Pixies in the Garden? Making money.

Keith Rankin, 28 November 2014

In 2009, John Key said "there aren't little pixies at the bottom of the garden printing cash" (John Armstrong, Colin Espiner).

He was wrong of course. Just about every country has its own pixie-in-chief, though not at the bottom of the garden. In 2009 there was a world pixie-in-chief frantically printing money; his name was Ben Bernanke. New Zealand currently has quite a stern pixie-in-chief, resident nine-to-five in The Terrace (#2) garden. And the Reserve Bank Governor has many pixie helpers in the country's commercial banks.

Money remains for most of us a matter of supreme mystery. And we would rather leave it that way, as if it was just a pile of gold coins created by some mythical being. Part of the problem is that we use the word money to mean different things: 'wealth'; 'income'; 'savings'. What money really is, is a circulating medium of exchange that may also be used as a store of credit. In other words, the purpose of money is to be spent on goods and services, but it doesn't have to be spent straight away. ***Money is a social technology***, and, as such, it is made by human rather than otherworldly pixies.

In comments on some of my past Daily Blogs, I am frequently reminded that banks create money out of "thin air", and that this must a problem. Most debates about money (always arcane) are between those who believe that money is a commodity (like gold) – or at least behaves *as if* it were such a commodity – and people who are aware that money is no such thing but wish it was.

The reality is that modern money is credit money, which is code for debt money; and that makes many people uncomfortable, because debt (like blood) makes people uncomfortable. Yet debt is absolutely intrinsic to any economy beyond that of a small stone-age tribe.

So, avoiding any narrow technical meanings, conceptually debt means enjoying something today in return for an obligation to forego something tomorrow; debt arises from borrowing. ('Something' here means some mix of goods and services. 'Enjoying' means consuming or investing, where 'investing' means purchasing something like a new building, machine or an education.) Debt's exact counterpart is 'credit', which means having foregone something today in return for a claim on something tomorrow; credit arises from lending. Lending equals borrowing, by definition.

Debt therefore is an accumulation of borrowed enjoyment, and credit is an accumulation of foregone enjoyment. The process of foregoing enjoyment of goods and services is more commonly known as *saving*, and accumulated saving is called *savings*. Savers are creditors, and borrowers are debtors. Creditors and debtors are 'joined at the hip' to use Margaret Atwood's phrase in her very readable 2008 book *Payback*.

Commodity money was created (minted) by Kings converting gold, silver or copper bullion into coins. The believers in commodity money still hold that it was the amount of that metal in the coin that gave the coin its value, and they still yearn for the days of the gold standard when this belief was vaguely credible. In fact it was the imprint of the King's head that gave coins their value, as Felix Martin convincingly argues in *Money: The Unauthorised Biography*. Debased and clipped coins generally exchanged for their face value as if they were complete. The king's image was equivalent to a signature; a promise. We believe that kings have the capacity and moral authority to make good their promises.

Modern credit money is a promise, initially of individual banks, but nowadays of the banking system as a whole. And it is a product of ***double-entry book-keeping***, one of the great unsung inventions (attributed to Luca Pacioli in the 15th century, but essentially the Venetian system of bookkeeping) without which capitalism would have been impossible. (See *Double Entry: how the merchants of Venice shaped the modern world - and how their invention could make or break the planet*, by Janet Gleeson [2011].)

So what is the dark art of the modern garden pixie?

Money is created when a bank adds the same number to both sides of its ledger. So both a new debt and a new credit are created. If I borrow money to buy a house, a new debit account is created while the money is transferred into (say) my cheque account. I am simultaneously debtor and creditor. When I pay the builder the credit balance is transferred to the builder's cheque account. I am now debtor, and the builder is now creditor. I get to enjoy the house now. The builder foregoes the house he created, but has a claim on goods of equal value (or the ability to discharge a debt). I am in debt; he is in credit.

From the point of view of the banking system the critical transaction was the initial crediting of the loan, not my paying the builder. That new double-entry was brand-new money, printed by two strokes of a banker's pen. The banking system is indifferent as to whether the credit balance is in my account or the builder's account.

So far so good. What most irks the money-reform brigade is the matter of interest. Interest is really a conflation of two concepts, and it is widely believed that it must be a positive number. One meaning, that of 'yield', derives from agriculture and animal husbandry.

The other meaning is essentially a compensation price. So if wannabe lenders are scarce and wannabe borrowers are abundant (the normal state of affairs in the minds of most economists) then lenders must be compensated by borrowers. So if I borrow $10,000 I may agree to repay $10,500 a year later. My debt would be $10,500 inclusive of $500 interest. And the lenders' credit would be $10,500 inclusive of interest. There is no mystery about interest. A bank's margin on interest is simply a service fee (or 'clipping the ticket', which amounts to the same thing).

So modern money is created by banks, not kings. It represents a promise by the banks, analogous to the promises of kings in relation to ancient money. The banks cannot redeem that promise, except by giving a customer another form of money (eg $US). The promise is that the other people we do business with choose to believe in it as much as we ourselves do, because it's in everyone's interest to believe in money as a social medium of exchange.

The global banking system has a near unlimited capacity to create money, and the global financial system has a near unlimited capacity to create promises. In the lead-up to financial crises we see banks creating money that is spent mainly on financial assets (other promises) or real assets (land and buildings) rather than on goods and services. The reason this happens is because there are relatively many people (savers) who want to forego goods and services today, and relatively few bankable people who want to enjoy goods and services today in exchange for an obligation to forego more goods and services tomorrow. Savers outnumber borrowers. It's called a global savings glut.

Before banks existed we could save and invest by planting seedcorn, retaining livestock for breeding, or building ourselves a house or workshop; individually or by forming a company. Or we could save by finding a willing borrower who we could trust. Otherwise the goods we saved would just rot or wither.

Nowadays banks virtually guarantee us that we can save by lending to them, and that they will find suitable borrowers on our behalf. We expect the banks to do that, and we expect a positive rate of interest as well. We expect our savings to mature in storage like a good wine, rather than to depreciate like old nuts. We expect banks to be tantamount to alchemists. Sometimes the pixies at the bank have to work very hard to meet these expectations we place upon them. Sometimes they cannot find debtors who will have the capacity to repay us. Commonly we refuse to spend our savings, ever. And we do not like to accept that our unspent incomes, including interest, represent others' unpaid debts to us.

Both right-wingers and left-wingers expect too much of our banks. Indeed banks do much for us; they make our money. But did they cause the global financial crisis? No. Look in the mirror for that culprit.