Atlee Rapid Recovery Proposal

A Proposal for 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

Proposal by Dr. John S. Atlee, June 2010

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.

Moral equivalent of war -- Given the failure so far to bring recovery, the **first step in achieving rapid recovery** is the restoration of public confidence by means of a public commitment on the part of the administration and political leaders to view recovery from the present depression in a "moral equivalent of war" perspective, in which business as usual is set aside and different rules apply.

Requirements for a rapid recovery -- The **second step in achieving rapid recovery** is for the administration to publicly recognize the factors that go into such a recovery. By definition, rapid recovery requires a massive increase in GDP spending which, in the absence of sufficient increase in private spending, requires a massive and controlled increase in federal spending -- financed by a rapid and controlled increase in the nation's money supply, as was clearly demonstrated in World War II. The primary source of funding for growth of the money supply comes from new money originating outside the existing circulating flow of income and spending.

Where new money comes from -- Three centuries ago, European goldsmiths gave receipts to customers whose gold they were storing. The customers started using the paper receipts as effective money, backed by gold. Since customers seldom needed to reclaim the actual gold, the goldsmiths needed only enough on hand to meet occasional withdrawals. This allowed them to make loans far in excess of the value of the gold they held, creating new money "out of thin air" on which they collected interest. Three centuries later, our American system of banking -- now called the "fractional reserve system"-- operates the same way. It creates new money out of thin air in the process of bank lending. The process is seeded by the Federal Reserve injecting a relatively small amount of "high-powered" money into the system, which then grows much larger as each bank keeps a fraction for reserves and lends more money based on that.

The fractional reserve system as the source of our current problem -- During a recession, banks have a harder time finding credit-worthy borrowers. They stop lending, and the Fed's new money stops there, never entering the economy and multiplying. This is a good example of the old saying, "you can't push on a string." The banks respond to profit incentives, not the needs of the economy -- it's the federal government that is responsible for the needs of the economy. The solution to this problem lies in getting rid of the "string" by transferring money creation from the

banking system to the federal government, through its fiscal agent, the Federal Reserve, which already creates the seed money for monetary expansion.

How to transfer money creation -- At present, banks -- like the goldsmiths -- are required to keep on reserve at the Federal Reserve a very small fraction of the money in their depositors' checkable accounts. The smaller this fraction, the more money they can create out of thin air. Increasing this required fraction to 100% would end bank creation of money, leaving the Federal Reserve to create all new money, rather than just the seed amount. The process of "thin air" creation doesn't change, merely who does the creating. This **first proposed institutional reform** of a 100% reserve requirement on transaction accounts is the kind of fundamental change promised in 2008, and the kind called for in a "moral equivalent of war" situation.

This is not as extreme as it might at first sound. As bailout money has been pumped into the banking system by the Fed in the last two years, the failure of the banks to lend has caused the banks' reserves at the Fed to explode, rising far above the required level, to where these excess reserves already approximate -- at least for the banking system as a whole -- what would be required in a 100% reserve system. In addition, such a system would eliminate both the requirement that banks keep additional reserves to handle interbank check processing, and the need for FDIC insurance on checking accounts, since they would be 100% secure. While some might decry the loss to banks of lendable funds, in reality checking accounts make up only 11% of banks' lendable funds, a figure that would actually drop in the proposed system. Others might express concern at the prospect of unlimited "printing press money." For that, see below.

The money-GDP connection and interest on checking accounts -- People can't purchase goods and services (GDP) with savings accounts or CDs. Such purchases are made using currency and checkable accounts, or, as these are more aptly called, transaction accounts. The relationship between transaction accounts and GDP (discussed below) is vital to understanding how much new money is required for a rapid recovery, or, for that matter, maintaining stable growth once recovery is achieved. People and businesses keep in their transaction accounts what they feel they need to for servicing their purchases. This clear connection between money and GDP is seriously blurred by allowing the payment of interest on such accounts, which adds an investment incentive to how much is kept in those accounts. This problem was long recognized by a prohibition of interest 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, set the stage for Chairman Greenspan's 2000 comment: "...what specifically constitutes money is a notion that has, so far, eluded our analysis." Thus, a **second institutional reform** is the re-establishment of that prohibition, so that all transaction money -- coins, currency, and checking accounts -- is interest-free.

Money is a medium of exchange, not credit -- It has been quite a while since Federal Reserve notes said "payable to the bearer on demand," implying that the Fed owed the bearer something. They now say "legal tender for all debts, public and private" -- i.e., a piece of physical money to be used for buying goods and services, with no liability implied. And yet, strangely, on its balance sheets the Fed still treats these notes as a liability toward the public, and banks consider checking accounts a liability owed their account holders.

However, currency and coins and checking deposits are not, in practical reality, liability credit items. They are a medium of exchange, and can be used in the same way gold and silver used to be. People own money which they keep in their pockets as currency, or put it in a storage place called a bank checking account, just as you would store furniture. They use this "inventory" of

transaction money to service their flow of spending on goods and services (GDP), just as a storekeeper maintains a certain level of inventory in order to service the 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 all savings/investment accounts and vehicles -- is a **third fundamental institutional reform** in this proposal, and is essential to keeping the economy healthy.

The Money Demand Ratio -- The sum of all these money transaction inventories is M1, the money supply. The net sum of all expenditures is GDP. The ratio between these -- the M/GDP stock/flow ratio -- is, for the economy as a whole, a close analogy of the inventory/sales ratios used by businesses to manage their flow of sales. It 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 **fourth fundamental institutional reform** 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 money-supply targets. As such, it represents the protective firewall against uncontrolled "printing press" money. The Fed must be required to monitor and analyze its behavior 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.

Seigniorage income and account -- Seigniorage income is the income produced for the government by the Fed's creation of money. It should be clearly identified in government accounting as a non-credit item of income -- just like taxes, fees, etc. -- when it is deposited by the Fed in the Treasury's account. One solution to a legitimate concern on the part of the public over the transparency of monetary policy would be to have the Fed set up a separate "seigniorage account" for the sole purpose of handling monetary policy transfers. When GDP growth targets require new money, the Fed deposits that money transparently in the seigniorage account, from which it is then transferred to the Treasury's account. Such an account can also handle situations in which GDP targets call for a *reduction* in the money supply. In such a case, the Fed redirects the required amount from the government income flow into the seigniorage account, where it is accessible only by the Fed, and can be used, when available, as a substitute for newly-created money at times when further money growth is needed.

Getting debt-free money into the economy quickly and efficiently -- A rapid recovery requires that the new money that finances it enter the economy rapidly, for uses that generate maximum GDP effect. In the present system, entry can be completely blocked by the "pushing on a string" effect, and can be sidetracked by banks purchasing government securities or doing speculative gambles instead of lending it. In the case of government money creation, the money goes through the seigniorage account directly to the Treasury, from which Congress can use it for counter-recessionary policies such as unemployment insurance extensions or aid to state and local governments, which guarantees rapid expenditure. And because these expenditures are based on non-borrowed, interest-free seigniorage income, limited only by the express needs of the economy as defined in the above-mentioned formula, they do not increase the national debt.

On the web:

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

(summary prepared by Richard Atlee, in consultation, from proposal details)