

Advantages and Disadvantages of a Government Solely Depending on Money Newly Created on Banks

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ABSTRACT

Government spending is essential because it makes it possible to provide essential public goods and services and to build the necessary infrastructure. Taxes have historically been a major revenue source for governments. To fund government operations, taxes are charged on a person's or company's income, profits, or consumption. It would be a radical shift from the status quo if the government instead relied on money that was generated by the bank. In this alternate scenario, the central bank prints money to fund government spending instead of collecting massive amounts of tax revenue. By raising the supply of currency or reserves, the central bank expands the monetary base and injects fresh money into the economy. This study will analyze the pros and cons of having governments increasingly rely on bank-created money rather than tax revenue.

Advantages of Relying Solely on Money Newly Created by the Bank

Increased Flexibility in Funding Government Expenditure

Governments that depend primarily on bank-created money have more leeway in how they choose to spend that money. With this method, the government has more leeway and flexibility in distributing money to address a wide range of budgetary requirements. The bank can print money on demand, unlike tax income, which must be collected and processed, which takes time. This facilitates the virtually instantaneous availability of cash to the government. Having access to cash quickly is always important, but it becomes more important in times of economic crisis or emergency. The newly formed funds allow the government to promptly react to unanticipated occurrences such as natural catastrophes or disruptions in the financial markets.

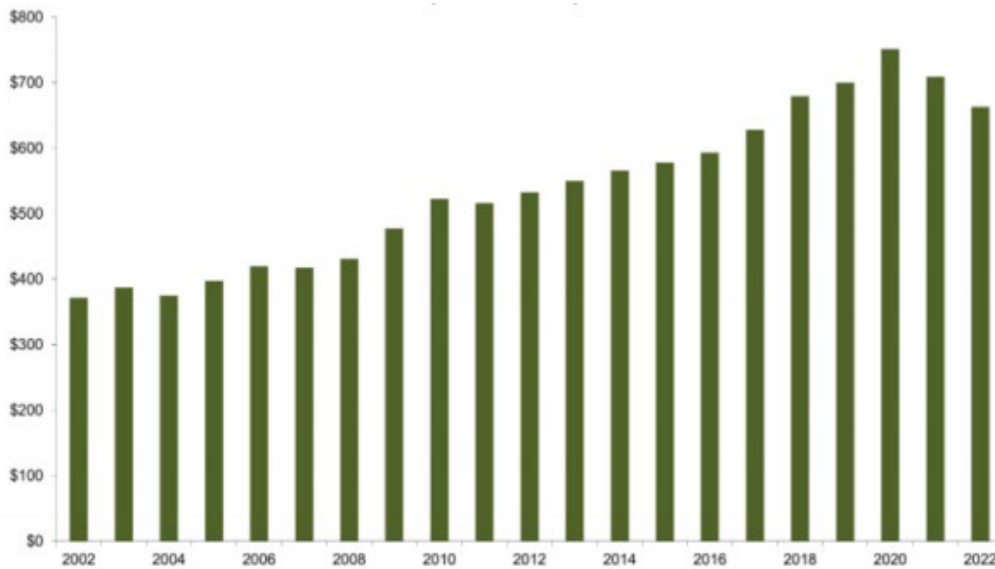


Figure 1. Federal Reserve Currency operations (Federal Reserve 2023)

The reaction of nations, notably the United States, during the COVID-19 epidemic is a real-world example of improved flexibility in supporting government spending using freshly produced money. The United States, for example, depended on freshly produced money by using the Federal Reserve's capacity to perform quantitative easing operations. The government was able to quickly deploy cash to different initiatives, stabilize financial institutions, and stave off a worse economic collapse as a result. The Federal Reserve resumed its purchase of massive amounts of debt securities, a tool used to prevent recession in an action known as quantitative easing. Without having to wait for tax income, which may have been delayed due to the difficult conditions produced by the epidemic, freshly minted money allowed for immediate access to finances.

The FED actions were aimed at mortgage-backed securities markets to ensure the markets would run smoothly since these markets play a critical role in ensuring a smooth supply of credit to the overall economy. This action of Quantitative Easing involved the creation of new money from the bank which provided the government with enough flexibility in the manner in which it spent the funds. The central banks created money out of thin air to fulfill their liquidity needs.

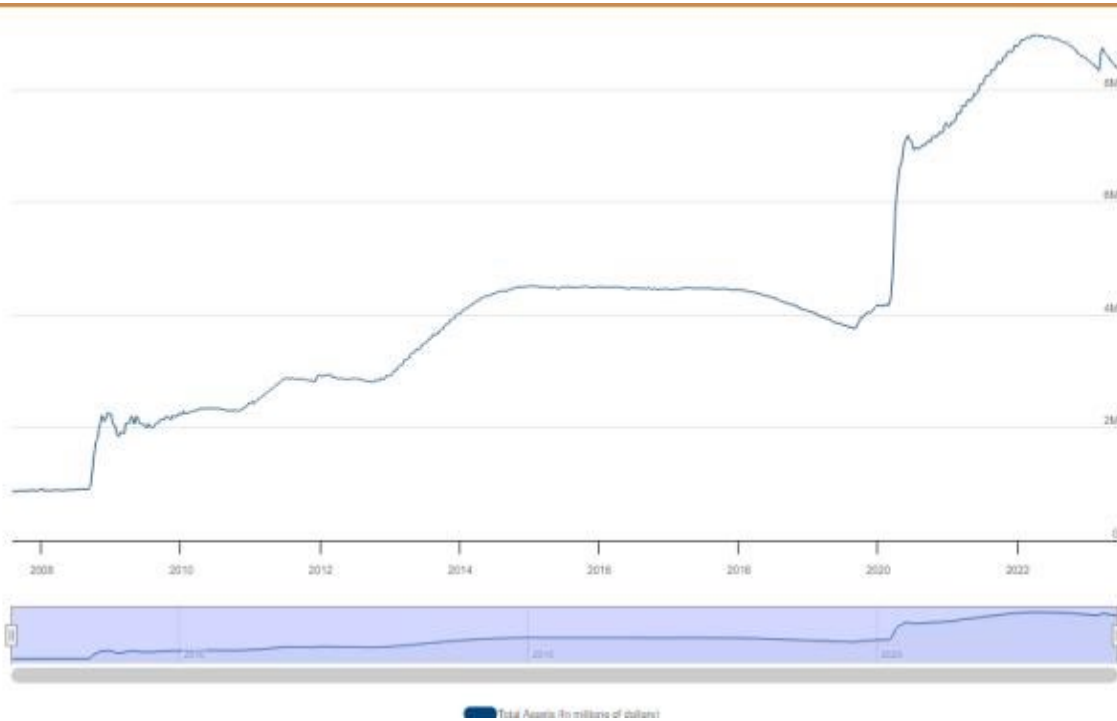


Figure 2. Federal Balance Sheet over the years (Federal Reserve 2019)

Extra Money Is Being Poured into the Economy

One clear benefit of governments using just freshly minted money from the bank is that more money is injected into the economy. This may be accomplished via direct governmental expenditure and quantitative easing (QE) initiatives. Quantitative easing is employed by the federal government to bolster the economy during times of economic distress. The government encourages economic development and activity by expanding the money supply.

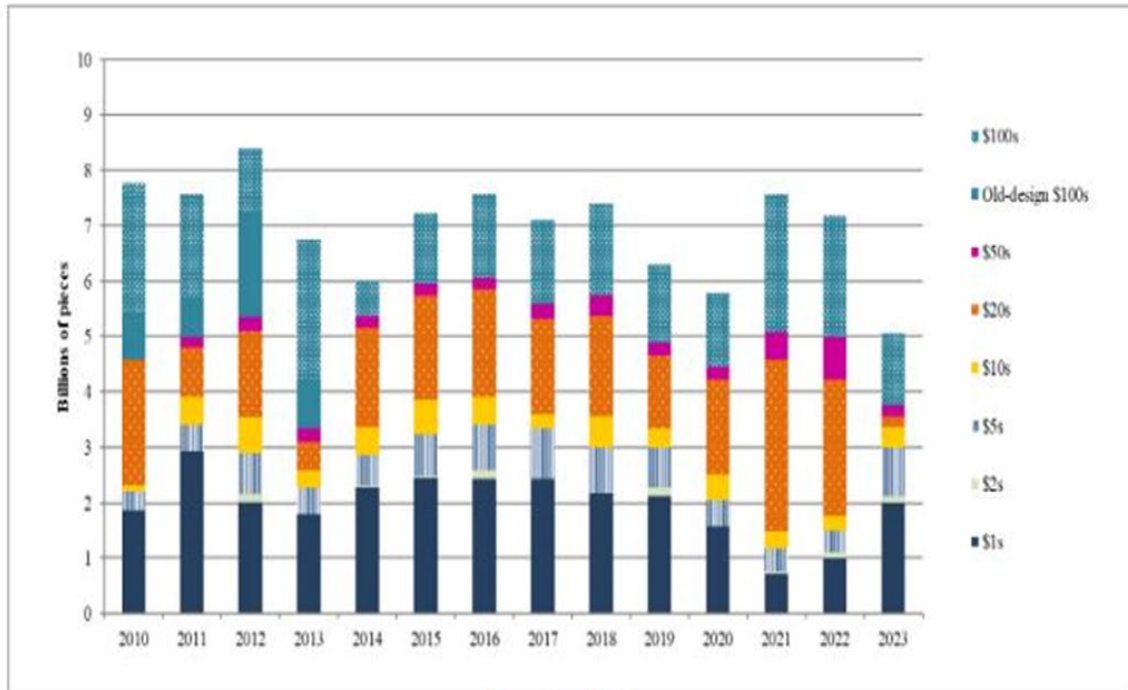


Figure 3. Money Printed in US notes over the Years (Federal Reserve 2023)

The potential increase in aggregate demand is a major benefit of injecting more money into the economy. The buying power of both individuals and companies rises as the money supply rises. As a result, there may be a rise in retail sales, corporate investment, and overall economic activity. Therefore, the increased demand may help to drive production, provide new employment opportunities, and boost the economy as a whole.

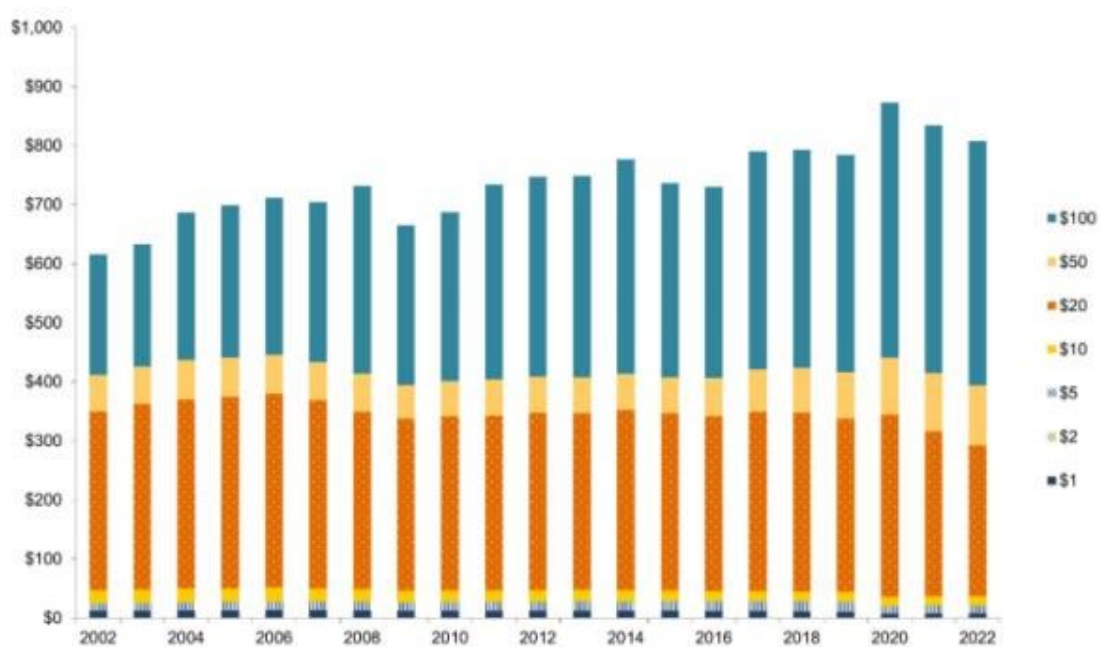


Figure 4. Payment of Currency in the Circulation (Federal Reserve 2023)

Financial institutions may have liquidity shortages and find it difficult to service the lending demands of consumers and companies during economic downturns. The government ensures the health of the banking system by providing liquidity to banks via the creation and injection of new money into the system. As a result, lending activities are bolstered, credit is more easily accessible, and faith in the financial system is boosted through Quantitative Easing.

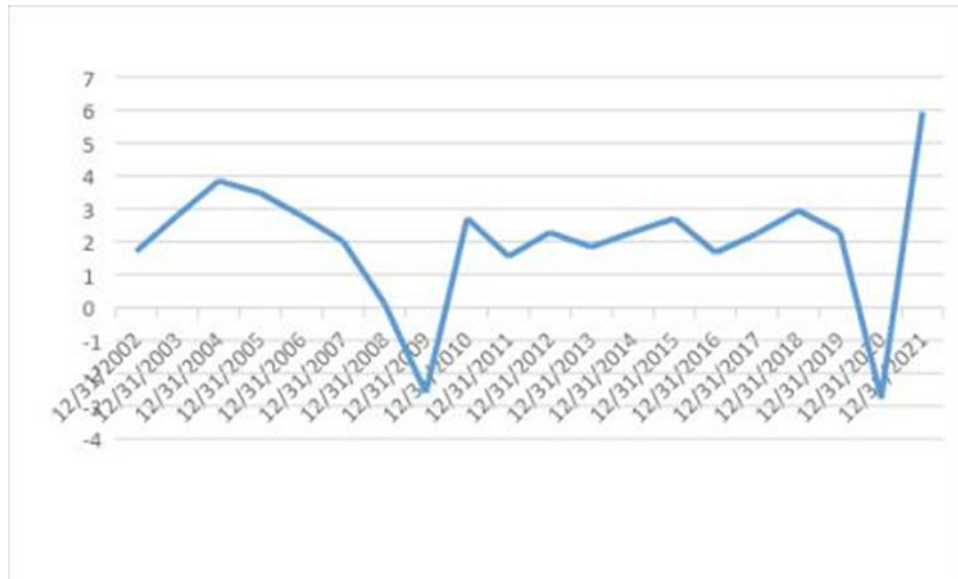


Figure 5. US GDP Growth in percentage (Federal Reserve Board 2023)

The reaction of governments to the 2008 financial crisis is a concrete example of injecting more money into the economy. The United States Federal Reserve used QE programs to buy financial assets like sovereign debt and mortgage-backed securities using newly-created money. As seen in Figure 4 the volume of currency in circulation during the 2008 crisis increased to boost the declining economy as seen in Figure 5. These purchases of assets served to stabilize markets, infuse more capital into the economy, and increase the liquidity available to banks which led to the rapid recovery of the economy as shown in Figure 5. Figure 3 shows huge sums of money were printed to replace the money released into the economy, for example, huge sums of money were used by the federal reserve for the Quantitative easing initiatives. This led to the printing of huge sums of money in successive years (2010, 2011, 2012). The economy greatly recovered characterized by Increasing GDP after the Federal Reserve quantitative easing initiatives (see Figure 5).

Consequences of Being Overly Dependent on Bank-Created Money

Increased Inflation

One drawback of governments using just freshly produced money from the bank is higher inflation. A continuous increase in the general price level may result from excessive money generation without an equivalent increase in the manufacturing of goods and services, weakening the buying power of people and companies. Over expansion of the monetary supply is possible when the government must rely only on money freshly generated by the bank to cover its expenditures. The outcome is a higher ratio of currency in circulation to the value of goods and services produced by the economy. When there is an increase in the money supply competing for a fixed or decreasing quantity of goods and services, inflation increases.

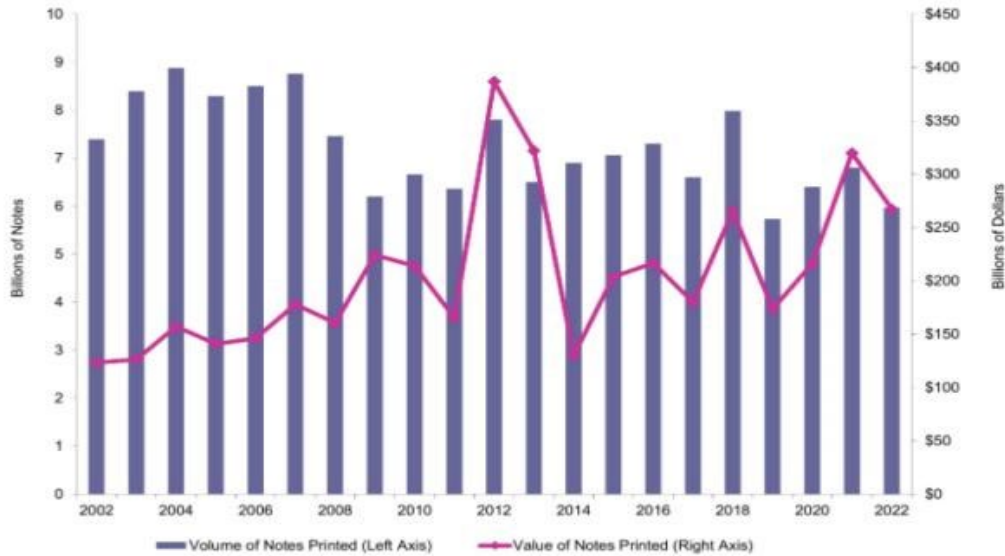


Figure 6. The value and Volume of Notes Printed over the years (Federal Reserve 2023)

Rising inflation is problematic because it reduces the buying power of people and families. This lowers their level of life by eroding their actual income. It may also cause people to lose faith in the economy and cause them to worry about where prices are headed, both of which can have a detrimental effect on their ability to make sound financial choices.

Savings and investments may potentially suffer losses due to inflation. People whose savings are in cash or other low-interest accounts may see their buying power erode as the value of their money decreases over time. As a result, people may be less inclined to save, and they may adopt riskier investing tactics to keep up with inflation. Inflation may also make it difficult for firms to precisely anticipate their expenses and profits, which can reduce investment and slow economic development.

Increased inflation also has the potential to misallocate resources within economies. Rapid price increases make it difficult for companies to accurately assess the worth of their inputs and products. Because of this, companies may put short-term gains ahead of long-term sustainability, which may lead to an incorrect allocation of resources. Industry competitiveness and market efficiency may both be negatively impacted by relative pricing distortion.

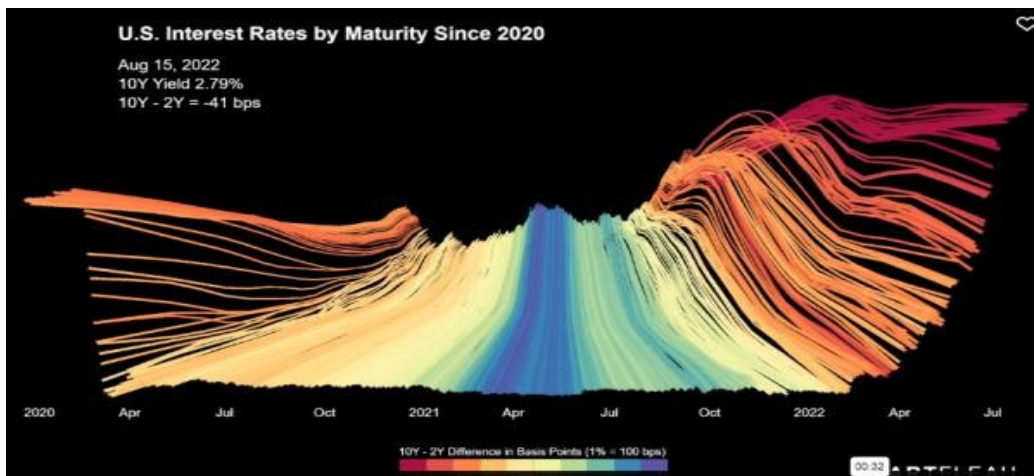


Figure 7. Interest rates Change since the Pandemic (Varsava 2022).

A good example is the recent collapse of the Silicon Valley Bank, which occurred as a result of increasing interest rates caused by rising inflation rates due to the Quantitative Easing initiatives introduced during the Covid-19 pandemic. The Silicon Valley bank collapse threatened to stir the economy since most-small tech ventures held many deposits in the bank, which in turn put the money into long-term U.S. treasury bonds for higher returns (Helmore 2023). However, the bank was compelled to sell a few of those bonds at a loss once interest rates began to rise dramatically last year since depositors wanted better yields. Most Small scale tech ventures and start-ups usually left money in their Silicon Valley Bank primary account, which means their working capital needed to pay bills and payroll mainly depended on access to their deposits.

Table1. Impacts of Quantitative Easing On the Yield Curve After the Covid-19 Pandemic (Varsava 2022)

Yield Curve Inversion Date	Number of Months	Maximum Difference (10 yr - 2 yr bps)
Aug 1978	21	-241
Sep 1980	13	-170
Jan 1982	4	-71
Jun 1982	1	-34
Dec 1988	6	-45
Aug 1989	2	-18
Jun 1998	1	-7
Feb 2000	10	-51
Feb 2006	1	-16
Jun 2006	1	-7
Aug 2006	7	-19
Jul 2022	2*	-48

Possible Decline in Confidence in the Currency

Another major drawback of governments using just freshly produced money from the bank is that it might lower the trust in the currency. Money is used to buy and sell goods and services and to save for future purchases. Trust and faith in a currency are crucial to its value, both among people and among market players. Concerns about the currency's stability and purity might arise when a government depends extensively on freshly minted money

by the bank to cover its expenditures. If people believe the government is printing too much money, they may lose faith in the currency's stability and value.

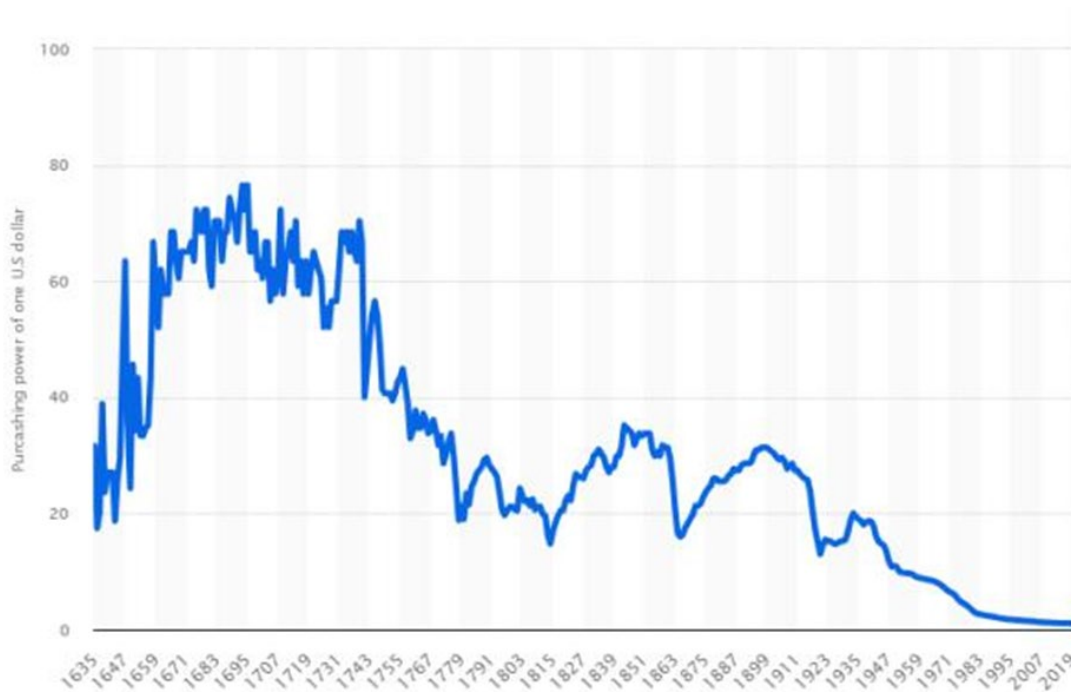


Figure 8. Value of Currency in circulation (Statista 2022)

Loss of faith in a currency may have severe repercussions. The exchange rate of the currency is one immediate effect. When people stop trusting a currency, they may try to trade it in for something they perceive to be more secure. This may cause a decline in the value of the currency on global exchanges, which in turn may affect exports, inflation, and import prices.

The United States is a real-world example of a country where people lose faith in their currency during times of economic turmoil. The 2008 financial crisis is one such event. Concerns regarding inflation and the stability of the U.S. currency arose as a result of the Federal Reserve's excessive money creation via Quantitative Easing (QE) initiatives. Some people and businesses, fearing a devaluation, sought alternate assets and currencies.

As shown in figures 3 and 4 the volume of currency in circulation and money printed increases after economic distress. For example, the money in circulation increased in 2008 as a result of government Quantitative Easing, in the following years (2010, 2011, and 2012) the amount of money in circulation decreased as the amount of money being printed increased. This decreased the value of the money as a result of inflation as shown in figure 6 and 8 thus reducing the purchasing power of the dollar. After the economy had recovered as shown in Figure 5, the Federal Reserve intervened to curb the rate of inflation by increasing interest rates in an effort known as Quantitative tightening. For example, figure 7 shows increasing interest rates in 2022 and Figure 6 shows a reduction of the volume of currency in circulation right after the economic distress caused by covid-19 in 2022 as shown in Figure 5. However, the value of the US dollar continues to decline as the federal reserve continues to print more money.

Conclusion

There are benefits and drawbacks to using just newly produced money from the bank to pay for government spending. Taxation is the tried-and-true method of generating money for the government, allowing for the provision of essential public goods, services, and infrastructure. On the other hand, there are pros and cons to relying entirely on new money created by the bank as shown in this paper. Therefore, governments should find a balance between using money from taxation and money freshly generated from the bank to support a healthy running economy.

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