QE), as currently practised, is highly ineffective in stimulating new employment and investment**

* **There is no strategic regulatory guidance to ensure that commercial bank credit supports productive investment rather than speculation,** in contrast to previous practice in the UK, and widespread current practice among our industrial competitors

And yet, the ICB does not examine the implications of the role of banks as creators of new money in its 358 page final report.

Tony Greenham, head of Finance and Business at **nef**, former investment banker and co-author of the report said: ***"The Vickers Commission was charged with preventing a repeat of the financial crisis of 2008, but their proposals do not touch the root cause of that crisis: namely, the process of money creation when banks extend credit. How can the ICB expect to prevent another huge credit bubble when they haven't even asked, let alone answered, the***

question ‘where does money come from?’. Unless policymakers understand the process of money creation, and ensure that it serves the public interest, we will never get sustained economic growth in the sectors that provide jobs and improve society, and we will always be at risk from financial crisis.”

The book identifies several implications of the power of banks to create new money:

* The system is ***inherently unstable*** because it depends on the confidence of the private banks themselves, and ***not on interest rates***..

* ***The government has no direct involvement in the money creation*** and allocation process, through fiscal policy or otherwise.

* ***Banks make the decision where to allocate credit in the economy, but are inherently incentivised to channel new money into property and financial speculation rather than small businesses and manufacturing.***

* Current capital adequacy requirements have not and do not constrain money creation, and are ***unable to prevent credit booms.***

If you want to get to the root of this issue, then this is where to start.