DEBUNKING THE MYTHS OF MONEY AND ECONOMICS

POLICY ROUNDTABLE
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Brussels
What do these two politicians have in commons?
“MONEY DOES NOT GROW ON TREES”

MONEY MYTH #1
“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

Who do you think created more than 95% of the money in circulation?

- Don't know: 30%
- Central banks: 28%
- Governments: 31%
- Private / commercial banks: 20%

Who do you think should create most of the money? One answer possible

(n = 23,618)
“Commercial [i.e. high street] banks create money, in the form of bank deposits, by making new loans.”
Money creation in the euro area

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.
Money creation in the modern economy

By Michael McAteer, Amar Basila and Roland Thomas of the Bank's Monetary Analysis Directorate

- 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 are sent to them, and nor do they 'multiply up' central bank credit 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 these 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 directly without limit. Banks are limited in how much they lend if they are to remain solvent and maintain a competitive banking system. Prudential regulation 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 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 limited by the need 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). QL is intended to boost the amount of money in the economy directly by purchasing assets, mainly from non-bank financial companies.

QL initially increases the amount of bank deposits those companies hold—in place of the assets they sell. These companies will then wish to rebalance their portfolios of assets by buying higher yielding assets, using some of these assets and accumulating spending in the economy.

As a by-product of QL, 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.
Percentage of new money created by UK banks from 1997-2007:

**BUSINESS LENDING**
Lending to private non-financial corporations

**CONSUMER LOANS**
Credit cards
Personal loans

**FINANCIAL SECTOR**
Trading
Mergers & acquisitions
Financial sector activity

**PROPERTY**
Residential and commercial mortgages

8%
8%
31%
51%

Percentage of new money created by UK banks from 1997-2007.
“The financial crisis of 2007/08 occurred because we failed to constrain the private financial system’s creation of private credit and money.”

ADAIR TURNER
Former FSA Chair
Quantitative easing

USA: $4.5 trillion
UK: £445 billion
Europe: €2.5 trillion
Japan: $1.4 trillion
INFLATION IS ALWAYS A MONETARY PHENOMENON

MONEY MYTH #2
"inflation is always and everywhere a monetary phenomenon"
What is inflation anyway?

Production capacity

Price stability

Consumer demand (money spent)
What is inflation anyway?

Production capacity

INFLATION

Consumer demand
What is inflation anyway?

- Production capacity
- Consumer demand

DEFLATION
Why is deflation so bad?
Inflation depends on where the money is injected in the economy

- Production
- Consumer demand (money spent)

Price stability
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

MONEY MYTH #3
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
- Fair
- Democratic
- Sustainable
THANK YOU!

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