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The Retreat of the Shadow Lenders, Why Deflation and not Inflation is the Order of the Day

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While contrarians are screaming "hyperinflation!", the money supply is actually shrinking. This is because most money today comes into existence as bank loans, and lending has shrunk substantially. That means the Fed needs to "monetize" debt just to fill the breach.

On June 3, 2009, Federal Reserve Chairman Ben Bernanke assured Congress, "The Federal Reserve will not monetize the debt." Bill Bonner, writing in The Daily Reckoning, said it had a ring to it, like President Nixon's "I am not a crook" and President Clinton's "I did not have sex with that woman." Monetizing the debt is precisely what the Fed will do, says Bonner, because it has no other choice. The Chinese are growing reluctant to lend, the taxpayers are tapped out, and the deficit is at unprecedented levels. "Even good people do bad things when they get in a jam. The Feds are already in pretty deep . . . and they're going a lot deeper."

But Mr. Bernanke denied it. "Either cuts in spending or increases in taxes will be necessary to stabilize the fiscal situation," he said.

Both alternatives will be vigorously opposed, leaving Congress in the same deadlock California has been in for the last year. That makes the monetization option at least worth a look. What is wrong with it? Bill Bonner calls it "larceny on the grandest scale. Rather than honestly repaying what it has borrowed, a government merely prints up extra currency and uses it to pay its loans. The debt is 'monetized' . . . transformed into an increase in the money supply, thereby lowering the purchasing power of everybody's savings."

So say the pundits, but in the past year the Fed has "monetized" over a trillion dollars worth of debt, yet the money supply is not expanding. As investment adviser Mark Sunshine observed in a June 12 blog:

"[W]hile media talking heads were ranting about how the Fed was running their printing presses overtime to push up money supply, the facts were very different. M1 has actually declined since the middle of December, 2008. During the same six month period M2 has only risen by a little less than 3%."

The Fed is no longer reporting M3, the largest measure of the money supply, but according to Sunshine:

"[W]e know that broader measures of money supply, like M3, haven't materially risen in 2009.

M3 followers can get a very rough idea of what M3 would have been, if it were published, by looking at the Federal Reserve quarterly Flow of Funds Accounts of the United States which was distributed yesterday. As it turns out, total net borrowing of the United States (private and public) dropped approximately $255 billion in the first quarter and other indicators of M3 fell or are about flat (on a net basis). . . . [T]his data supports [the] theory that the fall in private borrowing is more than offsetting the rise in government borrowing and therefore, at least for the time being, financing the deficit isn't a problem."

All of this flap about the Fed driving the economy into hyperinflation because it is creating money on its books reflects a fundamental misconception about how our money and banking system actually works. In monetizing the government's debt, the Fed is just doing what banks do every day. All money is created by banks on their books, as many authorities have attested. The Fed is just stepping in where the commercial banking system has failed. Except for coins, which are issued by the government and compose only about one ten-thousandth of the money supply (M3), our money today is nothing but bank credit (or debt); and we're now laboring under a credit freeze, which means banks aren't creating nearly as many loans as they used to. In February, the Bank for International Settlements published research showing that European banks could not settle their debts because of a $2 trillion shortage of U.S. dollars. Proposals for alternative reserve currencies followed. And in March, Blackstone Group CEO Stephen Schwarzman reported that up to 45% of the world's wealth has been destroyed by the credit crisis. The missing "wealth" cannot be restored without putting the missing "money" back into the system, and that means getting the credit engine going again.

Congress, the Treasury and the Federal Reserve have therefore been throwing money at the banks, trying to build up the banks' capital so they can make enough loans to refuel the economy. At a capital requirement of 8%, $8 in capital can be leveraged into $100 in loans. But lending remains far below earlier levels, and it's not because the banks are refusing to lend. The banks insist that they are making as many loans as they're allowed to make with their existing deposit and capital bases. The real bottleneck is with the "shadow lenders" – those investors who, until late 2007, bought massive amounts of bank loans bundled up as "securities," taking those loans off the banks' books, making room for yet more loans to be originated out of the banks' capital and deposit bases. In a Washington Times article titled "Banks Still Standing Amid Credit Rubble," Patrice Hill wrote:

"Before last fall's financial crisis, banks provided only $8 trillion of the roughly $25 trillion in loans outstanding in the United States, while traditional bond markets provided another $7 trillion, according to the Federal Reserve. The largest share of the borrowed funds – $10 trillion – came from securitized loan markets that barely existed two decades ago. . . .

"Many legislators in Congress complain that banks aren't lending, and cite that as an excuse to vote against further bank bailout funds. . . . But Mr. Regalia [chief economist at the U.S. Chamber of Commerce] said these critics are wrong. 'Banks are lending more, but 70 percent of the system isn't there anymore,' he said."

Seventy percent of the system isn't there anymore because the traditional bond markets and securitized loan markets have dried up. Writes Hill:

"Congress' demand that banks fill in for collapsed securities markets poses a dilemma for the banks, not only because most do not have the capacity to ramp up to such large-scale lending quickly. The securitized loan markets provided an essential part of the machinery that enabled banks to lend in the first place. By selling most of their portfolios of mortgages, business and consumer loans to investors, banks in the past freed up money to make new loans. . . .

"The market for pooled subprime loans, known as collateralized debt obligations (CDOs), collapsed at the end of 2007 and, by most accounts, will never come back. Because of the surging defaults on subprime and other exotic mortgages, investors have shied away from buying the loans, forcing banks and Wall Street firms to hold them on their books and take the losses."

The retreat of the shadow lenders has created a credit freeze globally; and when credit shrinks, the money supply shrinks with it. That means there is insufficient money to buy goods, so workers get laid off and factories get shut down, perpetuating a vicious spiral of economic collapse and depression. To reverse that cycle, credit needs to be restored; and when the banks can't do it, the Fed needs to step in and start "monetizing" debt.

So why don't Fed officials just say that is what they are up to and put our minds at ease? Probably because they can't without exposing the whole banking game. The curtain would be thrown back and we the people would know that our money system is sleight of hand. The banks never had all that money they supposedly lent to us. We've been paying interest for something they created out of thin air! Indeed, their credit money is less substantial than air, which at least has some molecules bouncing around in it. Bank credit exists only in cyberspace.

Ben Bernanke's predecessor Alan Greenspan was sometimes compared to the Wizard of Oz, the little man who hid behind a curtain pulling levers and twisting dials, maintaining the smoke and mirrors illusion that an all-powerful force was keeping things under control. Early in his term, Chairman Bernanke was criticized for revealing too much. "If you're going to play the Wizard," said one TV commentator, "you have to stay behind the curtain." The Chairman has evidently learned his lesson and is now playing the role, wrapping his moves in that veil of mystery expected of the man considered the world's most powerful banker, the Wizard who moves markets with his words.

The problem with the Wizard playing his cards close to the chest is that investors don't know how to play theirs. The Chinese have grown so concerned about the soundness of their dollar investments that the head of China's second-largest bank recently said the U.S. government should start issuing bonds in China's currency, the yuan. What do we want with yuan? We need dollars; and we would be better off getting them from our own central bank than borrowing them from foreign rivals. We could then spend them on projects aimed at internal domestic development – as the Chinese themselves have been doing – and get the wheels of production turning again.

If Ben Bernanke stands by his word and refuses to monetize the federal debt, Congress should consider issuing the money itself, as the U.S. Constitution provides. The "full faith and credit of the United States" is an asset of the United States, and it should properly be issued and lent by the United States rather than by unaccountable private banks and shadow lenders. The true path to economic recovery – the path from an economy strangled in debt to one blooming in prosperity – is to reclaim money and credit as public resources, transforming money from private master to public servant.

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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