expand credit to the maximum of their ability. Why not? Loans are interest-earning assets, and in good times there is little fear of borrowers' defaulting. But if depression clouds appear on the economic horizon, bankers may hastily withdraw their invitations to borrow, seeking the safety of liquidity even if it involves the sacrifice of potential interest income. Bankers may fear the large-scale withdrawal of deposits by a panicky public and simultaneously doubt the ability of borrowers to repay. It is not too surprising that during some years of the depression of the 1930s, banks had considerable excess reserves but lending was at a low ebb. Obviously, if the amount actually lent by each trading bank falls short of its excess reserves, the resulting multiple expansion of credit will be curtailed.

The need for control

The fact that bankers may not expand the supply of money to their maximum ability is of more than passing interest. It may be a factor which contributes significantly to business fluctuations. By holding back on credit expansion as the economy begins to slip into a depression, the trading banks may further inhibit total spending and intensify that cyclical downswing. Conversely, by lending and thereby creating money to the maximum of their ability during prosperity, trading banks may contribute to an excess of total spending and to the resulting inflationary pressures. Chapter 16 will explore the means by which the Reserve Bank attempts to influence the lending policies of trading banks so that they will offset rather than enforce cyclical fluctuations.

SUMMARY

1. Trading banks create money — that is, current deposits, or bank money — when they make loans. The creation of current deposits by bank lending is the most important source of money in Australian capitalism.
2. The ability of a single trading bank to create money by lending depends upon the size of its *excess* reserves. Generally speaking, a trading bank can lend only an amount equal to the size of its excess reserves. It is thus limited because, in all likelihood, cheques drawn by borrowers will be deposited in other banks, causing a loss of reserves and deposits to the lending bank equal to the amount which it has lent.
3. The trading bank system as a whole can lend by a multiple of its excess reserves because the banking *system* cannot lose reserves, although individual banks can lose reserves to other banks in the system. The multiple by which the banking system can lend is the reciprocal of the reserve ratio. This multiple credit expansion process is reversible.