Hard Money & Cyber Cash:

Bankers vs. Bureaucrats in the Changing Payments System & Money Markets

Christopher Whalen

CMRE

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I. Introduction

> "There was a time in the Western world when money as we know it was a new thing, and its appearance was like a strange ware which men gathered in the marketplace to gaze upon in wonder."
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> Elgin Groseclose
> *Money and Man*

There is a general consensus in the academic and professional community that the U.S. financial markets are in the midst of enormous change. The consolidation of the banking industry, innovations in financial products, and the impact of technology on areas such as electronic payments, devices to store "value" on plastic cards, and the Internet, are all changing the nature of the financial markets and the U.S. economy.

Traditional banks are now faced with direct competition from technology companies such as IBM and Microsoft, communications giants like AT&T and MCI, and non-bank financial giants such as GE Capital and Merrill Lynch. In many cases, commercial banks have seen large parts of their traditional business of cash management and payments stolen away by unregulated non-bank firms.[1]

The major reason for this change is economic: A recent study by Booz-Allen & Hamilton found that 154 European banks have already established sites on the World Wide Web and the number of sites is roughly doubling every year. The study also found that the cost of using the Internet is far lower than the alternatives. A payment made via the Internet cost 13 cents or less, vs. 26 cents for payments made via a proprietary personal computer network, 54 cents for telephone banking service and $1.08 for a payment made at a traditional bank branch. Given the relative differences in cost, it is small wonder that the automated teller machine now frequently outnumbers humans in most bank branches.[2]

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1 See Authers, John, "Dinosaurs get hungry," *Financial Times*, September 18, 1996.
2 See Graham, George, "Rise of Internet threatens traditional banks' market." *Financial Times*, August 12, 1996.

The possibilities for customers to bank directly via the Internet or through proprietary networks is streamlining and flattening the traditional pyramidal structure of financial intermediation. For example, late in 1996 the software firm Netscape announced an alliance with CyberCash Inc. of Reston, VA, in order to expand the use of the Internet for retail transactions. Netscape will be including CyberCash's transaction and encryption software into future versions of its popular Navigator software package, which allows computer users to "surf" the World Wide Web of computer sites across international borders and around the globe.[3]

At the same time, significant political changes are underway in the U.S., changes that have as much to do with shifts in the international economy as in the changing demographic patterns of the American population. A conservative tide, driven by economic pressures, hopefully is moving the U.S. away from the liberal, managed economy ideas and practices of the past half century and toward a greater emphasis on individual responsibility, fiscal discipline and accountability for all government departments and independent agencies. Heretofore unthinkable changes have occurred in areas such as welfare and entitlements, beginning the process of rolling back the statist structures put in place by FDR, Lyndon Johnson and Richard Nixon.[4]

Internationally, the dominance of America's unique financial culture and the dollar is growing every day. Over the past several decades, numerous observers have predicted that the use and acceptance of the American currency would decline as the German mark, Japanese yen and other competing currencies grew in importance and gradually supplanted the dollar. Some economists and financial analysts made dire predictions of the impending decline of the American financial system and the concurrent rise of Japan as the new global banking and financial power.

In fact, the opposite seems to be the case. Japan's economy is caught in a classical deflation, with consumer prices continuing to fall despite massive neo-Keynesian fiscal spending initiatives totaling into the many hundreds of billions of dollars.[5] The near-collapse of Daiwa Bank, the ongoing debacle in the world metals market involving manipulation of copper prices by Sumitomo Corp., and the general malaise that still grips Japan's financial sector, seems to suggest that America's financial and business culture, and not the Japanese economic model, is positioned to dominate the global market for financial transactions well into the next century.

America's financial, commercial and legal structures remain unique in the world in terms of its sophistication and adaptability for consumers and business, for financing new industry, creating personal wealth, and controlling financial risk. Indeed, it appears that American standards of accounting and business practices are becoming the norm in much of the world.[6] Many companies from Europe and Asia, for example, have chosen to list their shares on the New York Stock Exchange rather than on exchanges located in their home markets, a decision that of necessity requires the firm to conform to U.S. accounting principles. Competition for capital, information and market access is forcing companies around the world to emulate American business practices and products.

While both the political environment and the financial markets are continuously evolving, and the status of the dollar and America's financial culture are paramount, there is one crucial part of the American political-economy that is not only static but relatively unchanging: the Federal Reserve System. Created by Act of Congress in 1913 to provide (1) a stable national currency and (2) a source of

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[3] See Hilzenrath, David S., "Netscape Agrees to Use CyberCash Technology," *Washington Post*, October 8, 1996, Pg. D-1.

[4] FDR of course borrowed a great many ideas from his Republican predecessor, Herbert Hoover. Johnson appears in this infamous list because of his Great Society initiatives. But the Republican Nixon was perhaps the most pronounced socialist of the group, both because of his enormous expansion of domestic entitlements and his short-lived wage and price controls schemes. See Todd, Walker F., "From Constitutional Republic to Corporate State," CMRE Monograph No. 51 (October 1995). See also Whalen, Richard J., "Catch the Falling Flag: A Republican's Challenge to His Party," Houghton Mifflin (1972), Pg. 263-274.

[5] The attempts by the Japanese government to reflate its economy has the indirect result of subsidizing the U.S.budget and current account deficits. Massive dollar purchases by the Bank of Japan tend to keep U.S. interest rates lower than in past years and have fueled the recent rally in U.S. stock prices.

[6] See Kelly, Jim, "SEC expert keeps eye on global accounting standards," *Financial Times*, September 19, 1996.

liquidity for markets generally in times of crisis, today the Federal Reserve System has expanded from its original role as primarily a bank of issue to a more interventionist, even socialist economic position of managing the macro economy and even the fate of individual industries and companies.

Far beyond simply providing currency and liquidity to the marketplace, the Fed acts to target interest rates for the private credit markets on an almost daily basis and at the same time acts as a primary regulator of the American financial markets. Many investors also believe that the Fed acts covertly to stabilize stock and bond markets during periods of great volatility, an opinion that has been confirmed by statements from various government and Fed officials since the October 1987 stock market crash

Additionally, the Federal Reserve System competes with private financial institutions in areas such as clearing checks and electronic transactions. At the same time, the Fed provides *credit* to individual private financial institutions and foreign governments via the discount window and over the electronic payments system known as the Fedwire.[7] In an age when reliance upon private-sector initiative and market-discipline are again becoming important political objectives for a majority of the electorate and their representatives in Washington, the Federal Reserve System stands as an monument to the corporate statism of past decades and an obstacle to economic liberty and financial innovation in areas that include (but are not limited to) electronic payments and clearing.

[7] For example, the Federal Reserve System has extended credit to a number of failing and troubled financial institutions over the past two decades, including Continental Illinois, Bank of New England and Citibank. Following the 1982 debt crisis, the Federal Reserve System extended credit to Mexico and did so again in 1986 and 1988, and again, in massive fashion, following the 1994 peso devaluation. A number of other nations have received extensions of credit from the Federal Reserve System. See Hoskins, W. Lee and Coons, James W., "Mexico: Policy Failure, Moral Hazard, and Market Solutions," Cato Institute, *Policy Analysis*, No. 243 (October 10, 1995). See also Broaddus, Alfred and Goodfriend, Marvin, Federal Reserve Bank Richmond, *Annual Report* (1995); Todd, Walker, Brief for Plaintiffs, *Schultz et al. vs. State of New York et al.*, 95CV0133, Northern District of New York.

To his credit, Fed Chairman Alan Greenspan opined during the middle of 1996 that regulators should stay out of the way and let the market for electronic money develop without government meddling.[8] He said: "The private sector will need the freedom to experiment without broad interference from the government." Greenspan noted that too much interference could impede innovation, but at the same time he observed that electronic payments "account for a very small percentage of transactions... Even the use of popular credit cards has only recently begun to challenge paper's dominance."[9]

Despite Greenspan's admirable statements about the need for a hands-off policy toward financial innovation, the reality is that the Federal Reserve System is one of the most important impediments to change in the dollar payments and clearing system. When American banks, broker-dealers and non-bank financial firms are increasingly competing with each other in the expanding private market for electronic transactions, the Federal Reserve System straddles both sides of the market, acting as a competitor in the form of a government-owned monopoly in the money markets, while at the same time regulating and supervising these very same markets. The Fed's presence in the payments system as a competitor serves to dissuade new market entrants. The regulatory environment maintained by the Fed stifles innovation and has slowed technological change in areas such as smart cards and other types of electronic payment devices, particularly when compared to the progress made in other G-7 nations.

Cleveland Federal Reserve Bank President Jerry Jordan commented on the impact of technology on the banking industry and related topics such as monetary policy:

> "The proliferation of money assets and increasing speed of money transfers are two trends that clearly will persist into the next century. So, too, will the third trend -- the elimination of regulatory and other legal restrictions on the money industry erected by governments. On a global scale, modern

[8] See "Fed Chief to U.S: Back Off On Electronic-Cash Rules," *Wall Street Journal*, September 20, 1996.
[9] Ibid.

> communications technology assured the free flow of information through the Iron Curtain and flattened the Berlin Wall. In the United States, the same technology flattened artificial walls between groups of depository and other regulated financial institutions, and between regulated and unregulated institutions. Telecommunications-based information technology made it cheaper and cheaper to avoid costly regulations. Initially, this perpetuated a kind of cat-and-mouse game between regulators and markets. In banking, at least, the game now is ending.[10]

Market forces, at the end of the day, evade and erode all obstacles, including institutions as mighty as the Federal Reserve System. Even with the considerable institutional inertia of the Federal Reserve System, the impact of evolving technology on the money markets is changing the nature of the payments system and of how money is used and defined by society. Jordan notes that "the closer technology brings us to real-time payments, the closer we are to genuine 24-hour banking and trading, and a worldwide set of assets that might be used for wealth storage."[11]

Many observers, both in and outside of academia, believe that "government issued currency may experience a substantial decline or even disappear as a transaction medium in the long run with seigniorage passing to the private sector in the form of a cheaper and more efficient payments system, unless those competitive advantages were somehow countered by central banks."[12] A report by the Bank for International Settlements says that central banks could lose billions of dollars of annual revenue if consumers start to jettison the traditional banknote in favor of electronic money.[13] At the same time, the BIS warns against central banks issuing their own standardized

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10 See Jordan, Jerry L., "Money in the 21st Century," Cato Institute Annual Monetary Conference, May 23, 1996, Pg. 4.

11 Ibid., Pg. 4.

12 See Browne, Frank X. and Cronin, David, "Payment Technologies, Financial Innovation and Laissez-Faire Banking: A Further Discussion of the Issues," Cato Institute Annual Monetary Conference, May 23, 1996, Pg. 3.

13 See Graham, George, "Electronic money threat to central banks," *Financial Times*, November 18, 1996, Pg. 1.

"electronic money," arguing that such a move "could limit competition or reduce incentives to innovate."

Monetary analyst and accountant Bert Ely observes that the changes which have already occurred in the financial market place, for example the shift away from the use of specie to paper or electronic currency which is a liability of the Treasury or a depository institution, have rendered Fed monetary policy in the traditional sense moot. Since the Fed inevitably provides whatever reserves are required by the banking system as a result of deposit growth, argues Ely, and since there is no effective difference between electronic money and the currently used non-specie money that already comprises the money markets, electronic money has no particular monetary policy implications

"Contrary to popular belief, the Fed does <u>not</u> control the money supply, argues Ely. "The reservable deposit portion of the money supply, like the currency portion, is entirely demand-driven... Monetary policy today consists entirely of the Fed's interest rate signaling. Specifically, the Fed's Federal Open Market Committee periodically sets and openly announces a Fed Funds Rate Target (FFRT). That is, Fed bureaucrats tell the financial markets what they, the bureaucrats, believe should be the benchmark rate off of which other short-term interest rates should be set. The Fed then manipulates the quantity of excess reserves so that it can hold the daily Fed Funds rate close to the FFRT... Interestingly, except for the daily Fed Funds rate, the Fed cannot move interest rates through brute force, the buying or selling of large quantities of Treasury securities. Unfortunately, many financial market participants still believe that the Fed can move rates generally. In fact, the Fed's influence over interest rates stems entirely from the perception that it can move rates, much as the Wizard of Oz's influence over the Munchkins grew from their belief in his power. Toto, though, revealed the truth."[14]

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14 See Ely, Bert, "Electronic Money and Monetary Policy: Separating Fact from Fiction," Cato Institute Annual Monetary Conference, May 23, 1996, Pg. 6-7. It must be noted that a number of participants at the Cato event, include Cato head William Niskanen, took issue with Ely's comments about the Fed's lack of control and preferred to embrace a more tradition view of what the Fed can and cannot do in controlling the supply of credit.

The ongoing evolution of the financial markets and, by definition, in the nature of money is disconcerting to conservatives, particularly those who believe that money should be defined in terms of a tangible asset such as gold. And yet just as gold and silver coins once served as the primary means of exchange, today electronic money has evolved into a universal unit of value separate from the price of precious metals that still meets the definition of traditional currency:

Money performs three functions: (1) as a medium of exchange, (2) as an immediate measure of value or unit of account, and (3) as a standard of deferred payments and a store of value.[15] Gold and silver coins and ingots once provided the basic definition of "money," but today central banks issue unbacked instruments made of paper or even plastic currency, as in the case of Australia and many countries of South Asia. The fact that the newest, non-specie electronic currency has largely escaped the control of the Fed and other central banks is lost on most observers, who like the inhabitants of Oz are fascinated by the Federal Open Market Committee's policy pronouncements regarding interest rates and inflation.

The central role of consumers, both individual and institutional, in defining and determining the behavior of money is often overlooked by government officials and their allies among the ranks of liberal economists. For example, when asked in an interview about the velocity of money, former Citibank Chairman Walter Wriston replied:

> [The velocity of money is] the number of times a dollar bill turns over in the course of the year. The money supply turns over on average about three times a year. When economists fail to predict the future, it's not because they don't know how much money has been created by the Federal Reserve Board and released through the banks. It's because they don't know what people are doing with it. When people feel threatened, they put their money in the bank and the velocity goes down. When they feel good about life, they buy everyone a beer and the velocity goes up."[16]

Contrary to the fears expressed by many conservatives and hard-money proponents, the changes now underway in the money markets are not necessarily deleterious to traditional principles of sound money and individual liberty. In fact, as the reliance upon physical paper currency slowly declines and electronic payments play a greater and greater role in the U.S. and global economy, an opportunity arises to scale-back or eliminate entirely the role of the Fed as economic "manager." Instead, by encouraging a diminished role for central banks, the private sector may regain more control over the definitions of the methods of payments and stores of value used in day-to-day commerce.

In this discussion, however, caution is needed in distinguishing money from credit. Most of the growth visible today on the balance sheets of private financial intermediaries -- the biggest area of expansion of electronic money -- is credit, insoluble into the underlying base supply of money as classically defined. Credit and money are distinct and always must be analyzed separately. For example, critics of the views expressed by Ely and others about the Fed's lack of control over the supply of bank reserves, believe that he has failed to make precisely this distinction between money and credit.

In classical terms, some multiple of credit can be supported on a smaller monetary base -- assuming low and stable interest rates. In a hard money regime where paper bills are convertible into gold or silver, that multiple probably is three or even two-to-one. Today, however, the multiple of domestic credit is about ten-to-one, balanced atop a currency backed only by Uncle Sam's debt instruments. On a global basis, world dollar credit exceeds this suspect dollar monetary base by a multiple of 25-to-30 to one (excluding derivatives).

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[15] Groseclose, Elgin, "Money and Man," University of Oklahoma Press 1976, Pgs. 22-23. [ISBN 0-8061-1338-3]

[16] See Bass, Thomas A., "Want to Know About the Future of Money?" *Wired*, October 1996. Pg. 143.

The fact of burgeoning dollar credit has led many otherwise calm and sober market participants to wonder aloud whether the entire world dollar system of money and credit will not one day implode under its own weight. As discussed below, successive Fed Chairmen in Washington have encouraged this worrisome trend, thus the fact that technological advances tend to lessen the influence of the Federal Reserve System on money and credit may be welcomed as a positive development.

Indeed, in the age of electronic banking and real-time payments, and declining influence for central banks, there may again be a real-world, socially accepted role for gold and silver as both a unit of account and a medium of exchange. Such questions are best answered by the marketplace rather than through legislation, but at the very least one can envision a time when sophisticated individuals might rely upon some new form of specie and electronic payments as the sole means of exchange and measuring wealth. Gold and silver coins might be circulated in standardized weights, without any explicit monetary value, in order to give consumers greater choice of how and where to hold their wealth. In that event, physical paper notes such as those now issued by the Fed on behalf of the Treasury might disappear from use entirely or even remain as alternative, but a lesser form of payment and store of value.[17]

Catherine England of George Mason University believes that the ongoing changes in the payments system are already diminishing the role of government and paper currency. "The vast majority of the money supplies of developed countries today is already in the form of electronic credits in bank accounts that are transferred through checks, debit cards, and electronic funds transfer orders," she notes. "I am relatively unconcerned about who will print the remaining pieces of circulating paper. Instead, [we should address] questions surrounding (1) who will be the "keepers" of the electronic credits that are used to pay for the transfers of goods and services and (2) who will determine the supply of credits in an economy at any point in time."[18]

By working to minimize or even eliminate the role of government in the money markets and clearing systems, possibilities arise that may help to achieve the very goals long sought by proponents of hard money and conservative values while simultaneously taking advantage of new technology and innovation. By working to lessen Washington's direct control over the dollar money supply, in part by eliminating the contrary and inconsistent role of the Federal Reserve System as both regulator and near-monopoly participant in the money markets, more fundamental questions about the nature of money and the role of the American financial system in the world economy will not only be resolved, but may essentially untangle themselves.

The American Century

Henry Luce, one of the giants of American publishing of the 20th Century, once described the current millennium as "the American Century." In fact, it may be that Luce and his contemporaries were 100 years too early. In the 21st Century, American economic power, culture, financial prowess and technological innovations will put an imprint on the entire world that may be far more profound than even the many contributions of the past century.

In large part, the power and importance of the American economy, our financial system and the almost universally accepted dollar, will be the vehicles whereby American business practices, financial standards and even social and cultural values are spread around the world. For example, geopolitical and military issues are profoundly affected by the encroachment of the dollar into Russia, China and many other nations of the world. Yet the first and most crucial point to recognize is that it is the strength of the American

[17] Ely notes that a full transition to electronic payments would represent a cost to the government because of the loss of seignorage. He supposes, for example, that if half of the population over age 14 carried a stored value card with an average balance of $100, electronic money would displace $10 billion worth of currency and cost the Treasury $600 in interest expenses because of the need to issue more public debt.

[18] England, Catherine, "Cyber Banking and Currency Competition," Cato Institute Annual Monetary Conference, May 26, 1996. Pg. 1.

economy and financial culture, and not the bureaucratic role played by the Federal Reserve System, which makes the dollar the most desirable and sought after currency in the world.

By allowing and, indeed, even promoting the use of the dollar as the world's currency, America may be able to undermine anti-democratic, authoritarian regimes by means of finance rather than through military might. The fact is that dollars are already the *de facto* means of exchange and stores of value in many foreign countries. A recent Fed study suggests that between 50 and 70 percent of all U.S. currency is held abroad and that about 80 percent of the demand growth in U.S. currency since 1980 has come from offshore.[19] The financial and geopolitical implications of the *dollarization* of much of the world economy should be an important *positive* consideration for people interested in the evolution of the money markets and payments system.

In order to ensure American leadership in the global capital markets and make this positive and expansive vision a reality, it is necessary to eliminate much of the current structure of the Federal Reserve System and, in many respects, restore the control over the nation's money supply and payments system to the more limited, private-sector role originally envisioned by the Constitution and even by the Congress in 1913. While preserving those necessary monitoring functions that make the Fed the guardian of the American financial system, it is crucial that leaders in finance and politics recognize the changes that have occurred in society and update the purposes and functions of the Federal Reserve System to meet these new realities, including protecting the integrity of the private electronic payments system from fraud and international terrorism.

Accordingly, the purpose of this monograph is to advance a vision of how the Federal Reserve System might be restructured to make it a complement, rather than an obstacle and competitor, to the growth and evolution of the private financial markets. Both with respect to the Fed's role in monetary policy and in its role as a regulator of and participant in the money markets, Congress needs to carefully examine the legal and economic basis of the Federal Reserve System. In addition to making arguments in favor of such changes, this paper will also discuss the practical aspects of putting these changes into effect.

II. Purposes & Functions: Appearances & Legalities

The Federal Reserve System is the *de facto* central bank of the United States and an "independent" agency chartered by the National Congress. In a strictly legal sense, the 12 banks that comprise the operational aspects of the Federal Reserve System are "owned" by the commercial banks that are members of the Federal Reserve System or "member banks." In reality, however, the Federal Reserve System is an agency of the federal government.

Under the Federal Reserve Act of 1913, as amended, the Federal Reserve System acts as a bank of issue and monetary authority, a provider of short-term liquidity to private commercial banks and a regulator over certain aspects of the banking and securities markets. It is crucially important to recall that the Federal Reserve System did not assume its role as the principal bank of issue until 1933 in the depths of the Great Depression. Likewise, federal reserve notes, that is, "dollars," did not become legal tender until 1933.

Here is a list of the functions currently performed by the Federal Reserve System:

◆ Issues legal-tender federal reserve notes, dollars, and backs said currency through purchases of government debt.[20] As agent for the Treasury, provides cash and coin services to depository institutions and other major vendors, and acts as agent for the Secret Service to detect forged government securities and counterfeit currency.[21]

[19] See Carlson, J.B. and Keen, Benjamin D., "Where is All the U.S. Currency Hiding?, *Economic Commentary*, Federal Reserve Bank of Cleveland, April 5, 1996. See also Whalen, Christopher, "The G-3 Money Launderers," *International Economy*, Pg. 52. The article is available at www.l-r-i.com/G-3.html

[20] The purchase of government debt by the Federal Reserve Banks was not authorized until 1918 as means of financing WW I.

[21] The Federal Reserve System took on this oversight and enforcement function in 1921.

◆ Monitors and adjusts monetary policy based upon the analysis and deliberations of the Federal Open Market Committee.[22] The Federal Open Market Committee sets policy based upon its internal findings, then reports to the Congress its achievement of certain economic goals that have been set legislatively since 1976.

◆ Acts as agent for the U.S. Treasury in the issuance of government debt and the collection of taxes (since 1913). Also acts as agent for the Treasury in the world currency markets, buying and selling dollars based on instructions from the Secretary of the Treasury. This latter, agency activity in the world currency markets has <u>never</u> been authorized by Congress and is unconstitutional.[23]

◆ Regulates and supervises the operations of state-chartered banks that are members of the Federal Reserve System (since 1938), and bank holding companies (since 1956), and foreign banks authorized to conduct business in the U.S. (since 1978).

◆ Operates and supervises the national electronic payments system (since 1986), known as the "Fedwire,"[24] through which private banks and financial institutions send over $1 trillion per day in cash payments and securities. The Federal Reserve System also provides intra-day credit or "float" to Fed member banks operating on the Fedwire.

◆ Operates a national check and payments clearing network through the 12 Federal Reserve Banks and roughly 50 branches and check processing centers. The Federal Reserve System has dominated check clearing since the 1920s, but increasingly faces competition from private commercial banks and financial companies that are seeking to streamline the cumbersome and technologically outdated use of paper checks to effect payments.

22 The FOMC became the *de facto* mechanism for setting monetary policy as early as 1923, but this role was not authorized by Congress until 1933.

23 Federal Reserve System officials argue that operations in the foreign currency markets are an extension of domestic open market operations and conducting relations with foreign central banks, but the fact is that there is no specific legal authority for Federal Reserve System currency operations.

24 The Fedwire has only functioned in a significant way since 1974.

Political Realities

Of all of these functions, only the first -- namely issuing currency -- is a defensible function of the currency or note issue department of a central bank in the classical sense of the term. Of course, "central banks" conflict with and don't exist in classical free market economics. Public outcry against fraud in banking and dire need drove the Congress to discard traditional American preference for a decentralized, *private* monetary regime and to establish the Federal Reserve System. This decentralized central bank was intended to limit is activities to the issuance of a sound currency that was not subject to fraudulent financial practices or political manipulation.[25]

The second function, allowing the FOMC to control the rate at which currency is issued by the central bank and conduct open market operations to achieve this result, is a statist arrangement consistent with models of authoritarian, managed economies. The present system of centralized control of monetary policy from Washington was a creation of the 1930s and, after WW II, the post war mentality of official Washington, which paradoxically reflected the heyday of Keynesian economic thought and central planning in the world's leading democratic nations.

Rather than following guidelines set by Congress regarding price stability and growth, instead the Federal Reserve System currently reports to the Congress, after-the-fact, as to its success or failure in meeting its own, internally generated goals or targets for employment and price stability. As already mentioned, there are some observers who believe that the Fed has no real control over the growth in the supply of money by managing reserves, thus the Fed simply targets the price of private credit and manipulates markets on a daily basis to preserve the illusion of stability, a situation entirely at odds with traditional American values and models of a democratic,

25 In fact, the creation of the Federal Reserve System was not strictly necessary to eliminate currency fraud. The New York banks and some southern and western agrarian interests pushed for a central bank out of concern for availability of credit, not the soundness of money. See generally Timberlake, Richard, "Monetary Policy in the United States: An Intellectual and Institutional History," University of Chicago (1994).

privately-controlled, free market economy. [26] The presence of foreign central banks from Japan and other nations in the market for dollars increases even further the lack of accountability of Federal Reserve System monetary policy.

In addition to the realities of the conduct of present-day monetary policy, there are several other economic reasons why giving the Federal Reserve System politically unaccountable latitude with respect to monetary policy is incompatible with a free-market economy and a democratic society. Yet the most important issue, the factor that underlies all of the technical and financial considerations, is the question of political manipulation of money and credit policy inside the Beltway in Washington.

The Federal Reserve System is, in theory, owned by its member banks, who appoint directors to each Federal Reserve Bank and should have a great deal of influence in how each Federal Reserve Bank is managed and operated. That is, the Federal Reserve System was supposed to be comprised of private corporations, *supervised* by the Board of Governors in Washington that reflected the views and opinions of different segments of business, finance and society from around the nation -- and in any event, outside of Washington.[27]

[26] For example, in a private meeting with Wall Street brokers on October 9, 1996, Peter Fisher, head of the New York Fed's open market operations, declared his intention to identify hedge funds and firms trying to manipulate "overnight repurchase and cash markets." The clear implication of Fisher's statement is that he intends to prevent investors or groups of investors from cornering deliverable collateral in the money markets. Apparently Fisher, a lawyer by training, and many others within the Federal Reserve System believe that there is some evil effect from speculative activity in private financial markets, hard evidence of the statist, managed economy mindset that pervades the thinking of the Federal Reserve System. Or to put it another way, perhaps Fisher worries that George Soros and other managers of large hedge funds are horning in on his turf!

[27] The selection of A, B and C class directors of each Federal Reserve Bank was intended by Congress to achieve the result of geographic and social diversity in the views and management of Reserve Banks. Three are nominated by the Board of Governors and six are elected by the Fed member banks in each district, including three representing the lending member banks and three representing the borrowing public. For a discussion of the organization of the 12 Federal Reserve Banks, see "Combined Financial Statements of the Federal Reserve Banks," *Federal Reserve Bulletin*, August 1996, Pg. 783.

In practice, however, the Federal Reserve Bank's have increasingly become appendages of the Board of Governors in Washington, a European-style, centralized bureaucracy which is dominated by liberal financial economists and which has usurped many of the functions given by Congress to the Federal Reserve Banks. It is not an exaggeration to say that among the 12 Federal Reserve Banks, only the Federal Reserve Bank New York has any appreciable degree of operational independence at all from the Board of Governors.

Consistent with the structure of checks and balances found throughout the federal government, the individual boards of directors and management of the Federal Reserve Banks were meant to offset the power of Washington, but this function has been largely eviscerated by successive Fed chairmen. Not surprisingly, in the process of usurping the managerial independence of the Federal Reserve Banks, the Board of Governors also has gradually become less and less accountable to the Congress and the American people.

Indeed, over the past 50 years since W.W.II, the Board of Governors has progressively become subservient to the Executive branch of the federal government. This process of perversion of the original intent of Congress has moved at an accelerating pace since Arthur Burns became Fed chairman in 1970. Under Burns, the Fed embraced the policy of cooperation with the White House on economic policy, leaving the respected Fed chief obliged to accommodate the whims of a Republican White House.

The trend toward Executive Branch hegemony over the Fed violates the basic Constitutional precept that it is the Congress solely that has the power to coin money, levy taxes and control spending. Since Burns and right up to the present day, successive Fed Chairmen have pandered to whoever occupied the White House, while often refusing to be accountable to the Congress for monetary policy or even the operations of the Federal Reserve Banks. [28] The political reality of

[28] See Haldeman, H.R., "Haldeman Diaries: Inside the White House," CD-Rom edition (Sony 1994). A search under "Burns, Arthur" reveals that President Nixon and chief of staff Haldeman talked to or about Burns on average about once a week for the two years covered in the Haldeman Diaries. Burns continued the practice of meeting privately with the President under Gerald Ford, when a younger Alan

the Fed's current posture vis-à-vis the Washington governing elite was perfectly illustrated by Fed Chairman Alan Greenspan's attendance as the guest of honor at President Bill Clinton's First State of the Union address in 1993, when he was seated beside First Lady Hillary Rodham Clinton.

Within the Beltway and reading between-the-lines, it is very common for members of the staff of the Board of Governors to argue to members of Congress and the national media that the Federal Reserve Banks are unreasonable bastions of iconoclastic ideas -- notions like sound money and low inflation -- and that only the Board of Governors is capable and supremely willing to accommodate the needs of a profligate federal government. Thus over the past two decades, the Board of Governors has conceded its traditional and congressionally mandated role as the independent arbiter of U.S. monetary policy and has become more and more concerned with serving the needs of whoever occupies the White House, regardless of political affiliation.

Greenspan's Faustian Bargain

For example, during the first nine months of 1996, much of Wall Street waited in vain for the Federal Open Market Committee to raise interest rates. Economists and other necromancers argued back and forth as to why the central bank should or should not raise the cost of credit, but neither politics nor the science of macroeconomics held the answer.

Greenspan did not raise interest rates before the election of 1996 because he and the other members of the Board of Governors recognized the huge degree of leverage employed in financial markets. A change in Fed interest rate policy, say during the summer of 1996, most likely would have sent stock and bond prices falling, adversely affecting Bill Clinton's chances for reelection.

Wall Street has always lived off of "carry," the difference between short-term interest rates and the yields on longer-term debt instruments, both government bonds and private obligations. Leverage is also an important component in stocks and commodities, as well as the myriad of derivative instruments that now populate the vast global credit and money markets. Everything from equities to futures to cash foreign exchange is affected by the price of money -- that is, *dollar denominated credit.*

Fed Chairman Greenspan has constructed the current stability that prevails in the U.S. and international markets on the assumption that the Treasury yield curve will remain positive. As already noted, the price of short-term credit is determined by Fed targeting of the FFRT and market acquiescence in these targets. In late September of 1996, the modest difference between short-term money rates, with Fed Funds at 5.25 percent, and the 10-year Treasury bond at 6.65 percent and 30-year long bonds just shy of 7 percent, was just enough to support the bond market and also fuel speculative investments in stocks, bonds and derivatives in the U.S. and various emerging markets.

The differential between the two-year Treasury note and the 30-year long bond that prevailed at the end of September 1996 was roughly 80 basis points, a substantial gap but not the widest "spread" in recent years. The peak for the key, "twos-to-thirties" relationship was an extraordinary 360 basis points in September 1992, when the Fed had the money spigots wide open in order to reflate a commercial banking industry badly damaged by losses in commercial real estate.

"Back in 1992, Fed policy was aimed at subsidizing the banks and had no credibility with the bond market," notes former Fed research officer and attorney Walker Todd. "The Fed's policy with respect to interest rates was purely political and was aimed at reelecting Bill Clinton. This is clearly the *quid pro quo* for Greenspan's reappointment last summer. Unless all of the historical signals have become moot, higher inflation will be the result of Greenspan's temporizing. Whereas a half-point rate hike now would head-off potential inflation problems a year or so hence, a larger move will be required later."

Since the October 1987 market crash, the Fed has apparently shifted from targeting money supply growth to interest rates in a deliberate effort to avoid another, sudden stock market correction. The Greenspan-led FOMC is aware of the fact that Wall Street is

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Greenspan was Chairman of the Council of Economic Advisers. Even today, Chairman Greenspan remains a member of the National Economic Council, a body established under the Bretton Woods Act in 1945.

dependent upon a positive yield curve to survive and knows that a flatter yield curve would spell increased volatility and lower prices for both stocks and bonds. Whereas in 1987 and as recently as February of 1994, the Fed tried to slowly let the air out of a credit-driven financial market, today the huge amount of leverage driving the cash and derivatives markets virtually precludes the Fed from taking any significant action. The reason for this reluctance by the Fed to raise the cost of *credit* to the financial markets is as much a function of politics as economics.

So addicted are the U.S. credit markets to the short-term stability engineered by Greenspan that the idea of a change in Fed policy entirely dominated discussions on Wall Street during much of 1996. Economists pretend that the Fed is considering an increase in the target for short-term interest rates to stifle the threat of inflation, a problem that is again growing albeit at single digits.[29] True, the heads of the regional reserve banks have argued for a rate hike, but they are as much concerned by the FOMC's preoccupation with the desires of Washington and Wall Street as with the possibility of higher inflation.

In August 1971, when Richard Nixon abandoned the international gold exchange standard, roughly one tenth of the turnover in the money markets was attributable to speculation while the vast remainder was tied to commerce. Cash was king and leverage was used sparingly on and off Wall Street. Today the roles are reversed and the dominant portion of money market activity is speculative. Credit is king and investment banks routinely run stock and bond positions leveraged 50:1 or more (not including derivatives). Not surprisingly, Fed policy is now focused on the convenience of speculators -- and incumbent presidents in Washington -- rather than the needs of American consumers and industry. The Dow Jones Industrial Average, not the economic welfare of Main Street, is the key barometer of the success of a given administration in Washington. And thus Chairman Greenspan and the majority on the FOMC did not raise the rates through the November 1996 election. [30]

III. Regulator vs. Competitor: The 21st Century

Outside of issuing physical currency and coin, and providing reserves to financial institutions, all of the other functions performed by the Federal Reserve System arguably fall outside of the traditional definition of the activities of a central bank, particularly in those areas where the Federal Reserve System actually competes with private entities as in the case of check clearing and the daily management of the Fedwire. Occasional press treatment of the Fed's non-monetary activities usually focus on cost and efficiency, without ever asking the most basic question of whether the Fed should be involved in what were traditionally areas of private sector business and finance.

Before the establishment of the Federal Reserve System and the expansion of the Fed's activities beyond those basic activities that are necessary for the functioning of a central bank, private banks operated clearing houses around the country and still do today.[31] Given the advances of technology and the increased competition from non-bank financial institutions, there seems to be no reason to allow the Federal Reserve System to continue operating as a competitor of commercial banks in the clearing and electronic payments businesses. In fact, all private banks are indirectly competing with the Federal Reserve System, an entity that they supposedly own.

Financial commentator Martin Mayer, a guest scholar at the Brookings Institution and author of the new book (Spring 1997) "The Bankers: The Next Generation," skillfully describes the conflicting role of the Federal Reserve System as competitor and regulator.

Specifically, the situation involves privately-owned U.S. Check (a subsidiary of AirNet Systems), which competes with the 12 regional Federal Reserve Banks in the business of clearing checks. U.S. Check serves one particularly large group of 120 banks that have organized themselves into a private clearing group, writes Mayer, "the National

[29] At the October 23, 1996 Dinner meeting of CMRE, guest speaker John Makin noted that inflation is on the rebound in the U.S. and that the reality of deflation in other industrial nations has allowed the U.S. to cheaply finance its current account and fiscal deficits.

[30] It is interesting to note that as of September 1996, eight of the 12 regional Federal Reserve Banks had requested an increase in the Discount Rate.

[31] See Wilke, John R., "Showing Its Age: Fed's Huge Empire, Set Up Years Ago, Is Costly and Inefficient," *Wall Street Journal*, September 12, 1996.

Clearinghouse Association, that permits banks to settle their debts to and credits from other, out-of-town banks without going through the processing centers operated by the Federal Reserve System." Mayer continues:

> "We tell the governments of developing countries that they won't develop right until they realize that goods and services that can be produced in the private sector should be produced in the private sector. Countries where payments are cleared through private enterprise are moving toward economical electronic payments much faster than the United States, because in the home of capitalism the government insists on doing this business itself. The real lesson of the U.S. Check fight with the Fed is that the time has come to privatize the payments systems in America, too. No bureaucracy can efficiently or honestly regulate a market where it is in competition with private companies for the business."[32]

Check clearing, of course, is a relatively low-tech business that is tied to pieces of paper, albeit paper encoded with router numbers and other automated signatures. If there is any validity to the predictions about the future growth of electronic payments, it seems that within a generation or so, the importance of check clearing will be considerably diminished. Indeed, in view of the changes that have occurred and are likely to occur in the global dollar economy and payments system over the next several decades, it is prudent to ask whether the Federal Reserve System should pro-actively get out of the check clearing business before the economics of the activity become unattractive.

Given the views and considerations presented above, several basic conclusions can be reached:

1. The means of payment and asset valuation used in the marketplace are already changing in such a way as to give the private sector greater control over the definition of money (or at least, "near moneys") and lessen the influence of the Federal Reserve System. These changes, however, are being retarded and slowed by the participation of the Fed in the private money markets and its regulation of the electronic payments system, allowing the U.S. to fall behind the pace of change and innovation seen in other industrial nations.[33]

2. There is no public policy objective consistent with a free market economy that is achieved by having the Federal Reserve System involved in private financial activities such as check clearing and electronic payments. A Congress dedicated to fiscal reform and less intrusive government should make reforming the Fed a top priority.

3. The current role played by the Federal Reserve System in monetary policy is statist and inconsistent with free-market models of political economy. Successive Fed chairmen have allowed the Federal Reserve System to become subservient to the Executive Branch and unresponsive to the will of Congress, lending institutions and the borrowing public.

Therefore, it is reasonable to say that the Congress should enact legislation that will restructure the Federal Reserve System and specifically "spin off" the existing check clearing and electronic payments activities back to the private sector -- namely the member banks which are supposed to own the Federal Reserve System in the first instance.

As part of this "privatization" process, the Congress should take the opportunity to re-examine many of the other activities of the Federal Reserve System and also reform or eliminate those functions -- the discount window, open market operations, foreign exchange operations -- that are no longer necessary to the operation of the U.S. financial markets.

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[32] See Mayer, Martin, "Held In Check: The private sector finds it tough competing with the Fed, *Barron's*, September 23, 1996.

[33] During the October 23, 1996 CMRE Dinner Meeting, guest speaker Martin Mayer observed that innovation in consumer payment options inside countries such as Holland, France and Japan far outstrips the U.S. Mayer blames the Fed and its enforcement of Regulation E for making it more difficult for U.S. firms to introduce smart cards and similar devices. Mayer characterizes the Fed as "a legacy system" and calls Regulation E a "dead weight" that the U.S. financial system must carry in the competitive race for the future in electronic payments.

It can be anticipated that Federal Reserve System officials will object to the idea of eliminating the Fed from the business of check clearing and electronic payments. Volumes of text have been written and numerous speeches have been given by current and former Federal Reserve System officials about benefit of having the Federal Reserve System involved in check clearing, for example to assist smaller banks and prevent these institutions from being dominated by larger money center banks. Federal Reserve System officials have also created an enormous body of literature and accompanying regulations concerning electronic payments, the "risks" present on the Fedwire and the need to "manage" such risks to protect the U.S. financial system and the larger economy.[34]

Of course, given that banks already have the capacity to use U.S. Check or other means to clear checks, it is no longer true that the Federal Reserve System provides a crucial service to smaller institutions. Whereas in the early part of the 20th Century it might have been valid to say that the Federal Reserve System provided a counter-weight to the power of the larger banks based in major cities, today in the age of interstate banking, electronic payments and instantaneous information flows, the situation has changed radically and the role of played by the Federal Reserve System is no longer needed.[35]

The primary arguments about maintaining the role of the Federal Reserve System in electronic payments usually fall around (1) the need for confirmed payments and (2) national security. Because financial professionals and officials of the Federal Reserve System have always assumed that the Fed would be the center of the electronic payments system, the focus of discussions about payment and credit risk on the Fedwire have been made with respect to protecting the Federal Reserve System itself.

Bureaucratic concern about daylight overdrafts on the payments system and other related issues are only a valid subject for public policy debates because the Fed is involved in the electronic payments system in the first instance. In the absence of the Federal Reserve System, the question of extending credit via electronic payments becomes a matter for private individuals, financial institutions and groups of institutions that belong to private clearing houses or exchanges.[36]

The Fed has responded to concerns about intra-day float on the payments system by initiating charges for overdrafts, but the real answer lies in getting the Federal Reserve System out of the business of extending credit to private borrowers. Indeed, the proliferation of bilateral and multilateral clearing and payments associations between commercial banks and non-bank financial institutions suggests that the marketplace is already moving *around* the Federal Reserve System's former monopoly over electronic payments.[37]

The assumption within the Federal Reserve System is that in the foreseeable future, cyberspace payments of any type are likely to command a minor share of the payments system stream,[38] but a similar comment was once made about electric lighting. As already mentioned, economics is the single most important factor driving innovation in the development of new methods and systems for electronic payments. Yet within the Federal Reserve System, the institutional view, perhaps understandably, is that the status quo will be maintained for some time to come, even though most Federal

[34] One of the chief proponents of a role for the Federal Reserve System in managing private sector financial risk is former NY Fed President and Goldman Sachs partner E. Gerald Corrigan. See Corrigan, Gerald, "Luncheon Address: Perspectives on Payment System Risk Reduction," in Humphrey, David B. Editor, *The U.S. Payment System: Efficiency, Risk and the Role of the Federal Reserve System*, Pp. 129-139. Federal Reserve Bank Richmond Payments System Symposium (1990). See also "Gone Fishing," *The Herbert Gold Society*, February 1, 1993. A copy of the article is available at www.l-r-i.com.

[35] Indeed, cynical observers of the steady increase in bank fee charges for electronic transfers and account maintenance might argue that the Fed could provide a useful role in eliminating non-par collection charges for ATMs (the $1 "foreign fee" charged by other banks) in much the same way that the Federal Reserve System eliminated non-par checking clearing charges in the 1920s.

[36] See Folkerts-Landau, David et al., "The Reform of Wholesale Payments Systems and its Impact on Financial Markets," Group of Thirty, Occasional Paper 51, 1996.

[37] For example, See Hansell, Saul, "Paying Bills Without Any Litter," *New York Times*, July 5, 1996, D-1. The article describes how Visa is developing a system whereby customers can effect payments using their personal computers. Visa, American Express and other credit card vendors already have similar systems that are used via the telephone.

[38] See Bauer, Paul W., "Making Payments in Cyberspace," *Economic Commentary*, Federal Reserve Bank Cleveland, October 1, 1995, Pg. 3.

Reserve System officials acknowledge that technology is driving innovations at a very rapid pace:

> "What makes the emerging cybermarket particularly exciting is that the technology will allow many new products to be developed and markets to be tapped. With communications and computing cost plunging, cyberservices will be available to anyone with a telephone and a personal computer."[39]

A Blueprint for Change

In a June 1996 article in *Byte* magazine,[40] author Udo Flohr suggested that there are four basic technology issues that need be resolved before the goal of "electric money," as he describes it, can be achieved:

Security: For on-line transactions, transferring funds, and minting electric currency.

Authentication: So buyers and sellers can verify that the electric currency they receive is real.

Anonymity: To assure that consumers, merchants and the transactions themselves remain confidential.

Divisibility: So electric money will come in cent or less denominations that can make high-volume, small-value transactions on the Internet practical.

All of these points and many others are crucial if the U.S. money markets are going to continue to evolve and retain a leading role in the international marketplace. Some observers, including many officials of the Federal Reserve System, argue that these points need not be addressed immediately and that electronic transactions will only slowly supplant traditional paper currency and checks, but technology-based observers such as Flohr politely disagree with the wait-and-see approach:

[39] Ibid., Pg. 1.

[40] See Flohr, Udo, "Electric Money," *Byte*, June 1996, Pg. 74-84.

> "Of course, there's a second strategy [instead of dealing with the technical issues raised by electronic payments]: Check back at the millennium. This skeptical approach takes the somewhat cynical view that electric money's technical problems will see only moderately successful answers to our security questions, and that the sophistication of thieves will grow at the same pace as that of security experts. Transaction will become more secure but never enough to gain our full confidence. In the meantime, traditional currencies will prevail. This attitude recognizes the technical hurdles that have yet to be overcome, but it doesn't acknowledge the fact that the electric-money genie is already out of the bottle. The market will demand electric money because of the accompanying new efficiencies that will shave costs in both consumer and supplier transactions. Consumers everywhere will want the bounty of a global marketplace, not one that's tied to bankers' hours. These efficiencies will push developers to overcome today's technical hurdles, allowing bits to replace paper as our most trusted medium of exchange."

Congress needs to provide a sound and ample foundation for the new age of electronic credit and payments by scaling back the role of the Federal Reserve System and empowering private business to take over many roles now played by the federal government. Introducing new gold and silver coinage for the voluntary use of the public should also be a priority of any reform legislation. For example, the law might provide that gold and silver coins would be legal tender, but with the value based upon prevailing market rates rather than a pre-set face amount or dollar value.

In order to help expedite and encourage the process of technical innovation, including the adoption of adequate security measures for electronic transactions, the Congress needs to make some basic structural changes in the country's financial system and particularly in the role of the Federal Reserve System. In large part, many of these changes entail eliminating the role of the Federal

Reserve System as a *competitor* of private financial institutions, but that does not mean that the Federal Reserve System has no role to play. In place of the Federal Reserve System's current and inconsistent role of acting as both competitor and regulator, the Congress should give the Federal Reserve System an expanded mandate to protect the integrity of the national payments system with respect to fraud, consumer protection, and most importantly, national security.

In a perfect world free from terrorism and organized crime, it would be preferable that the government and agencies such as the Federal Reserve System would have no role in the market for electronic payments, but given the threat posed by criminal gangs and even foreign governments, there obviously must be some type of official oversight and surveillance of the market for electronic payments in the same way that the U.S. Secret Service today acts as the guardian of physical currency.[41] As economist Mark Melcher of Prudential Securities noted recently: "Mobs, like businesses, are going global."

Despite the apparent complexity of and political obstacles to restructuring the Federal Reserve System, the steps needed to re-define the purposes and functions of the Fed are relatively straight forward. A list of legislative and functional changes that would be required in order to end the participation of the Federal Reserve System in the private marketplace and otherwise restructure the central bank follows below.

1. The Federal Reserve System would be split into two separate entities. One entity, call it the Federal Services Corporation (FSC), would be a federally chartered, temporary holding company created solely as a vehicle to conduct the privatization of the Fed's cash, check clearing and Fedwire functions. The activities now conducted in each reserve district would be reconstituted within a number of individual subsidiaries of the FSC, probably many more than the current 12 Fed districts. Given the enormous geographic changes that have taken place since the creation of the Federal Reserve System more than 80 years ago, it would be appropriate to divide the current Federal Reserve System into more than 18 or more clearing and payments districts. For example, California, which currently has only a single Federal Reserve Bank, would probably end up with several of the new FSC subsidiaries.

2. Each FSC subsidiary (FSCS) would also be federally chartered and would be owned by the banks and other financial and commercial institutions in the area of the country that was served its check, cash and electronic clearing services. Membership in the FSCS would be differentiated between full clearing membership (for banks, exchanges and other regulated financial intermediaries) and associate membership (for commercial entities, governments, and other large users of cash and/or clearing services). Like all U.S. futures exchanges, each FSCS would be a multilateral clearing entity whereby members and associate members would clear transactions using the FSCS as counterparty.[42] Such a setup would have significant benefits for members, including the ability to utilize multilateral netting, both among members of a FCSC and, conceivably, between different FSCSs. As on the Fedwire today, payments from a FSCS would be confirmed, same-day funds. Credit, if any, that was extended as part of the clearing process would be subject to the rules established by the FSCS clearing members.

[41] Perhaps the most prominent example of cyberfraud in recent years was the $10 million electronic fraud perpetrated against Citibank by a Russian computer hacker using a telephone and a computer is St. Petersburg. At first, press reports indicated that the fraud was committed via electronic means only, but sources inside and outside the bank later revealed that the 24-year old hacker was assisted by a confederate operating *inside* Citibank. See Mason, John, "Russian in $2.8 million Citibank computer fraud," *Financial Times*, August 18, 1995, Pg. 1. See also Hansell, Saul, "A $10 Million Lesson in the Risks of Electronic Banking," *New York Times*, August 19, 1996, Pg. 31.

[42] For a good discussion of the mechanics of multilateral clearing, see Moser, James T., "What is multilateral clearing and who cares?," *Chicago Fed Letter*, Federal Reserve Bank Chicago, November 1994.

3. The remaining functions of the Federal Reserve System, would be housed in a streamlined Fed based in New York -- that is, outside of Washington. The Federal Reserve Bank New York would perform two basic functions: (1) monitor the financial operations of the FSCSs and (2) perform general surveillance of the U.S. payments system to protect against counterfeiting, international terrorism and various types of financial fraud. Each of the privately-owned FSCSs would have its own monitoring and surveillance functions, which would cooperate with the Federal Reserve Bank New York and federal law enforcement agencies, such as the Secret Service, Drug Enforcement Agency and FBI.

4. The Federal Open Market Committee would be eliminated and the sole remaining Federal Reserve Bank in New York would take over all of the monetary functions now performed in Washington, with the FCSs performing the day-to-day cash functions of the bank of issue as contractual agents of the Federal Reserve Bank of New York. Bank supervision functions now conducted by the Federal Reserve System would be merged into the Office of the Comptroller of the Currency. Research functions at the Board of Governors, which are primarily focused on supporting the Federal Reserve System's illegal and ill-advised foreign currency operations, would be terminated. Open market operations, foreign exchange trading and the discount window would be eliminated and, indeed, impossible since the restructured Federal Reserve Bank of New York would have no cash operations. Next time the Treasury wanted to bail out Mexico or some other deserving dictatorship, it would be forced first to go before Congress (and the American people) to appropriate the money and then arrange with private banks to carry out the actual financial operations.

5. The Federal Reserve Bank in New York would remain the symbolic bank of issue and would continue to act as issuing agent for the Treasury in the distribution of paper currency, but the privately run FSCSs would handle the actual distribution of currency and coin. The rate at which currency was provided to the FSCSs would be governed by annual legislative directives from Congress to the Federal Reserve Bank of New York, which would be responsible to supervise the currency activities of each FSCS. Significantly, the collateralization of the currency would continue under the supervision of the Federal Reserve Bank of New York, but with the modification that FSCSs could invest in several classes of assets: (1) gold, silver or convertible foreign exchange (including debt of no more than two years in maturity issued by the other G-7 nations); (2) real bills (claims on short-term, self-liquidating private commercial transactions involving real goods and services);[43] and (3) U.S. Treasury debt or investment grade private obligations of no more than two years in maturity. Such investments would be made at the sole discretion of the member institutions that own each of the FSCSs. Thus the Treasury could no longer rely upon the bank of issue as a captive financing mechanism as is now the case.

The U.S. financial markets are on the threshold of the 21st Century and have the potential to create new products and services that could help to make the dollar and the American economic system the dominant model for the entire world. But other nations are already moving rapidly into the world of electronic payments and "cybercash."

By consolidating and restructuring the Federal Reserve System to reduce regulation and allow private enterprise to grow and take maximum advantage of technological innovation, the Congress can help to make the U.S. clearing and payments system more competitive and secure. The challenge facing leaders in politics and among the U.S. financial services industry is to fight the bureaucratic inertia and resistance to change in Washington in order to make this bright opportunity a reality. In addition, there are purely domestic political and economic benefits to restructuring the Federal Reserve System that will serve to add transparency and accountability to how the federal government manages its finances.

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[43] For a discussion of "real bills" in the context of a conservative, sound money regime, see Kemp, Jack, "The Renewal of Western Monetary Standards," *Wall Street Journal*, April 7, 1982. Kemp writes: "The Federal Reserve note is a promise to pay itself. It is what John Exter aptly calls an 'IOU nothing.' We have had IOU nothing money before: with John Law and the Mississippi Bubble; the *assignats* of the French Revolution; the Continental dollar; the Civil War greenback. In every case, these IOU nothings have ultimately been rejected by people in the market. They have always caused high prices, high interest rates, a flight to real values and general stagnation."

When asked about "smartcards" and similar innovations now emerging in the financial markets, Citibank's former chairman Walter Wriston replied in a way that reminds us of the past while also outlining the major obstacle to the growth of the electronic payments system: bureaucracy and official inertia:

> "The United States had no central bank until 1913, so every bank issued its own dollar bills. In the early days these bills were different colors and sizes, and some weren't worth the paper they were printed on. The same thing is happening with smartcards. 7-Eleven is issuing smartcards... The idea of carrying a card with both built-in identification and money has a certain charm, as opposed to carrying a bunch of cash that can get lost or stolen. The card is secure, because it won't work unless you know the personal ID numbers. In France, they introduced smartcards by fiat: they just announced one day that you had to use smartcards for all automatic teller machines. Smartcards are very big in Germany, and in 1995, 400 million smartcards were shipped to Asia. You can't make a phone call in Japan without one. Maybe I'm wrong, but I think money is about to remake itself... Yap islanders kept huge stones in their front yards. The size of your stone indicated how rich you were. Nobody could move these stones, but nobody cared, because they knew you had "money in the bank." We've used wampum, beads, silver, and gold, and now we use paper and call it money. The next transition will be smartcards... The first thing the government will want to do is regulate them: "If it's new it must be bad."[44]

[44] See Bass, Pg. 142.

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About Christopher Whalen

R. Christopher Whalen is Director and CFO of Legal Research International., a specialized financial services and due-diligence firm based in Washington, D.C. He advises companies investing in Mexico and Latin America, and also counsels clients on international financial and credit matters. Mr. Whalen is the editor of two newsletters: *The Mexico Report* and *Washington & Wall Street*, and has contributed numerous articles and commentaries to publications in the U.S. and overseas. He appears before Congress to discuss subjects ranging from third world debt to money laundering, and is a regular guest on *CNBC* as well as various radio programs. Prior to returning to Washington in 1988, Mr. Whalen worked in London as a bond dealer for Bear, Stearns & Co., as a financial analyst for the Federal Reserve Bank of New York, and as a staff writer for the House Republican Conference Committee in Washington. The eldest son of Richard J. Whalen, he was graduated from Villanova University in 1981 with a B.A. degree in History.

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