

All money is a confidence trick

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I [wrote the blog reproduced below in September 2007](#): Northern Rock was falling over at the time and needed bailing out. I issued it again in 2011, and now it looks like it needs a third outing given the comments on the blog over the last few days.

The point is a simple one, and is that banks create money not out of deposits but out of lending. Without it the economy does not function. Money supply is, despite QE, 12% down since the start of the recession in the UK as measured by the standard measure called M4. And that's down to saving, which repays loans, reduced lending and a lack of consumer confidence. But unless we understand money we can't address these things and get out of recession and the reality is that money is literally a confidence trick as it literally comes out of thin air, and the trouble is that right now we don't have that confidence:

"It amazes me that most people think that money is printed. It isn't. Only 3% of all money in the UK is created by the government. The rest is created by banks.

How does a bank create money? The honest answer is out of thin air. It happens whenever they create a loan.

Most people think when they ask a bank for a loan money paid in by one person is paid on to them. That's not true. Not true at all, in fact.

Instead what the bank does is a conjuring trick. They agree to give you a loan. They do it by opening two accounts for you. One is a current account (for ease, let's assume you haven't already got one). The other is a loan account. If you borrow £10,000 they mark your current account as having £10,000 in it. You're now free to spend that however you like.

They also mark your loan account as having £10,000 in it. You now owe that to the bank.

Add the two together and they add up to nothing. One you apparently own (the current account) and one you apparently owe (the loan account). But if you decided to cancel

the deal you could straight away repay the loan using the current account and there would be nothing left. Which is why I mean they add up to nothing.

Note there's no cash involved in this process at all. It's just an accounting trick. Nothing more.

And now the bank charge you interest for the benefit of having created that money. Even though there is no money as such, even though you think there is, because you can spend what's in the current account as if it were money. Which is what I mean about the banks creating that money. You can see why they make so much profit, can't you? They make money out of nothing and then charge you to use it.

Of course they need some cash. That's necessary to ensure that if anyone does want their money back in straightforward cash they can pay it to them. That's why they need part of that 3% of money created by the government.

And of course they can't repeat this lending trick forever because if they did people would realise there was no substance behind the promise they made to you when you agreed to pay them back a loan. That promise is that the money in your current account can be used to pay other people — a promise that is only as good as the bank on which the cheque is written on.

But that's the confidence part of the rick. So long as people believe the banks will pay they don't need money. They can just pretend they have it. When people don't have that confidence they do need money. Trouble is, they always lend far more money than they actually have. That's the risk in a 'run on the bank' of the sort Northern Rock has suffered.

But now that risk has been taken away. The government has said it will cover it. So the banks can lend more money at limited risk to themselves. And so make more interest on something they have created out of thin air. Are you surprised that banks are the biggest companies in the world? After all, their basic product really does not cost them anything to make. Amazing, isn't it?

You don't believe me? Actually, you wouldn't be alone. When explaining this the second greatest economist of the last century (J. K Galbraith) said:

The process by which banks create money is so simple that the mind is repelled

(John K. Galbraith, in "Money: Whence it came, where it went", p. 29.)

He was right, because it's true: the process is so simple that we're repelled by the idea that we pay for it."