BANK OF ENGLAND

News release

Press Office
Threadneedle Street
London EC2R 8AH
T 020 7601 4411
F 020 7601 5460
press@bankofengland.co.uk
www.bankofengland.co.uk

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Quarterly Bulletin pre-release articles: 'Money in the modern economy: an introduction' and 'Money creation in the modern economy'

Where does money come from? 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 in which they are created is through commercial banks making loans: whenever a bank makes a loan, it creates a deposit in the borrower's bank account, thereby creating new money. As 'Money creation in the modern economy' explains, though, banks cannot create money in this way without limit: how much banks lend will rest on the profitable lending opportunities available to them which will, crucially, depend on the interest rate set by the Bank of England. In this way, monetary policy acts as the ultimate limit on money creation.

This description of how money is created differs from the story found in some economics textbooks. For instance, in normal times, the central bank does not in practice choose the amount of money in circulation. Nor is central bank money 'multiplied up' into more loans and deposits. Rather, the Bank of England implements monetary policy – which is set to be consistent with low and stable inflation – by setting the interest rate on central bank reserves ('Bank Rate'). This then influences a range of interest rates – including those on bank loans – and, in turn, the aggregate amount of spending in the economy.

When interest rates were reduced to their effective lower bound, the focus of monetary policy shifted to boosting the quantity of money in the economy directly, via a series of asset purchases, or 'quantitative easing' (QE). The Bank of England electronically creates new money and uses it to purchase gilts from private investors such as pension funds and insurance companies. These investors typically do not want to hold on to this money, because it yields a low return. So they tend to use it to purchase other assets, such as corporate bonds and shares. That lowers longer-term borrowing costs and encourages the issuance of new equities and bonds to stimulate spending and keep inflation on track to meet the government's target.

As a by-product of the purchases of gilts from investors, new central bank reserves are created. But these are not an important part of the transmission mechanism. The article dispels a number of misconceptions about how QE works:

- Just as in normal times, the reserves created by QE cannot be 'multiplied up' into additional loans and deposits.
- Nor can reserves be directly lent out, since only commercial banks hold reserves accounts.
- And while banks do earn interest on the newly created reserves, QE also creates an accompanying liability for the bank – the investors' deposits following sales of gilts – which the bank will itself typically have to pay interest on.

A more fundamental question still than “Where does money come from?” is “What is money?”. ‘Money in the modern economy: an introduction’ addresses precisely this question. While most people in the world use some form of money on a daily basis to buy or sell goods and services, to pay or get paid, or to settle contracts, there is not universal agreement on what money actually is.

Assuming no prior knowledge of economics, the article explains that money today is a type of IOU, but one that is special because everyone in the economy trusts that it will be accepted by other people in exchange for goods and services. It is because money is a form of IOU that banknotes still have the ‘promise to pay’ inscription: but money today is fiat or ‘paper’ money that is not convertible to any other asset (such as gold or other commodities). In addition to currency, bank deposits and central bank reserves are the main types of money in the modern economy. Each one represents an IOU from one sector of the economy to another. Most of the money circulating in the economy is in the form of bank deposits which, as the companion article explains, are created by commercial banks themselves. A box in the article briefly outlines some recent developments in payment technologies, including e-money and digital currencies.