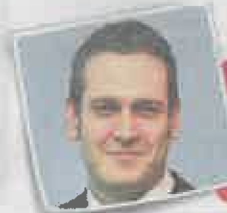

mr money

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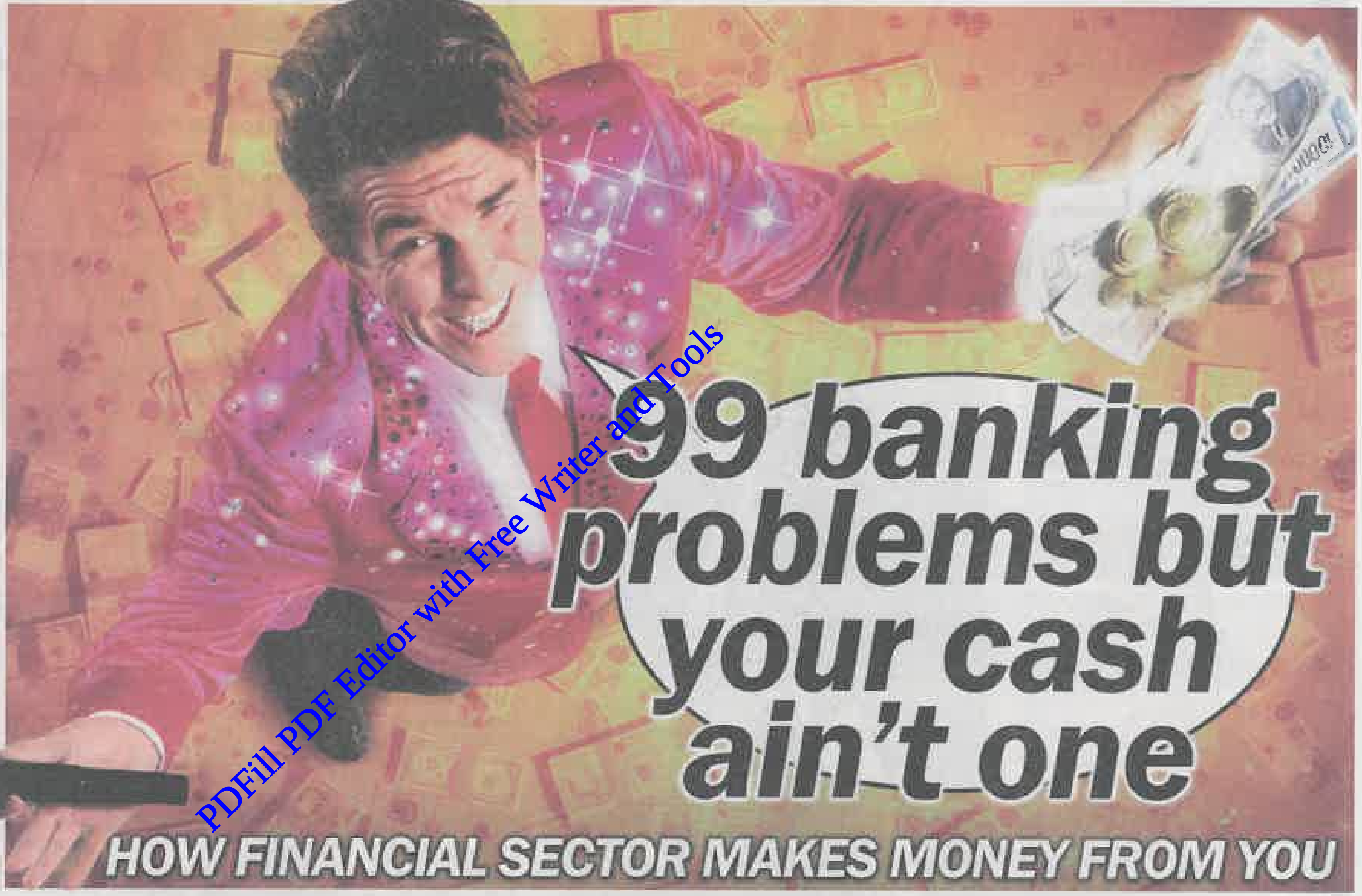

99 banking problems but your cash ain't one

HOW FINANCIAL SECTOR MAKES MONEY FROM YOU

LAST week I set about explaining how our money system is just a big confidence game.

As long as we believe money is 'real' it simply is – that's the joy of collective credence in anything.

And while I don't want to necessarily change the system, I do want to make sure you know how it really works.

This is perhaps the most overlooked facet of finance, it's like discussing how the world works but ignoring the laws of physics.

Foundations

At the most basic level the creation and destruction of money are the foundations of the entire thing.

This week we'll work on joining up further dots – of how money is created out of nothing and comes into the system.

Last week I showed you how loans create deposits and not the other way around.

Now we'll show you how.

Imagine you pay a friend with a cheque for €100 and you both bank at the same place.

What happens is money is credited from your account and debited to theirs.

Your bank statement shows 'credit' when money hits it but this is the bank doing the accounting.

They say 'credit' because it's a liability for them, owed to you, it is in fact a debit to your account.

Anyway, the amount of money in the bank doesn't change in this instance, they simply resolve the accounts within the bank.

That all sound quite easy, right?

Now go up a step, imagine you buy a house and take out a loan to do so.

In this case we'll say it's a 100 per cent mortgage for €100,000 (just to make the counting easy).

You obtain €100,000 from the bank and again, the seller banks with the same place, so they put a €100,000 loan on their balance sheet (loans to the bank are assets, deposits are liabilities) and the person who sold lodges their cheque for €100,000.

The bank now has increased loans by €100,000 and also deposits by €100,000.

They can then lend out that same €100,000 again (putting some aside for reserves) – if you thought 'but the money to finance that came from a deposit' then you are paying attention, but that isn't strictly how it works.

System

I'll have to brush over a lot of nuance, but in short, a bank can re-lend the same money, or they might place the loan collateral with a Central Bank and get the €100,000 back, so what actually occurs is that about €100,000 comes into the system.

Another way of looking at it is that if a person took out a loan that the bank creates a liability (deposit in the borrowers account) and an asset (the loan) for the same amount, so the figures balance up.

As the person then spends that money for whatever they got it for, liabilities actually reduce.

That's money creation – and that, fundamentally, is how money is created.

Money represents a claim on goods and services – it has no backing, it has no anything other than a commonly held belief that it represents value which you can exchange for other goods and services or put into savings.

Money is at its root, a representation of wealth, it isn't strictly 'wealth in and of itself'.

Actual money creation can create growth with deflation in many circumstances – and that's yet another article in the making because it contravenes what we all get taught along the way!

The folks at sensiblemoney.ie disagree with this system and believe in 'full reserve banking' also known as the 'Chicago plan' – something we covered in this column last year, and this is where I personally differ with them.

If banks were only allowed to lend what they have and Central Banks were in charge of the supply, it would undo the current system and we have no predecessor upon which to base the outcomes.

A 'state bank' such as the Bank of North Dakota may have merit, as may other solutions which aim for this objective, but a full about-face at this point in time could be disastrous.

There are no guaranteed outcomes, and should the Central Bank take a certain stance (for or against circulating more money) they would effectively be the drivers of the economy – not something many of us would be willing to countenance.

We also had multiple crises under the full reserve system which is how banking started off.

Economy

For instance, a hawkish ECB could unhinge an economy, or create a slowdown – much to the chagrin of everybody working within the economy.

It would be nice to see a bank make money from banking and not from the various black magic-type tricks that create much of their current profits.

It is insanity to propose or believe that Central Banks know best.

They don't.

They didn't see the crisis coming and acted too late in many instances to do what they are mandated to do.

It is clear that giving them godlike economic power carries big risks.

The status quo is easy to criticise, but it does have one key advantage. It is known to be workable by the very fact that it exists. Full reserve banking, on the other hand, cannot make this claim.

However, in the main, if we were to take a sincere look at full reserve banking it would have better incentives than the current system.

The question is perhaps, 'where do we go from here' and 'how do we get there' without breaking the current working system.