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Only the ignorant live in fear of hyperinflation

By Martin Wolf

Failure to understand the monetary system has made it more difficult for central banks to act

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 think it does.

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 byproduct 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.

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