<u>The Federal Reserve System—Introduction</u>

Necessarily, this section will be a bit longer than the others, but what you should understand better at the end is how money is created in this and other countries, how fractional reserve banking works in practice, and how inflation is theft—or if you prefer "invisible taxation".

In our country and as far as I know *all* industrialized nations, the first key concept is that of the Central Bank. A central bank is an institution—normally a government run one in all countries but our own—which has the power to create and extinguish money. In our country the central bank is called the Federal Reserve. In England it is called the Bank of England; in France the "Banque de France"; in Germany the Deutsche Bundesbank.

In most European nations the central banks were created to enable deficit spending and money printing, normally first for wars and then later for social programs.

The Federal Reserve System, in contrast, was conceived in great secrecy by Wall Street bankers to protect their hold on the money system. In general terms, of course, this is an opinion, but the fact of the matter is we know who the people were who came up with the system, and the devious tactics they used to sell it, first to Congress, then to the public. All of them were bankers, and several of them were direct competitors. The group that wrote the legislation represented between them roughly one fourth of the wealth in the world, and it is not unreasonable to suppose they wanted to keep it that way.

Think of the Fed as Apple, Microsoft, Oracle, Sun and IBM getting together to form a body with the legal power—unchecked by Congress--to determine who could make computers and write software, and under what terms. There was collusion at the very top and at the very beginning.

It was intended to be the sole source of currency in the United States, and to serve to bail out big banks who lent out too much relative to their reserves, and got bitten. It accomplished those goals.

As things stand today, <u>the Federal Reserve operates without any Congressional oversight</u>, and literally has the power to do <u>***anything***</u> it wants with our monetary system. They could write a $10 trillion check if they wanted to, to virtually anyone they wanted to, backed by nothing (they "create" money in the very act of writing the check), with vast and immediate inflationary consequences. They could cut our money supply in half by selling off their securities and drastically raising bank reserve requirements. <u>Unelected, they nonetheless have control of our money, and by extension our economy and lives.</u>

Internationally, their counterparts at the IMF and World Bank can likewise write checks in any amount to anyone they want, subject to no effective authority outside the boardrooms they control. Obviously, they value these privileges, so they rarely abuse them in obvious ways, but the fact remains that these statements are quite accurate.

If this sounds scary, it is. This is why the Federal Reserve intentionally shrouds what it does in mystery[1]. They claim that they are needed to fight inflation, but the simple and unavoidable fact is that inflation is impossible without the creation of money, and since they are by law the sole entity empowered to create money (directly or indirectly), they are deceiving us. *They are creating inflation with one hand, and demanding our respect for fighting it with the other.* It is a cruel lie.

The simple reality is that the so-called "business cycle" is impossible without inflation. Since the Fed creates inflation, the "business cycle" would be impossible without them. All a business cycle is, is growth funded by easy credit, followed by a crash when it becomes obvious too much credit has been extended. This may sound extreme or simplistic, but it is quite sound economically. This is the protocol for boom/bust cycle. And if you take this pattern, combine it with deflationary monetary policy, and add Keynesian economics, you get the Great Depression. That claim will be supported in a later chapter.

For now, let's return to fractional reserve banking, which is to say the practice of banks of loaning out most of their money, such that if all their depositors asked for it at once, they would go bankrupt. It's the problem of our goldsmith creating 4 receipts for every piece of gold.

At one time, all paper money was backed by—redeemable for—gold. The United States practiced fractional reserve gold banking until the 1930's—which meant we kept some percentage, say 1/10th , the gold we needed to redeem outstanding notes—then abolished the gold standard completely in the 1970's. That's why gold was in Fort Knox.

The abolition of the gold standard means that all the dollars in existence today are backed by nothing, except the "legal tender" laws which require all of us, under penalty of criminal prosecution and possible jail time, to accept the dollar for all debts, public and private. (As a side note, there have been times when "money" came in different forms, where some could only be used for taxes, and other sorts only for private debts.)

Practically, this means that there are no limits to money creation. That's all gold really does, is limit how much money you can print. Even on a fractional gold standard you have to add gold to add money. As we saw, inflation is nothing but money that is created and circulated. If you suddenly have twice of something, then it is worth half what it was. If you have a printing press, then you can buy things with money that is worth more than it will be after it is exchanged a few times. Many dictators (such as Chavez and Mugabe)figure this out, and buy themselves whatever they want, to the great detriment of their people. It's a great game, since most people don't know how inflation happens.

The analogy that made this all clear to me was to imaginatively place a teacup on one side of a table. That teacup stands in for all the material goods in existence, such as railroads, houses, cars, and

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[1] ". . .there is a federal agency that tops the others [including the CIA and DIA] in secrecy by a country mile. The Federal Reserve System is accountable to no one; it has no budget; it is subject to no audit; and no Congressional committee knows of, or can truly supervise, its operations. The Federal Reserve, virtually in total control of the nation's vital monetary system, is accountable to nobody. . .". Murray Rothbard. <u>The Case against the Fed</u>

consumer items. On the other we place a dollar bill. This stands in for all the money in existence in that system, which is to say the legal tender for that country, which here is the dollar.

Common sense will tell you that as productivity increases, the cost of goods will fall. In this analogy, the cost of teacups should be dropping steadily. For every dollar you have, you should be able to buy two, then three, then four teacups, in an on-going expansion of the purchasing power of that dollar.

To take a very concrete example, when farmers switched from wooden plows to iron plows, they were able to farm much bigger areas with the same work. This meant they were more easily able to provide for themselves, and therefore had more available for sale. This meant more goods at the market, more competition, and lower prices for the consumers.

Technology has produced *enormous* gains in productivity in the last 100 years. We all know this. Yet, we work more hours than our grandparents did. Our houses may be bigger, and we may have two cars in the garage, but both parents in most families work to provide them. We seem to have done better providing the basics 50 years ago. Most people owned their houses, their cars, and did not struggle the way we do. What happened?

The short answer is we got hooked on easy credit. One of the explicit goals of the Federal Reserve (and of Keynesian economics, which will be dealt with shortly) was to reduce private capital accumulation. They wanted people to have to come to them to buy large ticket items.

Let us, then, look at the dollar side of the table. We have the teacup and the dollar. We then place a second dollar next to the first. This dollar doesn't belong to you. It belongs to a bank or the Federal Government. That bank (or Washington) created that money out of nothing, but now it holds a share of the physical property of the nation. This is inflation. ***Inflation is a system for the transfer of wealth from those who produce things (which of course includes ideas) to those who produce money or government.***

On this last point, we need to be clear that inflation is taxation. The Federal Government could literally suspend taxation tomorrow, and just print money to cover its bills. As a child I used to wonder why they didn't do this. Why would an entity powerful enough to force people to take its money not just, in effect or actually, take what it wants? How can a government ever go broke, when it makes the money?

The answer is that this solution has been tried many times, and it won't work indefinitely without the complete collapse of the financial system. Take modern Zimbabwe, under Mugabe, or Weimar Germany just after WW1, or the American colonies during the Revolutionary War. You can run the presses 24/7, but the more money you put into circulation, the less it is worth. We have all seen the pictures of Germans with wheelbarrows full of money with which they hoped to buy a loaf of bread.[2] The same thing happened with the Continental, our currency that was used to pay for the Revolutionary War.

This sort of policy leads to widespread impoverishment, social unrest, and economic instability. As we will see with Keynes, it can be used as a tool to undermine private property rights, but for now please accept that there is no fundamental difference between open taxation, and inflation, except that one is obvious, and one is covert. Both involve the transfer of wealth from individuals and corporations to those printing and distributing the money.

Discussion Questions

1. Who do you think has most of the wealth in this country? What do they produce? Your answer need not be "bankers". Really think about it, and do some research. Who owns the skyscrapers downtown?

[2] In their case, it was almost certainly the result of intentionally inflationary policy the German pursued to pay their war debts with devalued currency.