Monetary Policy and Money Creation: The Forgotten Solution

My father was a banker, not the investment kind but the hometown kind (who made lots of commercial loans to ranchers and farmers). I majored in economics in college. In my senior year I submitted a fellowship application where I identified Keynes' *General Theory of Employment, Interest, and Money* as one of the most important books I had ever read. Despite all this, I've only recently come to understand some things about money that everybody ought to know.

The first thing is that most of our money does not exist as currency or coin. In fact, this "printed" and "minted" money is no more than 3% of the U.S. money supply. In other words, the U.S. mints and the Bureau of Engraving and Printing produce a very small fraction of our total money supply. Most of our money comes into existence as a result of loans made by banks and other financial institutions, including borrowings by the U.S. Treasury.

What this means, and here is the crucial point, is that in our money system most money creation occasions an equal amount of debt creation. For example: Let's say you borrow $100,000 to buy a house. The bank creates an account (mortgage debt) that offsets the money that it credits to you so you can make your purchase. The amount of money created is equal to the amount of debt created!

Moreover, the money that is created is created out of next-to-nothing. Where did the bank get the money that it loans to you? It did not give you money that others had deposited with the bank. Rather, it created this money by a ledger entry (these days, an electronic data entry). Now, the bank may have some reserves that are required by law to "back up" this loan. However, these reserves are a tiny fraction of the total amount loaned by the bank to you. This is called the fractional reserve requirement. We are probably talking about less than 10% of the amount loaned.

Look at it another way. Mr. A deposits $10,000 with the bank. The bank must keep a fraction in reserve (say 10%), but can loan out the other $9,000 to Mrs. B. Mrs. B deposits this money, 90% of which ($8,100) can then be loaned out to Ms. C. And so on. Add up all the loans that are possible, given the initial deposit of $10,000, and the sum is $100,000. In other words, by loaning money the bank can expand the money supply ten-fold. [Note that simultaneously a total indebtedness of $100,000 from all the loans has also been created.] If everyone who deposited money with the bank attempted to withdraw their funds at the same time, the bank would be in a pickle. It would be able to pay out only 10% ($10,000 of the $100,000) before running out of funds.

As simple (and crudely simplified) as these examples are, they may still seem mind-boggling, perhaps even unbelievable. Most people mistakenly assume that banks only loan out money they already have. They scorn the notion that the government can "print" money, which it does, though in extremely modest amounts compared to how much is created by banks. Just as stock traders can buy on margin, banks can and do loan on fractional reserves, creating money and debt at the same time.

One of the last things you want to happen in a system like this is for everyone to pay off their debts! If they did so, the money supply would shrink drastically and bring economic activity to a halt. The whole economy would collapse.

Recently economist Morton Marcus observed in a guest column that our current economy remains sluggish because consumer spending is sluggish. The fact is, there's nothing like borrowing and spending to get the economy going! The money must keep circulating.

Unfortunately, there is a long-term problem here that we have yet to solve. Insofar as the amount of debt created through borrowing equals the amount of money generated by that borrowing, there is theoretically enough money to go around. But creditors also expect a return in interest on money loaned. Debtors must pay back more than they borrow. But our current money system does not create the additional money to pay that interest. Moreover, the interest on unpaid debt compounds, creating even more interest debt. Economic expansion and growth must occur at a pace commensurate with the growing demand for interest payments, or there will be huge defaults. At some point the amount of interest owed can become so large that no amount of new economic activity can keep up.

Here's the real kicker: Austerity measures cannot solve this problem. Belt-tightening, reduced spending, and loan repayments all contribute to reductions in money supply and economic activity, with precisely the opposite effects to what is needed. In other words, what common sense tells us is wrong! Austerity measures may work for individual households or small businesses that need to gain control of their finances, but they are counter-productive for the economy as a whole. If implemented, they are bound to impose great pain and suffering on certain sectors of the economy and the population. We've seen this with declining tax revenues, business collapses, mortgage defaults, loss of pension funds, bankruptcies, high unemployment, and other economic breakdowns in the current recession. Social security, medicare, and medicaid continue to be threatened.

There is no simple solution to this mess, but there is a better way:

- First, citizens need to understand that it isn't debt itself, so much as our debt-money system, that puts us in our current bind.
- Second, we must understand that our economic life has been fueled by continued expectations of growth. Frugality, conservation, and genuine economy are mostly vices in these circumstances. In the short run, profligacy is a virtue that keeps money flowing and the economy moving.
- Third, we must understand that, in the long run, profligacy will do us in. We cannot continue indefinitely to ravage the planet, polluting the environment and consuming our non-renewable resources, while our total debt continues to mount. Time is running short, if it has not already run out, to stop borrowing from the future to finance past debts and fund the present. If we do not, the future may expire.
- Fourth, we must not leave the regulation of our money supply in the hands of the profit- and power-driven banking and financial industry. Governments (state and federal, and perhaps even municipal) must become creators of new money.

In a time of great crisis, Abraham Lincoln funded the Union cause with the greenback, a fiat currency printed by the federal government, created "out of nothing" – except that the greenback was backed by the good faith and credit of the U. S. government. Like it or not, that's as good as it gets when it comes to the soundness of the dollar. When the United States completely abandoned the gold standard in 1971, it was not so radical as some make out. At the time there was nowhere near enough gold to go around. It would have been impossible for everyone to convert their currency to gold. And if they had, what then? You cannot eat gold any more than you can eat a dollar bill.

To address the current crisis and our long-term situation, we need a national bank, as well as state banks (like the one that is currently keeping North Dakota in the black). Our Federal Reserve banks, while subject to government regulations, are privately owned. Their role in money creation requires interest payments from the U.S. government (our public tax dollars) that profit mostly large financial institutions that purchase U.S. debt.

We need governments to fund public works, alternative energy research and development, education, health care, and a whole host of other social goods. Additional tax revenues from those most able to pay can provide some of the funding, but most of it must come either from the federal government "printing" money that it uses to purchase needed social goods and services, or from direct loans from governments, where the people's money is loaned out to the people, at low or no interest. Wall Street will never let this happen, of course, because it would take away much of its profits and greatly reduce its powers. It can only happen if and when the American people recognize that Wall Street is central to the crises of our current political and economic life. We citizens must refuse to remain party to our own exploitation by the financial industry and its allies.