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The Missing Link Of Democracy

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The Missing Link of Democracy:

The Federal Reserve Submission to the Democratic Government

> *"If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, (i.e., the "business cycle") the banks and corporations that will grow up around them will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered.*"
>
> **Thomas Jefferson**

Abstract

This paper examines the shortcomings of the Federal Reserve (the "Fed") as an institution, its power and policy under a democratic system of government, and the consequences thereof.

America is in the midst of an economic crisis, possibly worse than any of its previous crises. Economic contraction, high unemployment, banks bailouts, unstable interest rates, the weak dollar, inflation and intense fear loom over the oldest democracy in the world.

At the root of each of these issues is the Federal Reserve of The United States of America.

The Federal Reserve (the "Fed") has the role of central bank; it is the banker's bank, the lender of last resort, and the marketplace regulator. We have heard that the creation of the Fed was "a compromise, that it would control the supply of funds on which the banks depended to make loans, injecting more money into the banking system put downward pressure on interest

rates, while its opposite, restricting the supply of potential credit, pushed up rates. The regional banks were intended to help make the flow of credit even across the country." [1] The Fed, however, far exceeded its original mandate.

The economic crisis of 2008 raised serious disputes about the existence of the Fed, and the juridical nature supporting its existence. Further controversy surrounded the issue of the economic system of the United States and its dependency the Fed; more importantly, whether the Fed as it currently exists fits in a democratic system. This paper will examine these issues, as well as unveil urban myths, such as that the Federal Reserve has existed from the beginning of the democracy, and worse, as a large percentage of American citizens believe, that the Fed is a branch of the government. Questions have risen about its juridical nature: is the Fed unconstitutional? Is the Fed a privately-owned corporation? During the crisis, did the Fed work for the welfare of the country or just help special interest groups? These are important topics to address. Resolving these questions would provide support to Congress in deciding whether to abolish the Federal Reserve System. If abolished, the Presidential branch of the United States would assume complete responsibility for bank regulation and monetary policy.

Analysis

History

During its existence, America has had three central banks, and one long period without a central bank, from 1817 to 1913. Each period, with or without the existence of a central bank, has been marked by business cycles, good times mixed with recession, financial panic and

[1] **New York Times, Federal Reserve System, June 28, 2010.**

depression.

The Federal Reserve as it now exists was created when President Wilson signed the Federal Reserve Act (the "Fed Act") on December 23, 1913. The Fed Act included the creation of a seven-member board of governors, the office of the Fed chairman, and twelve regional banks.

The Federal Reserve's webpage indicates the process of appointment of the Board of Directors:

> "The seven members of the Board of Governors are appointed by the President and confirmed by the Senate to serve 14-year terms of office. Members may serve only one full term, but a member who has been appointed to complete an unexpired term may be reappointed to a full term. The President designates, and the Senate confirms, two members of the Board to be Chairman and Vice Chairman, for four-year terms."[2]

The governors are appointed by the president and approved by Congress; the regional bank presidents are selected by the regional bank's board of directors, who are, in turn, largely elected by banking leaders in their respective communities. The list of appointments is usually provided by the stockholding banks.

How did we get to the point of what is now the current-day Fed? Was there an economic theory about the necessity of a central bank that provided the foundation for what currently exists as the Federal Reserve? Was it another economic crisis that pushed for the change that led to the creation of the Fed?

[2] **http://federalreserve.gov/pubs/frseries/frseri.htm**

In order to better understand the Federal Reserve as an institution, its origin and the purpose of its creation must be examined.

According to Liaquat Ahamed's book, "Lords of Finance," it was the consequence of the economic crisis of 1907:

> "….in October 1907, The United States was rocked by a severe financial crisis. The panic began, like so many before it, with the failure of a large speculative venture, this time an attempt by a couple of unscrupulous characters to corner the stock of a copper company. When they failed and one of them, the president of a Brooklyn-based bank, was rumored to have lost $50 million, most of it borrowed, a run on his bank set in. By the end of October, the fear had infected the whole city and there were runs on a variety of banks across New York, including the Knickerbockers Trust Company, the third largest in the city."[3]

Similar to the controversy surrounding the Fed's existence today, at the time of its inception, there was significant opposition to the creation of a central bank. Farmers from the West (at that time the major borrowers), as well as a wide sector of politicians, were suspicious of the creation of a central bank, fearing that it would place too much power in a single institution.

> "The United States was the only major economy power without a central bank. Throughout its history, the country had displayed an unusually ambivalent attitude to the whole institution of central banking. While east coast financers, who were lenders of money, kept pressing the case for placing authority over the country's monetary system in a single overarching bank, there was much support for the argument, particularly from farmers, who typically borrowed money, that putting so much power in the hands of one institution was somehow un-American and undemocratic. Because of this fundamental disagreement, banking policy in the United States had careened from one extreme to another."[4]

[3] **Liaquat Ahamed's book Lords of Finance: The Bankers Who Broke the World (page 52)**
[4] **Liaquat Ahamed's book Lords of Finance: The Bankers Who Broke the World (page 52)**

After several deliberations between bankers and government officials without results, there was a secret meeting held in 1912 in which the largest banks in the United States were represented, as well as the government.

> "In 1912, Davison, now a Morgan partner, frustrated by the lack of progress and fearing that without changes the next panic would be even more catastrophic, set out to convene a meeting of experts to develop a formal plan to establish an American central bank - the third in the nation's history. Only five men were invited. Before Davison himself, there was Senator Aldrich; Frank Vanderlip, the forty-eight-year-old president of the National City Bank, the largest in the country; Paul Warburg, of the well-known Hamburg banking family, a forty-two-year-old partner at Kuhn Loeb who, although he had only just moved to New York, was probably the greatest expert on central banking in the United States; A. Piatt Andrew jr., the thirty-nine-year-old assistant Secretary of Treasury, who had been professor at Harvard and accompanied the original commission on its European study tour; and Benjamin Strong, then thirty-nine years old**."**[5]

In preliminarily examination of the participants, it is evident that there were three representatives of the major banks of the country and two representatives of the government. Ironically, one was Senator Aldrich, a passionate promoter of a private bank without government control. (To note, he was accused of representing the banks' interest because of his daughter's marriage to John D. Rockefeller, Jr.) People of the country didn't participate in these negotiations. The general public was not informed of the negotiations, because they "wouldn't understand the technical terms and decisions either way."[6]

The basis of the undertaking was to address the country's need of a banking and currency reform that could provide a reserve of liquid assets in case of financial panic, allowing the currency and credit to expand and contract seasonally within the U.S. economy.

The opposition was fierce, an example of which can be found in the letter that Senator

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5 **Liaquat Ahamed's book Lords of Finance: The Bankers Who Broke the World (page 52)**

6 **Liaquat Ahamed's book Lords of Finance: The Bankers Who Broke the World (page 52)**

Henry Lodge of Massachusetts wrote to Senator John Weeks:

> "My Dear Senator Weeks:
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> Throughout my public life I have supported all measures designed to take the Government out of the banking business. This bill puts the Government into the banking business as never before in our history. The powers vested in the Federal Reserve Board seen to me highly dangerous especially where there is political control of the Board. I should be sorry to hold stock in a bank subject to such dominations. The bill as it stands seems to me to open the way to a vast inflation of the currency. I had hoped to support this bill, but I cannot vote for it cause it seems to me to contain features and to rest upon principles in the highest degree menacing to our prosperity, to stability in business, and to the general welfare of the people of the United States.
>
> Very Truly Yours,
>
> Henry Cabot Lodge"

Nevertheless, the projected bill became, with few modifications, the Federal Reserve Act, establishing the central banking system of the United States of America in December of 1913.

Unlike most government entities, the Federal Reserve System was not established under the direct control of any branch of the federal government. Nor was the system funded by government appropriations. Instead, each Federal Reserve Bank, or District Bank, was established as a banking corporation and acquired funds from interest earned on government securities and income provided by the banking industry. Each District Bank, like any private corporation, also maintained the power to appoint its own board of directors, officers, and employees. The board of directors, comprised of two local bankers, headed each District Bank. However, by the late 1920s, nine members made up of the board--three of whom were selected from the member banks, another three of whom were selected from the banking industry, and a final three of whom were appointed by the Federal Reserve Board. The board of directors for each District Bank maintained the power to elect one representative to the Federal Advisory Board, which periodically met in Washington D.C.[7]

The Federal Reserve as a Federal Agency

It cannot be ignored that the Fed has significant leverage beyond any democratic control. There are a number of unresolved questions, such as what is the Fed's juridical nature? Is the Fed a private institution or a federal agency? Is it a hybrid between public and private institutions? Is the Fed subject to the law and governmental control like every federal agency?

<u>Constitutional and Judicial Approach</u>

The Constitution of the United States doesn't say anything with respect to the creation and function of a central bank. Moreover, Sections 8 and 10 of Article 1 of the Constitution collide with the creation and function of the Federal Reserve. Article 1, Section 8 specifically indicates:

> "The Congress shall have Power ...to coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures."[8]

When the Constitution refers to establishing value, it is not establishing purchasing power. According to these words, the founding fathers viewed money as gold or silver, but not as paper.

"The Congress shall have power to coin the money."[9] No clause exists that allows the

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[7] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**
[8] **U.S. Constitution, I, sec. 8.**

Congress to subcontract or sub-delegate its power to coin money. The Federal Reserve is not the Congress; hence, it cannot be viewed as unconstitutional.

Next is Section 10, which relates to the Fed's principal activity, printing money. Article I, Section 10 states that:

> "No state shall… make anything but gold and silver coin a tender in payment of debts."[10]

Finally, the Tenth Amendment specifies that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[11]

The apparent conclusion of this analysis is that there is no reference to a central bank in the Constitution, and should the Supreme Court accept its existence, under the current Constitution, the Fed cannot tender money.

Despite these antecedents, the Supreme Court of the United States in 1819, in McCulloch V. Maryland, a case that involved the right of Congress to create the Bank of the United States and to authorize it to issue notes for circulation, the Supreme Court conceded that the Constitution has no specific grant to this creation. It was argued, however, that as a necessary means for the government to collect, transfer, and pay out its revenues, the organization of a bank with these functions was within the power of the Congress.[12]

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[9] **U.S. Constitution, I, sec. 8.**
[10] **U.S. Constitution, I, sec. 10.**
[11] **U.S. Constitution, I, sec. 10.**
[12] **McCulloch V. Maryland (17 US 316) 1819.**

The juridical nature of the Federal Reserve was challenged in a case in 1982, Lewis v. the United States of America, where the question was raised of whether the Federal Reserve was a federal agency within the meaning of the Federal Tort Claim Act.

In 1982, the Supreme Court of the United States held that the Federal Reserve Banks are

> "independent, privately owned and locally controlled corporations", and there is not sufficient "federal government control over 'detailed physical performance' and 'day to day operation'" of the Federal Reserve Bank for it to be considered a federal agency."[13]

In this same sentence the Supreme Court analyzed the Congress's intentions to enact the Federal Reserve Act:

> "It is evident from the legislative history of the Federal Reserve Act that Congress did not intend to give the federal government direction over the daily operation of the Reserve Banks:
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> It is proposed that the Government shall retain sufficient power over the reserve banks to enable it to exercise a direct authority when necessary to do so, but that it shall in no way attempt to carry on through its own mechanism the routine operations and banking which require detailed knowledge of local and individual credit and which determine the funds of the community in any given instance. In other words, the reserve-bank plan retains to the Government power over the exercise of the broader banking functions, while it leaves to individuals and privately owned institutions the actual direction of routine."[14]

In other words, the Court says that the Federal Reserve is a government instrument, but that it is not a federal agency. The Court's intention to avoid the consideration of the Fed as a federal agency is understandable; otherwise, this terminology would subject the Fed under the federal government's direct control, opposing the principle of its political independence.

Fearing entrapment within its own definition, the Supreme Court avoided any reference of the Fed as a federal agency. Paying attention, however, to the following paragraph, most

[13] **Lewis v. United States, 680 F.2D 1239 (1982)**
[14] **H.R. Report No. 69, 63 Cong. 1st Sess. 18-19 (1913)**

importantly the last sentence, it is possible to appreciate the Fed's confusion regarding legal and functional design:

> "The Reserve Banks are deemed to be federal instrumentalities for purposes of immunity from state taxation. ...The test for determining whether an entity is a federal instrumentality for purposes of protection from state or local action or taxation, however, is very broad: whether the entity performs an important governmental function. …The Reserve Banks, which further the nation's fiscal policy, clearly perform an important governmental function."[15]

Hence, according to the Supreme Court, the Fed "further(s) the nation's fiscal policy, clearly perform an important governmental function,"[16] while simultaneously being considered a private institution. Evidently, the Supreme Court is not sufficiently clear with respect to the Fed, and for the populous, instead of clarifying the Fed's juridical nature, it is now more complicated to define.

The United States Court of Appeals, 3rd circuit, in Fassano v. Federal Reserve of New York, 457 F.3d 274 (2006) held that there is not a "federal instrumentality" beyond the field of taxation.

> "We also take issue with the contention that federal instrumentalities do not exist beyond the field of taxation. See, e.g., United States Postal Serv. v. Flamingo Indus. (USA) Ltd., 540 U.S. 736, 124 S.Ct. 1321, 158 L.Ed.2d 19 (2004)
> …Moreover, while we acknowledge that the Supreme Court has been less than crystal clear in elucidating a test for federal instrumentalities, the mere fact that the Federal Reserve Banks are organized in the corporate form does not itself prevent them from being federal instrumentalities. As the New York Fed correctly notes, the Bank of the United States in the bedrock case of McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 4 L.Ed. 579 (1819), was found to be a federal instrumentality despite its corporate status.[17]

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[15] **Lewis v. United States, 680 F.2D 1239 (1982)**
[16] **Lewis v. United States, 680 F.2D 1239 (1982)**
[17] **Fassano v. Federal Reserve of New York, 457 F.3d 274 (2006)**

But the Court continues: "…we decline to formally reach here whether Federal Reserve Banks should be considered federal instrumentalities. We note, however, that strong arguments have been made in favor of such status."[18]

Up to this point, the Supreme Court's opinion had been that the Fed is not a Federal Agency under the Federal Tort Claim Act, and that it takes corporate form but it is not a corporation. Still, it is not evident (at least for the Court of Appeals) if the Fed can be considered as a "federal instrumentality" or not.

Another important case to define the Federal Reserve's judicial power within the United States occurred when the financial news publisher Bloomberg requested information during the crisis of 2008 regarding the whereabouts of the $2 trillion in Fed money; the Board of Governors of the Federal Reserve refused to give complete disclosure regarding the money. Thereafter, Bloomberg filed a FOIA (Freedom of Information Act) request against the Board, to which it responded, stating that it didn't have to comply because the records were housed at the Federal Reserve Bank of New York, which was "not an agency" and therefore not subject to the Act. This answer was understood as acknowledgement of its private juridical nature as a private corporation.[19]

An anecdotic to this case was the result, in which the United States District Court of New York granted Bloomberg's motion for summary judgment, while the Board of Directors of the Fed had to produce the report initially required. The Federal Reserve secrecy became a public issue during these days.

[18] **Fassano v. Federal Reserve of New York, 457 F.3d 274 (2006)**
[19] **Bloomberg L.P. v Board of Governors of Federal Reserve System. 649 F. Supp. 2d 262.**

> "Their secrecy privilege is protected by law. If the creature can come into being without constitutional authority, it can escape all oversight that other government agencies must submit to. Even the CIA has more responsibility to report to a select few in Congress on its activity…The Government Account Office has the responsibility of auditing all government agencies. Title 31, Chapter 7 of the money and finance section of the code describes its duties and powers to audit all financial institutions, including "the Federal Reserve Board, Federal Reserve Banks, Federal Deposit Insurance Corporation, and the Office of Comptroller of the Currency." That sounds pretty inclusive and clear. But there is a proviso in the law. It goes on to say: Audits of the Federal Reserve Board and Federal Reserve Banks may not include: Transactions for or with a foreign Central Bank, government of a foreign country, or non private international financing organization;
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> Deliberations, decisions, or actions on monetary matters, including discount window operations, reserves of member banks, securities credit, interest on deposits, and open market operations;
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> Transactions made under the direction of the Federal Open Market Committee; or a part of a discussion or communication among or between members of the Board of Governors and officers and employees of the Federal Reserve System related to clauses (1) – (3) of this subsection."[20]

The Federal Reserve Board web page states that, "The Board will provide any reasonably segregable portion of a record that is requested after deleting the portions that are exempt from disclosure. Under the Freedom of Information Act, 5 U.S.C. § 552 (b), the following records of the Board are exempt from disclosure," then enumerates the several exceptions: national defense, internal personnel rules and practices, statutory exemption, trade secrets; commercial or financial information, inter- or intra-agency memorandums, information compiled for law enforcement purposes, examination, inspection, operating, or condition reports, and confidential supervisory information, geological and geophysical information and data.[21]

As mentioned above, the President of the United States has the power to appoint the President of the Fed and the six governors. But can the President remove them from their

[20] **"End the Fed," Ron Paul, (page 173)**
[21] **Federal Reserve Board, FOIA Exemptions.**

positions?

In Humphrey's Executor v. United States, the Supreme Court held that the President doesn't have unlimited power to remove the head officials of independent agencies.[22]

The President doesn't have direct control over regulation of banks and bank holding companies, because of the "independence" of the Federal Reserve which has that control' therefore, there is a weakness over the presidential power established by the Constitution.

<u>How Does the System work?</u>

During the 2008 economic crisis, the Fed printed trillions of dollars and circulated them in the form of bailouts. From where that money comes and to where it is going is a good question. After the abolition of the gold standard principle in 1973, the Fed was able to inject money into the market almost limitless. The limit of that action can be established only by the Board of Directors.

To explain how the system works from the beginning we will follow William Greider, who stated in his best seller Secrets of the Temple.

> "…money is worthless unless everyone believes in it…the cattle used as currency by some African tribes were, after all, valuable in themselves. If the money illusion collapsed for some reason, the coins were still cattle… Paper money, it is said, originated with the goldsmiths of Europe who held the private gold hoards deposited by wealthy citizens for safekeeping…modern banking originated in the goldsmiths' discovery that they could safely write more receipts and lend then to people, exceeding the total gold that was on hand, so long as they always kept a responsibly minimum in reserve to honor withdrawals. This was the origin of fractional – reserve banking and the bank lending created money."[23]

It is important to remember that at the beginning and during a long part of its existence,

[22] **Humphrey's Executor v. United States, 295 U.S. 602 (1935)**
[23] **Secrets of the Temple: How the Federal Reserve Runs the Country. William Greider (page 227)**

the Fed was subjected to the gold-standard system as a regulator. This system consisted in a standard economic unit of account that was a fixed weight of gold, where the government had to guarantee a fixed exchange rate with another country that was on the gold standard.

We saw the suspension of the gold standard system numerous times, frequently during war time, due (some claim) to the inelasticity of the system.

> "History and politics argued that a nation at war, threatened with survival, will do whatever it needs to do in order to win and worry later about the financial consequences."[24]

Banks had found limits in the system in order to increase money and credit, so they called for elimination of the gold standard system.

> "This private money system endured for centuries and was inherited by the American Republic: privately owned banks by a promise that any time it could be redeemed in gold… banking scandals were recurrent, particularly on the frontier, where ambitious bankers, eager to make loans for new enterprises, sometimes printed paper money that had no gold behind it. Governments imposed regulations to keep banks honest, but the bankers still were free to create their own variety of money. When banks failed, their money failed with them.
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> …The money illusion was transferred to a new object with the rise of demand deposits, better known as checking accounts. Instead of currency, the paper money created by banks, people hesitantly came to accept that money also existed simply as an account in the bank's ledger, redeemable by personal drafts or checks – In the United States, the transition was inadvertently stimulated by government regulation. The National Bank Act, enacted during the civil war, placed a heavy tax on new bank notes issued by states banks encouraged customers to use demand deposits – writing personal checks instead of drawing out their money in cash. It took generations for the public to overcome its natural distrust of checks, written by buyers themselves, were accepted as just as valuable as dollar bills. Currency remained in use, but demand deposits were now the bulk of the money supply. The nationalization of currency issuance, completed with the creation of the Federal Reserve in 1913, simply continued this arrangement. A new dimension of trust had added to the illusion.

[24] **Secrets of the Temple: How the Federal Reserve Runs the Country. William Greider (Page 322)**

> Finally, the last prop for the money illusion was kicked away in this century: the gold standard was abandoned… a citizen can still go to the bank and redeem it, but his money will be redeemed only in new, identical Federal Reserve Notes."[25]

Today there are several groups theorizing about a new role for the Fed, two of them have opposite ideas about it. The fervent monetarist school, which some of its adepts subscribed to the gold standard practice and in some other cases to the free banking system, and the other who consider themselves more pragmatic and progressive and support the "elastic system" or fractional reserve system but eliminating the current cash for international electronic money.

> America's bubble economy and the world's current dependence on it are all part of the bumpy, messy transition in the evolution of money from metals-based money to something entirely different – not paper money, but the next step in the STEP Evolution of money: an international all-electronic currency…Why an international currency? Because it will be necessary to avoid repeating the pain of another global bubblequake. A single international currency will eliminate the problems with foreign currency exchange, making currency bubbles (like our current dollar bubble) impossible. It will also block us from spending our way into huge foreign trade imbalances (like our current international trade deficit bubble). … a global economy requires a global currency.[26]

Around this crisis, the Austrian monetarist school took different stage, following its long criticism over the Federal Reserve System. Their examination of the economy is based principally in its principles around the concept of inflation. They sustain that it is the increase in the money supply which boosts to a higher nominal price level for assets (goods and services) in demand, and the real value of the monetary unit is consumed.

William Greider continues his brilliant exposition.

> "Without gold, what is money really worth? The question still troubles a fervent minority sometimes called "goldbuyers," people who yearn for a return of the gold guarantee – "a dollar as good as gold" instead of the government-issued

[25] **Secrets of the Temple: How the Federal Reserve Runs the Country. William Greider, Page 228.**
[26] **"America's Bubble Economy." David Wiedener, Robert Wiedener, Cindy Spitzer and Eric Janszen, Page 247-48.**

> currency they speak of contemptuously as "fiat money." John Maynard Keynes, on the contrary, described the transition from gold as a historic liberalization for the World's economies – an enlightened step beyond the fetishistic values attached to shiny minerals. "Commodity money" was replaced by "representative money." Keynes agreed with the goldbuyers on one point: without the gold standard, money must be managed."[27]

POLITICAL ENVIRONMENT

Evidently, the Fed's importance in the economy of the country was reduced in the gold standard times. The confidence in the economy was based on the idea that a person could change money (printed paper) for gold anytime he wanted because the government required an equal amount of gold backed by the government to be held by the Federal Reserve. Later, it would change. Bankers established the notion that the confidence the people had held about those bills backed in gold was not necessary. All a person needed, according to the banks, was confidence in a strong economy.

Some see this as the beginning of the end. The Federal Reserve can print money and inject the market with paper backed only by the confidence in America's strong economy. What might happen if a political or economic problem were to emerge and produce a "run on the bank" effect? No federal government exerts direct control over the Board of Directors' actions.

This situation is crucial to the analysis of potential repercussive situations because the Federal Reserve is the country's most important economic institution. The next question is whether the United States' economy is strong enough to sustain confidence here and abroad.

[27] **Secrets of the Temple: How the Federal Reserve Runs the Country. William Greider, Page 229.**

In the last thirty years, the United States, a country essentially based in manufacturing from its origins, has moved slightly but not slowly toward becoming an economy structured around services, banking and intellectual property. Some economists call this classification the difference between the real economy and the fictional economy. America was built around what we call the real economy, manufacturers and factories throughout the country, and positive balance between import-export. The Columbia University professor Joseph Stiglitz gives some statistics about it.

> With manufacturing in the developed world shrinking – today it represents only 11 percent of American employment and output – American and European trade negotiators would have to deliver something in services (which are now 70 % of America's economy, and nearly that in Europe or Japan) and in intellectual property to satisfy their constituents.[28]

This process is not without consequences. American workers in today's market are highly skilled labor who want to work in the service industry, and let the unskilled workers coming from developing countries take the work in the manufacturing sector. America is rich in technology, but on the other hand, its workers are expensive. Moreover, manufacturing and automotive companies are establishing overseas due to the high cost of the labor and tax, and the service, banking, and intellectual property business cannot accommodate the amount of workers ready to work in the country. The high unemployment will continue for years; this is yet another of the consequences of the actions of the Fed.

> The number of manufacturing jobs in the United States has been shrinking since 1979, and the fraction of Americans working in manufacturing has been declining since the 1940s. (In 1945, 37 percent of working Americans were employed in manufacturing, while today the figure is less than 11 percent.)[29]

[28] **(Joseph E. Stiglitz, Making Globalization Work, 76, Norton paperback 2007).**
[29] **(Joseph E. Stiglitz, Making Globalization Work, 76, Norton paperback 2007).**

One of the weapons that the Fed can utilize to address this problem is to respond directly to economic issues through its committee, the Federal Open Market Committee (FOMC), which reviews economic information, sets up the key interest rates, and meets periodically during the year to assess the current economic climate.

In this era of high unemployment, the FOMC acts through its monetary policy power; if it believes that the economy is in recession, it may likely decrease the interest rate in order to expand the credit. Expanding the credit would work if the productive sector immediately accompanied that decision; otherwise, the inflation will swallow the “fiat money” put in the market by the Fed, producing drastic consequences. According to economic analysts, the high unemployment will subsist for several years in the country despite the recent recovery of the economy, which some call illusory recovery because its monetary consequences.

In fact, some economists fear that the nascent recovery will leave more people behind than in past recessions, failing to create jobs in sufficient numbers to absorb the record-setting ranks of the long-term unemployed.[30]

Ostensibly, the Federal Reserve hasn’t moved aggressively to avoid the stock market crash, credit crunch, and elevated unemployment. Again, the Fed dumped trillions of dollars in the market, but the whereabouts of these allocations is not well defined. Whether that money is already working for the recovery of America economy or not is something to be discovered. So far the country is in an decidedly large recession, and the risk of higher inflation looms in the short term.

[30] **Millions of Unemployed Face Years Without Jobs. New York Times. 02/21/2010.**

Why the Fed should become a Democratic Institution

As Allan Metzer, a Carnegie Mellon economist and expert, said, "I've never seen so much anger directed to the Fed." As the Fed was created because of the political debility of the democratic power to hold the economic crisis, today is the right moment to return the monetarist power and banking control to the people of the United States through its elected governments; not just from the political point of view, but from the technical and economic as well.

> *Today, the fiscal climate in America is much different than it was at the time of the Federal Reserve's creation. While there is still self-interest, modern innovations such as the Internet have facilitated more collective activity. Technology has also made blatant corruption harder to conceal because information becomes public knowledge as soon it is disclosed. In turn, elected politicians are more aware (and concerned) about public sentiment, making it nearly impossible for unilateral corruption to occur. In this new climate, Congress can be trusted to enact sound monetary policy. Accordingly, by making Congress directly accountable to the electorate for its monetary decisions, the proposed monetarist plan has the benefit of incorporating political accountability into monetary policy.*[31]

Monetary Policy of the Federal Reserve

The Federal Reserve Act of 1913 doesn't have regulations which allow the Federal Reserve to establish monetary policy. Evidently, the purpose of the creation of the Federal Reserve was to diminish the risk of failures in the banking industry. Nevertheless, the Federal Reserve Board exercised the control over monetary policy. At the beginning, the Federal Reserve didn't have the huge amount of policy making tools that now possesses to regulate

[31] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

banks and the money supply.[32]

This lack of provisions was made by the framers on purpose. There are no clauses in the Constitution that allow the Federal Reserve to issue the monetary policies. Therefore, taking away that power and passing it to the Congress is perfectly aligned with constitutional provisions.

To reiterate, Article 1 of the Constitution states: "The Congress shall have Power ...to coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standards of Weights and Measures ...." Therefore, the Congress should regulate the controlling the money supply.[33]

Today the Federal Reserve has four important instruments: (1) open market operations, (2) the discount rate, (3) reserve requirements, and (4) authority over member banks and bank holding companies. Even though there many countries around the world that give the government direct control of bank regulation, the Federal Reserve keeps that power.

The discount rate is the second most important function of the Federal Reserve. Initially, each Federal Reserve District Bank set the discount rate; eventually, in order to provide uniformity throughout the country, the Federal Reserve defined one discount rate.

Through this important tool, the Federal Reserve tries to keep under control the money supply.

However, there is no proof that the system has been working well. On the contrary, critics maintain that in using this tool, the Federal Reserve is reacting slowly against the velocity

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[32] **See Shahriar Tavakol, Comment, Digital Value Units, Electronic Commerce and International Trade: An Obituary for State Sovereignty over National Markets, 17 J. MARSHALL J. COMPUTER & INFO. L. 1197, 1206-07 n.94 (1999) (citing N. GREGORY MANKIW, MACROECONOMICS 144 (2d ed. 1994)).**

[33] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

of money. One issue is that the individual banks decide the amount of reserves they hold when the Federal Reserve decides to raise (or lower) the discount rate.[34]

> The reserve requirement consists in that banks must keep a percentage of their deposits on reserve with the Federal Reserve System in specified assets. By ordering only a small increase (or decrease) in reserve requirements, the Federal Reserve can remove (or inject) an enormous amount of funds into the money supply. Because the precise quantitative effect of a change in reserve requirements is nearly impossible to predict, the Federal Reserve rarely uses reserve requirements as a policy-making tool. Furthermore, like the discount rate, reserve requirements have not functioned effectively as a policy-making tool. From the Federal Reserve's perspective, a good policy-making tool is one that produces fine, graduated changes in the money supply. Changes in the reserve requirements typically do not have this effect. Rather, such changes more often result in crude, haphazard changes in the money stock. Thus, ordinarily, the Federal Reserve will implement monetary policy by changing reserve requirements only as a measure of last resort.[35]

The last important instrument of the Federal Reserve is the power to regulate member banks and bank holding companies. The Bank Holding Company Act of 1956 marked the enactment of the Federal Reserve's regulation of bank holding companies. Congress viewed the Federal Reserve as the most competent organization to regulate the power of the bank holding companies. Subsequent events demonstrate the opposite.

CONCLUSION

The creation and evolution of the Federal Reserve was due to historical events. There were powerful bankers that took the advantage of weak governments, which couldn't stop the "business cycle," therefore, delegating the monetary and regulatory power to them.

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[34] **The Federal Reserve adjusts the discount rate when the market reflects a change in the velocity of money. Since the Federal Reserve usually changes its policy in reaction to a change in the velocity of money, the discount rate is said to be a lagging indicator. Because lagging indicators record instead of predict changes in the economy, they are not effective policy-making tools. See Thibaut De Saint Phalle, The Federal Reserve: An Intentional Mystery 48-49, 54 (1985).**

[35] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

To date, the Federal Reserve hasn't accomplished its objectives, but exceeded its mandate.

The instruments the Federal Reserve uses must change hands in order to save the economy of the United States. In a best-case scenario, the monetary policy would be mandated by Congress. In the absence of Congress' control, it would be better to dissolve the Federal Reserve and let the market act freely than let the Federal Reserve act in favor of the largest banks with the false belief that action for their own good is action taken for the good for the country. Finally, the Chairman would have the power to adjust interest rates and reserve requirements.

> The President does not have this power vis-a-vis the modern Federal Reserve. Accordingly, the monetarist plan represents an improvement upon the existing system because it establishes an executive mechanism to check monetary policy.[36]

The board of directors would include seven members: two from Congress (one representing the majority and one, the minority), two representatives from the banking industry, and two academic elections. The Chairman would be elected by the President, but would only be eligible to vote in order facilitate a decision in the case of a tied vote amongst the other six members.

Under these circumstances, the banking regulation should pass to the direct control of President of the United States.

Some monetarist economists support the idea that pass the monetary power to the Congress form the Federal Reserve is perfectly right and accorded to the Constitution. Also, these economists consider that monetary policy is directly influenced by the value of money.

[36] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

They presume that changes in the value of money are proportional to changes in the money supply. This position matches article 1 of the Constitution or at least it cannot be ignored.

> "Monetarists think that less government is better government regarding the issue of monetary policy. In their belief, the most effective means of establishing monetary policy is by having the central government play only a minimal role in managing the money supply."[37]

Today, none of the three branches of government controls the money supply. This function is exclusive to the Federal Reserve. In a proposed plan to pass this power to the Congress, according to the article "Rethinking The Federal Reserve System,"

> Congress would enact new legislation that provides the federal government only minimal control over the money supply. This legislation would also require Congress, through its subcommittees, to conduct open market operations and set monetary targets on an annual or semiannual basis. Consistent with the monetarist theory, no other intervention would occur between those times. Thus, true to the philosophical and separation of powers principles underlying the Constitution, power over the "value of money" would reside in the federal legislative branch."[38]

This modification will add a different perspective in terms of responsibility. Politics are subject to the political pressure and responsible to their constituents while appointed officials not. Therefore, there is an advantage to pass this power to the Congress instead to keep it with the actual Federal Reserve.

Other benefits include the predictability and timing. Modifying the money supply, lowering that process to one or two times per year, will provide more predictability to the financial market. Poor timing is a common criticism in analysis of the Federal Reserve monetary policy which has been generally ineffective. The proposed annual or semiannual setting of the

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[37] **See Rudiger Dornbusch & Stanley Fischer, Macroeconomics 375-76 (Paul V. Short ed., 4th ed. 1987), see also, Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

[38] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

interest rate will eliminate intermittent resolutions, and once the growth rate is set by Congress, it cannot be modified.[39]

Also, transferring the monetary policy to Congress will eliminate the excessive power that the Federal Reserve possesses today. In 1964, Congressman Wright Patman had already forewarned us of the danger of excessive power, demanding an audit of all the Fed's activities. According to his view of point, by assuming this power, Congress will benefit the poor, small businesspeople, and farmers. However, this position has been widely criticized as a populist idea. On the other hand, a different solution resides in the laissez-faire movement of a real free market in the currency without no intervention on behalf of the Federal Reserve. In fact, critics believe in an economic system free of central banks, or, in this case, the Federal Reserve.

> The Federal Reserve keeps interest rates lower than otherwise would be. In a free market, low rates would indicate adequate savings and signal the businessperson that it's an opportune time to invest in capital projects. But the system the Fed operates discourages savings, and the credit created out of thin air serves as the signal for investors to spend, invest, and borrow excessively, compared to a system where interest rate are set by the market. This causes a major problem. A boom results, and overinvestment and excesses are built into the system, creating a bubble. A recession or depression doesn't come for some extraneous reason; it is a predictable result of the excessive credit and artificially low interest rates orchestrated by the Federal Reserve.[40]

Bank regulation should be administered by an agency under direct control of the President. The Federal Reserve hasn't acted wisely regulating banks. There was a predominantly strong ideology within capitalism, the so-called neo-liberalism, where regulation was passive at best. Followers of Ayn Rand, and, subsequently, other intellectuals like Milton Freedman, sustained theories endorsing this point of view. The Federal Reserve Presidents, governors and directors were influenced by these theories. They were fierce opponents to

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[39] **Michael Wade Strong Indiana Law Review Rethinking The Federal Reserve System: A Monetarist Plan For A More Constitutional System.**

[40] **"End the Fed," Ron Paul, (page 178)**

control and regulation; they were true believers in the "Invisible Hand," the beautiful metaphor created by Adam Smith in his "Theory of the Moral Sentiments." After several crises, however, people no longer believe in these theories and policies. Joseph Stiglitz, for example, states that "the reason that the invisible hand often seems invisible is that it is often not there."[41]

The authority and responsibility of control and regulation must be given to an agency directly controlled by the President. This agency would have a director appointed by the President with the advice and consent of the Senate, and the President would have the power to remove this director. The Chairman of this agency would serve a four-year term running concurrently with the President's term of office. The Chairman would also supervise all agencies responsible for bank regulation.

In actuality, the Federal Reserve System hasn't worked very efficiently to date, and a new organization is required to assume control of the economy. Giving or returning this power to the government is consistent with the constitution and with a democratic system. The legal organization that have been explained in this paper would bring a new breath to the choked economy of the country, with new rules, more transparency and confidence, and the power will remain in the people, the taxpayers, the real victims from the Federal Reserve mistakes today. This system would add transparency, diminish the uncertainty of the current market, and, above all, provide more concrete ethics to the economic community. The country as a whole, as opposed to a singularly invested sector, would benefit.

Fernando Leila

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[41] **ALTMAN, Daniel. Managing Globalization. In: Q & Answers with Joseph E. Stiglitz, Columbia University and The International Herald Tribune, October 11, 2006 05:03AM.**