

likelihood that cheques for the entire amount of the loan will be drawn and cleared against the lending bank. A lending bank can anticipate the loss of reserves to other banks equal to the amount it lends.<sup>6</sup>

If trading banks create current deposits — that is, money — when they make loans, it seems logical to inquire whether money is destroyed when the loans are repaid. The answer is “Yes”. Using balance sheet 6b, let us see what happens when the Grisley company repays the \$50 000 it borrowed.

To simplify, we shall (1) suppose that the loan is repaid not in instalments but rather in one lump sum three years after the date of negotiation, and (2) ignore interest charges on the loan. The Grisley company will write a cheque for \$50 000 against its current deposit, which presumably has been fattened by extra profits resulting from the company’s expanded operations. As a result, the Wahoo Bank’s current-deposit liabilities decline by \$50 000; the Grisley company has given up \$50 000 worth of its claim against the bank’s assets. In turn, the bank will surrender the Grisley company’s IOU which it has been patiently holding these many months. The bank and the company have reswapped claims. But the claim given up by the Grisley company is money; the claim it is repurchasing — its IOU — is not. The supply of money has therefore been reduced by \$50 000; that amount of current deposits has been destroyed, unaccompanied by any increase in the money supply elsewhere in the economy. The Grisley company’s IOU has been “demonetised”. On the Wahoo Bank’s balance sheet, demand deposits and loans both fall by \$50 000. You will note that the decline in current deposits increases the bank’s holdings of excess reserves; this provides the basis for new loans to be made.

In the highly unlikely event the Grisley company repays the loan with cash, the supply of money will still decline by \$50 000. In this case, the Grisley company would repurchase its IOU by handing over \$50 000 in cash to the bank. This causes loans to fall on the bank’s balance sheet by \$50 000 and, obviously, cash to increase by \$50 000. Remember that we specifically excluded currency held by banks from the money supply on the ground that to

include such cash would be double counting; it is apparent that this constitutes a \$50 000 reduction in the supply of money.

*Transaction 7: Buying government securities*

When a trading bank buys government bonds, the effect is substantially the same as that of lending. New money is created. To illustrate, let us assume that the Wahoo Bank’s balance sheet initially stands as it did at the end of transaction 5. Now assume that, instead of making a \$50 000 loan, the bank buys \$50 000 of government securities from a securities dealer. The bank receives the interest-bearing bonds which appear on its balance statement as the asset “Securities” and gives the dealer an increase in its demand-deposit account. The Wahoo Bank’s balance sheet would appear as follows:

**Balance sheet 7: Wahoo Bank**

Liabilities and net worth		Assets	
Current deposits*	\$100 000	Reserves	\$ 60 000
Capital stock	250 000	Securities*	50 000
		Property	240 000

The important point is that current deposits, that is, the supply of money, have been increased by a total of \$50 000, as in transaction 6a. *Trading bank bond purchases increase the supply of money in the same way as does lending to the public.* The bank accepts government bonds — which are not money — and gives the securities dealer an increase in its current deposits — which is money.

Of course, when the securities dealer draws and clears a cheque for \$50 000 against the Wahoo Bank, the bank will lose both reserves and deposits in that amount and therefore will just be meeting the legal reserve requirement. Its balance sheet will now read precisely as in 6b except that “Securities” is substituted for “Loans” on the asset side.

Finally, as you undoubtedly suspect, the selling of government bonds by a trading bank —

<sup>6</sup> Qualification: If some of the cheques written on a loan are redeposited back in the lending bank by their recipients, then that bank will be able to lend an amount somewhat greater than its initial excess reserves.