THE CREATURE FROM JEKYLL ISLAND

A Second Look at the Federal Reserve

Fourth edition

by G. Edward Griffin

American Media

Dedicated to the next generation–especially my own brood:
James, Daniel, Ralph, and Kathleen.
May this effort help to build for them a better world.

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What is the Federal Reserve System? The answer may surprise you. It is not federal and there are no reserves. Furthermore, the Federal Reserve Banks are not even banks. The key to this riddle is to be found, not at the beginning of the story, but in the middle. Since this is not a textbook, we are not confined to a chronological structure. The subject matter is not a curriculum to be mastered but a mystery to be solved. So let us start where the action is.

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The eight chapters contained in this and the following section deal with material that is organized by topic, not chronology. Several of them will jump ahead of events that are not covered until later. Furthermore, the scope is such that the reader may wonder what, if any, is the connection with the Federal Reserve System. Please be patient. The importance will eventually become clear. It is the author's intent to cover concepts and principles before looking at events. Without this background, the history of the Federal Reserve is boring. *With* it, the story emerges as an exciting drama which profoundly affects our lives today. So let us begin this adventure with a few discoveries about the nature of money itself.

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There is another dimension to the game, however, that involves more than mere profits and scam. It is the conscious and deliberate evolution of the IMF/World Bank into a world central bank with the power to issue a world fiat currency. And that is an important step in an even larger plan to build a true world government within the framework of the United Nations.

Economically strong nations are not candidates for surrendering their sovereignty to a world government. Therefore, through "loans" that will never be paid back, the IMF/World Bank directs the massive transfer of wealth from the industrialized nations to the less developed nations. This ongoing process eventually drains their economies to the point where they also will be in need of assistance. No longer capable of independent action, they will accept the loss of sovereignty in return for international aid.

The less developed countries, on the other hand, are being brought into The New World Order along an entirely different route. Many of these countries are ruled by petty tyrants who care little for their people except how to extract more taxes from them without causing a revolt. Loans from the IMF/World Bank are used primarily to perpetuate themselves and their ruling parties in power—and that is exactly what the IMF/World Bank intends. Rhetoric about helping the poor notwithstanding, the true goal of the transfer of wealth disguised as loans is to get control over the leaders of the less developed countries. After these despots get used to the taste of such an unlimited supply of sweet cash, they will never be able to break the habit. They will be content—already *are* content—to become little gold-plated cogs in the giant machinery of world government. Ideology means nothing to them: capitalist, communist, socialist, fascist, what does it matter so long as the money keeps coming. The IMF/World Bank literally is *buying* these countries and using our money to do it.

The recent inclusion of Red China and the former Soviet bloc on the list of IMF/World Bank recipient countries signals the final phase of the game. Now that Latin America and Africa have been "purchased" into the New World Order, this is the final frontier. In a relatively short time span, China, Russia, and the Eastern European countries have now become the biggest borrowers and, already, they are in arrears on their payments. This is where the action will lie in the months ahead.

Section II

A CRASH COURSE ON MONEY

The eight chapters contained in this and the following section deal with material that is organized by topic, not chronology. Several of them will jump ahead of events that are not covered until later. Furthermore, the scope is such that the reader may wonder what, if any, is the connection with the Federal Reserve System. Please be patient. The importance will eventually become clear. It is the author's intent to cover concepts and principles before looking at events. Without this background, the history of the Federal Reserve is boring. *With* it, the story emerges as an exciting drama which profoundly affects our lives today. So let us begin this adventure with a few discoveries about the nature of money itself.

Chapter Seven

THE BARBARIC METAL

The history and evolution of money; the emergence of gold as the universal money supply; the attempts by governments to cheat their subjects by clipping or debasing gold coins; the reality that any quantity of gold will suffice for a monetary system and that "more money" does not require more gold.

There is a great mystique surrounding the nature of money. It is generally regarded as beyond the understanding of mere mortals. Questions of the origin of money or the mechanism of its creation are seldom matters of public debate. We accept them as facts of life which are beyond our sphere of control. Thus, in a nation which is founded on the principle of government by the people, and which assumes a high level of understanding among the electorate, the people themselves have blocked out one of the most important factors affecting, not only their government, but their personal lives as well.

This attitude is not accidental, nor was it always so. There was a time in the fairly recent past when the humble voter—even without formal education—was well informed on money matters and vitally concerned about their political implementation. In fact, as we shall see in a later chapter, major elections were won or lost depending on how candidates stood on the issue of a central bank. It has been in the interest of the money mandarins, however, to convince the public that, now, these issues are too complicated for novices. Through the use of technical jargon and by hiding simple reality inside a maze of bewildering procedures, they have caused an understanding of the *nature* of money to fade from the public consciousness.

WHAT IS MONEY?

The first step in this maneuver was to scramble the definition of money itself. For example, the July 20, 1975 issue of the *New York*

Times, in an article entitled "Money Supply: A Growing Muddle," begins with the question: "What is money nowadays?" The *Wall Street Journal* of August 29, 1975, comments: "The men and women involved in this arcane exercise [of watching the money supply] ... aren't exactly sure what the money supply consists of." And, in its September 24, 1971 issue, the same paper said: "A pro-International Monetary Fund Seminar of eminent economists couldn't agree on what money is or how banks create it."

Even the government cannot define money. Some years ago, a Mr. A.F. Davis mailed a ten-dollar Federal Reserve Note to the Treasury Department. In his letter of transmittal, he called attention to the inscription on the bill which said that it was redeemable in "lawful money," and then requested that such money be sent to him. In reply, the Treasury merely sent two five-dollar bills from a different printing series bearing a similar promise to pay. Mr. Davis responded:

> Dear Sir:
>
> Receipt is hereby acknowledged of two $5.00 United States notes, which we interpret from your letter are to be considered as lawful money. Are we to infer from this that the Federal Reserve notes are not lawful money?
>
> I am enclosing one of the $5.00 notes which you sent to me. I note that it states on the face, "The United States of America will pay to the bearer on demand five dollars." I am hereby demanding five dollars.

One week later, Mr. Davis received the following reply from Acting Treasurer, M.E. Slindee:

> Dear Mr. Davis:
>
> Receipt is acknowledged of your letter of December 23rd, transmitting one $5. United States Note with a demand for payment of five dollars. You are advised that the term "lawful money" has not been defined in federal legislation.... The term "lawful currency" no longer has such special significance. The $5. United States Note received with your letter of December 23rd is returned herewith.[1]

The phrases "...will pay to the bearer on demand" and "... is redeemable in lawful money" were deleted from our currency altogether in 1964.

1. As quoted by C.V. Myers, *Money and Energy: Weathering the Storm* (Darien, Connecticut: Soundview Books, 1980), pp. 161, 163. Also by Lawrence S. Ritter, ed., *Money and Economic Activity* (Boston: Houghton Mifflin, 1967), p. 33.

Is money really so mysterious that it cannot be defined? Is it the coin and currency we have in our pockets? Is it numbers in a checking account or electronic impulses in a computer? Does it include the balance in a savings account or the available credit on a charge card? Does it include the value of stocks and bonds, houses, land, or personal possessions? Or is money nothing more than purchasing power?

The main function of the Federal Reserve is to regulate the supply of money. Yet, if no one is able to define what money is, how can we have an opinion about how the System is performing? The answer, of course, is that we cannot, and that is exactly the way the cartel wants it.

The reason the Federal Reserve appears to be a complicated subject is because most discussions start somewhere in the *middle*. By the time we get into it, definitions have been scrambled and basic concepts have been assumed. Under such conditions, intellectual chaos is inevitable. If we start at the beginning, however, and deal with each concept in sequence from the general to the specific, and if we agree on definitions as we go, we shall find to our amazement that the issues are really quite simple. Furthermore, the process is not only painless, it is—believe it or not—intensely interesting.

The purpose of this and the next three chapters, therefore, is to provide what could be called a crash course on money. It will *not* be complicated. In fact, you already know much of what follows. All we shall attempt to do is tie it all together so that it will have continuity and relativity to our subject. When you are through with these next few pages, you *will* understand money. That's a promise.

So, let's get started with the basics. What is money?

A WORKING DEFINITION

The dictionary is of little help. If economists cannot agree on what money is, it is partly due to the fact that there are so many definitions available that it is difficult to insist that any of them is the obvious choice. For the purpose of our analysis, however, it will be necessary to establish *one* definition so we can at least know what is meant when the word is used within this text. To that end, we shall introduce our own definition which has been assembled from bits and dabs taken from numerous sources. The structure is designed, not to reflect what we think money *ought* to be or to

support the view of any particular school of economics, but simply to reduce the concept to its most fundamental essence and to reflect the reality of today's world. It is not necessary to agree or disagree with this definition. It is introduced solely for the purpose of providing an understanding of the word *as it is used within these pages*. This, then, shall be our working definition:

Money is anything which is accepted as a medium of exchange and it may be classified into the following forms:

1. Commodity money
2. Receipt money
3. Fiat money
4. Fractional money

Understanding the difference between these forms of money is practically all we need to know to fully comprehend the Federal Reserve System and to come to a judgment regarding its value to our economy and to our nation. Let us, therefore, examine each of them in some detail.

BARTER (PRE-MONEY)

Before there was any kind of money, however, there was barter, and it is important first to understand the link between the two. Barter is defined as that which is directly exchanged for something of like value. Mr. Jones swaps his restored Model-T Ford for a Steinway grand piano.[1] This exchange is not monetary in nature because both items are valued for themselves rather than held as a *medium* of exchange to be used later for something else. Note, however, that both items have intrinsic value or they would not be accepted by the other parties. Labor also may be exchanged as barter when it, too, is perceived to have intrinsic value to the person for whom the labor is performed. The concept of *intrinsic value* is the key to an understanding of the various forms of money that evolved from the process of barter.

COMMODITY MONEY

In the natural evolution of every society, there always have been one or two items which became more commonly used in barter than all others. This was because they had certain characteristics which made them useful or attractive to almost everyone. Eventually, they were traded, not for themselves, but because they represented a storehouse of value which could be exchanged at a later time for something else. At that point, they ceased being barter and became true money. They were, according to our working definition, a *medium* of exchange. And, since that medium was a commodity of intrinsic value, it may be described as *commodity money*.

Among primitive people, the most usual item to become commodity money was some form of food, either produce or livestock. Lingering testimony to this fact is our word *pecuniary*, which means pertaining to money. It is derived from the word *pecunia*, which is the Latin word for cow.

But, as society progressed beyond the level of bare existence, items other than food came into general demand. Ornaments were occasionally prized when the food supply was ample, and there is evidence of some societies using colored sea shells and unusual stones for this purpose. But these never seriously challenged the use of cattle, or sheep, or corn, or wheat, because these staples possessed greater intrinsic value for themselves even if they were not used as money.

METALS AS MONEY

Eventually, when man learned how to refine crude ores and to craft them into tools or weapons, the metals themselves became of value. This was the dawning of the Bronze Age in which iron, copper, tin, and bronze were traded between craftsmen and merchants along trade routes and at major sea ports.

The value of metal ingots was originally determined by weight. Then, as it became customary for the merchants who cast them to stamp the uniform weights on the top, they eventually were valued simply by counting their number. Although they were too large to carry in a pouch, they were still small enough to be transported easily and, in this form, they became, in effect, primitive but functional coins.

The primary reason metals became widely used as commodity money is that they meet all of the requirements for convenient trading. In addition to being of intrinsic value for uses *other* than money, they are not perishable, which is more than one can say for

1. Strictly speaking, each party holds the value of what he is receiving to be more than what he is giving. Otherwise he would not make the trade. In the mind of the traders, therefore, the items have *unequal* value. That opinion is shared *equally* by them both. The shorter explanation, however, is less unwieldy.

cows; by melting and reforming they can be divided into smaller units and conveniently used for purchases of minor items, which is not possible with diamonds, for example; and, because they are not in great abundance, small quantities carry high value, which means they are more portable than such items as timber, for example.

Perhaps the most important monetary attribute of metals, however, is their ability to be precisely measured. It is important to keep in mind that, in its fundamental form and function, money is both a storehouse and a *measure* of value. It is the reference by which all other things in the economy can be compared. It is essential, therefore, that the monetary unit itself be both measurable and constant. The ability to precisely assay metals in both purity and weight makes them ideally suited for this function. Experts may haggle over the precise quality of a gemstone, but an ingot of metal is either 99% pure or it isn't, and it either weighs 100 ounces or it doesn't. One's opinion has little to do with it. It is not without reason, therefore, that, on every continent and throughout history, man has chosen metals as the ideal storehouse and measure of value.

THE SUPREMACY OF GOLD

There is one metal, of course, that has been selected by centuries of trial and error above all others. Even today, in a world where money can no longer be defined, the common man instinctively knows that gold will do just fine until something better comes along. We shall leave it to the sociologists to debate *why* gold has been chosen as the universal money. For our purposes, it is only important to know that it *has* been. But we should not overlook the possibility that it was an excellent choice. As for quantity, there seems to be just the right amount to keep its value high enough for useful coinage. It is less plentiful than silver —which, incidentally, has run a close second in the monetary contest—and more abundant than platinum. Either could have served the purpose quite well, but gold has provided what appears to be the perfect compromise. Furthermore, it is a commodity in great demand for purposes other than money. It is sought for both industry and ornament, thus assuring its intrinsic value under all conditions. And, of course, its purity and weight can be precisely measured.

THE MISLEADING THEORY OF QUANTITY

It often is argued that gold is inappropriate as money because it is too limited in supply to satisfy the needs of modern commerce. On the surface, that may sound logical—after all, we *do* need a lot of money out there to keep the wheels of the economy turning—but, upon examination, this turns out to be one of the most childish ideas imaginable.

First of all, it is estimated that approximately 45% of all the gold mined throughout the world since the discovery of America is now in government or banking stockpiles.[1] There undoubtedly is at least an additional 30% in jewelry, ornaments, and private hoards. Any commodity which exists to the extent of 75% of its total world production since Columbus discovered America can hardly be described as in short supply.

The deeper reality, however, is that the supply is not even important. Remember that the primary function of money is to *measure* the value of the items for which it is exchanged. In this sense, it serves as a yardstick or ruler of value. It really makes no difference if we measure the length of our rug in inches, feet, yards, or meters. We could even manage it quite well in *miles* if we used decimals and expressed the result in *millimiles*. We could even use multiple rulers, but no matter what measurement we use, the reality of what we are measuring does not change. Our rug does not become larger just because we have increased the quantity of measurement units by painting additional markers onto our rulers.

If the supply of gold in relation to the supply of available goods is so small that a one-ounce coin would be too valuable for minor transactions, people simply would use half-ounce coins or tenth-ounce coins. The amount of gold in the world does not affect its ability to serve as money, it only affects the *quantity* that will be used to measure any given transaction.

Let us illustrate the point by imagining that we are playing a game of Monopoly. Each person has been given a starting supply of play money with which to transact business. It doesn't take long before we all begin to feel the shortage of cash. If we just had more *money*, we could really wheel and deal. Let us suppose further that someone discovers another game-box of Monopoly sitting in the

1. See Elgin Groseclose, *Money and Man: A survey of Monetary Experience*, 4th ed. (Oklahoma: University of Oklahoma Press, 1976), p. 259.

closet and proposes that the currency from that be added to the game under progress. By general agreement, the little bills are distributed equally among all players. What would happen?

The money supply has now been doubled. We all have twice as much money as we did a moment before. But would we be any better off? There is no corresponding increase in the quantity of property, so everyone would bid up the prices of existing pieces until they became twice as expensive. In other words, the law of supply and demand would rapidly seek exactly the same equilibrium as existed with the more limited money supply. When the quantity of money expands without a corresponding increase in goods, the effect is a reduction in the purchasing power of each monetary unit. In other words, nothing really changes except that the quoted price of everything goes up. But that is merely the *quoted* price, the price as expressed in terms of the monetary unit. In truth, the *real* price, in terms of its relationship to all other prices, remains the same. It's merely that the relative value of the money supply has gone down. This, of course, is the classic mechanism of inflation. Prices do not go up. The value of the money goes down.

If Santa Claus were to visit everyone on Earth next Christmas and leave in our stockings an amount of money exactly equal to the amount we already had, there is no doubt that many would rejoice over the sudden increase in wealth. By New Year's day, however, prices would have doubled for everything, and the net result on the world's standard of living would be exactly zero.[1]

The reason so many people fall for the appealing argument that the economy needs a larger money supply is that they zero in only on the need to increase *their* supply. If they paused for a moment to reflect on the consequences of the *total* supply increasing, the nonsense of the proposal becomes immediately apparent.

Murray Rothbard, professor of economics at the University of Nevada at Las Vegas, says:

> We come to the startling truth that *it doesn't matter what the supply of money is.* Any supply will do as well as any other supply. The free market will simply adjust by changing the purchasing power, or effectiveness, of its gold-unit. There is no need whatever for any planned increase in the money supply, for the supply to rise to offset

1. Those who rushed to market first, however, would benefit temporarily from the old prices. Under inflation, those who save are punished.

> any condition, or to follow any artificial criteria. More money does not supply more capital, is not more productive, does not permit "economic growth."[1]

GOLD GUARANTEES PRICE STABILITY

The Federal Reserve claims that one of its primary objectives is to stabilize prices. In this, of course, it has failed miserably. The irony, however, is that maintaining stable prices is the easiest thing in the world. All we have to do is stop tinkering with the money supply and let the free market do its job. Prices become *automatically* stable under a commodity money system, and this is particularly true under a gold standard.

Economists like to illustrate the workings of the marketplace by creating hypothetical micro and macro economies in which everything is reduced to only a few factors and a few people. In that spirit, therefore, let us create a hypothetical economy consisting of only two classes of people: gold miners and tailors. Let us suppose that the law of supply and demand has settled on the value of one ounce of gold to be equal to a fine, custom-tailored suit of clothes. That means that the labor, tools, materials, and talent required to mine and refine one ounce of gold are equally traded for the labor, tools, and talent required to weave and tailor the suit. Up until now, the number of ounces of gold produced each year have been roughly equal to the number of fine suits made each year, so prices have remained stable. The price of a suit is one ounce of gold, and the value of one ounce of gold is equal to one finely-tailored suit.

Let us now suppose that the miners, in their quest for a better standard of living, work extra hours and produce more gold this year than previously—or that they discover a new lode of gold which greatly increases the available supply with little extra effort. Now things are no longer in balance. There are more ounces of gold than there are suits. The result of this expansion of the money supply over and above the supply of available goods is the same as in our game of Monopoly. The quoted prices of the suits go up because the relative value of the gold has gone down.

The process does not end there, however. When the miners see that they are no better off than before in spite of the extra work, and especially when they see the tailors making a greater profit for no

1. Murray Rothbard, *What Has Government Done to Our Money?* (Larkspur, Colorado: Pine Tree Press, 1964), p. 13.

increase in labor, some of them decide to put down their picks and turn to the trade of tailoring. In other words, they are responding to the law of supply and demand in labor. When this happens, the annual production of gold goes down while the production of suits goes up, and an equilibrium is reached once again in which suits and gold are traded as before. The free market, if unfettered by politicians and money mechanics, will always maintain a stable price structure which is automatically regulated by the underlying factor of human effort. The human effort required to extract one ounce of gold from the earth will always be approximately equal to the amount of human effort required to provide the goods and services for which it is freely exchanged.

CIGARETTES AS MONEY

A perfect example of how commodities tend to self-regulate their value occurred in Germany at the end of World War II. The German mark had become useless, and barter was common. But one item of exchange, namely cigarettes, actually became a commodity money, and they served quite well. Some cigarettes were smuggled into the country, but most of them were brought in by U.S. servicemen. In either case, the quantity was limited and the demand was high. A single cigarette was considered small change. A package of twenty and a carton of two hundred served as larger units of currency. If the exchange rate began to fall too low—in other words, if the quantity of cigarettes tended to expand at a rate faster than the expansion of other goods—the holders of the currency, more than likely, would smoke some of it rather than spend it. The supply would diminish and the value would return to its previous equilibrium. That is not theory, it actually happened.[1]

With gold as the monetary base, we would expect that improvements in manufacturing technology would gradually reduce the cost of production, causing, not *stability*, but a *downward* movement of all prices. That downward pressure, however, is partially offset by an increase in the cost of the more sophisticated tools that are required. Furthermore, similar technological efficiencies are being applied in the field of mining, so everything tends to balance out. History has shown that changes in this natural equilibrium are minimal and occur only gradually over a long

1. See Galbraith, p. 250.

period of time. For example, in 1913, the year the Federal Reserve was enacted into law, the average annual wage in America was $633. The exchange value of gold that year was $20.67. That means that the average worker earned the equivalent of 30.6 ounces of gold per year.

In 1990, the average annual wage had risen to $20,468. That is a whopping increase of 3,233 per cent, an average rise of 42 per cent each year for 77 years. But the exchange value of gold in 1990 had also risen. It was at $386.90 per ounce. The average worker, therefore, was earning the equivalent of 52.9 ounces of gold per year. That is an increase of only 73 per cent, a rise of less than 1 per cent per year over that same period. It is obvious that the dramatic increase in the size of the paycheck was meaningless to the average American. The reality has been a small but steady increase in purchasing power (about 1 per cent per year) that has resulted from the gradual improvement in technology. This and only this has improved the standard of living and brought down real prices—as revealed by the relative value of gold.

In areas where personal service is the primary factor and where technology is less important, the stability of gold as a measure of value is even more striking. At the Savoy Hotel in London, one gold sovereign will still buy dinner for three, exactly as it did in 1913. And, in ancient Rome, the cost of a finely made toga, belt, and pair of sandals was one ounce of gold. That is almost exactly the same cost today, two-thousand years later, for a hand-crafted suit, belt, and a pair of dress shoes. There are no central banks or other human institutions which could even come close to providing that kind of price stability. And, yet, it is totally automatic under a gold standard.

In any event, before leaving the subject of gold, we should acknowledge that there is nothing mystical about it. It is merely a commodity which, because it has intrinsic value and possesses certain qualities, has become accepted throughout history as a medium of exchange. Hitler waged a campaign against gold as a tool of the Jewish bankers. But the Nazis traded heavily in gold and largely financed their war machine with it. Lenin claimed that gold was used only to keep the workers in bondage and that, after the revolution, it would be used to cover the floors of public lavatories. The Soviet Union under Communism became one of the world's biggest producers and users of gold. Economist John Maynard

Keynes once dismissed gold as a "barbaric metal." Many followers of Keynes today are heavily invested in gold. It is entirely possible, of course, that something other than gold *would* be better as the basis for money. It's just that, in over two thousand years, no one has been able to find it.

NATURAL LAW NO. 1

The amazing stability of gold as a measure of value is simply the result of human nature reacting to the forces of supply and demand. The process, therefore, may be stated as a natural law of human behavior:

> LESSON: When gold (or silver) is used as money and when the forces of supply and demand are not thwarted by government intervention, the amount of new metal added to the money supply will always be closely proportional to the expanding services and goods which can be purchased with it. Long-term stability of prices is the dependable result of these forces. This process is automatic and impartial. Any attempt by politicians to intervene will destroy the benefit for all. Therefore,
>
> LAW: Long-term price stability is possible only when the money supply is based upon the gold (or silver) supply without government interference.

As the concept of money was slowly developing in the mind of ancient man, it became obvious that one of the advantages of using gold or silver as the medium of exchange was that, because of their rarity as compared to copper or iron, great value could be represented by small size. Tiny ingots could be carried in a pouch or fastened to a belt for ease of transportation. And, of course, they could be more readily hidden for safekeeping. Goldsmiths then began to fashion them into round discs and to put their stamps on them to attest to purity and weight. In this way, the world's first coins began to make their appearance.

It is believed that the first precious metal coins were minted by the Lydians in Asia Minor (now Northwest Turkey), in about 600 B.C. The Chinese used gold cubes as early as 2100 B.C. But it wasn't until the kings stepped into the picture that true coinage became a reality. It was only when the *state* certified the tiny discs that they became widely accepted, and it is to the Greeks more than anyone that we owe this development. Groseclose describes the result:

> These light, shining discs, adorned with curious new emblems and a variety of vigorous, striking images, made a deep impression on both Greek and barbarian. And to the more practical minded, the abundance of uniform pieces of metal, each of a standard weight, certified by the authority of the state, meant a release from the cumbersomeness of barter and new and dazzling opportunities in every direction....
>
> All classes of men succumbed to money, and those who had formerly been content to produce only for their needs and the necessities of the household, found themselves going to the market place with their handicraft, or the fruits of their toil, to exchange them for the coins they might obtain.[1]

EXPANDING THE MONEY SUPPLY BY COIN CLIPPING

From the very beginning, the desire for a *larger* money supply led to practices which were destructive to the economy. Unscrupulous merchants began to shave off a tiny portion of each coin they handled—a process known as coin clipping—and then having the shavings melted down into new coins. Before long, the king's treasury began to do the same thing to the coins it received in taxes. In this way, the money supply was increased, but the supply of gold was not. The result was exactly what we now know always happens when the money supply is artificially expanded. There was inflation. Whereas one coin previously would buy twelve sheep, now it would only be accepted for ten. The total amount of gold needed for twelve sheep never really changed. It's just that everyone knew that one coin no longer contained it.

As governments became more brazen in their debasement of the currency, even to the extent of diluting the gold or silver content, the population adapted quite well by simply "discounting" the new coins. That is to say, they accepted them at a realistic value, which was lower than what the government had intended. This was, as always, reflected in a general rise in prices quoted in terms of those coins. *Real* prices, in terms of labor or other goods or even of gold itself remained unchanged.

Governments do not like to be thwarted in their plans to exploit their subjects. So a way had to be found to *force* people to accept these slugs as real money. This led to the first legal-tender laws. By royal decree, the "coin of the realm," was declared legal for the

1. Groseclose, *Money and Man*, p. 13.

settlement of all debts. Anyone who refused it *at face value* was subject to fine, imprisonment, or, in some cases, even death. The result was that the good coins disappeared from circulation and went into private hoards. After all, if the government forces you to accept junk at the same rate of exchange as gold, wouldn't you keep the gold and spend the junk? That is what happened in America in the '60s when the mint began to issue cheap metal tokens to replace the silver dimes, quarters, and half-dollars. Within a few months, the silver coins were in dresser drawers and safe-deposit boxes. The same thing has happened repeatedly throughout antiquity. In economics, that is called Gresham's Law: "Bad money drives out good."

The final move in this game of legal plunder was for the government to fix prices so that, even if everyone is using only junk as money, they can no longer compensate for the continually expanding supply of it. Now the people were caught. They had no escape except to become criminals, which most of them, incidentally, chose to do. The history of artificially expanding money is the history of great dissatisfaction with government, much lawlessness, and a massive underground economy.

GOLD IS THE ENEMY OF THE WELFARE STATE

In more modern times, rulers of nations have become more sophisticated in the methods by which they debase the currency. Instead of clipping coins, it is done through the banking system. The *consequences* of that process were summarized in 1966 by Alan Greenspan who, a few years later, would become Chairman of the Board of Governors of the Federal Reserve. Greenspan wrote:

> The abandonment of the gold standard made it possible for the welfare statists *to use the banking system* as a means to an unlimited expansion of credit....
>
> The law of supply and demand is not to be conned. As the supply of money (of claims) increases relative to the supply of tangible assets in the economy, prices must eventually rise. Thus the earnings saved by the productive members of the society lose value in terms of goods. When the economy's books are finally balanced, one finds that this loss in value represents the goods purchased by the government for welfare or other purposes....
>
> In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. If there were, the government would have to make its holding illegal, as was done in the case of gold.... The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves.
>
> This is the shabby secret of the welfare statists' tirades against gold. Deficit spending is simply a scheme for the "hidden" confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights.[1]

Unfortunately, when Greenspan was appointed as Chairman of the Federal Reserve System, he became silent on the issue of gold. Once he was seated at the control panel which holds the levers of power, he served the statists well as they continued to confiscate the people's wealth through the hidden tax of inflation. Even the wisest of men can be corrupted by power and wealth.

REAL COMMODITY MONEY IN HISTORY

Returning to the topic of debasing the currency in ancient times, it must be stated that such practices were by no means universal. There are many examples throughout history of regents and kingdoms which used great restraint in money creation. Ancient Greece, where coinage was first developed, is one of them. The *drachma* became the defacto monetary unit of the civilized world because of the dependability of its gold content. Within its borders, cities flourished and trade abounded. Even after the fall of Athens in the Peloponnesian War, her coinage remained, for centuries, as *the* standard by which all others were measured.[2]

Perhaps the greatest example of a nation with sound money, however, was the Byzantine Empire. Building on the sound monetary tradition of Greece, the emperor Constantine ordered the creation of a new gold piece called the *solidus* and a silver piece called the *miliarense*. The gold weight of the *solidus* soon became fixed at 65 grains and was minted at that standard for the next eight-hundred years. Its quality was so dependable that it was freely accepted, under the name *bezant*, from China to Brittany, from the Baltic Sea to Ethiopia.

Byzantine laws regarding money were strict. Before being admitted to the profession of banking, the candidate had to have sponsors who would attest to his character, that he would not file

1. Alan Greenspan, "Gold and Economic Freedom," in *Capitalism: The Unknown Ideal*, ed. Ayn Rand (New York: Signet Books, 1967), p. 101.
2. Even the Greeks, under Solon, had one, brief experience with a debased currency. But it was short lived, and never repeated. See Groseclose, *Money and Man*, pp. 14, 20–54.

or chip either the *solidi* or the *miliarensia,* and that he would not issue false coin. Violation of these rules called for cutting off a hand.[1]

It is an amazing fact of history that the Byzantine Empire flourished as the center of world commerce for eight-hundred years without falling into bankruptcy nor, for that matter, even into debt. Not once during this period did it devalue its money. "Neither the ancient nor the modern world," says Heinrich Gelzer, "can offer a complete parallel to this phenomenon. This prodigious stability...secured the *bezant* as universal currency. On account of its full weight, it passed with all the neighboring nations as a valid medium of exchange. By her money, Byzantium controlled both the civilized and the barbarian worlds."[2]

BAD COMMODITY MONEY IN HISTORY

The experience of the Romans was quite different. Basically a militaristic people, they had little patience for the niceties of monetary restraint. Especially in the later Empire, debasement of the coinage became a deliberate state policy. Every imaginable means for plundering the people was devised. In addition to taxation, coins were clipped, reduced, diluted, and plated. Favored groups were given franchises for state-endorsed monopolies, the origin of our present-day corporation. And, amidst constantly rising prices in terms of constantly expanding money, speculation and dishonesty became rampant.

By the year 301 A.D., mutiny was developing in the army, remote regions were displaying disloyalty, the treasury was empty, agriculture depressed, and trade almost at a standstill. It was then that Diocletian issued his famous price-fixing proclamation as the last measure of a desperate emperor. We are struck by the similarity to such proclamations in our own time. Most of the chaos can be traced directly to government policy. Yet, the politicians point the accusing finger at everyone else for their "greed" and "disregard for the common good." Diocletian declared:

1. *Le livre du préfet ou l'empereur Léon le Sage sur les corporations de Constantinople,* French translation from the Geneva text by Jules Nicole, p. 38. Cited by Groseclose, *Money and Man,* p. 52.
2. Byzantininsche Kulturgeschichte (Tübingen, 1909), p. 78. As quoted by Groseclose, *Money and Man,* p. 54.

> Who is of so hardened a heart and so untouched by a feeling of humanity that he can be unaware, nay that he has not noticed, that in the sale of wares which are exchanged in the market, or dealt with in the daily business of the cities, an exorbitant tendency in prices has spread to such an extent that the unbridled desire of plundering is held in check neither by abundance nor by seasons of plenty.... Inasmuch as there is seen only a mad desire without control, to pay no heed to the needs of the many,...it seems good to us, as we look into the future, to us who are the fathers of the people, that justice intervene to settle matters impartially.[1]

What followed was an incredibly detailed list of mandated prices for everything from a serving of beer or a bunch of watercress to a lawyer's fee and a bar of gold. The result? Conditions became even worse, and the royal decree was rescinded five years later.

The Roman Empire never recovered from the crisis. By the fourth century, all coins were weighed, and the economy was slipping back into barter again. By the seventh century, the weights themselves had been so frequently changed that it was no longer possible to effect an exchange in money at all. For all practical purposes, money became extinct, and the Roman Empire was no more.

RECEIPT MONEY

When new civilizations rose from the ruins of Rome, they reclaimed the lost discovery of money and used it to great advantage. The invention was truly a giant step forward for mankind, but there were many problems yet to be solved and much experimentation lay ahead. The development of paper money was a case in point. When a man accumulated more coins than he required for daily purchases, he needed a safe place to store them. The goldsmiths, who handled large amounts of precious metals in their trades, had already built sturdy vaults to protect their own inventory, so it was natural for them to offer vault space to their customers for a fee. The goldsmith could be trusted to guard the coins well because he also would be guarding his own wealth.

When the coins were placed into the vault, the warehouseman would give the owner a written receipt which entitled him to

1. As quoted by Groseclose, *Money and Man,* pp. 43–44.

withdraw at any time. At first, the only way the coins could be taken from the vault was for the owner to personally present the receipt. Eventually, however, it became customary for the owner to merely endorse his receipt to a third party who, upon presentation, could make the withdrawal. These endorsed receipts were the forerunners of today's checks.

The final stage in this development was the custom of issuing, not just one receipt for the entire deposit, but a series of smaller receipts, adding up to the same total, and each having printed across the top: PAY TO THE BEARER ON DEMAND. As the population learned from experience that these paper receipts were truly backed by good coin in the goldsmith's warehouse and that the coin really would be given out in exchange for the receipts, it became increasingly common to use the paper instead of the coin.

Thus, *receipt money* came into existence. The paper itself was useless, but what it represented was quite valuable. As long as the coin was held in safe keeping as promised, there was no difference in value between the receipt and the coin which backed it. And, as we shall see in the next chapter, there were notable examples of the honest use of receipt money at the very beginning of the development of banking. When the receipt was scrupulously honored, the economy moved forward. When it was used as a gimmick for the artificial expansion of the money supply, the economy convulsed and stagnated.

NATURAL LAW NO. 2

This is not a textbook on the history of money, so we cannot afford the luxury of lingering among the fascinating details. For our purposes, it is sufficient to recognize that human behavior in these matters is predictable and, because of that predictability, it is possible to formulate another principle that is so universal that it, too, may be considered a natural law. Drawing from the vast experience of this early period, it can be stated as follows:

> LESSON: Whenever government sets out to manipulate the money supply, regardless of the intelligence or good intentions of those who attempt to direct the process, the result is inflation, economic chaos, and political upheaval. By contrast, whenever government is limited in its monetary power to only the maintenance of honest weights and measures of precious metals, the result is price stability, economic prosperity, and political tranquility. Therefore,
>
> LAW: For a nation to enjoy economic prosperity and political tranquility, the monetary power of its politicians must be limited solely to the maintenance of honest weights and measures of precious metals.

As we shall see in the following chapters, the centuries of monetary upheaval that followed that early period contain no evidence that this law has been repealed by modern man.

SUMMARY

Knowledge of the nature of money is essential to an understanding of the Federal Reserve. Contrary to common belief, the topic is neither mysterious nor complicated. For the purposes of this study, money is defined as anything which is accepted as a medium of exchange. Building on that, we find there are four kinds of money: commodity, receipt, fiat, and fractional. Precious metals were the first commodity money to appear in history and ever since have been proven by actual experience to be the only reliable base for an honest monetary system. Gold, as the basis of money, can take several forms: bullion, coins, and fully backed paper receipts. Man has been plagued throughout history with the false theory that the quantity of money is important, specifically that more money is better than less. This has led to perpetual manipulation and expansion of the money supply through such practices as coin clipping, debasement of the coin content, and, in later centuries, the issuance of more paper receipts than there was gold to back them. In every case, these practices have led to economic and political disaster. In those rare instances where man has refrained from manipulating the money supply and has allowed it to be determined by free-market production of the gold supply, the result has been prosperity and tranquility.

Chapter Eight

FOOL'S GOLD

The history of paper money without precious-metal backing forced on the public by government decree; the emergence of our present-day fractional-reserve banking system based on the issuance of a greater amount of receipts for gold than the bank has in gold to back them up.

We previously have broken down the concept of money into four categories: commodity, receipt, fiat, and fractional. In the last chapter we examined commodity and receipt money in some detail. In doing so, we also established certain monetary principles which apply regardless of their form. We shall now turn to the remaining two categories, both of which are represented by paper and which are at the root of almost all of modern man's economic woes.

FIAT MONEY

The *American Heritage Dictionary* defines fiat money as "paper money decreed legal tender, not backed by gold or silver." The two characteristics of fiat money, therefore, are (1) it does not represent anything of intrinsic value and (2) it is decreed legal tender. Legal tender simply means that there is a law requiring everyone to accept the currency in commerce. The two always go together because, since the money really is worthless, it soon would be rejected by the public in favor of a more reliable medium of exchange, such as gold or silver coin. Thus, when governments issue fiat money, they always declare it to be legal tender under pain of fine or imprisonment. The only way a government can exchange its worthless paper money for tangible goods and services is to give its citizens no choice.

The first notable use of this practice was recorded by Marco Polo during his travels to China in the thirteenth century. The famous explorer gives us this account:

> The Emperor's mint then is in this same City of Cambaluc, and the way it is wrought is such that you might say he hath the Secret of Alchemy in perfection, and you would be right!...
>
> What they take is a certain fine white bast or skin which lies between the wood of the tree and the thick outer bark, and this they make into something resembling sheets of paper, but black. When these sheets have been prepared they are cut up into pieces of different sizes. The smallest of these sizes is worth a half tornesel.... There is also a kind worth one Bezant of gold, and others of three Bezants, and so up to ten.
>
> All these pieces of paper are issued with as much solemnity and authority as if they were of pure gold or silver; and on every piece, a variety of officials, whose duty it is, have to write their names and to put their seals. And when all is prepared duly, the chief officer deputed by the Kaan smears the Seal entrusted to him with vermilion and impresses it on the paper, so that the form of the Seal remains stamped upon it in red; the money is then authentic. Any one forging it would be punished with death. And the Kaan causes every year to be made such a vast quantity of this money, which costs him nothing, that it must equal in amount all the treasures in the world.
>
> With these pieces of paper, made as I have described, he causes all payments on his own account to be made, and he makes them to pass current universally over all his Kingdoms.... And nobody, however important he may think himself, dares to refuse them on pain of death. And indeed everybody takes them readily.[1]

One is tempted to marvel at the Kaan's audacious power and the subservience of his subjects who endured such an outrage; but our smugness rapidly vanishes when we consider the similarity to our own Federal Reserve Notes. They are adorned with signatures and seals; counterfeiters are severely punished; the government pays its expenses with them; the population is forced to accept them; they—and the "invisible" checkbook money into which they can be converted—are made in such vast quantity that it must equal in amount all the treasures of the world. And yet they cost nothing to make. In truth, our present monetary system is an almost exact replica of that which supported the warlords of seven centuries ago.

1. Original from Henry Thule's edition of *Marco Polo's Travels*, reprinted in W. Vissering, *On Chinese Currency: Coin and Paper Money* (Leiden: E.J. Brill, 1877), reprinted 1968 by Ch'eng-wen Publishing Co., Taiwan, as cited by Anthony Sutton, *The War on Gold* (Seal Beach, California: '76 Press, 1977), pp. 26–28.

THE COLONIAL EXPERIENCE

Unfortunately, the present situation is not unique to our history. In fact, after China, the next place in the world to adopt the use of fiat money was America; specifically, the Massachusetts Bay Colony. This event has been described as "not only the origin of paper money in America, but also in the British Empire, and almost in the Christian world."[1]

In 1690, Massachusetts launched a military raid against the French colony in Quebec. She had done this before and, each time, had brought back sufficient plunder to more than pay for the expedition. This time, however, the foray was a dismal failure, and the men returned empty handed. When the soldiers demanded their pay, Massachusetts found its coffers empty. Disgruntled soldiers have a way of becoming unruly, so the officials scrambled for some way to raise the funds. Additional taxes would have been extremely unpopular, so they decided simply to print paper money. In order to convince the soldiers and the citizenry to accept it, the government made two solemn promises: (1) it would redeem the paper for gold or silver coin just as soon as there was sufficient tax revenue to do so, and (2) absolutely no additional paper notes would ever be issued. Both pledges were promptly broken. Only a few months later, it was announced that the original issue was insufficient to discharge the government's debt, and a new issue almost six times greater was put into circulation. The currency wasn't redeemed for nearly forty years, long after those who had made the pledge had faded from the scene.

A CLASSIC PATTERN

Most of the other colonies were quick to learn the magic of the printing press, and the history that followed is a classic example of cause and effect: Governments artificially expanded the money supply through the issuance of fiat currency. This was followed by legal tender laws to force its acceptance. Next came the disappearance of gold or silver coins which went, instead, into private hoards or to foreign traders who insisted on the real thing for their wares. Many of the colonies repudiated their previous money by issuing new bills valued at multiples of the old. Then came political

1. Ernest Ludlow Bogart, *Economic History of the American People* (New York: Longmans, Green and Co., 1930), p. 172.

discontent and civil disobedience. And at the end of each cycle there was rampant inflation and economic chaos.

In 1703, South Carolina declared that its money was "a good payment and tender in law" and then added that, should anyone refuse to honor it as such, they would be fined an amount equal to "double the value of the bills so refused." By 1716, the penalty had been increased to "treble the value."[1]

THE PRINTING PRESS AND INFLATION

Benjamin Franklin was an ardent proponent of fiat money during those years and used his great influence to sell the idea to the public. We can get some idea of the ferment of the times by noting that, in 1736, writing in his *Pennsylvania Gazette,* Franklin apologized for its irregular publication, and explained that the printer was "with the Press, labouring for the publick Good, to make Money more plentiful."[2] The printing of money was apparently a major, time-consuming operation.

In 1737, Massachusetts devalued its fiat currency by 66%, offering one dollar of new currency for three of the old. The promise was made that, after five years, the new money would be fully redeemed in silver or gold. The promise was not kept.[3]

By the late 1750s, Connecticut had prices inflated by 800%. The Carolinas had inflated 900%. Massachusetts 1000%. Rhode Island 2300%.[4] Naturally, these inflations all had to come to an end and, when they did, they turned into equally massive deflations and depressions. It has been shown that, even in colonial times, the classic booms and busts which modern economists are fond of blaming on an "unbridled free market" actually were direct manifestations of the expansion and contraction of fiat money which no longer was governed by the laws of supply and demand.[5]

1. Statutes at Large of South Carolina, II. 211,665, as cited by George Bancroft, *A Plea for the Constitution* (Originally published by Harpers in 1886. Reprinted in Sewanee, Tennessee: Spencer Judd Publishers, 1982), p. 7.
2. Leonard W. Labaree, ed., *The Papers of Benjamin Franklin* (New Haven: Yale University Press, 1960), Vol. 2, p. 159.
3. Province Laws, II. 826, cited by Bancroft, p. 14.
4. Ron Paul and Lewis Lehrman, *The Case for Gold* (Washington, D.C.: Cato Institute, 1982), p. 22. Also Sutton, *The War on Gold*, p. 44.
5. See Donald L. Kemmerer, "Paper Money in New Jersey, 1668–1775," New Jersey Historical Society, *Proceedings* 74 (April 1956): pp. 107–144, as cited by Paul and Lehrman, *The Case for Gold*, p. 22.

By this time, coins had completely disappeared from the scene. Some were in private hoards, but most of them had been exported to other countries, leaving the colonies with little choice but to use fiat money or barter. Merchants from abroad were interested in neither of those, however, and international trade ground almost to a halt.

A BLESSING IN DISGUISE

The experiment with fiat money was a calamity to the colonists, but it was also a thorn in the side of the Bank of England. The bank had used its influence with the Crown to forbid the colonies to mint their own coins or to establish local banks. This meant that, if the colonists wanted the convenience of paper money, they would be forced to use the notes issued by the Bank of England. No one had anticipated that the colonial governments would be so inventive as to create their own *paper* money. So, in 1751, Great Britain began to pressure the colonies to redeem all of their currency and withdraw it from circulation. This they eventually did, and at bargain prices. By then, their fiat money was heavily discounted in the market place and the governments were able to buy back their own currency for pennies on the dollar.

The decree from the British Parliament, although heavily resented by the colonists, turned out to be a blessing in disguise. The paper notes of the Bank of England never did become a primary medium of exchange. Probably because of their recent bad experience with paper money, the colonists merely brought what few gold and silver coins they had out of hiding and returned to a true commodity-money system. At first, the doomsdayers predicted this would spell further ruin for the colonial economy. "There isn't enough money" was the all-too-familiar cry. But there was, indeed, quite enough for, as we have already seen, *any* amount is sufficient.

TOBACCO BECOMES MONEY

There was, in fact, a period in which other commodities became accepted as a secondary medium of exchange. Such items as nails, lumber, rice, and whisky filled the monetary void, but tobacco was the most common. Here was a commodity which was in great demand both within the colonies and for overseas commerce. It had intrinsic value; it could not be counterfeited; it could be divided into almost any denominational quantity; and its supply

could not be increased except by the exertion of labor. In other words, it was regulated by the law of supply and demand, which gave it great stability in value. In many ways, it was an ideal money. It was officially adopted as such by Virginia in 1642 and a few years later by Maryland, but it was used *unofficially* in all the other colonies, as well. So close was the identity of tobacco with money that the previous fiat currency of New Jersey, not a tobacco growing state, displayed a picture of a tobacco leaf on its face. It also carried the inscription: "To counterfeit is *Death*." Tobacco was used in early America as a secondary medium of exchange for about two-hundred years, until the new Constitution declared that money was, henceforth, the sole prerogative of the federal government.[1]

The primary currency at that juncture, however, was still gold and silver coin, or *specie*, as it is called. And the immediate result of returning to a sound monetary unit was a rapid recovery from the economic stagnation previously inflicted by the booms and busts of fiat money. Trade and production rose dramatically, and this, in turn, attracted an inflow of gold and silver coin from around the world, filling the void that had been created by years of worthless paper. The law of supply and demand was visibly at work. For a while, Massachusetts had returned to specie while Rhode Island remained on fiat money. The result was that Newport, which had been the trade center for the West Indies, lost its trade to Boston and became an empty port.[2] After the colonies had returned to coin, prices quickly found their natural equilibrium and then *stayed* at that point, even during the Seven Years War and the disruption of trade that occurred immediately prior to the Revolution.[3] There is no better example of the fact that economic systems in distress can and do recover rapidly if government does not interfere with the natural healing process.

WAR BRINGS A RETURN OF FIAT MONEY

The War for Independence brought all of this to a sudden halt. Wars are seldom funded out of the existing treasury, nor are they even done so out of increased taxes. If governments were to levy

1. Galbraith, pp. 48–50.
2. Paul and Lehrman, pp. 22–23.
3. "The Colonial Monetary Standard of Massachusetts," by Roger W. Weiss, *Economic History Review*, No. 27, November, 1974, p. 589.

taxes on their citizens fully adequate to finance the conflict, the amount would be so great that many of even its most ardent supporters would lose enthusiasm. By artificially increasing the money supply, however, the real cost is hidden from view. It is still paid, of course, but through inflation, a process that few people understand.

The American Revolution was no exception. In order to pay the bill for independence, both the Confederation and the individual states went heavily into the printing business. At the beginning of the war in 1775, the total money supply stood at $12 million. In June of that year, the Continental Congress issued another $2 million. Before the notes were even put into circulation, another $1 million was authorized. By the end of the year, another $3 million. In 1776, another $19 million. $13 million in 1777. $64 million in 1778. $125 million in 1779. And still more: the Continental Army issued its own "certificates" for the purchase of supplies totalling $200 million. A total of $425 million in five years on top of a base of $12 million is an increase of over 3500%. And, in addition to this massive expansion of the money supply on the part of the central government, it must be remembered that the states were doing exactly the same thing. It is estimated that, in just five years from 1775 to the end of 1779, the total money supply expanded by 5000%. By contrast, the amount raised in taxes over the five-year period was inconsequential, amounting to only a few million dollars.

AND A MASSIVE INFLATION

The first exhilarating effect of this flood of new money was the flush of apparent prosperity, but that was quickly followed by inflation as the self-destruct mechanism began to operate. In 1775, paper Continentals were traded for one dollar in gold. In 1777, they were exchanged for twenty-five cents. By 1779, just four years from their issue, they were worth less than a penny. The phrase "Not worth a Continental" has its origin in this dismal period. Shoes sold for $5,000 a pair. A suit of clothes cost a million.

It was in that year that George Washington wrote, "A wagon load of money will scarcely purchase a wagon load of provisions."[1]

1. Quoted by Albert S. Bolles, *The Financial History of the United States* (New York: D. Appleton, 1896, 4th ed.), Vol. I, p. 132.

Even Benjamin Franklin began to see the light. In a mood of sarcasm, he wrote:

> This Currency, as we manage it, is a wonderful machine. It performs its Office when we issue it; it pays and clothes Troops and provides Victuals and Ammunition; and when we are obliged to issue a Quantity excessive, it pays itself off by Depreciation.[1]

When speaking of deficit spending, it is common to hear the complaint that we are saddling future generations with the bill for what we enjoy today. Why *not* let those in the future help pay for what will benefit them also? Don't be deceived. That is a misconception encouraged by politicians to calm the public. When money is fiat, as the colonists discovered, every government building, public work, and cannon of war is paid out of current labor and current wealth. These things must be built *today* with *today's* labor, and the man who performs that labor must also be paid *today*. It is true that *interest* payments fall partly to future generations, but the *initial cost* is paid by those in the present. It is paid by loss of value in the monetary unit and loss of purchasing power for one's wages.

INFLATION IS A HIDDEN TAX

Fiat money is the means by which governments obtain instant purchasing power without taxation. But where does that purchasing power come from? Since fiat money has nothing of tangible value to offset it, government's fiat purchasing power can be obtained only by subtracting it from somewhere else. It is, in fact, "collected" from us all through a decline in *our* purchasing power. It is, therefore, exactly the same as a tax, but one that is hidden from view, silent in operation, and little understood by the taxpayer.

In 1786, Thomas Jefferson provided a clear explanation of this process when he wrote:

> Every one, through whose hands a bill passed, lost on that bill what it lost in value during the time it was in his hands. This was a real tax on him; and in this way the people of the United States actually contributed those... millions of dollars during the war, and by a mode of taxation the most oppressive of all because the most unequal of all.[2]

1. Letter to Samuel Cooper, April 22, 1779, quoted by Albert Henry Smyth, ed., *The Writings of Benjamin Franklin*, (New York: Macmillan, 1906), Vol. VII, p. 294.
2. Thomas Jefferson, *Observations on the Article Etats-Unis Prepared for the Encyclopedia*, June 22, 1786, from *Writings* (New York: G.P. Putnam's Sons, 1894), Vol. IV, p. 165.

ENTER PRICE CONTROLS AND LEGAL TENDER LAWS

As prices skyrocketed, the colonies enacted wage and price controls, which was like plugging up the whistle on a tea kettle in hopes of keeping the steam from escaping. When that failed, there followed a series of harsh legal tender laws. One law even invoked the specter of treason. It said: "If any person shall hereafter be so lost to all virtue and regard for his Country as to refuse to receive said bills in payment...he shall be deemed, published, and treated as an enemy in this Country and precluded from all trade or intercourse with the inhabitants of these colonies."[1]

Rhode Island not only levied a heavy fine for non-acceptance of its notes but, upon a *second* offense, an individual was stripped of citizenship. When a court declared the act unconstitutional, the legislature called the judges before it and summarily dismissed the offenders from office.[2]

ENTER ECONOMIC CHAOS AND INSURRECTION

If the ravages of war were a harsh burden for the colonies to bear, the havoc of fiat money was equally so. After the war, inflation was followed by deflation as reality returned to the market place. Prices fell drastically, which was wonderful for those who were buying. But, for the merchants who were *selling* or the farmers who had borrowed heavily to acquire property at inflated wartime prices, it was a disaster. The new, lower prices were not adequate to sustain their fixed, inflated mortgages, and many hard-working families were ruined by foreclosure. Furthermore, most people still did not understand the inflation process, and there were many who continued to advocate the "paper money cure." Several of the states were receptive to the pressure, and their printing presses continued to roll.

Historian Andrew McLaughlin recalls a typical scene in Rhode Island at that time as witnessed by a visiting Frenchman:

> A French traveler who passed through Newport about this time gives a dismal picture of the place: idle men standing with folded arms at the corners of the streets; houses falling to ruins; miserable shops offering for sale nothing but a few coarse stuffs;...grass growing in the streets; windows stuffed with rags; everywhere announcing misery,

1. David Ramsay, *History of the American Revolution* (London: Johnson and Stockdale, 1791), Vol. II, pp. 134–36.
2. Merrill Jensen, *The New Nation* (New York: Vintage Books, 1950), p. 324.

the triumph of paper money and the influence of bad government. The merchants had closed their stores rather than take payment in paper; farmers from neighboring states did not care to bring their produce.[1]

Idleness and economic depression also led to outbursts of rebellion and insurrection. In 1786, George Washington wrote to James Warren: "The wheels of government are clogged and ... we are descending into the vale of confusion and darkness."[2] Two years later, in a letter to Henry Knox, he said: "If ... any person had told me that there would have been such formidable rebellion as exists, I would have thought him a bedlamite, a fit subject for a madhouse."[3]

Fortunately, there is a happy ending to that part of the story. As we shall see in a subsequent chapter, when the state delegates assembled to draft the Constitution, the effects of fiat money were so fresh in their minds they decided to put an end to it once and for all. Then, the new republic not only rapidly recovered but went on to become the economic envy of the world—for a while, at least—until the lesson had been forgotten by following generations. But that is getting ahead of our story. For now, we are dealing with the topic of fiat money; and the experience of the American colonies is a classic example of what *always* happens when men succumb to its siren call.

NATURAL LAW NO. 3

Let us pause at this point and observe another of those lessons derived from centuries of experience. That lesson is so clear and so universal and so widely seen throughout history that it may be stated as a natural law of human behavior:

> LESSON: Fiat money is paper money without precious-metal backing and which people are required by law to accept. It allows politicians to increase spending without raising taxes. Fiat money is the cause of inflation, and the amount which people lose in purchasing power is exactly the amount which was taken from them and transferred to their government by this process. Inflation, therefore, is a hidden tax. This tax is the most unfair of all because it falls most heavily on those who are least able to pay: the small wage earner and those on fixed incomes. It also punishes the thrifty by eroding the value of their savings. This creates resentment among the people, leading always to political unrest and national disunity. Therefore,
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> LAW: A nation that resorts to the use of fiat money has doomed itself to economic hardship and political disunity.

1. Andrew C. McLaughlin, *The Confederation and the Constitution* (New York: Collier Books, 1962), pp. 107–08.
2. Harry Atwood, *The Constitution Explained* (Merrimac, Massachusetts: Destiny Publishers, 1927; 2nd ed. 1962), p. 3.
3. *Ibid.*, p. 4.

FRACTIONAL MONEY

Let us turn, now, to the fourth and final possible form of money: a most intriguing concept called *fractional money*. And, to understand how this functions, we must return to Europe and the practice of the early goldsmiths who stored the precious metal coins of their customers for a fee.

In addition to the goldsmiths who *stored* coins, there was another class of merchants, called "scriveners," who *lent* coins. The goldsmiths reasoned that they, too, could act as scriveners, but do so with *other* people's money. They said it was a pity for all that coin to just sit idle in their vaults. Why not lend it out and earn a profit which then could be split between themselves and their depositors? Put it to *work*, instead of merely gathering dust. They had learned from experience that very few of their depositors ever wanted to remove their coins at the same time. In fact, net withdrawals seldom exceeded ten or fifteen per cent of their stockpile. It seemed perfectly safe to lend up to eighty or even eighty-five per cent of their coins. And so the warehousemen began to act as loan brokers on behalf of their depositors, and the concept of banking, as we know it today, was born.

That's the way many history books describe it, but there is more involved here than merely putting idle money to work. First of all, sharing the interest income with the owners of the deposits was not part of the original concept. That only became general practice many years later after the depositors became outraged and needed to be reassured that these loans were in their interest as well. In the beginning, they didn't even know that their coins were being lent out. They naively thought that the goldsmiths were lending their *own* money.

DEPOSITS ARE NOT AVAILABLE FOR LENDING

In the second place, we need to consider whether the coin in the vault was even *available* for lending—regardless of whether or not the depositors received a part of the profit. Let us suppose that we are playing a game of poker at the home of Charlie Smith. Each of us has given $20 to Charlie who, acting as the banker, has put our money into a shoe box and given us, in return, twenty poker chips. It is the understanding that, anytime we want to go home, we can get back a dollar for each chip we have at that time. Now let us suppose that Charlie's brother-in-law, Larry, shows up, not to play poker, but to borrow some money. Since six of us are playing and each has put in $20, there is a total of $120 in the shoe box, and that turns out to be perfect for Larry's needs. You can imagine what would happen if Charlie decided to lend out the "idle" money. It is not *available* for lending.

Neither Charlie nor any of the players have the right to lend *those* dollars, because they are being held in escrow, so to speak, pending completion of the contract between Charlie and his guests. Those dollars no longer even exist as money. They have been replaced—in concept at least—by the poker chips. If any of us are so touched by Larry's story that we decide to lend him the money ourselves, we would have to do it with *other* dollars or cash in our chips for the dollars in the shoe box. In that case, of course, we could no longer stay in the game. *We cannot spend, lend, or give away the deposit and also consider the chips to be worth anything.*

If you are a member of an organization and have given your proxy to a friend to vote in your absence at the annual meeting, you cannot then show up and cast your own vote *in addition* to your proxy. Likewise, in the beginning of banking, the certificates which were circulated as money were, in effect, *proxies* for the coins. Consequently, those coins were not *available* for lending. Their monetary value had been assigned to the certificates. If the certificate holders had wanted to lend out their coins, they should have retired the certificates first. They were not entitled to hold spendable paper money and *also* authorize their banker to lend that same money as coins. *One cannot spend, lend, or give away the coins and also consider the certificates to be worth anything.*

All of this is just common sense. But there is another dimension to the problem which has to do with honesty in business contracts.

When the bankers used those coins as the basis for loans, they were putting themselves in a position of not having enough coin in the vault to make good on their contracts when it came time for depositors to take their money home. In other words, the new contracts were made with the full knowledge that, under certain circumstances, they would have to be broken. But the bankers never bothered to explain that. The general public was led to believe that, if they approved of putting these supposedly idle funds to work, they would be helping the economy and earning a little profit besides. It was an appealing proposal, and the idea caught on like wildfire.

FRACTIONAL-RESERVE BANKING

Most borrowers wanted paper money, of course, not bulky coins, so, when they received their loans, they usually put the coins right back into the vault for safekeeping. They were then given *receipts* for these deposits which, as we have observed, were readily accepted in commerce as money. At this point, things began to get complicated. The original depositors had been given receipts for all of the bank's coins. But the bank now issued loans in the amount of eighty-five per cent of its deposits, and the borrowers were given receipts for that same amount. These were *in addition to* the original receipts. That made 85% *more* receipts than *coins*. Thus, the banks *created* 85% more money and placed it into circulation through their borrowers. In other words, by issuing phony receipts, they artificially expanded the money supply. At this point, the certificates were no longer 100% backed by gold. They now had a backing of only 54%,[1] but they were accepted by the unsuspecting public as equal in value to the old receipts. The gold behind all of them, however, now represented only a fraction of their face value. Thus, the receipts became what may be called *fractional money*, and the process by which they were created is called *fractional-reserve banking*.

None of this shortfall, unfortunately, was ever explained. The bankers decided that it would be better not to discuss reality where the public could hear. These facts became the arcane secrets of the profession. The depositors were never encouraged to question how the banks could lend out their money and still have it on hand to

1. 100 units of gold divided by 185 certificates equals .54

pay back on an instant's notice. Instead, bankers put on great airs of respectability, stability, and accountability; dressed and acted serious if not stern; erected great edifices resembling government buildings and temples, all to bolster the false image of being able to honor their contracts to pay *on demand*.

It was John Maynard Keynes who observed:

> A "sound" banker, alas! is not one who foresees danger, and avoids it, but one who, when he is ruined, is ruined in a conventional and orthodox way along with his fellows, so that no one can readily blame him. It is necessarily part of the business of a banker to maintain appearances, and to confess a conventional respectability, which is more than human. Life-long practices of this kind make them the most romantic and the least realistic of men.[1]

CREATING MONEY OUT OF DEBT

Let us step back for a moment and analyze. In the beginning, banks served as warehouses for the safe keeping of their customers' coins. When they issued paper receipts for those coins, they converted commodity money into receipt money. This was a great convenience, but it did not alter the money supply. People had a choice of using either coin or paper but they could not use both. If they used coin, the receipt was never issued. If they used the receipt, the coin remained in the vault and did not circulate.

When the banks abandoned this practice and began to issue receipts to *borrowers*, they became magicians. Some have said they created money out of nothing, but that is not quite true. What they did was even more amazing. They created money out of *debt*.

Obviously, it is easier for people to go into debt than to mine gold. Consequently, money no longer was limited by the natural forces of supply and demand. From that point in history forward, it was to be limited only by the degree to which bankers have been able to push down the gold-reserve fraction of their deposits.

From this perspective, we can now look back on fractional money and recognize that it really is a transitional form between receipt money and fiat money. It has some of the characteristics of both. As the fraction becomes smaller, the less it resembles receipt money and the more closely it comes to fiat money. When the fraction finally reaches zero, then it has made the complete

1. As quoted by Lever and Huhne, *Debt and Danger: The World Financial Crisis* (New York: The Atlantic Monthly, 1986), p. 42.

transition and becomes pure fiat. Furthermore, there is no example in history where men, once they had accepted the concept of fractional money, didn't reduce the fraction lower and lower until, eventually, it became zero.

No bank can stay in business for very long with a zero reserve. The only way to make people accept such a worthless currency is by government force. That's what legal-tender laws are all about. The transition from fractional-reserve money to fiat money, therefore, requires the participation of government through a mechanism which is called a central bank. Most of the balance of this book will be devoted to a study of that Creature, but, for now, suffice it to say that the euphoria of being able to create money without human effort is so great that, once such a narcotic is taken, there is no politician or banker who can kick the habit. As William Sumner observed: "A man might as well jump off a precipice intending to stop half way down."[1]

NATURAL LAW NO. 4

And so, once again, we come to one of those natural laws that emerge from centuries of human experience. It can be stated as follows:

> LESSON: Fractional money is paper money which is backed by precious metals up to only a portion of the face amount. It is a hybrid, being part receipt money and part fiat money. Generally, the public is unaware of this fact and believes that fractional money can be redeemed in full at any time. When the truth is discovered, as periodically happens, there are runs on the bank, and only the first few depositors in line can be paid. Since fractional money earns just as much interest for the bankers as does gold or silver, the temptation is great for them to create as much of it as possible. As this happens, the fraction which represents the reserve becomes smaller and smaller until, eventually, it is reduced to zero. Therefore,
>
> LAW: Fractional money will always degenerate into fiat money. It is but fiat money in transition.

So much for the overview and generalities. In the next chapter we shall see what history has to say on this process. And what a history it is!

1. William Graham Sumner, *A History of American Currency* (New York: Holt, 1884), p. 214.

SUMMARY

Fiat money is paper money without precious-metal backing which people are required by law to accept. The first recorded appearance of fiat money was in thirteenth century China, but its use on a major scale did not occur until colonial America. The experience was disastrous, leading to massive inflation, unemployment, loss of property, and political unrest. During one period when the Bank of England forced the colonies to abandon their fiat money, general prosperity quickly returned. The Revolutionary War brought fiat money back to the colonies with a vengeance. The economic chaos that resulted led the colonial governments to impose price controls and harsh legal tender laws, neither of which was effective.

Fractional money is defined as paper money with precious-metal backing for part, not all, of its stated value. It was introduced in Europe when goldsmiths began to issue receipts for gold which they did not have, thus only a fraction of their receipts was redeemable. Fractional money always degenerates into pure fiat money.

Chapter Nine

THE SECRET SCIENCE

The condensed history of fractional-reserve banking; the unbroken record of fraud, booms, busts, and economic chaos; the formation of the Bank of England, the world's first central bank, which became the model for the Federal Reserve System.

Banks of deposit first appeared in early Greece, concurrent with the development of coinage itself. They were known in India at the time of Alexander the Great. They also operated in Egypt as part of the public granary system. They appeared in Damascus in 1200 and in Barcelona in 1401. It was the city-state of Venice, however, which is considered the cradle of banking as we know it today.

THE BANK OF VENICE

By the year 1361, there already had been sufficient abuse in banking that the Venetian Senate passed a law forbidding bankers to engage in any other commercial pursuit, thus removing the temptation to use their depositors' funds to finance their own enterprises. They were also required to open their books for public inspection and to keep their stockpile of coins available for viewing at all reasonable times. In 1524, a board of bank examiners was created and, two years later, all bankers were required to settle accounts between themselves in coin rather than by check.

In spite of these precautions, however, the largest bank at that time, the house of Pisano and Tiepolo, had been active in lending against its reserves and, in 1584, was forced to close its doors because of inability to refund depositors. The government picked up the pieces at that point and a state bank was established, the *Banco della Piazza del Rialto*. Having learned from the recent experience with bankruptcy, the new bank was not allowed to make any loans. There could be no profit from the issuance of credit. The bank was required to sustain itself solely from fees for coin storage, exchanging currencies, handling the transfer of payments between customers, and notary services.

The formula for honest banking had been found. The bank prospered and soon became the center of Venetian commerce. Its paper receipts were widely accepted far beyond the country's borders and, in fact, instead of being discounted in exchange for gold coin as was the usual practice, they actually carried a *premium* over coins. This was because there were so many kinds of coin in circulation and such a wide variance of quality within the same type of coin that one had to be an expert to evaluate their worth. The bank performed this service automatically when it took the coins into its vault. Each was evaluated, and the receipt given for it was an accurate reflection of its intrinsic worth. The public, therefore, was far more certain of the value of the paper receipts than of many of the coins and, consequently, was willing to exchange a little bit more for them.

Unfortunately, with the passage of time and the fading from memory of previous banking abuses, the Venetian Senate eventually succumbed to the temptation of credit. Strapped for funds and not willing to face the voters with a tax increase, the politicians decided they would authorize a new bank without restrictions against loans, have the bank create the money they needed, and then "borrow" it. So, in 1619, the *Banco del Giro* was formed, which, like its bankrupt predecessor, began immediately to create money out of nothing for the purpose of lending it to the government. Eighteen years later, the *Banco della Piazza del Rialto* was absorbed into the new bank, and history's first tiny flame of sound banking sputtered and died.

Throughout the fifteenth and sixteenth centuries, banks had been springing up all over Europe. Almost without exception, however, they followed the lucrative practice of lending money which was not truly available for loan. They created excess obligations against their reserves and, as a result, every one of them failed. That is not to say that their owners and directors did not prosper. It merely means that their depositors lost all or a part of their assets entrusted for safekeeping.

THE BANK OF AMSTERDAM

It wasn't until the Bank of Amsterdam was founded in 1609 that we find a second example of sound banking practices, and the results were virtually the same as previously experienced by the *Banco della Piazza del Rialto*. The bank only accepted deposits and

steadfastly refused to make loans. Its income was derived solely from service fees. All payments in and around Amsterdam soon came to be made in paper currency issued by the bank and, in fact, that currency carried a premium over coin itself. The burgomasters and the city council were required to take an annual oath swearing that the coin reserve of the bank was intact. Galbraith reminds us:

> For a century after its founding it functioned usefully and with notably strict rectitude. Deposits were deposits, and initially the metal remained in storage for the man who owned it until he transferred it to another. None was loaned out. In 1672, when the armies of Louis XIV approached Amsterdam, there was grave alarm. Merchants besieged the bank, some in the suspicion that their wealth might not be there. All who sought their money were paid, and when they found this to be so, they did not want payment. As was often to be observed in the future, however desperately people want their money from a bank, when they are assured they can get it, they no longer want it.[1]

The principles of honesty and restraint were not to be long lived, however. The temptation of easy profit from money creation was simply too great. As early as 1657, individuals had been permitted to overdraw their accounts which means, of course, that the bank created new money out of their debt. In later years enormous loans were made to the Dutch East Indies Company. The truth finally became known to the public in January of 1790, and demands for a return of deposits were steady from that date forward. Ten months later, the bank was declared insolvent and was taken over by the City of Amsterdam.

THE BANK OF HAMBURG

The third and last experience with honest banking occurred in Germany with the Bank of Hamburg. For over two centuries it faithfully adhered to the principle of safe deposit. So scrupulous was its administration that, when Napoleon took possession of the bank in 1813, he found 7,506,956 *marks* in silver held against liabilities of 7,489,343. That was 17,613 *more* than was actually needed. Most of the bank's treasure that Napoleon hauled away was restored a few years later by the French government in the form of securities. It is not clear if the securities were of much value but, even if they were, they were not the same as silver. Because of foreign invasion, the bank's currency was no longer fully convert-

1. Galbraith, p. 16.

ible into coin as receipt money. It was now *fractional* money, and the self-destruct mechanism had been set in motion. The bank lasted another fifty-five years until 1871 when it was ordered to liquidate all of its accounts.

That is the end of the short story of honest banking. From that point forward, fractional-reserve banking became the universal practice. But there were to be many interesting twists and turns in its development before it would be ready for something as sophisticated as the Federal Reserve System.

EARLY BANKING IN ENGLAND

In England, the first paper money was the exchequer order of Charles II. It was pure fiat and, although it was decreed legal tender, it was not widely used. It was replaced in 1696 by the exchequer *bill*. The bill was redeemable in gold, and the government went to great lengths to make sure that there was enough actual coin or bullion to make good on the pledge. In other words, it was true receipt money, and it became widely accepted as the medium of exchange. Furthermore, the bills were considered as short-term loans to the government and actually paid interest to the holders.

In 1707, the recently created Bank of England was given the responsibility of managing this currency, but the bank found more profit in the circulation of its own banknotes, which were in the form of *fractional* money and which provided for the *collection* of interest, not the payment of it. Consequently, the government bills gradually passed out of use and were replaced by banknotes which, by the middle of the eighteenth century, became England's only paper money.

It must be understood that, at this time, the Bank of England was not yet fully developed as a central bank. It had been given a monopoly over the issue of banknotes within London and other prime geographic areas, but they were not yet decreed as legal tender. No one was forced to use them. They were merely private fractional receipts for gold coin issued by a private bank which the public could accept, reject, or discount at its pleasure. Legal tender status was not conferred upon the bank's money until 1833.

Meanwhile, Parliament had granted charters to numerous other banks throughout the empire and, without exception, the issuance of fractional money led to their ultimate demise and the ruin of

their depositors. "Disaster after disaster had to come upon the country," says Shaw, because "of the indifference of the state to these mere private paper tokens."[1] The Bank of England, however, was favored by the government above all others and, time after time, it was saved from insolvency by Parliament. How it came to be that way is an interesting story.

THE BANK OF ENGLAND

England was financially exhausted after half a century of war against France and numerous civil wars fought largely over excessive taxation. By the time of the War of the League of Augsberg in 1693, King William was in serious need for new revenue. Twenty years previously, King Charles II had flat out repudiated a debt of over a million pounds which had been lent to him by scores of goldsmiths, with the result that ten-thousand depositors lost their savings. This was still fresh in everyone's memory, and, needless to say, the government was no longer considered a good investment risk. Unable to increase taxes and unable to borrow, Parliament became desperate for some other way to obtain the money. The objective, says Groseclose, was not to bring "the money mechanism under more intelligent control, but to provide means outside the onerous sources of taxes and public loans for the financial requirements of an impecunious government."[2]

There were two groups of men who saw a unique opportunity arise out of this necessity. The first group consisted of the *political scientists* within the government. The second was comprised of the *monetary scientists* from the emerging business of banking. The organizer and spokesman of this group was William Paterson from Scotland. Paterson had been to America and came back with a grandiose scheme to obtain a British charter for a commercial company to colonize the Isthmus of Panama, then known as Darien. The government was not interested in that, so Paterson turned his attention to a scheme that *did* interest it very much, the creation of money.

The two groups came together and formed an alliance. No, that is too soft a word. The *American Heritage Dictionary* defines a *cabal*

1. W.A. Shaw, *Theory and Principles of Central Banking* (London & New York: Sir I. Pitman & Sons, Ltd., 1930), pp. 32–32.
2. Groseclose, *Money and Man*, p. 175.

as "A conspiratorial group of plotters or intriguers." There is no other word that could so accurately describe this group. With much of the same secrecy and mystery that surrounded the meeting on Jekyll Island, the Cabal met in Mercer's Chapel in London and hammered out a seven-point plan which would serve their mutual purposes:

1. The government would grant a charter to the monetary scientists to form a bank;
2. The bank would be given a monopoly to issue banknotes which would circulate as England's paper currency;
3. The bank would create money out of nothing with only a fraction of its total currency backed by coin;
4. The monetary scientists then would lend the government all the money it needed;
5. The money created for government loans would be backed primarily by government I.O.U.s;
6. Although this money was to be created out of nothing and would cost nothing to create, the government would pay "interest" on it at the rate of 8%;
7. Government I.O.U.s would also be considered as "reserves" for creating additional loan money for private commerce. These loans also would earn interest. Thus, the monetary scientists would collect *double* interest on the same nothing.[1]

The circular which was distributed to attract subscribers to the Bank's initial stock offering explained: "The Bank hath benefit of interest on all the moneys which it, the Bank, creates out of nothing."[2] The charter was issued in 1694, and a strange creature took its initial breath of life. It was the world's first central bank. Rothbard writes:

1. For an overview of these agreements, see Murray Rothbard, *The Mystery of Banking* (New York: Richardson & Snyder, 1983), p. 180. Also Martin Mayer, *The Bankers* (New York: Weybright & Talley, 1974), pp. 24–25.
2. Quoted by Caroll Quigley, *Tragedy and Hope: A History of the World in Our Time* (New York: Macmillan, 1966), p. 49. Paterson did not benefit from his own creation. He withdrew from the Bank over a policy disagreement within a few months after its formation and then returned to Scotland where he succeeded in selling his Darien scheme. Frugal Scots thronged to buy stock and to book passage to the fever-ridden land. The stock became worthless and almost all the 1200 colonists lost their lives.

> In short, since there were not enough private savers willing to finance the deficit, Paterson and his group were graciously willing to buy government bonds, provided they could do so with newly-created out-of-thin-air bank notes carrying a raft of special privileges with them. This was a splendid deal for Paterson and company, and the government benefited from the flimflam of a seemingly legitimate bank's financing their debts.... As soon as the Bank of England was chartered in 1694, King William himself and various members of Parliament rushed to become shareholders of the new money factory they had just created.[1]

THE SECRET SCIENCE OF MONEY

Both groups within the Cabal were handsomely rewarded for their efforts. The political scientists had been seeking about £500,000 to finance the current war. The Bank promptly gave them more than twice what they originally sought. The monetary scientists started with a pledged capital investment of £1,200,000. Textbooks tell us that this was lent to the government at 8% interest, but what is usually omitted is the fact that, at the time the loan was made, only £720,000 had been invested, which means the Bank "lent" 66% more than it had on hand.[2] Furthermore, the Bank was given the privilege of creating at least an equal amount of money in the form of loans to the public. So, after lending their capital to the government, they still had it available to lend out a second time.

An honest loan of their £720,000 at 8% would have yielded £57,600 interest. But, with the new secret science, they were able to earn 8% on £1,200,000 given to the government plus an estimated 9% on £720,000 lent to the public. That adds up to £160,800, more than 22% on their investment. The real point, however, is that, under these circumstances, it is meaningless to talk about a rate of interest. When money is created out of nothing, the true interest rate is not 8% or 9% or even 22%. It is *infinity*.

In this first official act of the world's first central bank can be seen the grand pretense that has characterized all those which have followed. The Bank *pretended* to make a loan but what it really did was to *manufacture* the money for government's use. If the government had done this directly, the fiat nature of the currency would

1. Rothbard, *Mystery*, p. 180.
2. See R.D. Richards, Ph.D., *The Early History of Banking in England* (New York: Augustus M. Kelley, original edition 1929, reprinted 1965), pp. 148–50.

have been immediately recognized, and it probably would not have been accepted at full face value in payment for the expenses of war. By creating money through the banking system, however, the process became mystifying to the general public. The newly created bills and notes were indistinguishable from those previously backed by coin, and the public was none the wiser.

The reality of central banks, therefore—and we must not forget that the Federal Reserve System is such a creature—is that, under the guise of purchasing government bonds, they act as hidden money machines which can be activated any time the politicians want. This is a godsend to the political scientists who no longer must depend on taxes or the good credit of their treasury to raise money. It is even easier than printing and, because the process is not understood by the public, it is politically safe.

The monetary scientists, of course, are amply paid for this service. To preserve the pretense of banking, it is said they collect *interest*, but this is a misnomer. They didn't lend money, they created it. Their compensation, therefore, should be called what it is: a professional fee, or commission, or royalty, or kickback, depending on your perspective, but *not* interest.

FROM INFLATION TO BANK RUNS

The new money created by the Bank of England splashed through the economy like rain in April. The country banks outside of the London area were authorized to create money on their own, but they had to hold a certain percentage of either coin *or* Bank of England certificates in reserve. Consequently, when these plentiful banknotes landed in their hands, they quickly put them into the vaults and then issued their own certificates in even greater amounts. As a result of this pyramiding effect, prices rose 100% in just two years. Then, the inevitable happened: There was a run on the bank, and the Bank of England could not produce the coin.

When banks cannot honor their contracts to deliver coin in return for their receipts, they are, in fact, bankrupt. They should be allowed to go out of business and liquidate their assets to satisfy their creditors just like any other business. This, in fact, is what always had happened to banks which lent out their deposits and created fractional money. Had this practice been allowed to continue, there is little doubt that people eventually would have understood that they simply do not want to do business with those

kinds of banks. Through the painful but highly effective process of trial and error, mankind would have learned to distinguish real money from fool's gold. And the world would be a lot better because of it today.

That, of course, was not allowed to happen. The Cabal is a *partnership*, and each of the two groups is committed to protect each other, not out of loyalty, but out of mutual self interest. They know that, if one falls, so does the other. It is not surprising, therefore, that, when there was a run on the Bank of England, Parliament intervened. In May of 1696, just two years after the Bank was formed, a law was passed authorizing it to "suspend payment in specie." By force of law, the Bank was now exempted from having to honor its contract to return the gold.

THE PATTERN OF PROTECTION WAS SET

This was a fateful event in the history of money, because the precedent has been followed ever since. In Europe and America, the banks have always operated with the assumption that their partners in government will come to their aid when they get into trouble. Politicians may speak about "protecting the public," but the underlining reality is that the government *needs* the fiat money produced by the banks. The banks, therefore—at least the big ones— must not be allowed to fail. Only a cartel with government protection can enjoy such insulation from the workings of a free market.

It is commonly observed in modern times that criminals often are treated lightly when they rob their neighbor. But if they steal from the government or a bank, the penalties are harsh. This is merely another manifestation of the Cabal's partnership. In the eyes of government, banks are *special*, and it has been that way even from the beginning of their brotherhood. For example, Galbraith tells us:

> In 1780, when Lord George Gordon led his mob through London in protest against the Catholic Relief Acts, the Bank was a principal target. It signified the Establishment. For so long as the Catholic districts of London were being pillaged, the authorities were slow to react. When the siege of the Bank began, things were thought more serious. Troops intervened, and ever since soldiers have been sent to guard the Bank by night.[1]

1. Galbraith, p. 34.

BOOMS AND BUSTS NOW GUARANTEED

Once the Bank of England had been legally protected from the consequences of converting debt into money, the British economy was doomed to a nauseating roller-coaster ride of inflation, booms, and busts. The natural and immediate result was the granting of *massive* loans for just about any wild scheme imaginable. Why not? The money cost nothing to make, and the potential profits could be enormous. So the Bank of England, and the country banks which pyramided their own money supply on top of the Bank's supply, pumped a steady stream of new money into the economy. Great stock companies were formed and financed by this money. One was for the purpose of draining the Red Sea to recover the gold supposedly lost by the Egyptians when pursuing the Isrealites. £150,000,000 were siphoned into vague and fruitless ventures in South America and Mexico.

The result of this flood of new money—how many times must history repeat it?—was even more inflation. In 1810, the House of Commons created a special committee, called the Select Committee on the High Price of Gold Bullion, to explore the problem and to find a solution. The verdict handed down in the final report was a model of clarity. Prices were not going up, it said. The value of the currency was going down, and that was due to the fact that it was being created at a faster rate than the creation of goods to be purchased with it. The solution? The committee recommended that the notes of the Bank of England be made fully convertible into gold coin, thus putting a brake on the supply of money that could be created.

IN DEFENSE OF THE GOLD STANDARD

One of the most outspoken proponents of a true gold standard was a Jewish London stockbroker by the name of David Ricardo. Ricardo argued that an ideal currency "should be absolutely invariable in value."[1] He conceded that precious metals were not perfect in this regard because they do shift in purchasing power to a small degree. Then he said: "They are, however, the best with which we are acquainted."[2]

1. David Ricardo, *The Works and Correspondence of David Ricardo: Pamphlets 1815–1823*, Piero Sraffa, ed. (Cambridge: Cambridge University Press, 1951), Vol. IV, p. 58.
2. *Ibid.*, p. 62.

Almost everyone in government agreed with Ricardo's assessment, but, as is often the case, theoretical truth was fighting a losing battle against practical necessity. Men's opinions on the best form of money were one thing. The war with Napoleon was another, and it demanded a constant inflow of funding. England continued to use the central-bank mechanism to extract that revenue from the populace.

DEPRESSION AND REFORM

By 1815, prices had doubled again and then fell sharply. The Corn Act was passed that year to protect local growers from lower-priced imports. Then, when corn and wheat prices began to climb once more in spite of the fact that wages and other prices were falling, there was widespread discontent and rebellion. "By 1816," notes Roy Jastram, "England was in deep depression. There was stagnation of industry and trade generally; the iron and coal industries were paralyzed.... Riots occurred spasmodically from May through December."[1]

In 1821, after the war had ended and there was no longer a need to fund military campaigns, the political pressure for a gold standard became too strong to resist, and the Bank of England returned to a convertibility of its notes into gold coin. The basic central-bank mechanism was not dismantled, however. It was merely limited by a new formula regarding the allowable fraction of reserves. The Bank continued to create money out of nothing for the purpose of lending and, within a year, the flower of a new business boom unfolded. Then, in November of 1825, the flower matured into its predestined fruit. The crisis began with the collapse of Sir Peter Cole and Company and was soon followed by the failure of sixty-three other banks. Fortunes were wiped out and the economy plunged back into depression.

When a similar crisis with still more bank failures struck again in 1839, Parliament attempted to come to grips with the problem. After five more years of analysis and debate, Sir Robert Peel succeeded in passing a banking reform act. It squarely faced the cause of England's booms and busts: an *elastic* money supply. What Peel's Bank Act of 1844 attempted to do was to limit the amount of money the banks could create to roughly the same as it would be if

1. Roy W. Jastram, *The Golden Constant* (New York: Wiley, 1977), p. 113.

their banknotes were backed by gold or silver. It was a good try, but it ultimately failed because it fell short on three counts: (1) It was a political compromise and was not strict enough, allowing the banks to still create lending money out of nothing to the extent of £14,000,000; in other words, a "fractional" amount thought to be safe at the time; (2) The limitation applied only to paper currency issued by the Bank. It did not apply to checkbook money, and that was then becoming the preferred *form* of exchange. Consequently, the so-called reform did not even apply to the area where the greatest amount of abuse was taking place; and (3) The basic concept was allowed to remain unchallenged that *man,* in his infinite political wisdom, can determine what the money supply should be more effectively than an unmanaged system of gold or silver responding to the law of supply and demand.

THE ROLLER COASTER CONTINUES

Within three years of the "reform," England faced another crisis with still more bank failures and more losses to depositors. But when the Bank of England tottered on the edge of insolvency, once again the government intervened. In 1847, the Bank was exempted from the legal reserve requirements of the Peel Act. Such is the rock-steady dependability of man-made limits to the money supply.

Groseclose continues the story:

> Ten years later, in 1857, another crisis occurred, due to excessive and unwise lending as a result of over-optimism regarding foreign trade prospects. The bank found itself in the same position as in 1847, and similar measures were taken. On this occasion the bank was forced to use the authority to increase its fiduciary [debt-based money] issue beyond the limit imposed by the Bank Charter Act....
>
> Again in 1866, the growth of banking without sufficient attention to liquidity, and the use of bank credit to support a speculative craze...prepared the way for a crash which was finally precipitated by the failure of the famous house of Overend, Gurney and Co. The Act of 1844 was once more suspended....
>
> In 1890, the Bank of England once again faced crisis, again the result of widespread and excessive speculation in foreign securities, particularly American and Argentine. This time it was the failure of Baring Brothers that precipitated the crash.[1]

1. Groseclose, *Money and Man,* pp. 195–96.

THE MECHANISM SPREADS TO OTHER COUNTRIES

It is an incredible fact of history that, in spite of the general and recurring failures of the Bank of England during these years, the central-bank mechanism was so attractive to the political and monetary scientists that it became the model for all of Europe. The Bank of Prussia became the Reichsbank. Napoleon established the Banque de France. A few decades later, the concept became the venerated model for the Federal Reserve System. Who cares if the scheme is destructive? Here is the perfect tool for obtaining unlimited funding for politicians and endless profits for bankers. And, best of all, the little people who pay the bills for both groups have practically no idea what is being done to them.

Leaders of the Leninist block of countries are no exception. They have been the most outspoken critics of the banking system of Western Countries. John Maynard Kenes writes:

> Lenin is said to have delared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method, they not only confiscate, but they confiscate *arbitrarily;* and while the process impoverishes many, it actually enriches some. ... As the inflation proceeds and the real value of the currency fluctuates wildly and from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so uterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.
>
> Lenin was right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.[1]

From this we may reasonably assume that the Leninists (and their Fabian counterparts) are well informed on this phenomenon. Yet, after all the words of wisdom have been written, wherever Leninists and their socialist counterparts come to power, they invariably form partnerships with banks and unleash all the hidden forces of inflation to plunder their own people.

1. John Maynard Keynes, *The Economic Consequences of the Peace* (New York, Harcourt, Brace, and Howe, 1919) p. 235 *ff.*

SUMMARY

The business of banking began in Europe in the fourteenth century. Its function was to evaluate, exchange, and safeguard people's coins. In the beginning, there were notable examples of totally honest banks which operated with remarkable efficiency considering the vast variety of coinage they handled. They also issued paper receipts which were so dependable they freely circulated as money and cheated no one in the process. But there was a great demand for more money and more loans, and the temptation soon caused the bankers to seek easier paths. They began lending out pieces of paper that *said* they were receipts, but which in fact were counterfeit. The public could not tell one from the other and accepted both of them as money. From that point forward, the receipts in circulation exceeded the gold held in reserve, and the age of fractional-reserve banking had dawned. This led immediately to what would become an almost unbroken record from then to the present: a record of inflation, booms and busts, suspension of payments, bank failures, repudiation of currencies, and recurring spasms of economic chaos.

The Bank of England was formed in 1694 to institutionalize fractional-reserve banking. As the world's first central bank, it introduced the concept of a partnership between bankers and politicians. The politicians would receive spendable money (created out of nothing by the bankers) without having to raise taxes. In return, the bankers would receive a commission on the transaction—deceptively called interest—which would continue in perpetuity. Since it all seemed to be wrapped up in the mysterious rituals of banking, which the common man was not expected to understand, there was practically no opposition to the scheme. The arrangement proved so profitable to the participants that it soon spread to many other countries in Europe and, eventually, to the United States.

Chapter Ten

THE MANDRAKE MECHANISM

The method by which the Federal Reserve creates money out of nothing; the concept of usury as the payment of interest on pretended loans; the true cause of the hidden tax called inflation; the way in which the Fed creates boom-bust cycles.

In the 1940s, there was a comic strip character called Mandrake the Magician. His specialty was creating things out of nothing and, when appropriate, to make them disappear back into that same void. It is fitting, therefore, that the process to be described in this section should be named in his honor.

In the previous chapters, we examined the technique developed by the political and monetary scientists to create money out of nothing for the purpose of lending. This is not an entirely accurate description because it implies that money is created first and then waits for someone to borrow it. On the other hand, textbooks on banking often state that money is created out of debt. This also is misleading because it implies that debt exists first and then is converted into money. In truth, money is not created until the instant it is borrowed. It is the act of borrowing which causes it to spring into existence. And, incidentally, it is the act of paying off the debt that causes it to vanish.[1] There is no short phrase that perfectly describes that process. So, until one is invented along the way, we shall continue using the phrase "create money out of nothing" and occasionally add "for the purpose of lending" where necessary to further clarify the meaning.

1. Printed Federal Reserve Notes that sit in the Treasury's vault do not become money until they are released into circulation in exchange for checkbook money that was created by a bank loan. As long as the bills are in the vault with no debt-based money to replace them, they technically are just paper, not money.

So, let us now leave the historical figures of the past and jump into *their* "future," in other words, into our present, and see just how far this money/debt-creation process has been carried—and how it works.

The first fact that needs to be considered is that our money today has no gold or silver behind it whatsoever. The fraction is not 54% nor 15%. It is 0%. It has travelled the path of all previous fractional money in history and already has degenerated into pure fiat money. The fact that most of it is in the form of checkbook balances rather than paper currency is a mere technicality; and the fact that bankers speak about "reserve ratios" is eye wash. The so-called reserves to which they refer are, in fact, Treasury bonds and other certificates of *debt*. Our money is pure fiat through and through.

The second fact that needs to be clearly understood is that, in spite of the technical jargon and seemingly complicated procedures, the actual mechanism by which the Federal Reserve creates money is quite simple. They do it exactly the same way the goldsmiths of old did except, of course, the goldsmiths were limited by the need to hold *some* precious metal in reserve, whereas the Fed has no such restriction.

THE FEDERAL RESERVE IS CANDID

The Federal Reserve itself is amazingly frank about this process. A booklet published by the Federal Reserve Bank of New York tells us: "Currency cannot be redeemed, or exchanged, for Treasury gold or any other asset used as backing. The question of just what assets 'back' Federal Reserve notes has little but bookkeeping significance."[1]

Elsewhere in the same publication we are told: "Banks are creating money based on a borrower's promise to pay (the IOU)... Banks create money by 'monetizing' the private debts of businesses and individuals."[2]

In a booklet entitled *Modern Money Mechanics*, the Federal Reserve Bank of Chicago says:

> In the United States neither paper currency nor deposits have value as commodities. Intrinsically, a dollar bill is just a piece of paper. Deposits are merely book entries. Coins do have some intrinsic value as metal, but generally far less than their face amount.

1. *I Bet You Thought*, Federal Reserve Bank of New York, p. 11.
2. *Ibid.*, p. 19.

> What, then, makes these instruments—checks, paper money, and coins—acceptable at face value in payment of all debts and for other monetary uses? Mainly, it is the confidence people have that they will be able to exchange such money for other financial assets and real goods and services whenever they choose to do so. This partly is a matter of law; currency has been designated "legal tender" by the government—that is, it must be accepted.[1]

In the fine print of a footnote in a bulletin of the Federal Reserve Bank of St. Louis, we find this surprisingly candid explanation:

> Modern monetary systems have a fiat base—literally money by decree—with depository institutions, acting as fiduciaries, creating obligations against themselves with the fiat base acting in part as reserves. The decree appears on the currency notes: "This note is legal tender for all debts, public and private." While no individual could refuse to accept such money for debt repayment, exchange contracts could easily be composed to thwart its use in everyday commerce. However, a forceful explanation as to why money is accepted is that the federal government requires it as payment for tax liabilities. Anticipation of the need to clear this debt creates a demand for the pure fiat dollar.[2]

MONEY WOULD VANISH WITHOUT DEBT

It is difficult for Americans to come to grips with the fact that their total money supply is backed by nothing but debt, and it is even more mind boggling to visualize that, if everyone paid back all that was borrowed, *there would be no money left in existence.* That's right, there would be not one penny in circulation—all coins and all paper currency would be returned to bank vaults—and there would be not one dollar in any one's checking account. In short, all money would disappear.

Marriner Eccles was the Governor of the Federal Reserve System in 1941. On September 30 of that year, Eccles was asked to give testimony before the House Committee on Banking and Currency. The purpose of the hearing was to obtain information regarding the role of the Federal Reserve in creating conditions that led to the depression of the 1930s. Congressman Wright Patman, who was Chairman of that committee, asked how the Fed got the money to

1. *Modern Money Mechanics*, Federal Reserve Bank of Chicago, revised October 1982, p. 3.
2. "Money, Credit and Velocity," *Review*, May, 1982, Vol. 64, No. 5, Federal Reserve Bank of St. Louis, p. 25.

purchase two billion dollars worth of government bonds in 1933. This is the exchange that followed.

ECCLES: We created it.
PATMAN: Out of what?
ECCLES: Out of the right to issue credit money.
PATMAN: And there is nothing behind it, is there, except our government's credit?
ECCLES: That is what our money system is. If there were no debts in our money system, there wouldn't be any money.

It must be realized that, while money may represent an asset to selected individuals, when it is considered as an aggregate of the total money supply, it is not an asset at all. A man who borrows $1,000 may think that he has increased his financial position by that amount but he has not. His $1,000 cash asset is offset by his $1,000 loan liability, and his net position is zero. Bank accounts are exactly the same on a larger scale. Add up all the bank accounts in the nation, and it would be easy to assume that all that money represents a gigantic pool of assets which support the economy. Yet, every bit of this money is owed by someone. Some will owe nothing. Others will owe many times what they possess. All added together, the national balance is zero. What we think is money is but a grand illusion. The reality is debt.

Robert Hemphill was the Credit Manager of the Federal Reserve Bank in Atlanta. In the foreword to a book by Irving Fisher, entitled *100% Money*, Hemphill said this:

> If all the bank loans were paid, no one could have a bank deposit, and there would not be a dollar of coin or currency in circulation. This is a staggering thought. We are completely dependent on the commercial banks. Someone has to borrow every dollar we have in circulation, cash, or credit. If the banks create ample synthetic money we are prosperous; if not, we starve. We are absolutely without a permanent money system. When one gets a complete grasp of the picture, the tragic absurdity of our hopeless situation is almost incredible—but there it is.[1]

With the knowledge that money in America is based on debt, it should not come as a surprise to learn that the Federal Reserve System is not the least interested in seeing a reduction in debt in this

1. Irving Fisher, *100% Money* (New York: Adelphi, 1936), p. xxii.

country, regardless of public utterances to the contrary. Here is the bottom line from the System's own publications. The Federal Reserve Bank of Philadelphia says: "A large and growing number of analysts, on the other hand, now regard the national debt as something useful, if not an actual blessing.... [They believe] the national debt need not be reduced at all."[1]

The Federal Reserve Bank of Chicago adds: "Debt—public and private—is here to stay. It plays an essential role in economic processes.... What is required is not the abolition of debt, but its prudent use and intelligent management."[2]

WHAT'S WRONG WITH A LITTLE DEBT?

There is a kind of fascinating appeal to this theory. It gives those who expound it an aura of intellectualism, the appearance of being able to grasp a complex economic principle that is beyond the comprehension of mere mortals. And, for the less academically minded, it offers the comfort of at least *sounding* moderate. After all, what's *wrong* with a little debt, prudently used and intelligently managed? The answer is nothing, *provided* the debt is based on an honest transaction. There is plenty wrong with it if it is based upon fraud.

An honest transaction is one in which a borrower pays an agreed upon sum in return for the temporary use of a lender's asset. That asset could be anything of tangible value. If it were an automobile, for example, then the borrower would pay "rent." If it is money, then the rent is called "interest." Either way, the concept is the same.

When we go to a lender—either a bank or a private party—and receive a loan of money, we are willing to pay interest on the loan in recognition of the fact that the money we are borrowing is an asset which we want to use. It seems only fair to pay a rental fee for that asset to the person who owns it. It is not easy to acquire an automobile, and it is not easy to acquire money—*real* money, that is. If the money we are borrowing was earned by someone's labor and talent, they are fully entitled to receive interest on it. But what are we to think of money that is created by the mere stroke of a pen or the click of a computer key? Why should anyone collect a rental fee on *that*?

1. *The National Debt*, Federal Reserve Bank of Philadelphia, pp. 2, 11.
2. *Two Faces of Debt*, Federal Reserve Bank of Chicago, p. 33.

When banks place credits into your checking account, they are merely *pretending* to lend you money. In reality, they have nothing to lend. Even the money that non-indebted depositors have placed with them was originally created out of nothing in response to someone else's loan. So what entitles the banks to collect rent on *nothing*? It is immaterial that men everywhere are forced by law to accept these nothing certificates in exchange for real goods and services. We are talking here, not about what is legal, but what is *moral*. As Thomas Jefferson observed at the time of his protracted battle against central banking in the United States, "No one has a natural right to the trade of money lender, but he who has money to lend."[1]

THIRD REASON TO ABOLISH THE SYSTEM

Centuries ago, *usury* was defined as any interest charged for a loan. Modern usage has redefined it as *excessive* interest. Certainly, any amount of interest charged for a *pretended* loan is excessive. The dictionary, therefore, needs a new definition. *Usury: The charging of any interest on a loan of fiat money.*

Let us, therefore, look at debt and interest in this light. Thomas Edison summed up the immorality of the system when he said:

> People who will not turn a shovel full of dirt on the project nor contribute a pound of materials will collect more money...than will the people who will supply all the materials and do all the work.[2]

Is that an exaggeration? Let us consider the purchase of a $100,000 home in which $30,000 represents the cost of the land, architect's fee, sales commissions, building permits, and that sort of thing and $70,000 is the cost of labor and building materials. If the home buyer puts up $30,000 as a down payment, then $70,000 must be borrowed. If the loan is issued at 11% over a 30-year period, the amount of interest paid will be $167,806. That means the amount paid to those who lend the money is about 2 ½ times greater than

1. *The Writings of Thomas Jefferson*, Library Edition (Washington: Jefferson Memorial Association, 1903), Vol XIII, p. 277–78.
2. As quoted by Brian L. Bex, *The Hidden Hand* (Spencer, Indiana: Owen Litho, 1975), p. 161. Unfortunately, Edison did not understand the whole problem. He was correctly opposed to paying interest to banks for their fiat money, but he was not opposed to *government* fiat money. It was only the interest to which he objected. He did not see the larger picture of how fiat money, even when issued solely by the government and without interest, has always been destructive of the economy through the creation of inflation, booms, and busts.

paid to those who provide all the labor and all the materials. It is true that this figure represents the time-value of that money over thirty years and easily could be justified on the basis that a lender deserves to be compensated for surrendering the use of his capital for half a lifetime. But that assumes the lender actually had something to surrender, that he had earned the capital, saved it, and then lent it for construction of someone else's house. What are we to think, however, about a lender who did nothing to earn the money, had not saved it, and, in fact, simply created it out of thin air? What is the time-value of nothing?

As we have already shown, every dollar that exists today, either in the form of currency, checkbook money, or even credit card money—in other words, our *entire* money supply—exists only because it was borrowed by someone; perhaps not you, but *someone*. That means all the American dollars in the entire world are earning daily and compounded interest for the banks which created them. A portion of every business venture, every investment, every profit, every transaction which involves money—and that even includes *losses* and the payment of *taxes*—a portion of all that is earmarked as payment to a bank. And what did the banks do to earn this perpetually flowing river of wealth? Did they lend out their own capital obtained through the investment of stockholders? Did they lend out the hard-earned savings of their depositors? No, neither of these was their major source of income. They simply waved the magic wand called fiat money.

The flow of such unearned wealth under the guise of interest can only be viewed as usury of the highest magnitude. Even if there were no other reasons to abolish the Fed, the fact that *it is the supreme instrument of usury* would be more than sufficient by itself.

WHO CREATES THE MONEY TO PAY THE INTEREST?

One of the most perplexing questions associated with this process is "Where does the money come from to pay the interest?" If you borrow $10,000 from a bank at 9%, you owe $10,900. But the bank only manufactures $10,000 for the loan. It would seem, therefore, that there is no way that you—and all others with similar loans—can possibly pay off your indebtedness. The amount of money put into circulation just isn't enough to cover the total debt, including interest. This has led some to the conclusion that it is necessary for you to *borrow* the $900 for the interest, and that, in turn, leads to still

more interest. The assumption is that, the more we borrow, the more we *have* to borrow, and that debt based on fiat money is a never-ending spiral leading inexorably to more and more debt.

This is a partial truth. It is true that there is not enough money created to include the interest, but it is a fallacy that the only way to pay it back is to borrow still more. The assumption fails to take into account the exchange value of *labor*. Let us assume that you pay back your $10,000 loan at the rate of approximately $900 per month and that about $80 of that represents interest. You realize you are hard pressed to make your payments so you decide to take on a part-time job. The bank, on the other hand, is now making $80 profit each month on your loan. Since this amount is classified as "interest," it is not extinguished as is the larger portion which is a return of the loan itself. So this remains as spendable money in the account of the bank. The decision then is made to have the bank's floors waxed once a week. You respond to the ad in the paper and are hired at $80 per month to do the job. The result is that you *earn* the money to pay the interest on your loan, and—this is the point—the money you receive is the *same* money which you previously had paid. As long as you perform labor for the bank each month, the same dollars go into the bank as interest, then out the revolving door as your wages, and then back into the bank as loan repayment.

It is not necessary that you work directly for the bank. No matter where you earn the money, its *origin* was a bank and its ultimate *destination* is a bank. The loop through which it travels can be large or small, but the fact remains all interest is paid eventually by human effort. And the significance of that fact is even more startling than the assumption that not enough money is created to pay back the interest. It is that the total of this human effort ultimately is for the benefit of those who create fiat money. It is a form of modern serfdom in which the great mass of society works as indentured servants to a ruling class of financial nobility.

UNDERSTANDING THE ILLUSION

That's really all one needs to know about the operation of the banking cartel under the protection of the Federal Reserve. But it would be a shame to stop here without taking a look at the actual cogs, mirrors, and pulleys that make the magical mechanism work. It is a truly fascinating engine of mystery and deception. Let us, therefore, turn our attention to the actual process by which the

magicians create the illusion of modern money. First we shall stand back for a general view to see the overall action. Then we shall move in closer and examine each component in detail.

THE MANDRAKE MECHANISM: AN OVERVIEW

DEBT

The entire function of this machine is to convert debt into money. It's just that simple. First, the Fed takes all the government bonds which the public does not buy and writes a check to Congress in exchange for them. (It acquires other debt obligations as well, but government bonds comprise most of its inventory.) There is no money to back up this check. These fiat dollars are created on the spot for that purpose. By calling those bonds "reserves," the Fed then uses them as the base for creating 9 additional dollars for every dollar created for the bonds themselves. The money created for the bonds is spent by the government, whereas the money created on top of those bonds is the source of all the bank loans made to the nation's businesses and individuals. The result of this process is the same as creating money on a printing press, but the illusion is based on an accounting trick rather than a printing trick. The bottom line is that Congress and the banking cartel have entered into a partnership in which the cartel has the privilege of collecting interest on money which it creates out of nothing, a perpetual override on every American dollar that exists in the world. Congress, on the other hand, has access to unlimited funding without having to tell the voters their taxes are being raised through the process of inflation. If you understand this paragraph, you understand the Federal Reserve System.

MONEY

Now for a more detailed view. There are three general ways in which the Federal Reserve creates fiat money out of debt. One is by making loans to the member banks through what is called the *Discount Window*. The second is by purchasing Treasury bonds and

other certificates of debt through what is called the *Open Market Committee*. The third is by changing the so-called *reserve ratio* that member banks are required to hold. Each method is merely a different path to the same objective: taking in IOUs and converting them into spendable money.

THE DISCOUNT WINDOW

The Discount Window is merely bankers' language for the *loan* window. When banks run short of money, the Federal Reserve stands ready as the "bankers' bank" to lend it. There are many reasons for them to need loans. Since they hold "reserves" of only about one or two per cent of their deposits in vault cash and eight or nine per cent in securities, their operating margin is extremely thin. It is common for them to experience temporary negative balances caused by unusual customer demand for cash or unusually large clusters of checks all clearing through other banks at the same time. Sometimes they make bad loans and, when these former "assets" are removed from their books, their "reserves" are also decreased and may, in fact, become negative. Finally, there is the profit motive. When banks borrow from the Federal Reserve at one interest rate and lend it out at a higher rate, there is an obvious advantage. But that is merely the beginning. When a bank borrows a dollar from the Fed, it becomes a one-dollar *reserve*. Since the banks are required to keep reserves of only about ten per cent, they actually can lend up to *nine* dollars for each dollar borrowed.[1]

Let's take a look at the math. Assume the bank receives $1 million from the Fed at a rate of 8%. The total annual cost, therefore, is $80,000 (.08 X $1,000,000). The bank treats the loan as a cash deposit, which means it becomes the basis for manufacturing an additional $9 million to be lent to its customers. If we assume that it lends that money at 11% interest, its gross return would be $990,000 (.11 X $9,000,000). Subtract from this the bank's cost of $80,000 plus an appropriate share of its overhead, and we have a net return of about $900,000. In other words, the bank borrows a million and can almost

1. This 10% figure (ten-to-one ratio) is based on averages. The Federal Reserve requires a minimum reserve of 10% on deposits over $47.6 million but only 3% on deposits from $7 million up to that amount and no reserves whatsoever below that amount. Reserves consist of vault cash and deposits at the Federal Reserve. See Federal Reserve Press Release: "Annual adjustments for reserve calculations, Reg D" October 6, 2004.

double it in one year.[1] That's *leverage*! But don't forget the *source* of that leverage: the manufacture of another $9 million which is added to the nation's money supply.

THE OPEN MARKET OPERATION

The most important method used by the Federal Reserve for the creation of fiat money is the purchase and sale of securities on the open market. But, before jumping into this, a word of warning. Don't expect what follows to make any sense. Just be prepared to know that this is how they do it.

The trick lies in the use of words and phrases which have technical meanings quite different from what they imply to the average citizen. So keep your eye on the words. They are not meant to explain but to deceive. In spite of first appearances, the process is *not* complicated. It is just absurd.

THE MANDRAKE MECHANISM: A DETAILED VIEW

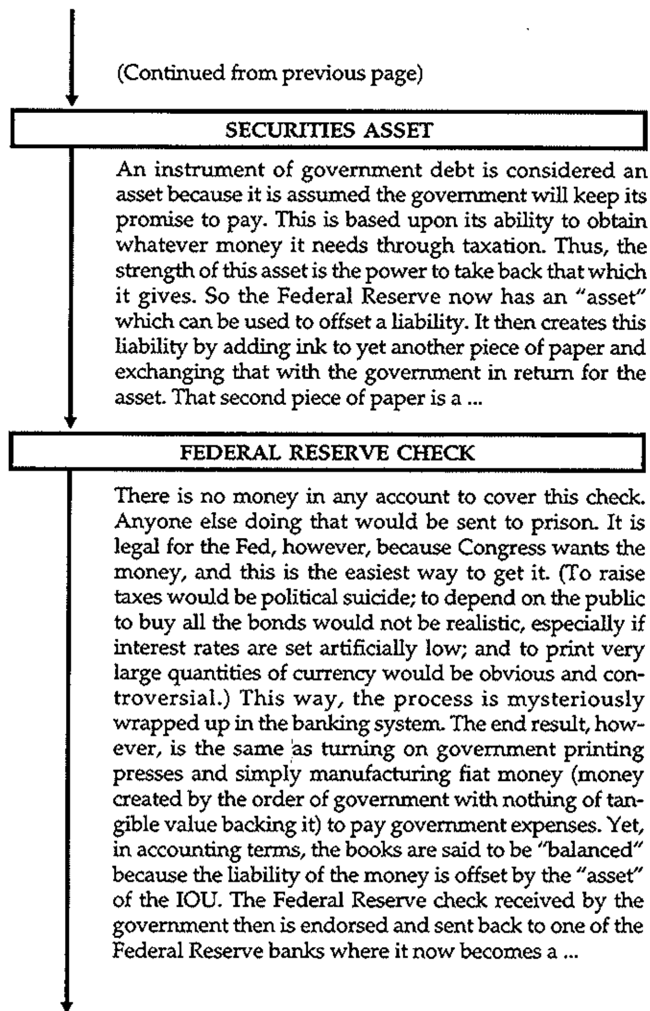
Start with...

GOVERNMENT DEBT

The federal government adds ink to a piece of paper, creates impressive designs around the edges, and calls it a bond or Treasury note. It is merely a promise to pay a specified sum at a specified interest on a specified date. As we shall see in the following steps, this debt eventually becomes the foundation for almost the entire nation's money supply.[2] In reality, the government has created cash, but it doesn't yet *look* like cash. To convert these IOUs into paper bills and checkbook money is the function of The Federal Reserve System. To bring about that transformation, the bond is given to the Fed where it is then classified as a ...

(Continued on next page)

1. The banks must cover these loans with bonds or other interest-bearing assets which it possesses, but that does not diminish the money-multiplier effect of the new deposit.
2. Debt obligations from the private sector and from other governments also are used in the same way, but government bonds are the primary instruments.



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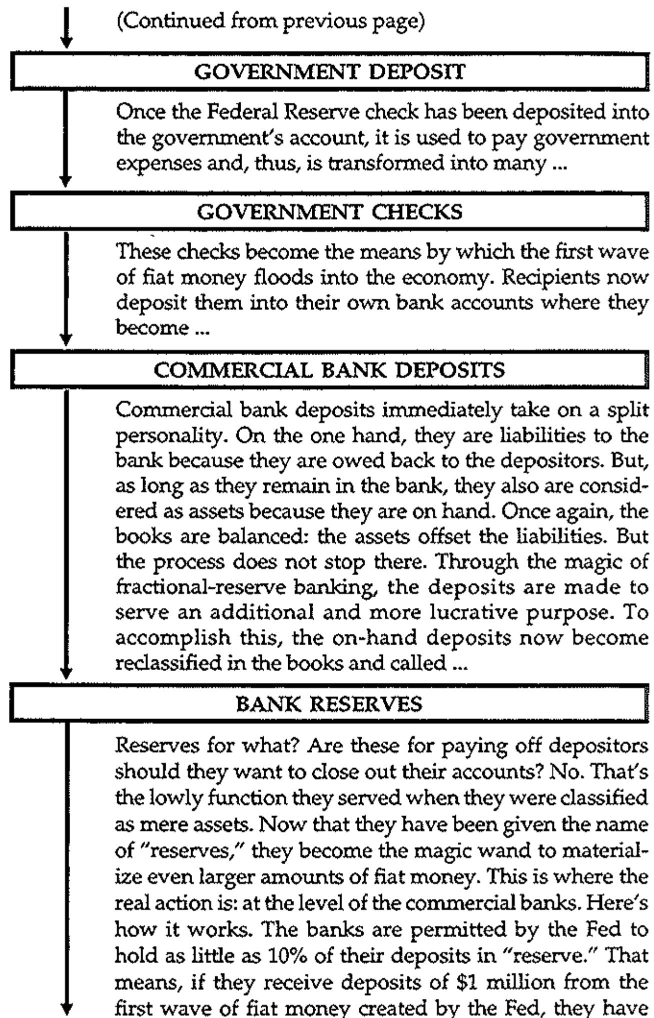
SECURITIES ASSET

An instrument of government debt is considered an asset because it is assumed the government will keep its promise to pay. This is based upon its ability to obtain whatever money it needs through taxation. Thus, the strength of this asset is the power to take back that which it gives. So the Federal Reserve now has an "asset" which can be used to offset a liability. It then creates this liability by adding ink to yet another piece of paper and exchanging that with the government in return for the asset. That second piece of paper is a ...

FEDERAL RESERVE CHECK

There is no money in any account to cover this check. Anyone else doing that would be sent to prison. It is legal for the Fed, however, because Congress wants the money, and this is the easiest way to get it. (To raise taxes would be political suicide; to depend on the public to buy all the bonds would not be realistic, especially if interest rates are set artificially low; and to print very large quantities of currency would be obvious and controversial.) This way, the process is mysteriously wrapped up in the banking system. The end result, however, is the same as turning on government printing presses and simply manufacturing fiat money (money created by the order of government with nothing of tangible value backing it) to pay government expenses. Yet, in accounting terms, the books are said to be "balanced" because the liability of the money is offset by the "asset" of the IOU. The Federal Reserve check received by the government then is endorsed and sent back to one of the Federal Reserve banks where it now becomes a ...



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GOVERNMENT DEPOSIT

Once the Federal Reserve check has been deposited into the government's account, it is used to pay government expenses and, thus, is transformed into many ...

GOVERNMENT CHECKS

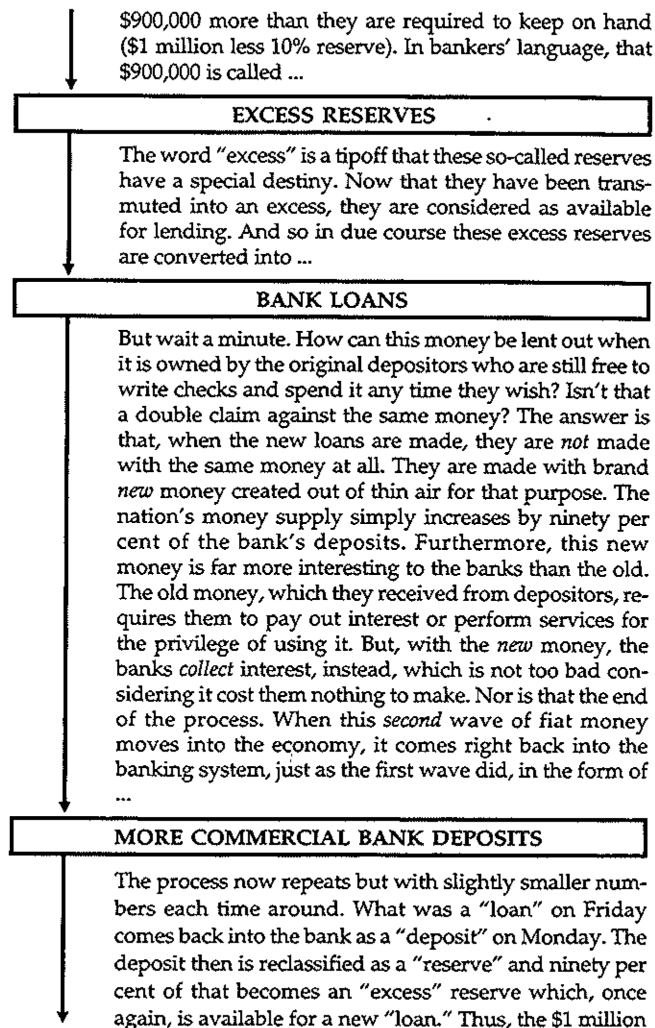
These checks become the means by which the first wave of fiat money floods into the economy. Recipients now deposit them into their own bank accounts where they become ...

COMMERCIAL BANK DEPOSITS

Commercial bank deposits immediately take on a split personality. On the one hand, they are liabilities to the bank because they are owed back to the depositors. But, as long as they remain in the bank, they also are considered as assets because they are on hand. Once again, the books are balanced: the assets offset the liabilities. But the process does not stop there. Through the magic of fractional-reserve banking, the deposits are made to serve an additional and more lucrative purpose. To accomplish this, the on-hand deposits now become reclassified in the books and called ...

BANK RESERVES

Reserves for what? Are these for paying off depositors should they want to close out their accounts? No. That's the lowly function they served when they were classified as mere assets. Now that they have been given the name of "reserves," they become the magic wand to materialize even larger amounts of fiat money. This is where the real action is: at the level of the commercial banks. Here's how it works. The banks are permitted by the Fed to hold as little as 10% of their deposits in "reserve." That means, if they receive deposits of $1 million from the first wave of fiat money created by the Fed, they have



$900,000 more than they are required to keep on hand ($1 million less 10% reserve). In bankers' language, that $900,000 is called ...

EXCESS RESERVES

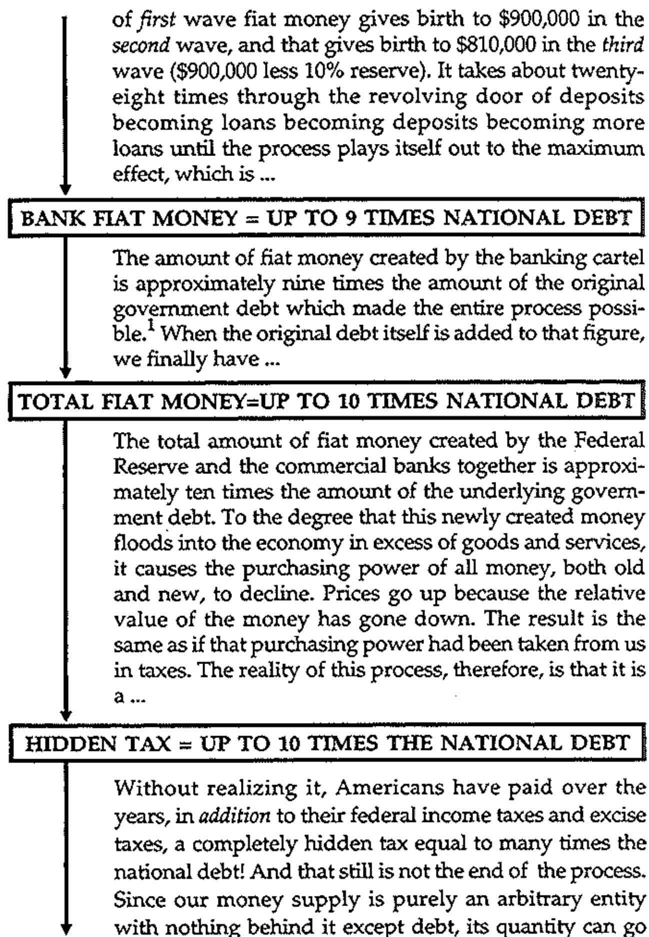
The word "excess" is a tipoff that these so-called reserves have a special destiny. Now that they have been transmuted into an excess, they are considered as available for lending. And so in due course these excess reserves are converted into ...

BANK LOANS

But wait a minute. How can this money be lent out when it is owned by the original depositors who are still free to write checks and spend it any time they wish? Isn't that a double claim against the same money? The answer is that, when the new loans are made, they are *not* made with the same money at all. They are made with brand *new* money created out of thin air for that purpose. The nation's money supply simply increases by ninety per cent of the bank's deposits. Furthermore, this new money is far more interesting to the banks than the old. The old money, which they received from depositors, requires them to pay out interest or perform services for the privilege of using it. But, with the *new* money, the banks *collect* interest, instead, which is not too bad considering it cost them nothing to make. Nor is that the end of the process. When this *second* wave of fiat money moves into the economy, it comes right back into the banking system, just as the first wave did, in the form of ...

MORE COMMERCIAL BANK DEPOSITS

The process now repeats but with slightly smaller numbers each time around. What was a "loan" on Friday comes back into the bank as a "deposit" on Monday. The deposit then is reclassified as a "reserve" and ninety per cent of that becomes an "excess" reserve which, once again, is available for a new "loan." Thus, the $1 million



of *first* wave fiat money gives birth to $900,000 in the *second* wave, and that gives birth to $810,000 in the *third* wave ($900,000 less 10% reserve). It takes about twenty-eight times through the revolving door of deposits becoming loans becoming deposits becoming more loans until the process plays itself out to the maximum effect, which is ...

BANK FIAT MONEY = UP TO 9 TIMES NATIONAL DEBT

The amount of fiat money created by the banking cartel is approximately nine times the amount of the original government debt which made the entire process possible.[1] When the original debt itself is added to that figure, we finally have ...

TOTAL FIAT MONEY=UP TO 10 TIMES NATIONAL DEBT

The total amount of fiat money created by the Federal Reserve and the commercial banks together is approximately ten times the amount of the underlying government debt. To the degree that this newly created money floods into the economy in excess of goods and services, it causes the purchasing power of all money, both old and new, to decline. Prices go up because the relative value of the money has gone down. The result is the same as if that purchasing power had been taken from us in taxes. The reality of this process, therefore, is that it is a ...

HIDDEN TAX = UP TO 10 TIMES THE NATIONAL DEBT

Without realizing it, Americans have paid over the years, in *addition* to their federal income taxes and excise taxes, a completely hidden tax equal to many times the national debt! And that still is not the end of the process. Since our money supply is purely an arbitrary entity with nothing behind it except debt, its quantity can go

1. That is a theoretical maximum. In actual practice, the banks can seldom lend out all of the money they are allowed to create, and the numbers fall short of the maximum.

down as well as up. When people are going deeper into debt, the nation's money supply expands and prices go up, but when they pay off their debts and refuse to renew, the money supply contracts and prices tumble. That is exactly what happens in times of economic or political uncertainty. This alternation between periods of expansion and contraction of the money supply is the underlying cause of ...

BOOMS, BUSTS, AND DEPRESSIONS

Who benefits from all of this? Certainly not the average citizen. The only beneficiaries are the political scientists in Congress who enjoy the effect of unlimited revenue to perpetuate their power, and the monetary scientists within the banking cartel called the Federal Reserve System who have been able to harness the American people, without their knowing it, to the yoke of modern feudalism.

RESERVE RATIOS

The previous figures are based on a "reserve" ratio of 10% (a money-expansion ratio of 10-to-1). It must be remembered, however, that this is purely arbitrary. Since the money is fiat with no precious-metal backing, there is no *real* limitation except what the politicians and money managers decide is expedient for the moment. Altering this ratio is the third way in which the Federal Reserve can influence the nation's supply of money. The numbers, therefore, must be considered as transient. At any time there is a "need" for more money, the ratio can be increased to 20-to-1 or 50-to-1, or the pretense of a reserve can be dropped altogether. There is virtually *no* limit to the amount of fiat money that can be manufactured under the present system.

NATIONAL DEBT NOT NECESSARY FOR INFLATION

Because the Federal Reserve can be counted on to "monetize" (convert into money) virtually any amount of government debt, and because this process of expanding the money supply is the primary cause of inflation, it is tempting to jump to the conclusion that federal debt and inflation are but two aspects of the same phenomenon. This, however, is not necessarily true. It is quite possible to have either one without the other.

The banking cartel holds a monopoly in the manufacture of money. Consequently, money is created only when IOUs are "monetized" by the Fed or by commercial banks. When private individuals, corporations, or institutions purchase government bonds, they must use money they have previously earned and saved. In other words, no new money is created, because they are using funds that are already in existence. Therefore, the sale of government bonds to the banking system *is* inflationary, but when sold to the private sector, it is *not*. That is the primary reason the United States avoided massive inflation during the 1980s when the federal government was going into debt at a greater rate than ever before in its history. By keeping interest rates high, these bonds became attractive to *private* investors, including those in other countries.[1] Very little new money was created, because most of the bonds were purchased with American dollars already in existence. This, of course, was a temporary fix at best. Today, those bonds are continually maturing and are being replaced by still *more* bonds to include the original debt plus accumulated interest. Eventually this process must come to an end and, when it does, the Fed will have no choice but to literally buy back all the debt of the '80s—that is, to replace all of the formerly invested private money with newly manufactured fiat money—plus a great deal more to cover the interest. *Then* we will understand the meaning of inflation.

On the other side of the coin, the Federal Reserve has the option of manufacturing money even if the federal government does *not* go deeper into debt. For example, the huge expansion of the money supply leading up to the stock market crash in 1929 occurred at a time when the national debt was being paid off. In every year from 1920 through 1930, federal revenue exceeded expenses, and there were relatively few government bonds being offered. The massive inflation of the money supply was made possible by converting commercial bank loans into "reserves" at the Fed's discount window and by the Fed's purchase of banker's acceptances, which are commercial contracts for the purchase of goods.[2]

Now the options are even greater. The Monetary Control Act of 1980 has made it possible for the Creature to monetize virtually *any*

1. Only about 11 to 15 per cent of the federal debt at that time was held by the Federal Reserve System.
2. See chapter twenty-three.

debt instrument, including IOUs from foreign governments. The apparent purpose of this legislation is to make it possible to bail out those governments which are having trouble paying the interest on their loans from American banks. When the Fed creates fiat American dollars to give foreign governments in exchange for their worthless bonds, the money path is slightly longer and more twisted, but the effect is similar to the purchase of U.S. Treasury Bonds. The newly created dollars go to the foreign governments, then to the American banks where they become cash reserves. Finally, they flow back into the U.S. money pool (multiplied by nine) in the form of additional loans. The cost of the operation once again is borne by the American citizen through the loss of purchasing power. Expansion of the money supply, therefore, and the inflation that follows, no longer even require federal deficits. As long as *someone* is willing to borrow American dollars, the cartel will have the option of creating those dollars specifically to purchase their bonds and, by so doing, continue to expand the money supply.

We must not forget, however, that one of the reasons the Fed was created in the first place was to make it possible for Congress to spend without the public knowing it was being taxed. Americans have shown an amazing indifference to this fleecing, explained undoubtedly by their lack of understanding of how the Mandrake Mechanism works. Consequently, at the present time, this cozy contract between the banking cartel and the politicians is in little danger of being altered. As a practical matter, therefore, even though the Fed may also create fiat money in exchange for commercial debt and for bonds of foreign governments, its *major* concern likely will be to continue supplying Congress.

The implications of this fact are mind boggling. Since our money supply, at present at least, is tied to the national debt, to pay off that debt would cause money to disappear. Even to seriously *reduce* it would cripple the economy.[1] Therefore, as long as the Federal Reserve exists, America will be, *must* be, in debt.

The purchase of bonds from other governments is accelerating in the present political climate of internationalism. Our own money

1. With the Fed holding only 7% of the national debt, the effect would still be devastating. Since the money supply is pyramided ten times on top of the underlying government bonds, each $1 eliminated from the federal debt would cause the money supply to shrink by 70¢ (1.00 X .07 X 10 = .70).

supply increasingly is based upon *their* debt as well as ours, and they, too, will not be allowed to pay it off even if they are able.

TAXES NOT EVEN NECESSARY

It is a sobering thought that the federal government now could operate—even at its current level of spending—without levying any taxes whatsoever. All it has to do is create the required money through the Federal Reserve System by monetizing its own bonds. In fact, most of the money it *now* spends is obtained that way.

If the idea of eliminating the IRS sounds like good news, remember that the inflation that results from monetizing the debt is just as much a tax as any other; but, because it is hidden and so few Americans understand how it works, it is more politically popular than a tax that is out in the open.

Inflation can be likened to a game of Monopoly in which the game's banker has no limit to the amount of money he can distribute. With each throw of the dice he reaches under the table and brings up another stack of those paper tokens which all the players must use as money. If the banker is also one of the players—and in our real world that is exactly the case—obviously he is going to end up owning all the property. But, in the meantime, the increasing flood of money swirls out from the banker and engulfs the players. As the quantity of money becomes greater, the relative worth of each token becomes less, and the prices bid for the properties goes up. The game is called *monopoly* for a reason. In the end, one person holds all the property and everyone else is bankrupt. But what does it matter. It's only a game.

Unfortunately, it is *not* a game in the real world. It is our livelihood, our food, our shelter. It *does* make a difference if there is only one winner, and it makes a *big* difference if that winner obtained his monopoly simply by manufacturing everyone's money.

FOURTH REASON TO ABOLISH THE SYSTEM

Make no mistake about it, inflation is a tax. Furthermore, it is the most unfair tax of them all because it falls most heavily upon those who are thrifty, those on fixed incomes, and those in the middle and lower income brackets. The important point here is that this hidden tax would be impossible without fiat money. Fiat money in America is created solely as a result of the Federal Reserve System. Therefore, it is totally accurate to say that *the Federal Reserve System*

generates our most unfair tax. Both the tax and the System that makes it possible should be abolished.

The political scientists who authorize this process of monetizing the national debt, and the monetary scientists who carry it out, know that it is not true debt. It is not true debt, because no one in Washington really expects to repay it—*ever.* The dual purpose of this magic show is simply to create free spending money for the politicians, without the inconvenience of raising direct taxes, and also to generate a perpetual river of gold flowing into the banking cartel. The partnership is merely looking out for itself.

Why, then, does the federal government bother with taxes at all? Why not just operate on monetized debt? The answer is twofold. First, if it did, people would begin to wonder about the *source* of the money, and that might cause them to wake up to the reality that inflation is a tax. Thus, open taxes at *some* level serve to perpetuate public ignorance which is essential to the success of the scheme. The second reason is that taxes, particularly *progressive* taxes, are weapons by which elitist social planners can wage war on the middle class.

A TOOL FOR SOCIAL PLANNING

The January 1946 issue of *American Affairs* carried an article written by Beardsley Ruml who, at that time, was Chairman of the Federal Reserve Bank of New York. Ruml had devised the system of automatic withholding during World War II, so he was well qualified to speak on the nature and purpose of the federal income tax. His theme was spelled out in the title of his article: "Taxes for Revenue Are Obsolete."

In an introduction to the article, the magazine's editor summarized Ruml's views as follows:

> His thesis is that, given control of a central banking system and an inconvertible currency [a currency not backed by gold], a sovereign national government is finally free of money worries and needs no longer levy taxes for the purpose of providing itself with revenue. All taxation, therefore, should be regarded from the point of view of social and economic consequences.[1]

Ruml explained that, since the Federal Reserve now can create out of nothing all the money the government could ever want, there

1. "Taxes for Revenue Are Obsolete," by Beardsley Ruml, *American Affairs*, January, 1946, p. 35.

remain only two reasons to have taxes at all. The first of these is to combat a rise in the general level of prices. His argument was that, when people have money in their pockets, they will spend it for goods and services, and this will bid up the prices. The solution, he says, is to take the money away from them through taxation and let the government spend it instead. This, too, will bid up prices, but Ruml chose not to go into that. He explained his theory this way:

> The dollars the government spends become purchasing power in the hands of the people who have received them. The dollars the government takes by taxes cannot be spent by the people, and therefore, these dollars can no longer be used to acquire the things which are available for sale. Taxation is, therefore, an instrument of the first importance in the administration of any fiscal and monetary policy.[1]

REDISTRIBUTION OF WEALTH

The other purpose of taxation, according to Ruml, is to redistribute the wealth from one class of citizens to another. This must always be done in the name of social justice or equality, but the real objective is to override the free market and bring society under the control of the master planners. Ruml said:

> The second principal purpose of federal taxes is to attain more equality of wealth and of income than would result from economic forces working alone. The taxes which are effective for this purpose are the progressive individual income tax, the progressive estate tax, and the gift tax. What these taxes should be depends on public policy with respect to the distribution of wealth and of income. These taxes should be defended and attacked in terms of their effect on the character of American life, not as revenue measures.[2]

As we have seen, Senator Nelson Aldrich was one of the creators of the Federal Reserve System. That is not surprising in light of the cartel nature of the System and the financial interests which he represented. Aldrich also was one of the prime sponsors of the federal income tax. The two creations work together as a far more delicate mechanism for control over the economic and social life of society than either one alone.

In more recent years, there has been hopeful evidence that the master planners were about to abandon Ruml's blueprint. We have

1. Ruml, p. 36.
2. *Ibid.*, p. 36.

heard a great deal both in Congress and at the Federal Reserve about the necessity of reducing expenses so as to diminish the growth of federal debt and inflation. But it has been lip service only. The great bulk of federal funding continues to be created by the Mandrake Mechanism, the cost of government continues to outpace tax revenues, and the Ruml formula reigns supreme.

EXPANSION LEADS TO CONTRACTION

While it is true that the Mandrake Mechanism is responsible for the expansion of the money supply, the process also works in reverse. Just as money is created when the Federal Reserve *purchases* bonds or other debt instruments, it is extinguished by the *sale* of those same items. When they are sold, the money is given back to the System and disappears into the inkwell or computer chip from which it came. Then, the same secondary ripple effect that *created* money through the commercial banking system causes it to be *withdrawn* from the economy. Furthermore, even if the Federal Reserve does not deliberately contract the money supply, the same result can and often does occur when the public decides to resist the availability of credit and reduce its debt. A man can only be tempted to borrow, he cannot be forced to do so.

There are many psychological factors involved in a decision to go into debt that can offset the easy availability of money and a low interest rate: A downturn in the economy, the threat of civil disorder, the fear of pending war, an uncertain political climate, to name just a few. Even though the Fed may try to pump money into the economy by making it abundantly available, the public can thwart that move simply by saying no, thank you. When this happens, the old debts that are being paid off are not replaced by new ones to take their place, and the entire amount of consumer and business debt will shrink. That means the money supply also will shrink, because, in modern America, debt *is* money. And it is this very expansion and contraction of the monetary pool—a phenomenon that could not occur if based upon the laws of supply and demand—that is at the very core of practically every boom and bust that has plagued mankind throughout history.

In conclusion, it can be said that modern money is a grand illusion conjured by the magicians of finance and politics. We are living in an age of fiat money, and it is sobering to realize that every previous nation in history that has adopted such money eventually was

economically destroyed by it. Furthermore, there is nothing in our present monetary structure that offers any assurance that we may be exempted from that morbid roll call.

SUMMARY

The American dollar has no intrinsic value. It is a classic example of fiat money with no limit to the quantity that can be produced. Its primary value lies in the willingness of people to accept it and, to that end, legal tender laws require them to do so. It is true that our money is created out of nothing, but it is more accurate to say that it is based upon debt. In one sense, therefore, our money is created out of *less* than nothing. The entire money supply would vanish into bank vaults and computer chips if all debts were repaid. Under the present System, therefore, our leaders cannot allow a serious reduction in either the national or consumer debt. Charging interest on pretended loans is usury, and that has become institutionalized under the Federal Reserve System. The Mandrake Mechanism by which the Fed converts debt into money may seem complicated at first, but it is simple if one remembers that the process is not intended to be logical but to confuse and deceive. The end product of the Mechanism is artificial expansion of the money supply, which is the root cause of the hidden tax called inflation. This expansion then leads to contraction and, together, they produce the destructive boom-bust cycle that has plagued mankind throughout history wherever fiat money has existed.

ADDENDUM: DEBT-CANCELLATION PROGRAMS

Because banks lend money that does not exist prior to the transaction, many debtors have concluded they are not obligated to repay. This is a compelling concept in view of the fact that bank and credit-card loan contracts typically lead customers to think they are borrowing someone else's money, which is why they are willing to pay interest. When challenged in court, these contracts often are judged to be fraudulent, and there now are companies offering "debt-cancellation" services to challenge these contracts with the end in mind that debts will be canceled. A discussion of the pros and cons of these programs is beyond the scope of this work, but interested parties are invited to read or view a video of the author's analysis at the following web site:

www.freedom-force.org/freedom.cfm?fuseaction=issues.

(A.) STRUCTURE AND FUNCTION OF THE FEDERAL RESERVE SYSTEM

The three main components of the Fed are: (1) the national Board of Governors, (2) the regional Reserve Banks, and (3) the Federal Open Market Committee. Lesser components include: (4) the commercial banks which hold the stock, and (5) the advisory councils.

The function of the national Board of Governors is to determine the system's monetary policy. The Board consists of seven members who are appointed by the President and confirmed by the Senate. Their terms of office are fourteen years and are staggered so that they do not coincide with the presidential term of office. The purpose of this is to insure that no single President can dominate Fed policy by stacking the Board with his appointments. One Board member is appointed as the Chairman for four years and another as Vice Chairman for four years. The Chairman controls the staff and is the single most powerful influence within the system.

Control is exercised by the Board and a handful of top staff employees. The Federal Reserve Act mandated that the President, when selecting Governors "shall have due regard to a fair representation of the financial, agricultural, industrial and commercial interests, and geographical divisions of the country." This mandate is now almost completely ignored, and the men come primarily from the fields of banking and finance.

The function of the regional Reserve Banks is to hold cash reserves of the system, supply currency to member banks, clear checks, and act as fiscal agent for the government.

The twelve regional Reserve Banks are located in Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, San Francisco, and St. Louis. They are corporations with stock held by the commercial banks which are members of the system. Member banks elect the directors of the regional Reserve Banks of which they are a part. The larger banks hold more shares but they have only one vote in the selection of the Directors.

Within each regional-bank system there are nine Directors. The member banks elect three Class-A directors who represent the banking industry and three Class-B directors who represent the general public. The remaining three Class-C directors are appointed by the national Board. The Chairman and Vice Chairman of each regional Reserve Bank must be Class-C directors. The selection of President and other officers is subject to veto by the national Board of Governors. In this way, the national Board is able to exercise control over the regional branches of the system.

The function of the Federal Open Market Committee is to implement the monetary policy set by national Board, although it exercises considerable autonomy in setting its own policy. It manipulates the money supply and interest rates primarily by purchasing or selling government securities—although it also accomplishes that through the purchase or sale of foreign currencies and the securities of other governments as well. Money is created and interest rates go down when it purchases. Money is extinguished and interest rates go up when it sells. Policy is formulated on a daily basis. In fact, it is monitored by the minute and the Committee often intervenes in the market to affect immediate changes.

The Open Market Committee is composed of the national Board of Governors plus five of the twelve regional Presidents who serve on a rotating basis. The exception to this is the President of the New York regional Bank who is always on the Committee. Thus, once again, the System is firmly in control of the national Board with the President of the New York regional Bank being more powerful than the others.

Twenty-four bond dealers handle all sales of government securities. Government agencies cannot exchange with each other without going through dealers who earn commissions on each transaction.

Decisions are made at secret meetings. A brief report is released to the public six weeks later, but transcripts of the deliberations are destroyed. That policy was begun in 1970 when the Freedom-of-Information Act was passed. Not even the CIA enjoys such secrecy.

The function of the member banks is to conduct the nation's banking business and to implement the System's monetary policy in terms of putting money into or drawing it out of the system at the point of contact with individual or corporate borrowers.

This leads to the troublesome question of ownership. The federal government does not own any stock in the System. In that sense, the Fed is privately owned. That, however, is misleading in that it implies a typical private-ownership relationship in which the stockholders own and control. Nothing could be further from the truth. In this case, the stock carries no proprietary interest, cannot be sold or pledged as collateral, and does not carry ordinary voting rights. Each bank is entitled to but one vote regardless of the amount of stock it holds. In reality, the stock is not evidence of "ownership" but simply certificates showing how much operating capital each bank has put into the System. It is not a government agency and it is not a private corporation in the normal sense of the word. It is subject to political control yet, because of its tremendous power over politicians and the elective process, it has managed to remain independent of political oversight. Simply stated, it is a cartel, and its organizational structure is uniquely structured to serve that end.