The veil of deception over money: how central bankers and textbooks distort the nature of banking and central banking

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> *"The study of money, above all over fields in economics, is one in which complexity is used to disguise truth or to evade truth, not to reveal it."* John K. Galbraith

Introduction

This paper will argue that we are being intentionally and systematically mislead about the nature of money and about the role of central banks and commercial banks in the monetary system. We are led to believe by central bankers and by textbooks, like the ones of Krugman and Wells (2009) and Mankiw and Taylor (2011), that central banks have always been government institutions acting in the public interest. In reality, central banks' historical origin and role had more to do with the desire of private bankers to control and coordinate the process of private sector money creation. That most money is created in the private sector is something that central bankers like to gloss over and textbooks "explain" in a distorted and unnecessarily convoluted way.

While governments have increased their influence over central banks over time, these still fulfill functions which are mostly in the interest of the banking industry. They coordinate private sector money creation and act as lenders of last resort for commercial banks. It is far from clear, whether central banks will side with commercial banks or with the public at large, if their roles as protector and coordinator of the former and their role of promoting the interest of the latter are in conflict. The desire of central bankers to hide the lucrative role of commercial banks in the process of money creation and their distorted account of central bank history give reason to be suspicious in this regard.

This is particularly relevant today, as during the financial crisis central banks have emerged as the most powerful agents in economic policy. An examination of the disclosed calendar of US Treasury Secretary Tim Geithner by the research institute Bruegel revealed that the President of the European Central Bank was the person Geithner called most often in Europe, with a big margin to the runners up. Between January 2010 and June 2012, 58 out of 168 calls of Geithner to European officials went to the president of the ECB (Pisany-Ferry 2012)[2].

In Europe, the ECB is involved as a member of the so called "Troika" (with the EU-Commission and International Monetary Fund) in drawing up and enforcing reform and austerity programs for crisis countries like Greece, Portugal and Ireland. These Memoranda of Understanding go into almost all areas of economic, labor market and social policy and are

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[2] http://www.bruegel.org/nc/blog/detail/article/934-tim-geithner-and-europes-phone-number/#.UUsNr1ceWy0

very detailed. The ECB is taking their decisions in complete independence from governments and parliaments. Other major central banks are also independent from government, even though not in such an extreme way. If there is an important element of central banks serving the interests of the financial industry, this unchecked power should be regarded as highly problematic.

I will examine the rhetoric of two central bankers, Jens Weidman and Otmar Issing, regarding the process of money creation, inflation and the role of central banks. Weidmann is Präsident of Deutsche Bundesbank and member of the Governing Council of the European Central Bank (ECB). Otmar Issing was a former board member (Until 2006) of the European Central Bank in charge of economics. I use the rhetoric of these two German central bankers, because, due to the tradition of the Bundesbank to give prominence to monetary aggregates, German central bankers are more inclined to explicitly talk about money than the average European central banker.

I will also examine how two widely used economics textbooks by Krugman and Wells and by Mankiw and Taylor treat the subject. Drawing on Häring and Douglas (2012) I will juxtapose this rhetoric of central bankers and textbooks with the historical and current evidence. I will argue that this rhetoric frames the minds of central bankers, other policy makers, academics and - through economic journalists educated with the same textbooks - the general public, in a very unfortunate way. This prevents them from understanding the current financial crisis and from drawing the right policy conclusions from it.

The narrative of Jens Weidmann and Otmar Issing

According to the central bankers' narrative, governments created central banks to use and abuse fiat money creation for the financing of government expenditure, crating runaway inflation in the process. In a widely reported speech in Frankfurt in September 2012 entitled Money Creation and Responsibility,[3] Bundesbank-President Jens Weidmann (2012a) made references to Goethe's drama Faust II to take a swipe at government controlled fiat money.

In Faust II, Mephisto (the devil) talks the Emperor, who is in dire straits financially, into signing an IOU, which Mephisto copies many times to issue it as paper money for the benefit of the Emperor. Soon, however, money issuance gets out of hand. It ends with runaway inflation.

Weidmann interprets Goethe's scene as an impressive rendering of the dangers of creating fiat money for financing government expenditure. He argues that the government's power to create money from nothing brings with it the temptation to create too much money to get extra financial leeway, and he asserts that governments have historically more often than not given in to this temptation. "If we look back in history, we see that government-owned central banks were often created with the purpose of giving those governing the country free access to seemingly unlimited financial means." He proceeds to say that governments control over the central bank in combination with governments need for money often resulted in too much money and runaway inflation.

[3] http://www.bundesbank.de/Redaktion/EN/Reden/2012/2012_09_20_weidmann_money_creaktion_and_responsibility.html

The goal is clear and explicit. Weidmann wants to drive home the lesson that you cannot entrust government with managing the monetary system and that you therefore have to guard the central banks' independence from government.

In another speech, given a few days later (available here[4] in German), Weidmann gives the example of the first known paper money system of the Chinese-Mongolian Emperor Kublai Khan and his successors. "Off course, the Chinese Emperors recognized the importance of the invention and made much use of it. They produced more and more money bills – unfortunately without taking the old ones out of circulation. The result is hardly surprising. There was inflation. At the end of the 13th Century, one bill was worth 1000 copper coins, almost 150 years later it was worth less than one."

In his speeches on money and inflation, Jens Weidmann does not utter a single word about money creation by commercial banks; he does not even mention commercial banks. Even though he is not explicitly saying so, all his remarks give the impression that only the Government via a government owned and controlled central bank issues money, and only for the benefit of the government.

Otmar Issing, who talked at the same event in Frankfurt, made it even more obvious that money creation by commercial banks is a taboo subject in public. The former Chief Economist of the Bundesbank and later of the ECB talked about paper money, government finances and inflation. A focus of his talk was the free-banking alternative favored by Friedrich August von Hayek, which involves no central bank but has commercial banks issue their own banknotes in competition with each other. Even while discussing this proposal, Issing manages to entirely avoid the words bank and banknote, rather making it seem as if he was talking about different (national) "currencies", rather than about domestic money issued by commercial banks.

While this speech is not publically available, Issing gave a very similar speech in 2003 upon receiving the Hayek-Prize, which is available in German[5] on the ECB's website. The word bank does not appear, other than as "central bank".

Weidman and Issing are the rule rather than the exception. Western central bankers rarely, if ever, make it explicit that commercial banks create money.

Historical evidence and current practice[6]

Before we look at the treatment of the subjects: central banks, banks and money creation by leading textbooks, we will first take a look at the history of important central banks, to see if Weidmann's narrative is correct. We will see that it is not. Neither did or do governments have a monopoly on money creation, nor did they routinely abuse any power they had in this regard. The insinuation of Weidmann and Issing that it is only central banks who create money will turn out as just as wrong.

[4] http://www.bundesbank.de/Redaktion/DE/Reden/2012/2012_09_27_weidmann_markenverband.html

[5] http://www.ecb.int/press/key/date/2003/html/sp031012.de.html

[6] This section draws on Chapter 2 of Haering and Douglas (2012)

Paper money in early China

It is no coincidence that Weidman goes back to 13th Century China to give us an historical example of government-controlled money creation that went wrong. He has to do so because, contrary to his claim, the important central banks in the west historically were created by private bankers for private gain. It is true that bankers created them in cooperation with the government as a new scheme to give credit to the government. This usually involved privileges conferred on these commercial banks, notably the privilege that their notes would be accepted for payment of taxes and duties. But still, central banks were not government controlled entities, issuing money on behalf of the government. The bulk of the seignorage, i.e. the direct monetary gain from printing money, usually went to private bankers. There was a lot of political controversy, historically, about whether commercial banks or the government should issue money, and for a long time, the commercial banks prevailed in this fight even as far as banknotes are concerned. As far as deposit money is concerned, the largest part of the money supply, banks have prevailed until today. So Weidmann is clearly giving a badly distorted account.

Not even the Chinese example that Weidmann chooses is a good one to make his point. Contemporary reports about the economy of Kublai Khan's empire and of his successors stress how wealthy and well organized it was. China was far ahead of Europe at that time. The system of paper money might or might not have been instrumental, but it is far from straightforward to argue that this monetary system was a failure. The devaluation of this paper money over 150 years, that Weidmann alludes to, amounts to a hardly spectacular five or six percent inflation annually. According to Werner (2007), this paper money system worked well for decades, if not centuries, as all available research reports the Chinese economy as flourishing during that time.

The Bank of England

The Bank of England was founded in 1694 as a private enterprise. A consortium led by the Scottish businessman William Paterson had suggested the scheme. It would afford King William and Queen Mary a large loan. The consortium was granted the right to found the privately owned Bank of England and to create money by issuing banknotes. They lent those "Notes of the Bank of England" and some gold to the crown against interest of 8%. (Rothbard, 2008). The Bank of England was awarded the monopoly of issuing banknotes in London by the Bank Charter Act of 1844. Only in the 20th century did the Bank of England move away from commercial endeavors. It was nationalized in 1946. Until then it was a private institution working mostly for the financial benefit of its private shareholders.

No evidence here for the theory of central banks as creatures of governments over issuing money for the benefit of the government.

The US Federal Reserve and its predecessors

The merchant banker Alexander Hamilton, the first United States Secretary of the Treasury, successfully promoted the chartering by Congress of the privately owned First Bank of the United States in 1791, a bank with special money creation privileges. He staunchly opposed the idea that the government itself should issue the money needed to fund manufacturing and the settling of the west. He wanted commercial banks to do it, but they should have the strong backing of the government. This backing consisted, among other privileges, in accepting the notes of the First Bank in duties and taxes (Nettels, 1962).

The bank faced stiff political opposition. The fight was not about fears of over-issuance, though. It was about the constitutionality of outsourcing the regulation of money to a private company and about the privileges conferred to private bankers at the expense of farmers and other producers and the public at large.

Private bankers' highly privileged role remained a source of political controversy for more than a century. After its 20 year charter ran out in 1811, a bill to recharter the First Bank of America failed. Five years later, the banker Alexander Dallas, in his other capacity as Secretary of the Treasury, initiated the chartering of the Second Bank of the United States. He endowed the – again – predominantly privately owned bank with the same privileges as the First Bank had had (Rothbard 2008).

President Andrew Jackson eventually was successful in his campaign to take away the privileges of the Second Bank in 1836. Jackson insisted that it was improper for Congress to pass the important task of creating money and regulating its value to a private corporation.
Thus, the predecessors of the Federal Reserve offer nothing in evidence for the theory of central banks as creatures of governments, over-issuing of money for the benefit of the government.

For eight decades the US would not have a central bank. Banknotes were still printed and circulated in the economy, though. They were printed by a multitude of competing commercial banks. As Issing pointed out in this speech, such a system has the potential advantage that competition of banks might prevent over-issuance in such a system and the palpable disadvantage that transaction costs are very high, if notes of more than a thousand banks with different discounts from their nominal value are circulating.

In 1862, Salmon Chase, who had been installed as Treasury Secretary by banker and financier Jay Cooke and his newspaper owning brother, pushed through Congress a national banking law that alleviated the competitive limit to money creation that banks had faced in the absence of coordinating central bank (Rothbard 2008).

The new layered system had New York City based national banks at the top, designated as central reserve city banks. They could give loans and thus create deposit money as a multiple of the amount of Treasury bonds, gold and silver they held. Other nationally chartered banks in big cities, the reserve city banks, could hold their reserves in the form of deposits at central reserve city banks or in Treasury bonds. They could create a multiple of these reserves as checking accounts. National banks in smaller places called country banks, could hold more modest reserves also at reserve city banks to back up the loans they gave (Champ 2007; Rothbard 2008).

One can see that money creation in the national banking system was driven mostly by the interests of the banking community in the early United States. While it is true that the idea behind the national banking laws was, besides creating a national currency, to help the government finance the civil war. However, the money that the government created was only a fraction of the money that commercial banks were allowed to create on top of the government bonds that they were forced to hold. The result of the new system from which initiator Cooke benefitted very handsomely, was a great expansion of the number of banks and of deposits and also a series of severe financial crises in fairly short order. There were panics and bank runs in 1873, 1884, 1893 and 1907, because banks, notably those in New York at the top of the money issuing pyramid, repeatedly had difficulty to meet demand for redemption of their deposits (Champt 2007; Rothbard 2008).

As a reaction to these crises, the Federal Reserve System was created in 1913, again upon private bankers' initiative. At a secret meeting at Jekyll Island, Georgia in December 1910, they hammered out the essential features of the new Federal Reserve System. Bankers representing the interests of Rockefeller, JP Morgan and Kuhn, Loeb & company, the most powerful institutions of the time, dominated the meeting. The continental European, notably the German system served as a model for the basic structure. The idea was to make the process of money creation more disciplined and orderly and to have a deep pocketed institution to bail out the banks if the public lost confidence in the notes they had issued. The bankers wanted the government only as paymaster, though. Otherwise, it was supposed to have as little influence over the process as possible (Rothbard 2008).

To this day, the twelve regional Federal Reserve Banks, which are in charge of regulating banks, are owned and governed by their member banks. Before the subprime crisis, this fact was never advertised and often concealed by the pretense that the Federal Reserve System was a public institution.

The Federal Reserve Bank of New York is the one in charge of regulating, overseeing and bailing out Wall Street banks with public money. Wall Street banks chose the President of the New York Fed and charged him with regulating and controlling them. A board chosen and dominated by bankers makes sure he does it right. Only during the subprime crisis did the Federal Reserve give up the pretence of being a public institution. The New York Fed, managing US$1.7 trillion of emergency lending programs for banks and brokerages, was called upon to inform the public of the whereabouts of the public funds going to Wall Street. At this point, the Federal Reserve of New York insisted – ultimately in vain – that as a private institution it is not bound by the Freedom of Information Act.

Central banking in Germany

In Prussia, the political powerhouse of mid-19th Century pre-unification Germany, a central bank called Preussische Bank was created in 1846 as a hybrid institution, which was run by government representatives but with a capital base which was mostly provided by wealthy businessman and private bankers, who would have a right to a dividend as long as the bank was profitable (Lichter 1999).

The reason for founding the central bank was a dearth of money in circulation in a period of beginning industrialization. There were coins circulating and small denomination treasury obligations, but not enough. In stark contrast to Weidman's account, the Prussian bureaucracy under-issued the debt certificates that served as small denomination paper money rather than over-issuing them and the Royal Bank was stingier with credit than the business community in the commercial centers wanted them to be.

The Prussian bureaucrats were loath to give commercial banks the freedom to emit currency, because they feared that too much money would be issued. Their mistrust was fuelled by the fact that none of the bankers' proposals for the licensing of private note-issuing central banks had a provision of unlimited liability of the banks' owners as prevailed in the Scottish free banking system. The contemporary US-system with private note issuing banks and correspondingly many different notes trading at varying discounts was regarded as a bad example to be avoided (Lichter 1999).

The fight in Prussia over the right to issue notes had an important political dimension. The fact that private shareholders were invited to provide the capital for the Preussische Bank was a compromise between the preference of Prussian bureaucrats like Minister Christian von Rother, who wanted to keep note emission in public hands and mistrusted profit oriented private bankers in this respect, and the King's perceived need in pre-revolutionary times to appease a dissatisfied moneyed citizenry, which was pressing for the right to issue banknotes (Lichter 1999, p. 89f).

From 1871 to 1876 the Prussian Bank would serve as the central bank of the newly unified German Reich and eventually would become the Reichsbank, which was also run by the government and owned by private shareholders.

The German model of giving a (near-)monopoly of note issuance to a government run central bank was considered highly successful and would later, together with the Bank of England, become the blueprint for the Federal Reserve System.

Money creation by commercial banks today

We have seen that for much of history, government was only indirectly involved in issuing banknotes, and had nothing like a monopoly on it. Over time, most governments took over the responsibility for central banks and the issuance of banknotes, which functioned as means of payment. (Some of that control they have relinquished again recently by deciding to let independent technocrats, often with commercial banking backgrounds make the relevant decisions.) However, even where the government had or has this monopoly to issue notes, this is far from being a monopoly to issue *money*. Today, only a fraction of the money which circulates in the economy consists in cash issued by the central banks. M3, the preferred definition of money of the European Central bank is 11 times larger than the sum of currency in circulation and reserves of commercial banks at the central bank, i.e. base money. We make by far the largest part of our payments without using any government issued banknotes. We pay by transferring deposits at commercial banks to someone else and we receive our paychecks in the form of deposits in the bank, i.e. in electronic money, created by commercial banks.

This money is created any time a commercial bank gives credit to a non-bank or buys an asset from a non-bank. If I take a mortgage loan from a bank of €100,000, the bank will credit my account with a deposit of €100,000 in exchange for my obligation to pay back, say €150,000 over time. €100,000 in new deposits has been created by a few keystrokes and signatures. It might soon leave my bank account, as I pay my house with it, but it will remain in the banking system, as I will transfer the money to somebody else's account at another bank. (The money market, on which commercial banks exchange liquidity, will in normal times make sure that my bank will be able to obtain the central bank deposit needed to make the transfer.)

This deposit money created by commercial banks is equivalent to legal tender for all practical purposes. The government accepts a transfer of this deposit money as taxes and everybody is obliged to accept it for payment in normal business. That these deposits created by commercial banks are "money" is also recognized by the fact that all major central banks, like the Federal Reserve, the European Central Bank and the Bank of England count them as money in the monetary statistics they compile.

Even when commercial banks were refused the privilege to issue banknotes in 19th Century Prussia, they were able to create money by issuing fungible deposit slips on current account balances of their customers. Whoever presented these deposit slips had the right to have the balance paid out in cash. This enabled commercial banks to lend out much more money than they had in deposits, since most customers would leave the deposits in the bank and transfer the deposit slips to pay their bills (Lichter 1999).

The Reserve Position Doctrine (RPD), also called Monetarism, which was first propagated by the Federal Reserve (Bindseil 2004) and later also by the Deutsche Bundesbank and, for a few years, by the ECB, rests on the assumption that central banks control the process of money creation. They issue so-called base money in the form of currency and bank deposits at the central bank, i.e. reserves. Banks use this base money to give credit and thus create a more or less fixed multiple of the monetary base in deposits, according to the money multiplier (see next section).

In reality even central banks ostensibly adhering to the Reserve Position Doctrin, have not been steering the monetary base, but have been occupied with setting an interest rate on the money market, with which they try to influence and smooth short-term interest rates in the economy in general. Goodhart (2001) claims that the Fed continued to use interest rates as its fundamental modus operandi, even if it pretended to pursue monetary base control. He talks of play-acting and even deception in this regard.

Ulrich Binseil (2004) who used to be head of liquidity operations of the ECB and currently is Deputy Director General of financial market operations, makes it clear that interest rate targeting, which has long been the norm for all major central banks, and control over base money are incompatible: "Today, there is little debate, at least among central bankers, about what a central bank decision on monetary policy means: it means to set the level of short term money market interest rate that the central bank aims at in its day-to-day operations." And he quotes Goodhart (1989, p. 293) a renowned academic economist with central banking experience, saying "Central bank practitioners, almost always, view themselves as unable to deny setting the level of interest rates, at which such reserve requirements are met, with the quantity of money then simultaneously determined by the portfolio preferences of private sector banks and non-banks." In other words: the central bank will normally feel obliged to provide whatever demand for monetary base is created by the interaction of private borrowers and banks, because otherwise, short term interest rates would gyrate wildly.

Thus, according to this view prevailing among central banking practitioners, central banks fulfill the task of supporting money creation by commercial banks by providing reserves as needed and disciplining the process in such a way that runaway inflation does not erode the public's trust in the money thus created.

Even if one should be of the opinion that the central bank is able in our current monetary system, to control the amount of money that commercial banks create, it is certainly not justified to give the impression, as Mr Weidmann and Mr Issing do, that only (government owned) central banks create money and that all money creation is for the benefit of the government. Even if the central bank were to control commercial banks' money creation, it would still be done by commercial banks for the benefit of commercial banks (and at the risk of taxpayers who have to bail them out, if it goes wrong). Central bankers never, ever talk about the hugely profitable privilege that the ability to create legal tender means for commercial banks.

The textbooks' narrative

> *"The essence of the contemporary money system is creation of money, out of nothing, by banks often foolish lending."* Martin Wolf, Financial Times, November 9, 2010
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> *"It proved extraordinarily difficult for economists to recognize that bank loans and bank investments do create deposits."* Joseph Schumpeter (1954, p.1114)

There is very little on the history of central banks in the textbooks of Krugman and Wells and of Mankiw and Taylor, and what there is, is distorted. Thus, students who happen to find out about private ownership and control of central banks must regard it as an oddity, given that they have been led to believe that it is part of the nature of a central bank to be a public institution serving only the interest of the general public.

Mankiw and Taylor report that the Bank of England was created in 1694, but without giving any background. Then they proceed to claiming that "(a)rguably the most significant event in the Bank of England's 300-year history was when the UK government granted it independence in the setting of interest rates in 1997" (p.625-6). This wrongly implies that until then the Bank was taking its orders from government and could not set interest rates independently. However, this was only the situation for a few decades in this 300-year history. It is noticeable that for Mankiw and Taylor the granting of the monopoly to issue banknotes for Greater London in 1844 or the nationalization in 1846 are less important than the decision to partially reverse the nationalization by granting the Bank partial independence from the government.

Of the Federal Reserve, Mankiw and Taylor note the year of creation and that the president appoints the seven governors. They mention that the decision making body Federal Open Market Committee includes the Presidents of the regional Feds, but fail to mention that these are private institutions owned and controlled by the banks in the respective region.

Krugman and Wells are silent about the Bank of England, but are a little more explicit on the Fed. They let us know (p. 812) that "… the legal status of the Fed is unusual: It is not exactly part of the U.S. government, but it is not really a private institution either." What do they mean by "not exactly" part of the government, and "not really" a private institution, a description taken from the websites of the Federal Reserve System? Students are left in the dark. They mention that the Board of Governors is appointed by the President and approved by the Senate, but remain silent on who appoints the Presidents and boards of the twelve regional Federal Reserve banks. While earlier versions of the textbook only stated that the regional Federal Reserves have a board of directors, the 2009 version is at least hinting at the truth by adding that the board of directors is "chosen *from* the local banking and business community" (my italics). This is somewhat misleading. Two thirds are chosen *by* the local banking community, one third by the Board of Governors in Washington. Most members indeed come *from* the local financial community, but they don't have to. The point is: banks control the regional Federal Reserve Banks that are supposed to control them. You would not know from reading Krugman and Wells?

Without explaining the "unusual legal status", Krugman and Wells (p. 813) arrive at the surprising conclusion that "the effect of this complex structure is to create an institution that is ultimately accountable to the voting public, because the Board of Governors is chosen by the president and confirmed by the Senate." Had they given the complete picture they would risk being laughed at for this apologetic conclusion.

The equally apologetic treatment of commercial banks' money creation by the textbooks is also highly misleading. Mankiw and Taylor only start talking about where money comes from after page 600 under the unlikely headline "Money and Prices in the Long Run". That is: explaining our monetary system is relegated to near the end of the book and reduced to its impact on prices in the long run.

Krugman and Wells introduce the "hypothetical market for loanable funds" on page 678 to explain how savings are used to finance investment. Banks as intermediaries channel money from savers to investors. The interest rate is the price that equates saving and investment, just like it does in the market for potatoes. No money creation by banks at this point, actually no money at all. It might as well be a generic good like grain that is being saved and passed on to investors who need grain to pay workers until they can sell their product. Money in the modern sense appears only on page 804 under the equally unlikely header "Stabilization Policy". Again, money is relegated to the near-end of the book and does not deserve its own chapter.

In wording, Krugman and Wells continue to follow the loanable funds doctrine in the section on money. They pretend that banks are mere financial intermediaries, collecting deposits, from a multitude of savers and passing them on as loans to companies, households and government. This is very odd in a chapter in which they explain how banks *create* deposits. It is a clear contradiction. A banking system that creates deposits in the process of lending does not have to wait for deposits to come in, in order to intermediate them.

In order to hide the contradiction, both textbooks stubbornly insist that the process of money creation starts with cash being deposited in a bank. Deposits are created in the textbook examples, but they remain in the background. The textbooks rather focus on cash that is deposited in the bank and then is being lent out again as cash (with a small fraction retained in reserve), redeposited and lent out again. Thus, the rhetoric of loanable funds can in a superficial way still be used. Rather than individual banks creating money they only intermediate the cash that has been deposited. It just so happens that the banking system overall intermediates the same cash many times.

But why should banks limit themselves to creating money in this roundabout way? In reality, the process typically will start with a bank giving credit to someone and in the process crediting this person's bank account with the respective sum of deposit money, thus *creating* deposits, not *intermediating* them. If someone deposits €1000 in the bank, as in Krugman/Wells example, the bank can just deposit the whole €1000 at the central bank as reserves and – given a reserve requirement of 10% as in the US, or 1% in the euro area – be entitled to lend out €10,000 or €100,000 respectively, without having to wait for any further deposits. They will routinely do just this, rather than lending out €90 or €99 (depending on the reserve requirement) and then wait for new deposits to come in before lending more.

Mankiw and Taylor (p. 629) explicitly tackle the possible amazement of students that might arise from the fact that banks can create money out of nothing: “At first, this creation of money by fractional-reserve banking may seem too good to be true, because it appears that the bank has created money out of thin air”, they concede. Then they try to appease their readers' minds by alerting them to the fact that no wealth is created by this creation of deposits, because “… as the bank creates the asset money, it also creates a corresponding liability for its borrowers.”

Here the explanation ends, even though here it would only start to get interesting. The bank creates “the asset money” for itself in the sense that the bank can demand interest on it. This is real wealth that the banks derive from their money creation. In the process they create a debt for someone else. For society, no wealth is created, that is true. But for themselves, their shareholders and managers, banks have created wealth and the rest of society has the debt.
In the pre-crisis version of their textbook, Krugman and Wells (2005, p. 969) had a box, in which they explicitly defended banks against the possible charge of being dishonest, because they promise to pay back deposits in full upon demand, while they know they will not have the liquid funds to do so, if many customers require it at the same time. Krugman/Well's (2005) answer was negative, and they offered a bizarrely out of place comparison to justify this. They equated the expectation of the bank's customers being able to take out their money in the bank at any time they want to the expectation of (potential) customers of car rentals to be able to rent a car any time they want. If too many (potential) customers want to do this at the same time, not enough cars will be available, they remind us. Everybody accepts that, and equally, everybody should accept the risk of losing their money in a bank run, is their conclusion. The fact that banks have entered into a contractual obligation with somebody who entrusted their money to them, while car rentals have not taken any money from potential customers and have not legally promised anybody to give them a car at any time, plays no role in their comparison.

The extensive space that most major textbooks afford to the money multiplier is a relic of the monetaristic Reserve Position Doctrine, which claims that central banks control base money and, through the money multiplier, overall money. ECB policy maker Ulrich Bindseil (2004) is puzzled by the stubbornness with which influential textbook authors teach an outdated doctrine. He blames it on the interest of central bankers to avoid responsibility about unemployment:

> Overall, the 20th century thus seemed to have witnessed in the domain of monetary policy implementation a strange symbiosis between academic economists stuck in reality-detached concepts, and central bankers who were open to such concepts, partially since they allowed them to avoid explicit responsibility. Masking responsibility seemed to be of particular interest whenever the central bank's policies were strongly dis-inflationary and thus causing recession and unemployment.

This kind of deception is not the topic of this paper. Bindseil is quoted here to show that even seasoned policy makers, intimately involved in the interaction of the central bank with commercial banks, considers the money multiplier fetish of economic textbooks an aberration.

Capture by financial interests

The interest of central banks in making their influence on the economy less clear cut might go some way in explaining this aberration. However, there is also the interest of commercial banks in having something hidden. And this interest could be even more influential. There is a complete absence in all major textbooks of any mention of the pecuniary benefit, which banks derive from their role in "the money multiplier". This points to a taboo imposed by the interest of a very powerful group. If you present the money multiplier in the distorted way textbooks do, with banks appearing to be mere intermediaries, it is very hard to see this profitable privilege. Money gets somehow multiplied, but you do not see anybody directly claiming the value of this newly created money.

If you were to describe the process in the less convoluted, direct way, as it really happens, it would be obvious who gets to claim the value of the new money. The borrower who takes a loan of €1000 from the bank gets credited 1000 in deposit money in exchange for the promise to pay back €1000 plus interest. The bank gets interest on deposit money, which it can create out of nothing and which will disappear again from the banking system as the loan is paid back. All it costs the bank is the (usually lower) interest rate it has to pay on the small fraction of reserves required (or necessary) to give a loan of €1000.

The authors of the most influential textbooks are highly recognized economists with very close ties to central banks and to the financial elite. There is no dearth of opportunity in which members of these groups could tell them about perceived anti-finance biases or mistaken thinking, if they had passages in their textbooks, which could be construed as anti-finance or having some perceived bias.

Recently an intense discussion has started about the close ties of economists with the financial industry and about undisclosed conflicts of interest of this sort – a discussion that was almost completely absent until the latest financial crisis. Only in 2012 did the American Economic Association approved a code of conduct for its members. Economist Devesh Kapur (2009) was still a rarity when he spelled out these conflicts of interest in the *Financial Times* in June 2009. He noted that "there would be little chances of being invited to a lucrative talk at Citigroup if one were in favor of sovereign debt-forgiveness in the 1980s, against capital account liberalization in the 1990s or against stock options in the 2000s."

What is still lacking is a serious discussion of the even closer ties of many central bankers with the financial elite and about the undisclosed and unfettered conflicts of interest that arise from them. It is standard for influential central bankers to obtain highly paid jobs in the financial industry after they leave their public office. ECB-board member and chief economist Otmar Issing caused a bit of an uproar, because he did not even obey the informal cool-off period of one year ususally observed by top-ranking ECB officials before taking a job with Goldman Sachs as an advisor after leaving office in 2006.

It would go beyond the scope of this paper to delve much further into this, but a look at a microcosm called Group of Thirty (G30) can serve to illustrate the overly cozy relationship of high finance, central banking and eminent economists.

According to its own website[7], the G30 is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia, whose work impacts the current and future structure of the global financial system by delivering actionable recommendations directly to the private and public policymaking communities. One such set of recommendations was delivered in February 2013 in the form of a report called: "Long Term Finance and Economic Growth".[8] The report reads like a wish-list of the leading internationally active banks. Recommendations include more public-private partnerships, more capital market based (rather than pay-as-you-go) private pension saving, reviving loan-securitization, promoting international capital movements, toning down bank regulation, government guarantees to take away the risk of certain investments.

If you look at the membership of this lobby-group it turns out that it is packed with current and former central bankers with strong ties to the financial industry. Textbook-author Paul Krugman is also among the members, as is Mario Draghi (President of the ECB, formerly Golman Sachs), Mark Carney (President of the Bank of Canada – from July 2013 of the Bank of England – formerly Goldman Sachs), William Dudley (President of the New York Fed, formerly Goldman Sachs), Gerald Carrigan (Goldman Sachs, formerly President of the New York Fed), Axel Weber (UBS, formerly President of Deutsche Bundesbank), Jacob Frenkel (JP Morgan Chase, formerly Governor of the Bank of Israel), Paul Volcker (former Fed-Chairman), Jean Claude Trichet (former President of the ECB), Leszek Balcerowicz (former Governor of the National Bank of Poland), Jaime Caruana (General Manager of the Bank for International Settlements and former Governor of the Bank of Spain), Guillermo de la Dehesa Romero (Santander, formerly Deputy Director of the Bank of Spain), Roger Ferguson (TIAA-CREF, formerly Swiss Re and formerly Vice-Chairman of the Fed), Stanley Fisher (Governor of the Bank of Israel, formerly IMF and formerly Citigroup), Arminio Fraga Neto (Gavea Investimentos, formerly Governor of the Central Bank of Brazil), Philipp Hildebrand (Blackrock, formerly Chairman of the Swiss National Bank), Mervyn King (Governor of the Bank of England until June 2013), Guillermo Ortiz (Grupo Financiero Banorte; formerly Governor of the Bank of Mexico), Masaaki Shirakawa (Governor of the Bank of Japan), Yutaka Yamaguchi (former Deputy Governor of Bank of Japan) and Zhou Xiaochuan Governor of the People's Bank of China).

This makes twenty current or former top-level central bankers of the most important central banks of the world, the majority of which are now holding or have held very senior positions in commercial financial institutions. While this might look like a convenient venue for central bankers to exchange views, it is important to note that active central bankers meet regularly at the Bank of International Settlements in Basel for gatherings which are behind closed doors but nonetheless official. The unofficial Group of Thirty is better characterized as a private sector pressure group dominated by those central bankers who are particularly inclined to straddle the narrow divide between public service and private gain in commercial financial endeavors.

The conflicts of interest arising for this are very relevant for the subject of this paper and might well explain, why leading central bankers and central banks seem to have tabooed talk and research about money creation by commercial banks. As a (rare) economic journalist writing about the workings of the monetary system occasionally, I have routinely been confronted with two reactions in the general public: outrage or disbelief. Since the privilege of having your debt declared legal tender is extremely unusual, this sector has a very big interest in avoiding

[7] http://www.group30.org/
[8] http://www.group30.org/rpt_65.shtml

the first of these two reactions by the public. Pretending that central banks are the only ones "printing" money is a probate strategy to achieve that. Central bankers seem to play along, for reasons that are not too hard to fathom, if you consider the history of important central banks and the typical career path of influential central bankers as evidenced by the membership of the Group of Thirty.

A consequence of the taboo: policy failure

Given the long-standing taboo to talk about money creation/credit creation by commercial banks in a reasonable way even in textbooks, it is no wonder that central bankers and other policy makers did not have the frame of mind to understand what was going on in the credit booms in the run ups to the Asian crisis and the dotcom bubble and the subprime crisis. In the run-up to the most recent financial crisis, banks were pumping massive amounts of credit into the real estate market in the US and in parts of Europe. In the Euro area as an aggregate, this led to many years of double digit growth in credit volumes and in monetary aggregates, including M3, to which the ECB long pretended to pay special attention. Real estate credit increased with excessive rates of up to 30% for years in several countries like Ireland, Greece and Spain. There was a similarity strong lending boom in the US which also was ignored.

The money flowing into real estate created a self-reinforcing bubble of rising prices, a booming economy and even more credit, until the bubble finally burst. According to a large empirical study of Schularick and Taylor (2012) on many historical financial crises, this episode was typical. They characterize most financial crises of the last five decades as "credit booms gone bust".

Even after this failure to understand the role of finance in producing boom and bust cycles was exposed, the intellectual situation has not improved much, if any.

US Secretary of the Treasury Tim Geithner, who had been President of the New York Fed in the run-up to the crisis, said in written testimony to the Financial Services Committee of Congress on September 23, 2009 (quoted from Petifor 2013): "The purpose of the financial system is to let those who want to save, save. It is to let those who want to borrow, borrow. And it is to use our banks and other financial institutions to bring savers' funds and borrowers' needs together and carefully manage the risks involved in transfers between them." No wonder the Fed could not see the credit bubble building that the banks were blowing up, if the President of the most influential Federal Reserve Bank can see banks exclusively as intermediator of pre-existing funds.

Vitor Gaspar, in his capacity as Portuguese Minister of Finance, came to Frankfurt in January 2013 to praise his country's adjustment program. He diagnosed the excessive build-up of debt by households, government and companies as the underlying cause of the Portuguese crisis. This built-up of debt had happened partly while he had been working in Frankfurt for the ECB as head of Economic Research. Commercial banks had provided that excessive credit refinancing with funds from the ECB. It had showed up in double digit growth of the money aggregate M3, which the ECB ignored. However, debt buildup or debt in general was not part of the research program of the ECB. Asked if he would draw any lessons from the diagnostic failure of the ECB and its failure to do anything about this debt buildup, he said: "I am embarrassed, because this is an important question and I have to admit that I have not thought about it. I cannot answer out of hand", (Haering 2013).

The situation in the ECB's economic research department did not improve post Gaspar. A paper in which one could have expected some lengthy and explicit analysis of money and credit creation by commercial banks is the ECB's October 2012 "Report on the first two years of the macro-prudential research network" (European Central Bank 2012).[9] It aims to answer questions like: "How does widespread financial instability affect the real economy? How can the leverage cycle be described theoretically and empirically? How can these models help understand the causes and features of the recent financial crisis.

You would not easily infer from reading this 80 page review of the state of knowledge by the ECB that this is about a crisis produced by a credit boom. The tabooed expressions credit creation or money creation do not appear. The expression "credit boom" is used twice in a rather cursory way, barely enough to include the paper by Schularick and Taylor (2012) in the reference list. The work of Minsky on financial instability, which focuses on cycles in credit creation is mentioned once, but not at all discussed. Neither is the work of scholars, who do not obey the loanable funds doctrine but rather have included credit creation in their models and were able to predict the latest crisis on that basis, like Robert Shiller, Nouriel Roubini, Steve Keen, Michael Hudson, Dean Baker and Wynne Godley. The list is from Bezemer (2009). None of these are included in the references.

In the rhetoric of this ECB report, banks do not create and destroy credit and money. All they do is increase or decrease their leverage, which is defined in the report as the ratio of debt to equity.

In its Monthly Report of October 2012 (European Central Bank 2012, p.56), the ECB's economics department makes the fallacious thinking behind this explicit: "The concept of monetary liquidity attempts to capture the ability of economic agents to settle their transactions using money, an asset the agents cannot create themselves." As Knibbe, Mahé and Schrijvers (2013) point out, this refusal of the ECB economics department to accept the fact that private agents can create money is in direct contradiction to the very monetary statistics that the ECB assembles and presents. These are based squarely upon the idea that banks can create money and even legal tender.

Conclusion

This paper aimed to give substance to the claim that central bankers and prominent textbook authors share a desire to let us think that the creation of the vast majority of our means of payment by commercial banks for their own benefit is normal, harmless, without alternative and under the control of the central banks. Central bankers do so by avoiding any mention of private money creation or credit creation, and by pretending instead that central banks have a monopoly to create money. Textbook authors do so by distorting the process of money creation, using the rhetoric of the inappropriate loanable funds model. Their account of the role and legal status of central banks is highly selective and biased. Alternative monetary systems are hardly ever seriously discussed.

The result is that even five years into the financial crisis brought about by a long and pronounced credit boom, economists working for central banks and most prominent

[9] http://www.ecb.int/pub/pdf/other/macroprudentialresearchnetworkreport201210en.pdf

economist outside central banks still seem to lack a frame of mind that would allow them to understand credit cycles.

The look into the history of central banks and the mechanisms by which commercial banks create money has revealed that there is indeed an important element in the nature of central banks of serving the interests of the banking community. We have seen that leading textbook authors and central bankers are actively trying to disguise this. This should be kept in mind then assessing the appropriateness of letting independent central banks, which do not have to answer to the electorate or their representatives, wield wide ranging powers in economic policy and banking supervision.

A suggestion for further research is to examine, how the major scholarly journals, notably finance journals, deal with these issues. Cursory observation suggests that credit creation or money creation are taboo words in the leading journals. The strong role of economists very closely related to the Federal Reserve System in the leading finance journals might go pretty far in explaining any such finding.

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