Financial Meltdown: The Greatest Transfer of Wealth in History

How to Reverse the Tide and Democratize the US Monetary System

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"Admit it, mes amis, the rugged individualism and cutthroat capitalism that made America the land of unlimited opportunity has been shrink-wrapped by half a dozen short sellers in Greenwich, Conn., and FedExed to Washington, D.C., to be spoon-fed back to life by Fed Chairman Ben Bernanke and Treasury Secretary Hank Paulson. We're now no different from any of those Western European semi-socialist welfare states that we love to deride."– Bill Saporito, "How We Became the United States of France," Time (September 21, 2008)

On October 15, the Presidential candidates had their last debate before the election. They talked of the baleful state of the economy and the stock market; but omitted from the discussion was what actually caused the credit freeze, and whether the banks should be nationalized as Treasury Secretary Hank Paulson is now proceeding to do. The omission was probably excusable, since the financial landscape has been changing so fast that it is hard to keep up. A year ago, the Dow Jones Industrial Average broke through 14,000 to make a new all-time high. Anyone predicting then that a year later the Dow would drop nearly by half and the Treasury would move to nationalize the banks would have been regarded with amused disbelief. But that is where we are today.1

Congress hastily voted to approve Treasury Secretary Hank Paulson's $700 billion bank bailout plan on October 3, 2008, after a tumultuous week in which the Dow fell dangerously near the critical 10,000 level. The market, however, was not assuaged. The Dow proceeded to break through not only 10,000 but then 9,000 and 8,000, closing at 8,451 on Friday, October 10. The week was called the worst in U.S. stock market history.

On Monday, October 13, the market staged a comeback the likes of which had not been seen since 1933, rising a full 11% in one day. This happened after the government announced a plan to buy equity interests in key banks, partially nationalizing them; and the Federal Reserve led a push to flood the global financial system with dollars.

The reversal was dramatic but short-lived. On October 15, the day of the Presidential debate, the Dow dropped 733 points, crash landing at 8,578. The reversal is looking more like a massive pump and dump scheme – artificially inflating the market so insiders can get out – than a true economic rescue. The real problem is not in the much-discussed subprime market but is in the credit market, which has dried up. The banking scheme itself has failed. As was learned by painful experience during the Great Depression, the economy cannot be rescued by simply propping up failed banks. The banking system itself needs to be overhauled.

A Litany of Failed Rescue Plans

Credit has dried up because many banks cannot meet the 8% capital requirement that limits their ability to lend. A bank's capital – the money it gets from the sale of stock or from profits – can be fanned into more than 10 times its value in loans; but this leverage also works the other way. While $80 in capital can produce $1,000 in loans, an $80 loss from default wipes out $80 in capital, reducing the sum that can be lent by $1,000. Since the banks have been experiencing widespread loan defaults, their capital base has shrunk proportionately.

The bank bailout plan announced on October 3 involved using taxpayer money to buy up mortgage-related securities from troubled banks. This was supposed to reduce the need for new capital by reducing the amount of risky assets on the banks' books. But the banks' risky assets include derivatives – speculative bets on market changes – and derivative exposure for U.S. banks is now estimated at a breathtaking *$180 trillion*.2 The sum represents an impossible-to-fill black hole that is three times the gross domestic product of all the countries in the world combined. As one critic said of Paulson's roundabout bailout plan, "this seems designed to help Hank's friends offload trash, more than to clear a market blockage."3

By Thursday, October 9, Paulson himself evidently had doubts about his ability to sell the plan. He wasn't abandoning his old cronies, but he soft-pedaled that plan in favor of another option buried in the voluminous rescue package – using a portion of the $700 billion to buy stock in the banks directly. Plan B represented a controversial move toward nationalization, but it was an improvement over Plan A, which would have reduced capital requirements only by the value of the bad debts shifted onto the government's books. In Plan B, the money would be spent on bank stock, increasing the banks' capital base, which could then be leveraged into ten times that sum in loans. The plan was an improvement but the market was evidently not convinced, since the Dow proceeded to drop another thousand points from Thursday's opening to Friday's close.

One problem with Plan B was that it did *not* really mean nationalization (public ownership and control of the participating banks). Rather, it came closer to what has been called "crony capitalism" or "corporate welfare." The bank stock being bought would be non-voting preferred stock, meaning the government would have no say in how the bank was run. The Treasury would just be feeding the bank money to do with as it would. Management could continue to collect enormous salaries while investing in wildly speculative ventures with the taxpayers' money. The banks could not be forced to use the money to make much-needed loans but could just use it to clean up their derivative-infested balance sheets. In the end, the banks were still liable to go bankrupt, wiping out the taxpayers' investment altogether. Even if $700 billion were fanned into $7 trillion, the sum would not come close to removing the $180 trillion in derivative liabilities from the banks' books. Shifting those liabilities onto the public purse would just empty the purse without filling the derivative black hole.

Plan C, the plan du jour, does impose some limits on management compensation. But the more significant feature of this week's plan is the Fed's new "Commercial Paper Funding Facility," which is slated to be operational on October 27, 2008. The facility would open the

Fed's lending window for short-term commercial paper, the money corporations need to fund their day-to-day business operations. On October 14, the Federal Reserve Bank of New York justified this extraordinary expansion of its lending powers by stating:

"The CPFF is authorized under Section 13(3) of the Federal Reserve Act, which permits the Board, in unusual and exigent circumstances, to authorize Reserve Banks to extend credit to individuals, partnerships, and corporations that are unable to obtain adequate credit accommodations. . . .

"The U.S. Treasury believes this facility is necessary to prevent substantial disruptions to the financial markets and the economy and will make a special deposit at the New York Fed in support of this facility."4

That means the government and the Fed are now committing even *more* public money and taking on even *more* public risk. The taxpayers are already tapped out, so the Treasury's "special deposit" will no doubt come from U.S. bonds, meaning more debt on which the taxpayers have to pay interest. The federal debt could wind up running so high that the government loses its own triple-A rating. The U.S. could be reduced to Third World status, with "austerity measures" being imposed as a condition for further loans, and hyperinflation running the dollar into oblivion. Rather than solving the problem, these "rescue" plans seem destined to make it worse.

The Collapse of a 300 Year Ponzi Scheme

All the king's men cannot put the private banking system together again, for the simple reason that it is a Ponzi scheme that has reached its mathematical limits. A Ponzi scheme is a form of pyramid scheme in which new investors must continually be sucked in at the bottom to support the investors at the top. In this case, new borrowers must continually be sucked in to support the creditors at the top. The Wall Street Ponzi scheme is built on "fractional reserve" lending, which allows banks to create "credit" (or "debt") with accounting entries. Banks are now allowed to lend from 10 to 30 times their "reserves," essentially counterfeiting the money they lend. Over 97 percent of the U.S. money supply (M3) has been created by banks in this way.5 The problem is that banks create only the principal and not the interest necessary to pay back their loans. Since bank lending is essentially the only source of new money in the system, someone somewhere must continually be taking out new loans just to create enough "money" (or "credit") to service the old loans composing the money supply. This spiraling interest problem and the need to find new debtors has gone on for over 300 years — ever since the founding of the Bank of England in 1694 – until the whole world has now become mired in debt to the bankers' private money monopoly. As British financial analyst Chris Cook observes:

"Exponential economic growth required by the mathematics of compound interest on a money supply based on money as debt must always run up eventually against the finite nature of Earth's resources."6

The parasite has finally run out of its food source. But the crisis is not in the economy itself, which is fundamentally sound – or would be with a proper credit system to oil the wheels of production. The crisis is in the banking system, which can no longer cover up the shell game it has played for three centuries with other people's money. Fortunately, we don't need the credit of private banks. *A sovereign government can create its own*.

The New Deal Revisited

Today's credit crisis is very similar to that facing Franklin Roosevelt in the 1930s. In 1932, President Hoover set up the Reconstruction Finance Corporation (RFC) as a federally-owned bank that would bail out commercial banks by extending loans to them, much as the privately-owned Federal Reserve is doing today. But like today, Hoover's plan failed. The banks did not need more loans; they were already drowning in debt. They needed customers with money to spend and to invest. President Roosevelt used Hoover's new government-owned lending facility to extend loans where they were needed most – for housing, agriculture and industry. Many new federal agencies were set up and funded by the RFC, including the HOLC (Home Owners Loan Corporation) and Fannie Mae (the Federal National Mortgage Association, which was then a government-owned agency). In the 1940s, the RFC went into overdrive funding the infrastructure necessary for the U.S. to participate in World War II, setting the country up with the infrastructure it needed to become the world's industrial leader after the war.

The RFC was a government-owned bank that sidestepped the privately-owned Federal Reserve; but unlike the private banks with which it was competing, the RFC had to have the money in hand before lending it. The RFC was funded by issuing government bonds (I.O.U.s or debt) and relending the proceeds. The result was to put the taxpayers further into debt. This problem could be avoided, however, by updating the RFC model. A system of public banks might be set up that had the power to create credit themselves, just as private banks do now. A public bank operating on the private bank model could fan $700 billion in capital reserves into $7 trillion in public credit that was derivative-free, liability-free, and readily available to fund all those things we think we don't have the money for now, including the loans necessary to meet payrolls, fund mortgages, and underwrite public infrastructure.

Credit as a Public Utility

"Credit" can and should be a national utility, a public service provided by the government to the people it serves. Many people are opposed to getting the government involved in the banking system, but the fact is that the government is *already* involved. A modern-day RFC would actually mean *less* government involvement and a *more* efficient use of the already-earmarked $700 billion than policymakers are talking about now. The government would not need to interfere with the private banking system, which could carry on as before. The Treasury would not need to bail out the banks, which could be left to those same free market forces that have served them so well up to now. If banks went bankrupt, they could be put into FDIC receivership and nationalized. The government would then own a string of banks, which could be used to service the depository and credit needs of the community. There would be no need to change the personnel or procedures of these newly-nationalized banks. They could engage in "fractional reserve" lending just as they do now. The only difference would be that the interest on loans would return to the government, helping to defray the tax burden on the populace; and the banks would start out with a clean set of books, so their $700 billion in startup capital could be fanned into $7 trillion in new loans. This was the sort of banking scheme used in Benjamin Franklin's colony of Pennsylvania, where it worked brilliantly well. The spiraling-interest problem was avoided by printing some extra money and spending it into the economy for public purposes. During the decades the provincial bank operated, the Pennsylvania colonists paid *no* taxes, there was *no* government debt, and inflation did not result.7

Like the Pennsylvania bank, a modern-day federal banking system would not actually need "reserves" at all. It is the sovereign right of a government to issue the currency of the realm. What backs our money today is simply "the full faith and credit of the United States," something the United States should be able to issue directly without having to draw on "reserves" of its own credit. But if Congress is not prepared to go that far, a more efficient use of the earmarked $700 billion than bailing out failing banks would be to designate the funds as the "reserves" for a newly-reconstituted RFC.

Rather than creating a separate public banking corporation called the RFC, the nation's financial apparatus could be streamlined by simply nationalizing the privately-owned Federal Reserve; but again, Congress may not be prepared to go that far. Since there is already successful precedent for establishing an RFC in times like these, that model could serve as a non-controversial starting point for a new public credit facility. The G-7 nations' financial planners, who met in Washington D.C. this past weekend, appear intent on supporting the banking system with enough government-debt-backed "liquidity" to produce what Jim Rogers calls "an inflationary holocaust." As the U.S. private banking system self-destructs, we need to ensure that a public credit system is in place and ready to serve the people's needs in its stead.

Ellen Brown, J.D., developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and "the money trust." She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her eleven books include the bestselling Nature's Pharmacy, co-authored with Dr. Lynne Walker, and Forbidden Medicine. Her websites are www.webofdebt.com and www.ellenbrown.com.