

## Money, Credit and Crisis

by Mason Gaffney

(Adapted by Lindy Davies from Prof. Gaffney's lecture notes for a college course of the same name. The full notes can be found [here](#).)

### *The Amount of Money*

There is about \$1.37 trillion of checking deposits and currency in circulation, 2006. Deposits and currency constitute "M1." That amount is about 14% of the GNP.

Of course, money is an entirely fluid phenomenon. The static quantity, "M1" is only part of the story; the other part of the supply of spendable money is how quickly each recipient spends it, or in other words, money's velocity. The ratio of GNP/M1 is what standard macroeconomics texts call "velocity." More exactly it is "GNP-velocity." "Velocity" alone, in proper banking parlance, means transactions-velocity or deposit turnover. This is a much higher figure which covers the use of money in all intermediate transactions, not just those that enter into GNP.

### *How Liquidity is Created*

How can anyone or any bank create net liquidity? A's asset is always B's debt on its flip side. However, bank liabilities are more liquid than bank assets. Banks do create net liquidity, in spite of the flip side; that's what banks get paid for. The flip side makes it tricky and hazardous, which puts thrills and chills in the Magic Mountain of banking. People have been doing it, nonetheless, for centuries.



Here's how a bank creates new deposits: it finds a borrower who will pledge some asset (collateral) to secure payment of a loan. It takes the borrower's IOU and records it on the asset side of its balance sheet. In return, it gives the borrower the bank's IOU, now called a demand deposit. (Originally it was a bank "note," a piece of paper

reading “will pay to the bearer on demand ...”) This demand deposit goes on the liability side of the bank’s balance sheet.

In the American colonial period, the original banks did not even accept deposits. They started, rather, by creating bank notes (like deposits, these are bank demand liabilities). There was little currency circulating for them to accept as deposits, so instead they created a currency by accepting collateral in return for issuing bank notes. When you cut through the fog, the effect is the same as though title to the collateral were now chopped into small units, circulating in bearer form.

Why does the borrower pay interest to the bank? The bank’s IOU is worth more because it is liquid: the borrower can spend it immediately, and the bank must be able to cover, i.e. to redeem it. Banks borrow short, but lend long.

The bank’s IOU is liquid because the bank spends money to make it so. That is how it uses the interest it receives from borrowers. Banks use their income to create liquidity by offering valuable services, such as guarding your money, paying cash on demand from an attractive building in a convenient location, clearing checks, holding reserves and maintaining a reputation for always meeting their obligations on demand. For those benefits, depositors are willing to forego interest income.

Banks play the percentages, and are never literally in a position to perform on their contracts, that is, to redeem all their deposits on demand. Some have advocated “100% reserve” banking, to avoid that. This cause is a remote dream and a diversion from reality. Required reserves provide an element of liquidity that is only specious. They are in dead storage and can never be used. So why are they required? Ceremony, symbolism, tradition and mystery. They are thought to help sustain confidence. The need for such mumbo-jumbo reveals the basic instability of banking.

The workable alternative is to require banks to stay highly liquid by restricting their loans to commercial paper secured by highly liquid collateral like accounts receivable. Such short-term loans finance the working capital of businesses and are therefore automatically self-liquidating in a few months. The idea that liquidity is important is known as the “commercial loan theory,” aka the “real bills doctrine.” In England, it is called the “banking school” position. An early and eloquent advocate was Adam Smith, in *The Wealth of Nations*.

Banks and their economist-spokesmen resist this policy, which they parody and flay mercilessly with all the considerable influence and authority at their command. Ordinary texts today foolishly dismiss it, citing the studies of Lloyd Mints, the

predecessor of Milton Friedman at Chicago. Adam Smith, the apostle of laissez faire, is too regulation-minded for them. Chicago orthodoxy, now articulated by Milton Friedman, brooks no twilight shadow of qualitative control on bank lending.

The valid idea in “real bills” — not to be confused with “real estate” — is that banks should avoid lending on real estate collateral and for long terms. Default on real estate loans was the major cause of bank failures from 1929-33, the period in which half the nation’s banks failed. Chicago orthodoxy has taken that disastrous cataclysm and stuffed it down the memory tubes. The resulting collective amnesia is one of the greatest, most brazen feats of thought control in history.

### *Why Chicago Orthodoxy Cannot Tolerate the Real Bills Doctrine*

1. It implies there is some systemic weakness in the market, out of which collapses are generated. Chicago ideology demands that collapses be caused only by errors of short-term policy judgment on the Federal Reserve Board. It cannot accept the reality of factors outside the banking system — namely, the land-value boom and bust cycle.

The ordinary economist, even more than the ordinary person, is terrified of being thought different, or outside the loop, or “poorly trained,” or “unaware” of what others are saying. Ordinary texts therefore keep in step with each other, in stupefying conformity. This has some social value, especially of course to the extent that the conventional wisdom is true, and when the alternative is chaos. However, conformity breeds habits of suppressing observation, and shutting out facts that do not fit one’s model. It also lets a few influential people manipulate and intimidate and exploit others by controlling their “training,” and defining quality, and dehumanizing those outside what they call “the mainstream.” This leads to error at all times, but moreso in times of change and crisis. — Mason Gaffney, from the introduction to this course, 1991

2. It implies that banks need to be monitored more closely and specifically than they like to be. Chicago accepts general “quantitative” controls, and rather tight ones at that, in order to be rid of all specific “qualitative” controls. It is this ideology, in the names of Reaganomics and Deregulation, that led directly to the \$500 billion S&L fiasco.

3. It withdraws a major support from the value of real estate, an interest with which Chicago identifies. It also tends to desanctify property as a good in itself, property for

the sake of property. Rather, it points up the danger of using land as a “store of value” instead of using it simply as a factor of production.

Nevertheless, banks have followed Chicago and flouted the real bills doctrine once again, as they did in the early 1980s and once again they will soon be stuck with non-performing (defaulted) long-term loans backed by real estate collateral in agriculture, in energy, in some urban areas, and overseas. In a larger sense, most corporate debt is secured by pledging corporate real assets, in every industry.

Why is bank regulation justifiable? Adam Smith never questioned it, because there are things that individuals can do one at a time which they cannot do collectively — and one of those things is liquidating real estate investments. Real bills as a policy compels the banks to stick with “self-liquidating” loans which turn into money through sale of the collateral to consumers. That is something that can be done collectively, because it is done routinely, daily, in the normal course of production and exchange.

Land, in sharpest contrast, is not self-liquidating. The cash flow from unappreciating land is just enough to pay interest on its purchase price. But most land today is appreciating. Its cash flow is less than enough, and must be augmented each year by additional outside payments. If we stop to remember that some 70% of all loans currently finance the purchase of real estate, we can see the outrageous load that collateralization of land values places on the financial system.

### *Land Values, Interest Rates, and Investment*

There is direct conflict between high land values and the rate of return on productive, job-making real investments. High land values may mean low rates of return on new investments. The high land values are supported by siphoning off part of cash flow to income payments to those who own the land, or to those who lend entrepreneurs funds to buy it. The combination of high credit-worthiness with low returns on newly-created capital can only spell trouble: banks expand as real investment falls. At the same time, rising land values discourage saving and encourage consumption, e.g. by using home-equity loans.

When land is so overpriced as to cut deeply into rates of return on job-making new investment, banks turn to taking land itself as collateral. When land gets so overpriced the borrowers can't pay the loans, banks panic, freeze up, and stop originating new loans. Then as old debts are paid, the money goes into the bank and never comes out

again. What banks have created they can destroy. Just as expanding banks issue new money, contracting banks swallow it up again.

This is a major source of the notions of oversaving and cash-hoarding, notions so common in depressions. “Where has all the money gone?”, people ask, and look under the mattresses of misers. Most of it has simply been retired by banks that collect old debts without originating new ones. The financial system is most vulnerable to collapse when an unexpected sharp rise of interest rates pulls the plug on the expected cash flows from durable capital, and from land. Land values are especially sensitive to interest rates; and doubly so in a rising market. Remember: banks borrow short, but lend long. If land value is the basis for a loan being repayable, and land value declines as interest rates increase, then we can see how shaky land values are as a basis for loans.

A bank that lends long gets repaid only slowly, and can therefore originate only a small volume of new loans each year, relative to its assets. A bank whose borrowers default is in the same pickle, only worse. And their pickle becomes everyone’s pickle to the extent that we depend on them to finance the flow of investment that keeps The Great Wheel of economic life turning.

The world of credit is a world of confidence and illusion, so there is lots of room for magicianship, deception and “financial wizardry.” That is how we deviate from the simple logic that every asset is someone else’s liability. Credit is highly conventional, institutionalized, interdependent, fragile, and vulnerable to loss of confidence.

We will not undergo another banking collapse as extreme as Herbert Hoover’s, because bank assets now include a higher fraction of Federal debt. This is undefaultable because the Federal Reserve System now stands ready — entirely too ready — to bail out the system by issuing new money. Default will therefore take the form of more and faster inflation, on top of the chronic slow inflation we have lived with for generations. Washington has fooled us into ignoring slow inflation by jiggering the Consumer Price Index downwards, e.g. by omitting housing and energy prices. It cannot paper over fast inflation so easily, and voter reaction may rise in a tsunami. Reforms will result. Let us hope they are better informed than the ones that gave us the system in place today.