

Money creation

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I published this glossary entry on money creation on Sunday. Does it work? Are there suggestions for improvements? Comments are welcome:

In a fiat currency system, which system is now used by almost all money-creating jurisdictions in the world (including the UK, USA and eurozone) all that money represents is a promise to pay, which is otherwise called debt. All money creation must, as a result, recognise the creation of new debt between the parties who give rise to that new money creation.

This process is not as complicated as it sounds. Only two types of organisation can be involved in transactions that create money.

One is the government of a jurisdiction that creates a fiat currency. A government can create new money at will by demanding that its central bank make a loan to it to finance its expenditure. This is the source of all new government-created money, otherwise known as base money, which is used to enable the banking system of a jurisdiction to function by providing the liquidity required so that the jurisdiction's commercial banks can settle their liabilities to each other.

Government-created money is injected into the economy via the central bank reserve accounts that commercial banks maintain with a jurisdiction's central bank.

Government-created money is destroyed through the payment of tax. This is important. It explains why tax does not fund government spending. Money creation by the government funds government spending. Taxation takes the money the government creates to fund its spending out of circulation as a mechanism to control inflation. That money is then destroyed. Tax as a result never funds government spending: it cancels money creation.

Government-created money can also be effectively neutered by the issue of

government bonds: these effectively lock away government-created money from use in the economy for significant periods of time. They do not have the same impact of destroying money as taxation does, but the impact is not far short of that: the money, or debt, is locked out of use.

Commercial banks also take part in the money-creation process. They do so by lending. The money that they create is destroyed by loan repayment. This was [acknowledged as a fact](#) by the Bank of England in 2014.

There is no fixed stock of money. The amount of money in circulation depends on the amount of money created by both the government and the commercial banks of a jurisdiction, and the amount of money destroyed by taxation and loan repayment. In that case, the control of inflation necessarily requires the integration of tax policy and monetary policy. The fact that this rarely happens is a major weakness within modern macroeconomics.

Money creation by banks is pro-cyclical. That means when the economy is booming the banks lend more and so create more money. When an economy is sluggish borrowing is reduced and loan repayments tend to increase. The result is that if money supply is to be maintained across an economic cycle a government has to spend more money into existence during economic downturns. This is a major reason why austerity economics has been so counter-productive because it reinforces the pro-cyclical swings created by commercial bank lending policies and exaggerates the economic cycle as a result.