

2014

BANK-CREATED MONEY, MONETARY SOVEREIGNTY, AND THE FEDERAL DEFICIT: TOWARD A NEW PARADIGM IN THE GOVERNMENT-SPENDING DEBATE

Ashton S. Phillips

Follow this and additional works at: <http://digitalcommons.law.wne.edu/lawreview>

Recommended Citation

Ashton S. Phillips, *BANK-CREATED MONEY, MONETARY SOVEREIGNTY, AND THE FEDERAL DEFICIT: TOWARD A NEW PARADIGM IN THE GOVERNMENT-SPENDING DEBATE*, 36 W. New Eng. L. Rev. 221 (2014), <http://digitalcommons.law.wne.edu/lawreview/vol36/iss3/3>

This Article is brought to you for free and open access by the Law Review & Student Publications at Digital Commons @ Western New England University School of Law. It has been accepted for inclusion in Western New England Law Review by an authorized administrator of Digital Commons @ Western New England University School of Law. For more information, please contact pnewcombe@law.wne.edu.

ARTICLES

BANK-CREATED MONEY, MONETARY SOVEREIGNTY, AND THE FEDERAL DEFICIT: TOWARD A NEW PARADIGM IN THE GOVERNMENT-SPENDING DEBATE

ASHTON S. PHILLIPS*

The privilege of creating and issuing money is not only the supreme prerogative of Government, but it is the Government's greatest creative opportunity.¹

* J.D., 2009, The George Washington University Law School. The author wishes to thank the organizers of the ClassCrits VI Conference titled: *Stuck in Forward? Debt, Austerity and the Possibilities of the Political*, for providing both a welcome excuse to further explore this topic and a fertile environment for the development of the thesis. He also wishes to extend particular thanks to Professors Tayyab Mahmud, Athena Mutua, and Charles Pouncy for their thoughtful comments on earlier drafts as well as the Editors of the Western New England Law Review for their confidence and work. Although the author is an attorney for the United States government, this Article is written solely in his personal capacity and the opinions expressed herein are entirely his own.

1. ROBERT L. OWEN, NATIONAL ECONOMY AND THE BANKING SYSTEM OF THE UNITED STATES, S. REP. NO. 39-7, at 91 (1939).

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 and 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.

Id. Presented by Mr. Logan on January 24, 1939, the quoted language has been characterized as an abstract of Abraham Lincoln's monetary policy from Mayor McGeer's *Conquest of Poverty*, which has been certified as correct by the Legislative Reference Service of the Library of Congress at the instance of Hon. Kent Keller, Member of the House of Representatives.

INTRODUCTION²

On November 1, 2013, Congress allowed funding for the Supplemental Nutrition Assistance Program, the federal benefits program popularly known as “food stamps,” to fall for the first time in American history.³ This effective cut to food benefits for the neediest Americans is projected to save the government a relatively trifling \$5 billion in discretionary spending in fiscal year 2014 and \$6 billion in fiscal year 2015.⁴ As the American Reinvestment and Recovery Act of 2009 expires, other fiscal stimulus spending is also sunseting, including a payroll tax holiday and, as of January 1, 2014,⁵ extended unemployment benefits.

To compound matters, the Budget Control Act of 2011, passed in an ill-fated resolution to the 2011 debt-ceiling crisis, continues to mandate large, automatic, across-the-board spending cuts to the federal budget. These cuts, which have come to be known as “sequestration,” were designed to put pressure on the Joint Select Committee on Deficit Reduction (better known as the Simpson-Bowles Commission) to negotiate a “grand [fiscal] bargain” prior to December 31, 2011. But, no such “bargain” was forthcoming. In 2013 alone, sequestration forced a total of \$85.3 billion in cuts to federal spending.⁶ As amended by the Bipartisan Budget Act of 2013, the Budget Control Act of 2011 continues to require another chunk of cuts each fiscal year from 2016 to

2. This Article was originally submitted as part of: *Stuck in Forward? Debt, Austerity and the Possibilities of the Political*, ClassCrits VI Workshop presented by Southwestern Law School Law Review, November 15-16, 2013, and sponsored by The Baldy Center for Law & Social Policy at SUNY Buffalo and UC Davis School of Law. The full symposium published by Southwestern Law School Law Review is forthcoming. See 43 SW. L. REV. (forthcoming 2014).

3. See Ron Nixon, *House Republicans Pass Deep Cuts in Food Stamps*, N.Y. TIMES Sept. 19, 2013, http://www.nytimes.com/2013/09/20/us/politics/house-passes-bill-cutting-40-billion-from-food-stamps.html?_r=0.

4. See *Id.*

5. See Catherine Rampell, *As Cuts to Food Stamps Take Effect, More Trims to Benefits Are Expected*, N.Y. TIMES, Oct. 31, 2013, http://www.nytimes.com/2013/11/01/us/as-cuts-to-food-stamps-take-effect-more-trims-to-benefits-are-expected.html?_r=0.

6. See Dylan Matthews, *The Sequester: Absolutely Everything you could Possibly Need to Know*, in *One FAQ*, WASH. POST, Mar. 1, 2013, <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/02/20/the-sequester-absolutely-everything-you-could-possibly-need-to-know-in-one-faq/>. These cuts included:

- \$42.7 billion in defense cuts (a 7.7% cut)
- \$26.1 billion in domestic discretionary cuts (a 5.1% cut)
- \$11.1 billion in Medicare cuts (a 2% cut)
- \$5.4 billion in other mandatory cuts (a 5.2% cut)

Id.

2023 until \$1.5 trillion is cut from the annual federal budget.⁷

We are told that these cuts are necessary to balance the budget. When proponents of these and other fiscal austerity measures are pressed to explain why balancing the budget is so essential (especially in the aftermath of the worst economic crisis since the Great Depression), we are frequently offered only misleading platitudes.⁸ For example, the preamble to the Simpson-Bowles Commission Report, ominously titled “The Moment of Truth,” explains that deficit reduction is necessary because “America cannot be great if we go broke” and “we have a patriotic duty to keep the promise of America to give our children and grandchildren a better life.”⁹ The report’s authors, including both Republican and Democratic Senators,¹⁰ do not explain how federal

7. *See id.* While the Bipartisan Budget Act of 2013, which President Obama signed into law on December 26, 2013, has provided a total of \$63 billion in “sequester relief” for fiscal years 2014 and 2015, it does not provide permanent relief or authorize a net reduction in the Budget Control Act of 2011’s mandatory spending cuts. The new Act replaces the part of the sequestration cuts previously scheduled to take effect in fiscal years 2014 and 2015 with \$28 billion in “mandatory-sequester extension[s]” for fiscal years 2022 and 2023 and other “savings.” *Summary of the Bipartisan Budget Act of 2013*, U.S. HOUSE OF REPRESENTATIVES, COMMITTEE ON THE BUDGET, (Dec. 10, 2013), available at <http://budget.house.gov/uploadedfiles/bba2013summary.pdf>; H.R.J. Res. 59-2, 113th Cong. § 101 (2013), available at <http://www.gpo.gov/fdsys/pkg/BILLS-113hjres59enr/pdf/BILLS-113hjres59enr.pdf>. The intended effect of the Bipartisan Budget Act of 2013 is to reduce deficit spending by an additional \$20 to \$23 billion on top of those reductions mandated by the Budget Control Act of 2011. *Id.*

8. This is not a new phenomenon. John Maynard Keynes, the economic darling of many Democratic politicians since the New Deal and Richard (“we are all Keynesians now”) Nixon, famously said “we must go on pretending that fair is foul and foul is fair; for foul is useful and fair is not.” ROBERT SKIDELSKY, *KEYNES 47* (Oxford 1996) (discussing Keynes’ rejection of socialism as described in his essay, *Economic Possibilities for our Grandchildren*, published in 1930).

9. JOINT COMM’N ON FISCAL RESPONSIBILITY, *THE MOMENT OF TRUTH: REPORT OF THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM* (Dec. 2010) [hereinafter JOINT COMM’N REPORT], http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf (recommending that Congress cap revenue at 21% of GDP by 2022 and cap spending at 21% of GDP “eventually” and containing such other nuggets of wisdom as “the most significant threat to our national security is our debt”).

10. While the eighteen members of the Joint Commission included Democratic and Republican Senators, Representatives, and other stakeholders, only eleven of the eighteen members endorsed “The Moment of Truth” report. Endorsers included Democratic Senators and Representatives and Republican Senators. All three House Republicans declined to endorse the report, including Representative Paul Ryan. Commission member Andy Stern, former President of the Service Employees International Union, also declined to endorse the report. Because the report failed to garner fourteen yes votes, it was not automatically submitted to Congress for a vote. *See In a 11-7 Tally, the Fiscal Commission Falls Short on Votes*, N.Y. TIMES, Dec. 3, 2010, http://www.nytimes.com/interactive/2010/12/03/us/politics/deficit-commission-vote.html?_r=0.

spending threatens our children's promise of a better life or how America can "go broke." Instead, they turn to the intellectually fraught "pocketbook" metaphor, proclaiming:

Ever since the economic downturn, families across the country have huddled around kitchen tables, making tough choices about what they hold most dear and what they can learn to live without. They expect and deserve their leaders to do the same. The American people are counting on us to put politics aside, pull together not pull apart, and agree on a plan to live within our means and make America strong for the long haul.¹¹

The problem with this parable and related anxiety over the federal deficit¹² is that the United States is not a family sitting around a kitchen table contemplating its credit card debt. Instead, as will be discussed more fully in Part I, the United States is a monetary sovereign with the Constitutional power to coin money and regulate the value thereof.¹³ As such, the Supreme Court made clear more than 125 years ago that the Constitution grants Congress the power to print money backed by nothing and force people to accept that fiat money as legal tender for the payment of the federal government's (and everyone else's) debts.¹⁴ If an entity can print money and force its creditors to accept that money in

11. JOINT COMM'N REPORT, *supra* note 9, at 6. Some have suggested, echoing Max Weber's seminal work on *The Protestant Ethic and the Spirit of Capitalism*, that this kind of moralizing over public debt stems from Protestant religious tradition and its characterization of personal debt as sinful. See, e.g., Chris Bowlby, *The Eurozone's Religious Faultline*, BBC NEWS (July 18, 2012), <http://www.bbc.co.uk/news/magazine-18789154> (noting that European countries with majority Protestant populations also tend to be those countries most in favor of austerity measures); see also, DAVID GRAEBER, DEBT: THE FIRST 5,000 YEARS 59 (2012) (noting that in all Indo-European languages, words for "debt" are etymologically related to those for "sin" or "guilt").

12. Perpetually exposed to this kind of rhetoric, the public has come to believe that the federal debt and deficit are urgent and serious problems. In a March 2013 Gallup Poll, 61% of respondents stated that they personally worry about federal spending and budget deficit a "great deal." 21% worried a "fair amount." Only 15% worried "not at all" or "only a little." See *Federal Budget Deficit*, GALLUP, <http://www.gallup.com/poll/147626/Federal-Budget-Deficit.aspx> (last visited May 14, 2014). In a January 2013 Gallup Poll asking respondents to identify "the most important problem facing this country today," the second most common response was the federal budget deficit with 20%, trailing only "the economy in general" (21%), and surpassing unemployment (16%) for the first time since 2009. See Frank Newport, *Debt Gov't Dysfunction Rise to Top of American Issue List*, GALLUP (Jan. 14, 2013), http://www.gallup.com/poll/159830/debt-gov-dysfunction-rise-top-americans-issue-list.aspx?utm_source=alert&utm_medium=email&utm_campaign=syndication&utm_content=morelink&utm_term=All%20Gallup%20Headlines.

13. U.S. CONST. art. I, § 8, cl. 1 (listing as one of Congress's enumerated powers, the power: "[t]o coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures").

14. See *Juilliard v. Greenman*, 110 U.S. 421, 451 (1884) (discussed *infra* Part I.A).

payment of its debts, that entity cannot really “go broke.” Popular discourse to the contrary notwithstanding, this is no secret. Former Chairman of the Federal Reserve, Alan Greenspan, for example, has explained: “[A] government cannot become insolvent with respect to obligations in its own currency. A fiat money system, like the ones we have today, can produce such claims [as those created against the government when it creates money] without limit.”¹⁵

Of course, any mention of government money creation as a solution to popular anxiety over the federal deficit is usually snuffed out immediately with one word: *inflation*. Maybe, the government *could* print money to finance its expenses, the narrative goes, *but* such an approach would surely be short-lived because any government printing money to pay its bills would quickly destroy the value of its currency (and thereby lose its power to print anything of value) by triggering runaway-inflation. So we are told, but the analysis is not so simple.

For one thing, inflation is not a necessary result of governments spending printed money. Inflation occurs only when increases in the money supply over a particular time period exceed increases in the real value of the economy over the same time period.¹⁶ Thus, if the government spends its printed money on projects that increase Gross Domestic Product (GDP), including, for example, improvements in

15. Alan Greenspan, Chairman, Board Of Governors Of The Fed. Reserve Sys., Remarks on Cent. Banking and Global Fin. at The Catholic Univ. Leuven, Leuven, Belg. 2 (Jan. 14, 1997) (transcript available through Westlaw, at 1997 WL 10937 (F.R.B.)). Of course, Congress arguably can and has ordered the Treasury via statute to stop issuing new debt instruments whenever the numeric value of outstanding debt equals some arbitrary number. Even recognizing this statutory limitation, America cannot “go broke” in the same way a natural person can. In the case of a debt-ceiling induced default, Congress would have defaulted on its debts and other obligations (arguably in violation of the Fourteenth Amendment) not because the government itself lacks the power to pay its bills as they become due, but because Congress refuses to exercise its power to do so. For more on the relevance of the Fourteenth Amendment’s Public Debts clause to the debt-ceiling debacle, see Neil H. Buchanan & Michael C. Dorf, *How to Choose the Least Unconstitutional Option: Lessons for the President (and Others) from the Debt Ceiling Standoff*, 112 COLUM. L. REV. 1175, 1189 (2012).

16. See, e.g., ROGER LEROY MILLER & ROBERT W. PULSINELLI, MODERN MONEY AND BANKING 437–40 (Scott D. Stratford 2d ed. 1989) (discussing general theories of inflation including the theory that inflation is a monetary phenomenon and noting that proponents on this theory conclude that “inflation results when the money supply increases *faster than output [GDP] increases*”) (emphasis added); DAVID A. MOSS, A CONCISE GUIDE TO MACROECONOMICS: WHAT MANAGERS, EXECUTIVES, AND STUDENTS NEED TO KNOW 38 (2007) (“Money growth . . . tends to drive up the price level. With more cash in their pockets and bank accounts, consumers often find new reasons to buy things. But *unless the supply of goods and services has increased in the meantime*, the consumers’ mounting demand for products will simply bid up prices, thus stoking inflation. Economists sometimes say that inflation rises when ‘too much money is chasing too few goods.’”) (emphasis added).

infrastructure, energy production, education, or healthcare technology, the inflationary effect of printing the money to pay for these projects should be tempered or even eliminated to the extent that the increase in the real value of the economy is proportionate to the increase in the money supply.¹⁷ By contrast, if a government arbitrarily sprinkles new money into the economy, the increase in the money supply may stimulate economic activity in the short run, but unless the new money causes or at least corresponds with growth in the real value of the economy, the arbitrary money printing will likely cause inflation, at least in the long run.¹⁸ Similarly, any action that leads to the *net* destruction of real value in an economy (e.g., a domestic war or a natural disaster

17. Introductory economics courses teach students about these dynamics of inflation with the equation of exchange: $MV = PQ$, where:

M is the nominal value of money;

V is the velocity of money in final expenditures;

P is the general price level; and

Q is an index of the real value of final expenditures (as a proxy for Gross Domestic Product, or the real value of the economy).

While monetarists, such as Milton Friedman, famously relied on this equation to justify their view that the quantity of money directly determined the price of goods and services (i.e. inflation), that interpretation depends on the assumption that neither the real value of the economy nor the velocity of money could be affected by increases or decreases to the money supply. While Q and V may remain fairly constant when increases or decreases in the money supply are affected by the Federal Reserve's open market operations, the equation of exchange could just as easily describe the principle cited. If the quantity of the real value of the economy (Q) increases, as a result of how the created money is spent, and the nominal quantity of money in the economy (M) increases in proportion to the increase in the real value of the economy (Q), the general price levels in the economy (P) should remain the same. If the quantity of money (M) is increased, but, due to the way the created money is spent, there is no increase in the real value of the economy (Q), price levels (P) will rise, assuming the velocity of money (V) remains constant. For a thoughtful discussion of the history, debated meaning, and accuracy of the "quantity theory of money," see Mark Blaug, *Why is the Quantity Theory of Money the Oldest Surviving Theory in Economics?*, in *THE QUANTITY THEORY OF MONEY: FROM LOCKE TO KEYNES AND FRIEDMAN* 27-49 (Edward Elgar 1995). Blaug concludes that "[m]oney . . . can affect both output and prices in the short run and it may even affect output in the long run, depending on how and at what rate the extra money is injected into the economy." *Id.* at 43 (emphasis added).

18. Even John Maynard Keynes, the economist most often associated with the position that governments should use both fiscal deficit spending and monetary policy to stimulate the economy and worry about deficits and inflation later, conceded that arbitrary money creation could result in inflation in the long run. SKIDELSKY, *supra* note 8, at 122 ("So long as there is unemployment, *employment* will change in the same proportion as the quantity of money; and when there is full employment, *prices* will change in the same proportion as the quantity of money.") (emphasis added). Of course, Keynes is also famous for discounting the significance of long run economic effects, noting "in the long run, we're all dead." See JOHN MAYNARD KEYNES, *A TRACT ON MONETARY REFORM* 79-80 (1923) ("But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.").

without corresponding reconstruction efforts) could cause inflation without any increase in the volume of money because the system would have the same amount of money “chasing” fewer goods and services.¹⁹ In short, whether printing money causes price inflation depends not simply, if at all, on the quantity of money created but on *how the printed money is spent*.

Moreover, even if inflation sometimes results from creating money, it is not necessarily true that the United States would experience higher rates of inflation if Congress were directly to finance some of its expenditures with printed money because, as nearly all economics students (and startlingly few lawyers) know, and as I will explore further in Part II, the Federal Reserve and private commercial banks currently enjoy the power to create and spend or loan into existence virtually unlimited amounts of new money. Because the Constitution gives Congress plenary control over the creation of money, however, Congress could modify the status quo at any time both: (1) to print money to directly finance deficit spending and (2) to directly or indirectly control the overall quantity of money created in the economy, including money created by the Federal Reserve and private banks, such that no net change in the quantity of created money need result from Congress’s direct money creation.

As such, and as explored in Part III, the question presented to Congress and brought into sharp relief in the present moment of economic crisis, debt-ceiling standoffs, government shutdowns, food stamp cuts, increasing economic inequality, sequestration, quantitative easing, credit bubbles, and liquidity traps, is not how America can learn to “live within its means,” or whether members of Congress can make the “tough choices about what they hold most dear and what they can learn to live without,” but: *how the sovereign power to create money should be exercised and (crucially) who should benefit from the exercise of that power?*

Rather than endorsing a particular answer to this monumental policy question, Part III explores some of the interests, arguments, and

19. For an alternative, but not necessarily mutually exclusive, view of the causes of inflation, see HETERODOX MACROECONOMICS: KEYNES, MARX AND GLOBALIZATION 30-31 (Jonathan P. Goldstein & Michael G. Hillard eds., 2009) [hereinafter HETERODOX] (“Inflation is a non-monetary phenomenon in the sense that changes in the stock of money do not determine the rate of inflation in any causal sense, but rather the rate of change of the stock of money (endogenously) adjusts to the pace of inflation” and characterizing inflationary pressure as a product of the struggle over income shares, changes in aggregate demand without corresponding changes in aggregate supply, and “cost-push factors” including particularly changes from the foreign sector affecting import prices and exchange rates).

proposals Congress and voters would do well to consider when answering this question and concludes with the more limited proposition that the Constitution vests the responsibility for determining the winners and losers of the fiscal/monetary system squarely in Congress's hands and that an honest and informed evaluation of Congress's choices relating to the federal debt must at the least acknowledge and incorporate the following, perhaps inconvenient, realities: (1) Congress has the constitutional power to create fiat money and has done so in the past; (2) Congress has delegated this power to the Federal Reserve, which thereby enjoys the practically unlimited power to create legal tender money; (3) the Federal Reserve is currently exercising that power to "ease" billions of dollars in new money into existence per year; (4) private banks enjoy the power to transform every dollar the Federal Reserve creates into ten dollars (or more) of legally protected money; (5) this fiscal/monetary system is not economically or politically neutral in that it creates certain predictable winners and losers; and (6) alternative models exist that would allow Congress to exercise its sovereign power to create money without risking net increases in the currently accepted rates of inflation, including models that leave the Federal Reserve Act entirely in place.²⁰

20. Those familiar with the history of monetary theory and philosophy will note that many writers have spent a significant amount of energy wrestling with the precise meaning of "money." These writers attempt to define money by its function, noting that "money" operates as: (1) a medium of exchange; (2) a measure of value or a standard for contractual obligations; (3) a store of value or wealth; and (4) a unit of account. See, e.g., CHARLES PROCTOR, *MANN ON THE LEGAL ASPECT OF MONEY* 10 (6th ed. 2005); THOMAS CRUMP, *THE PHENOMENON OF MONEY* 1-31 (Routledge & Kegan Paul eds., 1981) (discussing these attributes of money, the nature of money more broadly, and characterizing "money" as a cultural tautology). These discussions, while interesting, are not particularly important to this work or to the fiscal anxiety gripping the nation. "Money" for purposes of this Article means simply: (1) *legal tender*, or whatever fungible unit or item (be it paper note, coin, electronic credit entry, bead, shell, etc.) the State vows to accept for the satisfaction of public debts and orders individuals to accept for the satisfaction of private debts; and (2) that bank-created money that the State insures through depository insurance and sanctions through statutory reserve rates. Put more simply, "money" is whatever the State says it is. For those keeping track, I am not the first to take this State-centric approach to the nature of money. See, e.g., L. Randall Wray, *Alternative Approaches to Money*, 11 *THEORETICAL INQUIRIES* L. 29, 39-44 (2010) (characterizing those who emphasize the central role of the nation-state in the production and regulation of money as advocating the "state theory of money" and identifying John Maynard Keynes and A. Mitchell Innes as proponents); GRAEBER, *supra* note 11, at 47-49 (discussing G.F. Knapp's *State Theory of Money* as foundational to this School).

I. CONGRESS'S MONETARY POWERS AND POLICY

A. *As a Monetary Sovereign, Congress Has the Constitutional Power to Create Money*

As a matter of Constitutional law, the federal government need not borrow money nor raise revenue through taxation to pay its bills. Although the Constitution prohibits state governments from coining money, issuing “Bills of Credit,” or making anything other than “gold and silver Coin a Tender in Payment of Debts,” nothing in the Constitution prohibits the federal government from issuing paper money or other fiat currency (paper, coin, or electronic).²¹ Some have disagreed with this conclusion, citing the Founders’ purported abhorrence of paper money,²² but, as will be discussed presently, the Supreme Court sanctioned the view that Congress can issue legal tender to fund its expenditures, even if that money is not backed by any commodity, as early as 1884.

Relying on the Necessary and Proper Clause and Congress’s various enumerated powers relating to money and federal debt, the Supreme Court in *Julian v. Greenman* (the most sweeping of the famous Civil War Era *Legal-Tender Cases*) upheld Congress’s power to issue fiat “greenbacks” and to force individuals to accept that fiat currency in satisfaction of private debts.²³ In reaching this conclusion, the Court

21. Compare U.S. CONST. art. I, § 8 (granting Congress the power to coin money and regulate the value thereof), with *id.* § 10, cl. 1 (“No State shall . . . coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts . . .”).

22. See, e.g., Ali Khan, *The Evolution of Money: A Story of Constitutional Nullification*, 67 U. CIN. L. REV. 393, 407 (1999) (“Finally, it can be said with ‘moral certainty’ that the framers of the Constitution prohibited making any paper bills a legal tender money.”). But see, e.g., Letter from Benjamin Franklin to Thomas Ruston (Oct. 9, 1780), in 33 THE PAPERS OF BENJAMIN FRANKLIN, July 1 through November 15, 1780, 390, 390-92 (Barbara B. Oberg ed., Yale Univ. Press 1997), available at <http://founders.archives.gov/documents/Franklin/01-33-02-0331> (“[The Continental Congress] is, as you well suppose not well skilled in Financing. But their Deficiency in Knowledge has been amply supply’d by Good Luck. They issued an immense Quantity of Paper Bills, to pay, clothe, arm & feed their Troops, & fit out Ships, and with this Paper, without Taxes for the first three Years, they fought & baffled one of the most powerful Nations of Europe. They hoped notwithstanding its Quantity to have kept up the Value of their Paper. In this they were mistaken. It depreciated gradually. But this Depreciation, tho’ in some Circumstances inconvenient, has had the general good and great Effect, of operating as a Tax, and perhaps the most equal of all Taxes, since it depreciated in the Hands of the Holders of the Money, and thereby taxed them in proportion to the Sums they hold and the Time they held it, which is generally in proportion to Mens Wealth.”).

23. See U.S. CONST. art. I, § 8, cls. 1, 2, 5, and 18 (“The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common [defense] and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; To borrow Money on the credit of the

characterized this monetary power as necessary and inherent to the United States' sovereignty, stating:

It appears to us to follow, as a logical and necessary consequence, that congress has the power to issue the obligations of the United States in such form, and to impress upon them such qualities as currency for the purchase of merchandise and the payment of debts, as accord with the usage of sovereign governments. The power, as incident to the power of borrowing money, and issuing bills or notes of the government for money borrowed, of impressing upon those bills or notes the quality of being a legal tender for the payment of private debts, was a power universally understood to belong to sovereignty, in Europe and America, at the time of the framing and adoption of the constitution of the United States The exercise of this power not being prohibited to congress by the constitution, it is included in the power expressly granted to borrow money on the credit of the United States.²⁴

Justice Fields, writing in dissent, took the logic of the majority opinion to its necessary conclusion, arguing (aptly enough for this Article, albeit in apparent horror): if the majority is right, then there is no sense in paying “interest on the millions of dollars of bonds now due, when Congress can in one day make the money to pay the principal.”²⁵

The Civil War era Supreme Court was not the first to recognize the relationship between the power to create money and sovereignty.²⁶ Indeed, some scholars estimate that the notion of monetary sovereignty predates that of political sovereignty by thousands of years, as priests and rulers from various ancient civilizations claimed the exclusive power

United States; . . . To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures . . . [a]nd To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.”).

24. *The Legal-Tender Cases*, 110 U.S. 421, 447-48 (1884). For a more modern articulation of this view, see *Naamloze Vennootschap Suikerfabriek ‘Wono-Aseh’ v. Chase Nat’l Bank of N.Y.*, 111 F. Supp. 833, 845 (S.D.N.Y. 1953) (“Control of the national currency and of foreign exchange is a necessary attribute of sovereignty.”).

25. *Legal-Tender Cases*, 110 U.S. at 470 (Field, J., dissenting).

26. It was also not the last. In 1935, the Supreme Court again affirmed Congress’s “broad and comprehensive national authority over the subjects of revenue, finance, and currency,” in *Norman v. Balt. & Oh. R.R. Co.* (The Gold Clause Cases), 294 U.S. 240, 303 (1935). There, the Court, relying on *Greenman* and the aggregate of the powers granted to the Congress by the Constitution, upheld a 1933 Joint Resolution of Congress declaring “gold clauses” in private contracts, which purported to require parties to pay contractual obligations in gold, void as against public policy. *See, e.g., id.* at 312. Because Congress’s conclusion that these clauses interfered with its broad power to set monetary policy was not arbitrary or capricious, the Court upheld the Joint Resolution. *Id.* at 417–20.

to create money long before rulers developed the notion of sovereign nation-states.²⁷ Indeed, the connection between sovereignty and monetary power is so well established that the State's sovereignty over its own currency is "traditionally recognized by public international law."²⁸

Recent history bears out the wisdom of this view, with Greece and the other European Union member nations now facing external demands to implement so-called "Austerity Programs" as the most powerful examples. Prior to joining the euro area, Greece (like any other monetary sovereign) retained the power to create money to pay for its expenses, be they generous pension programs or public transportation projects, and to collect otherwise impossibly low tax revenues.²⁹ Within its boundaries, Greece (again, like any other monetary sovereign) had the power to give this created currency value by pledging to accept the currency in satisfaction of tax liabilities to the State and to require (or at least order) all citizens to accept the currency in satisfaction of private debts. By joining the euro area, Greece gave up this sovereign power to create money and with it the power to deficit spend without debt in exchange for the prestige of full membership in the European Union and the convenience and reduced transaction costs associated with a single European currency.³⁰ Many Greeks realized only too late the value of the power they gave up.³¹

27. ROSA MARIA LASTRA, LEGAL FOUNDATIONS OF INTERNATIONAL MONETARY STABILITY 4-14 (2006) (listing Sumer, India, Babylon, Persia, Egypt, and Rome as ancient civilizations with rulers or priests proclaiming the power to create money and providing a brief history of the development of the concept of political sovereignty in western civilization, locating the acceptance of the concept in 1648 with the Treaty of Westphalia); *see also* David Glasner, *An Evolutionary Theory of the State Monopoly over Money*, in MONEY AND THE NATION STATE: THE FINANCIAL REVOLUTION, GOVERNMENT AND THE WORLD MONETARY SYSTEM 21-45 (Kevin Dowd & Richard H. Timberlake, Jr. eds., 1998) (noting the relationship between state security and the state monopoly over money, "[i]n the ancient world . . . states that allowed private mints to operate were vulnerable to takeover by owners of private mints who could raise large sums of money quickly to finance their takeovers").

28. PROCTOR, *supra* note 20, at § 19:02.

29. For a detailed discussion of the difference between the spending powers of monetary sovereigns, like the United States, the United Kingdom, and Japan, and monetary non-sovereigns, including all members of the euro area, see L. RANDALL WRAY, MODERN MONEY THEORY: A PRIMER ON MACROECONOMICS FOR SOVEREIGN MONETARY SYSTEMS 141-43, 169-85 (2012).

30. For a discussion of the advent of the European Monetary Union as an example of voluntary or consensual limitations of monetary sovereignty, see LASTRA, *supra* note 26, at 27-29 (noting that "[t]he adoption of a single currency, the euro, and the creation of the European System of Central Banks with responsibility to formulate and implement the monetary policy of the Community has been described as 'the most profound limitation to monetary sovereignty ever to be agreed by sovereign states'").

31. For a critical take on the advent of the single currency market in the EU and its

The position of less-than-sovereign American states and municipalities is not unlike that of Greece in the wake of the European currency union, with similar results. As noted earlier, the United States Constitution forbids American cities and states from exercising Congress's sovereign power to create money by forbidding states from issuing "Bills of Credit" or making anything other than gold or silver coin legal tender. As a direct result, unlike the federal government American states and municipalities, including most recently and infamously the city of Detroit, actually can "go broke."³²

B. *Congress Has and Does, to a Limited Degree, Directly Issue Fiat Money to Finance Government Expenses.*

Not only does Congress have the power to unilaterally issue and spend money backed by nothing other than its sovereignty, it has done so before and continues to do so to a limited degree even now. After the outbreak of the Civil War, Congress authorized three issues of non-interest-bearing United States Notes convertible to nothing. These U.S. Notes, which became known as "greenbacks" due to the distinctive green ink used in their manufacture, were the paper money at issue in the *Legal-Tender Cases* discussed above.³³

Although these greenbacks were initially justified as a necessary evil to finance the war, they became a politically popular and lasting part

resulting effects on the sovereignty of member nations, including Greece, see PAUL CRAIG ROBERTS, *THE FAILURE OF LAISSEZ FAIRE CAPITALISM* 159-74 (2013) (discussing the Greek public revolt, complete with street protests and Molotov cocktails, after a severe austerity program, including wage, pension, and employment reductions, and the privatization of state lottery, municipal water companies, and ports, was proposed).

32. Of course, the federal government can and has bailed out American cities, just as it bailed out banks and financial institutions (often with created money) in the wake of the 2008 financial crisis. For example, in 1975, the federal government famously bailed out New York City with \$2.3 billion of seasonal financing to help prevent it from declaring bankruptcy. Gretchen Morgenson, *Lessons from Bailout of New York*, N.Y. TIMES, <http://www.nytimes.com/2008/05/11/business/worldbusiness/11iht-morg12.1.12762783.html> (last visited May 14, 2014). For a review of the Federal Reserve's \$16 trillion bailout of private banks and corporations including foreign-owned banks between 2008 and 2010, see U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-696, *FEDERAL RESERVE SYSTEM: OPPORTUNITIES EXIST TO STRENGTHEN POLICIES AND PROCESSES FOR MANAGING EMERGENCY ASSISTANCE* 131 (July 2011), available at <http://www.gao.gov/new.items/d11696.pdf>.

33. See JOHN KENNETH GALBRAITH, *MONEY: WHENCE IT CAME, WHERE IT WENT* 84-100 (1975); see also WILLIAM F. HIXSON, *TRIUMPH OF THE BANKERS: MONEY AND BANKING IN THE EIGHTEENTH AND NINETEENTH CENTURIES* 132 (1993) (characterizing Congress's situation in 1862, in the face of enormous increases in civilian and military expenditures, as requiring a choice between "inconvertible government created money [and] inconvertible bank created money" and concluding that Congress wisely chose the former, at least at that historical moment).

of United States currency.³⁴ In response to efforts to retire the greenbacks from circulation following the end of the Civil War, a national political party calling itself the Greenback Party (or sometimes the Greenback Labor Party) formed.³⁵ This Party, comprised mostly of farmers who believed they would benefit from inflation and increased government spending, argued that the greenback issue should be expanded rather than retired because it was the sole and sacred role of the government, not private banks, to issue money. In the election of 1878, the Party received more than a million votes and elected fourteen congressmen.³⁶ Although it was not successful in convincing Congress to prohibit bank created money and replace it with greenbacks, the Party has been credited with at least convincing Congress and “hard money” advocates to abandon their efforts to retire the existing issue of greenbacks.³⁷

This compromise lasted. To this day, Congress continues to authorize the Treasury to maintain a permanent issue of \$300 million in non-interest bearing, inconvertible U.S. Treasury Notes (i.e., greenbacks) the same volume authorized in 1878.³⁸ These United States

34. GALBRAITH, *supra* note 33, at 84-100. In 1866, with the immediate need for war financing subsided, Congress began retiring greenbacks from circulation. It halted the retirement in 1868 in response to political pressure, especially from farmers who – not necessarily incorrectly – blamed concurrent deflation and the related increase in the real cost of their debt burdens on the retirement of the paper money. In 1871 and 1872, the Treasury reversed course authorizing a few million increase in the issue of greenbacks. In 1874, Congress authorized the greenback circulation at a permanent total of \$400 million. Ulysses S. Grant vetoed the measure stating: “I am not a believer in any artificial method of making paper money equal to coin, when the coin is not owned or held ready to redeem the promises to pay.” *Id.* at 96.

35. GALBRAITH, *supra* note 33, at 96-97.

36. GALBRAITH, *supra* note 33, at 97.

37. The Democratic Party also adopted a similar plan in 1867, known as the Pendleton Plan, which proposed, *inter alia*, replacement of the national bank notes with greenbacks. For more information on the Pendleton Plan, see generally Max L. Shipley, *The Background and Legal Aspects of the Pendleton Plan*, 24 MISS. VALLEY HIST. REV. 329 (Dec. 1937), available at <http://www.jstor.org/stable/1891818> (the Pendleton Plan involved demands for the payment of the five-twenty bonds in greenbacks, substitution of greenbacks for national bank notes, and discontinuation of the policy of withdrawing greenbacks from circulation, with possibly some slight inflation of the currency).

38. The statute reads:

(a) The Secretary of the Treasury may issue United States currency notes. The notes—

(1) are payable to bearer; and

(2) shall be in a form and in denominations of at least one dollar that the Secretary prescribes.

(b) The amount of United States currency notes outstanding and in circulation—

(1) may not be more than \$300,000,000; and

(2) may not be held or used for a reserve.

Notes are still in circulation and are still legal tender, redeemable at par for any Federal Reserve Note.³⁹ As of December 2012, the U.S. Treasury calculated that \$239 million in United States Notes, or greenbacks, were in circulation.⁴⁰

Congress also continues to authorize the U.S. Treasury to issue *coin*, in various quantities and denominations.⁴¹ One such coinage statute,⁴² authorizing the Treasury to create platinum coins in any denomination, gave rise to the recent “\$3 Trillion Coin” proposals.

31 U.S.C. § 5115 (2013).

39. The Treasury website explains it like this:

United States Notes (characterized by a red seal and serial number) were the first national currency, authorized by the Legal Tender Act of 1862 and began circulating during the Civil War. The Treasury Department issued these notes directly into circulation, and they are obligations of the United States Government. The issuance of United States Notes is subject to limitations established by Congress. It established a statutory limitation of \$300 million on the amount of United States Notes authorized to be outstanding and in circulation. While this was a significant figure in Civil War days, it is now a very small fraction of the total currency in circulation in the United States.

Both United States Notes and Federal Reserve Notes are parts of our national currency and both are legal tender. They circulate as money in the same way. However, the issuing authority for them comes from different statutes. United States Notes were redeemable in gold until 1933, when the United States abandoned the gold standard. Since then, both currencies have served essentially the same purpose, and have had the same value.

Resource Center: Legal Tender Status, U.S. DEPT. OF THE TREASURY [hereinafter U.S. DEPT. OF THE TREASURY], <http://www.treasury.gov/resource-center/faqs/currency/pages/legal-tender.aspx> (last visited May 4, 2014); *see also* 31 U.S.C. § 5103 (2013) (“United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) are legal tender for all debts, public charges, taxes, and dues. Foreign gold or silver coins are not legal tender for debts.”); *id.* § 5119 (listing United States currency notes, including those issued under the Legal Tender Acts as public debts bearing no interest).

40. BUREAU OF THE PUB. DEBT, MONTHLY STATEMENT OF THE PUBLIC DEBT OF THE UNITED STATES (Dec. 31, 2012), *available at* <http://www.treasurydirect.gov/govt/reports/pd/mspd/2012/opdm122012.pdf>. Thus, even though Congress has authorized the Treasury to maintain a circulation of \$300 million in United States Notes, the Treasury has not done so, declining to place any new U.S. Notes in circulation since 1971. As explanation, the Treasury states: “Because United States Notes serve no function that is not already adequately served by Federal Reserve Notes, their issuance was discontinued, and none have been placed in to circulation since January 21, 1971.” U.S. DEPT. OF THE TREASURY, *supra* note 39. Of course, there is one major “function” United States Notes serve that Federal Reserve Notes do not: United States Notes provide direct revenue to the federal government. *See* Bruce G. Carruthers & Sarah Babb, *The Color of Money and the Nature of Value: Greenbacks and Gold in Post-Bellum America*, 101 AM. J. SOC. 1556, 1558 (1996); *see also* R. CHRISTOPHER WHALEN, *INFLATED: HOW MONEY AND DEBT BUILT THE AMERICAN DREAM* 29-61 (1959).

41. 31 U.S.C. §§ 5111-5112 (2013).

42. *Id.* § 5112 (k) (“The Secretary may mint and issue platinum bullion coins and proof platinum coins in accordance with such specifications, designs, varieties, quantities, denominations, and inscriptions as the Secretary, in the Secretary’s discretion, may prescribe from time to time.”); *see also id.* § 5112 (h) (“The coins issued under this title shall be legal tender as provided in section 5103 of this title.”).

These proposals, which were endorsed by various commentators, including *New York Times* columnist and Nobel Prize-winning economist, Paul Krugman, suggested that rather than defaulting on federal obligations, the Treasury could and should coin a trillion dollar platinum coin to pay the government's expenses in the event Congress refused to increase the statutory debt-ceiling.⁴³

While coinage of such a high denomination coin would be highly unusual, especially in the absence of clear Congressional direction to produce trillion-dollar platinum coins, it is not unusual for Congress to enjoy some seigniorage revenue from the Treasury's manufacture and sale of coin.⁴⁴ Here is how it works: Congress authorizes the Treasury to mint coins in various quantities and denominations. The U.S. Mint then sells these coins to the Federal Reserve if directed by statute (otherwise it sells the coins to the public), which credits the Treasury's account at the Federal Reserve with money equal to the nominal or face value of the coin.⁴⁵ The difference between the cost of producing these coins and the face value of the coins (i.e., the "seigniorage") is profit for the government.⁴⁶

Thus, not only does Congress have the constitutional power to directly finance its expenditures with created money, it has done so

43. Compare Paul Krugman, *Be Ready to Mint That Coin*, N.Y. TIMES, Jan. 7, 2013, http://krugman.blogs.nytimes.com/2013/01/07/be-ready-to-mint-that-coin/?_r=0, and Evan Soltas, *Economics Is Platinum: What the Trillion-Dollar Coin Teaches Us*, BLOOMBERG.COM (Jan. 14, 2013, 4:20 PM), <http://www.bloomberg.com/news/2013-01-14/economics-is-platinum-what-the-trillion-dollar-coin-teaches-us.html>, and Ezra Klein, *Former Head of U.S. Mint: The Platinum Coin Option Would Work*, WASH. POST, Jan. 8, 2013, <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/01/08/former-head-of-u-s-mint-the-platinum-coin-option-would-work/>, with Ezra Klein, *Why We Won't Mint the Coin, Why We Can't Just Pay Off the Bonds, and Other Scary Debt-Ceiling Facts*, WASH. POST, Oct. 3, 2013, <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/10/03/why-we-wont-mint-the-coin-why-we-cant-just-pay-off-bonds-and-other-scary-debt-ceiling-facts/>, and Ezra Klein, *Treasury: We Won't Mint a Platinum Coin to Sidestep the Debt Ceiling*, WASH. POST, Jan. 12, 2013, <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/01/12/treasury-we-wont-mint-a-platinum-coin-to-sidestep-the-debt-ceiling/>.

44. See Keeley McCarty, Recent Developments, *Flip the Coin to the Fed: A Comment on the Dysfunctional Relationship Among the Federal Reserve System, Congress, and the United States Mint*, 64 ADMIN. L. REV. 315, 321 (2012) (concluding that the Federal Reserve should have control over coin as well as bills) ("The Federal Reserve purchases coins from the Mint at face value, generating an immediate profit for the Mint and, ultimately, the government.").

45. *Id.*

46. Since 2007, for example, the government has received more than \$680 million in seigniorage profits as a result of its "gold" dollar program. As part of that program, Congress directed the Treasury to mint 2.4 billion "dollar coins," which cost taxpayers about \$720 million to produce. By selling \$1.4 billion of these dollar coins to the public at face value, the government has made about \$680 million in profit. *Id.* (also discussing the Federal Reserve's resistance to purchasing these dollar coins).

before and continues to do so to some degree even today.

II. THE FEDERAL RESERVE AND PRIVATE BANK MONEY CREATION SYSTEM

A. *The Federal Reserve's Monetary Powers and Policy*

According to its former Chairman, Alan Greenspan, the Federal Reserve enjoys an “unlimited power to create money.”⁴⁷ Congress granted this power to the Federal Reserve in Section 16 of the original Federal Reserve Act of 1913, which provided:

Federal Reserve notes, *to be issued at the discretion of the Federal Reserve Board* for the purpose of making advances to Federal reserve banks through the Federal reserve agents as hereinafter set forth and for no other purpose, are hereby authorized. The said notes shall be obligations of the United States and shall be receivable by all national and member banks and Federal reserve banks and for all taxes, customs, and other public dues.⁴⁸

The modern provision is nearly identical, except that the Federal Reserve's discretionary power to create Notes is even less restricted today than it was in 1913 because the Act no longer requires the Federal Reserve to maintain a 40% reserve in gold for all notes issued.⁴⁹

The Federal Reserve creates, loans, or spends legal tender money into existence through a variety of mechanisms, including the discount window and open market operations.⁵⁰ The discount window is not a

47. Greenspan, *supra* note 15, at 4 (noting relatedly that this power implicates inflation: “[I]f central banks effectively insulate private institutions from the largest potential losses, however incurred, increased laxity could threaten a major drain on taxpayers or produce inflationary instability as a consequence of excess money creation”).

48. Federal Reserve Act, 38 Stat. 251, 265 (1913) (current version at 12 U.S.C. § 411 (2013)) (emphasis added).

49. See 12 U.S.C. § 411 (2013). The original 1913 provision provided that the Federal Reserve Notes “shall be redeemed in gold on demand at the Treasury Department of the United States, in the city of Washington, District of Columbia, or in gold or lawful money at any Federal reserve bank.” Federal Reserve Act, 38 Stat. 251, 265 (1913), available at http://www.constitution.org/uslaw/sal/038_statutes_at_large.pdf. To ensure that the Federal Reserve could meet this convertibility requirement, Congress originally required it to maintain a 40% reserve in gold against Notes actually in circulation and a 35% reserve, also in gold, against its deposits. In addition, it was required to keep a reserve with the Treasury of the United States equal to not less than 5% of Notes outstanding, but this reserve could be counted as part of the 40% requirement. Federal Reserve Act, 38 Stat. 251, 266 (1913); see also CARL H. MOORE, THE FEDERAL RESERVE SYSTEM: A HISTORY OF THE FIRST 75 YEARS 35-37 (1990). This restriction was eliminated in 1935 along with the convertibility requirement.

50. MOSS, *supra* note 16, at 62-64. The third classic monetary tool of the Federal Reserve is the power to set private bank's reserve rates. Because the Federal Reserve does not directly create or destroy money when it adjusts private banks' reserve rates, rather it allows

literal window, but the mechanism through which the Federal Reserve Banks loan created money to banks in exchange for “discounted” assets, which the banks pledge as collateral. Traditionally, banks would pledge commercial paper (i.e., business loans owned by the banks) in exchange for the created funds.⁵¹ Today, the Federal Reserve through its various “lending facilities” accepts an increasingly broad array of assets, including the mortgage-backed securities that collapsed in trading value during the 2008 financial crisis, as collateral for its loans of created money.⁵²

The Federal Reserve also uses created money to *purchase* assets through so-called “open market operations.” The Federal Open Market Committee (FOMC) conducts these outright purchases of assets (to expand the money supply) and sales of assets so purchased (to contract the money supply). Traditionally, the FOMC used created money to purchase short-term government debt instruments, thereby not only manipulating the money supply, but also indirectly supporting federal deficit spending.⁵³ Since 2008, however, the FOMC has used Congress’s sovereign power to create money to embark on a historically unprecedented program of “quantitative easing” (QE).⁵⁴

QE is a technical-sounding (and obscuring) term for Central Bank’s increasingly popular practice of creating money “out of thin air” to buy up a wide range of privately held financial instruments.⁵⁵ Since December 2008, the Federal Reserve has “eased” into existence more than \$3 trillion through various programs, more than three times the amount spent on the Recovery Act during the same period.⁵⁶ These

the banks to create more or less money; that power and its relevance to the fiscal spending debate is discussed separately below.

51. RONNIE J. PHILLIPS, *THE CHICAGO PLAN & NEW DEAL BANKING REFORM* 15-18 (1995) (noting that this approach was consistent with the classic “real bills” doctrine, which held that banks should loan money only to facilitate bona fide commercial transactions, which were believed to be inherently less risky than other loans, such as real estate loans).

52. See U.S. GOV’T ACCOUNTABILITY OFF., *supra* note 32 (providing lists of assets accepted as collateral in exchange for Fed-created loans in the wake of the 2008 crisis).

53. MOORE, *supra* note 49, at 39.

54. For full audit report on the Federal Reserve’s activities in the wake of the financial crisis, see U.S. GOV’T ACCOUNTABILITY OFF., *supra* note 32.

55. For a broad discussion of post-2007 central bank quantitative easing, see *Controlling Interest*, *ECONOMIST* (Sept. 21, 2013), <http://www.economist.com/news/schools-brief/21586527-third-our-series-articles-financial-crisis-looks-unconventional> (explaining, for example, “[p]rinting money to buy assets is known as ‘quantitative easing’ (QE) because central banks often announce purchase plans in terms of a desired increase in the quantity of bank reserves”).

56. The Federal Reserve’s “balance sheet” expanded from \$925.10 trillion in January 2008 to \$3,504.10 trillion in July 2013. *Monetary Policy Report*, Bd. of Governors of the Fed. Reserve Sys. (July 17, 2013), <http://www.federalreserve.gov/monetarypolicy/mpr-20130717-part2-accessible.htm#fig47>; see also *Factors Affecting Reserve Balances*, FED. RESERVE,

programs include: QE 1, which lasted from November 2008 to November 2010, and through which the Federal Reserve spent \$600 billion in created money to purchase agency mortgage-backed securities from struggling financial firms; QE 2, whereby the Federal Reserve credited member banks reserve accounts with \$75 billion per month in unilaterally invented money between November 2010 and June 2011; and now QE 3, whereby the Federal Reserve spent into existence \$85 billion per month from December 2012 to December 2013, followed by the QE3 “taper,” through which the Federal Reserve created and spent \$75 billion into the money supply in January 2014, \$65 billion per month in February and March 2014, and plans to spend \$55 billion into existence per month from April 2014 until at least June 2014.⁵⁷

<http://www.federalreserve.gov/releases/h41/> (last visited May 14, 2014). By the end of January 2014, the Federal Reserve’s balance sheet expanded to \$4 trillion. *Monetary Policy Report*, Bd. of Governors of the Fed. Reserve Sys. (Feb. 11, 2014), http://www.federalreserve.gov/monetarypolicy/files/20140211_mprfullreport.pdf (last visited May 14, 2014). The balance sheet is one way of tracking how much money the Federal Reserve has printed into the economy over time. As a balance sheet, the Federal Reserve’s assets and liabilities must always match. When the Federal Reserve creates currency out of nothing and spends or loans it out, it “credits” the liabilities side of the balance sheet (Federal Reserve Notes in Circulation or Deposits of Depository Institutions when the created cash is deposited in the member banks’ reserve accounts with the Federal Reserve). At the same time, it “debits” the asset side of the balance sheet with an entry representing whatever it receives in exchange for the created money (for example, treasury securities or mortgage-backed securities). Thus, if the Federal Reserve creates \$100 billion to buy U.S. Treasury bills from the public, the balance sheet will “expand” by \$100 billion. Specifically, the Federal Reserve will credit the liabilities side of the balance sheet with \$100 billion (if it used physical cash to make the purchase, it would credit the Federal Reserve Notes in Circulation “account”; if it used newly created electronic money to purchase the securities, it would credit the deposits of depository institutions account). At the same time, the Federal Reserve would debit Treasury Securities account on the assets side of the balance sheet with \$100 million dollars. By contrast, if the Federal Reserve simply sold Treasury securities it already owned to owners of mortgage-backed securities (MBS) in exchange for those MBS, without creating any new money, the sums of two of the asset accounts would change in value, but the overall entry for assets would not change and the balance sheet would not “expand” or “contract.”

57. Mark Gertler & Peter Karadi, *QE 1 vs. 2 vs. 3 . . . A Framework for Analyzing Large Scale Asset Purchases as a Monetary Policy Tool*, FED. RESERVE (Mar. 2012), <http://www.federalreserve.gov/Events/conferences/2012/cbc/confpaper1/confpaper1.pdf>; *The Federal Reserve’s response to the financial crisis and actions to foster maximum employment and price stability*, FED. RESERVE, http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm (describing these measures in more detail) (last visited May 14, 2014). For a thoughtful critique of Central Banks’ newfound endorsement of non-standard monetary policy, see Andrew Bowman et al., *Central Bank-Led Capitalism?*, 36 SEATTLE U. L. REV. 455, 481 (2013) (characterizing the central bank response as an “on-going system of bank welfare”). As to taper figures, see Press Release, Bd. of Governors of the Fed. Reserve Sys. (Dec. 18, 2013), available at <http://www.federalreserve.gov/newsevents/press/monetary/20131218a.htm>; Press Release, Bd. of Governors of the Fed. Reserve Sys. (Jan. 29, 2014), available at <http://www.federalreserve.gov/newsevents/press/monetary/20140129a.htm>; Press Release, Bd. of Governors of the Fed. Reserve Sys. (Mar. 19, 2014), available at <http://www.federalreserve.gov/newsevents/press/monetary/20140319a.htm>.

Even though the Constitution vests the power to create legal tender money exclusively in Congress, the Federal Reserve's money creation is considered legal (or at least non-justiciable) because courts treat the Federal Reserve Act as a delegation of Congress's sovereign monetary power to the Federal Reserve. For example, in *Milam v. United States*, the Ninth Circuit affirmed the legitimacy of Federal Reserve Notes as legal tender because "[t]he power so precisely described in [*Greenman*] has been delegated to the Federal Reserve System under the provisions of 12 U.S.C. § 411."⁵⁸ Similarly, in *Walton v. Keim*, the Colorado Court of Appeals dismissed a taxpayer's protest suit challenging the legitimacy of Federal Reserve Notes, explaining that "Congress has exercised [its power to declare things other than gold or silver legal tender for all debts] by delegation to the federal reserve system." Therefore, "[f]ederal reserve notes are legal tender for all debts, including taxes."⁵⁹

Some have challenged this delegation of sovereign powers to a quasi-private entity as a violation of the Appointments Clause of the Constitution,⁶⁰ given that (1) many of the voting members of the Federal Open Markets Committee are not appointed by the President with the advice and consent of the Senate and (2) anyone with the discretionary power to create legal tender must be an "Officer of the United States." Although these challenges appear at least colorable, none have succeeded, with most being dismissed on political question or standing grounds.⁶¹

58. 524 F.2d 629, 630 (9th Cir. 1974) (relying on the following passage from *Juilliard v. Greenman*, discussed in Part I, see *supra* text accompanying notes 22-24, "[u]nder the power to borrow money on the credit of the United States, and to issue circulating notes for the money borrowed, its power to define the quality and force of those notes as currency is as broad as the like power over a metallic currency under the power to coin money and to regulate the value thereof. Under the two powers, taken together, Congress is authorized to establish a national currency, either in coin or in paper, and to make that currency lawful money for all purposes, as regards the national government or private individuals").

59. 694 P.2d 1287, 1289 (Colo. Ct. App. 1984) (collecting cases in support of its contention that the illegality of paper money had been rejected by every federal and state appellate court to have considered it in the preceding fifty years).

60. U.S. CONST. art. II, § 2, cl. 2 provides:

[The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

61. See *Riegle v. Fed. Open Mkt. Comm.*, 656 F.2d 873, 882 (D.C. Cir. 1981) ("We hold that Senator Riegle has standing to bring this action [challenging constitutionality of private appointment of members of the Federal Open Market Committee] but exercise our equitable discretion to dismiss the case on the ground that judicial action would improperly

And so, we come face to face with the uncomfortable tension hidden but endemic in contemporary law and discourse regarding America's fiscal/monetary system. On the one hand, as discussed at the outset, we live in a moment of enormous anxiety about federal debt and deficits. Harnessing this anxiety, Congress has insisted that serious cuts to federal spending are necessary to make America great again and save our children from some unspeakable fiscal nightmare. Both major political parties appear to agree that cuts to essential social safety programs, including the Food Stamps program, are a necessary evil on the road to the ultimate good of a "balanced budget." Whenever the prospect of creating money to finance fiscal spending is raised, Congress and voters cry 'inflation!' and move on to other topics. And, yet, at the same time, the Federal Reserve is exercising Congress's sovereign power to create legal tender money to spend into existence tens of billions of dollars a month on top of the money it otherwise creates to purchase short-term government securities through the Federal Open Market Committee's traditional operations. To make matters more absurd, the Federal Open Market Committee has cited the recession-inducing efforts of Congress's new fiscal restraint as justification for its continued expansionary money-creation activities.⁶² In other words, the

interfere with the legislative process."); *Comm. for Monetary Reform v. Bd. of Governors of Fed. Reserve Sys.*, 766 F.2d 538, 539 (D.C. Cir. 1985) (private businesses and individuals who allegedly have suffered financial damage as a result of the money supply policies of the Federal Reserve System did not have standing to raise constitutional challenges to the exercise of power by the System and to the composition of one of its elements, the Federal Open Market Committee); *Reuss v. Balles*, 584 F.2d 461, 462 (D.C. Cir. 1978) (Congressman lacked standing as legislator or bondholder to sue seeking declaratory and injunctive relief from the allegedly unconstitutional composition of the Federal Open Market Committee, an integral component of the Federal Reserve System). One District Court did reach the merits of a Senator's Appointment Clause claim against the FOMC, holding that the selection of the FOMC's "Reserve Bank members" by private individuals, rather than by President, did not violate the Constitution. *Melcher v. Federal Open Market Committee*, 644 F.Supp. 510, 517-24 (D.D.C. 1986). On appeal, however, the D.C. Circuit affirmed the dismissal on the alternative ground that the court should have exercised its equitable discretion not to hear the case. *Melcher v. Fed. Open Mkt. Comm.*, 836 F.2d 561, 562 (D.C. Cir. 1987).

62. See, e.g., Press Release, Bd. of Governors of the Fed. Reserve Sys. (May 1, 2013), available at <http://www.federalreserve.gov/newsevents/press/monetary/20130501a.htm> (noting that "fiscal policy is restraining economic growth," and concluding that "[t]o support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate" the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of \$40 billion per month and longer-term Treasury securities at a pace of \$45 billion per month); see also *BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT 9* (July 17, 2013), available at http://www.federalreserve.gov/monetarypolicy/files/20130717_mprfullreport.pdf (reporting that: "[F]iscal policy changes—including the expiration of the payroll tax cut, the enactment of other tax increases, the effects of the budget caps on discretionary spending, the onset of

Federal Reserve is exercising Congress's sovereign power to print money to stimulate the economy, at least in part, *because* Congress is refusing to do so itself.

B. *Private Banks' Monetary Powers and Policy*

The Federal Reserve is not the only institution creating new money and loaning or spending it into the economy. Under the legal status quo, private commercial banks are also permitted to create money or at least its very close equivalent.⁶³ Indeed, most of the money in the money supply has been created not by Congress and not (at least directly) by the Federal Reserve, but by private banks.⁶⁴ As of February 2014, the Federal Reserve reported that the broad money supply (known as "M-2"), which includes deposits in checking and savings accounts, equaled

the sequestration, and the declines in defense spending for overseas military operations—are estimated, collectively, to be exerting a substantial drag on economic activity this year”).

63. Unlike United States Notes and Federal Reserve Notes, the “money” created by banks is not itself legal tender. See 31 U.S.C. § 5103 (2013) (United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) are legal tender for all debts, public charges, taxes, and dues). *But see In re Reyes*, 482 B.R. 603, 606 (D. Ariz. 2012) (“[A]n interpretation of [§ 5103] to forbid all but cash payments ‘would strain logic.’”); *Genesee Scrap & Tin Baling Co., Inc. v. City of Rochester*, 558 F. Supp. 2d 432, 436 (W.D.N.Y. 2008) (ordinance requiring payments by check for purchases of scrap metal was not in conflict with § 5103 because it did not “attempt to confer legal-tender status upon checks, nor d[id] it deem cash not to be legal tender.” Instead, “[a]ll that the Ordinance does is specify the form in which payments for a particular category of transactions are to be made. The buyer must pay by check, but that check is a promise of payment in legal tender, upon presentation of the check to a bank.”). As a practical matter, however, bank account (demand deposit) money is nearly identical to legal tender because it is nearly always and everywhere convertible at par for legal tender, including for Federal Reserve Notes. Moreover, unlike private bank notes of the past, which were convertible to specie on demand as long as the bank maintained sufficient specie reserves to pay noteholders, modern bank account money is protected by the government, such that the likelihood of bank account money losing its convertibility to legal tender money is virtually nil. These protections include Federal Depository Insurance and the Federal Reserve System itself, which is authorized to loan created money to banks (in exchange for appropriate collateral) when no one else will loan currency to the banks.

64. See RICHARD S. THORN, INTRODUCTION TO MONEY AND BANKING 85-104 (1976) (explaining private banks' role in the creation of money and noting “[d]emand deposits of commercial banks . . . are by far the largest component of the money supply”). LASTRA, *supra* note 26, at 30-32 (“Commercial banks have an important role in the process of money creation: current accounts (demand deposits) are used as means of payment. Demand deposits constitute the major part of the narrow definition of the money supply (M1). This characteristic of bank liabilities provides the rationale for many monetary and banking laws and regulations. The role of banks and other private financial institutions in the creation of money cannot be underestimated.”); Wray, *supra* note 20, at 42 (“[M]ost money used in modern society is issued by private financial institutions.”).

\$11.103 trillion.⁶⁵ For the same month, the monetary base, which consists of all currency physically held by the public and bank reserves, was \$3.728 trillion.⁶⁶ Thus, as of February 2014, private banks were responsible for transforming \$3.833 trillion in monetary base into \$11.088 trillion in money supply. Private banks create this money through fractional-reserve banking and a process referred to, somewhat euphemistically, as the “money-multiplier” effect.⁶⁷

It works like this: Individual A deposits \$100 into a checking account at a private commercial bank (Bank 1). The Federal Reserve has set the reserve rate at 10%. Therefore, Bank 1 need only retain \$10 of A’s deposit and can loan out or invest the remaining \$90. Assuming the bank will seek to make as much money as possible (and it turns out we actually cannot assume that),⁶⁸ the bank lends out \$90 of A’s initial \$100 deposit to B. Bank 1 can charge B whatever interest rate B is willing to pay and Bank 1 gets to keep that money (as well as any collateral on the loan should B fail to repay Bank 1). Meanwhile, A continues to behave and believe that she has \$100 in her account at Bank 1 and can withdraw that money at any time. B takes the \$90 loan and uses it to purchase goods or services from C. C deposits his \$90 in a new bank (Bank 2). Bank 2 (also subject to the 10% reserve rate) is now legally permitted to use \$81 of C’s deposit to purchase some mortgage-backed securities from D. D, ecstatic to get those virtually unsellable mortgage-backed securities off his hands, goes to deposit his \$81 into a checking account at Bank 3. Bank 3 is happy to have the money because

65. *Federal Reserve Statistical Release: Money Stock Measures*, FED. RESERVE, <http://www.federalreserve.gov/releases/h6/current/> (defining M1 and M2 monetary aggregates) (last visited May 14, 2014).

66. *Table 1-3*, FED. RESERVE (Feb. 6, 2014), <http://www.federalreserve.gov/releases/h3/current/h3.htm#a121-53b9045f5>. The monetary base consists of (1) total required reserves plus (2) the currency component of the money stock plus (3) excess reserves.

67. THORN, *supra* note 64, at 85-104.

68. The money multiplier assumes that banks will loan out or invest as much money as the Federal Reserve (or other applicable regulator) permits them to lend. In reality, however, banks, especially in the wake of the financial crisis, do not always lend out the maximum amount of deposits permitted by law. Instead, banks often retain “excess reserves.” *See Aggregate Reserves of Depository Institutions and the Monetary Base-H.3*, BD. OF GOV. FED. RESERVE (Feb. 20, 2014), <http://www.federalreserve.gov/releases/h3/current/> (Federal Reserve report quantifying nominal value of excess reserves currently held by banks and showing that as of October 2013, banks held \$73,111 million in required reserves, and \$2,301,847 million in excess reserves). Economists refer to these excess reserves as well as the reality that individuals sometimes prefer to hold their money in cash as “leakages.” There are various theories to explain these leakages, including that banks in an artificially low interest rate environment, such as the current one supported by the Fed’s expansive monetary policies, prefer to wait until interest rates go up before they loan out excess reserves. If the banks wait to loan out their excess reserves until interest rates increase, banks will be able to charge borrowers more for the same loans and receive higher profits.

that means it can now loan out or otherwise spend \$72.90 of D's cash however it sees fit. As this process continues, the \$100 initially deposited into Bank 1 will be expanded into \$1000 (assuming a reserve rate of 10%). In other words, the private banking system will have taken \$100 in new money (narrow money) and created an additional \$900 in credit money (broad money).⁶⁹

Banks have engaged in this practice of creating effective money for centuries.⁷⁰ Initially, banks created effective money or money substitutes by printing and lending out bank notes nominally convertible to specie (i.e., gold or silver). This process expanded the money supply because the banks created bank notes with nominal values well in excess of their stores of specie. In other words, because the banks chose to maintain less specie than would be necessary to redeem all of their outstanding notes at any given time, they could "expand" a certain amount of gold into a quantity of bank notes with a nominal value many times in excess of the bank's specie holdings.⁷¹

In the United States, this practice became less frequent, at least at the state level, when Congress placed a punitive tax on state-chartered banks' notes during the Civil War in an effort to increase demand for the Treasury's Greenbacks. Adapting to this restriction, banks turned their efforts to checkable demand deposit accounts (checking accounts) as a means of keeping the game (or "money multiplying") going.⁷²

If you are a lawyer or law student and this is the first time you have read about how banks create money, you might be asking yourself how this practice could possibly reconcile with the principles of the common law of property, trusts, contracts, bailments, agency, and/or torts.⁷³ You

69. THORN, *supra* note 64, at 85-104. There is even an equation to calculate how much bank-created money the Federal Reserve can expect based on the reserve rate: $m=1/R$. Where m is the "money multiplier" and R is the reserve requirement. Thus, where the reserve ratio is 10/100, $m = 1/10/100$ or 10/1 or 10. This means that for any dollar invented by the Federal Reserve (or coined by Congress) and deposited into the banking system, the private banks will—or at least can—loan or spend \$10 into the economy.

70. See generally MARION ARCHIBALD ET AL., MONEY: A HISTORY 34-35 (Jonathan Williams ed., 1997); GRAEBER, *supra* note 11; HIXSON, *supra* note 32; WHALEN, *supra* note 40, at 1-28.

71. For a concise history of the evolution of money creation in the United States, including privately-created money, see Khan, *supra* note 22, at 408, 430 (noting role of bank notes as dominant medium of exchange in the United States prior to the Civil War).

72. PHILLIPS, *supra* note 51, at 13-15.

73. Of course, the textbook description of commercial banking explains the process as a simple fee-for-services arrangement. Professor Thorn, for example, describes commercial banks as socially beneficial financial intermediaries connecting those with "surplus-spending units" with those with "deficit-spending units" and earning a legitimate profit on the spread between the income generated from loans and the expenses paid to depositors. THORN, *supra* note 64, at 27-46. This characterization of the role of commercial banks is not inconsistent

would not be the first to so wonder. Bank practices of creating money through reserve banking has garnered many legal contests over the years, including some successful early challenges.⁷⁴ After some initial resistance, however, courts decided, in many cases more than a century ago, that—assuming no agreement to the contrary between the parties—banks could legally create “money” out of other peoples’ money through fractional reserve banking and keep the profits associated with that process for themselves.

As the Supreme Court put it in 1905 in *Burton v. United States*:⁷⁵

The general transaction between the bank and a customer in the way of deposits to a customer’s credit, and drawing against the account by the customer, constitute the relation of creditor and debtor. . . . “It is an important part of the business of banking to receive deposits; but when they are received, unless there are stipulations to the contrary, they belong to the bank, become part of its general funds, and can be loaned by it as other moneys. The banker is accountable for the deposits which he receives as a debtor, and he agrees to discharge these debts by honoring the checks which the depositor shall, from time to time, draw on him. The contract between the parties is purely a legal one, and has nothing of the nature of a trust in it. This subject was fully discussed by Lords Cottenham, Brougham, Lyndhurst, and Campbell in the House of Lords in the case of *Foley v. Hill*, 2 H. L. Cas. 28, and they all concurred in the opinion that the relation between a banker and customer, who pays mo[n]ey into the bank, or to whose credit money is placed there, is the ordinary relation of debtor and creditor, and does not partake of a fiduciary character, and the great weight of American authorities is to the same effect.”⁷⁶

Because the bank takes “title” to the moneys once they are

with the contention that banks create money through the very process of loaning out depositors’ money. THORN, *supra* note 64, at 41 (characterizing the banking system as having “dual functions – creating money and acting as a financial intermediary”). It is also not inconsistent with the view that the practice of accepting money from those with surplus-spending units and loaning it to those with deficit-spending units might be inconsistent with the deep principles of the common law to the extent that a depositor does not realize that she is giving up title to her money when she deposits it into a checking account and instead believes she is giving cash to the bank to keep safe for her later withdrawal. For additional discussion of money and credit in “intermediation,” see ARIE ARNON, *MONETARY THEORY AND POLICY FROM HUME AND SMITH TO WICKSELL: MONEY, CREDIT, AND THE ECONOMY* 161-67 (Craufurd D. Goodwin ed., 2011).

74. See *Rights of Depositor on Failure of Collecting Bank*, 48 *BANKING L.J.* 361 (1931) [hereinafter *Rights of Depositor*] (providing a review of successful and unsuccessful cases).

75. 196 U.S. 283, 301-02 (1905).

76. *Id.* (quoting Mr. Justice Gray, in *National Bank of the Republic v. Millard*, 19 L. Ed. 897, 899 (1869), in speaking of this relationship).

deposited, the depositor no longer owns the money as a matter of law, and the bank can loan it out or spend it as it pleases.⁷⁷ If the bank manages its deposits unwisely and therefore lacks sufficient reserves to honor a depositor's request for a withdrawal from "his" account, the depositor cannot claim that the bank has converted (or stolen) his money or committed a tort (in the vein of damaging bailed property) by mismanaging his deposited property. The depositor cannot even claim that the bank breached its fiduciary duty to the depositor by imprudently or disloyally using the deposited money. Instead, the depositor stands before the bank as a general unsecured creditor, unless he negotiated some special terms with the bank in advance of his deposit. While this treatment of the relationship between a depositor and bank might seem to strain the limits of credulity, or at least strain the principles of the common law, courts had to treat the relationship as such if fractional-reserve banking was to be considered legal.⁷⁸

The contemporary case of *Texas State Bank v. United States* provides a somewhat amusing take on this body of law.⁷⁹ There, Texas State Bank took issue with the *Burton v. United States* line of authority after it was forced by Congress to deposit its reserves with a Federal Reserve Bank. The Texas State Bank argued that the Federal Reserve's earnings on its deposited reserves belonged to it as a matter of law because "interest follows principal."⁸⁰ The Court dismissed the complaint on the merits for failure to state a claim after explaining to the

77. See, e.g., *Rights of Depositor*, *supra* note 74, at 363 (quoting Jordan, C.J. in *Union Nat'l Bank v. Citizens' Bank*, 54 N.E. 97, 100 (1899)) ("The rule which prevails and is generally recognized in regard to bank deposits is that where a deposit is made in a bank in the ordinary course of business, either of money, or of drafts or checks received and credited as money, the title to the money or to the drafts and checks deposited, in the absence of any special agreement or direction, passes to the bank, and the relation of debtor and creditor arises between the depositor and the bank, without any element of a trust entering into the case. The bank, in such cases acquires title to the money, checks, or drafts deposited, upon the implied agreement upon its part to pay full consideration for the same when called upon by the depositor in the usual course of business.").

78. See, e.g., 8 C.J.S. BAILMENTS § 16 (1988) ("A deposit of money by one person with another for safekeeping, and either to be returned to the depositor or paid out on instructions of the depositor, is a bailment, and if no provision exists or is contemplated for payment of the bailee for the service rendered the bailment is gratuitous."); 46 AM. JUR. PROOF OF FACTS 3D 361 (1998) ("It is well-settled that once a bailment contract is created between a bailor and bailee, either expressly or by implication, the bailee is charged with a duty of care to protect the bailed property from damage or loss. Although the precise level of care required of the bailee can vary with the circumstances and nature of the bailment, when damage, loss or theft of the bailed property results from the bailee's failure to exercise due care, the bailee may be held liable to the bailor for damages in an action for breach of bailment contract and/or negligence.").

79. 423 F.3d 1370, 1378 (Fed. Cir. 2005).

80. *Id.* at 1374 (citation omitted).

Bank (an entity that had obviously benefitted from this rule for more than a century) that it gave up title to the subject moneys when it deposited them into the Federal Reserve's accounts, and that, as such, the bank had no property interest in the income generated by the Federal Reserve through its open market operations.⁸¹

C. *Congress and the Federal Reserve's Roles in Sanctioning and Regulating Bank-Created Money*

Prior to 1913, Congress did not directly restrict or support private banks' practice of creating money. Over the course of the last 100 years, however, Congress has become increasingly involved in banks' money-creation practices, both extending legal protections to money created through the process of fractional-reserve banking and subjecting banks to certain federal controls, including reserve rates and capital requirements, designed to protect depositors and the economy from the instability associated with fractional-reserve banking.⁸²

Although Congress, as a monetary sovereign, could have responded to public concerns over bank panics and economic instability by restricting banks' arguably inherently destabilizing money-creation practices, it chose reforms that permitted the practice to continue largely unfettered. For example, the bank-runs associated with the Panic of 1907 are widely credited with creating the political support for the Federal Reserve Act.⁸³ Yet, the Federal Reserve Act of 1913 did not restrict private banks' power to create effective money. Instead, the Act attempted to prevent bank runs by positioning the Federal Reserve as a "lender of last resort" and allowing the Federal Reserve to loan printed money to any member banks that lacked sufficient reserves to meet depositors' withdrawal demands.⁸⁴

When even this fairly dramatic intervention failed to prevent

81. *Id.*

82. Jaromir Benes & Michael Kumhof, *The Chicago Plan Revisited 5* (International Monetary Fund Working Paper No. WP/12/202, 2012), available at <http://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf> (concluding that fractional-reserve banking contributes to the boom and bust cycle and explaining that "[i]n a financial system with little or no reserve backing for deposits, and with government-issued cash having a very small role relative to bank deposits, the creation of a nation's broad monetary aggregates depends almost entirely on banks' willingness to supply deposits. Because additional bank deposits can only be created through additional bank loans, sudden changes in the willingness of banks to extend credit must therefore not only lead to credit booms or busts, but also to an instant excess or shortage of money, and therefore of nominal aggregate demand.").

83. PHILLIPS, *supra* note 51, at 15-18; *see also*, THORN, *supra* note 64, at 330-33; THOMAS WILSON, *THE POWER 'TO COIN' MONEY: THE EXERCISE OF MONETARY POWERS BY THE CONGRESS 179-186*, 208 (1992).

84. PHILLIPS, *supra* note 51, at 15-18.

destabilizing bank runs in the wake of the stock market crash of 1929, Congress and the President again intervened and again declined to meaningfully restrict the power of banks to create money. In 1933, after several states unilaterally shut down banks to stop widespread bank runs, Franklin D. Roosevelt's first act as President was to sign an executive order declaring a national bank "holiday," immediately shutting banks across the nation.⁸⁵ At the same time, he called an emergency joint session of Congress, which after fourteen days passed the Emergency Banking Act of 1933.⁸⁶ Several other major banking and Federal Reserve reforms would soon follow.

These New Deal banking reforms further legitimized banks' money creation by implementing federal deposit insurance for the first time.⁸⁷ While not expressly designating accounting entries in bank deposit accounts to be legal tender, this insurance made clear to all that those entries (at least up to a certain account balance) would be converted to legal tender (i.e., government-produced currency) even in the event of bank insolvency.⁸⁸ As a result, the New Deal legislation extended near-legal tender status to money unilaterally created by private banks, even though Congress had no direct control over when or how the banks created or destroyed this legally protected money.

With the passage of the Bank Act of 1935, Congress gave the Federal Reserve the power to set the minimum reserve rates of its member banks and thereby limit how much money certain private banks could create.⁸⁹ This reform was proposed by advocates of the Chicago

85. WILSON, *supra* note 83, at 209.

86. WILSON, *supra* note 83, at 209.

87. PHILLIPS, *supra* note 51, at 56-57.

88. PHILLIPS, *supra* note 51, at 56-57. ("Deposit insurance made banks 'safe' not by direct restrictions on their assets, but rather by the promise that the government would guarantee a percentage of the deposits in *all* banks, both good and bad.") (emphasis added); see also Morgan Ricks, *A Regulatory Design for Monetary Stability*, 65 VAND. L. REV. 1289, 1290-91 (describing core regulatory techniques of the depository sector since the establishment of the Federal Deposit Insurance Corporation (FDIC) in 1933 and concluding, "[i]n short, U.S. depository banks operate under a public-private partnership regime.")

89. PHILLIPS, *supra* note 51, at 56-57. The Federal Reserve Bank of St. Louis explains this tool as follows:

Reserve requirements are the portions of deposits that banks must hold in cash, either in their vaults or on deposit at a Reserve Bank. A decrease in reserve requirements is expansionary because it increases the funds available in the banking system to lend to consumers and businesses. An increase in reserve requirements is contractionary because it reduces the funds available in the banking system to lend to consumers and businesses. The Board of Governors has sole authority over changes to reserve requirements. The Fed rarely changes reserve requirements.

Plan, a plan originally introduced by several economists at the University of Chicago and later championed by economist Irving Fischer to prevent bank runs and promote monetary stability by requiring, among other things, 100% reserve banking for all deposit accounts.⁹⁰ Advocates concluded that it would be politically unfeasible to directly legislate 100% reserve rates for private banks, so they drafted legislation amending the Federal Reserve Act to allow the Federal Reserve to set member banks' reserve rates.⁹¹

The Federal Reserve was quick to exercise its new power to manipulate reserve rates, not to reduce the swings of the business cycle and prevent bank runs as the Chicago Plan advocates had envisioned, but rather to prevent inflation. In 1936, noticing a buildup of excess reserves much like those observed on banks' balance sheets today, the Federal Reserve doubled the existing reserve rates. It justified this move by claiming that it must take away banks' ability to convert those excess reserves into a flood of new money in order to prevent a sudden inflationary expansion in the money supply. The banks responded by withdrawing even more money from the money supply and restricting credit markets further. The Federal Reserve declined to offset this contraction in the money supply with a commensurate increase in the volume of government-created money. Not surprisingly, many experts credit this move with extending and worsening the Great Depression.⁹² In the wake of that widely panned experiment, the Federal Reserve has refrained from using its power to modify the reserve rates much, tinkering only at the margins and then usually to lower rates.⁹³

With the passage of the Monetary Control Act of 1980, the Federal

Educational Resources: How Monetary Policy Works, FED. RESERVE BANK OF ST. LOUIS, <http://www.stlouisfed.org/inplainenglish/howmonetarypolicyworks.cfm> (last visited May 14, 2014).

90. PHILLIPS, *supra* note 51, at 105-14.

91. PHILLIPS, *supra* note 51, at 125-28.

92. GALBRAITH, *supra* note 33, at 214-15 (noting that reserve requirements were increased to eliminate excess reserves after "some durably anxious officials considered what a huge volume of loans and deposits [the excess reserves] would sustain were they ever used" and that banks responded by stiffening interest rates and reducing outstanding loans, concluding that "[t]he combination of restrictive monetary policy and restrictive budget policy brought a sharp new recession within the arms, as it were, of a larger depression"); *see also*, e.g., Bruce Bartlett, *Are We About to Repeat the Mistakes of 1937?*, N.Y. TIMES ECONOMIX BLOG (July 12, 2011), http://economix.blogs.nytimes.com/2011/07/12/are-we-about-to-repeat-the-mistakes-of-1937/?_r=0 (blaming the recession of 1937 and 1938 on a premature combination of fiscal and monetary tightening including the Federal Reserve's decision to double reserve requirements leading to a restriction in credit markets).

93. *See Historical Changes of the Target Federal Funds and Discount Rates*, FED. RESERVE BANK OF N.Y., <http://www.newyorkfed.org/markets/statistics/dlyrates/fedrate.html> (listing the historical reserve rates since 1971) (last visited May 14, 2014).

Reserve gained the power to set reserve rates for all banks operating in the United States (not just nationally-chartered Federal Reserve member banks), but lost the discretion to modify the rates above 14%.⁹⁴ The current reserve rate is 0% for banks with “net transaction accounts” of less than \$13.3 million, 3% for banks with up to \$89 million, and 10% for banks with net transaction accounts in excess of \$89 million.⁹⁵ Net transaction accounts include demand deposit accounts (i.e., ordinary checking accounts).⁹⁶ Under current law, eligibility for the zero reserve rate (i.e., the “reserve requirement exemption”) and for the “low-reserve tranche” rate of 3% are set by statutory formula.⁹⁷ The reserve rate for time deposits and savings accounts is 0%.⁹⁸ The Federal Reserve retains the power to set the reserve rate for all other banks (i.e., banks with net transaction accounts in excess of the low-reserve tranche, currently \$89.9 million) at any rate between zero and 14%.⁹⁹ The last time it changed this rate, however, was in 1990, when it revised the reserve rate down from 12% to 10%.¹⁰⁰

As such, even though the Federal Reserve has not used this tool much recently, it retains the power to manipulate the volume of bank-created money, at least marginally, by adjusting the reserve rate for most banks.¹⁰¹

94. For background on this development as a response to member attrition, see Joshua N. Feinman, *Reserve Requirements: History, Current Practice, and Potential Reform*, FED. RESERVE BULLETIN 578 (June 1993), available at <http://www.federalreserve.gov/monetarypolicy/0693lead.pdf>. The Monetary Control Act of 1980 also created the reserve requirement exemption and low-reserve tranche categories, which are regulated directly by statute, and constrained the range of reserve rates the Federal Reserve could set for remaining banks. See 12 U.S.C. § 461(2)(A) (2013) (“Each depository institution shall maintain reserves against its transaction accounts . . . in a ratio of not greater than 3 percent (and which may be zero) for that portion of its total transaction accounts of \$25,000,000 or less, subject to subparagraph (C); and . . . in the ratio . . . not greater than 14 per centum (and which may be zero), for that portion of its total transaction accounts in excess of \$25,000,000 . . .”).

95. Bd. of Governors of the Fed. Reserve Sys., *Reserve Requirements*, FED. RESERVE (Nov. 5, 2013) [hereinafter *Reserve Requirements*], <http://www.federalreserve.gov/monetarypolicy/reservereq.htm>; see also 12 U.S.C. § 461 (2)(A) (2013).

96. *Reserve Requirements*, supra note 95.

97. *Reserve Requirements*, supra note 95.

98. *Reserve Requirements*, supra note 95.

99. *Reserve Requirements*, supra note 95.

100. *Reserve Requirements*, supra note 95.

101. As discussed in more detail *infra* Part III.A-B, the reserve rate is probably better understood as a powerful tool for siphoning privately-created money out of the economy rather than an effective means of siphoning or adding money to the money supply. This is because banks are permitted to keep reserves in excess of the reserve rate. Thus, if the Fed’s goal is to increase the money supply, lowering the reserve rate will not always work. By contrast, if the goal is to decrease the money supply, increasing the reserve rate above bank’s current reserves will always work, as long as the new reserve rate requires banks to hold more

III. TOWARD A NEW PARADIGM FOR THE FEDERAL SPENDING DEBATE

At present, Congress has ceded its constitutional role in the process of creating money to the Federal Reserve and private banks for so long and in such a manner that it (and the American people) seems to have forgotten that it was ever theirs to begin with. Under the cloud of this collective amnesia and confusion, voters and politicians are engaged in a high-stakes debate over the future role of government, with virtually all parties to the debate seeming to accept the legally, economically, and logically flawed premise that Congress must either cut some spending programs or raise taxes to reduce the federal debt and prevent America from “going broke.” While the erroneous basis of this debate alone might not merit further inquiry (as people routinely debate matters on flawed terms), the federal deficit debate and related pushes for austerity measures pose very real dangers to all those who benefit from federal spending and all taxpayers.

Therefore, at the least, Congress should be pressed to acknowledge and consider that: (1) it has the constitutional power to create money backed by nothing to directly finance its expenses; (2) it is allowing the Federal Reserve to create hundreds of billions of dollars a year in fiat legal tender money; (3) it is sanctioning and protecting private banks’ creation of many more trillions of dollars each year, with—as will be discussed presently—questionable public benefits and plausible public harm; and (4) consequently, any debate over how to cut the federal debt or deficits is in reality a debate about how Congress should exercise its sovereign power to create money and who should benefit from that power.

A. *This Fiscal/Monetary System is Not Economically or Politically Neutral in That It Creates Predictable Winners and Losers*

Perhaps Congress avoids framing the federal deficit and debt debate in terms of its monetary sovereignty because it would rather avoid the uncomfortable reality that, like nearly all policy decisions, *any* discretionary exercise of the sovereign power to create money, including a decision to continue on the present course or a decision to not exercise the power, will necessarily produce winners and losers.¹⁰² But,

reserves than they are electing to hold at the time of the increase. This phenomenon is sometimes referred to as the “pushing a string” problem.

102. In contrast to the framing proposed herein, the consensus quasi-Keynesian view as popularly endorsed by many politicians and central bankers allows policymakers to pretend that there is some monetary approach that produces only winners (i.e., flooding private banks with central-bank created money and pretending the government cannot create money to finance its expenses). This approach to monetary policy, as now widely practiced throughout

pretending this is not the case does not make it so. Indeed, the fact that the question presented so forcefully implicates the distribution of wealth and power in society makes it all the more important that voters and Congress face it head on.

1. Private Beneficiaries of the Status Quo

The Federal Reserve is currently exercising Congress's sovereign monetary powers to print trillions of dollars into existence, including \$55 billion per month in the latest round of quantitative easing.¹⁰³ Economists have noted that the popularity of this "new monetary ideology" probably turns not so much on its effectiveness in terms of monetary policy (which remains to be seen and is very much contested by experts), but on the fact that quantitative easing is "helpful to the financial services and those who work in them."¹⁰⁴ John Kay, a *Financial Times* commentator, explained the situation even more bluntly, concluding "[t]he one certain outcome of QE is that those with assets benefit relative to those without."¹⁰⁵

Meanwhile, Congress is almost literally taking food out of the mouths of the hungry to save \$5 billion a year and perennially threatening to order the Treasury to default on government obligations, risking further economic crisis, in the name of a problem that is entirely within its power to correct.

Perhaps not surprisingly then, the Centre for Research in Socio-Cultural Change (CRESC), at the University of Manchester, U.K., after examining the distributive effects of Central Banks' "nonstandard" monetary policies in the wake of the 2008 crisis, concluded that Central Banks have created "a new and hugely expensive system of bank welfare even as social welfare is being cut back in many debt-burdened countries

the world, is purportedly good for everyone because allowing central banks to print money and distribute it to private banks and allowing those private banks to create legally-protected money and profit richly off of that power drives down interest rates and thereby, eventually, increases aggregate investment *and* reduces unemployment. This popularly embraced view also conveniently justifies Congress's abdication of its role in deciding the fundamental policy question presented by characterizing the setting of monetary policy as an elaborate science, separate and apart from the work-a-day dealings of elected representatives.

103. See *supra* note 57 and the authorities cited therein; see generally *supra* Part II.A.

104. Robert Skidelsky, *Quantitative Easing: The New Monetary Ideology*, *ECONOMIST* (July 26, 2013), <http://www.economist.com/blogs/freeexchange/2013/07/quantitative-easing> (noting that quantitative easing is a newly loved means of stimulating the economy even though "no one is quite sure how it works").

105. John Kay, *Quantitative Easing and the Curious Case of the Leaky Bucket*, *FIN. TIMES*, July 9, 2013, <http://www.ft.com/intl/cms/s/0/6b0d5268-e7ba-11e2-babb-00144feabdc0.html#axzz2jzFy8EvT>.

like the United Kingdom.”¹⁰⁶ Under these new nonstandard monetary policies, “which put a floor under high levels of remuneration for investment bankers,” CRESC continues, “the order of priorities is investment bankers first, shareholders a poor second, and the public nowhere, even though taxpayers are either paying for or are liable for everything that the central bankers do.”¹⁰⁷

These benefits of the present monetary system to the financial sector are not limited to the post-2008 asset purchasing programs. Even before the 2008 financial crisis, when most of the Federal Reserve’s created money went to purchase federal debt instruments, the monetary system ensured that various “middlemen,” including banks and large investors, profited mightily from the government’s practice of essentially borrowing money from itself. Even one-time Federal Reserve Chairman, Marriner Eccles, found this aspect of the system “outrageous.”¹⁰⁸

106. Bowman et al., *supra* note 57, at 482.

107. Bowman et al., *supra* note 57, at 482 (explaining, among other things, how quantitative easing and other Central Bank “improvisations” have allowed the velocity of trading to continue even while the profitability of investment instruments has plummeted, benefitting investment bankers who are often paid based on the volume of activity, with little benefit to equity holders); *see also* Ricks, *supra* note 88, at 1303 (“It is no exaggeration to say that practically the entire emergency policy response to the recent crisis was aimed at stabilizing the market for private money-claims.”); Felix Salmon, *Chart of the Day: U.S. Financial Profits*, REUTERS-U.S. (Mar. 30, 2011), <http://blogs.reuters.com/felix-salmon/2011/03/30/chart-of-the-day-us-financial-profits/> (noting that financial industry profits are roaring back to more than 30% of all domestic US profits, which is “an amazing share given that the sector accounts for less than 10% of the value added in the economy”); Kathleen Madigan, *Like the Phoenix, U.S. Business Profits Soar*, WALL ST J., Mar. 25, 2011, <http://blogs.wsj.com/economics/2011/03/25/like-the-phoenix-u-s-finance-profits-soar/>; Lawrence Hunter, *Is the Federal Reserve Using Money Laundering Techniques to Cleanse Banks’ Balance Sheets?*, FORBES (Oct. 29, 2012), <http://www.forbes.com/sites/lawrencehunter/2012/10/29/are-federal-reserve-regulated-banks-laundering-dirty-money/>; *accord*, RON PAUL, END THE FED 14 (2009) (“What the largest banks desire is precisely what we might expect any large corporation to desire: privatized profits and socialized losses. The privatized profits come from successful loan activities, sometimes during economic booms. But when the boom turns to bust, the losses are absorbed by third parties and do not affect the bottom line. To cover losses requires a supply of money that stretches to meet bankers’ demands. This is something that every industry would like if they could get it. But it is something that the free market denies them, and rightly so.”).

108. Journalist William Greider characterized Chairman Eccle’s critique of this aspect of the monetary system, as follows:

The periodic Victory bond drives staged by Treasury [which are indistinguishable from any other Treasury security issues, for purposes of this critique] meant ‘outrageous profits’ for banks and large investors because the arrangement allows a daisy-chain exploitation of the Fed’s money creation. To ensure a successful bond sale and stable interest rates, the Fed expanded bank reserves by buying up outstanding government securities. The commercial banks lent the expanded money supply to private customers who would in turn lend it to the government by buying the new Treasury issues. The customers then sold

The Federal Reserve System itself (in contrast to the private banks that benefit from the Federal Reserve System) does not reap significant profits from its activities. Instead, it is required by statute to send 6% of its annual profits to its “owners” (private banks) as a dividend and the remainder of profits to the U.S. Treasury.¹⁰⁹ Of course, individuals within the Federal Reserve System can and do “profit” in other ways from the Federal Reserve’s power to create money. A 2011 General Accountability Office Audit of the Federal Reserve’s activities, for example, identified a widespread failure of the system to properly screen its employees for conflicts of interest and a troubling “revolving door” policy whereby employees of the Federal Reserve System and the private banking sector (where inside knowledge of Federal Reserve practices would be considered very valuable) frequently transferred between the two sectors.¹¹⁰

2. Claimed Public Benefits of the Status Quo

Proponents of the status quo tout its many supposed public benefits. For example, proponents argue that allowing private banks to create money through the practice of fractional-reserve banking ensures cheap credit for consumers and investors and “free” banking services.¹¹¹ If banks were required to maintain full (or even higher) reserves, they argue, they would *have* to charge customers higher interest rates on loans and fees for checking and settlement services.

Similarly, proponents of the Federal Reserve System note that the Federal Reserve is required by statute to exercise its power to create (and destroy) money to maximize employment and promote stable prices, goals that are at least presumably in the public interest. Proponents also

their new government securities to the commercial banks – and they eventually sold them back to the Fed when the central bank was again required to expand the money supply. In a roundabout way, the government was borrowing its own money – and paying a fixed fee to middlemen for the privilege.

WILLIAM GREIDER, *THE SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY* 323 (1988).

109. Bd. of Governors of the Fed. Reserve Sys., *Current FAQs: Who Owns the Federal Reserve?*, FED. RESERVE (Aug. 2, 2013), http://www.federalreserve.gov/faqs/about_14986.htm; Binyamin Appelbaum, *Fed Profit of \$88.9 Billion Sent to Treasury in 2012*, N.Y. TIMES, Jan. 10, 2013, http://www.nytimes.com/2013/01/11/business/economy/feds-2012-profit-was-88-9-billion.html?_r=0.

110. See U.S. GOV’T ACCOUNTABILITY OFF., *supra* note 32 (containing various recommended reforms to correct this situation).

111. See, e.g., PHILLIPS, *supra* note 51, at 181-89 (discussing pros and cons of 100% reserve banking); cf. Ricks, *supra* note 88, at 1292 (discussing “immense economic value” of depository banks and other money-claim issuers that channel economic agents’ pooled cash reserves into the capital markets, and “do so without compromising the ‘moneyness’ of those cash reserves”).

claim that the Federal Reserve can and has prevented economic crises, recessions, and depressions, by injecting the money supply with new money when necessary to stimulate economic activity. More broadly, proponents of the status quo argue that the System's supply of easy money ensures an elastic money supply, a "healthy" level of inflation, and "grease" for the economy, all of which enable maximum employment and flexible responses to financial and other economic shocks.

Of course, these arguments are only as persuasive as their factual predicates are accurate. Opponents of fractional-reserve banking point out that simple commercial banking services could be provided at minimal cost, for example at U.S. post offices, and that cheap credit could be supported by publicly created money just as well as by privately created money.¹¹²

Opponents of the Federal Reserve System point out that the macro-economy is far too complex to be predictable or singularly controlled.¹¹³ Opponents also argue (sometimes relatedly) that the Federal Reserve's actions have actually *caused* and contributed to economic crises in the past as often as they have prevented them and that the Federal Reserve's conduct is likely contributing to future financial instability even now.¹¹⁴

112. See generally PHILLIPS, *supra* note 51, at 40-41 (noting wide support, including Justice Louis D. Brandeis, for the expansion of the postal savings system to function as public banks). Senator Elizabeth Warren recently endorsed a similar idea as a remedy to a problem identified by the Office of the Inspector General: "68 million Americans . . . have no checking or savings account and are underserved by the banking system." Elizabeth Warren, *Coming to a Post Office Near You: Loans You Can Trust?*, HUFFINGTON POST, Feb. 1, 2014, http://www.huffingtonpost.com/elizabeth-warren/coming-to-a-post-office-n_b_4709485.html.

113. See, e.g., EDWARD ELGAR, THE ELGAR COMPANION TO POST-KEYNESIAN ECONOMICS 5-9 (J. E. King 2003) (discussing Austrian School of Economics and Friedrich von Hayek's view that the dispersed, partial, continually changing, and frequently contradictory information possessed by different economic agents in any advanced economy make it impossible for governments to direct economic activity with any semblance of economic efficiency); HETERODOX, *supra* note 19 (discussing the role of fundamental uncertainty in the economy and the endogenous (rather than exogenous) nature of macroeconomic forces, including interest rates, money supply, and inflation).

114. As to the role of Federal Reserve in contributing to economic crises, see, most famously, MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867-1960 (1963) (blaming the depth and length of the Great Depression on the Federal Reserve's contemporaneous conduct); Ben Bernanke, Governor, Fed. Reserve Bd., Remarks at the Conference to Honor Milton Friedman on His 90th Birthday, Univ. of Chicago, Chicago, Ill. (Nov. 8, 2002), *available at* <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021108/> (containing a summary of Friedman and Schwartz' work and concluding, "You're right, we [i.e., the Federal Reserve] did it. We're very sorry. But thanks to you, we won't do it again."); ELLEN FRANK, THE RAW DEAL: HOW MYTHS AND MISINFORMATION ABOUT THE DEFICIT, INFLATION, AND WEALTH IMPOVERISH AMERICA 142-152 (2004) (concluding that the Federal Reserve's efforts to control inflation during the 1980s and 90s contributed to financial volatility that fed

Although it is not so frequently touted as such, another public benefit of the status quo is that it allows the federal government to *indirectly* print money to pay for some of its deficit spending because the Federal Reserve sometimes uses its power to print money to purchase and effectively extinguish some government debt.¹¹⁵

In ordinary political times, these purported public benefits of the present system might be sufficient to pass some minimal legitimacy threshold and assuage at least superficial concerns about the prudence and fairness of the present fiscal/monetary system. But, these are not ordinary political times, as the legally unnecessary federal debt has triggered public alarm, resulting in widespread cuts to federal spending, including cuts to essential social safety net programs. Thus, the current method of using Federal Reserve and bank-created money to extinguish (at least some of) the federal debt and to thereby indirectly use created money to pay for federal spending is not just inefficient (if the goal is simply to finance federal spending), it is also dangerous because it enables widespread confusion about the legal and economic nature of sovereign money and debt. To the extent that the complexity of the present system and the opaque jargon of contemporary discourse on monetary policy sow confusion in the electorate and in government about the nature of sovereign money and debt, the status quo is also profoundly hazardous to those that benefit from direct federal spending, as the widespread confusion over the legal and economic nature of

stock bubbles and exacerbated inequality). For a view that the Federal Reserve's contemporary economic interventions may be contributing to future financial crises through the creation/re-inflation of credit and asset bubbles, see, e.g., Nouriel Roubini, *Is the Fed Blowing Bubbles?*, PROJECT SYNDICATE (May 5, 2013, 7:15 AM), http://www.slate.com/articles/business/project_syndicate/2013/05/the_fed_faces_a_tricky_exit_from_its_third_round_of_quantitative_easing.html.

115. See, e.g., THORN, *supra* note 64, at 116-17 ("although the direct issue of currency by the government is relatively small, an overwhelming portion of the monetary base issued by the Federal Reserve (bank reserves) is an indirect issue of the government (because it is issued in exchange for outstanding government debt). This fact, more than the small amount of currency issued by the Treasury, justifies linking together of the government and the central bank as the monetary authorities."); see also THORN, *supra* note 64, at 127 (federal "borrowing from the Federal Reserve is almost costless, since the Federal Reserve System turns over all of its excess earnings to the Treasury"); CARL E. WALSH, *MONETARY THEORY AND POLICY* 144 (2d ed. 2003) ("An open market purchase increases the stock of money, but by reducing the interest-bearing government debt held by the public, it has implications for the future stream of taxes needed to finance the interest cost of the government's debt. So an open market operation potentially has a fiscal side to it[.]"); Wray, *supra* note 20, at 47-48 ("It is commonly believed that fiscal policy faces a budget constraint such that its spending must be 'financed' by taxes, borrowing (bond sales) or 'money creation.' Since many nations prohibit direct 'money creation' by the government's treasury, the last option is possible only through complicity of the central bank – which buys the government's bonds, financing deficits by 'printing money.'").

sovereign money and debt frustrates the democratic process and prevents Congress from squarely and openly evaluating the costs and benefits of the status quo and its alternatives.¹¹⁶

B. *What Could We Do Instead?*

The Constitution entrusts the power to exercise the nation's monetary sovereignty to Congress. Unlike many countries,¹¹⁷ the Federal Reserve System and its sanctioning of fractional-reserve banking is not incorporated into the U.S. Constitution. Therefore, Congress could change the status quo with a simple majority vote and the signature of the President.

Alternative models have already been developed, including the National Emergency Employment Defense Act (NEED Act), which was introduced in the House of Representatives in 2010 and 2011 by Representative Dennis Kucinich. The NEED Act would both ban fractional-reserve banking and take the power to create money back from the Federal Reserve, vesting that power in a new monetary authority under the direct control of the U.S. Treasury.¹¹⁸ As such, the NEED Act is not dissimilar to earlier efforts to return the exercise of the sovereign power over money creation to Congress, including the Greenback Party's proposals and the Chicago Plan for full reserve banking, discussed *supra*.

Congress should consider the costs and benefits of this and similar proposals. A recent IMF working paper, for example, concluded that adoption of the Chicago Plan would not just result in a "dramatic

116. To the extent that confusion over the nature of sovereign money and debt has contributed to austerity measures, the status quo is not just damaging to the poor, but to the economy more generally, and, therefore (ironically), to the fiscal budget. See *Stimulus v. Austerity, Sovereign Doubts*, THE ECONOMIST, Sept. 28, 2013, at 72 (discussing the counterproductive nature of austerity, which typically results in more losses to the government in the form of lost tax revenue than savings to the government in the form of lower expenditures because the austerity measures themselves dampen economic growth and therefore reduce tax revenue).

117. See, e.g., Eva Gutierrez, *Inflation Performance and Constitutional Central Bank Independence: Evidence From Latin America and the Caribbean* 16 (Int'l Monetary Fund, Working Paper No. WP/03/53, 2003), available at <http://www.imf.org/external/pubs/ft/wp/2003/wp0353.pdf> (identifying Chile, Brazil, Paraguay, Mexico, and Peru as enshrining central bank "independence" into their respective constitutions during the 1980s in an effort to curb inflation).

118. H.R. 2990, 112th Cong. (2011) (stating that the purpose of the Act is to: "create a full employment economy as a matter of national economic defense; to provide for public investment in capital infrastructure; to provide for reducing the cost of public investment; to retire public debt; to stabilize the Social Security retirement system; to restore the authority of Congress to create and regulate money, modernize and provide stability for the monetary system of the United States; and for other public purposes").

reduction of the (net) public debt,” but also allow:

(1) Much better control of a major source of business cycle fluctuations, sudden increases and contractions of bank credit and of the supply of bank-created money; (2) Complete elimination of bank runs; . . . [(3)] Dramatic reduction of private debt, as money creation no longer requires simultaneous debt creation; [(4)] [Economic] output gains approach[ing] 10 percent [; all while (5)] steady state inflation can drop to zero without any problems for the conduct of monetary policy.¹¹⁹

When considering these proposals, Congress should also understand that while such measures would certainly succeed in restoring Congress to its constitutional role over money creation and may promise additional benefits beyond immediate debt-free federal financing, such as those just identified, such wholesale reform is likely *not* necessary to allow further federal deficit spending without increased inflationary risks.

The Supreme Court has made clear that Congress has the constitutional power to create fiat money and declare it legal tender. Congress has exercised this power in the past, including after the Civil War, when it granted Treasury the power to issue fiat “greenbacks” and declared those fiat dollars legal tender. As that historical episode makes clear, Congress does not have to prohibit banks from creating money before it allows itself to create money. Just as during the late 19th century, today’s Congress could pass a statute directing the Treasury to issue additional United States Notes (beyond the \$300 million currently authorized) at the same time that Congress allows the Federal Reserve (then, the National Banks) to issue Federal Reserve Notes. Under existing law, both forms of currency would be legal tender for the payment of all debts public and private and redeemable at par for one another.¹²⁰

Of course, Congress might fear inflation if it joins the Federal Reserve and private-banks in the money creation business. Therefore, before authorizing the Treasury to create and spend more legal tender

119. Benes & Kumhof, *supra* note 82, at 1.

120. 31 U.S.C. § 5103 (2013) (“United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) are legal tender for all debts, public charges, taxes, and dues. Foreign gold or silver coins are not legal tender for debts”); *id.* at § 5119 (listing United States currency notes and Federal Reserve Notes as non-interest bearing public debts); U.S. DEPT. OF THE TREASURY, *supra* note 39 (stating that “[s]ince [U.S. Notes were made irredeemable for gold], both currencies [i.e. both U.S. Notes and Federal Reserve Notes] have served essentially the same purpose, and have had the same value”); *see also, e.g.*, Khan, *supra* note 22.

money, Congress might feel compelled to prohibit or restrict the Federal Reserve or private bank's money creation powers. Given the power and wealth that is at stake, we can be sure that such efforts would be fiercely opposed.¹²¹ But, if the Federal Reserve abides by its existing statutory mandate, Congress would not necessarily have to touch the Federal Reserve Act. The Federal Reserve Act provides the Federal Reserve with a "dual mandate" to "maintain stable prices and ensure maximum employment."¹²² Congress has empowered the Federal Reserve with a variety of tools to meet these goals, including (as discussed) the power to create money to sell or lend into existence *and* the power to take money out of the money supply (through open market operations, the discount window, and through the reserve rate for private banks). Thus, to the extent that congressional money printing triggered undesirable rates of inflation, the Federal Reserve would at least arguably be *required* by its existing mandate to use its very powerful tools to temper inflation.¹²³

Because the Federal Reserve and private banks currently create so much of the money in the money supply, there is plenty of room for the Federal Reserve to adjust. For example, if Congress printed the \$1.086 trillion necessary to fund the federal deficit for fiscal year 2013, the Federal Reserve could remove a corresponding amount from the money supply by either ceasing QE 3 (which pumped \$1.02 trillion in created money into the economy in 2013), reducing the volume of money it otherwise spends or loans into creation through its open market operations, or by increasing private banks' reserve rates.

Thus, while it is not at all certain that the Federal Reserve would have to change anything to accommodate congressionally printed money because (as discussed at the outset) inflation does not necessarily result

121. See *supra* Part III.A (discussing the private beneficiaries of the present monetary system).

122. 12 U.S.C. § 225a (2013) ("The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."); see also *The Federal Reserve's Dual Mandate*, FED. RESERVE BANK CHI. (Feb. 14, 2014), http://www.chicagofed.org/webpages/publications/speeches/our_dual_mandate.cfm (characterizing this provision as providing the Fed with its "dual mandate").

123. Chairwoman of the Federal Reserve Board of Governors, Janet Yellen, appears to agree both that the Federal Reserve's primary goal is to maintain price stability and that it is within the power of the Federal Reserve to do so. See Janet L. Yellen, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Nat. Ass'n of Bus. Economists, Washington, D.C. *1 (March 13, 1996) (transcript available on Westlaw, at 1996 WL 111362 (F.R.B.)) ("In my view, the appropriate primary long-term goal for the Federal Reserve should be price stability, an objective which no one would deny is within the power of the central bank to accomplish.").

from governments spending created money into the economy, Congress could print money to finance the entire federal deficit without touching the Federal Reserve Act and without necessarily causing any even potentially inflationary increase in the quantity of money in the money supply.

Of course, there are numerous and serious policy implications associated with such an approach, including potentially dramatic effects on private credit markets and interest rates. For example, if the Federal Reserve were to suddenly stop using printed money to drive down interest rates, it is possible that interest rates on private loans would increase dramatically. This is by no means certain, however, especially if Congress offsets the Federal Reserve's decrease in money creation with its own money creation (thereby stabilizing the "supply" of money). In addition, if private banks were no longer permitted to loan out all or nearly all of their deposits, they would have to choose between reduced profits and charging customers higher interest rates for private loans. Assuming the banks chose the latter, loans, including home mortgages, could become scarcer and more expensive. This may not be a bad thing, though, given that the availability of cheap and easy mortgages is often credited with contributing to the 2009 financial crisis by facilitating a housing (and mortgage-backed securities) bubble. Moreover, to the extent Congress wants to keep home financing and other loans affordable, it could offset this effect on the credit markets by providing direct lending to the public.

A full exploration of these policy implications is outside the scope of this Article. I raise them here, as I have raised everything, in the hopes of starting the conversation, not concluding it. My goal is not to say how Congress's monetary sovereignty should be exercised, but simply to show that the contemporary, popular discourse on the nature of the federal debt is profoundly flawed, relying on assumptions that are false as a matter of law and logic and to propose an alternative paradigm for that discussion moving forward. As maintained throughout, that new paradigm must recognize that Congress has the sovereign power to create money, that the Federal Reserve and private banks are exercising that power on behalf of Congress to create trillions of dollars in new effective money each year, and that, therefore, the question presented to Congress by historically high federal deficits and debt and related fiscal anxiety is not simply what can we learn to live without. The question, whether Congress knows it or not, is: how should the peoples' sovereign power to create money be exercised and who should benefit from the exercise of that power? Even if the answer to that question is that the status quo should be maintained, I suspect that voters would not be so

afraid of federal spending if they understood the real nature of the present fiscal/monetary system. They might even muster the political will to demand a fully funded Food Stamps program.