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Economics Briefing 9a

Finance and money

This briefing provides an introduction to the financial system and its interactions with the economy. It is divided into two parts: The first part (9a) provides an overview of finance, money, credit and debt. The second part (9b) critiques the existing institutional arrangements and suggests alternatives.

It should be borne in mind that the systems described here are products of a complex institutional history - a fact which suits the beneficiaries of the status quo (e.g. private banks) very well, because it keeps the general public and civil society in a state of passive ignorance. For this reason we encourage perseverance with this extended briefing as it is critical in understanding finance, banks, debt, growth and urgently needed alternatives…

Part one

Modern finance: its functions and forms

The main function of the financial system is to facilitate the creation and allocation of economic resources – money, credit or other exchange instruments – across space and time in a manner that maximises human welfare. Aside from this, finance provides four other functions:[1]

1. A payments system for the secure exchange of goods and services.
2. A means of managing uncertainty and controlling risk.
3. A signpost providing price information, thereby helping coordinate decision-making in various sectors of the economy.
4. A solution to the problems of asymmetric-information – when one party to a financial transaction has knowledge that the other party does not.

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Modern financial systems are made up of mainly private institutions that carry out the above functions. Insurance companies, for instance, help control uncertainty by pooling risk, whilst stock-exchanges help ease information asymmetries by making the changing prices of goods and services rapidly available to market participants. Banks are unique: not only do they create and allocate credit and money, but they provide the payment system that enables us to exchange with each other every day.

Finance can be obtained in three main ways:

1. Debt-based financing via 'credit creation': Consumers and companies can obtain finance through 'borrowing' money from banks, building societies or credit unions – collectively known as 'deposit-taking institutions'.

   Actually, the term 'borrowing' or 'lending' is an inaccurate way of describing such activity because in reality banks create new credit and money when they make loans, fulfil overdrafts or buy existing assets. [2]

   When loaning out money, for instance, a bank creates both an 'asset' (the loan itself) and a 'liability' in the form of new deposits credited to the borrowers' account. Importantly, the bank doesn't take money from anywhere else in the economy in order to fund this deposit, it simply expands its balance sheet.

   After creating the loan, the bank will then charge interest on the loan to cover the risk of default and generate profits. (Unsurprisingly, banks pay interest to depositors at a much lower rate than that charged to borrowers)

2. Debt-based financing via bond issuance: medium and larger sized companies and governments also obtain finance by issuing debt-instruments called 'bonds' to investors. The investor, who could be an individual but these days is more often an institutional investor (e.g. a pension fund) loans a certain amount of money, for a certain amount of time (a term), with a certain interest rate. In return they receive a certificate, which is effectively an 'I.O.U' note that can be used redeem the bond when it 'matures' at the end of its term.

   Bond issuance does involve real 'borrowing' of money, and interest is charged to cover the opportunity cost (briefing 1) of not having access to those funds for the fixed time period. Different types of bonds mature over different lengths of time, and therefore have different names to distinguish them. They are also, usually, tradable – there is an enormous market in the sale of corporate and government bonds (known as the 'bond market').

3. Equity-based financing: larger companies can also obtain finance through issuing equity (otherwise known as 'shares' or 'stocks'), where the investor buys a share of the company. Rather than receiving interest, the investor may receive a proportion of company profits in the form of a 'dividend' (usually annually). The investor hopes that the value of the share will rise as the company grows. The opposite also applies of course – so if the company contracts, the value of its shares will fall and the investor will lose money. The risk is thus more equally shared between the investor and then recipient than is the case with debt-based financing.

Money, banks, credit, debt and interest

In orthodox economic models, money is just the oil that lubricates the exchange of goods and services. It enables us to move beyond 'barter' and is not viewed as a resource –

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such as labour or land - that determines long run economic trends such as employment or growth.

In such models, banks are simply intermediaries that recycle one person's savings into another person's loan, and vice versa. In fact, as discussed, banks are not primarily intermediaries but creators of credit (or money) that enables economic activity to take place.

More broadly, money – the way it works, how it is created and who shares it out– is of fundamental significance to the economy and its relationship with nature. Money is generally viewed as having three key functions:

- A store of value – holding money gives us confidence in our future ability to access goods and services; it gives us future 'purchasing power'.
- A medium of exchange – money enables us to conduct efficient transactions and trade with each other.
- A unit of account – without a widely accepted unit of measurement we cannot settle debts or establish effective price systems – both of which are key elements of capitalist economies.

  The 'unit of account' (sterling, euro, dollar, or ounce of silver) has historically been determined by the state demanding the unit in which taxes must be paid.[3] Since taxes are our most routine and legally important payments, we tend to use the same unit for all our other transactions.

In the UK, in common with most developed economies, the monetary system is monopolised by commercial banks: 97% of the money supply is created by bank credit creation (as explained above). The central bank (the Bank of England) creates just 3% of the money supply in the form of sterling notes, coins and reserves. Private banks must hold enough notes to meet customer withdrawals. Banks must also hold enough reserves in their accounts at the Bank of England to settle payments between themselves.

At any point in time, the total money supply in such countries will be equal to 'net lending' – the amount of loans created by banks minus the amount of loans that have been repaid. If more loans have been paid off than created, the national money supply will actually contract, and vice versa. So, just as money is created when loans are made, it is destroyed when loans are repaid.

In modern, deregulated financial systems, central banks have chosen to have a very limited control over credit expansion by private-sector banks. Whilst all banks must hold a proportion of central bank reserves in order to settle their accounts at the end of any particular trading day, the Central Bank is not in a position to deny the banking system sufficient reserves. This is because bank's liabilities – the deposits in their bank accounts – have come to be used as the economy's main medium of exchange. If any bank was to become illiquid (i.e. unable meet its payment obligations) it could result in a collapse of the whole economy's payment system.

This system where the bulk of the money supply is created as commercial bank credit is usually termed 'fractional reserve banking'. Its emergence had very little to do with conscious design in terms of enhancing general welfare, economic efficiency or ecological sustainability. Rather, it was the outcome of historical accident and power relations, particularly those between banks and politicians.[4]

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References from part 1

[1] Adapted from Merton R (1995) 'A functional perspective of financial intermediation' *Financial Management* **24**(2).

[2] "When banks extend loans to their customers, they create money by crediting their customers' accounts.", pronounced Mervyn King, Governor of the Bank of England, in a recent speech http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech613.pdf 23rd October 2012; for a detailed explanation, see Ryan-Collins, J., Greenham, T., Werner, R., Jackson, A., 2012, *Where does money come from: a guide to the UK money and banking system*, 2nd edition, nef (the new economics foundation): London, chapter 2.

[3] For classic accounts of the neutrality of money, see Menger, C. (1892). "On the Origins of Money." Economic Journal 2: 239–255 and Walras, L. (1954). Elements of Pure Economics. London, Allen & Unwin

[4] see Knapp, G. F. (1905) The State Theory of Money, London: MacMillan; Innes Innes, A., M., (1913) 'What is Money?' *Banking Law and Journal*, May 377-408; Grierson, P. (1977), *The Origins of Money*, London: Athlone Press. p19-21.

For a full explanation see

See Ryan-Collins, J., Greenham, T., Werner, R., Jackson, A., *Where does money come from: a guide to the UK money and banking system*, Second edition,**nef** (the new economics foundation): London, ch. 2

For a visual explanation of this process, see the campaigning organization Positive Money's website and videos: http://www.positivemoney.org/

The **Marine Socio–Economics Project** (MSEP) is a project funded by The Tubney Charitable Trust and coordinated by **nef** in partnership with the WWF, MCS, RSPB and The Wildlife Trusts.

The project aims to build socio-economic capacity and cooperation between NGOs and aid their engagement with all sectors using the marine environment.

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