

# Discussion of the problems in monetary control that the bank of england faces

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Discussion of the problems in monetary control that the Bank of England faces. A problem on controlling the money supply by the Bank of England partly stems on the relative difficulty in determining it. Given the unique nature of the demand for money, the "identification" problem for broad money (often used by central banks to measure money in the economy) is not easily resolved by simply deriving the separate demand and supply relationships of broad money in the economy. According to Thomas (1997, p. 7) two important econometric issues arise for any researcher attempting to model a supply-demand relationship of broad money. The first relates to the determination of the money stock, that is if one is measuring the demand for money, the supply of money or some combination of the two.

The second issue is exogeneity. This is because existing models of money demand have traditionally treated explanatory variables in theoretical money demand functions as exogenously given (or determined elsewhere). However, consistent estimates of the parameters of the money demand functions are easy to be retrieved (Thomas 1997, p. 2).

Thomas (1997, p. 46) also found out that increases in the stock of money have a strong short-term impact on consumption which conquers the effects of real interest rates. Despite that money is treated as an indicator of economic circumstances facing households, households' response to a variety of economic shocks is a complex dynamic interaction of money, credit and expenditure that interpretation of these shocks' effects on broad money cannot be simply made. As Thomas' study results suggest that there is a strong interaction between personal sector holdings of M4 and consumption, factoring consumption patterns into money demand and

supply determination may ease the problem on monetary control.

Another solution to the problem is the use of the Divisia money concept.

However, the use of such concept entails a new set of difficulties, particularly, the choice of the benchmark asset and rate; the interest the rates paid on individual Divisia components; the appropriate level of aggregation; and problems of 'break-adjustments' (Hancock 2005, p. 40). For example, as for the first problem optimal benchmark asset should provide at least as good a store of value as the components of the money supply, but have no use for transactions. This implies that in equilibrium the rate of return on such an asset should be greater than the return on any components that are useful in transactions (Hancock 2005, p. 40).

Explain the process of credit creation used by the banks.

To understand the model of credit creation in banks, we assume in a hypothetical economy that there is only one bank (operating like a monopolist), Bank A, and that cash is the only liquid asset held by the bank. We then assume that a customer Benjie the Bum to make a cash deposit of 1000 in the bank. Rather than let Benjie the Bum's deposit become idle and earn no interest, the bank recognizes that it has an incentive to lend in order to earn profits.

Let us then assume that Ivo the Inventor wants to obtain some funds to get his latest invention brought into the market. He goes to Bank A and decides to borrow 1000 and provide for himself a personal bank account. Assume that the bank has no responsibility of maintaining a cash ratio. Bank A then decides to lend the 1000 in full. Since the bank did not removed the 1000 from its custody but credited instead the same amount of money into Ivo the

Inventor's account, the bank's liability (represented by deposits) increased by 1000 while its assets also increased, particularly the loans section, by exactly the same amount, while still maintaining the same amount of cash in its vault.

Now suppose Minda the Manager also decides to provide for herself a personal bank account at Bank A with 1000 by borrowing it from the bank. Bank A decides to provide her an account with 1000 by immediately crediting it to her new account. As such, similar to Ivo the Inventor's case, the bank's deposits increased by another 1000 while its loan assets increased by the same amount. Take note that all of these happened even without the exchange of currency.

From the above model, we can infer that based from the stages Bank A has gone through, the bank has increased its assets (in the form of loans) by crediting the accounts to its borrowers while it does not lend out its cash. As the loans are transferred from one account to another at the monopoly bank, it creates deposits, and thus, increases the amount of money but not wealth. Also, it can be observed that the cash ratio, the ratio of cash to the bank's liabilities also increases. An important implication of this is that the bank has to maintain a safety net for its cash and liquidity ratios so as it can still meet its obligations to its depositors whenever they want to take out their money from the bank.

## References

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