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The Real Antidote to Inflation: Stoking the Fire Without Burning Down the Barn

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The Fed has options for countering the record inflation the U.S. is facing that are more productive and less risky than raising interest rates.

The Federal Reserve is caught between a rock and a hard place. Inflation grew by 6.8% in November, the fastest in 40 years, a trend the Fed has now acknowledged is not "transitory." The conventional theory is that inflation is due to too much money chasing too few goods, so the Fed is under heavy pressure to "tighten" or shrink the money supply. Its conventional tools for this purpose are to reduce asset purchases and raise interest rates. But corporate debt has risen by $1.3 trillion just since early 2020; so if the Fed raises rates, a massive wave of defaults is likely to result. According to financial advisor Graham Summers in an article titled "The Fed Is About to Start Playing with Matches Next to a $30 Trillion Debt Bomb," the stock market could collapse by as much as 50%.

Even more at risk are the small and medium-sized enterprises (SMEs) that are the backbone of the productive economy, companies that need bank credit to survive. In 2020, 200,000 more U.S. businesses closed than in normal pre-pandemic years. SMEs targeted as "nonessential" were restricted in their ability to conduct business, while the large international corporations remained open. Raising interest rates on the surviving SMEs could be the final blow.

Cut Demand or Increase Supply?

The argument for raising interest rates is that it will reduce the demand for bank credit, which is now acknowledged to be the source of most of the new money in the money supply. In 2014, the Bank of England wrote in its first-quarter report that 97% of the UK money supply was created by banks when they made loans. In the U.S. the figure is not quite so high, but well over 90% of the U.S. money supply is also created by bank lending.

Left unanswered is whether raising interest rates will lower prices in an economy beset with supply problems. Oil and natural gas shortages, food shortages, and supply chain disruptions are major contributors to today's high prices. Raising interest rates will hurt, not help, the producers and distributors of those products, by raising their borrowing costs. As observed by Canadian senator and economist Diane Bellemare:

> Raising interest rates may cool off demand, but today's high prices are tightly tied to supply issues – goods not coming through to manufacturers or retailers in a predictable way, and global markets not able to react quickly enough to changing tastes of consumers.

> … A singular focus on inflation could lead to a ratcheting up of interest rates at a time when Canada [and the U.S.] should be increasing its ability to produce more goods, and supplying retailers and consumers alike with what they need.

Rather than a reduction in demand, we need more supply available locally; and to fund its production, credit-money needs to *increase*. When supply and demand increase together, prices remain stable, while GDP and incomes go up.

So argues UK Prof. Richard Werner, a German-born economist who invented the term "quantitative easing" (QE) when he was working in Japan in the 1990s. Japanese banks had pumped up demand for housing, driving up prices to unsustainable levels, until the market inevitably crashed and took the economy down with it. The QE that Werner prescribed was not the asset-inflating money creation we see today. Rather, he recommended increasing GDP by driving money into the real, productive economy; and that is what he recommends for today's economic crisis.

How to Fund Local Production

SMES make up around 97-99% of the private sector of almost every economy globally. Despite massive losses from the pandemic lockdowns, in the U.S. there were still 30.7 million small businesses reported in December 2020. Small companies account for 64 percent of new U.S. jobs; yet in most U.S. manufacturing sectors, productivity growth is substantially below the standards set by Germany, and many U.S. SMEs are not productive enough to compete with the cost advantages of Chinese and other low-wage competitors. Why?

Werner observes that Germany exports nearly as much as China does, although the German population is a mere 6% of China's. The Chinese also have low-wage advantages. How can German small firms compete when U.S. firms cannot? Werner credits Germany's 1,500 not-for-profit/community banks, the largest number in the world. Seventy percent of German deposits are with these local banks – 26.6% with cooperative banks and 42.9% with publicly-owned savings banks called Sparkassen, which are legally limited to lending in their own communities. Together these local banks do over 90% of SME lending. Germany has more than ten times as many banks engaged in SME lending as the UK, and German SMEs are world market leaders in many industries.

Small banks lend to small companies, while large banks lend to large companies – and to large-scale financial speculators. German community banks were not affected by the 2008 crisis, says Werner, so they were able to increase SME lending after 2008; and as a result, there was no German recession and no increase in unemployment.

China's success, too, Werner attributes to its large network of community banks. Under Mao, China had a single centralized national banking system. In 1982, guided by Deng Xiaoping, China reformed its money system and introduced thousands of commercial banks, including hundreds of cooperative banks. Decades of double-digit growth followed. "Window guidance" was also used: harmful bank credit creation for asset transactions and consumption were suppressed, while productive credit was encouraged.

Werner's recommendations for today's economic conditions are to reform the money system by: banning bank credit for transactions that don't contribute to GDP; creating a network of many small community banks lending for productive purposes, returning all gains to the community; and making bank behavior transparent, accountable and sustainable. He is chairman of the board of Hampshire Community Bank, launched just this year, which lays out the model. It includes no bonus payments to staff, only ordinary modest salaries; credit advanced mainly to SMEs and for housing construction (buy-to-build mortgages); and ownership by a local charity for the benefit of the people in the county, with half the votes in the hands of the local authorities and universities that are its investors.

Public Banking in the United States: North Dakota's Success

That model – cut out the middlemen and operationalize community banks to create credit for local production – also underlies the success of the century-old Bank of North Dakota (BND), the only state-owned U.S. bank in existence. North Dakota is also the only state to have escaped the 2008-09 recession, having a state budget that never dropped into the red. The state has nearly six times as many local banks per capita as the country overall. The BND does not compete with these community banks but partners with them, a very productive arrangement for all parties.

In 2014, the Wall Street Journal published an article stating that the BND was more profitable even than JPMorgan Chase and Goldman Sachs. The author credited North Dakota's oil boom, but the boom turned into a bust that very year, yet the BND continued to report record profits. It has averaged a 20% return on equity over the last 19 years, far exceeding the ROI of JPMorgan Chase and Wells Fargo, where state governments typically place their deposits. According to its 2020 annual report, in 2019 the BND had completed 16 years of record-breaking profits.

Its 2020 ROI of 15%, while not quite as good, was still stellar considering the economic crisis hitting the nation that year. The BND had the largest percentage of Payroll Protection Plan recipients per capita of any state; it tripled its loans for the commercial and agricultural sectors in 2020; and it lowered its fixed interest rate on student loans by 1%, saving borrowers an average of $6,400 over the life of the loan. The BND closed 2020 with $7.7 billion in assets.

Why is the BND so profitable, then, if not due to oil? Its business model allows it to have much lower costs than other banks. It has no private investors skimming off short-term profits, no high paid executives, no need to advertise, and, until recently, it had only one branch, now expanded to two. By law, all of the state's revenues are deposited in the BND. It partners with local banks on loans, helping with capitalization, liquidity and regulations. The BND's savings are returned to the state or passed on to local borrowers in the form of lower interest rates.

What the Fed Could Do Now

The BND and Sparkassen banks are great public banking models, but implementing them takes time, and the Fed is under pressure to deal with an inflation crisis right now. Prof. Werner worries about centralization and thinks we don't need central banks at all; but as long as we have them, we might as well put them to use serving the Main Street economy.

In September 2020, Saqib Bhatti and Brittany Alston of the Action Center on Race and the Economy proposed a plan for stimulating local production that could be implemented by the Fed immediately. It could make interest-free loans directly to state and local governments for productive purposes. To better fit with prevailing Fed policies, perhaps it could make 0.25% loans, as it now makes to private banks through its discount window and to repo market investors through its standing repo facility.

They noted that interest payments on municipal debt transfer more than $160 billion every year from taxpayers to wealthy investors and banks on Wall Street. These funds could be put to more productive public use if the Federal Reserve were to make long-term zero-cost loans available to all U.S. state and local governments and government agencies. With that money, they could refinance old debts and take out loans for new long-term capital infrastructure projects, while canceling nearly all of their existing interest payments. Interest and fees typically make up 50% of the cost of infrastructure. Dropping the interest rate nearly to zero could stimulate a boom in those desperately needed projects. The American Society of Civil Engineers (ASCE) estimates in its 2021 report that $6.1 trillion is needed just to repair our nation's infrastructure.

As for the risk that state and local governments might not pay back their debts, Bhatti and Alston contend that it is virtually nonexistent. States are not legally allowed to default, and about half the states do not permit their cities to file for bankruptcy. The authors write:

> According to Moody's Investors Service, the cumulative ten-year default rate for municipal bonds between 1970 and 2019 was just 0.16%, compared with 10.17% for corporate bonds, meaning corporate bonds were a whopping 63 times more likely to default. …[M]unicipal bonds as a whole were safer investment than the safest 3% of corporate bonds. … US municipal bonds are extremely safe investments, and the interest rates that most state and local government borrowers are forced to pay are unjustifiably high.
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> … The major rating agencies have a long history of using credit ratings to push an austerity agenda and demand cuts to public services …. Moreover, they discriminate against municipal borrowers by giving them lower credit ratings than corporations that are significantly more likely to default.
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> … [T]he same banks that are major bond underwriters also have a record of collusion and bid-rigging in the municipal bond market. … Several banks, including JPMorgan Chase and Citigroup, have pleaded guilty to criminal charges and paid billions in fines to financial regulators.
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> … There is no reason for banks and bondholders to be able to profit from this basic piece of infrastructure if the Federal Reserve could do it for free. [Citations omitted.]

To ensure repayment and discourage overborrowing, say Bhatti and Alston, the Fed could adopt regulations such as requiring any borrower that misses a payment to levy an automatic tax on residents above a certain income threshold. Borrowing limits could also be put in place. Politicization of loans could be avoided by making loans available indiscriminately to all public borrowers within their borrowing limits. Another possibility might be to mediate the loans through a National Infrastructure Bank, as proposed in HR 3339.

All of this could be done without new legislation. The Federal Reserve has statutory authority under the Federal Reserve Act to lend to municipal borrowers for a period of up to six months. It could just agree to roll over these loans for a fixed period of years. Bhatti and Alston observe that under the 2020 CARES Act, the Fed was given permission to make up to

$500 billion in indefinite, long-term loans to municipal borrowers, but it failed to act on that authority to the extent allowed. Loans were limited to no more than three years, and the interest rate charged was so high that most municipal borrowers could get lower rates on the open municipal bond market.

Private corporations, which the authors show are 63 times more likely to default, were offered much more generous terms on corporate debt; and 330 corporations took the offer, versus only two municipal takers through the Municipal Liquidity Facility. The federal government also made $10.4 trillion in bailouts and backstops available to the financial sector after the 2008 financial crisis, a sum that is 2.5 times the size of the entire U.S. municipal bond market.

Stoking the Fire with Credit for Local Production

Playing with matches that could trigger a $30 trillion debt bomb is obviously something the Fed should try to avoid. Prof. Werner would probably argue that its policy mistake, like Japan's in the 1980s, has been to inject credit so that it has gone into speculative assets, inflating asset prices. The Fed's liquidity fire hose needs to be directed at local production. This can be done through local community or public banks, or by making near-zero interest loans to state and local governments, perhaps mediated through a National Infrastructure Bank.

This article was first posted on ScheerPost.

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