From The Ecology of Money: How the Bank of England controls the Money Supply at:

http://www.feasta.org/documents/moneyecology/box1.htm

1 How the Bank of England controls the money supply.

The explanation of the way banks create money makes it appear that the amount of notes and coins in circulation, coupled with the reserve ratio the banks set themselves, determine the extent of a country's money supply. Actually, this is not quite the case. In most countries, the central bank does not attempt to control the total value of the notes and coins in circulation. In Britain, for example, the Bank of England (BoE) will sell as many notes and coins to the commercial banks as they wish. It simply debits the accounts these banks operate with it by the appropriate amount. So the cash base of the British monetary system is not just the notes and coins that the banks have in their branches, but whatever money they have in their accounts with the BoE as well.

Another minor difference is that it is not the commercial banks themselves that decide the reserve ratio they want to follow, but the central bank to which they report. For example, in Britain until 1981, the BoE specified the total amount of notes and coins a bank must have available at its branches, plus the amount on deposit with it, in relation to the amount of money the bank had created by granting its customers overdrafts and other loans. This meant that if at any time the BoE felt that the amount of money in circulation was too high and was causing inflation, it could force banks to reduce their lending by requiring them to deposit more funds in their accounts. A reduction in the reserve ratio from 20:1 to 10:1 would have halved the total of the amount of money that banks could create. That system still applies but in a less rigid form. Responding to pressure from the commercial banks (who argued that they would otherwise lose overseas business to foreign banks), the BoE abolished its minimum reserve ratio in 1981. It now agrees a reserve requirement individually with each bank. This reflects both the level of competition the bank is experiencing from its foreign rivals, and the lending and other risks that it is perceived to be running. This change has weakened the BoE's ability to control the money supply by varying the reserve ratio.

The second way that the BoE can control the money supply is by 'open market operations'. These involve the BoE in buying, or selling, interest-bearing bonds. If it sells bonds, the purchasers (financial institutions or members of the public), pay for them by writing out cheques drawn on their commercial bank accounts in favour of the BoE. Subsequently, the BoE debits the accounts that the commercial banks operate with it by the relevant amounts. Unless the commercial banks make up these debits in some way, the volume of lending they are able to make (and thus the amount of money in circulation), has to be reduced by a figure set by whatever the reserve ratio they had agreed with the central bank. If the ratio were 20:1, their lending would have to be reduced by twenty times the amount of bonds that the BoE had sold.

If the reserve requirement is increased, or the amount in its account with the BoE falls, a bank could maintain its lending by raising more capital and depositing this with the central bank. The new capital could come from selling more shares, or from making a trading profit and paying that to the BoE (rather than distributing it to shareholders as a dividend). For many years the Irish commercial banks attempted to justify their huge profits with the argument that they were necessary to enable the banks to lend enough money to finance a rapid expansion of business activity. Profits made by the UK's twelve banks and former building societies quoted on the Stock Exchange are high too. In 1998/9 they totalled £22bn, around £400 for every man, woman and child in the country. If the BoE wants to increase the amount of money in circulation, it can do so by buying up bonds that it, or perhaps a local council, had issued previously. In fact, a possible way that Begg's hypothetical customer obtained the £100 to depositwith their bank was by selling some government stock (perhaps Consuls or War Bonds that they had inherited). Alternatively, their lodgement could have been a payment from overseas.

The third way in which the BoE can control the national money supply is to alter the interest rate at which it lends funds to banks that fail to keep positive balances in their accounts with it. According to an official BoE statement,9 this is the main way that the money supply is controlled at present. The technique involves keeping the banking system short of money and then lending the banks the money they need at an interest rate that the BoE decides. The BoE statement explains, "If, on a particular day, more funds move from the private sector [i.e., non-government accounts held in the commercial banks], to the Government's accounts than vice versa, for example because banks' customers are paying their taxes, then the banking system will be short of the funds needed [by the commercial] banks to maintain positive balances on their accounts at the Bank." Alternatively, if the government is spending more than it is collecting, the BoE can create a shortage by selling bonds itself. The Bank then lends the banks the funds they need to keep their accounts with it in credit at a rate of interest that sets the rates at which the banks lend to each other, and to their customers. And that rate of interest, of course, determines how much the banks' customers borrow, and hence the national money supply.