

How is electronic money made? An explanation

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Yesterday [I explored what money is.](#)

I said it was a promise to pay that is backed up by the government, which is in turn backed up by its ability to tax.

That explanation did not, however, explain how electronic money is created, because it has to be. This recording does that.

Next I will explain how this process of money creation and the government's promise to pay are intimately connected. But that's for another day.

<https://soundcloud.com/user-371490417/electronic-money-an-explanation>

The transcript of what I said (near enough, because a few words always seem to change during a recording) is as follows:

Almost all the money that we use is electronic.

It is not notes and coins.

There is no gold, or anything else, sitting in banks to back it up.

And when 97p in every pound spent in the UK, overall, is spent electronically, there aren't notes and coins sitting in bank vaults to back all that electronic money up either.

Our money is nothing more than an entry in a computer.

But those entries do have value. They get that from the fact that all electronic money is a promise to pay.

That promise is written on banknotes. But it's not written on our bank accounts.

And although it's easy to see how a banknote is created - by simply turning on a printing press - how is electronic money made? After all, it has to come from

somewhere.

And it does. It is made. It has to be. And the process by which it is made is deceptively simple.

Money is made whenever a bank lends money. An example helps.

Suppose a person wants a loan. Suppose they want £10,000 to buy a car and haven't got that money. So, they ask a bank to borrow it.

The bank asks them for information - almost certainly online. And then the bank checks it out. That's called a credit check. If the person passes that check the bank agrees to lend the money.

It does that because it has decided that the person who has asked for the loan is likely to fulfil their promise to repay it. They trust them. So they create a bank loan account with £10,000 owed by the customer in it.

In return the bank makes a promise. Its promise is to put £10,000 in the borrower's bank current account which they can then use to buy the car.

And that process - of the borrower promising to repay the loan and the bank promising to pay whoever the borrower wants to make payment to, is all that it takes to create all the electronic money that there is in the world.

Importantly, note that the bank does not give the borrower another customer's money. In fact, no one else is involved in any way in creating the loan and the money it creates.

All that money creation requires is two equal and opposite entries in the bank's books that in return reflect the two promises made.

The bank's promise is reflected by their being £10,000 in the customer's current bank account.

And the customer's promise is reflected in the fact that there is £10,000 in their loan account at the bank, which is what they now owe it.

These entries are all it takes to make the new money that is needed to pay for the car.

But that means something quite important as well. That is that when the loan is repaid the money it created is destroyed.

What that in turn means is that money is being made and destroyed by lending and loan repayment all the time.

And some of that lending is from you to the bank, which is what you do if you're in what

is called credit, and some of it is lending by the bank to you. But all it takes is that process of lending and borrowing to make all our money.

Money does then come down to just one thing - which is the promise to pay.

And bank lending is now the only way we now have to create all the money that we need to make the economy work.