The Problem with Printing Money

Readers Comment. The obvious question is why doesn't the Bank of England just print the money instead of borrowing the money?

Many often ask why governments don't print more money to deal with the problem of National debt. The reason is that printing more money doesn't increase economic output in any way - it merely causes inflation.

- **Suppose an economy produces £10 million worth of goods. e.g. 1 million books at £10 each.**
- **If the government doubled the money supply, we would still have 1 million books but people have more money. Demand for books would rise and firms would push up prices.**
- **The most likely scenario is that if money supply was doubled. we would have 1 million books sold at £20. The economy is now worth £20 million rather than £10 million. But, the number of goods is exactly the same.**
- **We can say that the increase in GDP is a money illusion. – True you have more money, but if everything is more expensive, you are not any better off.**
- **In this simple model, printing more money has made goods more expensive, but hasn't change the quantity of goods.**

Problems of Inflation

Why is inflation such a problem?

1. **Fall in value of savings. If people have cash savings, then inflation will erode the value of your savings. £1 million marks in 1921 was a lot. But, two years later, your savings would have become worthless. High inflation can also reduce the incentive to save.**
2. **Menu costs. If inflation is very high then it becomes harder to make transactions. Prices frequently change. Firms have to spend more on changing price lists. In the hyperinflation of Germany, prices rose so rapidly, people used to get paid twice a day. If you didn't buy bread straight away, it would become too expensive. This destabilises an economy.**
3. **Uncertainty and confusion. High inflation creates uncertainty. Periods of high inflation discourage firms from investing and can lead to lower economic growth.**

More on problems of inflation

Printing Money and National debt

Governments borrow by selling government bonds / gilts to the private sector. Bonds are a form of saving. People buy government because they assume a government bond is a safe investment. However, this assumes that inflation will remain low.

- **If governments print money to pay off national debt, inflation would rise. This increase in inflation would reduce the value of bonds.**
- **If inflation increases, people will not want to hold bonds because their value is falling. Therefore, the government will find it difficult to sell bonds to finance the national debt. They will have to pay higher interest rates to attract investors.**
- **If the government print too much money and inflation gets out of hand, investors will not trust the government and it will be hard for the government to borrow anything at all.**
- **Therefore, printing money could create more problems than it solves.**
- **See also: Printing money and national debt**

Hyper Inflation in Germany during the 1920s

Inflation was so bad in Germany that money became worthless. Here a child is using money as a toy. Money was used as wallpaper, to make kites. Towards the end of 1923, so much money was needed, people had to carry it about in wheel barrows. You hear stories of people stealing the wheel barrow, but leaving the money.

Printing more money is exactly what Weimar Germany did in 1922. To meet Allied reparations, they printed more money; this caused the hyper inflation of the 1920s. The hyper inflation led to the collapse of the economy.

Hyper inflation also occurred in Zimbabwe in the 2000s.

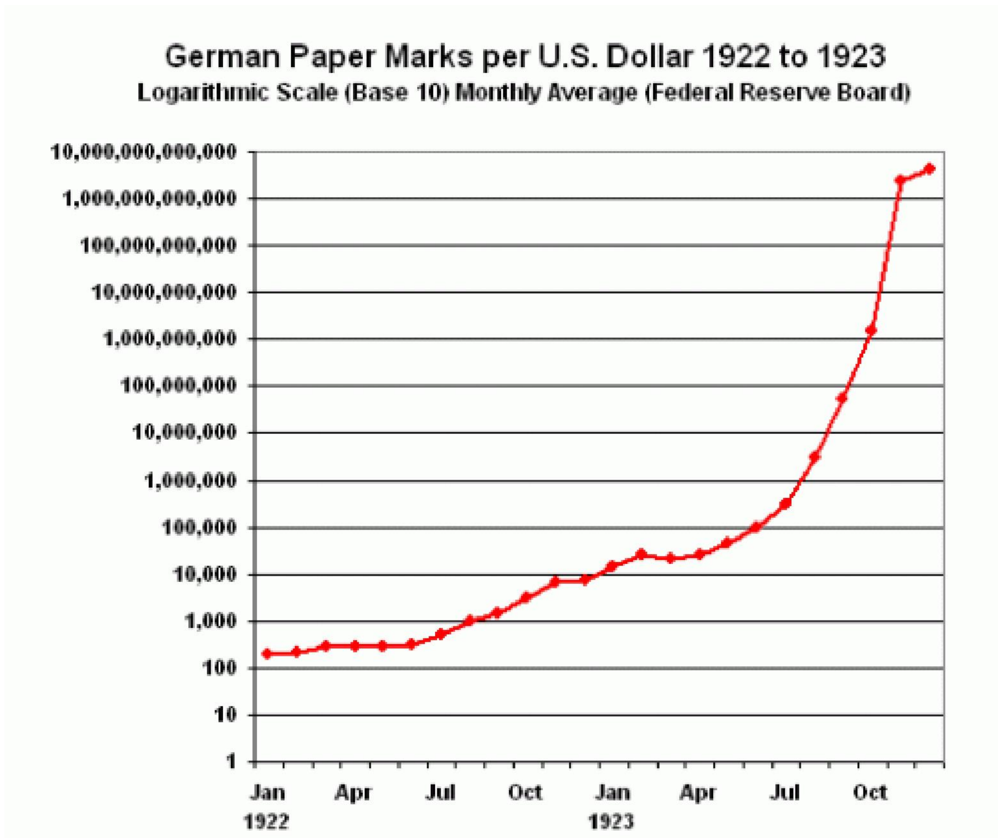
Printing Money and the Value of a Currency

If a country prints money and creates inflation, then there will be a decline in the value of the currency.

- **Suppose inflation in Germany is 100%, and inflation in UK is 0%.**
- **This means German prices are doubling compared to the UK.**
- **You will need twice as much Germany currency to buy same quantity of goods.**

- The purchasing power of the German currency is declining, therefore the value of mark will fall on exchange rates.
- See also: Printing money and the exchange rate

Value of One German Mark to US Dollar 1922-23



Hyperinflation in Germany causes a rapid fall in the value of the German mark to dollar.

In a period of hyperinflation, investors will try and buy a stable foreign currency because that will hold its value much better.

Printing Money doesn't always cause inflation

In a recession, with periods of deflation, it is possible to increase the money supply without causing inflation.

This is because the money supply depends not just on monetary base, but also velocity of circulation. For example, if there is a sharp fall in transactions

(velocity of circulation) then it may be necessary to print money to avoid deflation

In the liquidity trap of 2008-2012, the Bank of England pursued quantitative easing (increasing the monetary base) but this only had a minimal impact on underlying inflation. This is because although banks saw an increase in their reserves, they were reluctant to increase bank lending.

However, if a Central Bank pursued quantitative easing (increasing money supply) during a normal period of economic activity then it would cause inflation.