GlobalResearch
Center for Research on Globalization

The Biggest Myth Preventing an Economic Recovery: "Private Debt Doesn't Matter"

By Washington's Blog
Global Research, June 18, 2012
Washington's Blog 18 June 2012

Region: USA
Theme: Global Economy, Poverty & Social Inequality

The Widespread Economic Myths Destroying the Economy

There are many widespread myths preventing an economic recovery, including the following myths:

- Military spending stimulates the economy
- The banks are acting more conservatively now than before the financial crisis
- We've got to prop up the big banks
- We've got to protect the bondholders against suffering big losses
- The government has prosecuted the financial fraud which it has discovered, but it's hard to make out a case against most of Wall Street's acts
- The economy always returns to equilibrium and stability by itself

Obama's belief that unemployment is good for the economy, and Greenspan's belief that too little debt is *bad* for the country are also ridiculous.

But the most dangerous myth – because a lot of economic policy is based upon it, and because so few know that it is false – is the myth about how banks make loans.

The Myth that Private Debt Doesn't Matter

Before we can address the myth about how banks make loans – and as a way to understand the deadly effect of that misconception, we need to talk about debt.

As economics professor Steve Keen documents in his must-read book, Debunking Economics: The Naked Emperor Dethroned, mainstream economists – from both the left and the right – don't *even take debt into consideration* in their models of what makes for healthy economies.

As Keen noted in September:

> The vast majority of economists were taken completely by surprise by this

> crisis—including not just … the ubiquitous "market economists" that pepper the evening news, but the big fish of academic, professional and regulatory economics as well.
>
> ***
>
> Why did conventional economists not see this crisis coming, while I and a handful of non-orthodox economists did [?] Because we focus upon the role of private debt, while they, for three main reasons, ignore it:
>
> ***
>
> They believed that the level of private debt—and therefore also its rate of change—had no major macroeconomic significance:
>
> ***
>
> Finally, the most remarkable reason of all is that debt, money and the financial system itself play no role in conventional neoclassical economic models. Many non-economists expect economists to be experts on money, but the belief that money is merely a "veil over barter"—and that therefore the economy can be modeled without taking into account money and how it is created—is fundamental to neoclassical economics. Only economic dissidents from other schools of thought … take money seriously, and only a handful of them—including myself (Steve Keen, 2010; http://www.economics-ejournal.org/economics/journalarticles/2010-31)—formally model money creation in their macroeconomics.
>
> Even the most "avant-garde" of neoclassical economists … have only just begun to consider the role that debt might play in the economy ….

In other words, most economists think that debt – and our money system – don't matter.

(Don't freak out … this essay does not argue for ruthless austerity for Mom and Pop on Main Street. Virtually all of the economists we quote stress that the bondholders bad debt must be written down. And this post also focuses on *private* – rather than public – debt.)

For example, The economists who have the most influence over government policy – such as Ben Bernanke and Paul Krugman – think that the amount of private debt is *totally irrelevant* to the health of the economy:

> Fisher's idea was less influential in academic circles, though, because of the counterargument that **debt-deflation represented no more than a redistribution from one group (debtors) to another (creditors)**. Absent implausibly large differences in marginal spending propensities among the groups, it was suggested, pure redistributions should have **no significant macro-economic effects**… (Bernanke 2000, p. 24)
>
> ***
>
> Ignoring the foreign component, or looking at the world as a whole, **the overall level of debt makes no difference to aggregate net worth** — one person's liability is another person's asset…
>
> In what follows, we begin by setting out a flexible-price endowment model in which "impatient" agents borrow from "patient" agents, but are subject to a

> debt limit. If this debt limit is, for some reason, suddenly reduced, the impatient agents are forced to cut spending… ([Krugman and Eggertsson 2010, p. 3)])
>
> ***
>
> People think of debt's role in the economy as if it were the same as what debt means for an individual: there's a lot of money you have to pay to someone else. But that's all wrong; the debt we create is basically money we owe to ourselves, and the burden it imposes does not involve a real transfer of resources.
>
> That's not to say that high debt can't cause problems — it certainly can. But these are problems of distribution and incentives, not the burden of debt as is commonly understood. ([Krugman 2011)])

Specifically, Bernanke and Krugman assume that huge levels of household debt don't hurt the economy because more debt among households just means that savers have loaned them money … i.e. that it is a net wash to the economy.

To make this assumption, they rely on the myth that banks can only loan as much money out as they have in deposits. In other words, they assume that if bank customer John Doe has $100 in the bank, then the bank can loan that $100 to someone else.

But as Keen notes, banks actually loan out money *whether or not* they have enough in deposits … and then borrow the shortfall from the Fed or other sources.

Keen therefore says that it is *not* a wash … and that high levels of private debt are the *cause* of the current economic crisis.

I wrote to L. Randall Wray to get his view on who is right. Wray is a professor of economics and research director of the Center for Full Employment and Price Stability at the University of Missouri–Kansas City. Wray is one of the country's top experts on money creation.

Wray is the author of *Money and Credit in Capitalist Economies*, 1990, and *Understanding Modern Money: The Key to Full Employment and Price Stability*, 1998. He is also coeditor of, and a contributor to, *Money, Financial Instability, and Stabilization Policy*, 2006, and *Keynes for the 21st Century: The Continuing Relevance of The General Theory, 2008*.

I asked Wray:

> As you might have heard – Paul Krugman argues that banks only loan out based upon their deposits, while Steve Keen argues that loans are created through double entry bookkeeping, so that money is created endogenously [i.e. banks create their own money].
>
> For example, here is Scott Fullwiler's (Associate Professor of Economics and James A. Leach Chair in Banking and Monetary Economics at Wartburg College) take on the debate: http://www.nakedcapitalism.com/2012/04/scott-fullwiler-krugmans-flashing-neon-sign.html Or summary here: http://unlearningeconomics.wordpress.com/2012/04/03/the-keenkrugman-debate-a-summary/

> As a leading expert on modern monetary theory, who do you think is right? Do banks need deposits before they can lend … or do they lend regardless of deposits, and only bounded by reserve and capital requirements (or access to Fed monies)?

Wray responded:

> Bank deposits are bank IOUs; an IOU can only come from the issuer. Where do your IOUs come from? Do you borrow them? NO. [Professor] Scott [Fullwiler] is right, **Krugman does not know what he is talking about.**

Indeed, economics professor and money expert Fullwiler says that Krugman should wear a flashing neon sign saying "I don't know what I'm talking about", and explains:

> As is well known, and by the logic of double-entry accounting, the bank does make a loan out of thin air—no prior deposits or reserves necessary.
>
> ***
>
> [Krugman writes:]
>
>> And currency is in limited supply — with the limit set by Fed decisions.
>
> This statement is simply mindboggling. It's so wrong I don't know where to begin. The Fed NEVER limits the supply of currency. Never. Ever. To do otherwise would be to violate its mandate in the Federal Reserve Act to provide for an elastic currency and maintain stability of the payments system.

Economics professor Michael Hudson also slams Krugman for having a blindspot on debt:

> Mr. Krugman's failure to see today's economic problem as one of debt deflation reflects his failure (suffered by most economists, to be sure) to recognize the need for debt writedowns, for restructuring the banking and financial system, and for shifting taxes off labor back onto property, economic rent and asset-price ("capital") gains. The effect of his narrow set of recommendations is to defend the status quo – and for my money, despite his reputation as a liberal, that makes Mr. Krugman a conservative. I see little in his logic that would oppose Rubinomics, which has remained the Democratic Party's program under the Obama administration.
>
> ***
>
> Mr. Krugman got lost in the black hole of banking, finance and international trade theory that has engulfed so many neoclassical and old-style Keynesian economists. Last month Mr. **Krugman insisted that banks do not create credit, except by borrowing reserves that (in his view) merely shifts lending savings from wealthy people to those with a higher propensity to consume.** Criticizing Steve Keen (who has just published a second edition of his excellent Debunking Economics to explain the dynamics of endogenous money creation), he wrote:

> Keen then goes on to assert that lending is, by definition (at least as I understand it), an addition to aggregate demand. I guess I don't get that at all. If I decide to cut back on my spending and stash the funds in a bank, which lends them out to someone else, this doesn't have to represent a net increase in demand. Yes, in some (many) cases lending is associated with higher demand, because resources are being transferred to people with a higher propensity to spend; but Keen seems to be saying something else, and I'm not sure what. I think it has something to do with the notion that creating money = creating demand, but again that isn't right in any model I understand.Keen says that it's because once you include banks, lending increases the money supply. OK, but why does that matter? He seems to assume that aggregate demand can't increase unless the money supply rises, but that's only true if the velocity of money is fixed;

But "velocity" is just a dummy variable to "balance" any given equation – a tautology, not an analytic tool. As a neoclassical economist, Mr. **Krugman is unwilling to acknowledge that banks not only create credit; in doing so, they create debt**. That is the essence of balance sheet accounting. But … Krugman offers the mythology of banks that can only lend out money taken in from depositors (as though these banks were good old-fashioned savings banks or S&Ls, not what Mr. Keen calls "endogenous money creators"). Banks create deposits electronically in the process of making loans.

***

Said Krugman:

> First of all, any individual bank does, in fact, have to lend out the money it receives in deposits. Bank loan officers can't just issue checks out of thin air; like employees of any financial intermediary, they must buy assets with funds they have on hand.***
>
> There are vehement denials of the proposition that banks' lending is limited by their deposits, or that the monetary base plays any important role; banks, we're told, hold hardly any reserves (which is true), so the Fed's creation or destruction of reserves has no effect.

***

The problem with Mr. Krugman's analysis is that bank debt creation plays no analytic role in Mr. Krugman's proposals to rescue the economy. It is as if the economy operates without wealth or debt, simply on the basis of spending power flowing into the economy from the government, and being spent on consumer goods, investment goods and taxes – not on debt service, pension fund set-asides or asset price inflation. If the government will spend enough – run up a large enough deficit to pump money into the spending stream, Keynesian-style – the economy can revive by enough to "earn its way out of debt." The assumption is that the government will revive the economy on a broad enough scale to enable the individuals who owe the mortgages, student loans and other debts – and presumably even the states and localities that have fallen behind in their pension plan funding – to "catch up."

Without recognizing the role of debt and taking into account the magnitude of negative equity and earnings shortfalls, one cannot see that what is preventing

> American industry from exporting more is the heavy debt overhead that diverts income to pay the Finance, Insurance and Real Estate (FIRE) sector. How can U.S. labor compete with foreign labor when employees and their employers are obliged to pay such high mortgage debt for its housing, such high student debt for its education, such high medical insurance and Social Security (FICA withholding), such high credit-card debt – all this even before spending on goods and services?
>
> In fact, how can wage earners even afford to buy what they produce?

Banks DO, In Fact, Create Money Out of Thin Air

If you're still not convinced that banks create money out of thin air, without regard to whether or not they have deposits on hand, please note that the Fed has said as much.

For example, a 1960s Chicago Federal Reserve Bank booklet entitled "Modern Money Mechanics" said:

> [Banks] do not really pay out loans from the money they receive as deposits. If they did this, no additional money would be created. What they do when they make loans is to accept promissory notes in exchange for credits to the borrowers' transaction accounts.

Moreover:

> (1) William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, said in a speech in July 2009:
>
>> Based on how monetary policy has been conducted for several decades, banks have always had the ability to expand credit whenever they like. They don't need a pile of "dry tinder" in the form of excess reserves to do so. That is because the Federal Reserve has committed itself to supply sufficient reserves to keep the fed funds rate at its target. If banks want to expand credit and that drives up the demand for reserves, the Fed automatically meets that demand in its conduct of monetary policy. In terms of the ability to expand credit rapidly, it makes no difference.
>
> (2) On February 10, 2010, Ben Bernanke proposed the elimination of **all** reserve requirements:
>
>> The Federal Reserve believes it is possible that, ultimately, its operating framework will allow the elimination of minimum reserve requirements, which impose costs and distortions on the banking system.

Under the current fractional reserve banking system, banks can loan out many times reserves. But even that system is being turned into a virtually *infinite* printing press for banks.

Germany's central bank – the Deutsche Bundesbank (German for German Federal Bank) – has also admitted in writing that banks create credit out of thin air.

And there's an overwhelming amount of additional proof:

> As PhD economist Steve Keen pointed out recently, 2 Nobel-prize winning economists have shown that the assumption that reserves are created from excess deposits is not true:
>
> > The model of money creation that Obama's economic advisers have sold him was shown to be empirically false over three decades ago.
> >
> > The first economist to establish this was the American Post Keynesian economist Basil Moore, but similar results were found by two of the staunchest neoclassical economists, **Nobel Prize winners Kydland and Prescott** in a 1990 paper Real Facts and a Monetary Myth.
> >
> > Looking at the timing of economic variables, they found that credit money was created about 4 periods before government money. However, the "money multiplier" model argues that government money is created first to bolster bank reserves, and then credit money is created afterwards by the process of banks lending out their increased reserves.
> >
> > Kydland and Prescott observed at the end of their paper that:
> >
> > Introducing money and credit into growth theory in a way that accounts for the cyclical behavior of monetary as well as real aggregates is an important open problem in economics.
>
> In other words, if the conventional view that excess reserves (stemming either from customer deposits or government infusions of money) lead to increased lending were correct, then Kydland and Prescott would have found that credit is extended by the banks (i.e. loaned out to customers) after the banks received infusions of money from the government. Instead, they found that the extension of credit preceded the receipt of government monies.
>
> Keen explained in an interview Friday that 25 years of research shows that creation of debt by banks precedes creation of government money, and that debt money is created first and precedes creation of credit money.
>
> As Mish has previously noted:
>
> > Conventional wisdom regarding the money multiplier is wrong. Australian economist Steve Keen notes that in a debt based society, expansion of credit comes first and reserves come later.
>
> This angle of the banking system has actually been discussed for many years by leading experts:
>
> "The process by which banks create money is so simple that the mind is repelled."
> – Economist John Kenneth Galbraith
>
> "[W]hen a bank makes a loan, it simply adds to the borrower's deposit account in the bank by the amount of the loan. The money is not taken from anyone else's deposit; it was not previously paid in to the bank by anyone. It's new

money, created by the bank for the use of the borrower."
– Robert B. Anderson, Secretary of the Treasury under Eisenhower, in an interview reported in the August 31, 1959 issue of U.S. News and World Report

"Do private banks issue money today? Yes. Although banks no longer have the right to issue bank notes, they can create money in the form of bank deposits when they lend money to businesses, or buy securities. . . . The important thing to remember is that when banks lend money they don't necessarily take it from anyone else to lend. Thus they 'create' it."
-Congressman Wright Patman, Money Facts (House Committee on Banking and Currency, 1964)

"The modern banking system manufactures money out of nothing. The process is perhaps the most astounding piece of sleight of hand that was ever invented."
– Sir Josiah Stamp, president of the Bank of England and the second richest man in Britain in the 1920s.

"Banks create money. That is what they are for. . . . The manufacturing process to make money consists of making an entry in a book. That is all. . . . Each and every time a Bank makes a loan . . . new Bank credit is created — brand new money."
– Graham Towers, Governor of the Bank of Canada from 1935 to 1955.

I've also noted:

> In First National Bank v. Daly (often referred to as the "Credit River" case) the court found that the bank created money "out of thin air":
>
> > [The president of the First National Bank of Montgomery] admitted that all of the money or credit which was used as a consideration [for the mortgage loan given to the defendant] was created upon their books, that this was standard banking practice exercised by their bank in combination with the Federal Reserve Bank of Minneaopolis, another private bank, further that he knew of no United States statute or law that gave the Plaintiff [bank] the authority to do this.
>
> The court also held:
>
> > The money and credit first came into existence when they [the bank] created it.
>
> (Here's the case file).
>
> Justice courts are just local courts, and not as powerful or prestigious as state supreme courts, for example. And it was not a judge, but a justice of the peace who made the decision.
>
> But what is important is that the president of the First National Bank of Montgomery apparently admitted that his bank created money by simply making an entry in its book …

Moreover, although it is counter-intuitive, virtually all money is actually created as debt. For example, in a hearing held on September 30, 1941 in the House Committee on Banking and Currency, then-Chairman of the Federal Reserve (Mariner S. Eccles) said:

> That is what our money system is. If there were no debts in our money system, there wouldn't be any money.

And Robert H. Hemphill, Credit Manager of the Federal Reserve Bank of Atlanta, said:

> If all the bank loans were paid, no one could have a bank deposit, and there would not be a dollar of coin or currency in circulation. This is a staggering thought. 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. It is so important that our present civilization may collapse unless it becomes widely understood and the defects remedied very soon.

Indeed, even Paul Krugman admits that "banks can create inside money". Inside money is "debt that is used as money".

Why Is The Myth About Banks So Dangerous?

Even if banks don't really loan based on their deposits and reserves, who cares? Why is this such a dangerous myth?

Because, if banks don't make loans based on available deposits or reserves, that means:

> (1) This was never a liquidity crisis, but rather a solvency crisis. In other words, it was not a lack of available liquid funds which got the banks in trouble, it was the fact that they speculated and committed fraud, so that their liabilities far exceeded their assets. The government has been fighting the wrong battle, and has made the economic situation worse.
>
> (2) The giant banks are not needed, as the federal, state or local governments or small local banks and credit unions can create the credit instead, if the near-monopoly power the too big to fails are enjoying is taken away, and others are allowed to fill the vacuum.

Indeed, the big banks do very little traditional banking. Most of their business is from financial speculation. For example, ***less than 10%*** of Bank of America's assets come from traditional banking deposits.

Time Magazine gave some historical perspective in 1993:

> What would happen to the U.S. economy if all its commercial banks suddenly closed their doors? Throughout most of American history, the answer would have been a disaster of epic proportions, akin to the Depression wrought by the chain-reaction bank failures in the early 1930s. But [today] the startling answer is that a shutdown by banks might be far from cataclysmic.

> ***
>
> Who really needs banks these days? Hardly anyone, it turns out. While banks once dominated business lending, today nearly 80% of all such loans come from nonbank lenders like life insurers, brokerage firms and finance companies. Banks used to be the only source of money in town. Now businesses and individuals can write checks on their insurance companies, get a loan from a pension fund, and deposit paychecks in a money-market account with a brokerage firm. "It is possible for banks to die and still have a vibrant economy," says Edward Furash, a Washington banks consultant.

So we the government has been barking up the wrong tree by propping up the big banks.

Moreover, as discussed above, the fact that banks can create money means that the level of private debt *does* matter … and economists like Bernanke and Krugman who encourage massive levels of private debt are hurting the economy.

As professor Keen [explains]:

> In a credit-based economy, aggregate demand is therefore the sum of income plus the change in debt, with the change in debt spending new money into existence in the economy. This is then spent not only goods and services, but on financial assets as well—shares and property. Changes in the level of debt therefore have direct and potentially enormous impacts on the macroeconomy and asset markets, as the GFC—which was predicted only by a handful of credit-aware economists (Bezemer 2009)—made abundantly clear.
>
> If the change in debt is roughly equivalent to the growth in income—as applied in Australia from 1945 to 1965, when the private debt to GDP ratio fluctuated around 25 per cent (see Figure 1)—then nothing is amiss: the increase in debt mainly finances investment, investment causes incomes to grow, and the economy moves forward in a virtuous feedback cycle. But when debt rises faster than income, and finances not just investment but also speculation on asset prices, the virtuous cycle gives way to a vicious positive feedback process: asset prices rise when debt rises faster than income, and this encourages more borrowing still.
>
> The result is a superficial economic boom driven by a debt-financed bubble in asset prices. To sustain a rise in asset prices relative to consumer prices, debt has to grow more rapidly than income—in other words, if asset prices are to rise faster than consumer prices, then rather than merely rising, debt has to accelerate. This in turn guarantees that the asset price bubble will burst at some point, because debt can't accelerate forever. When debt growth slows, a boom can turn into a slump even if the rate of growth of GDP remains constant.
>
> This process is easily illustrated in a numerical example. Consider an economy with a GDP of $1 trillion that is growing at 10% per annum, with real growth of 5% and inflation of 5%, and in which private debt is $1.25 trillion and growing at 20% p.a. Total spending on both goods & services and financial assets is therefore $1.25 trillion: $1 trillion is financed by income, and $250 billion is financed by the 20% increase in debt.
>
> In the following year, if the growth of debt simply slows down to the same rate at which nominal GDP is growing (without affecting the rate of economic growth), then the growth in debt will be $150 billion (10% of the $1.5 trillion level reached at the end of the previous year). Total spending will therefore be exactly the same as the year before: $1.25 trillion, consisting of $1.1 trillion in

> GDP plus a $150 billion growth in debt. However, since inflation is running at 5%, this amounts to a 5% fall in the real level of economic activity—which would be spread across both commodity and asset markets.
>
> If instead the growth of debt stopped, then total spending the next year will be $1.1 trillion, a 15% fall from the level of the previous year in nominal terms, and 20% in real terms. This would cause a massive slump in demand for goods & services, assets, or both, even without a slowdown in the rate of growth of GDP.
>
> This hypothetical example is not far removed from the actual experience of the GFC. As the US experience illustrates most clearly, the switch from rising to falling private debt ushered in the biggest economic downturn since the Great Depression, a prolonged period of high unemployment, and sharp falls in asset markets—all of which are plotted in Figure 3.
>
> **Figure 3**
>
> This is why the shift from the Age of Leverage to the Age of Deleveraging was so dramatic, and yet so unforeseen by conventional economists: it was caused by a huge reduction in aggregate demand from a factor they ignore. This debt-induced reduction in aggregate demand will persist as long as private debt levels are falling—as they still are in the USA, though at a much reduced rate from the peak rate of fall in early 2010.

In 2008, the Bank for International Settlements (BIS) – often described as the central bank for central banks – said that failing to force companies to write off bad debts "will only make things worse".

Indeed, Bernanke, Krugman and other mainstream economists from the left and the right who encourage more private debt are only creating a debt trap … where people take on new debt to try to pay for the old debt, and end up in a worse situation than they started:

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: **Washington's Blog**