Funding the Future

Money, debt and thin air

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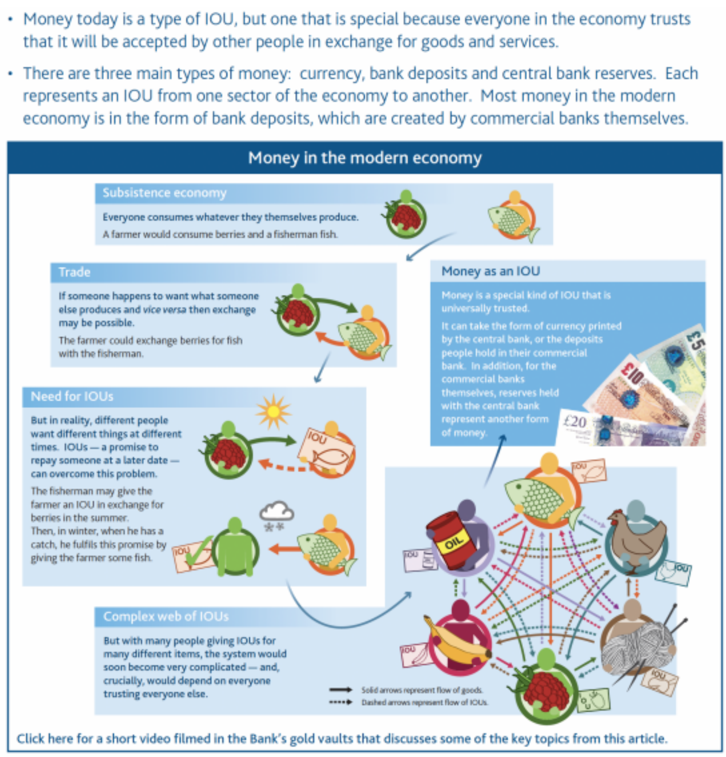
As a result of yesterday's thread on the relationship between banking, banks and the UK's central bank - the Bank of England - a number of challenges have been made to my claims. I think there are thee injections, in essence.

The first is that money is not debt. The second is that money is not created 'out of thin air' and the third is that the Bank of England does not create the balances on the central bank reserve account deposits that the commercial banks have with it. I think each needs to be addressed. I am going to do so using arguments published by the Bank of England in 2014. On these issues there is sufficient alignment between my position and that of the Bank for me to use their suggestions to support my own.

Money is debt

This chart was published by the Bank of England in 2014:



As they added:

Money in the modern economy is just a special form of IOU, or in the language of economic accounts, a financial asset.

Or, in other words, money is just debt. That is all there is to it.

That includes notes and coins too: they are just a tangible record of the debt the government incurred when spending them into the economy, because they do not give them away.

Anyone who wishes to argue money is not debt is welcome to, but please take it up with the Bank of England. And if the claim is that this is not what you were taught, note that the Bank says:

The reality of how money is created today differs from the description found in some economics textbooks.

The textbooks are wrong.

Money out of thin air

The **same 2014 publication** **from the Bank of England notes that:**

In the modern economy, most money takes the form of bank deposits. But how those bank deposits are created is often misunderstood: the principal way is through commercial banks making loans. Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.

That is how money is created. In a modern economy there is no other way to do it. The consequence, as the Bank of England also notes, is that:

Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.

In other words, savings are redundant to the process of lending and banks are not intermediaries between savers and investors. The only use for bank deposits from customers as far as banks are concerned is to provide them with very cheap capital: in effect the banks treat deposits as if they are money that they might lose, a fact **aided by the government guarantee** **for all customer deposits to £85,000, which means the banks know that they have no responsibility with regard to such sums.**

Why don't banks lend without limit then? As the Bank of England says:

Although commercial banks create money through lending, they cannot do so freely without limit. Banks are limited in how much they can lend if they are to remain profitable in a competitive banking system. Prudential regulation also acts as a constraint on banks' activities in order to maintain the resilience of the financial system. And the households and companies who receive the money created by new lending may take actions that affect the stock of money — they could quickly 'destroy' money by using it to repay their existing debt, for instance.

That last point is very important. What it says is that loan repayment destroys commercial bank-created money.

To summarise:

* Banks do not lend other people's money. They create all the money they lend;
* The money created in this way is how bank deposits are created;
* Repaying loans destroys money.

The central bank reserve accounts

As the Bank of England says in the same 2014 document:

A different definition of money, often called 'base money' or 'central bank money', comprises IOUs from the central bank: this includes currency (an IOU to consumers) but also central bank reserves, which are IOUs from the central bank to commercial banks. Base money is important because it is by virtue of their position as the only issuer of base money that central banks can implement monetary policy.

The central bank reserve accounts are the only depositories for this base money created by the Bank of England. The suggestion that it might come from elsewhere is wrong, although it can be destroyed by the government increasing the demand for tax or borrowing - when commercial money is used to destroy the base money in the central bank reserve accounts by the settlement of debt owing with regard to tax or bond purchases.

What, however, is never true is that the commercial banks can create base money: they can only be recipients of it. In that case if the central bank reserve accounts increase it is because the government via the Bank of England (and they are not in any way independent of each other) has decided that this should happen by:

* Spending more money into the economy
* Repurchasing government debt (QE)

This money injection, which requires no decision or active engagement by the commercial banks, inflates those commercial banks' balance sheets - hence my suggestion that the money is gifted to them.

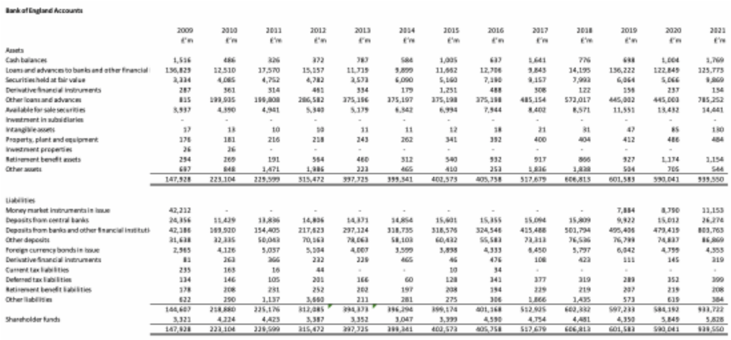
The Bank of England summarise this in this chart:

Figure 2 Stylised balance sheets of different types of money holders and issuers in the economy(a)

(a) Balance sheets are highly stylised for ease of exposition: the quantities of each type of money shown do not correspond to the quantities actually held on each sector's balance sheet.
(b) Central bank balance sheet only shows base money liabilities and matching assets. In practice the central bank holds other non-money liabilities. Its non-money assets are mostly made up of government debt. Although that government debt is held by the Bank of England's Asset Purchase Facility, so does not appear directly on the Bank of England's consolidated balance sheet.
(c) Commercial banks' non-money assets would include government debt and non-money liabilities would include long-term debt and equity.
(d) Consumers represent the private sector of households and companies. Balance sheet only shows broad money assets and corresponding liabilities. Consumers' non-money liabilities would include secured and unsecured loans.

Thye no money assets of the Bank of England are treasury bonds, in the main.

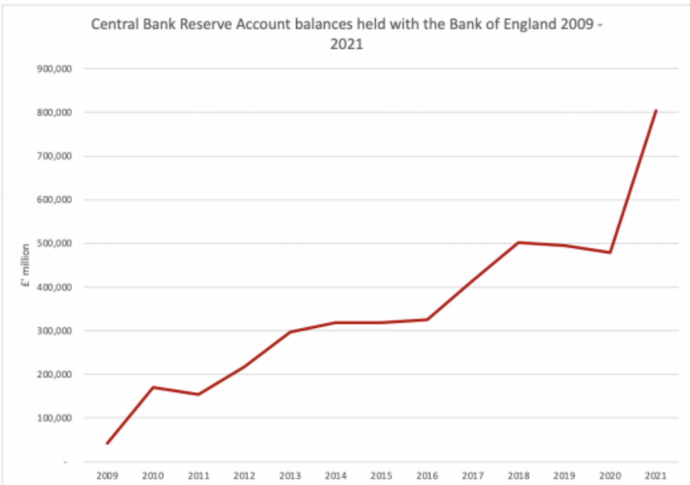
I have summarised the balance sheets of the Bank of England as follows from 2008 to 2021 (the latest available)(click the image twice for a larger version):



Bank of England Accounts

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
	£'m	£'m	£'m	£'m	£'m	£'m	£'m	£'m	£'m	£'m	£'m	£'m	£'m
Assets													
Cash balances	1,516	486	326	372	787	584	1,005	637	1,641	776	698	1,004	1,769
Loans and advances to banks and other financial	136,829	12,510	17,570	15,157	11,719	9,899	11,662	12,706	9,843	14,195	136,222	122,849	125,773
Securities held at fair value	3,334	4,085	4,752	4,782	3,573	6,090	5,160	7,190	9,157	7,993	6,064	5,066	9,869
Derivative financial instruments	287	361	314	481	334	179	1,251	488	308	122	156	237	134
Other loans and advances	815	199,935	199,808	286,582	375,196	375,197	375,198	375,198	485,154	572,017	445,002	445,003	785,252
Available for sale securities	3,937	4,390	4,941	5,340	5,179	6,942	6,994	7,944	8,402	8,571	11,551	13,432	14,441
Investment in subsidiaries	-	-	-	-	-	-	-	-	-	-	-	-	-
Intangible assets	17	13	10	10	11	11	12	18	21	31	47	85	130
Property, plant and equipment	176	181	216	218	243	262	341	392	400	404	412	486	484
Investment properties	26	26	-	-	-	-	-	-	-	-	-	-	
Retirement benefit assets	294	269	191	584	460	312	540	932	917	866	927	1,174	1,154
Other assets	697	848	1,471	1,986	223	465	410	253	1,836	1,838	504	705	546
	147,928	223,104	229,599	315,472	397,725	399,341	402,573	405,758	517,679	606,813	601,583	590,041	939,550
Liabilities													
Money market instruments in issue	42,212	-	-	-	-	-	-	-	-	-	7,884	8,790	11,153
Deposits from central banks	24,356	11,429	13,836	14,806	14,371	14,854	15,601	15,355	15,094	15,809	9,922	15,012	26,274
Deposits from banks and other financial instituti	42,186	169,920	154,405	217,623	297,124	318,735	318,576	324,546	415,488	501,794	495,406	479,419	803,763
Other deposits	31,638	32,335	50,043	70,163	78,063	58,103	60,432	55,583	73,313	76,536	76,799	74,837	86,869
Foreign currency bonds in issue	2,965	4,126	5,037	5,104	4,007	3,599	3,898	4,333	6,450	5,797	6,042	4,799	4,353
Derivative financial instruments	81	263	366	232	229	465	46	476	108	423	111	145	319
Current tax liabilities	235	163	16	44	-	-	10	34	-	-	-	-	-
Deferred tax liabilities	134	146	105	201	166	60	128	341	377	319	289	352	399
Retirement benefit liabilities	178	208	231	252	202	197	208	194	229	219	207	219	208
Other liabilities	622	290	1,137	3,660	211	281	275	306	1,866	1,435	573	619	384
	144,607	218,880	225,176	312,085	394,373	396,294	399,174	401,168	512,925	602,332	597,233	584,192	933,722
Shareholder funds	3,321	4,224	4,423	3,387	3,352	3,047	3,399	4,590	4,754	4,481	4,350	5,849	5,828
	147,928	223,104	229,599	315,472	397,725	399,341	402,573	405,758	517,679	606,813	601,583	590,041	939,550

The central bank reserve accounts rose like this:



The match to QE is not perfect: other funds flow through these accounts, but it is close.

I hope this makes all these issues a little clearer, but I am not much inclined to discuss the rights or wrongs of this explanation: as far as I and the Bank of England are concerned, these are facts.