How is Money Created?

My objective here is to explain the current system in terms for the layman, who still does not know the difference between personal/household finance and federal finance.

A good place to start is to define money. *Money* is an imaginary concept, an abstraction used to represent value; it can be seen as a store or a measure of value. It has historically been represented by *currency* (which includes metal coins and paper bills). Currency is a medium of exchange, a unit of account, durable, divisible, portable, and fungible (each unit is capable of mutual substitution, meaning units are of equal value). Currency is NOT money, but merely *represents* money.

Money was real once upon a time: this was when coins minted from precious metals (gold and silver) had a value based on the amount of the metal. It was also when paper currency was convertible to a fixed amount of gold (such as existed under a gold standard). Those times are past.

Fiat money, more accurately *fiat currency*, is currency that a government has declared to be legal tender, but is not backed by a physical commodity. Typically fiat money is paper currency or base metal coinage (like modern American coins), but it can also exist as data such as bank ledger balances and records of credit or debit card purchases. This is essentially the current state of the USA monetary system. Fiat currency has no intrinsic value. The value of fiat currency is derived from the relationship between supply and demand rather than the value of the material that the money is made of.

What gives fiat currency value, what motivates us to use the government's legal tender, is the fact that all tax obligations are denominated in and have to be extinguished with that currency.

The current money system is based on fractional-reserve banking, a system that has been in worldwide use since the late 1600s, and the use of fiat currency.

Commercial banks do not, as too many textbooks still suggest, take deposits of existing money from savers and lend it out to borrowers.

Before fractional-reserve banking came into existence, money was based on a commodity like gold or silver. Now it is based on deposits and loans.

What is Fractional-Reserve Banking? There are several tenets to this.
(1) Banks can lend more than they have on-hand in deposit accounts. How much more depends on the minimum reserve requirements for commercial banks.
(2) Deposit liabilities are considered money in their own right. Deposits are *liabilities* (an accounting term) owed by the bank to the depositors. Receipts and loans are typically deposited in domestic bank accounts, at which point they become money.
(3) The central bank can specify the form in which such assets are required to be held by the commercial banks (such as currency or bullion).
It is the second item that is the most important.

Thus fractional-reserve banking permits the money supply to grow beyond the amount of the underlying base money originally created by the central bank. Voila: when banks lend money in excess of their on-hand deposits, the amount of the loan increases the money supply—money is created. When the loan is repaid, the repayment reduces the money supply—money is destroyed.

It should be recognized that America's current monetary system exists to create and perpetuate debt.

Copyright 2016 by Susan J. Dorey

Fractional-reserve banking is generally administered by a central bank with the legal power to set the minimum reserves requirement for commercial banks, and to specify the form in which such assets are required to be held.

Fractional-reserve banking was adopted to expand the economy by freeing up capital that could be loaned out to other parties.

The Swedish Riksbank was the world's first central bank, created in 1668. Strictly-speaking, it was not a fractional-reserve bank, but it laid the groundwork for one.

The first fractional-reserve bank was the Bank of England, created as a corporation of subscribers in 1694 for the purpose of lending money to the government to carry on a war with France. During the 1700s common law debt legitimated fractional-reserve lending.

This system has its critics.

What has this to do with federal finance?

(a) The federal government is the monopoly issuer of fiat currency. The federal government can never be short of that currency, it can never run out of money. Spending is the prior act in a fiat monetary system; taxing and borrowing are following acts. In effect, the government is only taxing what it has already spent, and it's only borrowing back money that it has already spent.
(b) The federal government neither has nor does not have money. There is no finite sum of monetary value which the federal government has. There is no pool of money from which the federal government can pay its bills.
(c) One thing to keep in mind is that most money does not exist as currency, but as a balance in a bank ledger or an amount of a financial transaction (like a payment); the transaction ultimately affects two balances in bank ledgers.
(d) Money is created when the government purchases from the private sector (purchases can be for goods or wages, and the recipient deposits the payment in a bank account); money is wiped out when taxes are paid (and removed from the payee's bank account).

The primary consequence of fractional-reserve banking and fiat currency is that federal governments do not need receipts (from taxes and fees) in order to pay their bills. They can simply initiate payments through ledger transactions. Thus the federal government can create as much money as it needs in order to meet the needs of its citizenry and it spends what it wants on what it values. You can see what a government values by studying its budget.

At this time about 80% of federal payments and receipts are made by electronic funds transfer, the remainder of payments are made by U.S. Treasury checks. (You can still pay your federal income tax by check.)

Once you grasp this, the next step is to consider the honesty of the "market solution." The market solution is one, embraced by neoliberals, that relies on private enterprise (usually with the help of federal and/or state subsidies) to solve public problems, like deteriorating infrastructure and insufficient affordable homes; the private enterprises are encouraged to participate by the expectations of profit. Now that we understand money creation in modern America, we see that the government has completely within its power the ability to fund public solutions to these problems; we do not need to give public money to private enterprise!

Copyright 2016 by Susan J. Dorey