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THE MONEY MULTIPLIER IS DEAD

Posted by Frances Coppola on Mar 13th 2014, 4 Comments

The Bank of England's Quarterly Review contains a detailed description of how money creation works in the UK's fiat money economy. Partnered with a useful primer on money and a couple of explanatory videos entertainingly hosted in the gold vaults (where is the pallet labelled "Deutschland", I want to know?), it is a comprehensive and clearly-written guide.

And it is controversial. It rejects conventional theories of bank lending and money creation *(my emphasis):*

"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**."

To be sure, numerous papers from many eminent researchers and august institutions (including the Fed, the IMF, the ECB and the Bank for International Settlements) have cast doubt upon conventional theory as an adequate explanation of money creation in a modern fiat money system. But to my knowledge this is the first time that a central bank has presented an explanation of money creation that so comprehensively departs from conventional orthodoxy.

Predictably, heterodox economists such as Steve Keen and Cullen Roche, who have written extensively about endogenous money creation and the inadequacy of conventional theory, are rejoicing. Equally predictably, perhaps, others argue that the Bank of England's paper is confused, contradictory or simply wrong. It is of course difficult for mainstream economists to accept that the theory they have believed and taught for so many years – and upon which many models of the economy depend – is simply inadequate. But there are some genuine concerns that need addressing.

It is hard to argue that the Bank's simple explanation of how lending works is wrong:

"Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of pounds worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. **At that moment, new money is created**."

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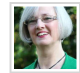
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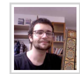
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