Only the ignorant live in fear of hyperinflation

By Martin Wolf - April 10, 2014 6:42 pm

(Martin Wolf, CBE is a British journalist, widely considered to be one of the world's most influential writers on economics. He is the associate editor and chief economics commentator at the Financial Times.)

Some years ago I moderated a panel at which a US politician insisted that the Federal Reserve's money printing would soon cause hyperinflation. Yet today the Fed's main concern is rather how to get inflation up to its target. Like many others, he failed to understand how the monetary system works.

Unfortunately ignorance is not bliss. It has made it more difficult for central banks to act effectively. Fortunately the Bank of England is providing much needed education. In its most recent *Quarterly Bulletin*, its staff explain the monetary system. So here are seven fundamental points about how it really works as opposed to how people

First, banks are not just financial intermediaries. The act of saving does not increase deposits in banks. If your employer pays you, the deposit merely shifts from its account to yours. This does not affect the quantity of money; additional money is instead a by-product of lending. What makes banks special is that their liabilities are money – a universally acceptable IOU. In the UK, 97 per cent of broad money consists of bank deposits mostly created by such bank lending. Banks really do "print" money. But when customers repay, it is torn up.

Second, the "money multiplier" linking lending to bank reserves is a myth. In the past when bank notes could be freely exchanged for gold, that relationship might have been close. Strict reserve ratios could yet re-establish it. But that is not how banking operates today. In a fiat (or government-made) monetary system, the central bank creates reserves at will. It will then supply the banks with the reserves they need (at a price) to settle payments obligations.

Third, expected risks and rewards determine how much banks lend and so how much money they create. They need to consider how much they have to offer to attract deposits and how profitable and risky any additional lending might be. The state of the economy – itself strongly affected by their collective actions – will govern these judgments. Decisions of non-banks also affect banks directly. If the former refuse to borrow and decide to repay, credit and so money will shrink.

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Fourth, the central bank will influence the decisions of banks by adjusting the price it charges (the interest rate) on extra reserves. That is how monetary policy works in normal times. Since it is the monopoly supplier of bank reserves and since the banks need deposits at the central bank to settle with one another, the central bank can in this way determine the short-term interest rate in the economy. No sane bank would lend at a rate lower than it must pay the central bank, which is the banks' bank.

Fifth, the authorities can also affect the lending decisions of banks by regulatory means – capital requirements, liquidity requirements, funding rules and so forth. The justification for such regulation is that bank lending creates spillovers or "externalities". Thus, if many banks lend against the same activity – property purchase, for example – they will raise demand, prices and activity, so justifying yet more lending. Such a cycle might lead – indeed often has led – to a market crash, a financial crisis and a deep recession. The justification for systemic regulation is that it will, or at least should, attenuate these risks.

Sixth, banks do not lend out their reserves, nor do they need to. They do not because non-banks cannot hold accounts at the central bank. They need not because they can create loans on their own. Moreover, banks cannot reduce their aggregate reserves. The central bank can do so by selling assets. The public can do so by shifting from deposits into cash, the only form of central bank money the public is able to hold.

Finally, quantitative easing – the purchase of assets by the central bank – will expand the broad money supply. It does so by replacing, say, government bonds held by the public with bank deposits and in the process expands the reserves of the banks at the central bank. This will increase broad money, other things being equal. But since there is no money multiplier, the impact on the money supply can be – and indeed has recently been – modest. The main impact of QE is on the relative prices of assets. In particular, the policy raises the prices of financial assets and lowers their yield. The justification for this is that at the zero lower bound normal monetary policy is no longer effective. So the central bank tries to lower yields on a wider range of assets.

This is not just academic. Understanding the monetary system is essential. One reason is that it would eliminate unjustified fears of hyperinflation. That might occur if the central bank created too much money. But in recent years the growth of money held by the public has been too slow not too fast. In the absence of a money multiplier, there is no reason for this to change.

A still stronger reason is that subcontracting the job of creating money to private profit-seeking businesses is not the only possible monetary system. It may not be even the best one. Indeed, there is a case for letting the state create money directly. I plan to address such possibilities in a future column.

Strip private banks of their power to create money

By Martin Wolf - April 24, 2014 1:32 pm

(Martin Wolf, CBE is a British journalist, widely considered to be one of the world's most influential writers on economics. He is the associate editor and chief economics commentator at the Financial Times.)

The giant hole at the heart of our market economies needs to be plugged

Printing counterfeit banknotes is illegal, but creating private money is not. The interdependence between the state and the businesses that can do this is the source of much of the instability of our economies. It could – and should – be terminated.

I explained how this works two weeks ago. Banks create deposits as a by-product of their lending. In the UK, such deposits make up about 97 per cent of the money supply. Some people object that deposits are not money but only transferable private debts. Yet the public views the banks' imitation money as electronic cash: a safe

Banking is therefore not a normal market activity, because it provides two linked public goods: money and the payments network. On one side of banks' balance sheets lie risky assets; on the other lie liabilities the public thinks safe. This is why central banks act as lenders of last resort and governments provide deposit insurance and equity injections. It is also why banking is heavily regulated. Yet credit cycles are still hugely destabilising.

What is to be done? A minimum response would leave this industry largely as it is but both tighten regulation and insist that a bigger proportion of the balance sheet be financed with equity or credibly loss-absorbing debt. I discussed this approach last week. Higher capital is the recommendation made by Anat Admati of Stanford and Martin Hellwig of the Max Planck Institute in *The Bankers' New Clothes*.

A maximum response would be to give the state a monopoly on money creation. One of the most important such proposals was in the Chicago Plan, advanced in the 1930s by, among others, a great economist, Irving Fisher. Its core was the requirement for 100 per cent reserves against deposits. Fisher argued that this would greatly reduce business cycles, end bank runs and drastically reduce public debt. A 2012 study by International Monetary Fund staff suggests this plan could work well.

Similar ideas have come from Laurence Kotlikoff of Boston University in *Jimmy Stewart is Dead*, and Andrew Jackson and Ben Dyson in *Modernising Money*. Here is the outline of the latter system.

First, the state, not banks, would create all transactions money, just as it creates cash today. Customers would own the money in transaction accounts, and would pay the banks a fee for managing them.

Second, banks could offer investment accounts, which would provide loans. But they could only loan money actually invested by customers. They would be stopped from creating such accounts out of thin air and so would become the intermediaries that many wrongly believe they now are. Holdings in such accounts could not be reassigned as a means of payment. Holders of investment accounts would be vulnerable to losses. Regulators might impose equity requirements and other prudential rules against such accounts.

Third, the central bank would create new money as needed to promote non-inflationary growth. Decisions on money creation would, as now, be taken by a committee independent of government.

Finally, the new money would be injected into the economy in four possible ways: to finance government spending, in place of taxes or borrowing; to make direct payments to citizens; to redeem outstanding debts, public or private; or to make new loans through banks or other intermediaries. All such mechanisms could (and should) be made as transparent as one might wish.

The transition to a system in which money creation is separated from financial intermediation would be feasible, albeit complex. But it would bring huge advantages. It would be possible to increase the money supply without encouraging people to borrow to the hilt. It would end “too big to fail” in banking. It would also transfer seignorage – the benefits from creating money – to the public. In 2013, for example, sterling M1 (transactions money) was 80 per cent of gross domestic product. If the central bank decided this could grow at 5 per cent a year, the government could run a fiscal deficit of 4 per cent of GDP without borrowing or taxing. The right might decide to cut taxes, the left to raise spending. The choice would be political, as it should be.

Opponents will argue that the economy would die for lack of credit. I was once sympathetic to that argument. But only about 10 per cent of UK bank lending has financed business investment in sectors other than commercial property. We could find other ways of funding this.

Our financial system is so unstable because the state first allowed it to create almost all the money in the economy and was then forced to insure it when performing that function. This is a giant hole at the heart of our market economies. It could be closed by separating the provision of money, rightly a function of the state, from the provision of finance, a function of the private sector.

This will not happen now. But remember the possibility. When the next crisis comes – and it surely will – we need to be ready.