<u>How to fix our financial system—version 2</u>

This one is quite a bit longer than the preceding pieces, but I am tackling a very large problem.

One thing I want to be clear about what follows: I am redefining Capitalism as a system for harnessing innovation for the public good. The motive for innovation is profit, and profit can only be earned, in the long run, through qualitative changes in the structure of production.

Within this framework, "Capitalists", so called, are the innovators, the aggregators of ideas, the entrepreneurs. Consider some Capitalist successes: Microsoft and Apple. Both companies were founded by men with visions and new products. From a Marxist standpoint, they should not have existed, since they didn't start out rich.

Yet, in my view any person who saves their money and invests it is, by definition, a Capitalist. It is through this process that the middle class—the bourgeoisie—came into existence, in direct contradiction to the predictions Marx made in Das Kapital and other works. If allowed to run without "leaks" of the sort I've described in the foregoing pieces, the entire Earth would be much wealthier than it is today.

And to be clear, plainly there are finite limits to growth. We cannot house the current population of the Earth in 10 room mansions. Not everyone can have 10 cars. Logically, then, we must imagine a steady state condition in which economies are balanced. What we must imagine, then, is that "wealth" is progressively converted to leisure, such that our current standards of living can be maintained, but with much less work. This will solve problems of structural unemployment, since as fewer hours are worked, more people can work at the same job. The work done by one person now could be done by 5. This will rapidly eliminate poverty as well.

These are big ideas, ones which are predicated on reimagining our financial system.

Free market capitalism has two key components: free markets, and capitalism. *As things stand today, neither applies fully to our banking system.*

To consider this topic more fully, let's consider the question of what a capitalistic, free market banking system would look like.

To begin with, inflation—which is to say the creation of money from nothing--is inconsistent with capitalism. We need a certain amount of money, but the precise quantity doesn't matter. If a pencil costs $2 and you make $2 an hour, has anything changed if it costs $4 and you make $4 an hour?

Capitalism works best when prices only change with changes in efficiency. This leads necessarily to deflation, which is to say an increase in the purchasing power of money. Deflation, in turn, provides an incentive to save, which is to say to personally capitalize your purchases as an individual and as a businessman. This is quite obviously the opposite of a reliance on borrowing facilitated by money creation, which as an economic system I have labeled "Monetary Mercantilism". This fact—that our purchasing power should be much, much greater than it is--is actually quite sad, because once you grasp it fully, you realize the sheer quantity of waste we have seen over the last 100 or more years. **<u>Core point: True Capitalism is self funding. It is a system for the conversion of innovation into wealth and wealth into leisure.</u>**

To be clear, if at one moment there is no money, then in the next there is, that money does not thereby become "capital". It is what economists call "fiat money". As I have already stated, those who control that process are positioned over time to own everything in our country, since they can get something for nothing, over and over and over. This is the process of inflation, and a just system would abolish it.

I should demolish a common misconception here, too. We hear, over and over and over, how our economy has to grow every year. If we don't grow for some reason, economists fret. What is actually happening is they are fretting over the lack of credit expansion. If people don't borrow, then we might lapse from our current system of Monetary Mercantilism back into genuine Capitalism. The bankers don't want that, and neither do their spokespeople.

The simple reality, though, is that many human societies have existed in relative stasis for thousands of years. At a certain point, enough is enough. If we had actually been able to keep the fruit of our labor—if our money was worth what it should have been worth, if we had not turned the keys to our lives over to Wall Street and Washington—our economy would likely be contracting, and no one would care. We would have plenty of money to live comfortable lives. We work so hard and so feverishly only because most of the product of our labor goes somewhere other than our pockets.

As far as free markets, the Federal Reserve prevents interest rates from reaching their natural levels. They do this by creating money as needed to keep us all awash in a sea of credit. When they create money, they affect the supply/demand equation by increasing the supply.

If the amount of money in circulation were fixed, then the price of that money—the interest rate charged—would go up as demand went up, and down as demand declined. This would automatically prevent the ups and downs of the business cycle, since it would incent rational investing behavior, and not gambling with other people's money.

A truly capitalistic bank would make money in three ways. First, they would warehouse people's money. If you don't want to keep your cash in a safe or your mattress at home, you would pay them a nominal fee to keep it safe for you. Private companies could come into existence to provide insurance for them in the event they were robbed.

Secondly, they could borrow money from individuals for a specified amount of time and rate of interest, and then loan it out at a higher rate of interest. This arrangement today is called a Certificate of Deposit. I am not in any way calling for an end to business or personal loans. I am calling for an end to loans of money that is already spoken for. Loans could still go into default, in which case the bank absorbs the loss, and will still owe the depositor. Again, private companies could be created to whom dues are paid in exchange for insurance against this. Good banks that make good loans would pay nominal rates, and risk-takers would pay higher rates. This will be a free market in banking.

The third option would be charging for clearing checks and debit card transactions. Currently, that is done through the Federal Reserve System. An argument used for this is that it prevents one bank from not accepting the checks of another. With 100% reserve banking, this would not be a problem, since all banks will have to have the money to clear checks drawn on their accounts. You pay a flat rate per transaction, or a monthly fee, or however your bank structures it in a free market.

What free market, capitalistic banking will not include is fractional reserve banking. We have covered it directly. Now let's use an analogy. Think of fractional reserve banking in the following way: a friend asks you to watch his house while he is away. You look at the empty house, and realize you can rent it out for your own profit. He comes back from time to time unexpectedly, so you can only rent it out a certain amount of the time. The luckier you feel, the more time it stays rented. When you do finally get caught, though, he fires you. This is the equivalent of a banking panic. Panics are an inevitable result of lending money you don't have.

All the Federal Reserve System, the FDIC, and the various Congressional bailouts serve to do is gloss over the fundamentally dishonest, illusory nature of our system, which is unsound in its very basis. It is a deck of cards, propped up by inflation/fiat money creation, which is to say the Federal Reserve.

If there is no variation in the quantity of money, there is no need for monetary policy, because monetary policy can only be the solution to business downturns because it is the *cause* of business downturns. It is no exaggeration to say that all the Fed does is inflate and deflate our currency, fund Federal budget deficits, and protect banks from the consequences of stupid risk taking. Particularly since inflation is wealth transfer, it is inconsistent with a just economic system.

Given all this, I have developed a plan for eradicating the risk of large scale financial trouble. This means no more recessions, depressions, and "melt-downs". It does not mean continuous high speed growth, but rather slow and steady growth, coupled with increases in the purchasing power of the average, middle class American. It will further enable the creation of the jobs that will help those living in poverty to raise themselves into comfort.

I am fully aware these are radical proposals, and likely only to be seriously considered *in extremis*. Yet, <u>we have reached a point where the bankruptcy of the United States is something reasonable people can view as possible, and even inevitable, if we continue on our current path. We are also seeing credible talk of another Great Depression.</u>

When things really hit the fan, we need to have thought the thing through. Any radical new idea has to be proposed for the first time, so people can get used to the sound of it. Here are my ideas:

1) Use the Federal Reserve Open Market Operations to buy up every Treasury Note and security in existence. To make sure this gets done (since Congress currently has no direct authority over the Fed) we would first pass legislation bringing it directly under Congressional control. We offer the holders of such securities the choice of either taking the money, or getting that debt cancelled directly through default.

This will eradicate our debt. To be clear, we use the Fed to write some $10 trillion in checks (we owe roughly $13 trillion, but they already hold roughly 20% of our debt), such that the Federal

Reserve holds the entirety of our debt. We further write checks to cover all the debts of all the States and municipalities in the country. This will be highly inflationary, which I will deal with in a later step.

2) Use the Federal Reserve Open Market Operations to fully capitalize all banks and lending institutions, and in exchange for that require them to forgive all loans. To this add a per person deposit of some substantial amount, say $25,000, or the amount that would be due them in whole with Social Security if they had reached retirement age.

First off, all personal debt disappears. All credit cards, all mortgages, all business loans. We start from zero, with sound banking.

Second, we add enough money to fund the liquidity requirements for business development. To avoid immediate inflation, this money will be unavailable until the person in question reaches retirement age. This will replace Social Security, and it will also ensure that the banks have money in their accounts to lend. Those whose money is lent do, however, earn interest on it (Social Security contributors currently earn negative interest, since the costs of administering Social Security come from their deposits).

Third, banks which operate in areas considered poor will be given money for local investment. This money will not be used for home ownership, or charity. It will be used for business loans, preferable of the microloan variety, in which small loans are easily obtained. Cultural training programs should be instituted, such that self discipline, basic financial management, business development, and accounting principles are taught to those wanting these loans. Once they complete this training, they get preferred interest rates. The most important problems in most poor areas are cultural, not financial, and throwing money at them manifestly has not worked.

The objection could be raised that we are giving banks money. This is true, but they create money already through the process of Fractional Reserve Banking, and when they screw up, taxpayers wind up paying for it anyway, one way or another.

This, too, will be somewhat inflationary. I have been unable to find a number for the amount of private indebtedness, but let's place it somewhere around $7 trillion for simplicity. The exact number doesn't matter until the implementation phase. It could be $20 trillion. It only matters when we try to reconcile the money in Step 4. By law, the Fed has the power to create money, and all American citizens have to accept it. No one is losing anything, except that the Lords of Wall Street lose their absolute power over our national finances. Since they get checks too, though, they do alright as well.

3) Require all banks to be henceforth 100% capitalized. They would only be allowed to make loans with actual investor capital, which would mean certificates of deposit held by individuals and investing institutions. All of the money held by individuals not of retirement age would be issued as a CD, with a maturation date of, say, 60 years old.

Such banks would ever-after only be able to make money through investing real money, through charging "warehousing" fees for the safe storage of money, and through transaction processing. No more pyramiding of money. All credit card issues would have to be backed by corresponding Certificates of Deposit, and have maturities. No more revolving lines of credit. The sheer volume of cash injected into the system would help reduce the economic impact of this, particularly since those already in debt would get a new start. This would be somewhat unfair to those few who were not in debt, but the task here is a global fix that will last. Such people would not be hurt; they simply wouldn't benefit. The resulting improvements in the economy, though, would more than make up for it.

4) Implement a stable currency based on gold. This needs to be done in steps.

First, Congress passes legislation to empower each of the fifty States to print their own currency, and establish gold depositories. The law will be a Federal law, but the implementation needs to be by the sundry States. These depositories are built, or converted from existing vaults.

Second, we create new currencies, which "translate" the inflation back to pricing we are used to. This is by far the hardest step, and some imprecision is inevitable. There is an easy way to look at this, and a hard one. The easy way, which I prefer, is to simply figure out how much money was in existence, determine the total of the checks written, and use that as a multiplier. If $13 trillion was in existence, and we wrote checks for $26 trillion, then the money supply has increased by 200%. It will now take $3 to buy what previous took $1.

Given this, we ask for $3 in the old money, and offer out $1 of the new. This will roughly normalize prices, and minimize economic disruption. All holders of U.S. Securities who were paid off do the same exchange.

This can be done through any bank. Obviously account balances are simply altered on a specified day, and money is distributed to banks to pay out. Excess currency can be printed to make sure there is enough, with the proviso that any leftovers will be returned promptly, then destroyed.

A few words of explanation are needed before I offer up the alternative.

There are two types of inflation: monetary inflation and price inflation. Monetary inflation is any increase in the amount of money that could be spent. The reality is that much of the money out there is not in circulation. Even if that money is sitting in a vault somewhere gathering dust, it has still been created, and could still be used to cause price inflation.

Price inflation is the actual increase in the costs of things like housing, food, and transportation. Following any injection of cash into the system, it takes some time for the prices to stop rising.

To expand on this point, which is a bit abstract, let us suppose that only 80% of the dollars in existence are actually in circulation. This means that the buying power of the dollars that *are* in circulation is artificially high. Our dollars are buying more than they would if the money left its hiding place. For the purpose of this translation, though, I'm assuming that money *was* in circulation.

To the point here, if we did this over the period of say one week or one month, the effects of the monetary inflation may not have worked through the system by the time we switch currencies.

Were we to wait, it would be very destabilizing. Frankly, it will be chaotic, no matter how we do it, but we're trying to save our democracy and way of life. Responsible adults understand that sometimes short term pain and confusion are the price of long term peace of mind and comfort.

Given this, the ratio may be somewhat deflationary in the near term, particularly if much of this money is held overseas, as it is today. Since the money to buy up our debt went out into the economy, prices will continue rising even after the transition, but in the near term $1 of the new money may not buy what $3 of the old money did.

The hard way, then, is to try to reconcile actual before and after purchasing power in our ratio—for example, maybe we make it 2.5: 1, or 2:1, or 10:1. I don't like this option, although self evidently economists should be employed to remove the bumps as much as possible. This appears to me to be a Gordian Knot best cut quickly with a sharp knife. Some slop is inevitable, so my thought is to just get to it, and sort out the wreckage as we go. If private citizens, the banks, and businesses are suddenly all out of debt, they can deal with some short term price disruptions.

To be clear, too, what this process will involve, done right, is not inflation, but debt transfer. <u>We move ownership of most real property back to We the People and away from Wall Street, Washington, and foreign governments</u>. They did nothing to earn it. Wall Street used its access to free money, and Washingon used its right to tax and borrow on our behalf. Most of our foreign debt holders run autocratic states with few human rights, and much tyranny.

If the ratio is wrong, prices and wages will go down or up quickly, and previous purchasing power will be restored in reasonably short order. It is, it should be noted, critical that the government not interfere with this process of price reconciliation.

This will be followed by permanent increases in our buying power, and corresponding standard of living, since the steady leak of our money into the pockets of the Monetary Mercantilists will have ceased**.**

In this system. Texas will have their own notes, as will Massachusetts. All the States will. All of them will equal one another. My thought process here is to begin returning the balance of power to the States, who were properly the focal political institutions in the intent of most of our Founders (for good reason, as I will argue in a later piece.) Practically, this may be more symbolic than real in its effect, but symbolism still counts for a lot. Not to be glib about such an important issue, but I think this would be fun, too. It would offer a lot of room for creative competition in the designs of the various currencies.

The "control" of the currencies is a moot point, since there will be no more monetary manipulation, but in theory this will still be in the end under the control of the Federal Government.

Third, transfer the gold currently held in reserve in Fort Knox and the Federal Reserve Bank of New York to the States, in proportion to the money they issued. Foreign owners of dollars can "redeem" them in any State they want. Since the goal is to tie the currencies to the gold, logically the gold goes to those who issued the currency, such that the currency/gold ratio of all States is equal.

Historically, nations on the gold standard either saw the value of their currency fluctuate with the value of gold (the currency was defined as how much gold it would buy on the open market), or artificially pegged their money to some amount of gold, such that a dollar by definition equals X amount of gold, say 1/10th of an ounce. I don't find either of these acceptable.

Returning to the analogy of the teacup and the dollar bill, please recall that inflation is equivalent to a decrease in the value of a dollar. Deflation equals an increase in the value of the dollar, achieved by reducing the number of dollars in circulation. In both cases, the value of real goods fluctuates for reasons extraneous to the actual value of the product. To put it bluntly, it can and has been manipulated by those able to do so.

There is absolutely no benefit to anyone in this, except the banks, who as we have seen benefit almost exclusively from this process, even though most of us have not historically seen this. Obviously, the Federal government benefits, too, as it uses fiat money to fund war, social spending, and whatever else is the issue de jour.

As I see it, the task is to fix the value of the dollar, once, and never change it again. You will see people claiming that if the amount of money is fixed, and people "hoard" it—put it in a mattress or vault somewhere—that there won't be enough. This is silly. What will happen is the value of the dollars in circulation will go up. When they reach a certain value, the money will come out of the mattresses, quite naturally. This is a good thing, and the only reason we don't realize this is we have never experienced it. It hasn't happened since the 19th Century, in the way it ought to.

Fifth, given the foregoing considerations, we fix the value of the money relative to the gold once, and never change it again. We have some 8,000 tons of gold in reserve. Let us say there are $13 trillion of the new dollars that are issued. This works out to some $50,000 per ounce. This is, of course, ridiculously higher than the price of gold currently, which I need to explain.

This concept is a hybrid between a true gold standard and fiat money. It is a gold standard, since gold backs the currency. It is "fiat" money, since the value of the money is fixed outside the marketplace, which would not come even close to valuing gold that high. In effect, I am inflating the value of this particular, "special" gold so the math works.

A logical question arises: if the "value" of the gold, or the money, is defined artificially, why use gold at all? I wrestled with this, and here is my answer: because the goal is to prevent any more money from being issued. That is it. This is best done if it is necessary to add gold to add money. Otherwise, it is too easy just to pass a bill to print your way out of trouble. Moreover, the knowledge that gold stands behind the money will strengthen our currency yet further. We were for many years on a fractional gold standard, which meant that a multiple of dollars were issued against the gold in reserve. Say the gold was valued at $50/ounce. At a multiple of ten, this meant $500 could be issued against it. If it eases the cognitive dissonance, think of it that way. The point is that the need to have gold to issue money decreases the issuance of money, and that *we already have this gold.*

On one point I want to be clear: in wars, and other sorts of troubles, we have historically relied on the Federal Reserve (or its predecessors) to print money. This seems clean, but it is a tax, plain and simple, that take the fruit of our labor and reassigns it to the Federal Government and their contractors, and to those who collect the interest. One obvious example is World War 1. We printed our way through that, with the result that the purchasing power of the dollar was cut in half. If you had $2,000 in savings in 1915, it was worth, effectively, $1,000 in 1920. Where did that value go? To the war. It was a tax.

In future such situations, if they occur, we simply need to tax our way through it. This makes it plain to everyone what the cost of the war is. <u>This will mean that the American people will need to be solidly behind the effort, or it won't happen.</u> This is more democratic than playing games with money only a few people understand. Obviously, the ability to play such games is one of the features that has made the Fed so attractive to the Federal Government all these years. It is not overstating the case to say that without central banks, here and abroad, neither of the World Wars could have happened. They could not have been funded.

5) Abolish the Federal Reserve System, root and branch, and abolish with it all our national debt. We should encourage everyone else to do likewise. The countries of Europe could use this method to solve their problems.

I will reiterate that I fully grasp how radical these ideas are. At the same time, *national bankruptcy, another Depression, and submergence in a dark age of Socialism are also quite radical*. There was a horrendous amount of suffering in the Great Depression. There is horrific suffering around the world, today, as a result of despotic economic policies. My intent here is to restore decency, fairness, and social justice to our economic system. Actually, "restore" is perhaps not the right word: our system has never been fully just, even in the periods when we didn't have a central bank, since it has always relied on fractional reserve banking.

Self evidently, "respectable" economists will howl in violent disagreement with substantially everything I say here. I will make two points in that regard.

First, many economists are more interested in the implementation of political views through economics than the use of the political system to generate wealth.

Second, many of them are bought and paid for by the money trust. Can anyone seriously think that institutions controlling many trillions of dollars in assets would be unable to find congenial spokespeople? It need not be a matter of corrupting people, so much as funding those who already agree with you, and keeping money away from those who don't. This process is quite basic, and regrettably common in many fields.

When the Federal Reserve was being sold, it a matter of historical fact that leading economists were recruited to write favorable reviews about it. Why would that basic process not have continued?

Please think for yourself. In the end, no one else can think for you, or take responsibility for your life. This is a truly, genuinely brave new world (in the positive sense) being proposed. Please consider it carefully.

And if you can do better, write it up and share it with the world.

You can post comments on my other blog www.moderatesunited.blogspot.com

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