Understanding Modern Banking: A Clear Perspective

Following the success of the first six articles in our series on the topic of money, this time we look at how, despite common misconceptions, central banks are not the primary creators of money in the economy.

In today's world, where banking is a pivotal part of our daily lives, the economy, and financial system globally, it's crucial to have an accurate understanding of how it operates. In reality, the creation of most money is in the hands of commercial banks, which generate funds not solely from deposits but also through loan creation, which actually creates new money.

The reality of modern money creation

A significant admission regarding the UK's modern banking came from the Bank of England's 2014 paper, "Money Creation in the Modern Economy". This paper clarifies that banks are more than mere intermediaries between depositors and borrowers. Instead, they actively create money through the process of issuing new loans. This means that the majority of money in circulation, in the form of bank deposits, is created as new loans are sanctioned. This concept is often misunderstood but is key to grasping the dynamics of the modern financial system.

But how did this all come to pass?

The journey to today's banking system began in medieval Italy with the advent of fractional reserve banking. Merchants and savers would store their gold and silver with goldsmiths, receiving a receipt in return. These receipts gradually became a form of paper money. Goldsmiths, noticing that not all deposits were claimed at once, began to lend out more than they had on deposit, in order to earn more interest. This marked the transition from mere storage services to the birth of interest-bearing bank loan activities. Thus fractional-reserve banking was born.

Setting reserve requirements

Modern central banks have typically set reserve requirements, dictating how much of a bank's deposits must be retained and how much can be loaned out. For instance, a 10% reserve requirement means a bank can lend $90 out of a $100 deposit, which can multiply through the banking system up to $1,000. Such mechanisms have allowed banks to play a significant role in money creation. The New York Federal Reserve explains on its website:

- If the reserve requirement is 10%, for example, a bank that receives a $100 deposit may lend out $90 of that deposit. If the borrower then writes a check to someone who deposits the $90, the bank receiving that deposit can lend out $81. As the process continues, the banking system can expand the initial deposit of $100 into a maximum of $1,000 of money ($100+$90+81+$72.90+…=$1,000).

Reserve requirements today

However, it's important to note that this traditional model of fractional reserve banking has evolved. In some economies, like the UK and the US, reserve requirements have been abolished and are now zero. This shift means that banks' ability to lend is less constrained by reserve requirements, though still influenced by other factors like interest rates.

This greater freedom to create new money through lending comes with increased responsibility and risk. Without the stringent requirement to hold a certain percentage of deposits in reserve, banks must rely more heavily on their risk management strategies. They need to ensure that their lending practices are sustainable and that they are not overextending credit, which could lead to defaults.

Regulators also play a crucial role in this new landscape. They must ensure that banks maintain adequate capita buffers and follow prudent lending practices to safeguard the financial system's stability. This includes close monitoring of banks' liquidity positions and the quality of their loan portfolios.

In this new paradigm, interest rates, as set by central banks, assume an even more significant role in controlling credit expansion. Lower interest rates can encourage banks to lend more, as borrowing costs are reduced, spurring economic activity. Conversely, higher rates can help cool down an overheated economy and control inflation by making borrowing more expensive, thus slowing down the pace of credit expansion.

The transition to a system with fewer reserve constraints also raises the potential for creating asset bubbles and amplifying economic cycles. In periods of economic optimism, easy credit can lead to overinvestment and speculative bubbles, which, when they burst, can cause economic downturns. Unfettered credit/money creation also erodes the value of money already in circulation i.e. causes inflation.

Banks with a low fractional reserve ratio are also vulnerable to bank runs. This is because there is always a risk that withdrawals will exceed their available reserves; as recently happened in the US. Between March and May of last year; Silicon Valley Bank, Signature Bank and First Republic Bank all failed. These were the second, third and fourth largest banks to fail in US history. At about the same time Credit Suisse failed. And more recently here in the UK, Metro Bank has had to be recapitalised.

Conclusion

The current banking system is characterised by the ability to lend being far less constrained. While some argue that this fosters an environment conducive to economic growth and expansion, it also necessitates careful navigation to avoid the pitfalls of inflation, asset bubbles and unstable economic cycles. Understanding these dynamics is crucial for stakeholders in the financial system to make informed decisions.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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