THE FEDERAL RESERVE SYSTEM,
FIAT MONEY AND
FRACTIONAL RESERVE BANKING

by

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"I sincerely believe . . . that banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale." Thomas Jefferson[1] Third President of the United States (1801 - 1809)

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This article is a brief primer on the Federal Reserve System (the "Fed"), the central bank of the United States. It is not a comprehensive exposition of the whys, the hows, or the players who control this system, or its manifold influence in all areas of life. Materials covering such topics proliferate in hundreds, if not thousands, of books, newspaper and magazine articles, videos, blogs and websites. Only the basic structure of the United States banking system and the nature of money and its creation are summarily set forth, with references for those who wish to pursue the subject further. The nature and workings of the US Federal Reserve System are relevant for European readers, as in many ways the Fed functions as the central bank of the world.

The Myth or the Great Deception

The story told by my grade school teachers, derived from our seventh grade text books, was that banks exist to act as collectors of the local community's savings and checking deposits so that they could be loaned out to other members of that same community for productive

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[1]. Thomas Jefferson in a letter to Richard Rush, June 1819. From *The Jefferson Cyclopedia* (New York; Funk & Wagnalls, 1900), quoted in Thoren &Warner at 141

purposes. As a result of the Great Depression of the 1930s, demand deposits[2] were for the first time protected by Federally-backed insurance.[3] Why risk hiding your money under the mattress or burying it in the back garden, as happened back then, when you can:

(1) put your money in a bank where it is guaranteed against future loss;

(2) put your money in a bank to work for you by earning compound interest; and,

(3) put your money to work for the community by allowing the bank to recycle it as loans to your neighbors.

Banking institutions have a beneficent side by supporting the prosperity of the whole community by allowing them to act as the intermediary between you and your neighbors. The bank, with its financial expertise invests your money wisely and earns a higher rate of return through its loans. It pays you a lower rate of interest because it must pay for all of the expenses of its operation out of its gross earnings. The bank's profit is the difference (the spread) between the interest rate it pays you and what it earns from its higher lending rate. From this spread it must pay all of its operating expenses. What is left over, the residual, net of all costs, fees and expenses, is their profit.

As you see, your local bank is a community-friendly institution . . . "neighbors helping neighbors" (its primary purpose), while it helps you and itself (its secondary purposes). Thus we were taught; thus we believed.

Although banks are private businesses - like automobile dealers, grocery stores, manufacturing companies, law firms, doctors offices - and although banks are very often family-owned private holdings passed down from generation to generation within the same extended family, the core fact of private ownership was never emphasized. When you visited a bank in the 1950s - 60s, one received the impression that it was somehow part of the government. The hushed stillness of the bank's lobby wrapped the profit-driven nature of the transactions in an aura of mystery and sanctity. Banks were even built like temples[4], with flags and insignia of the

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[2]. See Definitions section below.

[3]. Deposits were first insured by the Federal Government in 1934 with the creation of the Federal Deposit Insurance Corporation (FDIC). Since 2008 savings and checking accounts are insured (guaranteed) by the FDIC up to $250,000 per person, per bank.

[4]. Greider, *Secrets of the Temple* at page 54. The book's title refers to the Fed as the "Temple".

Federal Government appropriately positioned to catch your eye as you stood in the teller line, silently waiting your turn. There was always an outer court, where the common folk were allowed, and an inner sanctum, accessed only by a buzzered door or gate through which only the elect or monied were allowed. Corporate offices were always on the other side of this barrier, most often out of sight, or on another floor, or in another building.

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My father was treasurer of a commercial bank which had received its charter from the state government as opposed to being a commercial bank with a federal charter, a Federal Savings and Loan, a credit union, or a state bank with either a savings or federal charter.

Let the Myth, or Great Deception, crumble for you as it crumbled for me, when at age fourteen, while accompanying father on his regular Saturday morning visit to "his" bank, I was told the truth.

My father led me down a semi-circular staircase, below ground level, to the bank's basement where the intimidating Vault was kept: a massive block of steel wrapped in concrete, accessed via a circular steel door more than a foot thick, which opened via a circular wheel. Inside he showed me sacks of coins and stacks of old and new paper currency, held in tight security for the depositors. I was overawed to see so much money in one place at one time. So I asked:

"Gee, Dad! Is this where you keep all the money you lend out to your borrowers?"

"No, son. Not really. We try not to keep too much cash on hand, in case of robbery. We send most of it to the Federal Reserve Bank in Boston. We only keep enough here to satisfy the daily cash needs of our depositors. We actually have a lot more money, millions more, than what you see here."

"Wow! So what happens if someone asks for a loan that is more than the amount of money you have on hand? Do you go to Boston and bring it back here?

"No. We just give them our bank check for the loan and they deposit it to their account, usually in this bank, but sometimes in other banks."

"Well, if you do that, how do they get their money?

"Our check is drawn against our account at the Federal Reserve. After they deposit our check they can withdraw it as physical money. Most of the money we lend them is not ours; we create it out of nothing merely by making the loan. We are allowed to loan out roughly ten times the amount of deposits we have in our reserve account. If we have, say, $100 on reserve deposit, we are legally allowed to make a loan for $1,000. The same holds true further up the scale. If the bank has, say, $50 million in its reserve account, it can make up to $500 million in loans. About 90% of the money we lend is money which we create ourselves."

"What? I didn't know that you were allowed to create money! I thought you were lending out the money that people had deposited at your bank. How can you lend out more money than you actually have?"

"Like I said, we create it of out of nothing. We do it via bookkeeping entries into our ledgers. Don't be upset; it is all quite legal.

"What do you mean you 'create it out of nothing'? I thought only the government could create money!"

"We don't create actual *money*. Only the government creates physical money, through the Federal Reserve System. But that is only part of the story. We extend credit, which in turn, becomes money. Banks lend more money than they have through an old banking practice called 'fractional reserve lending'.

"Fractional Reserve Lending?" What is that? I'm getting confused. This is too much for me to take in."

"That's OK. We'll talk another time. Let's go to lunch."

And so my Saturday morning revelation came to a close. It took several more years to comprehend what my father had said and neglected to say. He left out the significant detail that the Federal Reserve is not part of the government, and didn't explain fully enough that banks technically don't create money but legally extend credit via deposit expansion. One summer a few years later I worked at my father's bank as a "mail teller", opening the daily mail from depositors who sent checks for deposit to their accounts or from mortgagors who were paying their monthly loan payments. The banking system became clearer to me then. But 1960 was a simpler time. Since the repeal of the Glass-Steagall Act[5] in 1999, the adoption of the Commodity

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[5]. The Glass-Steagall Act, signed into law on June 16, 1933, was reform legislation resulting from the banking and economic crash of 1929 and its ensuing Great Depression designed to control speculation. It created the FDIC (Federal Deposit Insurance Corporation) which insures bank deposits. It also separated the operations of commercial and investment banks, so that one

Futures Modernization Act of 2000[6] (both signed into law by President Bill Clinton) and the conversion of the last two private investment banks on Wall Street (Goldman Sachs and Morgan Stanley) into bank holding companies on Sunday, September 21, 2008[7] under President George W. Bush, banking in the United States has changed dramatically and disastrously. But we are getting too far ahead of ourselves; the consequences of those events take us well beyond the bounds of this present article. Let's get back to basics.

The US Federal Reserve System

To begin with, the Federal Reserve system is neither Federal nor does hold its own capital as bank "reserves". The Federal Reserve it is a private institution owned by private bankers which has no reserves other than what it creates for itself . . . out of nothing.

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institution could not conduct both activities. The Gramm-Leach-Bliley Act (November 1999) repealed its provisions which prohibited a bank holding company from owning other financial companies.

[6]. The CFMA, signed into law December 21, 2000, deregulated financial products known as over-the-counter derivatives so that most (nearly all) such transactions between "sophisticated parties" would not be regulated as "futures" under the commodity Exchange Act of 1936 or as "securities" under federal securities laws. Trading in such derivatives is not regulated, does not appear on any exchange, and determining the total market value of same is largely a guess.

[7]. Goldman Sachs and JPMorgan Chase were the last private investment banks (corporations) remaining on Wall Street after the collapses of Bear Sterns, Lehman Brothers and the sale of Merrill Lynch to the Bank of America. As investment banks they were regulated by the Securities & Exchange Commission. As bank holding companies they became regulated by the Federal Reserve system. More importantly, Goldman and JPMorgan were immediately able to access the Fed's discount window and allowed to borrow billions of dollars at low interest rates to stave off bankruptcy.

The Federal Reserve Act, passed by Congress just prior to its annual Christmas recess on December 22, 1913, was signed into law the very next day by President Woodrow Wilson. It transferred the right to print currency[8] from the United States sovereign government to a bank which is quasi-federal in form but private in operation. The Fed was created by the powers of international capital, known in the 19th century as The Money Trust[9], and given a clever but deceptive name which disguises the fact that it is a private money monopoly owned by its member banks but controlled by a handful of super-banks which are conveniently described as "too big to fail". The complexity of the system and its special terminology are designed to disguise and evade the truth - not to reveal it. And the Fed has morphed since its creation, becoming more powerful as the decades have rolled on. A private elite of Wall Street bankers[10] has been able to tap an unlimited supply of money created out of nothing at virtually no cost[11] to themselves. In effect, they received the limitless right to draw on the "the full faith and credit" of the United States for nothing to support their Federal Reserve Notes. It pays nothing to the government for this right; but the government pays the Fed for the right to borrow money from it

[8]. The United States government retained the right of coinage (to create coin money), which it has under the US Constitution (Article 1, Section 8). Governments, as the Sovereign, have the inherent right to create money. The creation of paper money, often referred to as "currency", was not even mentioned in the founding document. "The Founding Fathers were so disillusioned with paper money that they simply omitted it from the Constitution. Congress was given the power only "to coin money, regulate the value thereof" and "to borrow money on the credit of the United States" (Brown at 46). US money, at that time, consisted of coins (gold and silver).

[9]. For two excellent and entertaining histories documenting the machinations behind the creation of the Federal Reserve System see: Anthony C. Sutton, *The Federal Reserve Conspiracy* (Boring, OR: CPA Book Publishers, 1995); and, G. Edward Griffin, *The Creature from Jekyll Island* (Westlake Village, CA: American Media, 1998)

[10]. Paul M. Warburg, of the Warburg investment banking family from Hamburg, Germany (M. M. Warburg & Co.), and a partner in the Wall Street firm of Kuhn, Loeb & Company, was an expert on central bank procedures and the "mastermind" behind the Fed's creation. J. K. Galbraith commented that ". . . Warburg has, with some justice, been called the father of the [Federal Reserve] system". Professor E. Seligman of Columbia University wrote that ". . . in it fundamental features, the Federal Reserve Act is the work of Mr. Warburg more than any other man in the country." He became one of the wealthiest men in the United States. Daddy Warbucks, a character from the comic strip *Little Orphan Annie*, and later the stage play and film *Annie*, was modeled after Paul Warburg. See Griffin at pages 17-18.

[11]. Sutton at page 86

(when it sells its interest-bearing Treasury bonds to the Fed, which pays for them with self-created money!)

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The Federal Reserve System is comprised of the Board of Governors of the Federal Reserve, who meet in Washington, DC, the twelve (12) regional[12] Federal Reserve Banks, and the national and state member banks. There are seven (7) Governors on the Board of Governors, who are nominated to the position by the President of the US and confirmed by the US Senate. The regional Federal Reserve Banks are themselves individually incorporated as private corporations whose unique, non-marketable stock[13] is owned by its member banks in proportion to their size. All banks are regulated, directly or indirectly, by the Federal Reserve. Most banks are "members" of the Federal Reserve System; only nationally-chartered banks are legally required to be members. The larger the member bank, the more Federal Reserve corporate stock it owns, the greater degree of control it exercises over the Fed's policies. The major New York banks own a majority share of the Fed. Since Federal Reserve Banks are not governmental agencies, their employees do not fall under Federal Civil Service. The Federal Reserve Banks pay real estate taxes to the cities where they are located, while property owned by the United States government never pays taxes to state or local governments.[14] Their telephone numbers are not found under "US Government" in the phone book, but are listed in the white pages business listings under the letter "F", alongside other businesses whose names begin with "F". If you visit Washington DC and purchase a tourist map which highlights important government properties (the White House, Congress, the Treasury, the State Department et cetera) the Federal Reserve's headquarters on Constitution Avenue are neither identified nor shown on such maps.

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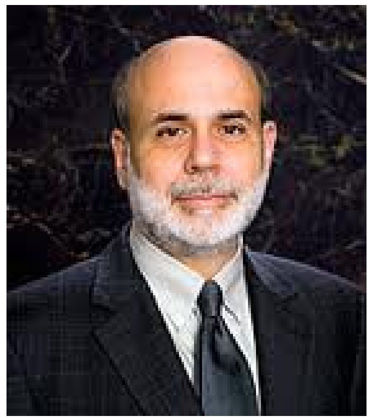
[2]2. Federal Reserve banks are located in New York City, Boston, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Kansas City, Dallas, Minneapolis and San Francisco. The New York Fed is the most powerful, is *primus unter pares, or first among equals.* The Board of Governor (headquarters) of the Fed is located on Constitution Avenue in Washington, DC.

[13]. Reserve Bank stock is so private that it may not be sold, traded or pledged as security for a loan; it carries no proprietary interest. You or I cannot own it. Only the consortium of private banks can own it. Annual dividends are paid, by law, at 6% per year. See Peter Cook's book *Federal Reserve* .... at page 221.

[14]. Under the Supremacy Clause of the US Constitution, Article 6, Clause 2

The system is “federal” in that the paper currency it issues (Federal Reserve Notes) are backed by the “full faith and credit of the United States”. But the system itself is owned by its member banks. Ben Bernanke, the current Chairman of the Board of Governors of the Federal Reserve System, although appointed to his post by the President of the US, who serves for a 14 year term, is not a US government employee, but is an employee of the very banks he is charged to oversee.



The Fed requires its member banks to maintain a certain percentage of their assets on deposit with their respective regional Federal Reserve Bank as reserves.[15] Reserve requirements are set by the Board of Governors. The Fed is also the bankers’ bank; many transactions are processed through the Federal Reserve System, like the clearing of all bank checks. The Fed sets the interest rates for the entire banking system; financial and other institutions are able to borrow money from the Fed at preferred (low) rates of interest. The Fed, as the government’s banker, processes all government revenues and expenses (checks or electronic payments) through the government’s various checking accounts. The Fed also buys and sells government securities and has a monopoly to create US paper currency (Federal Reserve Notes). Finally the Fed acts as the over-arching regulatory agency of the entire banking system.

Unlike other banks which have reserve accounts elsewhere, the Fed has no “reserves” except those funds which it creates for itself out of nothing. One normally might consider consider the meaning of the word “reserves” as something which has been saved up and set aside for emergency, “rainy day” or preservation purposes, as in “Army Reserve”, Strategic Petroleum Reserve, or a nature reserve. Not so with the Fed, since you don’t need traditional “reserves” when you can create them from this air. Their “reserves” are merely “bookkeeping credits

[15]. See Definitions for “reserves” and “reserve requirements”.

entered upon the ledgers of the Federal Reserve Banks. These credits are created by the Federal Reserve Banks and then passed along through the banking system."[16] Financial commentators describe this as "printing money", which is a misnomer because no money needs to be physically printed. An electronic deposit made by computer to the Fed's own accounts or to a member bank's reserve account at its regional Federal Reserve Bank is all that is required. In fact, physical money in circulation (bills and coinage) accounts for only 3% of the total US money supply. The other 97% exists as checkbook credit deposit (a/k/a checkbook money) data entries on computer screens, all of which has been created by banks[17] (by the Fed and other private banks). Representative Wright Patman,[18] Chairman of the US House of Representatives Banking and Currency Committee (1965 - 1975) put it plainly when answering his own rhetorical question: "Where does the Federal Reserve get its money?"

"It doesn't get money; it creates it. When the Federal Reserve writes a check for a government bond, it does exactly what any bank does, it creates money, it creates money purely and simply by writing a check. . . . The Federal Reserve, in short, is a total money-making machine."[19]

As the "lender of last resort"[20] no restrictions have been placed on the amount of money that the Fed can create. However, banks expand the money supply more than the Fed does through the magical "sleight of hand" known as "fractional reserve" banking.

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16. Wright Patman, Chairman of the House Banking and Currency Committee, in A Primer on Money; Government Printing Office, prepared for the Sub-committee on Domestic Finance, House of Representatives, Committee on Banking and Currency, Eighty-Eighth Congress, 2nd session, 1964). Quoted by Brown at page 25.

17. Brown at page 3

18. Wright Patman was a representative in the US House of Representatives from Texas' First District for 47 years (March 1929 - March 1976)

19. Brown at 25, citing Archibald Roberts, The Most Secret Science (Fort Collins, CO: Betsy Ross Press, 1984). See also similar language in *Money Facts*, published by the House Committee on Banking and Currency, 1964

20. The role of "Lender of Last Resort" in the Eurozone is the European Central Bank; in Switzerland it is the Swiss National Bank; in Japan it is Bank of Japan; in Russia it is the Central Bank of Russia. All create "fiat currency" out of nothing.

Fractional Reserve Banking

The term "fractional reserve" is derived from the fact that a bank's "reserve account" is only required to be a fraction of total amount of money which the bank is legally authorized to create, lend or spend. Banks expand the money supply by being able to lend out multiples of the funds they have in their reserve account. A private individual like yourself, or a private business, can only lend what they actually possess; they cannot lend more than they own without committing a crime. But a banker, under a 10% reserve requirement, can loan out ten times the amount in reserve, creating 90% of the loan from thin air, and it is all quite legal. Hence, the "sleight of hand" of the "fractional reserve" banker. A more accurate description of this system of banking is "fractional reserve deposit expansion", or "fractional reserve money creation". Only the Fed can "print" money (Federal Reserve Notes). Banks cannot print money, but they can expand credit, which then can be redeemed for money.[21]

We have all been taught that deposits create loans. First come the deposits, and loans follow as a result. Deposits make loans possible. In fact, the opposite is more accurate: loans create deposits! Let the Fed explain this miracle in its own words. The Chicago Federal Reserve Bank's booklet *Modern Money Mechanics: A Workbook on Bank Reserves and Deposit Expansion*[22] describes the process. Its opening sentence reads:

"The purpose of this booklet is to describe the basic process of money creation in a 'fractional reserve' banking system. . . in a fractional reserve banking system . . . the actual process of money creation takes place primarily in banks." It further states:

"[Banks] do not really pay out loans from the money they receive as deposits. If they did this, no additional money would be created. What they do when they make loans is to accept promissory notes in exchange for credits to the borrower's transaction accounts. . . [B]anks build up their deposits by increasing loans and investments so long as they keep enough currency on hand to redeem whatever amounts the holders of deposits want to convert into currency

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[21]. Credit, specifically Bank Credit, is really a substitute form of cash currency, as credit can be used as money and redeemed as money. Strict laws prohibit anyone from printing Federal Reserve Notes - which is the crime of counterfeiting. But there is no law which prohibits banks from creating credit via deposit expansion. Thus, banks do not create or print "money" but do create "credit". See Cook's *Federal Reserve* ..... at 6-7.
[22]. First published in 1961, last revised in 1992, this booklet is available on-line at http://www.rayservers.com/images/ModernMoneyMechanics.pdf

(cash). This unique attribute of the banking business was discovered many centuries ago. It started with goldsmiths . . ."[23] who learned that only a small percentage of the people who had deposited gold with them for safe keeping ever wanted access to or use of their gold. Goldsmiths began lending out more gold than they actually had physically on hand. Over time this developed into the official banking technique of fractional reserve lending.[24]

Simply said, banks lend credit (which, in turn, becomes money) by creating debt. Money is created by the creation of new debt. As the Governor of the Federal Reserve Board told the US House Committee on Banking and Currency in 1941: "That's what our monetary system is [issuing credit out of nothing.] *If there were no debts in our money system, there wouldn't be any money."*[25] Fractional reserve banking allows banks to lend out many times the amount they have on "reserve". Further, when banks need additional money to meet its "reserve requirements", they may borrow the required funds from the Federal Reserve at the federal discount rate, overnight, or for longer periods.[26] The Fed simply creates the money deposited in the bank's reserve account out of nothing. It's that simple. "Economist John Kenneth Galbraith would later comment, 'The process by which banks create money is so simple that the mind is repelled.'"[27]

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The United States government borrows money from the Federal Reserve by selling debt instruments (securities) - US Treasury bills, notes and bonds[28] - through specifically designated

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23. The introductory quote to the Chicago Fed's booklet, and the quote from the booklet itself, may be found in Brown at 26

24. "The oldest fractional reserve . . . money creating dates back to the Temple of Shamash, the sun-god at Sippar in old Babylon. See Cook's *Federal Reserve* .... at 4, citing the Encyclopedia Americana 1956 ed. Vol. 3.

25. Marriner Eccles, Governor of the Federal Reserve Board in hearings on September 30, 1941 before the House Committee on Banking and Currency cited in G. Edward Griffin op. cit. pages 187-188

26. It may also borrow the money from other banks at the federal funds rate.

27. Cited in Brown at 161

28. Treasury Bills are short-term government securities with maturities ranging from a few days to 52 weeks. Bills are sold at a discount from their face value. Treasury Notes are government securities issued with maturities of 2, 3 5 7 and 10 years and pay interest every six months.

securities dealers (like Goldman Sachs) to the Federal Reserve, which buys the securities with money it creates out of nothing. The Treasury trades pink pieces of paper (Treasury bonds) for green pieces of paper (Federal Reserve notes). The Fed purchases these securities through the activities of the Federal Open Market Committee (FOMC) and its "Open Market Operations", so-called because it buys these securities on the open market. It pays for the securities with a check drawn upon itself.

The FOMC is the principal organ of United States national monetary policy.[29] The FOMC consists of twelve members: the seven members of the Board of Governors of the Federal Reserve System; the President of the Federal Reserve Bank of New York; and four of the remaining Reserve Bank presidents who serve rotating one-year terms. The FOMC is where the real power lies since it establishes the Federal Funds Rate and the Discount Rate used at the Fed's Discount Window. These set the parameters for the widely-known Prime Rate, which is traditionally fixed at 3 percentage points (300 basis points in bankers' language) higher than the Federal Funds Rate.

If the Fed wishes to increase the money supply, it buys US securities; if it wishes to contract the money supply, it sells some of its own US securities on the open market. In the first instance, when it wishes to increase the money supply, it makes an electronic deposit to the reserve account the seller of the security has with its local Federal Reserve Bank - thereby creating more money from nothing. Alternatively, when it seeks to contract the money supply, to take a certain amount of money out of circulation, it sells some of its own US securities. The buyers must use their own money to pay for same, crediting the account of the regional Fed bank and reducing the amount of their own reserve account. The Federal Reserve Bank of Chicago explains:

"Carried through to theoretical limits, an initial $10,000 of reserves distributed within the banking system gives rise to an expansion of $90,000 in bank credit (loans and investments) and supports a total of $100,000 in new deposits under a 10 percent reserve requirement. . . . The contraction multiple is the same as that which applies in the case of expansion. Under a 10

Treasury Bonds pay interest every six months and mature in 30 years. See the US Treasury's website at http://www.treasurydirect.gov/indiv/products/products.htm.

[29]. Wikipedia http://en.wikipedia.org/wiki/Federal_Open_Market_Committee

percent reserve requirement, a $10,000 reduction in reserves would ultimately entail reductions of $100,000 in deposits and $90,000 in loans and investments."[30]

The deliberations of the FOMC are held in secret approximately eight times per year, every six weeks. Only a summary of the FOMC's minutes are reported several weeks after the next following FOMC meeting. The Fed Chairman is obligated by law to report to Congress only two times per year. The secrecy surrounding the operations of the Federal Reserve is phenomenal. Its actions are even more secret than the CIA's. The Federal Reserve System has never been audited. This bears repetition: the Federal Reserve has never been subject to a full and complete independent audit. No government official has the power to require the Fed to open up its books to public scrutiny. The only power the government has is to modify the Fed's charter by an act of Congress. Attempts to legislate a full and complete audit have always been vehemently opposed by the "powers that be".

Some nibbling away at the Fed's secrecy has recently occurred. A partial audit of a limited period of time - the first audit of any kind in its near 100 year history - took place in July 2011 when, as part of the Dodd-Frank[31] reform legislation, the Fed was forced to reveal whom it had lent money to during the financial debacle beginning in late 2007. The audit was carried out by the General Accounting Office (GAO) and is available on-line.[32] To say that its shocking findings have been under-reported by the media is a gross understatement.

During the period December 1, 2007 through July 21, 2010 the Fed created sixteen trillion ($16,000,000,000,000) dollars worth of credit (loans) to US banks and corporations and (notwithstanding its supposed jurisdiction as an agency of the United States) to foreign banks. These were secret bailouts engineered to prevent the borrowers from insolvency or bankruptcy; the money was loaned at nearly zero percent (.01%) interest. The notorious $700 billion TARP

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[30]. Chicago Federal Reserve Bank, Modern Money Mechanics op. cit. page 3 and page 12

[31]. The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Obama on July 21, 2010 in response to financial crises of 2008 and following.

[32]. http://www.unelected.org/audit-of-the-federal-reserve-reveals-16-trillion-in-secret-bailouts and at http://www.forbes.com/sites/traceygreenstein/2011/09/20/the-feds-16-trillion-bailouts-under-reported/

legislation[33] (bank bailout) of September 2008 was nothing compared to these secret loans which Congress was never informed about. To place this extraordinary sum in perspective, the US GDP (Gross Domestic Product) is about $14 trillion. The US total national debt is about $15 trillion. The current annual budget deficit approximates $1.5 trillion. This enormous sum of money, secretly created by the Fed in times of crisis and spread throughout the world to prevent global financial collapse, is difficult to comprehend. A brief list of recipients of the Fed's nearly free loans, as set forth on page 131 (Table 8) of the GAO's audit, follows:

Citigroup, Inc (Citibank): $2.5 trillion
Morgan Stanley: $2.04 trillion
Merrill Lynch & Co.: $1.949 trillion
Bank of America Corporation: $1.344 trillion
Barclays PLC (United Kingdom): $868 billion
Bear Sterns Companies, Inc.: $853 billion
Goldman Sachs Group, Inc.: $814 billion
Royal Bank of Scotland PLC (UK): 541 billion
JPMorgan Chase: $391 billion
Deutsche Bank AG (Germany): $354 billion
United Bank of Switzerland AG: $287 billion
Credit Suisse Group AG (Switzerland): $262 billion
Lehman Brothers Holdings, Inc. - NYC: $183 billion
Bank of Scotland PLC (UK): $181 billion
BNP Paribas SA (France): $175 billion
Dexia SA (Belgium): $105 billion
Wachovia Corporation: $142 billion
Dresdner Bank AG (Germany): $123 billion
Societe Generale SA (France): $124 billion

[33]. The Troubled Asset Relief Program (TARP), signed by President Bush on October 3, 2008 authorized the government to purchase assets and equity (toxic mortgage-backed securities and bank stock) from financial institutions to prevent their bankruptcy and implosion of the financial system.

General Electric Corporation: $16.1 billion[34]

Additionally, asset swap arrangements were made with banks in the UK, Mexico, Canada, Brail, South Korea, Norway, Singapore, Japan and Switzerland[35]

Fiat Money: The Dollar is no longer a Dollar but is a Federal Reserve Note.

The dollar bill is not really a US Dollar, although that is what the printing on it states. The print also declares on the top of the obverse (front) side that it is a *Federal Reserve Note* which may be lawfully substituted for dollars. The Federal Reserve Note, the only type of banknote in use in the United States, has been declared to be "legal tender" by law and as good as a dollar. It is, in effect, a *substitute dollar*. Unlike previous paper currency, which acted much like warehouse receipts which were redeemable in gold or silver, a paper dollar cannot be redeemed for anything. That is why it is called a "fiat" currency - "fiat" being the Latin for "Let it be done". It refers to money which is established by governmental decree only. The fiat phrase is found on the front of the bill: "This note is legal tender for all debts, public and private". It is money - "legal tender" - because the government says it is. (Both the US dollar

[34]. "Newly disclosed records show that during the 2008 financial crisis, the Federal Reserve essentially lent $16.1 billion to General Electric [G.E. Capital, the company's finance arm] by buying short-term corporate i.o.u.'s [commercial paper - Ed.] from the company at a time when the public market for such debt had nearly frozen. And on Sept. 15, 2008, the day Lehman Brothers filed for bankruptcy protection, JPMorgan Chase received a $3 billion loan from the Fed. ... The two companies received help even as their chief executives, Jeffrey R. Immelt of G.E. and Jamie Dimon of JPMorgan Chase, sat on the nine-member board of the Federal Reserve Bank of New York." *The New York Times*, December 5, 2010.

[35]. http://www.rawstory.com/rs/2011/07/21/audit-fed-gave-16-trillion-in-emergency-loans/

and the Euro are fiat currencies.) Most important, it is legally the only valid money accepted for the payment of governmental taxes.

Federal Reserve Notes are printed for the Federal Reserve by the US Treasury's Bureau of Engraving and Printing[36] at a cost of $.096 per bill.[37] Federal Reserve Notes are put into circulation by the twelve Federal Reserve Banks as currency is needed. Older bills are continually withdrawn from the market due to physical wear and tear or damage.

That raises two questions: what is a "note"; and, what is a Federal Reserve Note?

A "note" is shorthand for "promissory note", which is a promise to pay and is legal evidence of a debt. If you have ever purchased a home or an automobile and obtained financing for it from an institutional lender you were required to sign two separate documents: a note and a mortgage. The debt is represented by the "note". The security for the loan, the thing the lender can seize if you fail to make the promised payments on the note, is represented by the mortgage. In today's difficult financial environment the media refer to people who are "behind on their mortgage", when legally what they are behind on are the promises (payments) agreed to in their "note". A mortgage is a security document which normally is recorded at a public records office for all the world to see. A note is a debt document referenced in the mortgage which is rarely recorded, leaving its essential terms (effective interest rate, amortization period) private.

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The Federal Reserve's loans earn interest, and at the end of the year the Fed must return all of its profits to the US Treasury. On January 10, 2012 the Fed reported that it had returned $76.9 billion to the Treasury as its calendar year 2011 profits.[38] Of course, the Fed has never

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[36]. The Federal Reserve has nothing to do with "coinage". Coins are produced by another department of the US Treasury: the United States Mint, who delivers them to the Fed for distribution. Coins are a third kind of money: the first being money created by the Federal Reserve Banks; the second being money (credit) created by the banking system through the "magic" of fractional reserve lending.

[37]. More than half the cost is for the materials: 75% cotton fiber and 25% linen (made from flax).

[38]. New York Times January 10, 2012. "Almost 97% of the Fed's income was generated by interest payments on its investment portfolio, including $2.5 trillion in Treasury securities and mortgage-backed securities. . . Fed officials note that this cycle - payments flowing from Treasury to the Fed and back to the Treasury - still saves money for taxpayers because those interest payments otherwise would be made to other investors. 'It's interest that the Treasury

been fully audited, and taxpayers must trust that the Fed is telling the truth. Notwithstanding the above, the ability of a private banking cartel to set the monetary policy for the country, and indirectly for the world, and to help its member banks survive financial crises at minimal cost, are potent powers to be in private hands. When people wonder why, as a result of the financial crises of 2008 and following, the banks were saved and everyone else, including state and municipal governments, were left to fend for themselves ("socialism for the banks; capitalism for the rest of us", or "privatizing the profits and socializing the losses"), they only need to reflect that the Fed is a private banking cartel which takes care of its own.

Thus, all money in circulation, except for coinage, is based on debt. We have debt-based money which is created out of nothing, is backed by nothing tangible or physical, and yet, as a debt, it earns interest. And the interest it earns (as a note) is compound interest[39] earned by the Federal Reserve System, a private bank. A Federal Reserve Note is a debt owed to the Federal Reserve Bank. The Federal debt is never paid off but continues to grow, year after year, forming the basis of the US money supply. As a former Governor of the Fed once stated, if the Federal debt were ever paid off there would be no more money in circulation (see endnote #25).

A significant portion of the US national debt[40] (not the annual budgetary deficit, but the accrued national debt) is interest owed to the Federal Reserve. The rest of the national debt is owed to individuals who own Treasury bills, notes and bonds, and to other countries, like China, which as of October 2011 owned $1.134 trillion and Japan, which owned $997 billion in US Treasury bonds.

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The "dollar" was originally a gold coin and later became paper currency backed by gold. The paper dollar was similar to a "warehouse certificate" whereby one could redeem one paper dollar for a dollar's worth of gold. In 1929 silver was added to support the currency and one

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didn't have to pay to the Chinese' the Fed's Chairman, Ben S. Bernanke, half-jokingly told Congress. ."

[39]. See Definitions

[40]. The US total debt, as of December 2011, stood at slightly more than 15 trillion dollars. About half of this total is owed to the Federal Reserve and intragovernmental holdings (whatever they might be).

dollar “silver certificates” were issued, which could be redeemed for silver. Production of silver certificates was stopped in 1963 and their redemption for silver ceased in 1964. The debasing of the currency, meaning the withdrawal of any real asset (gold, silver) to back up its value is an interesting and complex history. On June 5, 1933 Congress, at the behest of President Franklin Roosevelt, took the dollar off the gold standard for domestic purposes.[41] Until that time Federal Reserve Notes were redeemable into gold. Roosevelt, with one law, changed them from a promise to pay in gold to legal tender backed only by the “full faith and credit of the United States”.[42] President Richard Nixon ended the convertibility of the US dollar to gold for foreign governments on August 15, 1971,[43] making the dollar completely “fiat” in character. Nixon felt forced to take this measure “when foreign creditors threatened to exhaust U.S. gold reserves by cashing in their paper dollars for gold.”[44] This meant that the US no longer honored the terms of the post-war Bretton Woods agreement (1946), whereby governments agreed to stabilize the exchange of foreign currencies by pegging their value to the US dollar. The value of the dollar, and other currencies, was allowed “to ‘float’ in the market so that they had to compete with each other as if they were commodities. Currency markets were turned into giant casinos that could be manipulated by powerful hedge funds, multinational banks and other currency speculators.”[45]

Summing up, there are three ways money is created in the US banking system. The least significant, oldest, and still genuine is when the US Treasury mints pennies, nickels, dimes,

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[41]. The United States had been on a gold standard since 1879. Bank failures during the Great Depression had frightened the public into hoarding gold, making it impossible to continue the convertibility of currency into gold. It suddenly became illegal for American citizens to own gold coins, gold bullion and gold certificates (currency redeemable in gold - as opposed to so-called Silver Certificates), all of which had to be turned in to the Federal Reserve by May 1, 1933 for the set price of $20.67 per ounce. In 1934 the government increased the price of gold to $35 per ounce, a price which held firm until August 15, 1971 when Nixon de-coupled the dollar and gold. President Gerald Ford signed legislation in 1974 allowing Americans to legally own gold again. Since then the price of gold fluctuates according to supply/demand factors on the world’s commodity exchanges.

[42]. See Brown at 156

[43]. Many sources describe this turning point, including Greider at 334 and Brown at 201-206

[44]. Brown at 201

[45]. Brown at 204

quarters, fifty cent pieces and one dollar coins. The Federal Reserve, a private banking cartel, creates substitute dollars (Federal Reserve Notes) out of nothing, without limit and without audit. Banks create new credit (checkbook money) out of nothing via fractional reserve lending, but are limited in the amount which can be created by the ratio of their loans to reserves.

What Is So Wrong about the Banking System?

There are enormous negative consequences to the type of banking system currently in place in the United States and other Western nations . . . enough so that their discussion is saved for another article. However, it is appropriate to let one of the world's great capitalists, Henry Ford, the creator of the assembly line technique of mass production, speak the closing words. When commenting on the mysteries of money and the Federal Reserve System he said: "It is well enough that the people of the nation do not understand our banking and monetary system for, if they did, I believe there would be a revolution before tomorrow morning."[46]

DEFINITIONS

Banks: there are several types of banks with different types of organizations, which generally are highly regulated by government (in the US, both state and local government). There are savings banks, cooperative (or mutual) savings banks, Federal savings banks, Federal Savings and Loan Associations, and National banks. The differences are complex and confusing. For the purposes of this article, banks are financial institutions which are primarily distinguished by *their ability to accept deposits and to expand the money supply via fractional reserve lending.* They are generally subject to minimum capital requirements which are based upon an international set of capital standards known as the Basel Accords. See Wikipedia under "banks".

Commercial Banks: financial institutions which accept a variety of deposit accounts (savings, checking, time deposits (certificates of deposit), make all manner of business loans, offer related services (financial management, estate planning and estate management, brokerage accounts). Nearly all are members of the Federal Reserve System.

[46]. Henry Ford, Sr. cited by Greider at 55

Commercial Paper: unsecured promissory notes with maturity dates from 1 to 270 days sold by large banks and corporations to get money to meet short term debt obligations. Since it is unsecured debt, only those companies with excellent credit ratings are able to sell commercial paper. It is sold at a discount from face value at rates higher than bond rates, but lower than the issuer's lending rates.

Compound Interest: interest calculated not only on the initial principal of a loan, but on the accumulated interest due from prior payment periods. **Simple Interest** is interest paid on the principal of a loan and not on previously accumulated interest. Compound interest is also known as "interest on interest". The longer the loan payment (amortization) period, the greater is the effect of compound interest on the total amount of the debt. For example, a 20 year loan at a 10% interest rate, 12 annual payments compounded monthly, the total debt is the principal plus an amount equal to the 231% of the original principal. With a 30 year amortization, the total amount of the debt is principal plus an amount equal to 315% of the original principal. Many characterize compound interest as a disguised form of usury.

Credit Default Swap (CDS): is an agreement that the seller of the CDS will compensate the buyer in the event of loan default. Upon default the buyer of the CDS receives compensation (usually the face value of the loan - as in a mortgage bond) and the seller takes possession of the defaulted loan (i.e. bond). Anyone may purchase a CDS, even buyers who do not hold the loan instrument and have no insurable interest in the loan (these are known as 'naked' CDSs). CDSs are not traded on any exchange and there is no required reporting of transactions to any government agency. In essence they are a bet made by a third party on a business transaction between two other parties - who may or may not be aware that the third party is betting on the outcome of their transaction. As of December 1, 2011 the European Parliament banned 'naked' CDSs. American billionaire Warren Buffett has called Credit Default Swaps "financial weapons of mass destruction" (*Fortune* magazine, March 3, 2003).

Demand Deposits: bank deposits which can be withdrawn at any time, on demand and without notice. Most checking and savings accounts are demand deposits.

Discount Rate (of the Federal Reserve): the Feds discount rate, also called the **base rate**, or the **repo rate**, is the interest rate charged by the Fed for short-term loans to member institutions to replenish their reserves in the event of a shortfall. The discount rate is typically set .50 (½) a point higher than the Federal Funds rate. For example the Prime, Discount and Federal Funds Rates on January 11, 2012 were:

Wall Street Journal Prime	3.25 %
Federal Discount Rate	.75%
Federal Funds Rate	.25 %

Discount Window (of the Federal Reserve): The discount window of the Fed allows eligible institutions to borrow money from the Fed, usually on a short-term basis, to meet temporary shortages of liquidity in their reserves. The interest rate charged is called the **discount rate.**

Derivatives: financial instruments whose characteristics and value depend upon the characteristics and value of some other asset, an "underlier", typically a bond, commodity, equity (stock) or a currency. The most notorious of these is the "credit default swap".

Federal (or National) Debt: the total amount of money a government owes to its creditors

Federal (or National) Deficit: the negative difference between governmental revenues and expenditures in any given (single) year. "Deficit" relates to annual revenue shortfall, while "Debt" includes all monies owed, including all previous annual deficits.

Federal Funds: are overnight borrowings by banks to maintain their bank reserves at the Federal Reserve. Depository institutions with reserve balances in excess of reserve requirements lend money, usually overnight, to institutions with reserve deficiencies at the federal funds rate. Federal funds are unsecured interbank loans.

Federal Funds Rate: the interest rate which depository institutions (banks) charge each other on overnight loans made between themselves on an uncollateralized basis. The Federal Funds rate is a significant benchmark in financial markets. Its movement, up or down, causes the Prime Rate to fluctuate in mirror fashion.

Gold Standard: a monetary system in which currency is convertible into fixed amounts of gold.

Investment Banks: private corporations or partnerships which help companies and governments issue securities, help investors purchase securities, manage financial assets, trade securities, engage in arbitrage, and provide financial advice. Unlike commercial banks they do not take deposits or make commercial loans. This was true until the repeal of the Glass-Steagall Act in 1999, when investment banks and commercial banks were both allowed to conduct the same activities.

Legal Tender: a medium of payment allowed by law or recognized by a legal system which is valid for meeting a financial obligation.

Open Market Operations: the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Open Market Operations are conducted only by the Federal Reserve Bank of New York.

Reserves: or Bank Reserves, are banks' holdings of deposits with their central bank (the Fed in the USA), which includes borrowed federal funds, plus currency which is physically held in the banks vault (vault cash). Banks do not lend out their reserves. The purpose of reserves is to provide the base upon which the banks create money. A more correct term for reserves is *monetary base*. The only source of "reserves" or "reserve account credits" are the Federal Reserve Banks. The monetary base (reserves) against which all deposit expansion takes place is not the individual bank's investment capital or earnings or their own bank-created credit; it is money the Federal Reserve deposited to their reserve account as a *gift*, because . . . the member banks own the Federal Reserve Banks. See Cook's *The ABC's of America's Monetary System* pages 20 - 25.

Reserve Requirement: the percentage of funds the Federal Reserve Board requires that member banks maintain on deposit at the Federal Reserve at all times.

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