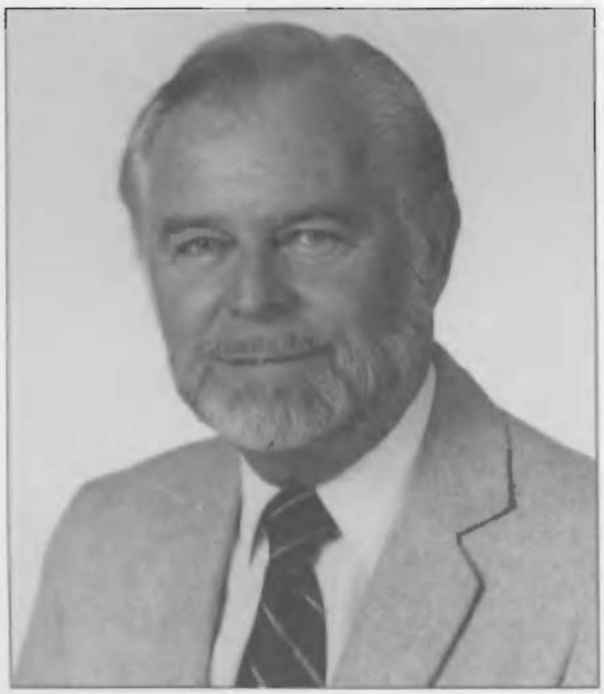
The Creature from Jekyll Island

by G. Edward Griffin

A Second Look at the Federal Reserve

ABOUT THE COVER

The use of the Great Seal of the United States is not without significance. At first we contemplated having an artist change the eagle into a vulture. That, we thought, would attract attention and also make a statement. Upon reflection, however, we realized that the vulture is really harmless. It may be ugly, but it is a scavenger, not a killer. The eagle, on the other hand, is a predator. It is a regal creature to behold, but it is deadly to its prey. Furthermore, as portrayed on the dollar, it is protected by the shield of the United States government even though it is independent of it. Finally, it holds within its grasp the choice between peace or war. The parallels were too great to ignore. We decided to keep the eagle.



G. Edward Griffin is a writer and documentary film producer with many successful titles to his credit. Listed in *Who's Who in America*, he is well known because of his talent for researching difficult topics and presenting them in clear terms that all can

(Continued on inside of back cover)

Where does money come from? Where does it go? Who makes it? The money magicians' secrets are unveiled. Here is a close look at their mirrors and smoke machines, the pulleys, cogs, and wheels that create the grand illusion called money.

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Dan Smoot
Publisher/Editor, Dan Smoot Report

"As a career banker and president of a bank consulting firm, I thought I had a good understanding of the Federal Reserve. But this book changed the way I view our entire monetary system."

Marilyn MacGruder Barnwall
Grand Junction, Colorado

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HOW TO READ THIS BOOK

Thick books can be intimidating. We tend to put off reading them until we have a suitably large block of time—which is to say, often they are never read. That is the reason a preview has been placed at the beginning and a summary at the end of each chapter. All of these together can be read in about one hour. Although they will not contain details nor documentation, they will cover the major points and will provide an overview of the complete story. The best way to read this book, therefore, is to begin with the previews of each section, followed by the chapter previews and summaries. Even if the reader is not in a hurry, this is still an excellent approach. A look at the map before the journey makes it easier to grapple with a topic such as this which spans so much history.

THE CREATURE FROM JEKYLL ISLAND

A Second Look at the Federal Reserve

Third edition

by G. Edward Griffin

American Media

Dedicated to the next generation–especially my own brood:
James, Daniel, Ralph, and Kathleen.
May this effort help to build for them a better world.

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What is the Federal Reserve System? The answer may surprise you. It is not federal and there are no reserves. Furthermore, the Federal Reserve Banks are not even banks. The key to this riddle is to be found, not at the beginning of the story, but in the middle. Since this is not a textbook, we are not confined to a chronological structure. The subject matter is not a curriculum to be mastered but a mystery to be solved. So let us start where the action is.

The eight chapters contained in this and the following section deal with material that is organized by topic, not chronology. Several of them will jump ahead of events that are not covered until later. Furthermore, the scope is such that the reader may wonder what, if any, is the connection with the Federal Reserve System. Please be patient. The importance will eventually become clear. It is the author's intent to cover concepts and principles before looking at events. Without this background, the history of the Federal Reserve is boring. *With* it, the story emerges as an exciting drama which profoundly affects our lives today. So let us begin this adventure with a few discoveries about the nature of money itself.

PREFACE

Does the world really need another book on the Federal Reserve System?

I have struggled with that question for several years. My own library is mute testimony to the fact that there has been no shortage of writers willing to set off into the dark forest to do battle with the evil dragon. But, for the most part, their books have been ignored by the mainstream, and the giant snorter remains undaunted in his lair. There seemed to be little reason to think that I could succeed where so many others have failed.

Yet, the idea was haunting. There was no doubt in my mind that the Federal Reserve is one of the most dangerous creatures ever to stalk our land. Furthermore, as my probing brought me into contact with more and more hard data, I came to realize that I was investigating one of the greatest "who-dunits" of history. And, to make matters worse, I discovered who did it.

Someone has to get this story through to the public. The problem, however, is that the public doesn't want to *hear* it. After all, this is bad news, and we certainly get enough of that as it is.

Another obstacle to communication is that this tale truly is incredible, which means *unbelievable*. The magnitude by which reality deviates from the accepted myth is so great that, for most people, it simply is beyond credibility. Anyone carrying this message is immediately suspected of paranoia. Who will listen to a madman?

And, finally, there is the subject matter itself. It can become pretty complex. Well, at least that's how it seems at first. Treatises on this topic often read like curriculum textbooks for banking and finance. It is easy to become ensnared in a sticky web of terminology and abstractions. Only monetary professionals are motivated to master the new language, and even they often find themselves in serious disagreement. For example, in a recent letter circulated by a group of monetary experts who, for years, have conducted an ongoing exchange of ideas regarding monetary reform, the editor said: "It is frustrating that we cannot find more agreement among ourselves on this vital issue. We seem to differ so much on definitions and on, really, an

unbiased, frank, honest, correct understanding of just how our current monetary system does function."

So why am I now making my own charge into the dragon's teeth? It's because I believe there is a definite change in the wind of public attitude. As the gathering economic storm draws nearer, more and more people will tune into the weather report—even if it *is* bad news. Furthermore, the evidence of the truth of this story is now so overpowering that I trust my readers will have no choice but to accept it, all questions of sanity aside. If the village idiot says the bell has fallen from the steeple and comes dragging the bell behind him, well,...

Lastly, I have discovered that this subject is not as complicated as it first appeared to be, and I am resolved to avoid the pitfall of trodding the usual convoluted path. What follows, therefore, will be the story of a crime, not a course on criminology.

It was intended that this book would be half its present size and be completed in about one year. From the beginning, however, it took on a life force of its own, and I became but a servant to its will. It refused to stay within the confines prescribed and, like the genie released from its bottle, grew to enormous size. When the job was done and it was possible to assess the entire manuscript, I was surprised to realize that *four* books had been written instead of one.

First, there is a crash course on money, the basics of banking and currency. Without that, it would be impossible to understand the fraud that now passes for acceptable practice within the banking system.

Second, there is a book on how the world's central banks—the Federal Reserve being one of them—are catalysts for war. That is what puts real fire into the subject, because it shows that we are dealing, not with mere money, but with blood, human suffering, and freedom itself.

Third, there is a history of central banking in America. That is essential to a realization that the *concept* behind the Federal Reserve was tried *three times* before in America. We need to know that and especially need to know why those institutions were eventually junked.

Finally, there is an analysis of the Federal Reserve itself and its dismal record since 1913. This is probably the least important part of all, but it is the reason we are here. It is the least important, not because the subject lacks significance, but because it has been written before by writers far more qualified and more skilled than I. As mentioned previously, however, those volumes generally have remained unread except by technical historians, and the Creature has continued to dine upon its hapless victims.

There are seven discernible threads that are woven throughout the fabric of this study. They represent the reasons for abolition of the Federal Reserve System. When stated in their purest form, without embellishment or explanation, they sound absurd to the casual observer. It is the purpose of this book, however, to show that these statements are all-too-easy to substantiate.

The Federal Reserve System should be abolished for the following reasons:

- It is incapable of accomplishing its stated objectives. (Chapter 1.)
- It is a cartel operating against the public interest. (Chapter 3.)
- It is the supreme instrument of usury. (Chapter 10.)
- It generates our most unfair tax. (Chapter 10.)
- It encourages war. (Chapter 14.)
- It destabilizes the economy. (Chapter 23.)
- It is an instrument of totalitarianism. (Chapters 5 and 26.)

This is a story about limitless money and hidden global power. The good news is that it is as fascinating as any work of fiction could be, and this, I trust, will add both pleasure and excitement to the learning process.

The bad news is that every detail of what follows is true.

G. Edward Griffin

ACKNOWLEDGMENTS

A writer who steals the work of another is called a plagiarist. One who takes from the works of *many* is called a researcher. That is a roundabout way of saying I am deeply indebted to the efforts of so many who have previously grappled this topic. It is impossible to acknowledge them except in footnote and bibliography. Without the cumulative product of their efforts, it would have taken a lifetime to pull together the material you are about to read.

In addition to the historical facts, however, there are numerous concepts which, to the best of my knowledge, are not to be found in prior literature. Primary among these are the formulation of certain "natural laws" which, it seemed to me, were too important to leave buried beneath the factual data. You will easily recognize these and other editorial expressions as the singular product of my own perceptions for which no one else can be held responsible.

I would like to give special thanks to Myril Creer and Jim Toft for having first invited me to give a lecture on this subject and, thus, forcing me to delve into it at some depth; and to Herb Joiner for encouraging me, after the speech, to "take it on the road." This book is the end result of a seven-year journey that began with those first steps. Wayne C. Rickert deserves a special medal for his financial support to get the project started and for his incredible patience while it crawled toward completion. Thanks to Bill Jasper for providing copies of numerous hard-to-locate documents. Thanks, also, to Linda Perlstein and Melinda Wiman for keeping my business enterprises functioning during my preoccupation with this project. And a very personal thanks to my wife, Patricia, for putting up with my periods of long absence while completing the manuscript, for meticulous proofreading, and for a most perceptive critique of its development along the way.

Finally, I would like to acknowledge those readers of the first three printings who have assisted in the refinement of this work. Because of their efforts most of the inevitable errata have been corrected for the second edition. Even so, it would be foolhardy to think that there are no more errors within the following pages. I have tried to be meticulous with even the smallest detail, but one cannot harvest such a huge crop without dropping a few seeds. Therefore, corrections and suggestions from new readers are sincerely invited. In my supreme optimism, I would like to think that they will be incorporated into *future* editions of this book.

INTRODUCTION

The following exchange was published in the British humor magazine, *Punch*, on April 3, 1957. It is reprinted here as an appropriate introduction and as a mental exercise to limber the mind for the material contained in this book.

Q. What are banks for?

A. To make money.

Q. For the customers?

A. For the banks.

Q. Why doesn't bank advertising mention this?

A. It would not be in good taste. But it is mentioned by implication in references to reserves of $249,000,000 or thereabouts. That is the money that they have made.

Q. Out of the customers?

A. I suppose so.

Q. They also mention Assets of $500,000,000 or thereabouts. Have they made that too?

A. Not exactly. That is the money they use to make money.

Q. I see. And they keep it in a safe somewhere?

A. Not at all. They lend it to customers.

Q. Then they haven't got it?

A. No.

Q. Then how is it Assets?

A. They maintain that it would be if they got it back.

Q. But they must have some money in a safe somewhere?

A. Yes, usually $500,000,000 or thereabouts. This is called Liabilities.

Q. But if they've got it, how can they be liable for it?

A. Because it isn't theirs.

Q. Then why do they have it?

A. It has been lent to them by customers.

Q. You mean customers lend banks money?

A. In effect. They put money into their accounts, so it is really lent to the banks.

Q. And what do the banks do with it?

A. Lend it to other customers.

Q. But you said that money they lent to other people was Assets?

A. Yes.

Q. Then Assets and Liabilities must be the same thing?

A. You can't really say that.

Q. But you've just said it. If I put $100 into my account the bank is liable to have to pay it back, so it's Liabilities. But they go and lend it to someone else, and he is liable to have to pay it back, so it's Assets. It's the same $100, isn't it?

A. Yes. But ...

Q. Then it cancels out. It means, doesn't it, that banks haven't really any money at all?

A. Theoretically....

Q. Never mind theoretically. And if they haven't any money, where do they get their Reserves of $249,000,000 or thereabouts?

A. I told you. That is the money they have made.

Q. How?

A. Well, when they lend your $100 to someone they charge him interest.

Q. How much?

A. It depends on the Bank Rate. Say five and a-half per cent. That's their profit.

Q. Why isn't it my profit? Isn't it my money?

A. It's the theory of banking practice that ...

Q. When I lend them my $100 why don't I charge them interest?

A. You do.

Q. You don't say. How much?

A. It depends on the Bank Rate. Say half a per cent.

Q. Grasping of me, rather?

A. But that's only if you're not going to draw the money out again.

Q. But of course, I'm going to draw it out again. If I hadn't wanted to draw it out again I could have buried it in the garden, couldn't I?

A. They wouldn't like you to draw it out again.

Q. Why not? If I keep it there you say it's a Liability. Wouldn't they be glad if I reduced their Liabilities by removing it?

A. No. Because if you remove it they can't lend it to anyone else.

Q. But if I wanted to remove it they'd have to let me?

A. Certainly.

Q. But suppose they've already lent it to another customer?

A. Then they'll let you have someone else's money.

Q. But suppose he wants his too ... and they've let me have it?

A. You're being purposely obtuse.

Q. I think I'm being acute. What if everyone wanted their money at once?

A. It's the theory of banking practice that they never would.

Q. So what banks bank on is not having to meet their commitments?

A. I wouldn't say that.

Q. Naturally. Well, if there's nothing else you think you can tell me ...?

A. Quite so. Now you can go off and open a banking account.

Q. Just one last question.

A. Of course.

Q. Wouldn't I do better to go off and open up a bank?

Section I

WHAT CREATURE IS THIS?

What is the Federal Reserve System? The answer may surprise you. It is not federal and there are no reserves. Furthermore, the Federal Reserve Banks are not even banks. The key to this riddle is to be found, not at the beginning of the story, but in the middle. Since this is not a textbook, we are not confined to a chronological structure. The subject matter is not a curriculum to be mastered but a mystery to be solved. So let us start where the action is.

Chapter One

THE JOURNEY TO JEKYLL ISLAND

The secret meeting on Jekyll Island in Georgia at which the Federal Reserve was conceived; the birth of a banking cartel to protect its members from competition; the strategy of how to convince Congress and the public that this cartel was an agency of the United States government.

The New Jersey railway station was bitterly cold that night. Flurries of the year's first snow swirled around street lights. November wind rattled roof panels above the track shed and gave a long, mournful sound among the rafters.

It was approaching ten P.M., and the station was nearly empty except for a few passengers scurrying to board the last Southbound of the day. The rail equipment was typical for that year of 1910, mostly chair cars that converted into sleepers with cramped upper and lower berths. For those with limited funds, coach cars were coupled to the front. They would take the brunt of the engine's noise and smoke that, somehow, always managed to seep through unseen cracks. A dining car was placed between the sections as a subtle barrier between the two classes of travelers. By today's standards, the environment was drab. Chairs and mattresses were hard. Surfaces were metal or scarred wood. Colors were dark green and gray.

In their hurry to board the train and escape the chill of the wind, few passengers noticed the activity at the far end of the platform. At a gate seldom used at this hour of the night was a spectacular sight. Nudged against the end-rail bumper was a long car that caused those few who saw it to stop and stare. Its gleaming black paint was accented with polished brass hand rails, knobs, frames, and filigrees. The shades were drawn, but through the open door, one could see mahogany paneling, velvet drapes, plush armchairs, and a well stocked bar. Porters with white serving coats were busying themselves with routine chores. And there was the distinct aroma of expensive cigars. Other cars in the station bore numbers on each end to distinguish them from their dull brothers. But numbers were not needed for this beauty. On the center of each side was a small plaque bearing but a single word: ALDRICH.

The name of Nelson Aldrich, senator from Rhode Island, was well known even in New Jersey. By 1910, he was one of the most powerful men in Washington, D.C., and his private railway car often was seen at the New York and New Jersey rail terminals during frequent trips to Wall Street. Aldrich was far more than a senator. He was considered to be the political spokesman for big business. As an investment associate of J.P. Morgan, he had extensive holdings in banking, manufacturing, and public utilities. His son-in-law was John D. Rockefeller, Jr. Sixty years later, his grandson, Nelson Aldrich Rockefeller, would become Vice-President of the United States.

When Aldrich arrived at the station, there was no doubt he was the commander of the private car. Wearing a long, fur-collared coat, a silk top hat, and carrying a silver-tipped walking stick, he strode briskly down the platform with his private secretary, Shelton, and a cluster of porters behind them hauling assorted trunks and cases.

No sooner had the Senator boarded his car when several more passengers arrived with similar collections of luggage. The last man appeared just moments before the final "aaall aboarrrd." He was carrying a shotgun case.

While Aldrich was easily recognized by most of the travelers who saw him stride through the station, the other faces were not familiar. These strangers had been instructed to arrive separately, to avoid reporters, and, should they meet inside the station, to pretend they did not know each other. After boarding the train, they had been told to use first names only so as not to reveal each other's identity. As a result of these precautions, not even the private-car porters and servants knew the names of these guests.

Back at the main gate, there was a double blast from the engine's whistle. Suddenly, the gentle sensation of motion; the excitement of a journey begun. But, no sooner had the train cleared the platform when it shuttered to a stop. Then, to everyone's surprise, it reversed direction and began moving toward the station

again. Had they forgotten something? Was there a problem with the engine?

A sudden lurch and the slam of couplers gave the answer. They had picked up another car at the end of the train. Possibly the mail car? In an instant the forward motion was resumed, and all thoughts returned to the trip ahead and to the minimal comforts of the accommodations.

And so, as the passengers drifted off to sleep that night to the rhythmic clicking of steel wheels against rail, little did they dream that, riding in the car at the end of their train, were seven men who represented an estimated one-fourth of the total wealth of the entire world.

This was the roster of the Aldrich car that night:

1. Nelson W. Aldrich, Republican "whip" in the Senate, Chairman of the National Monetary Commission, business associate of J.P. Morgan, father-in-law to John D. Rockefeller, Jr.;
2. Abraham Piatt Andrew, Assistant Secretary of the United States Treasury;
3. Frank A. Vanderlip, president of the National City Bank of New York, the most powerful of the banks at that time, representing William Rockefeller and the international investment banking house of Kuhn, Loeb & Company;
4. Henry P. Davison, senior partner of the J.P. Morgan Company;
5. Charles D. Norton, president of J.P. Morgan's First National Bank of New York;
6. Benjamin Strong, head of J.P. Morgan's Bankers Trust Company;[1] and
7. Paul M. Warburg, a partner in Kuhn, Loeb & Company, a representative of the Rothschild banking dynasty in England and France, and brother to Max Warburg who was head of the Warburg banking consortium in Germany and the Netherlands.

1. In private correspondence between the author and Andrew L. Gray, the Grand Nephew of Abraham P. Andrew, Mr. Gray claims that Strong was not in attendance. On the other hand, Frank Vanderlip—who was there—says in his memoirs that he was. How could Vanderlip be wrong? Gray's response: "He was in his late seventies when he wrote the book and the essay in question.... Perhaps the wish was father to the thought." If Vanderlip truly was in error, it was perhaps not so significant after all because, as Gray admits: "Strong would have been among those few to be let in on the secret." In the absence of further confirmation to the contrary, we are compelled to accept Vanderlip's account.

CONCENTRATION OF WEALTH

Centralization of control over financial resources was far advanced by 1910. In the United States, there were two main focal points of this control: the Morgan group and the Rockefeller group. Within each orbit was a maze of commercial banks, acceptance banks, and investment firms. In Europe, the same process had proceeded even further and had coalesced into the Rothschild group and the Warburg group. An article appeared in the *New York Times* on May 3, 1931, commenting on the death of George Baker, one of Morgan's closest associates. It said: "One-sixth of the total wealth of the world was represented by members of the Jekyll Island Club." The reference was only to those in the Morgan group, (members of the Jekyll Island Club). It did not include the Rockefeller group or the European financiers. When all of these are combined, the previous estimate that one-fourth of the world's wealth was represented by these groups is probably conservative.

In 1913, the year that the Federal Reserve Act became law, a subcommittee of the House Committee on Currency and Banking, under the chairmanship of Arsene Pujo of Louisiana, completed its investigation into the concentration of financial power in the United States. Pujo was considered to be a spokesman for the oil interests, part of the very group under investigation, and did everything possible to sabotage the hearings. In spite of his efforts, however, the final report of the committee at large was devastating:

> Your committee is satisfied from the proofs submitted ... that there is an established and well defined identity and community of interest between a few leaders of finance ... which has resulted in great and rapidly growing concentration of the control of money and credit in the hands of these few men....
>
> Under our system of issuing and distributing corporate securities the investing public does not buy directly from the corporation. The securities travel from the issuing house through middlemen to the investor. It is only the great banks or bankers with access to the mainsprings of the concentrated resources made up of other people's money, in the banks, trust companies, and life insurance companies, and with control of the machinery for creating markets and distributing securities, who have had the power to underwrite or guarantee the sale of large-scale security issues. The men who through their control over the funds of our railroad and industrial companies are able to direct where such funds shall be kept, and thus to create these great reservoirs of the people's money are the ones who are in a position to tap those reservoirs for the ventures in which they are interested and to prevent their being tapped for purposes which they do *not* approve....
>
> When we consider, also, in this connection that into these reservoirs of money and credit there flow a large part of the reserves of the banks of the country, that they are also the agents and correspondents of the out-of-town banks in the loaning of their surplus funds in the only public money market of the country, and that a small group of men and their partners and associates have now further strengthened their hold upon the resources of these institutions by acquiring large stock holdings therein, by representation on their boards and through valuable patronage, we begin to realize something of the extent to which this practical and effective domination and control over our greatest financial, railroad and industrial corporations has developed, largely within the past five years, and that it is fraught with peril to the welfare of the country.[1]

Such was the nature of the wealth and power represented by those seven men who gathered in secret that night and travelled in the luxury of Senator Aldrich's private car.

DESTINATION JEKYLL ISLAND

As the train neared its destination of Raleigh, North Carolina, the next afternoon, it slowed and then stopped in the switching yard just outside the station terminal. Quickly, the crew threw a switch, and the engine nudged the last car onto a siding where, just as quickly, it was uncoupled and left behind. When passengers stepped onto the platform at the terminal a few moments later, their train appeared exactly as it had been when they boarded. They could not know that their travelling companions for the night, at that very instant, were joining still another train which, within the hour, would depart Southbound once again.

The elite group of financiers was embarked on a thousand-mile journey that led them to Atlanta, then to Savannah and, finally, to the small town of Brunswick, Georgia. At first, it would seem that Brunswick was an unlikely destination. Located on the Atlantic seaboard, it was primarily a fishing village with a small but lively port for cotton and lumber. It had a population of only a few thousand people. But, by that time, the Sea Islands that sheltered

1. Herman E. Krooss, ed., *Documentary History of Currency and Banking in the United States* (New York: Chelsea House, 1983), Vol. III, "Final Report from the Pujo Committee, February 28, 1913," pp. 222-24.

the coast from South Carolina to Florida already had become popular as winter resorts for the very wealthy. One such island, just off the coast of Brunswick, had recently been purchased by J.P. Morgan and several of his business associates, and it was here that they came in the fall and winter to hunt ducks or deer and to escape the rigors of cold weather in the North. It was called Jekyll Island.

When the Aldrich car was uncoupled onto a siding at the small Brunswick station, it was, indeed, conspicuous. Word travelled quickly to the office of the town's weekly newspaper. While the group was waiting to be transferred to the dock, several people from the paper approached and began asking questions. Who were Mr. Aldrich's guests? Why were they here? Was there anything special happening? Mr. Davison, who was one of the owners of Jekyll Island and who was well known to the local paper, told them that these were merely personal friends and that they had come for the simple amusement of duck hunting. Satisfied that there was no real news in the event, the reporters returned to their office.

Even after arrival at the remote island lodge, the secrecy continued. For nine days the rule for first-names-only remained in effect. Full-time caretakers and servants had been given vacation, and an entirely new, carefully screened staff was brought in for the occasion. This was done to make absolutely sure that none of the servants might recognize by sight the identities of these guests. It is difficult to imagine any event in history—including preparation for war—that was shielded from public view with greater mystery and secrecy.

The purpose of this meeting on Jekyll Island was not to hunt ducks. Simply stated, it was to come to an agreement on the structure and operation of a banking cartel. The goal of the cartel, as is true with all of them, was to maximize profits by minimizing competition between members, to make it difficult for new competitors to enter the field, and to utilize the police power of government to enforce the cartel agreement. In more specific terms, the purpose and, indeed, the actual outcome of this meeting was to create the blueprint for the Federal Reserve System.

THE STORY IS CONFIRMED

For many years after the event, educators, commentators, and historians denied that the Jekyll Island meeting ever took place. Even now, the accepted view is that the meeting was relatively

unimportant, and only paranoid unsophisticates would try to make anything out of it. Ron Chernow writes: "The Jekyll Island meeting would be the fountain of a thousand conspiracy theories."[1] Little by little, however, the story has been pieced together in amazing detail, and it has come directly or indirectly from those who actually were there. Furthermore, if what they say about their own purposes and actions does not constitute a classic conspiracy, then there is little meaning to that word.

The first leak regarding this meeting found its way into print in 1916. It appeared in *Leslie's Weekly* and was written by a young financial reporter by the name of B.C. Forbes, who later founded *Forbes Magazine*. The article was primarily in praise of Paul Warburg, and it is likely that Warburg let the story out during conversations with the writer. At any rate, the opening paragraph contained a dramatic but highly accurate summary of both the nature and purpose of the meeting:

> Picture a party of the nation's greatest bankers stealing out of New York on a private railroad car under cover of darkness, stealthily hieing hundreds of miles South, embarking on a mysterious launch, sneaking on to an island deserted by all but a few servants, living there a full week under such rigid secrecy that the names of not one of them was once mentioned lest the servants learn the identity and disclose to the world this strangest, most secret expedition in the history of American finance.
>
> I am not romancing. I am giving to the world, for the first time, the real story of how the famous Aldrich currency report, the foundation of our new currency system, was written.[2]

In 1930, Paul Warburg wrote a massive book—1750 pages in all—entitled *The Federal Reserve System, Its Origin and Growth*. In this tome, he described the meeting and its purpose but did not mention either its location or the names of those who attended. But he did say: "The results of the conference were entirely confidential. Even the fact there had been a meeting was not permitted to become public." Then, in a footnote he added: "Though eighteen years have since gone by, I do not feel free to give a description of

1. Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Atlantic Monthly Press, 1990), p. 129.
2. "Men Who Are Making America," by B.C. Forbes, *Leslie's Weekly*, October 19, 1916, p. 423.

this most interesting conference concerning which Senator Aldrich pledged all participants to secrecy."[1]

An interesting insight to Paul Warburg's attendance at the Jekyll Island meeting came thirty-four years later, in a book written by his son, James. James had been appointed by F.D.R. as Director of the Budget and, during World War II, as head of the Office of War Information. In his book he described how his father, who didn't know one end of a gun from the other, borrowed a shotgun from a friend and carried it with him to the train to disguise himself as a duck hunter.[2]

This part of the story was corroborated in the official biography of Senator Aldrich, written by Nathaniel Wright Stephenson:

> In the autumn of 1910, six men [in addition to Aldrich] went out to shoot ducks. That is to say, they told the world that was their purpose. Mr. Warburg, who was of the number, gives an amusing account of his feelings when he boarded a private car in Jersey City, bringing with him all the accoutrements of a duck shooter. The joke was in the fact that he had never shot a duck in his life and had no intention of shooting any.... The duck shoot was a blind.[3]

Stephenson continues with a description of the encounter at Brunswick station. He tells us that, shortly after they arrived, the station master walked into the private car and shocked them by his apparent knowledge of the identities of everyone on board. To make matters even worse, he said that a group of reporters were waiting outside. Davison took charge. "Come outside, old man," he said, "and I will tell you a story." No one claims to know what story was told standing on the railroad ties that morning, but a few moments later Davison returned with a broad smile on his face. "It's all right," he said reassuringly. "They won't give us away."

Stephenson continues: "The rest is silence. The reporters dispersed, and the secret of the strange journey was not divulged. No one asked him how he managed it and he did not volunteer the information."[4]

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1. Paul Warburg, *The Federal Reserve System: Its Origin and Growth* (New York: Macmillan, 1930), Vol. I, p. 58. It is apparent that Warburg wrote this line two years before the book was published.
2. James Warburg, *The Long Road Home* (New York: Doubleday, 1964), p. 29.
3. Nathaniel Wright Stephenson, *Nelson W. Aldrich in American Politics* (New York: Scribners, 1930; rpt. New York: Kennikat Press, 1971), p. 373.
4. Stephenson, p. 376.

In the February 9, 1935, issue of the *Saturday Evening Post*, an article appeared written by Frank Vanderlip. In it he said:

> Despite my views about the value to society of greater publicity for the affairs of corporations, there was an occasion, near the close of 1910, when I was as secretive—indeed, as furtive—as any conspirator.... I do not feel it is any exaggeration to speak of our secret expedition to Jekyll Island as the occasion of the actual conception of what eventually became the Federal Reserve System....
>
> We were told to leave our last names behind us. We were told, further, that we should avoid dining together on the night of our departure. We were instructed to come one at a time and as unobtrusively as possible to the railroad terminal on the New Jersey littoral of the Hudson, where Senator Aldrich's private car would be in readiness, attached to the rear end of a train for the South....
>
> Once aboard the private car we began to observe the taboo that had been fixed on last names. We addressed one another as "Ben," "Paul," "Nelson," "Abe"—it is Abraham Piatt Andrew. Davison and I adopted even deeper disguises, abandoning our first names. On the theory that we were always right, he became Wilbur and I became Orville, after those two aviation pioneers, the Wright brothers....
>
> The servants and train crew may have known the identities of one or two of us, but they did not know all, and it was the names of all printed together that would have made our mysterious journey significant in Washington, in Wall Street, even in London. Discovery, we knew, simply must not happen, or else all our time and effort would be wasted. If it were to be exposed publicly that our particular group had got together and written a banking bill, that bill would have no chance whatever of passage by Congress.[1]

THE STRUCTURE WAS PURE CARTEL

The composition of the Jekyll Island meeting was a classic example of cartel structure. A cartel is a group of independent businesses which join together to coordinate the production, pricing, or marketing of their members. The purpose of a cartel is to reduce competition and thereby increase profitability. This is accomplished through a shared monopoly over their industry which forces the public to pay higher prices for their goods or services than would be otherwise required under free-enterprise competition.

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1. "From Farm Boy to Financier," by Frank A. Vanderlip, *The Saturday Evening Post*, Feb. 9, 1933, pp. 25, 70. The identical story was told two years later in Vanderlip's book bearing the same title as the article (New York: D. Appleton-Century Company, 1935), pp. 210–219.

Here were representatives of the world's leading banking consortia: Morgan, Rockefeller, Rothschild, Warburg, and Kuhn-Loeb. They were often competitors, and there is little doubt that there was considerable distrust between them and skillful maneuvering for favored position in any agreement. But they were driven together by one overriding desire to fight their common enemy. The enemy was competition.

In 1910, the number of banks in the United States was growing at a phenomenal rate. In fact, it had more than doubled to over twenty thousand in just the previous ten years. Furthermore, most of them were springing up in the South and West, causing the New York banks to suffer a steady decline of market share. Almost all banks in the 1880s were national banks, which means they were chartered by the federal government. Generally, they were located in the big cities, and were allowed by law to issue their own currency in the form of bank notes. Even as early as 1896, however, the number of non-national banks had grown to sixty-one per cent, and they already held fifty-four per cent of the country's total banking deposits. By 1913, when the Federal Reserve Act was passed, those numbers were seventy-one per cent non-national banks holding fifty-seven per cent of the deposits.[1] In the eyes of those duck hunters from New York, this was a trend that simply had to be reversed.

Competition also was coming from a new trend in industry to finance future growth out of profits rather than from borrowed capital. This was the outgrowth of free-market interest rates which set a realistic balance between debt and thrift. Rates were low enough to attract serious borrowers who were confident of the success of their business ventures and of their ability to repay, but they were high enough to discourage loans for frivolous ventures or those for which there were alternative sources of funding—for example, one's own capital. That balance between debt and thrift was the result of a limited money supply. Banks could create loans in excess of their actual deposits, as we shall see, but there was a *limit* to that process. And that limit was ultimately determined by the supply of gold they held. Consequently, between 1900 and 1910, seventy per cent of the funding for American corporate

1. See Gabriel Kolko, *The Triumph of Conservatism* (New York: The Free Press of Glencoe, a division of the Macmillan Co., 1963), p. 140.

growth was generated internally, making industry increasingly independent of the banks.[1] Even the federal government was becoming thrifty. It had a growing stockpile of gold, was systematically redeeming the Greenbacks—which had been issued during the Civil War—and was rapidly reducing the national debt.

Here was another trend that had to be halted. What the bankers wanted—and what many businessmen wanted also—was to intervene in the free market and tip the balance of interest rates downward, to favor debt over thrift. To accomplish this, the money supply simply had to be disconnected from gold and made more plentiful or, as they described it, more *elastic*.

THE SPECTER OF BANK FAILURE

The greatest threat, however, came, not from rivals or private capital formation, but from the public at large in the form of what bankers call a *run on the bank*. This is because, when banks accept a customer's deposit, they give in return a "balance" in his account. This is the equivalent of a promise to pay back the deposit anytime he wants. Likewise, when another customer *borrows* money from the bank, he *also* is given an account balance which usually is withdrawn immediately to satisfy the purpose of the loan. This creates a ticking time bomb because, at that point, the bank has issued more promises to "pay-on-demand" than it has money in the vault. Even though the depositing customer thinks he can get his money any time he wants, in reality it has been given to the *borrowing* customer and no longer is available at the bank.

The problem is compounded further by the fact that banks are allowed to loan even more money than they have received in deposit. The mechanism for accomplishing this seemingly impossible feat will be described in a later chapter, but it is a fact of modern banking that promises-to-pay often exceed savings deposits by a factor of ten-to-one. And, because only about three per cent of these accounts are actually retained in the vault in the form of cash—the rest having been put into even more loans and investments—the bank's promises exceed its ability to *keep* those promises by a factor of over three hundred-to-one.[2] As long as only a small percentage

1. William Greider, *Secrets of the Temple* (New York: Simon and Schuster, 1987), p. 274, 275. Also Kolko, p. 145.
2. Another way of putting it is that their reserves are underfunded by over 33,333% (10-to-1 divided by .03 = 333.333-to-1. That divided by .01 = 33,333%.)

of depositors request their money at one time, no one is the wiser. But if public confidence is shaken, and if more than a few per cent attempt to withdraw their funds, the scheme is finally exposed. The bank cannot keep all its promises and is forced to close its doors. Bankruptcy usually follows in due course.

CURRENCY DRAINS

The same result could happen—and, prior to the Federal Reserve System, often did happen—even without depositors making a run on the bank. Instead of withdrawing their funds at the teller's window, they simply wrote checks to purchase goods or services. People receiving those checks took them to a bank for deposit. If that bank happened to be the same one from which the check was drawn, then all was well, because it was not necessary to remove any real money from the vault. But if the holder of the check took it to *another* bank, it was quickly passed back to the issuing bank and settlement was demanded *between banks.*

This is not a one-way street, however. While the Downtown Bank is demanding payment from the Uptown Bank, the Uptown Bank is also clearing checks and demanding payment from the Downtown bank. As long as the money flow in both directions is equal, then everything can be handled with simple bookkeeping. But if the flow is not equal, then one of the banks will have to actually send money to the other to make up the difference. If the amount of money required exceeds a few percentage points of the bank's total deposits, the result is the same as a run on the bank *by depositors.* This demand of money by other banks rather than by depositors is called a *currency drain.*

In 1910, the most common cause of a bank having to declare bankruptcy due to a currency drain was that it followed a loan policy that was more reckless than that of its competitors. More money was demanded from it because more money was *loaned* by it. It was dangerous enough to loan ninety per cent of their customers' savings (keeping only one dollar in reserve out of every ten), but that had proven to be adequate *most* of the time. Some banks, however, were tempted to walk even closer to the precipice. They pushed the ratio to ninety-*two* per cent, ninety-*five* per cent, ninety-*nine* per cent. After all, the way a bank makes money is to collect interest, and the only way to do that is to make *loans.* The more loans, the better. And, so, there was a practice among some of

the more reckless banks to "loan up," as they call it. Which was another way of saying to push *down* their reserve ratios.

A BANKERS' UTOPIA

If all banks could be forced to issue loans in the same ratio to their reserves as other banks did, then, regardless of how small that ratio was, the amount of checks to be cleared between them would balance in the long run. No major currency drains would ever occur. The entire banking industry might collapse under such a system, but not *individual* banks—at least not those that were part of the cartel. All would walk the same distance from the edge, regardless of how close it was. Under such uniformity, no individual bank could be blamed for failure to meet its obligations. The blame could be shifted, instead, to the "economy" or "government policy" or "interest rates" or "trade deficits" or the "exchange-value of the dollar" or even to the "capitalist system" itself.

But, in 1910, such a bankers' utopia had not yet been created. If the Downtown bank began to loan at a greater ratio to its reserves than its competitors, the amount of checks which would come back to it for payment also would be greater. Thus, the bank which pursued a more reckless lending policy had to draw *against* its reserves in order to make payments to the more conservative banks and, when those funds were exhausted, it usually was forced into bankruptcy.

Historian John Klein tells us that "The financial panics of 1873, 1884, 1893, and 1907 were in large part an outgrowth of … reserve pyramiding and excessive deposit creation by reserve city … banks. These panics were triggered by the currency drains that took place in periods of relative prosperity when banks were loaned up."[1] In other words, the "panics" and resulting bank failures were caused, not by negative factors in the economy, but by *currency drains* on the banks which were *loaned up* to the point where they had practically no reserves at all. The banks did not fail because the system was weak. The system failed because the banks were weak.

This was another common problem that brought these seven men over a thousand miles to a tiny island off the shore of Georgia. Each was a potentially fierce competitor, but uppermost in their minds were the so-called panics and the very real 1,748 bank

1. See Vera C. Smith, *The Rationale of Central Banking* (London: P.S. King & Son, 1936), p. 36.

failures of the preceding two decades. Somehow, they had to join forces. A method had to be devised to enable them to continue to make more promises to pay-on-demand than they could keep. To do this, they had to find a way to force all banks to walk the *same* distance from the edge, and, when the inevitable disasters happened, to shift public blame away from themselves. By making it appear to be a problem of the national economy rather than of private banking practice, the door then could be opened for the use of tax money rather than their own funds for paying off the losses.

Here, then, were the main challenges that faced that tiny but powerful group assembled on Jekyll Island:

1. How to stop the growing influence of small, rival banks and to insure that control over the nation's financial resources would remain in the hands of those present;
2. How to make the money supply more elastic in order to reverse the trend of private capital formation and to recapture the industrial loan market;
3. How to pool the meager reserves of the nation's banks into one large reserve so that all banks will be motivated to follow the same loan-to-deposit ratios. This would protect at least some of them from currency drains and bank runs;
4. Should this lead eventually to the collapse of the whole banking system, then how to shift the losses from the owners of the banks to the taxpayers.

THE CARTEL ADOPTS A NAME

Everyone knew that the solution to all these problems was a cartel mechanism that had been devised and already put into similar operation in Europe. As with all cartels, it had to be created by legislation and sustained by the power of government under the deception of protecting the consumer. The most important task before them, therefore, can be stated as objective number five:

5. How to convince Congress that the scheme was a measure to protect the public.

The task was a delicate one. The American people did not like the concept of a cartel. The idea of business enterprises joining together to fix prices and prevent competition was alien to the free-enterprise system. It could never be sold to the voters. But, if the word cartel was not used, if the venture could be described

with words which are emotionally neutral—perhaps even alluring—then half the battle would be won.

The first decision, therefore, was to follow the practice adopted in Europe. Henceforth, the cartel would operate as a *central bank*. And even that was to be but a generic expression. For purposes of public relations and legislation, they would devise a name that would avoid the word *bank* altogether and which would conjure the image of the federal government itself. Furthermore, to create the impression that there would be no concentration of power, they would establish regional branches of the cartel and make that a main selling point. Stephenson tells us: "Aldrich entered this discussion at Jekyll Island an ardent convert to the idea of a central bank. His desire was to transplant the system of one of the great European banks, say the Bank of England, bodily to America."[1] But political expediency required that such plans be concealed from the public. As John Kenneth Galbraith explained it: "It was his [Aldrich's] thought to outflank the opposition by having not one central bank but many. And the word bank would itself be avoided."[2]

With the exception of Aldrich, all of those present were bankers, but only one was an expert on the European model of a central bank. Because of this knowledge, Paul Warburg became the dominant and guiding mind throughout all of the discussions. Even a casual perusal of the literature on the creation of the Federal Reserve System is sufficient to find that he was, indeed, the cartel's mastermind. Galbraith says "... Warburg has, with some justice, been called the father of the system."[3] Professor Edwin Seligman, a member of the international banking family of J. & W. Seligman, and head of the Department of Economics at Columbia University, writes that "... in its fundamental features, the Federal Reserve Act is the work of Mr. Warburg more than any other man in the country."[4]

1. Stephenson, p. 378.
2. John Kenneth Galbraith, *Money: Whence It Came, Where It Went* (Boston: Houghton Mifflin, 1975), p. 122.
3. Galbraith, p. 123.
4. The Academy of Political Science, *Proceedings*, 1914, Vol. 4, No. 4, p. 387.

THE REAL DADDY WARBUCKS

Paul Moritz Warburg was a leading member of the investment banking firm of M.M. Warburg & Company of Hamburg, Germany, and Amsterdam, the Netherlands. He had come to the United States only nine years previously. Soon after arrival, however, and with funding provided mostly by the Rothschild group, he and his brother, Felix, had been able to buy partnerships in the New York investment banking firm of Kuhn, Loeb & Company, while continuing as partners in Warburg of Hamburg.[1] Within twenty years, Paul would become one of the wealthiest men in America with an unchallenged domination over the country's railroad system.

At this distance in history, it is difficult to appreciate the importance of this man. But some understanding may be had from the fact that the legendary character, Daddy Warbucks, in the comic strip *Little Orphan Annie*, was a contemporary commentary on the presumed benevolence of Paul Warburg, and the almost magic ability to accomplish good through the power of his unlimited wealth.

A third brother, Max Warburg, was the financial adviser of the Kaiser and became Director of the *Reichsbank* in Germany. This was, of course, a *central bank*, and it was one of the cartel models used in the construction of the Federal Reserve System. The *Reichsbank*, incidentally, a few years later would create the massive hyperinflation that occurred in Germany, wiping out the middle class and the entire German economy as well.

Paul Warburg soon became well known on Wall Street as a persuasive advocate for a central bank in America. Three years before the Jekyll Island meeting, he had published several pamphlets. One was entitled *Defects and Needs of Our Banking System*, and the other was *A Plan for A Modified Central Bank*. These attracted wide attention in both financial and academic circles and set the intellectual climate for all future discussions regarding banking legislation. In these treatises, Warburg complained that the American monetary system was crippled by its dependency on gold and government bonds, both of which were in limited supply. What America needed, he argued, was an *elastic* money supply that

1. Anthony Sutton, *Wall Street and FDR (New Rochelle, New York: Arlington House, 1975), p. 92.*

could be expanded and contracted to accommodate the fluctuating needs of commerce. The solution, he said, was to follow the German example whereby banks could create currency solely on the basis of "commercial paper," which is banker language for I.O.U.s from corporations.

Warburg was tireless in his efforts. He was a featured speaker before scores of influential audiences and wrote a steady stream of published articles on the subject. In March of that year, for example, *The New York Times* published an eleven-part series written by Warburg explaining and expounding what he called the Reserve Bank of the United States.[1]

THE MESSAGE WAS PLAIN FOR THOSE WHO UNDERSTOOD

Most of Warburg's writing and lecturing on this topic was eyewash for the public. To cover the fact that a central bank is merely a cartel which has been legalized, its proponents had to lay down a thick smoke screen of technical jargon focusing always on how it would supposedly benefit commerce, the public, and the nation; how it would lower interest rates, provide funding for needed industrial projects, and prevent panics in the economy. There was not the slightest glimmer that, underneath it all, was a master plan which was designed from top to bottom to serve private interests at the expense of the public.

This was, nevertheless, the cold reality, and the more perceptive bankers were well aware of it. In an address before the American Bankers Association the following year, Aldrich laid it out for anyone who was really listening to the meaning of his words. He said: "The organization proposed is not a bank, but a cooperative union of all the banks of the country for definite purposes."[2] Precisely. A *union* of banks.

Two years later, in a speech before that same group of bankers, A. Barton Hepburn of Chase National Bank was even more candid. He said: "The measure recognizes and adopts the principles of a central bank. Indeed, if it works out as the sponsors of the law hope, it will make all incorporated banks together joint owners of a

1. See J. Lawrence Laughlin, *The Federal Reserve Act: Its Origin and Problems* (New York: Macmillan, 1933), p. 9.
2. The full text of the speech is reprinted by Herman E. Krooss and Paul A. Samuelson, Vol. 3, p. 1202.

central dominating power."[1] And that is about as good a definition of a cartel as one is likely to find.

In 1914, one year after the Federal Reserve Act was passed into law, Senator Aldrich could afford to be less guarded in his remarks. In an article published in July of that year in a magazine called *The Independent*, he boasted: "Before the passage of this Act, the New York bankers could only dominate the reserves of New York. Now we are able to dominate the bank reserves of the entire country."

MYTH ACCEPTED AS HISTORY

The accepted version of history is that the Federal Reserve was created to stabilize our economy. One of the most widely-used textbooks on this subject says: "It sprang from the panic of 1907, with its alarming epidemic of bank failures: the country was fed up once and for all with the anarchy of unstable private banking."[2] Even the most naive student must sense a grave contradiction between this cherished view and the System's actual performance. Since its inception, it has presided over the crashes of 1921 and 1929; the Great Depression of '29 to '39; recessions in '53, '57, '69, '75, and '81; a stock market "Black Monday" in '87; and a 1000% inflation which has destroyed 90% of the dollar's purchasing power.[3]

Let us be more specific on that last point. By 1990, an annual income of $10,000 was required to buy what took only $1,000 in 1914.[4] That incredible loss in value was quietly transferred to the federal government in the form of hidden taxation, and the Federal Reserve System was the mechanism by which it was accomplished.

Actions have consequences. The consequences of wealth confiscation by the Federal-Reserve mechanism are now upon us. In the current decade, corporate debt is soaring; personal debt is greater than ever; both business and personal bankruptcies are at an all-time high; banks and savings and loan associations are failing in

1. Quoted by Kolko, *Triumph*, p. 235.
2. Paul A. Samuelson, *Economics*, 8th ed. (New York: McGraw-Hill, 1970), p. 272.
3. See "Money, Banking, and Biblical Ethics," by Ronald H. Nash, *Durell Journal of Money and Banking*, February, 1990.
4. When one considers that the income tax had just been introduced in 1913 and that such low figures were completely exempt, an income at that time of $1,000 actually was the equivalent of earning $15,400 now, before paying 35% taxes. When the amount now taken by state and local governments is added to the total bite, the figure is close to $20,000.

larger numbers than ever before; interest on the national debt is consuming half of our tax dollars; heavy industry has been largely replaced by overseas competitors; we are facing an international trade deficit for the first time in our history; 75% of downtown Los Angeles and other metropolitan areas is now owned by foreigners; and over half of our nation is in a state of economic recession.

FIRST REASON TO ABOLISH THE SYSTEM

That is the scorecard eighty years after the Federal Reserve was created supposedly to stabilize our economy! There can be no argument that the System has failed in its stated objectives. Furthermore, after all this time, after repeated changes in personnel, after operating under both political parties, after numerous experiments in monetary philosophy, after almost a hundred revisions to its charter, and after the development of countless new formulas and techniques, there has been more than ample opportunity to work out mere procedural flaws. It is not unreasonable to conclude, therefore, that the System has failed, not because it needs a new set of rules or more intelligent directors, but because *it is incapable of achieving its stated objectives.*

If an institution is incapable of achieving its objectives, there is no reason to preserve it—unless it can be altered in some way to change its capability. That leads to the question: *why* is the System incapable of achieving its stated objectives? The painful answer is: *those were never its true objectives.* When one realizes the circumstances under which it was created, when one contemplates the identities of those who authored it, and when one studies its actual performance over the years, it becomes obvious that the System is merely a cartel with a government facade. There is no doubt that those who run it are motivated to maintain full employment, high productivity, low inflation, and a generally sound economy. They are not interested in killing the goose that lays such beautiful golden eggs. But, when there is a conflict between the public interest and the private needs of the cartel—a conflict that arises almost daily—the public will be sacrificed. That is the nature of the beast. It is foolish to expect a cartel to act in any other way.

This view is not encouraged by Establishment institutions and publishers. It has become their apparent mission to convince the American people that the system is not *intrinsically* flawed. It merely has been in the hands of bumbling oafs. For example, William Greider was a former Assistant Managing Editor for *The Washington Post*. His book, *Secrets of The Temple*, was published in 1987 by Simon and Schuster. It was critical of the Federal Reserve because of its failures, but, according to Greider, these were not caused by any defect in the System itself, but merely because the economic factors are "sooo complicated" that the good men who have struggled to make the System work have just not yet been able to figure it all out. But, don't worry, folks, they're *working* on it! That is exactly the kind of powder-puff criticism which is acceptable in our mainstream media. Yet, Greider's own research points to an entirely different interpretation. Speaking of the System's origin, he says:

> As new companies prospered without Wall Street, so did the new regional banks that handled their funds. New York's concentrated share of bank deposits was still huge, about half the nation's total, but it was declining steadily. Wall Street was still "the biggest kid on the block," but less and less able to bully the others.
>
> This trend was a crucial fact of history, a misunderstood reality that completely alters the political meaning of the reform legislation that created the Federal Reserve. At the time, the conventional wisdom in Congress, widely shared and sincerely espoused by Progressive reformers, was that a government institution would finally harness the "money trust," disarm its powers, and establish broad democratic control over money and credit.... The results were nearly the opposite. The money reforms enacted in 1913, in fact, helped to preserve the status quo, to stabilize the old order. Money-center bankers would not only gain dominance over the new central bank, but would also enjoy new insulation against instability and their own decline. Once the Fed was in operation, the steady diffusion of financial power halted. Wall Street maintained its dominant position—and even enhanced it.[1]

Anthony Sutton, former Research Fellow at the Hoover Institution for War, Revolution and Peace, and also Professor of Economics at California State University, Los Angeles, provides a somewhat deeper analysis. He writes:

> Warburg's revolutionary plan to get American Society to go to work for Wall Street was astonishingly simple. Even today,... academic theoreticians cover their blackboards with meaningless equations, and the general public struggles in bewildered confusion with inflation and the coming credit collapse, while the quite simple explanation of

1. Greider, p. 275.

> the problem goes undiscussed and almost entirely uncomprehended. The Federal Reserve System is a legal private monopoly of the money supply operated for the benefit of the few under the guise of protecting and promoting the public interest.[1]

The real significance of the journey to Jekyll Island and the creature that was hatched there was inadvertently summarized by the words of Paul Warburg's admiring biographer, Harold Kellock:

> Paul M. Warburg is probably the mildest-mannered man that ever personally conducted a revolution. It was a bloodless revolution: he did not attempt to rouse the populace to arms. He stepped forth armed simply with an idea. And he conquered. That's the amazing thing. A shy, sensitive man, he imposed his idea on a nation of a hundred million people.[2]

SUMMARY

The basic plan for the Federal Reserve System was drafted at a secret meeting held in November of 1910 at the private resort of J.P. Morgan on Jekyll Island off the coast of Georgia. Those who attended represented the great financial institutions of Wall Street and, indirectly, Europe as well. The reason for secrecy was simple. Had it been known that rival factions of the banking community had joined together, the public would have been alerted to the possibility that the bankers were plotting an agreement in restraint of trade—which, of course, is exactly what they were doing. What emerged was a cartel agreement with five objectives: stop the growing competition from the nation's newer banks; obtain a franchise to create money out of nothing for the purpose of lending; get control of the reserves of all banks so that the more reckless ones would not be exposed to currency drains and bank runs; get the taxpayer to pick up the cartel's inevitable losses; and convince Congress that the purpose was to protect the public. It was realized that the bankers would have to become partners with the politicians and that the structure of the cartel would have to be a central bank. The record shows that the Fed has failed to achieve its stated objectives. That is because those were never its true goals. As a banking cartel, and in terms of the five objectives stated above, it has been an unqualified success.

1. Sutton, *Wall Street and F.D.R.*, p. 94.
2. Harold Kellock, "Warburg, the Revolutionist," *The Century Magazine*, May 1915, p. 79.


Jekyll Island Museum
Nelson W. Aldrich


UPI/Bettmann
Henry P. Davison (L) and Charles D. Norton (R)


Jekyll Island Museum
Abraham Piatt Andrew

The seven men who attended the secret meetining on Jekyll Island, where the Federal Reserve System was conceived, represented an estimated one-fourth of the total wealth of the entire world. They were:

1. Nelson W. Aldrich, Republican "whip" in the Senate, Chairman of the National Monetary Commission, father-in-law to John D. Rockefeller, Jr.;
2. Henry P. Davison, Sr. Partner of J.P. Morgan Company;
3. Charles D. Norton, Pres. of 1st National Bank of New York;
4. A. Piatt Andrew, Assistant Secretary of the Treasury;
5. Frank A. Vanderlip, President of the National City Bank of New York, representing William Rockefeller.
6. Benjamin Strong, head of J.P. Morgan's Bankers Trust Company, later to become head of the System;
7. Paul M. Warburg, a partner in Kuhn, Loeb & Company, representing the Rothschilds and Warburgs in Europe.


Jekyll Island Museum
Frank A. Vanderlip


UPI/Bettmann
Benjamin Strong


Jekyll Island Museum
Paul M. Warburg

Chapter Two

THE NAME OF THE GAME IS BAILOUT

The analogy of a spectator sporting event as a means of explaining the rules by which taxpayers are required to pick up the cost of bailing out the banks when their loans go sour.

It was stated in the previous chapter that the Jekyll Island group which conceived the Federal Reserve System actually created a national cartel which was dominated by the larger banks. It was also stated that a primary objective of that cartel was to involve the federal government as an agent for shifting the inevitable losses from the owners of those banks to the taxpayers. That, of course, is one of the more controversial assertions made in this book. Yet, there is little room for any other interpretation when one confronts the massive evidence of history since the System was created. Let us, therefore, take another leap through time. Having jumped to the year 1910 to begin this story, let us now return to the present era.

To understand how banking losses are shifted to the taxpayers, it is first necessary to know a little bit about how the scheme was designed to work. There are certain procedures and formulas which must be understood or else the entire process seems like chaos. It is as though we had been isolated all our lives on a South Sea island with no knowledge of the outside world. Imagine what it would then be like the first time we travelled to the mainland and witnessed a game of professional football. We would stare with incredulity at men dressed like aliens from another planet; throwing their bodies against each other; tossing a funny shaped object back and forth; fighting over it as though it were of great value, yet, occasionally kicking it out of the area as though it were worthless and despised; chasing each other, knocking each other to the ground and then walking away to regroup for another surge; all this with tens of thousand of spectators riotously shouting in unison for no apparent reason at all. Without a basic understanding that this was a game and without knowledge of the rules of that game, the event would appear as total chaos and universal madness.

The operation of our monetary system through the Federal Reserve has much in common with professional football. First, there are certain plays that are repeated over and over again with only minor variations to suit the special circumstances. Second, there are definite rules which the players follow with great precision. Third, there is a clear objective to the game which is uppermost in the minds of the players. And fourth, if the spectators are not familiar with that objective and if they do not understand the rules, they will never comprehend what is going on. Which, as far as monetary matters is concerned, is the common state of the vast majority of Americans today.

Let us, therefore, attempt to spell out in plain language what that objective is and how the players expect to achieve it. To demystify the process, we shall present an overview first. After the concepts are clarified, we then shall follow up with actual examples taken from the recent past.

The name of the game is *Bailout*. As stated previously, the objective of this game is to shift the inevitable losses from the owners of the larger banks to the taxpayers. The procedure by which this is accomplished is as follows:

RULES OF THE GAME

The game begins when the Federal Reserve System allows commercial banks to create checkbook money out of nothing. (Details regarding how this incredible feat is accomplished are given in chapter ten entitled The Mandrake Mechanism.) The banks derive profit from this easy money, not by spending it, but by lending it to others and collecting interest.

When such a loan is placed on the bank's books it is shown as an asset because it is earning interest and, presumably, someday will be paid back. At the same time an equal entry is made on the liability side of the ledger. That is because the newly created checkbook money now is in circulation, and most of it will end up in other banks which will return the canceled checks to the issuing bank for payment. Individuals may also bring some of this checkbook money back to the bank and request cash. The issuing bank, therefore, has a potential money pay-out liability equal to the amount of the loan asset.

When a borrower cannot repay and there are no assets which can be taken to compensate, the bank must write off that loan as a loss. However, since most of the money originally was created out of nothing and cost the bank nothing except bookkeeping overhead, there is little of tangible value that is actual lost. It is primarily a bookkeeping entry.

A bookkeeping loss can still be undesirable to a bank because it causes the loan to be removed from the ledger as an asset without a reduction in liabilities. The difference must come from the equity of those who own the bank. In other words, the loan asset is removed, but the money liability remains. The original checkbook money is still circulating out there even though the borrower cannot repay, and the issuing bank still has the obligation to redeem those checks. The only way to do this and balance the books once again is to draw upon the capital which was invested by the bank's stockholders or to deduct the loss from the bank's current profits. In either case, the owners of the bank lose an amount equal to the value of the defaulted loan. So, to *them*, the loss becomes very real. If the bank is forced to write off a large amount of bad loans, the amount could exceed the entire value of the owners' equity. When that happens, the game is over, and the bank is insolvent.

This concern would be sufficient to motivate most bankers to be very conservative in their loan policy, and in fact most of them do act with great caution when dealing with individuals and small businesses. But the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Deposit Loan Corporation now guarantee that massive loans made to large corporations and to other governments will not be allowed to fall entirely upon the bank's owners should those loans go into default. This is done under the argument that, if these corporations or banks are allowed to fail, the nation would suffer from vast unemployment and economic disruption. More on that in a moment.

THE PERPETUAL-DEBT PLAY

The end result of this policy is that the banks have little motive to be cautious and are protected against the effect of their own folly. The larger the loan, the better it is, because it will produce the greatest amount of profit with the least amount of effort. A single loan to a third-world country netting hundreds of millions of dollars in annual interest is just as easy to process—if not easier—than a loan for $50,000 to a local merchant on the shopping mall. If the interest is paid, it's gravy time. If the loan defaults, the federal government will "protect the public" and, through various mechanisms described shortly, will make sure that the banks continue to receive their interest.

The individual and the small businessman find it increasingly difficult to borrow money at reasonable rates, because the banks can make more money on loans to the corporate giants and to foreign governments. Also, the bigger loans are safer for the banks, because the government will make them good even if they default. There are no such guarantees for the small loans. The public will not swallow the line that bailing out the little guy is necessary to save the system. The dollar amounts are too small. Only when the figures become mind-boggling does the ploy become plausible.

It is important to remember that banks do not really want to have their loans repaid, except as evidence of the dependability of the borrower. They make a profit from interest *on* the loan, not repayment *of* the loan. If a loan is paid off, the bank merely has to find another borrower, and that can be an expensive nuisance. It is much better to have the existing borrower pay only the interest and *never* make payments on the loan itself. That process is called rolling over the debt. One of the reasons banks prefer to lend to governments is that they do not expect those loans ever to be repaid. When Walter Wriston was chairman of the Citicorp Bank in 1982, he extolled the virtue of the action this way:

> If we had a truth-in-Government act comparable to the truth-in-advertising law, every note issued by the Treasury would be obliged to include a sentence stating: "This note will be redeemed with the proceeds from an identical note which will be sold to the public when this one comes due."

When this activity is carried out in the United States, as it is weekly, it is described as a Treasury bill auction. But when basically the same process is conducted abroad in a foreign language, our news media usually speak of a country's "rolling over its debts." The perception remains that some form of disaster is inevitable. It is not.

To see why, it is only necessary to understand the basic facts of government borrowing. The first is that there are few recorded instances in history of government—any government—actually getting out of debt. Certainly in an era of $100-billion deficits, no one lending money to our Government by buying a Treasury bill expects that it will be paid at maturity in any way except by our Government's selling a new bill of like amount.[1]

THE DEBT ROLL-OVER PLAY

Since the system makes it profitable for banks to make large, unsound loans, that is the kind of loans which banks will make. Furthermore, it is predictable that most unsound loans eventually will go into default. When the borrower finally declares that he cannot pay, the bank responds by rolling over the loan. This often is stage managed to appear as a concession on the part of the bank but, in reality, it is a significant forward move toward the objective of perpetual interest.

Eventually the borrower comes to the point where he can no longer pay even the interest. Now the play becomes more complex. The bank does not want to lose the interest, because that is its stream of income. But it cannot afford to allow the borrower to go into default either, because that would require a write-off which, in turn, could wipe out the owners' equity and put the bank out of business. So the bank's next move is to create additional money out of nothing and lend *that* to the borrower so he will have enough to *continue paying the interest*, which by now must be paid on the original loan plus the additional loan as well. What looked like certain disaster suddenly is converted by a brilliant play into a major score. This not only maintains the old loan on the books as an asset, it actually increases the apparent size of that asset and also results in higher interest payments, thus, greater profit to the bank.

THE UP-THE-ANTE PLAY

Sooner or later, the borrower becomes restless. He is not interested in making interest payments with nothing left for himself. He comes to realize that he is merely working for the bank and, once again, interest payments stop. The opposing teams go into a huddle to plan the next move, then rush to the scrimmage

1. "Banking Against Disaster," by Walter B. Wriston, *The New York Times*, September 14, 1982.

line where they hurl threatening innuendoes at each other. The borrower simply cannot, will not pay. Collect if you can. The lender threatens to blackball the borrower, to see to it that he will never again be able to obtain a loan. Finally, a "compromise" is worked out. As before, the bank agrees to create still *more* money out of nothing and lend *that* to the borrower to cover the interest on both of the previous loans but, this time, they up the ante to provide still *additional* money for the borrower to spend on something *other* than interest. That is a perfect score. The borrower suddenly has a fresh supply of money for *his* purposes plus enough to keep making those bothersome interest payments. The bank, on the other hand, now has still *larger* assets, *higher* interest income, and *greater* profits. What an exciting game!

THE RESCHEDULING PLAY

The previous plays can be repeated several times until the reality finally dawns on the borrower that he is sinking deeper and deeper into the debt pit with no prospects of climbing out. This realization usually comes when the interest payments become so large they represent almost as much as the entire corporate earnings or the country's total tax base. This time around, roll-overs with larger loans are rejected, and default seems inevitable.

But wait. What's this? The players are back at the scrimmage line. There is a great confrontation. Referees are called in. Two shrill blasts from the horn tell us a score has been made for *both* sides. A voice over the public address system announces: "This loan has been *rescheduled*."

Rescheduling usually means a combination of a lower interest rate and a longer period for repayment. The effect is primarily cosmetic. It reduces the monthly payment but extends the period further into the future. This makes the current burden to the borrower a little easier to carry, but it also makes repayment of the capital even more unlikely. It postpones the day of reckoning but, in the meantime, you guessed it: The loan remains as an asset, and the interest payments continue.

THE PROTECT-THE-PUBLIC PLAY

Eventually the day of reckoning arrives. The borrower realizes he can *never* repay the capital and flatly refuses to pay interest on it. It is time for the Final Maneuver.

According to the *Banking Safety Digest*, which specializes in rating the safety of America's banks and S&Ls, most of the banks involved with "problem loans" are quite profitable businesses:

> Note that, *except for third-world loans*, most of the large banks in the country are operating quite profitably. In contrast with the continually-worsening S&L crisis, the banks' profitability has been the engine with which they have been working off (albeit slowly) their overseas debt.... At last year's profitability levels, the banking industry could, in theory, "buy out" the entirety of their own Latin American loans within two years.[1]

The banks *can* absorb the losses of their bad loans to multinational corporations and foreign governments, but that is not according to the rules. It would be a major loss to the stockholders who would receive little or no dividends during the adjustment period, and any chief executive officer who embarked upon such a course would soon be looking for a new job. That this is not part of the game plan is evident by the fact that, while a small portion of the Latin American debt has been absorbed, the banks are continuing to make gigantic loans to governments in other parts of the world, particularly Africa, Red China, and Eastern European nations. For reasons which will be analyzed in chapter four, there is little hope that the performance of these loans will be different than those in Latin America. But the most important reason for not absorbing the losses is that there is a standard play that can still breathe life back into those dead loans and reactivate the bountiful income stream that flows from them.

Here's how it works. The captains of both teams approach the referee and the Game Commissioner to request that the game be extended. The reason given is that this is in the interest of the public, the spectators who are having such a wonderful time and who will be sad to see the game ended. They request also that, while the spectators are in the stadium enjoying themselves, the parking-lot attendants be ordered to quietly remove the hub caps from every car. These can be sold to provide money for additional salaries for all the players, including the referee and, of course, the Commissioner himself. That is only fair since they are now

1. "Overseas Lending ... Trigger for A Severe Depression?" *The Banking Safety Digest* (U.S. Business Publishing/Veribanc, Wakefield, Massachusetts), August, 1989, p. 3.

working overtime for the benefit of the spectators. When the deal is finally struck, the horn will blow three times, and a roar of joyous relief will sweep across the stadium.

In a somewhat less recognizable form, the same play may look like this: The president of the lending bank and the finance officer of the defaulting corporation or government will join together and approach Congress. They will explain that the borrower has exhausted his ability to service the loan and, without assistance from the federal government, there will be dire consequences for the American people. Not only will there be unemployment and hardship at home, there will be massive disruptions in world markets. And, since we are now so dependent on those markets, our exports will drop, foreign capital will dry up, and we will suffer greatly. What is needed, they will say, is for Congress to provide money to the borrower, either directly or indirectly, to allow him to continue to pay interest on the loan and to initiate new spending programs which will be so profitable he will soon be able to pay everyone back.

As part of the proposal, the borrower will agree to accept the direction of a third-party referee in adopting an austerity program to make sure that none of the new money is wasted. The bank also will agree to write off a small part of the loan as a gesture of its willingness to share the burden. This move, of course, will have been foreseen from the very beginning of the game, and is a small step backward to achieve a giant stride forward. After all, the amount to be lost through the write-off was created out of nothing in the first place and, without this Final Maneuver, the *entirety* would be written off. Furthermore, this modest write down is dwarfed by the amount to be gained through restoration of the income stream.

THE GUARANTEED-PAYMENT PLAY

One of the standard variations of the Final Maneuver is for the government, not always to directly provide the funds, but to provide the *credit* for the funds. That means to *guarantee* future payments should the borrower again default. Once Congress agrees to this, the government becomes a co-signer to the loan, and the inevitable losses are finally lifted from the ledger of the bank and placed onto the backs of the American taxpayer.

Money now begins to move into the banks through a complex system of federal agencies, international agencies, foreign aid, and direct subsidies. All of these mechanisms extract payments from the American people and channel them to the deadbeat borrowers who then send them to the banks to service their loans. Very little of this money actually comes from taxes. Almost all of it is generated by the Federal Reserve System. When this newly created money returns to the banks, it quickly moves out again into the economy where it mingles with and dilutes the value of the money already there. The result is the appearance of rising prices but which, in reality, is a lowering of the value of the dollar.

The American people have no idea they are paying the bill. They know that *someone* is stealing their hub caps, but they think it is the greedy businessman who raises prices or the selfish laborer who demands higher wages or the unworthy farmer who demands too much for his crop or the wealthy foreigner who bids up our prices. They do not realize that these groups *also* are victimized by a monetary system which is constantly being eroded in value by and through the Federal Reserve System.

Public ignorance of how the game is really played was dramatically displayed during a recent Phil Donahue TV show. The topic was the Savings and Loan crisis and the billions of dollars that it would cost the taxpayer. A man from the audience rose and asked angrily: "Why can't the government pay for these debts instead of the taxpayer?" And the audience of several hundred people actually cheered in enthusiastic approval!

PROSPERITY THROUGH INSOLVENCY

Since large, corporate loans are often guaranteed by the federal government, one would think that the banks which make those loans would never have a problem. Yet, many of them still manage to bungle themselves into insolvency. As we shall see in a later section of this study, insolvency actually is inherent in the system itself, a system called fractional-reserve banking.

Nevertheless, a bank can operate quite nicely in a state of insolvency so long as its customers don't know it. Money is brought into being and transmuted from one imaginary form to another by mere entries on a ledger, and creative bookkeeping can always make the bottom line appear to balance. The problem arises when depositors decide, for whatever reason, to withdraw their money. Lo and behold, there isn't enough to go around and, when that happens, the cat is finally out of the bag. The bank must close its doors, and the depositors still waiting in line outside are ... well, just that: still waiting.

The proper solution to this problem is to require the banks, like all other businesses, to honor their contracts. If they tell their customers that deposits are "payable upon demand," then they should hold enough cash to make good on that promise, regardless of when the customers want it or how many of them want it. In other words, they should keep cash in the vault equal to 100% of their depositors' accounts. When we give our hat to the hat-check girl and obtain a receipt for it, we don't expect her to rent it out while we eat dinner hoping she'll get it back—or one just like it—in time for our departure. We expect *all* the hats to remain there *all* the time so there will be no question of getting ours back precisely when we want it.

On the other hand, if the bank tells us it is going to lend our deposit to others so we can earn a little interest on it, then it should also tell us forthrightly that we *cannot* have our money back on demand. Why not? Because it is loaned out and not in the vault any longer. Customers who earn interest on their accounts should be told that they have *time* deposits, not *demand* deposits, because the bank will need a stated amount of time before it will be able to recover the money which was loaned out.

None of this is difficult to understand, yet bank customers are seldom informed of it. They are told they can have their money any time they want it *and* they are paid interest as well. Even if *they* do not receive interest, the *bank* does, and this is how so many customer services can be offered at little or no direct cost. Occasionally, a thirty-day or sixty-day delay will be mentioned as a possibility, but that is greatly inadequate for deposits which have been transformed into ten, twenty, or thirty-year loans. The banks are simply playing the odds that everything will work out *most of the time.*

We shall examine this issue in greater detail in a later section but, for now, it is sufficient to know that total disclosure is not how the banking game is played. The Federal Reserve System has legalized and institutionalized the dishonesty of issuing more hat checks than there are hats and it has devised complex methods of disguising this practice as a perfectly proper and normal feature of

banking. Students of finance are told that there simply is no other way for the system to function. Once that premise is accepted, then all attention can be focused, not on the inherent fraud, but on ways and means to live with it and make it as painless as possible.

Based on the assumption that only a small percentage of the depositors will ever want to withdraw their money at the same time, the Federal Reserve allows the nation's commercial banks to operate with an incredibly thin layer of cash to cover their promises to pay "on demand." When a bank runs out of money and is unable to keep that promise, the System then acts as a lender of last resort. That is banker language meaning it stands ready to create money out of nothing and immediately lend it to any bank in trouble. (Details on how that is accomplished are in chapter eight.) But there are practical limits to just how far that process can work. Even the Fed will not support a bank that has gotten itself so deeply in the hole it has no realistic chance of digging out. When a bank's bookkeeping assets finally become less than its liabilities, the rules of the game call for transferring the losses to the depositors themselves. This means they pay *twice*: once as taxpayers and again as depositors. The mechanism by which this is accomplished is called the Federal Deposit Insurance Corporation.

THE FDIC PLAY

The FDIC guarantees that every insured deposit will be paid back regardless of the financial condition of the bank. The money to do this comes out of a special fund which is derived from assessments against participating banks. The banks, of course, do not pay this assessment. As with all other expenses, the bulk of the cost ultimately is passed on to their customers in the form of higher service fees and lower interest rates on deposits.

The FDIC is usually described as an insurance fund, but that is deceptive advertising at its worst. One of the primary conditions of insurance is that it must avoid what underwriters call "moral hazard." That is a situation in which the policyholder has little incentive to avoid or prevent that which is being insured against. When moral hazard is present, it is normal for people to become careless, and the likelihood increases that what is being insured against will actually happen. An example would be a government program forcing everyone to pay an equal amount into a fund to protect them from the expense of parking fines. One hesitates even to mention this absurd proposition lest some enterprising politician should decide to put it on the ballot. Therefore, let us hasten to point out that, if such a numb-skull plan were adopted, two things would happen: (1) just about everyone soon would be getting parking tickets and (2), since there now would be so many of them, the taxes to pay for those tickets would greatly exceed the previous cost of paying them *without* the so-called protection.

The FDIC operates exactly in this fashion. Depositors are told their insured accounts are protected in the event their bank should become insolvent. To pay for this protection, each bank is assessed a specified percentage of its total deposits. That percentage is the same for all banks regardless of their previous record or how risky their loans. Under such conditions, it does not pay to be cautious. The banks making reckless loans earn a higher rate of interest than those making conservative loans. They also are far more likely to collect from the fund, yet they pay not one cent more. Conservative banks are penalized and gradually become motivated to make more risky loans to keep up with their competitors and to get their "fair share" of the fund's protection. Moral hazard, therefore, is built right into the system. As with protection against parking tickets, the FDIC increases the likelihood that what is being insured against will actually happen. It is not a solution to the problem, it is *part* of the problem.

REAL INSURANCE WOULD BE A BLESSING

A true deposit-insurance program which was totally voluntary and which geared its rates to the actual risks would be a blessing. Banks with solid loans on their books would be able to obtain protection for their depositors at reasonable rates, because the chances of the insurance company having to pay would be small. Banks with unsound loans, however, would have to pay much higher rates or possibly would not be able to obtain coverage at any price. Depositors, therefore, would know instantly, without need to investigate further, that a bank without insurance is not a place where they want to put their money. In order to attract deposits, banks would have to have insurance. In order to have insurance at rates they could afford, they would have to demonstrate to the insurance company that their financial affairs are in good order. Consequently, banks which failed to meet the minimum standards of sound business practice would soon have no customers and

would be forced out of business. A voluntary, private insurance program would act as a powerful regulator of the entire banking industry far more effectively and honestly than any political scheme ever could. Unfortunately, such is not the banking world of today.

The FDIC "protection" is not insurance in any sense of the word. It is merely part of a political scheme to bail out the most influential members of the banking cartel when they get into financial difficulty. As we have already seen, the first line of defense in this scheme is to have large, defaulted loans restored to life by a Congressional pledge of tax dollars. If that should fail and the bank can no longer conceal its insolvency through creative bookkeeping, it is almost certain that anxious depositors will soon line up to withdraw their money—which the bank does not have. The second line of defense, therefore, is to have the FDIC step in and make those payments for them.

Bankers, of course, do not want this to happen. It is a last resort. If the bank is rescued in this fashion, management is fired and what is left of the business usually is absorbed by another bank. Furthermore, the value of the stock will plummet, but this will affect the small stockholders only. Those with controlling interest and those in management know long in advance of the pending catastrophe and are able to sell the bulk of their shares while the price is still high. The people who create the problem seldom suffer the economic consequences of their actions.

THE FDIC WILL NEVER BE ADEQUATELY FUNDED

The FDIC never will have enough money to cover its potential liability for the entire banking system. If that amount were in existence, it could be held by the banks themselves, and an insurance fund would not even be necessary. Instead, the FDIC operates on the same assumption as the banks: that only a small percentage will ever need money at the same time. So the amount held in reserve is never more than a few percentage points of the total liability. Typically, the FDIC holds about $1.20 for every $100 of covered deposits. At the time of this writing, however, that figure had slipped to only 70 cents and was still dropping. That means that the financial exposure is about 99.3% larger than the safety net which is supposed to catch it. The failure of just one or two large banks in the system could completely wipe out the entire fund.

And it gets even worse. Although the ledger may show that so many millions or billions are in the fund, that also is but creative bookkeeping. By law, the money collected from bank assessments must be invested in Treasury bonds, which means it is loaned to the government and spent immediately by Congress. In the final stage of this process, therefore, the FDIC itself runs out of money and turns, first to the Treasury, then to Congress for help. This step, of course, is an act of final desperation, but it is usually presented in the media as though it were a sign of the system's great strength. *U.S. News & World Report* blandly describes it this way: "Should the agencies need more money yet, Congress has pledged the full faith and credit of the federal government."[1] Gosh, gee whiz. Isn't that wonderful? It sort of makes one feel rosy all over to know that the fund is so well secured.

Let's see what "full faith and credit of the federal government" actually means. Congress, already deeply in debt, has no money either. It doesn't dare openly raise taxes for the shortfall, so it applies for an additional loan by offering still more Treasury bonds for sale. The public picks up a portion of these I.O.U.s, and the Federal Reserve buys the rest. If there is a monetary crisis at hand and the size of the loan is great, the Fed will pick up the entire issue.

But the Fed has no money either. So it responds by creating out of nothing an amount of brand new money equal to the I.O.U.s and, through the magic of central banking, the FDIC is finally funded. This new money gushes into the banks where it is used to pay off the depositors. From there it floods through the economy diluting the value of *all* money and causing prices to rise. The old paycheck doesn't buy as much any more, so we learn to get along with a little bit less. But, see? The bank's doors are open again, and all the depositors are happy—until they return to their cars and discover the missing hub caps!

That is what is meant by "the full faith and credit of the federal government."

1. "How Safe Are Deposits in Ailing Banks, S&L's?" *U.S. News & World Report*, March 25, 1985, p. 73.

SUMMARY

Although national monetary events may appear mysterious and chaotic, they are governed by well-established rules which bankers and politicians rigidly follow. The central fact to understanding these events is that all the money in the banking system has been created out of nothing through the process of making loans. A defaulted loan, therefore, costs the bank little of tangible value, but it shows up on the ledger as a reduction in assets without a corresponding reduction in liabilities. If the bad loans exceed the size of the assets, the bank becomes technically insolvent and must close its doors. The first rule of survival, therefore, is to avoid writing off large, bad loans and, if possible, to at least continue receiving interest payments on them. To accomplish that, the endangered loans are rolled over and increased in size. This provides the borrower with money to continue paying interest plus fresh funds for new spending. The basic problem is not solved, but it is postponed for a little while and made worse.

The final solution on behalf of the banking cartel is to have the federal government guarantee payment of the loan should the borrower default in the future. This is accomplished by convincing Congress that not to do so would result in great damage to the economy and hardship for the people. From that point forward, the burden of the loan is removed from the bank's ledger and transferred to the taxpayer. Should this effort fail and the bank be forced into insolvency, the last resort is to use the FDIC to pay off the depositors. The FDIC is not insurance, because the presence of "moral hazard" makes the thing it supposedly protects against more likely to happen. A portion of the FDIC funds are derived from assessments against the banks. Ultimately, however, they are paid by the depositors themselves. When these funds run out, the balance is provided by the Federal Reserve System in the form of freshly created new money. This floods through the economy causing the appearance of rising prices but which, in reality, is the lowering of the value of the dollar. The final cost of the bailout, therefore, is passed to the public in the form of a hidden tax called inflation.

So much for the rules of the game. In the next chapter we shall look at the scorecard of the actual play itself.

Chapter Three

PROTECTORS OF THE PUBLIC

The Game-Called-Bailout as it actually has been applied to specific cases including Penn Central, Lockheed, New York City, Chrysler, Commonwealth Bank of Detroit, First Pennsylvania Bank, Continental Illinois, and others.

In the previous chapter, we offered the whimsical analogy of a sporting event to clarify the maneuvers of monetary and political scientists to bail out those commercial banks which comprise the Federal-Reserve cartel. The danger in such an approach is that it could leave the impression the topic is frivolous. So, let us abandon the analogy and turn to reality. Now that we have studied the hypothetical rules of the game, it is time to check the scorecard of the actual play itself, and it will become obvious that this is no trivial matter. A good place to start is with the rescue of a consortium of banks which were holding the endangered loans of Penn Central Railroad.

PENN CENTRAL

Penn Central was the nation's largest railroad with 96,000 employees and a payroll of $20 million a week. In 1970, it also became the nation's biggest bankruptcy. It was deeply in debt to just about every bank that was willing to lend it money, and that list included Chase Manhattan, Morgan Guaranty, Manufacturers Hanover, First National City, Chemical Bank, and Continental Illinois. Officers of the largest of those banks had been appointed to Penn Central's board of directors as a condition for obtaining funds, and they gradually had acquired control over the railroad's management. The banks also held large blocks of Penn Central stock in their trust departments.

The arrangement was convenient in many ways, not the least of which was that the bankers sitting on the board of directors were privy to information, long before the public received it, which would affect the market price of Penn Central's stock. Chris Welles, in *The Last Days of the Club*, describes what happened:

> On May 21, a month before the railroad went under, David Bevan, Penn Central's chief financial officer, privately informed representatives of the company's banking creditors that its financial condition was so weak it would have to postpone an attempt to raise $100 million in desperately needed operating funds through a bond issue. Instead, said Bevan, the railroad would seek some kind of government loan guarantee. In other words, unless the railroad could manage a federal bailout, it would have to close down. The following day, Chase Manhattan's trust department sold 134,300 shares of its Penn Central holdings. Before May 28, when the public was informed of the postponement of the bond issue, Chase sold another 128,000 shares. David Rockefeller, the bank's chairman, vigorously denied Chase had acted on the basis of inside information.[1]

More to the point of this study is the fact that virtually all of the major management decisions which led to Penn Central's demise were made by or with the concurrence of its board of directors, which is to say, by the banks that provided the loans. In other words, the bankers were not in trouble because of Penn Central's poor management, they *were* Penn Central's poor management. An investigation conducted in 1972 by Congressman Wright Patman, Chairman of the House Banking and Currency Committee, revealed the following: The banks provided large loans for disastrous expansion and diversification projects. They loaned additional millions to the railroad so it could pay dividends to its stockholders. This created the false appearance of prosperity and artificially inflated the market price of its stock long enough to dump it on the unsuspecting public. Thus, the banker-managers were able to engineer a three-way bonanza for themselves. They (1) received dividends on essentially worthless stock, (2) earned interest on the loans which provided the money to pay those dividends, and (3) were able to unload 1.8 million shares of stock—*after* the dividends, of course—at unrealistically high prices.[2] Reports from the Securities and Exchange Commission

1. Chris Welles, *The Last Days of the Club* (New York: E.P. Dutton, 1975), pp. 398–99.
2. "Penn Central," *1971 Congressional Quarterly Almanac* (Washington, D.C.: Congressional Quarterly, 1971), p. 838.

showed that the company's top executives had disposed of their stock in this fashion at a personal savings of more than $1 million.[1]

Had the railroad been allowed to go into bankruptcy at that point and been forced to sell off its assets, the bankers still would have been protected. In any liquidation, debtors are paid off first, stockholders last; so the manipulators had dumped most of their stock while prices were relatively high. That is a common practice among corporate raiders who use borrowed funds to seize control of a company, bleed off its assets to other enterprises which they also control, and then toss the debt-ridden, dying carcass upon the remaining stockholders or, in this case, the taxpayers.

THE PUBLIC BE DAMNED

In his letter of transmittal accompanying the staff report, Congressman Patman provided this summary:

> It was as though everyone was a part of a close knit club in which Penn Central and its officers could obtain, with very few questions asked, loans for almost everything they desired both for the company and for their own personal interests, where the bankers sitting on the Board asked practically no questions as to what was going on, simply allowing management to destroy the company, to invest in questionable activities, and to engage in some cases in illegal activities. These banks in return obtained most of the company's lucrative banking business. The attitude of everyone seemed to be, while the game was going on, that all these dealings were of benefit to every member of the club, and the railroad and the public be damned.[2]

The banking cartel, commonly called the Federal Reserve System, was created for exactly this kind of bailout. Arthur Burns, who was the Fed's chairman, would have preferred to provide a direct infusion of newly created money, but that was contrary to the rules at that time. In his own words: "Everything fell through. We couldn't lend it to them ourselves under the law.… I worked on this thing in other ways."[3]

The company's cash crisis came to a head over a weekend and, in order to avoid having the corporation forced to file for bankruptcy on Monday morning, Burns called the homes of the heads of the Federal Reserve banks around the country and told them to get

1. "Penn Central: Bankruptcy Filed After Loan Bill Fails," *1970 Congressional Quarterly Almanac* (Washington, D.C.: Congressional Quarterly, 1970), p. 811.
2. Quoted by Welles, pp. 404–05.
3. Quoted by Welles, p. 407.

the word out immediately that the System was anxious to help. On Sunday, William Treiber, who was the first vice-president of the New York branch of the Fed, contacted the chief executives of the ten largest banks in New York and told them that the Fed's Discount Window would be wide open the next morning. Translated, that means the Federal Reserve System was prepared to create money out of nothing and then immediately loan it to the commercial banks so they, in turn, could multiply and re-lend it to Penn Central and other corporations, such as Chrysler, which were in similar straits.[1] Furthermore, the rates at which the Fed would make these funds available would be low enough to compensate for the risk. Speaking of what transpired on the following Monday, Burns boasted: "I kept the Board in session practically all day to change regulation Q so that money could flow into CDs at the banks." Looking back at the event, Chris Welles approvingly describes it as "what is by common consent the Fed's finest hour."[2]

Finest hour or not, the banks were not that interested in the proposition unless they could be assured the taxpayer would co-sign the loans and guarantee payment. So the action inevitably shifted back to Congress. Penn Central's executives, bankers, and union representatives came in droves to explain how the railroad's continued existence was in the best interest of the public, of the working man, of the economic system itself. The Navy Department spoke of protecting the nation's "defense resources." Congress, of course, could not callously ignore these pressing needs of the nation. It responded by ordering a retroactive, 13 ½ per cent pay raise for all union employees. After having added that burden to the railroad's cash drain and putting it even deeper into the hole, it then passed the Emergency Rail Services Act of 1970 authorizing $125 million in federal loan guarantees.[3]

None of this, of course, solved the basic problem, nor was it really intended to. Almost everyone knew that, eventually, the railroad would be "nationalized," which is a euphemism for becoming a black hole into which tax dollars disappear. This came

1. For an explanation of the multiplier effect, see chapter eight, The Mandrake Mechanism.
2. Welles, pp. 407–08.
3. "Congress Clears Railroad Aid Bill, Acts on Strike," *1970 Congressional Almanac* (Washington, D.C.: 1970), pp. 810–16.

to pass with the creation of AMTRAK in 1971 and CONRAIL in 1973. AMTRAK took over the passenger services of Penn Central, and CONRAIL assumed operation of its freight services, along with five other Eastern railroads. CONRAIL technically is a private corporation. When it was created, however, 85% of its stock was held by the government. The remainder was held by employees. Fortunately, the government's stock was sold in a public offering in 1987. AMTRAK continues under political control and operates at a loss. It is sustained by government subsidies—which is to say by taxpayers. In 1997, Congress dutifully gave it another $5.7 billion and, by 1998, liabilities exceeded assets by an estimated $14 billion. CONRAIL, on the other hand, since it was returned to the private sector, has experienced an impressive turnaround and has been running at a profit—paying taxes instead of consuming them.

LOCKHEED

In that same year, 1970, the Lockheed Corporation, which was the nation's largest defense contractor, was teetering on the verge of bankruptcy. The Bank of America and several smaller banks had loaned $400 million to the Goliath and they were not anxious to lose the bountiful interest-income stream that flowed from that; nor did they wish to see such a large bookkeeping asset disappear from their ledgers. In due course, the banks joined forces with Lockheed's management, stockholders, and labor unions, and the group descended on Washington. Sympathetic politicians were told that, if Lockheed were allowed to fail, 31,000 jobs would be lost, hundreds of sub contractors would go down, thousands of suppliers would be forced into bankruptcy, and national security would be seriously jeopardized. What the company needed was to borrow more money and lots of it. But, because of its current financial predicament, no one was willing to lend. The answer? In the interest of protecting the economy and defending the nation, the government simply had to provide either the money or the credit.

A bailout plan was quickly engineered by Treasury Secretary John B. Connally which provided the credit. The government agreed to guarantee payment on an additional $250 million in loans—an amount which would put Lockheed 60% deeper into the debt hole than it had been before. But that made no difference now. Once the taxpayer had been made a co-signer to the account, the banks had no qualms about advancing the funds.

The not-so-obvious part of this story is that the government now had a powerful motivation to make sure Lockheed would be awarded as many defense contracts as possible and that those contracts would be as profitable as possible. This would be an indirect method of paying off the banks with tax dollars, but doing so in such a way as not to arouse public indignation. Other defense contractors which had operated more efficiently would lose business, but that could not be proven. Furthermore, a slight increase in defenses expenditures would hardly be noticed.

By 1977, Lockheed had, indeed, paid back this loan, and that fact was widely advertised as proof of the wisdom and skill of all the players, including the referee and the game commissioner. A deeper analysis, however, must include two facts. First, there is no evidence that Lockheed's operation became more cost efficient during these years. Second, every bit of the money used to pay back the loans came from defense contracts which were awarded by the same government which was guaranteeing those loans. Under such an arrangement, it makes little difference if the loans were paid back or not. Taxpayers were doomed to pay the bill either way.

NEW YORK CITY

Although the government of New York City is not a corporation in the usual sense, it functions as one in many respects, particularly regarding debt.

In 1975, New York had reached the end of its credit rope and was unable even to make payroll. The cause was not mysterious. New York had long been a welfare state within itself, and success in city politics was traditionally achieved by lavish promises of benefits and subsidies for "the poor." Not surprisingly, the city also was notorious for political corruption and bureaucratic fraud. Whereas the average large city employed thirty-one people per one-thousand residents, New York had forty nine. That's an excess of fifty-eight per cent. The salaries of these employees far outstripped those in private industry. While an X-ray technician in a private hospital earned $187 per week, a porter working for the city earned $203. The average bank teller earned $154 per week, but a change maker on the city subway received $212. And municipal fringe benefits were fully twice as generous as those in private industry within the state. On top of this mountainous overhead

were heaped additional costs for free college educations, subsidized housing, free medical care, and endless varieties of welfare programs.

City taxes were greatly inadequate to cover the cost of this utopia. Even after transfer payments from Albany and Washington added state and federal taxes to the take, the outflow continued to exceed the inflow. There were now only three options: increase city taxes, reduce expenses, or go into debt. The choice was never in serious doubt. By 1975, New York had floated so many bonds it had saturated the market and could find no more lenders. Two billion dollars of this debt was held by a small group of banks, dominated by Chase Manhattan and Citicorp.

When the payment of interest on these loans finally came to a halt, it was time for serious action. The bankers and the city fathers traveled down the coast to Washington and put their case before Congress. The largest city in the world could not be allowed to go bankrupt, they said. Essential services would be halted and millions of people would be without garbage removal, without transportation, even without police protection. Starvation, disease, and crime would run rampant through the city. It would be a disgrace to America. David Rockefeller at Chase Manhattan persuaded his friend Helmut Schmidt, Chancellor of West Germany, to make a statement to the media that the disastrous situation in New York could trigger an international financial crisis.

Congress, understandably, did not want to turn New York into a zone of anarchy, nor to disgrace America, nor to trigger a world-wide financial panic. So, in December of 1975, it passed a bill authorizing the Treasury to make direct loans to the city up to $2.3 billion, an amount which would more than *double* the size of its current debt to the banks. Interest payments on the old debt resumed immediately. All of this money, of course, would first have to be borrowed by Congress which was, itself, deeply in debt. And most of it would be created, directly or indirectly, by the Federal Reserve System. That money would be taken from the taxpayer through the loss of purchasing power called inflation, but at least the banks could be repaid, which is the object of the game.

There were several restrictions attached to this loan, including an austerity program and a systematic repayment schedule. None of these conditions was honored. New York City has continued to be a welfare utopia, and it is unlikely that it will *ever* get out of debt.

CHRYSLER

By 1978, the Chrysler Corporation was on the verge of bankruptcy. It had rolled over its debt to the banks many times, and the game was nearing an end. In spite of an OPEC oil embargo which had pushed up the cost of gasoline and in spite of the increasing popularity of small-automobile imports, the company had continued to build the traditional gas hog. It was now saddled with a mammoth inventory of unsaleable cars and with a staggering debt which it had acquired to build those cars.

The timing was doubly bad. America was also experiencing high interest rates which, coupled with fears of U.S. military involvement in Cambodia, had led to a slump in the stock market. Banks felt the credit crunch keenly and, in one of those rare instances in modern history, the money makers themselves were scouring for money.

Chrysler needed additional cash to stay in business. It was not interested in borrowing just enough to pay the interest on its existing loans. To make the game worth playing, it wanted over a *billion* dollars in new capital. But, in the prevailing economic environment, the banks were hard pressed to create anything close to that kind of money.

Managers, bankers, and union leaders found common cause in Washington. If one of the largest corporations in America was allowed to fold, think of the hardship to thousands of employees and their families; consider the damage to the economy as shock waves of unemployment move across the country; tremble at the thought of lost competition in the automobile market, of only two major brands from which to choose instead of three.

Well, could anyone blame Congress for not wanting to plunge innocent families into poverty nor to upend the national economy nor to deny anyone their Constitutional right to freedom-of-choice? So a bill was passed directing the Treasury to guarantee up to $1.5 billion in new loans to Chrysler. The banks agreed to write down $600 million of their old loans and to exchange an additional $700 million for preferred stock. Both of these moves were advertised as evidence the banks were taking a terrible loss but were willing to yield in order to save the nation. It should be noted, however, that the value of the stock which was exchanged for previously uncollectable debt rose drastically after the settlement was announced to the public. Furthermore, not only did interest payments resume on the balance of the old loans, but the banks now replaced the written down portion with fresh loans, and these were far superior in quality because they were fully guaranteed by the taxpayers. So valuable was this guarantee that Chrysler, in spite of its previously poor debt performance, was able to obtain loans at 10.35% interest while its more solvent competitor, Ford, had to pay 13.5%. Applying the difference of 3.15% to one and-a-half billion dollars, with a declining balance continuing for only six years, produces a savings in excess of $165 million. That is a modest estimate of the size of the federal subsidy. The real value was far greater because, without it, the corporation would have ceased to exist, and the banks would have taken a loss of almost their entire loan exposure.

FEDERAL DEPOSIT INSURANCE CORPORATION

It will be recalled from the previous chapter that the FDIC is not a true insurance program and, because it has been politicized, it embodies the principle of moral hazard and it actually increases the likelihood that bank failures will occur.

The FDIC has three options when bailing out an insolvent bank. The first is called a *payoff*. It involves simply paying off the insured depositors and then letting the bank fall to the mercy of the liquidators. This is the option usually chosen for small banks with no political clout. The second possibility is called a *sell off*, and it involves making arrangements for a larger bank to assume all the real assets and liabilities of the failing bank. Banking services are uninterrupted and, aside from a change in name, most customers are unaware of the transaction. This option is generally selected for small and medium banks. In both a payoff and a sell off, the FDIC takes over the bad loans of the failed bank and supplies the money to pay back the insured depositors.

The third option is called *bailout*, and this is the one which deserves our special attention. Irvine Sprague, a former director of the FDIC, explains: "In a bailout, the bank does not close, and everyone—insured or not—is fully protected.... Such privileged treatment is accorded by FDIC only rarely to an elect few."[1]

That's right, he said everyone—insured *or not*—is fully protected. The banks which comprise the elect few generally are the

1. Irvine H. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues* (New York: Basic Books, 1986), p. 23.

large ones. It is only when the number of dollars at risk becomes mind numbing that a bailout can be camouflaged as protection of the public. Sprague says:

> The FDI Act gives the FDIC board sole discretion to prevent a bank from failing, at whatever cost. The board need only make the finding that the insured bank is in danger of failing and "is essential to provide adequate banking service in its community."... FDIC boards have been reluctant to make an essentiality finding unless they perceive a clear and present danger to the nation's financial system.[1]

Favoritism toward the large banks is obvious at many levels. One of them is the fact that, in a bailout, the FDIC covers *all* deposits, whether insured or not. That is significant, because the banks pay an assessment based only on their *insured* deposits. So, if *un*insured deposits are covered also, that coverage is free—more precisely, paid by someone else. What deposits are *un*insured? Those in excess of $100,000 and those held outside the United States. Which banks hold the vast majority of such deposits? The *large* ones, of course, particularly those with extensive overseas operations.[2] The bottom line is that the large banks get a whopping free ride when they are bailed out. Their uninsured accounts are paid by FDIC, and the cost of that benefit is passed to the smaller banks and to the taxpayer. This is not an oversight. Part of the plan at Jekyll Island was to give a competitive edge to the large banks.

UNITY BANK

The first application of the FDIC essentiality rule was, in fact, an exception. In 1971, Unity Bank and Trust Company in the Roxbury section of Boston found itself hopelessly insolvent, and the federal agency moved in. This is what was found: Unity's capital was depleted; most of its loans were bad; its loan collection practices were weak; and its personnel represented the worst of two worlds: overstaffing and inexperience. The examiners reported that there were two persons for every job, and neither one had been taught the job.

With only $11.4 million on its books, the bank was small by current standards. Normally, the depositors would have been paid back, and the stockholders—like the owners of any other failed

1. Sprague, pp. 27–29.
2. The Bank of America is the exception. Despite its size, it has not acquired foreign deposits to the same degree as its competitors.

business venture—would have lost their investment. As Sprague, himself, admitted: "If market discipline means anything, stockholders should be wiped out when a bank fails. Our assistance would have the side effect ... of keeping the stockholders alive at government expense."[1] But Unity Bank was different. It was located in a black neighborhood and was minority owned. As is often the case when government agencies are given discretionary powers, decisions are determined more by political pressures than by logic or merit, and Unity was a perfect example. In 1971, the specter of rioting in black communities still haunted the halls of Congress. Would the FDIC allow this bank to fail and assume the awesome responsibility for new riots and bloodshed? Sprague answers:

> Neither Wille [another director] nor I had any trouble viewing the problem in its broader social context. We were willing to look for a creative solution.... My vote to make the "essentiality" finding and thus save the little bank was probably foreordained, an inevitable legacy of Watts.... The Watts riots ultimately triggered the essentiality doctrine.[2]

On July 22, 1971, the FDIC declared that the continued operation of Unity Bank was, indeed, essential and authorized a direct infusion of $1.5 million. Although appearing on the agency's ledger as a loan, no one really expected repayment. In 1976, in spite of the FDIC's own staff report that the bank's operations continued "as slipshod and haphazard as ever," the agency rolled over the "loan" for another five years. Operations did not improve and, on June 30, 1982, the Massachusetts Banking Commissioner finally revoked Unity's charter. There were no riots in the streets, and the FDIC quietly wrote off the sum of $4,463,000 as the final cost of the bailout.

COMMONWEALTH BANK OF DETROIT

The bailout of the Unity Bank of Boston was the exception to the rule that small banks are dispensable while the giants must be saved at all costs. From that point forward, however, the FDIC game plan was strictly according to Hoyle. The next bailout occurred in 1972 involving the $1.5 billion Bank of the Commonwealth of Detroit. Commonwealth had funded most of its

1. Sprague, pp. 41–42.
2. *Ibid.*, p. 48.

phenomenal growth through loans from another bank, Chase Manhattan in New York. When Commonwealth went belly up, largely due to securities speculation and self dealing on the part of its management, Chase seized 39% of its common stock and actually took control of the bank in an attempt to find a way to get its money back. FDIC director Sprague describes the inevitable sequel:

> Chase officers ... suggested that Commonwealth was a public interest problem that the government agencies should resolve. That unsubtle hint was the way Chase phrased its request for a bailout by the government.... Their proposal would come down to bailing out the shareholders, the largest of which was Chase.[1]

The bankers argued that Commonwealth must not be allowed to fold because it provided "essential" banking services to the community. That was justified on two counts: (1) it served many minority neighborhoods and, (2) there were not enough other banks in the city to absorb its operation without creating an unhealthy concentration of banking power in the hands of a few. It was unclear what the minority issue had to do with it inasmuch as every neighborhood in which Commonwealth had a branch was served by other banks as well. Furthermore, if Commonwealth were to be liquidated, many of those branches undoubtedly would have been purchased by competitors, and service to the communities would have continued. Judging by the absence of attention given to this issue during discussions, it is apparent that it was merely thrown in for good measure, and no one took it very seriously.

In any event, the FDIC did not want to be accused of being indifferent to the needs of Detroit's minorities and it certainly did not want to be a destroyer of free-enterprise competition. So, on January 17, 1972, Commonwealth was bailed out with a $60 million loan plus numerous federal guarantees. Chase absorbed some losses, primarily as a result of Commonwealth's weak bond portfolio, but those were minor compared to what would have been lost without FDIC intervention.

Since continuation of the bank was necessary to prevent concentration of financial power, FDIC engineered its sale to the First Arabian Corporation, a Luxembourg firm funded by Saudi

1. Sprague, p. 68.

princes. Better to have financial power concentrated in Saudi Arabia than in Detroit. The bank continued to flounder and, in 1983, what was left of it was resold to the former Detroit Bank & Trust Company, now called Comerica. Thus the dreaded concentration of local power was realized after all, but not until Chase Manhattan was able to walk away from the deal with most of its losses covered.

FIRST PENNSYLVANIA BANK

The 1980 bailout of the First Pennsylvania Bank of Philadelphia was next. First Penn was the nation's twenty-third largest bank with assets in excess of $9 billion. It was six times the size of Commonwealth; nine hundred times larger than Unity. It was also the nation's oldest bank, dating back to the Bank of North America which was created by the Continental Congress in 1781.

The bank had experienced rapid growth and handsome profits largely due to the aggressive leadership of its chief executive officer, John Bunting, who had previously been an economist with the Federal Reserve Bank of Philadelphia. Bunting was the epitome of the era's go-go bankers. He vastly increased earnings ratios by reducing safety margins, taking on risky loans, and speculating in the bond market. As long as the economy expanded, these gambles were profitable, and the stockholders loved him dearly. When his gamble in the bond market turned sour, however, the bank plunged into a negative cash flow. By 1979, First Penn was forced to sell off several of its profitable subsidiaries in order to obtain operating funds, and it was carrying $328 million in questionable loans. That was $16 million more than the entire stockholder investment. The bank was insolvent, and the time had arrived to hit up the taxpayer for the loss.

The bankers went to Washington and presented their case. They were joined by spokesmen from the nation's top three: Bank of America, Citibank, and of course the ever-present Chase Manhattan. They argued that, not only was the bailout of First Penn "essential" for the continuation of banking services in Philadelphia, it was also critical to the preservation of *world* economic stability. The bank was so large, they said, if it were allowed to fall, it would act as the first domino leading to an international financial crisis. At first, the directors of the FDIC resisted that theory and earned the angry impatience of the Federal Reserve. Sprague recalls:

> We were far from a decision on how to proceed. There was strong pressure from the beginning not to let the bank fail. Besides hearing from the bank itself, the other large banks, and the comptroller, we heard frequently from the Fed. I recall at one session, Fred Schultz, the Fed deputy chairman, argued in an ever rising voice, that there were no alternatives—we had to save the bank. He said, "Quit wasting time talking about anything else!"...
>
> The Fed's role as lender of last resort first generated contention between the Fed and FDIC during this period. The Fed was lending heavily to First Pennsylvania, fully secured, and Fed Chairman Paul Volcker said he planned to continue funding indefinitely until we could work out a merger or a bailout to save the bank.[1]

The directors of the FDIC did not want to cross swords with the Federal Reserve System, and they most assuredly did not want to be blamed for tumbling the entire world economic system by allowing the first domino to fall. "The theory had never been tested," said Sprague. "I was not sure I wanted it to be just then."[2] So, in due course, a bailout package was put together which featured a $325 million loan from FDIC, interest free for the first year and at a subsidized rate thereafter; about half the market rate. Several other banks which were financially tied to First Penn, and which would have suffered great losses if it had folded, loaned an additional $175 million and offered a $1 billion line of credit. FDIC insisted on this move to demonstrate that the banking industry itself was helping and that it had faith in the venture. To bolster that faith, the Federal Reserve opened its Discount Window offering low-interest funds for that purpose.

The outcome of this particular bailout was somewhat happier than with the others, at least as far as the bank is concerned. At the end of the five-year taxpayer subsidy, the FDIC loan was fully repaid. The bank has remained on shaky ground, however, and the final page of this episode has not yet been written.

CONTINENTAL ILLINOIS

Everything up to this point was but mere practice for the big event which was yet to come. In the early 1980s, Chicago's Continental Illinois was the nation's seventh largest bank. With assets of $42 billion and with 12,000 employees working in offices

1. Sprague, pp. 88–89.
2. *Ibid.*, p. 89.

in almost every major country in the world, its loan portfolio had undergone spectacular growth. Its net income on loans had literally doubled in just five years and by 1981 had rocketed to an annual figure of $254 million. It had become the darling of the market analysts and even had been named by *Dun's Review* as one of the five best managed companies in the country. These opinion leaders failed to perceive that the spectacular performance was due, not to an expertise in banking or investment, but to the financing of shaky business enterprises and foreign governments which could not obtain loans anywhere else. But the public didn't know that and wanted in on the action. For awhile, the bank's common stock actually sold at a premium over others which were more prudently managed.

The gaudy fabric began to unravel during the Fourth of July weekend of 1982 with the failure of the Penn Square Bank in Oklahoma. That was the notorious shopping-center bank that had booked a billion dollars in oil and gas loans and resold them to Continental just before the collapse of the energy market. Other loans also began to sour at the same time. The Mexican and Argentine debt crisis was coming to a head, and a series of major corporate bankruptcies were receiving almost daily headlines. Continental had placed large chunks of its easy money with all of them. When these events caused the bank's credit rating to drop, cautious depositors began to withdraw their funds, and new funding dwindled to a trickle. The bank became desperate for cash to meet its daily expenses. In an effort to attract new money, it began to offer unrealistically high rates of interest on its CDs. Loan officers were sent to scour the European and Japanese markets and to conduct a public relations campaign aimed at convincing market managers that the bank was calm and steady. David Taylor, the bank's chairman at that time, said: "We had the Continental Illinois Reassurance Brigade and we fanned out all over the world."[1]

In the fantasy land of modern finance, glitter is often more important than substance, image more valuable than reality. The bank paid the usual quarterly dividend in August, in spite of the fact that this intensified its cash crunch. As with the Penn Central Railroad twelve years earlier, that move was calculated to project an image of business-as-usual prosperity. And the ploy worked—

1. Quoted by Chernow, p. 657.

for a while, at least. By November, the public's confidence had been restored, and the bank's stock recovered to its pre-Penn Square level. By March of 1983, it had risen even higher. But the worst was yet to come.

By the end of 1983, the bank's burden of non-performing loans had reached unbearable proportions and was growing at an alarming rate. By 1984, it was $2.7 billion. That same year, the bank sold off its profitable credit-card operation to make up for the loss of income and to obtain money for paying stockholders their expected quarterly dividend. The internal structure was near collapse, but the external facade continued to look like business as usual.

The first crack in that facade appeared at 11:39 A.M. On Tuesday, May 8, Reuters, the British news agency, moved a story on its wire service stating that banks in the Netherlands, West Germany, Switzerland, and Japan had increased their interest rate on loans to Continental and that some of them had begun to withdraw their funds. The story also quoted the bank's official statement that rumors of pending bankruptcy were "totally preposterous." Within hours, another wire, the Commodity News Service, reported a second rumor: that a Japanese bank was interested in buying Continental.

WORLD'S FIRST ELECTRONIC BANK RUN

As the sun rose the following morning, foreign investors began to withdraw their deposits. A billion dollars in Asian money moved out that first day. The next day—a little more than twenty-four hours following Continental's assurance that bankruptcy was totally preposterous, its long-standing customer, the Board of Trade Clearing Corporation, located just down the street—withdrew $50 million. Word of the defection spread through the financial wire services, and the panic was on. It became the world's first global electronic bank run.

By Friday, the bank had been forced to borrow $3.6 billion from the Federal Reserve in order to cover its escaping deposits. A consortium of sixteen banks, lead by Morgan Guaranty, offered a generous thirty-day line of credit, but all of this was far short of the need. Within seven more days, the outflow surged to over $6 billion.

In the beginning, almost all of this action was at the institutional level: other banks and professionally managed funds which closely monitor every minuscule detail of the financial markets. The general public had no inkling of the catastrophe, even as it unfolded. Chernow says: "The Continental run was like some modernistic fantasy: there were no throngs of hysterical depositors, just cool nightmare flashes on computer screens."[1] Sprague writes: "Inside the bank, all was calm, the teller lines moved as always, and bank officials recall no visible sign of trouble—except in the wire room. Here the employees knew what was happening as withdrawal order after order moved on the wire, bleeding Continental to death. Some cried."[2]

This was the golden moment for which the Federal Reserve and the FDIC were created. Without government intervention, Continental would have collapsed, its stockholders would have been wiped out, depositors would have been badly damaged, and the financial world would have learned that banks, not only have to *talk* about prudent management, they actually have to *adopt* it. Future banking practices would have been severely altered, and the long-term economic benefit to the nation would have been enormous. But *with* government intervention, the discipline of a free market is suspended, and the cost of failure or fraud is politically passed to the taxpayers. Depositors continue to live in a dream world of false security, and banks can operate recklessly and fraudulently with the knowledge that their political partners in government will come to their rescue when they get into trouble.

FDIC GENEROSITY WITH TAX DOLLARS

One of the challenges at Continental was that, while only four per cent of its liability was covered by FDIC "insurance," the regulators felt compelled to cover the entire exposure. Which means that the bank paid insurance premiums into the fund based on only four per cent of its total coverage, and the taxpayers now would pick up the other ninety-six per cent. FDIC director Sprague explains:

> Although Continental Illinois had over $30 billion in deposits, 90 percent were uninsured foreign deposits or large certificates substantially exceeding the $100,000 insurance limit. Off-book

1. Chernow, p. 658.
2. Sprague, p. 153.

> liabilities swelled Continental's real size to $69 billion. In this massive liability structure only some $3 billion within the insured limit was scattered among 850,000 deposit accounts. So it was in our power and entirely legal simply to pay off the insured depositors, let everything else collapse, and stand back to watch the carnage.[1]

That course was never seriously considered by any of the players. From the beginning, there were only two questions: how to come to Continental's rescue by covering its *total* liabilities and, equally important, how to politically justify such a fleecing of the taxpayer. As pointed out in the previous chapter, the rules of the game require that the scam must always be described as a heroic effort to protect the public. In the case of Continental, the sheer size of the numbers made the ploy relatively easy. There were so many depositors involved, so many billions at risk, so many other banks interlocked, it could be claimed that the economic fabric of the entire nation—of the world itself—was at stake. And who could say that it was not so. Sprague argues the case in familiar terms:

> An early morning meeting was scheduled for Tuesday, May 15, at the Fed.... We talked over the alternatives. They were few—none really.... [Treasury Secretary] Regan and [Fed Chairman] Volcker raised the familiar concern about a national banking collapse, that is, a chain reaction if Continental should fail. Volcker was worried about an international crisis. We all were acutely aware that never before had a bank even remotely approaching Continental's size closed. No one knew what might happen in the nation and in the world. It was no time to find out just for the purpose of intellectual curiosity.[2]

THE FINAL BAILOUT PACKAGE

The bailout was predictable from the start. There would be some preliminary lip service given to the necessity of allowing the banks themselves to work out their own problem. That would be followed by a plan to have the banks and the government *share* the burden. And that finally would collapse into a mere public-relations illusion. In the end, almost the entire cost of the bailout would be assumed by the government and passed on to the taxpayer.

At the May 15 meeting, Treasury Secretary Regan spoke eloquently about the value of a free market and the necessity of having the banks mount their own rescue plan, at least for a part of

1. Sprague, p. 184.
2. *Ibid.*, pp. 154–55, 183.

the money. To work out that plan, a summit meeting was arranged the next morning among the chairmen of the seven largest banks: Morgan Guaranty, Chase Manhattan, Citibank, Bank of America, Chemical Bank, Bankers Trust, and Manufacturers Hanover. The meeting was perfunctory at best. The bankers knew full well that the Reagan Administration would not risk the political embarrassment of a major bank failure. That would make the President and the Congress look bad at re-election time. But, still, some kind of tokenism was called for to preserve the Administration's conservative image. So, with urging from the Fed and the Treasury, the consortium agreed to put up the sum of $500 million—an average of only $71 million for each, far short of the actual need. Chernow describes the plan as "make-believe" and says "they pretended to mount a rescue."[1] Sprague supplies the details:

> The bankers said they wanted to be in on any deal, but they did not want to lose any money. They kept asking for guarantees. They wanted it to look as though they were putting money in but, at the same time, wanted to be absolutely sure they were not risking anything.... By 7:30 A.M. we had made little progress. We were certain the situation would be totally out of control in a few hours. Continental would soon be exposing itself to a new business day, and the stock market would open at ten o'clock. Isaac [another FDIC director] and I held a hallway conversation. We agreed to go ahead without the banks. We told Conover [the third FDIC director] the plan and he concurred....
>
> [Later], we got word from Bernie McKeon, our regional director in New York, that the bankers had agreed to be at risk. Actually, the risk was remote since our announcement had promised 100 percent insurance.[2]

The final bailout package was a whopper. Basically, the government took over Continental Illinois and assumed all of its losses. Specifically, the FDIC took $4.5 billion in bad loans and paid Continental $3.5 billion for them. The difference was then made up by the infusion of $1 billion in fresh capital in the form of stock purchase. The bank, therefore, now had the federal government as a stockholder controlling 80 per cent of its shares, and its bad loans had been dumped onto the taxpayer. In effect, even though

1. Chernow, p. 659.
2. Sprague, pp. 159–60.

Continental retained the appearance of a private institution, it had been nationalized.

LENDER OF LAST RESORT

Perhaps the most important part of the bailout, however, was that the money to make it possible was created—directly or indirectly—by the Federal Reserve System. If the bank had been allowed to fail, and the FDIC had been required to cover the losses, the drain would have emptied the entire fund with nothing left to cover the liabilities of thousands of other banks. In other words, this one failure alone, if it were allowed to happen, would have wiped out the entire FDIC! That's one reason the bank had to be kept operating, losses or no losses, and that's why the Fed had to be involved in the bail out. In fact, that was precisely the reason the System was created at Jekyll Island: to manufacture whatever amount of money might be necessary to cover the losses of the cartel. The scam could never work unless the Fed was able to create money out of nothing and pump it into the banks along with "credit" and "liquidity" guarantees. Which means, if the loans go sour, the money is eventually extracted from the American people through the hidden tax called inflation. That's the meaning of the phrase "lender of last resort."

FDIC director Irvine Sprague, while discussing the press release which announced the Continental bail-out package, describes the Fed's role this way:

> The third paragraph ... granted 100 percent insurance to all depositors, including the uninsured, and all general creditors.... The next paragraph ... set forth the conditions under which the Fed, as lender of last resort, would make its loans.... The Fed would lend to Continental to meet "any extraordinary liquidity requirements." That would include another run. All agreed that Continental could not be saved without 100 percent insurance by FDIC and unlimited liquidity support by the Federal Reserve. No plan would work without these two elements.[1]

By 1984, "unlimited liquidity support" had translated into the staggering sum of $8 billion. By early 1986, the figure had climbed to $9.24 billion and was still rising. While explaining this fleecing of the taxpayer to the Senate Banking Committee, Fed Chairman Paul Volcker said: "The operation is the most basic function of the

1. Sprague, pp. 162–63.

Federal Reserve. It was why it was founded."[1] With those words, he has confirmed one of the more controversial assertions of this book.

SMALL BANKS BE DAMNED

It has been mentioned previously that the large banks receive a free ride on their FDIC coverage at the expense of the small banks. There could be no better example of this than the bail out of Continental Illinois. In 1983, the bank paid a premium into the fund of only $6.5 million to protect its insured deposits of $3 billion. The actual liability, however—including its institutional and overseas deposits—was ten times that figure, and the FDIC guaranteed payment on the whole amount. As Sprague admitted, "Small banks pay proportionately far more for their insurance and have far less chance of a Continental-style bailout."[2]

How true. Within the same week that the FDIC and the Fed were providing billions in payments, stock purchases, loans, and guarantees for Continental Illinois, it closed down the tiny Bledsoe County Bank of Pikeville, Tennessee, and the Planters Trust and Savings Bank of Opelousas, Louisiana. During the first half of that year, forty-three smaller banks failed without an FDIC bailout. In most cases, a merger was arranged with a larger bank, and only the uninsured deposits were at risk. The impact of this inequity upon the banking system is enormous. It sends a message to bankers and depositors alike that small banks, if they get into trouble, will be allowed to fold, whereas large banks are safe regardless of how poorly or fraudulently they are managed. As a New York investment analyst stated to news reporters, Continental Illinois, even though it had just failed, was "obviously the safest bank in the country to have your money in."[3] Nothing could be better calculated to drive the small independent banks out of business or to force them to sell out to the giants. And that, in fact, is exactly what has been happening. Since 1984, while hundreds of small banks have been forced out of business, the average size of the banks which remain—with government protection—has more than doubled. It will be recalled that this advantage of the big banks

1. Quoted by Greider, p. 628.
2. Sprague, p. 250.
3. "New Continental Illinois Facing Uncertain Future," by Keith E. Leighty, Associated Press, Thousand Oaks, Calif., *News Chronicle*, May 13, 1985, p. 18.

over their smaller competitors was also one of the objectives of the Jekyll Island plan.

Perhaps the most interesting—and depressing—aspect of the Continental Illinois bailout was the lack of public indignation over the principle of using taxes and inflation to protect the banking industry. Smaller banks have complained of the unfair advantage given to the larger banks, but not on the basis that the government should have let the giant fall. Their lament was that it should now protect *them* in the same paternalistic fashion. Voters and politicians were silent on the issue, apparently awed by the sheer size of the numbers and the specter of economic chaos. Decades of public education had left their mark. After all, wasn't this exactly what government schools have taught is the proper function of government? Wasn't this the American way? Even Ronald Reagan, viewed as the national champion of economic conservatism, praised the action. From aboard Air Force One on the way to California, the President said: "It was a thing that we should do and we did it. It was in the best interest of all concerned."[1]

The Reagan endorsement brought into focus one of the most amazing phenomena of the 20th century: the process by which America has moved to the Left toward statism while marching behind the political banner of those who speak the language of *opposing* statism. William Greider, a former writer for the liberal *Washington Post* and *The Rolling Stone*, complains:

> The nationalization of Continental was, in fact, a quintessential act of modern liberalism—the state intervening in behalf of private interests and a broad public purpose. In this supposedly conservative era, federal authorities were setting aside the harsh verdict of market competition (and grossly expanding their own involvement in the private economy)....
>
> In the past, conservative scholars and pundits had objected loudly at any federal intervention in the private economy, particularly emergency assistance for failing companies. Now, they hardly seemed to notice. Perhaps they would have been more vocal if the deed had been done by someone other than the conservative champion, Ronald Reagan.[2]

Four years after the bailout of Continental Illinois, the same play was used in the rescue of BankOklahoma, which was a bank

1. "Reagan Calls Rescue of Bank No Bailout," *New York Times*, July 29, 1984.
2. Greider, p. 631.

holding company. The FDIC pumped $130 million into its main banking unit and took warrants for 55% ownership. The pattern had been set. By accepting stock in a failing bank in return for bailing it out, the government had devised an ingenious way to nationalize banks without calling it that. Issuing stock sounds like a *business* transaction in the private sector. And the public didn't seem to notice the reality that Uncle Sam was going into banking.

SECOND REASON TO ABOLISH THE FEDERAL RESERVE

A sober evaluation of this long and continuing record leads to the second reason for abolishing the Federal Reserve System: Far from being a protector of the public, *it is a cartel operating against the public interest.*

SUMMARY

The game called bailout is not a whimsical figment of the imagination, it is for real. Here are some of the big games of the season and their final scores.

In 1970, Penn Central railroad became bankrupt. The banks which loaned the money had taken over its board of directors and had driven it further into the hole, all the while extending bigger and bigger loans to cover the losses. Directors concealed reality from the stockholders and made additional loans so the company could pay dividends to keep up the false front. During this time, the directors and their banks unloaded their stock at unrealistically high prices. When the truth became public, the stockholders were left holding the empty bag. The bailout, which was engineered by the Federal Reserve, involved government subsidies to other banks to grant additional loans. Then Congress was told that the collapse of Penn Central would be devastating to the public interest. Congress responded by granting $125 million in loan guarantees so that banks would not be at risk. The railroad eventually failed anyway, but the bank loans were covered. Penn Central was nationalized into AMTRAK and continues to operate at a loss.

In 1970, as Lockheed faced bankruptcy, Congress heard essentially the same story. Thousands would be unemployed, subcontractors would go out of business, and the public would suffer greatly. So Congress agreed to guarantee $250 million in new loans, which put Lockheed 60% deeper into debt than before. Now that government was guaranteeing the loans, it had to make sure Lockheed became profitable. This was accomplished by granting