

Fixing America's Central Banking System

Improving Prosperity, Sustainability, and Financial Stability



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Executive Summary

As the dust from the financial crisis of the past two years settles, the American public is still reeling and asking what went wrong.

While this historic financial and economic crisis had many fathers, one undisputed sire is the Federal Reserve. As the steward of our nation's monetary system and the regulator of the financial sector, the Fed presided over a series of bubbles and a long train of corrupt, abusive, and pernicious private practices.

The Fed is inexcusably opaque, dangerously susceptible to private interests, and unjustifiably expensive for American taxpayers. To correct these problematic elements of the Fed, it must be transformed and incorporated within the Executive Branch as an independent agency. The United States needs and deserves a central bank that is transparent wherever possible, publicly controlled, and effective in fostering sustainable prosperity.

There are four fundamental advantages associated with creating a public, democratic, and modern Central Bank of the United States.

First, a central bank would promote greater transparency within the nation's monetary policy-making apparatus. In our democracy, a central assumption has been reached: The supposed efficiency associated with secrecy is subordinated to the prudent decisions associated with an informed and engaged public. This arrangement may be inconvenient for policy-makers, but the arc of history demonstrates that when policy-making is complemented with public scrutiny, superior policy is created.

The Fed rejects this arrangement, resisting a complete audit of its balance sheet and decisions and clinging to a habitual opaqueness unacceptable in any democracy. The Fed releases minutes from monetary policy meetings only after a three-week waiting period. Moreover, the transcripts of these meetings are shielded for *five* years. Ultimately, the Fed is a relic from a time when party bosses settled elections and back-room deals produced legislation. It is time for the Fed follow these archaic traditions into history.

Second, a new central bank would wrest control of monetary policy from private interests and place control where it belongs: the people's elected government. Though the Fed is ostensibly a public agency, it nonetheless fosters a dangerous primacy of private interests. The five private banking representatives on Board of Governors can, on any given decision, control the Fed by persuading only two public appointees. Control of the nation's monetary policy should not be two votes away from being controlled by private interests. Additionally, the thousands of member banks that

constitute the Federal Reserve System exist as the vocal constituency of the Board of Governors and the FOMC. This constituency funds the entire Federal Reserve System and executes the policies of the Governors and FOMC. These banks desire capital, favorable interest rates, and other government-provided benefits, making them players *and* arbiters in the banking system. Playing the defendant and the judge, the Federal Reserve exists as an undesirable blending of incestuous interests.

And this private-interest primacy is not merely theoretical: As an example, in 2008 the CEO of JP Morgan served as a board member of the Federal Reserve branch of New York as he negotiated on behalf of JP Morgan for a \$29 billion bridge loan to allow his company to acquire Bear Sterns.

Another example of private-interest primacy within the Fed is the recent "Directo a Mexico" program. Under this new program, illegal Mexican immigrants in the United States are permitted to send remittances back to Mexico via the Federal Reserve's automated clearinghouse. The Fed permits illegal residents to use the banking system by requiring that they only produce a *Matricula Consular*, an illegitimate form of identification due to rampant counterfeiting and extremely low issuance standards.

This clumsy program flouts and undermines the immigration laws of this country. It also provides a valuable money-transferring tool to drug and human traffickers within this country, making law enforcement all but impossible. This program reveals the Fed's sympathy for profit-making and its accompanying disregard for the public good.

Third, a central bank would exercise the government's Constitutional authority to control the money supply and, in doing so, retire substantial swaths of the national debt. Under the current system, the Fed manipulates the money supply primarily by purchasing and selling U.S. Securities to banks. When the Fed intends to expand the money supply, it provides the value of securities to the banks holding them, swapping capital for the securities. Every dollar the Fed wishes to place into the money supply is a dollar of U.S. debt it creates out of thin air.

This arrangement is incredibly costly to U.S. taxpayers. Firstly, the U.S. Treasury has paid approximately 30 billions in debt interest to the Fed in each of the last three years. But this is only beginning. To fully understand the cost of the Fed to U.S. taxpayers, one must consider the concept of *opportunity cost*: What does it cost us to have the Fed create the funds to purchase debt from the Treasury, instead of a central bank creating the funds?

In our modern central banking system, the Fed expands the money supply by expanding the bank accounts of member banks by the click of a mouse. This power was arbitrarily ceded to the Fed by Congress and can therefore be taken away from the Fed and granted to the executive branch.

If the Federal government, rather than the Fed, were to exercise its authority to create money, the fiscal and monetary policy-making of this country would be provided a higher level of coherence. Most importantly, if the Federal government used its latent power to create money, a byproduct of increasing the monetary supply by a certain amount of dollars would be a lowering of the national debt by the same amount of dollars. Had this alternative been the status quo system, the approximately 600 billion dollars of the U.S. debt currently held by the Fed would remain in the money supply but not count towards the nation's debt.

Moreover, if a central bank had pumped trillions of dollars into the banking system over the past year instead of the Fed, the result would be identical except for the salient fact that the nation's debt would be trillions of dollars lower than it is today.

And finally, if the United States has a central bank capable of expanding the money supply through government spending, and not through the purchasing of bank-held U.S. Securities, a host of other positive benefits could be produced. The United States is suffering from a series of under-funded initiatives, neglected deficiencies, and cash-strapped municipalities. The billions of dollars saved through not needing to make interest payments would begin to alleviate these afflictions. And the trillions of dollars created by the CBUS in the long-term would transform the nation and place it on a previously unimaginable path of prosperity.

Under the current system, expansions to the money supply provide banks with increased capital to loan out and *profit* from. By making expansionary monetary policy profitable for private banks, this system incentivizes unwise expansions of the money supply. The result is needless inflation and increased national debt.

Ultimately, the transformation of the Federal Reserve and incorporation of it into the Executive Branch is a prudent, measured, practical, and essential step in putting this nation on the path to sustainable prosperity.

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At a time when the worst economic and financial crisis since the Great Depression is afflicting the country, you as the nation's leaders must determine the cause of this crisis and take steps to prevent a repeat of it.

While many factors contributed to the dire straits the nation finds itself mired in, the facts clearly demonstrate the Federal Reserve System is deserving of your time and attention. As the steward of our nation's monetary system and the regulator of the financial sector, the Fed presided over a series of bubbles and a long train of corrupt, abusive, and pernicious private practices.

This failure by the Fed to effectively perform its mission compels you to consider the Fed's role and configuration. Such consideration fulfills your oversight prerogatives, your Constitutional responsibilities, and your obligation to the people of the United States.

The Fed is inexcusably opaque, dangerously susceptible to private interests, and unjustifiably expensive for American taxpayers. To correct these problematic elements of the Fed, **it must be transformed and incorporated within the Executive Branch as an independent agency.** The benefits of doing so are significant, fundamental, and surprising in their scope and intensity.

A reform of this magnitude would create a more coherent approach to fiscal and monetary policy, an accountable purveyor of monetary policy, and trillions of dollars for investment in cash-starved efforts like Social Security, alternative energies, and education. Most importantly, these investments can be made at no additional cost to taxpayers.

The discussion to follow will dispense with extremist polemics frequently hurled against the Fed, outline the shortcomings of the Fed, discuss the benefits of a "post-Fed" economy, and propose a common sense alternative to the status quo.

If the United States is to successfully avoid a reprise of the current crisis, it must adopt a series of reforms. Although no silver bullet exists to shield us from a future crisis, a transformation of the Federal Reserve is an essential step in placing the country on a path to sustainable prosperity.

An Undemocratic Lack of Transparency

During this current financial crisis, the Fed took a series of actions to mitigate the effects of the downturn. These measures invited questions from citizens and Congress. Its response to these inquiries reveal the Fed to be an opaque relic of a time long passed.

In 2009, it is simply not acceptable for entities serving the public interest to secretly take actions and defiantly refuse to provide sought information. **The Federal Reserve Inspector General was not able to account for nearly two trillion dollars created and spent by the Fed.**

Moreover, the Fed is intensely resistant to an audit of its balance sheets and monetary decisions. In a democracy, this secrecy is not justifiable.

The Fed releases minutes from monetary policy meetings only after a three-week waiting period. Moreover, the transcripts of these meetings are shielded for *five* years.

In defending its opaqueness, the Fed argues that the nation's economic health depends on the sensitive cultivation of consumer confidence. On this point they are entirely correct. But they fail to recognize that public confidence can best be buoyed, and not eroded, when decision makers explain policies honestly, transparently, and frankly. The Fed fosters a culture antithetical to these elements of openness.

The Fed also defends its secretive tendencies by contending that it can only create sound monetary policy by insulating itself from public scrutiny. Certainly critical policies involving trillions of dollars cannot be formulated on CNBC—such openness would in fact introduce violent volatility into the market. But neither can the Fed hide behind controlled press statements and months-delayed releases of meeting minutes. Clearly, a happy medium between democratic transparency and necessary shielding must be found. The Fed does not inhabit this medium.

In our democratic form of government, a central assumption has been reached: The efficiency associated with secrecy is subordinated to the prudent decisions associated with an informed and engaged public. This arrangement may be inconvenient, but the arc of history demonstrates that when policy-making is complemented with public scrutiny, superior policy is created.

Ultimately, the Fed is a relic from a time when party bosses settled elections and back-room deals produced legislation. It is time for the Fed follow these archaic traditions into history.

A Dangerous Reliance on Private Interests

The Fed is legally under the authority of a Board of Governors comprised of presidentially-appointed and Congressionally-approved members. What's more, monetary decisions are made by the Federal Open Markets Committee (FOMC), a body where public appointees out-number bank representatives by a margin of seven to five.

This being said, though the Fed is ostensibly a public agency, it nonetheless fosters a dangerous primacy of private interests. **The five banking representatives on Board of Governors can, on any given decision, control the Fed by persuading only two public appointees. Control of the nation's monetary policy should not be two votes away from being controlled by private interests.**

Additionally, the thousands of member banks that constitute the Federal Reserve System exist as the vocal constituency of the Board of Governors and the FOMC. This constituency funds the entire Federal Reserve System and executes the policies of the Governors and FOMC. **These banks desire capital, favorable interest rates, and other government-provided benefits,**

making them players and arbiters in the banking system. Playing the defendant and the judge, the Federal Reserve exists as an undesirable blending of incestuous interests.

The Federal Reserve System is akin to a baseball game in which the umpires are responsible to and paid by the players. Baseball fans would balk at such a game. The people's representatives should balk at such a central banking system.

It must be emphasized that this danger is not merely theoretical. This system purveys and even encourages glaring conflicts of interest. In 2008, the CEO of JP Morgan served as a board member of the Federal Reserve branch of New York as he negotiated on behalf of JP Morgan for a \$29 billion bridge loan to allow his company to acquire Bear Sterns.

Another example of private interest primacy within the Fed is its recent "Directo a Mexico" program. Under this new program, illegal Mexican immigrants in the United States are permitted to send remittances back to Mexico via the Federal Reserve's automated clearinghouse. The Fed permits illegal residents to use the banking system by requiring that they only produce a Matricula Consular, a form of identification regarded by most law enforcement officers as illegitimate due to rampant counterfeiting and to extremely low issuance standards. For this reason, some US government agencies refuse to accept them as sufficient forms of identification.

This clumsy program flouts and undermines the immigration laws of this country. It also provides a valuable money-transferring tool to drug and human traffickers within this country, making law enforcement all but impossible. This program reveals the Fed's sympathy for profit-making and its frequent disregard for the public good. The purpose of *private banks* - the constituency of the Fed - is to make money, a purpose well-served by a program that promises to draw the business of hundreds of thousands of illegal immigrants. The purpose of *government* is to enforce laws - immigration and otherwise - to serve the public good. The Fed consistently fulfills its private purpose at the expense of its governmental purpose.

The Fed represents a private-public hybrid, a political compromise from pre-World War One America. In 1909, four years before the Fed was created, the titan JP Morgan saved the federal government and the financial system from collapse by loaning money to troubled institutions. We no longer live in a time when private bankers do or should have more power than the federal government.

The American Monetary Institute has written that **control over the monetary system "should never be alienated from democratically elected government and ambiguously placed into private hands as it is in American in the Federal Reserve System."** In the wake of rampant corruption and greed in the financial sector, this truth has never been more relevant.

The Fed is Costing American Taxpayers Trillions of Dollars

Under the current system, the Fed manipulates the money supply primarily by purchasing and selling U.S. Securities to banks. When the Fed intends to expand the money supply, it provides the value of securities to the banks holding them, swapping capital for the securities. **Every dollar the Fed wishes to place into the money supply is a dollar of U.S. debt purchased by the Fed.**

This arrangement, though ostensibly legitimate, is actually incredibly costly to U.S. taxpayers. **Firstly, the U.S. Treasury has paid approximately 30 billions in debt interest to the Fed in each of the last three years.**

But this is only beginning. To fully understand the cost of the Fed to U.S. taxpayers, one must consider the concept of *opportunity cost*: What does the Federal government's arrangement with the Fed prevent us from doing?

In our modern central banking system, the Fed expands the money supply by expanding the bank accounts of member banks by the click of a mouse. This power was arbitrarily ceded to the Fed by Congress and can therefore be taken away from the Fed and granted to the executive branch.

If the Federal government controlled the money supply, it would have the power to expand the supply by purchasing U.S. securities held by banks. **But instead of simply transferring ownership of U.S. debt—as the Fed currently does—the federal government would be able to retire the debt affected by increasing the money supply. Put another way, in a post-Fed monetary system, the Federal government could diminish the nation's debt each time it takes steps to increase the money supply.**

Had this alternative been the status quo system, the **approximately 600 billion dollars of the U.S. debt currently held by the Fed would remain in the money supply but not add to the nation's debt.**

While its impenetrable opaqueness makes the exact amount of money created by the Fed unknown, testimony by the Federal Reserve Inspector General reveals that this amount must number in the trillions. **This means that, under an alternative monetary system, the money supply could have been expanded and the climbing federal debt could be trillions of dollars less than it is today.**

Clearly the Fed afflicts the U.S. taxpayer with a staggering opportunity cost. Each year, a significant portion of federal income taxes are used to service this unnecessary debt and not used to fund valuable government services.

If the Federal government were to exercise the authority to create money, a power explicitly granted to it in Article I, Section 8 of the Constitution, the fiscal and monetary policy-making of this country would be provided a higher level of coherence. Additionally, if the Federal government used its latent power to create money, a byproduct of increasing the monetary

supply by a certain amount of dollars would be a lowering of the national debt by the same amount of dollars.

Under the current system, expansions to the money supply provide banks with increased capital to loan out and *profit* from. By making expansionary monetary policy profitable for private banks, this system incentivizes unwise expansions of the money supply. The result is needless inflation and increased national debt.

In short, when the Fed expands the money supply, the ownership of U.S. debt is transferred and preserved; if the Federal government were given control of the money supply, a substantial portion of U.S. debt could be retired. Such a monetary policy apparatus would begin to restore fiscal health and simultaneously produce responsible monetary policy.

The Alternative to the Fed

Creating a post-Fed monetary system that provides control over monetary policy to the Federal government invites legitimate concerns about the politicization of monetary policy and the specter of rapid inflation. However, careful examination reveals that the Federal Reserve System itself contributes to inflationary pressure in several ways. These pressures, stemming from the profit-motive of the Fed, can be alleviated by replacing the Fed with an accountable central bank carefully insulated from political pressures.

We propose deliberately and delicately creating an independent arm of the Treasury Department and imbuing it with the power to control monetary policy. This new entity, the *Central Bank of the United States (CBUS)*, should conform to the following specifications, each designed to strike the prudent balance between dangerous sensitivity to fluctuating political pressures and equally dangerous undemocratic inaccessibility.

Below are some mechanisms that could achieve this balance:

- A. The CBUS should be placed within the Executive Branch. Its administrator should serve in the cabinet, work closely with the Secretary of the Treasury, and report to the president to ensure unity of economic and financial policy-making.
- B. The Administrator of the CBUS should be presidentially appointed and Congressionally approved, and should serve a four-year term.
- C. The CBUS administrator should only be removed through the established impeachment process. The president and the Secretary of the Treasury can recommend impeachment but not supplant the process through unilateral termination of the CBUS administrator.
- D. There should be a limit of two terms. This permits the accumulation of experience while preventing careerism from creeping into decisions.
- E. All decisions controlling the monetary supply must be decided by a committee of seven members. The majority party in the House of Representatives should select four members; the minority party should select three members. The House has been awarded primacy because the Constitution clearly favors the House on matters of financial policy. These seven members should serve 14-year terms and should be appointed through a staggered schedule.

- F. The Financial Services Committee should be given oversight authority to insure that the CBUS operates efficiently and honestly. However, this Committee must not be give the authority to alter or interfere with monetary policy produced by the CBUS.
- G. The mandate of the CBUS should be to promote full employment and low inflation, per the 1978 Humphrey-Hawkins Act. **This mandate implicitly forbids policies designed to use manipulation of the money supply to rectify fiscal imbalances.**

Because of section G., the CBUS will not be allowed to make determinations about the money supply based on fiscal considerations. The retiring of U.S. debt through the expansion of the money supply must, by law and policy, be a corresponding byproduct, and not a motivating factor, in manipulation of the money supply.

Some critics argue that a CBUS-like entity would lead to higher inflation. The above parameters provide substantial shielding from political pressure, diminishing the likelihood that electoral considerations would induce the CBUS to create inflation through unwise expansions of the money supply. **Additionally, through its retirement of U.S. debt, the CBUS would have a deflationary effect on long-term tax rates, thereby off-setting inflation that may or may not result from its decisions to expand the money supply.**

And finally, the CBUS would lack the powerful profit motive that permeates the Federal Reserve System, and that results in inflationary expansions of the money supply. In formulating monetary policy, the CBUS will not consider the amount of capital banks have to loan and profit from. This is the first step in reducing inflation.

Worth noting is that **money created by the CBUS would be no more inflationary than the same amount of money created by the Fed.** The challenge, then, is to ensure that the CBUS not unduly expand the money supply beyond what the Fed would do. But this is a challenge that the government – the capable operator of the military and Social Security – can surely meet.

Recreating the nation’s monetary policy-making apparatus might appear daunting. Yet the complex challenges associated with reform pale in comparison to the insurmountable challenge of making the current system work for the American people. We as a nation must not allow the challenges associated with this reform to obscure the important benefits that would accrue under a reformed system.

The Benefits of a Post-Fed Economy

If expansions to the money supply were configured to retire national debt, trillions of dollars would be reduced from our national debt level. Additionally, if expansions to the money supply were injected through government spending, and not through the purchasing of bank-held U.S. Securities, a host of other positive benefits could be produced. The chain of reasoning is simple:

The United States is suffering from a series of under-funded initiatives, neglected deficiencies, and cash-strapped municipalities. The billions of dollars saved through not needing to make interest payments would begin to alleviate these afflictions. And the trillions of dollars created

by the CBUS in the long-term would transform the nation and place it on a previously unimaginable path of prosperity.

The American Society of Civil Engineers gives the nation's infrastructural health a grade of D. These experts estimate the need for 2.2 trillion dollars of increased funding for the nation's infrastructure. Without investment that ameliorates our failing bridges, roads, and dams, the nation's productivity and safety will be compromised. **Investment in infrastructure will also have the effect of adding jobs to our job-starved economy.**

This nation is currently mired in a debate over healthcare. What separates the two sides of this debate is, in part, approximately 100 billion dollars. **The CBUS could provide the funding health care reform proponents seek while addressing the concerns of fiscal hawks.**

As the world's oil reserves reach peak production, and as the foreign owners of this critical life-blood of our economy become increasingly hostile to American interests, investments in **alternative sources of energy** will evolve into national security necessities.

In 30 years, when the next generation is saddled with the responsibility of paying the debt accrued due to a global war on terrorism, two wars in the broader Middle East, and rampant domestic spending, a source of relief to these future taxpayers will be the CBUS' ability to actually lower the national debt.

Experts agree that, starting in 2017, Social Security will expend more in benefit payments than it receives in taxes. By 2042, the Social Security will be insolvent, leaving millions of Americans without the economic security they were promised. Through its money-creating powers, **the CBUS could contribute to a balancing of Social Security deficits in the future.**

It could also begin the process of making the Social Security Trust Fund, currently wholly invested in special U.S. securities, a liquid fund. Currently, excess Social Security taxes are invested in U.S. securities. In 2017, when these reserves will be needed on account of receipts falling below expenditures, the Social Security Administration will "call in" its debt. This will place a burden on the Federal budget above-and-beyond the burden already imposed by the four percent interest the Treasury is required to pay semiannually on the four trillion dollars it borrowed from Social Security. By slowly paying off the public's debt to Social Security, and by balancing deficits in Social Security through money creation, the CBUS could lower the national debt by almost four trillion dollars and liberate taxpayers from the obligations associated with owing trillions of dollars to the Trust Fund.

Certainly, the CBUS is not a silver bullet. And it should never be viewed primarily as a funding instrument for Federal programs or a bonanza for pet projects. **Yet it *would* play a constructive role in lowering the nation's debt and funding valuable investments in our economy, infrastructure, energy alternatives, senior citizens, and future stability.**

In Conclusion...

The American Monetary Institute, a think-tank devoted to study of these issues, wrote that “The power to create money is an awesome power –at times stronger than the Executive, Legislative, and Judicial powers combined. It’s like having a magic ‘check book’, where the checks never bounce. When controlled privately it can be used to gain riches, but more importantly it determines the direction of our society by deciding where money goes – what gets funded and what does not.”

In the end, we are proposing that the Federal government reassume control over monetary policy. This would have the effect of ending a pernicious reliance on private interest for the formulation of public policy; it would promote the transparency essential to a democracy; it would begin to reduce our soaring national debt; and it would provide billions and even trillions for investment in our country’s future.

Implementation of the CBUS is a nationalization of the money supply, not the banking industry. Unlike the controversial nationalization of General Motors and other private firms, what we are suggesting is entirely consistent with the Constitution and the central banks of America’s early history. Returning control of monetary policy to the democratically-elected government would win the support of Alexander Hamilton and, we think, the average American citizen.

Congressman Wright Patman, Chairman of the House Committee on Banking and Currency served in his capacity for 16 years. He is an unimpeachable expert. “I have never yet had anyone who could, through the use of logic and reason, justify the Federal Government borrowing the use of its own money...I believe the time will come when people will demand that this be changed. I believe the time will come in this country when they will actually blame you and me and everyone else connected with the Congress for sitting idly by and permitting such an idiotic system to continue.”

In the middle of the 19 Century, Civil War officer Major General Benjamin Franklin Butler said of America’s founders, “We marvel that they saw so much, but they saw not all things.” The American enterprise is a continuing experiment, a perennial and generational challenge passed down to each successive group of Americans. It is the mission of each new generation to move our national reality ever closer to the ideals set forth two centuries ago.

The creation of a public, modern, and democratic central bank continues this experiment, fulfills this mission, and moves us ever-closer to America’s founding principles.

