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As a matter of fact, the Bank of England can always create money out of thin air. But can commercial banks really do so? The answer is yes, subject to a massive caveat – which is that they can only do so under licence from the Bank of England, which means that the buck for all money creation ultimately stops with the government.

When we turned on the camera to make this video (which,like all of them, was unscripted) I did not realise it would take quite as long as it did to explain just how this all works, but I hope it was worth the effort:

https://www.youtube.com/watch?v=2Y0JOxRg5vE?si=UBGBADDjePbicepH

The audit version is here:

https://www.podbean.com/player-v2/?i=6cadc-16d7685-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=c73a3a&font-color=&logo_link=episode_page&btn-skin=ff6d00

This is the transcript:

Can commercial banks really create money out of thin air?

It's a question I've been asked in the light of recent videos that I've made about modern monetary theory, where I explain that this is a quality possessed of the Bank of England and other central banks that operate in similar ways. But those who know a bit about banking will know that commercial banks are also accredited with the same ability to produce money out of thin air.

Let me explain how that happens. You approach a bank and ask for a loan. The bank appraises your credit-worthiness, probably online, and as a consequence, decides that you are either good for the promise to pay that you are making to them - let's say, £10,000 for a car loan - or you're not good for that loan, in which case, they turn you down.

But let's presume they say, yes, you can have the loan. They don't then go to their vaults to see if there's a pile of gold, or notes and coins there, or any other representation of somebody else's money. Instead, they simply do two things.

Both involve picking up a keyboard. Once they've picked up that keyboard, they tap into it to say that you now have a current account with them. And they will put £10,000 into that current account. Which is very nice for you, because you can now go and buy your car.

The other side of the equation is that they will also put £10,000 into a loan account for you.

This is accounting double entry at work, of course. And I have said before, and I will say again probably many times, that all banks really do is double-entry bookkeeping.

What they have done is create two accounts, which if you then changed your mind and said you didn't want them, could be cancelled, and they would entirely disappear.

How could that happen? Quite simply. Because one is a positive £10,000 as far as you are concerned, that is the money in your current account.

And the other is a negative £10,000 as far as you are concerned, which is the money in the loan account.

Of course, the bank will view things the other way around. It thinks the positive is the loan account because you owe it to them, and the current account is the negative because they owe it to you. But whichever way we look at it, those two accounts add up to zero.

In other words, before they decided to give you the loan, none of that money existed. And if you decided to cancel the loan, none of that money would exist.

If you let the loan carry on and you go and buy the car or whatever else it is that you want, then the loan will be there. But it was created simply by those entries on a keyboard.

In other words, nobody else's money was involved. Absolutely, definitely, certainly, without question, you did not use some depositor's money that had been paid for safekeeping into the bank you borrowed your funds from.

So, did the bank make money out of thin air? Yes, it did. In exactly the same way as the Bank of England can create money out of thin air for the government, so can a commercial bank make money out of thin air for you.

But, and this is the important but, why can a bank do that, and what are the conditions for it doing so, and why can't you do that?

Well, actually, in principle, you can do that, by the way, and throughout the economy, every day, people extend each other credit.

For example, I run a business. I can ask somebody to supply me with services, they extend me credit to do so, and my promise to pay is what they accept until the date of payment. So, to some extent, this goes on everywhere that people extend credit to each other.

And it's important to remember that the vast majority of us do have credit extended to us in some way. For example, my electricity bill is paid on credit. I am allowed to consume electricity in my house and pay for it on credit after I have actually had the benefit. Now, of course, if I was on a payment meter, that would not be the case, but I'm not on a payment meter. I'm allowed credit.

So, the credit relationship that exists between a bank and its customer does, in a sense, get replicated in that way, but those credit relationships are not transferable. It would be very difficult for my electricity supplier to go along and say, individually, “I am owed this money by this chap, Richard Murphy. Can I settle my bill owing to you by transferring the liability owed to me by Richard Murphy to you so that he pays you instead of me?” That isn't the way that they're going to be able to manage their accounting system.

But of course, a bank is different. In practice, the only way in which a bank account works is precisely because the person - let's go back to that person who borrowed the £10,000 - the person who borrowed that money can transfer the cash they now have in their current account to somebody else - the person who is selling them the car - and that person who is selling the car is now owed money by their bank on their current account in the way that previously the borrower would have been.

The whole purpose of a banking operation is to shift debts between us. That's how we make payments to and from each other. One person's debt goes up, whether owed to the bank or from the bank, and the corollary takes place on the other side of the transaction. So, banks exist to transfer debts.

How do they transfer debts? They do it through a bank clearing system, and the bank clearing system, whilst operated by commercial banks, relies upon the existence of the Bank of England. In fact, the Bank of England takes control of the banking system because what it says is that only regulated banks who wish to undertake these transfer operations are allowed to have what is called a central bank reserve account maintained with it.

And the central bank reserve account has become particularly significant since 2008, at the time when Northern Rock tried to go bust, because what was realised then was that the banks no longer trusted each other to make payments to each other for the liabilities that they accepted as a consequence of one person who banks with one bank wishing to make settlement of a payment due to a person who banks with another bank, which have to be transferred between them to make sure that payment can take place. So the central bank reserve accounts of the Bank of England are used for this purpose and they are so large and necessarily large - which is the consequence of quantitative easing -because the banks don't trust each other and they need to have the belief that there are significant balances held by each bank with the central bank reserve account maintained at the Bank of England to ensure that payment can be made.

So, we now have the fact that a bank can only undertake its operations because of the involvement of the Bank of England. And in fact, the reason why the Bank of England is fundamental to what they're doing is even more significant than that. The Bank of England has to regulate a bank for it to be in existence.

That has been true since 1844, in effect, when there was a Banking Act passed. There have been many others since. But the point is, that no bank is a bank unless the Bank of England says it is. And that is critical because what it means is that when the bank provides you with a loan, it does so subject to regulation by the Bank of England.

In other words, it can create money out of thin air because it's a bank, and you can transfer that money from the bank that you have borrowed it from to somebody who banks with another bank because they can have access to the Bank of England central bank reserve accounting system but all of that is only possible because the banks are regulated.

In other words, banks can only create money out of thin air by lending it to you, or me, or anyone else, because they are regulated to do so by the Bank of England. So, they might be commercial operations, but in reality they are licensed to undertake that commercial activity by the Bank of England in a strictly controlled fashion which does require that they maintain reserves to ensure that at any time it is likely that they will be able to repay their depositors if necessary.

Now, of course the difference between depositors’ money and borrowers’ money is complete. They don't overlap. But, it is still necessary for a bank to be able to settle its liability to its creditors if they ask for money. And those creditors include depositors. Therefore, there has to be regulation on the amount of borrowing to make sure that the bank is solvent. If it lends too much over a long period of time, even if it looks as though it has a strong balance sheet, but it has borrowed all its money short term, the sort of situation that Northern Rock found itself in, then although it might look to be solvent, in the short term, it can have a cash flow crisis - exactly what brought that bank down. And, therefore, the Bank of England has to regulate it to prevent that happening.

Now, my point is, therefore, that whereas the ability of the Bank of England to make money out of thin air is unlimited so there is quite literally no constraint on its capacity to make money if it needs to do so, except, of course, the fact that no government would want to induce inflation as a consequence of that action, the action of a commercial bank to produce money out of thin air is, in effect, controlled by the Bank of England who does not want that commercial bank to take too much risk and therefore face the risk of insolvency with all the consequences that we saw in 2008/9 when bank after bank after bank began to tumble inside the UK economy because they did not have the means to pay each other.

This was one of the very good reasons why quantitative easing took place to boost their central bank reserve accounts to give them the solvency that they required to ensure that they could pay each other, and which is why the current programme of quantitative tightening by the Bank of England is so unwise, because it reduces that capacity to ensure that the banking system is robust.

So, what's the answer to the question I posed at the outset? It is that commercial banks can create money out of thin air, but subject to Bank of England control. And whereas before 2008, the impression was that the vast majority of money in our economy was created by the commercial banks with very little being created by the Bank of England. - in fact, little more than the notes and coins in circulation being their responsibility at that time - now, the balance has changed considerably. More than 40 per cent of our money is is created by the Bank of England now, and maybe 60 per cent is created by commercial banks.

So, we have a situation where the two are necessary to provide the liquidity that our banking system as a whole requires, but the balance between them does depend upon the economic circumstances of the moment.

So, for example, in 2020/2021, when we had Covid, the amount of bank-created money went down considerably because people weren't borrowing because they could not spend. On the other hand, the Bank of England had to create more money, because people were short of cash to make the economy go round, and therefore they had to make good the shortfall, otherwise, the repayment of existing bank loans, which of course carried on during the Covid crisis, would have reduced the money supply too greatly, and we would have ended up with a financial crisis for that reason. So this is a delicate balancing act.

We do need commercial banks. We do need them to take the commercial risk of making loans, because I do not think that is the job of the government or the Bank of England.

But we do need to regulate their capacity to create new money, to make sure that they do not take unnecessary risk which puts the economy in peril.

The consequence is, the Bank of England controls the whole process. So, whilst the commercial banks might be able to make money out of thin air, at the end of the day everything depends upon that backstop of the Bank of England ensuring that things work. There is an effective guarantee on the system, which is that the Bank of England will always pay, because these banks are too big to fail, as we saw in 2008 and 2009.

And, therefore, when we are talking about the real capacity to create money out of thin air, what we are dependent upon is the Bank of England. Money is a government creation. They let us use it. It is not ours. It is theirs. We simply have the right to partake in its use to make sure that the economy works.