l'éco en bref

Who creates money?

Key facts

Money is made up of:

- coins, produced by France's mint, the Monnaie de Paris;
- banknotes or fiduciary money, manufactured by the Banque de France;
- and entries in bank accounts: the bulk of money is scriptural.

Money is mainly created at the initiative of economic agents when they take out a loan to finance their activities. When a commercial bank grants a loan to an individual or a firm, for example, the amount of the loan extended is entered in the customer's bank account: the money has been created. It is said that "loans make deposits". This money can then be converted into fiduciary money by the withdrawal of cash, or give rise to cheques being written or transfers being made, for example. Subsequently, the money that has been created in this way by commercial banks continues to circulate between agents.

What is the central bank's role in this process?

The central bank manufactures fiduciary money and has a monopoly on the issuance of legal tender currency; it also steers the money creation process by setting the price of money. By means of key interest rates, the rates at which commercial banks can borrow from the central bank (see "What is monetary policy?"), it influences the interest rates on loans to firms and individuals in the economy as a whole. By encouraging economic agents to apply for more or less lending from their banks, changes in key interest rates influence the quantity of money created.

To meet the financing requirements of the economy, growth in money creation needs to vary in line with the growth in goods and services: it should be neither too much nor too little. This is one of the main tasks of central banks.

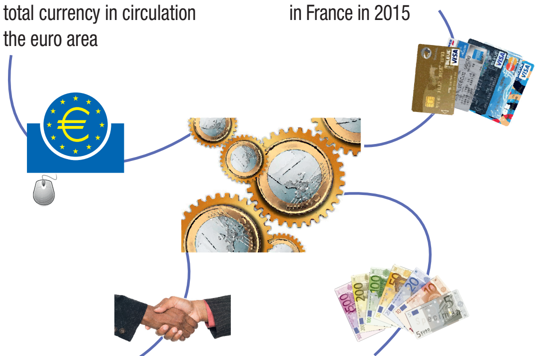
A brief history

- **1600-1046 BC**: traces have been found of the use of cowrie shells as a pre-monetary currency, under the Shang dynasty in China.
- **6th and 5th centuries BC**: first coin minted in Lydia. This currency was *dokima*, meaning that it had legal tender status in the kingdom.
- **335-333 BC**: Aristotle theorised the three characteristics of money for the first time, as a store of value, a unit of account and a medium of exchange.
- **1024**: under the Song dynasty, the Chinese administration gave legal tender status to the *jiaozi*, one of the first forms of banknote, which had already appeared unofficially in the 9th century.
- **1360**: Jean "the Good", King of France, who had been taken prisoner by the English, was freed in exchange for a ransom. To pay it, he created a new gold currency: the "*franc à cheval*". The new currency gradually became the only one to circulate in the whole of the kingdom. This was the birth of the franc.
- **1742**: English bankers could no longer issue banknotes as the Bank of England now had a monopoly on banknote issuance; they therefore invented a new means of payment: the cheque.
- **1848**: introduction of legal tender status for banknotes in France.
- **1974**: invention of the chip bank card.
- **1 January 2002**: changeover to the cash euro.

Key figures

90%
The proportion of scriptural money in total currency in circulation in the euro area

50%
The proportion of payments by bank card in France in 2015



715
billion euro
Total amount of lending obtained by firms in France at end-January 2016, a 3% increase year-on-year

2.8
billion euro
Number of euro banknotes produced by the Banque de France in 2015

Understanding money creation

The theoretical debate about money creation

While it is now generally agreed that "loans make deposits" (it is the banking system that initiates money creation), the opposite was argued until the 1970s by many economists who espoused the fractional reserve theory. According to this theory, the deposits of some bank customers are a prerequisite for any lending to be granted to other customers. In other words, deposits always precede loans.

This theory, which in the past held true for some banks, no longer corresponds to the reality. By a simple bank account entry, a loan immediately becomes a deposit, and this accounting entry expands the money in circulation in the economy. Economic agents' need for financing is the source of money creation; the latter thus supports economic activity. Loans are therefore the direct source of deposits, and not the other way round.

There are, however, limits on money creation

Commercial banks cannot extend unlimited lending and thereby create unlimited money. There are two types of limit on money creation: the price stability objective of monetary policy that leads the central bank to indirectly regulate the quantity of money in circulation in the economy; and banking regulation, which lays down prudential rules:

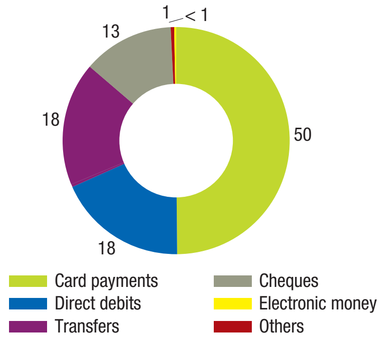
• Commercial banks must hold a minimum amount in their account with the central bank that is proportional to their customers' deposits in their accounts.

• The amount of their own funds (capital, reserves, etc.) must be proportional to the risks on the loans granted. Money creation through lending therefore goes hand-in-hand with increased capital requirements for banks.

• Banks must put in place internal control procedures in order to assess the ability of borrowers to repay their loans and thereby reduce payment default risk.

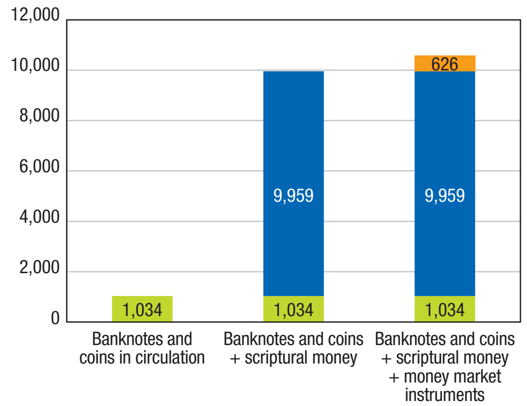
In addition to these regulatory safeguards, banks have their own internal requirements. They themselves limit their capacity for money creation so as not to take excessive risks in lending to insolvent customers who are unable to repay their debts.

Breakdown of means of payment in France, by volume
(in %)



Source: Banque de France, based on data from the Comité consultatif du secteur financier *(CCSF - Advisory Committee on the Financial Sector).*

Money in circulation
(in EUR billions)



Source: ECB.

Money and you

Money has three functions:

• It is a unit of account, a yardstick used to post prices and record debts. It is a unit of measurement of value in the economy.

• It is also a medium of exchange. Money is the most liquid asset available in the economy.

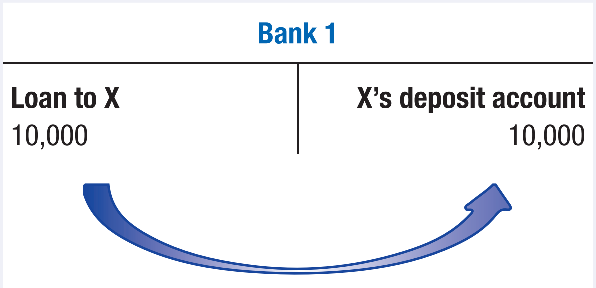
• Lastly, it is a store of value, something that can be used to transfer purchasing power from the present to the future. It serves to preserve purchasing power between the moment revenue is received and the time when it is spent.

Money is thus at the heart of our economic system and occupies a central place in our daily lives. It is therefore crucial that all the users of a currency have total confidence in its lasting value and ability to act as a means of exchange. This is the responsibility of the government and the central bank: the former can legislate, while the latter establishes its credibility over time through the effectiveness it demonstrates in achieving the objectives assigned to it.

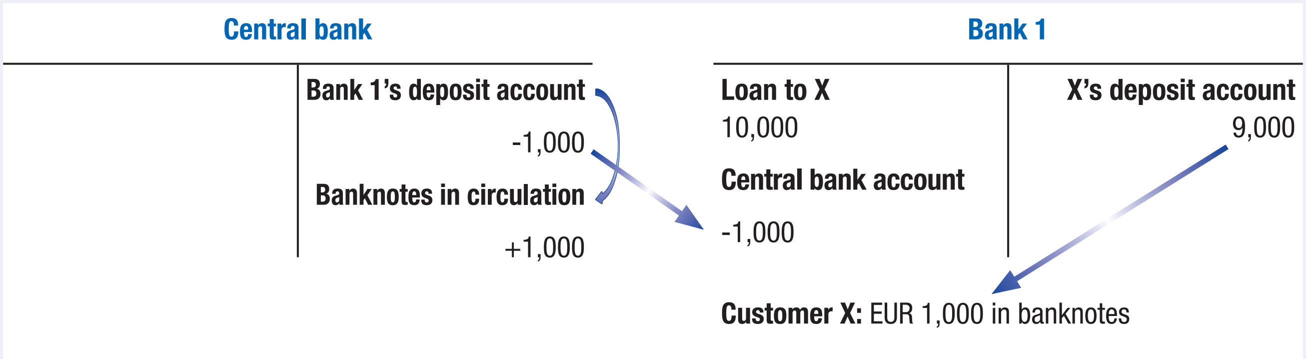
A simplified accounting diagram: money creation and putting banknotes into circulation

Let us take an economy composed of a single commercial bank, Bank 1, and a central bank that has a monopoly on issuing banknotes. Bank 1 has an account with the central bank.

- **Step 1:** individual X borrows EUR 10,000 from Bank 1. By means of a simple accounting entry, X's deposit account at Bank 1 is credited with EUR 10,000.



- **Step 2:** customer X withdraws EUR 1,000 in banknotes. For this to happen, Bank 1 has to buy these banknotes from the central bank. Its account at the central bank is debited by EUR 1,000 in exchange for the banknotes, which it can now deliver to its customer X.



To learn more

Suggested viewing:

➜ Money creation

Useful links:

➜ The dangers linked to the emergence of virtual currencies: the example of bitcoins