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There's Nothing Wrong With The Fed 'Printing Money'

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(Author's note: This is Part II in a series of posts on the printing of money.)

The biggest argument against the Fed's new round of monetary easing, dubbed QE2, accuses the Fed of printing money, a rare draconian measure bound to create high inflation and a weak dollar.

The Fed, of course, does not literally print money. In my previous post, I explained the process of how money gets printed and into circulation. Elsewhere, I have argued that, whatever you call it, what the Fed is doing is different from traditional monetary policy only in its magnitude and pre-announcement of amount and timing.

Open-market purchases by the Fed always create (print if you insist) new money. The main difference now is that a quantity ($600 billion) and a time frame (by June 2011) were announced in advance and the unfortunate QE2 label gives an impression of draconian size. It is large by historical measures, but the circumstances of very high unemployment, slow growth, and low inflation make large appropriate. If the economy improves faster than expected, the full program need not be implemented.

These points I've made before. My main intention here is to try to dispel the notion that "creating money," which is what economists mean when they use the more politically charged term "printing money" is not a drastic measure. There is less to it than people assume.

My conversations lead me to believe that most people equate printing money or creating money (the term I'll use from here on) with creating it out of thin air. They equate creating money with creating wealth—albeit paper wealth or false wealth with no corresponding real wealth production involved. I've been sloppy myself in referring to creating money "out of thin air," but that is simply not the case.

When the Fed buys government securities (long term or short term) or anything else, the ultimate seller gets funds transferred into his deposit account at his bank. In effect, the seller gets a check

that he deposits. Chances are his bank account is defined as part of the nation's money supply, which now grows by the amount of his deposit. Checking accounts would be part of the narrow definition of money, M1; most savings and money market accounts would be part of a broader definition of money, say M2. This is what is meant by new money being created.

Since banks have to hold only about 10 percent reserves against their deposit liabilities, they can create even more money as they bank lend and invest and create new deposits in the process. The initial excess reserves gradually become required reserves as deposit liabilities grow. These secondary rounds of deposit (money) expansion have been largely blocked in the past couple of years by the banks' desire to hold onto an extra cushion of excess reserves. They are excess in a regulatory sense, but not in the minds of nervous bankers being beat about the head and shoulders by a hostile Congress and Administration.

Now, here comes my main point. While the sellers of the securities to the Federal Reserve in the open market got deposits in exchange that we call money, they gave up bonds of equal value in exchange. Their wealth didn't increase—not even paper wealth. It just changed in form from bonds to deposits. Presumably the productive activity—the creation of real physical wealth—took place prior to the purchase of the bonds. I repeat: the increase in money was not an increase in wealth. It was mostly a change in labels, with perhaps a slight increase in the liquidity held by the public.

The former bond owners didn't find the bonds falling from the sky, they paid for them. To repeat, they paid for them with the fruits of their labor—or capital. In other words, the money ultimately created was indirectly associated with productive activity. It was obtained the old fashioned way. It was earned. From the macro viewpoint, money and output both increased.

In making the case that money creation is really an exchange of assets, I've probably weakened the case that it is the all-powerful elixir for the economy. Basically liquidity in the system increased, but the wealth stayed the same.

My example has the Fed buying the government securities from private-sector owners in the open market, which is the normal, accepted practice. Some—such as the creators of this popular cartoon—have criticized the Fed for not buying the securities directly from the Treasury and saving the presumed cost of going through broker dealers to make its purchases.

In such a back room purchase directly from the Treasury, money would be created out of thin air and it would not be an exchange of value for value. In that case, creating money would be much closer, in its effect, to literally printing money. That's why the Fed's open market operations are called open market operations. They are done in the open market—for a reason.