Bryan Gould: Brash doesn't seem to understand banking

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In my original piece, I referred to a Bank of England research paper, which describes in detail the process by which banks create money.

It is no surprise a former Governor of the Reserve Bank should seek to defend the banking system from its critics. But in denying the accuracy of points I made in the *Herald* about how the banks operate, Don Brash accused me of "peddling nonsense".

I made two basic points. First, I asserted the banks do not, as usually believed, simply act as intermediaries, bringing together savers (or depositors) and borrowers to their mutual benefit.

Secondly, I said the vast majority of new money in circulation is created by the banks "by the stroke of a pen", and they then make their profits by charging interest on the money they create.

If this is "nonsense", the "peddlers" include some very distinguished economists. My legal training has taught me the value of being able to turn to reliable authority to support what I say.

In my original piece, I referred to a Bank of England research paper, published in the bank's first Quarterly Bulletin 2014, which describes in detail the process by which banks create money.

First, they say,"One common misconception is that banks act simply as intermediaries, lending out the deposits that savers place with them...[that] ignores the fact that, in reality in the modern economy, commercial banks are the creators of deposit money...Rather than banks lending out deposits that are placed with them, the act of lending creates deposits - the reverse of the sequence typically described in textbooks.

"Bank deposits make up the vast majority - 97 per cent of the amount [of money] currently in circulation. And in the modern economy, those bank deposits are mostly created by commercial banks themselves."

They then go on to say, "Another common misconception is that the central bank determines the quantity of loans and deposits in the economy by controlling the quantity of central bank money - the so-called 'money multiplier' approach...[but that] is not an accurate description of how money is created in reality."

They go on. "Banks first decide how much to lend depending on the profitable lending opportunities available to them - which will, crucially, depend on the interest rate set... It is these lending decisions that determine how many bank deposits are created by the banking system.

"The amount of bank deposits in turn influences how much central bank money banks want to hold in reserve [to meet withdrawals by the public, make payments to other banks, or meet regulatory liquidity requirements], which is then, in normal times, supplied on demand by the [central] Bank."

It is a pity (and a surprise) that Don Brash seems unaware of these findings in one of the most important research papers published in recent years.

If he would care to proceed with his charge of "peddling nonsense", I could introduce him to the authors of the paper, with whom I have corresponded, and he could put that charge directly to them.

He argued (and apparently regards as clinching) that it cannot be the case that banks create money, since otherwise, he says, why would they bother to do anything other than write cheques to themselves?

This simply betrays a failure to understand the process described in the Bank of England paper. As that paper says, "Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created.

"For this reason, some economists have referred to bank deposits as 'fountain pen money', created at the stroke of bankers' pens when they approve loans.

"Commercial banks create money, in other words, by placing loans [or credits] into the bank accounts of borrowers. They then charge interest on, and demand security for and repayment of, those loans.

They have no capacity to create money in any other way or for any other purpose [though the central bank can pursue "quantitative easing" to increase the money supply if it thinks that is needed].

But the capacity they do have is hugely important. I concluded by asking whether it was wise to entrust such wide-ranging powers - so significant in their impact on the whole economy - to the banks, and then to arrange that the only person able to regulate that impact was himself a banker - the Governor of the Reserve Bank.

That concern is surely heightened if a former Governor seems not to understand what is really happening.