

The broad money supply is ALWAYS endogenous

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Monetary Realism starts with a simple understanding – money matters within the monetary and the dominant form of money in today’s monetary system is bank deposits. Bank deposits are created when banks make loans. And banks make loans when creditworthy customers have demand for loans. So the USA has a money supply that is “endogenous” and elastic. That is, the money supply is determined by the amount of new lending that is done and it’s elastic in that it can expand and contract (repayment of loans destroys deposits).

The central bank exists primarily to ensure that the payments system in the monetary system is stable. Because we have private for profit banking there’s an inherent instability in the banking system. That is, there are times during the business cycle when banks might ease lending standards and issue more loans than their customers can actually pay back. This can be potentially destabilizing and there are few things worse for the economy than a payments system (which is run by the banks) being unworkable. So the Fed tries to ensure an orderly payments system before all else.

The reason I bring all this up is because I noticed Scott Sumner making a relatively basic banking error in a recent post and I think it’s important to get this stuff right if we’re going to actually understand the monetary system and how various policies might impact the monetary system. He said:

“Individual banks are not constrained in making loans in the short run, as they can always borrow needed reserves in the fed funds market. If they do so that will put upward pressure on interest rates, and the Fed will supply the needed reserves to maintain their fed funds target.

In the long run banks are constrained, as the Fed will adjust the monetary base to prevent economic overheating. The endogenous money folks, who are right about the period between Fed meetings, overlook this longer run problem with their theory. Six weeks is not a long enough period to have major macroeconomic consequences. But in the very short run the banks are not constrained by a lack of reserves, if the Fed is targeting the short term interest rate. The base is endogenous during that period.”

The first paragraph is correct. The money multiplier is a myth. The Fed will always supply reserves to the banking system if the banking system as a whole cannot meet its reserve requirements. But the second paragraph gets things wrong. I won’t quibble over the fact that the “long-run” is just a series of “short-runs”, but I do have an issue with the rest. Adjusting the monetary base will not necessarily have any impact on the amount of loans the banking system can make.

Let’s say the Fed started to reduce QE tomorrow. This would not mean banks can make fewer loans. Banks make loans and find reserves later if they must. But the banking system is awash in excess reserves so finding reserves to cover their requirements is not necessary in today’s environment. The Fed could reduce the monetary base by several trillion dollars before it runs into a level where it would then NECESSARILY supply reserves to the banks if they needed to meet reserve requirements. But even at this point there would be no “Fed choice” in the matter. If it wants to maintain an orderly payments system the Fed MUST supply the reserves necessary for banks to settle payments and meet reserve requirements. But that concept is largely inapplicable to a system that has a \$3T+

monetary base and excess reserves through the nose.

Now, all of this might influence the spread at which banks make loans (in some cases of QE it might even impact bank capital which could impact lending), but that's secondary and doesn't make the broad money supply any less endogenous. It just means the Fed can very indirectly impact the lending capabilities of the broader banking system. But the monetary

base does not directly determine the amount of lending the banks can do.

Lastly, it's important to note that the thrust of Sumner's post is basically correct. That is, the Fed's exit strategy is rather simple from here. If it needs to raise interest rates while maintaining its current balance sheet it will simply raise the interest rate on excess reserves, which is today serving as a de-facto Fed Funds Rate.