Written by Jack Kenny on December 3, 2013

The Federal Reserve Still Going Wrong at 100

"Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

The statement above was made by Ben Bernanke, then one of the seven governors of the Federal Reserve Board, in a speech to the National Economists Club on November 21, 2002. Bernanke, who will retire in 2014 after seven years as chairman of the Fed, has been following a policy of "quantitative easing," keeping interest rates low and expanding the money supply with monthly purchases of $85 billion in bonds, including $45 billion in mortgage-backed securities. That raises again the question that has perplexed both the public and members of Congress for decades: Where does the Federal Reserve get the money to make these purchases? Consider the following exchange between Chairman Bernanke and Rep. Keith Rothfus (R-Pa.) at a July 17, 2013 hearing of the House Committee on Financial Services

> **Rep. Rothfus:** Simple question that I have is when I have someone in my district that is going out to buy a Treasury bill, an individual is looking to make an investment, they go to their bank, they go to their broker, they have $1,000 or $5,000, and they get a bill. Where does the Fed get its money to buy its Treasury bills?

Chairman Bernanke: When we buy securities from a private citizen, we create a deposit in their bank, and it shows up as reserves. So if you look up our balance sheet, our balance sheet balances. We have Treasury securities on the asset side. On the liability side we have either cash or reserves at banks, and on the margin that's what has been building up as excess reserves at banks.

Rep. Rothfus: You create the reserves?

Chairman Bernanke: Yes

Rep. Rothfus: Is that printing money?

Chairman Bernanke: Not literally.

"Not literally" because our paper dollars are literally printed at the Treasury Department, not the Federal Reserve. What the Fed has is, as Bernanke noted in that 2002 speech, not the printing press, but "its electronic equivalent." The Fed creates the "money" it uses to buy Treasury notes and other securities and transfers the IOUs as "assets" to its 12 regional banks with a few strokes of computer keys.

What Is Money?

Still, it is a difficult concept to grasp. Each dollar bill we may be fortunate enough to have left in our wallets at any given time is still labeled a "Federal Reserve Note" and "Legal Tender for All Debts, Public and Private." The word "reserve" suggests there is something of value stored behind the note, a function once served by metals of intrinsic worth, chiefly gold or silver. To create as many dollars as one might wish "at essentially no cost" sounds a lot like counterfeiting, but without the counterfeiter's need of paper and ink. The Fed, in its omnipotence, creates what is commonly called "fiat money" out of nothing, and our "legal tender" laws require us to accept it at face value. It is a power that has long mystified even those regarded as authorities in the field of banking and finance. An article in the *New York Times* of July 20, 1975 appeared under the headline, "Money Supply: a Growing Muddle." The *Wall Street Journal* on September 24, 1971 announced: "A pro-International Monetary Fund Seminar of eminent economists couldn't agree on what money is or how banks create it."

"The main function of the Federal Reserve is to regulate the supply of money," G. Edward Griffin wrote in his history of the Fed, entitled *The Creature From Jekyll Island*. "Yet if no one is able to define what money is, how can we have an opinion on how the System is performing? The answer, of course is that we cannot, and that is exactly the way the [banking] cartel wants it."

"Not Worth a Continental"

When the delegates arrived in Philadelphia in 1787 to amend the Articles of Confederation, they had plenty of experience with paper money. Individual colonies had begun printing their own paper currencies as early as the 1690s, sending prices soaring for decades. A popular attitude toward fiat money among the colonists was remarkably similar to that which apparently prevails in government and financial circles today. William M. Gouge, in an 1833 study entitled *A Short History of Paper Money and Banking in the United States*, quoted one colonial legislator as follows:

> Do you think, gentlemen, that I will consent to load my constituents with taxes, when we can send to our printer and get a wagon load of money, one quire [1/20T of a ream] of which will pay for the whole?

The paper money created by the Continental Congress during the colonists' war for independence quickly depreciated, as one issue of the new currency dollars followed another. In 1775, the Continental dollar could be traded for one dollar in gold. By 1778, it was exchanged for 25 cents. One year later it was worth less than a penny and finally went out of circulation. The demise of the new currency gave rise to the saying "Not worth a Continental"

"Bar the Door Against Paper Money"

The colonists were still fighting for independence when Robert Morris, a wealthy Philadelphia merchant and a member of the Continental Congress, founded the first central bank in the colonies in 1781. Morris patterned his Bank of North America after the Bank of England, including the practice of fractional reserve banking, holding in reserve only a fraction of the amount of money lent. The bank, in other words, would "lend" money it did not have. By the end of the war, merchants had lost confidence in the inflated bank notes, and the bank's charter was not renewed.

Sentiment at the Constitutional Convention ran firmly against paper currencies. "This is a favorable moment to shut and bar the door against paper money," said Oliver Ellsworth, a delegate from Connecticut, who would become the third chief justice of the Supreme Court. George Mason of Virginia expressed his "mortal hatred of paper money," which, he declared, is "founded upon fraud and knavery." James Wilson of Pennsylvania said banning paper money would have "a most salutary influence on the credit of the United Sates," while John Langdon of New Hampshire declared he would rather see the proposed Constitution defeated than to grant government the power to issue paper money. George Reed of Delaware regarded such a power "as alarming as the mark of the beast in Revelation."

The Constitution, in Article I, Section 8, gives Congress the power "To coin money and regulate the value thereof," and stipulates that no state shall be permitted to "emit bills of credit." While it does not specifically prohibit the federal government from doing the same, that appears to have been the intent of the Convention, in keeping with the principle, later ratified in the 10th Amendment, that the federal government has no power not delegated to it by the Constitution. A provision authorizing the granting of bills of credit appeared in an early draft of the Constitution, but the delegates voted to remove it by a margin of more than four to one.

"Juggling Tricks and Banking Dreams"

The question of a central bank for the new republic was the subject of a fierce battle between the two most prominent members of President Washington's Cabinet — Secretary of the Treasury Alexander Hamilton and Secretary of State Thomas Jefferson. Hamilton, a former aide to Robert Morris, wished to "unite the interest and credit of rich individuals with that of the state." Jefferson saw danger in the consolidation of that much wealth and power. In a statement as interesting for its view on armies as on banks, Jefferson wrote: "A private central bank issuing the public currency is a greater menace to the people than a standing army."

Hamilton's view prevailed, and in 1791, Congress granted a 20-year charter to the Bank of the United States. Like the Bank of North America, it was modeled closely after the Bank of England. The federal government "invested" $2 million in it, which the bank lent back to the government at interest. Over the next five years the bank lent to the government an additional $6.2 million it created for that purpose. As the fiat money circulated through the economy, wholesale prices rose by 72 percent during that same five-year period. The bank remained a polarizing issue for several years, and when the charter came up for renewal, it lost by one vote in the House and by the tie-breaking vote cast by Vice President George Clinton in the Senate. The Bank of the United States closed its doors for good on January 24, 1811.

War is always a spur to inflation, however, and during the War of 1812, the federal government persuaded state banks to purchase war bonds and convert the IOU's into bank notes the government then borrowed and spent on the war. The result was a tripling of the money supply and a rapid depreciation of the dollar. "By 1814," wrote Griffin, "when the depositors began to awake to the scam and demand their gold instead of paper, the banks closed their doors and had to hire extra guards to protect officials and employees from the angry crowds." Jefferson, now in retirement at Monticello, noted sadly that many of his countrymen "still expect to find in juggling tricks and banking dreams, that money can be made out of nothing and in sufficient quantity to meet the expense of heavy war."

"I Will Kill It."

Anxious to clean up the fiscal and monetary mess left by the war, Congress in 1816 issued a 20-year charter to yet another central bank, the Second Bank of America. In so doing, the lawmakers required

$1.5 million for the government “in consideration of the exclusive privileges and benefits conferred by this Act.” Though the charter required the bank to raise $7 million in hard currency, it still had not raised more than $2.5 million in precious metal or “specie” money by its second year of operation. It issued enough paper money, however, to support the demand of a rapidly growing number of state banks that joined the central bank in financing speculators in the postwar land boom in the western territories. When a growing number of the loans went bad, the Bank of the United States began to tighten its requirement for new loans and foreclose on the old. As the largest creditor to the state banks, the central bank was able to demand payment from them, forcing many of them into bankruptcy. The easy money, followed by the tightening of credit and the shrinking money supply, created the nation’s first cycle of “boom and bust” as the nation sunk into depression. Historian William Gouge observed: “The Bank was saved, and the people were ruined.”

With the election of Andrew Jackson in 1828, the country found in the White House a staunch opponent of a central bank, and “Old Hickory” was not bashful about making it a political issue. When Congress voted to renew the charter in July 1832, Jackson reportedly told his future vice president and heir-apparent Martin Van Buren: “The Bank, Mr. Van Buren, is trying to kill me, but I will kill it.”

Jackson vetoed the bill and made opposition to the bank the theme of that year’s reelection campaign. The choice, he declared at every gathering, was “bank and no Jackson or no bank and Jackson.” Voters chose Jackson, giving him 55 percent of the popular vote and 80 percent of the electoral votes over Henry Clay, an ardent supporter of the national bank.

Creating “Booms and Busts ”

The Civil War brought new demands for more dollars as both the Union and the Confederacy were unable to meet military needs with tax revenues. Congress, exceeding its authority to “coin money” and regulate its value, began printing money instead. The “greenback” dollars lost 65 percent of their purchasing power during the four years of war. Prices more than doubled during the four years of war, while wages rose by less than half. Midway through the war, on February 25, 1863, Congress passed the National Banking Act, establishing a new system of nationally chartered banks. While their bank notes were the “legal tender” for payment of federal taxes and duties, private citizens retained the right to demand payment in either precious metal coins or greenbacks. It wasn’t until the passage of the Federal Reserve Act 50 years later that acceptance of payment in a single paper currency would be required in all transactions, public or private.

The boom-and-bust cycles between the Civil War and the Federal Reserve Act, Griffin noted, were four in number and resulted in the banking panics of 1873, 1884, 1893, and 1907. “Each of them was characterized by inadequate reserves and the suspension of specie payment,” Griffin wrote, as the federal government relieved major banks of contractual obligations to redeem bank notes in metal (gold or silver) coin. That encouraged the banks to print more paper money, resulting in inflation and a later contraction of credit. “The Panic of 1907,” wrote Murray Rothbard in *The Case Against the Fed*, was “the result of an inflation stimulated by Secretary of the Treasury Leslie Shaw in the previous two years.”

A “Central Dominating Power”

The panic, nonetheless, gave impetus to a growing demand by the nation’s major bankers for a central bank to control the money supply and act as a “lender of last resort.” A bill sponsored by influential Senator Nelson Aldrich of Rhode Island was enacted, creating a National Monetary Commission to study the matter and make recommendations for currency reform. Aldrich, the father-in-law of John D. Rockefeller, Jr. and grandfather of future New York Governor and Vice President of the United States Nelson Rockefeller, chaired the commission, which was loaded with central bank advocates. After two years of studying central banking in Europe, Aldrich met in secret with representatives of J.P. Morgan, John D. Rockefeller, and other powerful banking interests at Morgan's private retreat on Jekyll Island off the coast of Georgia. Those present included Frank Vanderlip, president of the National City Bank of New York, and Paul Warburg of the international investment house of Kuhn, Loeb and Company. Long after the event, Vanderlip described the secrecy surrounding the trip, recalling that he felt "as furtive as any conspirator." In a 1933 article for the *Saturday Evening Post*, Vanderlip wrote:

> We were told to leave our last names behind us. We were told, further, to avoid dining together on the night of our departure. We were instructed to come one at a time and as unobtrusively as possible to the railroad terminal on the New Jersey littoral of the Hudson, where Senator Aldrich's car would be in readiness, attached to the rear end of a train for the South.

The challenge they faced was clear to the men at Jekyll Island and the powerful Northeast banking interests they represented. The number of banks in the United States, Griffin noted, had doubled in the previous decade, most of them in the South and West. The older, more established banks were losing market share. To make matters worse, 70 percent of American corporate growth between 1900 and 1910 had been financed by the corporations themselves, making industry less dependent on banks. The federal government had increased its stockpile of gold, was redeeming greenbacks issued during the Civil War, and reducing the national debt. To those who had made their fortunes by interest collected on debt created by "fiat" money, those trends were ominous.

The gentlemen at Jekyll Island sought a new banking system to create a more "elastic" supply of money and pool all banking reserves under one central authority that would control interest rates and deposit-to-loan ratios. It would also serve as the "lender of last resort" to bail out the big banks when their speculative loans turned bad and threatened to put them out of business. Their profits, in other words, would remain private, while their losses would be socialized.

The new system would function as a central bank, though it would not be called that. It was dubbed the Federal Reserve System and was sold to the public as protecting depositors and the nation as a whole from the ruinous effects of bank runs and bank failures. In fact it created a cartel — or as Aldrich put it, "a cooperative union of all the banks of the country" — to protect the banking establishment from the unwelcome effects of competition. "Indeed," said A. Barton Hepburn of Rockefeller's Chase National Bank, "if it works out as the sponsors of the law hope, it will make all incorporated banks together joint owners of a central dominating power."

The Federal Reserve Act was Congress' Christmas present to the banking industry, passed on December 23, 1913. A year later, Sen. Aldrich boasted: "Before the passage of this Act, the New York brokers could only dominate the reserves of New York. Now we are able to dominate the bank reserves of the entire country."

While the Progressives of that era frequently railed against "the money interests," many, including Progressive hero Teddy Roosevelt, supported the adoption of the Federal Reserve System that increased the power the banking giants had over the economic life of the nation. The "elastic" money supply would also prove essential in funding the growing bureaucratic and regulatory role of the federal government through the recent creation of new agencies, including the Federal Trade Commission, the Interstate Commerce Commission, the Food and Drug Administration, and others. Passage of the

Federal Reserve Act virtually guaranteed the future growth of the Federal government. As Ron Paul observed in his 2009 book, *End the Fed*: "The beast that promised all things to all people, made the wishes of all politicians come true, made life easy for the money creators and promised funding for every unconstrained vision was already created."

The New "Stability"

That creation also coincided with the adoption earlier that year of a constitutional amendment permitting the Congress to impose a direct tax on earned income. That effort was led by — you guessed it — Senator Nelson Aldrich. Revenue from the income tax would only partially offset the enormous debt the United States ran up by its entry into World War I in 1917, while the Fed's expansion of the money supply made possible the vast amount of lending by American financiers to Britain and France from the outset of the war in 1914. In addition to underwriting the war bonds for the Allies, the House of Morgan was the sole purchasing agent in the United States of war materials for Britain and France. The U.S. dollar lost half its purchasing power between 1915 and 1920, as the money supply nearly doubled from $20.6 billion to $39.8 billion.

During the "Roaring Twenties," the Fed alternately expanded and contracted the money supply, keeping the economy on an overall inflationary roller coaster ride that ended with the stock market crash of October 1929. From 1921 to June of 1929 the quantity of dollars increased at a significantly faster rate than the increase in production of goods and services. About 70 percent of the increase in bank loans from 1920 to 1928 was in speculative investments, Griffin pointed out. "And that money was created by the banks."

The enduring myth of the Federal Reserve System is that it has brought stability to the national economy, putting an end to what Nobel Laureate Paul Samuelson described in his widely used textbook *Economics* as "the anarchy of unstable private banking." Another Nobel Prize-winning economist, Milton Friedman, presented a markedly less sanguine view of the Fed's record for stability in a volume entitled *Money Mischief*:

> The Federal Reserve System, authorized by Congress in 1913, and beginning operation in 1914, presided over the more than doubling of prices during and after World War I. Its overreaction produced the subsequent sharp depression of 1920-21. After a brief interval of relative stability in the 1920's its actions significantly intensified and lengthened the great contraction of 1929-33. More recently, the Fed was responsible for the accelerating inflation of the 1970's — to cite just a few examples of how its powers have in fact been used.

A few, indeed. Since Friedman wrote that in 1983, we have also witnessed the Black Monday stock market crash in 1987, the collapse of the savings and loan banks during the 1980s, the inflation and bursting of the dot.com bubble in the following decade, the inflation and collapse of the housing market, and the meltdown of the major finance companies in 2007-2008. In fact, the National Bureau of Economic Research has recorded 18 recessions in the hundred years that the Fed has been in business, averaging more than one recession every six years. Meanwhile, the dollar has lost 95 percent of its purchasing power, meaning that what cost $1 in 1913 costs $20 today. "Stability" has had quite a ride.

The Global Bailout

With the creation of the International Monetary Fund and the World Bank at the United Nations International Monetary Conference in Bretton Woods, New Hampshire, in 1944, the Federal Reserve went global in its operations, underwriting loans for Third World nations as well as the United States.

While Congress in the fall of 2008 passed the Troubled Asset Relief Program, authorizing the purchase of $700 billion in assets from failing financial institutions, a Government Accounting Office audit of the Fed's TARP purchases showed $16.2 trillion — roughly the equivalent of the U.S. annual Gross Domestic Product — spent in bailing out banks in the United States, the United Kingdom, Germany, and Switzerland. The Federal Reserve has, in effect, become the Central Bank of the World.

As the Federal Reserve continues to pyramid mountains of debt on top of one another, all based on the "full faith and credit" of the United States, a growing number of Americans are anxiously wondering how much longer it will be before the whole house of cards collapses, leaving our nation enslaved by debt and reduced to the status of a Third World nation. Ron Paul's decades-long campaign against the Federal Reserve has raised awareness of the dangers it presents and inspired frequent cries of "End the Fed!" at rallies during his two presidential campaigns. Taking that slogan as the title for his book on the subject, Paul put the choice before the American people in stark, uncompromising terms: "Freedom and central banking are incompatible," he wrote. "It is freedom we seek, and when that precious goal is achieved, the chant 'End the Fed' will become a reality."