

Tackling the post-coronavirus economic myths: runaway i...

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I am beginning to see an increasing number of post-coronavirus economic myths emerging on twitter and other media. These need to be tackled now. I will do so as I note them. If people see issues to address, please let me know.

One such myth that appears quite commonplace at present is that the creation of money by the government to tackle this crisis will lead us, in very short time, to a situation like that of the Weimar Republic, with hyperinflation following. This is quite emphatically not true for a number of reasons.

Firstly, for there to be inflation there has to be something that drives it. For example, there has to be a shortage of available labour in the market which drives up wages. Right now there is a prospect of mass unemployment, meaning that the chance of wage driven inflation is, therefore, incredibly low.

Alternatively, there has to be excess demand for what is available in market, meaning that prices are pushed up by supply-side shortages. Whilst there is more risk of this, particularly with regard to some basic products at present, what almost invariably happens during a period of crisis, which in this case is likely to last for much longer than most people realise, is that people save because uncertainty creates that natural reaction. In that case excess demand for this reason is unlikely.

Excess demand for items in short supply is also unlikely because there is little chance that banks will be offering easy credit any time soon: their balance sheets are going to take a hammering during the course of the coronavirus crisis and if anything credit is going to be in short supply. Excess demand giving rise to inflation for that reason is also unlikely in that case.

There is also little sign that external price shocks e.g. oil price increases, are likely at present. Instead all commodity prices are falling because of declining demand which is likely to continue for a long time to come.

Second, we are in nothing like the situation the Weimar Republic found itself in during

the 1920s. What happened in that case was that following the First World War it was obliged to pay reparations to the winning countries in that conflict. They demanded payment in what were their own gold standard backed currencies of that era, meaning that in an effort to pay Germany had to focus its entire economy on exports to earn the foreign currency it owed and crush an already defeated population with what was, in effect, a massive austerity programme that sold their labour at an undervalue to the winning states. It could not achieve that goal and in the economic turmoil that followed, and as a result of the effort to serve its obligations to buy the currencies of other countries to make payment to them, it crushed the value of its own domestic currency, with disastrous consequences. But we have no such obligations now. Crucially, nor do we have the gold standard now. As importantly, nor does the UK government borrow in foreign currencies. And, as a matter of fact the rest of the world still seems rather keen to save in sterling. So we are not remotely in a situation like that of Weimar Germany even if we will see a lot of government-created money this year, and in the years to come.

There is a third, and perhaps most important reason why we will also not get inflation. That is because of the nature of modern money. It is crucial to understand that all modern money is just a promise to pay. We really should be familiar with that: it is written on our banknotes, after all. But it seems that we are not. As a result this requires explanation.

Electronic money, which represents about 97% of all money in use in the UK, has no more physical existence than an entry in an electronic bank statement. That is all it is: just an accounting entry. There is nothing to physically back it up. There is no gold in vaults, or cash in safes. There is just book-keeping. That is what our money is. It is accounting entries in bank ledgers.

Those accounting entries are made to record the real nature of money. That real nature is what is printed on our bank notes: money is always created by a promise to pay. The accounting records those promises.

So, for example, if you pay cash into a bank account the bank does not keep that cash for you. Instead, it records its promise to pay you back an equivalent sum when you ask for it on an electronic bank statement. You no longer have the cash: you have the bank's promise instead. That's it: you have now literally nothing else. You just have to trust that the bank is good to make the payment.

Such transactions in case are, however, the exception now: most electronic money entries in accounting records are made in a quite different way. In this other way they are always, and without exception, created by bank lending. This needs explanation.

When a bank makes a loan it does two things. It marks up its customer's current bank account with the amount of the loan, and then promises that the bank will then honour any payment that the customer tells it to make out of that account. This is one side of

the promise to pay: that form the bank to the customer.

The other side is that the bank marks up the customer's loan account with the amount of the loan to record the fact that the customer has also made a promise to pay. That is the other side of the promise to pay.

With those two simple records being created, new cash has been put into existence. It did not exist before these two entries were made into the bank accounts in question. It does afterwards. And that is the way in which about 97% of all money in the United Kingdom is created, whether that be by commercial banks or, as importantly as I note below, by the Bank of England.

Most importantly, this is also the way in which the government spends. Like absolutely everyone else in this country, and any other country with a similar banking system, there are just two conditions that must be met before the government can spend.

First, it must decide to do so, which is something that ministers and Parliament must do. We hold them to account for these decisions.

Second, it must have available credit with its bank to let it spend.

Both conditions are essential: money is not created without the decision to promise to pay, which Parliament and ministers can deliver, and then the ability of the government to deliver on that promise because a bank will agree to make the resulting payment, in exchange, of course, for a promise from the government to make repayment to it in due course.

Note that there is no requirement that there be cash in the government's bank account before it spends, because that is not necessary. Instead what is required is a bank willing to extend credit — to mark up its ledgers in the way I have just described in other words — on behalf of the government.

It's important to note that nobody else's cash was involved in the process of making the loan I previously described: the making of the new money that loan created was a matter that only involved the bank and the customer who took the loan. That's also true when the government asks a bank to make a payment for it: no previous cash deposit, whether from tax revenues or third-party borrowing is required to enable this spending to take place. All that is necessary is that a bank agree to advance the government the credit it wants and then the government can spend as it wishes, or as parliament has decreed in a budget.

There is, however, a twist to this tale. It just so happens that most governments are in a quite exceptional position when it comes to asking for credit. That is because the vast majority of governments own their own central bank. It is important to appreciate that these central banks are real banks. They can make real loans in exactly the same way

as I have already described. And they can, as a consequence, make loans to the governments that own them, subject to the rules and constraints that those governments have voluntarily or otherwise imposed upon them, as many have in areas like the Eurozone. Those rules and constraints have been put in place to restrict the ability of central banks to lend to their governments, largely for the benefit of the private banking sector which has, in most countries, considerably over-expanded and became too powerful as a result. But these rules and constraints apart, and however and whenever they are imposed, there is no reason at all why a government should not borrow from its own central bank.

But, in this exceptional case of a government borrowing directly from its central bank something quite unusual happens. Precisely because the government owns the central bank it borrows from any promise to pay that they make to each other can be open-ended. No date needs to be attached to it. There is good reason for that: you cannot, in effect, owe yourself money, which is what happens when a government borrows from its own central bank. And in that case when you repay is a matter of inconsequence: in truth it changes nothing.

Despite that, however, the government can spend from its account with its central bank based on promise that it has made. But, crucially, it need never repay that bank, if it so wishes, because if it did it would only be repaying itself, in effect. So something quite different from what happens in a normal loan arrangement happens in this circumstance: the money that is created can be left circulating in the economy in perpetuity if the government so wishes, at no cost to the government itself. In effect, what has happened is that the debt that the government owes its central bank has been turned into money itself.

This was considered a threat to economic stability from 1971 onwards, when the world did, in effect, come off the gold standard with the United States, which happened in that year. Because this whole process was so little understood at the time, and because many of the economic theories of money were also deeply underdeveloped back then, the whole school of monetary economics came into place to try to restrict the ability of the government to create money at will because it was believed that this would lead to hyperinflation. Instead economies were forced to rely solely on private-sector banks to create most new money through their lending, driving the economy into ever-increasing debt cycles that have had a significant adverse impacts upon income and wealth inequality, growth and economic stability. The policy has remained in place ever since, constraining the whole of the Eurozone, creating the policy of independent central banks, imposing austerity through the artificial constraint that it creates upon the government's ability to fund its activities, and causing untold harm as a consequence. The cost of not understanding money is enormous. But now we do: it works as I have explained.

As importantly, what we also know is that if there is an economic downturn — and the coronavirus crisis is going to create a massive economic downturn — then two things

happen.

First of all, many banks trying to recover the loans that they have made. And, when a bank loan is repaid the money that it created is then destroyed: quite simply, the creation process is put into reverse. As a result of the money supply is restricted.

Second, banks tend to substantially reduce the amount of new lending that they make. Partly that is because worried people tend not to apply for bank loans, because they reduce their spending instead. More problematically, though, banks also refuse to extend new credit precisely because many of the potential customers do not look as though they can fulfil any promise that they make to repay the bank. This is precisely the situation that many UK businesses, homeowners, and others are facing.

The result is a reduction in the money supply. What that means is that if we were solely dependent upon our banks to create our money then the amount available to make the economy go around would be reduced. We would get what is called a liquidity crisis. And that is exactly what we now have: people and companies are going to fail precisely because they cannot get access to the cash that they need to make the payments that they owe even if they believe that their incomes might recover in the post coronavirus crisis period. Unimaginable harm might come to the economy as result, which the government's inability to deliver on its promises of support on a timely basis will only exacerbate.

Government can correct for this. Precisely because most private-sector banks will be reducing their risk at present by calling in their loans, or by refusing to make new ones, the government has to compensate by creating new money instead.

It did this after the 2008 global financial crisis. The process used at that time was called quantitative easing (QE). This was a bit cumbersome but what, in effect, happened was that central banks bought government bonds that were already in issue from the financial institutions like banks, pension funds and life-insurance companies that already owned them with the intention of providing more liquidity to the financial markets, which they hoped would do two things.

One expectation was that this would encourage investment in new assets. This failed. The money was mainly used for financial speculation instead.

Second, they intended to push the interest rate down, which the government also believed would encourage more economic activity. The objective of reducing interest rates undoubtedly worked: the official rates have been at, or near, zero per cent for almost a decade now. There is, however, little sign that this boosted economic activity, although it might, again, have increased inequality in all its forms.

The QE program was, then, deeply flawed: whatever success it achieved in helping people and businesses to afford their loan obligations was more than compensated for

by the divisions in income and wealth that it produced in society.

Thankfully, we do not need to use the QE process again now. Precisely because no one wishes to reduce official interest rates any further, largely because there is considerable uncertainty as to the impact of negative interest-rates, QE is no longer needed because the type of liquidity it created was otherwise unhelpful. Instead, the process of direct funding from central banks to governments can be used instead.

And, importantly, and to return to the theme of this post, this will not be inflationary unless three situations occur.

The first is that full employment is restored and the policy is perpetuated. Then there will be wage inflation. It's a risk, of course, but not for a long time to come.

The second is banks start recreating money by lending again. They will, eventually, but not for a long time to come, I suspect. Everyone's balance sheet is going to be very weak after this crisis and that's always bad for lending.

And the third is that governments do not react to the first two situations when they arise by then (and only then) beginning to withdraw the cash that they have created from the economy, with the effect of cancelling it, just as loan repayment does in other lending situations. That's when tax increases will be needed. They serve this purpose of destroying money at that time. Until then they're wholly counterproductive, because they will drag money out of the economy and destroy it when that money will still be required to provide the essential liquidity that the economy needs to function as it returns to full employment, which should be the goal of any government.

So, there is an inflation risk, but it's at some time in the future. And we know how to deal with it then. That will not be by increasing interest rates — which creates debt insolvencies — but by tax increases, but these are required only when the pressure is apparent.

What chance is there of significant inflation in a year or so then? I'd call it zero, for all practical purposes. In fact, I would suggest that the chance is very low indeed for several years to come.

So might we do two things then? One is let's stop discussing inflation risk.

And the other is to stop discussing the need for tax increases unless those are designed to redistribute income and wealth i.e. the increases for those with higher incomes and wealth are matched by cuts for those with less of both. But generic overall tax increases are simply not required now.

There is much that we need to fear about this crisis. Inflation and tax rises do not need to feature on a list of those things.