

Money
and
Macroeconomic Dynamics

Accounting System Dynamics Approach

Edition 3.2

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Preface

My Off-Road Journey for A Better World

Futures Studies

In early 1980's, I was told by one of the graduate colleagues at the University of California, Berkeley, that if I continue the research involving Marx and Keynes in addition to neoclassical theory, I would never get a good job offer in the United States. He was right. It was a time for Reganomics which has eventually evolved to the era of globalization in 1990's. Paying little attention to his thoughtful suggestion, I pursued my Ph.D. thesis on the subject "Beyond Walras, Keynes and Marx - Synthesis in Economic Theory Toward a New Social Design", which, alas, became a start of my off-road journey. Main part of the thesis was luckily published with the same title [78], yet it has been left unnoticed among main stream economists.

When I started teaching at the Dept. of Economics, University of Hawaii at Manoa, I almost lost my energy to continue the research on neoclassical mathematical theory for academic survival, because the theory seemed to be totally detached from the economic reality. It was in those discouraged days when my introduction to the futures studies and Prof. Jim Dator, then secretary general of the World Futures Studies Federation, took place by chance in Hawaii in 1987. Upon arrival to Japan next year, I immediately joined the Federation, and became very active on futures studies for more than ten years since then.

Among the activities of futures studies I have been involved, a major one was the organization of futures seminar series in Awaji Island, Japan, with an objective to establish a future-oriented higher institution dubbed the Network University of the Green World (<http://www.muratopia.org/NUGW>). The seminars had been held for seven years from 1993 through 1999, then suspended due to the lack of fund. In the book based on the first seminar in 1993, I have proclaimed that

Thus, what has been missing in industrial-age scientific research, and hence in the academic curricula of present-day higher institutions, is a study of interrelated wholeness and interdependences [81, p.200].

In order to fill the missing niche, I have tried, with a help by the seminar participants, including Nobel laureate Jerome Karle, to establish a new wholistic

field of study dubbed FOCAS, meaning Future-Oriented Complexity and Adaptive Studies, in vain. Yet, my conviction on the need for such futures studies for higher education continued to remain as worth being upheld. Faced with the threat of our survival due to climate changes and environmental disasters, future-oriented studies of interrelated wholeness and interdependence is, I believe, more urgently needed for solving these complex problems, since solutions offered by fragmented professionals at the current higher institutions might be the causes of another problems as Asian wisdom connotes. For our survival and sustainability, we need future-oriented higher education which provides wholistic visions and solutions to the present complex problems caused by fragmented science and technology of the present-day higher education. This conviction became a fruit of reward for me at the cost of abandoning neoclassical economic research in a traditional academic stream.

System Dynamics

Throughout the future-oriented activities later on, I was luckily led to the systems view, specifically a method called system dynamics, by chance. It seemed to me a totally new field of study that makes a heavy use of computer simulation for analyzing dynamic behaviors of system structures in physics, chemistry, engineering, environmental studies, business and economics, and public policies, to name a few, in a uniform fashion. In short, its methodology can uniformly cover many fragmented fields of studies, and in this sense it seemed for me to be able to share a similar interdisciplinary vision with future-oriented studies. After many years' frustration on the futures studies, I've jumped in the field by attending its international conference in Istanbul, Turkey, in 1997. Since then I have been continually attending the system dynamics conferences up to the present day.

It didn't take much time to realize that, due to its interdisciplinary nature, system dynamics is also facing a similar difficulty in finding an academic position as a discipline in the current extremely fragmented higher educational system, as future-oriented studies have been suffering similarly. In other words, system dynamics and futures studies can have no comfortable places in the current universities. The only difference is the use of computer in the former, and the use of our brain in the latter.

Hence, it seemed to me that future-oriented studies and system dynamics constitute two major fields of future's higher education, using our brain on the one hand and computer on the other hand for a study of interrelated wholeness and interdependence in order to attain human and environmental sustainability. In fact, it has been repeatedly argued at the international conferences whether system dynamics is merely a tool or discipline. For me it seemed to be not to the point and accordingly a fruitless argument.

On the contrary, the following description by Prof. Jay Forrester, a founder of system dynamics, on the nature of system dynamics looked to me to the point.

Such transfer of insights from one setting to another will help to break down the barriers between disciplines. It means that learning in one field becomes applicable to other fields. There is now a promise of reversing the trend of the last century that has been moving away from the “Renaissance man” toward fragmented specialization. We can now work toward an integrated, systemic, educational process that is more efficient, more appropriate toward a world of increasing complexity, and more compatible with a unity in life [19].

It is a useless effort to search for an appropriate academic citizenship at the current fragmented higher education. In this sense, it seems to be a right choice to introduce the visions and methods of system dynamics to the K-12 education where academic fragmentation does not yet break down into the learning process. The reader may visit a creative learning Web site for its successful introduction at <http://clexchange.org>.

I felt I have finally been led to a right truck, after more than a decade-long off-road journey, toward a better world. If I had stayed at the economics profession, I would have never encountered system dynamics as most economists are currently still unaware of it. What I have learned from system dynamics is the importance of system design.

My continuing off-road journey got refurbished with this spirit of system design. In the falls of 1998 and 1999, I had a chance to visit MIT where I was introduced systems thinking and system dynamics for the first time as if I was a first-hand learning student by Prof. John Sterman and his doctorate students as well as Prof. Jay Forrester and his undergraduate team of Road Map project (educational self-learning system dynamics program through Web). This became my off-road journey of no return from system dynamics in my profession.

Accounting System Dynamics

Instead of being forced to stay in the economics profession, I was luckily given a chance to teach system dynamics at two management schools in Japan; first at the Osaka Sangyo University in Osaka, then Doshisha Business School in Kyoto. System dynamics obtained its first citizenship in this way as academic subject to be taught in the fragmented higher educational system in Japan.

Eventually, as a faculty member of management and business schools, I strongly felt it necessary to cover accounting system in my system dynamics class. Yet, my search for SD-based accounting system turned out to be unsuccessful, giving me an incentive to develop a SD method of modeling financial statements and accounting system from a scratch. I started working on the SD-based accounting system in the summer of 2001 when I was spending relatively a quiet time on a daily rehabilitation exercise in order to recover from the physical operation on my shoulder in June of the same year. This retreat environment provided me with an opportunity to read books on accounting intensively. My readings mainly consisted of the introductory books such as [29], [38], [43], [68] and [69], since my knowledge of accounting was limited in those

days¹. Through such readings, I have been convinced that system dynamics approach is very effective not only for understanding the accounting system, but modeling many types of business activities. This conviction fruitfully resulted in my presentation on the principle of accounting system dynamics at the 21st international conference of the System Dynamics Society in New York in 2003 [83], which became a turning point in my off-road journey.

Rekindled in Berkeley, California

In the same summer of 2003, I was luckily offered an 8 months' sabbatical leave, and came back to Berkeley in almost 18 years since I left in 1986, this time as a visiting scholar at the Haas School of Business, not the Economics Department. My old friend, Nobie Yagi, from Berkeley days kindly provided his second house on his site for my family's stay, which gave me a good opportunity to talk with him almost daily. He received Ph.D. in finance and options trading from Berkeley around the same time as I did.

Conversation with him, together with my research environment at the business school rekindled my interest in economics, specifically macroeconomics and finance again. Even so, in those days I have already taken an off-road journey away from main stream economics, and decided to investigate it from my off-road side way. Specifically, I resolved to start reconstructing macroeconomic theories on the basis of the principle of accounting system dynamics which was completed in the same summer.

Since then, being led by the inner logic of accounting system dynamics and macroeconomics, I have spent almost my entire off-road journey on a step-by-step construction of macroeconomic models, which turned into a series of presentation of papers such as [85], [86], [87] and [88]. This series of macroeconomic modeling was completed in 2008 as [89] with a follow-up analytical refinement method of price adjustment mechanism in [90] next year.

An Oasis in Wellington, New Zealand

Second good luck visited me on my off-road journey as two months' short sabbatical leave in 2009 at the Victoria Management School, Victoria University of Wellington, New Zealand. Prof. Robert Y. Cavana, a well-known leading scholar in system dynamics, kindly hosted my visit. This good luck enabled me to review the above paper series uniformly for the publication of this book. Almost daily conversation with him over lunch, as well as a lovely research environment in Wellington, encouraged me to keep working on the draft. Without this stopover in New Zealand as an oasis in my off-road journey, the draft would not have been completed.

¹In addition to these books, a paper dealing with corporate financial statements [2] was published in 2002. However, current research for modeling financial statements is independently carried out here with a heuristic objective in mind.

National Model

I was a late comer to the research community of system dynamics. While my step-by-step macroeconomic modeling was advancing, some researchers have kindly suggested at the conferences that I should review the research papers on the National Model project that was led by Prof. Jay Forrester with several Ph.D. students at MIT.

Unfortunately, the national model itself was not available and its related papers were scattered around. Under such situation, my survey managed to cover the following papers [15], [16], [17], [18], [20], [21], [22], [23], [24], [25], [26], [27], [32], [36], [61], [62]. Yet, the review of these papers only gave me an impression as if I were, with my eyes closed, touching various parts of an elephant without knowing what the elephant looks like. During the 23rd international conference of System Dynamics Society in New York, July, 2005, in which I presented a SD-based Keynesian model, I have strongly felt that my research cannot advance without understanding a whole picture of National Model, because my modeling approach, I feared, might have been already taken by the National Model project team.

Without losing time, in September of the same year, I visited Prof. Jay Forrester in his office at MIT. We spent almost two hours on discussing about his National Model. He told me that the national model is still going on, and I may have no chance to take a look at it until it's completed. Even so, the conversation turned out to be very fruitful to me, out of which I got convinced that my modeling approach on the basis of accounting system dynamics is quite different from his modeling method. This conviction gave me an energy to continue my off-road journey in my own way. At the same time, I truly hoped that the national model would be completed in the near future.

In the spring of 2007, I was invited to review the Ph.D. dissertation by David Wheat at the University of Bergen, Norway, whose title is "The Feedback Method: - A System Dynamics Approach to Teaching Macroeconomics [75]". His model, written by Stella software, seemed to me to be a simple version of the National Model. In this sense it became the first complete macroeconomic model ever presented to the public, and his effort should be congratulated. In the following year, at the 26th international conference of System Dynamics Society, Athens, Greece, I have presented a complete macroeconomic model, written by Vensim, on the basis of accounting system dynamics [89].

US Congressional Briefing

After a completion of my macroeconomic model in 2009, I was taking a rest in a foggy day at a vista point on my off-road journey. Financial crisis triggered by the bankruptcy of Lehman Brothers in 2008, followed by a series of government debt crises in the US and EU, blew away thick fog and all of a sudden a lofty peak of better world I've been searching for emerged in front of me. It was a peak of new macroeconomic system of public money. When I looked back the trail I followed so far, it turned out to be a macroeconomic system of debt

money.

A glimpse of this new peak of hope drove me again into writing papers [91] and [92] toward a better world. On the next day of the presentation of my paper [92] at the 29th International Conference of the System Dynamics Society in Washington DC, that is, on July 26, 2011, I was invited by the Congressman Dennis Kucinich to present the findings of my macroeconomic simulations on the workings of public money system at the US Congressional Briefing. This unexpected invitation recharged my driving energies toward a steeper trail on my off-road journey.

The peak of the better world is a green and sustainable world. It will be described in the last chapters of 12, 13, 14 and 15 (Part IV). Coincidentally this turned out to be the reinvigorated world of MuRatopian economy I've vehemently pursued in my dissertation in 1980's as a new social design.

Beyond

While working on my dissertation on "Beyond Walras, Keynes and Marx", I was once visited by a daydream that an academic torch of economic thoughts has been handed over from Karl Marx to John M. Keynes and from Keynes to me. It occurred unexpectedly when I happened to realize the fact that Keynes was born in the year 1883 when Marx passed away, and I was born in the year 1946 when Keynes passed away. Since then I've been enslaved by a sense of scientific mission, though the reader may laugh at its mirage, that I should carry on and go beyond their economic thoughts for a better world.

Modern macroeconomic foundation was laid by the Keynes's esteemed book: The General Theory of Employment, Interest and Money published in 1936. When I encountered the title for the first time as a young student of economics, I got puzzled and confused by the order of "employment, interest and money". Nowadays, students may have no such puzzles because almost all macroeconomic textbooks start with the analysis of GDP that determines the level of employment, followed by the aggregate demand that constitutes GDP such as consumption and investment. Then interest and money supply are introduced as a determinant of investment. Under the Keynesian analytical framework, money has been all the time treated as an adjunct to the macroeconomic system; that is, money has been regarded as an exogenous entity, not as an endogenous one. This may be the reason why employment comes first, followed by interest and money comes last in the title of the book.

On the contrary, the title of this book, though it deals with similar subjects as Keynes, starts with the analysis of money and interest, followed by macroeconomic dynamics. The book is founded on the method of Accounting System Dynamics. Accounting system has been the most rigorous method in social science, while system dynamics has been the robust foundation of dynamic analysis (that is, differential equations) in natural science since Newton. In this sense, this methodology could be said to provide the most robust tool for analyzing the structure of macroeconomic behaviors. This analytical method that is being applied to the macroeconomic analysis has revealed that *money matters by all*

means or *money is all the time endogenous* as the reader may be convinced by going through the book. In other words, without money comprehensive macroeconomic models are first of all unable to be constructed. Money continues to sit in the center of all macroeconomic behaviors. This is why the title of this book becomes “Money and Macroeconomic Dynamics” In the Keynesian sense, the title of the book may be called “The General Theory of Money, Interest and Employment. The torch of Keynes’ General Theory is now to be carried over in a thoroughly reversed order!

Moreover, it lights up the macroeconomic systems analyzed in Part II and III of the book as a *debt money* system in which Walras, Keynes and Marx used to live and we are living today, while it illuminates the macroeconomic systems designed in Part IV as a *public money* system in which we’ll live in the near future as a sustainable world beyond the current debt money system.

Let me stop my off-road journey at this point. It is my hope that the reader will continue this off-road journey to the summit, so that, as travelers and hikers increase, it eventually becomes a main road journey for a better and green world.

With many thanks to those who guided me and offered a cordial help during my off-road journey, on my birthday:

June 24, 2013

Awaji Island, Japan

Acknowledgments

First of all, I would like to give my cordial thanks to those who have helped me during my off-road journey: Jim Dator, Matthias Ruth, Jay Forrester, John Sterman, Nobie Yagi, Robert Y. Cavana, David Wheat, Andrew Ford, Dennis Kucinich.

I have started using this draft as a main reference in my MBA classrooms since 2009. Feedback comments and suggestions from my students, Hisashi Deguchi, Hiroyuki Hori and Nobuo Nishi, turned out to be very helpful to improve the draft, for which I do express my acknowledgments. Prof. Yutaka Takahashi has read the draft and given me some valuable comments, to whom I am very grateful.

Meanwhile, I have taken opportunities to offer the SD workshops at the 28th International Conference of the System Dynamics Society, in Seoul, Korea, July 29, 2010, at the 29th Conference in Washington DC, USA, July 28, 2011, and at the 30th Conference in St. Gallen, Switzerland, July 26, 2012, under the theme: An Introduction to Macroeconomic Modeling – Accounting System Dynamics Approach. Many SD researchers and students from the conferences have participated in the workshops and gave me very valuable suggestions and comments on my analytical method of macroeconomic modeling, convinced me simultaneously that it's on the right track, for which I truly thank them all.

Additionally I was given invaluable opportunities to present the contents in Part IV: Macroeconomic Systems of Public Money at the 6th, 7th and 8th Annual AMI (American Monetary Institute) Monetary Conferences in Chicago, USA, in 2010, 2011, and 2012. I truly thank Stephen Zarlenga, the director of AMI, and Jamie Walton, the AMI researcher, for providing these opportunities, and conferences participants, specifically Joe Bongiovanni, for their worthy comments and suggestions. These turned out to be very prolific for deepening my analyses.

Finally, I do warmheartedly appreciate the patience of my families; Naomi, Dychi and Yokay for my relinquishing fun time with them on holidays due to my off-road journey.

Gassho!

A Quick Tour of the Off-Road Journey

Some Figures in this book may be too small to identify the details. Under the circumstances, the reader is recommended to refer to the attached M&MD CD Book which includes all figures used in this book. These figures are also freely downloaded, for the convenience of the reader, from the author's Web site at www.muratopia.org. The reader is also encouraged to confirm our simulation results by running the companion models simultaneously that are included in the same CD Book. Additionally, the reader may enjoy running simulations according to his or her own interest in macroeconomic behaviors. In this case, this book could be partially used as User's Guide for macroeconomic simulations.

Let us now begin with a quick tour of the author's off-road journey. The reader is recommended to follow chapter by chapter except the section 3.6, Accounting System Dynamics in Action, in order to fully comprehend the macroeconomic model-building structures, because most models built in the book are constructed step by step by following the previous models. Your feedbacks are mostly appreciated by the author through his email at kaoru3@muratopia.org.

Part I Accounting System Dynamics

Chapter 1 introduces the author's way of understanding system dynamics from a dynamics viewpoint. Those who have its background may still find some useful features of system dynamics.

Chapter 2 compares general equilibrium price adjustment mechanism of demand and supply with off-equilibrium adjustment mechanism that is made possible by the system dynamics method of incorporating inventory. This off-equilibrium approach becomes a point of departure of our macroeconomic analysis from the neoclassical equilibrium analysis.

Chapter 3 combines the principles of system dynamics with those of accounting system. The unified principle is called the Principle of Accounting System Dynamics, which constitutes one of the most robust foundations for the analysis of macroeconomic dynamics.

Part II Macroeconomic Systems of Debt Money

Chapter 4 sets off macroeconomic analyses of debt money system through chapter 9. This chapter investigates a simple capitalist market economy consisting of traditional budget equations by applying the principle of accounting system dynamics. The economy is constructed on the framework of monetary flow such that the so-called Say's law holds; that is, a well-known Goodwin Growth Cycle model.

Chapter 5 explores the nature of money and its creation through a fractional reserve banking under current debt money system. Functional-money creation processes under both flow and stock approaches are comparatively

investigated step by step from the case of the gold standard to the case of loan to banks, then loan to government.

Chapter 6 expands the analysis of money to interest and examines the equity distribution between non-financial sector and banks. It is then applied to the monetary Goodwin model to find out if this integrated monetary economy with interest triggers business cycles into economic recessions.

Chapter 7 discusses a typical Keynesian macroeconomic model of aggregate demand where Say's law no longer holds by applying system dynamics adjustment process. Then, a Keynesian IS-LM equilibrium model is explored within the framework of monetary circulation among producers, consumers, government and banks.

Chapter 8 integrates real part and monetary part of macroeconomic activities analyzed in the previous chapter by distinguishing nominal and real units of macroeconomic variables such as nominal vs real interest rates and nominal vs real GDP.

Chapter 9 incorporates population dynamics and labor market with the introduction of Cobb-Douglas production function. This chapter completes our comprehensive macroeconomic analysis under the debt money system. It reveals an inescapable accumulation of government debt even under an ideal equilibrium path in the real sector.

Part III Open Macroeconomic Systems of Debt Money

Chapter 10 sets off macroeconomic analyses of open debt money systems through chapter 11. This chapter explores a dynamic determination of foreign exchange rate in an open macro economy in which goods and services are freely traded and financial capital flows efficiently for higher returns.

Chapter 11 expands the comprehensive macroeconomic model in chapter 9 to the open macroeconomies on the basis of the framework developed in the previous chapter. It provides a complete generic macroeconomic model of open macroeconomies as a closed system of debt money.

Part IV Macroeconomic Systems of Public Money

Chapter 12 sets off our macroeconomic analyses of public money systems through chapter 15. This chapter discusses how the government debt crisis is structurally built in the current macroeconomic system of debt money. Then it demonstrates how the government debt can be liquidated under an alternative macroeconomic system of public money, proposed by the American Monetary Act, by revisiting the integrated macroeconomic model developed in chapter 8.

Chapter 13 analyzes the workings of a public money system under the most comprehensive open macroeconomies developed in chapter 11. Then it is demonstrated that under the public money system government debt can be liquidated without triggering recession, unemployment and inflation both in domestic and foreign economies.

Chapter 14 explores monetary and financial stability under the public money system in comparison with the current debt money system by constructing a simplified macroeconomic model with a stock approach of credit creation presented in chapter 5.

Chapter 15 searches for a better design of our macroeconomic system for our sustainable futures. First, it examines the public money system in comparison with the current debt money system. Then, the MuRatopian economy that was introduced in 1988 is revisited as a complementary system. Finally, the integrated system of these two is proposed as the best design of macroeconomic system for our sustainable futures.

Chapter 16 proposes a transition process from the debt money system to the public money system by constructing a simple macroeconomic model based on the accounting system dynamics. The model briefly handles main features of the debt money system, in 8 steps, that cause “booms and depressions”, debt accumulation and failures of recent quantitative easing financial policy. It then offers a transition process to the public money system in 6 steps.

Postscript

Due to the budgetary constraint², the author was unable to get an editorial help in English. Accordingly, the reader would be kindly asked to accept the author’s apologies for some clumsy writings that still remain in this book.

²This was caused by the sudden termination of the author’s academic position, in March 2013, at the Graduate School of Business, Doshisha University, Kyoto, due to the use of system dynamics in his MBA lecture of Business Economics. Concerned researchers of system dynamics and economics overseas sent letters of petition to the president and dean of the university to stop the violation of academic freedom in vain.

Edition Notes

Edition 1.1 Figure 3.10 is revised. Minor type errors in Preface, Chapters 1, 9 and 15 are corrected.

Edition 2.0 Chapter 16 is newly added. Figure 11.6 is revised. Minor type errors are corrected.

Edition 3.0 Chapter 5 is fully revised with money creation models of both flow and stock approaches. Terminologies such as "money supply" and "monetary base" in the Chapter are replaced with "money stock" and "base money", respectively.

Edition 3.1 Chapter 3 is partly revised with revised definitions of Asset Management Ratios.

Edition 3.2 Classification of Money (Table 5.2 in Chapter 5) is slightly revised. Type errors in Bibliography are corrected.

Contents

I	Accounting System Dynamics	1
1	System Dynamics	3
1.1	Language of System Dynamics	3
1.2	Dynamics	5
1.2.1	Time	5
1.2.2	Stock	5
1.2.3	Stock-Flow Relation	6
1.2.4	Integration of Flow	8
1.3	Dynamics in Action	9
1.3.1	Constant Flow	10
1.3.2	Linear Flow of Time	10
1.3.3	Nonlinear Flow of Time Squared	13
1.3.4	Random Walk	15
1.4	System Dynamics	16
1.4.1	Exponential Growth	16
1.4.2	Balancing Feedback	18
1.5	System Dynamics with One Stock	21
1.5.1	First-Order Linear Growth	21
1.5.2	S-Shaped Limit to Growth	22
1.5.3	S-Shaped Limit to Growth with Table Function	23
1.6	System Dynamics with Two Stocks	25
1.6.1	Feedback Loops in General	25
1.6.2	S-Shaped Limit to Growth with Two Stocks	25
1.6.3	Overshoot and Collapse	27
1.6.4	Oscillation	28
1.7	Delays in System Dynamics	29
1.7.1	Material Delays	29
1.7.2	Information Delays	30
1.8	System Dynamics with Three Stocks	33
1.8.1	Feedback Loops in General	33
1.8.2	Lorenz Chaos	34
1.9	Chaos in Discrete Time	37
1.9.1	Logistic Chaos	37
1.9.2	Discrete Chaos in S-shaped Limit to Growth	37

2	Demand and Supply	41
2.1	Adam Smith!	41
2.2	Unifying Three Schools in Economics	43
2.3	Tâtonnement Adjustment by Auctioneer	45
2.4	Price Adjustment with Inventory	50
2.5	Logical vs Historical Time	53
2.6	Stability on A Historical Time	54
2.7	A Pure Exchange Economy	56
2.7.1	A Simple Model	56
2.7.2	Tâtonnement Processes on Logical Time	58
2.7.3	Chaos Triggered by Preferences	61
2.7.4	Off-Equilibrium Transactions on Historical Time	63
2.8	Co-Flows of Goods with Money	64
3	Accounting System Dynamics	71
3.1	Introduction	71
3.2	Principles of System Dynamics	73
3.3	Principles of Accounting System	74
3.4	Principles of Accounting System Dynamics	78
3.5	Accounting System Dynamics Simplified	80
3.6	Accounting System Dynamics in Action	84
3.7	Making Financial Statements	96
3.8	Ratio Analysis of Financial Statements	98
3.9	Toward A Corporate Archetype Modeling	101
II	Macroeconomic Systems of Debt Money	103
4	Macroeconomic System Overview	105
4.1	Macroeconomic System	105
4.2	A Capitalist Market Economy	106
4.3	Modeling a Capitalist Market Economy	108
4.4	Fund-Raising Methods	110
4.5	A Goodwin Growth Cycle Model	114
4.6	A Monetary Goodwin Model	121
5	Money and Its Creation	127
5.1	What is Money?	127
5.1.1	Aristotle's Definition of Money	127
5.1.2	Issuance of Legal Tender	129
5.1.3	Classification of Money	131
5.1.4	Bank Deposits are not Money	132
5.1.5	Debt Money System	134
5.2	Flow Approach of Functional-Money Creation	136
5.2.1	Three Sectors and Twofold Double Entry Rule	136
5.2.2	A <i>Fractional Reserve</i> Banking: Flow Approach	137

5.2.3	Accounting Presentation of Flow Approach	144
5.3	Stock Approach of Functional-Money Creation	145
5.3.1	A <i>Fractional Reserve</i> Banking: Stock Approach	145
5.3.2	Accounting Presentation of Stock Approach	147
5.3.3	Masqueraded Economists for Flow Approach	149
5.4	Functional-Money Creation under Gold Standard	150
5.4.1	Flow Approach Simulations	150
5.4.2	Stock Approach Simulations	159
5.5	Functional-Money Creation out of Loan to Banks	162
5.5.1	Discount Loans: Flow Approach Simulations	163
5.5.2	Discount Loans: Stock Approach Simulations	166
5.6	Functional-Money Creation out of Loan to Government	166
5.6.1	A Complete Money Creation Model: Flow Approach	166
5.6.2	A Complete Money Creation Model: Stock Approach	177
5.7	The Heads and Tails of Functional-Money Creations	178
6	Interest and Equity	183
6.1	What is Interest?	183
6.2	Money and Interest under Gold Standard	184
6.3	Money and Interest under Bank Debt	186
6.4	Money and Interest under Government Debt	187
6.5	A Monetary Goodwin Model with Interest	189
6.6	Interest and Sustainability	196
7	Aggregate Demand Equilibria	199
7.1	Macroeconomic System Overview	199
7.2	A Keynesian Model	200
7.3	Aggregate Demand (IS-LM) Equilibria	206
7.4	Modeling Aggregate Demand Equilibria	210
7.5	Behaviors of Aggregate Demand Equilibria	216
7.6	Price Flexibility	225
7.7	A Comprehensive IS-LM Model	232
7.8	Conclusion	235
8	Integration of Real and Monetary Economies	241
8.1	Macroeconomic System Overview	241
8.2	Changes for Integration	242
8.3	Transactions Among Five Sectors	249
8.4	Behaviors of the Integrated Model	256
8.5	Conclusion	268

9	A Macroeconomic System	269
9.1	Macroeconomic System Overview	269
9.2	Production Function	269
9.3	Population and Labor Market	275
9.4	Transactions Among Five Sectors	277
9.5	Behaviors of the Complete Macroeconomic Model	285
9.6	Conclusion	298
III	Open Macroeconomic Systems of Debt Money	301
10	Balance of Payments and Foreign Exchange	303
10.1	Open Macroeconomy as a Mirror Image	303
10.2	Open Macroeconomic Transactions	304
10.3	The Balance of Payments	309
10.4	Determinants of Trade	314
10.5	Determinants of Foreign Investment	317
10.6	Dynamics of Foreign Exchange Rates	319
10.7	Behaviors of Current Account	322
10.8	Behaviors of Financial Account	324
10.9	Foreign Exchange Intervention	328
10.10	Missing Feedback Loops	330
10.11	Conclusion	333
11	Open Macroeconomies as A Closed System	335
11.1	Open Macroeconomic System Overview	335
11.2	Transactions in Open Macroeconomies	336
11.3	Behaviors of Open Macroeconomies	354
11.4	Where to Go from Here?	357
11.5	Conclusion	360
IV	Macroeconomic Systems of Public Money	361
12	Designing A Public Money System	363
12.1	Search for An Alternative System	363
12.2	Debt Crises As A Systemic Failure	364
12.3	A Public Money System	369
12.4	Macroeconomic System of Debt Money	375
12.5	Behaviors of A Debt Money System	379
12.6	Macroeconomic System of Public Money	386
12.7	Behaviors of A Public Money System	390
12.8	Conclusion	394

13 Workings of A Public Money System	395
13.1 Modeling A Debt Money System	395
13.2 Behaviors of A Debt Money System	398
13.3 Modeling A Public Money System	405
13.4 Behaviors of A Public Money System	410
13.5 Public Money Policies	412
14 Monetary and Financial Stability	419
14.1 The Chicago Plan Revisited	419
14.2 Debt vs Public Money Systems Simplified	421
14.3 Behaviors of A Debt Money System	426
14.4 Behaviors of A Public Money System	439
15 Public Money and Sustainability	447
15.1 Public vs Debt Money System Structures	447
15.2 Public vs Debt Money System Behaviors	451
15.3 The MuRatopian Economy Revisited	455
15.4 The Green Village(MuRatopia) Economy	459
16 A Transition to the Public Money System	467
16.1 Volatile Behaviors of Debt Money System	467
16.2 A Transition to the Public Money System	485

List of Figures

1.1	Language of System Dynamics	4
1.2	Stock-Flow Relation	7
1.3	Linear Flow of Time	11
1.4	Linear Flow and Stock	11
1.5	Nonlinear Flow and Stock	14
1.6	Random Walk	16
1.7	Stock-Dependent Feedback	17
1.8	Examples of Exponential Feedback	19
1.9	Balancing Feedback	19
1.10	Examples of Balancing Feedback	20
1.11	Exponential Decay	20
1.12	Examples of Exponential Decay	21
1.13	First-Order Linear Growth Model	21
1.14	Exponential Growth and Decay	22
1.15	S-shaped Growth Model	22
1.16	S-Shaped Limit to Growth 1	23
1.17	S-Shaped Limit to Growth Model with Table Function	24
1.18	S-Shaped Limit to Growth 2 with Table Function	24
1.19	Feedback Loops in General	25
1.20	S-shaped Growth Model	25
1.21	S-Shaped Limit to Growth 3	26
1.22	Overshoot & Collapse Model	27
1.23	Overshoot & Collapse Behavior	27
1.24	An Oscillation Model	28
1.25	Oscillation under Euler Method	28
1.26	Oscillation under Runge-Kutta2 Method	29
1.27	Structure of Delays	29
1.28	First-Order Material Delays	30
1.29	Second-Order Material Delays	31
1.30	First-Order Information Delays	31
1.31	Second-Order Information Delays	32
1.32	Adaptive Expectations for Random Walk	32
1.33	Feedback Loop in General	33
1.34	Lorenz Feedback Loop	34

1.35	Lorenz Chaos	35
1.36	Sensitive Dependence on Initial Conditions	36
1.37	Chaos in Logistic Function	37
1.38	Chaos in S-shaped Limit to Growth	38
2.1	Price Mechanism of Demand and Supply	42
2.2	Demand and Supply Functions	46
2.3	Auctioneer's Tâtonnement Model	47
2.4	Stability of Equilibrium	48
2.5	Chaotic Price Behavior	49
2.6	Short-side Transaction Model and Inventory	50
2.7	Price Adjustment Model with Inventory	51
2.8	Price Adjustment with Inventory	52
2.9	Effects of the Changes in Demand, Supply and Inventory Coverage	53
2.10	Auctioneer vs Inventory Price Mechanism Compared	54
2.11	Auctioneer vs Inventory Price Behaviors	54
2.12	Historical Price Stability with Adjusted Supply Schedule (1)	55
2.13	Historical Price Stability with Adjusted Supply Schedule (2)	56
2.14	A Causal Loop of A Pure Exchange Economy	58
2.15	A Pure Exchange Economy Model	59
2.16	Tâtonnement Adjustment Process	59
2.17	Price Movement of Period 1, 2, 4 and Chaos	60
2.18	Chaotic Price for λ	60
2.19	Sensitive Dependence on Initial Conditions	61
2.20	Price Movement of Period 1, 2, 4 and Chaos Caused by Tastes	62
2.21	Chaotic Price for α	62
2.22	Co-flows of Goods and Money	65
3.1	Stock-Flow Relation	73
3.2	Balance Sheet in [38] as a Collection of Stocks	75
3.3	Net Fixed Assets (Book Value) Relation	75
3.4	Income Statement as Stock-Flow Relation	77
3.5	Double Entry Rule of Bookkeeping as Debit and Credit	78
3.6	Double Entry Rule of Bookkeeping (1)	79
3.7	Double Entry Rule of Bookkeeping (2)	79
3.8	Double Entry Rule of Bookkeeping (3)	80
3.9	Double Entry Rule of Bookkeeping (4)	80
3.10	Accounting System Dynamics Simplified	83
3.11	Inventories with Production	88
3.12	Double Transactions caused by Customer Order	92
3.13	Balance Sheet	95
3.14	Cash Flow Statement	96
3.15	List of Transaction Data	97
3.16	Ratio Analysis Diagram	99
3.17	Returns on Assets and Equity	100
3.18	Net Cash Flow and Net Income	101

4.1	Macroeconomic System Overview	106
4.2	Macroeconomic System Flow Chart	109
4.3	Cash Flow of Producers	110
4.4	A Macroeconomic System Flow Chart with Banks	111
4.5	A Macroeconomic System Flow Chart with Investment Institutions	113
4.6	Macroeconomic System Flow Chart of Utopianism Economy . . .	114
4.7	Causal loops of A Goodwin Model	116
4.8	A Goodwin Growth Cycle Model	117
4.9	Wage Rates and Output	118
4.10	Adjustment in Labor Market	119
4.11	Business Cycle	119
4.12	Ratio Elasticity of Desired Wage Rate	120
4.13	Phase Diagram of Labor-Employment Ratio and Workers' Share	121
4.14	A Monetary Goodwin Model	122
4.15	Business Cycle caused by A Monetary Constraint	123
4.16	Desired Investment and Borrowing	124
4.17	Output and Unemployment Rate caused by A Credit Crunch . .	124
4.18	Accumulating Debt caused by A Business Cycle and Credit Crunch	125
5.1	Coflow of Money and Commodity	128
5.2	Base Money as Legal Tender	130
5.3	Issuance of Base Money Backed by Various Types of Assets . . .	130
5.4	Deposits as Functional-Money	133
5.5	Debt Money System	134
5.6	Japan's M_0 , M_1 and M_3 (1980-2015)	135
5.7	Three Sectors for Money Stock	136
5.8	Flow Approach of Money Creation	139
5.9	Money Stock Definitions: Flow Approach	142
5.10	Money Multiplier and Convertibility Coefficient in Japan	143
5.11	Stock Approach of Money Creation	147
5.12	Money Creation Model under Gold Standard: Flow Approach . .	151
5.13	Money Stock under Gold Standard	153
5.14	Currency Outstanding and Cash outside the Central Bank	154
5.15	Money Stock when Loan Adjustment Time triples.	155
5.16	Money Stock when Excess Reserve Ratio is 0.04.	156
5.17	Money Stock when Currency Ratio doubles at $t = 8$	157
5.18	100% Fractional Reserve	158
5.19	Money Stock, Assets, Equity and Debt	158
5.20	Money Stock Definition: A Stock Approach	159
5.21	Money Creation Model under Gold Standard: Stock Approach . .	160
5.22	Money Stock under Gold Standard: Stock Approach	161
5.23	Base Money, Deposits and Money Stock: Stock Approach	162
5.24	Money Creation Model out of Loan to Banks	164
5.25	Money Stock Creation out of Loan to Banks	165
5.26	Assets, Equity and Debts	165
5.27	Money Creation Model out of Loan to Banks: Stock Approach . .	167

5.28	Money Stock Creation out of Loan to Banks: Comparison	168
5.29	A Complete Money Creation Model: Non-Financial Sector	169
5.30	Non-Financial Sector (Government)	170
5.31	A Complete Money Creation Model: Commercial Banks	171
5.32	A Complete Money Creation Model: Central Bank	172
5.33	Simulation of Government Securities (Debt)	174
5.34	Simulation of Open Market Operation	174
5.35	Open Market Operation with Currency Ratio Doubled	175
5.36	Assets, Equity and Debt of Non-Financial Sector (Public)	175
5.37	A Complete Money Creation Model: Stock Approach	176
5.38	Simulation of Open Market Operation	177
5.39	Behaviors of Base Money and Money Stock: Flow Approach . . .	178
5.40	Behaviors of Base Money and Money Stock: Stock Approach . .	178
6.1	Money and Interest under Gold Standard	185
6.2	Money Supply and Equity under Gold Standard	186
6.3	Money Supply and Equity under Banks Debt	186
6.4	Equity Distribution between non-financial sector and Banks . . .	187
6.5	Money Supply and Equity under Government Debt	188
6.6	Public and Government Equities under Government Debt	188
6.7	Non-Financial and Central Bank Equities under Government Debt	188
6.8	Balance Sheet of the Monetary Goodwin Model with Interest . .	190
6.9	Output and Unemployment with Interest Rate: 0 - 30 years . .	191
6.10	Output and Unemployment with Interest Rate: 30 - 50 years . .	191
6.11	Increasing Bank Equity and Debt-GDP ratio: 30 - 50 years . . .	192
6.12	Desired Investment and Borrowing at a Prime Rate Spread=3% .	193
6.13	Breaking Phase Diagram of Labor-Employment Ratio and Work- ers' Share	193
6.14	Debt-GDP Ratio and Unemployment Rate: 20 - 50 years	194
6.15	Recovering Output with Interest Rate: 30 - 55 years	195
6.16	Recovering Unemployment with Interest Rate: 30 - 55 years . . .	195
6.17	Financial (Interest) System of Deposits/ Debts	196
7.1	Macroeconomic System Overview	200
7.2	Causal loops of Neoclassical and Keynesian Models	202
7.3	Keynesian Determination of GDP	203
7.4	Keynesian SD Model of GDP	204
7.5	Keynesian Determination of GDP	205
7.6	Revised Keynesian SD Model of GDP	207
7.7	SD Determination of GDP	207
7.8	IS-LM Determination of GDP and Interest Rate	209
7.9	Interest Rate Adjustment Process	211
7.10	Transactions of Producers	213
7.11	Transactions of Consumer	214
7.12	Transactions of Government	217
7.13	Transactions of Banks	218

7.14	Full Capacity Production	219
7.15	Aggregate Demand Mostly Equilibria	220
7.16	Aggregate Demand Disequilibria	221
7.17	Effect of Monetary Policy	222
7.18	Effect of Fiscal Policy	223
7.19	Behaviors of Interest Rate Compared	224
7.20	Skyrocketing Government Debt	224
7.21	Price and Interest Rate Adjustment Processes	226
7.22	Flexible Price Equilibria	227
7.23	Growth, Price, Money Supply, Demand and Interest Rate	228
7.24	Aggregate Demand and Supply Curves	228
7.25	Flexible Price Disequilibria	229
7.26	Growth, Price, Money Supply, Demand and Interest Rate	230
7.27	Growth-dependent Money Supply and its Effect on Interest Rate	230
7.28	Growth-dependent Money Supply on GDP and Growth Rate	231
7.29	Growth-dependent Money Supply on IS-LM	231
7.30	Interest Rate and Price Adjustment Process Revisited	233
7.31	Disequilibria triggered by A Technological Progress	234
7.32	Business Cycles under Price Flexibility	235
7.33	Aggregate Demand and Supply Curves	236
8.1	Macroeconomic System Overview	242
8.2	Real Production of GDP	244
8.3	Interest Rate and Price Adjustments	247
8.4	Lending by the Central Bank and its Growth Rate	248
8.5	Transactions of Producers	251
8.6	Transactions of Consumer	252
8.7	Transactions of Government	253
8.8	Transactions of Banks	255
8.9	Transactions of Central Bank	257
8.10	Mostly Equilibrium States	258
8.11	Growth and Inflation Rates of Mostly Equilibrium States	258
8.12	Fixprice and Mostly Equilibrium States	259
8.13	Business Cycles by Inventory Coverage	259
8.14	Business Cycles by Elastic Price Fluctuation	260
8.15	Money Supply and Interest Rate by Credit Crunch	260
8.16	Economic Recession by Credit Crunch	261
8.17	Currency in Circulation and Deposits by Bank Run	261
8.18	Money Supply and Depression by Bank Run	262
8.19	Monetary Policy: Open Market Purchase and GDP	263
8.20	Fiscal Policy: Change in Income Tax Rate and Interest Rate	264
8.21	Accumulation of Government Debt	265
8.22	Government Debt Deduction	266
8.23	Effect of Government Debt Deduction	266
8.24	Price Flexibility, Business Cycles and Debt Reduction	267
8.25	Comparison of GDP paths	267

9.1	Macroeconomic System Overview	270
9.2	Real Production of GDP	274
9.3	Population and Labor Market	276
9.4	Interest Rate, Price and Wage Rate	278
9.5	Transactions of Producers	279
9.6	Transactions of Consumer	280
9.7	Transactions of Government	282
9.8	Transactions of Banks	284
9.9	Transactions of Central Bank	286
9.10	Mostly Equilibrium States	287
9.11	GDP Gap Ratio and Unemployment Rate of the Equilibrium States	287
9.12	Fixprice and Mostly Equilibrium States	288
9.13	Business Cycles caused by Inventory Coverage	288
9.14	Business Cycles caused by Elastic Price Fluctuation	289
9.15	Business Cycles caused by Cost-push Price	289
9.16	Wage, Inflation and Unemployment Rates and GDP Gap	290
9.17	Okun's Law and Phillips Curve	290
9.18	Money Supply and Interest Rate by Credit Crunch	291
9.19	Economic Recessions caused by Credit Crunch	291
9.20	Currency in Circulation and Deposits by Bank Run	292
9.21	Money Supply and Depression by Bank Run	292
9.22	Depression by Bank Run	293
9.23	Monetary Policy of Open Market Purchase and GDP	294
9.24	Fiscal Policy of a Change in Income Tax Rate and GDP	295
9.25	Accumulation of Government Debt	295
9.26	Government Debt Deduction	296
9.27	Effect of Government Debt Deduction	297
9.28	GDP Gap and Unemployment Rate under Price Flexibility	297
9.29	Comparison of GDP paths	298
10.1	Foreign Sector as a Mirror Image of Domestic Macroeconomy	304
10.2	Transactions of Producers	306
10.3	Transactions of Foreign Producers	307
10.4	Transactions of Consumers and Government	308
10.5	Transactions of Banks	310
10.6	Transactions of Foreign Banks	311
10.7	Transactions of the Central Bank	312
10.8	The Balance of Payments	313
10.9	A Simulation of Balance of Payments	314
10.10	Normalized Demand Curve	314
10.11	Trade Balance vs Foreign Exchange Rate	316
10.12	Direct and Financial Investment Indices	318
10.13	Net Capital Inflow vs Foreign Exchange Rate	319
10.14	Determination of Foreign Exchange	321
10.15	Causal Loop Diagram of the Foreign Exchange Dynamics	322
10.16	Equilibrium State of Trade and Foreign Exchange Rate (S)	322

10.17	Foreign GDP Plunge and Restoring Trade Balance (S1)	323
10.18	Foreign Inflation and Restoring Trade Balance (S2)	324
10.19	Random Expectations and Foreign Investment (S3)	325
10.20	Interest Plummet under Random Expectations (S4)	326
10.21	Comparison of the Balance of Payments between S3 and S4	327
10.22	Foreign GDP Plunge and Foreign Investment (S5)	327
10.23	Official Intervention and Default (S6)	329
10.24	Zero Interest Rate and Default (S7)	330
10.25	No Official Intervention (S8)	331
10.26	Missing Feedback Loops Added to the Foreign Exchange Dynamics	332
11.1	Open Macroeconomic System Overview	336
11.2	Fixed Missing Loops in the Foreign Exchange Dynamics Model	341
11.3	Population and Labor Force	342
11.4	GDP Determination	343
11.5	Interest Rate, Price and Wage Rate	344
11.6	Transactions of Producers	345
11.7	Transactions of Consumers	346
11.8	Transactions of Government	347
11.9	Transactions of Banks	348
11.10	Transactions of Central Bank	349
11.11	Foreign Exchange Market	350
11.12	Balance of Payment	351
11.13	Simulation Panel of GDP	352
11.14	Simulation Panel of Trade and Investment Abroad	353
11.15	Mostly Equilibria under Trade and Capital Flows	354
11.16	Trade Balance and Balance of Payments	355
11.17	Interest Arbitrage and Financial Investment	355
11.18	Inventory Business Cycles under Trade and Capital Flow	356
11.19	Inventory Business Cycles Affecting Foreign Macroeconomy	356
11.20	Credit Crunch under Trade and Capital Flow	357
11.21	Credit Crunch Affecting Foreign Macroeconomy	357
12.1	U.S. National Debt and its Forecast: 1970 - 2020	366
12.2	Impasses of Defaults, Financial Meltdown and Hyper-Inflation	367
12.3	Transactions of Government	377
12.4	Transactions of Banks	378
12.5	Transactions of Central Bank	380
12.6	Mostly Equilibrium States	381
12.7	Lending by the Central Bank and its Growth Rate	382
12.8	Accumulation of Government Debt and Debt-GDP Ratio	383
12.9	Liquidation Policies: Spend Less and Tax More	384
12.10	Comparison of GDP paths	385
12.11	Transactions of Government	387
12.12	100% Required Reserve Ratios	388
12.13	Transactions of the Public Money Administration	389

12.14	Liquidation of Government Debt and Debt-GDP Ratio	390
12.15	Comparison of GDP and Growth Rates	391
12.16	Price Level and Inflation Rate	391
12.17	No Inflation under GDP Gap	392
12.18	Inflation under No GDP Gap	392
12.19	Business Cycles caused by Inflation under No GDP Gap	392
13.1	Mostly Equilibrium States	399
13.2	GDP Gap and Unemployment Rate of Mostly Equilibrium States	399
13.3	Lending by the Central Bank and its Growth Rate	400
13.4	Accumulation of Government Debt and Debt-GDP Ratio	401
13.5	Liquidation Policies: Spend Less and Tax More	402
13.6	Recessions triggered by Debt Liquidation	403
13.7	GDP Gap and Unemployment	404
13.8	Wage Rate and Inflation	404
13.9	Foreign Recessions Contagiously Triggered	405
13.10	Liquidation Traps of Debt	405
13.11	Causal Loop Diagram of Liquidation Traps of Debt	406
13.12	Transactions of Government	407
13.13	100% Required Reserve Ratios	408
13.14	Transactions of Public Money Administration (Central Bank)	409
13.15	Liquidation of Government Debt and Debt-GDP Ratio	410
13.16	No Recessions Triggered by A Public Money System	411
13.17	GDP Gap and Unemployment	411
13.18	Wage Rate and Inflation	411
13.19	Foreign Recessions are Not Triggered	412
13.20	Public Money Policies	413
13.21	GDP Gap and Its Public Money Policy	414
13.22	GDP Gap and Unemployment Recovered	414
13.23	Price and Inflation Rate	415
13.24	GDP Gap and Unemployment	415
13.25	Business Cycles caused by Inflation under No GDP Gap	416
14.1	Transactions of Producers	423
14.2	Transactions of Consumers	424
14.3	Transactions of Banks	425
14.4	Keynesian GDP Determination	426
14.5	Determination of GDP and Price	427
14.6	Keynesian Determination of GDP	428
14.7	Monetary Constraint GDP	430
14.8	Credit Creation	431
14.9	Equilibrium GDP by Credit Creation(100%)	431
14.10	Money Supply: M0, M1 and M2	433
14.11	Changes in Money Supply and Net Interest Income of Bankers	434
14.12	Greed of Bankers	435
14.13	Price Levels and Inflation Rates with Credit Overshooting	435

14.14	Interest-Wage Ratio and Wage Distribution	436
14.15	Reduction of M1 and Deflation by Credit Crunch	437
14.16	Recession (GDP and Growth Rate) triggered by Credit Crunch	437
14.17	Causal Loop Diagram of Debt Money System	438
14.18	Sensitivity of Credit Creation on Growth Rates	439
14.19	Sensitivity of Credit Creation on Inflation Rates	439
14.20	GDP under Debt vs Public Money System	441
14.21	Money Supply and Inflation under Debt vs Public Money	442
14.22	Interest Income and Wage Distribution under Debt vs Public Money	442
14.23	Causal Loop Diagram of Public Money System	443
14.24	Debt-vs-Public System Sensitivity: Inflation Rates	444
14.25	Debt-vs-Public System Sensitivity: Wage Distribution	444
14.26	Debt-vs-Public System Sensitivity: GDP	445
15.1	Inequality under Debt Money System	454
15.2	Re-unified Co-Workers	458
16.1	(0) Initial Base Money	468
16.2	Definition of Money Supply	469
16.3	Bubbles and Recessions under the Debt Money System	471
16.4	(1) Fractional Reserve Banking System	473
16.5	(2) Making Bubbles	474
16.6	(3) Bubble Burst and Bank-runs	475
16.7	(4) Credit Crunch → Depressions	476
16.8	(5) Issuing Securities → Restore Money Supply	477
16.9	(6) Bailout → Accumulated Debt	479
16.10	(7) Collapse of Securities	480
16.11	(8) Financial Quantitative Easing (QE)	481
16.12	Monetary Instability under the Debt Money System	483
16.13	Parameters under the Debt Money System	483
16.14	Definition of Money Multiplier	484
16.15	Instability of Money Multiplier	485
16.16	(T1) Conversion to the Public Money	489
16.17	(T2) Securities as Reserves Collateral	490
16.18	(T3) Public Money Issued	491
16.19	(T4) Debt Liquidation: Money Supply Unchanged	492
16.20	(T5) Public Money Converted to Time Deposits	493
16.21	(T6) Public Money Added into Circulation for Welfare and Growth	494
16.22	From Debt Money to Public Money System	496
16.23	Money Multiplier from Debt Money to Public Money System	496
16.24	Monetary Stabilization under the Public Money System	497

List of Tables

1.1	Classification of Stock	6
1.2	Linear Flow Calculation of $x(10)$ for $dt=1$ and 0.5	13
1.3	Discrete Approximation for $x(10)$	13
1.4	Discrete Approximation for $x(6)$	15
1.5	2nd- and 4th-Order Runge-Kutta Method ($dt = 1$)	15
1.6	Discrete Approximation	18
1.7	Equations of the First-Order Growth Model	22
1.8	Same Number of Calculation	39
2.1	Demand and Supply Schedules in [76]	45
2.2	Effect of Inventory Ratio on Price	51
3.1	Balance Sheet in [38]	74
3.2	Income Statement in [38]	76
3.3	Cash Flow Statement in [38]	76
3.4	All Transaction Data	85
3.5	Inventory Valuation Worksheet for Transaction 18	90
3.6	Balance Sheet Table	98
5.1	Journal Entries of Transaction with Cash	129
5.2	Public Money vs Debt Money	132
5.3	Journal Entries of Transaction with Deposits	133
5.4	Journal Entries of Flow Approach in (2) and (3)	144
5.5	Transactions of Non-Banking Sectors: Flow Approach	145
5.6	Journal Entries of Stock Approach in (2) and (3)	148
5.7	Transactions of Non-Banking Sector: Stock Approach	149
12.1	Public Debt-GDP Ratio(%) of OECD Countries in 2010	365
15.1	Public Money vs Debt Money System Structures	448
15.2	Public Money vs Debt Money System Behaviors	451
15.3	The Green Village(MuRatopia) Economic System of Public Money	461