



HM TREASURY

1 Horse Guards Road
London
SW1A 2HQ

20 July 2010

J Hoontrakul

Information Rights Unit

By email:
Request-40086-b8e834c6@whatdotheyknow.com

Tel: 0207 270 4558
Fax: 0207 270 4861

www.hm-treasury.gov.uk
FOI.responses@hmtreasury.gsi.gov.uk

Ref: 10/544

Re: Freedom of Information Act 2000: Money Creation

Thank you for your enquiry dated 28 June requesting information under the Freedom of Information Act 2000.

2. You asked for information addressing the following question -

how the government deals with inevitable monetary collapse resulting from fractional reserve lending.

3. Formally, under the Act, I need to register that we do not hold any information that directly addresses your premise. I hope the following observations are nonetheless helpful.

4. The fractional reserve system is based on the principle that the cash reserves at a bank available to repay bank deposits need only be a fraction of the cash deposits held by depositors. It is fundamental to the role of banks in the effective creation of credit as it enables banks to have more claims outstanding against them than they actually have in cash to pay those claims. The potential danger of this system is that depositors can withdraw all of their deposits at the same time. If that happens there would be a run on the bank and it would fail in the absence of any intervention by monetary authorities. But such occurrences are rare as central banks typically guarantee deposits at commercial banks and act as lenders of last resort in the unlikely event of a bank run. In the absence of a financial crisis triggering a bank run, the fractional reserve system can function quite smoothly because at any one time relatively few depositors will make cash withdrawals simultaneously compared with the total amount on deposit.

5. The central bank has direct control over the cash base, or the monetary base, which in the UK is defined as M0. This consists of currency (notes and coins) held by the public and the banks, and deposits held by banks with the central bank. But even the central bank cannot create money from nothing. In order to issue new banknotes central banks typically buy interest-bearing bonds. So in expanding the monetary base, the central bank is expanding both sides of its balance sheet. At the same time as it increases its liabilities (the monetary base), it purchases assets of equal value.

6. Households and businesses settle many transactions using their deposits with banks. These deposits are typically included in a wider definition of money known as broad money. The standard measure of broad money in the UK is M4. Notes and coins make up only 3 per cent of total M4. Sterling deposits with banks and building societies largely make up the remaining 97 per cent. The largest role in creating broad money is, therefore, played by the banking sector. Banks intermediate funds by taking deposits and lending part of that money to others. When banks make loans they



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create additional deposits for those that have borrowed money. There is, therefore, a strong link between the growth of money and credit.

7. The banking problems experienced by many countries in the late 1980s and early 1990s demonstrated the critical role of capital as a defence against adverse shocks and the importance of robust capital regulation. Setting out a global framework for capital requirements in the banking industry, the 1988 Basel Capital Accord (i.e. Basel 1) was an attempt to link mandatory capital levels to the risk profile of the banking institution and, at the time, was seen as a major step forward in the design of capital regulation. It proposed an 8 per cent regulatory minimum capital requirement for banks' exposures to credit and (in 1998) market risks. According to the Bank of England June 2010 Financial Stability Report UK banks strengthened their resilience during 2009. Capital increased significantly with average capital ratios now at their highest level in more than a decade.

8. If you have any queries about this letter, please contact me. It will be helpful to us if you remember to quote the reference number above in any future communications.



Paul Morran
Information Rights Unit

Your right to complain under the Freedom of Information Act 2000

If you are not happy with this reply, you may request a review by writing to HM Treasury, Information Rights Unit, 2/S2, 1 Horse Guards Road, London SW1A 2HQ.

Email FOI.responses@hmtreasury.gsi.gov.uk

Any review request must be made within 2 months of the date of this letter.

It would assist our review if you set out which aspects of the reply concern you and why you are dissatisfied.

If you are not content with the outcome your complaint, you may apply directly to the Information Commissioner for a decision. Generally, the ICO cannot make a decision unless you have exhausted the complaints procedure provided by the Treasury. The Information Commissioner can be contacted at: The Information Commissioner's Office, Wycliffe House, Water Lane, Wilmslow, Cheshire SK9 5AF.

