

Background

Redefining Safety in a High-Debt Economy

The Fed, America's central bank, is the only institution on earth that can create U.S. dollars.

Think of money as a system to be managed, and to be managed *right*. When you run the system that creates money, you must do it carefully, with prudence and integrity, or else terrible things can happen.

The Federal Reserve system is unlike any other in the world; it is an unusual mix, part private bank and part government agency.

The American financial system was badly broken in late 2008, after the investment bank Lehman Brothers collapsed. This event was called the Global Financial Crisis (GFC) which was considered an apocalypse, even potentially more harmful than the Great Depression.

The Fed's one superpower is its ability to create new dollars and pump them into the money supply via the banking system.

For example, between 1913 and 2008 the Fed gradually increased the money supply from about \$5 billion to \$847 billion. Money supply is related to the total economy, measured by Gross National Product (GDP). As the economy grows so does the money supply. That relationship changed in response to the GFC. The Fed increased the money supply between late 2008 and 2010 by \$1.2 trillion. Meaning it printed a hundred years' worth of money in just over one year.

This new money makes its way into the economy via deposits of only about twenty-four special banks and financial institutions that are used as a seedbed for the money supply. The amount of excess money in the banking system swelled from \$2 billion in 2008 to \$1.2 trillion in 2010, 800 times higher than before.

Another thing that the Fed did in response to GFC was to slash the interest rate to zero. The interest rate is really the price of money. When interest rates are zero, money is effectively free for banks who can get it straight from the Fed.

These policies perhaps more so than any other have reshaped the American economy. They widen the divide between the rich and the poor. This happens because asset prices increase, the stock market booms, and the American middle class fall farther behind.

The Global Financial Crisis of 2008 didn't come out of nowhere. The collapse came after many years of decay inside the economic system that had stopped working for a majority of Americans. The problems were varied and complex, and they all helped create the conditions for the crisis, with indebted workers, powerful banks extending risky loans and significantly overvalued market prices.

Also, an aging population relied increasingly on underfunded government programs like Medicare, Medicaid, and Social Security, creating huge levels of government debt. These were and continue to be huge challenges facing the nation, and the federal government has not addressed any of them.

Another factor in all this is inflation, which is a dangerous situation when prices rise and the value of money falls. And the Fed sees inflation as a condition to be avoided at all costs. It can cause it by keeping interest rates too low for too long.

One of the tools the Fed used to manage the GFC was quantitative easing. It had been thought of as a temporary measure. Not normal operating tool.

The basic mechanics and goals of quantitative easing are actually pretty simple. It is a plan to inject trillions of newly created dollars into the banking system at a time when banks have almost no incentive to save money. The Fed does this by using one of the most powerful tools it already has at its disposal: a group of financial traders in New York who are already buying and selling assets from a select group of twenty-four financial firms that are known as "primary dealers". The primary dealers have special bank vaults at the Fed called reserve accounts. To execute quantitative easing, a trader in New York Fed would call up one of the primary dealers and offer to buy \$8 billion worth of Treasury bonds from the bank. The dealer would then sell the Treasury bonds to the Fed trader. Then the Fed trader tells the dealer (bank) to look inside their reverse account. There it is, the Fed has instantly created \$ 8 billion out of thin air, in the reserve account. The bank can now in turn use the money to buy assets in the wider marketplace. This is how the fed creates money. Before the crisis, it would have taken about sixty years to add that much money to the money supply. Doing this devalues each dollar.

There's one more thing about quantitative easing that makes it so powerful. The Fed now buys long-term government debt like 10-year Treasury bonds. Before the crisis the Fed had always bought short term debt because it's their job to control short term interest rates. But the Fed is now targeting long-term bonds for one reason: to control the interest rate on the nation's debt. This is called Yield Curve Control (YCC).

Quantitative easing is like kudzu for our economy. It grows and grows, and it becomes impossible to control once it takes root.

In many ways, the financial crash of 2008 has never ended. It was a long crash that crippled the economy for years. The problems that caused it have not been resolved. And the remedies used to address it continue to weaken the value of the dollar. When America relied on the Federal Reserve to manage the economy's problems it relied on some flawed tools. More so making those tools which were intended to be used long enough to correct a crisis become normal operating measures continue weakening the economy. All the Fed's money creation policies that are not aligned with the economy's real value (GDP) make each dollar less valuable. This fragile system was also wrecked by the pandemic and Fed created yet more new money just amplifying the cap between the haves and the have nots and weakening the financial health of small businesses.

The crisis, GFC, Great Recession, whatever we call it, continues. And bills caused by Fed policies have yet to be paid. We cannot change the ongoing Fed policies, but we will be wise to redefine what money is worth in running our businesses and lives.

These comments are not mine. They are interpretation, excerpts, and verbatim words mostly form *The Lords of Easey Money*, by Christopher Leonard.

Respectfully, Robert