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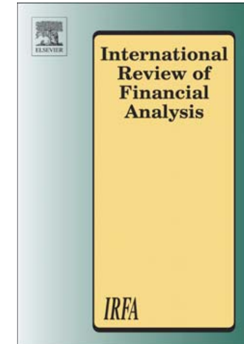

Do banks really create money out of nothing? Another empirical test of the three theories of banking

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Do banks really create money out of nothing? Another Empirical Test of the Three Theories of Banking

Richard A. Werner[1]

Abstract

The financial crisis has heightened interest in the question of how banks operate. This had been neglected by economists and finance researchers, but thanks to the crisis a wider debate on this issue seems to be the 'new normal'. Over the past century and a half, the role of banking in the economy has been described by three different theories, which are differentiated by their accounting implications. The currently dominant theory is the financial intermediation theory of banking, which says that banks collect deposits and then lend these out, without any power to create money, just like other non-bank financial intermediaries. The fractional reserve theory of banking says that each individual bank is a financial intermediary, gathering deposits and then lending these out without the power to create money, but the banking system collectively is able to create money through the process of 'multiple deposit expansion' (the 'money multiplier'). The credit creation theory of banking says that banks are not financial intermediaries and do not gather deposits to lend out, but instead each individual bank has the power to create credit and money out of nothing. Eminent scholars have been supporting each one of these different theories. Recently, the Bank of England (2014) argued that textbooks have been wrong in their presentation of banks, and that the credit creation theory is, after all, correct. Needless to mention, the question which of the three theories is correct has major implications for economics, finance, monetary and general government policy and bank regulation. The Basel approach has been predicated on the veracity of the financial intermediation theory. Yet, proponents of each of the theories – including the recent intervention by the Bank of England – merely assert their viewpoints. So far only one empirical test exists. It is the purpose of the present paper to present another empirical test of the three theories, using a different methodology. Analysing bank operations and bank accounting via the bank's annual accounts reporting software, which allows the control of all other factors, it is found that the financial intermediation and the fractional reserve theories of banking are rejected by the evidence. Policy implications are discussed, in particular for regulating bank capital adequacy as a tool to avoid banking crises.

JEL Classifications: E30, E40, E50, E60

Keywords: bank accounting; bank credit; credit creation; financial intermediation; fractional reserve banking; money creation

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