16

Money and Banking

What is money, and what is it good for?

In this book, we've tried to discuss economics in very concrete, real terms. Production is how we make useful goods and services. Work is the human effort that goes into that production. Consumption is the use of some of those goods and services to keep us alive, and make life enjoyable. Investment is the use of some of that output as "tools," allowing us to produce even more output in the future. All of these things are *real*: they all consist of actual goods and services. None of them need be measured in terms of money. They are all real stuff.

But just look around at the actual economy: there are dollar signs *everywhere*. Prices in stores. Amounts in bank accounts. Values on stock markets. GDP in statistical reports. All measured in terms of money.

A visitor from Mars would quickly conclude that the economy is *totally* about money. Yet underneath, the economy must be more real and tangible. Underneath, the economy needs to produce concrete goods and services, to meet concrete needs.

Explaining money, and linking the real activities at the core of the economy with the money that represents them (prices, revenue flows, wealth) has bedevilled economists for centuries. What is money, anyway? How are money prices determined? Why do they change over time? How does money affect real economic activity?

Very broadly, money is anything that allows its holder to purchase other goods and services. In other words, money is purchasing power. Early forms of money were tangible objects with an inherent value (usually official coins minted by government from precious metal). Today, money is very different: it is usually intangible, and its value depends on social convention and government pronouncement. What's more, in a modern economy money is constantly changing – mostly because of the creativity of financial companies (like banks) who seek more profitable ways to facilitate financial transactions, and accumulate and store financial wealth. Indeed, in modern capitalism those private companies control the *creation* of money.

Stanford 02 chap08 189 4/4/08 13:32:10

Modern money comes in many shapes and sizes:

- **Currency** Currency is no longer minted from precious metal. Instead, currency consists of paper money and non-precious coins officially issued and sanctioned by the government. Most people think of "money" as "currency." But in fact currency accounts for a very small share (around 5 percent) of total money in an advanced modern economy.
- **Deposits** Most people don't keep a lot of cash on hand. They deposit extra cash in the bank, so they don't lose it and can earn interest. But money in the bank is still money. And with modern electronic banking, deposits can quickly change hands, without ever touching hands. These deposits come in many different forms: standard savings and chequing deposits, term deposits, foreign currency deposits, and even money market investments (like short-term government bonds).
- **Credit** Today customers can make many purchases without paying anything at all – simply by promising to pay in the future. Think of the furniture store offering a great bargain on a new sofa: "Don't pay anything until next year!" Strictly speaking, credit is not money, but it does allow spending to occur, and it is the most important way that money is *created* in modern capitalism. Credit gives a person or company purchasing power, even when they don't yet own the funds to pay for their purchases. No longer does an individual have to save all the money required before making a major purchase (like a sofa, a home, or a car). Even more importantly, no longer does a business have to save all the money required (from their profits) before making a major new investment. Instead, a bank or other financial institution provides borrowed purchasing power: through a loan, a line of credit, a deposit into a chequing account, or the issuance of a credit card. In return, the borrower promises to pay the loan back later – with interest. Credit accounts for most new money in a modern capitalist economy. When a new loan is issued, new money is created. When a loan is paid back (without a corresponding new loan being taken out), then money is destroyed. The emergence of this credit system fundamentally changed the way capitalism works.

Money has many economic uses:

- Money is a **means of payment**. It allows people to buy products or services. It also allows them to make other kinds of payments (like taxes or loan repayments).
- Money is a **unit of account**. It provides a common way for companies, households, and governments to measure income and wealth, evaluate different products or assets, and determine whether a firm is profitable.
- Money is a **store of value**. Money allows individuals or companies to store some of their wealth in a flexible, convenient form. Few people get intrinsic value from money, purely for its own sake. True, it must be thrilling for rich people to see all those zeros in their bank statements. But in general, money is useful only for what it can buy. However, when they can't find anything better to do with it, or when they fear losses on other types of assets, individuals or firms will simply set aside some of their wealth as money (in cash, bank accounts, or term deposits). Holding onto money in this way is called HOARDING, and it can

Stanford 02 chap08 191 4/4/08 13:32:10

cause major problems for the overall economy. Money's use as a store of value is the most complicated, unpredictable, and potentially troublesome aspect of its multifaceted personality.

- Thanks to its usefulness as both a means of payment and a store of value, money is an excellent way to **facilitate exchange** between different buyers and sellers. Without money, all trade would have to occur on a BARTER basis – where one product or service is traded directly for another. This is tremendously inefficient: no deal can be made until a seller finds a buyer who has something to offer that the seller also wants. Imagine trying to sell a used car this way. You'd have to find someone who wanted to buy your used car, but also wanted to part with something you wanted – like a month's rent on a vacation cottage, a large-screen television set, or whatever else you were interested in purchasing with the money from your car. It would be very hard to consummate such a deal. Money is thus essential for effective exchange.

Because of its obvious economic benefits, money has been used for thousands of years, in various forms. But the specific *form* that money takes is less important than the fact it must be accepted as a valid form of payment by most participants in an economy. Money is thus a *social* institution. Its usefulness relies on the political and legal authority of the official body (usually some branch of national government) that endorses it. It also requires the trust, even the faith, of the people who use it. Anyone who accepts money payment for something must be confident that they'll be able to spend that money when they want to buy something else.

Economies in which money is not widely accepted (due to war, political instability, extremely rapid inflation, or other catastrophes) generally suffer severe economic disruption. Usually, people in those economies try to find something other than the official currency (like the US dollar, gold, or even commonly-used commodities like cigarettes) to serve as a replacement form of money.

Capitalism and money

While money has a very long history, under capitalism money takes on a new and particular importance, for three broad reasons:

1. For the first time in economic history, accumulating more money becomes the *goal* of production. Companies initiate production in order to make a profit, and that profit is always measured in money.
2. In the act of initiating new production, companies actually *create* money. The financial system provides credit to companies to allow them to pay for capital investments, and for their initial purchases of labour and other inputs. Business credit is the main source of new money in capitalism, and that money is essential for economic growth and job creation.
3. Private profit-seeking financial companies (like banks) control the creation and destruction of money through their lending (that is, credit-creating) activities.

For all these reasons, capitalism is an *inherently* monetary economy. It is impossible to imagine a capitalist economy in which money does not play a central role. And thus, to understand how capitalism works, understanding money is a central priority. Money clearly matters.

Controlling and creating money

In modern capitalism, credit is the main source of new money. Who issues credit? Banks and other private financial institutions – and hence they have replaced government as the most important players in the monetary system.

Of course, government still plays a crucial role. Government endorsement is essential to the widespread acceptance of money. Governments closely control the printing and distribution of hard currency (supplied to the economy through the banking system) to prevent counterfeiting and other crimes. And government regulators oversee the money-creating activities of private banks, injecting extra funds into the banking system when needed, and trying to prevent bank collapses and other financial crises.

But the day-to-day creation and destruction of money is now the domain of the private banks and other financial institutions which control credit. And their actions, in turn, are driven by the same motivating force that propels capitalism as a whole: the pursuit of private profit.

Sleight of Hand

"The modern banking system manufactures money out of nothing. The process is perhaps the most astounding piece of sleight of hand that was ever invented."

Sir Josiah Stamp, President of the Bank of England (1927).

"The process by which banks create money is so simple that the mind is repelled."

John Kenneth Galbraith, Canadian-American economist (1975).

Modern banks are the product of a centuries-long process of corporate evolution. Early customers deposited currency in the bank for safe keeping, and withdrew it when needed to make a purchase – paying a fee for the service. Bankers realized that most of their clients' money was sitting idly in their vaults, most of the time. Why not lend it out to borrowers, generating interest for the bank? This would allow the banks to make profit on their lending, so long as the bank's depositors were happy to leave most of their money with the bank. If a lot of them came to withdraw their money at the same time, then the bank would be in trouble. (From time to time this actually happens, usually when customers lose faith in a bank's stability; the result is a "run" on the bank, as panicked customers withdraw funds, and the bank soon collapses.)

Banks compete with each other to entice depositing customers. Banks are equally aggressive in recruiting new borrowers, since only by lending can they earn a profit. The opportunity to earn profit on new loans, however, must always be balanced against the credit-worthiness of the borrowers (banks need to be confident their loans will be repaid). Banks earn their profit in two main ways: by charging higher interest rates on loans than they pay out on deposits, and by imposing service charges and fees for bank transactions.

The banks' balancing act between "greed" (for profits on loans) and "fear" (that loans won't be paid back) tends to evolve in cycles, and these cycles can affect the whole economy. When economic times are good, fewer borrowers go bankrupt, and banks become less sensitive to the risks of loan default; they thus push new loans

more aggressively, stimulating new purchasing power and faster economic growth. The reverse occurs when times turn bad: banks become hyper-sensitive to the risks of loan defaults, they pull back their lending, and this causes a CREDIT SQUEEZE which reduces overall purchasing power and growth even further. Ironically, banks' *fear* of defaults can actually *cause* defaults – since their lending restrictions produce an economic downturn and hence bankruptcies (among both businesses and households). This cyclical, profit-driven process is called the BANKING CYCLE, and it is a major cause of the boom-and-bust cycle visible under capitalism. As this book went to press (spring 2008) the US economy was entering a credit squeeze recession.

Of course, it takes two to tango, and every loan needs two willing participants: a borrower who wants to borrow, and a bank which is willing to lend. Banks can be quite aggressive in "pushing" loans into the economy – by reducing interest rates, or offering loans to increasingly risky customers. But they can't *force* anyone to borrow. For credit to expand, borrowers (both businesses and households) must *want* to borrow. The desire to take on new credit will depend on the level of interest rates, and on borrowers' degree of confidence about their future. If businesses and consumers are very pessimistic about future economic prospects, then even very low interest rates might not be effective in stimulating new credit and hence new spending (see box below).

Ultimately, then, the expansion of credit money (and hence the expansion of purchasing power) depends on the willingness of companies and consumers to borrow, overseen by the profit-maximizing judgements of private banks and other financial institutions.

No-Interest Loans!

In the 1990s, Japan's economy experienced a long, painful recession, following the meltdown of an overblown real estate "bubble." In response to the recession, Japan's central bank cut interest rates to zero: borrowing money became *free*. Despite this, credit (and hence spending) grew very slowly for several years, because Japanese businesses and consumers remained very pessimistic about the economy's future prospects.

The fragility of finance

Private bank lending is a lucrative business: private banks, quite literally, have a license to create money. But it is an inherently fragile business, too – always hanging on the hope that depositors will remain confident in the stability of their bank, and never collectively demand their money back at the same time. If that happens, a bank never has enough currency on hand to make those payouts, and the bank collapses.

In response to periodic bank failures (and the immense economic and social damage they caused), government regulators gradually instituted rules limiting how aggressively private banks can expand their lending. Initially, they utilized a FRACTIONAL RESERVE system: banks had to keep a certain fraction (usually less than 10 percent) of their total loans on hand at all times as hard currency, to guard against a rush of withdrawals. Governments also used other tools (including requiring banks to keep certain amounts of their own money on deposit with the government's CENTRAL BANK) to further stabilize the banking system, and also to try to smooth out the ups and downs of the private banking cycle.

Today, those rules have been relaxed considerably, and the private financial industry functions in a largely unregulated environment. Banks must meet very broad CAPITAL ADEQUACY requirements, maintaining enough internal resources (including the bank's own invested capital) to handle (with some safety margin) any foreseeable surge in withdrawals. But finance is still inherently fragile. Throughout its history, capitalism has experienced periodic episodes of collapse and crisis in private banking, and there's no reason to expect that this has changed. In Chapter 18, we will discuss the more sophisticated, and even more fragile, ways which private financiers have developed to extract extra profit from the buying and selling of paper assets.

Putting money on the map

Let's review the key features of the capitalist credit money system:

- The financial industry itself is not directly productive. You can paper your walls with currency, stocks, and bonds, line your birdcage, or even use them (in a pinch) as toilet paper. But the real value of money is not the paper it is printed on; it comes

from the things it can buy. Likewise, the financial industry is a "paper economy." It does not produce goods or services that are inherently useful. It produces money. In doing so, finance provides a service which allows (when it works well) genuinely productive companies and households to work, consume, and invest. Finance is economically valuable only to the extent that it stimulates and facilitates this real production and growth. And private finance doesn't always do that job well.

- The money-creating and money-destroying actions of banks are guided by their private profits, not by the needs of the broader economy. When credit expands rapidly, spending expands rapidly, and – to a point – the economy grows rapidly. When credit does not grow, or even contracts (as when banks "call in" existing loans), the economy stagnates or shrinks. Banks oversee how and when this happens, in line with their efforts to maximize their own profits. There are times when these private interests of banks, and the interests of society as a whole, diverge dramatically. For example, during an economic downturn fearful banks reduce lending, just when the economy needs *more* purchasing power, not less.
- The emergence of credit has broken the link between savings and investment. In pre-credit societies, producers had to physically save surplus production before it could be re-invested in new, more ambitious projects. Today, however, companies just take out loans to pay for new investment – and then repay those loans with a portion of the profits from future production. All the company needs is a credible business plan and a willing banker. In a credit system, investment *leads* economic growth; savings, meanwhile, are *produced* by economic growth.

Essentially, then, finance plays a subsidiary, helping role to the real economy, by providing credit for productive, growing, non-financial companies.

Figure 16.1 incorporates this subsidiary role into our map of the economy. Finance sits "above" the real economy. It provides credit (new money) to capitalists, allowing them to invest sooner and faster than if they had to pre-save all their investments. This flow is labelled D (for debt) on the map. In return, the banks receive a share of profits in the form of interest and loan repayments (the original debt D, plus i

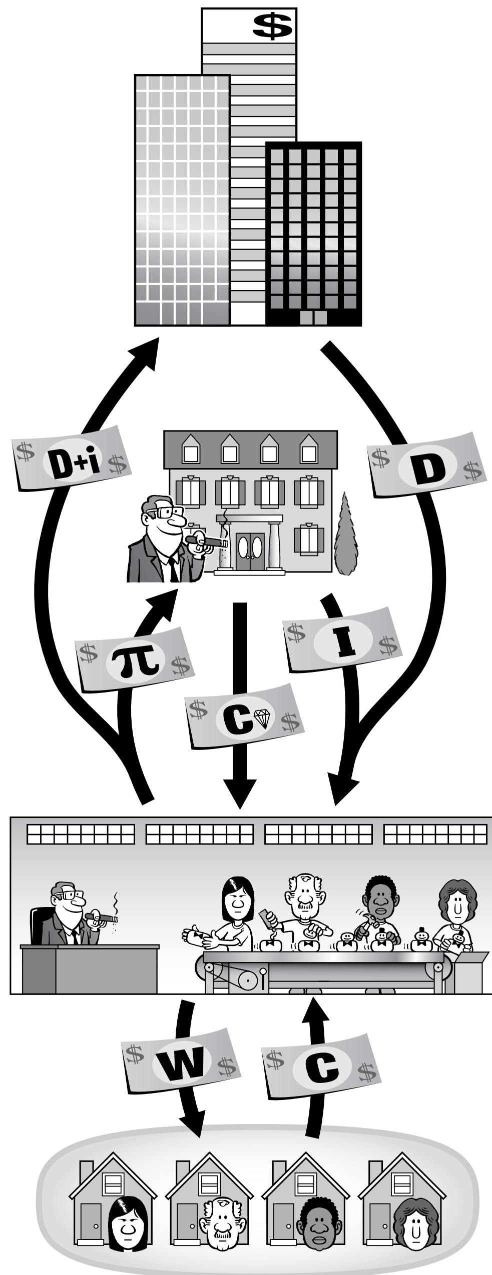

Figure 16.1 **Economic Road Map: Banks**

for interest) from the companies they financed. The remaining residual profit is retained by the actual owners of the company.

This sets up a potential conflict of interest between the financial sector and real, productive companies over how the profit pie is divided. If the banks' share becomes too large, then the incentive for companies to undertake real investment is reduced. On the other hand, both financiers and "real" capitalists have a shared interest in increasing the *total* return to capital. This explains why they have both strongly supported the overall direction of neoliberal economic policy. Indeed, it was a coming together of financial interests (appalled at the losses experienced in the 1970s) and real businesses (fatigued at the difficulty of extracting work effort from an increasingly uppity workforce) that was the crucial precondition for the political triumph of neoliberalism at the end of the 1970s.

In real-world practice, the financial industry also provides credit to households to facilitate major purchases, and recycles personal savings from those lucky households which do not spend all their income. But since households as a whole do not significantly save, this role is less important to overall economic growth than business lending; hence we have not portrayed it on this map.

Bankers, like capitalists, live very comfortable lives, and a portion of their interest income (which was siphoned off from capitalists' profit income) is devoted to the same luxury consumption patterns as the capitalists they lend to. For simplicity, then, Figure 16.1 includes bankers' consumption spending within overall capitalist spending.