How to Understand the Economy

What gets you out of bed every morning? Apart from the physical urges, in a word….Money! We need it!

For most of us, money is important as a practical matter. We know that however we earn it in whatever currency, most of what we do either requires money or is spent in pursuit of receiving it in return for goods and services. Money use is about as involuntary in our lives as breathing air.

But do we really understand it? So what do we really know about money? Where does it come from? What gives it value? Who controls it? How does all this affect you and your family?

At Functional Finance.Org, we're focused on helping you make sense of money, finance and all this talk about debt and deficits to understand how the economy works.

To celebrate, I mean illustrate let's throw a party. Besides for decades Federal Reserve Chairman have compared their job to a host taking away the punch bowl before everybody got too drunk on debt.

Now a pool operates as a system with elements similar to our economic system if slightly modified. So let's throw a pool party and instead of water we're going to fill it with money!

Pool ecosystems require features to keep the water clean and fresh. We have two: a Slide and Waterfall. These represent elements that manage the flow of money entering our pool and economic system. The slide represents banking operations what we'll call Bank Money. Financial institutions use monetary policy, credit creation or lending, to add money to the system. This recognition is poorly appreciated but represents the primary function of banks in the economy. To be clear this isn't banks taking deposits and lending them out but rather lending creating deposits. A banks job is to identify good credit risks, people that will pay them back, creating money as loans so consumers can slide into the pool of economic activity to start a business or mostly buy a home.

Our other feature, the waterfall, represents government spending and interest payments or State Money. Spending on education, defense, infrastructure and all those aspects of public spending that facilitate growth and society to function properly.

Now with all that money flooding into the pool from our borrowing and government spending the levels may become unsustainable causing our pool to overflow, possibly break or make for generally unsafe conditions. This mess is in the economic system is inflation and must be managed to maintain price and economic stability. Like pools the economy has drains built in to siphon away excess and are directly linked to the bank money and state money inputs. Those that create also destroy namely through taxes and deleveraging or debt repayments.

Bank loan repayments are separated into two parts: principal and interest. Bank repayments regulate the pool of money by destroying the principal portion and keeping the interest as income- a reward for picking good borrowers.

Modern state money, called fiat money, derives its value from being the only means to pay taxes. Since everyone needs to pay taxes dollars circulate as legal tender for all debts public and private. The government's role as scorekeeper of money also regulate the value and amount of state money with government deficits or surplus equal to the private sector's equivalent to the penny. This means sovereign governments issuing their own currency also manage inflation and are never with or without money in the same way as individuals or households of a state currency.

This descriptive view of how the economy works is based on the operational reality of how funds- money or water in our example-circulate within the economy. Just as democracy and civil rights have evolved over time so has money and our economic system. Now it's our job to understand, use and manage it properly to better support the public interest and invest in a more stable and sustainable future.

Together we can solve real problems and practice economics in the public interest. That's why we started FunctionalFinance.org and why we need your help and support.