1) This is THE WIZARDS OF MONEY Your Money and Financial Management Series…but with a twist. My name is Smithy, I'm a wizard watcher in the land of Oz.

In response to the ever growing supply of business and personal finance shows, from CNBC, to CNNfn and CNN Money, to Public Broadcasting's Wall Street Week and Suze Orman Specials, we bring you this new series on money but "with a twist". In this series we will look beyond the latest DOW and NASDAQ ups and downs, past the hot stocks of the day and the investment tip of the month, and see just how tricky and undemocratic our monetary system really is. The Wizards of Money will take a critical look at the mechanics of today's capital and debt markets, study those who make the critical decisions that drive them, and examine how these markets then affect everybody's lives.

Humans have inherited a monetary system that fueled the industrial revolution, lost its commodity backing during the Vietnam War and now travels by the trillions in the form of information packets over millions of miles in a matter of nano-seconds. Gold, silver and physical currency notes are almost irrelevant these days, having been replaced by a system of bits and bytes accounting in electronic networks. While money is simply an abstraction, an invention of the human mind - why, it's a mere measure stored in the computers of the banking system! - our lives revolve around it and its disappearance can bring trade to a grinding halt, collapsing whole communities. This bizarre situation is may be compared to a carpenter stopping work because he has run out of inches! Or a musician calling it quits because she's run out of decibels!

Funny, isn't it, how of all the things we wonder about when growing up - like "Where do babies come from?", "Why is the sky blue?", "How does this or that work?" there is one thing that never seems to be addressed. Sure you can ask grown-ups about money but all you'll hear is "Money doesn't grow on trees", "I'm not made of money, you know", "Money isn't everything". "Money is only useful when you get rid of it", and of course "Money is the root of all evil". This is all good advice, but good luck getting an answer about where money really comes from. Well, that's what Wizards of Money is all about. Wizards of Money will discuss the mechanics of money in a way the wide selection of today's financial shows wont. And today, we'll be finding out where money comes from.

Today, in Episode 1, we'll examine how money is made and who makes it. We'll explore the mysterious money making process by first exploring the origin, and role of, one of the most secretive bodies in the world, the Federal Reserve System. We will also look at the role of the commercial banking system, and why it is that the money origination process is not only magical and mysterious, but also quite unfair and undemocratic.

In future editions of the Wizards of Money we'll look further into the workings of the Federal Reserve, and its sole shareholders, the private banking industry. We will also investigate similarly
mysterious bodies such as the Bank for International Settlements in Switzerland, as well as the rapidly growing unregulated parts of the capital markets like Hedge Funds and the Derivatives Markets. We'll investigate the wizardry of financial accounting, and the role these things play in our own lives.

Wizards of Money has a web site with even more information about the wizards behind the monetary curtain located at www.wizardsofmoney.org. There you can find references and the audio and text of every episode of the Wizards of Money. And, for those wanting to wrap their heads around more intricate monetary mysteries, there's even a monetary quiz called the "Money Mysteries Game" to test your own wizardry skills.

2) WHERE DOES THE TITLE "THE WIZARDS OF MONEY" COME FROM?

The explanation of this will provide a good historical framework for this series, and remind us of a time a hundred years ago when the American citizenry had a much better understanding of their national monetary system and demanded active participation in it.

Today, however, for reasons that can only be speculated on, the majority of world citizens have very little understanding of how the international monetary system works. Yet in this day and age our lives are largely determined by our relationship to, and we are highly dependent on, the international monetary system.

When you live and work amongst something day in, day out, you take it for granted. Just like fish surrounded by water, many people seem to have stopped questioning the foundations of the monetary system and go through life unaware that these foundations may be on very shaky ground. Additionally those of us who work in finance have been “trained” to understand economics and finance in a certain way, often blinding us to new ways of looking at money. Personally, I like to look back on a time when lots of people were questioning all of these things.

The name of this series, the "Wizards of Money" is derived, of course, from the title of a book written just over 100 years ago, called "The Wonderful Wizard of Oz", by journalist L. Frank Baum. Many believe this book to be a social commentary of the times. And one of the most contested issues of the era was the monetary system and whether America should stay on the gold standard or move to a bi-metallic standard (meaning gold and silver). Gold would benefit the already rich and powerful financiers of the northeast, who owned most of the gold, such as JP Morgan and others. The bimetallic standard would make money more available to farmers and regular workers and was backed by the Populist movement of the time. The monetary system was such a popular public discussion item that talks on this issue drew crowds of ten of thousands from across the country. Interpreters of the "Wizard of Oz" have suggested the following meanings of characters and places in Oz:

- Oz, short for Gold Ounces, may be symbolic of the Gold Standard of Money
- The Wizardry in Oz may refer to the mysterious money making process itself.
- The YELLOW brick road to Oz, is probably the way to the grand financiers who supported the gold standard.
- I like to think of Emerald City as Wall Street, where the wealthy financiers who owned most of the gold were based, and where green glasses (green for money) were worn.
- Dorothy’s shoes in the original book were SILVER, not red as in the movie, and likely represented the other component of the bimetallic standard.
- The man operating the Wizard possibly represents the financiers behind the presidential candidate at the time who favored the Gold Standard. This candidate was William McKinley.
“Wizards” of Money, as in Oz, is a most appropriate name for those who are responsible for the mysterious money making process today. In this process, as we shall see, money is essentially created "out of thin air". It is only the Wizards who get to practice this art, and they do so in the absence public scrutiny which might ruin the magic.

The other main characters of Oz also have counterparts in US society at that time, that is, at the start of the 20th century. You can find some references to these interpretations at wizardsofmoney.org. Well, as it turned out, the Populist movement lost, McKinley was elected president and the Gold standard defined the monetary system. But the US still did not have an effective central bank system. At the instigation of financiers like JP Morgan and his right hand men, but most of all from the sheer energy and genius of one Mr. Paul M. Warburg, that was all about to change.

3) THE BIRTH OF THE FEDERAL RESERVE

The birthplace of the Federal Reserve System was not Wall Street or Washington as people might think. The founders wouldn’t dare hold a monetary design meeting in a place where public scrutiny might threaten the magical handiwork of the first Wizards. The target destination for the first wizard convention was in a place one generation removed from slavery, and with such a remarkable devotion to gold that, less than a century earlier, it uprooted its indigenous inhabitants and marched them off to Oklahoma at the first smell of gold. What better place could there be to design an undemocratic monetary system based on the gold standard? This state was Georgia, and in 1910, a special Wizard convention took place there on Jekyll Island. Duck-hunting was the excuse given for the participants having to go there. But numerous historical accounts of this event reveal that the duck population remained fully intact and, instead, the Federal Reserve System was designed.

Three years later, during the week before Christmas 1913 when several representatives were already on vacation, the US Congress slid through the Federal Reserve Act, thereby giving birth to the Federal Reserve System. Today, though the gold standard is "no more", we still live with the legacy of that Jekyll Island meeting and some of history’s real monetary wizards, particularly one Mr. Paul Warburg - a prominent banker of the times, who is also rumored to be the inspiration for the character Daddie Warbucks in the cartoon and then musical, Annie. Needless to say, the system they designed had little (well, effectively no) room for public input. It has survived fairly well, with the exception of the 1929 crash and subsequent depression, because the general public trusts it. However, they do so mostly without understanding it. This is a very interesting situation to have in a so-called democracy.

To this day, the mysterious body known as the Federal Reserve is not a government body. It's ownership equity is 100% held by the private banking system. It's one of those strange partly private, partly public bodies that have so much to do with how the world and its' markets run. True, its governors are appointed by the President, but their terms are for 14 years and the structure of appointments guarantees they represent the very best interests of the wealthy.

4) SO, How is money created, and what role does the Federal Reserve and its member banks play?

Let's start with some common misconceptions about money, and why they are not true:

Misconception 1: You make money by going to work, or by selling something.

FALSE: Nobody can make money except commercial banks (also called depository institutions) and the Federal Reserve, which is owned by the commercial banking industry. When you get paid for work it is merely a transfer of money that already exists. It was, at some time in the past,
created by the banking industry for a purpose for which they saw fit to create (or really lend) money. The main reason people get a job is to get a transfer of money from people who already have some themselves, so then they can buy stuff they need and want.

When we talk about money here we mean money that can be used in all transactions and in the repayment of all debts. This is what we are calling bank-money. However many non-bank types of so-called "money" raising instruments are increasingly being used by non-bank corporations to avoid direct contact with the bank money creating process. This includes things like corporate bonds and shareholder equity, which expand on the bank money supply, but all are completely dependant on, and rely on the confidence that they can be liquidated for, "bank money". We might call this other stuff "near money". Since, in our society, it is really bank money people seem to need for the basics of life, and these other near monies are storage instruments for people that have excess capital, we will focus just on bank money in this edition of Wizards.

**Misconception 2:** Money has something to do with gold and Fort Knox.

FALSE: The monetary system USED to be backed by the gold standard until President Nixon abolished the Gold Standard in 1971 during the Vietnam War. He did this because there was not enough gold at Fort Knox, KY to back all the money that needed to be created to fund the massive wartime expenditures. The axing of the gold standard backing the US dollar led to the "floating" of most national currencies, which were no longer pegged to a gold conversion standard.

In the post gold-peg era, the world saw phenomenal growth in speculation against international currencies, which has led to massive economic and social crises in various countries whose currencies were speculated against. Examples include the Mexican Peso crisis of 1994-95, the Asian financial crisis of the late 1990s, followed by the Russian ruble collapse.

Money supply and debt have exploded in the absence of gold convertibility and it is hard to make sense of what money really means anymore. Money is no longer a store of value. It is only a measure, an electronic accounting system of credits and debits that has come to be accepted world over as the only way of conducting trade, and assessing the status of fellow humans. Each day several trillion dollars travels the globe trying to attract more electronic credits for its owners. "Real economic" transactions account for smaller and smaller portions of financial transactions, and we truly live in the midst of a global casino.

Today's money is not backed by gold. It is now backed by nothing at all, except our trust in the monetary system. This is ultimately a trust in those that create and control money – the commercial banking system, and the closely related central banks, like the Federal Reserve. The statement on all Federal Reserve Notes "In God we Trust", is perhaps the most telling statement of this trust. For, who would even question something that appears to be so close to God?

**Misconception 3:** Money is Created by the Government Printing it.

FALSE: Today hardly any money is created by the government. Most of the total money supply is created by banks making loans to the non-bank public. Almost all money is created by the creation of a corresponding amount of debt. Currency notes in circulation are just a very small proportion of the total money supply and they are created by the Federal Reserve System, not the US Treasury or any other true government body. In truth, money is actually created "out of thin air" by the commercial banks and the Federal Reserve System.
5) Exactly How Does Money Get Created?

Having gotten some of these misconceptions out of the way, let’s talk about the actual mechanics of money creation. Money creation happens in two main ways; First is the creation of “base money”, which is mostly physical currency notes, created by the Federal Reserve. The second money creation process involves checking account or deposit money created by the commercial banks, and which makes up most of the money supply.

Base money, also called "high powered money", is created when the Federal Reserve performs what are known as Open Market Operations. In this process the Federal Reserve injects money by buying Government Bonds, which then become debt owed by the government (that is the American Taxpayer) to the Federal Reserve. And where does the Federal Reserve get this money to buy the government securities? Well, it just makes it up “out of thin air”. The Federal Reserve creates money out of nothing whenever it decides to inject some into the economy. Almost all money we come by has its basis in high powered money that the Federal Reserve invented at some time in the past. Most of this base money is currency in the form of Federal Reserve Notes. The Federal Reserve then creates a spurious "liability" on its balance sheet called Federal Reserve Notes outstanding, and in return gets an asset in the form of government bonds. Conversely, when the Federal Reserve wants to reduce the base money supply, it sells government bonds and writes off some of this spurious liability, making it vanish just as mysteriously as it was created.

Creating new money is equivalent to making money cheaper relative to real goods and so it’s equivalent to lowering interest rates, or the "price of money". Shrinking the money supply is equivalent to increasing interest rates. Therefore, every time the Federal Reserve creates or extinguishes base money the financial press and other mainstream media reports it as a Federal Reserve Interest Rate change. While not technically correct, it does sound rather more palatable than saying that the Federal Reserve just made some money up or just made some money disappear.

Once this base money is created, banks can create around 10 times this amount in checking accounts and other deposits. They do this by making loans to the non-bank public. A corresponding amount of checking account money is created for each new loan. So most money is created just by bankers writing some new numbers on a piece of paper, or these days, entering some new bits and bytes in computers, since money is really now just a bunch of computer records. This means that when you go to borrow money to buy a house or car, the money is really being created “out of thin air” by the bank, and being credited to the checking account of the seller.

The bank has a distinct advantage in all this just by being a bank. For if you can’t pay the loan through your hard work, they automatically get the house, and all they did was write some numbers into the computer! From the bank’s perspective however, if you don’t pay off the loan, they would have to write down their asset (i.e. your loan) and this would effect the earnings they report. Also, from the perspective of the banking system as a whole, note that the loan - which is an asset for the bank, comes back in as a deposit in the banking system, i.e. as an offsetting liability for the banking system. If a certain number of people ran out of money and couldn’t pay off their loans, the banks would have to write down a whole lot of their assets. But the banks would still have the same amount of deposits from the people who do have money, and would be in a position where they couldn’t cover these deposits. So you can see why the banking system wants to keep the house if you don’t pay your loan – they are taking a financial risk too, albeit one created completely out of "thin air".

This money creating process might seem kind of bizarre and out of control. You might be wondering what sorts of checks and balances exist in the system to:
(a) Make sure the Federal Reserve doesn't go wild creating so much money relative to the value of goods in the economy, that prices keep rising out of control and money becomes worthless; and

(b) Ensure that the banks don't go crazy making more and more loans so they can keep stuffing new assets on to their balance sheet and new money into the economy. Too much money created in this way could lead to a domino effect where, because some people can't pay off their loans, the parties that lent them money can't pay off their debts and so on, leading to a "domino effect" type of collapse.

These are good questions to ask, and they suffer from very little public curiosity and debate, despite the tremendous impact they could have on all of us. The monetary wizards have to make sure that just the right amount is available for current and future levels of economic activity - not too much more and not too much less. If the wizards don't keep control of these things, then money can become meaningless and worthless, - and that will surely effect us all, just like it did for everyone during the Great Depression and just like it did recently for countries like Argentina, Mexico, Thailand and Indonesia.

To answer the first part of this question, it is important to point out that the Federal Reserve has learnt how to create the appropriate amount of money primarily based on trial and error. Through spectacular screw-ups like the 1930's Great Depression, and the 1980's spike in interest rates, they have learned what not to do. However, while past experience is a useful guide, it doesn't help you with knowing how to operate in a totally renovated financial system. As we will see in future episodes of Wizard of Money, the financial landscape has changed radically over the past few decades with the proliferation of new debt instruments, the derivatives markets, unregulated entities like hedge funds, and a growing mound of consumer, government and corporate debt. Do the central banks and the regulators really know how to keep things under control in this environment?

On that note, let's answer the second part of the question about check and balances on money creation. In order to make sure that commercial banks don't go crazy making too many loans and creating too much money for the economy, central banks like the Federal Reserve, and several government regulators, set limits on how much money banks can create (or lend) based on how much money bank shareholders have at risk in the bank. These limits are referred to as the Risk-Based Capital Rules and we will talk about these in later episodes of the Wizards of Money. For now, we will just note that exactly the same issue applies as for controls on the Federal Reserve - and that is - How do we know these controls will work in the current financial environment with trillions of dollars controlled by unregulated entities and the complexity of modern financial instruments such that only geeky Math Professors understand them!

6) So, Is Money Democratic or Not?

Let's think about this:

Is the public invited to participate in the deliberations of the commercial banks?

Don't think so.

Do you recall seeing the Federal Reserve Open Market Committee meetings broadcast on C-SPAN?

Nope.
Remember Presidential Candidates discussing these issues in debates?

No way.

Which came as the biggest shock to you as a kid - the fact that Santa and the tooth fairy don't really exist - or that money is simply created out of thin air?

Of all the things that affect the quality of our lives, the mechanics of money is the one that stands out as escaping public scrutiny all together. Interestingly, and despite concerns professed by founding fathers like Thomas Jefferson, the heart of the monetary system was intentionally designed to be free of public influence. It is no accident that the process for appointing decision-makers at the Federal Reserve is the least influenced by politics of all federal appointments. You can interpret this how you want: Some may interpret this as a means of ensuring that the monetary system is always in the hands of a certain class of people, and others may interpret this as a means of ensuring stability in the monetary system for the good of all.

But what are the consequences of the general public having no input into decisions about money creation. It is only bank managers and the Open Markets Committee of the Federal Reserve Board that decide how much money gets created, and importantly, for what purpose money should be created. These decisions are closed to public input.

Decisions on making new money will always be based on whether a borrower can repay and how much interest the borrower can bring in, which is what creates bank profits. This means most money will be created to lend to people that already have previously created money, and/or certain advantages in life that will enable them to collect money in the future. Disadvantaged people will be more likely denied access to the money creating process, and because they are at a disadvantage, are more likely to be exploited by unfair loan terms. In our society, access to capital and opportunity go hand in hand. The ideal of "equal opportunity" meets its toughest adversary in the money creation process.

What this also means is that there is no link between the money creation process and the things most desired by society as a whole. In fact money is often created for exactly the things that many people do not want at all. This includes projects that involve excessive destruction of natural resources like logging, building dirty power plants, mining, and so forth, because the bank realizes that such projects are likely to bring back the money that will pay off the loans. It is also interesting to note that money is generally not created directly for the purpose of providing public goods, such as education and healthcare, for such services will not pay the bank back. Rather these services depend on recycled money through the tax system. Hence, because there is no link between money creation and common public needs/desires, it is not surprising that we have reached a situation where monetary value and social value are somewhat inversely correlated. By this I mean that a good or service with a high monetary value in the private property markets often has a low social value. Conversely high social value goods and services generally return a low monetary value. This is illustrated in the example where public goods providers such as teachers and nurses are some of the lowest paid workers, yet currency trading is one of the most lucrative professions there is, and has also become quite socially destructive. It is reasonable to expect that this situation would be largely reversed by taking social factors and public input into consideration at the point of money origination. Some would then argue that public input would de-stabilize the system and make us all worse off than the current closed system.

It is clear that origination of money at commercial banks is undemocratic and so encourages the creation of money (or loans) for many undesirable activities. But often overlooked is the unchecked power of the Fed, the creator of Base Money. One of the best reminders of this power is then Federal Reserve Governor Paul Volcker's hike in interest rates in 1979 that triggered the Latin America debt crisis. This came at tremendous cost to the people of Latin American
countries. While the activities of OPEC, the commercial banks and various dictators, played a major role in laying the foundations for this crisis, the final push was decided at one committee meeting conducted behind closed doors. The FOMC meetings have never been open to public input or scrutiny. While summaries of meetings are posted almost immediately, the full transcripts of FOMC are not even available until 5 YEARS after the event!

It is important to be concerned that the money origination process is not subject to democratic accountability. Many of these problems could be remedied if the public had more input into the decisions surrounding the origination of money but, as already noted, it could also lead to more problems than are being solved. At the very least, the mechanics of money should be high on the list of topics for public debate. In addition, once you understand the process for creating money out of thin air, you begin to see that what banks and the Federal Reserve do is not so difficult after all. People can, and are, creating their own monetary systems for their own communities and we will discuss these "home made" monetary systems in future episodes of the Wizards of Money.

7) THE ZERO SUM GAME

A most interesting outcome of this money creation process is that, because all money is matched by a corresponding amount of debt, money is a zero-sum game. The more of a positive net money balance I have, the more of a negative balance someone else has. I can put my positive balance to work earning more money, while I either sit around and do nothing, or go and work for more money. Because it's a zero sum game, if my balance is getting more positive, then someone else's is getting more negative. Compounding this imbalance is the fact that its easier to grow your balance if you are in a positive balance position, but because of the way credit is priced, combined with various social trends over the years such as the decline of union power, its harder for someone to turn a negative balance positive - either through exchanging labor for money, or borrowing to start a business.

This discussion is simply a restatement of the ages old criticism of capitalism - the rich get richer and the poor get poorer. This fact of increasing imbalance is a major reason for a system of taxation in a capitalist economy. In this context, taxation is a way to partially correct the monetary system's imbalance, by transferring money from the richer to the poorer. Other government sponsored programs also try to correct the imbalance such as in the provision of loans for housing and education at a reasonable, rather than exploitative, price for credit. But as we shall see in future episodes of the Wizards of Money, some of these government programs consist of even more hocus-pocus than the monetary system itself and/or have been an absolute boon to the already well-to-do along Wall Street. It's sometimes not clear who these programs were designed to help the most.

Often overlooked in this zero-sum game, is that most interesting of government objectives - ensuring that the monetary system cannot fail. This translates into ensuring that the major section of the world banking sector - namely the large Western financial institutions - must not fail. This would actually be disastrous for rich and poor alike, as in the Great Depression. To reduce risk of banking system failure (which ultimately comes from sudden loss of confidence or trust in the system) institutions such as the Federal Depository Insurance Corporation (FDIC), the International Monetary Fund (IMF) and other tax-payer funded institutions have evolved into mechanisms for preventing banking system collapse. Unfortunately, however, what these mechanisms often amount to is the transferring of the costs that could collapse the banking system to places outside of the banking system. Many of these costs end up being borne by those who have the least say in the financial system, such as the US taxpayers who funded the clean-up of the Savings and Loans Crisis and the peoples of Asian and Latin American countries who had to pay back sizeable IMF loans in the 1980s and 1990s. As we shall see in later episodes of the Wizards of Money, these "bail-out" mechanisms are one of the most dangerous
aspects of the contemporary financial structure and they significantly distort free markets where, ideally, investors would take personal responsibility for the financial risks they assume.

While it is true that the monetary system is a zero-sum game, it is also true that what it gives rise to are more and more “real” and tangible assets - from homes to cars, to appliances, clothes, electronics and the list goes on and on. But there is an obvious way to look at even this as a zero sum game - and that is in our relationship to the environment. The more natural resources we use for our own production and consumption, the less is available for non-human users who might be needing it. There is only a finite supply of fresh water, sunlight, and land, and only so much carbon you can stuff back in the air. But there are still no controls on how much we can come to dominate all these natural cycles or recognition that this may prove disastrous for us. Unfortunately the design of the current financial system tends to encourage more and more capitalization of these resources on the human side of the balance sheet, potentially bankrupting the other. Future episodes of Wizards will examine changes already taking place and proposed changes to the financial system to address these issues.

8) ANCIENT MONETARY WISDOM

What is surprising is that this knowledge is ancient wisdom and has been recorded in the primary texts of the world’s major religions. For example, The Old Testament of the Bible speaks of the sin of usury and the concept of Jubilee, the period eradication of all debts. Most likely this is from very similar realizations about money thousands of years ago.

It is ironic that the Federal Reserve Note bearing the statement "In God we Trust", is the symbol of the system that so blatantly violates the key principles of this ancient wisdom claiming to be God’s word itself.

On that Federal Reserve Note, that’s all for Wizards of Money #1. You can visit www.wizardsofmoney.org to get the text and audio of all Wizards episodes, to get links to more information and to exercise your brain with the Money Mysteries Game.

SONG/MUSIC: "The Merry Old Land of OZ!" The Wizard of OZ Soundtrack

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