

Economic Newsletter for the New Millennium

May 18, 2011

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THE GREAT CREDIT COLLAPSE OF 2008-2011: The Smoking Howitzer

Caveat!

The pictures accompanying the following article are very vivid and we recommend the weak of heart view this with adult supervision.

The Flow of Funds Accounts of the Federal Reserve System for the last five years goes a great distance in explaining the ongoing financial and economic malaise of the U.S. economy. The total credit creation was trending upward and reached a peak in 2007 at \$4.483 trillion. It fell to \$2.582 trillion in 2008 and dropped further, turning negative, (-\$634) billion in 2009. This means that in a net sense, no new net credit creation was occurring and outstanding credit was allowed to run off by either credit recipients paying off some of their debt or because lenders undertook bad debt write-offs. A very slight revival occurred in 2010 with \$736 billion credit being created. This was 83.6% less credit that was created in 2007. The Flow of Funds data for the first quarter of 2011 is not yet available.

Board of Governors of the [U.S.] Federal Reserve System
Flow of Funds Accounts of the United States
Flows and Outstandings
Fourth Quarter 2010

<http://federalreserve.gov/releases/z1/Current/z1.pdf>

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THE THEORETICAL AND HISTORICAL BACKGROUND

Just as Keynes shattered the neoclassical vision of what was to be called macroeconomics, economics, John Gurley and Edward Shaw shattered the accepted view of credit creation. What it boils down to is that credit creation has two sources, credit can be created by creating new M-1 money as depositories such as banks and credit union do, or it can be created by non-depositories such as finance companies, insurance companies, mutual funds and pension funds, to name but a few, by offering the holders of existing M-1 money, nearly always in a checkable deposit form, a substitute such as a certificate of deposit or pension fund claim or the cash surrender value of a life insurance policy and then "lending out" or investing the just acquired M-1 money. Gurley and Shaw viewed these substitutes as near M-1 money. Many of these substitutes are the non-M-1 components of the more inclusive monetary aggregates such as M-2, M-3, etc.

The monetary aggregate M-1 will support a larger GDP and thus the GDP velocity of M-1 is increased. In other words, the financial intermediaries can also create credit by increasing the velocity of M-1 money. While credit creation is related to M-1 money, the greater is the velocity of M-1 money, the greater the creation can be in relation to a given quantity of M-1 money.

This has been implicit in continental monetary theory and policy making. Especially in post WW II Germany where the monetary authority mandated required legal reserves for a much broader spectrum of monetary assets than in for example, the United States. The "spiritual father" of monetary policy on this side of the Atlantic Ocean has been the classical-neoclassical versions of the quantity theory, called monetarism in its modern form.

When the velocity of M-1 was stable or at least unstable but reliably predictable, monetarism dominated the FED's policy making activities. Hence defining, estimating their size, publicly reporting their size, and targeting the growth rates of five monetary aggregates, M-1 through M-5 were characteristics of monetary policy.

With the inflation driven explosion of substitutes for M-1, moving from M-1 to the broader aggregates or from those broader aggregates back to the narrower aggregates including M-1, caused the predictability of the velocity of the monetary aggregates to become increasingly unreliable, as the basis for monetary policy decisions. The reign of monetarism ended as did the estimating and reporting of the broader aggregates M-3, M-4, and M-5.

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Discontinuance of M3 (March 23, 2006)

<http://www.federalreserve.gov/releases/h6/discm3.htm>

Chairman Ben S. Bernanke

At the Fourth ECB Central Banking Conference, Frankfurt, Germany

November 10, 2006

Monetary Aggregates and Monetary Policy at the Federal Reserve: A Historical Perspective

"M4 and M5 were dropped in a 1980 redefinition of the monetary aggregates."

<http://www.federalreserve.gov/newsevents/speech/bernanke20061110a.htm>

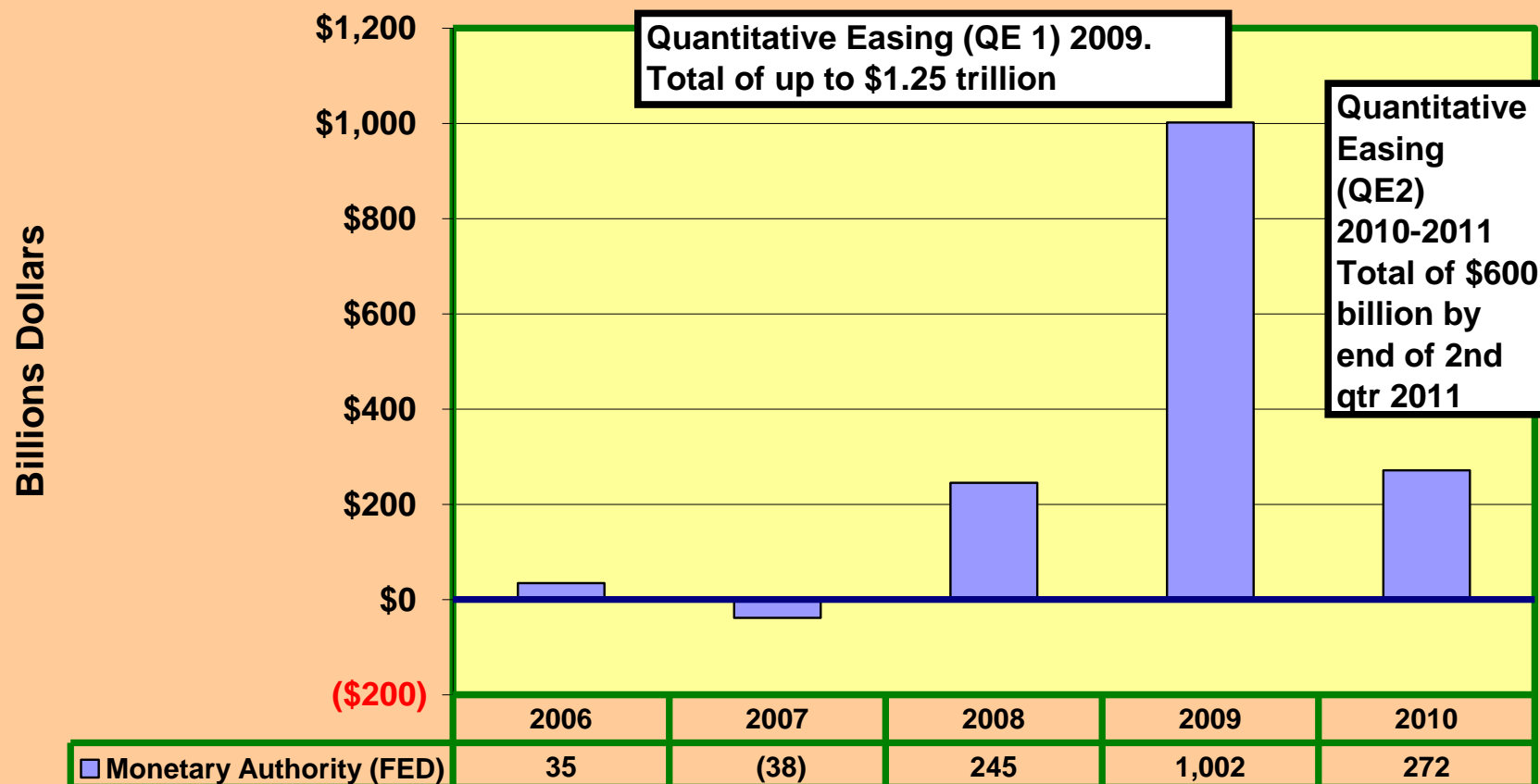
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Even when Monetarism was gaining wider acceptability, Monetarists disagreed on just what was the monetary aggregate that was a chief cause of price level changes. Most argued M-1 as being too narrow a measure. Many chose a broader and more inclusive monetary aggregate such as M-2 or M-3. The broader the aggregate, the less the impact on the velocity of these more inclusive monetary aggregates such movements between its components had. Some chose to define the appropriate aggregate differently than did the FED.

Velocity changes can become quantity changes in the broader aggregates. As the monetary aggregate is more broadly defined and more inclusive, it approaches the totality of credit creation. Estimates of such a broad aggregate become more difficult to make and time lags in the availability of their estimates become increasingly problematic. While the velocity problem is reduced, other such problems as just mentioned make the use of monetarism more difficult as the basis for money policy deliberations and policy choices.

Since the explosion of substitute financial assets, the FED has gradually returned to influence economic and financial behavior by attempting to control the cost and availability of credit.

Credit Market Lending Federal Reserve
Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011



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Tales of Quantitative Easing

QE 1 = 2009

Release Date: March 18, 2009

<http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm>

...In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee [Federal Open Market Committee] will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide greater support to mortgage lending and housing markets, the Committee decided today to increase the size of the Federal Reserve's balance sheet further by purchasing up to an additional \$750 billion of agency mortgage-backed securities, bringing its total purchases of these securities to up to \$1.25 trillion this year, and to increase its purchases of agency debt this year by up to \$100 billion to a total of up to \$200 billion. Moreover, to help improve conditions in private credit markets, the Committee decided to purchase up to \$300 billion of longer-term Treasury securities over the next six months.

QE 2 = 2010-2011

Release Date: November 3, 2010

<http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm>

To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee [Federal Open Market Committee] decided today to expand its holdings of securities. The Committee will maintain its existing policy of reinvesting principal payments from its securities holdings. In addition, the Committee intends to purchase a further \$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about \$75 billion per month.

There is an old expression that warns us, "You can lead a horse to water but you can't make him drink". To paraphrase it for purposes of this article:
You can supply all the legal reserves you want to the depositories but you cannot make them create M-1 money and credit.

We have pointed out in previous newsletters and blogs on this website that depositories create money (checkable deposit form of M-1 money) and credit (lending out the newly created money in the form of loans and investments) in order to increase profits. If such credit creation is not profitable, they will not undertake money and credit creation even with significant excess reserves. The pre- WW II literature on monetary policy referred to this reaction to monetary stimulus as the "reflux mechanism."

Thomas M. Humphrey – The Federal Reserve Bank of Richmond

"Tom Humphrey worked as an economist in the Research Department for 35 years. He retired from his position as senior economist and research advisor in 2005.

Humphrey published numerous journal articles and books during his career at the Richmond Fed. He continues to write on monetary policy history, most recently about the Federal Reserve's role as lender of last resort."

<http://www.richmondfed.org/research/economists/authors/humphrey2.cfm>

Taking apart the Fed's Balance Sheet...

<http://federalreserve.gov/releases/h41/Current/h41.pdf>

FEDERAL RESERVE statistical release



H.4.1

Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks

May 5, 2011

1. Factors Affecting Reserve Balances of Depository Institutions

Millions of dollars

Billions of dollars	Reserve Bank credit, related items, and reserve balances of depository institutions at Federal Reserve Banks	Averages of daily figures			Wednesday May 4, 2011
		Week ended May 4, 2011	Change from week ended		
			Apr 27, 2011	May 5, 2010	
Reserve Bank credit	2,686,943	+ 15,173	+ 375,182	2,702,884	
Securities held outright ¹	2,477,413	+ 12,484	+ 435,163	2,493,995	
U.S. Treasury securities	1,425,274	+ 18,720	+ 648,546	1,441,855	
Bills ²	18,423	0	0	18,423	
Notes and bonds, nominal ²	1,341,791	+ 18,636	+ 629,734	1,358,315	
Notes and bonds, inflation-indexed ²	58,065	0	+ 16,973	58,065	
Inflation compensation ³	6,995	+ 83	+ 1,838	7,053	
Federal agency debt securities ²	125,118	- 2,692	- 43,107	125,118	
Mortgage-backed securities ⁴	927,021	- 3,544	- 170,276	927,021	
Repurchase agreements ⁵	0	0	0	0	
Loans	16,608	- 599	- 61,490	16,277	
Primary credit	11	+ 2	- 5,336	12	
Secondary credit	1	+ 1	- 499	0	
Seasonal credit	12	0	- 21	14	
Credit extended to American International Group, Inc., net ⁶	0	0	- 27,062	0	
Term Asset-Backed Securities Loan Facility ⁷	16,584	- 602	- 28,572	16,252	
Other credit extensions	0	0	0	0	
Net portfolio holdings of Commercial Paper Funding Facility LLC ⁸	0	0	- 2,796	0	
Net portfolio holdings of Maiden Lane LLC ⁹	24,771	+ 395	- 3,460	24,796	
Net portfolio holdings of Maiden Lane II LLC ¹⁰	16,088	+ 120	+ 27	14,970	
Net portfolio holdings of Maiden Lane III LLC ¹¹	24,573	+ 1,316	+ 968	24,611	
Net portfolio holdings of TALF LLC ¹²	733	0	+ 294	733	
Preferred interests in AIA Aurora LLC and ALICO Holdings LLC ⁶	0	0	- 25,416	0	
Float	-1,084	- 122	+ 851	-1,241	
Central bank liquidity swaps ¹³	0	0	0	0	
Other Federal Reserve assets ¹⁴	127,841	+ 1,580	+ 31,040	128,742	
Gold stock	11,041	0	0	11,041	
Special drawing rights certificate account	5,200	0	0	5,200	
Treasury currency outstanding ¹⁵	43,864	+ 14	+ 808	43,864	
Total factors supplying reserve funds	2,747,048	+ 15,187	+ 375,990	2,762,989	

Note: Components may not sum to totals because of rounding. Footnotes appear at the end of the table.

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H.4.1

1. Factors Affecting Reserve Balances of Depository Institutions (continued)

Millions of dollars

Reserve Bank credit, related items, and reserve balances of depository institutions at Federal Reserve Banks	Averages of daily figures			Wednesday May 4, 2011
	Week ended May 4, 2011	Change from week ended		
		Apr 27, 2011	May 5, 2010	
Currency in circulation ¹⁵	1,014,599	+ 3,356	+ 78,333	1,017,258
Reverse repurchase agreements ¹⁶	59,078	+ 2,267	+ 1,448	56,973
Foreign official and international accounts	59,078	+ 2,267	+ 1,448	56,973
Others	0	0	0	0
Treasury cash holdings	161	- 27	- 39	151
Deposits with F.R. Banks, other than reserve balances	129,937	+ 11,482	- 153,944	141,941
Term deposits held by depository institutions	5,081	0	+ 5,081	5,081
U.S. Treasury, general account	115,026	+ 10,874	+ 38,359	125,397
U.S. Treasury, supplementary financing account	5,000	0	- 194,958	5,000
Foreign official	132	- 5	- 3,852	128
Service-related	2,545	- 1	- 117	2,545
Required clearing balances	2,545	- 1	- 117	2,545
Adjustments to compensate for float	0	0	0	0
Other	2,153	+ 614	+ 1,543	3,791
Funds from American International Group, Inc. asset dispositions, held as agent ⁶	0	0	0	0
Other liabilities and capital ¹⁷	75,875	+ 2,147	+ 4,375	73,663
Total factors, other than reserve balances, absorbing reserve funds	1,279,650	+ 19,226	- 69,826	1,289,986
Reserve balances with Federal Reserve Banks	1,467,397	- 4,040	+ 445,816	1,473,003

Note: Components may not sum to totals because of rounding.

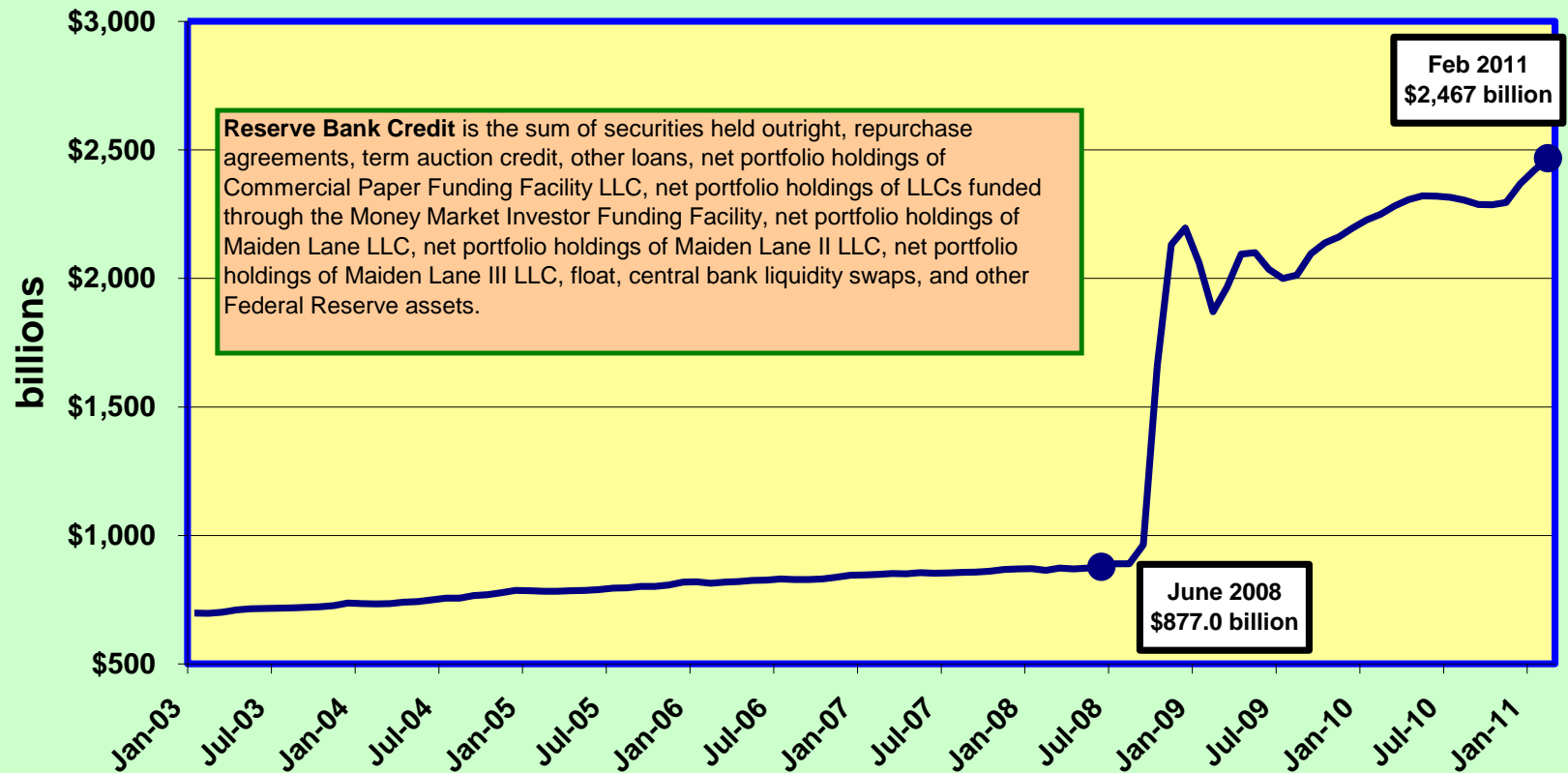
1. Includes securities lent to dealers under the overnight securities lending facility; refer to table 1A.
2. Face value of the securities.
3. Compensation that adjusts for the effect of inflation on the original face value of inflation-indexed securities.
4. Guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. Current face value of the securities, which is the remaining principal balance of the underlying mortgages.
5. Cash value of agreements.
6. As a result of the closing of the American International Group, Inc. (AIG) recapitalization plan on January 14, 2011, the credit extended to AIG was fully repaid and the Federal Reserve's commitment to lend any further funds was terminated. In addition, the Federal Reserve Bank of New York (FRBNY) has been paid in full for its preferred interests in AIA Aurora LLC and ALICO Holdings LLC. The funds from AIG asset dispositions that FRBNY held as agent were the source of repayment of the credit extended to AIG, as well as a portion of the FRBNY's preferred interests in ALICO Holdings LLC. The remaining FRBNY preferred interests in ALICO Holdings LLC and AIA Aurora LLC, valued at approximately \$20 billion, were purchased by AIG through a draw on the Treasury's Series F preferred stock commitment and then transferred by AIG to the Treasury as consideration for the draw on the available Series F funds.
7. Includes credit extended by the Federal Reserve Bank of New York to eligible borrowers through the Term Asset-Backed Securities Loan Facility.

8. Includes the book value of the commercial paper, net of amortized costs and related fees, and other investments held by the Commercial Paper Funding Facility LLC.
9. Refer to table 4 and the note on consolidation accompanying table 9.
10. Refer to table 5 and the note on consolidation accompanying table 9.
11. Refer to table 6 and the note on consolidation accompanying table 9.
12. Refer to table 7 and the note on consolidation accompanying table 9.
13. Dollar value of foreign currency held under these agreements valued at the exchange rate to be used when the foreign currency is returned to the foreign central bank. This exchange rate equals the market exchange rate used when the foreign currency was acquired from the foreign central bank.
14. Includes other assets denominated in foreign currencies, which are revalued daily at market exchange rates, and the fair value adjustment to credit extended by the FRBNY to eligible borrowers through the Term Asset-Backed Securities Loan Facility. Before the closing of the AIG recapitalization plan on January 14, 2011, included accrued dividends on the FRBNY's preferred interests in AIA Aurora LLC and ALICO Holdings LLC.
15. Estimated.
16. Cash value of agreements, which are collateralized by U.S. Treasury securities, federal agency debt securities, and mortgage-backed securities.
17. Includes the liabilities of Maiden Lane LLC, Maiden Lane II LLC, Maiden Lane III LLC, and TALF LLC to entities other than the Federal Reserve Bank of New York, including liabilities that have recourse only to the portfolio holdings of these LLCs. Refer to table 4 through table 7 and the note on consolidation accompanying table 9. Also includes the liability for interest on Federal Reserve notes due to U.S. Treasury. Refer to table 8 and table 9.

Sources: Federal Reserve Banks and the U.S. Department of the Treasury.

Reserve Bank Credit

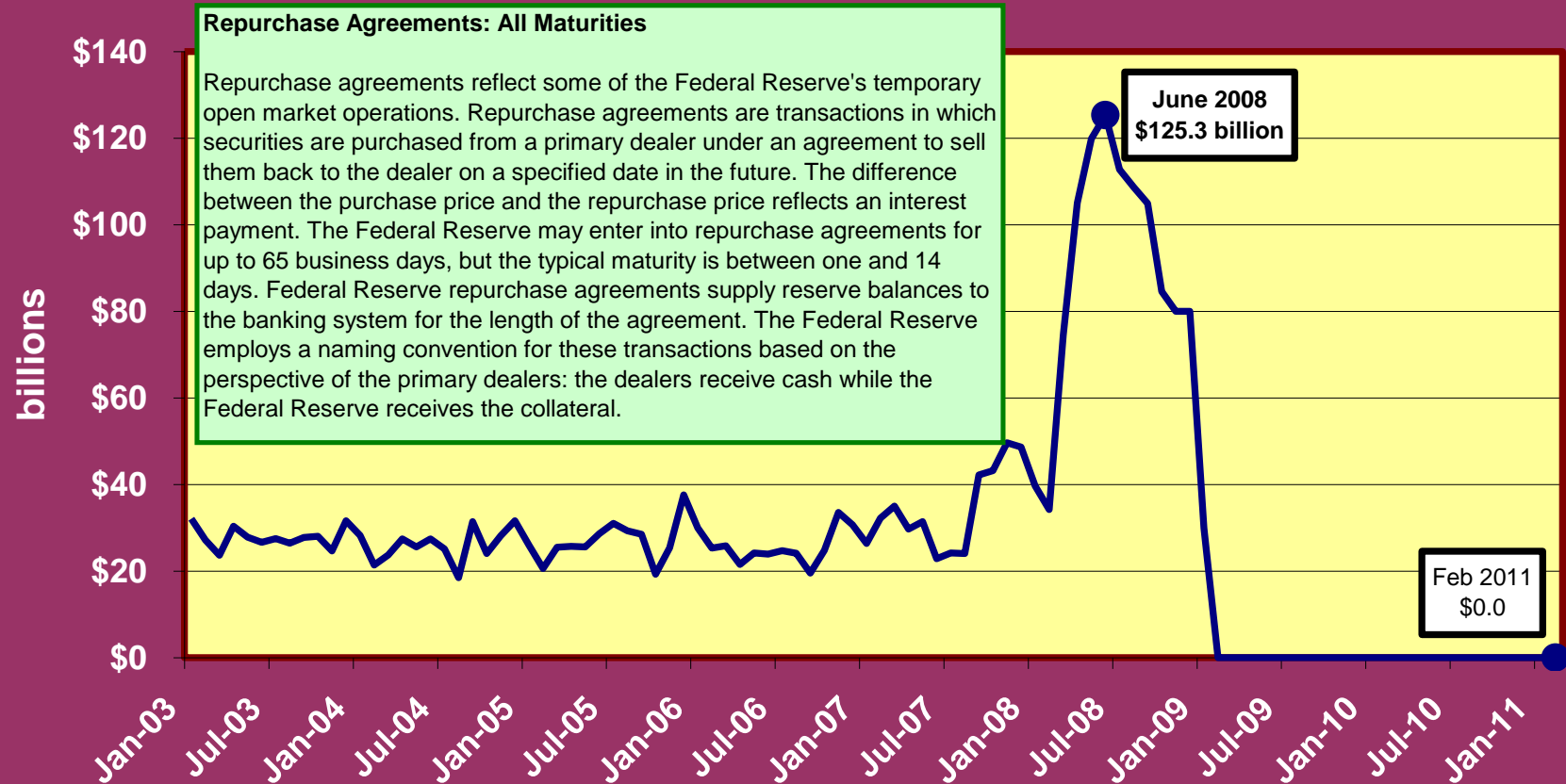
H.4.1 Factors Affecting Reserve Balances
Board of Governors of the Federal Reserve System
<http://www.federalreserve.gov/releases/h41/Current/research.stlouisfed.org>
February 2011



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Repurchase Agreements: All Maturities

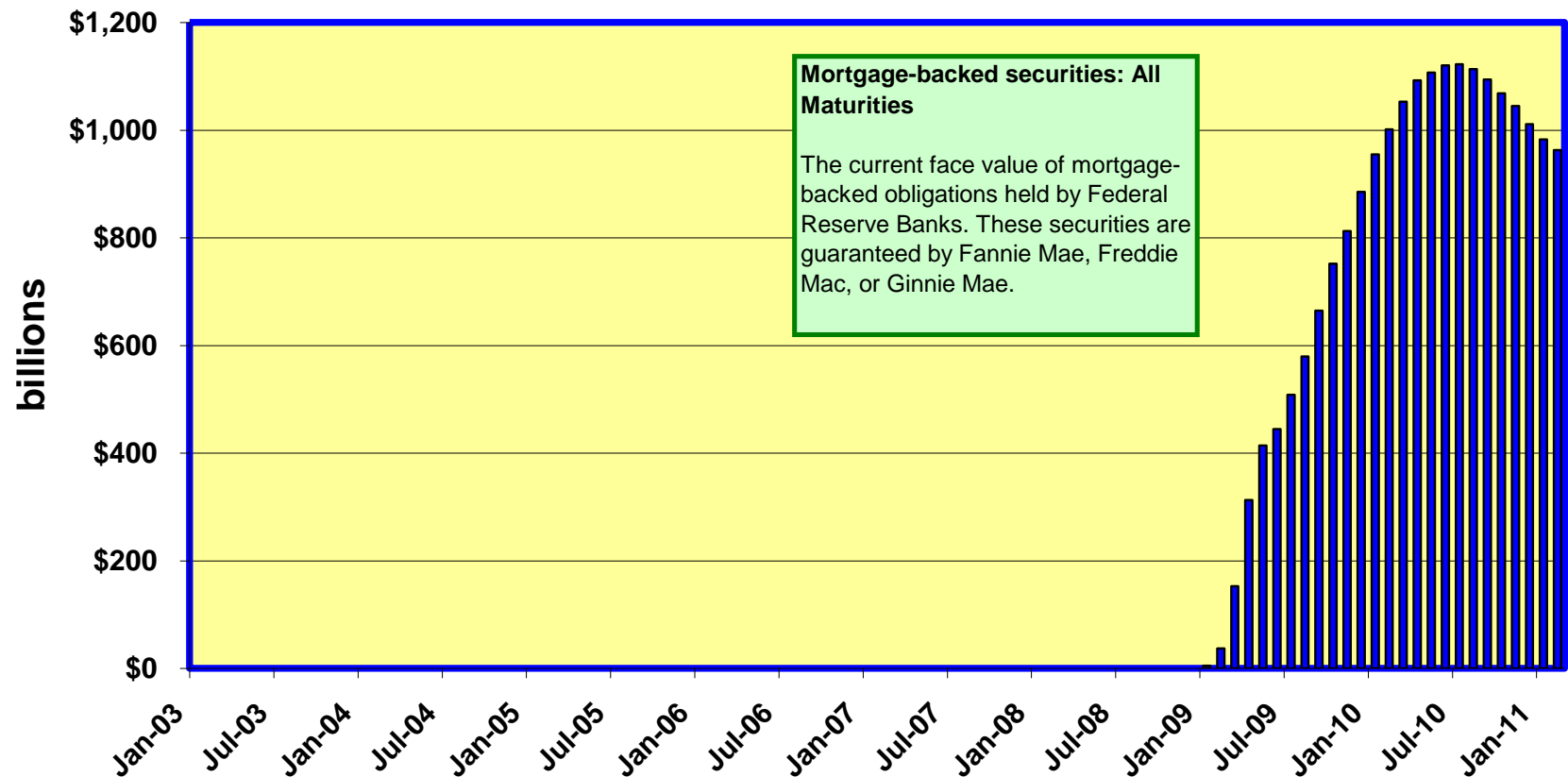
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[MBS] Mortgage-backed securities: All Maturities

H.4.1 Factors Affecting Reserve Balances
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research.stlouisfed.org](http://www.federalreserve.gov/releases/h41/Current/research.stlouisfed.org)
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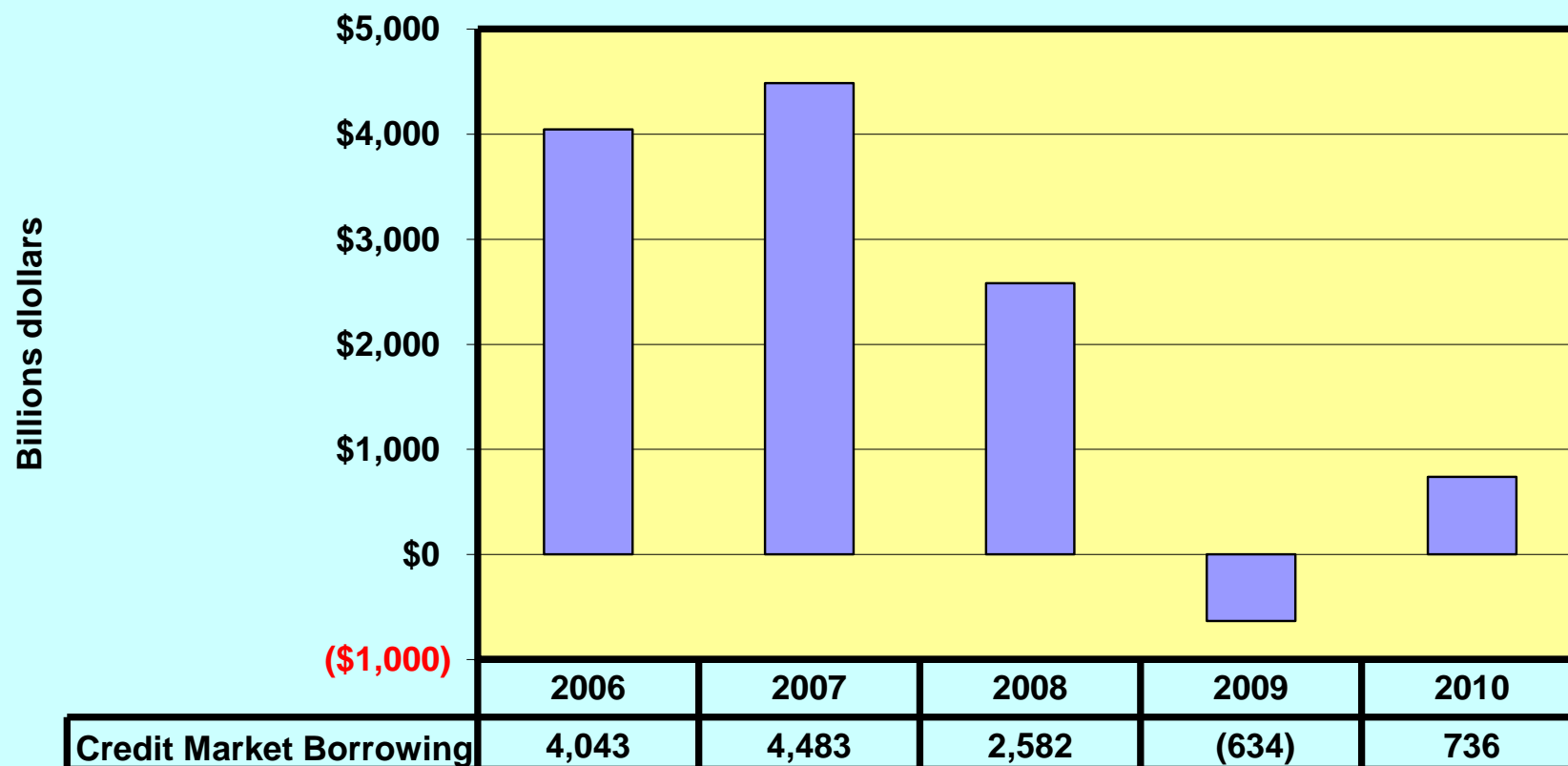


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An examination of the following charts is very helpful in revealing where credit creation has been weak. The first two charts below show total credit market borrowing and then its breakdown by sector. First note the collapse beginning in 2008 and the anemic revival in 2010.

Credit Market (Borrowing)

Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011



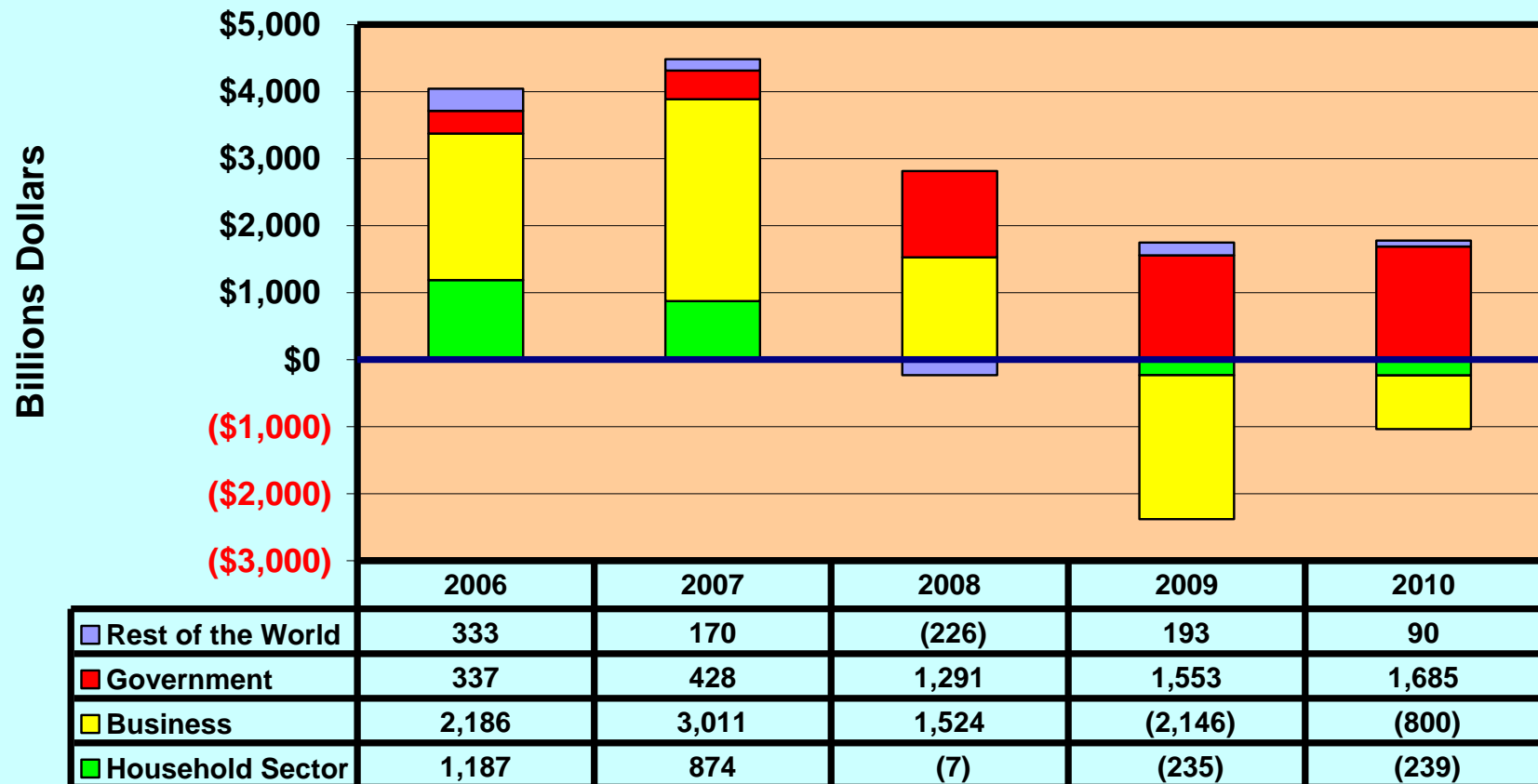
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Credit Market Borrowing by Sector

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



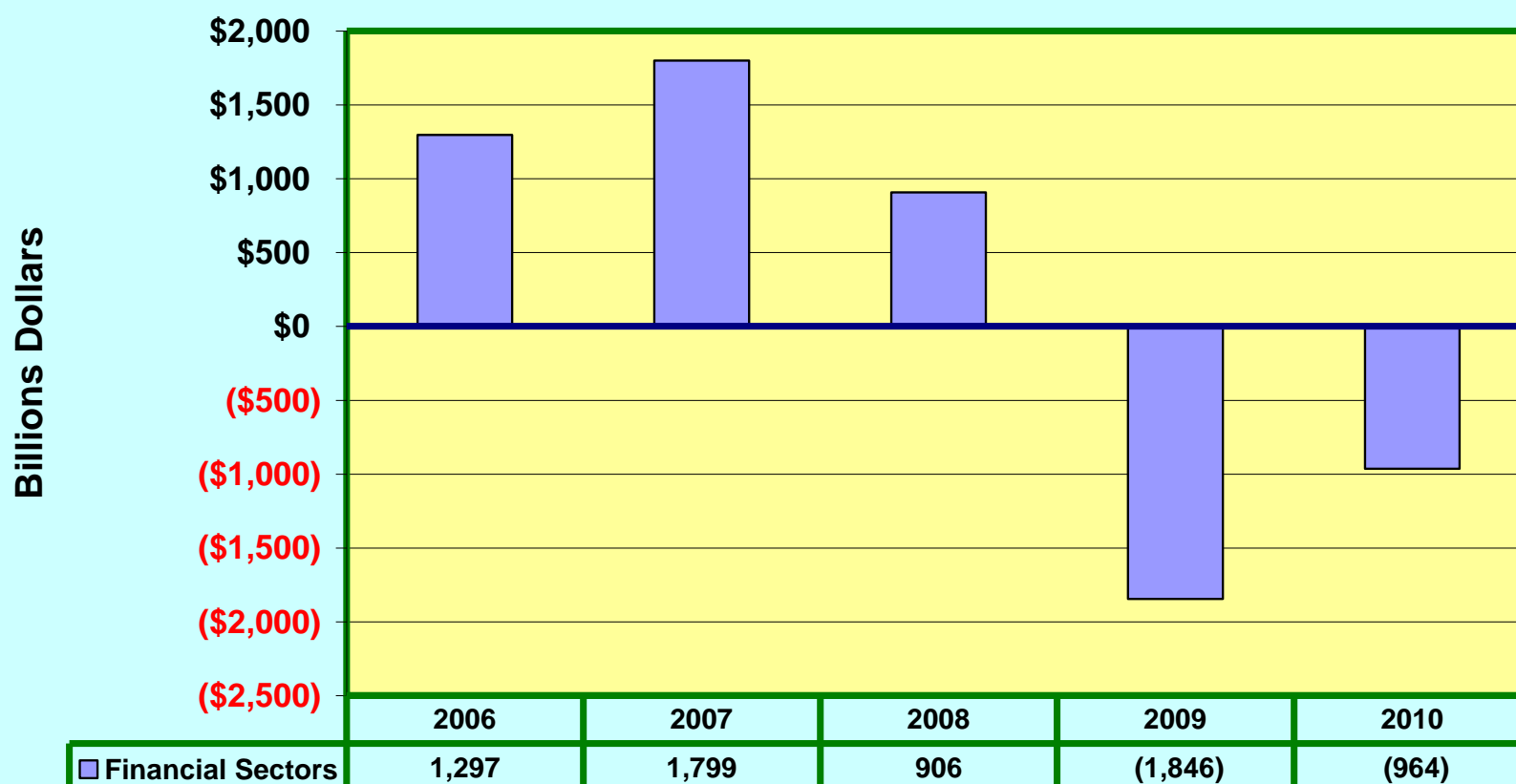
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Drilling down on the Financial Sectors...[BORROWING]

Credit Market Borrowing Financial Sector
Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011

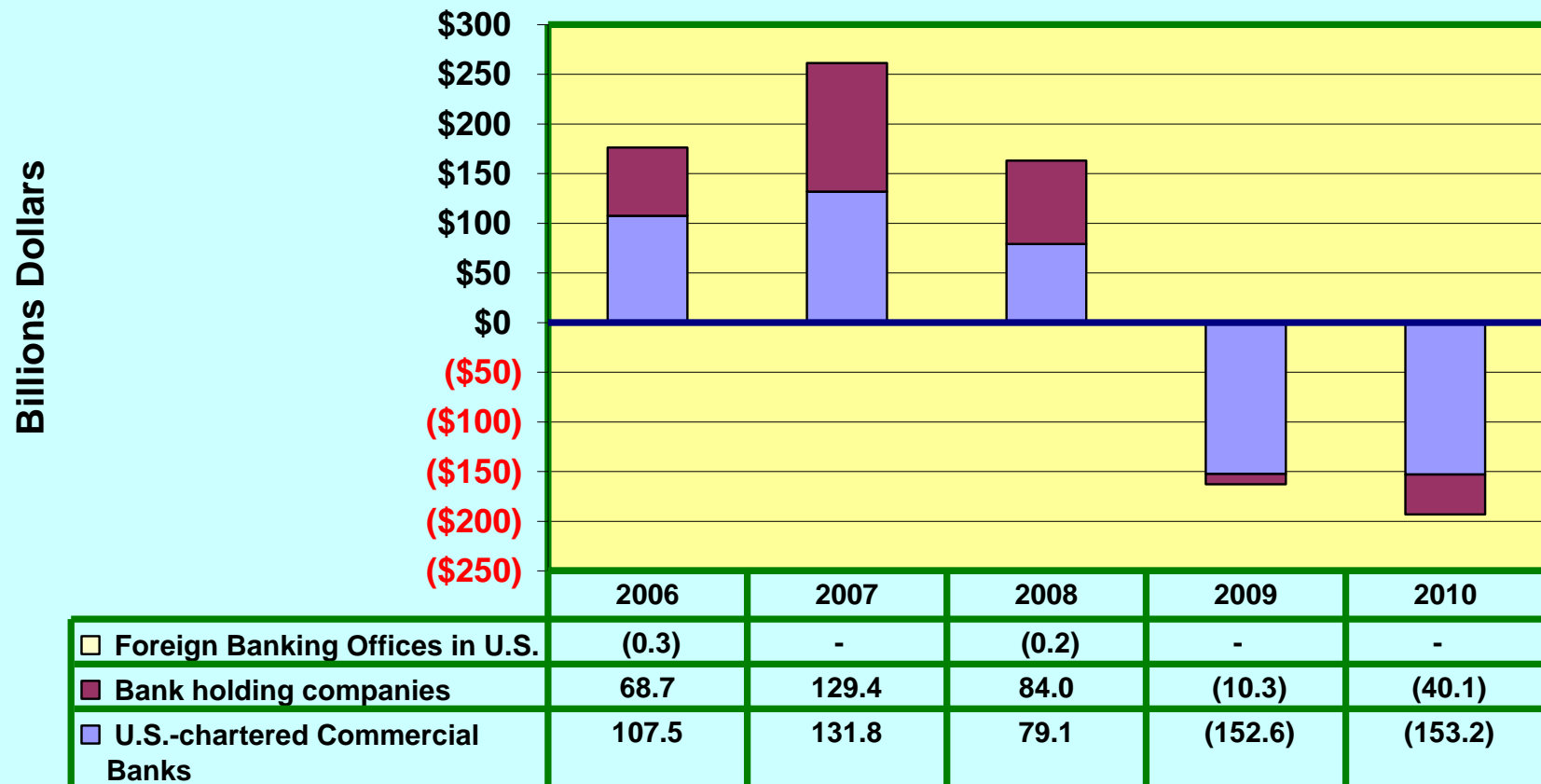


Credit Market Borrowing Commercial Banks

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



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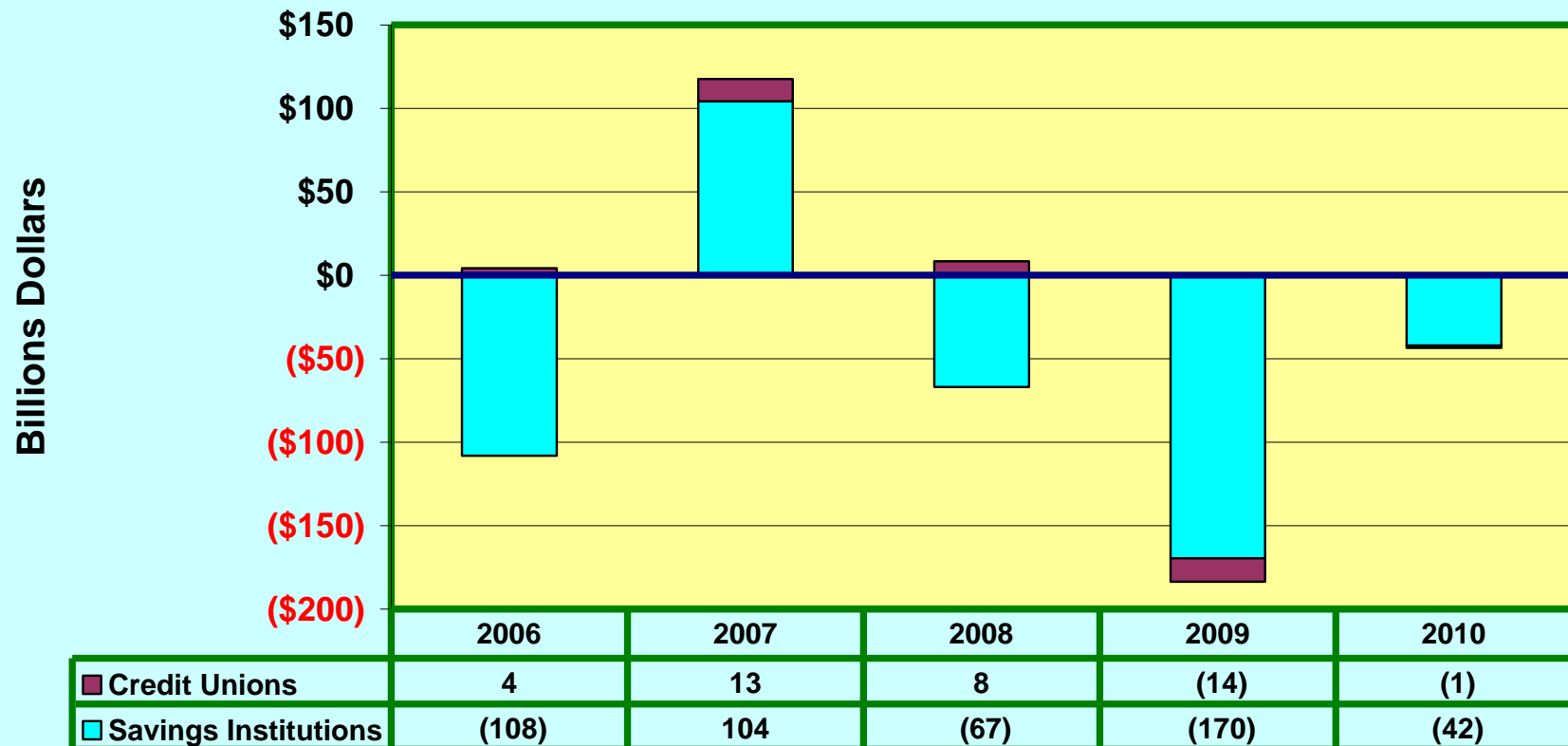
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Credit Market Borrowing Credit Unions and Savings Institutions

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011

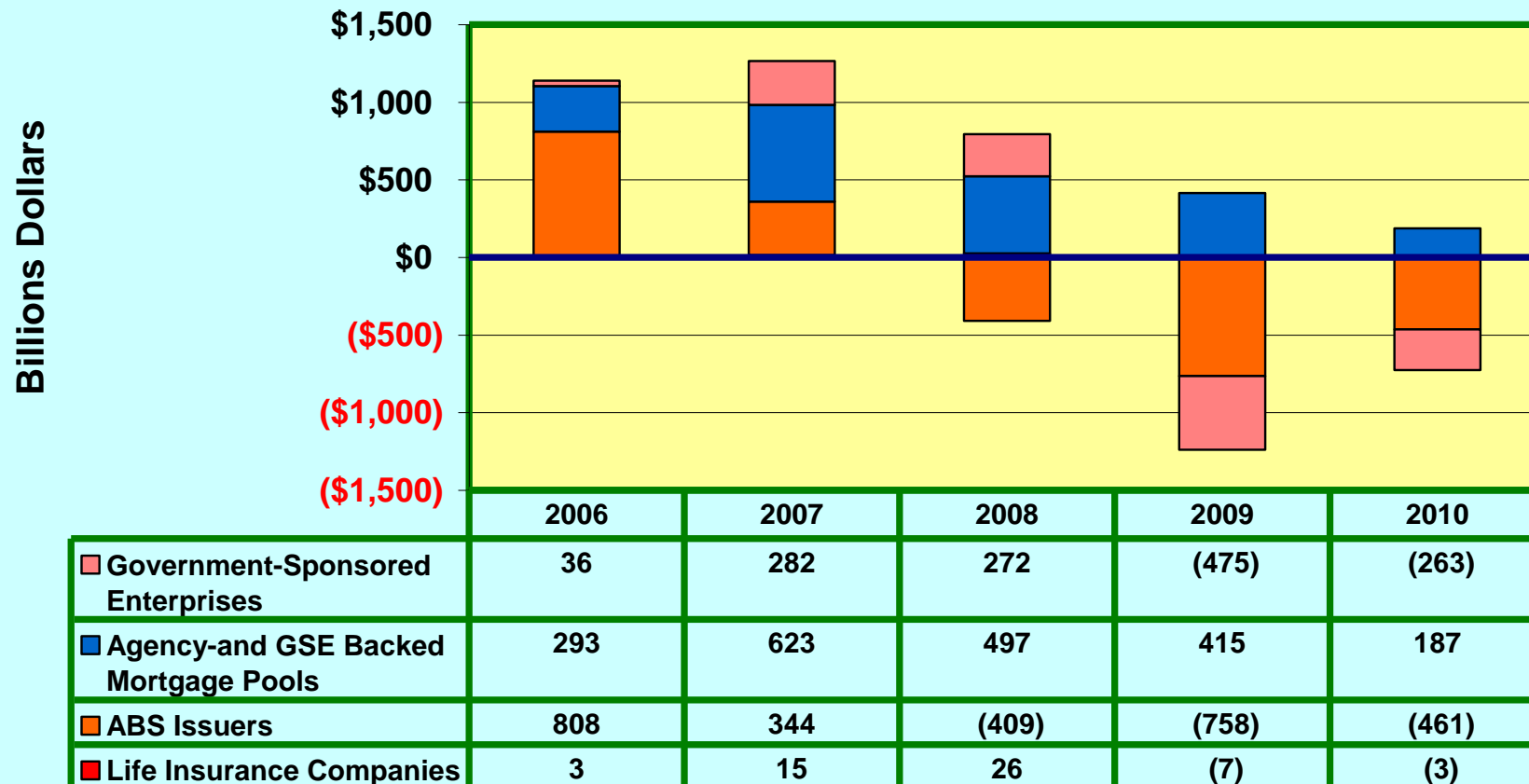


Credit Market Borrowing within Financial Sector

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



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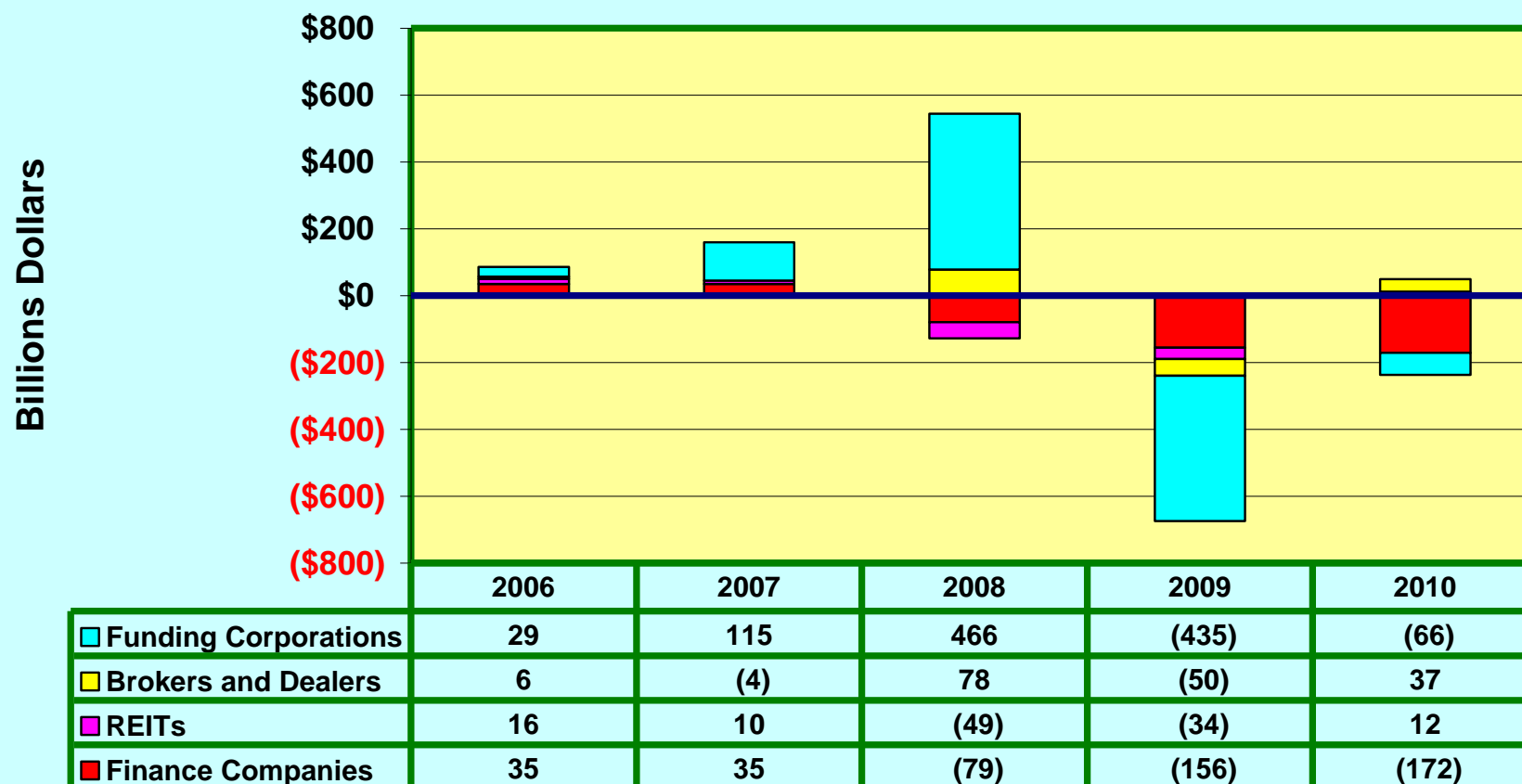
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Credit Market Borrowing within Financial Sector

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



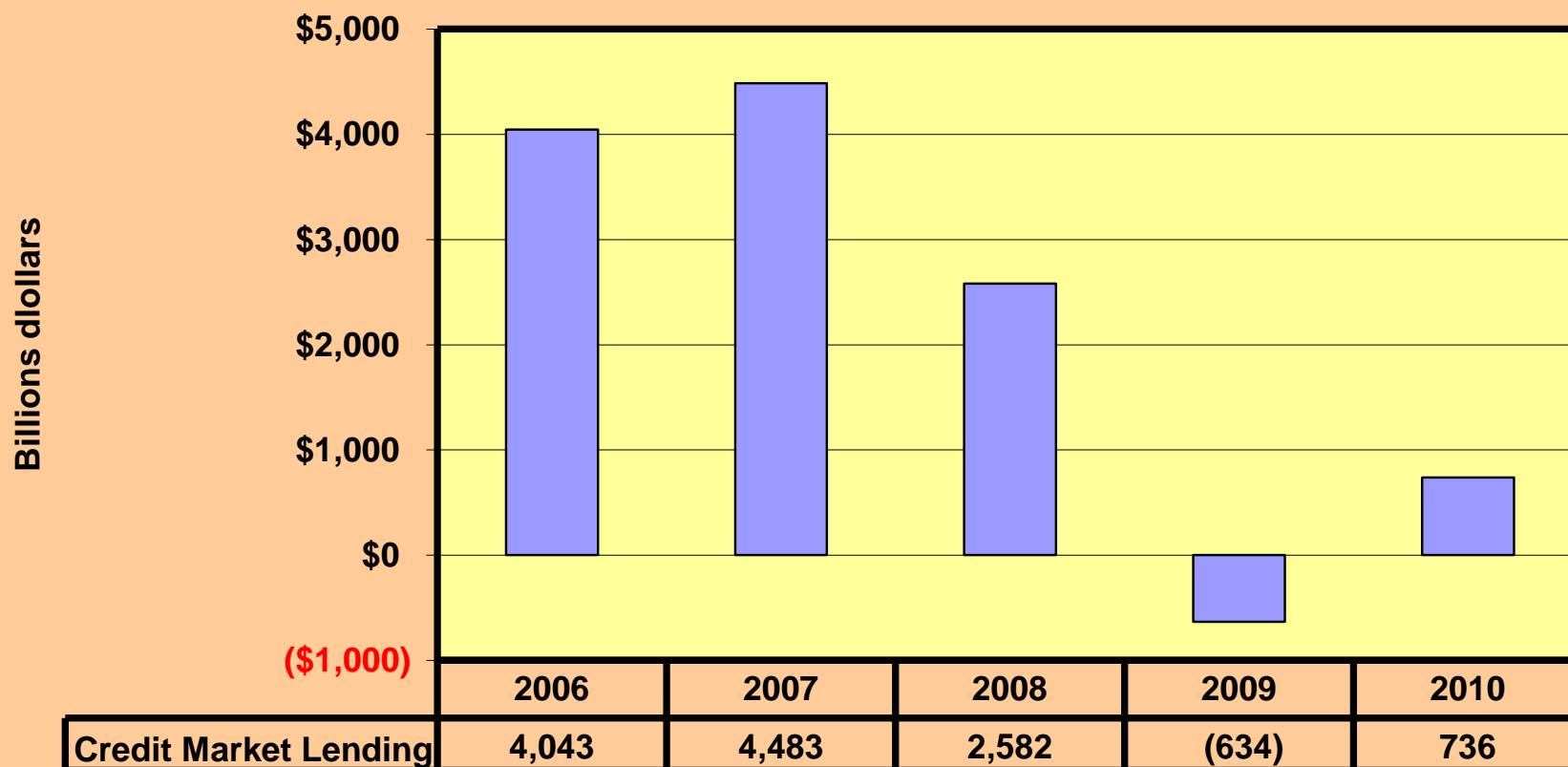
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Credit Market (Lending)

Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011



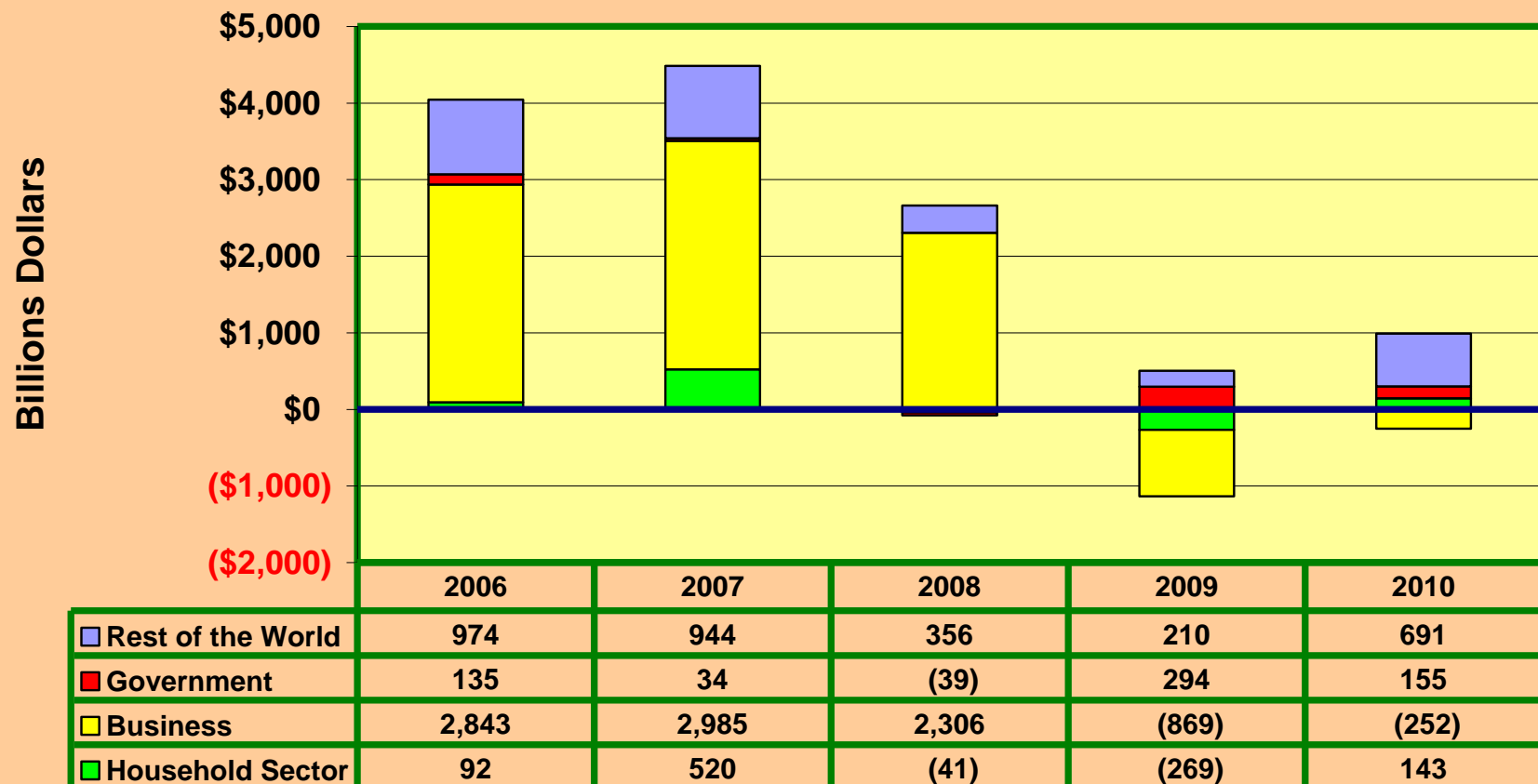
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Credit Market Lending by Sector

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



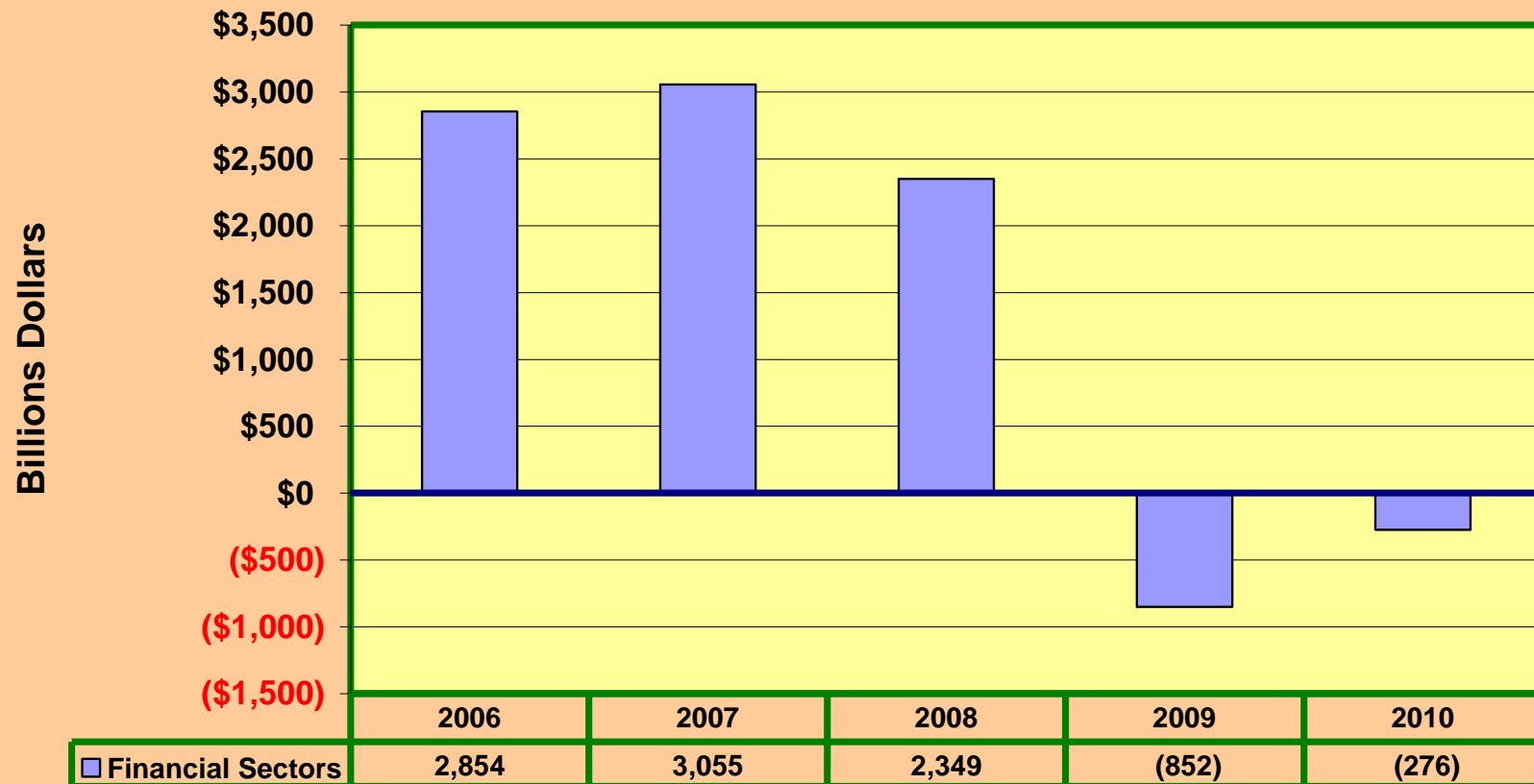
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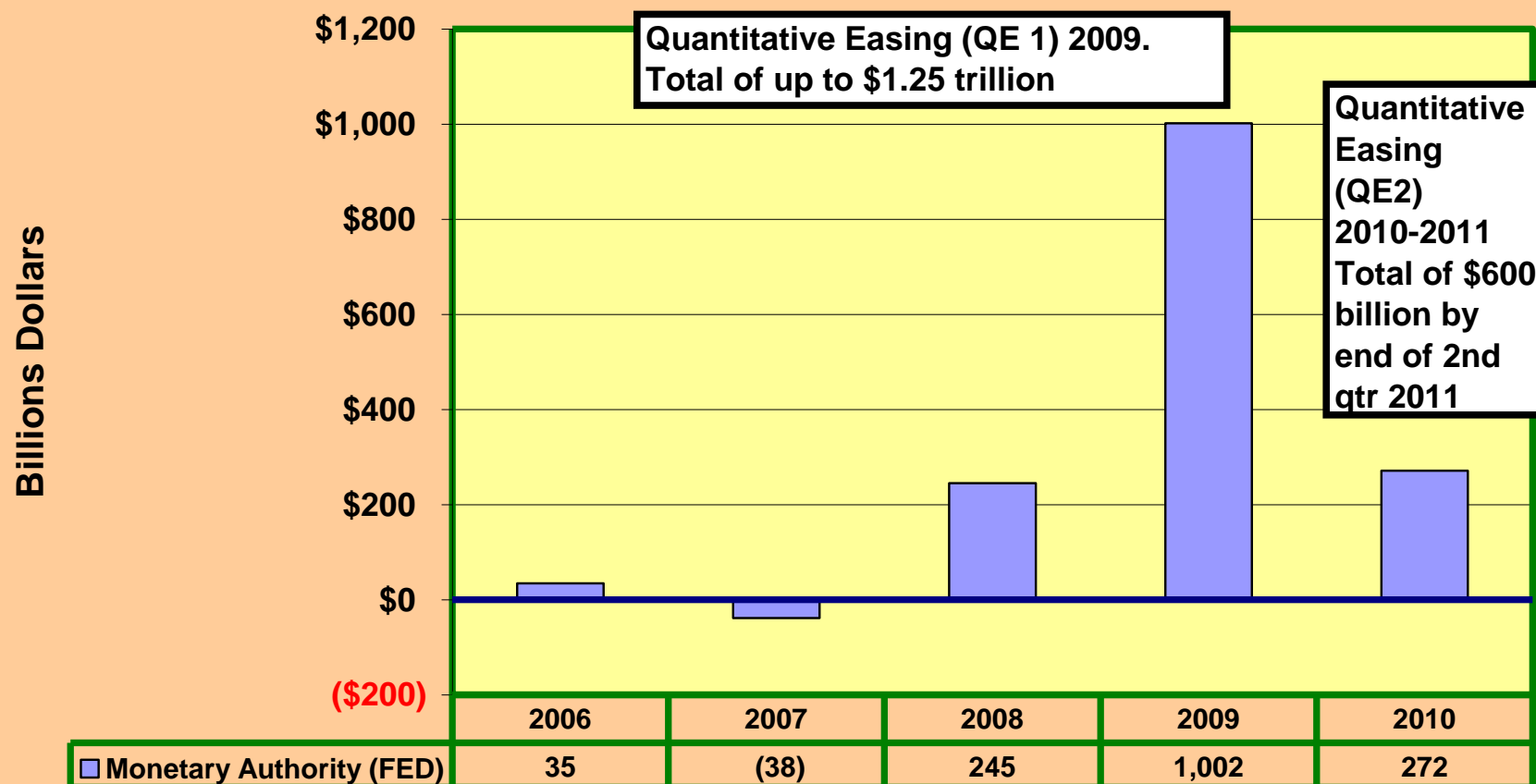
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Drilling Down in the Financial Sector...[LENDING]

Credit Market Lending Financial Sectors
Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011



Credit Market Lending Federal Reserve
Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011



QE 1 = 2009

Release Date: March 18, 2009

<http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm>

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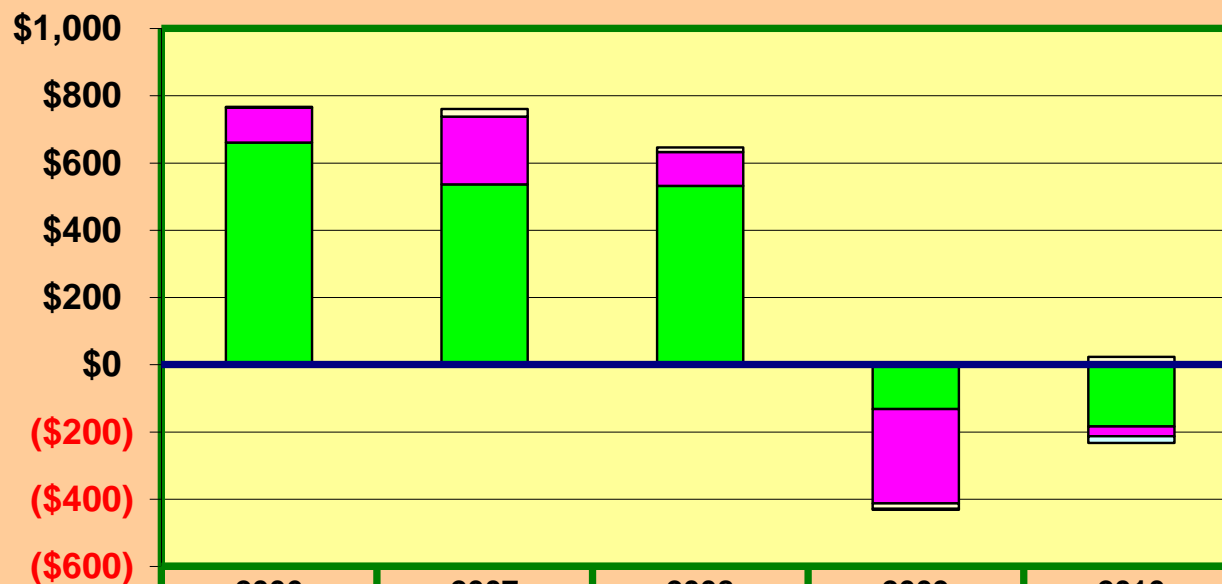
Credit Market Lending Commercial Banks

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011

Billions Dollars



	2006	2007	2008	2009	2010
Banks in U.S.-affiliated areas	(2)	(6)	(2)	(3)	(19)
Bank holding companies	3	23	14	(16)	23
Foreign Banking Offices in U.S.	104	202	101	(281)	(30)
U.S.-chartered Commercial Banks	660	536	531	(132)	(184)

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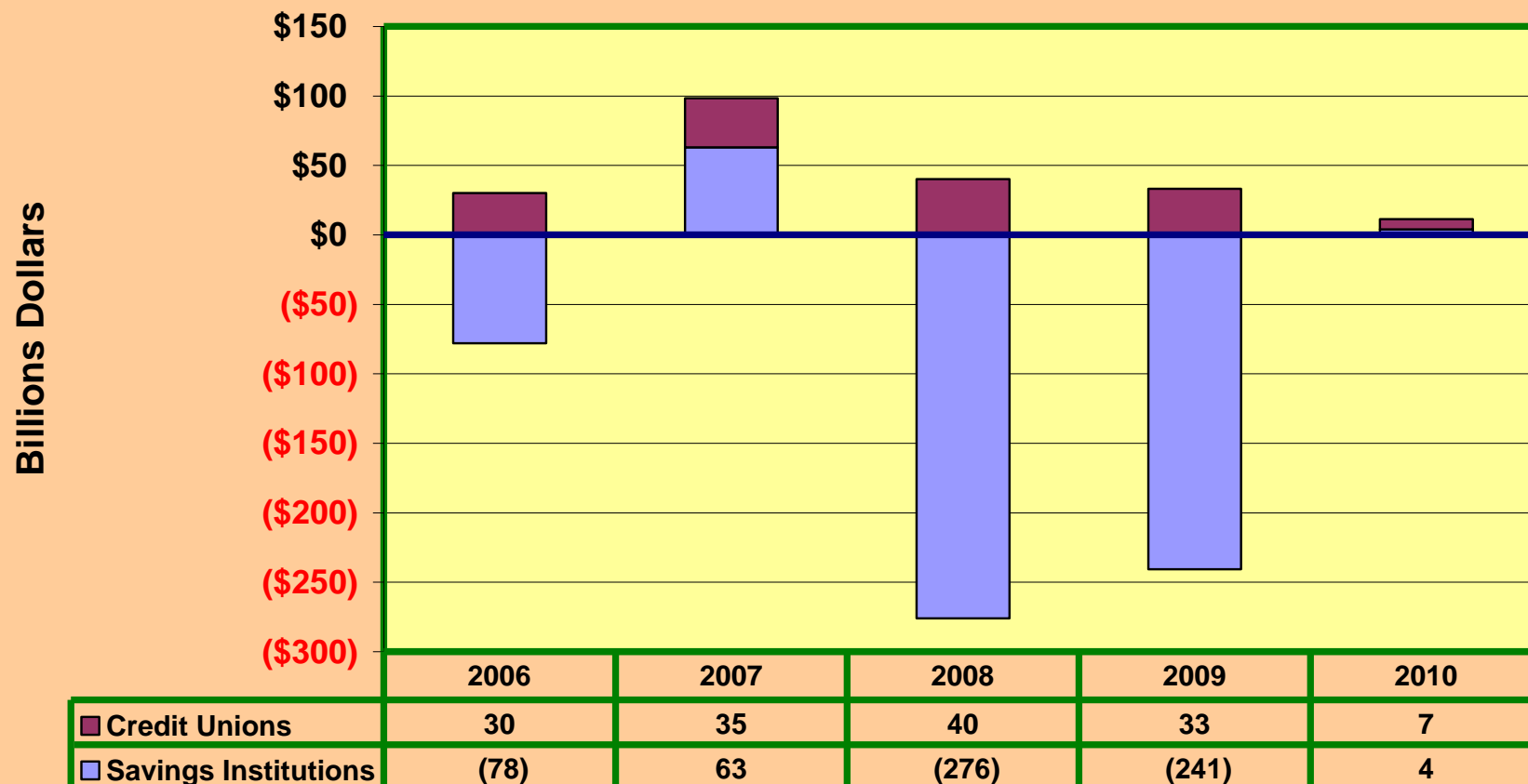
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Credit Market Lending Credit Unions and Savings Institutions

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

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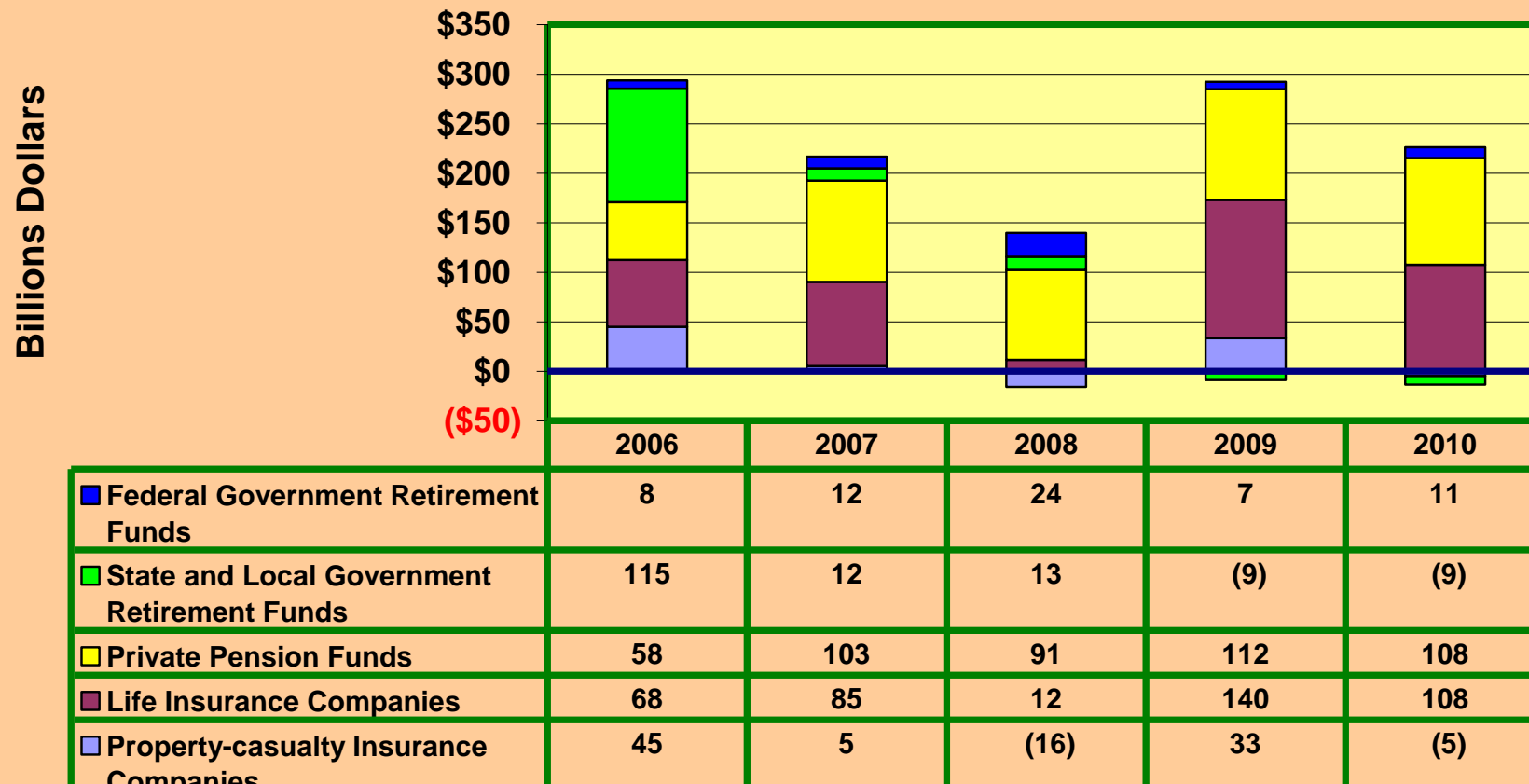
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Credit Market Lending Pensions and Insurance Companies

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



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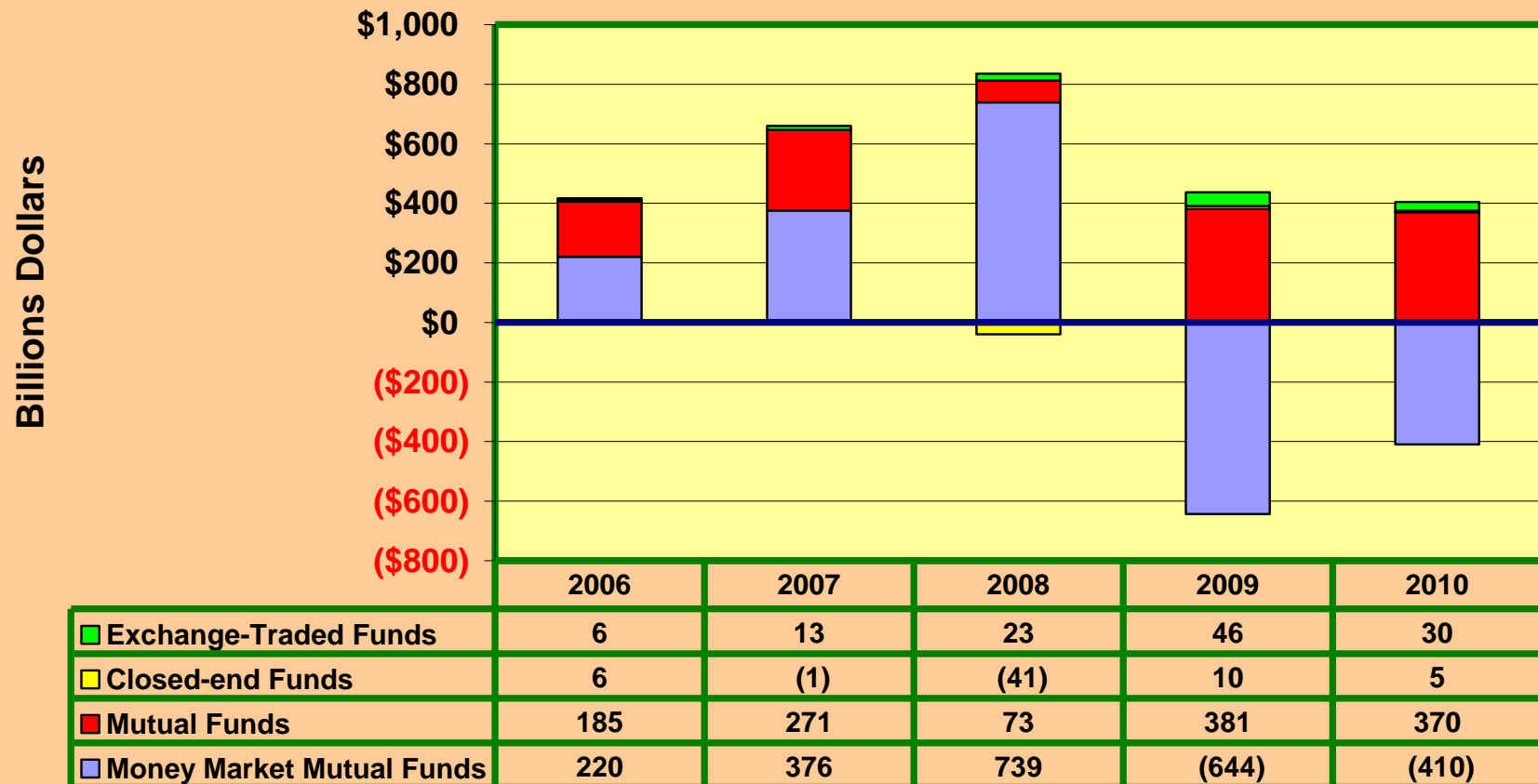
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Credit Market Lending [Investing]

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

March 10, 2011



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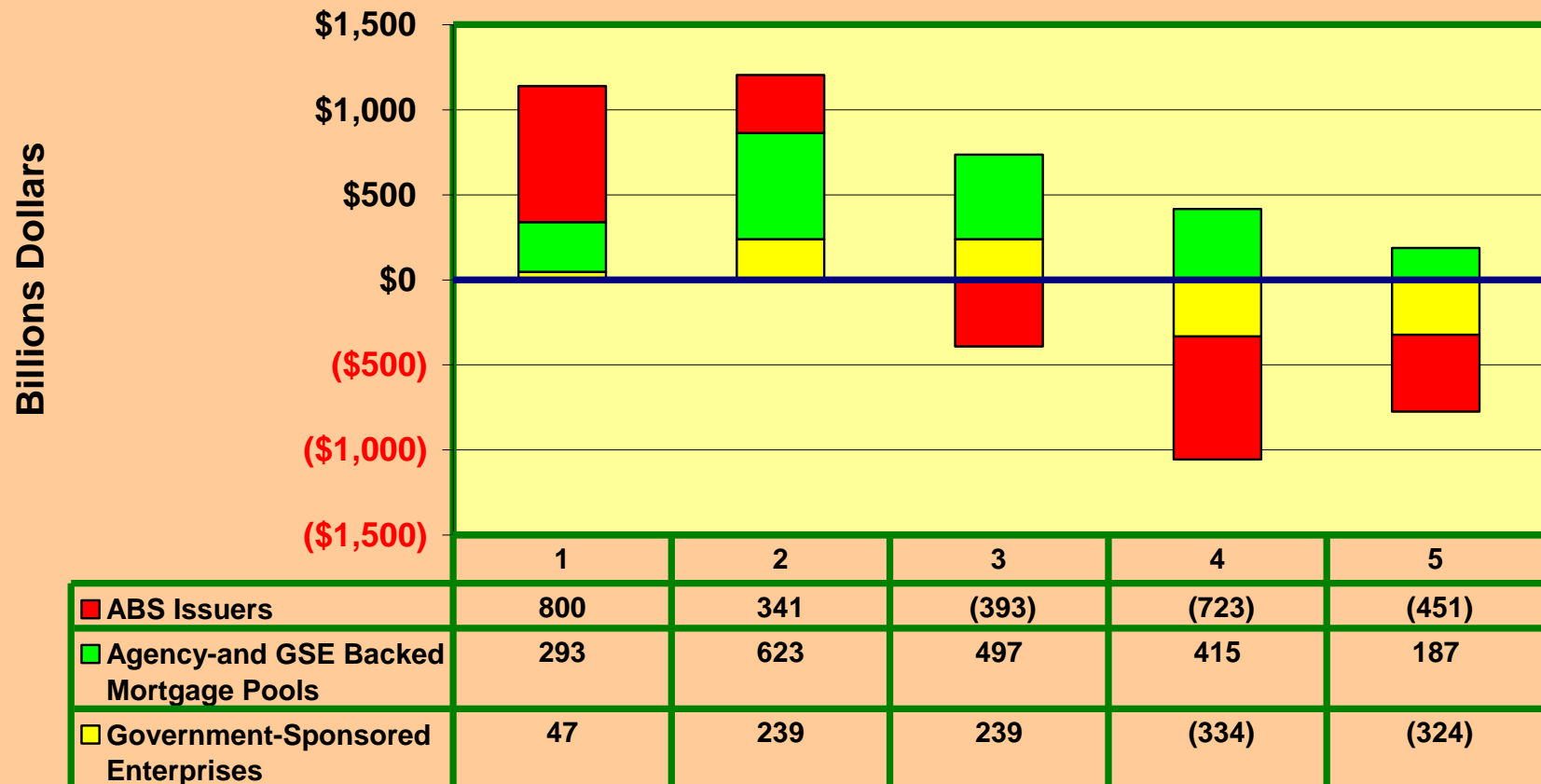
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Credit Market Lending [Investing]

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

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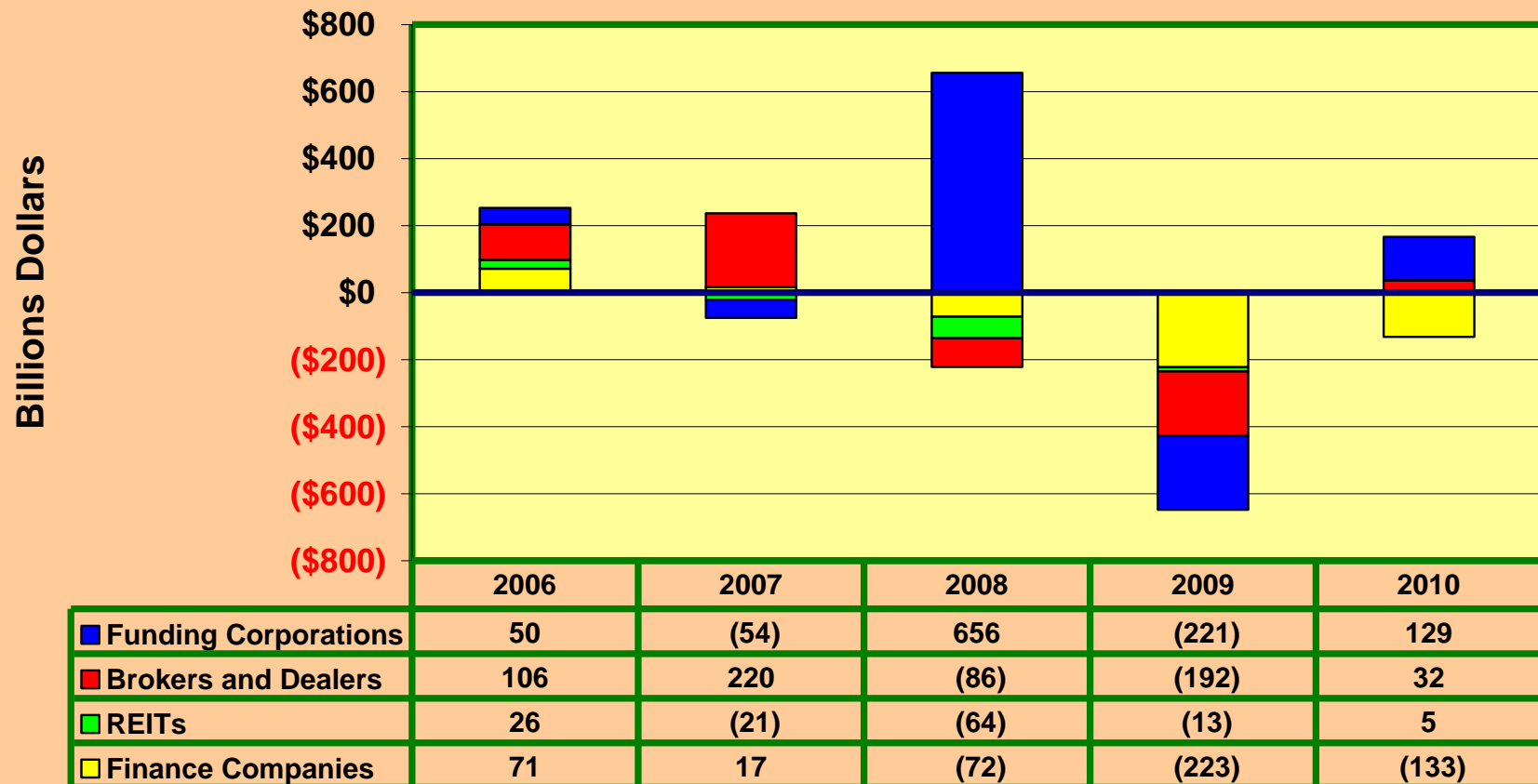
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Credit Market Lending [Investing]

Federal Reserve Flow of Funds

Table F.1 Total Credit Market Borrowing and Lending

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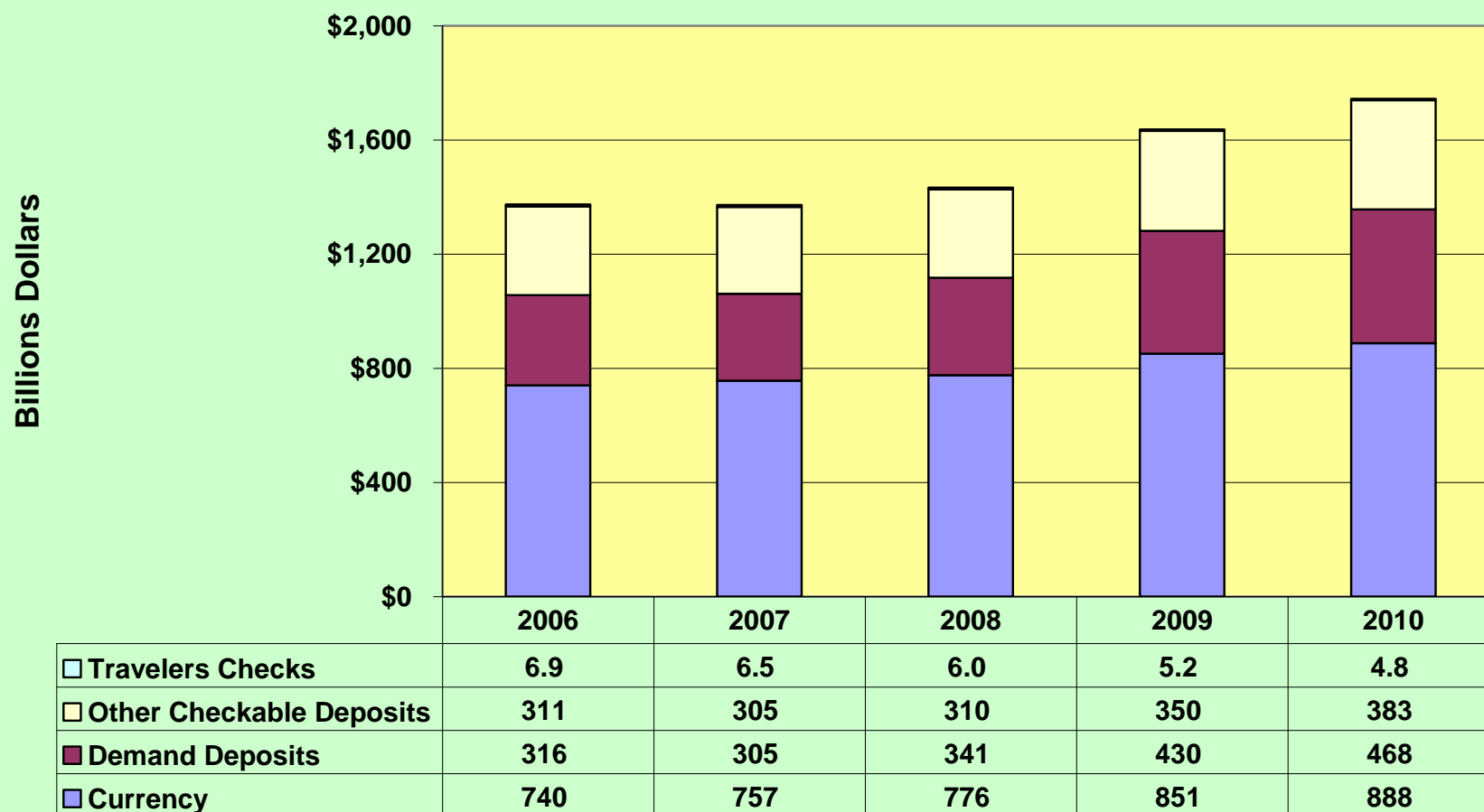
THE BASIC THEORY OF CREDIT CREATION

Recall that only depositories (commercial banks, savings banks, credit unions and savings and loan associations) can create credit by creating additional M-1 money and lending it out (in checkable deposit form: demand deposits, NOW accounts, share drafts at credit unions, and ATS accounts). Credit creation by non-depository financial intermediaries such as insurance companies, pension funds, finance companies and mutual funds, etc., is achieved by their increasing the velocity of existing M-1 money (by issuing substitute financial assets for already existing M-1 assets). These non-depository financial intermediaries cannot create checkable deposits and have to acquire the already existing M-1 money created by the depositories, usually in the process of creating credit. For example, a pension fund issues pension fund claims in exchange for checkable deposits from the contributors, either individuals or the firms that employ them. The pension fund can then lend the checkable deposits by making loans or investments, i.e. creating credit.

Components of M1 Money

U.S. Federal Reserve Board of Governors

H.6 Release <http://federalreserve.gov/releases/h6/current/h6.htm>

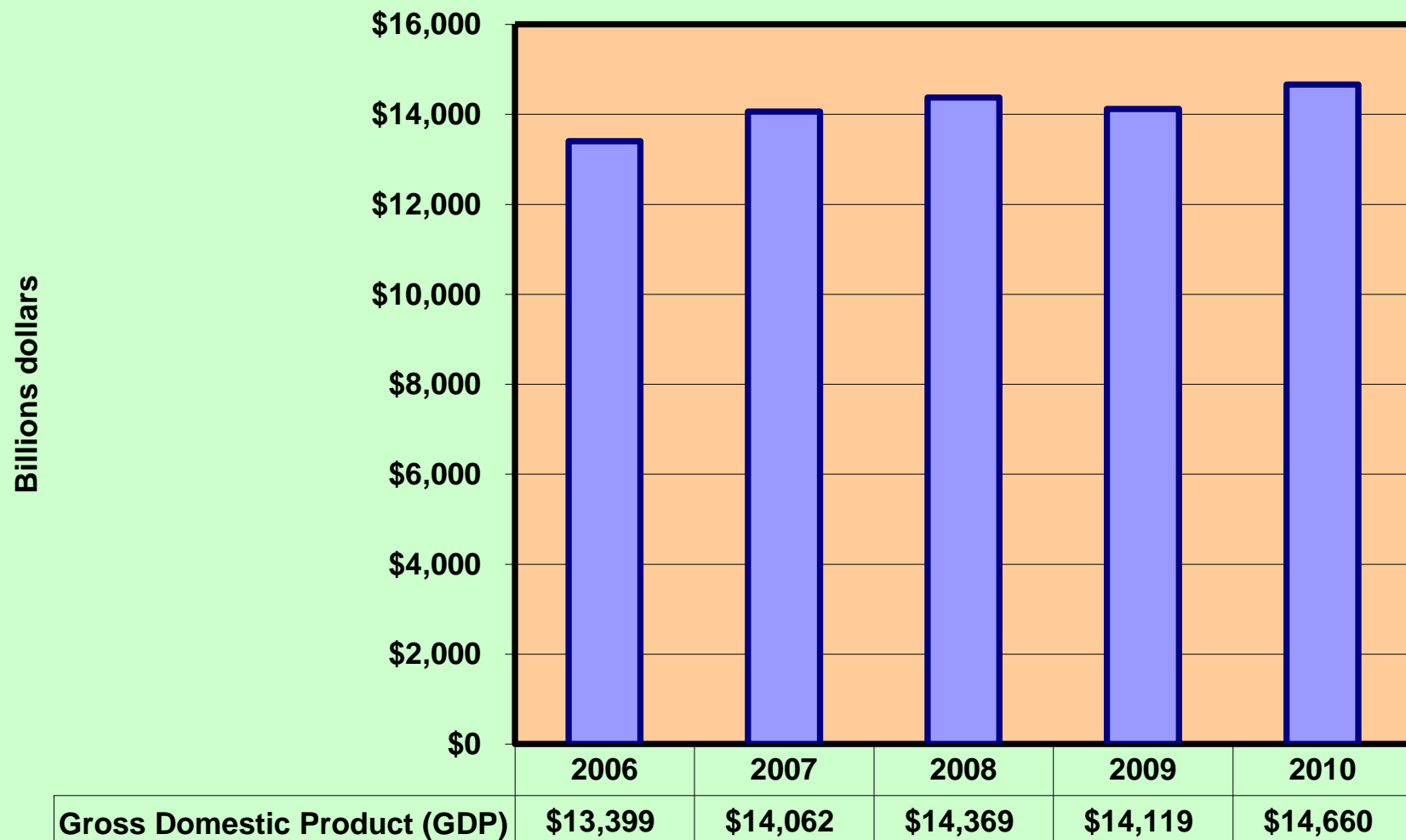


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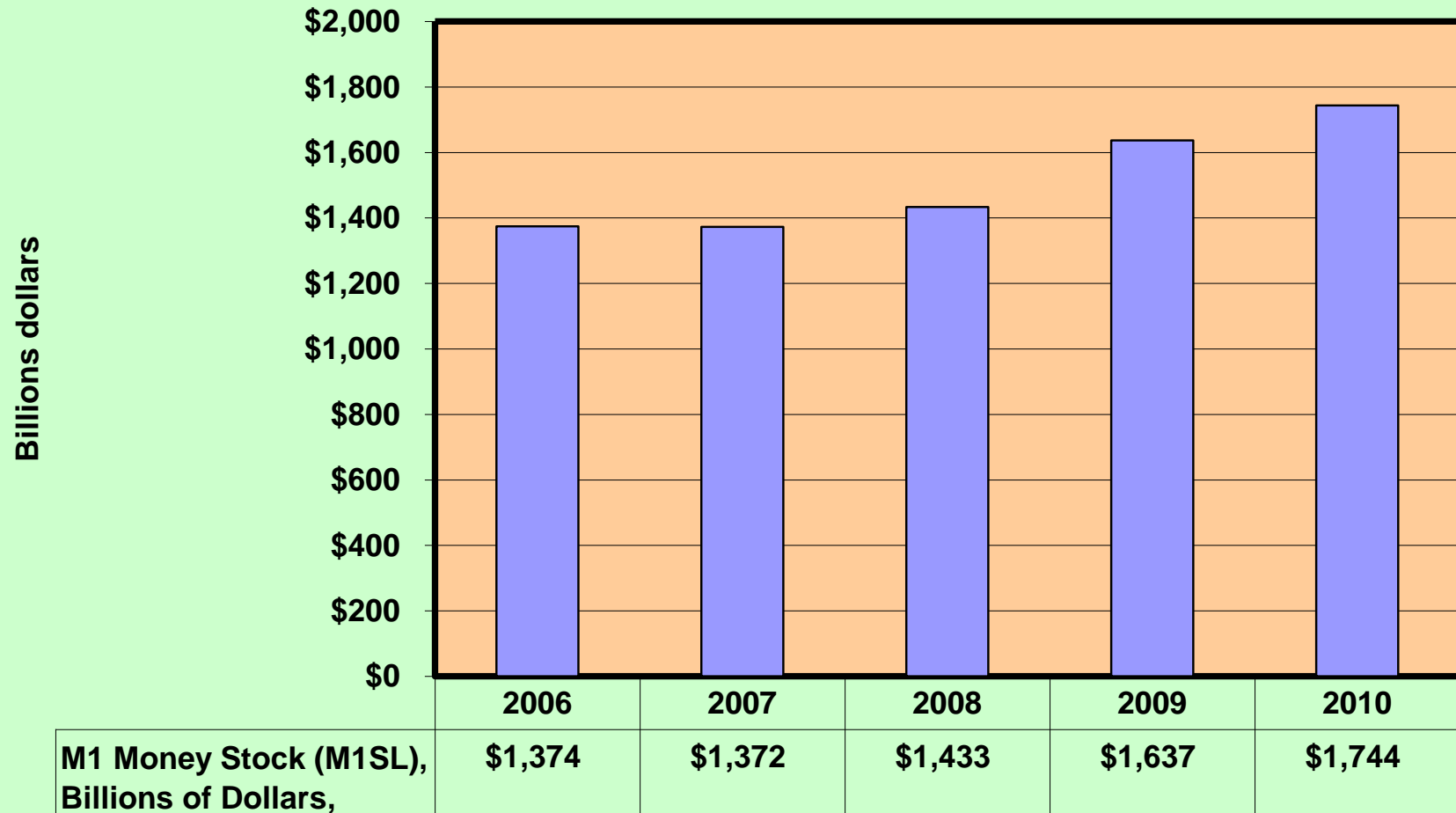
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Gross Domestic Product (GDP)



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M1 Money Stock (M1SL), Billions of Dollars **U.S. Federal Reserve**



Velocity of M1 Money
 (Gross Domestic Product / M1 Money Stock)
 M1 = Federal Reserve: GDP = Bureau of Economic Analysis



Velocity of M1 Money Stock	9.8	10.2	10.0	8.6	8.4
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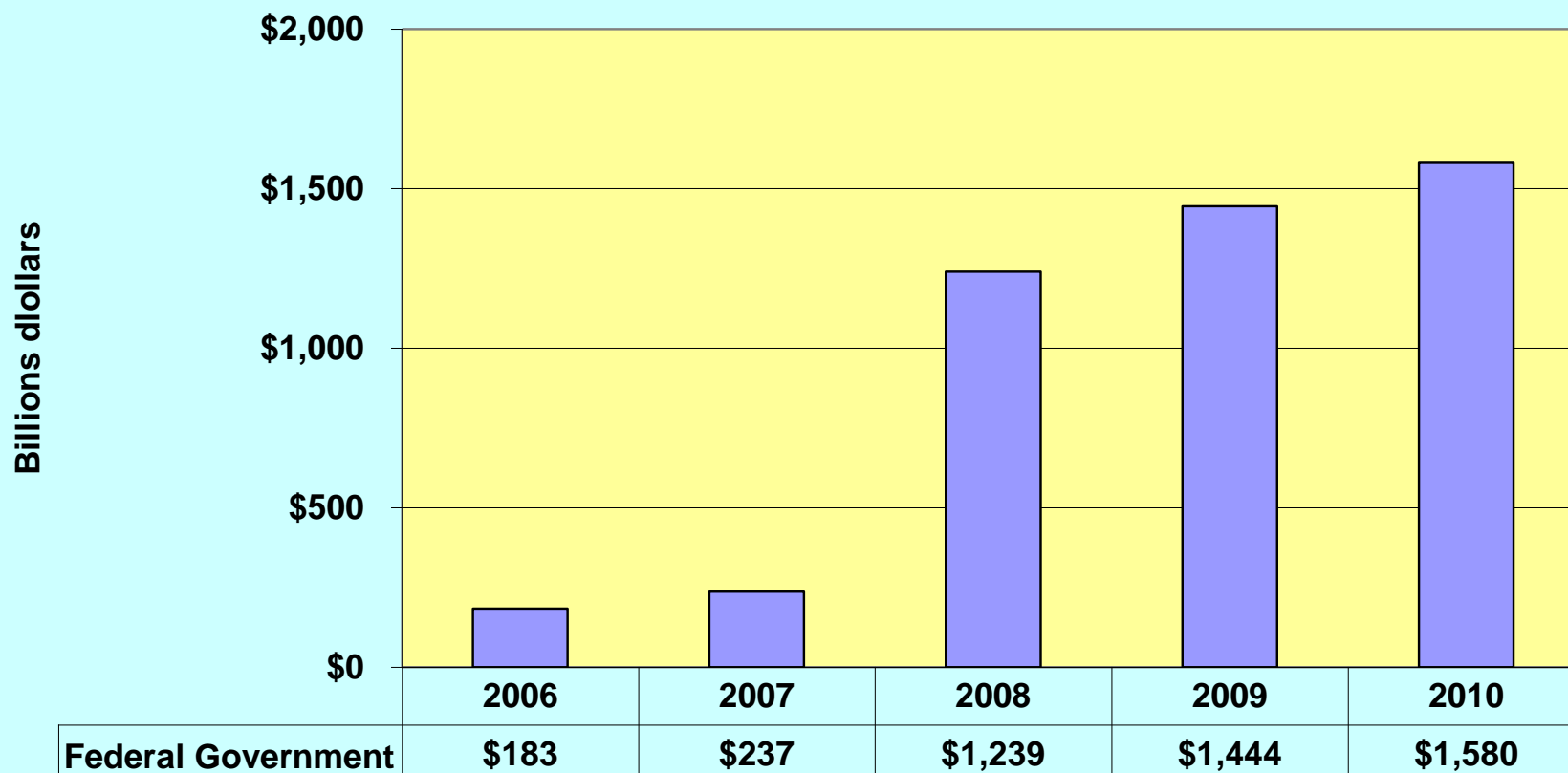
From the data, since all non-depository financial intermediaries as well as the depositories were reducing substantially their credit creation activities, the growth of M-1 slowed to a crawl and the velocity of M-1 fell sharply. This can be seen in the accompanying charts.

	Gross Domestic Product (GDP) (\$ billions)	M1 Money (\$ billions)	Velocity of M1 (GDP/Qty of M1)
2006	\$13,399	\$1,374	9.8
2007	\$14,062	\$1,372	10.2
2008	\$14,369	\$1,433	10.0
2009	\$14,119	\$1,637	8.6
2010	\$14,660	\$1,744	8.4

This was not the case for the U.S. Government which has been experiencing record deficits in the last (3) three years.

Federal Government (Borrowing)

Federal Reserve Flow of Funds
Table F.1 Total Credit Market Borrowing and Lending
March 10, 2011



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Glossary of Terms – Federal Reserve Board of Governors
http://www.federalreserve.gov/newsevents/reform_glossary.htm

just a few...

Asset-backed securities (ABS)

A security that is collateralized by a discrete pool of assets (such as loans, leases, or receivables) and that makes payments that are based primarily on the performance of those assets.

Agency mortgage-backed securities (agency MBS)

Mortgage-backed securities issued or guaranteed by federal agencies and government sponsored enterprises.

Mortgage-backed securities (MBS)

A security that is collateralized by a discrete pool of mortgage loans and that makes payments that are based primarily on the performance of those loans.

Depository institution

A financial institution that is legally permitted to accept deposits from individuals. Depository institutions include savings banks, commercial banks, savings and loan associations, and credit unions. These are often referred to as primary deposits. This is the chief way in which the depositories acquire legal reserves and enable them to create secondary deposits in the process of credit creation. Secondary deposits are those checkable deposits created by depositories in the process of their creating credit, i.e. making loans and investments. The total checkable deposits, as they relate to the total legal reserve of each depository institution, are called the legal reserve ratio.