Funding the Future

What's the biggest secret about money?

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People keep asking me how money is created, and the answer matters because misunderstanding money leads directly to bad economics and bad politics.

In this video, I explain:

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Why money is always a promise to pay

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How commercial banks create money when they lend

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How the Bank of England creates money for government spending

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Why tax does not fund spending, and instead controls inflation and inequality

If we misunderstand money, we accept false limits on spending on

* the NHS,
* social security,
* housing
* education,
* investment, and more.

Once we understand money properly, we can build a politics of care instead of a politics of austerity.

https://www.youtube.com/watch?v=vPKLgUDgnH0?si=Rl301bx-3c0FiQXu

This is the audio version:

https://www.podbean.com/player-v2/?i=97zep-1a57e9b-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

People keep asking me how money is created. So in this video, I want to offer the clearest explanation I can. That's because we need to understand money. Unless we do, we don't understand economics, government spending, or tax justice, and the simple fact is that money is debt. Banks create money, and that includes the Bank of England doing so for the government, as a result of which all the government's money comes from the Bank of England and not from tax and not from borrowing.

So, let's get into this. Most people think money is notes and coins, but notes and coins are only symbols. They aren't actually money themselves because money is not an object. Money is always a promise to pay. That's all it is. And what do those promises to pay represent? They represent debts, but you can never see a promise. You can never then see money because it has no physical existence. All that has physical existence is the record of promises made, and they are represented by bank statements or notes and coins.

To reiterate, money is debt, and in some ways, understanding that is the most important idea in economics.

A bank note is an IOU. That's even printed on it.

A positive bank balance is an IOU from the bank to you; it doesn't represent anything more than that.

And by the way, your bank loan is an IOU from you to the bank. Again, it doesn't represent anything more than that, and you know that's true because you haven't got a pile of cash sitting in your home that you could give back to the bank anymore than the bank has a pile of cash that it can give back to a depositor.

The IOUs are promises to pay in the future, but they don't represent piles of cash, and anyway, cash is just an IOU from the government.

So money is literally nothing more than a network of promises to pay, and that might sound strange, but it explains everything that you need to know about the economy and why most people don't understand the economy itself.

Let's also be clear, electronic money dominates the money scene. Today, more than 95% of money is electronic. So when people say they have "money in the bank", what they actually mean they've got is a claim on the bank. The bank recognises that it owes them money. That is an IOU from the bank to them. There is no pile of cash in the bank with your name on it. There is just that promise, and the only evidence you have of that promise is your bank statement, or a figure on the screen of your phone; that is it.

So, in that case, how is money created? Let's first of all look at the ways in which popular culture describes it, and then make clear why they are wrong.

For example, money is not printed. As I've already said, banknotes are just representations of a promise to pay. It is the promise that creates money, not the bank note.

And people say that money is created by businesses making a profit. They say, "That's making money": it is not.

And money isn't also created by hard work, and money isn't created by saving.

These are just things recorded using money as a measure; they don't create money. Only banks create money; nobody else can, at least if they want to stay out of prison.

Now, there are, for these purposes, two types of bank. There are commercial banks, the ones that we all do our dealings with, and they are familiar and well-known to everyone.

Much less well-known is the peculiar type of bank called a central bank, and in the UK, we have just one of these, of course, it's the Bank of England.

Commercial banks create money when they lend. Let's be clear, this is how most money in the UK is created.

Central banks create money by lending to the government and to the banking system itself. But let's be clear, the central bank is government-owned. The Bank of England has been owned by the government since 1946, 100%. And if you see anybody who says anything, otherwise they're just lying, ignore them.

And the important point about our central bank, the Bank of England, is that it regulates all other banks, who must comply with its rules or lose their license to create money. So, in other words, all money creation in the UK is licensed and regulated by the Bank of England, and therefore all money creation in the UK is ultimately down to government control and is subject to political oversight. Therefore, the government is in charge of money creation. Never doubt it. Never hear anything else. The government is in charge of our money.

So, let's carry on with this theme. How do commercial banks create money? The bank agrees a loan. That's how a commercial bank makes money. You ask for the loan, and in the process, you promise to repay it. The bank decides it trusts you and agrees to grant you the loan. It promises to make a payment out of the money that it will give you to whoever you want. That's the exchange of promises that creates the loan.

As a consequence, it credits your current account. New money appears.

Of course, there is an equal and opposite entry because we do everything with regard to bank lending through the double-entry accounting system, and the equal and opposite entry is in a loan account.

If you borrow £10,000, you get £10,000 in your current account. You have £10,000 in your loan account, at the moment the loan starts, and that is what money creation involves; it is no more mysterious than that. It is literally just two entries in a double-entry ledger. There's nothing more to it. It's just a record of two promises to pay: yours to the bank, and the bank's promise to pay whoever you want them to, that is it.

And the important point then is that you will spend the money that you've borrowed. After all, you don't borrow money to leave it sitting in your current account. Well, you don't if you are wise. You borrow it to spend it, and then the person who gets the money that you spent will have a deposit in their bank account, and this is a critical point to understand. Bank lending creates bank deposits, which we commonly call savings, but the point is, bank lending creates those deposits; deposits are never the basis of lending.

So banks do not lend out other people's money. Other people's money is created by bank lending. And that is critical because if you don't understand that loans create deposits, you've also failed to understand the way in which the banking system really works, and understanding how the banking system really works is fundamental to understanding the economy.

So, what happens when loans are repaid? Again, a critical question, because when loans are repaid, the money that was created by that loan disappears. Let me make it clear. It really does disappear. The promise has been fulfilled. The debt has been cancelled; it therefore vapourises. The money doesn't go somewhere else. It isn't then lent on. It isn't put in a vault. It just is cancelled.

Money is created by lending.

Money is destroyed by loan repayment.

That is probably the most difficult thing in this video that you need to get your head around, and yet it is a simple, straightforward statement of fact. If you understand that everything about a bank loan is about the creation of a debt, when the debt has been repaid, there is no money left.

So how does this work for the government? Well, almost in the same way, but with a slight twist, because the government is not like a commercial bank, and it's most certainly not like a household, but let's just stand back and look at the process.

When the government spends, the central bank, the Bank of England makes payments on its behalf. Now, they might make those payments directly to a commercial bank, which then passes it onto the recipient, but the point is the Bank of England always starts the process.

So long as the government has a legal budget to cover the payment it's making, the Bank of England can't refuse to make that payment for it. That's been the law since 1866. And how does it make the payment? It marks up the government's overdraft. Every day, the Bank of England runs an overdraft for the government, and it simply increases it as the day goes on, as more and more payments go out. And therefore, new money is created in the process of government spending.

And government spending always happens first in this process.

The money moves into the private sector, and then, of course, the government has a problem, because the more money it spends into the private sector, the greater the risk of inflation. So the government has to get some of that money back, or there will be too much money floating in the economy, and nobody wants excessive inflation. So how does it get the money back? In a slightly different way from a commercial bank?

A commercial bank demands repayment of its loan. But the government might have paid this into the economy, saying it's an IOU, but it didn't actually specify that a bank note does, for example, need to be repaid to it, so it has to do something else instead. And what it does is create a tax debt.

The tax debt is deliberately created by the government so that we have to pay the money that the government has created back to it. That is what the purpose of tax is. The tax debt is created to cancel the money that the government created and spent into the economy in the first place by borrowing it from the Bank of England. That is what happens. Spend happens first. Tax happens later. It cancels the money created, and that is its purpose.

And this matters enormously because again, what it shows is that the government is nothing like a household. It can create money, and it can tax, and it can do it without the constraints that anybody else faces. It is a fundamentally different economic organisation from you, me, a company, or anything else.

So what does tax actually do in this system? Well, let's be clear, and I'll say it again. Tax does not fund government spending. Instead, tax controls inflation. It reclaims the money that the government has spent into the economy.

But in the process, it also does something quite important. It creates a demand for that currency because you need it to pay your tax. You cannot settle your tax bill in anything but sterling in the UK or dollars in the USA or whatever else. The point is this: the government creates a demand for its currency by taxing, and then, as a result, that currency is used in its economy, and therefore, by controlling the supply of that currency, it can control the economy. So it is this combination of money creation and tax that gives the government control of the economy, which is what they want to create well-being.

On the way tax does some other things. It redistributes income and wealth. It compensates for market failures by repricing certain commodities like oil, tobacco, and so on, and at the same time, it can also create financial stability by using fiscal policy. But the point is, there is never a shortage of money for the government. It can always find the money to pay for any services it wishes because it has the power to do so.

But now that's an important point to understand before we move on to the next stage, both with regard to the government and commercial lending, and that is that banks do not lend out your savings.

Your deposit in a bank is just a promise owed by the bank to you. That is all it is; it's nothing else. As I keep saying, it's an IOU. And a loan to a new borrower is also a promise between the borrower and the bank. These are entirely separate relationships. There is no relationship between your loan to the bank for which they give you an IOU, and the bank's loan to the borrower for which other IOUs, the loan agreement, are exchanged.

So let's end forever the myth that savings fund bank lending, they don't. The idea that banks take in money and lend it out, which is still taught as if it's a fact, is wrong and horribly so. All that banks do is run a web of promises. That's it.

And how do they manage that web of promises? They do it using double-entry bookkeeping. You owe the bank, and the bank then thinks it's got an asset. If the bank owes you, it thinks it's got a liability. That's all there is to bank accounting. And that is fundamentally important because unless we understand that savings do not fund loans, we also have difficulty in understanding that taxes don't fund spending, but they don't do that either, because we have to accept that the reality is that, in fact, the government spends and then taxes, just as banks lend and create deposits.

Now, let's go back to the government then and explain why this matters politically. If we misunderstand money, we accept false limits. We're told we cannot afford the NHS, social security, green investment, new housing, whatever it might be, but the real limits within our economy are resources and inflation, and not money. After all, money is just a promise, and we can never run out of promises.

We can always make a new one, but we may not be able to fulfil all those promises if the real resources to do so don't exist. In other words, it has to be the real resources that matter. The promise is constrained only by the availability of real resources. That is why creating money when there aren't real resources does result in inflation. That is why inflation and real resources are absolutely inextricably linked to each other through the process of money creation when there is nothing to buy.

This is the reality. This is how we really deal with things, and this is the basis of a politics of care versus a politics of austerity.

A politics of austerity pretends that money is in short supply.

A politics of care knows it isn't, but it does know that it can only promise resources that really exist and that if they don't exist, it has to create them.

It's a fundamentally different starting point for the whole process of economic management.

There are then massive consequences of misunderstanding money. It creates myths if we misunderstand money:

* the myth of austerity,
* the myth of underfunded public services,
* the myth of the necessity of continuing inequality.

And we get fear about deficits and debts and false household analogies, and all of that is because of bad economics, based upon a misunderstanding of money, which in turn leads to bad politics and, more importantly, real suffering.

So these are my conclusions.

All money is debt; there is nothing else to understand about money, that is all it is.

Banks create money, and that's true of commercial banks and our central bank.

But the central bank has a very special role because it lets the government spend, creating a special type of money, the type that we and every commercial bank use, and no one else can do that.

That's why the central bank is so important, and that is why also the government is unlike any other type of organisation in the economy, and so the household analogy is completely wrong.

And then tax controls inflation and inequality so we can afford to build a better society if we choose to.

Politics and money are inextricably linked.

What we need then are some actions.

We must have honest economics education.

We must have proper regulation of banks, and I'm not sure we've got that right now, including of the Bank of England itself, which we pretend is independent of the government when very clearly it can't be because it's integral to the management of the economy itself.

We need investment in people and our planet because money does not stop us doing so.

And tax justice is also essential to control the economy if we are to reclaim the money the government has created, not just fairly, but as completely as the government wants.

We do, then, need a politics of care, but a politics of care based upon our proper understanding of money, and that proper understanding is the first step to changing the world.

That's what I think. What do you think? There's a poll down below.

Poll

[poll id="335"]