Some Common Misconceptions

Where does all the money go when stock prices plummet?

This question mistakes the monetary value of stocks for money itself. Stock prices simply reflect the current market value of the shares. At the end of the day, buyers own more shares and less money, while sellers own fewer shares and more money. Their aggregate financial wealth may be higher or lower, but the total amount of money they own remains unchanged in these transactions.

The government causes inflation when it prints too much money.

Money is literally printed by the government only to meet the demand for portable currency, i.e. Federal Reserve notes. The notes are issued to banks in exchange for deposits the banks hold at the Fed. The public acquires the notes in exchange for their own deposits at banks. The amount of currency issued is no more and no less than the public desires to hold as wallet money or rainy day money. It has no bearing on inflation.

Price inflation is mainly caused by too much money chasing too few goods.

This reflects a misunderstanding about how the money supply grows in a modern money system. Money exists mainly in the form of bank deposits, created when banks issue loans. Money growth thus depends on the demand for bank loans and the willingness of banks to lend. The Fed can influence the demand through its control of the interest rate, but it does not directly control the amount of bank lending. If the Fed sets the interest rate too low for an extended period, the amount of bank money could grow enough to put upward pressure on prices. That mainly affects asset prices, but is seldom the cause of consumer price inflation.

Banks lend the money of their depositors.

When banks issue loans, they create new deposits without disturbing existing deposits. That is precisely what causes the money supply to grow, and is what distinguishes bank lending from all other types of lending. A non-bank intermediary like a finance company lends what it has on deposit at a bank. It cannot create new deposits as a bank is able to do.

When a bank receives a new deposit, it can issue a new loan for ten times that amount.

The bank can loan that much only if its reserves at the Fed, including the amount received with the new deposit, is sufficient to cover a check written by the borrower for the full amount of the loan. It will lose that much in reserves to the payee bank when the check clears.

The money multiplier explains how much money banks can create.

The money multiplier has no predictive power. It is simply an after-the-fact observation of the ratio between aggregate demand deposits and banking system reserves. A bank's lending is constrained by its capital adequacy, not its reserves.
Bank reserves ensure that funds will be available for withdrawals by depositors.

Minimum reserve requirements on banks were once viewed as a protection for depositors. Many countries now impose no reserve requirement on their banks. Banks must hold sufficient reserves to cover withdrawals by depositors. But a solvent bank that is temporarily short of reserves can borrow them from the central bank or in the money market. Indeed a bank can hold ample reserves and still be insolvent. Protection for depositors against default is provided by deposit insurance, not by the reserves of the banks.

The Fed controls the size of the money supply.

A bank in the U.S. must hold reserves of base money in proportion to the amount of its demand deposit liabilities. However the amount a bank may lend is limited by its own capital, not its reserves. In order to maintain control of the Fed funds rate, i.e. interbank lending rate, the Fed must provide whatever reserves are required by the banking system as a whole. In fact if the Fed withheld reserves, it could imperil the liquidity of one or more banks. Thus for all practical purposes, the Fed cannot even control the amount of base money it issues.

Government deficit spending increases the money supply.

Deficit spending increases the net financial wealth of the private sector in the form of Treasury securities, not money. Every dollar the Treasury spends is money previously created by the Fed. The Treasury simply recycles the money it acquires from taxes and the sale of securities. In the aggregate, the public pays for Treasury securities out of the funds acquired from the deficit spending itself.

Government borrowing drains loanable funds needed within the private sector.

The government does not borrow to accumulate funds in the Treasury. It borrows only to cover its deficit spending, and thus does not affect the size of the private sector money supply on average. While government borrowing could temporarily reduce the supply of loanable funds within the private sector, that effect is short-lived and typically negligible.

The national debt is a burden on future generations.

This is based on the false premise that the national debt must be paid off by the private sector some day. In reality, the government itself pays to redeem its debt securities as they mature, using funds obtained by selling new securities to the public. This "rolling over" of the national debt can be continued indefinitely, since the government can pay whatever interest rate the market demands for its securities.

Interest paid on the debt reduces the funds available for other government spending.

There is no basic constraint on government spending in its own currency. Interest payments and the revenues that support them are part of the balanced reciprocal flow of funds between the Treasury and the private sector. Their only effect is a redistribution of financial assets, which of course is true of all government spending.