# Ep55: The Federal Reserve – The REAL Driving Force in the Economy

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PATTI BRENNAN: Hi, everybody. Welcome back to the "Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Today, we're going to be talking about the Federal Reserve and how the Federal Reserve works with the government. In our last podcast, we talked about the mounting debt that the Federal Government has accrued as a result of the stimulus programs that they've approved to get us through this crisis.

Now, I want to talk about how does the Federal Reserve work with the Federal Government to create stability and to grease the engine a little bit to make sure that there's ample liquidity for our economy to continue to be able to function?

Joining me again is the professor, Eric Fuhrman. He's our chief planning officer. A real student, he is amazing in terms of the depth of the research that he's willing to explore a particular subject.

We've had a lot of fun – if you call it, Eric, fun – just getting our brains around how these two separate entities work together to get us through very difficult times in our nation. Thank you so much for joining us today.

ERIC FUHRMAN: Patti, thank you so much. I couldn't imagine, I've been losing sleep over thinking about this day when we could come and talk about the Federal Reserve. National debt followed by the Federal Reserve, it doesn't get much better than that.

PATTI: You and me both. The reason I'm losing sleep is because we want to take a very complicated subject and boil it down into terms that people can wrap their heads around and understand a little bit.

ERIC: Here's the deal. It's not easy, but we sure are going to try, right? We'll give it our best, and that's all we can do.

PATTI: Absolutely. It is complicated, and yet it's so important. Especially as we go into this election, you're going to hear a lot of rhetoric, everybody, in terms of the debt and the Federal Reserve. We even heard about it a couple years ago in terms of "The Fed wasn't doing its job," yada, yada, yada.

It's easy to play Monday morning quarterback. It's easy to criticize. Yet, when you really think about what they're doing and what they've already done, you begin to realize and recognize – at least I do and I think that, Eric, you probably show this – that the leaders in government and the leaders at the Federal Reserve, they're really smart people.

There's a method to their madness. There's an important role that they both serve. They're different roles. Last podcast we talked about the Federal Government, what they're doing with all of this stimulus, why they're accruing this debt, why it's important for our economy.

Now, let's talk about the Federal Reserve and how the Federal Reserve's role is very different. Eric, let's start there.

In February and in March, there were headlines. You may not have read it in the local newspaper, but there was a lot of talk in our circles about the fact that the markets were beginning to freeze.

Things were seizing. The spreads were widening and the demand for the debt, there wasn't any demand, and the Federal Reserve needed to come in and save the day.

How does that work? Why did those things happen? Why is the credit market so important? What does that really have to do with the rest of the economy?

ERIC: Wow, there's a lot to unpack there. That's why I said we might be here for the next 30 minutes just talking about this. Credit is the lifeblood of the economy. You have to have credit flowing through because that's, ultimately, what keeps commerce going, keeps growth going, and everything else.

We want to basically dissect two distinct roles that the Federal Reserve plays in times of crisis. Many people are probably familiar with the term "lender of last resort." In the modern economy, we have a very complex financial system. They have also become the buyer of last resort. Those are two different functions. Why don't we talk about each one here a little bit?

PATTI: It's a great way to break it down.

ERIC: Yeah, just easy, digestible pieces, two at a time. Let's talk about the lender of last resort, explain that. All banks, they have an inherent mismatch in their assets and liabilities. What does a bank do? It takes in depositors' deposits, which is a short-term liability for the bank because the depositors can show up any time and request their money, right?

PATTI: Sure.

ERIC: What does a bank do? It takes the savings and then extends loans to entrepreneurs and people that want to engage in commerce and build their business. Those loans are long-term assets. For the most part, they're illiquid. They just can't call a loan if they need to pay a depositor back.

Maybe a good little example, many people are familiar with the movie from many years ago called "It's a Wonderful Life" with Jimmy Stewart. He played George Bailey. There's a scene where George Bailey goes to the Bailey Brothers Building and Loan and he sees all the customers of the community outside. This is an old-fashioned bank run. This was staged in the 1930s.

Everyone was worried and wanted their money back and he tried to explain to them, "I don't have your money. I gave a loan to this person and to that person and so you're…"

PATTI: Sure, this is how you bought your house and your car and this business. They're the ones that actually have the money. We have some of it, but we don't have all of it.

ERIC: Exactly right. That's the case he made, as impassioned as it might be, and they were unfazed. What did he have to do? He went and dipped into his anniversary savings, which was about, I think, it was $2,000 and he started giving depositors their money back.

In essence, George Bailey had become the lender of last resort. How does that apply in the real world? Think about the Federal Reserve. We have banks that are good banks, good collateral, but they might experience a liquidity squeeze, an event like, say, COVID or something like that, where all of a sudden, people are running to the bank to get their money out.

What the Fed does through what's called the discount window is that they step in and they will provide collateral or loan on banks that have good standing and good collateral to help them through that liquidity so they don't fold and don't have to sell assets in a fire sale.

Just to give you an example of how effective this is, in 1933, there is estimated over 4,000 bank failures occurred then. 2020, we've had two so far.

PATTI: Wow.

ERIC: In the last 20 years, I think we've only had about 559 bank failures that have happened right. That's how they act as the lender of last resort, to loan on good collateral, to make sure those institutions stay solvent and don't collapse when they have an unexpected run on deposits.

The other one is to basically operate as really the buyer of last resort and this is a new way to think about it. You talked about the credit market seizing. What does that look like?

Think about any financial transaction. There's an ask, what someone wants to sell something for, and then there's a bid, what somebody wants to buy it for. When you have a seizure of the credit market, there are no buyers. No one's going to step in and buy it.

Essentially, the market dries up. There's no liquidity. There are no trades being made at any price because the buyers are worried about the counterparty, the risk, and so forth.

PATTI: Why is the liquidity so important? We've got to get down to the baseline of what debt represents. You basically have a bond or you have a loan. You want to sell it to get the cash, but nobody wants to buy it. The liquidity part is you need cash. You can't live on a bond.

You need to live on money, but if nobody's willing to buy it, what are you going to do? You're going to lower the price, yada, yada, yada, or as what happened earlier in the year, there wasn't anybody that wanted to buy it. No ifs, ands, or buts. That's where you really get into a very difficult situation.

ERIC: Yeah, and that's what we saw earlier this year. Even the treasury market, one of the deepest liquid markets in the world, started to seize up spreads. The bid and ask started to widen, which creates a liquidity problem.

What does the Fed do? The Fed has an awesome, awesome power. They have monopoly over money creations.

PATTI: They're the Wizard of Oz, Eric. I just thought about that. You got the Wizard of Oz, Jerome Powell. He's got the little curtain thing going on and he just pushes a button, doesn't he?

ERIC: Yeah, well, that's probably the best way to describe it, right? They can literally conjure money into existence with a stroke of a key on a keyboard. They have infinite capacity to create money.

The idea is that their activities and the market are really supposed to be short-term. These are not long-term participations in the market. They want market forces to figure out the allocation of resources.

In times of trouble, the Fed will go in and set a floor for bonds. Call it municipal bonds. They have committed $500 billion to buying municipal bonds in this new facility that they have this year. They're putting a floor on it.

PATTI: The reason for that is because municipalities are running into their own liquidity crisis because municipalities have services that they need to deliver, but they're not getting the taxes because people are unemployed. It's a vicious, vicious cycle.

That plus the fact that people don't want to buy municipal bonds because they recognize that the municipality is having some financial trouble and they could default, which many municipalities have defaulted over the years.

Entire states have done that. Now, you've got a government service or a government entity that is there to provide services and they have their own form of debt and nobody wants to buy it, so who comes in to buy it but the Federal Reserve. The Federal Reserve gets the bond. The municipality gets the cash to conduct their services.

ERIC: Exactly right. There are criticism like, "How far do you go?" At what point is the Fed engaging in what you would call moral hazard? If the Fed exhibits this precedent for stepping in and solving these problems, as they did in 2008...Remember, they took equity stakes in companies like AIG and things like that.

The argument is, and this argument is even made for FDIC insurance, if there's going to be this backstop, this implicit guarantee that the government will save us, then what are you doing? You're encouraging bad risk-taking behavior because the government's going to step in and save us.

That's a fine line, probably well beyond this podcast, maybe another podcast. Join us next season where we'll entertain this topic. It is a legitimate question, but I think the Fed is doing this on a short-term basis to arrest the decline, the collapse, and the financial crisis in the economy.

PATTI: You mentioned short-term basis. Let's go back to 2008 and 2009. Up until then, when you look at the Federal Reserve balance sheet, all that was on it was the currency. In 2008 and '09, they went into some of these other programs, the QE programs, where they started to buy the Treasuries, the munis, and the mortgages that nobody else wanted.

Now they have these assets on their balance sheet. Over time, the goal was to reduce their balance sheet and go back to where they were before the crisis, but they never got there. Now here we are in 2020. Is that something we should worry about? The Federal Reserve balance sheet, it's probably going to double by the time this is all done.

What happens in that scenario? We've doubled the Fed balance sheet. It now owns these loans, these bonds, etc. How does that work?

ERIC: That's an interesting point. The point here is their operations that they're conducting are meant to be short-term. They don't want to create dislocations in how private individuals decide how to allocate resources.

But you make a good point. Prior to 2008, the Fed's only liability was currency in circulation. These are coins, dollars, and stuff like that. That's a liability of the Fed.

2008 was extraordinary because now they started ramping up Treasury bonds, mortgage-backed securities, all these other things. Effectively, what happens when they do that is they print money. They're conjuring money into existence. Where do they get the money to buy $10 trillion of bonds? $10 trillion's an extreme example. A keystroke, right?

PATTI: Right.

ERIC: They create the funds, they deposit the funds in the bank or whoever would sell them the bonds, and they inject cash into the system. The concern is that this is money-printing. It's going to lead to inflation.

PATTI: Let's stop right there. It would be reasonable for people to say, "Hey, that sounds pretty good. You just create a lot of money, you put it into the system, everybody's that much richer."

The issue with inflation, of course, is that's fine and dandy, but if you have a lot of dollars, and the same amount of goods and services are in the economy, you've got too many dollars chasing too few goods.

What happens to the price of those goods? They go up. "Hey, you know what? You really want this loaf of bread? OK, it's 10 bucks because there are a lot of people that want this loaf of bread." It is in a really interesting phenomenon. The Federal Reserve can't really, or shouldn't really, just print money out of the blue. Yet, to a certain extent, it has done a little bit of that during this crisis. Go ahead.

ERIC: I was going to say what's interesting about that is you make a great point. If there's more money…I think it was Milton Friedman who said, literally, "If things were really bad, just drop bails of money out of helicopters on people to just try and create some inflation."

What you're saying is correct. If the money supply doubles but our output can't increase, then you've got more money chasing the same quantity of goods, and basically inflation goes up.

The unique part, there's a lot of criticism of what the Fed did in 2008. It was unprecedented, and there was this notion that it was going to create runaway inflation.

The important distinction is the Fed has created additional money in the system, but that money is locked up in the banking system as excess reserves. This money is not entering the real economy. What the Fed is really trying to do is to set the conditions for growth, set the conditions for people to come back to the table and borrow.

You don't have inflation until you have the credit creation process. Banks have to use those excess reserves to then make loans. Then the money enters the real economy. If loan growth doesn't happen, the Fed can do all they want. We used the term in the last podcast about "pushing on a string." They can only do so much.

The conventional thinking is that if you lower interest rates, the price of money, that will increase demand. But we're finding out that there's some situations where it doesn't matter. Even at negative interest rates, there are no borrowers to come to the table.

PATTI: That is, again, getting back to the human element of all of this. Remember, we are an economy that is basically people and owners of businesses. When you go through economic contraction, unemployment goes up.

It's human nature to say, "You know, I'm not going to spend as much money. I don't want to borrow money. I don't want to get a home equity line of credit to do this renovation because I'm worried about my job or I'm worried about paying it back," so they don't do those things.

Getting back to the prior podcast, one person's expense is another person's income. Very basic, so important, one person's expense is another person's income.

If that person isn't doing the renovation, the contractors aren't earning an income. The companies that make the power tools that they would use for the renovation, they're not getting an income and creating jobs within their company.

Commerce has this domino effect. It's referred to as a multiplier effect. A dollar can multiply in terms of benefit for many. If everybody's pulling back and it's locked up – or as you say, trapped in the banking system – then it doesn't have the opportunity to have that multiplier effect.

If, on the other hand, businesses or people go out and get the money that they may not have themselves through a loan with the promise to pay it back, then they get that chunk of money, and they do whatever it might be. Whether it be to start a business or pay their employees, it has a really important function.

If, all of a sudden, the demand for that loan, the demand for all of that rises tremendously, that means that spending has risen tremendously.

That's where inflation can be the likely outcome because there's so much spending, there's so much pent-up demand that everybody is going out and buying all of this stuff.

If you've got the same number of companies, or even worse, if companies have gone out of business because of a crisis and there's not enough entities to produce the goods and services that people want and need, then inflation can become even a bigger issue.

It is interesting how the Federal Reserve works to provide that floor so that people can have access to money if they need it.

Back to the 2008 and 2009, and you and I saw this very clearly with some of our business owners, a lot of them were having trouble getting the loans from the banks. The banks got really paranoid because the banks were criticized because all lending standards seemed to have gone out the window during the 2000s, which created a problem for the banks.

The stability of our banking system, not only here in the US but on a worldwide basis, got in question, so the banks said, "OK, we're not going to be as freewheeling with our lending," and so businesses were having difficulty, people were having a really tough time getting mortgages, and that dampened the recovery in a really big way.

Inflation never showed up because the banks didn't lend it out as much as you would expect after a crisis like that.

ERIC: Yeah, you have them pulling back credit lines or increasing underwriting standards so they only lend to the most sterling credit available in the market. All those things happen and that puts a dampen on demand. You have to have people spending in a big way to have inflation show up.

PATTI: I think it's pretty interesting that in this particular crisis, what they've done is, they've really gone gangbusters.

Federal Government as well as the Federal Reserve are getting so much liquidity into the system, whether it be through some of the programs like the unemployment benefits and things of that nature, or the PPP loans to keep businesses solvent, to give them a bridge so that they don't have to let people go, creating another domino effect.

Again, the hope is that because of that, these businesses remain solvent so that banks feel comfortable to lend the money to these entities, so that commerce and this wonderful thing called the US economy could continue just going back with great output.

ERIC: Absolutely. I think an interesting observation too, there's a lot of worry about inflation and what the Fed is doing, but you and I as financial professionals, you look to the market for signals, what does the market tell you?

As much press as the stock market gets due to its capricious nature from time to time, the bond market is far larger than the stock market is. The credit markets are much bigger, and when you think about any corporation, bonds and credit have a senior claim on the assets. Equity is at the very bottom, which is why it's so volatile.

Ultimately, you look to the credit markets, right, Patti? We look to the credit markets for what are the telling us because in essence, they are senior to equity claims, so a healthy credit market gives you signals about where the economy and the stock market may go.

When you think about inflation, we can observe Treasury Inflation-Protected Securities, also known as TIPS, and what are they telling you? They're negative.

We don't have negative yields in government bonds like you would in, say, Germany, or Japan, or the UK, but the Treasury inflation-protected securities are negative yielding, and that tells you the problem is not inflation. It's deflation.

PATTI: That is a serious problem.

ERIC: Yes, that is far more devastating. Thankfully, periods of deflation in our country have been far and few between over the last 80 to 90 years, but that is something that is far more of a greater danger than, say, two or three percent inflation.

PATTI: Just to explain what deflation is, now, you have more goods and the people don't want, so it's the opposite effect, and that's one thing. Now, you've got to factor your warehouse filled with a whole bunch of stuff, and it just sits there and it's unproductive. It's not creating income for employees and things of that nature.

I think also equally as important is that if somebody has a loan, paying back that loan becomes that much more expensive, right?

ERIC: Yeah, and I think that's a great point. Your very visual point about inventory just sitting on the shelves and piling up, what's driving that? It's because in deflation, prices are falling. People defer consumption.

If you're sitting out to dinner with your sweetie and you're like, "Well, why buy the steak now? If I wait 10 minutes it's going to be cheaper, right? I'll just wait. I'm going to defer." That has a very pernicious effect throughout the economy. People delay. That ends up in people getting laid off.

For those that are working, if you see your wages slashed, the point that you just made, your income is going down because of deflation, but your debts have not changed. The mortgage, principal, and interest is still the same, and then that's when it leads to bankruptcies.

PATTI: That's a very difficult situation, and that's to a certain extent what Japan has been going through, a period of deflation. Japan is a nation of savers, not spenders. It's locked up in their banking system and it's gone on so long that it's going to be very difficult for them to get out of it.

The government didn't step in as our government did, whether you agree with where they put it or not, to really stimulate demand, to get out there and just get that inventory off the shelves of the warehouse, so that the businesses can stay and keep their employees and to prevent this thing called deflation, which is a much more difficult economic issue for a Federal Reserve to solve.

ERIC: Yeah, and it's interesting too, we love the idea of low interest rates, cheap credit. It's great. It allows us to do more things than we thought possible when your mortgage is three percent versus eight, but you remember, we look at long-term interest rates in 1981, and where were they? 13 percent.

Interest rates have been falling for the last 40 years. That is a sign we're having trouble with inflation. It's deflation that's taking over. There's various debate on why that is, or what the endgame will be. Low inflation is very good, but deflation is definitely a bad thing.

PATTI: A lot of the argument or the theory is that technology has really helped us to improve productivity and keep the cost. Every time you go out, the cost of the TV is getting cheaper and cheaper for a better TV, things of that nature.

Not everything is going down in price. Some things are still going to inflate. Services tend to inflate faster than goods. You've got tuitions, and medical care, and things of that nature continue to go up.

Just as an economy in general, you want to have that balance where prices don't go down and peoples stop spending money and, now all of a sudden, paying back that $100,000 or $500,000 mortgage. Wow, that's stayed the same, and it's going to be harder and harder to do that.

ERIC: Absolutely.

PATTI: As we think about what the Federal Reserve does, now it's creating a lot of money. It's got these assets on the balance sheet. First question is, OK, well, these assets on the balance sheet happen to be treasury securities, mortgages, etc.

The Federal Reserve is a separate entity. To me, again, I'm nerding out on you, Eric, and I'm nerding out on all of you who are listening today, so bear with me, but what I think is really...

ERIC: This is a behind the scenes. This is the best part of Patti, by the way. When Patti nerds out, it's everybody's favorite moment of "Key Financial." I just want to let everybody know, because they don't always get to see it all the time…

PATTI: Totally, totally, totally.

ERIC: We love when Patti nerds out.

PATTI: Oh, man, what was I just going to say? I was about to nerd out, and I forget what I was nerding out about.

ERIC: Oh, no.

PATTI: Basically what the Federal Government does is, it's a separate entity. It has to manage its own finances, so it's got income. It's got where it gets its income, which is basically the interest on the assets on the balance sheet. It's got its own sets of expenses, and over the last 10 years, it's had a surplus. What does it do with the surplus?

Under federal law, the Federal Reserve must pay that surplus back to the treasury. Last year, it was $55 billion. In 2015, it was $117 billion. In effect, while they work separately, the Federal Government is actually benefitting from what the Federal Reserve is, ultimately, doing.

ERIC: I feel like I wish I would have thought about this in our last podcast, but I feel like the tag line for both of these is follow the money. When you're thinking about debt, you're thinking about all of these things. You have to think about the stages that the money goes to that really cement, solidify the understanding.

You're right. Think about it. The Federal Reserve, from our last podcast, I think you said it owns 21 percent of the US treasury debt out there, so they receive the interest income. As you said, they use that to cover their own expenses of the various Federal Reserve banks, but the surplus, by law, has to be remitted to the treasury, back to the government.

In essence, when the Federal Reserve buys bonds, they are effectively providing interest-free financing to the government in one way, shape or form, because the government taxes us for the interest. Simply, they buy the bonds and then they remit that back to the treasury. I wish I could get that deal because it's not too bad.

PATTI: You and me both.

ERIC: It's not bad. By the same token, I don't think people should take that as though there's something surreptitious going on here. It's just a function of how the system works. The money has to go somewhere.

PATTI: Again, to go back to the previous podcast, again, using the Abe Lincoln quote from the "Gettysburg Address," the government, meaning the Federal Reserve and the Federal Government, it is basically a body of the people, selected by the people, for the people, so that's a really important concept.

Then again, as we said last time, as we go into this election, to remember the principles of what our government and what our founding fathers intended, take away personalities, whether you like them or not, understand their role, and how all of that works.

ERIC: I think that's such an interesting point that you break up. I love that quote from Abraham Lincoln and we used it in the last podcast, but it's so interesting, when people think about government debt, and they always say, "Well, this has got to be paid back. How are they ever going to pay it back?"

They're going to pay it back to you, the American people. They borrow the money from you. We're borrowing from ourselves, and we owe the money to ourselves, so we've got to pay it right back.

PATTI: The simplest example of that is, and again, we're off topic, but that's the way we always do these things.

ERIC: As long as you can rollover your debt, then you never have an issue.

PATTI: We'll wing it. You think about it, think about World War II and the War Bonds.

The War Bonds were issued to finance the war because the Federal Government needed cash, and so it went out to the United States citizens and said, "OK, we'll give you this war bond to finance the war."

Let's say that it's May, "I'm going to give the Federal Government. Yeah, of course, I want to support my husband who happens to be overseas fighting for our country. I want him to have the best supplies. I want him to do that. Here's $10,000 to finance the war."

The government says, "OK, great, Patti. I'll pay you the interest, and they take the $10,000, and they buy supplies."

I never thought about this, Eric, but they bought supplies from my grandfather's company He had a big company, big company, I don't know, hundreds of employees. What they made, my grandfather was instrumental in this thing that we refer to now as gauze. His company manufactured bandages, gauze.

The Federal Government took my $10,000 and used it to purchase gauze from my grandfather's company. That gauze went back to the Federal Government. It was sent over to my husband who was wounded. By the way, I was working in my grandfather's company so I got a salary from my grandfather, and I went and spent the money.

It's the way that the money works all around within a system to keep everybody afloat, provide the goods that are necessary, in that case, to provide our servicemen, the people willing to go over there and defend our nation and Europe in World War II.

What's a little different now, fast forward, is that there's an extra entity out there buying those bonds, and that's the Federal Reserve.

During February, you know what, this is all fine and dandy, but I don't want your bonds. People didn't want them. The market froze.

That's where the Federal Reserve came in and purchased the bonds, gave the Federal Government the cash to provide higher unemployment benefits, the PPP loans, etc. Yes, again, because it's a liability, it's debt, it's debt that it owes now to the Federal Reserve.

Again, we're trying to boil this down and bring this down in a way that, hopefully, it makes sense for all of you and to give you a sense of it's not hocus-pocus here. There's a real reason why these things are happening. It's exactly why the government, any government, really exists. It's to support its people during very difficult times. They do that in the ways that they're doing with this.

For everybody listening, for all of you listening, it's also important to understand the role that the Federal Reserve plays versus the government.

Eric, why don't you talk about the Fed being that, providing the floor, but we still need the government. Right? What is the difference? The Federal Reserve is there to provide that liquidity, that relief, but they can't stimulate the economy.

ERIC: That goes right back to a very interesting discussion of fiscal policy and monetary policy that sounds like that. It looks like that. I think that's where we're going, right?

PATTI: You got it. Go for it.

ERIC: There's two different policy tools here. The Federal Reserve is really in charge of the monetary policy. They're given several mandates by Congress to promote full employment, stable prices, but also to support the smooth functioning of our economy.

They use interest rates to try and manage and maximize employment and borrowing costs, which is a tricky thing to do. They're using data that's already happened to try and see where the puck is – a wonderful analogy that I've heard you use many times. It's a difficult job, and they don't always get it right.

What's interesting is that they have learned from the past. They have learned from their mistakes.

Central banking monetary policy is something that really continues to evolve. The things that are happening today were really forged in the depths of the financial crisis by Ben Bernanke, the former chairman. These are all new tools and things that really didn't exist prior to that point. It will continue to evolve.

Ultimately, they're there to provide that stability and prudent management of the financial system. Where the government steps in, they make policy decisions about what services, what kind of things do we provide, what kind of investments do we make for the country whether it's roads, and bridges, and different infrastructure.

The infrastructure, ultimately, that makes us more productive. If we're more productive in the future, we have higher standards of living because we're producing more for a better cost. They're really in charge of figuring out how to structure those safety nets, how to allocate the big, big things that an individual or a private company just couldn't do.

Did they get that right? They are not beyond criticism of not doing this right. Ultimately, they get most of it right. That's what they're there to do is really to provide and direct those funds into investment and support and to do big things.

PATTI: The bottom line to this is the Federal Reserve can print money till they're blue in the face. Again, they're not really printing it, but they're using their operations, etc. They can print money till they're blue in the face, but if it's not lent out, it's not going to do any good.

You need that demand. If the demand isn't there from you and I, from the consumer, then the government steps in to create the demand where it doesn't exist during a difficult period in our economy.

Eventually, hopefully, the consumer comes back, and some of those programs, whether it be the public-private partnership with pharmaceutical companies, the Federal Government is giving money to the pharmaceutical companies to find this vaccine, things of that nature.

ERIC: That's a reoccurring point that we just want to keep reinforcing and continue to echo this notion that we're a market-based society. We believe that individuals make the best decisions to allocate resources, and own property, and make those decisions.

Occasionally, the business cycle's volatile. Those things break down. People don't spend.

What we've learned from the past is what you're saying. The Federal Reserve can only do so much to create an environment where the economy can come back.

Many times, there's a responsibility on the government to step in and extract that money, tap into that pool of savings from the private sector, households and businesses, to pull that money out and then spend it in a real economy when those private individuals are not spending.

That, ultimately, helps us get through these crisis and hopefully sets the foundation where we can grow again and hopefully not experience significant, significant difficulties that just persist on and on for years.

PATTI: Again, and when you refer to that, you're talking about GDP. When we talk about GDP, the goal here, assuming that we're still in this recession, is to get out of the recession. A recession is defined as two quarters back to back of negative GDP where you're not growing. You're actually contracting. They want to get us back growing again one way or the other.

When you hear about these terms like a V recovery, or a U, what have you, a lot of times, these commentators, they confuse the economy with the market. They are two separate entities. I cannot emphasize that enough. Yes, the market is on a significant upswing, but we're still, from an economic perspective, we're trudging though. We're still in this recession.

That is not unusual. The market is a forward-leading indicator. It is taking a look at the amount of money that is now sloshing into the system, and it believes that, eventually, we're going to come out of this. The market is hoping we're going to come out of this sooner than anybody every realized or anticipated.

That's where you're seeing a lot of this upward volatility, and the market is recovering and doing quite well when the economy really isn't. Again, not unusual. That's the way it typically happens.

ERIC: It's important, too, to remember that the stock market is not the economy.

Ultimately, publicly-traded companies have advantages that do not exist for the majority of employers, which are small businesses, which they don't have access to the credit lines. They don't have access to the capital markets to sell debt or issue equity to see them through. They don't have the diversity of revenue streams that businesses do. The stock market is distinctly different.

A lot of people ask the question how can the stock market only be down a couple percent when we're mired in probably one of the most severe contractions we've seen almost ever. It's a different kind of thing. The support that's going on, that's certainly helping the stock market, but it's really aimed to help some of these small businesses and people that are hurting out there for the most part.

PATTI: Excellent. I'm just going to go through just a couple of, few concepts, and then we're going to wrap this up. What is it, Eric, when they talk about monetizing the debt? What does that really mean in English?

ERIC: It almost sounds like a dirty word, doesn't it?

PATTI: It does.

ERIC: Monetizing the debt, it's just some kind of negative, devious thing that's going on there.

PATTI: Again, it's this Wizard of Oz thing behind the curtain.

ERIC: Basically what monetizing the debt is, that's literally if the Federal Reserve wants to influence interest rates, what do they do? They go to the New York Fed, and they tell them we'd like to buy $50 billion in Treasury securities.

They, with the stroke of a key, they create the money. They literally conjure it into existence, and they buy the debt. They're monetizing debt in that they're buying debt and they're just creating the money out of thin air literally, and that's what it is.

PATTI: Over time, that helps in terms of they continue to do that, they monetize the debt. 10 years from now if they continue to do that, that creates some inflation because you've got more dollars circulating in the system, so the cost of paying down that debt is a lot less.

ERIC: It goes two ways too. Remember that the Federal Reserve is trying to just create the conditions. They can monetize the debt, but they can also demonetize the debt.

If they want interest rates to rise, what do they do? They sell the treasury bonds they own on the balance sheet to the banks, and they extract cash out of the system and that cash doesn't go back to the Federal Reserve. It just disappears out existence. It can really go both ways. They can monetize, they can demonetize the debt.

PATTI: That's how they control inflation.

ERIC: Right. They look at inflation and then they try and control interest rates based on where inflation would be. They don't want it getting out of control and so forth because, ultimately, businesses and consumers can't make decisions if prices are going all over the place like they did when we had the gold standard.

PATTI: One last question. When you think about the Federal Reserve, they're printing these dollars and that's circulating in our system. We talked about this a little bit, but for those people who weren't able to listen to the last podcast, why is it that the US dollar is considered the reserve asset for the rest of the world? Why is that? What does that really mean?

We talked about this before. We can only do it on the surface, or we can go real deep and talk about Bretton Woods and the gold standard, and that kind of stuff.

ERIC: What door do we go through, Patti? Do we go through door number one, or just we see how far the rabbit hole goes?

Patti: The simple answer, if I may answer my own question, is to say it's not really the reserve currency. It's the reserve asset.

The United States, the treasuries, and the dollar is the most liquid, transparent, largest entity market of anything. It's a very reliable asset to hold, or in this case, dollars, and other countries peg their currencies to something that is so reliable, right?

ERIC: Right.

PATTI: Go ahead and go into a little bit about how that all happened.

ERIC: I think the dollar supplanted the British pound after World War II, but people may have heard of this. Basically, the Bretton Woods Agreement, this was the Bretton Woods Conference that was conducted in New Hampshire.

In the post-World War II environment, the major economic powers, our allies, got together in New Hampshire and they forged the framework for what the new international monetary system would look like.

We have to remember that the United States, at that point, was the lone superpower, after having vanquished two foes on the Atlantic and on the other side of the Pacific, but the United States was the largest creditor nation in the world.

We had accumulated the largest stock of gold reserves in the entire world by far. Our allies in Europe had devastated economies and they had to rebuild those economies, and they needed dollars to be able to import food and energy to start building up, and so forth.

The intent of the Bretton Woods was to establish the dollar, because we had the most gold, as the world reserve currency that all other nations would peg their currencies to, but the idea was to overvalue the dollar, undervalue the foreign currencies so we could create a trade deficit.

Foreign countries, our allies, would run trade surpluses with the United States because their currencies were systematically undervalued. That would provide them the means to accumulate the dollars to then...

PATTI: Get the goods and services.

ERIC: ...import the basics of life, food, energy, all the things that you need.

That established the marker in history where we went from a creditor nation to what we would call a debtor nation, and now we always get talked about that we're the greatest world's debtor nation ever, separate podcast, by the way. We've got lots of good ones coming up...

PATTI: Absolutely.

ERIC: ...is what is what I'm getting at with this, but that's where it established that. What happened is that gave them the ability to start to rebuild their economies and so forth, so that's where we became the world reserve currency, was after World War II, because of just the favorable conditions in our economy.

Things have changed over time that, eventually, we were seeing massive outflows of gold. I think it was 1971, Richard Nixon called a gathering of his top advisers and Camp David and they said, "That's it. We're going to suspend the convertibility of the dollar into gold." Now, we have what we have today, which is a credit-based system, based on what they would call fiat.

Now, rather than countries getting gold when they run a trade surplus, they accumulate dollars.

PATTI: Simple.

ERIC: Yeah, easy.

PATTI: Easy, and then basically, like we said in the last podcast, they've got a number of different choices on what to do with the dollars because they can't spend it in their own economy, because that's not their currency.

Very briefly, they hold the cash, but then that's dead money. They can spend it in the United States by buying our goods. That helps our economy because now they're buying our stuff, and that gives our employees incomes, things of that nature.

They could invest in the United States. BMW can build a plant down in South Carolina and use dollars to do so, or they can convert the US dollar into a different currency.

Instead of holding dollars, they can convert that into euros, but now they're back to the same problem. Now they own euros. Euros, great nations, wonderful, but they've got a whole separate issue in that they have one monetary system but they have different fiscal systems. Germany is different than France, etc.

It's not a united framework as we have here in the United States, so I think that most nations prefer not to hold the euros because it's less reliable in that vein, so what do they do? They buy US treasuries, and that's basically what they do. They give us those dollars, and we pay them the interest on the treasuries.

If they want their money back, if they want to sell the treasuries, that's fine, but if they do too much of it, what happens to the value of the dollar? It goes down. They're shooting themselves in the foot.

ERIC: Right, because then our exports become competitive, right?

PATTI: Right.

ERIC: You make an interesting comparison to Europe, how they're set up versus us. We have the benefit of a fiscal and monetary union across all states in the land.

Could you imagine if suddenly Texas, or Idaho, or whoever, wanted to suddenly have their own currency? This was problematic back in the Civil War, but that's one of the advantages that we have.

I think part of what does not fall into the public discourse that I think is a disservice is, there's so much focus on the trade deficit, this imbalance between what we export versus what we import, and that's in the headlines and so forth.

What is missing is, the trade deficit is part of what we call the current account, but every nation has what they call a balance of payments, hence the word balance. If you have a deficit in one area, so a deficit in your trade account, you have to have an equal and corresponding surplus in your financial account.

When we run a trade deficit, that can have negative effects in certain segments of the economy, but it also means that we're importing capital from abroad, so we're creating a source of funds in the financial account.

PATTI: That's exactly right. You have the dollars here.

ERIC: I would say, every time you hear about the trade deficit, just remember that is just one component of a broader set of what we call the national accounting identities, which is the balance of payments. The system has to balance. If there's a deficit here, there's got to be a surplus somewhere else.

PATTI: You know, Eric, it's exactly what we were talking about last time. We hear so much about the debt in the United States, and this rising debt of $26 trillion. You never hear about the assets. It's balance sheet. It's accounting 101. There's got to be assets, and we happen to be the wealthiest nation in the world.

Americans hold $117 trillion worth of assets. That doesn't even include what the Federal Government holds, and the state governments, with the land, and buildings, and things of that nature. There's assets, pick a number, $140 trillion, $150 trillion with a T dollars, to offset the $26 trillion that we owe, frankly, to ourselves.

ERIC: It's interesting. The numbers are pretty big, but that again, which I was really excited about this series of podcasts because I just feel like so much when you talk about it or if the topic comes up, is that people only focus on the liability.

Nobody ever asks the question about assets. I've never heard anybody say that, and that's so fascinating to me, because it would certainly put things in context if you thought about the assets.

PATTI: Here's the deal, Eric. They wouldn't get elected, because fear is a powerful motivator. People don't want to think that we're going to have so much debt, and the implications for our families and things of that nature.

I hope it's been helpful for everybody who's listening. I find it fascinating. Thank you so much for all the research and your contribution, professor, and thanks to all of you for joining us.

I hope this was helpful. I hope that we were able to boil a very complicated subject into fairly simple terms, and maybe restore a little bit of confidence in the system that we call the United States of America's economy, and the leadership, and how some of this stuff can work.

Pull back the curtain, simplify it, to help you to understand that there's really a reason and there's a method behind everything and a lot of the decisions.

Again, we may not always agree with them. We can go on and on about how the money is being used and is it frivolous, but the intent is to keep this wonderful economy in the United States growing. We stabilize it first and then we return to the growth that has really made our nation what it is today.

Thank you so much for joining us. I hope you found it helpful. Go to our website. Listen to the other podcasts. Definitely, please let us know if you have any questions, if you want to talk about this further one on one, that's what we're here for.

As you think these things through, always remember, we're here for you. Thank you so much for joining us. Thank you, Eric, for joining us. You're terrific and I hope you all have a terrific day.