Money and the Pandemic: “Magic Money”

Anne Emerson, October 2020

In the early days of the COVID-19 pandemic, there was a focus on keeping people safe and also buying time, in the form of providing relief/stimulus money. An unusually large amount of money was approved, and it materialized, with bipartisan support. Some of us may wonder where it came from.

What follows is a brief response to that question. The discussion is economic, not political. The first part is a summary, for non-economists, of what beginning students of economics are taught about how the US banking system creates money. Then, pandemic economics is addressed within that context.

To begin, we discuss how commercial banks (such as Chesapeake Bank) make profits. The most basic description of how a commercial bank operates is that it takes in depositors’ money and then lends out much of that money. The bank’s profits are typically made by paying depositors a lower interest rate than the rate which borrowers are charged. Thus, more interest earnings come in than go out.

Depositors are entitled to withdraw their own money. A bank, or its regulator, decides how much money can safely be lent, assuming that many depositors will keep savings in the bank for the long run. This attribute of modern banking means that the amount of money lent by banks can vary, depending on how comfortable banks might feel about lending.

Next, we come to the role of the Federal Reserve System (the Fed). The Fed is the US central bank, or bankers’ bank. The Fed facilitates and oversees the banking industry in various ways, and uses several techniques to make it easier or harder for banks to lend money. The Fed has a stake in commercial banks’ behavior because money that is lent changes the economy. That is, borrowers usually use the loan money to make or build something, or otherwise contribute to the economy.

This discussion focuses on the most commonly used of the Fed’s techniques for encouraging lending – purchasing an asset in order to add money to the banking system. As will be explained in what follows, money is created when the impact of such a purchase ripples through the banking system.

Just as citizens and businesses have accounts at commercial banks, such as checking accounts and savings accounts, so commercial banks have accounts with the Fed. Banks’ deposit accounts with the Fed have a special property. (It is a

property of the rules of the system, not of the account in itself.) That is, an increase in a commercial bank's deposit account at the Fed can start a chain of new lending, when the banking system has, up to that point, lent all it can, or all it wishes to lend.

The Fed increases a bank's deposit account when it purchases an "instrument of debt" from the bank. An instrument of debt is a promise to pay back an amount lent, sometime in the future. (Suppose, for example, I have lent my son money and he has signed a note telling me he will pay it back in five years. If I want the money now, I might ask a neighbor whether she will buy the note from me. If she agrees, now I have the money, and my son owes the debt to her. When deciding whether to purchase a debt, a person considers the likelihood that he or she can collect on the debt – that is, the risk associated with the debt.)

When the Fed buys a debt from a bank, the bank gets an increase in its deposit account at the Fed, and the Fed takes ownership of the debt. (The Fed "pays" the bank for the debt, and the bank's account at the Fed increases, as your checking account increases when someone pays you with a check.) The bank is now allowed to lend, against the increase in its deposit account at the Fed. Similarly, if your checking account balance increases, you could lend someone that money, if you wished. So, the first step in money creation, is that the Federal Reserve purchases debt from someone selling it. (A debt asset changes hands. There is no "magic" in this transaction.)

Then, each time one bank receives new loanable funds (someone deposited money into his or her checking account), it can lend a proportion of that money. Then, another bank gets a new deposit (because the loan proceeds get deposited in another person's bank). That bank can lend a proportion of the new deposit (i.e., its new money); and so on. In this way, the price of the initial purchase by the Fed (the debt asset) can be counted many times over, as its impact ripples through the banking system.

The amount of money created may be greater than the amount of debt originally purchased by the Fed. This is magic in the sense that the initial purchase can generate double or triple the money (or more). This process has a well-established history. But, when analysts speak of "magic money" or "free money" with regard to the pandemic, they may intend something different, as explained below.

Finally, we return to the pandemic. According to the Federal Reserve Bank of St. Louis, between March and September 2020, the Fed's assets grew from

approximately 4.2 trillion dollars to more than 7 trillion dollars. In normal times, we would expect this behavior to increase the money supply and encourage economic activity (via increased lending, as explained above). It should generate an environment of "easy money" – where money and loans are readily available, and interest rates are low.

Unfortunately, an easy money environment already existed when the pandemic hit. It was a holdover from attempts to mitigate the 2008-9 recession. At that time, there had been little option by traditional means to avoid a depression, and so the Fed had begun purchasing different types of debt from what used to be customary. In order to address the economic downturn associated with the pandemic, the Fed continues to purchase less-than-customary debt instruments.

Basic economics suggests that the above-described process, by which the Fed's debt purchases increase the money supply, has not changed. Any "creative" Fed behavior lies in the *types of assets purchased*, not in the economic mechanisms by which they are expected to increase economic activity. To the extent that the amount of debt purchased during the pandemic is atypically large, the Fed may buy debt that it would have been ill-advised to buy under normal circumstances.

Creating instruments of debt is relatively easy. Selling them on financial markets may not be so easy. Knowing that the Fed will buy, regardless of mutual responsibilities, changes many behaviors. Therefore, money created when the Fed buys non-customary types of debts may be illusory in a different way from money multiplied in the well-established way via the banking system. If the inherent risk of loss – that comes with owning some types of debt – is transferred to the Fed, this is *different from conventional Fed operations,* buying and selling its usual types of debt. Ongoing discussions assess the importance and implications of such matters.

In summary, the customary way in which money is created, within an economic system such as that of the US, is that the central bank buys debt from other economic agents such as banks. When the Fed buys debt, new loanable funds enter the banking system. When (if) these funds are loaned out, economic activity should increase, as should the money supply. During the pandemic, the Fed is buying less-customary forms of debt in order to try to maintain economic activity, because the impact of customary kinds of debt purchases may already be at or approaching its limit.