Funding the Future

Money creation need never threaten an economy

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I was asked recently to comment on this statement made to my correspondent in response to the suggestion that a country with its own currency can never go bankrupt:

A country can default on its debts though or be so heavily in debt that its only hope is to print lots of money (like we do) to stay afloat, until that currency is destroyed and so the overbearing debt is hyperinflated away and a new currency is eventually born in its place after the collapse phase. Technically not "bankruptcy" as such, but still much the same effect. Also by unlimited money printing this could also lead to the collapse of the bond market which finances our deficits. If we can't do that, we are pretty much screwed.

There are so many falsehoods in here that it is hard to know where to start debunking.

First, let's be clear we're not printing lots of money to stay afloat. It is true that the Bank of England has created £435 billion of new money using quantitative easing since 2009. Despite this UK broad money supply (M4, as it is called) has fallen since then. To say that printing money is creating excess money supply is just wrong as a result.

To say that's we're heavily in debt is also wrong. I refer to the evidence here. The Bank of England would say we owe 89 per cent of GDP in national debt at present. This, however, ignores the fact that the Bank of England actually owns one quarter of that debt. The true figure for national debt actually owing to third parties (which is what matters) is, then, 67 per cent of GDP, which is historically an incredibly low rate.

Nor is inflation a concern. Inflation is running at just over two per cent now. There is not a hint (barring adjustments caused by Brexit) of more to come. To talk of hyperinflation is absurd.

The suggestion that money printing by our government is, then, a threat to our economy is absurd. In fact, to the contrary, money creation by our government has been essential when the private sector has refused to create enough cash, which is what has been happening in the UK due to net saving by business and the overseas sector and (until recently) households. It is only government money keeping our economy going. This should not, of course, by surprising to anyone: if banks do not do the job of money creation then it is inevitable government must. And do not be confused on this issue by the fact that we now have a personal debt crisis; whilst this might imply banks are over extending credit in some areas (and they are) this is happening whilst other sectors are simultaneously sitting on a glut of savings. It's the mix of debt that we have that is causing the crisis.

So, to summarise, the implication in this comment that the UK is heading for the rocks because the Bank of England has created new money is straightforward hyperbole without any economic foundation in fact. It can be dismissed as evidence free comment of no value at all.

Now let's turn to the bond markets. Money printing is done by denying the bond markets the product they want. That is because QE, which creates money, simultaneously takes bonds out of circulation. It does not flood the market with new bonds. Instead it reduces the supply of bonds because the new money created is either used to repurchase bonds already in existence or it could (if we do Brexit and so leave EU law behind) avoid the need for the issuance of bonds altogether with the Bank of England then lending money direct to the Treasury instead.

To the extent that money printing repurchased all bonds it would, I agree, then destroy the bond markets in UK government debt, which is a product which savers are desperately keen to buy. But this would not be because the market had been flooded with debt for which there was no buyer, as the comment made implies, but would instead be because there would be no bonds left to sell. Those wanting bonds would then be forced to look elsewhere for a safe place for savings, but they would not be able to find that in sterling. That is precisely why I think the government will keep bonds in issue at a net interest yield of around zero per cent, as now. It makes sense to keep the market hungry, but that is exactly what money creation, by rationing bond supply, does. As a result money printing supports rather than undermines bond markets, which are very healthy at present. Once again the comment made is wholly without an evidence base.

So is there anything else that money creation threatens? What it does threaten is price stability. That's because too much money in circulation can undoubtedly deliver inflation. But that can and must be addressed by taxing sufficiently, especially if near full employment. If that is done the risk is averted.

And in that case of all these things are taken into account let's then be clear that the exchange rate cannot be imperilled by money printing. In fact, again the exact opposite is likely to be true because money printing will boost the economy towards full employment, will encourage investment and will boost productivity, all of which improve the exchange rate. So once more the prediction made is wrong.

I emphasise the conditions I note. Money printing must be used wisely. But when it is there is a bonus to any economy using it. The UK has gained. But I stress, if the money printed was used as an investment fund to create jobs in every constituency in the country it could do better still. But what cannot ever be said is that the comment made to my correspondent is correct, because it is just pure economic nonsense.