The Role of Money Creation in Economic Development

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> "We are completely dependent on the commercial Banks. Someone has to borrow every dollar we have in circulation, cash or credit. If the Banks create ample synthetic money we are prosperous; if not, we starve. We are absolutely without a permanent money system. When one gets a complete grasp of the picture, the tragic absurdity of our hopeless position is almost incredible, but there it is. It is the most important subject intelligent persons can investigate and reflect upon." –Robert H. Hemphill, Credit Manager of the Federal Reserve Bank of Atlanta, 1934

Miners used to keep canaries in coal mines as an early warning device. If the air was so bad that it killed the canary, the miners would soon be next. Japan may be the canary for the out-of-control deficit spending policies now being pursued in the United States and the United Kingdom. In a November 1 article in the Daily Telegraph called "It Is Japan We Should Be Worrying About, Not America," international business editor Ambrose Evans-Pritchard wrote:

> "Japan is drifting helplessly towards a dramatic fiscal crisis. For 20 years the world's second-largest economy has been . . . feeding its addiction to Keynesian deficit spending – and allowing it to push public debt beyond the point of no return. The rocketing cost of insuring against the bankruptcy of the Japanese state is telling us that the model has smashed into the buffers.
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> ". . . Tokyo's price index fell 2.4% in October, the deepest deflation in modern Japanese history. . . . The government could stop this . . . . It could print money à l'outrance to stave off deflation. Yet it sits frozen, like a rabbit in the headlamps.
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> "Japan's terrible errors are by now well known. . . . QE was too little, too late, and this is the lesson for the West. We must cut borrowing drastically over the next decade, and offset this with ultra-easy monetary policy. Does Downing Street understand this? Does the White House? . . . Clearly not."

In case you too have forgotten your high school French, "a l'outrance" means "to the uttermost." "QE" is "quantitative easing" – printing money. Evans-Pritchard's proposed solution to the mounting fiscal crisis is that the government needs to quit borrowing money and start printing it.

More Funny Money? Please!

Your response is liable to be that we are doing that already, in spades; and it does not seem to be working. The Federal Reserve is madly printing money (or writing it into electronic accounts), increasing the money supply to the point that pundits are screaming about hyperinflation. Yet the nation is just plunging further into debt, while the credit crunch continues to get worse.

And that is true, but it is only half the picture. M1 is shooting up, but M3 and bank lending are both shrinking. (M1 is readily spendable money – coins and dollar bills, or M0, plus checkbook money. M3 is the broadest measure of the money supply, including savings deposits, money market funds, and other forms of liquid assets that are traded as money.) The Fed is creating money as fast as it can find federal and bank borrowers to take the money off its hands, yet it can't keep up with the rampant deflation in the real economy. Bank lending has dropped by 17 percent since October 2008, when the credit crisis was already in full swing. "There has been nothing like this in the USA since the 1930s," says Professor Tim Congdon of International Monetary Research. "The rapid destruction of money balances is madness."

The reason the level of bank lending is so important is that virtually all our money today originates as loans created by private banks. Most people think money is issued by the government, but the only money the government creates are coins, which compose less than one ten-thousandth of the money supply – about $1 billion out of $13.8 trillion (M3). Dollar bills are issued by the Federal Reserve, a privately-owned banking corporation, and lent to the government and to other banks. And coins and dollar bills together make up only about 7% of the money supply. All of the rest is simply written into accounts on computer screens by bankers when they make loans.

Contrary to popular belief, banks do not lend their own money or their depositors' money. Every time a bank makes a loan, it is brand new money, simply written into the account of the borrower. As explained on Wikipedia:

> "The different forms of money in government money supply statistics arise from the practice of fractional-reserve banking. Whenever a bank gives out a loan in a fractional-reserve banking system, a new sum of money is created. This new type of money is what makes up the non-M0 components in the M1-M3 statistics. In short, there are two types of money in a fractional-reserve banking system: (1) central bank money (physical currency, government money); and (2) commercial bank money (money created through loans) – sometimes referred to as private money, or checkbook money. In the money supply statistics, central bank money is M0 while the commercial bank money is divided up into the M1-M3 components."

If there were no banks, we would have no money except pennies, nickels, dimes and quarters. Money created as bank loans does not stick around, since loans eventually get paid back. When old loans get paid off and new ones aren't taken out to replace them, the money supply shrinks; and lately, new loans have fallen off dramatically.

Why? Banks insist that they are lending as much as they are prudently allowed to. The problem is that they have reached the lending limits imposed by the capital requirements set by the Bank for International Settlements. In the years of the credit boom, banks were able to leverage their capital into far more loans than are being created now. This was because loans were taken off the banks' books by investors, allowing the same capital to be used many times over to generate new loans. These investors, called "shadow lenders," have now exited the market, and they are not expected to return any time soon. They left after it became clear that the credit default swaps allegedly protecting their investments were only as good as the solvency of the counterparties (typically AIG or hedge funds), which had a bad habit of going bankrupt rather than paying up. An estimated $10 trillion disappeared from the money supply along with the shadow lenders, and the Fed has managed to get only a few trillion back into the market as replacement money.

“Shadow Money”: Another Blow to the Quantity Theory of Money

Along with the disappearance of the “shadow lenders,” there has been a dramatic decline in something called “shadow money.” The concept of shadow money was presented by two economists from Credit Suisse, James Sweeney and Carl Lantz, in a Bloomberg interview in May. As explained on DemandSideBlog, shadow money is money the market itself creates in order to finance a boom — “money” in the sense of a medium of exchange. In a boom there is not enough cash to go around, so collateral is used as near money or shadow money. Shadow money can include government bonds, private bonds, asset-backed securities, credit card debt (which can be incurred and paid off without drawing on the M1 money stock), and even real estate (when it is highly liquid and easily tradeable).

In a fuller explanation on Zero Hedge, Tyler Durden (a pen name) quotes from Friedrich Hayek’s Prices and Production (1935). Hayek said:

> “There can be no doubt that besides the regular types of the circulating medium, such as coin, notes and bank deposits, which are generally recognized to be money or currency, and the quantity of which is regulated by some central authority or can at least be imagined to be so regulated, there exist still other forms of media of exchange which occasionally or permanently do the service of money.
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> “. . . [I]t is clear that, other things equal, any increase or decrease of these money substitutes will have exactly the same effects as an increase or decrease of the quantity of money proper, and should therefore, for the purposes of theoretical analysis, be counted as money.”

Lantz and Sweeney calculate that at the peak of the boom there were six trillion dollars in the traditionally-defined money stock (or money supply). The private shadow stock accounted for $9.5 trillion, and government-based shadow money accounted for another $11 trillion. Thus the shadow money stock dwarfed the traditionally-defined money stock. This can be seen in the chart below provided by Tyler Durden. The blue strips at the bottom, called “outside money,” are dollars printed by the Federal Reserve. The red sections, called “inside money,” are money created as loans by the banks themselves. The green sections, called “public shadow money,” are money created by the government and the Fed as debt (or loans). The purple sections, called “private shadow money,” are the money created as private debt securities by the shadow lenders.

Lantz and Sweeney estimate the total drop in private shadow money (the purple blocks) during the current credit crisis at $3.6 trillion. This has been offset by an increase in public shadow money, both from the massive borrowing needed to finance the federal deficit and from the aggressive liquidity measures taken by the Fed in converting private securities into loans. Those measures helped prevent an even worse drop in the commercial money supply than actually occurred, but they were not sufficient to eliminate the credit squeeze from lowered commercial lending, which continues to act as a tourniquet on the productive economy.

Moreover, the lending situation is slated to get worse. At the G20 meeting in Pittsburgh in September, deadlines were set for increasing the amount of capital that financial institutions must set aside to cover their loans. That means that credit could get even tighter, further shrinking the global money supply and precipitating an even deeper depression.

Helicopter Money: Not Such a Bad Idea After All?

Ironically, it was in Japan in 2002 that Ben Bernanke gave the speech for which he has been much derided, in which he maintained that deflation could be reversed simply by dropping money from helicopters. He said, "The U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. . . . A money-financed tax cut is essentially equivalent to Milton Friedman's famous 'helicopter drop' of money."

But the Japanese froze in the headlights, as Evans-Pritchard writes. Instead of merely issuing the money it needed, the government borrowed from banks that issued it and lent it at compound interest.

Chairman Bernanke could not even implement his own plan in the U.S., because the Federal Reserve is not actually the government. The Fed Chairman is not authorized to print money and simply hand it over to the government or to spend it directly into the economy. The Fed has to lend it to the government and other financial institutions, which means finding willing and able borrowers; and today, creditworthy borrowers are in short supply. Moreover, when they do borrow, they eventually pay the money back, shrinking the money supply once again. Only the government is in a position to simply roll its debt over from year to year. But when Chairman Bernanke announced last spring that the Fed would be funding $300 billion in long-term government debt, the Chinese expressed grave concern. He then backed off from this form of quantitative easing, evidently to keep the creditors happy.

How to Save $400 Billion Yearly in Interest: Monetize the Debt

Although the Federal Reserve cannot create money and simply spend it into the economy, Congress can. The Constitution authorizes Congress "to coin money [and] regulate the value thereof." A former chairman of the House Coinage Subcommittee once observed that Congress could solve its financial problems just by minting some very large-denomination coins and paying off its debts. This solution is invariably rejected as dangerously inflationary; but when the "shadow money" is factored in, it actually wouldn't be. Government bonds already serve as a medium of exchange, trading in massive quantities around the world just as if they were money. Paying off government bonds with newly-printed dollars and then ripping up the bonds (or voiding them out on a computer screen) would not significantly affect the size of the overall money supply, since "shadow money" would just be replaced with dollar bills (paper or electronic). In the chart above, green money (public shadow money) would become blue money (dollar bills and checkbook money), leaving the total money stock unchanged.

It might be argued that the money borrowed by the government has already been spent into the economy, and that if the bonds are now turned into dollars, the money will be out there twice. And that is true; but on the shadow-money model, the inflation has already occurred and cannot now be reversed. It occurred when the government printed the bonds. The bonds are already out there serving as money. Whether the money stock takes the form of dollars or bonds, it will be used as a medium of exchange in the real economy.

Another argument often raised is that the money created as government securities and Federal Reserve loans has been "sterilized" by lodging it with central banks and commercial banks. When this money hits Main Street as dollars competing for goods and services, the floodgates will open and hyperinflation will be upon us. That is the alleged justification for keeping the stimulus money in the banks instead of in the marketplace. But then what was the point of the stimulus? If the money is only stimulating the banks, it is not doing anything for the real economy. We want money out there in the marketplace generating demand for products, which generates jobs. Price inflation results only when "demand" (money) exceeds "supply" (goods and services). If the money is used to create goods and services, prices will remain stable. We have workers out of work and factories sitting idle. They need some "demand" (money) stimulating them to create supply, in order to make the economy productive again.

Other critics point to gold's recent rise as an indicator of inflation already being upon us. But the more likely explanation for gold's rise is that foreign central banks are looking for something besides U.S. government bonds in which to park their money. They no longer want our bonds, so fine. We should tell them that no more are for sale. We will in the future sell our bonds to our own central bank, which will rebate the interest to the government after deducting its costs, making its credit the best deal in town. And we will use the money, not to feed a parasitic private banking empire by building up bank reserves, but for direct expenditures on infrastructure and other public projects that will put people back to work, add to the productive economy, and increase the collective well-being of the American people.

Ellen Brown developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her earlier books focused on the pharmaceutical cartel that gets its power from "the money trust." Her eleven books include Forbidden Medicine, Nature's Pharmacy (co-authored with Dr. Lynne Walker), and The Key to Ultimate Health (co-authored with Dr. Richard Hansen). Her websites are www.webofdebt.com and www.ellenbrown.com.

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