The Costs of Money Creation and Complexity

By Jeff Eder

Endorsed by Professor Steve Keen:

Professor Steve Keen, now a Distinguished Research Fellow at University Colllege London, was one of only 12 economists identified as having anticipated the 2008 crisis (https://voxeu.org/article/no-one-saw-coming-or-did-they), and won the Revere Award from the Real World Economics Review for being the economist *"who first and most clearly anticipated and gave public warning of the Global Financial Collapse and whose work is most likely to prevent another GFC in the future"* (https://rwer.wordpress.com/2010/05/13/keen-roubini-and-baker-win-revere-award-for-economics-2/).

Endorsed by Bodrun Nahar:

BSS (Hons) in Economics (Bangladesh), MSS in Economics (Bangladesh), Master of Economics (The University of New England, Australia), Ph.D. in Economics (The University of New England, Australia)

Endorsed by Jonathan Buttle:

BA (Honours) (University of Waterloo), MA – Economics (UVic)

Abstract

Chances are that you are unaware of how the money creation process works or the problems associated with it. It is not your fault, but rather the result of misinformation perpetuated by macroeconomic textbooks and the absence of information on how money creation actually functions. Interest paid on loans, boom and bust cycles in the economy, an unstable banking system, the fact that money only comes into existence if a banker believes he can profit from it, a concentration of wealth, and a system that requires unending growth are a result of our current banking and financial system. The following essay explores these problems in greater detail culminating in a recommendation that there should be a Royal Commission convened to expose the existing weaknesses in our current monetary system and explore the alternatives.

Note:

There will be a follow up to this essay that discusses alternative approaches to the existing system.

In Canada and other western countries, bankers, consultants, traders, and bank shareholders enjoy the advantages of money creation by privately owned commercial banks. The costs to the general public include the interest paid on loans, the boom and bust cycles in the economy, an unstable banking system that may need to be bailed out, the fact that money comes into existence only if a banker believes he or she can profit from it, a concentration of wealth, and a system that requires unending growth (Lietaer et al. 6-7). Money creation is commonly misunderstood by many Canadians including politicians, the media, and economists. John Kenneth Galbraith a Canadian-born American economist famously said, “The process by which banks create money is so simple that the mind is repelled.” (Galbraith 21). Every time a person or a business receives a loan from a commercial bank, the loans officer or other representative simply types that digital money into existence (McLeay et al. 1). That money does not come from anywhere; it is brand new digital money. This initial creation of money is a relatively simple process when compared to the further complex manipulation of money that follows, such as capital adequacy ratios, collateralized debt obligations, credit default swaps, and derivatives to name just a few. Refuse to be intimidated by these terms and ask this question. Why does the terminology seem to purposely cloak understanding, if not to deceive the unwary? “The study of money, above all other fields in economics, is the one in which complexity is used to disguise truth or to evade truth, not to reveal it” (Galbraith 5). In order to understand our banking and financial system better we need to open it up, map it out, and ferret out unnecessary complexity to make our banking system more transparent and accountable to the public. If other options present themselves in this process, we should consider alternative ways of doing business.

The birth of modern banking can be traced back as far as the 16th century in England when goldsmiths would hold gold and other metal coins for citizens. Goldsmiths started to pass out paper notes otherwise known as claim cheques that represented the dollar amount of coins that they held for their clients. Merchants accepted these paper notes as payment for products or services provided. Both merchants and customers were happy because of the convenience of handling paper money instead of bulky heavy coins and it was also beneficial to the goldsmiths, as they charged a small fee to keep the customers' money safe. After a time, the goldsmiths realized a very small number of customers would ever come to retrieve their gold and coins, and never all at once. As a result of this, Goldsmiths started to loan out paper notes in excess of the gold and coins they held in their vaults. Hence, the beginning of the fractional reserve banking system (a bank must keep a certain percentage of hard currency in relation to its liabilities) and some form of this system has persisted worldwide (Jackson and Dyson 37-38). However, in Canada between June of 1992 and June of 1994, fractional reserve requirements were phased out (The Bank Act of 1991, Section 457 (4)). Following the phase-out, the credit or money creation that a commercial bank can create are limited, but not entirely constrained by Capital Adequacy Ratios (CARs) (Eder). Since banking deregulation started in the 1980s, banking and financial instruments have become increasingly more complex.

When banks create money for loans, they do not create the interest that is expected to be paid back on top of the principle. Therefore, a loan must be taken out somewhere else to create additional amounts that can be used in repaying the interest on the original loan. In order to keep this cycle going, the economy must continue to grow and feed this perpetual debt machine. Currently the only way for money to come into existence in the private sector is for a loan to be taken out by a business or a person. However, the interest required in repayment is not created, resulting in perpetual debt, which inevitably results in bankruptcy for those caught at the bottom.

Lower income people also pay a higher percentage of interest relative to their income than do higher income people, which also increases the wealth gap.

In the business cycle, peaks and valleys in performance are exacerbated by private banks because in good economic times they grant more loans, as they see more opportunities for profit and the opposite in bad times. Granting more loans in good times increases spending and debt which expands the economy further, at some point resulting in economic overheating, asset bubbles, and another financial crisis. Then, in times of economic contraction, banks are hesitant to lend money, meaning less money is created precisely at a time when more is needed for economic recovery. This behaviour of banks makes sense from a profit motivated point of view. However, it is contrary to the public interest because the economy does not get what is needed (Doorman 28-29). The federal government must take a closer look at the behaviour of banks.

According to the International Monetary Fund (IMF) there were 145 banking crises, 208 monetary crashes, and 72 sovereign-debt crises between 1970 and 2010 worldwide. This represents a total of 425 systemic crises, an average of more than 10 countries getting into trouble each year! These crises have hit more than three-quarters of the 180 IMF member countries, many of whom have experienced them several times (Lietaer et al. 51-52). In Canada during the 2007 and 2008 financial crisis, some of our banks were at risk of becoming insolvent. While former Prime Minister Stephen Harper and former Minister of Finance Jim Flaherty were bragging about how good the Canadian banking system was compared with the rest of the world's, they were secretly bailing out the banks to the tune of 114 billion dollars between 2008 and 2010. They were very careful to call it "liquidity support" rather than a bail out. There were three institutions involved in the bail out: the Bank of Canada, the Canadian Mortgaging and Housing Corporation, and the U.S. Federal Reserve (Macdonald 5). If not for a report released in

2012 by the Canadian Centre for Policy Alternatives (CCPA) called “Big Banks’ Big Secret” no one would have been the wiser. When the report was released in 2012, there was almost no mainstream media coverage of it or any follow-up.

The Canadian government has allowed privately owned commercial banks the right to create digital money although they do not have any control over where that money flows. From a public interest perspective consumers may want to invest in the real economy which consists of goods and services being produced and traded, for example, in a healthier environment, improved education, quality health care, or the development of renewable energy. However, if such investments are not profitable for banks, no money is created for them. Instead, consumers must rely on federal government programs and when taxation does not cover the costs, the federal government borrows from the same banks that it has given the right to create money (Becklumb and Frignon. 2). Commercial banks are more likely to invest in risky financial assets for several reasons. First, it increases their capital which enables more money creation. Second, financial assets generally have a higher rate of return in a shorter period of time. The third reason is that banks know that if they get in trouble they will be bailed out by the federal government, which creates a moral hazard.

Since the beginning of the early 1990s, banks have created huge amounts of digital money that have ended up predominantly in financial markets. However, this digital money has few ties to the real economy (spending on goods and services). In fact, as reported in 2010 by the Bank for International Settlements (BIS), out of the $4 trillion of daily foreign exchange transactions, only about 2% was associated with the real economy; the other 98% was purely speculative. The sole purpose of a speculative transaction is to buy or sell a foreign currency to make money on the change in value between currencies (Lietaer et al. 45). The complexity of the banking system increased with the financial products famously called "financial weapons of mass-destruction" by American billionaire and "super-investor" Warren Buffett was the basis for the 2008 financial crisis. U.S. senator and critic of the current banking system Elizabeth Warren once said,”Complexity is the handmaiden of deception” (Make Markets be Markets Conference Mar 3, 2010, New York City). Banks prefer to create money for speculation, rather than for the real economy.

As a result of a greater proportion of money going into financial markets which is not tied to the real economy, this also increases the gap between the very rich and the very poor. “Trickle down economics” is arguably the most over-used term by defenders of the status quo, even though there is little evidence to support their assertion that only the rich can create jobs and improve the lives of the masses. Also, banks are not just financial intermediaries as stated in most macroeconomic textbooks. In the circular flow of income, the textbook implies that savings are necessary for investment to the business sector (Sayre and Morris 87), but this is true only when speaking about capital investment or when people pool money in a fund and then invest. Albeit, commercial banks do not lend out savings, they create brand new digital money in the process of making a loan (McLeay et al.1). However, in order to get a loan, a consumer must already have assets and prove they are a good credit risk. Bob Hope famously said, “A bank is a place that will lend you money on the condition you can prove you don’t need it.” The final point to make here is about the political lobbying by the rich, which further insures advantageous laws to protect their wealth and resulting power.

The money supply can, in theory, increase indefinitely, but raw materials, fresh water, land, and natural ecosystems are finite. In Canada, approximately 97.3% of the money in circulation today is digitally created through the issuance of loans; the other 2.7% is hard currency otherwise known as bank notes or paper money (Bank of Canada). The Bank of Canada is responsible for the distribution of all bank notes in Canada and the actual printing is done by the Canadian Bank Note Company Ltd, located in Ottawa, Ontario. Coins are produced by the Royal Canadian Mint which is also located in Ottawa, Ontario. The insanity of never ending growth to service consumers debts to the banks is best addressed by David Suzuki: “If we pollute the air, water and soil that keep us alive and well, and destroy the biodiversity that allows natural systems to function, no amount of money will save us.”

The government and thereby the people of Canada need to understand how the current banking and financial systems work against the majority of consumers while benefiting the very few at the top. As a result of increased complexity, the banking and financial system must become more transparent and accountable to the public. Given the combination of problems in the current system from the original creation of money, to where it flows, the business cycle, perpetual debt, the complexity of banking and financial instruments, and never ending economic growth, new ways of doing business need to be explored. A Royal Commission should be convened to expose the existing weaknesses in the current monetary system and move to a more stable and fair system for the many, not just the few.

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Hard currency (bank notes) as a percentage of money in circulation is approx. 2.7%

(In millions of dollars): Currency outside banks (Seasonally adjusted), 88,115. Divided by M2++ (gross) (Seasonally adjusted), 3,294,129 = approx. 2.7%

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