Atlee Rapid Recovery Proposal:

Reviving Obama's 2008 Vision of Hope and Basic Change By Quickly Ending the Present Devastating Recession/Depression Without Increasing the Federal Deficit and Debt

Dr. John S. Atlee, June 2010
contact: recovery (at) iea-macro-economics.org

(outline composed by Richard Atlee, with consultation, from the proposal's details)

On the web:

this outline:	HTML	http://www.iea-macro-economics.org/rapid_recovery_outline.html
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summary:	HTML	http://www.iea-macro-economics.org/rapid_recovery_summary.html
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Introduction

The severe 2007-10 recession effectively ended last Spring, leaving a continuing depression second in severity only to the 1930's Great Depression, with over ten million officially unemployed, devastating businesses and the lives of millions of individuals and households and sapping the national strength. Today the 2008 themes of hope and change have a hollow ring which does not bode well for the administration and the Democratic Congress. Without a rapid recovery, November will not bring good news. This proposal is an attempt to honor those promises of fundamental change and provide new hope, as well as channeling the present public anger at the recession-inducing banks in a constructive direction.

The proposal calls for the Obama administration to take the following steps

1. Publicly recognize the recession/depression as unique event (not "just another recession," as assumed by the Bush administration) and declare a start in new direction
2. Publicly acknowledge the basic mechanism of a rapid recovery (I.A, below)
3. Publicly commit to viewing the recession/depression from **moral/economic/political equivalent of war** perspective, and respond to it as with Pearl Harbor -- business-as-usual is unacceptable, old rules may not apply.
4. Adopt this new policy now, to give people an opportunity to vote on it in November

I. Conceptual basis for the institutional reforms in this proposal

A. Basic mechanism of a rapid recovery

1. A rapid recovery is, by definition, a massive increase in GDP spending
2. GDP spending is the sum of private and public spending
3. In a recession, private and state & local government spending is greatly reduced, and thus must be more than made up for by a massive and controlled increase in federal spending.
4. World War II showed that such an increase in federal spending must be financed by a massive and controlled influx of new money -- "exogenous" money that, coming from outside the existing flow of income and expenditure, is the only way to help the economy grow.
    a. It would appear on the surface that the World War II spending was financed by federal borrowing, but in fact most of it was financed by new money. The "borrowing" was from the Fed, which -- after the rule against the Fed buying Treasury securities directly from the Treasury was suspended during the war -- created new money out of thin air to buy the resulting-low-interest securities.

B. How the present fractional reserve system works

1. Invented by 17th century European goldsmiths
    a. They held gold for customers, gave them receipts which were eventually used by the customers as money (i.e., as a medium of exchange)
    b. They realized that gold owners didn't all want to withdraw all their gold at the same time. As a result, they could either lend much of gold out (keeping only a fraction on reserve), or print receipts in excess of the value of the gold and lend those receipts out at interest.
2. It's still in effect today -- banks are required to keep at the Fed a reserve consisting of a certain percentage of their transaction (checkable) accounts, although through various sleights-of-hand (like overnight swaps between checking and savings accounts) the effective percentage is much smaller than the published one.
3. To increase the money supply, the Fed creates "high-powered" new money "out of thin air" and uses it to buy Treasury securities, which adds the new money to the bank account of each securities seller (and, at the same time, to that bank's reserves)
4. The "bank-reserve multiplier" (the reciprocal of the Fed's required reserve ratio) then increases the new money many-fold
    a. The banks receiving the "high-powered" money can then lend out all of this new money, except the amount required for reserves, thus creating more money "out of thin air."
    b. When this loaned money is spent, the banks in which it is deposited can do the same, creating more money "out of thin air," and on and on until the amount of the original Fed "high-powered" new money is all tied up in reserves.
    c. There is another multiplier -- see the Money-GDP multiplier, below.

5. Disadvantages of the fractional reserve system

   a. Private winners, public losers -- the banks profit on the interest from all these loans, while increases in federal debt (securities purchases) are necessary in order to get the high-powered new money into circulation.

   b. Money growth is tightly linked to economic growth, and to the extent the Fed uses the former to achieve the latter, it has a hard time with the tremendous leverage exerted by the large bank-reserve multiplier that results from the at-present extremely small effective reserve requirement. Hitting money supply targets is like picking up peas with a ten-foot fork.

   c. In a recession, in the absence of credit-worthy borrowers, banks may stop lending, blocking the flow of "high-powered" Fed new-money into the economy that is created to fight the recession.

C. The vital distinction between money and credit

1. Central theme -- separation of money and credit is a central purpose of this 100% reserve proposal.

2. **Money** is the medium of exchange

   a. Used for GDP income/spending

   b. Physical money: coins, currency
   Electronic money: transaction accounts (a.k.a. checking accounts, demand deposits, "digital or electronic gold") -- i.e., from which physical money is available immediately on demand

3. **Credit** (as used in Fed's Flow of Funds accounts) is essentially a transfer of money from one party to another, on the basis of an expected return of the money at a later date, possibly with some form of interest.

   a. Savings/time deposits are credit assets, used for lending and investment for interest and capital gains

   b. They are not money -- their content must be converted into currency or checkable funds before it can be spent.

4. This distinction clarifies what is money

   a. "...what specifically constitutes money is a notion that has, so far, eluded our analysis." -- Alan Greenspan, 10/19/00 remarks to Cato Institute

   b. The definition of money (pre-1980 M1) is transactional funds (coins, currency, checkable deposits) used for GDP purchases.
   M2 and other measures that don't include all transactional funds, and do include savings/investment accounts and time deposits are not money.

5. Two views of transaction accounts:

   a. The **credit-money** view (the current view): the account is a liability of the bank to the depositor (or of the Fed to the banks who have reserves on deposit there)

b. The **non-credit** (i.e., **inventory stock** -- see D1, below) view: the bank is simply a storage location for the inventory of medium of exchange owned by the depositor.

c. Ambivalence of the system is illustrated by Federal Reserve Notes

1. Long ago, they were inscribed "payable to the bearer on demand" -- i.e., credit money

2. Now they say "legal tender for all debts public and private" -- i.e., part of the bearer's inventory of the medium of exchange (yet the Fed still treats them as if they were its liability to the public)

D. The money supply's relationship to economic growth -- the **Money Demand Ratio** (MDR = M/GDP) and the **Money Multiplier**

1. Money supply is an inventory stock -- a real entity, not a credit entity -- supporting the flow of GDP income/spending, similar to that used by manufacturers, retailers, and kitchens.

2. It is related to GDP through the "money demand ratio" -- the structural stock/flow ratio measured by M/GDP

3. The MDR is a measure of the public's desire for transaction balances to service their spending.

a. The relationship is obscured when investment incentives (interest) are permitted on otherwise purely transaction accounts.

b. Normal MDR not expected during war or recovery from recession or "moral equivalent of war" crises such as the recent one, which may require extra production of money by the Fed

4. The Money-GDP Multiplier (GDP/M)

a. When new money generated by the Fed enters an account, it increases the money-flow through that account. To the extent that the account holder implicitly uses a stock/flow ratio in determining the preferred balance for serving the flow through the account, that balance will increase slightly to take account of the increased flow, effectively locking in a bit of the money that entered the account.

b. With each successive account that the remainder of this money enters, the same thing occurs, until all of the initial influx is locked into account holders' larger preferred balances.

c. The ratio of the total flow of GDP spending that was generated in this process to the initial influx of new money is the Money-GDP multiplier.

d. Traditionally, the money multiplier is also referred to as "velocity."

5. Determination of the amount of new money needed must depend on the real needs of the economy, not on interest rates or concerns about Federal debt

E. Achieving economic growth and recovery requires effective control of the money supply
    1. Requires keeping transactional money separate from credit
    2. Requires monitoring of the MDR, and an ongoing understanding of the factors that are affecting it.
    3. Requires a dependable movement of new money into the economy -- i.e., an elimination of the "pushing on a string" problem caused when lowering interest rates does not stimulate movement of necessary new money from banks into the economy
    4. Requires elimination of the looseness and unpredictability characteristic of the extreme "leverage" created by the present extremely low effective reserve ratio and interest rates.
    5. Monetary growth (for both normal economic growth and to counter recessions) is a national systemic need and should not be tied to inappropriate and controversial increases in Federal debt.
    6. Note: The Fed has no control over currency, so it doesn't play a role in monetary management
F. Fed manipulation of interest rates should not (and cannot) be used to effectively control economic growth
    1. "pushing on a string" problem
    2. Injury caused to fixed-income people by very low interest rates.

II. Institutional reforms called for by the conceptual basis of this proposal

See Concepts section (I, above) for the basis for these reforms, and the Mechanics section (III, below) for how these can be implemented and problems addressed.

A. End the traditional and dysfunctional three-century old fractional reserve system, transferring money creation/reduction -- i.e., control of the money supply -- from the present Fed-and-banks system to the federal government (through the Fed as its fiscal agent).

B. Restore a clear distinction between money (transaction accounts) and credit (interest-bearing accounts and investments)

   1. Strengthens the functional connection between money and GDP

   2. There is no interest payment for currency, and there shouldn't be for any other transaction money

C. Increase transparency and effectiveness of monetary policy through use of a clear formula recognizing the relationship between money growth and economic growth through the Money Demand Ratio.

D. Establish the concept of Federal interest-free seignorage income associated with money creation, and Federal expenditure as the means of entry of new-money (from money-supply increases) into the general economy

   1. Eliminates debt concerns associated with money-supply increases that may be necessary for appropriate economic growth.

   2. Removes the pushing-on-a-string problem that can block new-money entry into the economy

   3. Improves appropriateness of new money's role in the economy during recoveries, by targeting unemployment insurance extensions, state & local government grants, etc.

   4 Avoids the kind of speculative misdirection of new money that banks have engaged in, by directing new money through the federal government to non-speculative real-economy uses

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III. Mechanics of implementing the institutional reforms called for in this proposal

A. Fed increases the reserve requirement to 100% on all checkable (demand) deposits.

1. Resolves a number of problems by transferring money creation from banks to the federal government

   a. Eliminates the "pushing on a string" problem of banks misusing or not lending new money.

   b. Enhances the precision of monetary policy by reducing the large "leverage" produced by the present very small effective reserve ratio.

   c. Removes the incurring of debt and deficits resulting from necessary systemic monetary expansion.

2. Conceptually, on an economy-wide basis, this would not be difficult, since excess reserves are at present about the equivalent of 100% reserves

   However, this may not be true at the individual bank level, so it might be necessary for the Fed to lend (temporarily, at negligible interest) sufficient funds to banks that are not immediately able to meet the requirement in the present recessionary context.

3. Applies to all checkable accounts (i.e., demand deposit -- accessible on demand): checking accounts, NOW accounts, checkable money market accounts, etc.

4. Does not significantly erode the present total supply of lendable funds, since transaction accounts amount to less than 11% of these funds (i.e., M1 + savings deposits + small time deposits) in commercial banks, 12% in thrift institutions.

B. Fed re-establishes the pre-1980 prohibition of interest payments on transaction accounts.

1. Funds currently in anomalous interest-bearing checkable accounts (NOW, money market, etc.) will then be divided between transaction and investment accounts, restoring some of the small amount of lendable funds lost by the removal of transaction accounts from that pool.

2. The host financial institutions will determine the procedures under which depositors will be involved in this.

3. The prohibition renders all elements of M1 (coin, currency, checking) the same in terms of interest

4. The seigniorage account has nothing to do with where/how the money ultimately is spent.

C. Fed removes other ambiguities about the distinction between money-as-inventory and credit.

1. Fed changes the way it handles currency on its books, so that currency is no longer considered a liability to the public (a non-money credit concept)

2. The present "Monetary aggregates" above M1 (i.e., that include savings and time deposits and other investment vehicles) are clearly identified as credit rather than money.

D. Fed determines the amount of monetary expansion/shrinkage needed by means of a money-growth formula

   1. The formula expresses the relationship between money growth and economic growth, mediated through the Money Demand Ratio (MDR). Whether new-money -- or money-supply reduction -- is required for a given economic growth target depends on what the MDR is doing.
   2. The formula permits the faster growth needed during recovery, But also enables a soft-landing (asymptotic) approach to Potential GDP by factoring in the potential output gap, preventing the inflationary inventory bottlenecks that might otherwise result from too rapid growth near Potential GDP.
   3. The formula does NOT permit continued potentially-inflationary growth
   4. The formula expresses the needs of the overall economy, not federal deficits as such, although counter-recessionary new money called for by the formula will obviously indirectly reduce deficits.
   5. The MDR requires constant monitoring by the Fed
   6. Tailoring the formula to deal with unusual conditions is done by consultation between Fed and Treasury

E. Fed establishes a seignorage account for monetary creation/reduction transfers

   1. "Seignorage" is income, handled on the federal books just like taxes, fees, etc.
   2. One principal purpose of the account is to make explicit and transparent the Fed's monetary policy, which is not the cases under the current system.
   3. The account serves as a device for managing increases and decreases in the money supply; as such, it is not part of the money supply.
      a. When a reduction in the money supply is needed, the Fed, as the Federal Government's fiscal agent, extracts the necessary amount from the federal inflow stream and deposits it in the seignorage account, thus removing it -- quarantining it -- from the functional money supply.
      b. When an infusion of new money is needed -- either for maintaining normal economic growth or to counter a recession -- the seignorage account provides it from two possible sources:
         1. "Quarantined" money from a previous money supply reduction can be used, if available.
         2. If sufficient "quarantined" money is not available, the Fed can deposit newly-created money in the account.
         3. Both of these avoid the addition to debt that characterizes present money creation; money creation is a national systemic necessity and should not be held hostage to debt considerations.

F. Money enters the economy through the Treasury (not through the banks)
    1. Main point: to get new money out into the general economy in the fastest morally/economically sound way
    2. Methods
        a. Direct to departments/agencies for spending
        b. Loans
            1. Through banking system OR
            2. Through a special government agency (as done in the 30's)
    3. It may make sense to include the Treasury's transaction account in M1, though this would require a precise way of accounting for the seasonal variations due to such things as tax receipts and SS payments.

G. Treasury establishes a stabilization fund
    1. Analogous to the "reserve" or "rainy-day" accounts maintained by state and local governments to deal with economic fluctuations.
    2. Deposits are made during "good years," amounts to be determined legislatively.
    3. Withdrawals are made during "bad years," amounts (and, possibly, acceptable-purposes) to be determined legislatively

H. Inflation
    1. Potential for inflation in rapid recovery scenario (i.e., 6-10% rather than normal 3-4%)
    2. Response to potential inflationary structural imbalances should be governed by "moral equivalent of war" frame of reference equivalent to that used in World War II:
        a. Price control legislation
        b. Anti-speculative legislation
        c. Business-as-usual not to be tolerated under such conditions
    3. Temporary loans to pay for inventory building (like seasonal agricultural loans)