Capital Solutions

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How Money Gets Made

One of the coolest things a bank does is little recognized by the public. They make money.

Yes, on your loan, deposit, or any other service you use, but they also literally make money. As in create more of it for the rest of us. And what's more, we all have a say in how much money they create for the economy.

How does that work?

It is the confidence level and financial capacity of borrowers and their lenders that largely determines the emergence of a robust economy or a listless one.

Most of the money in national economies is created when banks write it into their customers' accounts, virtually out of thin air, in the form of bank loans.

Here is a illustration:

You earn $100 and put it in the bank. And then…

- **The bank keeps $10 in its Federal Reserve account …**
- **This is the "reserve," which the bank uses when customers withdraw funds.**

Then the bank loans Susie $90, at interest.

Susie deposits the $90 in her bank.

That bank keeps 10% ($9) in reserve, and loans Joe $81, at interest.

See how it all adds up?

You now have $100 in your account. Susie has $90 in hers. Joe has $81.

There is now $271 total in accounts that you and Susie and Joe can spend. And it all came from your $100 deposit. The banks have created an additional $171 by loaning it into existence.

Imagine this money trick over and over.

If you do this operation 50 times, that $100 turns into $995.25—$885.25 in loans, and your original $100.

If those loans are for one year at 10% interest, the banks will make $88.53. If they'd only been able to loan your $100, they'd make $10.

So how do borrowers have a say in how much money gets created? From their desire to borrow and their capacity to do so.

In the illustration, say Suzie and Joe don't show up. They aren't interested in getting a loan, either due to a lack of opportunity to earn a return above the loan's interest rate, or an inability to qualify for a loan. Either way, that original $100 deposit stays parked at the first bank, and loses its multiplier effect, remaining just $100.

Every new loan that a bank makes creates new money. While this is often hard to believe at first, it's common knowledge to the people who manage the banking system. Banks create money on the basis of the promises of their borrowers to repay.

In March 2014, the Bank of England released a report called "Money Creation in the Modern Economy", where they state:

"Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created."

By creating money in this way, banks have increased the amount of money in the economy by an average of 11.5% a year over the last 40 years.

Of course, the flip-side to this creation of money is that with every new loan comes a new debt. Eventually the debt burden becomes too high, resulting in the wave of defaults that triggered the financial crisis.

Thanks for reading. Please let us know if you would like our help in improving your borrowing rate and terms.

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