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The note has been written by regular commentator Clive Parry, who has been a bond trader for 35 years, as a response to the discussion on government and bank money creation on this blog over the last few days.

I will be writing a response addressing issues I think needing discussion. That should come out late today if all goes well. My points will address matters arising from paras 3 (3) to 5. The rest I have no issue with at all, and I am not disputing the descriptions in the paras I refer to, but will instead discuss their consequences.

1 - Money creation

Pieces by Richard about money creation have attracted a lot of comment and quite a bit of trolling, too. Let me be clear, Richard is right – as supported by a string of Central Banks around the world (and every government bond trader I have ever known). However, this is just the start of the story and it is what happens next that seems to have muddled the waters. I thought it might be illuminating to explore this.

First, let's understand what a Central Bank Reserve Account is. The Bank of England (BoE) is "the bankers' bank"; every UK clearing bank will have a Reserve Account with the BoE – you can think of it as the Commercial Bank's current account with its bank.

2 - Money creation by the Government

Let's look at the creation/destruction of money by the government.... and then put it to one side. When the government spends money (eg. pays me my £1) the Central Bank Reserve Account of my bank will be credited with £1 and my bank will credit my current account with them with £1. Assets for the bank will have increased by £1 (the £1 in their account with the BoE); liabilities will have increased by £1 (my pound held with them). Total Central Bank Reserves for the banking system will have risen by £1. £1 has been created.

Equally, when I pay £1 in tax the reverse process happens. My current account is

reduced by £1, my bank's CBRA is reduced by £1 and £1 is destroyed.

Also, government activity in the gilt market creates and destroys money. If I buy £1 of a gilt sold at auction by the DMO my bank account is debited by £1 as is my bank's CBRA and £1 is destroyed. Equally, this is true if the gilt is sold from the BoE portfolio of gilts.

And, of course, the converse is true; if the BoE buys a gilt money is credited to my account and my bank's CBRA.

It is also true that open market operations conducted by the BoE via the Rep market add or drain Reserves from the system.

In short, any transaction where the government (in all its guises – BoE, DMO etc.) is on one side, money is created or destroyed and it shows up in the aggregate CBRA balances of all clearing banks.

So far, so good. I don't think anyone would disagree with this. What about money created by commercial banks?

3 - Money creation by banks

If I borrow £10,000 from my bank to buy a car...

* My bank will credit my current account with £10,000 and record (in a loan account) the fact that I owe the bank £10,000. There is NO movement in any CBRA. £10,000 has been created by the commercial bank. (Note that there is no change in aggregate CBRA balances when this £10,000 is created – it is a different type of money to government-created money but to us in our day-to-day lives we do not distinguish between them. Government-created money is base money. Commercial bank-created money is commercial bank-created money. In use, it's hard to spot the difference).

* I will instruct my bank to pay the car dealer £10,000;

* If the car dealer banks with the same bank as me, my current account will be reduced by £10,000, the dealer's increased by £10,000, the loan account unchanged. No movement in any CBRA account, no money is created or destroyed by this payment.

* If the car dealer banks with a different bank, my current account will be reduced by £10,000, my bank's CBRA will be reduced by £10,000, the dealer's bank's CBRA will be increased by £10,000, the dealer's current account will be increased by £10,000 (my loan account is unchanged). There is a £10,000 movement between the two banks' CBRAs but no change in aggregate CBRA account balances. No money is created or destroyed by this payment. It is a transfer of existing money.

* Banks must maintain a positive balance in their CBRA. So, all other things being equal if the car dealer banks elsewhere my bank will have to attract £10,000 back into its CBRA. It has three choices:

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* Encourage someone to make a deposit (which will entail a transfer into my bank's CBRA).

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Borrow from another bank (handily, the car dealers bank may want to lend out the £10,000 it received).

* Borrow from the BoE. If my bank can't get the money elsewhere the BoE (as "lender of last resort") will lend to my bank as long as it can post collateral against that loan – and, no, the car loan is not eligible collateral with the BoE it has to be gilts. So, let's be clear ***the act of lending me money does NOT require my bank to borrow. However, if money starts to leave a bank's CBRA for any reason*** (e.g. the car dealer banking elsewhere) ***then the bank must borrow to keep its CBRA in good order with the BoE.***

Now, if my bank can borrow at (say) 4% and lend to me at (say) 6% they will make 2p a year (as long as I pay them back). Now 2p is slim pickings for a banker..... so can I scale it up? In short, no.

4 - Equity Capital

There is a risk that loans will default and the bank will not get its money back. Banks must have a cushion of (equity) capital to absorb losses that occur from bad loans so that depositors can always be paid on a timely basis in full. How much capital? Well, it depends on who you lend to but the numbers are all laid out in the Basel Accords that apply globally to all banks. Regulators have continually tightened these rules and now, as a rough estimate, a bank requires 3 or 4 times as much capital for a given level of credit risk than it did in 2008. There is a limited amount of capital and that constrains lending.

Banks have had to shut down since 2008 but they have done so without recourse to financial support from governments (although the jury is still out on SVB and Credit Suisse, but it looks reasonably encouraging). You can't make stupidity illegal but having enough capital insulates the rest of us from banker's poor lending decisions.

Lending decisions are dominated by the amount of capital required to make the loan versus the interest earned over and above a bank's cost of funds. Nobody asks "do we have anything in our account to lend out?" – but it should be noted that the ability to raise deposits will factor into the "cost of funds" for a bank and therefore, obliquely into the lending decision.

5 - Liquidity

So, let's look at "cost of funds". We currently live in a world of "excess reserves". This means that the aggregate balances held by commercial banks exceed the levels required by the BoE. They came into being because the Government spent money without draining it out of the system by issuing gilts. (Well, they did go through the charade of issuing with one hand and then buying back with the other under the QE programme but the rise in CBRA balances is clear proof that it was a charade). That money was spent as (say) furlough payments that went into people's bank accounts

and had a corresponding increase in their banks CBRA account. Whatever they did with it (except pay tax or buy gilts) it remained in the CBRA of one or other commercial bank. These reserve balances peaked at almost £1,000bn and are currently £800bn and the banks receive interest on them at the Base Rate and there are not enough borrowers who want to borrow these reserves so, going back to my car loan, if my bank pays the car dealer (who banks elsewhere) all they need to do is bid Base Rate plus a smidgen and other banks will be happy to lend their reserves to earn that smidgen over and above the alternative they have with the BoE. So, a simple view would maintain that the cost of funds is Base Rate plus a smidgen.... But it is not so simple. This set up of lending to me for 5 years and funding it in the overnight interbank market is not permitted. Not permitted because it makes my bank very vulnerable to a bank run. Banks need stable funding and this comes at a price. For Barclays this price is almost 1% above Base Rate for locking in funding for 5 years. Now, it is pretty certain that Barclays will be able to borrow overnight at Base Rate every day for the next 5 years – so why pay so much more to lock in money for 5 years? It is because regulators require it to protect banks from bank runs. So, “cost of funds” for their lending business is certainly not zero or even Base Rate.

What we should probably do is think about commercial banks in two parts; running current account banking/payment services and lending.

The lending side is where money is created. To meet LCR regulations they must finance their business by borrowing from (selling bonds to) the non-bank sector (borrowing from other banks just passes the problem round) and that costs. (I would say that a retail deposit base of insured deposits is handy, too, but meeting liquidity requirements is tough). Increased capital requirements and tighter liquidity rules make this a much tougher business than it was 15 years ago. ***The license to create money by lending is not “free money”.***

* ***So where is the free money?***

The current account bit is where the “free money” is. Whenever a customer receives £1 into their account it is mirrored by receipt of £1 in the bank's CBRA. The CBRA pays interest at Base Rate; my bank pays me considerably less (zero). Yes, there are costs associated with running a branch network, ATMs and Internet banking systems, and the interest margin earned was the quid pro quo for free current account banking. This was fine when Reserve balances were small (about £30bn prior to 2008) but now they are at £800bn the sums are huge £40bn at 5%, or £8bn for each percentage point Interest Margin earned. Not bad for doing very little. It does not have to be this way. You can't walk off with Reserves, they are “trapped” in the system so paying banks £40bn seems a bit unnecessary. ***This is “free money” for banks and should be tackled.***