Macroeconomics and Finance textbooks misrepresentations of Money and Banking:
An alternative way to teach money and banking through balance sheets

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The paper illustrates the misconceptions spread by bestseller Macroeconomics and Finance textbooks about the money creation process by commercial banks and central banks. Despite the pedagogical efforts of central banks, such as the Bank of England in McLeay *et al.* (2016 a and b), and other organisations, such as IMF in Kumhof and Jakab (2016), to get the story straight, leading textbooks in Macroeconomics or in Finance, even in their latest editions, still perpetuate wrong ideas that undermine the understanding of phenomena involving banks and central banks, such as fractional reserve banking, intermediation, securitisation or quantitative easing to name only a few. There are concerns that these enduring misrepresentations are contributing to the demonisation of banks in the eye of the public, which paints banks as fraudulent creators of money out of thin air or blames them for sitting on their reserves instead of lending to businesses in period of crisis. More worryingly, there is some evidence that some misconceptions have found their way in academic research in banking.

The paper outlines a common key assumption used in textbooks that triggers a series of mistakes. Systematically, banknotes (cash) are assumed to be the default and original form of money for households and businesses; this results in perceiving bank deposits as exclusively deposits of notes in banks and viewing loans as the cash from deposits that are given away rather than being kept as reserves. A second assumption, linked to the first one, is to present banknotes as the default form of money for banks, with the implication that central bank deposits come exclusively from deposits of banknotes by banks at the central bank. One could argue that simplifications are necessary at the early stage of learning economics and that more complex representations will follow in advanced courses. This does not apply here though, as the assumption used is actually not a simplification or a short-cut but a mistake. Many incorrect stories have been built on the wrong foundations and it is likely that that vision is strongly set in students' mind. The paper provides a few examples from leadings textbooks such as Mankiw (2018), Dornbusch *et al.* (2017), Hubbard and O'Brien (2018), and Mishkin and Eakins (2018), that have been badly impacted by presenting banknotes as the default form of money or by overlooking the specificity of banks' balance sheet.
These examples relate to the money multiplier, fractional reserve banking, the intermediary role of banks channelling funds from savers to borrowers, the money supply in the money market, or even securitisation.

The paper then proposes an alternative approach that puts bank deposits as the default form of money for households and businesses and central bank deposits as the default form of money for banks. It also acknowledges the specificity of banks and central banks' balance sheets operation. Banks and central banks by managing money in their liabilities have a balance sheet working very differently from the balance sheet of other agents in the economy; one of these specific features, among many others, is that banks create the bank deposits that they lend and do not need funding for their loans in the traditional sense.

The author recommends then a particular sequence of steps that can be followed to provide students with solid foundations. This approach has been developed in an undergraduate course ECON3210 Financial markets and institutions at the University of Queensland,

Australia and will be available as open source in Bracoud (2022). Step 1) the direct payment in bank deposits between two depositors and the role of central bank deposits in settling the payment; Step 2) the source of additional central bank deposits from the RBA or the interbank markets to allow banks in deficit to manage the payment system; Step 3) the creation or destruction of bank deposits in the financial system for all transactions involving a bank dealing with a non-bank party; the case of bank loans is only one example of these many creation of money by banks; Step 4) the issue of liabilities that do not bring funds to banks and the purchase of assets that do not cost funds from the banks; the case of bank loans is only one example of these purchase of assets that do not cost money; and Step 5) the creation or destruction of central bank deposits for all transactions involving the central bank dealing with business, households or banks. For each of these 5 steps, the paper explains its pedagogical rationale, shows the balance sheets in operation at that step and distinguishes each type of money involved with a different symbol to fully acknowledge that they circulate in separate networks.

Equipped with these tools, the paper then revisits some of the examples of the Macroeconomics and Finance textbooks, such as the money multiplier, the role of banks in the channelling of funds in the economy, and securitization, and offers a new way to present them that is compatible with bank deposits as the default form of money and banks' balance sheet special operation.

[835 words]

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economics education, banks, central banks, money creation, oversimplification

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