



Hi! I'm Don Anderson. I am going to explore a topic suggested by my wife, Dana. She did not understand how the Federal Reserve created dollars and the role that commercial bankers play. Maybe some of you don't either.

The expansion of the number of dollars in circulation does not generate corresponding value, but gradually dilutes the value of all prior existing dollars. The Federal Reserve has been very successful with this process causing the value of the dollar to fall about 97% since the organization's creation in 1914.

The commercial banks have an important role in this process. If they make loans with the Fed created dollars, they will be responsible for about nine-tenths of the monetary expansion. If this expansion is more rapid than growth in the economy's productivity, we will see a general increase in prices. If it is less rapid, we will see a decrease in prices. Banks who successfully loan the dollars created by the Federal Reserve and spent by the federal government have the opportunity to become quite rich—if they successfully avoid poor credit risks.

## How the Federal Reserve creates dollars

- 1. Its Open Market Committee can buy government and other high rated bonds with Federal Reserve Notes.**
- 2. It sets the Reserve Ratio that banks and other institutions must observe when creating loans.**
- 3. Its Discount Window makes short term loans to banks to meet temporary "reserve" shortages.**

2

### How the Federal Reserve creates dollars

The Federal Reserve has three mechanisms for creating money. The name of each process doesn't necessarily describe what it does:

- 1) The Federal Reserves' Open Market Committee can buy government and other high rated bonds with Federal Reserve Notes (which have no backing). This is the major lever the Fed uses to expand the money supply. Government bonds bought by the public with real savings do not expand the number of dollars, but those bought by the Fed do expand the money supply since their money has no backing in either precious metals, commodities, or in fact any production.
- 2) The Federal Reserve can change the Reserve Ratio that the commercial banks and other institutions must observe when creating loans. This sets the limit on how much money the commercial banks can loan. The Reserve Ratio is seldom changed since its effects are more disruptive than dollars created by the Open Market Committee.

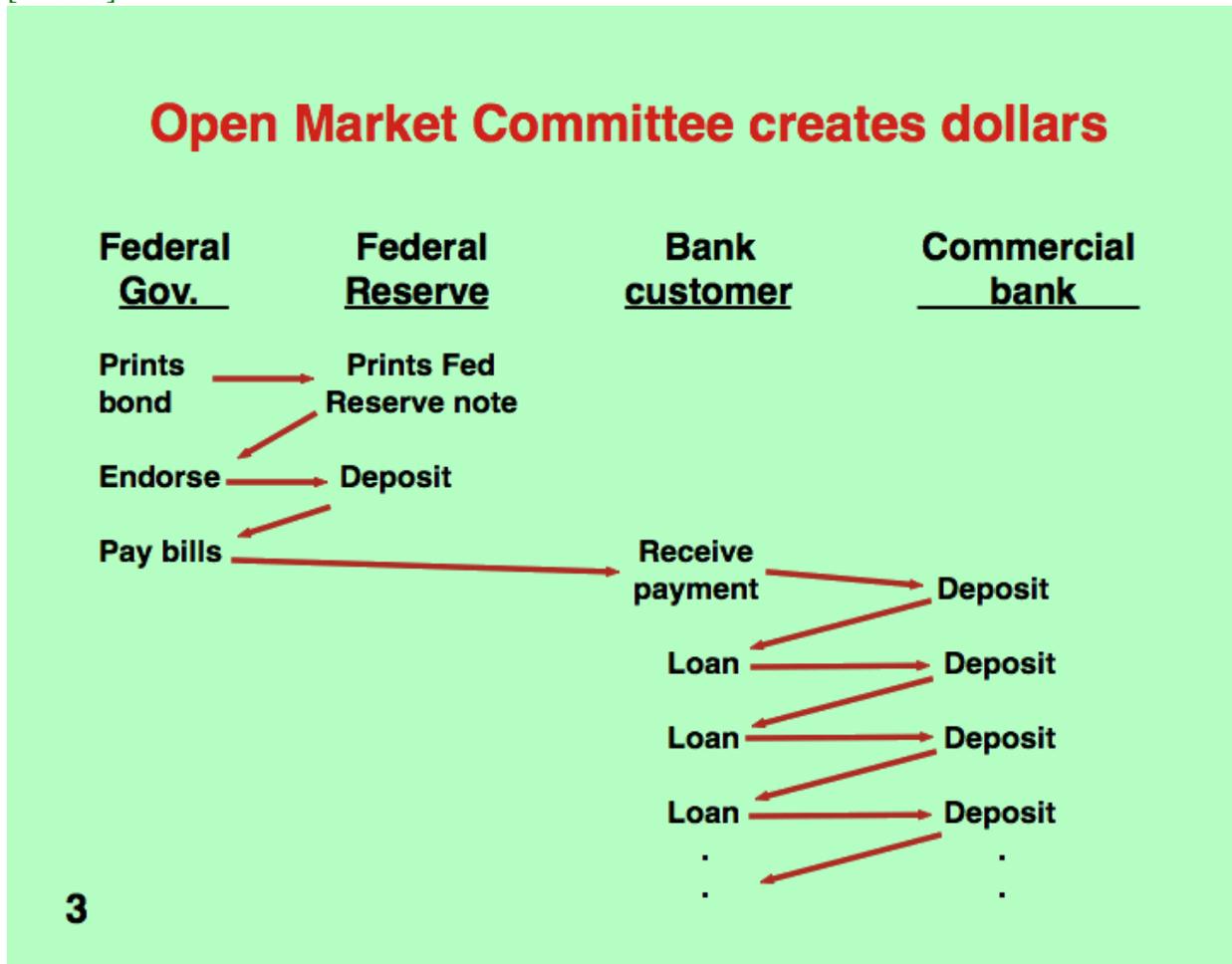
- 3) The Federal Reserves' discount window can make short term loans to the commercial banks within their system (national banks) to meet temporary "reserve" shortages. Rates are set high enough that most banks borrow reserves from other banks.

We often say the Fed prints money. If that method were directly used it would be too easy to track and people would ask where the money goes and would want a piece of the action. By making the process a bit more obscure our government reduces the questioning and buys the absolute loyalty of the bankers. The Federal Reserve does not directly lie, but does use words in ways that generate an impression that differs from reality. For example deposits are really the property of a depositor, but the Fed defines over 90% of the depositors money as excess reserves and permits them to be loaned to another borrower.

Also, if people understood how easily the government and banks create money, they would have less confidence in its value, and ask more questions about the resulting inflation (or deflation when the supply shrinks).

Here is the full, more deliberately convoluted, process used:

[Slide 3]



## The Open Market Committee

The Federal Reserve's Open Market Committee has the most control over the quantity of money in circulation. This control is not absolute, but rather like an enabling feature that permits banks to lend more if they have qualified customers who want to borrow the money.

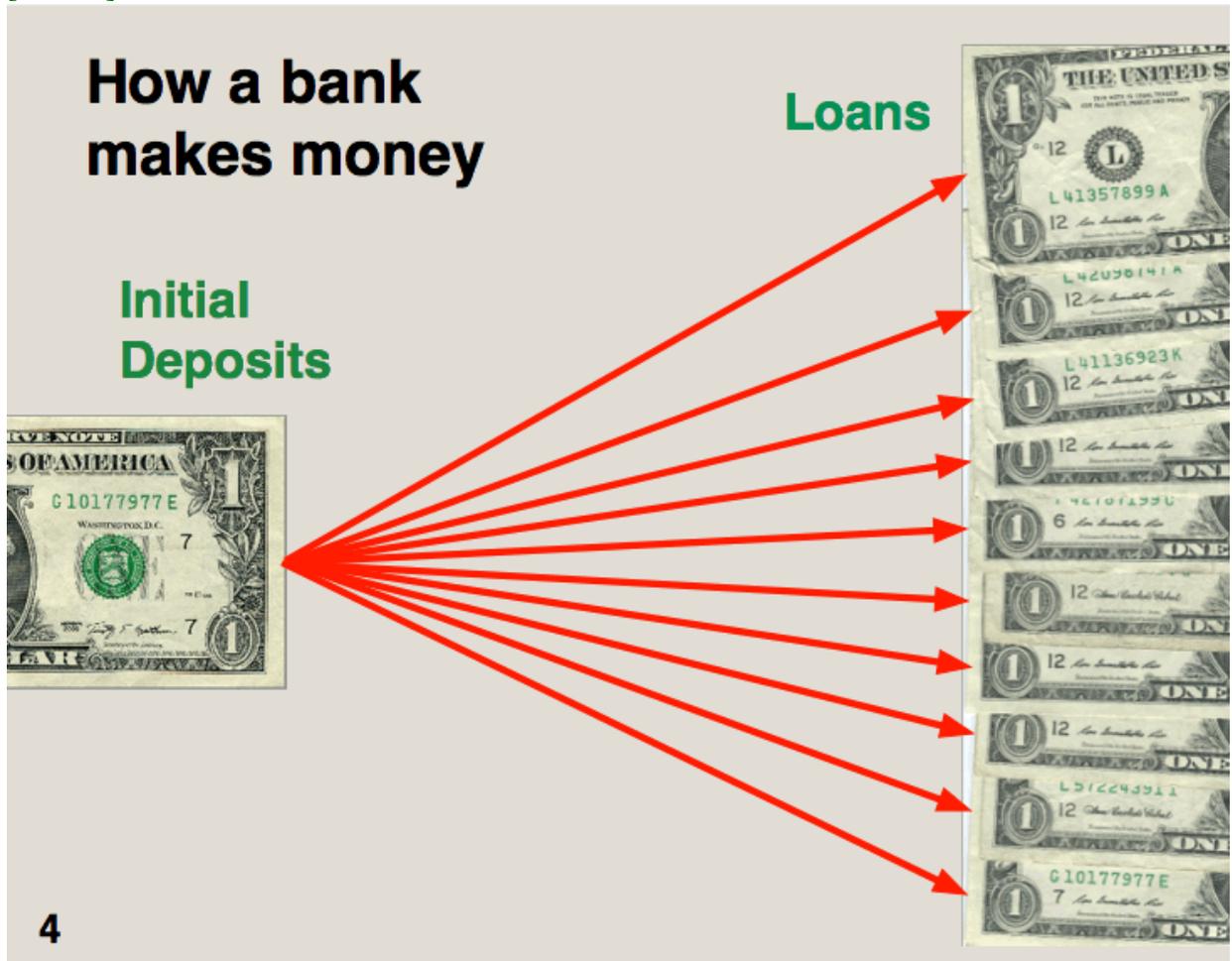
In the following, we follow a paper trail to make the process more transparent. However in the modern age this process is now carried out electronically. The difference is higher speed and lower transaction cost. It does not affect the process.

The steps in expanding the money supply:

- The Federal Government's Treasury prints up a pretty piece of paper saying it will pay a certain number of dollars (say \$2 billion) with specific interest (possibly 4% annually) after a given period (eg. 10 years). They sell many to the public, but we are concerned only with those "purchased" by the Fed.
- The Fed prints up a pretty Federal Reserve Note (a much bigger denomination than the ones in your wallet) in the appropriate amount to "buy" the bond and sends it to the Treasury.
- The government endorses the Fed Note and deposits it in one of the Federal Reserve's 12 Regional branches.
- The government then draws dollars from the Federal Reserve against that deposit to pay its bills. Note that money is spent for real goods and services. Once the dollars are spent by the government, these unsupported dollars are indistinguishable from any others in circulation.
- The folks that receive the resulting checks deposit them in banks and other institutions. Let's say one supplier receives a check for a million dollars which he deposits in Bank AA.
- In Fed speak those deposits are then classified as reserves, so Bank AA now has a million dollars more reserves. Applying the Reserve Ratio, let's assume 10%, \$900,000 of those reserves are called Excess Reserves and are the basis for creating a loan of \$900,000.
- Borrowers, or the ultimate recipients of the borrower's purchases, deposit the funds in a bank. Let's say they all deposit in Bank BB.
- Bank BB has received \$900,000 in deposits which with a little fairy dust becomes \$810,000 in Excess Reserves to justify a loaning \$810,000.

- These last two steps are repeated until the total money created (with the initial Fed payment to the government) can be 10 times the government bond.

[Slide 4]



## How a bank makes money.

The real business of a bank is loaning money at interest. Therefore injecting new money and permitting them to loan 10 times their deposits (which they already owe to the depositor) puts them in the position to make a lot of loans.

Note: A bank need put up none of its own money to make the loan. The cost of these loans to the bank is merely the interest paid (if any) for any deposit, which becomes Reserves to fulfill the Feds Reserve Ratio.

My bank currently pays nothing for most demand deposits (checking accounts) and less than 0.2% for savings less than \$25,000.

The money comes into existence (it is generated by a notation on a bank account) when it is borrowed (because the money on deposit is being held for someone else). Likewise it goes out of existence when it is repaid to a bank.

The danger to the bank occurs when a borrower defaults. Then the bank is faced with real money and no loan to offset it. If enough defaults occur the bank will deplete its own capital and be declared insolvent and closed or merged by the Fed. Obviously, banks are very reluctant to declare a borrower in default.

An occasional very conservative bank, like the Cuddy's (now called National Bank of Alaska, may only use 75% of their reserves (rather than 90%). This limits their expansion of the money supply to about 9 times the government borrowings rather than 10. Few banks are willing to forego the extra income, so many loan up to their limit.

When eight Alaska banks became insolvent in the late 1980's Cuddy's bank, with its conservative lending, was one of three survivors.

Banking can be risky, but with caution and frugal operations, it can be very profitable.

[Slide 5]

## **A few final points**

- **The Federal Reserve creates money for the federal government to spend out of thin air.**
- **When spent, that money creates deposits in commercial banks permitting them to loan 9 times as much money as was deposited.**
- **Money is created when a loan is made.**
- **Money disappears when a loan is paid.**
- **The money created by these loans reduces the value of every dollar you own.**
- **In 100 years of theft, the Fed has reduced the value of every dollar by about 97%.**

**5**

In conclusion, I would like to summarize a few points:

- 1) When it desires to expand the money supply, the Fed buys U.S. Treasury bonds with phantom money.
- 2) When the treasury spends the money, the recipients put it their bank.
- 3) The banks treat it as reserves and can loan 9 times as much money as was originally deposited.
- 4) Money is created when a loan is made.
- 5) Money vanishes when a loan is paid.
- 6) These additional dollars dilute the value of every dollar you own or have contracted for.
- 7) This dilution is called inflation and it has averaged about 3.5% per year for the last 100 years leading to the dollar's loss of 97 % of its value.
- 8) Inflation does not measure all of the theft, since with a steady supply of money, increases in productivity translate into lower prices.

Our elected federal politician's love the Fed because they get to spend money that they have not had to raise with taxes. Almost none of their constituents blame them for the Fed's theft. And almost none of them would like the extra taxes necessary to fund our current government!

Stealing 3.5% of your money every year must be tolerable, because the American people have not risen up to abolish the Federal Reserve System.

Thank you for your attention!