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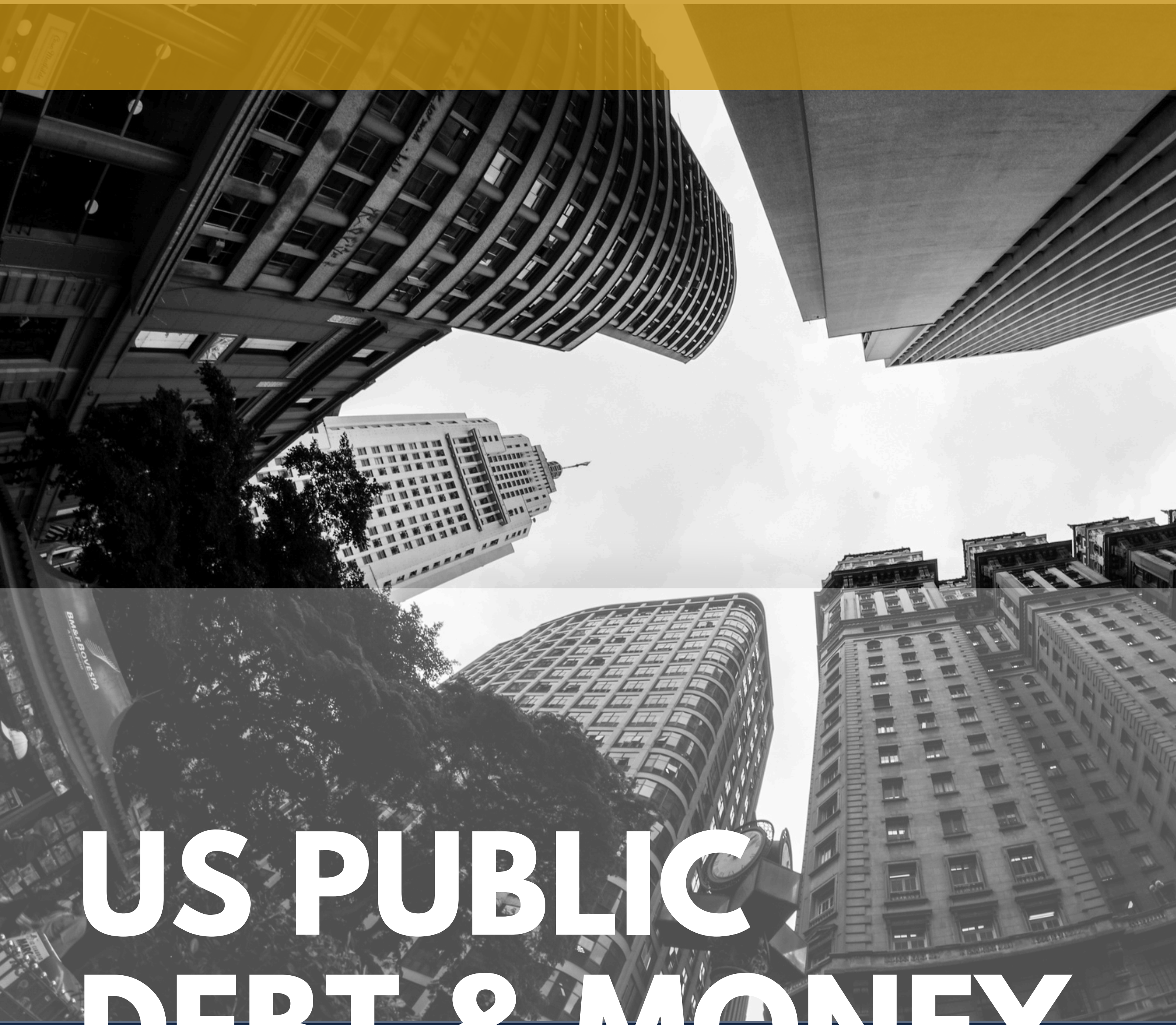


US PUBLIC DEBT & MONEY CREATION

PANEL DISCUSSION SUMMARY

US Public Debt and Money Creation

In a meeting with Brandes Center Advisory Board members during 1Q25, Mark Higgins, CFA and Jim Brown, CFA, discussed the related topics of US government debt and US monetary policy.

Executive Summary

Higgins expressed concern over the refusal of most policymakers to acknowledge the threat posed by the nation's chronic fiscal deficits and the mountain of public debt that it continues to amass in its wake. He argued that unsustainable spending and debt accumulation constitute the greatest financial challenges for the country in the 21st century.

Higgins recounted how the country abandoned two fundamental financial principles articulated by founding father Alexander Hamilton regarding the treatment of the public credit. And the real issue today? "There's no dry powder to handle an emergency—and that is exactly what Hamilton feared," Higgins said.

Brown was critical of the U.S. Federal Reserve's Quantitative Easing program which created new money—but tended to reward existing securities owners.

Looking ahead, Brown said governments around the world may try to rein in debt using measures he described as "financial repression." He encouraged investors to own stocks, avoid long-term bonds and buy gold.

PANELISTS

Mark Higgins, CFA wrote *Investing in U.S. Financial History: Understanding the Past to Forecast the Future*.

The book achieved Amazon #1 bestseller in Macroeconomics, and Money and Monetary Policy, and it has earned multiple book awards. Higgins also is a member of the Editorial Board of the Museum of American Finance, and he is a frequent writer for the Museum's Financial History magazine.

Jim Brown, CFA, a member of The Brandes Center's Advisory Board, wrote *A Black Hole in Economics: Money Creation and Its Consequences*.

Before retiring from Brandes Investment Partners, he was a partner and voting member of various investment committees.

Brown also has served President of the Ayn Rand Institute, CEO of the Prometheus Foundation and Board member of Monetary Metals & Co.

The full discussion is saved here at The Brandes Center's YouTube channel. In this article, we share an extended summary of the authors' key points and excerpts of the ensuing conversation.

Higgins: The Historical Perspective on the Use of the Public Credit of the United States of America

Mark Higgins' comments during the meeting focused on use of public credit in the United States, but his 500+ page book addresses everything from political influences, asset bubbles and industrialization to criminal activity, wars and shifting macroeconomic forces.

He referred to the incredible vision of founding father Alexander Hamilton, the first U.S. Secretary of the Treasury. In his First Report on the Public Credit, Hamilton recommended two guiding principles for the use of public credit:

1. It should be used in times of public danger (especially foreign war); and
2. When that danger subsided, the debt should be extinguished

Higgins emphasized that the United States is not currently experiencing a public danger, yet the nation is running substantial deficits as if it is in the midst of such danger. This is the result of many decades of policies that were "…inconsistent with the two Hamiltonian principles established in 1790."

Specifically, Higgins focused on the post-World War II-era when Americans abandoned the discipline of running budget surpluses after a public danger subsides. Prior to World War II, this was critical to restoring budget capacity and preparing the nation for responses to future crises. It was this discipline that Hamilton described as the key to "rendering public credit immortal."

"Americans had tremendous wealth after World War II, and we became emboldened by it," Higgins said. He then added that "Nobody wants to talk about it, but the unsustainable spending is driven primarily by Social Security and healthcare entitlements."

In addition, he said there is a temptation to think of the reserve currency of the U.S. dollar as permanent. To be fair, reserve currencies don't change often, but Higgins warned, "They do get lost eventually, if they're abused."

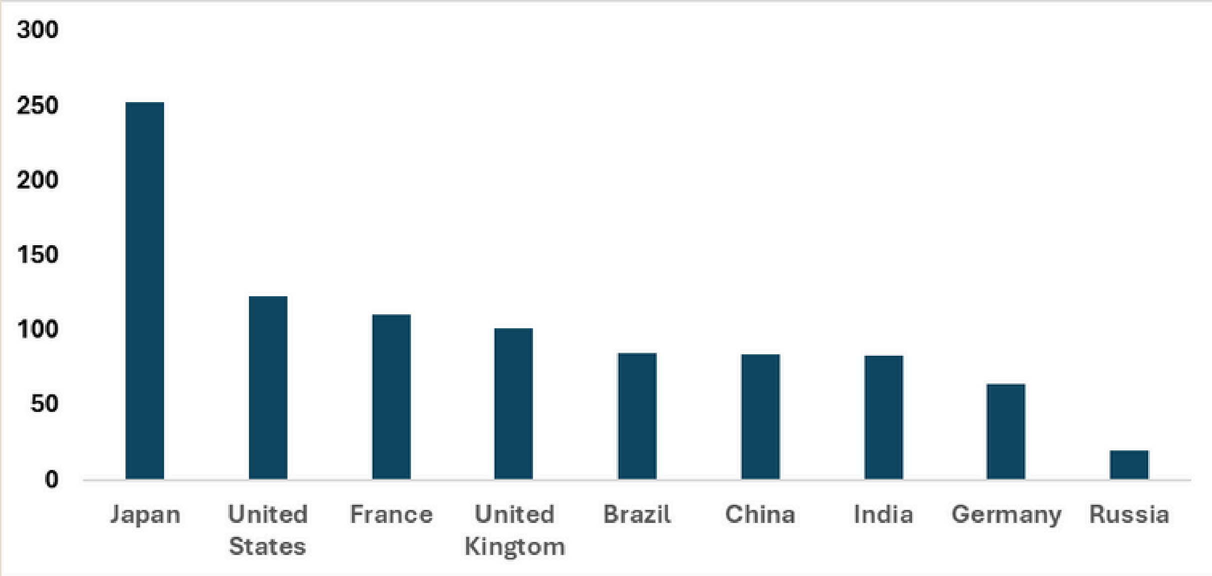
"The pound sterling lost out to the US dollar after World War I and World War II," he said. "We have put ourselves in a situation where we're vulnerable to that sort of thing, but when and how it's going to happen—that's anybody's guess. And it's what Hamilton worried about. He wanted to have sufficient capacity to handle emergencies."

The overconfidence in the durability of the U.S. dollar despite unsustainable growth of the national debt constitutes "the biggest challenge for this country," Higgins said.

To better understand the gravity of the issue, we share Exhibits 1, 2 and 3.

> *"Nobody wants to talk about it, but the unsustainable spending is driven primarily by Social Security and healthcare entitlements."*
> --Mark Higgins, CFA

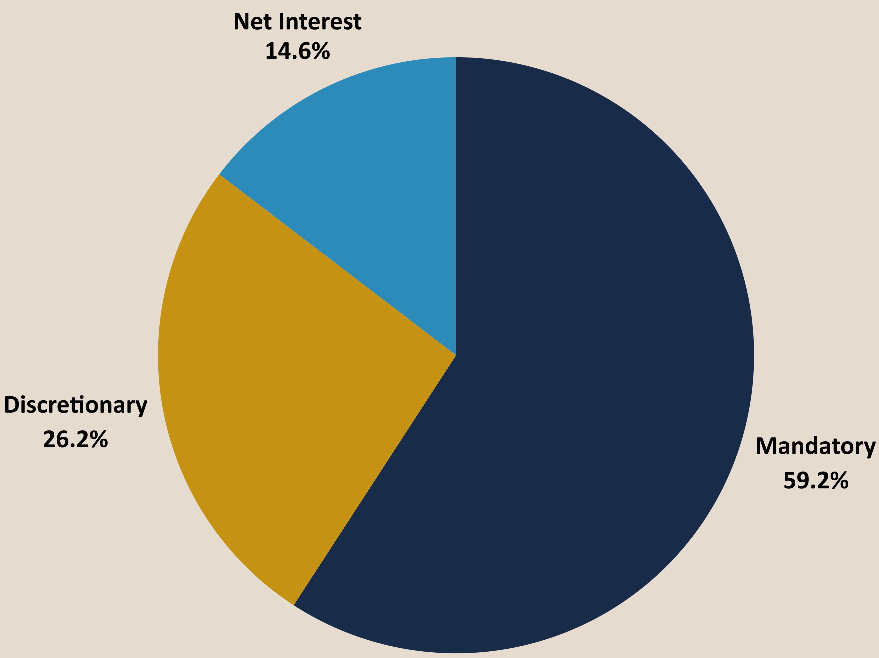
Exhibit 1 | National Debt to GDP Ratio for Select Countries (2023)



Source: Statista.com, published April 2024

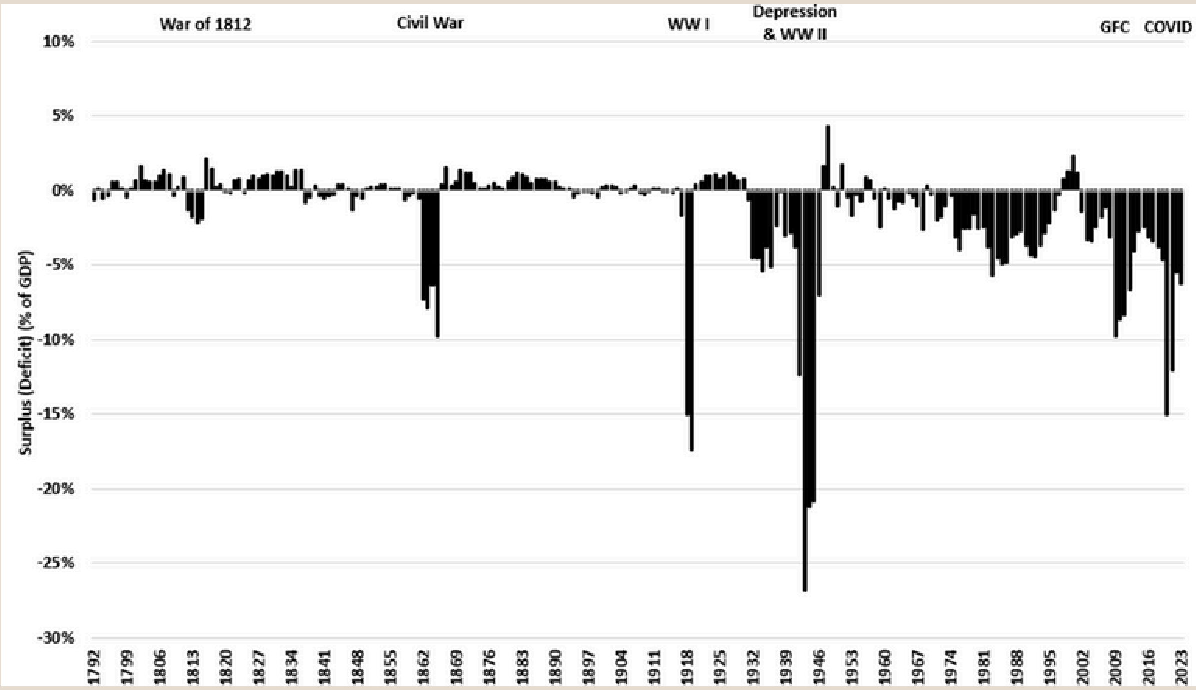
Exhibit 1 shows the United States' national debt to GDP ratio is second-highest among nine of the world's leading economic powers. Exhibit 2 breaks out U.S. government spending for 2025. The data is based on the Congressional Budget Office projections, as reported by Reuters on Jan. 9, 2025.

Exhibit 2 | U.S. Government Spending Projections for 2025 (~7.0 US$ trillions)



Source: https://www.reuters.com/markets/us/fed-can-soothe-trump-or-treasuries-not-both-mike-dolan-2025-01-09/

Exhibit 3 | Annual Federal Surplus or Deficit as Percent of Gross Domestic Product (GDP), Not Seasonally Adjusted (1792 to 2023)



Sources: Sources: Bureau of the Census, Historical Statistics of the United States, 1789–1945 (Washington, DC: U.S. Bureau of the Census, 1949), https://www.census.gov/library/publications/1949/compendia/hist_stats_1789-1945.html. Budget of the U.S. Government Fiscal Year 2023, Office of Management and Budget (Washington D.C.: Government Printing Office, 2022), https://www.whitehouse.gov/wp-content/uploads/2022/03/budget_fy2023.pdf

Mandatory spending (sometimes called entitlement spending), required under existing laws, reflects $4.13 trillion and includes funding for programs such as Medicare and Social Security.

Discretionary spending must be appropriated by Congress every year. For 2025, it totals $1.83 trillion and reflects payment for things such as road construction and maintenance, salaries for federal workers and purchases of goods and services from the private sector, according to the Brookings Institute.

Exhibit 3 illustrates the deficit the United States has experienced since the end of World War II.

While entitlements reflect a large portion of the debt, Higgins noted the sensitivity around funding for Social Security and other publicly funded programs. “I understand you can't just cut people off entirely,” he said. “This is not an easy problem to solve, as shown by the math of the finances. And people need to recognize that [solving the issue] is really what I'm trying to do. The sooner we address this, the more we can spread out the costs. If you can spread the costs out, you can make it tolerable.”

Higgins reiterated the forecasts for greater debt levels don't account for another crisis. “Maybe that’s a major natural disaster,” Higgins speculated. “Maybe it's a war that breaks out that nobody thinks is even possible. Who knows what that is? But the real problem? There's no dry powder to handle an emergency—and that is exactly what Hamilton feared.”

He also looked at the “false hope” of trying to outgrow the debt, commenting on the major drivers of economic output:

- labor force participation rate
- natural employment rate
- total hours worked per year and
- productivity

In his estimation, none of these factors offer real hope. He shared a variety of statistics and charts (none reproduced here) that show these drivers are falling.

Board member Peter Branner shared the story of what he referred to as Denmark’s “Potato Cure” during the 1980s. At marketmonitorist.com, we found a link to a story with more details on “Expansionary Fiscal Contraction” or EFC in Denmark.

Facing economic challenges such as high inflation, rising unemployment, and growing public debt, the Danish government implemented a comprehensive fiscal consolidation program. Under Prime Minister Poul Schlüter’s leadership starting in 1982, Denmark enacted spending cuts, increased taxes, and pegged the krone to the Deutsche Mark in an effort to stabilize inflation.

The results, while not immediate, were significant. Inflation and interest rates gradually declined, and private sector confidence improved. Over time, Denmark’s current account balance shifted from a deficit into a surplus. While unemployment remained high in the short term, it began to steadily decline as structural reforms took hold, contributing to more stable economic growth. While often cited as an example of EFC, experts note that multiple factors contributed to the recovery. For more details on this episode, visit this site.

“This seems pretty dark,” Higgins admitted after sharing much of his prepared remarks. “But the United States has a good track record of fixing things when they're forced. And the important thing is, the sooner we act, the less painful it will be. I actually do have faith. And it's based on a track record. It's not just blind faith that the United States will solve this. We are a nation of innovators when it comes down to it.” Board member Barclay Douglas asked about specific negative consequences of the Federal debt, having heard and read about its perils for nearly four decades.

Higgins said he felt we were seeing them already. “If you look at the rise of the Trump Administration, I believe the real root is a desire for the United States to return to its isolationist roots—which we haven't seen in almost a hundred years. I think it's the debt that is driving this and people starting to realize that they don't want to spend on some of these things anymore.” In response to a question as to why the debt wasn’t considered as dire when it was rising in the 1970s and 1980s, Higgins stressed that the gross U.S. debt has now breached 120% of GDP. “Why wasn't this a big deal 40 years ago? Back then, it was 40% of GDP. We are fundamentally in a different place than we were 40 years ago.”

Board member Jay Malick asked about the remedies. “Is it going back to really high tax rates again? And people just having to get into their minds that there is probably only going to be one way to balance this—either cutting benefits or growing GDP.”

“It's pretty clear that what’s changed is spending. It's not taxes,” Higgins said. He added that over the last 60 years, tax revenue as a percent of GDP has gone up and down but has not changed that much on average. But spending has risen sharply.

Jim Brown on Money Creation and Monetary Policy

Brown started by stressing the main theme in his book: money creation has important economic consequences that very few people are aware of.

He added: “If you understand money creation, you're in a much better position to understand why we have this great debt, and how we might get out of it.”

Brown shared the story of his daughter and son-in-law who bought their first home a few years earlier. Brown told them how the bank created new money specifically for their mortgage.

He told the couple, “Your mortgage loan is money that didn't even exist before the banker made the loan.”

Brown said he was corrected and told that banks “lend out money that people are not using.”

Brown said he had to correct *them*. “Banks create *new* money every time they make loans,” he explained. “And in the modern banking system, all the money that exists was first created by a commercial bank when it made an investment.”

During that conversation with his family, he wondered how many other people have questions or false ideas about how money comes into existence. The questions and confusion he sees when reading about it among academics and journalists prompted him to write his book.

During his comments, Brown shared six key tenets:

1. Money creation by banks has ancient historical roots. Throughout history, money creation in the banks has been essentially unchanged; however, the nature of bank reserves has changed radically.

2. Individual banks create money by investing, i.e., by making loans or purchasing securities. The implications are that commercial banks do not lend out reserves or deposits. Bank reserves play a limited role in constraining the money supply and the “money multiplier” (which most of us were taught in school) is not a real thing.

3. The purpose of Quantitative Easing was to create money (or "monetize debt") when banks were unwilling to lend. It was not to create more bank reserves, as is often claimed.

4. Money creation by profit-seeking banks is subject to market discipline and, therefore, is generally productive and non-inflationary. However, money creation, when it is controlled by government monetary authorities, is often unproductive and inflationary.

5. The ability of central banks to monetize debt encourages governments to borrow excessively. As a result, sovereign debt has now reached a critical level.

6. Governments will likely address their high levels of sovereign debt through "financial repression," which will profoundly affect investors.

Brown provided a brief history of banknotes, citing 16th century European goldsmith guilds as the forerunners of banking. He explained that when customers deposited gold with a guild, they would receive a paper receipt as a record of that deposit.

Soon, people traded these receipts as money—as each receipt was backed by gold. Eventually, the goldsmiths realized that few people actually came to them to exchange their receipts for gold. And they decided …"to print more receipts than the amount of gold in deposit, lend those receipts out and charge interest," Brown said. This act expanded the money supply and, at its best, led to business growth and wealth creation.

When loans were repaid, the borrowed banknotes were returned so they no longer circulated in the money supply. "The loan, which is a promissory note, was torn up and the bank's balance sheet—and the money supply—shrank," Brown said.

Brown emphasized that this example reflects a loan from a commercial bank, not from a non-bank such as an investment fund. Brown said, "…when a non-bank lends money, the balance sheet doesn't expand. No new money is created and no new money is destroyed. It just changes hands."

The fundamental difference between commercial banking "then" (under a gold standard) and "now" (a fiat standard) is how bank reserves are created and regulated. Under a gold standard, "depositors are the main regulators of the banks activities." Brown said. "If depositors didn't like the interest rate they were getting—if it was too low—they could withdraw their gold and the bank had to raise the rate to attract more reserves. That's just one example."

He contrasted this traditional banking dynamic with today's banking system. Today, Brown said, "…bank reserves are created and controlled by a central bank that has been vested with the legal authority to do this.

Bank reserves now consist of paper cash in the bank vault plus its electronic equivalent, which is a ledger entry deposit at the central bank in an account for the commercial bank."

Central banks create cash reserves through an open market purchase. Brown said the technique has been used for decades. "It's a three-party transaction that's accomplished in two steps. The three parties: a private, non-bank investor; the investor's commercial bank; and the central bank."

Brown said when a central bank wants to create bank system reserves, it contacts a private investor in the open market—and that could be any non-bank owner of a government bond with a bank account.

"The central bank will then offer to purchase a Treasury bond and the investor agrees to the price to pay for the bond," he said. "The central bank instructs the investor's commercial bank to credit the investor with a new deposit. Then, to compensate the commercial bank for its new liability, the central bank creates new made-up reserves to the commercial bank's account at the central bank. Last, the central bank takes ownership of the bond."

While it sounds complicated, the net effect is to expand both the central bank and commercial bank balance sheet, and "new money, a spendable bank deposit, is added to the money supply in the investor's bank account."

What's most important to understand about this open market purchase? "Under traditional open market operations, prior to QE, the main purpose was to increase bank reserves. The equal increase in the money supply was a secondary effect."

But under the U.S. Federal Reserve Board's Quantitative Easing (QE) program, "increasing the money supply becomes its main purpose while creating reserves becomes the sideshow," This happens because the amount of reserves and bank deposits are in the hundreds of billions, not just a few billion, Brown said.

Repeat this process with trillions of dollars during the Great Financial Crisis in 2008 and 2009 and "new bank deposits were handed directly to the owners of Treasuries and mortgage-backed securities."

These securities were owned "…by members of the investor class who used this new money to buy more investment assets, bidding up prices. And this cycle went on for years."

He added the new money created by this process tended to stay within the investment markets, and it has been the main cause of what he described as our current asset bubble. Brown added, "The purchase of financial assets does not affect GDP. It caused a lot of *asset* inflation, but not very much consumer price inflation (CPI)."

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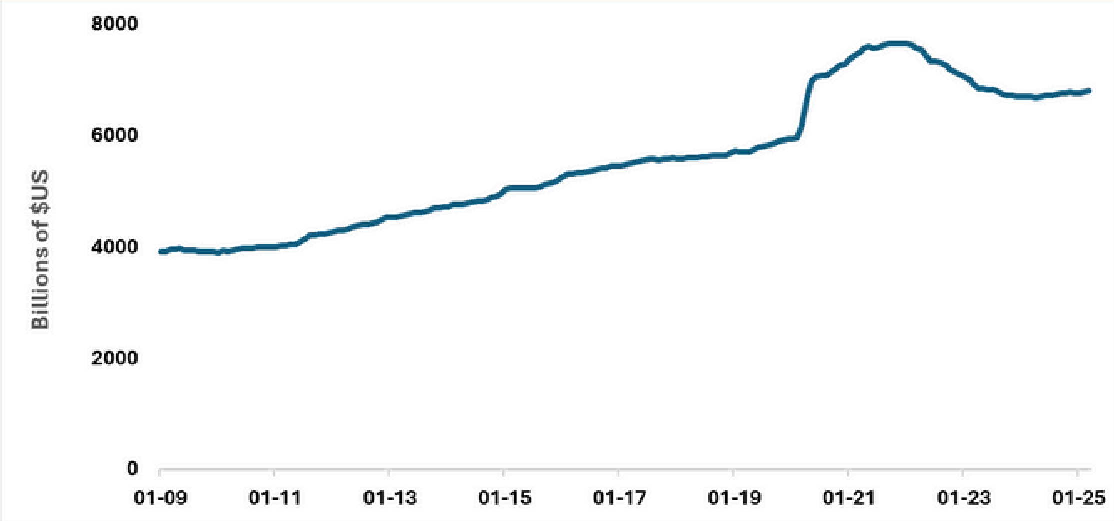
> --Jim Brown, CFA

Exhibit 4| Increase in Money Supply (M2) Jan. 2009 to March 2025



Source: Federal Reserve Bank of St. Louis via FRED® https://fred.stlouisfed.org/series/M2REAL

Brandes Center Executive Director Bob Schmidt asked, “Are you saying that whether it’s the Great Financial Crisis or Covid, the Fed is trying to help the economy by creating money through its commercial bank affiliates, but that new money is going toward asset purchases and not necessarily getting out into the marketplace where consumers can help drive economic growth?”

“That’s mostly right,” Brown said. He pointed to Ben Bernanke’s op-ed piece that he wrote in 2010 for The Washington Post. In it, Bernanke said he anticipated the Fed’s moves to increase asset prices, raise bond prices and, in so doing, lower interest rates, would stimulate capital markets. (A copy of Bernanke’s piece is available here at the Federal Reserve website.)

“He thought the benefits to Wall Street would trickle down and cause more hiring and more economic stimulus,” Brown said. “I don't believe he counted on the money staying largely confined to the investment markets for so many years.” Exhibit 4 shows the increase in the money supply from 2009 to 2024.

Brown referred to government intervention such as QE as “bad money creation” and argued it “is usually caused by policy that is not subject to market discipline.” This “bad money” may cause asset bubbles, “their inevitable destructive contractions, rising commodity and consumer prices and false price signals that lead to misallocation of capital.”

He added these developments result “…in slow, real economic growth, wealth inequality, and it encourages an unwholesome increase in sovereign debt.”

Next, Brown pivoted to what he called "good money creation," a concept he said he developed and explores in more detail in his book.

In essence, Brown argued that when bank credit is used for "productive investment, such as the creation of new goods and services," then "this new money would not result in any form of overall inflation, either consumer price or asset price because the new purchasing power created is used to produce higher value-added output and, hence, the extra demand due to money creation is met with higher supply."

"The number one economic problem facing us today, which Mark highlighted, is the huge, unpayable, sovereign debt. It's $36 trillion in debt deficits and increasing every year." Like Higgins, Brown pointed to refinancing costs, higher interest rates and unfunded obligations.

The causes?

Brown cited, "the perverse incentives that politicians have to spend money and the power of government officials to force banks to create the money which the politicians can then spend."

"This foolhardy policy—and I have to say, this anti-'Hamiltonian' policy,
is now, in my view, embedded in politicians' DNA. Neither side of the aisle will address reducing the budget. They don't want to touch entitlements."

Brown cited four ways to reduce the national debt—all of which are difficult for citizens, bad for the economy and/or unpopular for politicians and their hopes of reelection:

1. Reduce promised entitlements
2. Reduce interest costs
3. Increase taxes
4. Increase borrowing

Brown shared a quote about politicians and their motivation from the then Prime Minister of Luxembourg, Jean-Claude Juncker. During Eurozone reform discussions in 2007, Juncker said, "We all know what to do. We just don't know how to get reelected after we do it."

Branner pointed again to Denmark in the 1980s. He said, "The cure in Denmark was a lot of taxes, a lot of implications for borrowing, namely that you couldn't borrow anymore and interest rates were heightened a lot. Of course, GDP was suffering and there was high unemployment. But over the longer term, the debt-to-GDP ratio was brought under control. By the late 1990s and early 2000s, it had dropped to around 30%, and Denmark has generally maintained a low debt level since. It was a tough cure, but in this case at least, it worked."

Brown foreshadowed his next topic by saying the cure in Denmark must have also included the "…transfer of a lot of wealth from individuals back to [the government] to pay the debts off, which is the ultimate thing you have to do."

Financial Repression

"My belief is that we will see the government—and not just in the United States—choose a soft default on this debt in the form of what I call 'financial repression.'"

Brown described it as less disruptive to the political order and avoids severe austerity measures, hyperinflation or outright default.

Brown said he would not get into great detail, but government policies would take into account the four factors he described earlier and "…rely on a combination of coercion, public complacency and probably ignorance" to remedy the situation.

For example, with respect to entitlements, he argued the government might keep nominal entitlements, but reduce real future payments by understating CPI. "This reduces the cost of living adjustments," he said.

He added, in the United States, the government might pursue policies that weaken the dollar—without an outright devaluation. They also "might even install capital controls to discourage investors from pursuing better returns overseas. So collectively, these strategies will impede wealth accumulation by channeling an individual's wealth back to the government that needs the money to pay down the debt."

Brown closed with thoughts on how investors may wish to consider responding if his forecast of "financial repression" comes to fruition:

1. Avoid long-term bonds
2. Own stocks
3. Own gold

Brown said the United States enjoyed "a 40-year period of declining rates that made any long-term bondholder look like a genius." He said the low point in rates (and, in turn, the peak in bond prices) happened in March 2020 with "…the lowest interest rates in 4,000 years of recorded history. And I don't mean 400, I mean 4,000 years." He cited the book "A History of Interest Rates" by Sidney Homer and Richard Sylla.

In terms of stock ownership, Brown said, "I want to avoid popular indexes like the S&P 500, which is not a diversified portfolio anymore because of its concentration in the Magnificent 7. I believe that stock picking is going to be your best bet in a more volatile market, and to me, that means value investing will come back."

Brown turned to history for a guide on what investors may expect over the next decade or so. He compared the current environment to what the US experienced between 1966 and 1982.

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>
> --Jim Brown, CFA

He said small-cap and large-cap value stocks did well during that period—especially small caps. (He added these asset classes delivered gains after inflation—which rose sharply during the period.) Conversely, long-term Government and corporate bonds and large-cap growth stocks posted negative, real returns.

Branner revisited the measures in Denmark and added a point about tariffs. (Keep in mind this discussion took place on January 28, 2025.) “There has been a lot of talk about tariffs. In Denmark, the vehicle registration tax—often cited at around 180% of a car’s value—was introduced decades ago. That tax is still there today in a modified form. It basically means that every day when someone buys one car, they pay the equivalent of two or three. Of course,” he added, “my example partly worked because Denmark doesn’t produce any cars. It didn’t hurt a domestic car industry.”

Brown and Branner debated the implementation of similar tariff/tax policies and implications for the stock market.

“If you see a big increase in tariffs, I believe it will be a wealth killer,” Brown said. “But it will redirect money. And you will find winners where that money is going to flow. This is another reason I would not be an investor in a broad index.”

Brown added, “This may be the most controversial thing, but I want to own gold because I view gold and other precious metals as the go-to asset during financial repression—both because of the inflation that's involved, and because of the low, real yields on bonds which tend to make gold more attractive.”

His last suggestion? “We should consider our role as voters and good citizens as we look at public debt. If we're ever going to restore sound money, we have to first understand money creation better, and then we'll be able to elect better, more knowledgeable representatives who could implement needed reforms.”

Higgins brought up the point from history that people are reluctant to change—until they have to. “What worries me is where reserve currencies get lost,” he said. He cited examples from history where the combination of a debt crisis and new, unanticipated emergency, changed the financial landscape radically. “It's some shock. It could be a major natural disaster. It could be a war that we didn't anticipate. Who knows what it's going to be?”

Ron Peyton, CEO at Callan asked, “With a weaker dollar, what do you think about international stocks and bonds and emerging markets?”

Brown said, “You're on to something great. And I would never restrict my search for stocks to the US. The MSCI World Index shows the US component is at 75%. Normally, it's 40, 50, maybe 60 percent. 75%? And it’s gone nothing but up since the Great Financial Crisis. That seems extreme to me.” He added opportunities outside the United States may prove even more favorable with a weaker US dollar.

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