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Critique:

Richard A. Werner. 2014. “Can banks individually create money out of nothing?” *International Review of Financial Analysis* 36 (2014) 1–19

http://www.sciencedirect.com/science/article/pii/S1057521914001070

Misuse of the term “money”

Professor Werner uses the term “money” indiscriminately including bank-created deposits which are not money. The misapplication of the term “money” is not saved by the public’s misconception which treats bank deposits as money, or as Irving Fisher (1935) writes, “check book money”.[1]

Money is legal tender, not bank-created deposits by way of double-entry bookkeeping. Only central banks create legal tender. Bank-created deposits are also known as quasi-money as opposed to high-powered central bank money. Quasi-money cannot leave a bank that created it. The so called payment systems in its daily clearing only offsets incoming requests for deposit against outgoing requests for deposit which is not a transfer of money but a netting of each bank’s position against the clearing house which conducts the so called payment system. During the global financial crisis 2007 and beyond, the payment clearing broke down and was maintained my massive loans by the central banks to individual systemic banks of legal tender to the tune of $10 trillion in dollars, pounds and euros as well as currency swaps between the central banks.

The indiscriminate use of the term “money” for bank deposits sanctifies bookkeeping entries with settlement powers in the nature of legal tender which they are not, except that part of bank deposits which is covered by legal tender, normally around 5% not more.

Would I be happy to receive my million euro lottery winnings in the form of a bank deposit. Of course, I would, like a fish flocking to water, and so does every participant in the day-to-day economy.

The point of discussion, however, more serious, is whether a system of producing quasi-money is sustainable, or does it benefit the quasi-money creating banks at the expense of the public and the public purse which must go and borrow their fictitious trash to cover budget deficits, resulting in unsustainable national debts, resulting in the so called euro crisis and austerity programs in Ireland and the South of Europe, where unemployment among a lost generation of young peoples is 50%. And if the banks fail, why must their losses be socialized instead of changing the unworkable system which has caused ongoing financial crises for the past 300 years without any hope of ever ending. [2]

Political economist are entrusted with running our central banks, bank regulators, and populate the Basel Committee on Banking Supervision, creating capital adequacy requirements under ancient misconceived textbook notions of what is money, what protects deposits, and since 1988 have not

[1] Irving Fisher. 1935. “100% Money: Designed to keep checking banks 100% liquid; to prevent inflation and deflation; largely to cure or prevent depression; and to wipe out much of the National Debt.” New York: Adelphi Press; reprinted 2011 ThaiSunset Publications ISBN 9781463553357.
[2] Michael Schemmann. 2014. “The Ten Day Banker. Professional Guide.” IICPA Publications.

prevented any of the world's disastrous financial crises, asset bubbles, and currency collapses including the so called euro crisis.

We are still in the Global Financial Crisis of 2007 and beyond. Nothing has been fixed while our economists dream the dream of a thousand years in their cozy quarters, their ivory towers. They are not professional accountants, bankers, financial analysts; have no grasp on banking realities which they bathe in their own illustrious theories.

Let's hear:

To his credit, Professor Werner laments that "there has been no progress in scientific knowledge in economics, finance and banking in the 20th century concerning one of the most important and fundamental facts for these disciplines. Instead, there has been a regressive development. The known facts were unlearned and have become unknown. This phenomenon deserves further research. For now it can be mentioned that this process of unlearning the facts of banking could not possibly have taken place without the leading economists of the day having played a significant role in it. The most influential and famous of all 20th century economists, as we saw, was a sequential adherent of all three theories, which is a surprising phenomenon." The name Keynes is mentioned who "used his considerable clout to slow scientific analysis of the question whether banks could create money, as he instead engaged in ad hominem attacks on followers of the *credit creation theory*. Despite his enthusiastic early support for the *credit creation theory*…"

The three theories on the functioning of the banking sector

Werner writes "The three theories are based on a different description of how money and banking work and they differ in their policy implications. Intriguingly, the controversy about which theory is correct has never been settled. As a result, confusion reigns: Today we find central banks – sometimes the very same central bank – supporting different theories; in the case of the Bank of England, central bank staff are on record supporting each one of the three mutually exclusive theories at the same time…"

Banking is accounting by (1) recognition of a transaction, (2) determining a value on the transaction, (3) recording the transaction, and (4) reporting the transaction as it affects the entity's results of operations (income statement), financial position (balance sheet), and liquidity (cash flow statement), in accordance with generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS).

IFRS and GAAP are the concept, the framework, the principles, rules and regulations. That is the theory and nothing else. If there is a discord between the creation of bank deposits and the concepts, framework and principles, then the creation constitutes a breach, if serious a fraud, and has its resolution in professional disciplinary proceedings and eventually the criminal justice system.

Now comes academe and turns the underlying simplicity into complexity by describing bank practices and giving them the names of theories. Even if bankers did care to know, which they don't, which theory is the right one, the credit creation, fractional banking or intermediary theories, none of the three being mutually exclusive may in fact co-exist.

Regarding fractional reserve banking: The central banks' minimum reserves of legal tender, as a matter of fact, impose a fractional reserve system. Minimum reserves have not been abandoned except in Canada, the UK and Sweden.

Regarding the intermediary theory: In the daily payment clearing, banks may obtain claims against the central bank or the payment clearing house and credit deposit accounts as instructed. If banks then go and make deposits for others by way of loans, these are in addition to the deposit made upon receipt as instructed. If the amount of liquid assets held by the banks remains unchanged, then the additional deposits created by the banks increase the risk of illiquidity in case of demands for redemption of the deposits. Depositors' rights of redemption can be slowed by requiring notice to the bank which is the idea behind time deposits including savings deposits.

The fractional reserve theory, and for that matter also the intermediary theory, highlights the received assets without, or without sufficient, regard of the corresponding liabilities simultaneously incurred with the receipt of assets. It is not even a theory, but an expression of wishful thinking of a multiplier effect (or intermediation by relocation), in that a bank receiving assets for deposit could create deposits (intermediary theory), or additional deposits (fractional reserve theory, unless received in the form of central bank reserves) that it could not previously create.

Basel capital adequacy requirements

Werner writes that the Basel I and II are based on the financial intermediary theory, and "If the financial intermediation theory is not an accurate description of reality, it would throw doubt on the suitability of Basel III and similar national approaches to bank regulation, such as in the UK."

A banking theory is a thought model developed by economists in the ivory tower not on the floor of reality. Banking's reality is accounting and nothing else. Under GAAP and IFRS bank capital is not a protector of deposits which the Basel Accords aim to achieve, because liquid assets are required to redeem deposits, while capital is a residual of total assets minus total liabilities and is shown on the liability side of the balance sheet. How can one liability pay another?

Werner admits that Basel I and II have not prevented banking crises, let alone the Global Financial Crisis. Only the massive injection of trillions of dollars/pounds/euros of high powered central bank money prevented the world's payment system collapse if one disregards the refusal of the central banks to save Lehman Brothers, an inexcusable blunder of economists misplaced at the switches of monetary power (Professors Ben Bernanke US Fed and Mervyn King, Bank of England and their ministers of finance Hank Paul, US, and Alistair Darling, UK).

All in all, it is NOT important "for research and policy to determine which of the three theories is an accurate description of reality."

Underlying complexity is simplicity promulgated by GAAP and IFRS, both of which are massively violated by the reporting banks creating deposits by monetizing promises and recording the corresponding assets as loans receivable.[3] Complexity created by economic theories masquerading as descriptions of reality may lead us to some very remote places.

John Kenneth Galbraith (1975) in "Money. Whence It Came, Where It Went," Chapter 1, "Money":

> "A word must be said about the frame of mind in which one wishes the reader to approach a book [on money] such as this. Much discussion of money involves a heavy overlay of

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[3] Michael Schemmann. 2015. "Putting a Stop to Fictitious Bank Accounting. With a Plan to Redeem the US and Euro Area National Debts." IICPA Publications; — 2012. "Accounting Perversion in Bank Financial Statements: Root Cause of the Ongoing Global Financial Crisis." IICPA Publications.

> priestly incantation. Some of this is deliberate. Those who talk of money and teach about it and make their living by it gain prestige, esteem, and pecuniary return, as does a doctor or a witch doctor, from cultivating the belief that they are in privileged association with the occult – that they have insights that are not available to the ordinary person. Though professionally rewarding and on occasion personally profitable, this too is a well-established form of fraud. There is nothing about money that cannot be understood by the person of reasonable curiosity, diligence and intelligence."

Werner refers to Keynes who argued that a bank with excess reserves at the Bank of England can make an additional loan which creates an additional deposit on the balance sheet of this or some other bank, referring the reader to the "ECB's proposal to introduce negative interest rates on banks' reserve holdings at the central bank, as an incentive for them to 'move' their money from the central bank and increase lending." Money created by a bank including the EC cannot leave the bank or ECB, only transfer by way of offset. Negative interest is therefore a punitive charge if not on the one bank holding the reserves or on another receiving the reserves, the ECB punishing the hindmost. Negative interest on central bank reserves cannot be avoided by the banking system as a whole through lending. Once again, economic theory by the learned economist from MIT, Professor Mario Draghi, is utterly misconceived, including Richard Werner, who apparently accepts.

Werner's "Empirical test"

Professor Werner's empirical study with a population of 1 is a case study from which inferences are made that cannot be generalized.

When I was a young banker in training, fresh out of high school, I went to the Landeszentralbank of the Deutsche Bundesbank in Kassel, Germany, on a daily, sometimes hourly, basis, depositing and withdrawing large amounts of cash. Every morning, we sent a telex to Frankfurt head office's treasury desk, advising our cash position in the Postal Chequing Account, saying "dispose of XXX amounts of Deutsche Mark postal chequing". The Commerzbank Frankfurt's central treasury desk was very keen of knowing the bank's overall liquidity in order to lend or borrow excess reserves within the banking system, one bank's shortages always ending as an other bank's surpluses.

It should be noted that of Werner's local Raiffeisenbank, the bank being a member of the 100 times larger Raiffeisen banking system, was large holding interbank loans receivable that act as the slush fund for interbank payment imbalances, presumably within the Raiffeisen System. A statement by the lending officer in writing, that the bank did not inquire of its reserve position to guard against illiquidity before making a demand loan of only 200,000 euros is a very small matter to support any conclusion.

I spent the first 15 years of my life-long career in commercial and investment banking in Germany, Switzerland under the illustrious best-selling author Paul E. Erdman, and Canada moving up the ranks from apprentice to accountant, to credit officer and eventually controller at corporate credit in charge of three Canadian provinces, taking out an MBA and PhD in California before becoming a licensed Certified Public Accountant in the State of Washington, eventually retiring as an author and professor of accounting & finance and department chair in South East and Central Asia. I would think I have seen it all: fixed foreign exchange rates, the closing of the London Gold Pool, the Savings & Loan debacle in the United States, the rise of Microsoft and the IT revolution, the introduction of the euro, and then the Global Financial Crisis, the failure of Lehman Brothers, General Motors, and now what—Volkswagen?

One thing sticks in my mind. I remember asking my boss, the powerful general manager at corporate credit of the Bank of Nova Scotia in Toronto, Reginald Gage, how the bank got all the hundreds of millions of dollars for which we had just made loans in the daily credit meeting. He answered: “Don’t worry, Mike. We’ll find it somewhere.” My boss did not know. No one in this large Canadian chartered bank knew, except the chief treasury officer, but he did not tell. I went to research the matter on my own and published my first book a few years later: Michael Schemmann, 1992, “Money in Crisis,” Vancouver, Canada1992, learning by reading Irving Fisher, the Chicago Plan, and everything else I could find in the book stacks of the magnificent library at the University of British Columbia.

Werner’s thought experiments include accounting entries.

In observance of the fractional reserve system, he proposes the following entries for a bank loan in the amount of 200,000 units of account, say euros.

Table 2

Step 1 - Suggested “Precondition”:

ASSETS		LIABILITIES	
Excess reserves at the central bank	200,000	Deposits	200,000

Step 2 – Suggested “The bank loan”:

ASSETS		LIABILITIES	
Excess reserves at the central bank	- 200,000		
Loans and investments	200,000		

To an accountant, the suggested accounting treatment appears to be flawed.

The making of a loan by creating the alleged asset “loans and investments” of 200,000 should result directly in the corresponding deposit creation of 200,000. The suggested results do not show that.

Werner’s notional reduction of excess reserves at the central bank should not be booked into the financial accounting system because there is no outflow of funds from the central bank. It should therefore be treated an off-balance sheet memory entry reducing the balance in the excess reserves control account, not the actual bank account. Under fractional reserve, not the whole loan amount reduces the excess reserves at the central bank, but only a fraction of the loan amount, say 20,000 or 10%. A single reduction of the excess reserves control account, which must not be negative, is sufficient; the rules of double-entry bookkeeping do not necessarily apply to control accounts.

The results of the correct control and financial accounting entries are as follows:

Step 1 - “Precondition”:

MEMORY – CONTROL ACCOUNT	
Beginning balance	Say 3,000,000
Reduction based on the creation of	- 20,000

200,000 additional deposits	
Ending balance	2,980,000

Step 2 – “The bank loan”:

ASSETS		LIABILITIES	
Loans and investment	+ 200,000	Deposits	+ 200,000

Assume the depositor’s loan proceeds are immediately paid out in funds at the central bank resulting in an asset switch, increasing loans and investment while decreasing central bank account balance.

Step 1 – The control account if loan paid out in FULL with central bank funds:

MEMORY – CONTROL ACCOUNT	
Beginning balance	Say 3,000,000
Excess reserves at the central bank control	- 200,000
Ending balance	2,800,000

Step 2 – “The bank loan” if paid out in central bank funds:

ASSETS	
Loans and investment	+ 200,000
Central bank account balance	- 200,000

Werner then goes on to show the accounting impact for bank lending under the intermediary theory of banking, stating that “If banks are merely financial intermediaries, indistinguishable from other intermediaries, then all bank funds are central bank money that can be held in reserve at the central bank or deposited with other banks. The balance sheet implications are shown below in [Werner’s] Table 3. According to this theory, the bank balance sheet does not lengthen as a result of the bank loan: the funds for the loan are drawn from the bank's reserve account at the central bank.”

Werner’s proposed accounting treatment under the intermediary theory of banking:

ASSETS	
Excess reserves at the central bank	- 200,000
Loans and investments	+ 200,000

Werner shows the accounting treatment as a switch in assets: A decrease of the central bank balances with a corresponding increase of the loans and investments.

Once again, to an accountant Werner’s accounting treatment appears to be flawed.

The *intermediary function* of a bank is a theory only, not a fact. At best the above treatment by Werner reflects the 100% Money proposal by Irving Fisher (1935) who proposed that all bank deposits be covered 100% by balances at the central bank.

The accounting treatment under GAAP and IFRS must reflect economic reality, or what the banks perceive to be such and the auditors agree, not economic theory.

The accounting treatment during the last 100 years, as I have learned and seen to be done is to increase the asset account of loans receivable by 200,000 and increase the liability account by the corresponding deposit of 200,000 in the same manner as under the so called fractional reserve system, but without the memory entries in the excess reserve control account, except when minimum reserves at the central bank are a regulatory requirements.

ASSETS		LIABILITIES	
Loans and investments	+ 200,000	Deposits	+ 200,000

If minimum reserve requirements are present, the excess reserve control account must receive a charge reflecting the change in the required reserves, not the actual reserves, this entry being made by the lending bank's internal controller or the bank's treasury department, not the financial accounting department.

Werner's description of the loan obtained from a Raiffeisenbank in Germany states his surprise that his loan proceeds (the deposit of 200,000 euros) were not segregated but reported as customer deposits on the liability side of the bank's daily financial statement (balance sheet). He states: "This contradicts the financial intermediation theory, which assumes that banks are not special and are virtually indistinguishable from non-bank financial institutions that have to keep customer deposits off balance sheet." In England, not in Germany.

The banks would reply that the inclusion of the bank's customer deposits in the bank's liabilities reflects economic reality, supported by the legal position that the banks customers are general creditors for amount in excess of 250,000 euros.

Germany's finance minister Wolfgang Schäuble went so far as to impose haircuts on depositors of failed Cypriot banks, arguing like a lawyer who is, that creditors of a failed bank must contribute to the resolution of a bank in bankruptcy, making no distinction between a commercial entity and a depository institution.

If and when reserve requirements are 100% — under Irving Fisher's 100% Money system, the so called "Vollgeld" System, which is the German term — then customer deposits ought to be shown narrow as a reduction of the bank's balances at the central bank instead of broad on the bank's liability side.

Example:

ASSETS		
Central bank balances	3,000,000	
Less: Customers' demand deposits	- 2,900,000	
Net amount (which must not be negative)		100,000
Loans and investments		xxx,xxx
Other assets		xx,xxx
Total assets		**xxx,xxx**

LIABILITIES

Savings deposits with notice requirements	xxx,xxx
Time deposits	xxx,xxx
Long-debt	xxx,xxx
Capital equity	xx,xxx
Total liabilities and equity	**xxx,xxx**

Werner's article excels as a literary review. For a trained banker and certified public accountant, his insights into the art of accounting for banks are mixed at best. Too much learned theory, not enough hands-on practical knowledge. Bankers and industry know this to be true, and students really know it, demanding practical training of the kind which the professions such as accounting and auditing, financial analysis, and law provide.

The empirical evidence presented by Werner can be derived from the banks' published financial statements to demonstrate that commercial bank created customer deposits by monetizing customers' promises is an abuse of the five-hundred year old art of double-entry bookkeeping.[4]

[4] Michael Schemmann, 2012