DEBUNKING THE MYTHS OF MONEY AND ECONOMICS

POLICY ROUNDTABLE
6 November 2018
Brussels

PositiveMoney Europe

What do these two politicians have in commons?

“MONEY DOES NOT GROW ON TREES”

*"There isn't **a magic money tree** that we can shake that suddenly provides for everything that people want."*

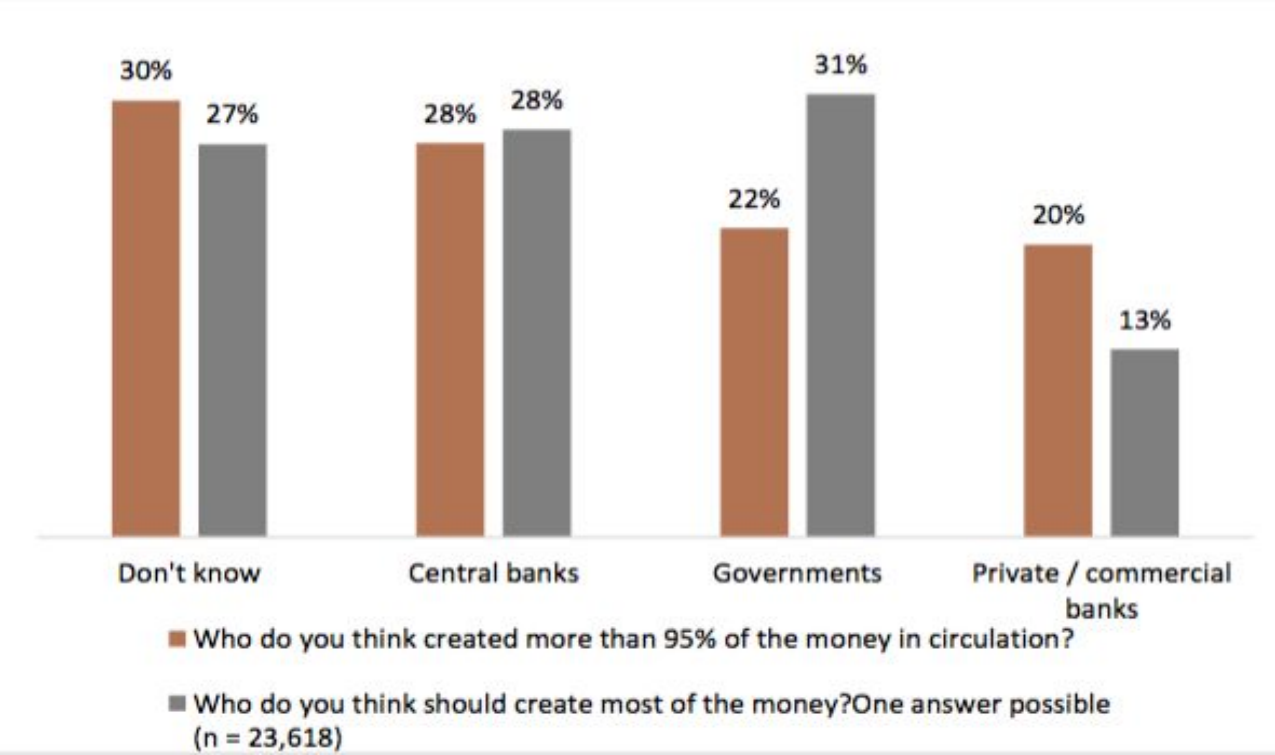
*"There is **no magic money.** (…) in a country where we have never reduced our public deficit…. Your children will pay for it."*

Who creates money?

95% of the money is created by commercial banks

And yes, I'm talking about those guys:

What People think



"Commercial [i.e. high street] banks create money, in the form of bank deposits, by making new loans."

Money creation in the euro area

European Central Bank **Commercial banks** **People & businesses**

Commercial banks can also create so-called "inside" money, i.e. bank deposits – this happens every time they issue a new loan. The difference between outside and inside money is that the former is an asset for the economy as a whole, but it is nobody's liability. Inside money, on the other hand, is named this way because it is backed by private credit: if all the claims held by banks on private debtors were to be settled, the inside money created would be reversed to zero. So, it is one form of currency that is created – and can be reversed – within the private economy.

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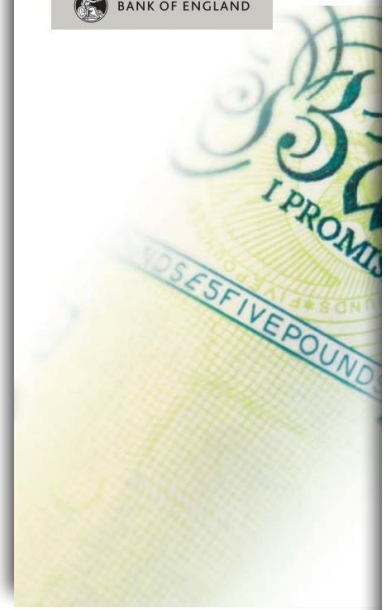
BANK OF ENGLAND



Money creation in the modern economy

By Michael McLeay, Amar Radia and Ryland Thomas of the Bank's Monetary Analysis Directorate.(1)

- This article explains how the majority of money in the modern economy is created by commercial banks making loans.
- Money creation in practice differs from some popular misconceptions — banks do not act simply as intermediaries, lending out deposits that savers place with them, and nor do they 'multiply up' central bank money to create new loans and deposits.
- The amount of money created in the economy ultimately depends on the monetary policy of the central bank. In normal times, this is carried out by setting interest rates. The central bank can also affect the amount of money directly through purchasing assets or 'quantitative easing'.

Overview

In the modern economy, most money takes the form of bank deposits. But how those bank deposits are created is often misunderstood: the principal way is through commercial banks making loans. **Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money.**

The reality of how money is created today differs from the description found in some economics textbooks:

- Rather than banks receiving deposits when households save and then lending them out, bank lending creates deposits.
- In normal times, the central bank does not fix the amount of money in circulation, nor is central bank money 'multiplied up' into more loans and deposits.

Although commercial banks create money through lending, they cannot do so freely without limit. Banks are limited in how much they can lend if they are to remain profitable in a competitive banking system. Prudential regulation also acts as a constraint on banks' activities in order to maintain the resilience of the financial system. And the households and companies who receive the money created by new lending may take actions that affect the stock of money — they could quickly 'destroy' money by using it to repay their existing debt, for instance.

Monetary policy acts as the ultimate limit on money creation. The Bank of England aims to make sure the amount of money creation in the economy is consistent with low and stable inflation. In normal times, the Bank of England implements monetary policy by setting the interest rate on central bank reserves. This then influences a range of interest rates in the economy, including those on bank loans.

In exceptional circumstances, when interest rates are at their effective lower bound, money creation and spending in the economy may still be too low to be consistent with the central bank's monetary policy objectives. One possible response is to undertake a series of asset purchases, or 'quantitative easing' (QE). QE is intended to boost the amount of money in the economy directly by purchasing assets, mainly from non-bank financial companies.

QE initially increases the amount of bank deposits those companies hold (in place of the assets they sell). Those companies will then wish to rebalance their portfolios of assets by buying higher-yielding assets, raising the price of those assets and stimulating spending in the economy.

As a by-product of QE, new central bank reserves are created. But these are not an important part of the transmission mechanism. This article explains how, just as in normal times, these reserves cannot be multiplied into more loans and deposits and how these reserves do not represent 'free money' for banks.

Click here for a short video filmed in the Bank's gold vaults that discusses some of the key topics from this article.

(1) The authors would like to thank Lewis Kirkham for his help in producing this article.

Die Rolle von Banken, Nichtbanken und Zentralbank im Geldschöpfungsprozess

Die im Zuge der Finanz- und Staatsschuldenkrise ergriffenen expansiven geldpolitischen Sondermaßnahmen des Eurosystems ließen die Zentralbankguthaben der Geschäftsbanken im Euro-Währungsgebiet stark ansteigen. Die Tatsache, dass die jahreswachstumsrate der Geldmenge M3 in den letzten zwei Jahren dennoch auf einem moderaten Niveau verharrte, hat das Interesse an den Zusammenhängen zwischen der Schaffung von Zentralbankguthaben und dem Wachstum der breiter gefassten Geldmenge neu entfacht.

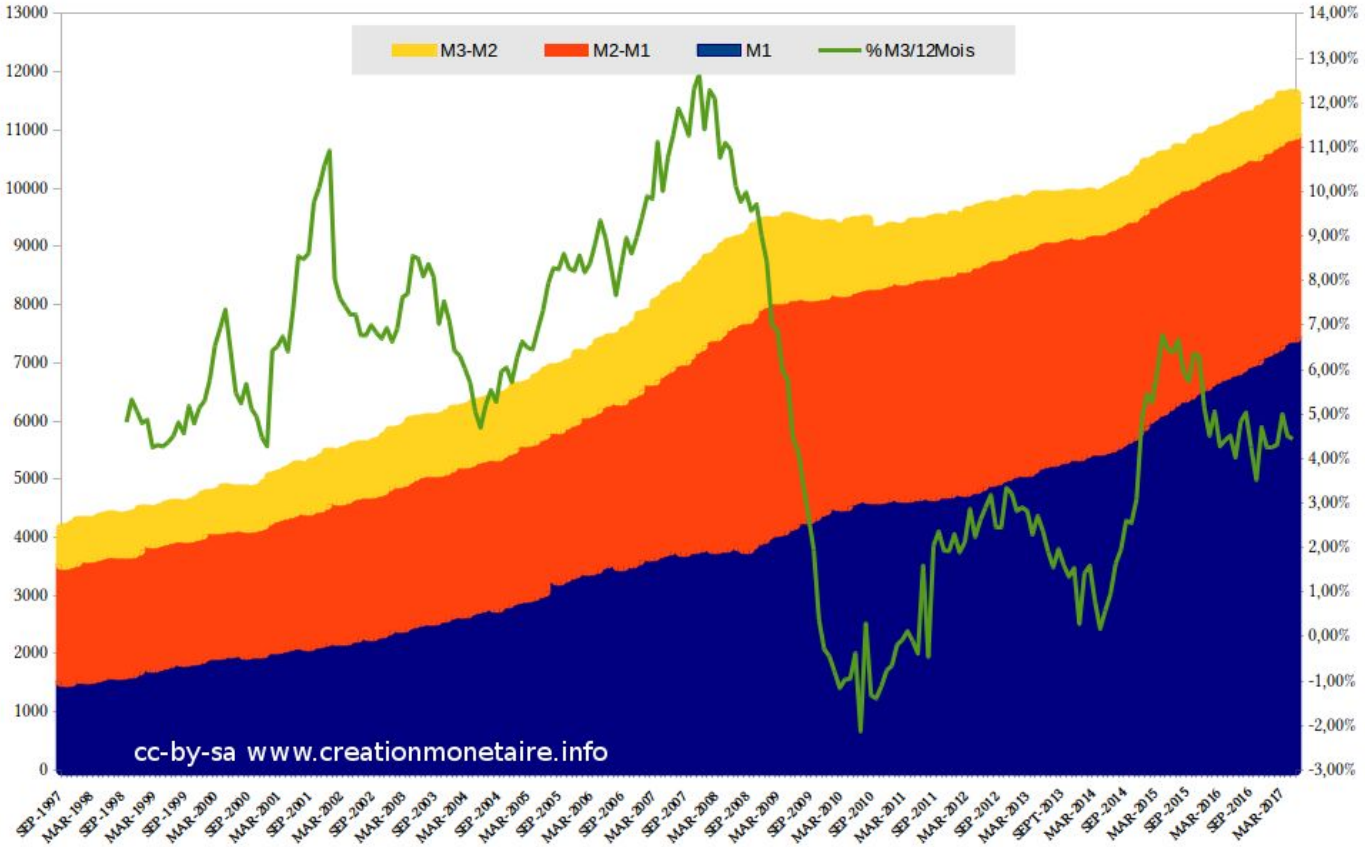
Bereits die rein buchungstechnische Betrachtung der Entstehung von Buch-Geld verdeutlicht, dass die Kredit- und Geldschöpfung das Ergebnis komplexer Interaktionen zwischen Banken, Nichtbanken und Zentralbank ist. Dabei hängt die Fähigkeit der Banken, Kredite zu vergeben und Geld zu schaffen, nicht davon ab, ob sie bereits über freie Zentralbankguthaben oder Einlagen verfügen. Vielmehr wird der Geldschöpfungsprozess durch eine Reihe von ökonomischen und regulatorischen Faktoren begrenzt. Bankintern findet die Geldschöpfung ihre Grenzen im Ertrags-Kosten-Kalkül der einzelnen Banken sowie in makro- und mikroprudenziellen Regulierungsvorschriften. Darüber hinaus wird deutlich, dass auch die Kreditnachfrage und das Portfolioverhalten der Nichtbanken die Geldschöpfung beschränken. Die Zentralbank beeinflusst den Geld- und Kreditschöpfungsprozess in normalen Zeiten über die Zinspolitik, die über verschiedene Transmissionskanäle auf die Finanzierungs- und Portfolioentscheidungen der Banken und Nichtbanken wirkt.

Auch unkonventionelle geldpolitische Maßnahmen können die Geld- und Kreditschöpfung beeinflussen. Das Staatsanleiheankaufprogramm des Eurosystems als ein Beispiel hierfür führt im Unterschied zur Zinspolitik zu einem direkten, angebotsseitigen Anstieg der Zentralbankguthaben. Zudem haben derartige Ankaufprogramme direkte, unmittelbar aus dem Wertpapierverkauf entstehende, expansive Effekte auf die von Nichtbanken gehaltene Geldmenge, die im Euro-Raum allerdings dadurch abgeschwächt werden, dass das Eurosystem die Wertpapiere nicht nur von heimischen Nichtbanken erwirbt. Hinzu kommen indirekte Effekte, die aus der Transmission des Ankaufprogramms und seiner Wirkung auf die Kreditvergabe und die Portfoliozusammensetzung resultieren.

Für Kritiker ist die Geldschöpfungskapazität des Bankensystems eine der zentralen Ursachen für destabilisierende Finanzzyklen und Finanzkrisen. Deshalb werden seit einiger Zeit Vorschläge diskutiert, die auf einer vollständigen Deckung von Einlagen durch Zentralbankgeld basieren und so die Kreditschöpfungsmöglichkeiten des Bankensektors begrenzen wollen. Es ist jedoch nicht erkennbar, dass diese Beschränkungen tatsächlich zu einem insgesamt stabileren Finanzsystem führen, als dies über eine zielführende Regulierung ohnehin auch möglich wäre. Zugleich würde ein solcher Systemübergang über das Risiko eröffnen, wichtige volkswirtschaftliche Funktionen des Bankensystems in Mitleidenschaft zu ziehen, die für eine stabile realwirtschaftliche Entwicklung notwendig sind.

PositiveMoney Europe

6 November 2018, Brussels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BUSINESS LENDING

Lending to private non-financial corporations

8%

CONSUMER LOANS

Credit cards
Personal loans

8%

FINANCIAL SECTOR

Trading
Mergers & acquisitions
Financial sector activity

31%

PROPERTY

Residential and commercial mortgages

51%

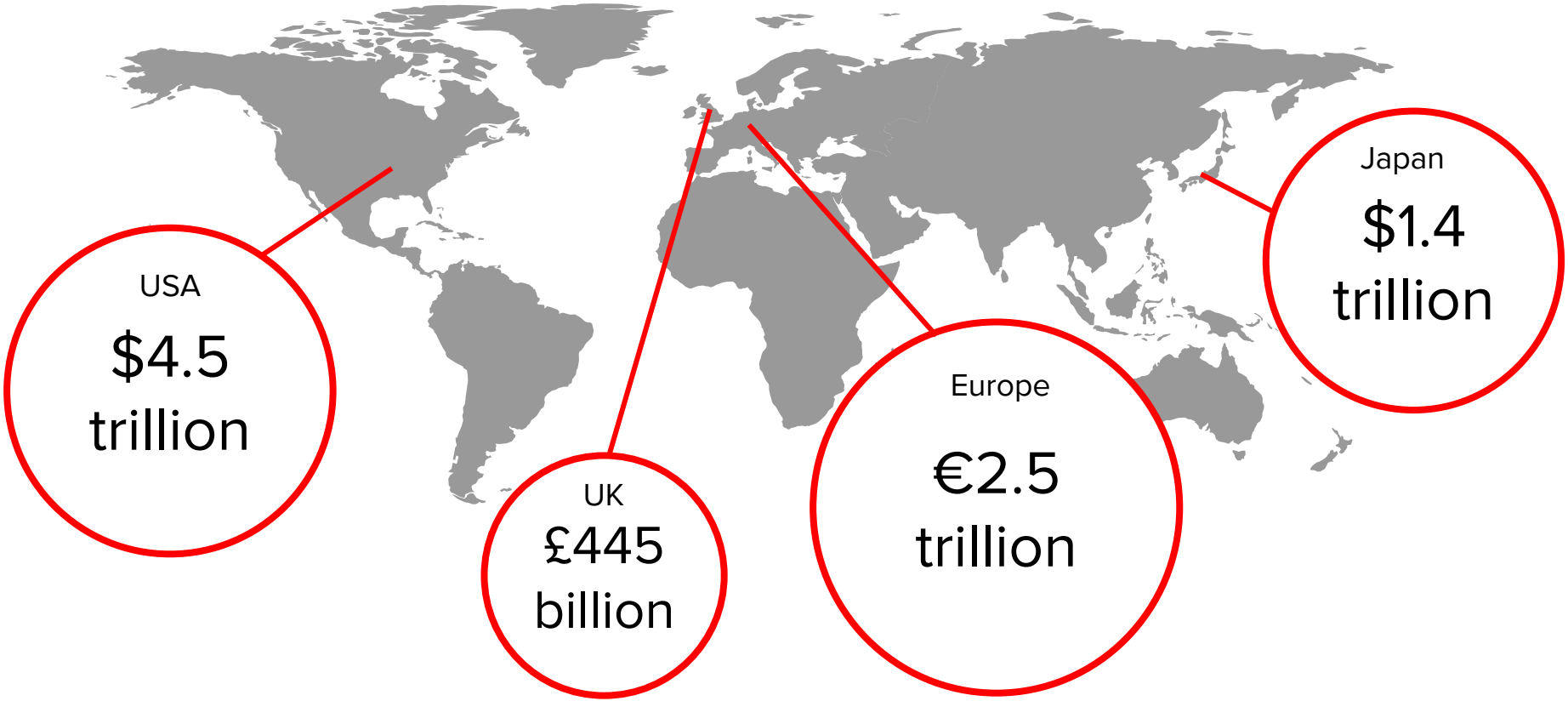
Percentage of new money created by UK banks from

ADAIR TURNER

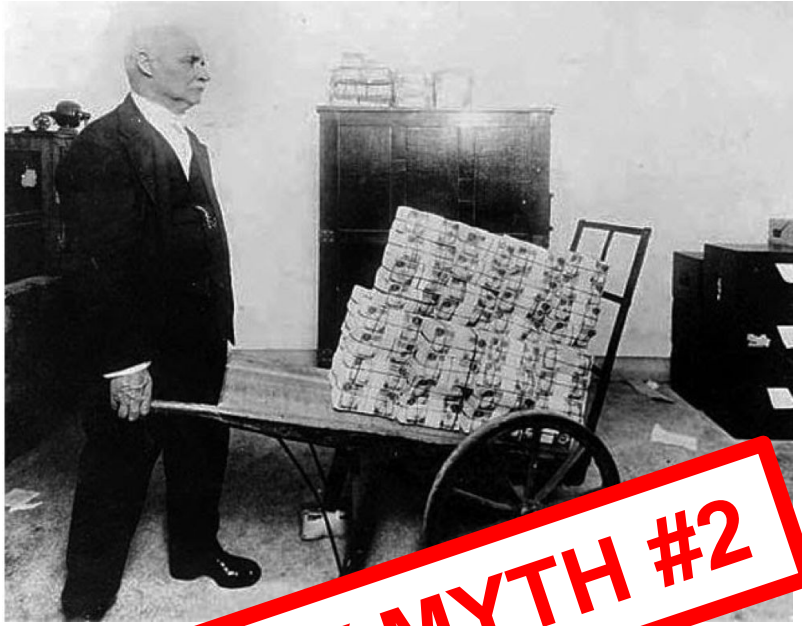
Former FSA Chair

"The financial crisis of 2007/08 occurred because we failed to constrain the private financial system's creation of private credit and money."

Quantitative easing

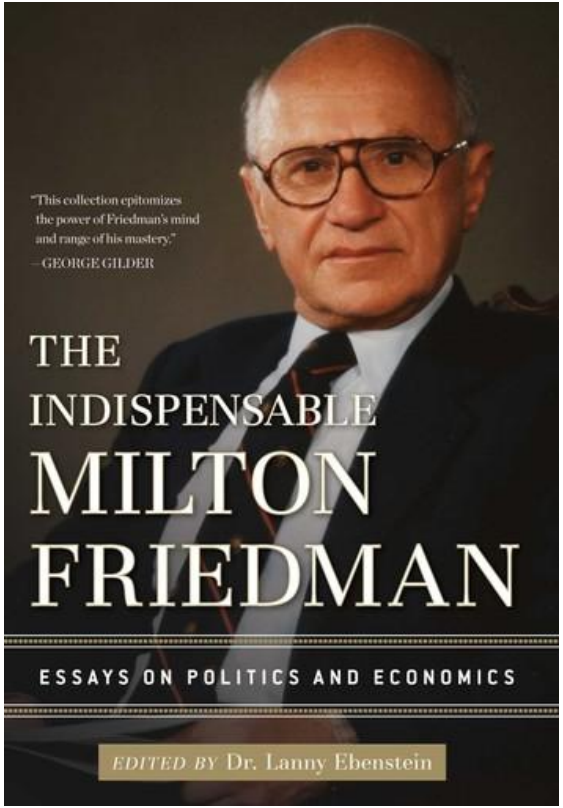


INFLATION IS ALWAYS A MONETARY PHENOMENON

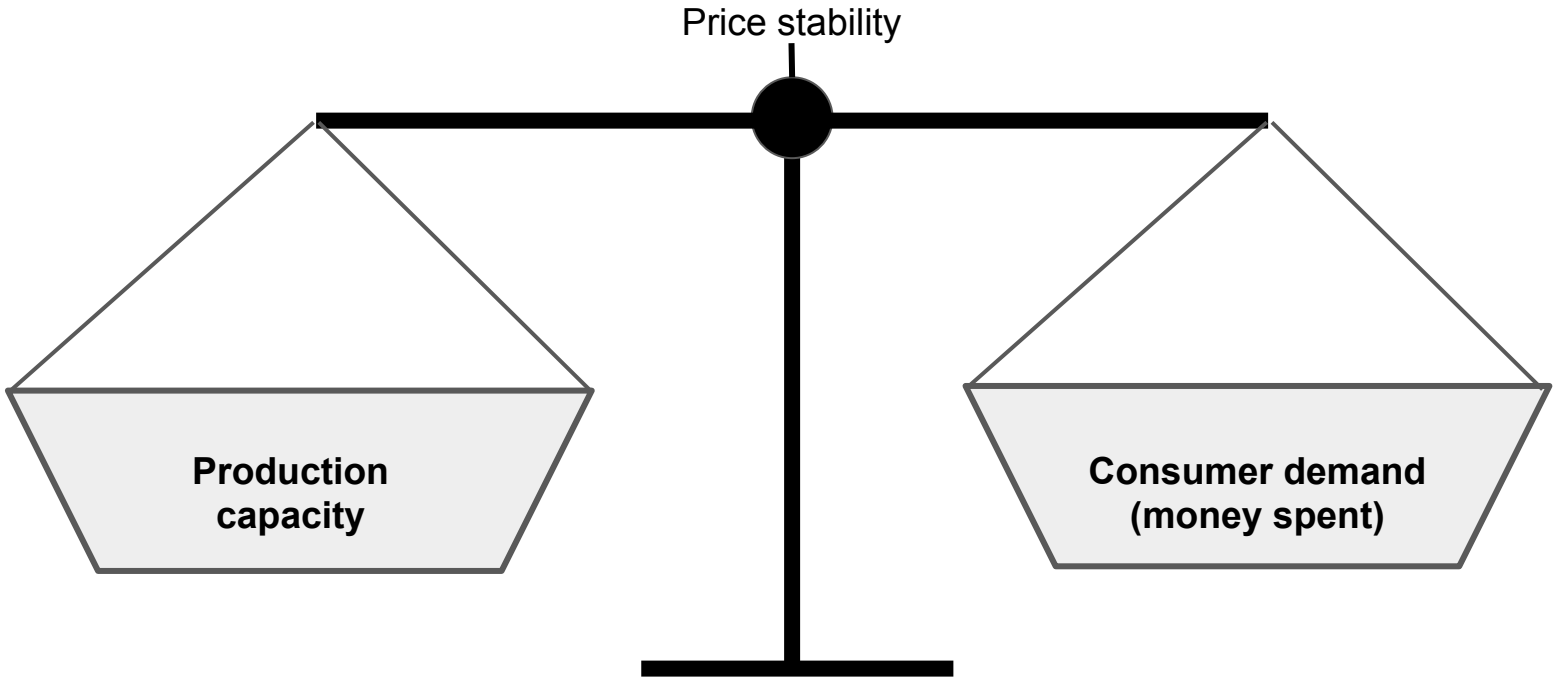


MONEY MYTH #2

"**inflation is always and everywhere a monetary phenomenon**"



What is inflation anyway?



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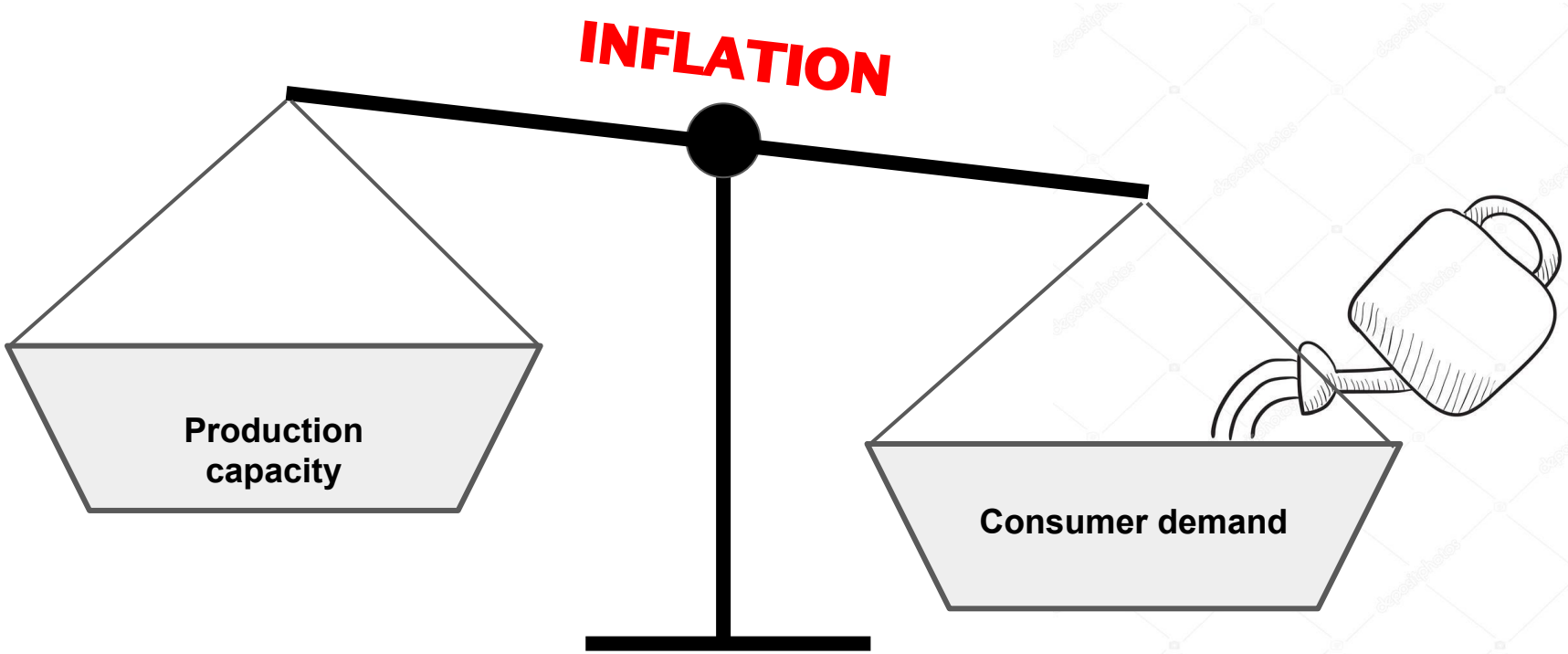

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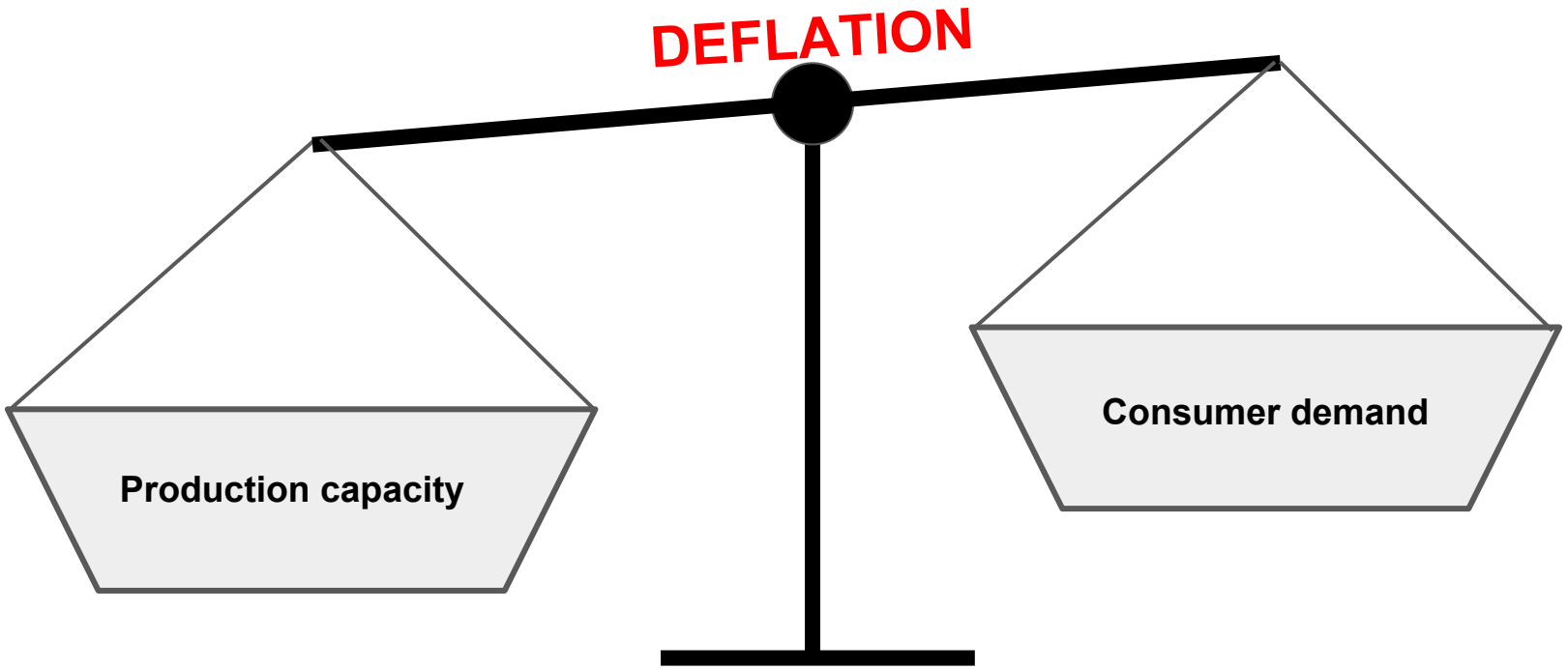
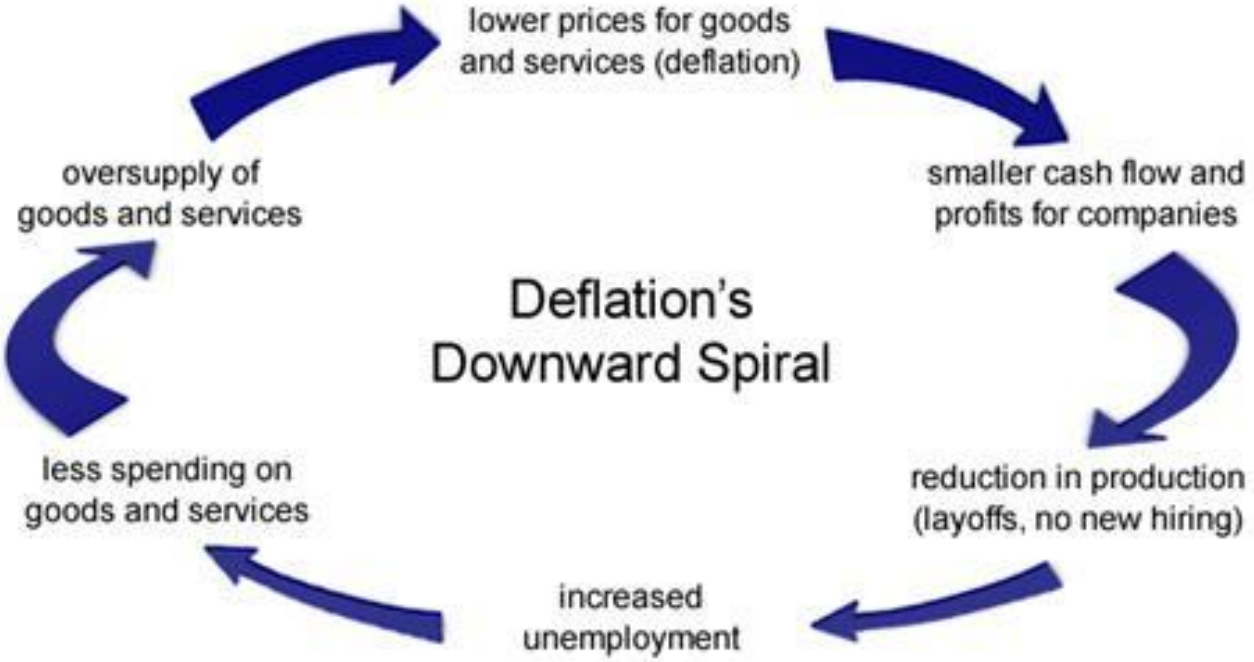
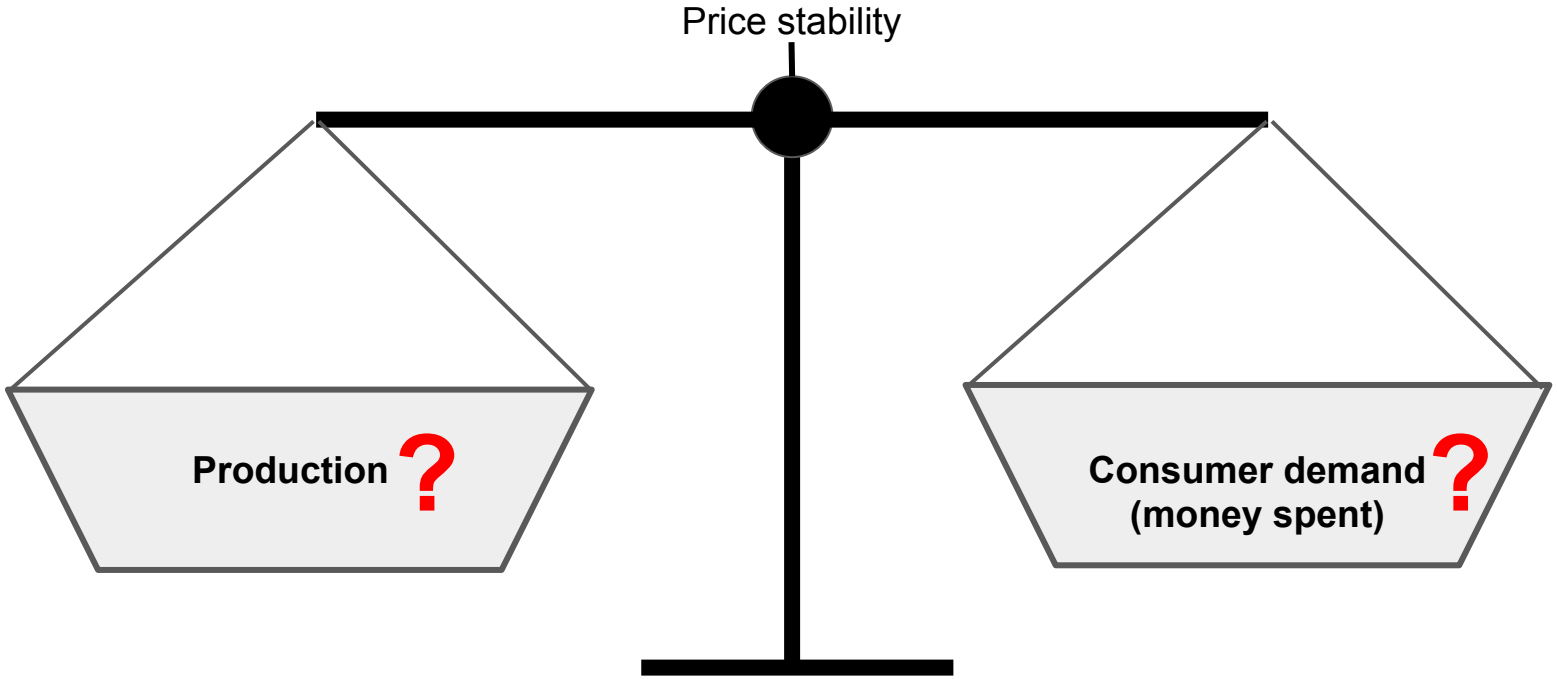


Why is deflation so bad?



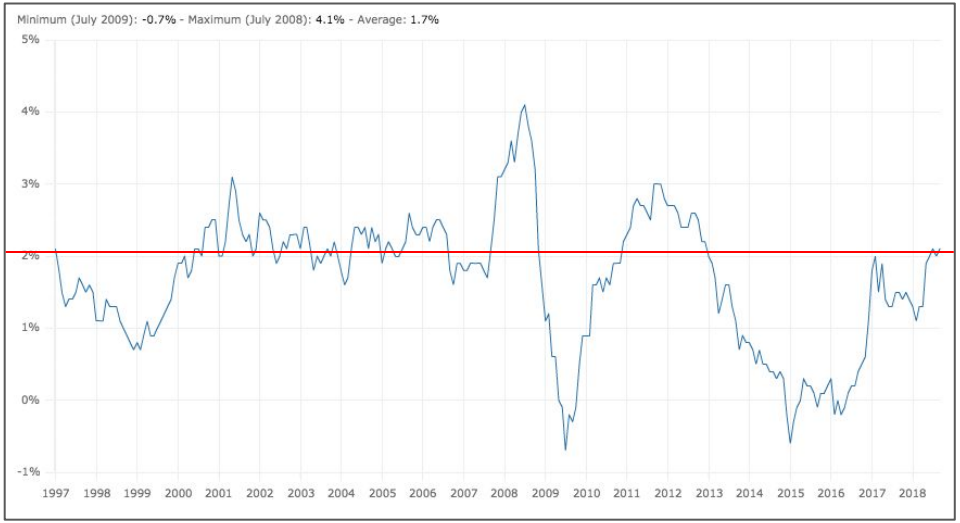
Inflation depends on where the money is injected in the economy



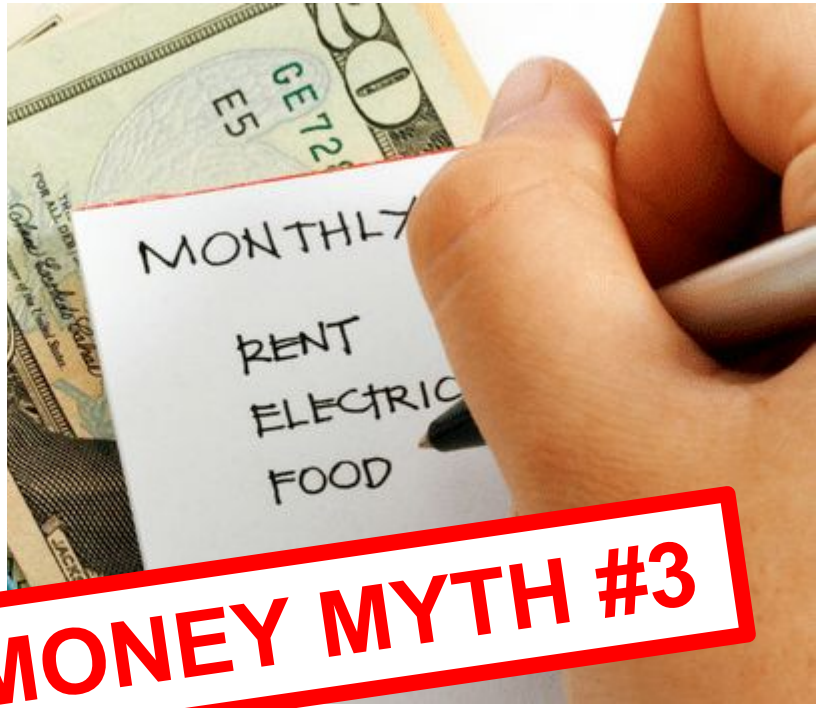
Other factors driving inflation today

- Globalisation
- Energy prices
- Wars
- Political crises

⇒ Historically, hyperinflation is always connected to extreme geopolitical disruptions.



GOVERNMENTS SHOULD RUN THEIR BUDGET LIKE A GOOD HOUSEHOLD



Governments are not like households… because they have a central bank in their garden.

We could use central banks' ability to **create money** for:

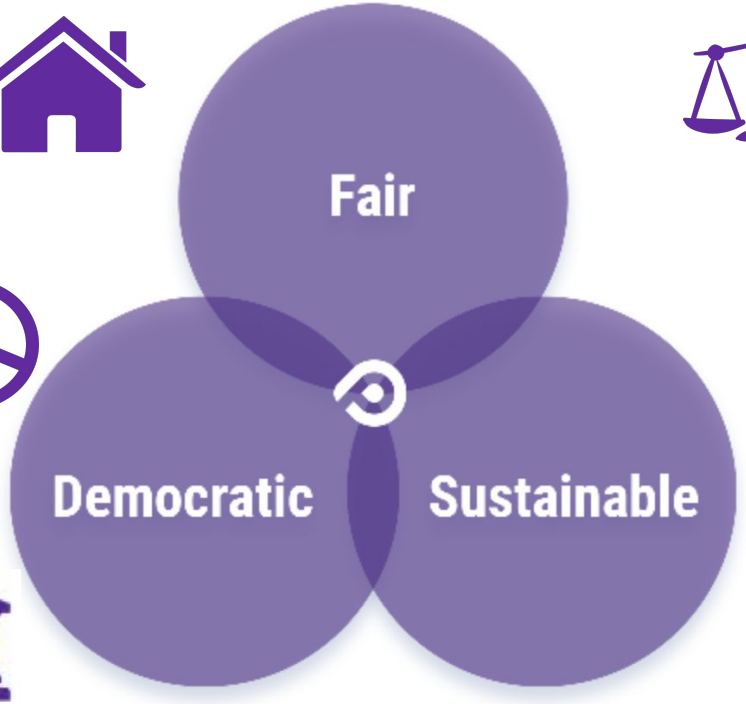
- Investing in public investment for the energy transition
- Better allocation of credit towards the real economy
- Distributing a social dividend to all citizens
- Writing-off debts

POSITIVE MONEY'S VISION

Prevent another Financial crisis

End austerity

Democratic accountability



Fight inequality

Reduce debt

Protect the planet

THANK YOU!

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