
FINANCIAL MELTDOWN: THE END OF A 300 YEAR PONZI SCHEME

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Panic struck on Wall Street, as the Dow Jones Industrial Average plunged a thousand points between July and August, and commentators warned of a 1929-style crash. To prevent that dire result, the U.S. Federal Reserve, along with the central banks of Europe, Canada, Australia and Japan, extended a 315 billion dollar lifeline to troubled banks and investment firms. The hemorrhage stopped, the markets turned around, and investors breathed a sigh of relief. All was well again in Stepfordville. Or was it? And if it was, at what cost? Three hundred billion dollars is about a third of the total paid by U.S. taxpayers in personal income taxes annually. A mere \$188 billion would have been enough to repair all of the 74,000 U.S. bridges known to be defective, preventing another disaster like that in Minneapolis in July. But the central banks' \$300 billion was poured instead into the black hole of rescuing the very banks and hedge funds blamed for the "liquidity" crisis (the dried up well of investment money), encouraging loan sharks and speculators in their profligate ways.

Where did the central banks find the \$300 billion? Central banks are "lenders of last resort." According to the Federal Reserve Bank of Atlanta's Economic Review, "to function as a lender of last resort [a central bank] *must have authority to create money, i.e., provide unlimited liquidity on demand.*"¹ In short, central banks can create money out of thin air. Increasing the money supply ("demand") without increasing goods and services ("supply") is highly inflationary; but this money-creating power is said to be necessary to correct the periodic market failures to which the banking system is inherently prone.² "Busts" have followed "booms" so regularly and predictably in the last 300 years that the phenomenon has been dubbed the "business cycle," as if it were an immutable trait of free markets like the weather. But in fact it is an immutable trait only of a banking system based on the sleight of hand known as "fractional-reserve" lending. *The banks themselves routinely create money out of thin air, and they need a lender of last resort to bail them out whenever they get caught short in this sleight of hand.*

Running through this whole drama is a larger theme, one that nobody is talking about and that can't be cured by fiddling with interest rates or throwing liquidity at banks making too-risky loans. The *reason* the modern banking system is prone to periodic market failures is that *it is a Ponzi scheme*, one that is basically a fraud on the people. Like all Ponzi schemes, it can go on only so long before it reaches its mathematical limits; and there is good evidence that we are there now. If we are to avoid the greatest market crash in history, we must eliminate the underlying fraud; and to do that we need to understand what is really going on.

The 300 Year Ponzi Scheme Known as "Fractional-Reserve" Lending

A Ponzi scheme is a form of pyramid scheme in which earlier players are paid with the money of later players, until no more unwary investors are available to be sucked in at the bottom and the pyramid collapses, leaving the last investors holding the bag. Our economic Ponzi scheme dates back to Oliver Cromwell's "Glorious Revolution" in seventeenth century England. Before that, the power to issue money was the sovereign right of the King, and for anyone else to do it was considered treason. But Cromwell did not have access to this money-creating power. He had to borrow from foreign moneylenders to fund his revolt; and they agreed to lend only on condition that they be allowed back into England, from which they had been banned centuries earlier. In 1694, the Bank of England was chartered to a group of private moneylenders, who were allowed to print banknotes and lend them to the government at interest; and these private banknotes became the national money supply. They were ostensibly backed by gold; but under the fractional-reserve lending scheme, the amount of gold kept in "reserve" was only a fraction of the value of the notes actually printed and lent. This practice grew out of the discovery of the goldsmiths, that customers who left their gold for safekeeping would come for it only about 10 percent of the time. Ten paper banknotes "backed" by a pound of gold could therefore safely be printed and lent for every pound of gold the goldsmiths held in reserve. Nine of the notes were essentially counterfeits.

The Bank of England became the pattern for the system known today as "central banking." A single bank, usually privately owned, is given a monopoly over issuing the nation's currency, which is then *lent* to the government, usurping the government's sovereign power to create money itself. In the United States, formal adoption of this system dates to the Federal Reserve Act of 1913; but private banks have created the national money supply ever since the country was founded. Before 1913, multiple private banks issued banknotes with their own names on them; and as in England, the banks issued notes for much more gold than was in their vaults. The scheme worked until the customers got suspicious and all demanded their gold at once, when there would be a "run" on the banks and they would have to close their doors. The Federal Reserve (or

"Fed") was instituted to rescue the banks from these crises by creating and lending money on demand. The banks themselves were already creating money out of nothing, but the Fed served as a backup source, generating the customer confidence necessary to carry on the fractional-reserve lending scheme.

Today, coins are the *only* money issued by the U.S. government, and they compose only about one one-thousandth of the money supply. Federal Reserve Notes (dollar bills) are issued by the privately-owned Federal Reserve and *lent* to the government and to commercial banks. Coins and Federal Reserve Notes together, however, compose less than 3 percent of the money supply. The rest is created by commercial banks as loans. The notion that virtually all of our money has been created by private banks is so foreign to what we have been taught that it can be difficult to grasp, but many reputable authorities have attested to it. (See E. Brown, "Dollar Deception: How Banks Secretly Create Money," www.webofdebt.com/articles, July 3, 2007.)

Among other problems with this system of money creation is that banks create the principal but not the interest necessary to pay back their loans; and that is where the Ponzi scheme comes in. Since loans from the Federal Reserve or commercial banks are the *only* source of new money in the economy, additional borrowers must continually be found to take out new loans to expand the money supply, in order to pay the interest creamed off by the bankers. New sources of debt are fanned into "bubbles" (rapidly rising asset prices), which expand until they "pop," when new bubbles are devised until no more borrowers can be found, and the pyramid finally collapses.

Before 1933, when the dollar went off the gold standard, the tether of gold served to limit the expansion of the money supply; but since then, the Fed's solution to collapsed bubbles has been to pump more newly-created money into the system. When the savings and loan associations collapsed, precipitating a recession in the 1980s, the Fed lowered interest rates and fanned the 1990s stock market bubble. When that bubble collapsed in 2000, the Fed dropped interest rates even further, creating the housing bubble of the current decade. When lenders ran out of "prime" borrowers, they turned to "subprime" borrowers - those who would not have qualified under the older, tougher standards. It was all part of the structural imperative of all Ponzi schemes, that the inflow of cash must continually expand to pay the people at the top. This expansion, however, has mathematical limits. In 2004, the Fed had to begin raising rates to tame inflation and to support the burgeoning federal debt by making government bonds more attractive to investors. The housing bubble was then punctured, and many subprime borrowers went into default.

The Subprime Mess and the Derivatives Scam

In the ever-growing need to find new borrowers, lending standards were relaxed. Adjustable rate mortgages, interest-only loans, no- or low-down-payment loans, and no-documentation loans made "home ownership" available to nearly anyone willing to take the bait. The risks of these loans were minimized by off-loading them onto unsuspecting investors. The loans were sliced up, bundled with less risky mortgages, and sold as mortgage-backed securities called "collateralized debt obligations" (CDOs). To induce rating agencies to give CDOs triple-A ratings, "derivatives" were thrown into the mix, ostensibly protecting investors from loss.

Derivatives are basically side bets that some investment (a stock, commodity, etc.) will go up or down in value. The simplest form is a "put" that pays the investor if an asset he owns goes down, neutralizing his risk. But most derivatives today are far more difficult to understand than that. Some critics say they are impossible to understand, because they were intentionally designed to mislead investors. By December 2006, according to the Bank for International Settlements, the derivatives trade had grown to *\$415 trillion*. This is a Ponzi scheme on its face, since the sum is nearly nine times the size of the entire world economy. A thing is worth only what it will fetch in the market, and there is no market anywhere on the planet that can afford to pay up on these speculative bets.

The current market implosion began when investment bank Bear Stearns, which had been buying CDOs through its hedge funds, closed two of those funds in June 2007. When the creditors tried to get their money back, the CDOs were put up for sale, and there were no takers at anywhere near their stated valuations. Panic spread, as increasing numbers of investment banks had to prevent "runs" on their hedge funds by refusing withdrawals by investors concerned about fraudulent CDO valuations. When the problem became too big for the investment banks to handle, the central banks stepped in with their \$300 billion lifeline.

Among those institutions rescued was Countrywide Financial, the largest U.S. mortgage lender. Countrywide has been called the next Enron, not only because it was facing bankruptcy but because it was guilty of some quite shady practices. It underwrote and sold hundreds of thousands of mortgages containing false and misleading information, which were then sold in the market as "securities." The lack of "liquidity" was blamed directly on these corrupt practices, which had frightened investors away from the markets. But that did not deter the Fed from sending in a lifeboat. Countrywide was saved when Bank of America bought \$2 billion of its stock with a loan made available by the Fed at newly-reduced interest rates. Bank of America also got a nice windfall, since when investors learned that Countrywide was being rescued, the stock it just purchased shot up.

Where did the Fed itself get the money? Chris Powell of GATA (the Gold Anti-Trust Action Committee) commented, "[I]n central banking, if you need money

for *anything*, you just sit down and type some up and click it over to someone who is ready to do as you ask with it." He added:

If it works for the Federal Reserve, Bank of America, and Countrywide, it can work for everyone else. For it is no more difficult for the Fed to conjure \$2 billion for Bank of America and its friends to "invest" in Countrywide than it would be for the Fed to wire a few thousand dollars into your checking account, calling it, say, an advance on your next tax cut or a mortgage interest rebate awarded to you because some big, bad lender encouraged you to buy a McMansion with no money down in the expectation that you could flip it in a few months for enough profit to buy a regular house.³

Which brings us to the point here: if *somebody* is going to be "reflating" the economy by typing up money on a computer screen, it should be Congress itself, the publicly accountable entity that alone is authorized to create money under the Constitution.

The Way Out

Economic collapse has been the predictable end of all Ponzi schemes ever since the Mississippi bubble of the eighteenth century. The only way out of this fix is to reverse the sleight of hand that got us into it. If new money must be pumped into the economy, it should be done, not by private banks for private profit, but by the people collectively through their representative government; and the money should be spent, not on bailing out banks and hedge funds that have lost speculative market gambles, but on socially productive services such as rebuilding infrastructure.

When deflation is tackled by creating new money in the form of debt to private banks, the result is a spiraling vortex of debt and price inflation. The better solution is to put *debt-free* money into consumers' pockets in the form of wages *earned*. Workers are increasingly losing their jobs to "outsourcing." A government exercising its sovereign right to issue money could pay those workers to build power plants using "clean" energy, high-speed trains, and other needed infrastructure. The government could then charge users a fee for these services, recycling the money from the government to the economy and back again, avoiding inflation.

Other considerations aside, we simply cannot afford the bank bailouts coming down the pike. If it takes \$300 billion to avert a market collapse precipitated by a few failing hedge funds, what will the price tag be when the \$400-plus trillion derivatives bubble collapses? Rather than bailing out banks that have usurped our sovereign right to create money, we the people should skip the middlemen and create our own money, debt- and interest-free. As William Jennings Bryan said in a historic speech a century ago:

[The bankers] tell us that the issue of paper money is a function of the bank and that the government ought to go out of the banking business. I stand with Jefferson . . . and tell them, as he did, that the issue of money is a function of the government and that the banks should go out of the governing business. . . . [W]hen we have restored the money of the Constitution, all other necessary reforms will be possible, and . . . until that is done there is no reform that can be accomplished.

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