

DAYLIGHT ROBBERY



State asset sales. Finance company collapses. The controversy over Allan Hubbard. Compulsory Kiwisaver. The global crisis. You've been stung for billions. Are you ready for what's around the corner?

Ian Wishart

#1 BESTSELLING AUTHOR

*For Logan and Taryn,
with love*

DAYLIGHT ROBBERY

A STORY OF BANKERS, SHYSTERS
& OTHERS WHO WANT TO STEAL
YOUR MONEY

Ian Wishart

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Introduction

THERE'S A REPUTEDLY ANCIENT CHINESE curse: "May you live in interesting times". It first appears to have hit Western consciousness in 1939, just a few months before the outbreak of World War 2. Now, we're living it again.

My reason for updating and re-releasing this book - the original version of which was released in 2001, is simple. For the past 18 months I've been facing increasing demand from bookshops and members of the public wanting copies, in the wake of recent world developments. It seemed like an opportune time to go back to the future and find out whether we've learnt anything in the decade since *Daylight Robbery* was first published.

Since 2008, people around the world have been waking up to the surreal knowledge that the world economy of the past half century has been built on sand. Collectively, we're watching the foundations of everything we've ever known and worked for being washed away in a tsunami of financial upheaval.

The global financial crash, crisis, or GFC as it has been dubbed, is simply a bigger version of the shonky activities that brought our own Bank of New Zealand to its knees in 1990. That story, which you'll find in these pages, is intricately tied up with the first round of state asset sales carried out by the David Lange Labour Government and Jim Bolger National Government in the 1980s and early 90s, and it's a story of greed and backroom deals that enriched some well-connected people and left the public feeling fleeced.

Two decades later, as we try and rebuild our economy on the back of the crash and the expense of a major natural disaster, New Zealand voters are being asked to endorse another round of state asset sales and/or partial privatisations and the question has to be asked, have we learnt from the mistakes of the past? What did the first privatisations end up costing taxpayers?

Since I wrote the first edition of this book ten years ago, taxpayers have spent huge sums of money bailing out previously privatised assets like Air New Zealand and Tranz Rail. If privatisation is supposed to place the risk in the hands of private billionaires, how did we get left holding the baby regardless? Could it happen again?

What about the taxpayer bailouts of failed finance companies? Billions of dollars of your money has now disappeared down a rabbit hole – to whose benefit? And what about the new financial world we face, what will the impact of the GFC end up being?

These are all important questions – ones I intend to answer in this revised edition. Moving forward, we are facing the kind of social, political and economic conditions that preceded World War 2. Prime Minister John Key's plea for a new mandate on asset sales should cause everyone, at the very least, to reacquaint themselves with what has happened so far. And that's what this book is about. It is not intended to be an exhaustive investigation into everything that has gone wrong - the subject is simply too big - but it is intended to give you a solid, easy-to-read overview of the situation.

By rediscovering the mistakes of our past, we might just avoid making them again in the future.

Prologue

IT WAS 1992 WHEN I first paid any real attention to the collapse of the Bank of New Zealand two years earlier. My primary focus at the time as a journalist was the death of a computer dealer named Paul White, and a heated political campaign by Winston Peters over what became known as “the Winebox affair”.

Although the Bank of New Zealand was Peters’ main focus, my own attention remained riveted to the Winebox. It was only at the end of the 90s, in returning to information gathered during the course of a four year investigation, that I was able to piece together the untold story of the rise and fall of the Bank of New Zealand: who caused it, who made money out of it, why it happened.

The 80s and early 90s were the breeding ground for an economic policy that argued strongly in favour of state asset sales, and partial or full privatisation where possible. There was a philosophy that the Government could help pay its bills by selling off what some called “the family silver”.

The logic went that governments should be in the business of governing, and leave commerce to the private sector. All well and good, except that some people couldn’t see why a state-owned enterprise operating under a fully commercial business model and making profits for the taxpayer, should be flicked off to someone else at possibly a discount price. Why sacrifice the revenue streams and dividends, merely for the sake of an ideology?

On the other hand, you could see most of New Zealand’s government agencies needed a major overhaul for the sake of efficiency.

Back in the day when government-owned New Zealand Rail held the monopoly on transport, and trucks could only venture 90 kilometres from their home city without special dispensation, long-haul freight – including household furniture removals – was forced to go by rail nationwide. It was horrendously inefficient – goods had to be loaded from your home or business onto a truck in the first instance, then de-trucked at the rail storage depot. There, it remained on hold until it was scheduled onto a long-haul freight train going in the required direction, when the goods had to be re-loaded onto a wagon. Sometimes your wagon was left on a siding partway

down the country to wait for a connecting train to take it to your particular destination. Sometimes your wagon was re-attached to the wrong train, and your houselot travelled to Invercargill instead of Christchurch. Eventually, having reached its destination, the wagon needed to be unloaded, and then re-loaded onto a truck for the final journey to the home or business the freight was meant for. Once there, of course, it had to be unloaded again.

All told, such a use of the state monopoly transport system cost huge amounts of money, because of all the extra handling, big insurance payouts because of the heavily increased number of breakages and loss caused by extra handling, and big time delays – it could take eight weeks for a houselot of goods to arrive if a family moved from Wellington to Dunedin, or vice versa. Eight weeks!

Such massive inefficiencies were one of the prime reasons rail was finally opened up to competition from long-haul trucking in 1982, a move that helped take the brakes off the New Zealand economy. Having forced New Zealand Rail to compete, the monolith was corporatized to become a proper functioning business, and then sold off – more of which later.

The way New Zealand used to operate threw up some strange bureaucratic events, and I had the personal good fortune to be at the centre of one of them.

In 1983, as the Radio Windy newsroom's most junior journalist, I was stunned when the planned introduction of private television to New Zealand was gazumped in the middle of that year because the state-owned Broadcasting Corporation of New Zealand (which then administered TVNZ and Radio New Zealand) refused to allow private TV to share or lease transmission facilities from it. The decision, announced by the then Minister of Broadcasting, meant New Zealand would not get a third TV channel because the BCNZ was locking competitors out of the transmission network.

My father was a senior executive with the New Zealand Post Office (formerly Post & Telegraph) which, in those days, included Telecom. I knew from experience that Telecom had transmission links covering the entire country. Why, I asked my father, couldn't the Post Office offer to lease transmission facilities to private television? "Because we are not allowed under current regulations," he answered.

"But can't you suggest it to the Minister in charge?" I asked.

"We're not allowed to make direct suggestions to the Minister, it will have to come from outside."

Fine, I thought. That morning when I arrived at work, I contacted Radio Windy's parliamentary bureau run by Barry Soper and Fraser Folster, and suggested they ask the Minister, Postmaster-General Rob Talbot, whether he

was prepared to allow private television to lease spare transmission circuits from the Post Office.

“That’s a novel idea,” replied Soper. “I don’t think it will fly, but I will ask the question.”

That same day, July 20, 1983, at 10.45am, the newsroom teleprinter clattered into life with all of its alarm bells ringing.

“URGENT: ATTENTION WINDY (IAN) AND AUCKLAND STATIONS

“The Post Office might in the future provide transmission facilities for television services and be able to lease them to private television companies, according to Postmaster-General Rob Talbot.

“He says this would be outside the normal range of Post Office services but he says providing transmitters for television would require much the same skills as for telecommunications.

“Mr Talbot says if involvement by the Post Office is seen by private television companies as assisting their plans for getting into operation, he’s prepared to take a proposal to his cabinet colleagues...

“The Minister says it should be borne in mind that any arrangements the Post Office might be able to enter into would need to be available freely and fairly to any organisation successful in a [TV broadcasting licence] application on the same basis.

“He says it would be prepared to give similar consideration to any requests from FM radio warrant seekers for the Post Office to lease transmission facilities to them.”

The news alert sent to all private radio stations had a footnote on the end, in brackets:

“Virtually full text of press release just come through the door and in response to Windy query. The Minister will not be releasing these comments generally for an hour or two yet, so private network has this first. Attention Ian At Windy: I think you struck gold with an alternative to the BCNZ system now mooted by the Postmaster-General.”

So there you have it. A question from a 19 year old radio journalist catapulted the New Zealand Post Office into offering transmission and data circuits to private companies as a business operation for the first time. If you are watching TV or listening to one of the numerous radio stations that sprang up as a result of this, or if your office uses Telecom data circuits, you can send me a royalty cheque if you feel so inclined.

The realisation that the Post Office, which back then comprised the postal system, the phone system and the Post Office Savings Bank, could do direct business in the private sector and compete against other government depart-

ments like the Broadcasting Corporation, was one of the factors leading to the split of the giant Post Office into three business units: Post, Telecom and Banking, two of which were later sold off as part of state asset sales.

Ironically, some of New Zealand's big state assets, like New Zealand Rail and the Broadcasting Corporation, had begun life as privately owned companies, but had been taken over by the taxpayer in the distant past. One of these was the Bank of New Zealand...

—PART ONE—

THE LOVE OF MONEY

CHAPTER 1

Birth Of A Nation

"It is manifest to those who have directed attention to the subject, that the Banking establishments in New Zealand have derived immense profits which are payable entirely to a foreign proprietary, from a trade carried on with the funds of the colonists"

— BNZ prospectus, 1861

IT BEGINS, AS ALL GOOD bank stories should, with the dirt and scum of a new land, and that's just some of the customers.

The year is 1861. The place is Auckland: a village of some 8,000 inhabitants scattered over acres of pastureland and dusty tracks leading to outlying settlements like Mt Eden or Onehunga.

In the United States at this time, Abraham Lincoln has just been elected President on a campaign platform of abolishing slavery and monetary reform. The US Civil War is about to break out. But in New Zealand, the buzz of summer cicadas, the clatter of horse hooves and carriage wheels, and the shouted greetings between colonial settlers are all that disturbs the mantle of unseasonal autumn heat that's wrapped up the town for the past two weeks leaving residents gasping for some cool relief.

The sparkling waters of the Waitemata harbour lap at the shoreline along what is now Fort Street, and stevedores on the rickety wharf shoulder aside Imperial troopers, merchants, sailors and donkeys as they shift cargo under the beating sun of an Indian Summer.

It is a new land politically, a young land physically, and on the harbour where sleek America's Cup yachts will sluice through a massive spectator fleet little more than one person's lifetime later, the vista in March of 1861 is of barques and scows, trading ships and Maori waka.

By the dusty hillside goat track known now as Shortland Street, two men are in earnest discussion outside the Oriental Bank office. One is a senior banker, the other is prominent lawyer Thomas Russell – a man whose family name remains closely linked to controversy and banking a hundred and forty years later through the auspices of the Russell McVeagh lawfirm.

It would be fair to say Russell was a mover and shaker in colonial Auckland: as a Member of Parliament his word carried added weight.

As a British colony, New Zealand had just turned 21. With colonisation had come settlers, and commerce, and a demand for banking. Although the Auckland Savings Bank had been launched in 1847, and attempts had been made to set up a national New Zealand bank, the market was dominated in the fifties and early sixties by the Australians through the Union Bank of Australia, and London's Oriental Bank. So far, no one had successfully created a bank of New Zealand.

But that was about to change.

Russell's eyes briefly followed a team of asses on their way up Shortland St – a path well trodden by lawyers these days – but it was a momentary distraction. A chance comment from the man rambling to him in the bank's doorway shook him back to reality.

"We're closing the bank," explained Oriental's Auckland manager Falconer Larkworthy. "Melbourne feels our efforts would be better expended in the Far East, not New Zealand."

Russell felt his stomach clench. He had a lot of business with Oriental. He'd borrowed a lot of money. The bank couldn't just close and call in all its loans!

As if reading the lawyer's mind, Larkworthy hastily added:

"It's not a complete closure – they've asked Bank of New South Wales to step into Oriental's shoes over here. They'll close many accounts, I'm sure, but many will also be transferred to the Wales."

The memorandum to Larkworthy from his superiors had been clear:

"Let your discounts slip gradually into the hands of the new bank. You will have difficulties with some of those accounts which have so often been discussed before, and whether you will be able to come out of the fire unburnt, I cannot tell.

"You will not precipitate matters, and yet you must remember that inevitable loss had better be looked plainly in the face.

“Try to get the New South Wales Bank to take your clerks,” the letter ended forlornly.

As Russell stumped his own way up Shortland Street later that afternoon, he pondered the vicissitudes of fate: After 21 years, New Zealand’s banking system was still in disarray, still at the mercy of foreigners coming and going when the mood took them. Things needed to change, he grumbled.

It wasn’t that the Australian and London-based banks were incapable of servicing Victoria’s youngest realm. It was more the problem that the first loyalty of these banks was to their home markets: when money was tight in Australia, the Australian banks squeezed credit in New Zealand regardless of local conditions.

And so it was, a couple of weeks later, that MP and lawyer Thomas Russell found himself once again darkening the doorstep of the Oriental Bank, only this time it was a Bank of New South Wales officer who was giving him trouble.

As BNZ historian N M Chappell described it in *New Zealand Banker’s Hundred*:

“It is related by Larkworthy that [David] Murdoch, the inspector of the Bank of New South Wales, when taking over the accounts of the Oriental Bank...had hesitated long upon the question of accepting Russell’s account, which was a large and troublesome one. Russell was annoyed at the delay, and in an interview with Murdoch declared that if the ‘Wales’ would not have it, neither should the ‘Union’.”

Russell’s solution, as he steamed back up Shortland St, was to set up his own bank.

“A plague on both your houses!” he muttered.

“Murdoch is said to have smiled incredulously at the notion of another bank being established,” wrote Chappell in 1961. “He realised later that Russell was in deadly earnest.”

Being a politician, Russell networked like a man possessed and, in late May of 1861, he called meetings attended by a number of prominent MPs – men like John Logan Campbell, W C Daldy or Otago’s Edward McGlashan, and merchants like James Williamson, Thomas Crummer or Thomas Henderson, men whose names now grace streets or suburbs. Their goal? To thrash out a prospectus for a new financial institution: the Bank of New Zealand.

It is somewhat ironic in the 21st century, with New Zealand banks almost entirely foreign-owned with a free outflow of money and profits, to reflect on the situation facing the colonists in 1861 and stated clearly in the BNZ’s original prospectus:

“It is manifest to those who have directed attention to the subject, that the Banking establishments in New Zealand have derived immense profits which are payable entirely to a foreign proprietary, *from a trade* CARRIED ON WITH THE FUNDS OF THE COLONISTS: [their emphasis] a circumstance which must lead to the consideration whether the Colonists of New Zealand are not now in a position to enjoy, and *entitled to receive*, whatever advantages can be derived from the employment of their own capital.”

In other words, after 21 years of freemarket economics and financial markets controlled by foreign interests, it had finally dawned on the Colonists that they were sending all their profits offshore needlessly. As they say, history repeats.

“Another consideration,” the prospectus continued, “which should unite the Colonists of New Zealand in an effort to establish a New Zealand Bank, is this, no Foreign Bank will study the interests of New Zealand; but the interests of such an establishment are regarded as paramount; the New Zealand branches being of necessity made to feel the effects of financial pressures in other Colonies, and accommodation is given or refused, frequently, not according to the requirements of the Bank’s customers in New Zealand, but measured by the Bank’s engagements and necessities elsewhere.

“A New Zealand institution would not be disturbed by these influences: its capital would be specially devoted to New Zealand interests.”

This, then, was the birth of the BNZ bank.

Although begun as a private company, it still needed State protection and, on June 19, 1861, Thomas Russell introduced a Private Member’s Bill to Parliament, “The New Zealand Bank Bill”, which went before Queen Victoria in July and was law by August.

As the *Southern Cross* newspaper of August 6 noted:

“The Colony requires such a local institution notwithstanding the liberal management of the English and Australian Banking corporations having agencies in New Zealand.

“There is a necessity for identifying our Colonial Bank with our Colonial interests, but this can never be wholly attained so long as our banking business is done with institutions managed for the settled purpose of enriching an alien proprietary.”

It took only a matter of months for the Bank of New Zealand to spread its operational tentacles around the country – a task made particularly simple by virtue of the fact that the major settlements could be counted on one and a half hands.

Purely by coincidence, just days after the meetings in May of 1861 that

resulted in the BNZ's establishment, prospector Gabriel Read struck gold in a gully in Central Otago, near the town of Lawrence.

The resulting boomtimes were a natural playground for bankers and the BNZ was no exception. Wherever there were hard-drinking men, saloon girls and gold dust, you'd also find a bank manager.

The logic was simple. With tonnes of the precious metal being panned and hacked out of the Otago hillcountry, and living quarters for the average miner confined to a tent between two shrubs, security was a foreign concept. There was a common joke that if the saloons were empty, it was probably because of a rumoured thief on the loose, and sure enough if you ventured down to tent city you'd find four thousand hairy grimy and smelly miners all sitting outside their quarters eyeing each other suspiciously whilst trying to look as though they'd planned all along to "have an evening in".

Before the banks arrived, it was common for nuggets to go missing from tents, and New Zealand's singular lack of packrats meant miners needed to beware of rats of the two-legged variety.

Back in the 1860s the banks all printed their own money, and for the BNZ in the Otago goldfields that created a whole new ballgame.

Falconer Larkworthy, who'd quit the retreating Oriental Bank for a senior position with the BNZ, was sent to Dunedin with orders to corner the market. Prior to his arrival in New Zealand for Oriental, he'd worked as a banker in the South Australian goldfields.

Knowing that the BNZ had not yet begun to print its own bank notes, Larkworthy opted for Plan B, designing his own and furiously printing them over a weekend on a lithographic press.

The bank notes were nothing more than a promise by the bank to pay the bearer of the note its face value in bullion, on demand.

Armed with a sack of these bank notes worth £20,000, Larkworthy clambered into a Cobb & Co stagecoach and set off for Gabriel's Gully.

There was disappointment on arrival when he found that both the Union Bank and the Bank of New South Wales had beaten him to it with branches at Gabriel's Gully and Waitahuna, but he finally located fertile ground at a settlement called Wetherstones, some distance further out.

Renting space in a general store, Larkworthy hung out his Bank sign and waited for business. It didn't take long to come. Miners who were sick of having to carry around their precious heavy cargo were more than happy to swap it for lightweight paper notes.

"The tidings of my presence went like wildfire," he later wrote, "and I stood all day buying gold dust as hard as I could."

Within four days, he'd cleaned out the Wetherstones field, and set off for Dunedin with 4,000 ounces of gold (about NZ\$9 million worth at 2011 prices) under escort – leaving behind a supply of bank notes with friendly storekeepers so they could purchase more gold on his behalf.

But unfortunately, as often came to be the case in the BNZ's chequered history, the best laid plans of packrats and mortals sometimes come unstuck.

While Larkworthy was away, some of his rival banks began to play – refusing to honour the new BNZ bank notes and telling stunned miners that the notes were false “duffers”.

Naturally, thousands of hairy, grimy and smelly gold prospectors were none too keen on this, and they stormed the merchants at Wetherstones demanding the storekeepers either return their gold dust or honour the notes in coinage.

When the retailers refused to do so there was chaos, and at least one merchant was arrested and chained to an iron bed for a couple of days until the police team escorting BNZ gold returned to the town and sorted out the trouble.

In a mercy dash to prevent further violence, Dunedin's police chief located Larkworthy and told him he'd need to return to Wetherstones with coin of the realm, and be prepared to refund the angry miners.

It was the first ever run on the BNZ bank.

Larkworthy bought up every gold sovereign he could find in Dunedin – eight thousand of them – and rejoined the police escort for a hurried journey back to the goldfields.

Once the miners realised he had coin of the realm to refund them, they settled down and ironically no refunds were actually asked for.

As for the cause of the crisis? The rival bank's tellers had refused to accept the BNZ notes because they were dated on a Sunday. Ultimately this hiccup, too, was resolved. The Bank of New Zealand was well and truly open for business.

For its first 15 years, the BNZ returned an average yearly dividend to its shareholders of 14 percent. Not bad money. But a depression in the 1880s caused financial pain. Despite that pain, the BNZ kept paying dividends, a sure-fire path to an early death. In April 1887 it was forced to pay a dividend and bonus from its cash reserves, then in October 1887 the board decided not to pay the next half-yearly dividend. The shareholders were far from impressed, and their reaction forced directors to pay another half-yearly dividend in April 1888, despite worsening financial performances.

“It was felt the shareholders should not be deprived of a dividend for two half years in succession,” bank historian N M Chappell writes.

Despite running at a continuous loss, the BNZ paid out £4 million in dividends and lent a further £160,000 to directors. By 1894, it was nearly all over, rover. Cap in hand, the privately owned New Zealand bank went to the Government. Both Houses of Parliament met under urgency to debate the crisis.

“The Lower House adjourned at 4.12am,” writes Chappell. “The Governor had been kept waiting before the fire in his dressing gown and slippers to give assent.”

And when that assent came, it came with £500,000 in cash, stock guarantees of £2 million and assorted other goodies. *The Evening Star* newspaper wrote:

“The people of New Zealand awoke this morning to find, if not a state bank in the strictest sense of the term, something like it, fully established, with splendid buildings, and with branches and agencies all over the country. Was ever such a financial wonder worked between the setting and the rising of the sun?”

In 1895, more money was funneled in, and eventually the Government would own a third of the share capital and appointed two thirds of the board of directors.

“In 1890,” reported the *New Zealand Times* newspaper 96 years later in 1986, “a parliamentary inquiry had been set up to investigate claims that ministers had used public money to assist the bank. It was also alleged that the Attorney-General, Sir Frederick Whitaker, who was also chairman of the bank’s board, owed a large sum to the bank and was therefore using his influence to place public funds in the bank’s hands. The inquiry collapsed when the committee failed to get the bank to supply sufficient records.

“In 1896, inquiries ran into similar problems. Both the Upper and Lower Houses had set up committees to investigate the bank. The Lower House committee wanted to know the names, people and corporations whose debts had been written off.

“Bank president William Watson refused to give details of individual accounts. The House responded by fining him £500 for breach of privilege and having him detained in custody by the sergeant-at-arms until payment was made.”

In a historical precursor to the BNZ collapse a hundred years later, dripping with irony, it was a top Russell McVeagh lawyer, acting as an adviser to the Bank of New Zealand, who during the 1896 inquiry told the Bank’s president to “on no account” divulge to a hostile MP “which of the BNZ’s past directors had supposedly received large loans on inadequate security, thereby placing the bank in jeopardy.”

The lawyer, Theophilus Cooper, left the banker clear instructions.

“If you are asked, don’t tell them, and let Parliament do its damndest, but you will get away with it.”

And he did. The BNZ paid the fine two days later. Watson was never detained in anything but name.

Theophilus Cooper went on to be rewarded with an appointment as a Supreme Court judge shortly afterward and earned a knighthood to boot.

The Bank of New Zealand was back in business.

CHAPTER 2

The Truth About Banks

"If the American people allow private banks to control the issuance of their currency, first by inflation and then by deflation, the banks and corporations that will grow up around them will deprive the people of all their property until their children will wake up homeless on the continent their fathers conquered."

– Thomas Jefferson, 1787

TO UNDERSTAND THE REAL SIGNIFICANCE of this book, you first need to understand the concepts behind modern banking as we know it. Modern banking is a financial fiction. In the past, such as when the BNZ first began, governments operated under what was known as "The Gold Standard". This meant that all paper banknotes issued by a bank were backed up by the equivalent amount of precious metals – either silver or gold – held in the bank's vaults and repositories.

The reason for this was simple: if currency wasn't backed up by something of real value, how could it have any worth? Up until the invention of the printing press, all currency was "coin of the realm", usually silver or gold. The value of a coin was exactly equal to its metallic composition and weight.

Coinage had its own problems, however, such as unscrupulous merchants, bankers and officials who stole tiny scrapings of metal from each coin they handled, thus accumulating a pile of gold dust over a period of time that they could melt into gold for themselves.

With the advent of paper money, not only did people not have to carry large amounts of heavy coinage around with them but they were guaranteed that if they took their paper banknote to the issuing bank they would get their money back in the form of physical bullion.

This state of affairs lasted for hundreds of years, even into New Zealand's

recent history as you saw in the previous chapter.

So what changed? The financial system moved from a “what goes in comes out” mode to a credit-based system – and it is credit, or fake money, that lies at the heart of the modern financial world.

In the 1500s, wealthy Spanish or Italian families like the Medicis began using their surplus profits to invest in other businesses – effectively providing credit and being paid interest or use of money dividends.

So large were the profits they made from their loans, and so ruthless their enforcement measures, that the “merchant banks” quickly became self-sustaining businesses, lenders of last resort, in their own right. An indicator of how they were seen by their contemporaries is clear from a commentary published in 1544 by Dr Saravia de la Calle, who described them as “hungry gluttons, who swallow everything, destroy everything, confuse everything, steal and dirty everything, like the harpies of Pineo”, before then comparing the merchant banks to brothels. Obviously a man with a bad banking experience.

The huge influx of gold and precious metals and gems from the discovery of the Americas 50 years earlier was having a big financial impact on the merchants and economies of Spain and the Italian city-states.

The merchant banks ended up with huge sums on deposit in their vaults as European explorers plundered the new world. This vast haul of wealth didn’t go unnoticed in high places, and Spain’s King Carlos V swooped on the House of Seville in 1545 to forcibly uplift the millions in storage there. It was a move of royal prerogative, in direct conflict with common law property rights. Carlos V didn’t care. As Emperor of Spain and her domains, he simply confiscated the money that savers had deposited with the bank.¹

That royal raid led to a major change of direction for the merchant banks. Wary now of future royal incursions, the merchant bankers decided to lend as much of the money out again as soon as it came in, so as to leave as little gold as possible in storage in the vaults.

Naturally, this led to an explosion in the creation of credit. The banks were now lending out other people’s money – money entrusted to them for safe-keeping. They didn’t tell depositors this – to do so would have caused a run on the banks.

At this stage, depositors were not paid interest on their money. Rather, they paid the banks a fee to look after their money. That was how the banks

1 <http://web.archive.org/web/20010210100729/http://www.ucm.es/info/econap4/archivos/prehistory.htm>

made money. Thus, the lending out of money with interest allowed the merchant banks to double-clip the ticket – taking a fee from depositors and charging interest on the money loaned out, and the money didn't even belong to the banks in the first place. Under existing contract law at the time, it was highly illegal.

The Emperor, however, was no slug either. He continued to raid the banks for the bullion reserves they still retained in their vaults, and when the cupboard was bare he forced the banks to underwrite loans to the Crown. Either way, the nobles figured they were on to a good racket.

Within 30 years, by 1575, however, the pressure was beginning to tell. King Felipe II was bankrupted for a second time when he failed to repay loans, and in turn a number of the key bankers themselves went bankrupt when depositors discovered the missing funds. It was the start of what we now know as “boom and bust”.

“Saravia de la Calle indicates how the bankers have a great tendency to become bankrupt,” writes Spanish historian Jesús Huerta de Soto, “even making a brief theoretical analysis which shows that, after the expansionary phase resulting from the artificial expansion of the credits which these *logreros* (“moneylenders”) grant, there inevitably comes a phase of recession in which the bad debts cause a chain of bankruptcies among the banks. And he adds that, “if the merchant does not pay the moneylender, it makes him bankrupt, and thus he suspends payments and all is lost, of all which, as is notorious, these moneylenders are the beginning, occasion and cause, because if they did not exist, each person would trade with his money as he could and no more, and thus things would cost their fair price and more than the price in cash would not be charged.”

It became clear to both the bankers and the Crown that some system of repaying Crown borrowings would have to be devised, and this is where the modern income tax comes in.

Although income tax as New Zealanders know it is only just over a hundred years old, and in fact only a little over 90 years old in the USA, it was the latest in a string of moves by European monarchs and Parliaments to find ways of paying for their financial excesses.

The introduction of income tax in both countries was forced when both adopted the European “fractionalised reserve banking” system, with the US providing a particularly stark example. From the time of the US War of Independence in the late 1700s, and through to the mid 1860s, the European merchant banks had been increasingly active in the US economy. Prime among these was Rothschilds.

The Rothschild Brothers of London and Berlin had been pushing for the US Government to abandon the gold standard in favour of fractionalised reserve banking (FRB). FRB is a fine-tuning of the Medici-style banks of the Renaissance, and allows banks to lend out up to 20 times the money that they actually have stored on deposit.

The system works on the basis that only five to ten percent of the deposits are ever asked for at any one time, so that's all that needs to be held in reserve.

In practice, it works like this: You deposit \$1000 with the Bank of New Zealand. The BNZ can then lend out \$20,000, based on that reserve ratio. Now obviously the extra \$19,000 isn't cash. It's credit. Loan documentation, existing on paper and on a computer. A promise by a borrower to pay back money from his or her future earnings to the bank, for the privilege of having access to \$20,000 now.

You may have noticed that most banks get quite shirty if you try to withdraw a \$20,000 loan in cash. That's because turning it into cash eats into their capital reserves. They would far rather hand you a cheque, just a piece of paper, to circulate through the system.

Ninety-five percent of the money in existence is fake money. Created out of thin air by a bank. If everyone walked into their banks tomorrow and demanded their money the entire system would collapse. There is simply not enough real money in existence. Yet the banks get to charge interest on this non-existent money. Twenty times more interest than they would have been able to charge under the old system.

Of course, if an ordinary New Zealander ran a business where their liabilities exceeded their assets by a factor of 20, they would be charged with trading whilst insolvent and bankrupted – usually at the instigation of a bank. What's good for the masters is certainly not good for the peasants, in this case.

It is little wonder that Baron de Rothschild boasted of his plans in a letter to an American colleague in 1867.

“A few who can understand the system [cheques, credit facilities] will either be so interested in its profits, or so dependent on its favours, that there will be no opposition from that class,” he said, referring to Governments and businesses who would have access to much greater amounts of loan finance, “while on the other hand the great body of the people mentally incapable of comprehending the tremendous advantage that capital derives from the system, will bear its burdens without complaint, and perhaps without even suspecting that the system is inimical [hostile] to their interests.”

And for those naïve people who don't believe in conspiracies, try this one for size: the Rothschilds and other merchant bankers had stayed focused

on the goal of capturing the US money supply for *eighty years* prior to the letter quoted above. Eighty years of plotting and scheming, never taking their eyes off the ball.

At the US Constitutional Convention of 1787, future president Thomas Jefferson waxed lyrical about the evils of the merchant bankers.

“I believe that banking institutions are more dangerous to our liberties than standing armies. Already, they have raised up a money aristocracy that has set the Government at defiance.

“The Central Bank is an institution of the most deadly hostility existing against the principles and form of our Constitution. I am an enemy to all banks, discounting bills or notes for anything but coin.

“If the American people allow private banks to control the issuance of their currency, first by inflation and then by deflation, the banks and corporations that will grow up around them will deprive the people of all their property until their children will wake up homeless on the continent their fathers conquered.”

The chief reason for opposing fractional reserve banking, controlled by private banks, was simple: “Gold and silver are recognised around the world for their tangible wealth,” wrote one commentator, “because someone has to work very hard to get it out of the earth. How much effort does a banker expend in applying ink to paper to create a fractional reserve banknote?”

Even more to the point, the ability to “create money out of thin air” was a privilege belonging only to the banks. Jefferson and others saw the powers that could be wrought by those with the ability to keep printing unlimited money, and knew that in the end everything would be owned by the bankers, and people would end up mortgaging their entire working lives to the banks.

But Rothschilds and others continued to plot and scheme. Finally, in 1913, US Senator Nelson Aldrich, the maternal grandfather of current Chase Manhattan Bank supremo David Rockefeller and under the guidance of Rothschilds of London, championed two key pieces of US legislation.

The first was the Income Tax Act via the 16th Amendment to the US Constitution in 1913. The second was the Federal Reserve Act. The latter was drafted by Paul Warburg, of the Warburg banking family and another close associate of Rothschilds. What it did was revolutionary.

From that moment forward, control of the US currency and money supply passed from the US Government, where it had been since independence in 1783, to an essentially private banking conglomerate known as the Federal Reserve, and the US Government was, allegedly, given the power to levy

income taxes on its citizens as a guarantee that the Government could meet its debts on borrowings from the Federal Reserve.

Technically, US dollars are not “money” (not being gold or silver coins), so what are they? The greenbacks you buy are Federal Reserve Notes, which are a promise by the Fed to meet the debt represented by the note.

It actually says this on the US dollar note, or the one I’m holding anyway: “This certificate is legal tender for all debts, public and private”.

In other words, if you buy a hat for \$20 and hand over a US \$20 note to the shopkeeper, legally you are not using money but a Federal Reserve IOU which promises the shopkeeper that he will receive \$20 credit for the note, and so on down the food chain it goes.

Up until 1963, US dollars were named on the notes “Silver Certificate”, with the words “This certifies that there is on deposit in the Treasury of the United States of America, one dollar in silver payable to the bearer on demand”.

In New Zealand, the old “sterling” notes likewise entitled the bearer to sterling silver in exchange.

During the period prior to the introduction of fractionalised reserve banking, inflation was almost non-existent. As all paper money had to be backed up by real gold or silver, new money (and hence inflation) could only be created if more gold or silver was introduced into the currency system.

Thus, the ability to create money simply by writing a paper loan and extend credit was a godsend to the merchant banks.

“Give me control of a nation’s money supply, and I care not who makes the laws,” boasted Meyer Amschel Rothschild, the founder of the banking dynasty, back in the late 1700s.

Two US presidents in particular did try to buck the system, however.

“The privilege of creating and issuing money is not only the supreme prerogative of Government,” said President Abraham Lincoln in a speech shortly before his assassination, “but is the Government’s greatest creative opportunity. By the adoption of these principles, the taxpayers will be saved immense sums of interest.

“The monetary needs of increasing numbers of people advancing towards higher standards of living can and should be met by the Government. The Government should create, issue, and circulate all the currency needed to satisfy the spending power of the Government, and the buying power of consumers.

“The financing of all Government enterprises, the maintenance of stable government and ordered progress, and the conduct of the Treasury will become matters of practical administration. Money will cease to be the master, and become the servant of humanity.”

What Lincoln was talking about was ordering the US Treasury to print its own bank notes, rather than borrow foreign currency from the Bank of England to pay its international debts. The latter, privately run and associated with the Rothschilds, wanted to charge Lincoln up to 36% interest on loans to pay for the North's war against the South. Although he managed to introduce the greenback, the original US dollar bill, and therefore financed the Civil War by printing his own money, Lincoln was murdered before he could complete the US Government's takeover of the banking system. Conspiracy theorists may be interested to know there is evidence to support the contention that Lincoln's assassination was instigated by a merchant banker. While those caught red-handed for the assassination plot were certainly die-hard southern rebels, vast amounts of money were washing through their bank accounts and it is certainly feasible that bankers manipulated the crisis for their own ends.

President John F Kennedy pulled a similar banknote stunt on June 4 1963, when he issued Executive Order 11110, effectively giving the Treasury authority to print up to US\$3 billion worth of United States Notes, backed by silver, in competition with the Fed. Again, Kennedy didn't survive to see his US Government banknotes go into circulation. Stocks of the notes were destroyed soon after Kennedy's assassination at Dallas that year, and the Treasury Secretary under President Lyndon Johnson² decided in March 1964 to ban the redemption of silver certificate notes for silver coins. The US stock of silver dollar coins was effectively taken off the market and later sold for collectible value. On November 26 1963, the day Kennedy was buried, the first shipment of Federal Reserve banknotes that were *no longer redeemable for silver* on demand were issued into the money system.

Numerous political leaders had tried to break the stranglehold created by Rockefeller's grandfather, but they couldn't.

"The real truth of the matter is," wrote President Franklin D Roosevelt to a friend in 1933, "that a financial element in the large centres has owned the Government of the US since the days of Andrew Jackson."

"I am a most unhappy man," lamented former US President Woodrow Wilson – who'd presided over Senator Aldrich's Income Tax and Federal Reserve Acts – "I have unwittingly ruined my country. A great industrial nation is controlled by its system of credit. Our system of credit is concentrated. The growth of the nation, therefore, and all our activities, are in the hands of a few men."

² In one of those quirks of coincidence, assassinated presidents Lincoln and Kennedy were both succeeded by Vice-Presidents named "Johnson".

In a 1975 investigation of the banking system, Congressman Wright Patman, the Chairman of the House Banking and Currency Committee, reported to Congress that:

“In the United States we have, in effect, two governments. We have the duly constituted Government... Then we have an independent, uncontrolled and uncoordinated government in the Federal Reserve system, operating the money powers which are reserved to Congress by the Constitution.

“In its 60 year history, the Federal Reserve system has never been subjected to a complete, independent, audit, and it is the only important agency that refuses to consent to an audit by the Congress’ agency, the General Accounting Office.

“GAO audits of the Federal Reserve will, moreover, fill the glaring gap that now exists in our information about the Fed’s activities and programmes. As things now stand, the only information that we get on programmes of the Fed is what the Fed itself wants us to have.”

The crime of counterfeiting money is a crime – not against fellow citizens – but against those who have the sole power to create credit: the banks. This much was admitted by former Bank of England director, Lord Josiah Stamp.

“The modern banking system manufactures money out of nothing. The process is perhaps the most astounding piece of sleight of hand that has ever been invented. Banking was conceived in iniquity and born in sin. Bankers own the earth; take it away from them, but leave them with the power to create credit, and with the stroke of a pen they will create enough money to buy it back again... If you want to be slaves of the bankers, and pay the costs of your own slavery, then let the banks create money.”

The Bank of England, like the Federal Reserve, is privately owned.

Yet, ironically, these bastions of the free-market are themselves anti free-market when it comes to their own activities. Banks in New Zealand, and overseas, are one of the few legalised cartels allowed to exist. One presumes they can only do so because they control the money supply and therefore write the rules.

One of the best analyses around on the horrors of fractional reserve banking was written by distinguished US economics professor Murray Rothbard before he died in 1995:

To the extent that banks lend their own savings, or mobilize the savings of others, their activities are productive and unexceptionable. Even in our current commercial banking system, if I buy a \$10,000 CD (“certificate of deposit”) redeemable in six months, earning a certain fixed interest return, I am taking my

savings and lending it to a bank, which in turn lends it out at a higher interest rate, the differential being the bank's earnings for the function of channeling savings into the hands of credit-worthy or productive borrowers. There is no problem with this process.

The same is even true of the great "investment banking" houses, which developed as industrial capitalism flowered in the nineteenth century. Investment bankers would take their own capital, or capital invested or loaned by others, to underwrite corporations gathering capital by selling securities to stockholders and creditors. The problem with the investment bankers is that one of their major fields of investment was the underwriting of government bonds, which plunged them hip-deep into politics, giving them a powerful incentive for pressuring and manipulating governments, so that taxes would be levied to pay off their and their clients' government bonds. Hence, the powerful and baleful political influence of investment bankers in the nineteenth and twentieth centuries: in particular, the Rothschilds in Western Europe, and Jay Cooke and the House of Morgan in the United States.

By the late nineteenth century, the Morgans took the lead in trying to pressure the U.S. government to cartelize industries they were interested in – first railroads and then manufacturing: to protect these industries from the winds of free competition, and to use the power of government to enable these industries to restrict production and raise prices.

In particular, the investment bankers acted as a ginger group to work for the cartelization of commercial banks. To some extent, commercial bankers lend out their own capital and money acquired by CDs. But most commercial banking is "deposit banking" based on a gigantic scam: the idea, which most depositors believe, that their money is down at the bank, ready to be redeemed in cash at any time. If Jim has a checking account of \$1,000 at a local bank, Jim knows that this is a "demand deposit," that is, that the bank pledges to pay him \$1,000 in cash, on demand, anytime he wishes to "get his money out."

Naturally, the Jims of this world are convinced that their money is safely there, in the bank, for them to take out at any time.

Hence, they think of their checking account as equivalent to a warehouse receipt. If they put a chair in a warehouse before going on a trip, they expect to get the chair back whenever they present the receipt. Unfortunately, while banks depend on the warehouse analogy, the depositors are systematically deluded. Their money ain't there.

An honest warehouse makes sure that the goods entrusted to its care are there, in its storeroom or vault. But banks operate very differently, at least since the days of such deposit banks as the Banks of Amsterdam and Hamburg in

the seventeenth century, which indeed acted as warehouses and backed all of their receipts fully by the assets deposited, e.g., gold and silver.

This honest deposit or "giro" banking is called "100 percent reserve" banking. Ever since, banks have habitually created warehouse receipts (originally bank notes and now deposits) out of thin air. Essentially, they are counterfeiters of fake warehouse receipts to cash or standard money, which circulate as if they were genuine, fully backed notes or checking accounts. Banks make money by literally creating money out of thin air, nowadays exclusively deposits rather than bank notes.

This sort of swindling or counterfeiting is dignified by the term "fractional-reserve banking," which means that bank deposits are backed by only a small fraction of the cash they promise to have at hand and redeem. (Right now, in the United States, this minimum fraction is fixed by the Federal Reserve System at 10 percent.)

Let's see how the fractional reserve process works, in the absence of a central bank. I set up a Rothbard Bank, and invest \$1,000 of cash (whether gold or government paper does not matter here). Then I "lend out" \$10,000 to someone, either for consumer spending or to invest in his business. How can I "lend out" far more than I have? Ahh, that's the magic of the "fraction" in the fractional reserve. I simply open up a checking account of \$10,000 which I am happy to lend to Mr. Jones. Why does Jones borrow from me? Well, for one thing, I can charge a lower rate of interest than savers would. I don't have to save up the money myself, but simply can counterfeit it out of thin air. (In the nineteenth century, I would have been able to issue bank notes, but the Federal Reserve now monopolizes note issues.) Since demand deposits at the Rothbard Bank function as equivalent to cash, the nation's money supply has just, by magic, increased by \$10,000. The inflationary, counterfeiting process is under way.

The nineteenth-century English economist Thomas Tooke correctly stated that "free trade in banking is tantamount to free trade in swindling." But under freedom, and without government support, there are some severe hitches in this counterfeiting process, or in what has been termed "free banking." First: why should anyone trust me? Why should anyone accept the checking deposits of the Rothbard Bank?

But second, even if I were trusted, and I were able to con my way into the trust of the gullible, there is another severe problem, caused by the fact that the banking system is competitive, with free entry into the field. After all, the Rothbard Bank is limited in its clientele. After Jones borrows checking deposits from me, he is going to spend it. Why else pay money for a loan? Sooner or later, the money he spends, whether for a vacation, or for expanding his

business, will be spent on the goods or services of clients of some other bank, say the Rockwell Bank.

The Rockwell Bank is not particularly interested in holding checking accounts on my bank; it wants reserves so that it can pyramid its own counterfeiting on top of cash reserves. And so if, to make the case simple, the Rockwell Bank gets a \$10,000 check on the Rothbard Bank, it is going to demand cash so that it can do some inflationary counterfeit-pyramiding of its own. But, I, of course, can't pay the \$10,000, so I'm finished. Bankrupt. Found out. By rights, I should be in jail as an embezzler, but at least my phony checking deposits and I are out of the game, and out of the money supply.

Hence, under free competition, and without government support and enforcement, there will only be limited scope for fractional-reserve counterfeiting. Banks could form cartels to prop each other up, but generally cartels on the market don't work well without government enforcement, without the government cracking down on competitors who insist on busting the cartel, in this case, forcing competing banks to pay up.

Hence the drive by the bankers themselves to get the government to cartelize their industry by means of a central bank. Central Banking began with the Bank of England in the 1690s, spread to the rest of the Western world in the eighteenth and nineteenth centuries, and finally was imposed upon the United States by banking cartelists via the Federal Reserve System of 1913.

Particularly enthusiastic about the Central Bank were the investment bankers, such as the Morgans, who pioneered the cartel idea, and who by this time had expanded into commercial banking.

In modern central banking, the Central Bank is granted the monopoly of the issue of bank notes (originally written or printed warehouse receipts as opposed to the intangible receipts of bank deposits), which are now identical to the government's paper money and therefore the monetary "standard" in the country. People want to use physical cash as well as bank deposits. If, therefore, I wish to redeem \$1,000 in cash from my checking bank, the bank has to go to the Federal Reserve, and draw down its own checking account with the Fed, "buying" \$1,000 of Federal Reserve Notes (the cash in the United States today) from the Fed. The Fed, in other words, acts as a bankers' bank. Banks keep checking deposits at the Fed and these deposits constitute their reserves, on which they can and do pyramid ten times the amount in checkbook money.

Here's how the counterfeiting process works in today's world. Let's say that the Federal Reserve, as usual, decides that it wants to expand (i.e., inflate) the money supply. The Federal Reserve decides to go into the market (called the "open market") and purchase an asset. It doesn't really matter what asset it buys;

the important point is that it writes out a check. The Fed could, if it wanted to, buy any asset it wished, including corporate stocks, buildings, or foreign currency. In practice, it almost always buys U.S. government securities.

Let's assume that the Fed buys \$10,000,000 of U.S. Treasury bills from some "approved" government bond dealer (a small group), say Shearson, Lehman on Wall Street. The Fed writes out a check for \$10,000,000, which it gives to Shearson, Lehman in exchange for \$10,000,000 in U.S. securities. Where does the Fed get the \$10,000,000 to pay Shearson, Lehman?

It creates the money out of thin air. Shearson, Lehman can do only one thing with the check: deposit it in its checking account at a commercial bank, say Chase Manhattan. The "money supply" of the country has already increased by \$10,000,000; no one else's checking account has decreased at all. There has been a net increase of \$10,000,000.

But this is only the beginning of the inflationary, counterfeiting process. For Chase Manhattan is delighted to get a check on the Fed, and rushes down to deposit it in its own checking account at the Fed, which now increases by \$10,000,000. But this checking account constitutes the "reserves" of the banks, which have now increased across the nation by \$10,000,000. But this means that Chase Manhattan can create deposits based on these reserves, and that, as checks and reserves seep out to other banks (much as the Rothbard Bank deposits did), each one can add its inflationary mite, until the banking system as a whole has increased its demand deposits by \$100,000,000, ten times the original purchase of assets by the Fed. The banking system is allowed to keep reserves amounting to 10 percent of its deposits, which means that the "money multiplier"—the amount of deposits the banks can expand on top of reserves—is 10. A purchase of assets of \$10 million by the Fed has generated very quickly a tenfold, \$100,000,000 increase in the money supply of the banking system as a whole.

Interestingly, all economists agree on the mechanics of this process even though they of course disagree sharply on the moral or economic evaluation of that process. But unfortunately, the general public, not inducted into the mysteries of banking, still persists in thinking that their money remains "in the bank."

Thus, the Federal Reserve and other central banking systems act as giant government creators and enforcers of a banking cartel; the Fed bails out banks in trouble, and it centralizes and coordinates the banking system so that all the banks, whether the Chase Manhattan, or the Rothbard or Rockwell banks, can inflate together. Under free banking, one bank expanding beyond its fellows was in danger of imminent bankruptcy. Now, under the Fed, all banks can expand together and proportionately.

But even with the backing of the Fed, fractional reserve banking proved

shaky, and so the New Deal, in 1933, added the lie of "bank deposit insurance," using the benign word "insurance" to mask an arrant hoax. When the savings and loan system went down the tubes in the late 1980s, the "deposit insurance" of the federal FSLIC [Federal Savings and Loan Insurance Corporation] was unmasked as sheer fraud. The "insurance" was simply the smoke-and-mirrors term for the unbacked name of the federal government. The poor taxpayers finally bailed out the S&Ls, but now we are left with the formerly sainted FDIC [Federal Deposit Insurance Corporation], for commercial banks, which is now increasingly seen to be shaky, since the FDIC itself has less than one percent of the huge number of deposits it "insures."

The very idea of "deposit insurance" is a swindle; how does one insure an institution (fractional reserve banking) that is inherently insolvent, and which will fall apart whenever the public finally understands the swindle? Suppose that, tomorrow, the American public suddenly became aware of the banking swindle, and went to the banks tomorrow morning, and, in unison, demanded cash. What would happen? The banks would be instantly insolvent, since they could only muster 10 percent of the cash they owe their befuddled customers. Neither would the enormous tax increase needed to bail everyone out be at all palatable. No: the only thing the Fed could do, and this would be in their power, would be to print enough money to pay off all the bank depositors. Unfortunately, in the present state of the banking system, the result would be an immediate plunge into the horrors of hyperinflation.

Let us suppose that total insured bank deposits are \$1,600 billion. Technically, in the case of a run on the banks, the Fed could exercise emergency powers and print \$1,600 billion in cash to give to the FDIC to pay off the bank depositors. The problem is that, emboldened at this massive bailout, the depositors would promptly redeposit the new \$1,600 billion into the banks, increasing the total bank reserves by \$1,600 billion, thus permitting an immediate expansion of the money supply by the banks by tenfold, increasing the total stock of bank money by \$16 trillion. Runaway inflation and total destruction of the currency would quickly follow.³

And here's the twist, here's the ball to keep your eye on throughout this book: the fake credit created by the banks cost them nothing to create. Yet you'll be charged full interest to utilise it.

³ (Murray Rothbard (1926-1995) was the S. J. Hall Distinguished Professor of economics at the University of Las Vegas, and Academic Vice President of the Ludwig von Mises Institute. This article originally published by The Foundation for Economic Education, 30 South Broadway, Irvington-on-Hudson, NY 10533.)

No wonder banks make money. They charge real interest on fictitious money, whilst maintaining the charade in the news media that there are only small profits to be made in interest rate margins.

And don't get sidetracked by the valid point that the fake credit is then extended out into the community and used to buy goods and services. It is, but it still cost the issuing bank *nothing* to create. Yet the community must create and sell real goods and services just to pay the interest, let alone the principal, on the fictitious credit.

We are actually born into a financial slavery, if you take a birdseye view of it. All of the land, all of the houses, all of the buildings, all of the vehicles – virtually any item of substance you care to name – is owned by banks via mortgage or loan finance. You can have none of it until you purchase it all from the banks which, for an average person, will take most of their working lives before they become financially independent. It wasn't always so. Prior to fractional reserve banking, the banks owned very little in the way of real property. Two hundred years later there has been a massive transference of wealth from individuals and businesses to the banks. The banks used their position to create inflation, pushing up prices so that people would be forced to borrow money, and a vicious cycle began.

But what about, I hear some ask, all the investment finance made available as a result of fake credit? Hasn't the western world enjoyed a technological boom as a result of investment and research undertaken using money obtained from fake credit?

Yes, it has. There is no doubt that access to that kind of money has created some major advances for society. But it has also led to the sharemarket crashes of 1929 and 1987, and latterly the crash of 2008-present. The Depression of the 1930s was caused because the banks deliberately called a halt to the money-go-round. The food was in the shops, the clothes were in the shops, but nobody could get any money out of the banks to buy the products. Businesses collapsed, workers were not paid, those who did have money refused to spend it, the system fell over.

Internationally, critics of the privately run Federal Reserve question why western governments choose to pay private banks to print money, using taxes levied against their own citizens to foot the bills, when the Governments could print their own money much cheaper, without imposing taxes.

"Fractional reserve banking is a scam," writes one financial commentator on the website profit2u.com. "It is a fraud of the highest order. Yet the practice is endorsed and supported by governments and hare-brained economists who claim that it is the engine for growth."

“Yes, Economic growth does require money. Currency. The real issue is whether or not private banks should issue that currency. And whether or not interest should be charged.”

Should interest be charged on what is effectively “free money”?

A perfect example of the conundrum is found in New Zealand’s student loan system. Billions of dollars are now owed by students who’ve been forced to borrow from private banks to pay a state bill. Hundreds of millions of dollars in interest is payable.

That money will ultimately be paid by people who use those students’ services once they enter the workforce, in exactly the same way that a contractor repaying a loan for capital equipment builds the cost into his chargeout fee structure.

In the current student loan structure, private banks have created the credit out of thin air and been given the luxury of charging interest on it. A more economically sensible solution (since put in place) might have seen the Government create the same amount of credit out of thin air, without the interest.

The western world is living on a financial house of cards, and it is little wonder that commentators are beginning to suggest it is no longer a case of *whether* the monkeys will wake up and beat the living daylights out the organ grinders, only a matter of *when*. Anyone watching the anti-globalisation protests in Melbourne, Ottawa, Seattle and London could be forgiven for thinking the revolution is already well underway. It is not inconceivable the protestors may carry out terrorist attacks directly against the banking system itself. What chaos might that cause?

New Zealand’s Reserve Bank was, initially, structured on exactly the same lines as the Fed and the Bank of England. Up until 1933 the various trading banks in New Zealand – the BNZ, ANZ and the Bank of New South Wales (Westpac) – issued their own banknotes. The money was largely interchangeable between the banks and redeemable for physical bullion if a customer wished.

The use of Imperial gold, silver and copper coins had been lawful in New Zealand since 1840, but 48 merchants and retailers actually minted their own coins between 1857 and 1881 after the colony suffered a major Imperial coin shortage.

In 1897 the laws were changed to shut out the widespread use of Australian gold and silver coins, and the Imperial currency became the only lawful money in New Zealand.

Gold sovereigns were withdrawn from general circulation in 1914, coincidentally just after the US Federal Reserve was set up. But money supply problems and shortages continued to dog the colony. There had been a

growing push since 1886 for some kind of central bank to be set up in New Zealand, and 1933 was the year it finally happened.

The Government Year Book for 1973 records that “Initially the Reserve Bank, as established by the Reserve Bank of New Zealand Act 1933, was a privately-owned institution.

“Of the seven full directors other than the Governor and Deputy Governor, three only were appointed by the Governor-General. The Secretary to the Treasury, although a member of the board, did not have the right to vote.

“The bank was therefore to a large extent independent of the Government, but the original Act required it, as its primary duty, to exercise control over monetary circulation and credit to the end that the economic welfare of the Dominion might be promoted and maintained.”

From that moment forward, only the Reserve Bank could issue banknotes. In a significant divergence, however, the NZ Treasury Department retained responsibility for all coinage right up until 1989.

Importantly, the new Reserve Bank was still required to swap banknotes for sterling silver “on demand” if customers required it, and to hold enough silver in stock to meet demand.

The fledgling private central bank had its wings clipped by the newly-elected first Labour Government in 1936, however, when it nationalised the Reserve Bank.

“Its general function was changed to that of giving effect to the monetary policy of the Government, as communicated to it by the Minister of Finance. For this purpose, and the promotion of economic and social welfare, the bank was still required to regulate and control currency and credit, but was also empowered to control the transfer of money to and from New Zealand [exchange controls], and the disposal of export proceeds. Power was taken to suspend the bank’s duty to sell sterling on demand.”

The privately-owned Bank of New Zealand was itself nationalised when the Labour Government took it over in 1945 after almost 85 years of private ownership. Ironically, one of the stated reasons for nationalisation was that it would allow the New Zealand Government to create cheap credit for growth in New Zealand. Labour Cabinet Minister Frank Langston told the party faithful at the time that the nationalisation “would make it possible for the sunshine of economic prosperity and progress to shine in even the darkest corners.”

Although many commentators have assumed the motivation behind nationalisation was a socialist one, it wasn’t. Prime Minister Walter Nash’s biographer, Keith Sinclair, says the plan was sprung by a group of Labour dissidents known as monetary reformers.

“The dissidents’ aim was not socialism but cheap credit. [John A] Lee believed that a trading bank should be taken over to make credit available for industry.”

Prime Minister Nash had tried to resist the idea, but was forced to cave into it in principle in 1944 when the dissidents secured enough votes at Labour’s annual conference to out-vote the Prime Minister’s supporters.

12,000 workers, organised by union support, marched in Wellington in 1945 calling for urgent nationalisation of the BNZ as per the Government’s promise. Nash did it, but that was all he did.

The grandiose idea of allowing a state bank to manufacture cheap credit in competition with the world’s private banking families – similar to Lincoln and Kennedy’s visions – was going to die a quiet death.

By 1973, New Zealand and other countries had moved well away from the Gold Standard. Official figures show the Reserve Bank of New Zealand maintained overseas gold reserves of only \$700,000, out of overall assets totaling nearly \$1.1 billion. Its assets exactly matched its liabilities.

In 1994, the total value of credit and cash in the New Zealand economy was \$75 billion. By 2001 when the first edition of this book was written, the Reserve Bank reported the amount of money in the economy had ballooned to \$100 billion, of which only \$2 billion was cash: banknotes or coins. The remaining \$98 billion was credit.

In the ten years since, however, the amount of cash money in circulation has increased to around \$3 billion, but the credit burden has exploded to more than \$300 billion.

Just to labour this point so it really sinks in: during the seven years between 1994 and 2001, NZ’s credit economy grew by \$25 billion. In the ten years since 2001, our credit borrowings have grown by more than \$200 billion.

Ninety-nine percent of money in circulation in New Zealand is officially ‘fake’⁴ money – built on the promise of future repayment from wages we have not yet earned. Every man, woman and child in New Zealand now personally owes around \$75,000 on average – or at least that’s our personal share of the financial money-go-round. If the New Zealand economy ever does a Greece, that’s the value of personal wealth that will be shaved off each of us in some way, shape or form, whether directly or indirectly. That’s collectively what we owe.

⁴ Officially, the term is ‘fiat money’, meaning money created on a whim that exists only because we choose to believe it has value. When I use the term ‘fake money’, it is in comparison with hard currency. Credit is real money as long as the community supports it. When communities lose faith in credit, the financial system crashes.

But the major role of the Reserve Bank, as it pertains to the story you are about to read, is its supervision of the banking industry to ensure that crashes, like the one that subsequently took out the BNZ, don't happen.

In the United States, the scandals surrounding mortgage lending institutions Fannie Mae and Freddie Mac and the collapse of the financial system caused a crisis which we will return to later in this book. For the moment, New Zealand's BNZ bank collapse provides a useful local example from which to explore the wider issues of state asset sales, financial crises and taxpayer-funded bailouts.

The whole point of a central reserve bank, whether it is the Fed or the Reserve Bank of NZ, is to provide a clearing house for rival trading banks to cash their currencies, and a regulation of those banks to ensure they stay within fractional reserve prudential limits.

That means that a bank, the BNZ for example, is required to place a certain portion of its funds on deposit in an account at the Reserve Bank where it can't get at it. The Reserve Bank examines reports from the various banks to determine what their capital adequacy ratios should be. Usually they are between five and ten percent of deposits.

There are also very strong rules in the banking world about how much money shareholders in a bank are allowed to borrow from it – the logic being that shareholders may wish to use a financial institution as their own private piggy bank, conveniently overlooking the fact that they are playing with other people's money.

As you shall see, a merchant bank named Fay Richwhite did exactly that, borrowing far more from the BNZ than the rules allowed, allegedly placing the entire safety of the bank, and public money, at risk.

To understand the gravity and enormity of the financial crisis now looming we first have to set the scene, because understanding the events of the 80s and 90s will help readers put the rest of this book in a real context. The collapse of New Zealand's largest bank back then cost taxpayers only a fraction of what has recently been paid out for failed finance companies, but in both cases shonky behind the scenes deals were taking place that contributed to the robbery of ordinary people's savings accounts.

Additionally, as you will see later in this book, the impact of the eighties on the banking system ricocheted into the nineties and eventually lit the fuse of the 2008 global financial crash.

In a touch of pure historical irony, we can trace that collapse back, in part, to the events surrounding some of the Winebox deals I wrote about in *The Paradise Conspiracy*, and which the BNZ was donkey-deep in. Those

tax haven deals involved a massive billion dollar fraud against the Japanese tax department, using a series of major Japanese banks, the Bank of New Zealand and the forex facilities of Citibank New York.

While the Winebox deals themselves were not the death knell of the Japanese economy, they were another nail in the credibility coffin for an already stressed Japanese financial system. The Japanese banks found themselves mired in a series of scandals (the Winebox was just one) and by the mid 1990s, just as the Winebox transactions were finishing up, the Japanese banking system collapsed taking the economy of the former Asian powerhouse with it.

Instead of inflation, Japan was suddenly hit with several years of deflation.

Mum and Dad investors in that country were being offered interest rates barely above zero percent for their cash in Japan, and suddenly investing in places like New Zealand, Australia and Ireland looked like a good idea. The Western nations were looking for funding and offering much better interest rates than you could get in downtown Tokyo.

To kickstart the ailing economy, Japan's central bank opened up the money supply in the hope that by offering really cheap money things would begin to improve.

So it didn't take long for people to figure out there was an even better way to make money on the interest rate margins. Here's how it worked. A Japanese investor would borrow the equivalent of \$1,000,000, say, in Japanese yen, and they would be charged an interest rate of around 0.3% on their loan drawdown. The Japanese investor immediately deposited their loan balance into New Zealand dollar bonds. The interest they earned in New Zealand was around 6.5% per annum, which on a \$1,000,000 investment equated to \$65,000 a year of interest income, but their interest obligation on the original Japanese loan was only \$3,000 a year. You can see why being able to borrow cheap money in Japan and deposit it in high interest overseas accounts became very popular, much like the BNZ's excursion into Swiss Franc deposits for New Zealanders that you'll read of shortly.

These deals became known as yen carry-trades, or *uridashi* in the Japanese language. In the late 1990s they became one of the prime forms of foreign investment into the West, out of Japan.

In early 2007, *Investigate* magazine writer Selwyn Parker predicted the yen carry trade was on the verge of imploding:

"There's hardly a single respected authority in The City or in the central banks who doesn't think the yen carry trade will unwind sometime next year. The question is when, and how violently. The big worry is that nobody

knows the size of the yen carry trade and therefore the effects of a collapse are unpredictable. Measured in US dollars, it's certainly billions and possibly trillions. Most authorities hope for an orderly phase-out but some fear the worst. "The entire global financial system is on the verge of disintegration, as a result of the imminent collapse of the yen carry trade", predicted the *Daily Telegraph*, not normally a doom-saying newspaper, back in February."

Selwyn Parker's report was eerily prescient of what was about to come. His article made the point that Iceland had relied heavily on uridashi deals to keep its economy afloat, offering interest rates of nearly 11% to Japanese investors, compared to New Zealand's 7%. At the time of writing his article, January 2007, Iceland had not yet collapsed. But it would. In 2008 it was the first European country to hit the skids in the global financial crash.⁵

Uridashi money tended to be short term, and was the major player in three and five year fixed mortgage finance in New Zealand during the last housing boom:

"The kiwi soon acquired the doubtful accolade of one of the carry-trade currencies of choice, largely because of its high official rate," wrote Parker. "This is largely driven by New Zealand households' insatiable appetite for debt but uridashi investors don't really care about the factors that create high official rates. They are just looking for high-yielding assets in a world of low inflation. By late 2004, about NZ\$4bn worth of uridashis had been issued. In general the Reserve Bank still welcomed the foreign investment. After all, Japanese investors had been here before with the samurai bonds of the mid-nineties. And it's generally good for debt markets to be liquid.

"But in 2005 it all started going through the roof. By the middle of the year, the value of uridashis was approaching NZ\$8bn. By the end of 2005, it was NZ\$10bn. Over August, October and November, more uridashi bonds were issued in kiwis than in any other currency, more even than the mighty greenback and the much more stable Aussie dollar. In October alone, an incredible NZ\$2.5bn of uridashis were snapped up, the highest monthly amount on record. Clearly, something was going on; foreigners were hardly buying the kiwi dollar for its long-term prospects and underlying strengths.

"It was about now that the Reserve Bank began to worry about the de-

⁵ The official report into Iceland's banking system collapse found – just like you will discover in this book about the Bank of New Zealand – that the banks were being bled dry by their owners: "The largest owners of all the big banks had abnormally easy access to credit at the banks they owned, apparently in their capacity as owners. The examination conducted by the SIC of the largest exposures at Glitnir, Kaupthing Bank, Landsbanki and Straumur-Burðarás revealed that in all of the banks, their principal owners were among the largest borrowers." Source: Report of the Special Investigation Commission, (Executive Summary), April 2010, <http://sic.althingi.is/>

stabilizing effect of all this short-term money. By the end of 2005, nearly NZ\$45bn of uridashis were outstanding.

“As the Reserve Bank noted with typical understatement: ‘Given the small size of the New Zealand government securities markets relative to those of the major economies, flows of these magnitudes stand out’. The problem was that all this attention is driving up the kiwi to abnormal levels relative to other currencies.”

Great sweeping changes in the tides of civilisational fate don't usually happen out of the blue. The changes, for those trained to recognise them, can be spotted coming from a mile away. The purpose of this book is to make those signs blindingly obvious by giving examples from our recent past. Now that we know a little of what happened to Iceland's banks (and later those of the US, Greece, Britain, Spain, Ireland, Germany and France), let's see what ...

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