

Understanding the Benjamin's

The United States currently operates under a mixed monetary system, and the Federal Reserve is the institution responsible for monitoring and maintaining it. The Federal Reserve uses several tools and methods for maintaining this system. Throughout the course of this article, the author will discuss these tools, explain how money is created, and describe 2 monetary systems that have worked well and do work well.

Overview and Purpose of the Federal Reserve

The Federal Reserve was initially created in 1913 to prevent banking panics which were common about once per decade. Under the direction of such distinct individuals, J.D. Rockefeller, J.P. Morgan, and Nelson Aldrich, the draft for a central reserve system was created and proposed. While hotly debated between Republicans and Democrats, a system was finally agreed upon and the Federal Reserve was born. Not only does the Federal Reserve control the financial stability of the United States, but also controls bank scares, manages interest rates, and attempts to balance the working relationships of private and public financial institutions.

Another function of the Federal Reserve is to influence and initiate monetary policy. Monetary policy establishes a relationship between interest rates and the actual availability of funds. Monetary policy is generally categorized one of two ways: expansionary policy or as a contractionary policy. An expansionary policy is generally used to lower interest rates and battle social issues such as unemployment. A contractionary policy is used to suppress the money supply- thus potentially inflation.

Finally and possibly the most important function of the Federal Reserve is to create an "elastic currency." By use of the phrase "elastic currency," the author implies that the Federal Reserve is capable of increasing the flow of funds and contracting the availability of funds. The Federal Reserve closely monitors the economic conditions of the nation and adjusts the availability based on current social conditions.

The Federal Reserve uses a number of methods in controlling the money supply. A few of these tools include: the discount rate, open market operations, creating fiat money, and the reserve requirement.

1. The discount rate: "The discount rate is the interest rate charged to commercial banks and other depository institutions on loans they receive from their regional Federal Reserve Bank's lending facility--the discount window" (The Federal Reserve, 2008).

2. Open Market Operations: "Open market operations are the means of implementing monetary policy by which a central bank controls its national money supply by buying and selling government securities, or other financial instruments. Monetary targets, such as interest rates or exchange rates, are used to guide this implementation" (Johnson, 1994).

3. Fiat Money: "In a fiat money system, money is not backed by a physical commodity (i.e.: gold). Instead, the only thing that gives the money value is its relative scarcity and the faith placed in it by the people that use it" (Kwaves, 2008).

4. The reserve requirement: "Required reserves are an amount of funds equal to a specified percentage of the bank's own deposit liabilities. A bank must keep these reserves on deposit with the Federal Reserve Bank in its district or as cash in the bank's vault" (McConnell et al, 2004, p. 254).

Creating Money

A common misconception is that the Federal Reserve backs every bill it creates with either gold or silver. That statement has held true until the last few decades (under the gold standard). No longer do banks back the bills being printed. Banks create money through lending. When a bank lends money, it has ultimately monetized an "IOU." The bank in return will be paid back the IOU plus interest--thus producing a substantial profit for the lender. According to Elvis Manning (2007), "The Society of Bankers create money out of nothing by writing numbers in their ledger books, and then giving loans to the American people with this money. This allows the people to write checks or take cash (Federal Reserve Notes) on the numbers written in their accounts, and then requiring payment with interest. Money is simply numbers."

Negative Effects of the Federal Reserve

Henry Ford once said, "It is well that the people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning." The effect of creating fiat money, fictitious monetary supplies, has an outstanding effect on inflation. For example, say an individual wakes up one day and has twice the funds in their bank accounts. The individual is going to spend some, invest some, and maybe save a bit. Suddenly, they realize the same thing has just happened to everyone else across the United States. Because more money has been put into circulation, prices begin to increase as the demand for more items increase. People begin to look for higher salaries to afford items they were once able to afford, suppliers will charge more for goods and services, and the revolving door of debt continues to spin. Though this is an extreme example, it magnifies the effects of banks creating money from nothing—money that isn't backed by "real" funds.

In the words of former US President, Thomas Jefferson (1791), "I believe that banking institutions are more dangerous to our liberties than standing armies. If the American people ever allow private banks to control the issue of currency, first by inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children will wake up homeless on the continent their fathers conquered."

The concept of using fiat money has been around for hundreds of years. Interestingly enough, section 10 of the United States Constitution forbids states from creating fiat money with anything other the silver or gold. So why has our "sovereign" nation taken it upon themselves to create a

Federal Reserve that creates money not produced with or even backed by a truly universal currency? Our country has fallen into a state where it has become easier to create fictitious funds than to accept responsibly for the tremendous amounts of debt incurred from years of war, frivolous spending, and bank-backed politics. Year after year the United States fall further into a national debt that realistically cannot be paid off.

Successful Monetary Policy

Inflation targeting is very popular among many successful nations across the globe. Inflation targeting is a monetary policy in which a government's central banking system strives to maintain a targeted inflation rate by manipulating interest rates. By following the strict guidelines provided by inflation targeting, the central banking system should ideally maintain strong control over their inflation rate. Examples of these major economic players that employ such a policy include: England, Australia, Canada, and Egypt.

While this system appears to control unemployment rates, inflation, and maintain levels of economic growth, no system is perfect. Critics of inflation targeting label this system as "idealistic." This system does an amazing job of maintaining control of domestic economic issues and pressures, but ignores the external influences that can directly influence the consumer price index. A prime example of such a force is the current hike in the price of oil. In this case, economies that are dependent on other nations for importing necessary products fall victim to costs outside their control.

Another monetary system that has been the traditional universal monetary system is The Gold Standard. Currently the world does not operate under a standard monetary system. Countries are slaves to shifty exchange rates and to the temporary controls a particular economy may have. Historically, the gold standard has acted as a universal currency that backed the faces of bills and legal tenders printed by such nations. No longer does money maintain a "real value." Loans, bonds, and electronic transfers merely represent the potential of an agreed upon amount. So, is it feasible to return to a universal system such as the gold standard? Not likely—but such a system maintains a higher level of control that current monetary systems cannot provide.

Conclusion

While the Federal Reserve System works to maintain our inflation rates by manipulating interest rates, our money is only worth so much elsewhere. Understanding how each economy is interlinked and interdependent on one another is important because the external forces directly affect the decisions made by the Federal Reserve.

References

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