The government can create all the money we need: an exp...

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I have argued that now is the time for the government to create all the money that might be needed to keep our economy going in the face of the coronavirus crisis. My argument is that the government should, quite literally, run any deficit that is necessary to achieve this goal, given how important it is to our long-term economic survival, subject (of course) to the spending making sense for that same purpose i.e. it is consistent with the logic of building a future sustainable economy.

This does, though, give rise to the question of how this money can be found. The purpose of this post is to answer that question. The answer is that it can simply be created.

I stress, that this is an electronic process. It amazes me that most people think that money is printed. It isn't. Only 3% of all money in the UK is physical. The rest is created by banks, but that includes the Bank of England, of course.

How does a bank create money? The honest answer is out of thin air. It happens whenever they create a loan.

Most people think when they ask a bank for a loan money paid in by one person is paid on to them. That's not true. Not true at all, in fact.

Instead what the bank does is a conjuring trick. To make it easier to understand presume that you have asked a bank you have not dealt with before for this loan. When they agree to the loan they open two accounts for you. One is a current account. The other is a loan account. If you borrow £10,000 they mark your current account as having £10,000 in it. You're now free to spend that however you like.

They also mark your loan account as having £10,000 in it. You now owe that to the bank.

Add the two together and they add up to nothing. One you apparently own (the current account) and one you apparently owe (the loan account). But if you decided to cancel the deal you could straight away repay the loan using the current account and there would, literally, be nothing left. Which is why I mean they add up to nothing. There was no money before the loan was agreed. There is none when it is repaid. In the meantime the loan created money. And repaying it destroyed it.

Note there’s no cash involved in this process at all. It’s just an accounting trick. Nothing more.

And no one else’s money is involved in the process.

Or any existing money, at all.

This loan creates entirely new money, from nowhere.

Now, of course banks can’t repeat this lending trick forever because if they did people would realise there was no substance behind the promise the bank makes to you when making the loan that the money they put in your current account is good to spend.

And that’s the confidence part of the trick. So long as people believe the banks will pay they don’t need money. They can just pretend they have it. When people don’t have that confidence they do need money. Trouble is, they always lend far more money than they actually have. That’s the risk in a ‘run on the bank’ of the sort Northern Rock once suffered.

But there is one bank that can never run out of money. And that is a central bank of a government that has its own sovereign currency, such as the Bank of England in the UK. The Bank of England can always pay. It can never fail. Because as the creator of all money, it can simply mark up its account with the government, and issue some more currency at will whenever it wants.

The relationship between the Bank of England and the government is crucial here. The Bank can always lend what the government wants. So there need never be a shortage of money, most especially in situations of the type that now exist.

But, of course, this still involves a confidence trick. People have to believe that this government created money is worth using. They do for three reasons.

First, for many there is no practical alternative, and that is not just a matter of choice. Because we have to pay a significant part of our earnings in tax and the only currency we can actually pay in is sterling, as a matter of fact, then we must have access to that sterling and so we use it for our day-to-day exchanges.

Second, we trust the currency precisely because we know that the country will tax, which means that the currency will have value in the future. A strong and significantly sized tax system that is properly enforced is, then, key to the stable valuation of a currency. That tax also, and crucially, is the means to cancel this government created money. Tax pays the same role as loan repayment in cancelling money creation in the example previously given. And cancelling government created money is important: this means government spending need not create inflation when full employment is reached, which would otherwise be the case. So tax does not actually fund government spending: it cancels their inflationary impact of it if (and that’s a crucial if) that inflationary impact arises, which only arises domestically when full employment arises.

And third, we usually trust our government and economy to broadly prosper in a fashion compatible with other economies, so our currency can usually be exchanged with others of similar type on a fairly consistent basis, meaning that those from outside the country are happy to use it too. So, again, the currency has value. And it’s not money creation that ever changes this: it’s poor tax and economic policy that does, because they are what prevent the control of inflation.

But it’s still all down to confidence, because that is all there is to money creation.

Well, that, and a trick of double entry bookkeeping.

Who would have thought it? Not many, actually. When explaining this phenomenon the second greatest economist of the last century (J. K Galbraith) said:

The process by which banks create money is so simple that the mind is repelled

(John K. Galbraith, in “Money: Whence it came, where it went”, p. 29.)

He was right, because it’s true: the process is so simple that we’re repelled by it. But it’s time we got used to it, because government created money is an essential part of our new economic paradigm, as I will explain in blogs to come.