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Are banks really magic money trees?

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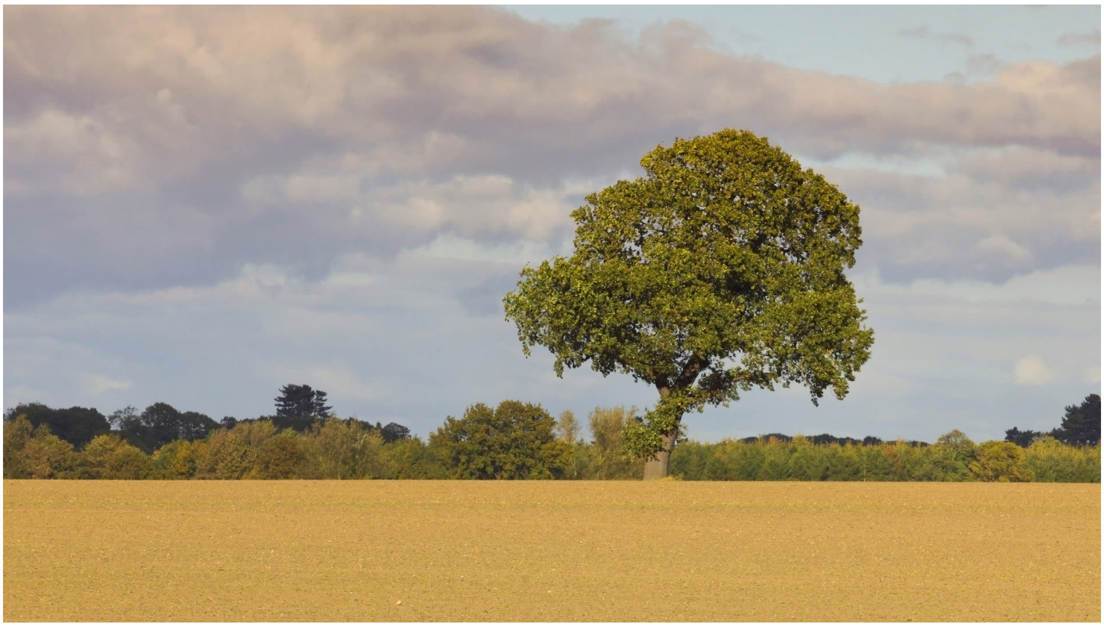

In a wide-ranging attack (https://www.nybooks.com/articles/2019/12/05/against-economics/) on the economics profession published in the New York Review of Books, David Graeber, the anthropologist, paid particularly close attention to the concept of money.

He pointed to Theresa May's claim, during the UK general election in 2017, that "there is no magic money tree," which was part of the debate on austerity and government spending:

> The truly extraordinary thing about May's phrase is that it isn't true. There are plenty of magic money trees in Britain, as there are in any developed economy. They are called "banks." Since modern money is simply credit, banks can and do create money literally out of nothing, simply by making loans. Almost all of the money circulating in Britain at the moment is bank-created in this way.

Graeber, reviewing a new book from Robert Skidelsky, goes on to cite a Positive Money poll (https://positivemoney.org/2017/10/mp-poll/) showing most politicians "don't know" where money comes from. The think-tank, which has generally spearheaded a view of the economy predicated on the above observation about money creation, also drew on this precise reference to the May speech in 2017, here (https://positivemoney.org/2017/06/magic-money-tree/).

We're not saying May is right on government spending. But is the magic money tree meme, which has circulated widely (https://www.theguardian.com/global/shortcuts/2017/oct/29/how-the-actual-magic-money-tree-works), a useful or insightful way to think about banks? The answer is straightforwardly no, irrespective of your politics.

The claims in question are typically traced to a Bank of England paper (https://www.bankofengland.co.uk/quarterly-bulletin/2014/q1/money-creation-in-the-modern-economy) from 2014, entitled "Money Creation in the Modern Economy", to which Graeber devotes several paragraphs. That paper critiqued traditional textbook explanations of money, and showed how commercial banks create money through the act of lending. It invigorated those who saw academic economics as flawed.

The seemingly radical and counterintuitive points contained in the paper, regarding commercial bank money creation, are by no means new (nor are they the thing wrong on the internet here). Economist Joseph Schumpeter, in his 1954 tome the History of Economic Analysis, stated that by 1930, the "large majority" of economists had been converted to the view that bank lending creates deposits, though he does add that it had proved hard for them to come round.

The point is now generally agreed upon, which answers Graeber's question of why there was no "media response" when the BoE paper was published. And while he claims the insight is only held by a “minority” of “mostly heterodox” economists, he does not provide examples of working economists who today believe that banks cannot create money through lending (if they do disagree, it will probably amount to a linguistic disagreement).

So, already, the heterodox characterisation is flawed. But, beyond that, the term “magic money tree” goes beyond the contents of the paper. It implies that banks can create money without any constraints. The Bank of England paper itself shows that such a view would be incorrect – that instead, various factors impinge on a bank’s ability to magic money out of thin air.

Halfway through the paper, the Bank’s economists point out that, for a single bank, its level of reserves constrain lending (h/t to the economist Karl Whelan for pointing this out on Twitter (https://twitter.com/WhelanKarl/status/1196234091022168064?s=20) on Monday). This is not the same thing as a reserve requirement. Instead, it is a question of transfers within the banking system.

If a bank creates money through lending, and the borrower spends it straight away (which is typically the case with mortgages) then the deposit will probably need to be transferred to a person at another bank. For that second bank to accept a new liability (the created deposit), it will demand some asset from the first bank (reserves). From the paper:

> … the buyer’s bank settles with the seller’s bank by transferring reserves. But that would leave the buyer’s bank with fewer reserves and more loans relative to its deposits than before. This is likely to be problematic for the bank since it would increase the risk that it would not be able to meet all of its likely outflows. And, in practice, banks make many such loans every day. So if a given bank financed all of its new loans in this way, it would soon run out of reserves.

So individual banks do create money, but their reserves constrain their capacity to do so. New deposit inflows, however, bring with them more reserves. Hence, banks spend a huge amount of time and energy attracting deposits by building branches, or by marketing themselves. If they were magic money trees, why bother? Banks do need to attract customers, even if it is not simply to transfer their funds directly to someone else.

To be as fair as possible to the Magic Money Tree school of thought, the BoE paper thereafter points out that, despite this constraint on individual banks, the banking system as a whole can still create money in a manner effectively unconstrained by reserves if they all increase lending together. Is there perhaps a magic money forest, if not one single tree?

The answer is still no. Many other factors constrain bank money creation, and they are also mentioned in the same Bank of England paper. One of these is monetary policy (what the BoE calls the "ultimate constraint"), which can change the incentives of commercial banks to make loans. Another is demand from households. Another is credit risk. Another, we'd add, are capital requirements, rules enforced by the government that moor the total volume of risk-weighted assets (that would result from unhinged lending) to the size of the bank's capital (mostly meaning its equity).

It is true that banks can create deposits, which work as money, through the act of lending. But the magic money tree meme not only delinks the relationship between borrowers and depositors. It also creates a false impression, that downplays the many constraints on the way banks wield this power.

The fact that banks do, undoubtedly, wield power brings us to one final point. The magic money tree meme is one which invariably advocates a particular political position (which this post is neither arguing for nor against). It is orientated around a post-crisis antipathy towards banks, and a call for greater government intervention.

The way banks distribute credit, and the questions of to whom and for what, should be scrutinised relentlessly. But that point can be engaged with through the language of lending, rather than money creation.

Despite claiming to break through a wall of outdated economic orthodoxy, the magic money tree theory of banking is just as misleading as any doctrine it seeks to dispel.

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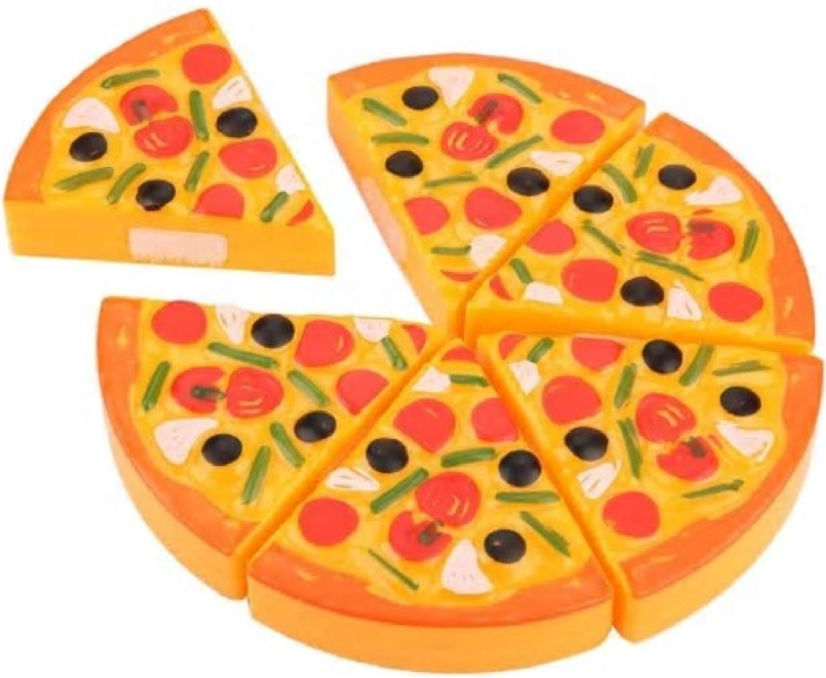

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