CHAPTER 15

How banks create money

In Chapter 14 we saw that the Reserve Bank is the source of the economy's paper money. However, we shall find in the present chapter that trading banks are the fountainhead of the major component of the money system – current deposits.

More specifically, in this chapter we want to explain and compare the money-creating abilities of (1) a *single* trading bank which is part of a multibank system, and (2) the trading bank *system* as a whole.

It will be convenient for us to seek these objectives through the trading bank's balance sheet. An understanding of the basic items which make up a bank's balance sheet, and of the manner in which various transactions change these items, will provide us with a valuable analytical tool for grasping the workings of our monetary and banking systems.

The balance sheet of a trading bank

What is a *balance sheet*? It is merely a statement of assets and claims which portrays or summarises the financial position of a firm – in this case a trading bank – at some specific point in time. Every balance sheet has one overriding virtue: By definition, it must balance. Why? Because each and every known *asset*, being something of economic value, will be claimed by someone. Can you think of an asset – something of monetary value – which no one claims? A balance sheet balances because assets equal claims. The claims shown on a balance sheet are divided into two groups: the claims of the owners of a firm against the firm's assets, called *net worth*, and the claims of non-owners, called *liabilities*. Thus, it can be said that a balance sheet balances because

Assets = liabilities + net worth

A balance-sheet approach to our study of the money-creating ability of trading banks is invaluable in two specific respects: On the one hand, a bank's balance sheet provides us with a convenient point of reference from which we can introduce new terms and concepts in a more or less orderly manner. On the other hand the use of balance sheets will allow us to quantify certain strategic concepts and relationships which would defy comprehension if discussed in verbal terms alone.

A single trading bank in a banking system

Our immediate goal is an understanding of the money-creating potential of a single bank which is part of a multibank banking system. What accounts constitute a trading bank's balance sheet? How does a single trading bank create and destroy money? What factors govern the money-creating abilities of such a bank?

Formation of a trading bank

The answers to these questions demand that we understand the ins and outs of a trading bank's balance sheet and how certain, rather elementary transactions affect that balance sheet. We start with the organisation of a local trading bank.

Transaction 1: The birth of a bank

Let us start from scratch. Suppose some far-sighted citizens of the town of Wahoo decide that their town is in need of a new trading bank to provide all the banking services needed by that growing community. Assuming these enterprising individuals are able to obtain