

Chapter 3: THE (CENTRAL) BANKING SCAM

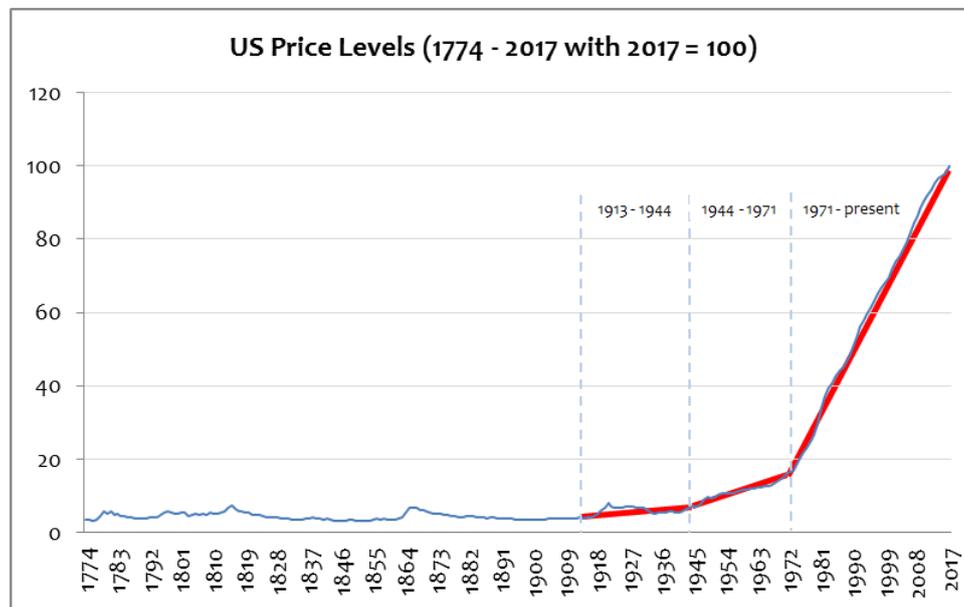
At this point, we've established the very important distinction between money and currency and learned that although gold is no longer legal tender, it's still money, otherwise there would be no reason for governments to hold reserves in the hundreds, and in some cases thousands, of tonnes. That is not to say that other forms of money can't or shouldn't be considered, but until all the major economies of the world stop holding vast stockpiles of gold, it's safe to assume that it still has a role in our financial system, albeit a dormant one. No other element serves the purpose of money better than gold, and no other substance is as counterfeit proof as an element.

When used as money, gold provides a *fair* means of wealth transfer. On a gold-based monetary system, once you've earned an ounce of gold, you have a store of value that cannot be artificially eroded, as the gold itself cannot be artificially multiplied. The vast majority of gold on earth has already been discovered and mined. What's left is increasingly more difficult and expensive to recover. Current gold production is around 3,000 tonnes per year, a fraction of the 175,000 tonnes already mined. 'New' gold therefore barely changes the total supply, which minimizes inflation.

Currency on the other hand is not only susceptible to inflation, but deliberately inflated by The Federal Reserve and banking system. Since the Federal Reserve was established in 1913, the US dollar has lost over 98% of its value as a direct consequence of The Fed's authorized mandate to create currency and the 'fractional reserve' banking system that it enables.

The devaluation started gradually when currency creation was limited to a 40% gold reserve ratio, it increased a little faster when the reserve ratio was essentially decreased under Bretton Woods,

and it has since increased at its fastest rate ever following the removal of gold from the international monetary system altogether in 1971. We can observe these three periods of increasing inflation very clearly in our graph from Chapter 1:



Once you've earned a dollar of currency, its value decreases over time as more and more currency is created. Currency has zero intrinsic value and is approaching worthlessness at an increasing rate. More currency has been created since 2008 than in the previous 200 years combined. The reason this hasn't halved the value of dollars since then is because most of the new currency hasn't filtered into the real economy, yet. What this means will become clearer as we understand banking, debt and inflation over the next few chapters.

The Federal Reserve Act specifies its key objectives are to maximize employment, stabilize prices and moderate interest rates – a noble purpose indeed. It has a number of tools at its disposal to achieve these goals, namely; dictating bank reserve ratios, setting interest rates, and manipulating currency supply.

Bank reserve ratios stipulate the amount of currency banks are required to hold in reserve, typically around 10%. This means that for every \$100 of deposits, the bank is only required to keep \$10 of reserves. \$90 can be loaned or invested as desired by the bank. By *increasing* the reserve requirement The Fed *decreases* the currency supply as the banks now have to keep more currency in reserve and therefore have less currency to lend or invest. Likewise if The Fed *decreases* the reserve requirement, the currency supply *increases*.

In practice, banks deposit their reserves in a Federal Reserve account, in much the same way as we deposit our currency in a bank account. The reserves are then loaned to the government by purchasing Treasury Securities. Each day millions of deposits and withdrawals are made so the reserves of an individual bank may increase or decrease depending on the net value of total deposits and withdrawals. This means that each bank must increase or decrease their reserves accordingly, but rather than individually transacting with the Federal Reserve, they simply borrow and lend reserves from each other.

For example, if Bank A and B both have \$1,000 of deposits, their Federal Reserve accounts would have a balance of at least \$100 each. If at the end of the day Bank A has \$1,100 and Bank B has \$900 then Bank A is short by \$10 and bank B has excess reserves of \$10. Rather than Bank A adding \$10 to its reserve account and Bank B withdrawing \$10 from its reserve account, they simply borrow and lend from each other. In this case, Bank A would borrow \$10 worth of Treasuries from Bank B so both accounts now have the correct reserves. The borrowing rate for these overnight loans is known as the Federal Funds Rate.

But what if there are no reserves to borrow? Let's say Bank A ends up with \$1,100 and Bank B has \$1,000. Since Bank A cannot borrow from Bank B, it must top-up its reserve account with 10% of

the new deposits it received. Conversely if Bank A ends up with \$1,000 and Bank B has \$900 there are now excess reserves in the system. In this scenario, Bank B is better off redeeming its \$10 worth of Treasuries and lending it to a customer that will pay a higher rate of interest.

In reality it's rare that the system ends up with a significant aggregate shortage or excess of reserves. This is because over 99% of all transactions these days are electronic, so as Bank A's deposits increase, Bank B's decrease by the same amount as currency moves seamlessly between them. The system only fails to balance when currency is withdrawn and held in cash, as withdrawals don't offset deposits in this scenario. This is why banks take a grim view of people who withdraw large amounts of cash, and are increasingly pushing consumers toward a 'cashless society'. When everything is electronic, banks have **complete control over the system**. Physical currency is a hindrance as it prevents them from doing what they do best, creating debt.

In the old days before technology enabled electronic banking, currency was created by the 'fractional reserve' system. This meant that holding \$100 of physical cash in your pocket effectively removed currency from the banking system, restricting the bank's capacity to make loans. As soon as you deposit it, \$90 (\$100 less the 10% reserve requirement) is available to be loaned instantly.

The fact that \$90 out of your \$100 has been loaned to another person or company and the remaining \$10 has been loaned to the government and is sitting in an account at the Federal Reserve doesn't mean you can't get it back. There are thousands, if not hundreds of thousands of other people that have also deposited currency into the same bank, 10% of all their deposits are also invested in Treasuries held in a reserve account at The Fed, and the other 90% may also be loaned out.

In practice, it's highly unlikely that every single dollar has been loaned out at the same time, and even then the bank would receive millions of dollars each day in loan repayments, so there is always currency available to return deposits, as long as not too many people want their deposits back at the same time. This would constitute a bank run, but if you read the fine print in the documents you signed when opening your account, you'll find that the bank has every right to suspend withdrawals and stop you from accessing your own currency. Digital currency all but eliminates the possibility of a good old fashion bank run.

Let's say Bank A has \$1,000 of deposits. If up to 90% of it is loaned out, there must be beneficiaries who receive \$900 for whatever goods or services the loans were used to purchase. When this currency is deposited, there is now \$1,900 of deposits. \$900 has been 'created' by the issue of new debt.

And it doesn't end there. \$90 of this 'new' currency is added to reserves and the remaining \$810 is used to make more loans or investments. When that currency is deposited there is now \$2,710 in circulation. \$81 is now reserved and \$729 is loaned out, increasing the currency supply to \$3,439. As this process repeats, the original \$1,000 of deposits end up back at The Fed's reserve account, while facilitating the creation of up to \$9,000 of loans, a tenfold increase in currency supply courtesy of the **fractional reserve banking** system.

Given the reserves themselves are loaned to the government, this means every dollar in circulation is someone's debt. Now, if all the currency in circulation represents debt, where do the dollars to repay interest come from? The creation of more currency! The system is no different to a Ponzi scheme; since new currency needs to be created to service the interest and repayment of old debt, there is never enough currency in existence to repay the debt at any

given time, so the currency supply and prices increase perpetually as a result.

This may sound like an outrageous claim, but consider that total US national debt at the end of 2016 was around \$19.5 trillion, but the 'money' supply (incorrectly termed 'money' as we now understand it's actually the *currency* supply) was only around \$13 trillion. In other words, if all US currency was repaid, every dollar in every bank account of every citizen and corporate entity including savings would still be \$6.5 trillion short of the amount owed by the government.

It follows that the debt cannot possibly be repaid as there is never enough currency at any given time to repay the outstanding balance. Just like a Ponzi scheme requires new investors to pay returns to old ones, The Fed needs to create new currency so there is enough in circulation to pay off the old debt.

In our example there is \$9,000 of debt currency in the economy. If interest on the loans is 5% per annum and the loans are repaid in full after 12 months, the bank would need to receive \$9,450. This is clearly impossible given there is only \$9,000 of currency in the system. To keep the mouse-wheel turning, banks must create *more* loans.

How can banks lend even more without more deposits? Simply by The Federal Reserve creating new currency out of thin air, and using it to purchase Treasuries. This has the effect of removing loans to the government from the bank's balance sheet, so now the government owes The Fed, and the banks have more cash to make loans.

The fractional reserve banking system described above is how things *used* to work in the old days when the economy functioned on physical paper currency. There were no computers back then so banks *needed* physical deposits to lend physical currency in most

cases. These days a bank can simply type '1' followed by six '0's on its computer system and a million dollars springs into existence, ready to be loaned.

The loan becomes a debt in one customer's account, a deposit in another customer's account, and the required reserves can be borrowed in the overnight interbank lending process. The modern banking system isn't short on reserves, it's short on borrowers. It can theoretically expand the currency supply through the creation of debt indefinitely, as long as there are borrowers willing and able to get into debt.

Creating too many loans too quickly can be bad for the economy as increasing currency supply can cause too much inflation. How much is 'too much'? Anything above two per cent according to the Federal Reserve, as this is its *target* inflation rate. If inflation creeps too high above 2%, it typically indicates there is too much borrowing and spending in the economy. In order to slow things down, The Fed can increase reserve requirements or manipulate the currency supply and interest rates.

By increasing reserve requirements, The Fed can somewhat limit, or at least slow down, the amount of debt banks create. A reserve requirement of 20% would limit debt creation to \$4,000 for every \$1,000 of reserves as opposed to \$9,000 created for every \$1,000 of reserves under a 10% reserve ratio. In practice, increasing the reserve requirement in the modern banking system simply requires borrowing more Treasury Securities at the Federal Funds Rate.

A more effective way to slow down the economy is to manipulate interest rates. The interest rate is simply the *price* of currency as it represents the cost of borrowing it. When interest rates are low, currency is said to be cheap, since it doesn't cost much

to borrow. Conversely, when interest rates are high, currency is expensive and individuals and corporates are less inclined to borrow.

When there is too much borrowing and spending in the economy, The Fed *increases* interest rates to reduce borrowing and spending. It does this by *selling* Treasury Securities. When The Fed sells Treasuries to banks, it's essentially exchanging government I.O.U.'s for cash. In doing so, it *removes* cash from the economy and causes the currency supply to shrink. When there is less currency in the economy, the price of it (the interest rate) increases, making it more expensive to borrow.

It's important to note here that when The Fed removes currency from the economy, it isn't so much reducing the currency supply but rather decreasing the rate at which new currency is created. Banks are still free to create currency as they please, it's just harder to find borrowers when interest rates are high.

On the other hand, if inflation was below 2% this would indicate there is not enough borrowing and spending in the economy. In order to speed things up The Fed increases currency supply and lowers interest rates by *purchasing* Treasury Securities. This removes loans to the government from the banks' lending portfolio and replaces them with cash the banks can then lend to consumers and corporates. This increases currency in the economy, so the price of it (the interest rate) decreases, encouraging more borrowing and spending in the economy.

Remember, The Fed doesn't have any currency or assets of its own, but under the Federal Reserve Act, it's authorized to *create* currency out of thin air and use it to purchase securities, in this case Treasury Securities, from banks.

“Whoever controls the volume of money in any country is absolute master of all industry and commerce” – James A Garfield, 20th President of the United States.

Control over the supply and price of currency is an incredible amount of economic power, arguably more than the government itself has. Yet The Fed’s private shareholders remain undisclosed, drawing criticism and promoting a variety of conspiracy theories about its owners’ intentions.

In reality, the banks themselves create the majority of currency in the economy. The Fed is actually a quasi-government entity - although privately owned, the government has considerable influence over its activities - the board of governors are chosen by the president himself and confirmed by the Senate. Each year, only a 6% dividend is paid to the undisclosed shareholders and the remaining profits are remitted back to the Treasury. So when The Fed creates currency out of thin air to buy Treasuries, the majority of its profits go back to you, the taxpayer.

The real beneficiaries of system are the **banks**. The Federal Reserve is just a facilitator that aims to moderate the *pace* of currency creation. Too fast and inflation accelerates. Too slow and the economy grinds to a halt. It’s a delicate balance that’s critical to maintaining the greatest Ponzi scheme in history. Meanwhile, banks can focus on dishing out loans to maximise their income. The more they lend, the more they earn, and the greater the debt burden on society.

To summarize, banks get ‘new’ currency from The Fed by selling Treasury Securities that increase their reserves. For every new dollar of reserves, banks can create up to nine dollars of new loans (assuming a 10% reserve requirement). Most of the new currency is loaned to the private sector, but a fraction is also loaned to the

government by purchasing Treasuries (the government borrows the rest of its needs from the pool of new currency created in the private sector). The banks earn high returns lending currency to corporates and people that want to buy homes, cars etc. but low returns on loans to the government. That's okay though because there isn't enough currency circulating to repay all the debt in the economy so sooner or later, The Fed creates more currency out of thin air and injects it into the economy by purchasing more Treasuries from the banks.

“It is well 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.” Henry Ford.