The Federal Reserve Bank - Lifting Up the Skirt

[Another one of the author's favorite chapters cut out by the editors for being too technical and lacking general interest.]

HISTORICAL

Most nations have a central bank. Sweden is set up a central bank in 1668 in England established there is and 1694.

The US was late to the central banking game because of America's long history of distain for centrally coordinated government authorities.

In the 1791, the First [central] Bank of the United States was chartered under the first Sec. of the treasury, Alexander Hamilton. It's twenty-year charter was allowed to expire in 1812.

The Second [central] Bank of the US was chartered in 1816 and it's twenty-year charter was allowed to expire in 1836. From 1837 two 1862 was known as the Free Banking Era where there was no US central bank and once again banks issued their own notes (currency).

In 1863 the National Banking Act instituted a system of nationally chartered banks that lasted until 1913.

In 1910, nine prominent men from banking, the federal government and Congress is secretly gathered at the remote summer residence of JP Morgan on Jekyll island off the coast of Georgia. This secrecy and intrigue of the mysterious rail cars and specifically selected staff is interestingly and well told in *The Creature of Jekyll Island* by G Edward Griffin (1994).

"Even at the arrival at the remote Island Lodge, the secrecy continued. For nine days the rule for first- name-only remained in effect. Full-time caretakers and servants had been given vacation, and an entirely new, carefully screened staff was brought in for the occasion. This was done to make absolutely sure that none of the servants might recognized by site the identities of these guests." [1].

"To sell the plan to Congress, the cartel had to be hidden and in the name "Central Bank" had to be avoided. The word 'federal' was chosen to make it sound like it was a government operation; the word 'reserve' was chosen to make it appear financially sound; in the word 'system' was chosen to conceal the fact that it was a central bank. [2].

The 1946 Employment Act called upon the government to pursue maximum employment. In 1977 Congress got more specific and passed the Federal Reserve Reform Act which instructs the Federal Reserve to use monetary policy to promote employment and to control inflation.

The Fed today has what is known as a "dual mandate" to control inflation at 2 ½% and to maximize employment at the same time.

ORGANIZATION

The Federal Reserve System was created December 23, 1913, with the enactment of the Federal Reserve Act, in response to a series of financial panics accommodating with the severe financial panic of 1907 that almost bankrupted the United States.

The Federal Reserve is neither federal nor a reserve.

The Federal Reserve's System has a unique structure that is considered to be both public and private and it is technically referred to as being independent "within" the government as opposed to independent "of" the government. Its authority is derived from the Congressional Federal Reserve Act of 1913 it is as such technically subject to congressional repeal.

BOARD OF GOVERNORS is comprised of seven members appointed by the President, and confirmed by the Senate, to serve staggered a 14 year terms. The chairman and vice chairman are appointed by the President.

FEDERAL OPEN MARKET COMMITTEE This consists of 12 members, seven from the presidentially appointed Board of Governors in five appointed from the private regional Federal Reserve Bank presidents. The FOMC oversees monetary policy with the dual mandate of controlling inflation (currently at 2.5%) and maximizing employment.

FEDERAL RESERVE BANKS – There are 12 Federal Reserve Banks strategically located around the country that are responsible for member banks located in their district. These Federal Reserve Banks have some features of private corporations and some features of public

MEMBER BANKS include all national chartered a banks which are required to hold stock and some state-chartered banks.

The US government, specifically the US Treasury Department, receives all of the Federal Reserve's profit above and beyond the statutory 6% dividend on member banks stocks. In 2010 the Federal Reserve transferred $79 billion to the US Treasury and in 2011 transferred $77 billion.

The Federal Reserve is considered an independent central bank because its monetary policy decisions do not need to be approved by either the Executive or Legislative branches of government; it does not receive funding appropriated by Congress; and the terms of the members of the Board of Governors span multiple presidential and congressional terms.

The main issue which is coming under increasing scrutiny is the lack of transparency of this "Creature from Jekyll Island" with which refuses to allow itself to be audited. It is much akin to being told to enjoy the sausage but don't ask to see how it is made.

MANDATES OR MISSION

The Federal Reserve's dual mandates are (1) price stability, better known as controlling swings of inflation and deflation; and (2) maximum employment.

In his book, "The Federal Reserve and the Financial Crisis" (2013), author and former Federal Reserve Board Chairman Ben Bernanke describes the central bank's mission:

"The first is to try to achieve macroeconomic stability. By that I mean achieving stable growth in the economy, avoiding big swings – recessions and the like – and keeping inflation low and stable.… They try to either prevent or mitigate financial panics or financial crises.” [3]

FEDERAL RESERVE TOOLS

The economy is controlled by two “levers” – both of which are like the oars rowboat.

(1) Fiscal Policy – the spending and taxation tools of the federal government, specifically Congress.

(2) Monetary Policy – The Federal Reserve’s management of and control over interest rates by purchasing short-term treasuries or long-term mortgages. If the Fed wants the economy to slow down, it will sell bonds out of its inventory which removes cash out of the economy and slows the economy down. Conversely, if the Fed wants the economy to speed up, it will computer keystroke out of thin air fiat money to buy bonds or mortgages by crediting commercial banks’ accounts at the Federal Reserve, thus, injecting more cash into the economy and, in theory, stimulating the economy. This was called Quantitative Easing (QE #1-#4) in 2008-2014.

In his book, former Federal Reserve Chairman Ben Bernanke states:

“For economic stability, the principal tool is monetary policy; in normal times, that involves adjusting short-term interest rates.” [4].

“For financial stability, the main tool the central banks have is the ‘lender of the last resort’ powers by providing short-term liquidity to financial institutions, replacing lost funding.” [5].

Regarding the central banks role as lender of last resort he states:

“… The notion that in a financial panic, a central bank should follow Bagehot’s Rule of lending freely against a good collateral at a penalty rates, and by providing short-term credit to financial institutions, a central bank can halt or reduce a run on or a panic in and the accompanying damage to the financial system and the economy.” [6].

An example of the Federal Reserve exercising its prerogative of lender of last resort powers was its authorization of an $85 billion loan to the event of the bankruptcy of international insurance giant American International Group (AIG) in September 2008.

The main challenge facing the Federal Reserve is the lack of Congressional fiscal management (too much spending) which leaves the Federal Reserve as the only oar in the water so it needs to overcompensate more than it normally word if it were not operating in the absence of responsible Congressional fiscal management.

Thus began the smoke and mirrors.

THE SMOKE

“Secrets of the Temple” (William Greider, 1987) exposed the awesome powers of the Federal Reserve that were shielded from scrutiny by the Feds deliberate mystique: the intertwined public/private status, secrecy of the minutes of the meetings, and refusal to allow an audit by Congress.

To some extent, the Federal Reserve considers itself government and at other times, it considers itself not a government debt. This is been the case from the very beginning, as noted by "Secrets of the Temple" (1987) author William a Greider:

"This government versus private ambiguity started back in 1937 when the new Federal Reserve building on Constitution Avenue was completed. The treasury department signed over the deed to the Federal Reserve relinquishing 'the right to title and interest of the United States of America'. The District of Columbia tax collector sent the bill for property taxes to the Federal Reserve Board of Governors who refused to pay the taxes and quite claimed the property back to the government and the re-designated itself as an "independent department" of the federal government." [5].

THE MIRRORS

The Federal Reserve is both a bankers bank and the US government's bank. The U.S. Treasury keeps a checking account with the Federal Reserve through which incoming federal tax deposits and outgoing government payments are handled.

The Federal Reserve Act of 1913 gave authority of the Federal Reserve to issue notes (currency/money)– that paper in your wallet says "Federal Reserve Note" and no longer "United States Note" or "Silver Certificate". See the Money Chapter). Legally, they are the liabilities of the Federal Reserve Bank (not the United States government) and are considered obligations but not liabilities of the United States government.

The U.S. Treasury, through its Bureau of the Mint and Bureau of Engraving and Printing, actually manufactures the nation's cash supply. The treasury then sells to the Federal Reserve coins at face value (much higher than the intrinsic metal value of the coin) and paper notes at manufacturing cost of about four cents each. The Fed then puts the coins into circulation at face value and the fourth cent paper notes (US currency) into circulation also at face value of five dollars, $10, $20, $50 or $100 each.

Although not issued by the US Treasury Department, Federal Reserve Notes (currency) carries the signatures of both of the Treasurer of the United States and the United States Sec. of the Treasury.

At the time of the Federal Reserve's creation in 1913 the law provided for notes (US currency) to be redeemed to the treasury for gold or other lawful money which included gold backed US Notes, and the National Banking Notes.

Franklin D Roosevelt's Emergency Banking Act of 1933 removed to the convertibility of notes (US currency) to gold by US citizens. Under the 1944 Bretton Wood's Accord, although US citizens still could not possess gold OR exchange US currency for gold; foreign central banks were still granted the ability to convert US dollars in the gold at $35/ounce in return for recognizing the US dollar as the world reserve currency. US currency inscribed with "Silver Certificate" could still be redeemed for silver at face value until 1968.

In 1971 Pres. Richard Nixon ended the foreign central banks ability to redeem US currency for gold; with this being the final step in creating a truly "fiat" currency where the Federal Reserve note (US currency) was no longer backed by convertibility to any commodity, specifically, neither gold nor silver.

FEDERAL FUNDS

Federal funds are the reserve balances (also called the Federal Reserve accounts) that private banks keep at their local Federal Reserve Bank. The purpose of keeping these funds at a Federal Reserve Bank is to have a mechanism for private banks to lend funds to one another. This system is what forms the basis for exercising monetary policy.

As part of the Feds monetary policy efforts to keep interest rates low, it buys assets, treasury bills and mortgages from Federal Reserve member banks. Since the Fed normally does not earn enough money to make these purchases, the only way it can get his hands on money to make these purchases is to created out of thin air with computer keystrokes. This commonly, but incorrectly, referred to as "printing money", but, in actuality it is not the printing presses that are being turned on for this purpose but rather the computers.

For example: The Fed will offer to buy $1 billion worth of treasury bills from a Federal Reserve member bank. When the US treasury or the Federal Reserve member bank agrees to the sale, it transfers ownership of the treasury bills to the Federal Reserve and in return the Fed credits the banking institution with $1 billion in the reserve account the institution maintains at the Fed reserve.

The Federal Reserve has been given the unique right to create this digital money (fiat money not backed by gold or any other commodity) with keystrokes. That's where the magician's mirrors come in to play, and this will be all fine and dandy right up until the day when people or countries accepting this keystroked digital money for their goods and services finally figure it out.

In "The Creature from Jekyll Island" author Greider states:

"The Mandrake Mechanism by which the Fed converts debt into money may seem complicated at first it, but it is simple if one remembers that the process is not intended to be logical but to confuse and deceive. The end product of the Mandrake Mechanism is artificial expansion of the money supply, which is the root cause of the hidden tax called inflation." [9].

2005 – 2014 FEDERAL RESERVE POLICIES

The best account of the Federal Reserve's actions during the "Great Recession" can be found in Ben Bernanke's own words in his book "The Federal Reserve and the Financial Crisis." (2013).

"So as of December 2008, conventional monetary policy was exhausted. We could not cut the Fed fund rate any further. And yet, the economy clearly needed additional support. In 2009 the economy was still contracting at a rapid rate. We needed something else to support recovery and so we turned to less conventional monetary policy. The main tool we have to use is what we at the Fed call "large scale asset purchases" or 'LSAP', known in the press and elsewhere as Quantitative Easing abbreviated as QE. These large scale asset purchases were an alternative way of easing monetary policy to provide support to the economy"

"… The securities and that the Fed has been purchasing are government guaranteed securities, either treasury securities, that is, government debt of the United States, or Fannie and Freddie securities, which were guaranteed by the United States government after they were taken into conservatorship." [6].

A couple of informative and interesting quotes from former Federal Reserve Chairman's book are:

"In fact, because the Fed gets interest on the securities we hold, we actually make a nice profit on these LSAPs. What we have done over the past three years is transfer about $200 billion in profits to the treasury. That money goes directly to reducing the deficit. So these actions are not deficit increasing; they are in fact significantly deficit reducing. So a major tool we used when we ran out of room to lower short-term interest rates was LSAPs, asset purchases." [7].

"You might ask 'the Fed is buying $2 trillion worth of securities. How do we pay for that?' The answer is that we paid for those securities by crediting the bank accounts of the people who sold them to us. And those accounts at the banks showed up as reserves that the banks would hold with the Fed. So the Fed is a bank for the banks. Banks can hold deposit accounts with the Fed, essentially, and those are called reserve accounts. And so as the purchases of securities occurred, the way we pay for them was basically by increasing the amount of reserves that the bank had in their accounts with the Fed." [8]

As mentioned above, it is not actually "printing money" it is digital money created by keystrokes known in Federal-Reserve-speak as "electronic entries".

Dr. Bernanke goes on to explain:

"Sometimes you hear that the Fed is printing money in order to pay for the securities we acquire. But as a literal fact, the Fed is not printing money to acquire the securities. And you could see it from the balance sheet here. That layer is basically flat; the amount of currency in circulation has not been affected by these activities.

What has been affected is the layer above that, reserve balances. Those are the accounts that commercial banks hold with the Fed, assets to the banking system and liabilities to the Fed, and that is basically how we pay for those securities. The banking system has a large quantity of these reserves, but they are **electronic entries** at the Fed. They basically just sit there. They are not in circulation. They are not part of a broad measure of the money supply. They are part of what is called the monetary base, but they certainly are not cash." [9].

"Or, put another way, if there is a smaller available supply of those securities in the market, investors are willing to pay a higher price for those securities, which is the inverse of the yield.

So by purchasing Treasury securities, bringing them into our balance sheet, and reducing the available supply of those Treasuries, we effectively lowered the interest rate of long termed Treasuries and GSE securities as well… and so the net effect of these actions was to lower yields across a range of securities. And as usual, low interest rates have supportive, stimulative effects on the economy. So this was really a monetary policy by another name: instead of focusing on the short-term rate, we were focusing on the long-term rates." [10].

THE TAYLOR RULE

You have probably been pulling out your hair over the "smoke and mirrors" of the execution of Fed's monetary policy. Stanford University economics professor and former U.S. Treasury Undersecretary for International Affairs, John Taylor has proposed a transparent, Federal Reserve policy system consisting of a logical and predictable framework for Federal Reserve responses to cyclical economic changes

Taylor presented his paper in Cambridge, Massachusetts in 1992, containing what would be labeled by *The Economist* magazine as the "Taylor Rule", a policy he proposed for the Fed to follow in setting interest rates in order to achieve price instability. He uses counterfactual analysis, a statistically supported model economic historians analyzed cause and effect to model what would have transpired, in retrospect, if the Fed had responded in a different manner.

In his book "First Principles" (2012) John B Taylor states:

"To be more precise, the Taylor rule states that the interest rate should be one and a half times the inflation rate plus one-half times the GDP gap +1. (The GDP gap measures how far the GDP is from its normal trend level)" [11].

Basically, according to the Taylor rule, the Fed should address a 1% increase in inflation by increasing the Fed Fund short term interest rate by 1.5 percentage points (approximately 1.5 percentage points, based on a sliding scale and not to be confused with 1.5 %); and address a 1% fall in GDP by decreasing the Fed Fund rate .5 percentage point (again based on a sliding scale). In 2000 – 2006 this would have prevented the long-term very low interest rates that led to the housing boom and subsequent home mortgage bust.

THE GOOD

Although the Federal Reserve is often blamed for causing the 1929 – 1933 Great Depression by prematurely tightening the money supply, (Ben Bernanke's Doctoral thesis supported this theory), the subsequent period from the 1940s to 2008 has been financially much less eventful than the 1800s and early 1900s which both had serial, catastrophic bank failures. Whether this is coincidental or a result of the Federal Reserve's countercyclical monetary policy will always be open to the endless speculation.

As far as the housing mortgage crisis unfolded, most economists would agree that Federal Reserve Chairman (-------) Alan Greenspan had his , fingerprints all over this event with his over extended period of low interest rates.

Most economists would also agree that the Federal Reserve's intervention in the fall of 2008 to relieve the frozen credit markets with it's flood of liquidity did pull both the US and the world back from the abyss of a world financial collapse of. Whether or not the subsequent five years of the Fed's Quantitative Easing (QE 1-4) was beneficial to the economy, is still being debated.

THE BAD - US DEBT DOWNGRADE

In August 2011 the US debt AAA credit rating was decreased for the first time in over 100 years and whether this is because of the economy or the Federal Reserve's expansion of its balance sheet will always be debated.

LIQUIDITY TRAP

This is best been described by Economic Nobel Prize winner and Princeton economics professor Paul Krugman in his book "End This Depression Now" (2013):

"With an economy in recession and short-term interest rates near zero we are in what has been referred to as a 'liquidity trap'.

During normal economic times the banks take in deposits and loan money back out at a higher rate. But when the going rate for loans is very low it is hard for the banks to justify making even relatively safe loans, never mind more risky small business loans. So when the Fed buys Treasury bills or mortgages from the banks and credit their reserve accounts at the Federal Reserve, the banks just let it sit there.

And this 'liquidity trap' is the reason why the $85 billion/month the Fed is putting into bank reserve accounts is actually not being pumped into the economy which is its intended destination.

This is why the Fed it wants to let interest rates rise, so banks will move this idle cash from its reserve accounts into the economy by making loans at higher rates which justified the risks." [12].

THE UGLY

It took the US 198 years to borrow the first trillion dollars and another 12 years to borrow the second trillion dollars. Now, in 2014, our public debt is over $17 trillion. For several years (2008 – 2014) the Federal Reserve has been placing $85 billion per month onto its balance sheet by purchasing treasuries and mortgages with keystroked, digital money the Federal Reserve Chairman refers to as "electronic entries".

Even with interest rates at an all-time low, the government is still paying $400 billion a year in debt service. Remember the economic principle of "reversion to the mean" (chapter – – – –) which states that during cyclical events, as in economic cycles, the data will almost always revert back to, and usually over-shoot, the mean or average value over time – that's why it is the mean. When the interest due on treasuries reverts back to the historical mean of 6.6% from the current 2.9% today, the cost of servicing the national debt will be unmanageable. When debt service becomes unmanageable, defaulted is not far behind. (see chapter – – – – –).

We will surely default ("reorganize", "write down", "discount") the debts to our second and third largest creditors, China and Japan respectively; but the largest creditor has recently become our own Federal Reserve's balance sheet, thanks to five years of the Quantitative Easing policies.

But there is a solution already in the works. The Guaranteed Retirement Account (GRA) will be set up when the IRAs and 401(k)s are rolled over into (confiscated) a national program.

COMMENT BOX

Did you see the 2014 nationalization of your health care system too? That was just the first act of our now central planning a government. See chapter – – – – – IRA for the details.

To save the IRAs, 401(k)s and pensions from the ravages of the stock market, bond market and other evils of personal choice that we poor, helpless, childlike citizens might fall victim to; the nationalized GRA will only invest in "safe" US treasuries. And it just so happens that to the Federal Reserve will have a huge inventory of these now almost worthless Treasuries and is looking to unload onto its next unsuspecting victim. This will be sold as a "win-win" for big government and another giant step toward the government's central planning of your life.

As economist and MIT economics professor Rudy Dornbusch famously stated: "None of the U.S. expansions of the past 40 years died in bed of old age; every one was murdered by the Federal Reserve."[13].

SUMMARY