

## What is Money?

([http://iea-macro-economics.org/what\\_is\\_money.html](http://iea-macro-economics.org/what_is_money.html))

Much of the material on the Institute for Economic Analysis's website, and used in its communications, is based on a concept of money and its role in the economy that is different, though more functional, from the one held by many people. The purpose of this document is to explain this concept and role of money as briefly as possible, noting the changes to present policy that are needed to make use of them in maintaining a healthy economy. The tools which embody the IEA monetary concept and role are described in a longer piece, of which this is the introductory material (see [http://iea-macro-economics.org/understanding\\_economic\\_tools.html](http://iea-macro-economics.org/understanding_economic_tools.html)).

Money is what we buy things and pay bills with. It is our "medium" of exchange. It is never used up, but constantly flows around the economy in a circular flow of people's income and spending. Paper money, coins and checking accounts are all examples of this medium of exchange.

**The confusion between Money and Credit: Blame it on the goldsmiths** -- People own paper money and their checking accounts, just as they own their coins. These should not be viewed as a form of credit -- i.e., that requires repayment, as implicitly asserted by banks and many economists. This widespread misunderstanding of money, and its misrepresentation of how the economy functions, has its roots in the practices of medieval goldsmiths four centuries ago, when gold was used as money. It was heavy and subject to theft, so people would deposit their gold with a goldsmith for safekeeping, receiving in exchange paper deposit receipts, which they began using as paper money.

Since this meant people didn't have to be constantly making gold withdrawals, the goldsmiths needed only a fraction of that gold on hand -- say, 20% -- to back up occasional withdrawals. This made it possible for a goldsmith to make loans, handing out paper "deposit receipts" based on the other 80%. Since the gold still belonged to the original owners, the money represented by these new receipts had been created "out of thin air." Through the following centuries, banks inherited from the goldsmiths this creation of money "out of thin air" in the process of bank lending. The natural incentive of banks was to increase loans in booms, with the inevitable busts that followed.

Now, four centuries later, the gold basis of this system is obsolete. However, because those original paper receipts were redeemable in gold, and thus represented a "debt" of the goldsmith to the holder of the paper, the idea lingers on that currency and checking accounts are "credit" -- something owed to someone -- rather than the simple medium of exchange. Remarkably, the Federal Reserve considers the Federal Reserve notes in our wallets as their credit liability to us, even though the original inscription on those bills, "payable to the bearer on demand," was long ago replaced with "legal tender for all debts public and private" -- i.e., something you own and can spend, rather than something owed to you. Likewise, banks consider checking accounts a debt they owe to the account holders, even though the account holders already **own** the money in those accounts.

**Money as inventory stock rather than credit liability** -- People **own** their transaction money. They keep in their pockets as currency or store it in a checking account at a bank. They use their **inventory stock** of transaction money to service their **flow** of spending on goods and services, just as a storekeeper maintains a certain level of inventory to service the normal flow of sales, or a homemaker keeps a stock of food in a pantry to keep a family fed. Recognition of money as inventory rather than credit -- and thus rejecting, as a measure of money, savings accounts and all other financial instruments that are used for saving rather than spending -- is a **fundamental institutional reform** necessary for understanding the relationship between money and GDP, and for providing the resulting tools for maintaining a healthy economy.

### **The Money-GDP Relationship**

**Money and GDP** -- As noted above, money is the inventory stock of the medium of exchange with which people buy goods and services (GDP). They can't buy these directly with savings accounts or CDs, only with currency and checkable accounts. People and businesses keep in their checkable accounts and wallets what they feel they need to for servicing their purchases. The sum of all these checkable accounts and currency -- about \$900 billion each -- is the nation's money supply (M1), and the net overall sum of those purchases of goods and services is GDP.

**"New money"** -- Because of this relationship, if the economy is to grow, either to keep up with normal population growth or to recover from a recession resulting from an insufficient money supply, the economy requires an infusion of "new money." New money is money that comes from outside the regular circle of spending and income. In our "fractional reserve" economy, thanks to the medieval goldsmiths mentioned earlier, this new money is created "out of thin air" in the process of bank lending. A bank need only keep a certain fraction of its depositors' checkable accounts on reserve, and can lend the rest. In a similar fashion, when the Federal Reserve buys a Treasury security, it does so by creating the money out of thin air in the seller's bank account.

**The problem of interest payments on checking accounts** -- The functional relationship described above between checkable accounts and GDP is vital to understanding how much new money is required for a rapid recovery, or, for that matter, maintaining stable economic growth once recovery is achieved. And for this, it is essential that the sole reason money be kept in checkable accounts be for those GDP transactions. If interest is paid on such accounts, they suddenly have a savings/investment aspect. They no longer represent solely the inventory needed to support GDP spending, and thus render unclear the amount of money the economy needs.

This problem was long recognized by the Fed in the form of a prohibition of interest payments on checking accounts, which kept a clear distinction between transaction money and savings money. The loss of that clear definition of money, which resulted from the Fed's 1980 ending of the interest prohibition, created a confusion that resulted in Chairman Greenspan's 2000 remarkable comment: "...what specifically constitutes money is a notion that has, so far, eluded our analysis." Thus, effective monetary management requires the re-establishment of that prohibition, so that all transaction money -- coins, currency, and checking accounts -- is interest-free, and thus solely dedicated to GDP spending.

**The Money Demand Ratio (MDR)** -- As noted earlier, the nation's money supply (M1) is the sum of all individual transaction inventories. The net sum of all expenditures is GDP. The ratio between these -- the M1/GDP stock/flow ratio -- is, for the economy as a whole, a close analogy of the inventory/sales ratios, referred to earlier, that are used by businesses for managing their inventories to support their flow of sales. This "Money Demand Ratio" (the inverse of the traditional and less appropriate concept of "monetary velocity") is the key to determining how much money needs to be added to or withdrawn from the economy to achieve growth goals and avoid inflation as the economy nears its potential after a rapid recovery. Thus, a further requirement of effective monetary management is the recognition of the purpose of this ratio, and a legal requirement for its use in a "money-growth" formula as the transparent determinant of quantitative money-supply targets and a protective firewall against uncontrolled "printing press" money creation. The Fed must be required to monitor and analyze the behavior of the MDR in "normal" times to establish norms for it, and to do further requisite analysis of its behavior in unsettled times like these to determine appropriate money supply targets. (For a further elaboration on the MDR, see: <http://iea-macro-economics.org/mdr.html> .)