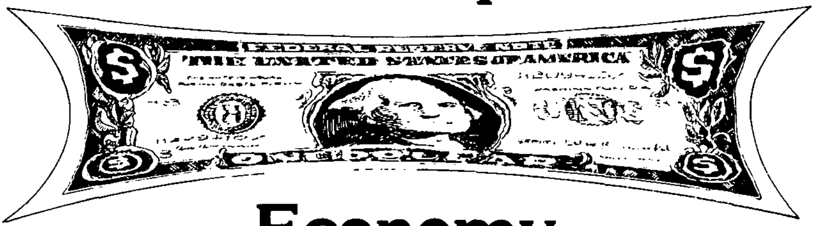
Clarence B. Carson

A Credit Expansion Economy



WE have a penchant for naming things around my house. For example, at one time we owned two Chevrolet Impalas. The more ancient of the two we dubbed The Old Impala, and the one of more recent vintage The New Impala, though the latter was only "new" by comparison. These names evolved as a shorthand for distinguishing between the cars. Of course, we name any pets who take up with us, though lately we appear to be running out of names. At present, we have an all white tomcat, whose name is Kitty, and a terrier of some sort whose name is Mutt. The way things are going, it would not surprise me that if we had a male child he would be named Boy.

While we may be unusually deficient in devising imaginative titles, my family is not much different from other people in its penchant for naming things. It is a trait common to the human race, and one which aids discourse greatly. By naming things we distinguish them from others, provide a convenient individual reference for them, and either recognize or accord individuality to them. The more precisely we identify them with names the more accurate is our discussion about them, assuming that accuracy is our aim. This last is especially the case when it comes to such things as patterns of action, trends, developments, and other so-

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cial phenomena. These tend to be somewhat amorphous quite often, and naming is a part of the process of getting a handle on them.

Now to the subject at hand. Ours is a credit expansion economy. Indeed, credit expansion may be the feature which distinguishes it best from others and is in many ways the most crucial aspect of our economy. A credit expansion economy is one that is geared to and more or less dependent upon continual (if not continuous) credit expansion. That is not to deny the applicability of such terms as interventionist economy, welfare state, a managed economy, and the like, to describe our present hodgepodge economic system.

The Moving Force

But I am not looking for a new term or phrase to describe the whole vehicle, so to speak. Rather, I am trying to get a handle on the mainsail, the oars, the propeller, the motor, or the motive power that is peculiar to our economy. Not, mind you, what moves people to produce or trade—these are market phenomena, not peculiar to any contemporary economy—nor what moves government to intervene, but rather the key or central mechanism of the intervention. I believe that an apt name for it is credit expansion, and that the use of the name may help to bring some things into focus more clearly than we can without it.

It may be objected that what I am here calling credit expansion has already been clearly identified and has a name. It is none other than inflation, and an economy geared to it could be called an inflationary economy. That might be so, *if* certain things were accepted. If it were commonly accepted and generally agreed that inflation means increasing the money supply (including credit expansion) the terms might be made to serve the descriptive purpose I have in mind. However, that is by no means the case.

When President Reagan declares that his administration has brought inflation under control, he is clearly referring to price increases, not to monetary or credit expansion. Newscasters and almost all public commentators use the word in that meaning, as do most people in conversation. Even those who are aware that monetary increases are the cause of the general price rises are inclined to think of them as the cause of price increases rather than inflation. Trying to use the word in its original signification is somewhat like spitting into a contrary gale force wind. It doesn't get very far.

But even if the term inflation had not been so widely appropriated for referring to price increases, I think it would be useful to refer to our economy as a credit expansion economy. However it is employed, inflation is a generic term, and historians, at least, need terms to refer to particular cases. It is highly useful, for example, to name each particular war, for instance World War I, although generically it was clearly a war. All credit expansions are probably inflationary (whatever the word is taken to mean), but not all inflations have been achieved by credit expansions.

In any case, we need a name for the central operative feature by which government attempts to exert control over and spur our economy. My nominee is credit expansion. There can be no reasonable doubt that we have had, and have, an ongoing credit expansion in the United States. The impact of the credit expansion, and its ongoing character, can be seen most clearly in the rise of the national debt since the early 1930s. At the end of the fiscal year 1930 the national debt was slightly under $16.2 billion. By 1940 it had risen to nearly $43 billion; by 1950 to over $256 billion; by 1960 to over $284 billion; by 1965 to just under $314 billion; by 1970 to over $370 billion; by 1975 to over $533 billion; and by 1979 to over $826.5 billion. Between 1979–1984, the national debt has approximately doubled, and in recent action Congress raised the debt ceiling just above $1.8 trillion. If this continually mounting debt were plotted on a graph, it would provide about as clear a picture as we could get of what is perhaps the most important dimension of the ongoing credit expansion.

Obviously, if there is debt, there must be credit which has been extended in equal amount from some source or sources. And if the debt has continually mounted over a period of more than fifty years, there must have been a credit *expansion* which made it possible. In fact, that has been the case. The means did not exist in 1930 from all available sources to provide $1.7 trillion, say, in credit to the United States. Nor have the liquid resources been adequate to provide the credit increase from $16 billion to $1.7 trillion. The major portion of the increase has come from *credit* expansion. To put it another way, the major portion of the debt increase did not result from borrowing from savings; it arose instead from the expansion of credit, *per se.*

Monetizing Debt

The credit expansion, *per se*, takes place by monetizing debt. Monetizing debt can be visualized concretely in this way. A borrower executes a note for a certain amount of money which he proffers to a creditor. The creditor runs off the amount of paper money desired on a printing press and gives it to his debtor. Thus, a debt would have been monetized. Credit would have been expanded by increasing the supply of currency. The trouble with this simple illustration is that it is misleading. It equates the increase of the supply of currency with credit expansion. Whereas, in our system, the increasing of the supply of currency, i.e., Federal Reserve notes, is an adjunct only to credit expansion, not the thing itself. The total of currency in circulation is to the total credit as cash flow is to the total assets of a corporation, say. Indeed, credit expansion is much more nearly an increase above the amount of currency in circulation than it is any increase in the currency. The increase in currency is always only a small portion of the total of the credit expansion. In our system, it is usually that amount reckoned to be sufficient for cash holdings and transactions.

What I am here calling credit expansion usually occurs upon a basis of a fraction of reserves of savings against the total of the amount of credit. Credit can be expanded either by increasing the reserves of savings or reducing the fractional amount required against credit extended. From one point of view, then, the credit expansion (that portion of credit extension beyond the actual savings) is created out of thin air. In effect, however, the credit expansion is achieved by debasing the currency. In practice, as the credit is expanded, each unit of our savings is reduced in the amount it will buy to give the created credit its buying power. Hence, credit expansion is the other side of the coin, so to speak, of the debasement of our currency and its declining purchasing power.

The expansion of credit is done by banks in the United States. Indeed, banks, or bank-like institutions, have exclusive franchises to expand credit by fractional reserve procedures. Although commercial banks, i.e., banks of deposit, are central to this undertaking, an assortment of other banks, public and private, play some role in it. The lynchpin of the credit expansion system is the Federal Reserve system, whose active arms are the regional Federal Reserve banks. These banks can expand credit in a variety of ways: by rediscounting the notes held by member banks, thus increasing their reserves; by raising or lowering the reserve requirements of member banks; and by buying government securities. Federal Reserve notes are our paper money now, and they can undergird credit expansion by increasing the currency supply.

A Spending Spree

This credit expansion system provides the life blood of the American economy today. It has made credit expansion the key ingredient to such prosperity as we can expect to have. Credit expansion not only fuels an increasing proportion of government spending but also much of private spending as well. While the national debt best exemplifies the vast credit expansion that has taken place, credit expansion is entailed in public and private debts, as well as foreign loans and support by the United States of international lending institutions. (Private debts differ significantly from public, in that private indebtedness fluctuates, and individuals and organizations actually retire portions or all of their debts from time to time. Thus, private debts are not dependent on an ongoing increasing credit expansion to the same extent as the government debt is.) Credit expansion provides the means for the purchase of a large portion of durable goods in the country, fosters the concentration of wealth to provide the capital for industrial expansion, and spurs demand through government redistribution programs.

But to see most fully that the American economy has become a credit expansion economy, it is necessary both to consider the role of money in the economy and the impact of credit expansion on the money. Money plays, or has played, three fairly distinct roles in society. It is, first and foremost, the medium of exchange. That is, it is ordinarily that through which exchanges of goods for goods are effected. Second, money is that in which the prices of goods are expressed. (This has sometimes been described as the "standard of value," but since this is somewhat more controversial as a formulation, I will say only comparative valuations get expressed in the market as prices.) Third, money has historically been used for saving, or, in the conventional phrase, for the storage of wealth.

A Money Economy

Ours is basically a money economy. That is, our economy is based on exchanges of goods for goods and services (or goods) for services. As individuals and families we ordinarily produce only a few, if any, of the numerous goods that we use. Instead, we usually specialize in producing some good for the market and in turn buy in the market the goods that we want. The medium through which we effect the exchanges is money. Hence, ours is predominantly a money economy.

Today, however, to say that we have a money economy translates correctly as a credit expansion economy. Our currency today is not money in any but a residual sense of the word. It is the paper residue of a long term credit expansion which has turned our money into credit. Thus, when we make exchanges, we exchange our goods for credit and exchange credit for goods. I am not referring simply to the widespread use of credit cards and checks in transactions. They are excellent symbols of what has happened, but if every transaction was made in cash the above statement would still hold. Our currency is no longer backed by anything; it consists of bills of credit, to use a phrase from earlier times. This may be made clearer by describing how the transformation took place.

Early Days of the New Deal

The first major steps toward demonetizing United States currency occurred in the early days and months of the New Deal (1933). Prior to that time, the main currency had been redeemable in gold. The government called in all gold and all currency redeemable in gold. These were paid for with Federal Reserve notes, which thereafter became the general currency in this country. These notes were forced into circulation by making them legal tender, invalidating all contracts calling for payment in gold, and prohibiting ownership or transactions in gold except for those especially licensed to do so. Even so, the currency was not completely demonetized in 1933 and the immediately ensuing years. The Federal Reserve banks were still required by law to hold gold reserves in some sort of relationship to their issues of notes. Moreover, the government put itself in position to defend the dollar abroad in gold, when it became necessary to do so. Actually, it was not necessary for quite a while. The government raised the price it would pay for gold from $20 to $35 per ounce (devaluing the dollar technically), and in the ensuing years much of the gold in the world was drawn into the United States.

The dollar had been only partially demonetized. In a roundabout way it was still being partially backed by gold. It had some silver backing as well. The subsidiary coins, several of them, had significant silver content. Also, the government issued $1 silver certificates which could be redeemed in silver. No doubt about it, the currency had been debased, and the situation would worsen in the ensuing decades, but it was still in some degree monetarily backed. Moreover, control over the money had shifted from the people to the government.

However, with the ongoing credit expansion and the supporting increase of the currency, the monetary base of the currency could not be maintained. In the late 1960s and early 1970s, the government ceased to support the dollar at any fixed ratio of precious metals, both at home and abroad. The subsidiary silver coinage was replaced with a base metal alloy—cupra-nickel. The government called in the silver certificates by fixing a date after which it would not redeem them in silver. This was followed by refusal to defend the dollar abroad at any fixed ratio to gold. Not even the residue of backing in gold or silver remained after 1971.

The United States had fullfledged fiat money, i.e., money by government decree, money because government by its tender laws proclaimed Federal Reserve notes to be money. While the phrase does aptly describe the relation of government power to the currency, it is doubtful that this paper currency should be dignified by the name of money. The only base on which it is issued is credit. It is basically credit extended to the government in return for debt instruments, i.e., government securities. Thus, the older phrase, bills of credit, much more precisely describes Federal Reserve notes.

These notes do serve some money-like functions; they are in that sense *as-if money, if you will*. They can be used as if they were money. Thus, Federal Reserve notes serve in a fashion as a medium of exchange. We exchange goods for them, and take them in exchange for our goods, or at least to the casual observer, that is what we appear to be doing. That is more appearance than reality, however. What we actually do is give *credit* for payment to those who give us the notes in return for some good, or receive *credit* for payment from those who have sold us some good. This character of the *transaction* is borne out by the language on Federal Reserve notes: to wit, "This note is legal tender for all *debts*, public and private." Granted, one of the functions of money is to extinguish debt; it is an after-the-fact function of a medium of exchange. Indeed, it attributes much more to a medium of exchange than the market ever would. It is a legal concept, not a market concept. In the market, the creditor and debtor may fix by agreement what amount of goods will satisfy the debt. Any legal good or service may be specified. By contrast, Federal Reserve notes are legal tender for *all* debts. Be all that as it may, Federal Reserve notes do serve as a medium of exchange for extinguishing debt.

Federal Reserve Notes

In this sense, Federal Reserve notes are a simulacrum of a medium of exchange, bearing a faint or residual resemblance to a medium. They offer credit only in exchange for goods, not a quid pro quo. That in itself might not matter, but they are not promises to pay in any specific amounts of any good. Hence, the person who accepts them does so in the hope only that he can trade them for some good that will provide him his quid. Of course, if he is going to extinguish a debt with the Federal Reserve notes he receives, which is more than likely in a credit economy such as ours, he does get a known quantity. Otherwise, he has accepted a raffle ticket, so to speak, in exchange for his goods. It will bring only what it will bring, if anything, when it is offered in the market for goods. If it be objected that such is the case, too, with goods, the answer is, yes, but they are goods already and do not need to be exchanged for something to have that status; whereas, paper currency—Federal Reserve notes—is not a good. It is only credit.

But if our bills of credit are unsatisfactory in their prime function as a medium of exchange, they are even less so in performing the other functions of money. The second function of money, as I said, is to serve as that in terms of which prices are expressed, or relative valuations of goods are made. Our Federal Reserve notes do that job very poorly and often produce confusion rather than clear signals in the economy. Prices of goods fluctuate in any case. Normally, however, the fluctuations of prices indicate changes in supply or demand or both (at different rates) of particular goods.

Thus, a rise in price of a good may signal to producers the desirability of increasing their production. On the other hand, a drop in price may signal declining demand for a particular good. When the currency consists of bills of credit in an ongoing credit expansion, rises in prices may signal nothing more than another expansion of credit. Relative valuations may be more than a little confused as well. While prices may be rising in general, they do not do so in lockstep fashion but rather within the exigencies of particular businesses as the effects of the expansion are felt there. Prices tend to become ephemeral, continually changing, usually upward, with no readily discernible distinctions among the things impelling them on their course.

A Store of Wealth?

In regard to the third function of money—as a storage of wealth—bills of credit tend to be much more nearly anti-money devices than they do money. In an ongoing credit expansion such as ours, the currency is almost continually depreciating. As the credit expands, any given unit of the currency tends to buy less and less. In consequence, storing it is somewhat like storing a perishable commodity. It must be used immediately after it is obtained, or it will become progressively worth less and less. A dollar earned in 1970, say, and simply saved without interest, would have shrunk in purchasing power to about 30 cents by 1984. And that does not take into account any appreciation that might have taken place in a stable currency as the result of efficiencies in production.

In sum, then, it is highly doubtful that our Federal Reserve notes qualify as money. To call them fiat money is almost equally doubtful, for the phrase suggests that government can create money by fiat, when in fact it has only created bills of credit. These bills of credit are to money as cupra-nickel is to silver. To call them money only serves to hide from us the full function of a commodity money. It obscures, too, the working of the process by which our currency becomes worth less and less as it sinks to its true level, which is worthless. Worst of all, by calling Federal Reserve notes money, we hide from ourselves the fact that we do not have any money. We have credit instead, and that credit rests on the one hand on our desiccated savings in dollars and on the other on our mounting national debt. We have a potential avalanche of paper which is ever increasing as credit is expanded and debt increases.

This precarious condition has been arrived at by taking away from the American people control over their own economic affairs. Government has usurped that control over their affairs which people had when they had a currency based on precious metals. It has taken their money from the people and given them in its place bills of credit. The currency has been thoroughly institutionalized by making virtually all banking and credit institutions the instruments both for putting the currency into circulation and for credit expansion. Since much of this has come about gradually and has been going on for the better part of a lifetime, it is difficult for most of us to conceive how things could be different from what they are, or begin to grasp the full advantages of having actual money in our possession. We have been thoroughly acclimated to play money, as it were, or, as children would say, "play like" money.

Precious Metals Lend Stability

Money backed by precious metals can be saved, and, even if it is not loaned out for interest, the amount it may buy may increase with productivity. Since the amount of it does not increase at will, prices which are measured in it tend to remain fairly stable except for shifts in supply and demand. Thus, changes in prices tend to be good market signals. Wages may increase in the amount of goods they will buy even though the monetary amount of them may remain the same. Raises in wages or increases in income indicate real increases rather than futile attempts to catch up with the depreciation of the currency. Transactions can be completed on a quid pro quo basis, although one party pays in money, for when the currency is either precious metals or redeemable in them, goods have been traded for goods, even though the money may be used later to purchase other goods.

Moreover, unless some fractional reserve system is used to increase the currency, there need be no business cycles occasioned by expansions and contractions of the currency. And, government indebtedness can be checked by the necessity of appealing to those private persons or groups willing to make loans. The debt could not grow and grow, for none could be found to make the loans to sustain it. Both public and private would have to live ultimately on current income plus savings, not upon credit expansion.

As matters stand, however, government power has been vastly augmented by its arbitrary control over the currency. It can increase the currency at will, and thus ultimately destroy what we have by way of a medium of exchange. It can expand credit more or less at will, and with that power often exercise decisive control over the economy. Attempts of government to manage the economy are centered in this power to expand or contract credit and to increase the currency. It can often spur economic growth by expanding credit, or slow it down by contracting credit. More precisely, it can take actions aimed at doing these things and create havoc within the economy.

How Monetary Manipulations Affect Individuals

Economy is an abstraction, of course, and the actual impact of these manipulations falls upon people. Individuals, families, and groups are caught in the matrix of these manipulations. Their freedom and independence is curtailed and circumscribed by the credit activities of government. Since their currency continually deteriorates, they turn to all sorts of expedients to minimize the impact and to somehow guard what they have gained from dissipating. They buy common stocks, invest in land, purchase jewelry and precious stones, seek the highest interest rates they can find on their savings—ever questing for something that will appreciate to offset the currency depreciation.

The credit expansions and contractions produce wave-like alterations in industrial activity, temporary expansions alternating with contractions with their shutdowns and bankruptcies. Farmers shift from crop to crop in desperate efforts to read correctly the confused signals of distorted markets. But of course there are hundreds of interventions in the market, in addition to credit and currency expansion. All these interventions confine economic activity and channel activities within the framework of what freedom remains.

The master intervention, however, the intervention by which government has planted its power at the heart of all productive and exchange activity, is control over the supply of credit, upon which we must depend for facilitating exchanges in the absence of commodity money. Thus, we have essentially a credit expansion economy.

There are a host of infelicities, inequities, and dangers in a credit expansion economy. Many of them have been detailed by writers who have explored them, usually in connection with inflation. But I will conclude this discussion with some remarks about what I suppose is the greatest economic danger. I have suggested already that this vast credit expansion can be thought of as a mountain of paper precariously perched so that it can become an avalanche. Our system of credit expansion built upon fractional reserves and a fraction of currency to the total of the debt is highly vulnerable to a liquidity crisis. To put it bluntly, if a large number of people demanded cash for their claims at the same time, the mountain of credit would come tumbling down.

FDIC Offers No Safeguard Against Liquidity Crisis

The United States government has erected safeguards against such a liquidity crisis, the most notable of which is the Federal Deposit Insurance Corporation. The great difficulty with this, however, is that in this case the very safeguard could become an instrument of destruction. If large numbers of people demanded cash from credit institutions, the most immediate result would be a great credit contraction as the reserves against credit were withdrawn. If the FDIC intervened, as it almost certainly would, both to make good on its insurance promises and in a desperate effort to forestall some sort of crash and depression, it would quickly exhaust its own reserves. If the government came to the rescue by printing large quantities of paper money, it could well set off hyper—or runaway—inflation. In short, our intricate and vast credit expansion has us poised between a debilitating credit contraction and runaway inflation. The great expansion of branch banking in many states in recent years, the portending interstate banking, and huge loans, both foreign and domestic, increase the likelihood of the kind of bank failures which could trigger a liquidity crisis.

The above is not a prediction; it is only a scenario of what may be the most probable course to a collapse. How and when the collapse will come, or what particular consequences will follow, we cannot know in advance. That it will collapse is approximately as certain as that a balloon will eventually burst if more and more air is blown into it. If, instead of an indirect credit expansion, we had inflated more directly by issuing huge quantities of unbacked paper currency, a runaway inflation would long since have wiped it all out. By resorting to an intricate, complex, and sophisticated credit expansion, supported by a fractional increase of the actual currency, the whole process has been strung out almost indefinitely. But indefinitely does not mean forever; it only means that we do not know when the string will run out.

Whatever the future holds, it is high time we face squarely what has been going on with as precise language as can be had. It needs to be very clear that the villain of the piece is not rising prices. We need to understand, too, that there is more involved than increases of the currency; that is a necessary adjunct to it but not the whole thing. The villain of the piece is an ongoing credit expansion which has produced a credit expansion economy. When we think of it that way we can see more clearly that we have substituted credit for money, and built a Frankenstein credit economy which holds us in its grip. Once we see that clearly, we may be able to see that the way to loosen that grip and regain control of our own financial affairs is to restore commodity money, reduce our debts, and bring credit under control.

One of the lesser credit organizations sponsored by the United States government is entitled the Production Credit Association. I think the United States government has become a Credit Production Association. We need to get the government out of the business of credit production, allow the economy to be devoted to its appointed task of producing goods in terms of supply and demand, not pushed this way and that by credit expansion, and allow prices to signal the market conditions. To call what is going on credit expansion helps me to see that more clearly.

Robert Awenius

The Forgotten Man

IN the last ten years of the 19th century and the first ten years of the present the American republic was thrust into a great drama of American Destiny carried to the far reaches of the world. America breached the trade barriers of Japan and China, and after winning the Spanish-American War, wrenched Cuba and the Philippines from Spain. The Philippines became an American colony and the idea of American Destiny moved strongly across the Pacific Ocean. We witnessed American imperialism; we were told it was our duty to carry the American concept to the world.

We strongly backed freedom for the Philippines, placing at one time as many as seventy thousand troops there and later sending ten thousand young American teachers and experts on sanitation, nutrition, tropical medicine, and agriculture to improve living conditions and wipe out disease. This Philippine adventure was a great pivot-point in American history, and as was stated by Richard O'Connor in his book *Pacific Destiny*:

> It signaled our determination to gain and hold supremacy in the Pacific and over as much of Asia as our military power could sustain. The consequences of that move have involved us in three wars so far and promise an unending, possibly unavailing conflict on the Asian littoral.[1]

Not all persons approved this stated American notion of world power. One great voice in opposition was a crusty conservative Yale Uni-

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