

Funding the Future

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As I often explain about my writing of this blog, much of my motivation for doing so is to work out what I think about an issue. This is why I will, for example, put half-formed ideas on here to test reaction to them, and why I am, on many occasions, willing to change my mind about things that I have said because others have presented me with better ideas.

When I first raised the subject of Sir Howard Davies not understanding that banks are not intermediaries, but do, instead, create money out of thin air to loan to their customers, I did not expect the number of blog posts that have followed, or the several hundred comments that have appeared on them. Sometimes issues get a life of their own, and this one certainly has.

What I think is worthwhile now is to summarise what has been established, and what now needs to be thought about some more. This is largely for my benefit, but if others find it useful that makes it doubly worthwhile.

In my opinion, evidence has been assembled here that unambiguously proves that central bankers are of the opinion that every time a commercial bank makes a loan to a customer then new commercial bank money is created. This now appears to be established fact. Bill Kruse has documented much of this, and I am grateful to him for sharing that documentation with me, and the readers of this blog. Others have now added to that collection.

It follows that if new commercial bank money is created every time that there is a loan made by a commercial bank, deposits in those commercial banks must always increase in exactly similar amount as a consequence of those loans. It cannot be otherwise.

It necessarily follows that in principle commercial banks do not require deposits to lend, but create deposits by lending.

What also necessarily follows, but which has not been much discussed here, is the fact that the reverse of the suggestions must also be true, i.e. the repayment of bank loans necessarily destroys commercial bank created money, and will reduce the quantum of bank deposits in the same amount. Once more, it cannot be otherwise.

There has also been discussion of government created money in the course of this narrative. It has been agreed, and central bankers have regularly confirmed this, that whenever a central bank funds spending by the government that it serves it necessarily creates a loan to that government. The represents new base money. This loan can be reduced by the receipt of either taxation revenues or the proceeds of government deposit taking (whether by offering government banking facilities, such as those provided by NS&I, or by the sale of bonds or gilts).

It has also been agreed that the singular transmission mechanism for funds between the central bank and the government and commercial banks are the central bank reserve account that the central bank, or the Bank of England in the case of the UK, maintain for commercial banks and a limited range of other financial institutions within the jurisdiction. The funds in these bank accounts, maintained with the Bank of England, represent what is called base money, which term also covers notes and coins, although these are now of much smaller proportionate value.

Importantly, although not discussed in detail in the narrative to this point, base money cannot become commercial money, or vice versa. This is a necessary consequence of the nature of money within the modern banking system. Money has no tangible or physical qualities within the modern economy. This is as true of notes and coins as anything else: they are not money in themselves, but are tokens that represent debt, which debt is as intangible as all other money is because all other money only exists as entries in bank ledgers.

The entries in government and central bank ledgers represent base money. All entries in commercial bank ledgers represent commercial bank money. However, money does not move between these ledgers. All that happens when payments and receipts are made within either of these banking systems is that the balance on one account within that banking system is either increased or reduced, and the equal and opposite transaction is recorded in another part of that system. Whilst this gives the impression of money moving that is quite incorrect: bank account balances might change, but nothing ever moves. The impossibility of base money becoming commercial bank money, and vice versa, is explained by this fact.

It is my suggestion that the above are established facts. I am aware that many commentators who refused to disclose their identity or qualifications sought to challenge these facts in the early stages of this narrative but they have, perhaps wisely, mainly stopped making their claims now.

Consequences

I now think it is appropriate to record some of the consequences that have arisen as a result of this discussion. These are not necessarily facts: they are suggestions with varying degrees of tentativeness.

Firstly, if there was a single commercial bank within a jurisdiction then the suggestion made that such a bank need never borrow as a consequence of making a loan would be true. In that situation, the deposit arising from any loan will necessarily flow back to the bank making that loan, and it would, as a result, always have a balanced loan and deposit ledger. In effect, the depositor loans their new funds back to the bank that made the loan that created them. I think this necessarily follow from the discussions noted above, and I am rather hoping that no one disagrees, but I am open to alternative suggestion.

The problem with bank regulation which has taken up a great deal of time in this narrative arises because there are multiple commercial banks within the UK. It does, therefore, necessarily follow that a bank may make a loan to a customer who then makes payment to a person who uses the facilities of another bank, meaning that this other bank gets the benefit of the deposit that the loan the first bank has made gives rise to. The risk within the banking system arises because of this disaggregation between commercial banks, and nothing else.

Banking regulation seeks to address the risk that this disaggregation creates arising from the different risk and timing profiles of deposits and loans between differing banks. It should, however, be noted that because banks almost invariably borrow short term and lend long term nothing within banking regulation can ever totally overcome the liquidity risk within the banking system as a whole. Any attempt to do so will always, necessarily, be futile in the event of their being a complete loss of confidence in that system.

In that case the greatest risk within banking regulation might be that it presumes risk within disaggregated banking can be controlled independently of the risk within the aggregate system. The possibility that almost all banking risk gives rise to the possibility of contagion, and that banks almost invariably stand or fall together, with all of them now being considered too big to fail, is an issue overlooked if banking regulation assumes (based upon microeconomic theory) that these entities are independent of each other and represent individual, siloed, risk. If there is a single problem with banking regulation, this might be it.

Having noted this issue, and having also noted that bank regulation appears to have failed to take into consideration the substantial change in balances held on central bank reserve accounts since 2008, which were deliberately provided to replace missing liquidity within that system, it is then appropriate to note that banking regulation requires that the working capital provided by governments through the inflation of central bank reserve accounts cannot be considered as a source of working capital within those banks' routine banking operations. The inevitable consequence of this is that a bank making loans in excess of the consequent value of deposits that it creates is required by banking regulation to borrow funds from those banks that have enjoyed a surfeit of deposits in excess of loans they have made, with funds necessarily being transferred between those banks through their central bank reserve accounts as a

consequence.

The lending bank that has the surfeit of deposits does, of course, charge for making this loan at a rate above Bank of England rate. This is despite that fact that the deposited funds made available to them will be paid a rate much less than that they will charge the bank that made the original loan. In fact, it is likely that the bank enjoying excess deposits will probably make a bigger margin on its making a loan to the bank that initially created the credit that gave rise to its surfeit of deposits than will the bank that created that deposit creating loan to a third-party customer.

Banking regulation is not, as a consequence, likely to be a zero sum game between banks. Those banks that are considered the safest places of deposit, largely because of their size and length of establishment, may well make excess profits from lending funds to competitor banks who take greater risk in loan creation than do those banks who are actually engaged in providing credit within the economy.

If my suggestion in the previous paragraph is correct, and it is a tentative conclusion, then the reason for banking regulation in its current form becomes apparent. The largest, longest established, banks that enjoy oligopolistic power and that are most likely to enjoy excess deposits (most of whom will have names which are very familiar) will be heavily invested in this system of bank regulation that is likely to give them the opportunity to make substantial margins on bank lending to other financial institutions who are significantly more likely to actually create credit within the financial system. They have literally no incentive to do otherwise, and every advantage from the status quo. In that case, whether this form of regulation is necessary, or desirable, is not the question: it will be defended, very strongly, precisely because vested interest have a considerable interest in making sure that it persists.

Presuming that this logic is correct, then banking regulation creates a series of particularly perverse consequences. Firstly, those banks most able to lend have little incentive to do so: for them the accumulation of deposits that have no useful economic role within the economy, except to apparently be used as the basis for lending to those banks that do advance loans, is in itself one of their most profitable activities. The largest players within the banking market are, therefore, disincentivised from actually taking risk that they are able to bear, and they are instead incentivised to pass that risk to those banks least able to sustain losses. A more perverse outcome is hard to imagine.

Second, these banks are able to use their quasi-monopoly power to maintain the situation.

Third, as a consequence, credit availability can be inappropriately rationed within the UK economy, giving rise to all the phenomena of under investment resulting in low productivity and other consequences that have been well documented for a long time.

Fourth, the Bank of England, by refusing to recognise that it could overcome this deficiency in the banking market by using central bank reserve account balances as a form of capital moderation within the market, facilitates this situation.

Fifth, the apparent failure of banking regulation to take account of the systemic risk within the market as a whole when creating these obligations represents a failure on the part of those promoting that regulatory system.

Finally, let me clear as to why I am raising these issues. There are a number of very good reasons for doing so.

Firstly, the opacity of banking makes this a subject of inherent interest.

Secondly, as is apparent from data that I have already published, banks are profiting enormously as a consequence of the boost in the size of the central bank reserve accounts and the decision of the Bank of England to pay base rate interest on these sums when the banks had no involvement in the creation of these assets that they have had transferred to them, makes this an issue of real public concern.

Third, if as seems likely, banking regulation exists not so much to support the effectiveness of banking, but more to facilitate the transmission mechanism for Bank of England base rate decisions into the economy then this, too, is a matter of public concern, most particularly when the bank of England's base rate decisions are creating destitution for UK households and firms and a recessionary environment in the economy as a whole.

Fourth, if as seems likely, banking regulation assists the extraction of monopoly profits from the economy, then that is a matter of public concern.

Fifth, the absolute absence of scrutiny of these arrangements because of their complexity and opacity makes this discussion worthwhile.

Sixth, I cannot help but think that a better system of banking regulation is available that would recognise the integral nature of banking as a whole, the systemic risks inherent in it, and the fact that the pretence of a market in banking when the whole banking edifice is underpinned by public funding is a sham.

I am not at present, suggesting an alternative regulatory system. What I am interested in is comments on these suggestions.