Money Creation and Central Bank

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MiR@W day: The Dynamics of Money
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Central Bank and Money Creation

Who creates money?

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What is money?

- **Central bank money**

  currency in circulation and the sight deposits held by commercial banks at the central bank

- **Commercial bank money**

  create by issuing loans worth many time the value of reserves they hold

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Central Bank's balance sheet

Assets	Liabilities
Foreign Assets (net)	Currency
Government Balances (net)	Commercial Bank Reserves
Central Bank Operations (net)	Capital Reserves (net worth)
Other items (net)	

BASE MONEY

Commercial banks' balance sheet

Assets	Liabilities
Reserves	Deposits
Loans	Interbank
Securities	Net Worth

MONEY CREATION

Customer's balance sheet

Assets	Liabilities
Deposits	Loans
Currency	Non money

BROAD MONEY

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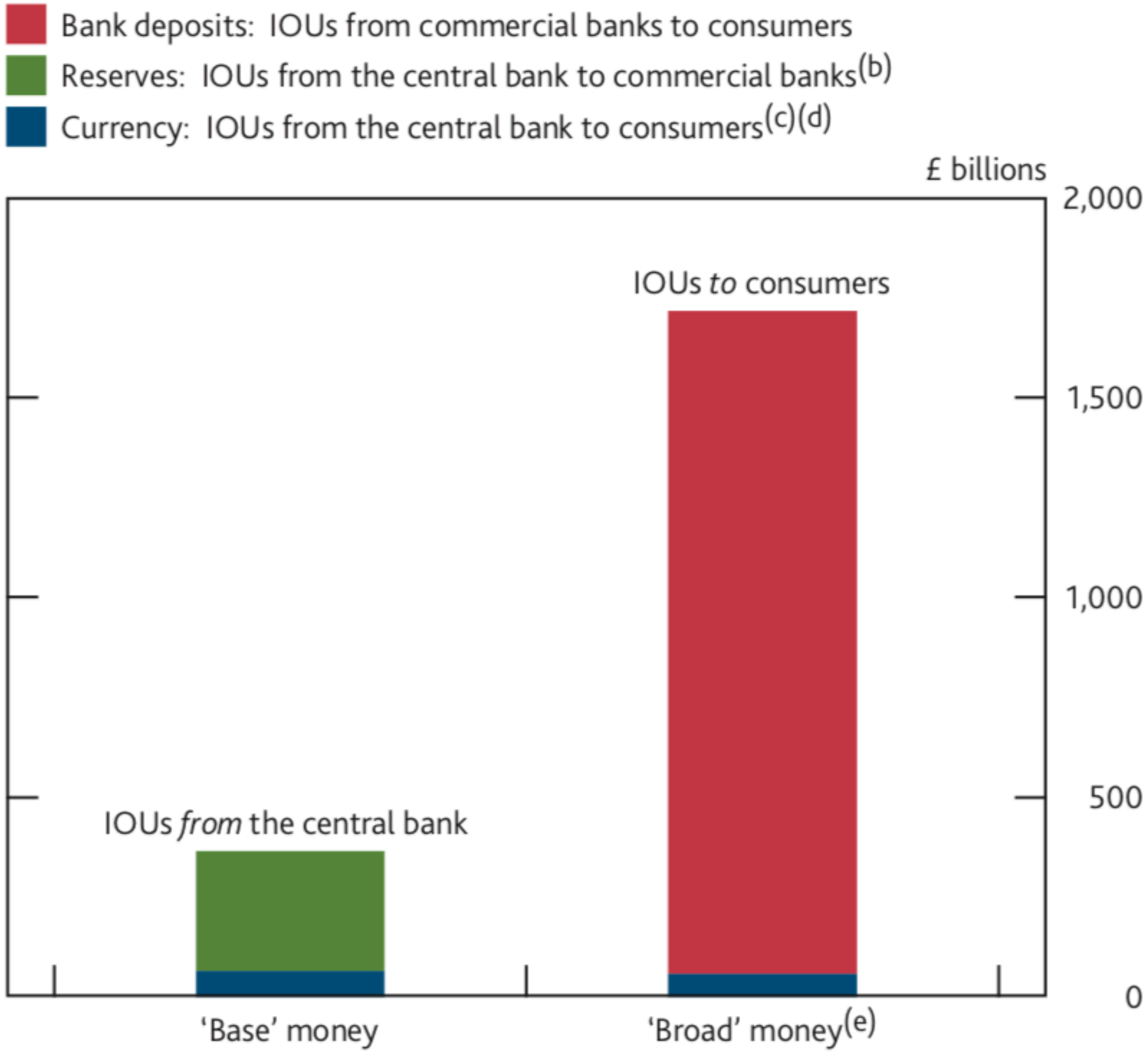
Chart 1 Amounts of money in circulation[a]



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From commercial banks as financial intermediaries…

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... to commercial banks as money creators.

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What is the role of the central bank?

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Monetary policy

Price stability

Inflation targeting - set policy rate

(new) Financial stability

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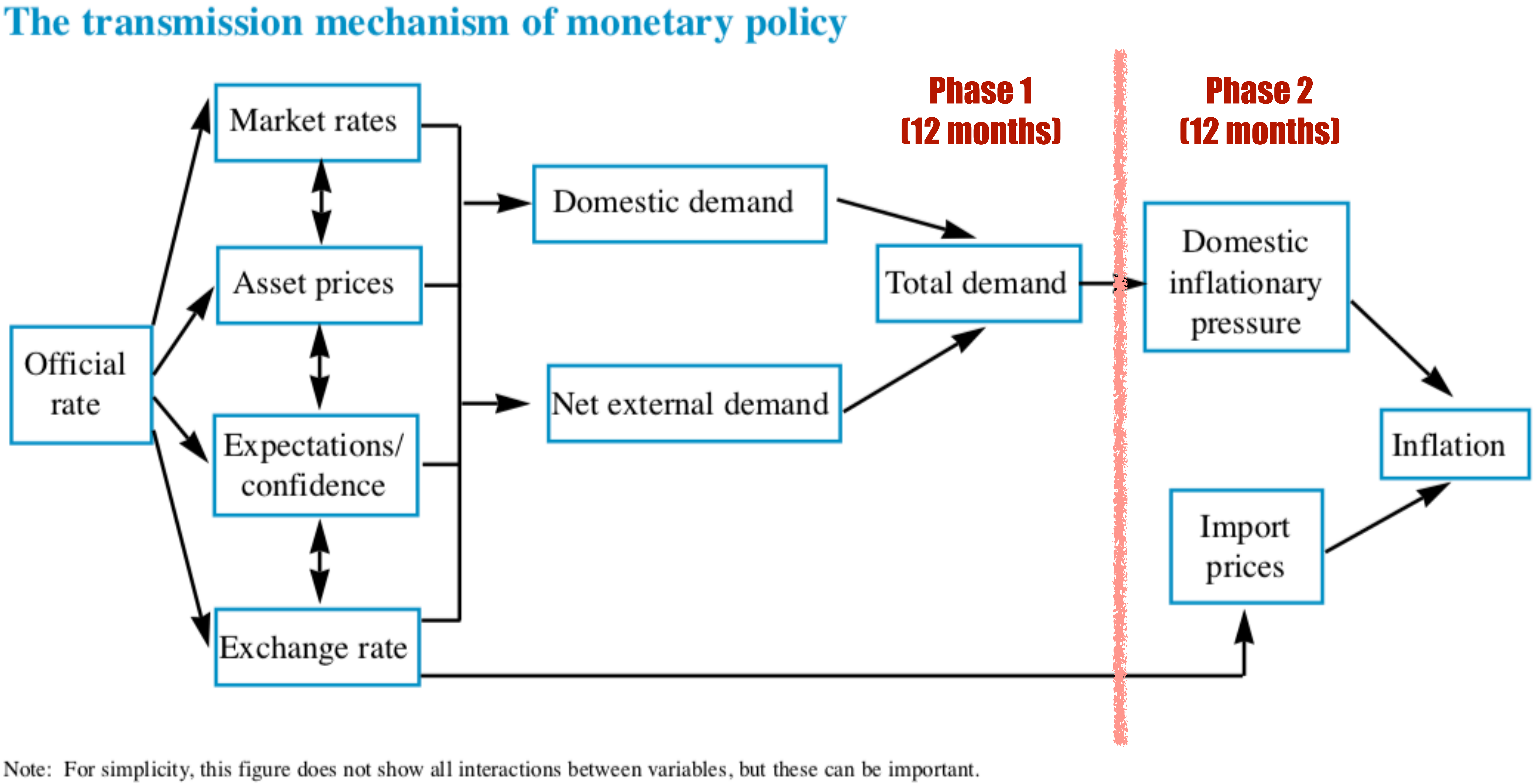

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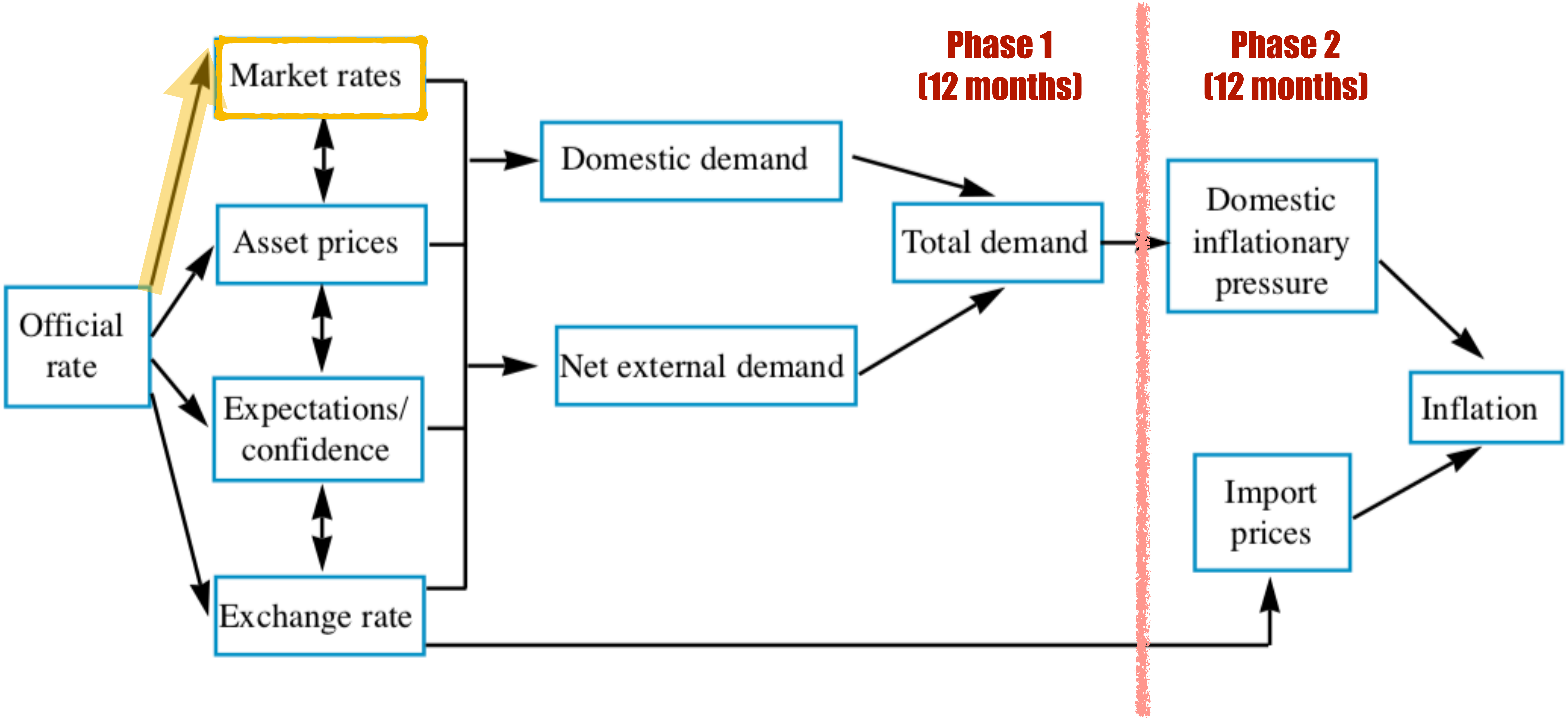
The transmission mechanism of monetary policy



Note: For simplicity, this figure does not show all interactions between variables, but these can be important.

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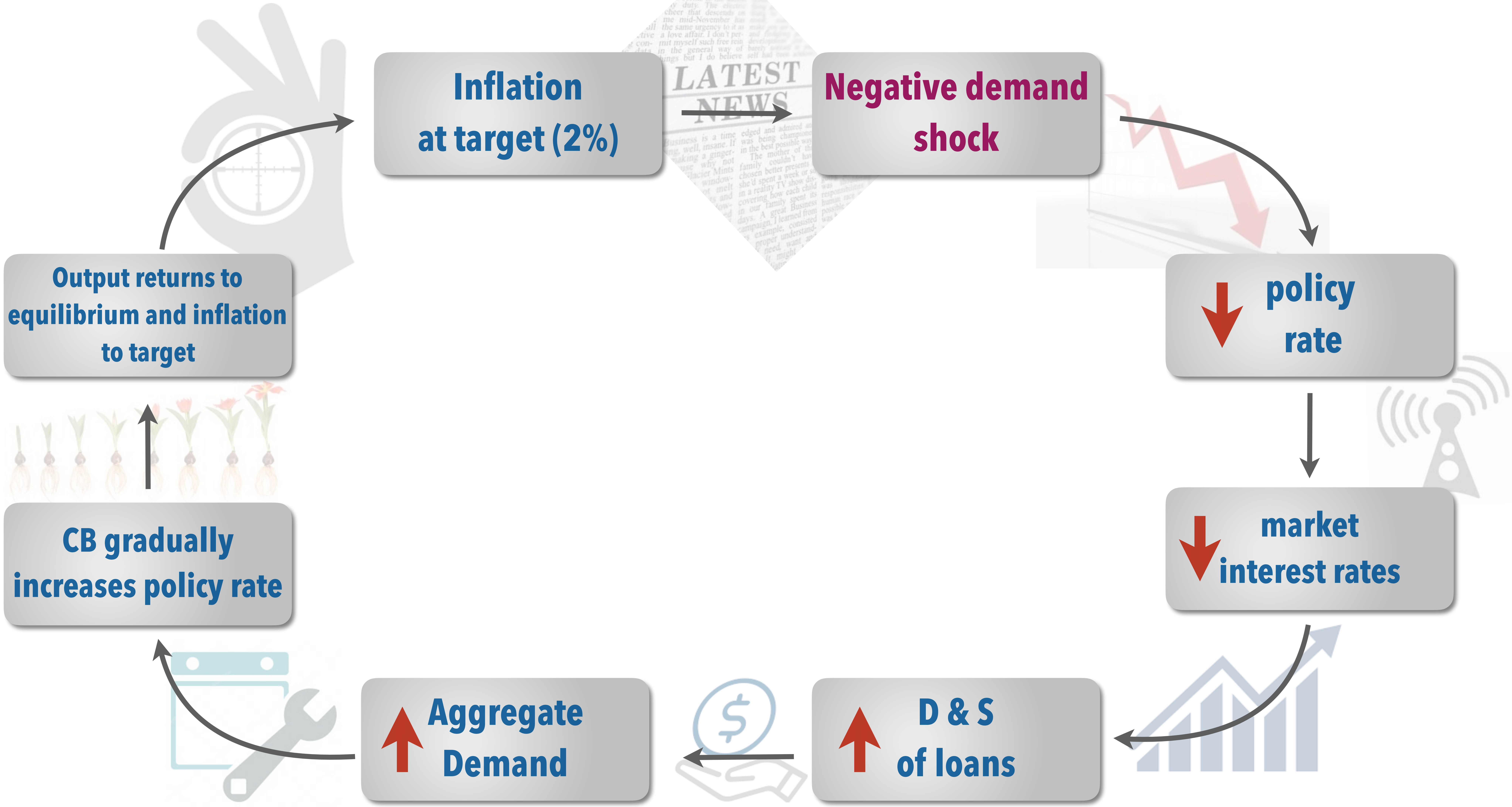

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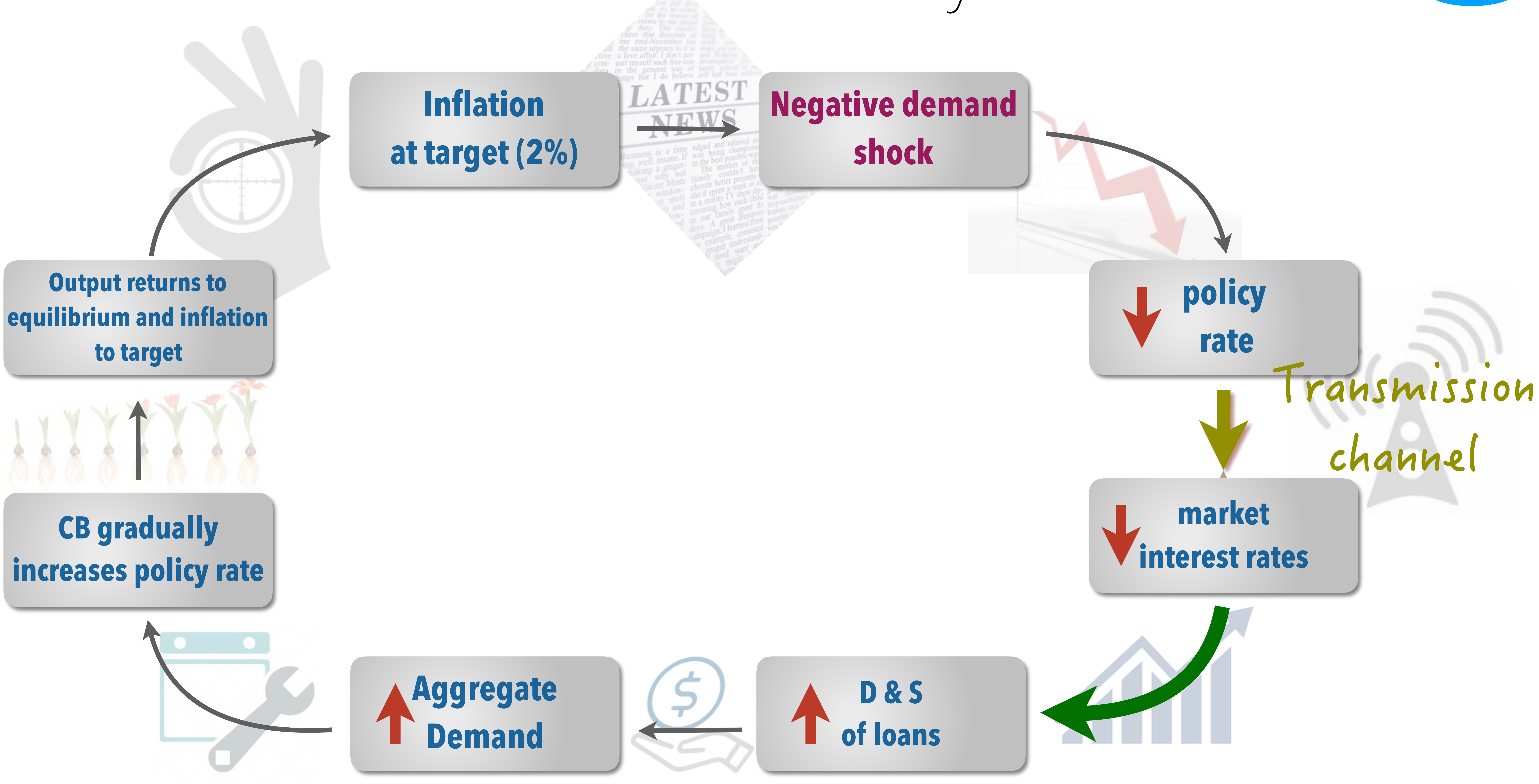


QUESTION:
WHO WAS RESPONSIBLE FOR THE
BANKERS
RATING AGENCIES
MORTGAGE SALES


Financial crisis
The news on this year


DOES THIS DATE BACK TO THE FINANCIAL CRISIS?

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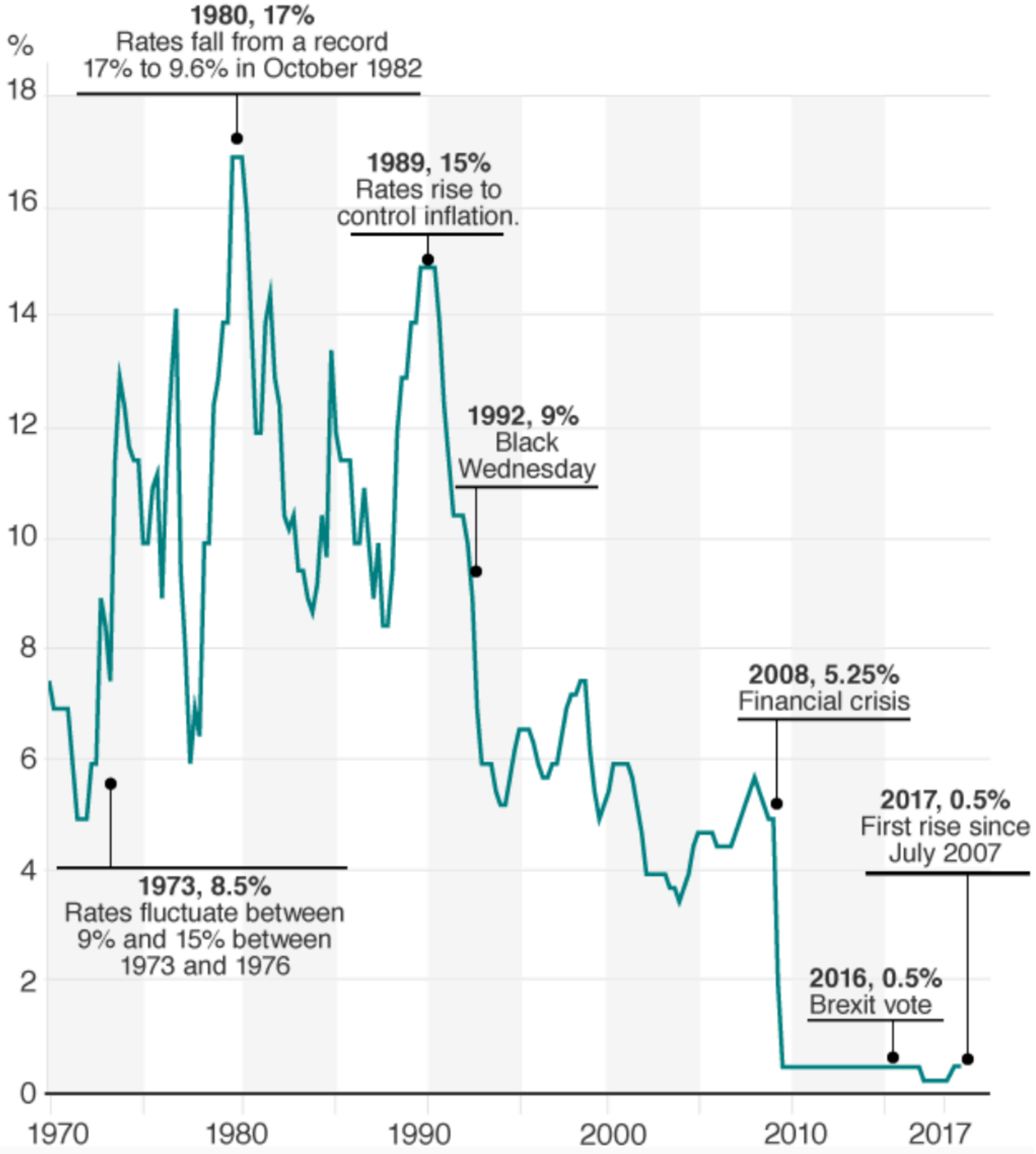

Interest Rate in the UK

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- The relationship between changes in policy rate and market rates broke down
- Banks were holding onto funds
- transmission channels broke down!

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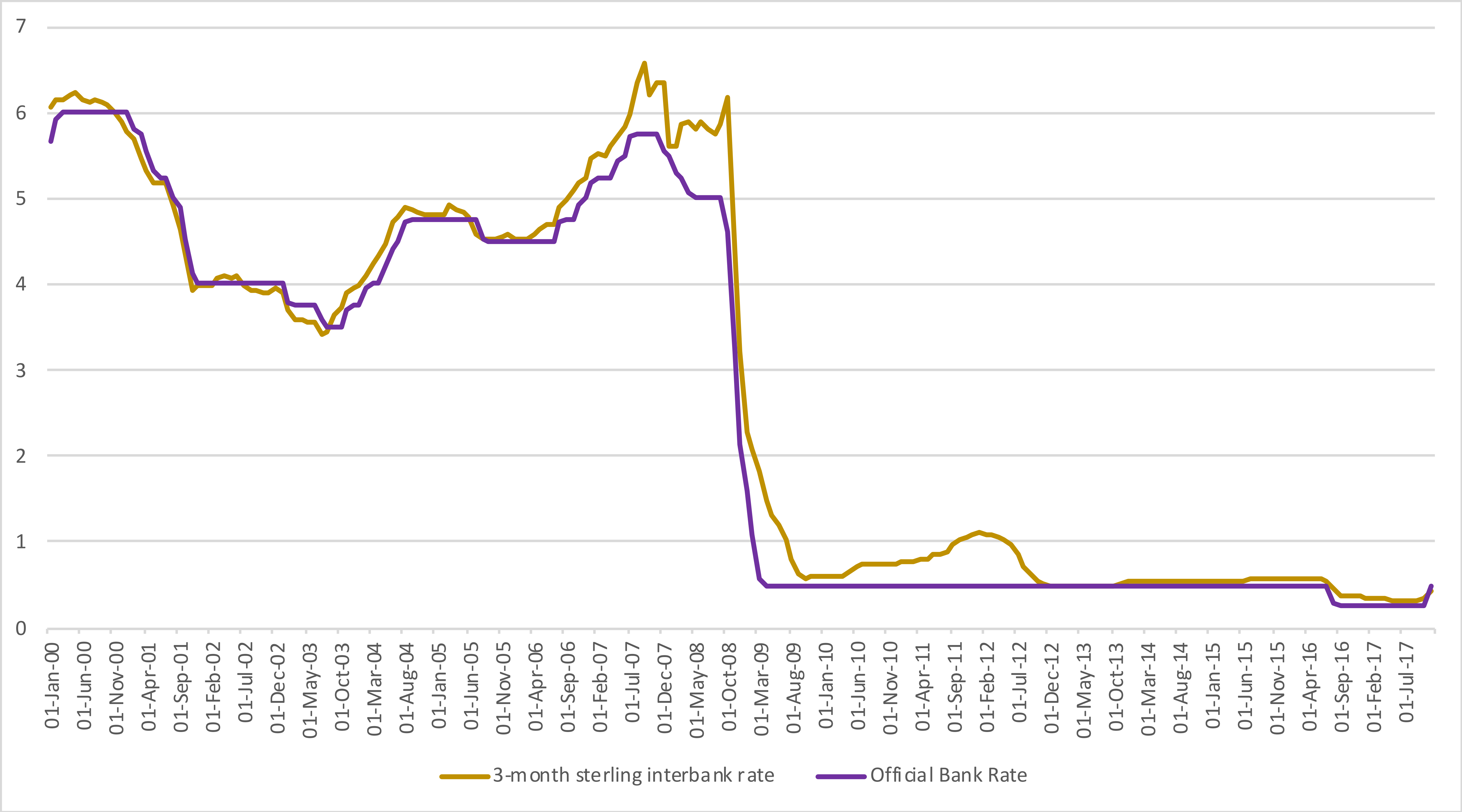

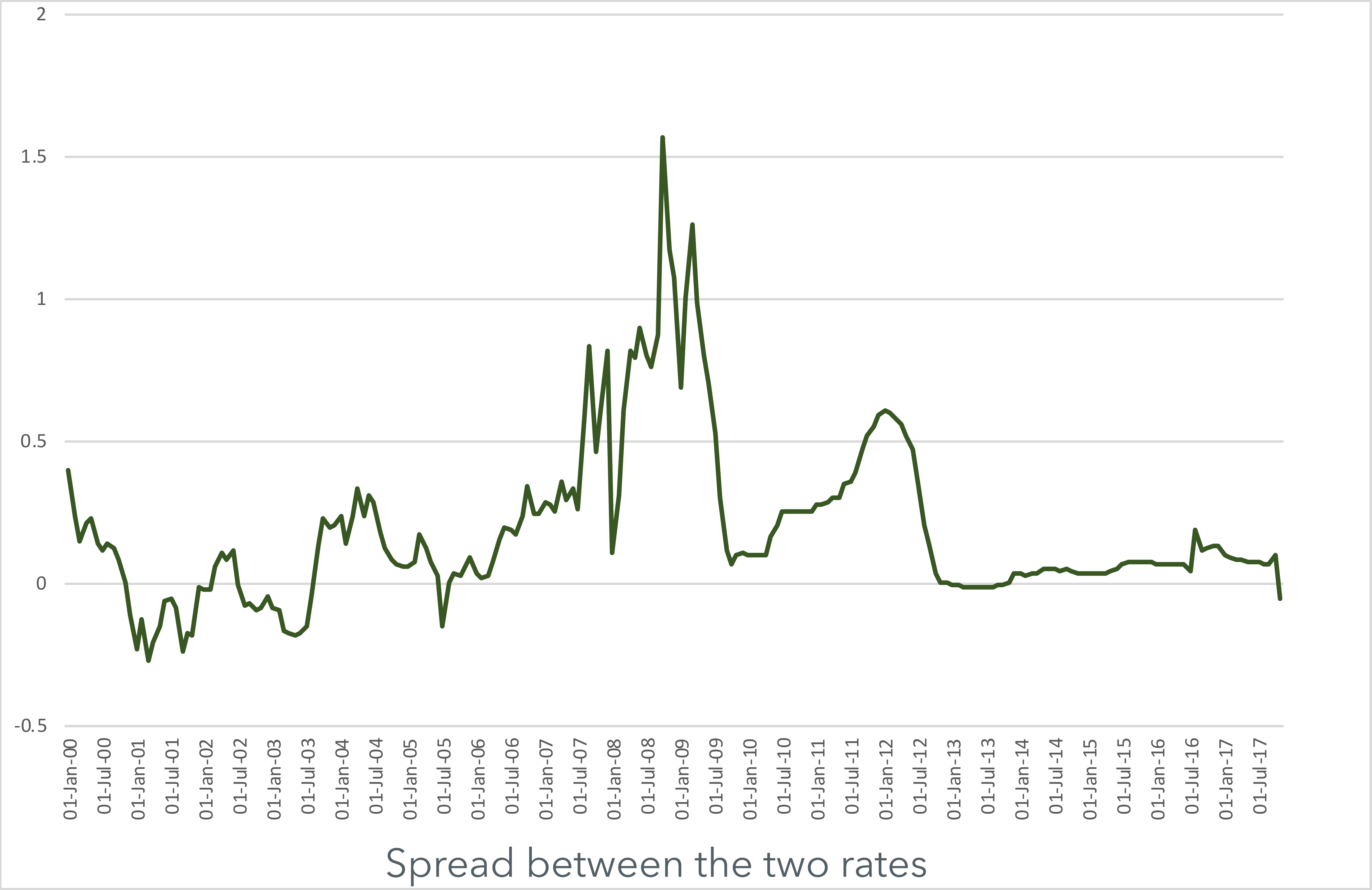

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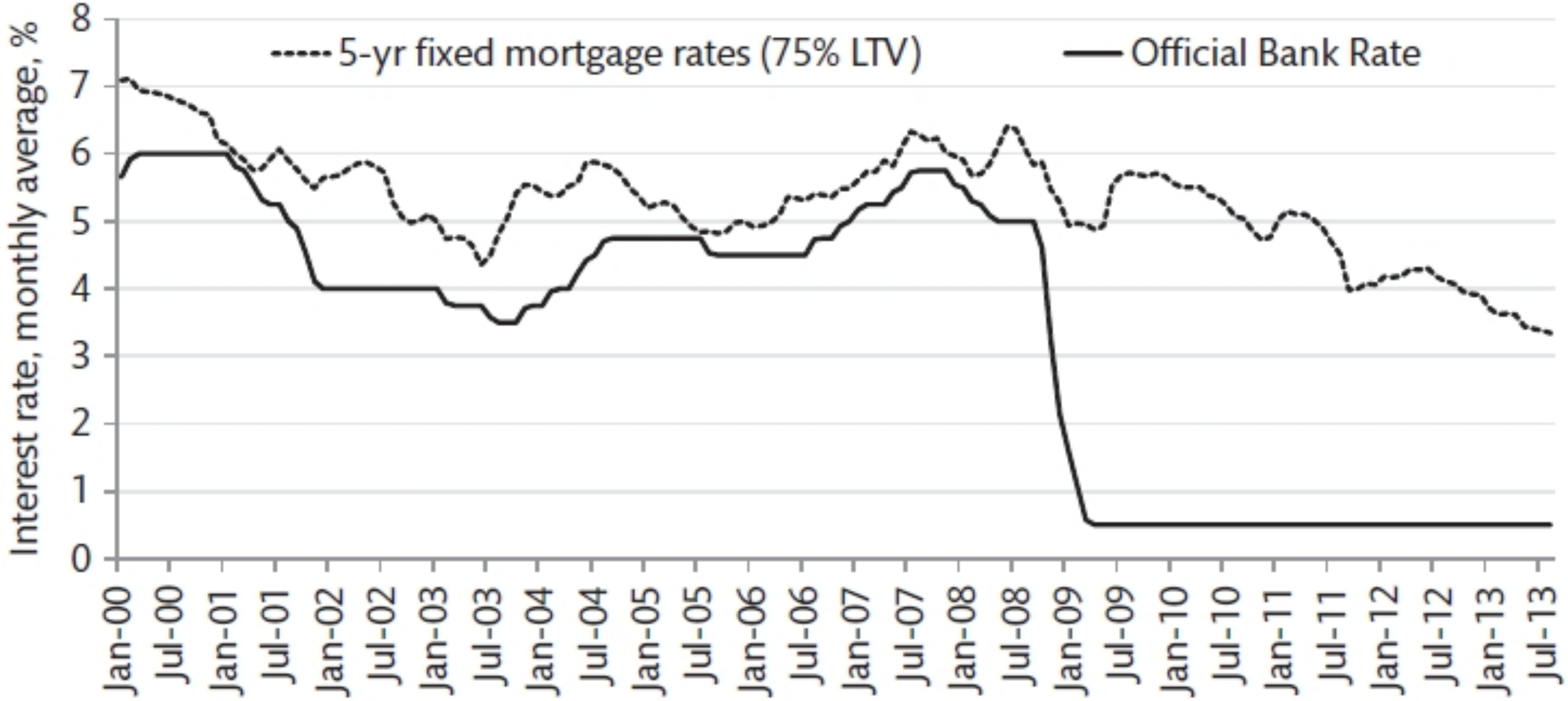

Figure 5.4 UK Official Bank Rates and 5-yr fixed mortgages rates (75% LTV): Jan 2000–Aug 2013.

Source: Bank of England (data accessed October 2013).

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M4 net lending from financial institutions to the private sector (Bank of England)

US, September 2008

UK, September 2007

[Too big to fail]

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What was wrong with the banks?

1. Correct monetary policy is all that is needed to secure financial stability

- supported the misconception that CBs could control the money supply and credit

2. Financial markets price risks correctly on average

- Efficient Market Hypothesis (Fama): security prices fully reflect all available information (weak/semi-strong versions)

3. Mark-to-Market (M2M) and value at risk (VaR) frameworks offer accurate measures of value and thus are appropriate ways of managing risk

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- Central banks have limited control over the money created in the economy
- Changes in the commercial banks balance sheets have strong effects on the real economy
- Bank lending is pro-cyclical
  - Boom in credit creation during good times
  - Banks will cut back lending during recessions
- Credit expansion may create **instability**

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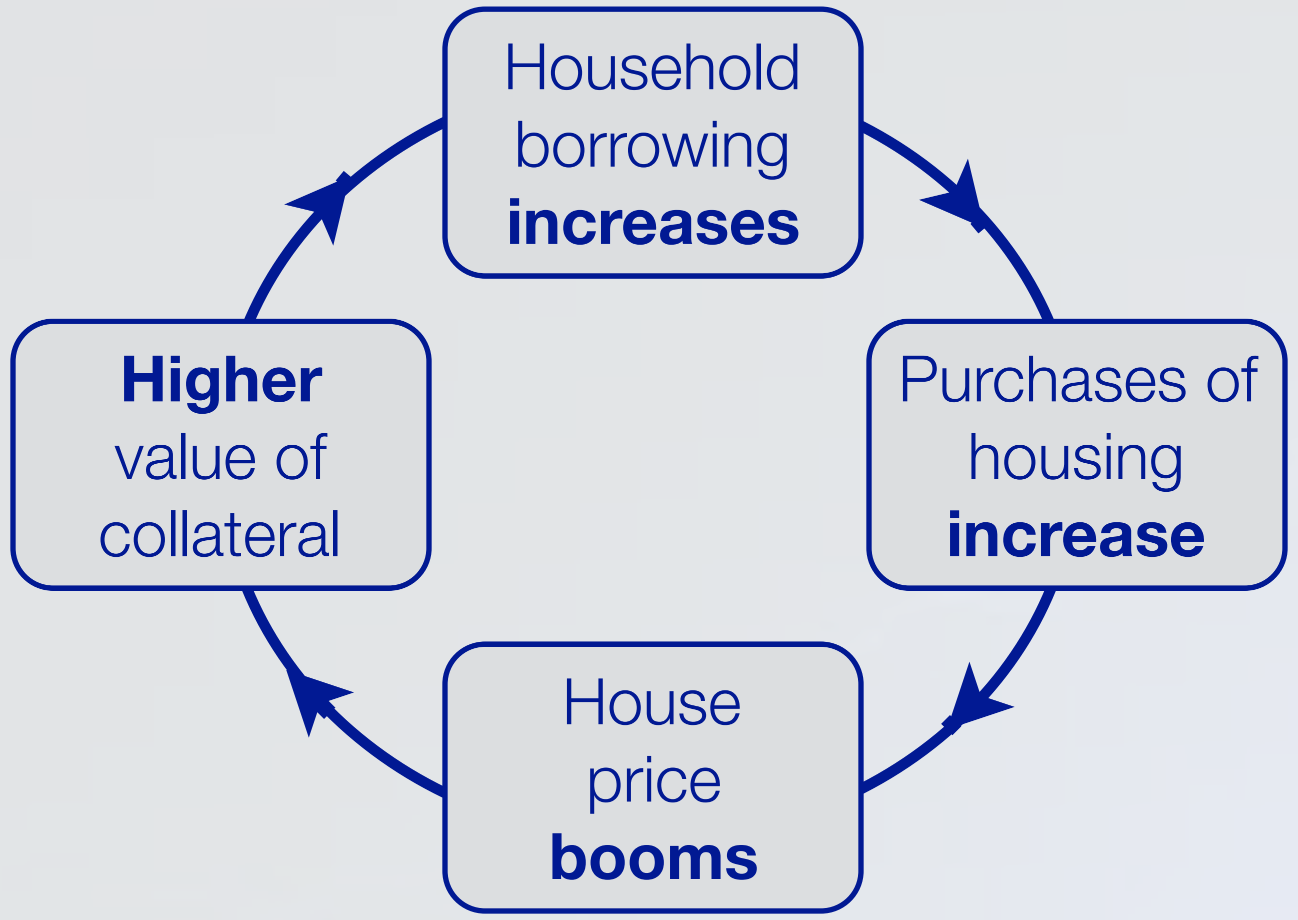
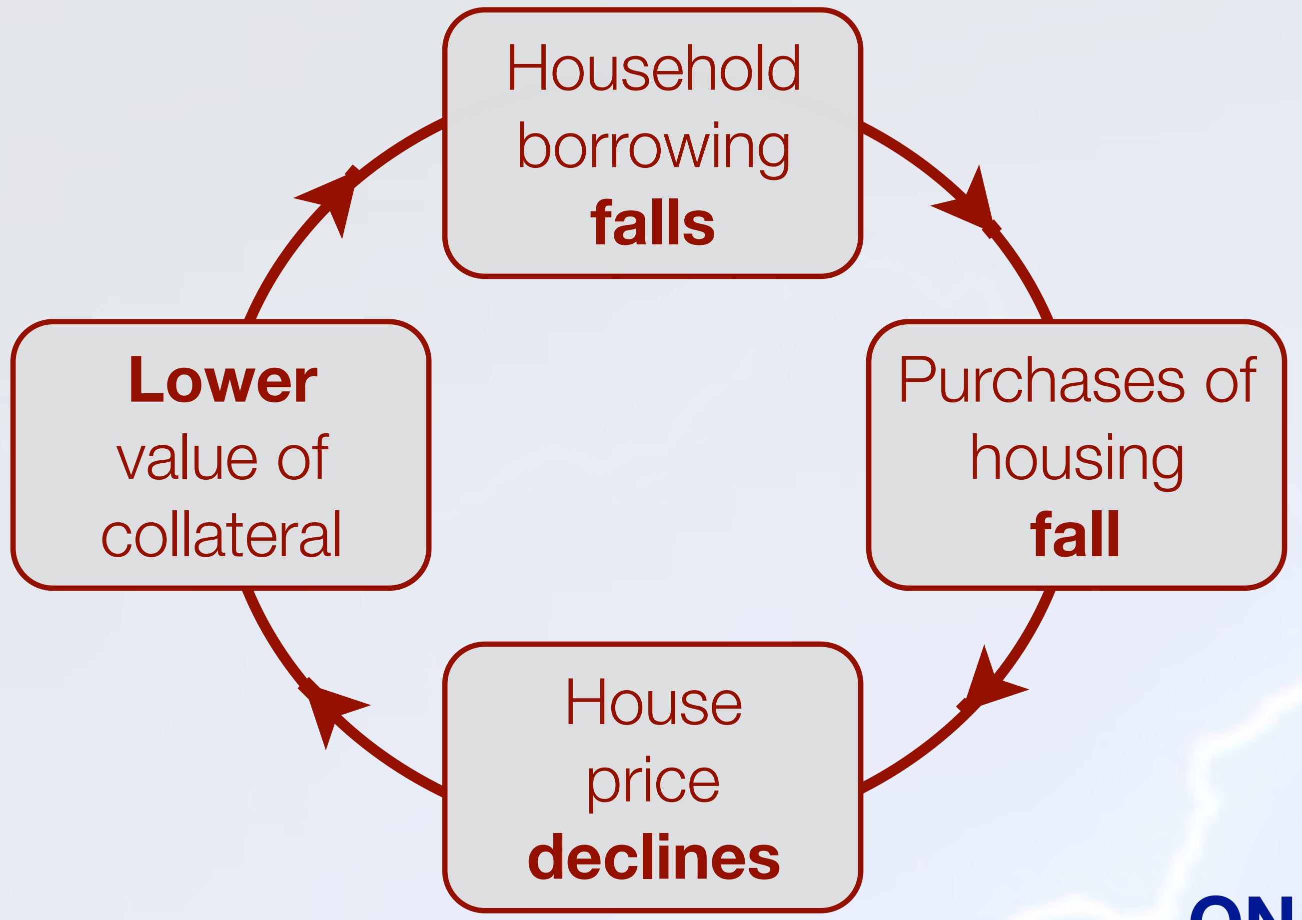
2008's financial crisis



ON THE WAY UP

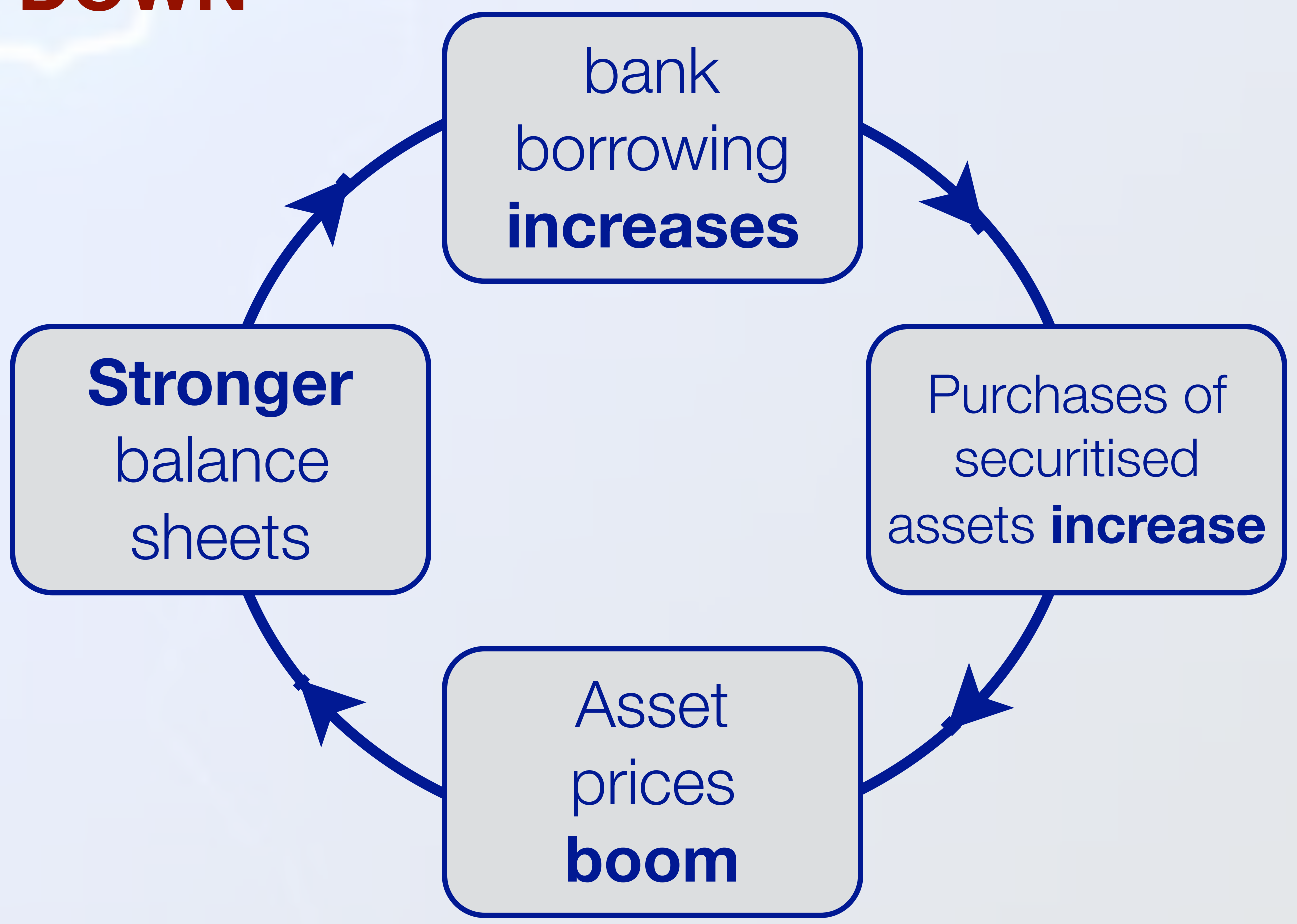


ON THE WAY DOWN

Households

Banks

ON THE WAY UP



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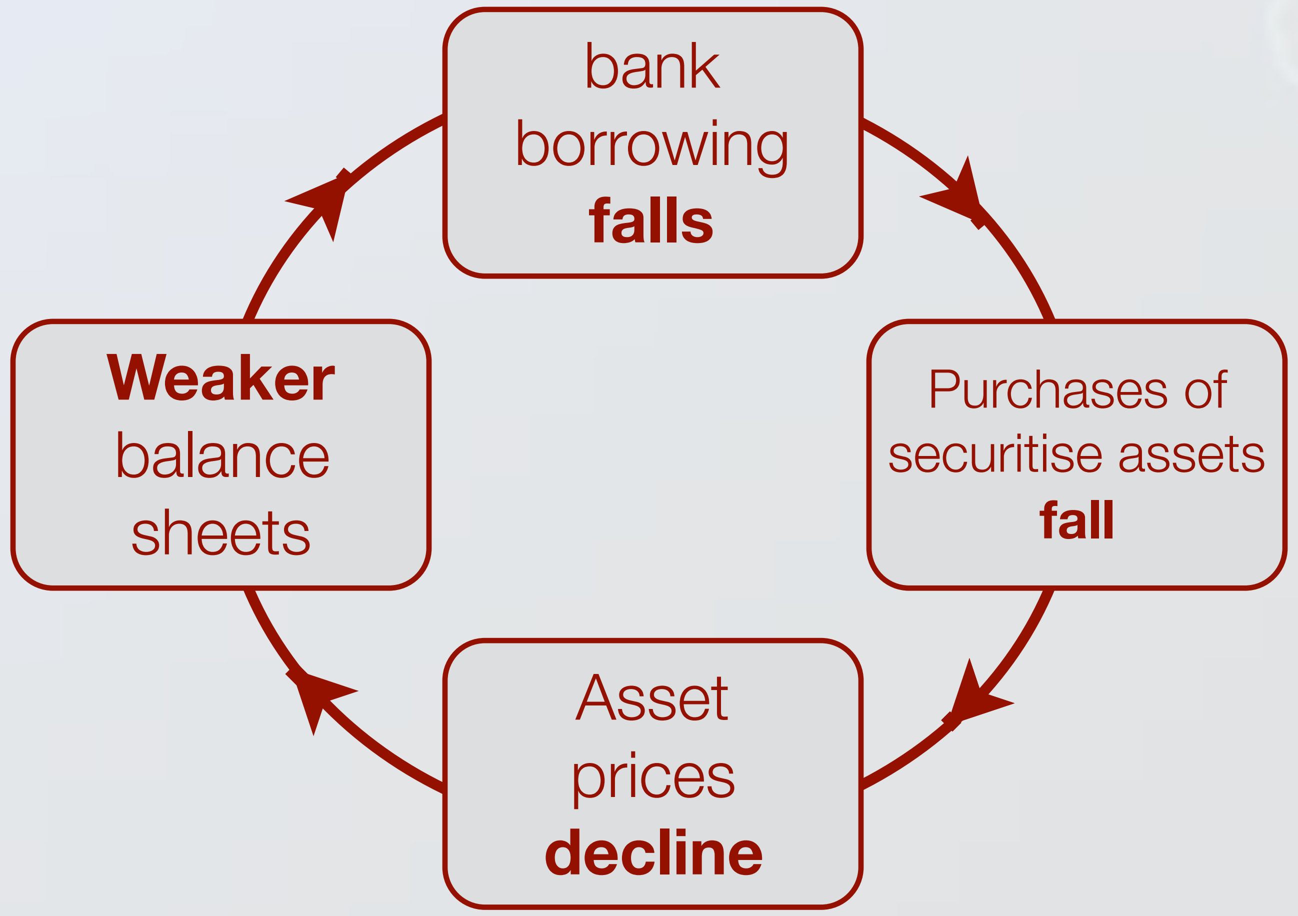

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What was wrong with the banks?

1. Correct monetary policy is all that is needed to secure financial stability

- supported the misconception that CBs could control the money supply and credit

- Pre-2008: Banks were efficient in allocating capital, by correct judgment of risks
  Post-crisis: Strengthen banks' ability to *manage risk*
  (no much on how capital is allocated)

- Pre-2008: Price stability as only goal for central banks
  Post-crisis: + Financial stability and Macro-prudential regulation

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The current scenario

- Interest rates still low
  (zero lower bound)

- Unemployment rates historical low levels

- Consumer credit is high

- BoE has announced an increase in interest rates

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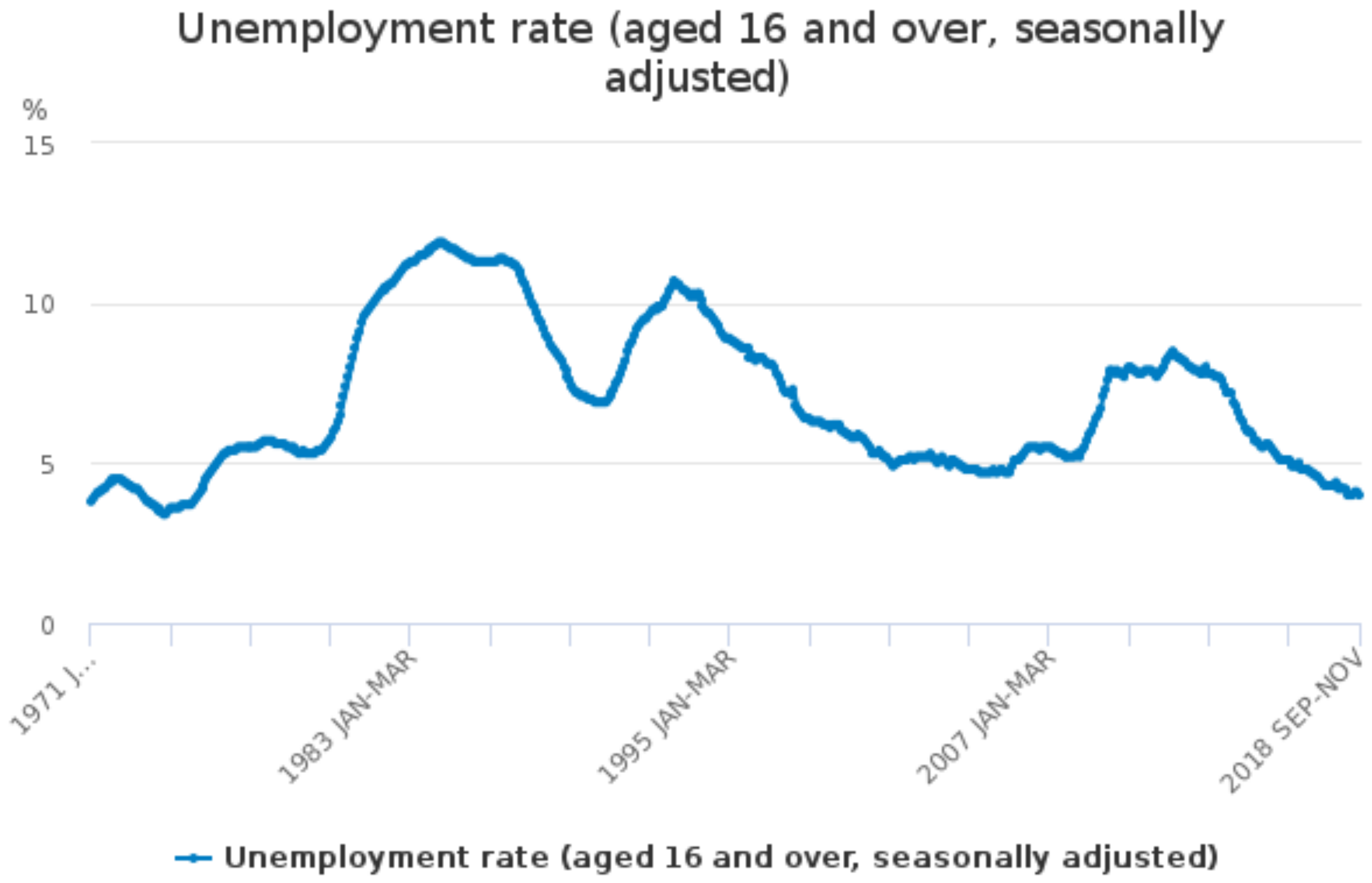
The current scenario



Source: ONS

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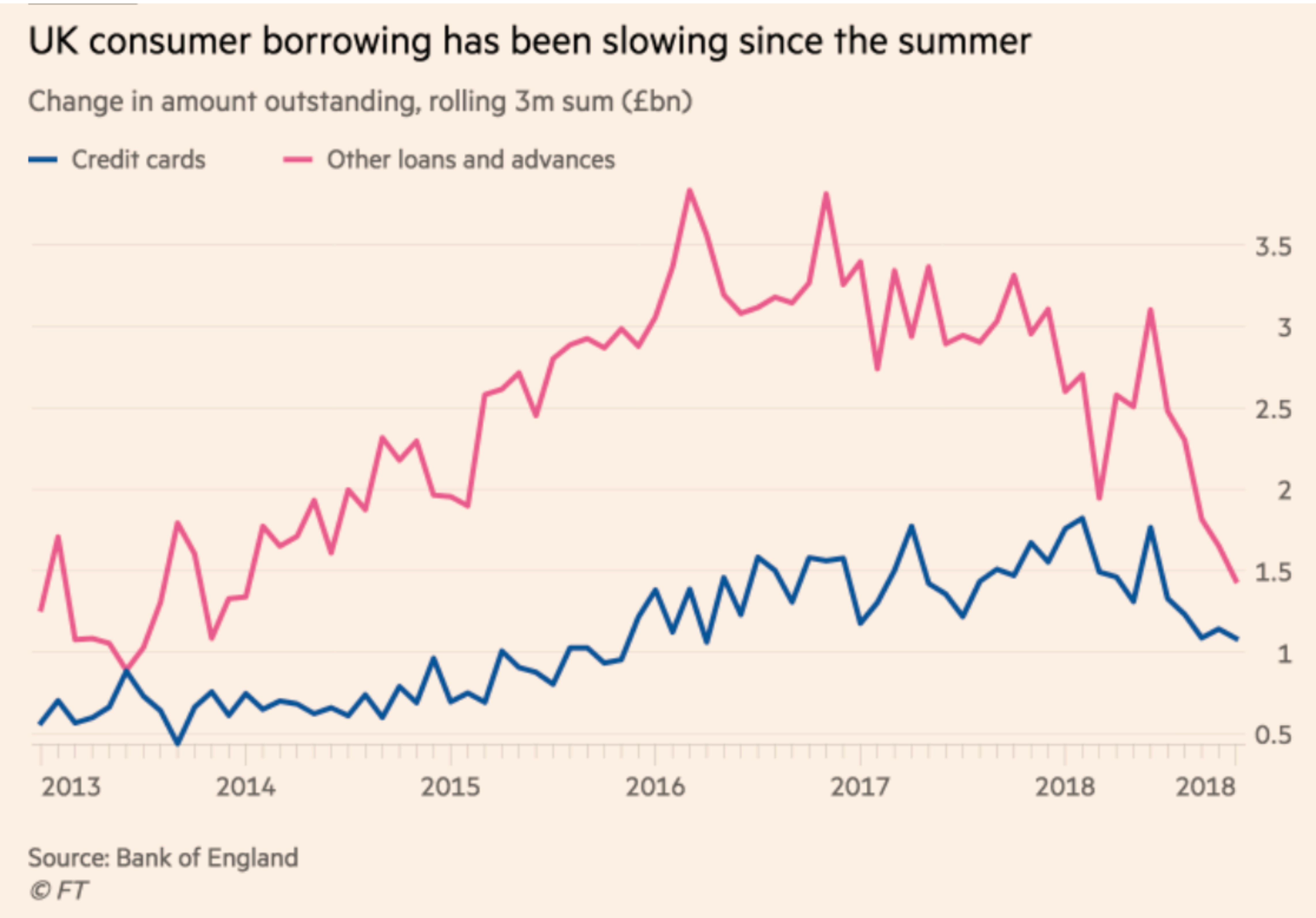
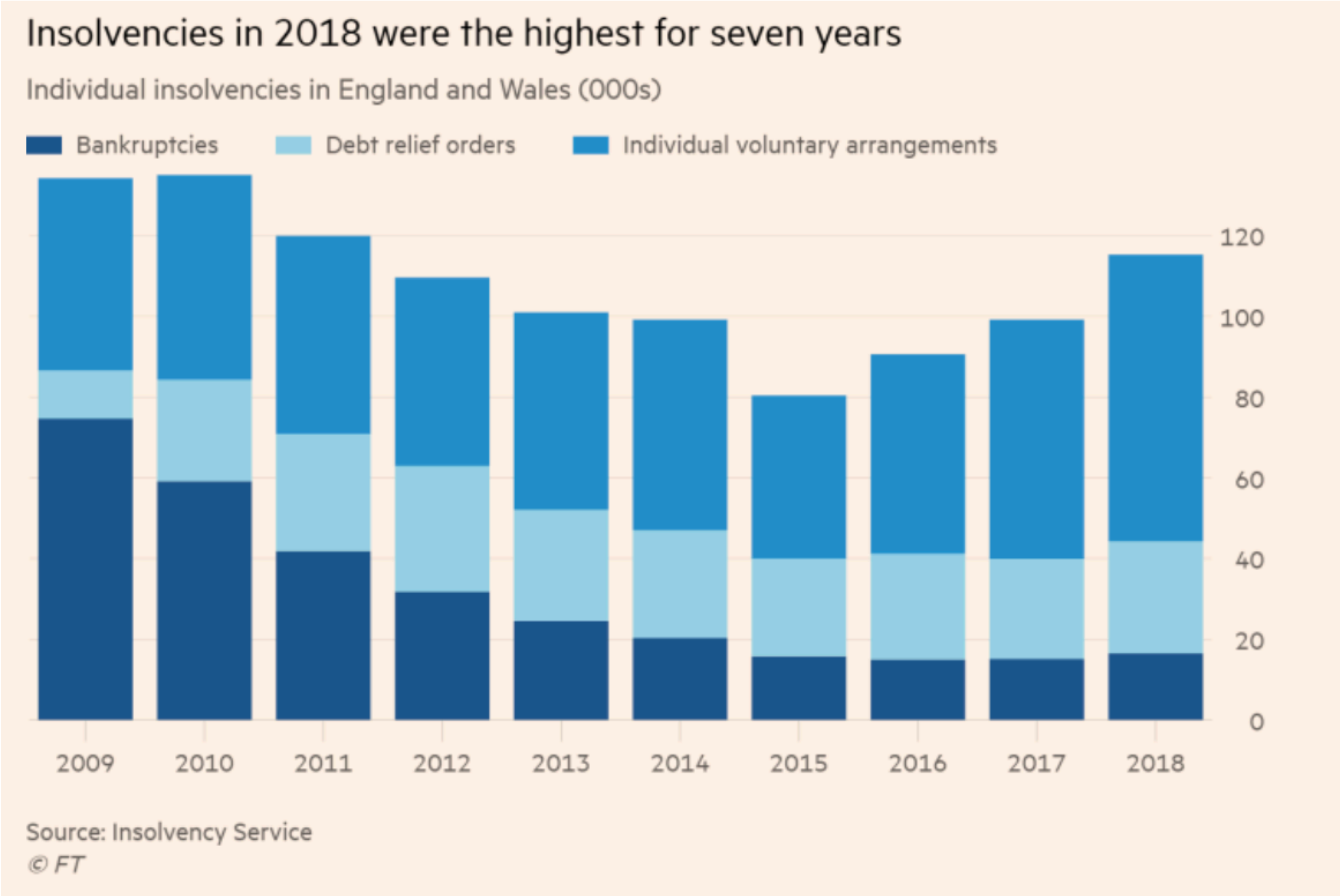
The current scenario





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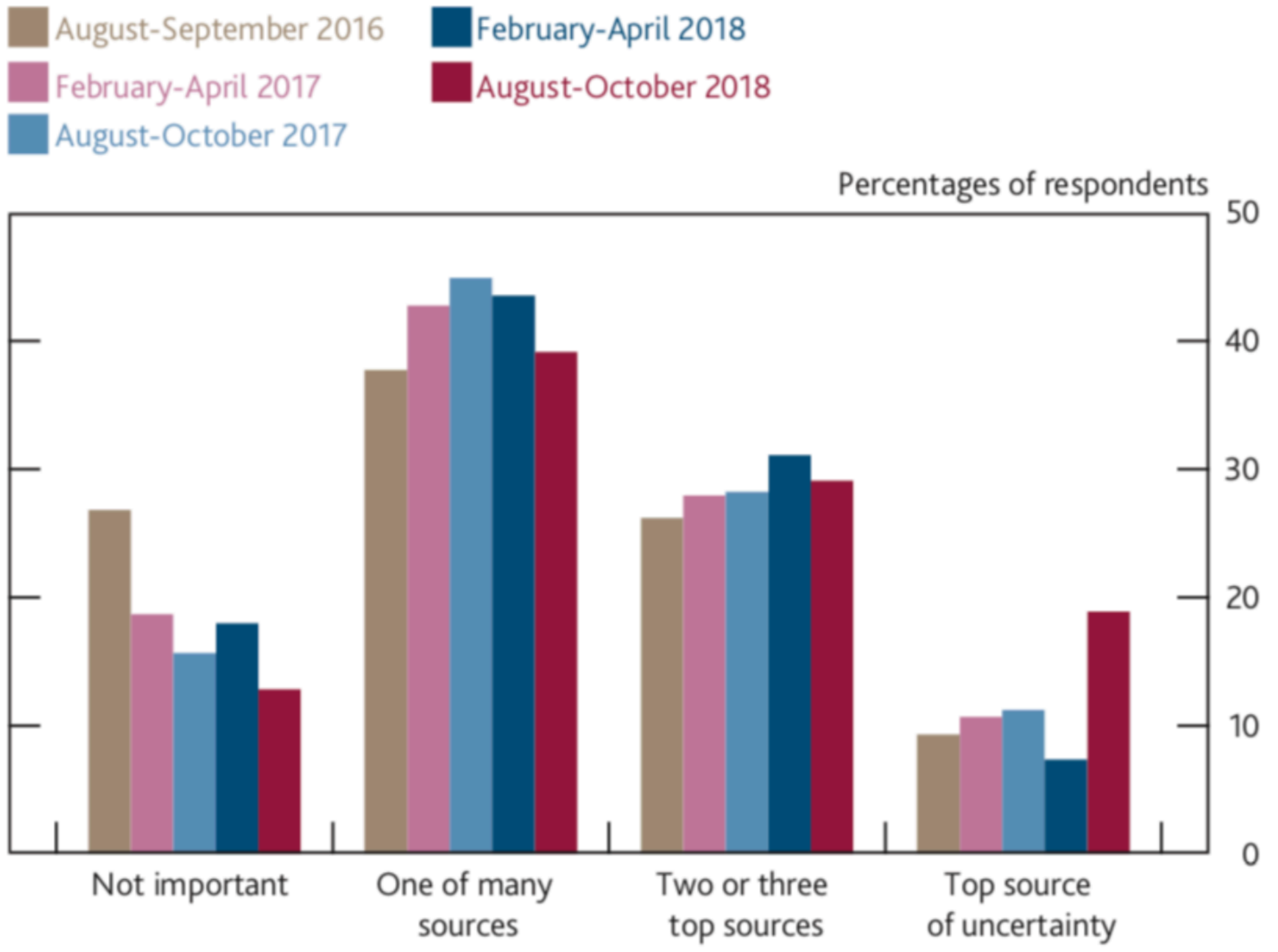
The current scenario

Chart 2.11 Brexit-related uncertainty among companies has risen

Decision Maker Panel: Brexit as a source of uncertainty[(a)]



(a) Responses to the question 'How much has the result of the EU referendum affected the level of uncertainty affecting your business?'.

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Epoch	Prior conventional wisdom	Economic outcomes	What did we learn	Protagonist
1920 - 1941 (Great Depression)	Markets are self-correcting, efficient, and ensure the full use of resources	Collapse of aggregate demand, high and persistent unemployment.	Instability is an intrinsic feature of the aggregate economy and aggregate demand can be stabilized by government policy.	Keynes
1940s - 1970	Government policy can implement an employment target by picking a point on the Phillips curve.	Late-60s decline in profits, investment, and productivity growth. Stable Phillips curve trade-off disappears.	With given institutions, the need to maintain profits, investment, and productivity growth can limit the ability of a government to implement sustainable low unemployment using aggregate demand policies.	Friedman
1970s - 2008 (Great Recession)	Instability has been purged from capitalist dynamics; minimally regulated financial markets work well.	Financial and housing market crash of 2008.	Debt-fuelled financial and housing bubbles can co-exist with low and stable inflation, and will destabilize an economy in the absence of appropriate regulations.	Minsky
2008 - 2019 (Austerity and Brexit)	Austerity to keep government debt under control; Macro Prudential regulation as policy for financial stability	?	?	?

Source: adapted from The Economy (Unit 17)

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What next?

- Brexit shock: real test for the current monetary policy framework and banking system
- Monetary policy committee has announced an increase in interest rates (7 Feb 2019)
- Problems in the banking system amplified the negative effects of the 2008 financial crisis, is the current system ready for a new crisis?