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Creating “Wealth”: The Fed Shows No Reserve

The Federal Reserve has been in the news a lot lately, for this most recent action as well as many other headline-grabbing efforts to "get the economy moving again," as the talking heads are fond of saying. Unfortunately very few, even among the economic and business commentators in the news, truly understand how the Federal Reserve works. Were it otherwise, it would be more widely recognized that what Bernanke is doing is nothing new, except perhaps in degree. By using the Federal Reserve, with its monopoly on the issuance of currency, to manipulate the money supply, he is merely doing what central bankers like the Federal Reserve Chairman have always done — and the results will be the same that they have always been in the past.

Sordid History of Central Banks

The Federal Reserve, despite its misleading name, is in fact a type of bank known in the rest of the world as a central bank. Explained Liaquat Ahamed, a former employee of the World Bank turned financial historian: "Boiled down to its essentials, a central bank is a bank that has been granted a monopoly over the issuance of currency. This power gives it the ability to regulate the price of credit — interest rates — and hence to determine how much money flows through the economy." Central banks, in other words, are the ultimate trusts; they, and they alone, are authorized to issue a nation’s money supply, giving them complete ascendancy over world finances.

Although central banks date all the way back to the late 17th century (the Riksbank of Sweden was the first), central banking in its modern form arose from the ashes of the First World War. Prior to the war, most of the world’s largest economies had central banks, but although they exerted great power over world finance, they did not enjoy complete monopolies over money supplies. Nor, for that matter, were they free to create quantities of money without limit, for the world of the 19th century was a world tied to the gold standard (and, among poorer nations like Mexico and China, the silver standard). That is, money issued by banks, central or otherwise, needed to be backed by guarantees of redemption in "specie," the economists’ term for precious metals.

Soon after the outbreak of World War I, European central banks, recognizing that they did not have enough gold reserves to finance an international war, suspended specie redemption so that they could begin to create money without regard for the limits of the gold standard. This was, properly speaking, the inauguration of the modern age of central banking.

"Endless money forms the sinews of war," the Roman statesman Cicero observed in the *Philippics*, and so it proved true throughout history. The governments of Europe, no longer bound by the limits of their gold reserves, issued vast amounts of unbacked paper money through their respective central banks to finance the war effort. The United States, which acquired a central bank of its own in 1913 with the creation of the Federal Reserve, was similarly able to fund its involvement in the war, including the enormous expense of transporting hundreds of thousands of men and armaments across the Atlantic Ocean.

When the war finally ended, the belligerents were left with destroyed towns and cities, millions of war casualties, crippling debts, and oceans of paper money that could not possibly be redeemed in specie. The result was an economic maelstrom that destroyed the currencies of Germany and Austria and brought about severe recession elsewhere. Even the United States, which had gotten off comparatively easily, saw its economy collapse in 1920.

Amid the turmoil, the great powers, including Great Britain, made the fateful decision to return to the gold standard without discounting the value of their currencies against gold in spite of all the excess money that had been printed during the war. Not only that, the standard they tried to put in place was not a true gold standard but a gold *exchange* standard. This meant that gold no longer circulated in most countries (except in the United States, which remained on a true gold standard until the early 1930s) as currency. Redemption in specie was only guaranteed for big investment concerns, foreign and domestic.

The gold exchange standard was a disaster. No one had any idea how much new money was actually in circulation as a result of the wartime printing presses, and currency values oscillated wildly. At the time, the pound sterling was still the international reserve currency, so the governor of the Bank of England, Montagu Norman, devoted an enormous amount of energy trying to get the central banks of the other great powers, especially France, Germany, and the United States, to conduct parallel operations so that the pound would be able to preserve its value.

Money-supply Manipulation

But how exactly do central banks exert control over the money supply? The most important technique is called open-market operations, where the Federal Reserve, the Bank of England, or some other such institution, actually purchases debt (in the form of Treasury bonds, bills, and the like) issued by its government, and creates money out of thin air to pay for it. Ordinarily, open-market operations are carried out with certain privileged investing houses rather than with the government directly, so that the new money issued by central banks enters the economy in the form of payment for government securities to the banks and other authorized investment firms that sell them. From there, the money is loaned out to other banks. Because modern banking operates on a "fractional reserve" basis, banks are free to keep only a fraction — usually around 10 percent — of money on deposit available for withdrawal. The rest they lend out. That money is in turn deposited in other banks, and a sizeable portion of it loaned out again, and so on.

The so-called "money multiplier" effect means that new money originating with the Federal Reserve or other central bank will increase manyfold as it is loaned, deposited, and loaned again. With a reserve requirement of 10 percent, new money is typically multiplied by a factor of 10 so that, e.g., a billion new dollars injected by the Federal Reserve into the money supply will amount, in the long run, to an increase in the monetary base of about 10 billion dollars.

In practice, the mechanism is considerably more subtle than this. For one thing, open-market operations are usually carried out as repurchase agreements or repos. This means that the purchase or sale of government securities is usually for a short term only, and the effect of any individual transaction means that the money supply contracts when the seller of government securities repurchases the instrument when the term expires. But open-market operations are carried out every week, meaning that the contractionary effect of securities that the central bank resells can be easily offset — and usually is, in the long run — by a greater volume of purchases.

Central banks also have other means to manipulate the money supply, including raising or lowering reserve requirements. If, for example, the reserve requirement is lowered from 10 percent to five percent, the money multiplier effect will cause a billion dollars in new money created by the Fed to expand into 20 billion dollars in the money supply as a whole.

The Federal Reserve and other central banks are most closely identified with interest rates in the public mind. But what interest rates are meant? In point of fact, the Federal Reserve concerns itself with two very different interest rates, only one of which it actually sets. This latter is the discount rate, the rate at which the Federal Reserve is willing to lend out its own assets to member banks, via what is called the "discount window." In theory, at least, lowering this rate will encourage banks to borrow more, and hence will tend to increase the money supply, while lowering it will have the opposite effect. But in practice, banks have become very wary of borrowing through the discount window, fearing that such activity will be interpreted as a sign of a weak balance sheet.

The other interest rate that the Fed is concerned with, and the one that is meant whenever the media speak of the Fed "raising" or "lowering" interest rates, is the federal funds rate. This is the average interest rate that Fed member banks charge to one another for short-term loans of funds on deposit at the Fed. Banks make such loans to make sure their funds on reserve do not fall below legal requirements. However, the Fed does not set the federal funds rate directly. Instead, it announces a target value, to be arrived at by expanding or contracting the amount of funds available to banks, via the aforementioned open-market operations.

Inflation and Central Banking

All of these activities of central banks in general, and of the Federal Reserve in particular, are the cause of inflation. The public tends to believe that inflation is rising prices, especially of consumer goods, but in reality, inflation denotes an increase in the money supply, of which rising prices are the most visible *effect*. Whenever the amount of money available is increased relative to the amount of goods and services, prices will go up. Although, as we have seen, central banks do not inflate the money supply by running the printing presses directly, the creation of money via open-market operations and artificially low interest rates has an effect similar to what would happen if money were simply printed and then tossed out of helicopters — except that in the latter case, people would understand exactly what was going on, and the illusion of easy money could not be perpetrated for very long.

The effects of inflation always appear first in those sectors of the economy closest to the new credit bubbles emanating from the central bank. In modern economies, this means inflationary increases in pricing are manifested first and foremost in the form of highly inflated asset values and prices for claims on capital — in real estate, in securities markets, and (at least in the United States) in higher education, because these are the sectors of the economy that benefit first from an expanded credit base. Huge sums of new money are poured into the purchase of stocks and bonds by large investment firms, hedge funds, and other financial entities, while a large proportion of loans that commercial banks make with the new money are always real estate and education-related. As a result, stock prices rise at a dizzying clip — but so does the cost of college education or a new house. Inflation thus has the effect of enriching those who own securities, but driving middle-class home buyers and college students very deeply into debt. In this way, the mechanism of central banking really does make the rich richer and the middle class poorer.

Unfortunately, although the George Soroses and Warren Buffets of the world understand exactly how the system works, most ordinary Americans do not. Enticed by easy credit terms for higher education and mortgages, they take on irrational amounts of debt as the inflationary bubble expands, secure in the belief that, as the value of assets continues to grow, they will have no trouble paying down their debts.

Inflationary bubbles always result from the operation of modern central banks because central bankers are always motivated first and foremost by political, not economic, considerations. Despite the pretense of political neutrality, all central bankers are well aware that their primary job is to enable modern governments, which typically recognize few if any limitations on their own power, to do anything they want, no matter how unpopular. Wars, for example, especially wars of occupation fought for prestige or for conquest, are typically unpopular the moment taxes are raised to pay for them. But thanks to the magic of central banking, governments can in effect print the money they need — that is, issue debt which the central bank then converts into money — without directly encumbering the taxpayer.

But of course, there is always a price to be paid since, as we all learned on our parent’s knee, money — real money, at any rate — does not grow on trees. Inflation destroys the value of money and hence of savings accounts. It is therefore a kind of tax on the thrifty, and withal a thoroughly dishonest, underhanded kind of tax. Since the inception of the Federal Reserve, the U.S. dollar has lost more than 95 percent of its value, courtesy of the slow but steady artificial expansion of the money supply by the Federal Reserve.

But as long as prices at the gas pump and the supermarket increase only gradually — say, at two or three percent a year — then inflation is deemed acceptable by the manufactories of public opinion and consent.

Occasionally, however, the huge amounts of funny money issued by central banks find their way into the money actually in circulation. When this happens, a financial cataclysm called hyperinflation occurs. Prices of consumer goods soar, sometimes at the rate of thousands or even millions of percent a year. Savings accounts in banks quickly become worthless, and paper money in circulation no longer suffices to buy anything. This happened in Germany after World War I, in Argentina in the late ’70s and early ’80s, in the Balkans in the ’90s, and is happening in Zimbabwe at the time of this writing. Next to total war, hyperinflation is the worst man-made disaster that can beset any society. It often leads to the overthrow of governments, to civil war, and to dictatorship. In postwar Germany, it paved the way for the supremacy of the Nazis.

Inflationary Bubbles Always Burst

But even without the appearance of hyperinflation, all central bank-created financial bubbles burst, leaving devastation in their wake. At some point, realization dawns on investors and the general public that, thanks to years of unnaturally low interest rates and low credit, valuations and allocations of capital have been enormously distorted. There ensues a crackup in which asset prices tumble, over-leveraged businesses fail, and other corrective measures take their inevitable toll. It is as if the economy, after years of addiction to artificial, habit-forming stimulants, is now forced to undergo the painful symptoms of withdrawal from a long-term addiction.

This is in effect what happened in 1929 through the early 1930s, after the end of an international bubble inflated by the coordinated policies of the Bank of England, the Federal Reserve, and other European central banks. It is also what is happening right now. In our day, however, the bubble is much larger, and has actually been imploding for years, beginning with the market crash in 2000.

The end of the so-called dot-com bubble was in fact only the beginning of the end of a credit bubble decades in the making, a bubble that had produced the fantastic run-up in stock and other asset prices from the early ’80s until the end of the 20th century. During that era, public confidence — on which all inflationary bubbles crucially depend — was buoyed by a series of auspicious world events: the fall of the Berlin Wall, the breakup of the Soviet Union, an easy American victory in the Gulf War (purging the demons of Vietnam, and reinforcing the illusion of American military invincibility), the growth of modern industry in huge new markets like India and China, and the appearance of a panoply of new technologies, like cellphones and the Internet, that promised to transform lifestyles permanently for the better. In fine, it was a time of almost unbridled optimism, allowing the bubble economy to expand and expand.

The new century, however, witnessed a series of events that helped to puncture the illusion of unending prosperity. First came the Clinton administration’s successful antitrust case against Microsoft, which showed the world that, contrary to the giddy expectations of the high-tech crowd, Washington’s venal politicians were determined to control, regulate, and extort money from billionaire Internet parvenus and the exciting new industry they had created. On the day Microsoft was found in violation of antitrust statutes, the dot-com portion of the bubble burst.

Then came 9/11, the long and costly occupations of Iraq and Afghanistan, and Hurricane Katrina, which drained national coffers and pointed up the vulnerability of America. Not that any of these events "caused" the bubble to burst; they only helped to catalyze its demise.

It is impossible to predict how long inflationary bubbles and the booms they engender will last, only that they will not last forever. On the other hand, when they end, it is possible to limit the extent and duration of the damage by doing — nothing at all. This is how governments acted during what used to be called "panics," allowing the liquidation of bad assets during market corrections to run their course quickly.

With the Great Depression, however, governments reacted very differently, trying to prop up failed corporations (especially banks), creating jobs by spending taxpayer dollars on wasteful public works projects, and, in general, doing everything they could to hamper the ability of the markets to correct themselves. The result: a long and brutal depression that did not end until the conclusion of World War II, when the United States government finally was forced to do what it should have done years earlier: cut spending and get out of the way.

Now, of course, history is repeating itself as the Bush and Obama administrations pour trillions of dollars into an economy that refuses to respond to their aptly named "stimulus" packages. For just as the hard-core drug addict reaches a point where no further enjoyment can be derived from chemical stimulation, so too an inflationary economy will reach a point where no amount of funny money can rouse it from its corrective lethargy.

For the ability of the Federal Reserve to inflate the money supply depends crucially on the willingness of banks to borrow and lend. If banks refuse to drink from the Fed’s money spigots, or if (as has been the case lately) they hold on to new money to strengthen their balance sheets instead of lending it to customers, the money supply will not increase.

When this happens, every edifice built on excessive debt — every speculative real estate venture, every over-leveraged business, every factory making overpriced products — will come tumbling down. In the short run, this means bankruptcy and layoffs, but in the long run, it means an increase in national savings that will be the basis of a sounder national prosperity, as profligacy is transformed into thrift.

Time to End the Fed

But none of the economic devastation we are now experiencing could come about without the help of the Federal Reserve and kindred central banks abroad. The evils of inflation, the deadly illusion of economic bubbles, the migration of wealth from the savings of the middle class to the asset portfolios of the wealthy and well-connected — all are by-products of the Federal Reserve and its arcane financial wizardry.

But no Federal Reserve chairman will ever admit that, least of all the man most responsible for the great bubble of the ’80s and ’90s, Alan Greenspan. Nor has his successor, Ben Bernanke, been chastened by events. Bernanke, a longtime adherent of the so-called "monetarist" school of economics, popularized by the likes of Irving Fisher, Milton Friedman, and Anna Schwarz, believes, like all monetarists, that the Great Depression was caused by the failure of the Federal Reserve to act decisively. Instead of pumping more money into the economy when stocks were plummeting and banks failing, the Fed turned off the money spigots — so goes the monetarist argument. In fact, as Murray Rothbard and other Austrian economists have shown, the Fed tried to reinflate the bubble, but was unable to overcome the reluctance of banks and the general public to continue to borrow and lend.

Nevertheless, Ben Bernanke has chosen to take the advice of Milton Friedman et al., and has, since the onset of the latest crisis, been doing everything he can to open the Fed’s money spigots wider, hoping to soften the effects of the recession. He has even created a whole new set of facilities, starting with the Term Auction Facility, whereby the Fed can pump credit into the economy along entirely new pathways — by lending directly to a much wider range of financial institutions, and against a much broader spectrum of collateral than was previously the case. And to date, all of the actions of the Fed have been for naught.

Undeterred, Bernanke and his economic coreligionists are now insisting that greater international coordination of financial policies, as well as a global regulatory structure, will be necessary to prevent such crises in the future. "This is very much an international problem, and it requires international solutions," Bernanke told the members of the New York-based Council on Foreign Relations recently. The Fed chairman continued:

> In particular we need to work together effectively, to make sure that we have solutions for our banking systems that are not mutually inconsistent or create problems across jurisdictions. We need to make sure that we’re working together, to stabilize the banking system and to avoid the failure of systemically critical firms. We need to begin to establish a framework.

The failures of the Federal Reserve, as well as the utter inability of the likes of Bernanke to anticipate the economic catastrophe that is overwhelming us, are now being used as a pretext, not to abolish the system but to strengthen its powers to manipulate the money supply and to regulate and micromanage the once-free markets.

This, then, is the Federal Reserve System: a central bank tasked with manipulating the supply of paper money to the advantage of politicians and other privileged classes. Because of its ability to convert instruments of government debt into money, it is the unelected, unaccountable leadership of the Federal Reserve, not Congress — in spite of what the Constitution stipulates — that controls the purse strings of the federal government. Not only that, because of its power to destroy the value of the dollar over time and perpetuate boom and bust economic cycles, the Federal Reserve has ultimate control over the purse strings of every American household.

Until the Federal Reserve is abolished and replaced with a free, specie-based banking system, Americans will not enjoy the economic and financial freedom our ancestors enjoyed. We will continue to be at the mercy of booms and busts unleashed by the mandarins of high finance to serve their own political ends.

What You Can Do: Demand Fed Accountability Now as a First Step to Ending the Fed

Texas congressman Ron Paul has long been a vocal critic of the Federal Reserve. Recently, Congressman Paul introduced H.R. 1207, the Federal Reserve Transparency Act of 2009, which as of March 23 had more than 40 cosponsors. The bill, introduced on February 26, is intended to rectify one of the long-standing complaints about the Federal Reserve, its secrecy and complete freedom from congressional oversight. H.R. 1207 provides for the Comptroller General to conduct a thorough audit of the Fed and submit his findings, along with policy recommendations, to Congress. Click here to write to your senators and representative in support of H.R. 1207.

Congressman Paul also introduced H.R. 833, a bill that would abolish the Federal Reserve and repeal the Federal Reserve Act altogether. Click here to write to your senators and representative in support of ending the Fed.

While Congress is unlikely to consider abolishing the Federal Reserve — yet — the notion of a congressional audit of America's central bank may be an idea whose time has come. H.R. 1207, which would at least throw more light on the Fed's clandestine monetary policy, seems to have considerable momentum. Congressman Paul told Judge Napolitano on Freedom Watch that even Ben Bernanke, chairman of the Board of Governors of the U.S. Federal Reserve, called Congressman Paul to indicate his support of the bill!

See also: "Our Monetary Mayhem Began With the Fed."