NATIONAL CENTER FOR CONSTITUTIONAL STUDIES

Monetary Reform

- Main Page
- Part 1
- Part 2
- Part 3

PART 2:

HOW THE FEDERAL RESERVE SYSTEM OPERATES AND WHY IT HAS FAILED

Contents:

It is not necessary to review all of the intrigue and deception which surrounded the passage of the Federal Reserve Act. We will simply outline its highly persuasive promises compared with the cold reality of its historical performance during the past sixty-five years. The record shows that Woodrow Wilson was one of the first to recognize what a horrendous mistake had been made.

"From Woodrow Wilson with Regrets"

In 1916, just three years after the Federal Reserve System went into operation, President Wilson seems to have suddenly realized what a virtually uncontrollable power monopoly had been vested in the nation's new Federal Reserve System. He wrote:

> A great industrial nation is controlled by its system of credit. Our system of credit is concentrated [in the Federal Reserve System]. The growth of the nation, therefore, and all our activities are in the hands of a few men.... We have come to be one of the worst ruled, one of the most completely controlled and dominated governments in the civilized world-no longer a government by free opinion, no longer a government by conviction and the vote of the majority, but a government by the opinion and duress of small groups of dominant

> men. (Quoted in "National Economy and the Banking System," Senate Documents Co. 3, No. 23, Seventy-sixth Congress, First session, 1939.)

President Wilson's protest against the "duress" of a few dominant men is especially interesting in view of the dozens of articles he had written, as head of the political science department at Princeton, criticizing the thinking of the Founding Fathers and calling for stronger centralized power in Washington.

In fact, these men from whom President Wilson was feeling such duress and domination in 1916 were the very ones he had been praising a few years earlier.

It would seem that the superior wisdom of the Founding Fathers had become increasingly apparent, even to Wilson.

Additional Mourners

The Federal Reserve Act was sponsored by Senator Robert L. Owen (D-Okla.) and Congressman Carter Glass (D-Va.), who succeeded McAdoo as Secretary of the Treasury and later became a Senator. Senator Owen was chairman of the Senate Banking and Currency Committee, where the bill was drafted. The original bill required the Federal Reserve to maintain stable money which would produce a stable price level.

Very shortly Senator Owen also became one of the mourners and wrote:

> This mandatory provision was stricken out in the House under the leadership of Carter Glass. I was unable to keep this mandatory provision in the bill because of the secret hostilities developed against it, the origin of which at that time I did not fully understand.

But he later found out where these hostilities were coming from. He said:

> Under the administrations of Wilson, Harding, Coolidge and Hoover, this act was diverted from its proper purpose on the advice of some who controlled the policies of a number of the largest banks. (Quoted in Gertrude M. Coogan, Money Creators [Hawthorne, Calif.: Omni Publications, 19351, p. ix.)

Owen spent the rest of his life trying to get the Federal Reserve System repealed.

It is mentioned in most of the texts that the Federal Reserve Act would never have passed the House without the support of Secretary of State William Jennings Bryan (D-Neb.), a former Democratic Party Whip.

Bryan also became a mourner and wrote:

> In my long political career, the one thing I genuinely regret is my part in getting the banking and currency legislation enacted into law. (Quoted by Kenan, The Federal Reserve Bank, p. 127.)

Unfortunately, all of these powerful political personalities who had so much to do with the adoption of the Federal Reserve System found that it was too big and too powerful to control or repeal once it had become entrenched. All they could do was mourn.

Federal Reserve System Operates on Three False Premises

The whole purpose of establishing the Federal Reserve System was to prevent depressions, stabilize the currency, and protect the savings and checking deposits of the people in the custody of the banks.

However, there are three things that the Founding Fathers identified as outright enemies to any sound money system, and the Federal Reserve contains all three of them.

The first thing they said the nation should avoid is turning over to a group of private bankers the right to print the official currency of the nation. They said this right is inherent in the people and belongs to the people's government. Whenever this right has been delegated to private bankers, they have always used it to abuse the people and gradually devour the wealth of the nation. It will be recalled that Jefferson wrote:

> If the American people ever allow private banks to control the issue of currency, first by inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children will wake up homeless on the continent their fathers conquered. (Quoted in ibid., p. 247.)

Abraham Lincoln also warned about possible abuses by private bankers. After the National Bank Act was passed in 1863, he wrote:

> I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country. Corporations [of banking] have been enthroned, an era of corruption in high places will follow, and the money power of the country will endeavor to prolong its reign by working upon the prejudices of the people, until the wealth is aggregated in a few hands and the Republic destroyed. (Quoted in ibid., p. 9.)

When the U.S. Prints Its Own Currency It Has to Pay Interest on It

The second deception in the whole Federal Reserve System is the fact that the private banks which own the stock in the Federal Reserve System charge the United States interest for borrowing the country's own currency!

The Federal Reserve scheme provides not only that all U.S. currency shall be printed as Federal Reserve notes, but that if the government wants to use these notes it must give the Federal Reserve IOUs in the form of government bonds on which interest will be paid until the bonds have been redeemed.

The question immediately arises, "Well, what did the banks loan to the government in exchange for these bonds?" The answer is, "Nothing, absolutely nothing." The banks paid for the printing of their Federal Reserve notes and gave them to us, but they are not redeemable in gold, silver, or anything else of value. They are just paper, backed by virtually nothing. The question next arises, "Then why are they able to charge us interest when all they are doing is printing our own currency?"

The answer is that in 1913 the Congress gave the Federal Reserve the legal "right" to print our money, and that right is "as good as gold." Therefore, if we want to use the Fed's money, we have to borrow it and give them federal IOUs for the amount obtained. And, of course, each IOU (government bond) is something on which interest must be paid.

This whole arrangement is so totally irrational that the former chairman of the Banking and Currency Committee, Congressman Wright Patman (D-Texas), asked Marriner S. Eccles, the Utahn who served as chairman of the Federal Reserve Board from 1934 to 1948, the following:

> "Mr. Eccles, how did you get the money to buy these two billion dollars of government bonds?"
> Mr. Eccles: We created it.
> Mr. Patman: Out of what?
> Mr. Eccles: Out of the right to create credit money.

A Denunciation of This Second Fallacy in Government Financing

Since it is the government's right to create money in the first place, why should it have to borrow its own money from the Federal Reserve banks and give interest bearing bonds or IOUs in exchange for the money?

A modern scholar, H. S. Kenan, has written:

> Government, possessing the power to create and issue currency and credit as money and enjoying the right to withdraw both currency and credit from circulation by taxation or otherwise, need not, and should not borrow capital at interest as the means of financing governmental work and public enterprise. The government should create, issue, and circulate all the currency and credit needed to satisfy the spending power of the government and the buying power of consumers. The privilege of creating and issuing money is not only the supreme prerogative of government, but it is the government's greatest creative opportunity. (Kenan, Federal Reserve Bank, p. 202; emphasis added.)

By creating and issuing its own money, Kenan said the people could avoid a "debt" economy which bankers instinctively promote. He wrote:

> The taxpayers will be saved immense sums in interest, discounts, and exchanges. The financing of all public enterprises, the maintenance of stable government and ordered progress, and the conduct of the Treasury will become matters of practical administration. The people can and will be furnished with a currency as safe as their own government. Money will cease to be master and become the servant of humanity. Democracy will rise superior to the money power. (Ibid., p. 202.)

The Third Fallacy of the Federal Reserve Is "Fractional" Banking

As we mentioned earlier, fractional banking was invented in Europe around four hundred years ago. It allows a bank to set up a "reserve" to cover any claims which happen to come in, and then to go ahead and loan many times more money on credit than the "reserve" in the bank. By this means the bank loans out and charges interest on considerable credit it doesn't even have. For everybody else, it is a fraud to loan, rent, or sell something which does not exist. Fractional banking should have been outlawed many years ago.

One of the most dangerous devices employed by the Federal Reserve under fractional banking is its power to bounce the level of required reserves up and down so as to control the money supply and the interest rates. The Congress which passed the Federal Reserve Act assumed that this would be done in the interest of the public, but as we shall see later, the opposite occurred.

Promises of the Federal Reserve Turned Out to Be Pie Crusts--Made to Be Broken

As mentioned earlier, the original promises of the Federal Reserve promoters were so glorious that it seemed it would be the height of stupidity to turn down such a marvelous opportunity, the Constitution to the contrary notwithstanding.

All the Federal Reserve wanted was the privilege of printing the nation's currency and serving as the government's bank. In exchange for this great privilege, the following promises were made:

1. The Federal Reserve promised to operate entirely under the direction and control of the President and his appointees to the Board of Governors. The Fed escaped from this control almost immediately. It has so much influence in Congress that over two hundred amendments were added to the original act, and these gradually altered the entire statutory profile of the act. Even the Secretary of the Treasury and the Controller of Currency were eliminated from its Board of Governors. Hundreds of times the Fed has defiantly acted against the interests of the American people and made billion dollar decisions favorable to its banker stockholders. In these cases, the President and the Congress found themselves helpless and unable to intervene. The former chairman of the Federal Reserve Board, Marriner S. Eccles, admitted this to the head of the Banking and Currency Committee of the House. When Mr. Eccles was asked if the Federal Reserve had more power than either the Congress or the President, Mr. Eccles replied: "In the field of money and credit, yes." (Quoted in ibid., p. 206.)

The Fed Pays Nothing for the "Right" to Print Money

2. Section 16 of the act provided that the Federal Reserve would pay the government interest for the privilege of printing Federal Reserve notes as the nation's currency. However, the act left this to the discretion of the Board of Governors, who elected from the beginning to pay the government zero interest for this right to manufacture the nation's money. No legal remedy to enforce this section is available.

Failure to Provide Free Banking Services

3. The Fed promised to perform many banking services for the government free of charge, but in spite of this provision it began charging for its services right from the start.

   Wright Patman, chairman of the House Banking and Currency Committee, asked Mr. Eccles: "Wasn't it intended when the Federal Reserve Act was passed that the Federal Reserve Bank would render this service without charge-since under the Act the government would give them the use of government's credit free?"

   Mr. Eccles seemed shocked and replied, "I wouldn't think so!"

Failure to Stabilize the Dollar

4. It was promised that the Federal Reserve would manage the nation's money supply so that the American dollar would be protected and remain stable so as to keep prices relatively stable. The Federal Reserve stockholders are now known to have manipulated the dollar until today its purchasing power is not worth more than ten cents of what it was when the Federal Reserve took over. The Federal Reserve was behind the legislation which took the nation off the gold standard and used its lobby in Congress to force the bill through without a hearing. Later it removed the nation from what was left of the silver standard and has since been found maneuvering behind the scenes in an attempt to get the dollar replaced with some kind of international money.

Failure to Eliminate the Control of Wall Street

5. It was promised that the Federal Reserve Act would take the United States out from under the control of Wall Street. This was the biggest deception of all. The most powerful money trusts on Wall Street were the ones behind the passage of the bill, and it was their money managers who took over the Federal Reserve System as soon as the act went into operation. During debates in the House, Congressman Charles A. Lindbergh, father of the famous Atlantic nonstop flyer, declared:

> This Act establishes the most gigantic trust on earth. When the President signs this bill, the invisible government by the monetary power will be legalized.... The worst legislative crime of the ages is perpetrated by this banking and currency bill. The caucus and the party bosses have again operated and prevented the people from getting the benefits of their own government. (Quoted in Kenan, p. 138-39.)

Failure to Forestall Depressions

6. It was promised that the Federal Reserve would prevent any future depressions. Now it is known that the Federal Reserve deliberately engineered and prolonged the worst depression in the history of the United States. As the well-known economist Dr. Milton Friedman states in his text, Capitalism and Freedom:

> I am myself persuaded, on the basis of extensive study of the historical evidence, that ... the severity of each of the major contractions [depressions]-1920-21, 1929-33, and 1937-38-is directly attributable to acts of commission and omission by the [Federal] Reserve authorities and would not have occurred under earlier monetary and banking arrangements. (Capitalism and Freedom [Chicago: The University of Chicago Press, 19621, p. 45.)

Failure to Serve the Farmer and Small Business

7. The promise was made that the Federal Reserve would be the friend and helper of the farmer and the monetary needs of small businesses. The Fed so completely failed in this promise that entirely new lending agencies had to be created by Congress to help the farmers and small-business men. Furthermore, the Federal Reserve used its power in 1920 to deliberately manipulate the economy to produce an agriculture collapse. This caused tens of thousands of farmers to lose their farms. (Kenan, pp. 129-30.)

Failure to Decentralize Banking

8. The promise was made that the new system would forever remain decentralized so that the Federal Reserve Bank of San Francisco would have as much to say about monetary policies as the one in New York. This proved fallacious from the first year of operation. The centralized money market in the United States is in New York City, and the New York Federal Reserve Bank has dominated the other eleven districts to the point where the latter are usually not even consulted when decisions are made by the Open Market Committee.

Foreign Entanglements

9. The promise was made that the Federal Reserve would protect American interests against foreign monetary assaults. Studies show that the privately owned money trust which set up the Federal Reserve System is riddled with foreign entanglements. It operates European branch banks and was found to have drained off billions in American resources to underwrite its interests abroad. In the midst of the Depression, Congressman Louis T. McFadden (R-Pa.) declared:

    > Mr. Chairman, we have in this country one of the most corrupt institutions the world has ever known. I refer to the Federal Reserve Board and the Federal Reserve Banks. The Federal Reserve Board, a government board, has cheated the Government of the United States and the people of the United States out of enough money to pay the national debt.... The wealth of the United States and the working capital of the United States have been taken away from them and has either been locked in the vaults of certain banks and the great corporations or exported to foreign countries for the benefit of foreign customers of these banks and corporations. So far as the people of the United States are concerned, the cupboard is bare. (Quoted in Kenan, pp. 141, 172-73; also in Collective Speeches of Congressman Louis T. McFadden, [Hawthorne, Calif.; Omni Publications, 1970], p. 298.)

Domestic Commercial Banks at the Mercy of the Federal Reserve

10. The Federal Reserve System was specifically committed to supervising and inspecting the local banks and also providing funds in case they were pressed by unexpected demands for payment. It was recognized that every time a bank is forced to close its doors the savings and deposits as well as the stock of the bank's investors and stockholders are lost. But instead of being its protector, the policies of the Federal Reserve frequently have been a nightmare to the neighborhood commercial bank with which most Americans are familiar. Thousands of them have been forced into bankruptcy by inconsistent and selfish policies imposed on them by the big money trusts operating out of New York and Europe.

How the Federal Reserve System Is Structured

The present structure of the Federal Reserve System consists of a board of seven governors who serve fourteen years, with the term of one of the members expiring every two years. The new members of the board are appointed by the President of the United States, who also selects the chairman. The original design was to have these seven men represent the "public interest" as opposed to the special interest of the member banks. However, the chairman of the Board of Governors has nearly always been a prominent member of the banking community. Great pressure is also exerted from Wall Street to have sympathetic board members appointed by the President.

The nation is divided into twelve Federal Reserve Districts, with a Federal Reserve Bank in each district and branch banks in major cities as needed. Local commercial banks which become part of the Federal Reserve System are called "member" banks. Each member bank is required to subscribe "stock" in the Federal Reserve Bank. This amounts to 6 percent of its capital and surplus. Only 3 percent must be paid into the bank, but the remainder is subject to call if needed. The bank receives an interest payment of 6 percent per annum on its paid-up stock. Washington, D.C., will tell the bank how much "reserve" it must maintain with the Federal Reserve, but this will always be a small fraction of what the bank is allowed to loan out at interest. On occasion it may be allowed to loan out as much as thirty times more than what it has in reserves. Of course, by doing so, it may risk having a "run on the bank" by its depositors if they begin to suspect the soundness of the bank. In these instances, the Federal Reserve is supposed to come to the bank's rescue, but very often it has not. Thousands of banks have gone under in recent years with losses of hundreds of millions by its depositors.

Each of the twelve district banks has a board of directors. Six are usually bankers, and three are selected from the nonbanking business sector.

Four times a year each of the twelve districts sends a representative to Washington, D.C., to confer with the Board of Governors. These meetings are called the Federal Advisory Council, but it is not really too significant.

An important function of the Federal Reserve System is to provide clearinghouses for collecting checks, notes, drafts, and so forth. This is not done by transferring currency but by simply adding and subtracting from the accounts of the various banks. Banks with a balance owing send in the difference.

The Board of Governors is also responsible for a large staff of bank inspectors to check the practices and lending policies of the member banks. The Board can suspend a bank from operation or remove the officers of any bank which are considered to be using unsound practices.

The inspection and check-clearing services of the Federal Reserve is one part of the system which is reported to be administered with dispatch and efficiency.

The Real Center of Power Is the Federal Open Market Committee

When it comes to controlling the money supply, the interest rates, and the purchase or sale of securities, the real foot on the throttle and toe on the brake belong to the Open Market Committee. It makes all of the important decisions and meets in Washington, D.C., behind closed doors every three weeks.

The Open Market Committee consists of the seven members of the Board of Governors and five of the board chairmen selected from the twelve district banks. One of these will always be the chairman of the New York Bank. The others rotate in turn. Although the chairman from all twelve districts may attend these meetings, only the five who serve on the committee can vote.

The Congress originally intended this powerful committee to be under the close supervision of the nonbanking members of the Board of Governors, but it is recognized today that this is strictly a banking-fraternity committee operating completely outside the control of the President, the Secretary of the Treasury, the Comptroller, or the Congress. As of this writing (February 1982) the Open Market Committee operates just like any of the privately owned central banks of Europe. Dr. Milton Friedman, a most astute student of the Federal Reserve, and also William E. Simon, former Secretary of the Treasury, consider this Open Market Committee a dangerous threat to the economic stability of the United States and recommend that it be terminated.

There Has to Be a Better Way

There is no doubt that history has caught up with the Federal Reserve System. The Federal Reserve Act unconstitutionally delegated to a consortium of private bankers one of the most precious rights a nation possesses-the right to manage its own system of money and credit.

Under the policies of the Federal Reserve System, national indebtedness has been encouraged, inflation has skyrocketed, and the value of the American dollar has sunk so low that savings have been eaten up, fixed incomes have become a dribble, and a once wealthy nation finds itself owing more than all the rest of the nations of the earth combined.

Fortunately, there is a way out of all this. It was provided in the section of the act which is now designated as Section 31. This is the section which allows the federal government to "amend, alter, or repeal" the Federal Reserve Act at any time. It is time Americans began talking seriously about Section 31 of the Federal Reserve Act so that we can save what is left of the American economic heritage. This may be the only means by which the President can save his program.

Return to Part 1 Return to Main Page Continue to Part 3