How money is made

By Karl-Theodor zu Guttenberg and Richard Werner
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Last month, the BRICS countries (Brazil, Russia, India, China, and South Africa) announced the establishment of their own development bank, which would reduce their dependence on the Western-dominated, dollar-focused World Bank and International Monetary Fund. These economies will benefit from increased monetary-policy agency and flexibility. But they should not discount the valuable lessons offered by advanced-country central banks' recent monetary-policy innovation.

In June, the European Central Bank, following the example set by the Bank of England in 2012, identified "bank credit for the real economy" as a new policy goal. A couple of weeks later, the Bank of England announced the introduction of a form of credit guidance to limit the amount of credit being used for property-asset transactions.

Before the financial crisis hit in 2008, all of these policies would have been disparaged as unwarranted interventions in financial markets. Indeed, in 2005, when one of us (Werner) recommended such policies to prevent "recurring banking crises," he faced vehement criticism.

This March, however, the Bank of England acknowledged the observation that he and others had made – that, by extending credit, banks actually create 97% of the money supply. Given that a dollar in new bank loans increases the money supply by a dollar, banks are not financial intermediaries; they are money creators.

The growing recognition of banks' true function will be a game-changer in areas like monetary policy and financial regulation, enabling officials to tackle effectively problems like recurring banking crises, unemployment, and underdevelopment. But it will take time to be fully accepted – not least because it challenges a fundamental tenet of traditional economics. Indeed, according to this new paradigm, savings, while useful, are not an essential prerequisite to investment and thus to economic growth. The United States, which experienced a prolonged period of growth without savings, is a case in point.

In general, economic growth depends on an increasing number of transactions and an increasing amount of money to finance them. Banks provide that finance by extending more credit, the impact of which depends on who receives it. Bank credit for GDP transactions affects nominal GDP, while bank credit for investment in the production of goods and services delivers non-inflationary growth.

The problem lies in bank credit-for-asset transactions, which often generate boom-bust cycles. By extending too much of this type of credit, banks pump up asset prices to unsustainable levels. When credit inevitably slows, prices collapse. As the late-coming speculators go bankrupt, the share of non-performing loans on banks' balance sheets rises, forcing banks to reduce credit further. It takes only a 10% decline in banks' asset values to bankrupt the banking system.

With an understanding of this process, policymakers can take steps to avert future banking crises and resolve post-crisis recessions more effectively. For starters, they should restrict bank credit for transactions that do not contribute to GDP.

Moreover, in the event of a crisis, central banks should purchase non-performing assets from banks at face value, completely restoring banks' balance sheets, in exchange for an obligation to submit to credit monitoring. Given that no new money would be injected into the

rest of the economy, this process – which the US Federal Reserve undertook in 2008 – would not generate inflation.

In order to stimulate productive bank credit – and boost the effectiveness of fiscal policy – governments should stop issuing bonds, and instead borrow from banks through loan contracts, often available at lower rates than bond yields. This would bolster bank credit and stimulate demand, employment, GDP, and tax revenues.

Finally, a network of small not-for-profit local banks should be established to provide universal banking services, and loans to small and medium-size firms, like the scheme that has underpinned Germany's economic strength and resilience over the last 200 years. Beyond making the banking sector more robust, such an initiative would boost job creation per dollar in bank credit.

Of course, large multinational banks, which have long benefited from the perception that economies need savings, are likely to resist such reforms. For decades, these banks have been selling "foreign savings" to developing countries by lending at high interest rates and in a foreign currency, fueling the accumulation of massive amounts of foreign debt, which would often be converted into equity. In other words, they issued credit that contributed little to the local economy, and then drained local resources through interest and exploding foreign currency-denominated debt.

Just as the BRICS have rejected Western-led economic institutions, developing economies would do well to expel foreign banks and allow local financial institutions to create money for productive purposes. After all, successful economic development – in countries like the US, Germany, Japan, and China – has depended on domestic credit creation for productive investment.

During the Great Depression of the 1930s, Michael Unterguggenberger, the mayor of the Tyrolean town of Wörgl, performed an experiment. In order to reduce unemployment and complete much-needed public-works projects, he hired workers and paid them with "work receipts" that could be used to pay local taxes. With the local authority effectively issuing money for work performed, the local economy boomed.

The central bank, however, was not pleased, and decided to assert its monopoly over currency issuance, forcing Unterguggenberger to scrap the local public money and causing Wörgl to fall back into depression. Some 80 years later, the English city of Hull has begun to implement a similar scheme, using a digital crypto-currency that is, so far, not prohibited by law.

The unfettered creation of money by large private banks has generated overwhelming instability, undermining the fundamental principle that money creation should serve the public good. This does not have to be the case. By implementing safeguards that ensure that credit serves productive and public purposes, policymakers can achieve debt-free, stable, and sustainable economic growth.

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