

The Money Monopoly

How the Federal Reserve rips you off

By Ron Paul

MOST AMERICANS haven't thought much about the strange entity that controls the nation's money. Visitors to Washington can see the Federal Reserve's palatial headquarters, the monetary parallel to the Supreme Court or the U.S. Capitol. We hear the Fed chairman testify to Congress, citing complex data, making predictions, and attempting to intimidate anyone who would take issue. He postures as master of the universe, completely knowledgeable and in control.

But how much do we really know about what goes on inside the Fed? Even with the newest round of bailouts, journalists had difficulty determining where the money was coming from and where it was headed. From its founding in 1913, secrecy and inside deals have been part of the way the Fed works.

It says that its job is to keep inflation in check. But this is like the car industry claiming to control road congestion. The Fed might attempt to stop the effects of inflation, namely rising prices. But under the old definition of inflation—an artificial increase in the supply of money and credit—the reason for its existence is to generate more, not less.

The banking industry has always had trouble with the idea of a free market that provides opportunities for both profits and losses. The first part, the industry likes. The second is another matter. That is the reason for the constant drive in American history toward the centralization of money, a trend that not only benefits the largest banks with the most to lose from a sound-money system, but also the government, which is able to use an elastic system as an

alternative form of revenue support.

Whenever instability turns up, we see efforts to socialize the losses, but rarely do people question the source of instability. Economist Jesús Huerta de Soto places the blame on the institution of fractional-reserve banking. This is the notion that depositors' money in use as cash may also be loaned out for speculative projects, then re-deposited. The system works as long as people do not attempt to withdraw their money all at once. In the face of such a demand, banks turn to other banks to provide liquidity. But when the failure becomes system-wide, they turn to government.

The core of the problem is the conglomeration of two distinct functions of a bank. The first is warehousing, whereby banks keep money safe and provide checking, ATM access, record keeping, and online payment, services for which consumers are traditionally asked to pay. The second service the bank provides is a loan service, seeking out investments and putting money at risk in search of return.

The institution of fractional reserves mixes these functions, such that warehousing becomes a source for lending. The bank loans out money that has been warehoused—and stands ready to use in checking accounts or other forms of checkable deposits—and that loaned money is deposited yet again in checkable deposits. It is loaned out again and deposited, with each depositor treating the loan money as an asset on the books. In this way, fractional reserves create new money, pyramiding it on a fraction of old deposits. An initial deposit of \$1,000, thanks to this “money multiplier,” turns

into \$10,000. The Fed adds reserves to the balances of member banks in the hope of inspiring ever more lending.

As customers, we believe that we can have both perfect security for our money, withdrawing it whenever we want and never expecting it not to be there, while still earning a return on that same money. In a true free market, however, there tends to be a tradeoff: you can enjoy the service of a warehouse or loan your money and hope for a return. The Fed, by backing up fractional-reserve banking with a promise of endless bailouts and money creation, attempts to keep the illusion going.

The history of banking legislation can be seen as an elaborate attempt to patch the holes in this leaking boat. Thus have we created deposit insurance, established the “too-big-to-fail” doctrine, and approved schemes for emergency injections to keep an unstable system afloat.

The story can be said to begin in 1775, when the Continental Congress issued paper money called the Continental. The currency was inflated to the point of disaster, the first great hyperinflation in U.S. history, and it gave rise to a hard-money school of thought that would agitate against central banking and paper money for generations. It also explains why the Constitution placed a ban on paper money and permitted only gold and silver.

In 1791, the First Bank of the United States was chartered, and in 1792, Congress passed the Coinage Act recognizing the dollar as the national currency. Fortunately, the charter on the incipient central bank was not renewed and expired in 1811.

In 1812, with war raging between Britain and the U.S., the government issued notes to finance the war, resulting in suspensions of payment as well as inflation. During a war, inflation is something you might expect, but instead of permitting normal conditions to return, in 1816, Congress chartered the Second Bank of the United States, which aided and abetted ever more expansion and the creation of a boom-bust cycle.

Nineteenth-century banking theorist Condy Raguet explains:

The sanction of the community was extended to them during the continuance of the war then existing with Great Britain, on account of the belief that their condition was forced upon them by the peculiar circumstances of the country; but no sooner had peace returned in the early part of 1815, than all their pledges were violated, and instead of manifesting by their actions a desire to contract their loans so as to place themselves in a situation for complying with their obligations, they actually expanded the currency by extraordinary issues, whilst there was no existing check upon them, until its depreciation became so great that speculation and overtrading in all their disastrous forms, involved the country in a scene of wretchedness, from which it did not recover in ten years.

The inevitable downturn came—the Panic of 1819. But it ended peacefully precisely because nothing was done to stop it. Jefferson pointed out that the panic was only wiping out wealth that was fictitious to begin with. After massive political agitation, and following Andrew Jackson's Executive Order that withdrew the federal government's deposits from the bank, the Second Bank closed in 1836.

But the war between North and South set off another round of inflationary

finance, eventually killing off wartime currencies and prompting another deflation that set the stage for a gold standard that was solid but not perfect. Its flaws—banks were permitted fractional reserves and were beginning to rely on regulations to dampen competition—created the dynamic that led to the Federal Reserve.

Jacob Schiff, head of Kuhn, Loeb, and Co., gave a speech in 1906 that began the push for a central bank. He explained that the “country needed money to prevent the next crisis.” He worked with his partner Paul Moritz Warburg and Frank Vanderlip of the National City Bank of New York to create a commission that called for a “central bank of issue under the control of the government.” They began to work within other organizations to push the agenda, winning over the American Banking Association and important players in government.

Once the groundwork was laid, the crisis atmosphere of 1907 assisted. During this brief contraction many banks stopped paying out gold to depositors. This led to a consolidation of opinion in favor of a general guarantor.

In 1908, Congress created a National Monetary Commission to look into banking reform. It was staffed by people close to the largest banks: First National Banking of New York, Kuhn Loeb, Bankers Trust Company, and the Continental National Bank of Chicago. By 1909, President William Howard Taft endorsed a central bank and the *Wall Street Journal* ran a 14-part series making the case. The series was unsigned but was written by a NMC member, Charles A. Conant, and made the usual arguments for elasticity, but added additional functions that the central bank could play, including manipulating the discount rate and gold flows as well as bailing out failing banks. Pamphleteering, scholarly statements, political speeches, and press releases by merchant groups followed.

By November 1910, the time was right for drafting the bill that would become the Federal Reserve Act. A meeting was convened at a Georgia resort called the Jekyll Island Club, co-owned by J.P. Morgan. The players took elaborate steps to preserve secrecy, and the press reported that it was a duck-hunting expedition. But history recorded who was there: John D. Rockefeller's man in the Senate, Nelson Aldrich; Morgan senior partner Henry Davison; German émigré and central-banking advocate Paul Warburg; National City Bank vice president Frank Vanderlip; and NMC staffer A. Piatt Andrew, who was also assistant secretary of the Treasury. Two Rockefellers, two Morgans, one Kuhn Loeb person, and one economist—the essence of the Fed: powerful bankers and government officials working together to make the nation's money system serve their interests, with economists there to provide scientific gloss. It has been pretty much the same ever since.

The structure they proposed would be “decentralized” into 12 member banks, providing cover for the cartelization, and was presented to the National Monetary Commission in 1911. Then the propaganda was stepped up with newspaper editorials, phony citizens' leagues, and endorsements from trade organizations.

With a vote by Congress, the government conferred legitimacy on a cartel of bankers and permitted them to inflate the money supply at will, insulating them against the consequences of bad loans and overextension of credit. Hans Sennholz called the creation of the Fed “the most tragic blunder ever committed by Congress. The day it was passed, old America died and a new era began. A new institution was born that was to cause, or greatly contribute to, the unprecedented economic instability in the decades to come.”

It was a form of financial socialism that benefited the rich and powerful. As

for the excuse, it was then what it is now: the Fed would protect the monetary and financial system against inflation and violent swings in market activity. It would stabilize the system by providing stimulus when it was necessary and pulling back on inflation when the economy overheated.

A statement by the comptroller of the currency in 1914 promised nirvana: the Fed “supplies a circulating medium absolutely safe.” Further, “under the operation of this law such financial and commercial crises, or ‘panics,’ as this country experienced in 1873, in 1893, and again in 1907, with the attendant misfortunes and prostrations, seem to be mathematically impossible. ... It is hoped that the national-bank failures can hereafter be virtually eliminated.”

Reality has been much different. Consider the dramatic decline in the value of the dollar since the Fed was established. The goods and services you could buy for \$1 in 1913 now cost nearly \$21. We might say that the government and its banking cartel have together stolen \$0.95 of every dollar as they have pursued a relentlessly inflationary policy.

As for the abolition of panics, 20th-century recessions documented by the National Bureau of Economic Research include: 1918-19, 1920-21, 1923-24, 1926-27, 1929-33, 1937-38, 1945, 1948-49, 1953-54, 1957-58, 1960-61, 1969-70, 1973-75, 1980, 1981-82, 1990-91, 2001, 2007, and the current panic with no end in sight. Some mathematical impossibility!

One aspect of the promise that has been kept: banks don't fail as they used to. But is this really a good thing? If businesses are not allowed to fail, what gives them incentive to succeed with soundness and productivity to the common good? In a competitive and free system, deposits would not be unsafe; any that were not paid back as promised would fall under fraud laws. Deposits that would be unsafe would be loans to the

bank that would be treated like any other risky investment. Consumers would keep a more careful watch over the institutions that are handling their money and stop trusting regulators in Washington.

As the years have gone on, the Fed has been granted ever more leeway in the means it uses to inflate the money supply. It can now buy just about anything it wants and write it down as an asset. When it buys debt, it buys with newly created money. It maintains a strict system of low-reserve ratios that allows banks to pile loans on top of deposits and take the new deposits as the basis for ever more loans. It can set the federal funds rate at a level to its liking and influence interest across the entire economy. It intervenes in currency markets.

The Fed's architects might have imagined that it would help smooth out the business cycle—provided you think that the real problem of the cycle is its bust phase when credit contracts. And the Fed can provide liquidity in these times by printing money to cover deposits. But if you think of the cycle as beginning in the boom phase—when money and credit are loose and lending soars to fund unsustainable projects—matters change substantially.

In 1912, Ludwig von Mises wrote *The Theory of Money and Credit*, which warned that central banks would worsen and spread business cycles rather than eliminate them. The central bank can reduce the interest rate that it charges member banks for loans. It can buy government debt and add that debt as an asset on its balance sheet. It can reduce the reserve coverage for loans at member banks. But in doing all of this, it is toying with the signals that the banking industry sends to borrowers. Businesses are fooled into taking out longer-term loans and starting projects that cannot be sustained. Investors flush with new cash buy homes or stocks, activities that spread a buying-and-selling fever.

This activity creates a false boom. When lower interest rates result from real saving, the banking system is signaling that the necessary sacrifice of present consumption has taken place to fund long-term investment. But when central banks artificially push down rates, they create the impression that the savings are there when they are absent. The resulting bust becomes inevitable as goods that come to production can't be purchased. Reality sets in: businesses fail, homes are foreclosed upon, and people bail out of stocks.

International markets complicate the picture by allowing the boom phase of the cycle to continue longer than it otherwise would, as foreigners buy up and hold new debt, using it as collateral for their own monetary extensions. But eventually they, too, become ensnared in the boom-bust cycle of false prosperity followed by all-too-real bust.

Knowledge of this problem was not well spread among bankers and government officials in 1913, when the Federal Reserve was created. But it wouldn't be long before it became apparent that the Fed would bring not stability but more instability, not shorter booms and busts but deeper and longer ones. The longest one of all, dramatically exacerbated by bad economic policy, was the Great Depression. And now we appear to be entering another phase of extreme crisis—courtesy of the Federal Reserve. ■

Ron Paul is an 11-term congressman from Texas, bestselling author, and former presidential candidate. This essay is excerpted from the book END THE FED, Copyright (c) 2009 by the Foundation for Rational Economics and Education, Inc (FREE). Reprinted by permission of Grand Central Publishing, a Division of Hachette Book Group, Inc., New York, NY. All rights reserved.