

## Festival of Economics 2017

# Money at a glance

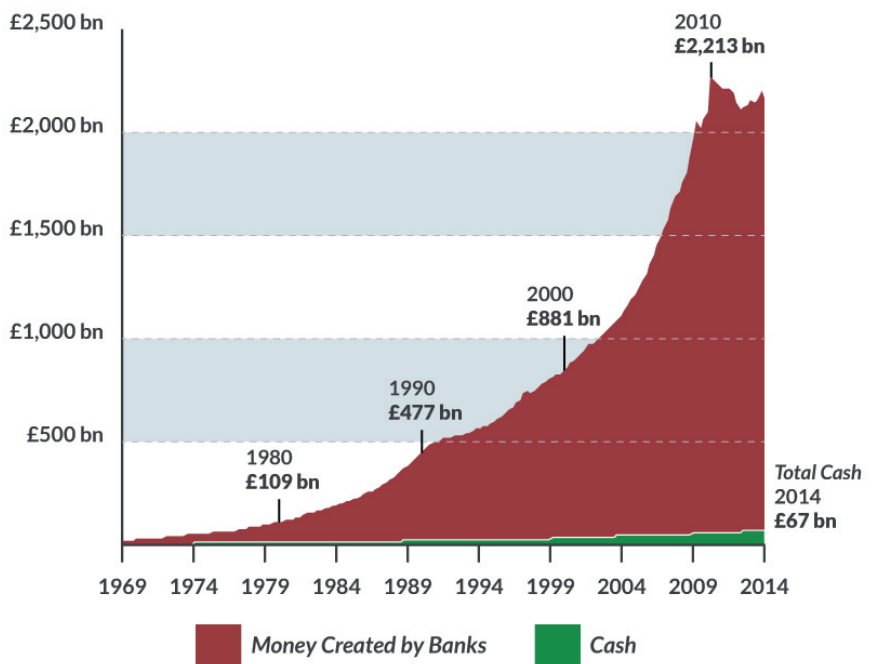
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**Key ideas**

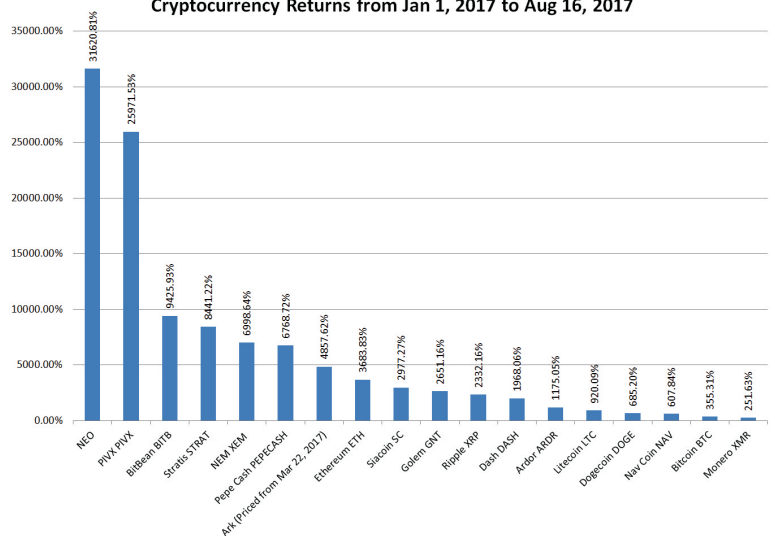
Commercial banks create money through loans; this accounts for 97% of the money in the economy. Should commercial banks have the power to create money from nothing?

As crypto-currencies gain traction, the economics community considers how central banks might adopt digital currency in the future.

Bitcoin, amongst other crypto-currency are experiencing exceptional growth. Is crypto-currency the future of money or is this another financial market bubble that is about to burst



Cryptocurrency Returns from Jan 1, 2017 to Aug 16, 2017



**Money of the future?**

- \*Cryptocurrency – relies on blockchain technology to operate + decentralized method of controlling the supply
- \* digital central bank currencies

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McLeay, M., Radia, A. and Thomas, R. (2014). Money creation in the modern economy. [online] <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q1prereleasemoneycreation.pdf>

## Money Creation in the Modern Economy

Did you know, new money is created every time a commercial bank extends a loan? The most important function of a commercial bank is to make credit available to households and businesses to help drive the economy. When someone takes a mortgage, or uses a credit card, the bank creates a matching deposit in the borrower's bank account, which essentially adds new money into the economy. Similarly, when a loan is repaid, money is destroyed. This contradicts common misconceptions that banks act as intermediaries that loan out funds collected from household savings.

The issuing of high-risk mortgage loans, funded via the shadow banking sector, was the main catalyst of the global financial crisis. Hence many believe banks have been irresponsible with their power to create money. Banks lending could lead to inflated asset prices; when it is easy to create money for mortgage purposes, house prices rise due to an increase in demand and willingness for lenders to lend. Banks are incentivized to lend substantial amounts as a result of higher returns. Naturally, this risk-taking behavior has angered society and triggered renewed reflections on whether the state have a monopoly on money creation. One famous proposal, the Chicago Plan advanced by Irving Fisher in 1930, was to reduce credit cycles by requiring banks to back their deposits with government-issued money. However, we have not yet seen any clear outcomes from these debates.

## Central Bank Digital Currency

What if everyone could open a deposit account at the Bank of England? At the moment, central banks can only provide digital currencies (reserves) to other banks and large financial institutions, and physical cash for

households. Once the central bank makes digital currency available for all parties, it would get a clearer understanding of financial transactions. Even though this might seem a simple process, the new infrastructure would need to run without any glitches and be strong enough to withstand cyberattacks. Its design would need to ensure that it does not crowd out deposit-issuing private banks. It would also face competition from cryptocurrencies due to their similar characteristics. Unlike cryptocurrencies, digital central bank money would act as store of value and means of payment.

## Money of the Future

Cryptocurrencies have seen a recent surge in popularity. There is however significant scepticism about their future role as money (as opposed to a tradable commodity) given price instability, slower transaction speeds as the block-chain gets larger and its unregulated nature. JP Morgan CEO recently threatened to fire any employee he found trading Bitcoin, whilst Goldman Sachs have just opened a Bitcoin trading department. There are projects that have the potential to change cryptocurrencies from a 'commodity' to a usable currency, notably 'Basecoin'. Basecoin founders recognize that cryptocurrencies will not become money while there is price instability and seek to create a central bank-like service whereby the price of Bitcoins would be controlled by selling Basebonds and Baseshares to increase/decrease the supply of coins. Many issues still arise though, primarily whether or not the economic theory they base their software on is reliable or if countries may wish to have a closer say in the creation and management of cryptocurrencies, as China did recently.