

Understanding Inside and Outside Money

By Cullen Roche

Money, as it exists in a modern monetary system, is a social construct that serves *primarily* as a medium of exchange. Money also serves other purposes, but for this piece we will focus primarily on its most basic function. As a social species we exchange goods and services via the use of this tool. Throughout history many things have served as money and still do serve as money. The most prominent form of modern money is fiat money. Fiat money is a specific legally mandated unit of account. These forms of money have no inherent value. That is, this money is not a physical “thing”. Instead, it serves as a specified unit of account by virtue of law. In the USA, the US Dollar is the legally mandated form of money that we use as a medium of exchange and unit of account.

Role of the Private Banking System

To understand the structure of the US monetary system it helps to understand why we have the system we have today. The USA was founded on the idea of a market-based economy with deep skepticism towards centralized government powers. Thus, the design of the system in the USA has always remained consistent with keeping the power of money creation from being controlled entirely by the government. Money creation in the USA is dominated by a private oligopoly that competes for business (Private Banking System). But this system designed around private money issuance has proven terribly unstable at times and in need of a stabilizing force. What has evolved over the course of hundreds of years is a complex private/public hybrid system.

Money is primarily distributed through the private competitive banking process. Banks compete for the demand of loans in a market-based system. The primary form of money in existence today resides in bank accounts as bank deposits. These deposits exist as a result of loans. Loans create deposits and banks can create these new loans independent of their reserve position. It's crucial to understand that the money multiplier is false. Banks do not multiply their reserve balances. Instead, banks lend first and find reserves later if necessary. This mechanism to distribute money is essentially a privatization of the money supply to an oligopoly of private banks. That is, the form of money we all utilize on a daily basis is controlled almost entirely by private banks (though it's growth is largely contingent upon demand).

Inside Money

This form of bank money is called “inside money”. Inside money is created inside the private sector. Inside money includes bank deposits that exist as a result of the loan creation process. It is the dominant form of money in the modern economy and as the economy has become increasingly electronic it has taken on

an increasingly prominent role in the modern economy. Money is no longer a physical thing, a cash note or a gold bar. Its most common form is now numbers in a computer system.

But inside money is inherently unstable as the entities that issue this money are inherently unstable. The 1800's and early 1900's, for instance, experienced substantial volatility in banking as an inherent conflict of interest developed. Banks, as private profit seeking entities are inclined to maximize profits at all times. As Hyman Minsky once noted, "stability creates instability". This is particularly true in banking, as economic stability tends to result in banks relaxing their lending standards to maximize loan creation and profit potential. But this stability is often a mirage that results in future instability and often banking crisis. Those who understand the credit crisis of 2008 know this all too well.

Role of the Federal Reserve

The early 1900's were a turbulent period in US banking history that resulted in massive changes. The US government created the Federal Reserve System to create a stabilizing entity for the private banking system. This independent entity would serve as a buffer that avoided having a nationalized money system (where all money was created and issued by the government) and maintained the private competitive money issuance system. Prior to the Federal Reserve System, the USA had what was essentially rogue banking dominated by these private entities. And when one of these entities experienced a crisis the system was often thrown into turmoil as Bank A would refuse to settle the payment of Bank B due to solvency concerns. The Federal Reserve System reduced this risk by creating one cohesive and internal settlement system. The Interbank Market is the banking market controlled and regulated by the Federal Reserve. Banks are required to maintain accounts with Federal Reserve banks where they maintain deposit accounts. This creates one clean market where banks can always settle payments and where the Fed can intervene and provide aid and oversight where necessary.

The Fed system was created to support the private for-profit banking system. So, in a sense, the Fed is a servant to the banking system as its design is consistent with a mandate to always support the private banking system. This system helps to maintain private competitive banking while also leveraging the strengths of the Federal government to create a support mechanism to help keep the banks from imploding on themselves due to their inherent inability to properly manage risk.

Outside Money

This brings us to the other form of money in our monetary system – outside money. Outside money is money created *outside* of the private sector. This includes cash notes, coins and bank reserves. Although cash is quickly becoming obsolete, it is still a prevalent form of money in many economies. This

cash form of money primarily serves for convenience a purpose that allows one to draw down a bank account of inside money to make transactions in physical currency. Coins serve a similar purpose, but are becoming equally obsolete as the modern economy evolves into a fully electronic system. The most important form of outside money is bank reserves or deposits held on reserve at Federal Reserve banks. These deposits are held for two purposes: 1) to settle payments in the Interbank Market; 2) to meet reserve requirements. Reserves are also how the Federal Reserve implements monetary policy via changes in the level of reserves.

What's crucial to understand here is the way that outside money serves primarily to facilitate the existence of inside money. That is, the creation of outside money is almost entirely a facilitating feature to influence or stabilize inside money, the primary form of money in the economy.

Through its vast powers the government can serve as an important stabilizing force in a system that is designed primarily around private competitive banking. Private competitive banking is not inherently evil. But like any system its users can corrupt it. And as a social construct, we have the need to properly regulate money as its corruption has far reaching impacts. The system in the USA is probably the most developed of all the monetary systems in the world. It is not perfect and one could even argue that it remains deeply flawed. But it is the system we presently have.