Money and Treasuries in the 21st Century

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Introduction

"The difficulty lies, not in the new ideas, but in escaping from the old ones."

That quotation* is from many years ago, but the point is highly relevant today. This paper is about how the modern US financial system actually works. But in order to fully grasp the concepts, we do have to escape from the old ideas – to put aside traditional views that might have been useful in the past - and approach the topics with genuinely open minds.

This brief paper looks first at the nature of "money" in the 21st century US financial system, explaining how money operates in ways very different from what was taught in the past. It then moves on to the nature of Treasury securities in the US financial system, and the interactions between Treasuries and money. Then to Treasuries and US money in the international financial system. And closes with implications for economic policy.

1. Money in the US financial system

In economics and finance, "money" is just one type of financial asset. "Wealth" includes Total Financial Assets - bank deposits, stocks, bonds, other financial instruments, and nonfinancial assets, notably real property. **"Money" consists mainly of bank deposits - which are liabilities of banks** - plus currency in circulation, which is relatively small.

Money in the modern reserve banking system of the US grows almost entirely by bank lending and investment: *banks actually create the money for loans as they lend.*

When a bank makes a loan, it adds the amount lent to a deposit account of the borrower, increasing the bank's liabilities, and records an equal increase in assets - the loan. **The new money is literally created by the bank in accounting entries in its books.** The banking system **cannot use existing money**, which are liabilities of banks to specific depositors, to provide money for borrowers. The banking system **always** creates new deposits exactly equal to its new lending and investment. **Growth in total money in the system is the *result* of increased bank lending, *not* the cause.**

The only other way that total deposits can be increased is by Fed purchase of bonds. Deposits in aggregate cannot be changed by the actions of depositors themselves; money is never consumed or created by depositors. Account holders just move money from one bank account to another, with no change in total deposits.

Sometimes articles assert that Americans need to save more so that there will be more money available for banks to lend for productive Investment. **But that is not right, for two reasons: consumers cannot increase the amount of money in the banking system; and banks do not and cannot use their deposits to make loans.**

Many people think of "money" as the "real thing" – the most solid financial asset they can hold –"money in the bank". But it is actually a set of bank liabilities, with bank risks.

Depositors with bank balances up to $250,000 can rely on FDIC insurance, in which the US government guarantees the safety of the deposits. But companies, investment funds, trust funds, foreign governments, and other **entities which may deal with tens of millions of dollars, or hundreds of millions, or billions, know that deposits are liabilities of banks, not backed by the US government.** Bank money is usually considered lower risk than corporate bonds and many other financial instruments, but has risks of each bank.

This paper uses the term "bank money" as a reminder that money is really claims on US banks, and a bank's ability to honor its deposit liabilities depends on the quality of its assets and operations at all times.

Banks themselves hold "reserves" with *their* bank - the Fed, which pays them interest on the reserves. Reserves can be used only for transactions between banks and the Fed and through the Fed; reserves cannot be loaned to bank customers. When a depositor moves money from bank A to bank B, the Fed electronically moves that amount of reserves from the Fed account of bank A to the Fed account of bank B; the aggregate reserves at the Fed are unchanged. An individual bank that may need more reserves at some point can borrow from other banks, since the total reserves in the system are far more than needed.

When the Fed buys bonds in the market, it adds to total deposits and reserves; it creates money. When the Fed sells bonds, it reduces deposits and reserves, taking money out of the system. **Deposits created over time by net purchases by the Fed currently amount to about 15% of total US deposits. Those deposits are not guaranteed by the Fed;** they are ordinary deposits, with bank risk.

Money and Inflation

Although many factors can cause inflation, fundamental inflation results when demand exceeds supply. When people try to buy more than is produced, prices naturally rise. If high spending occurs when there is not much free capacity, then the excess demand can lead to excessive inflation. In such a situation, the Fed often acts to slow demand by slowing the growth of lending by banks; the slower lending also slows down the growth of money. Even many who follow monetary theories believe that increased spending in strong economic times causes inflation; but many mistakenly believe that increase in money *causes* the increased spending. **It is often seen that growth in money and increased inflation occur with correlation; but the *causal* factor is the growth in bank lending, which enables borrower spending; the lending *also* creates the new money.**

The concern that growth in a "money supply" caused inflation traces back to monetary theories developed many years ago, when the banking system was much different from today. The theory was that a "supply" of money increases, likely from Fed actions, and the banking system uses that new money to lend more. **But that is not how the modern US banking system works.**

The concept of "money supply" reflected the practice when the Fed required that new deposits required a percentage moved from the "excess reserve" of each bank at the Fed to its "required reserve". This system was often referred to as **"fractional reserve banking"**, which meant that banks wanting to make loans had to have, in their Fed accounts, the excess reserves that would be required as a fraction of the resulting new deposits. The Fed kept total excess reserves very limited, controlling the amount available for banks that wanted to make new loans.

All that has changed for the US banking system. **In 2008,** in response to the financial crisis, the Fed started actively buying bonds - which **increased excess reserves by about 3,000 percent, to more than $3 trillion – far more reserves than US banks would need for loan growth**. **In addition, since 2020, the Fed has maintained a reserve requirement of zero percent**. So, although the fractional reserve system is still technically in place, it has no practical effect; banking system growth is no longer limited by reserves. Each bank is still required to maintain capital adequacy to support its total risk assets. But **total loan growth, and the growth in deposits (bank money) that is created by the lending, are not limited by a "money supply".**

2. Treasuries in the US Financial System

Now we move on to the most challenging part of "escaping from the old ideas", stepping back from preconceptions and common assumptions. **"National debt" has long been considered by many as similar to personal or business debt.** However, we know that there have been many instances, over history, when things turned out to be very different than they seemed. Perhaps most notable was that it seemed obvious for centuries that the sun moved around the earth – until thoughtful examination showed that is not how the solar system works. **As Mark Twain put it: "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."**

This paper looks at money and Treasuries in non-traditional ways, laying the groundwork to understand Treasuries as unique financial instruments issued and guaranteed by the US government. The analysis starts with how Treasuries fit in the modern US financial system, and how Treasuries are very different from "debt" as the term is normally used for commercial and personal purposes. **That leads to understanding of why the expression "national debt" is highly misleading, carrying perverse implications for Treasury securities.**

2.1 As discussed above, money is one form of US Dollar (USD) financial asset, with its own characteristics, including bank risks. **Treasuries are a form of financial asset issued by the US government, with its own characteristics, including the lowest risk of any USD asset.**

Paper currency, another form of government-issued financial asset, is handy for small transactions, but does not bear interest. **Treasuries are well suited for large investments, bear interest, and can readily be exchanged for bank money to accommodate financial transactions.** Treasuries are also important components of savings for individuals, companies, trusts, and others.

The Treasury and the Fed are separate organizations, but both are parts of the US Government, and often work together. The Fed can buy an *unlimited* amount of Treasuries in the market. Many banks and their depositors have been rescued by funds provided by the government from issuance of new Treasuries. **The realization that "money" means bank risk is most poignant when people's own deposits are threatened by problems at *their* banks – and then they are relieved when the Treasury and Fed help them.**

2.2 Treasuries are not like Personal or Corporate Debt

Thinking about Treasuries as just bigger versions of personal debt is like addressing the Atlantic Ocean as if it were a big swimming pool. Although both are full of water, they are fundamentally very different. **Treasuries are unique forms of government financial instruments that serve as a key component of the financial system.**

The terminology of "lending" to the government, and the US as a "borrower" is highly misleading. Investors do not invest in Treasuries because they want to lend money to the government out of a sense of patriotism, or in search of higher interest rates than they could find elsewhere. The US government does not make applications to banks to borrow money. It offers investors opportunities to exchange bank money for government-guaranteed securities, in public auctions, with interest rates determined in the market. New Treasuries take the place of previous ones, with the same backing of the US government, but new interest rates. Treasury auctions have been used very effectively for nearly a hundred years. **The term "national debt" is highly misleading, and will not be used for the US in the rest of this paper.**

When investors buy corporate bonds, they exchange some of their bank money for a higher-risk financial asset with an interest rate appropriate for the risk. **But no corporation has an affiliate – like the Fed - that can buy its bonds, creating bank money in exchange, in unlimited amounts.**

When a Treasury security matures, investors have to accept bank-money in exchange – or roll over into new Treasuries, as many investors do. The US Treasury market is extremely wide and deep – with an average of nearly a trillion dollars traded daily - and plays a key role in the market pricing of a large number of instruments.

For holders of USD, Treasuries are rightly considered essentially free of credit risk. Treasury Bills, which are short-term, also have virtually no interest-rate risk. But l**onger-term notes and bonds with fixed rates will naturally have interest-rate risk, so their prices will fluctuate as current and anticipated interest rates change.**

Investors who want the most secure, stable USD assets can hold Treasury Bills. (For example, Berkshire Hathaway (Warren Buffet) reported holdings in 2025 of more than $300 billion of short-term Treasuries.)

2.3 There is never a need for taxes to "pay off" Treasuries

The last time the total of Treasuries held by the public was zero was in 1837 - nearly 200 years ago . The only times in the past 50 years when the total of Treasuries outstanding were reduced at all were a few years at the end of the 1990's. The term "pay off" means to provide bank deposits in exchange for Treasuries. While individual Treasury securities are often exchanged for bank money at maturity, the aggregate total, in the modern US financial system, is never "paid off," and never needs to be paid off; and there is no need for taxes to pay them down.

How could it make sense to try to "pay off" Treasuries? The total of all deposits in the US is about $20 trillion, not enough to pay off the roughly $30 trillion of Treasuries held by the public even if every dollar was used for that purpose. "Paying off" Treasuries would require a **huge movement of money from taxpayers to bondholders**.
Many people in Washington think that any reduction in Treasuries outstanding would be helpful in some way. **But why? There is no good reason to believe that reduction in Treasuries held by the public would help the US economy and its citizens.**

Many Americans are under the misimpression that some of the taxes they pay are used to reduce Treasuries outstanding. In fact, the amount of our tax dollars used to pay down Treasuries this year is zero, last year was zero, last decade was zero, next year will be zero, and the next decade will almost certainly be zero. And that is just fine. **There is no need to worry about it.**

2.4 Treasuries and US bank money in the international financial system

2.4.1 International context

It is well known that the US and the USD play central roles internationally. It is less widely known how large the amounts of assets are. **Foreign investors, including government entities, now hold about $62 trillion of US assets, while Americans hold about $38 trillion of foreign assets.** These assets include plant and equipment, real estate, stocks, bonds, bank deposits, Treasuries, and other financial assets.

Many of the US assets owned by foreign entities have resulted from years of decisions about business investments. But another key portion comes from the **cumulative foreign trade surpluses of countries around the world over 50 years: roughly $15 trillion USD that foreign entities own outright.**

2.4.2 The Role of US Treasuries Internationally

Foreign governments and companies invest their USD in a range of assets, and often want to hold significant amounts in liquid, low-risk forms. Holders of very large amounts do not want to leave too much in US bank money, which would mean taking and constantly monitoring the risks of US banks. So foreign holders of USD deposits frequently move significant portions of their bank money into Treasuries – the safest place for USD.

China and Japan do not have programs to "lend" money to the USA. They have USD from their net exports, and have to do something with it. They want to keep some of it liquid and safe, and prefer not to have too much US bank risk. So they invest some of their USD in Treasuries, in the market or at auctions.

The US dollar assets held by foreigners after years of US trade deficits can be shifted among types of USD assets, and shifted among foreign holders, but cannot be reduced in total - unless the US were to move to an overall trade surplus.

If China, which holds about 3% of total Treasuries outstanding, wanted to reduce its USD holdings, and sold some Treasuries to US investors, it would be paid in US bank money, so would have no reduction in dollar assets, just more US bank risk. China could trade some of their Treasuries to investors in other countries, for bonds denominated in other currencies, such as Euros or Pounds. Those Treasuries would then be held by different non-US investors. Such a program would have practical limitations, since bonds in those currencies do not have nearly the depth, breadth, and liquidity of US Treasuries.

Treasuries are the safest financial assets for USD. Some international investors (and rating agencies) may think that Swiss government bonds, for example, are perhaps safer than US Treasuries. That might be fine advice for investors who hold Swiss Francs (CHF). But if some investors who hold dollars wanted to invest them in CHF, they would need to exchange USD for CHF, and then invest the CHF in a much smaller market.

2.5 How US Treasuries Work in the Financial System

There are many more misunderstandings about Treasuries. Here are some key clarifications:

2.5.1 Treasury issuance of securities does not change the total amount of money in the system. Treasury pays out the proceeds of new issuance for government expenditures. The public then holds the same amount of money as it did before. Money moves through the US financial system through many thousands of channels, to many accounts in many banks.

2.5.2 Interest paid on Treasuries does not consume economic resources such as labor or factory production. If interest expense increases, new Treasuries can be issued. Although government budgeting often treats interest as a part of total expense, economists have recognized this distinction for years, and use the terms "primary budget" and "primary deficit" for figures that exclude interest.

2.5.3 There are no marketable Treasury securities in the Social Security "fund". The fund has a set of internal accounting entries which represent IOUs from the government, mainly as an actuarial tool. **When funds are needed to pay Social Security benefits, the notional bonds recorded in the fund cannot be sold.** To pay for Social Security and other government outlays, Treasury uses its general-purpose cash – from tax revenue and issuance of public securities. **When speaking of Treasuries in total, it is most meaningful to use the amount issued to and held by the public, excluding internal government accounts.**

2.5.4 Treasuries do not have the risks of sovereign instruments issued by Eurozone countries. The financial systems of EZ nations have fundamental differences from the US. In an EZ nation, money can move, in euros, to banks in any EZ country. No EZ nation has its own currency or central bank. These are critical differences from the US banking system, in which all USD deposits must remain in US banks, and the US has its own currency and its own central bank. **In this respect, Eurozone countries are like states in the US.**

2.5.5 The often-used measure of "national debt/annual GDP" can be useful for nations with securities denominated in a currency that is not their own, including eurozone nations. Each EZ nation has to be concerned that investors might decide to move from euro securities of their nation to those of another EZ nation. But all USD have the US as their home, and the Fed can purchase Treasuries in any amount at any time. **A ratio of total Treasuries outstanding to annual GDP is just not useful for the US**, just as there is little use for a ratio of total money (bank deposits) to GDP. Both money and Treasuries are fundamental instruments in the economy.

2.5.6 While issuance of Treasuries does not increase total money, it adds risk-free assets to US Total Financial Assets (TFA), **which the Fed reports as about $350 trillion.** TFA is comprised primarily of many types of private-sector instruments. Treasuries comprise about 8% of TFA, and bank money about 6%.

2.5.7 The US is one of very few countries in the world that subjects issuance of securities by its government to a limit on total Treasuries (including the internal trust accounts). That has created needless political crises. This limitation could be removed by legislation; total spending could then be dealt with by appropriations legislation and budgeting, without reference to total Treasuries outstanding.

2.5.8 Sometimes political issues raise the question of what might happen if there were ever a technical default of Treasuries. This would have to result from deliberate government decision, since an unintended market disruption could be resolved, including by Fed purchases of bonds. **Default, especially if more than a day or so, would cause enormous problems for the entire banking and financial system, creating significant risks for every form of USD financial asset, and grievously disrupting the functioning of the entire financial system.** US investors, banks, companies, investment funds, security firms, and many other entities, as well as individuals, hold more than $20 trillion of Treasuries, more than the total of all deposits in US banks. While it is always challenging to predict political decisions, there would really be no choice other than for the government to correct any technical default immediately, and work to repair the substantial damage as much as possible as soon as possible.

2.5.9 For many years, **"bond vigilantes"** have predicted that "next year Treasuries will hit a brick wall" and will cause a financial and economic crisis. In fact, the only real financial crisis we've had this century was in 2008, based on problems in banks (the homes of "money"), not with Treasuries – and the government used Treasuries to help resolve the crisis. A suggestion for those who worry about Treasuries: **If a weather forecast model was wrong every year for 30 years, meteorologists would likely take a fresh look at their model.**

3. Implications for Economic Policy

This final section goes beyond explaining how the modern US banking system and Treasury securities work, moving on to economic matters related to the issuance of Treasuries.

It is *extremely* rare for an economy to produce just the right amount of Consumption, Investment, and Net Exports to achieve full employment and full capacity production on its own, without any government support.

Although we can and should take steps to strengthen the private sector over time, there is no "law" of economics that calls for such a perfect balance, and it almost never occurs. Actions by the Fed can help, but are not enough. **Some degree of government support for the economy through the issuance of Treasuries is needed and used almost every year.**

This need reflects a number of economic factors, notably the behavior of consumers and businesses regarding inclinations to spend, or to save – which really means to not spend.

Too much support can lead to inflation, especially in a strong economy. Too little, especially in a slow economy, will lead to unemployment and economic decline. Focus should be on choosing an appropriate amount of government spending (and/or tax change) in the context of the overall economic situation.

The government still has an important responsibility to spend wisely. There should be legitimate debates about many aspects of tax and spending programs. **But the total amount of Treasuries issued, and its ratio to GDP, should *not* be factors.**

Issuance of net new Treasuries will almost always be needed.

Treasuries are unique and fundamental components of the US financial system and economy.

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*Quotation from John Maynard Keynes.

These Notes include perspectives introduced in the book *Freedom from National Debt*, by Frank Newman, edited by Dan Newman, 2013.