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Money. Where's the money?

Steve H. Hanke, Financial Post · Aug. 4, 2012

Since September 2007, when the British Government and the Bank of England bungled the Northern Rock affair, one government after another has sent in the Boy Scouts in an attempt to douse what has become an international economic wildfire. Their efforts haven't worked. Indeed, they have often made matters worse - much worse - and the fire remains uncontained.

Heads of state continue to rush from one meeting to the next. Worryingly, the heads of state (and the army of pundits that follows them) continue to focus most of their rhetoric on whether fiscal austerity or more fiscal stimulus is the right strategy. Instead, they should be focusing on the money supply. As history shows us, money and monetary policy trumps fiscal policy.

But the monetary policy undertaken by European Central Bank president Mario Draghi and U.S. Federal Reserve chairman Ben Bernanke is not the kind of monetary policy we need to revive flagging economies in Europe and North America.

Allow me to explain. When the monetary and fiscal policies move in opposite directions, the economy will follow the direction taken by monetary (not fiscal) policy. For doubters, just consider Japan and the United States in the 1990s. The Japanese government engaged in a massive fiscal stimulus program, while the Bank of Japan embraced a super-tight monetary policy. In consequence, Japan suffered under deflationary pressures and experienced a lost decade of economic growth.

In the U.S., the 1990s were marked by a strong boom. The Fed was accommodative and Bill Clinton was the most austere president in the post-Second World War era. He chopped 3.9 percentage points off federal government expenditures as a percent of GDP. No other modern U.S. president has even come close to Clinton's record.

Since the current crisis commenced in the early fall of 2007, most countries have applied huge doses of fiscal stimulus, and - with the exceptions of China, Japan, Germany, and Canada - taken contractionary "monetary" stances. How could this be? After all, central banks around the world have turned on the money pumps. Isn't that simulative? Well, yes, it is.

But central banks only produce what John Maynard Keynes referred to in 1930 as "state money." And state money (also known as base or high-powered money) is a rather small portion of the total "money" in an economy. Even after the Fed more than tripled the supply of state money in the wake of the Lehman Brothers collapse in 2008, state money in the U.S. still accounts for only 15% of the total money in the economy.

This is the case because the commercial banking system creates most of the money in the economy by creating bank deposits. Accordingly, at present, 85% of the total money supply in the U.S. has been created by the banking system. In a wrongheaded attempt to make banks safe in the middle of a slump, politicians and regulators have mounted an international campaign to force banks to recapitalize and to increase their capital-asset ratios, driving down money supply.

The regulators are very proud of their progress. For example, the European Banking Authority issued a preliminary report on July 11 in which it congratulated itself for forcing banks in Europe to raise US$115.6-billion in capital since December 2011 and for boosting their capital-asset ratios.

But these bank capitalization mandates, when applied in the middle of a slump, are misguided and dangerous. They have forced banks to deleverage on a massive scale. In consequence, the privately produced portion of the money supply has contracted in most countries. And since this private part of the money supply is so much larger than that accounted for by state money, the net result has been a tight monetary reality in most countries - with the exception of China, Japan, Germany and Canada. This explains why we are witnessing so many credit crunches at the same time central banks are pouring out liquidity.

The nearby charts tell part of the story. For each country, lines representing a trend rate of money growth and the actual money supply are plotted. When the gap between trend rate and money supply is negative, there is a general deficiency in the total money supply and the economy is either in a growth recession (like the U.S.), or in a full-blown recession (like Greece). In Germany and Canada, where the gap is positive, growth is relatively strong.

Similar graphs for other countries around the world paint the same pictures of growth and recession, depending on money supply relative to trend. But how can the money supply be augmented?

To boost the money supply in the current environment, debt-market operations must be employed. At the centre of these operations are government transactions with non-banks that change the bank deposits held by those non-banks.

While there are many debt-operation possibilities, we will limit our discussion to one that would directly boost the money supply, without increasing the government's net debt. The process begins with the government borrowing from commercial banks. Short-dated government paper is transferred to banks. In exchange, the deposit balance of the government is credited. This new government deposit is not counted as a part of the money supply. The government then uses its bank deposits (which are not considered money) to purchase long-dated government bonds from the non-bank private sector. These transactions add to the non-bank private sector's bank deposits and directly to the money supply, because bank deposits in the name of private persons and entities are money.

So, the quantity of money is directly increased by this debt-market operation and an equivalent amount of long-dated government debt is reduced - literally eliminated. (Since there is little point in the government holding claims on itself, the government cancels the claims.)

Of course, the amount of short-dated government debt increases when the government initially borrows from the commercial banks. Accordingly, the debt-market operation leaves the government's total net debt unchanged, but it does change the composition of the government's debt, leaving it with a shorter average duration.

Debt-market operations - like the one described - would directly increase the money supply, contain the crisis, and allow for muchneeded market-friendly reforms.

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