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THE EPOCH TIMES

TRUTH AND TRADITION

THE FED'S DEBT ECONOMY

HOW THE CENTRAL BANK IMPACTS YOUR WALLET, INVESTMENTS, AND STANDARD OF LIVING

FROM THE EDITOR

MARK WILSON/GETTY IMAGES

Dear readers,

For most Americans, the Federal Reserve is an abstract concept–a distant institution in Washington.

Going by its name, many people would think it's a federal institution holding America's reserves.

In reality, nothing could be further from the truth.

The Fed isn't federally owned, nor does it hold reserves. Created under the Federal Reserve Act of 1913, it has the power to print money.

Its balance sheet–currently at over $4 trillion–forms the basis of the global financial system and allows for ever-expanding debt.

The Fed has failed to prevent the boom-and-bust cycles that it was created to prevent. On the contrary, the Fed's pumping of money into the economy to boost employment and production sowed the seeds for all financial crises and recessions, such as those in the 1930s and in 2008.

With the economy having improved under President Donald Trump, the Fed has been raising its interest rates and reducing its balance sheet, as it always has before great financial crises and recessions. In this cycle, interest rates have increased from 0.75 percent in December 2016 to 2.5 percent in December 2018.

These actions have sent shockwaves through financial markets, showing their reliance on easy money, as well as the excessive power of the Fed.

In this special edition, we explore the origins of the Fed and its impact on the U.S. economy and financial markets; whether it is constitutional; what we can expect from its policies and the effects of those policies on markets; and the fate of the institution itself.

Jasper Fakkert
Editor-in-Chief

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Standing outside of political interests and the pursuit of profit, our starting point and our goal is to create a media for the public benefit, to be truly responsible to society.

We endeavor to educate readers about today's most important topics, seeking to broaden and uplift minds. We believe that rational, balanced debate is key for fostering a healthy democracy and a compassionate society.

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We still believe journalism is a noble vocation, but only when it genuinely seeks to serve its communities and help them to flourish. In all that we do, we will hold ourselves to the highest standards of integrity.
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Sharon Kilarski, Arts & Culture Editor

CONTACT US

Epoch Times Inc.
229 W. 28th St., Floor 5
New York, NY 10001
212-239-2808

Advertising
advertisenow@epochtimes.com

Subscriptions
subscribe@epochtimes.com

General Inquiries
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ESIDENT'S SIGNATURE
NACTS CURRENCY LAW
on Declares It the First of Series
Constructive Acts to Aid Business.
Makes Speech to Group of Democratic Leaders.
Conference Report Adopted Senate by Vote of 43 to 25.
Banks All Over the Country Hasten Enter Federal Reserve System.
WILSON SEES DAWN OF NEW ERA IN BUSINESS
HOME VIEWS OF CURRENCY ACT
FOUR PENS USED BY PRESIDEN

A clipping of a Dec. 24, 1913, newspaper article about President Woodrow Wilson signing the Federal Reserve Act.

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COMMENTARY

THE FED DILEMMA

Yes, it is responsible for market crashes, but the origin of the problem can be traced back to the very roots of the institution

VALENTIN SCHMID

For the most part in 2017 and 2018, only academics and easy-money cranks scolded the Federal Reserve for raising rates. After all, the stock market was bubbling up and the economy was strong.

The economy is still strong, but the stock market has ended its record 10-year bull-market run with a bang. The 20-percent drop in the S&P 500 during one of the worst quarters in market history classifies as a bear market, although prices rebounded at the end of 2018.

Now everybody from traders to retirees as well as President Donald Trump is scolding Fed Chairman Jerome Powell for his relentless path to higher interest rates and a reduction in the Fed's balance sheet.

To make a long story short, yes, the Fed is chiefly responsible for this and other stock-market routs, which often precede recessions. There are other contributing factors, such as worries about the Chinese economy and trade, as well as the government shutdown, which will reduce the $1 trillion yearly spending spree of the federal government. But the Fed is at the center of the storm.

And the problem didn't begin with the Fed's actions over the past two years. The roots of the issues we now face have their immediate origins in the last financial crisis, but ultimately can be traced back to the founding of the Federal Reserve itself.

The Current Crash

The problem on the surface right now is that the Fed is taking away easy money from market participants and economic agents through its raising of the federal funds rate as well as the $50 billion per month reduction of its balance sheet.

The Fed balance sheet, as well as the federal funds rate, is the foundation of the entire global financial system. For every dollar by which the Fed expands its balance sheet, banks and shadow banks around the world can create many dollars' worth of debt on top of it.

Terms like balance-sheet expansion and contraction, or quantitative easing (QE) and quantitative tightening (QT), are fancy words for printing money or removing money from circulation.

Since its creation in 1913, the Fed has had the power to print money and fuel booms, and contract money and create busts. So it has to take responsibility for the vicious business cycles since its creation, such as the Great Depression or the 2008 financial crisis.

You can trace this game back to the Fed's origins, but here, let's confine it to recent history.

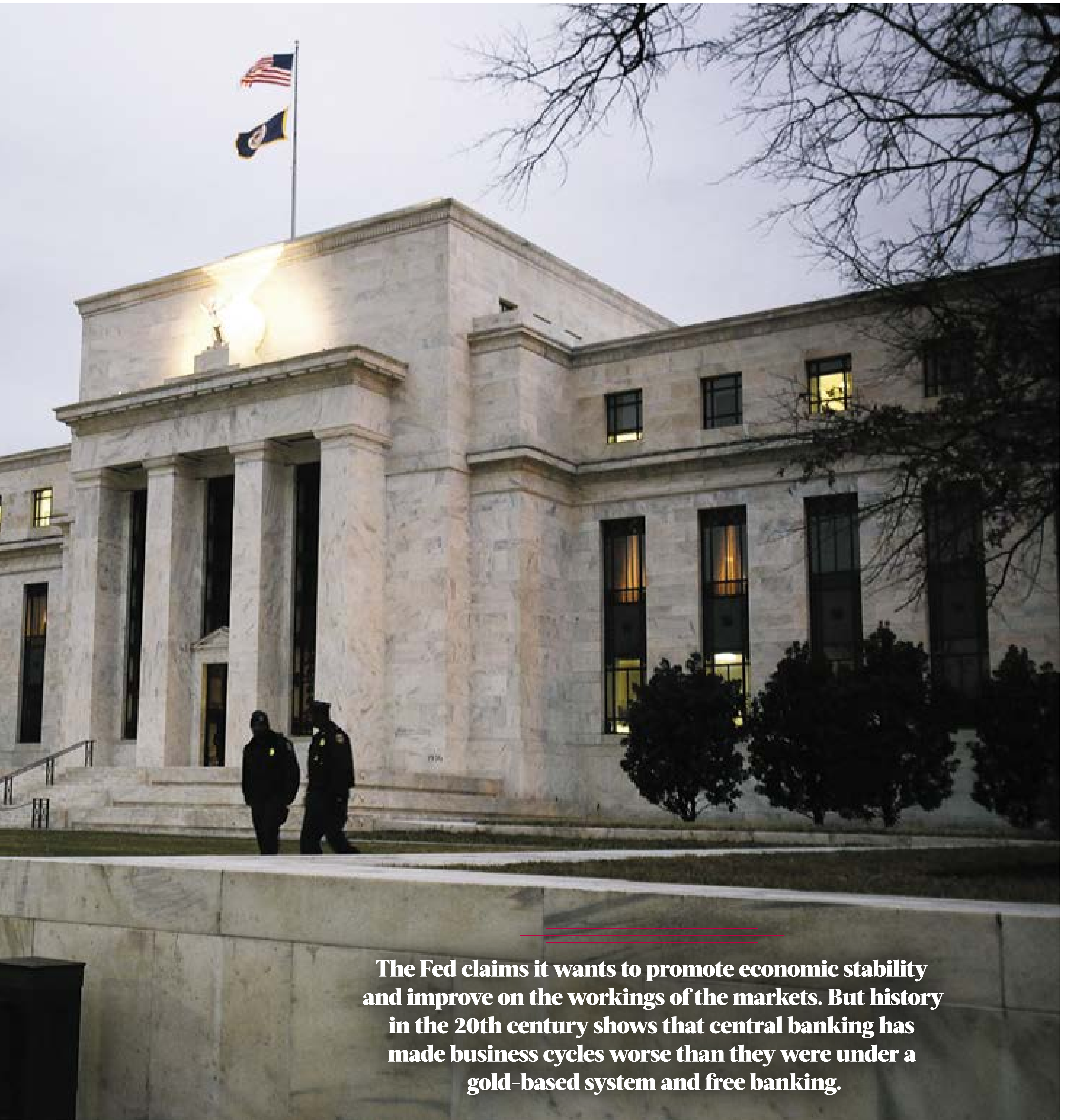
In 1998, the giant hedge fund Long Term Capital Management collapsed and almost took the global financial system with it. The Fed pumped money into the system and we had the dot.com boom, which ended in a bust in 2000 after the Fed had tightened credit conditions.

It then pumped even more into the system to create the subprime boom, which ended in a bigger bust in 2008, again after the Fed had been raising rates for some time.

To "save the system" this time, the Fed boosted its balance sheet to more than $4 trillion and lowered interest rates to zero, in an unprecedented exercise in money printing. This has led to a bubble in corporate debt, student loans, auto loans, and real estate—again.

The Federal Reserve building in Washington in this file photo. The Fed is one of the most powerful and most misunderstood institution in the United States.

MARK WILSON/GETTY IMAGES



The Fed claims it wants to promote economic stability and improve on the workings of the markets. But history in the 20th century shows that central banking has made business cycles worse than they were under a gold-based system and free banking.

Popping the Bubble

But booms fueled by money printing usually fuel economic mirages and lead to investments that wouldn't have been made otherwise, like subprime or dot.com. And even the boom from the past two years has seen a shallow economic recovery, with many people feeling left out.

Now, with interest rates up 2.5 percent, the balance sheet shrinking by $50 billion per month, and the stock market down 20 percent, we are looking to go into bust mode again.

The stock market reaction this time is particularly pronounced because the market has relied on the Fed to either ease monetary policy or delay tightening whenever there was a correction of 10 percent.

The fact that the market reacted so violently to a paltry 2.5 percent increase in rates tells us how dependent it is on easy money.

And Chairman Powell has made it very clear that he isn't "market dependent" but would rather follow his usually wrong and inaccurate models, as well as the philosophical concept of the neutral interest rate.

However, the economy can only be put back on solid footing if the bad investments of the boom are liquidated, which always causes asset-price collapses and economic recessions.

If the market is left to its own devices, these contractions are quick and painful, as in 1921, and then provide a solid basis for expansion.

So if Powell's intention is to pop the bubble and go through the readjustment pain to put the economy on a long-term real growth trajectory, he is doing the right thing, even though he won't be able to centrally plan the exact right rate for market clearing. It would be a good start, and would require no bailouts this time.

No Stability

The Fed claims it wants to promote economic stability and improve on the workings of the markets. But history in the 20th century shows that central banking has made business cycles worse than they were under a gold-based system and free banking, although credit crises existed before the Fed and are to be blamed on fractional reserve banking.

On top of that, the dollar has lost more than 90 percent of its value since the Fed's inception. Stability looks different.

Whether it is incompetence or malevolence, as some historians have suggested, it doesn't matter, because the Fed can't replace a free market for capital.

In essence, setting interest rates and printing legal tender and reserves or contracting them at a whim is central planning. And this gets worse because private players are forced to accept Fed money as legal tender and we are forced to use Fed-powered bank money in the payment of taxes.

DREW ANGERER/GETTY IMAGES

A trader on the floor of the New York Stock Exchange on Dec. 20, 2018.

The dollar has lost more than 90 percent of its value since the Fed's inception.

In fact, central banks look more like a Soviet politburo rather than a competitive market system, although they are privately owned. The few players in control of the system are using the state's power to reap private profits and pile losses onto the taxpayer.

In contrast, the competitive market system is also the best system for money and banking, not just for other goods.

As economist Murray Rothbard points out, nobody thinks about installing a Board of Governors to supervise shoe production and their prices, so why do we need one to supervise money production and set its price?

In fact, President Franklin D. Roosevelt did think central planning would also be better for shoes and chicken, so he set up private cartels similar to the Fed for almost every industry under the National Industrial Recovery Act.

Unfortunately for him, it was ruled unconstitutional. Not surprisingly, constitutional lawyers like Edwin Vieira and many others believe the Fed isn't compliant with the U.S. Constitution, of which Article 1, Section 10, states:

"No State shall ... coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts."

Now, we have paper and electronic notes issued by the privately owned but not privately accountable Federal Reserve System, with the number of such notes expanded and contracted at will.

Sound Money

The Founding Fathers were rather fond of gold and silver, and were against central banking and the ever-expanding government debt that central banks finance.

"And I sincerely believe with you, that banking establishments are more dangerous than standing armies; [and] that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale," Thomas Jefferson wrote in a letter to John Taylor in 1816.

The board of the Federal Reserve in 1917.

PUBLIC DOMAIN

Under the supervision of central banks with the power to print money and a government to bail them out, banks are indeed dangerous and will continue to cause boom-and-bust cycles. However, a return to sound money and competitive banking could put an end to this vicious loop.

Gold has traditionally served as sound money, and it could be used again by the marketplace and even banks to create a free market in capital, similar to the end of the 20th century.

"Look at the era of the classical gold standard, from 1871—the end of the Franco–Prussian War—until the beginning of World War I," monetary philosopher Saifedean Ammous said.

"There's a reason why this is known as the Golden Era, the Gilded Age, and La Belle Epoque. It was a time of unrivaled human flourishing all over the world. Economic growth was everywhere. Technology was being spread all over the world. Peace and prosperity were increasing everywhere around the world. Technological innovations were advancing.

"I think this is no coincidence. What the gold standard allowed people to do is to have a store of value that would maintain its value in the future. And that gave people a low time preference, that gave people the incentive to think of the long term, and that made people want to invest in things that would pay off over the long term."

And while gold would serve as a stable basis for the banking system, banks would have to be set free from the control of the Federal Reserve, be accountable for their actions, and be allowed to fail if they make bad investments.

This would remove moral hazard and create a more accurate clearing price for capital, which wouldn't prevent, but would greatly reduce malinvestments and business cycles.

Chance for the Future

Given its dismal track record and probable unconstitutionality, the Federal Reserve System should be dissolved and sound money returned to the United States and the globe.

The fact that Powell is maneuvering us into the bust cycle could provide the opportunity to execute this momentous plan.

The promoters of the Fed used the stock market and economic crisis of 1907 to push its creation through Congress in 1913.

If this bust cycle is going to be worse than 2008—and by many financial metrics, it well could be—the political elite around Trump could use the next crisis to do the reverse of 2008 and 1913. ■

OFF/AFP/GETTY IMAGES

HISTORICAL ANALYSIS

THE FED'S BOOM and BUST

Central banks were supposed to end the cycle of boom and bust; instead, they amplified it

Politicians created the U.S. Federal Reserve system in response to the 1907 Knickerbocker Crisis, when stocks fell 50 percent over a three-week period and the financial system froze up. This new centralized system, with the Fed as the lender of last resort, was supposed to end the boom and bust cycles for good.

JOSHUA PHILIPP & VALENTIN SCHMID

More than 100 years and many booms and busts later, it can safely be said that the Fed failed at preventing cataclysmic busts like the Great Depression of the 1930s or the Great Recession of 2008. But not only did it fail to prevent them, the Federal Reserve System and fractional-reserve banking—the practice of only holding reserves equal to a fraction of a bank's liabilities—have actually caused the booms and the busts.

The Crisis All Over Again

All banking crises, before and since the founding of the Fed, have been credit crises. Banks issue unbacked credit to finance loans for investment in physical capital like mortgages and factories.

Contrary to full-reserve banking, these loans aren't backed 100 percent by gold and are created out of nothing, providing a bad incentive for the banks to increase credit for uneconomic projects in good times and charging interest on them. Not only are the projects uneconomical—think of the subprime mortgage crisis that triggered the 2008 great recession—this incentive structure leads to rising prices and more demand in the boom phase and at the same time creates the oversupply, which will usher in the bust. Again, real estate is a good example.

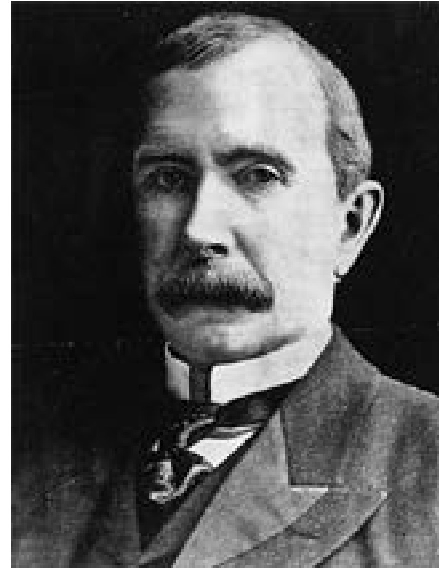
The economic law of reflux would normally lead to depositors withdrawing their money or demanding money in gold, driving the bank out of business to punish it for overlending or lending to bad projects.

However, because the government—then as now—allows for the payment of taxes with money issued by banks, bails out banks when they are in trouble, and also guarantees depositors funds, the incentive to remove one's money and demand payment in gold is diminished or completely removed.

A boom and bust cycle in the early 19th century saw the federal and state governments relieve banks from the duty to redeem their privately created notes in gold and gave artificial value to them by forcing the people to pay their taxes using the same notes.

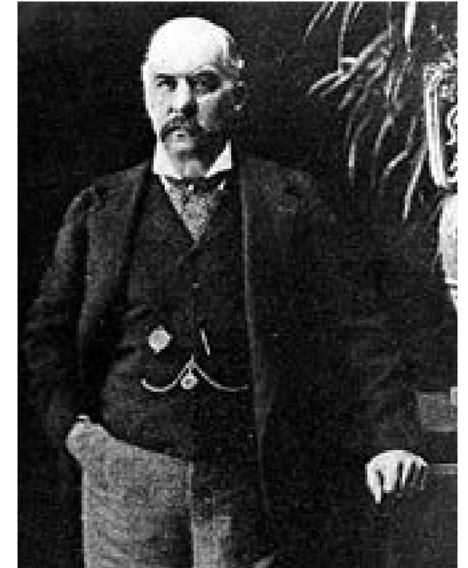
> **"The contraction of money and credit swiftly brought the United States its first widespread economic and financial depression. The first nationwide boom-bust cycle had arrived in the United States.**
>
> *From 'Mystery of Banking' by Murray Rothbard*

HULTON ARCHIVE/GETTY IMAGES



John D. Rockefeller benefited from the crash of 1929.

PICTURE POST/HULTON A HULTON ARCHIVE/GETTY IMAGES



J.P. Morgan circa 1890. The bank JPMorgan Chase was and is a pillar of the Fed and has benefited from its status.

Banknote circulation jumped by 87 percent from 1812 to 1816 and precious metal reserves fell by 9 percent. This was the inflationary boom.

The boom was exacerbated by another privately owned and federally-chartered bank called the Second Bank of the United States (1816), which financed the reckless lending of the many smaller banks at the end of the boom cycle, which then led to the first real depression in the young United States.

"Starting in July 1818, the government and the BUS [Bank of the United States] began to see what dire straits they were in; the enormous inflation of money and credit, aggravated by the massive fraud, had put the BUS in danger of going under and illegally failing to maintain [precious metal] payments. Over the next year, the BUS began a series of enormous contractions, forced curtailments of loans, contractions of credit in the south and west. ... The contraction of money and credit swiftly brought the United States its first widespread economic and financial depression. The first nationwide 'boom-bust' cycle had arrived in the United States. ... The result of this contraction was a rash of defaults, bankruptcies of business and manufacturers, and a liquidation of unsound investments during the boom," writes Murray Rothbard in "Mystery of Banking."

The centralization of banking and interest rate management in the hands of a few people at the Fed did not improve this incentive system but instead amplified faulty incentives.

A History of Crises

All of this was supposed to get better with the Federal Reserve System, which started operating in 1914. However, because the system applies the same principles that led to a credit boom, the results could only be the same.

Not only could the Fed print money without gold backing, its member banks issue even more loans using only a little bit of the Fed notes as reserves.

The federal government also made the Federal Reserve note legal tender providing artificial demand for the printed notes. Then as now, both the states and the federal government accept payment in taxes only in money issued by private banks.

Because the anchor to gold was weakened and completely removed in 1971, the century of the Fed has been a century of financial crises.

FOX PHOTOS/GETTY IMAGES

The crowds on Wall Street in New York, after the stock market crash in October 1929.

The Fed financed the World War I boom of the second decade of the 20th century only to cause the "Forgotten Depression" of the early 1920s by tightening credit after the war.

After this recession was over, the Fed loosened policy leading to the credit bubble of the 1920s. Then in August 1928 the Fed reversed its policy of expansion, sold its Treasury bonds, and hiked interest rates. This caused money to contract and ushered in the Great Depression.

Compared to the Great Depression, the 50 percent stock market loss of the 1907 panic was a walk in the park. Stocks cratered 86.1 percent from peak to trough and the United States only finally escaped the depression because of the government spending of World War II.

Adjusted for inflation, stocks lost more than half their value in the 1970s bear market as the economy spent 2 years contracting with inflation rates soaring into double digits. The Fed and its member banks had financed the 1960s boom of government spending for guns and butter.

And only after the Fed finally declared victory over the business cycle after 25 years of only mild recessions from 1982 to 2007 did the Great Recession of 2008 remind the central planners that fractional reserve banking inevitably leads to boom and bust.

All banking crises, before and after the founding of the Fed, have been credit crises.

The Fed had fueled the dot.com boom and then the housing boom with record low interest rates. Banks said thank you and took advantage of government protection through the FDIC to issue trillions in bad loans for mortgages to subprime borrowers.

When the bubble finally burst, thanks to the Fed raising interest rates to 5.25 percent, the whole financial system needed to be bailed out by the Fed itself and the federal government.

Cui Bono

Given the bad incentives of the system, one wonders why we have not gotten back to a simple set up where bad actors get punished–i.e. bad banks fail–and are therefore pushed to perform better.

Maybe we find the reason in a saying commonly attributed to the powerful 19th-century banker Mayer Amschel Rothschild: "Permit me to issue and control the money of a nation, and I care not who makes its laws."

The privately owned Federal Reserve System creates the currency and the reserves of the banking system by pressing a button. Private banks–protected by the government–issue trillions in credit money.

So it's hardly a surprise that the entities that "issue and control the money" of the United States never get punished and even profit handsomely from the boom and bust cycles.

"Power comes in many forms, but most decisive throughout the centuries is the power to advance or withdraw credit," writes James Nolt in "International Political Economy."

There are "culminating points during which the economy might tip one way or the other, depending on the relative power of the bears and bulls," just like in September of 1929 and 2008 writes Nolt.

Banks are in control at these crucial times as they can either increase or decrease credit (or money) at the turning points. They can engineer a crash but can also start a boom.

Because these insiders have knowledge in advance of the events to come, they can position themselves accordingly. Although there are winners and losers inside the banking system as well, it's always the bigger players who profit at the expense of the smaller ones.

Too Big to Fail

In the case of the Second Bank of the United States, it was a question of whether its stockholders would take a hit or the rest of the economy would fall into recession.

"The Bank, as the largest creditor [to the state banks], had two alternatives: it could write off its debts which of course would wipe out the stockholders' equity and result in bankruptcy, or it could force the state banks to meet their obligations which would mean the wholesale bankruptcy among state banks. There was no doubt about the choice. ... The pressure placed upon state banks deflated the economy drastically, and as the money supply wilted, the country sank into severe depression," writes Herman Krooss in "Documentary History of Banking and Currency."

James Nolt describes how bigger Japanese companies who controlled the nation's largest banks used their power to bankrupt and absorb smaller competitors, leading to the financial crisis of 1927:

"One day, the big banks controlled by the Big Four cut the credit line to their fast-rising competitors and adversaries. They demanded payment; when it was not forthcoming they forced several of Japan's largest new conglomerates into bankruptcy. The Big Four profited mightily. Since many ordinary investors panicked, not knowing which banks were exposed to the failing groups, deposits flowed out of scores of lesser banks and into the biggest banks, which were believed to be safe. Within months, these biggest banks doubled their share of Japan's total deposits from about one-fifth to two-fifths."

The Federal Reserve equally wasn't →

shy to recommend its member banks liquidate stock holdings in February of 1929, just as it further tightened policy. Paul Warburg, a partner with Kuhn, Loeb & Co., gave the same advice to the stockholders of his International Acceptance Bank. Sure enough, the big players like John D. Rockefeller, J.P. Morgan, Joseph P. Kennedy, Bernard Baruch, Henry Morgenthau, and Douglas Dillon, all got out in time.

It's important to note here that in the 1920s not all banks were members of the Federal Reserve System and many of those smaller non-member banks got absorbed by the bigger banks who had the capital to survive the crash. The larger players like JP Morgan and Kuhn, Loeb could also gobble up shares and other assets on the cheap once the liquidation was over in 1931.

This is essentially what happened in 2008. The biggest and most connected banks like JPMorgan Chase & Co., Goldman Sachs, Morgan Stanley, and Bank of America were largely unscathed thanks to a massive government bailout of the other weaker players, which the bigger banks could fairly and squarely count on. They, like Warren Buffett, knew that "Congress will do the right thing," as he said in a CNBC interview in 2008 before the infamous Troubled Asset Relief Program was passed in October that year.

The stronger players then gobbled up smaller rivals like Bear Stearns and Merrill Lynch with the help of the government. Lehman Brothers was allowed to fail, but its good assets were sold to Nomura Holdings Inc. and Barclays of the UK.

The others like Citigroup were saved by the government with their executives keeping record bonus payments from the boom period.

The history of money and banking contains many more examples like the ones cited above. And the future will, too, until the management of money is decentralized again, the government stops creating bad incentives, and bad actors are forced to take responsibility for their actions.■

SPENCER PLATT/GETTY IMAGES

A trader works on the floor of the New York Stock Exchange moments after the opening bell on Oct. 13, 2008.

WIN MCNAMEE/GETTY IMAGES

COMMENTARY

THE FED NEEDS ITS WINGS CLIPPED

Trump points to the cause of economic instability

FERGUS HODGSON

"It's a false economy that we're living in. We're in a bubble."

The man who said that, regarding Federal Reserve policy, was none other than President Donald Trump. He was right then, as a candidate, and he is right now, as president.

Trump's latest dustup with the Fed comes on the back of substantial stock-market declines last quarter. The S&P 500 even briefly dipped into bear market territory after a brutal sell-off in December.

Hardly alone in his assessment, Trump pointed to a slightly more hawkish Fed policy: "It's a correction that I think is caused by the Fed and interest rates." Bob Prince of Bridgewater Associates, an investment-management firm, explained to the Financial Times that "monetary tightening could produce, perhaps not a big downturn, but more pressure."

While critics have called on Trump not to politicize monetary policy, it is too late for that. These critics fail to understand the Fed's dual mandate, which gives the central bank immense power over politics, and the discriminatory treatment that Trump is receiving.

Chasing 2 Goals

The dual mandate is a structural problem well known to economists. It means that the Fed is supposed to chase "both stable prices and maximum sustainable employment," as stated by the Federal Reserve Bank of Chicago.

This is a problem because it assumes the central bank should be in the Keynesian business of so-called economic stimulus to promote employment. It is a recipe for the highs and lows of bubbles and can be timed to favor or oppose incumbents.

Further, the faulty premise of short-term stimulus compromises the Fed's capacity to restrain inflation. The Fed cannot lower interest rates and expand the money supply while also promoting stable prices.

In this case, the timing worked against Trump and the Republican Party in the midterm elections. That was because of the strong perception that the midterms were a referendum on Trump's performance.

Consider that Trump has experienced seven increases to the federal funds rate under his watch in the first two years. How many do you think former President Barack Obama faced during his entire eight-year tenure?

Two.

One need not be surprised Trump believes he is getting a raw deal.

Chickens Coming Home to Roost

The awkward truth is that the rate increases from Fed Chairman Jerome Powell are necessary. The federal funds rate still remains historically low and even negative in inflation-adjusted terms, but the incremental increases have arrived far too late. That is why they appear discriminatory and targeted at Trump, who has only voiced concern and not threatened Powell with dismissal.

Fed Chairmen Janet Yellen (2014–2018) and Ben Bernanke (2006–2014) generated this mess with their out-of-hand and cowardly response to the Great Recession of 2008 and 2009. Rather than allow a full correction for the vast bad debts that drove the bubble, they decided to lower interest rates to unprecedented levels.

Yellen and Bernanke even engaged in extremely aggressive "quantitative easing." This is gobbledygook for buying government and private securities to expand the money supply and inflate the stock market. It quadrupled the Fed's balance sheet to over $4 trillion.

You know where this strategy leads: another bubble, perhaps larger than the previous one.

As Robert Kiyosaki noted on "The Rich Dad Radio Show," Trump was dealt a bad hand. However, the optimism created by Trumponomics, particularly on account of tax reform and deregulation, has delayed and offset what will be an inevitable correction and recession.

Inflation Targeting

If there is to be a central bank in the United States, its role should be as limited as possible. Keep in mind that the Fed only came into being in 1913, and on account of surreptitious tactics.

Top-performing central banks around the world focus on one target: inflation. The Reserve Bank of New Zealand and the Bank of Canada, for example, have explicit agreements to keep inflation between 1 and 3 percent. Neither country suffered the severity of the repercussions felt by the United States during and after the Great Recession.

The range would be better off between 0 and 2 percent, as close to zero as possible. However, at least the sole focus on inflation recognizes that stable prices are pivotal for long-term planning and growth. Just ask Argentines and Venezuelans what happens when there is lack of stable prices.

The dual mandate is a structural problem well known to economists.

Commentary

Not only are stable prices pivotal for economic growth, the targeted focus keeps the central bank out of monkey business elsewhere in the economy. The Fed should never have bought up private securities nor facilitated ludicrous too-big-to-fail handouts for cronies, the magnitudes of which boggle the mind. If there needs to be legislative change to stop these actions from happening again, so be it.

Getting the Fiscal House in Order

If interest rates continue to rise, they will generate enormous pressure on the indebted federal and state governments. Even without higher rates, interest payments alone will push toward half a trillion dollars this year, from the federal government alone.

Such heavy reliance on debt places the federal government in an extremely vulnerable position and dependent on the Fed for cheap credit. If inflation arrives at higher levels, however, the Fed will be reluctant to provide.

This rising tension should be a wake up call for Trump and Congress. The federal deficit has hit a six-year high, approaching $1 trillion, and unfunded liabilities spell worse to come. These magnitudes crowd out private investment and, by pushing up interest rates, generate a downward spiral.

Tinkering around the edges will not suffice, nor will higher growth. If the GOP is serious about reining in the deficit, it will need to address the programs known as third rails: Social Security and Medicare. These largely automated programs are of sufficient size to make a dent and lessen reliance on expansionary monetary policy. ■

Fergus Hodgson is the founder and executive editor of Latin American intelligence publication Antigua Report.

President Donald Trump announces his nominee for chairman of the Federal Reserve, Jerome Powell, in the Rose Garden at the White House on Nov. 2, 2017. Since then, the president hasn't always been happy with Powell but has guaranteed his job security.

DREW ANGERER/GETTY IMAGES

Q&A

Is the Fed Unconstitutional?

Constitutional lawyer Edwin Vieira Jr. explains the history and legal structure of the Federal Reserve System

SETH HIRSCH/THE EPOCH TIMES

Edwin Vieira Jr. in New York on May 22, 2014.

The Epoch Times: Mr. Vieira, what do you, as a constitutional lawyer, have to say about the Fed?
Edwin Vieira Jr.: What most people don't realize is, the history of the Federal Reserve goes back really to the beginnings of this country and Alexander Hamilton.

He wanted to combine the big financial interests of the country with the U.S. Treasury so that the big financial interests would be in support of the new government.

That was the basis for his assumption by the new federal government of the state revolutionary war debts. So you had this kind of symbiotic or incestuous relationship set up between bankers and financiers in the private sector on the one hand and U.S. Treasury on the other.

That continued with the First Bank of the United States, which was a private bank chartered by Congress. And then the Second Bank of the United States, which resulted in the famous bank crisis with President Andrew Jackson, where Jackson essentially defeated the bank and the bank lost its charter.

Another one of these incestuous relationships was the National Currency Act, which created the national banking system and is now a part of the Federal Reserve.

All of these national banks trace back to Civil War legislation. That system had inherent instability because it is all based on fractional reserves and in that particular case, it was tied to the amount of U.S. debt that existed.

At that time, the United States government and the people were not interested in expanding the debt, but bankers didn't like that. So the Federal Reserve System is set up again on this same symbiotic relationship, the Treasury on the one side, the bankers on the other, in order to stabilize the entire system.

The Epoch Times: This fractional reserve system was responsible for most of the financial panics in the late 1800s and early 1900s.
Mr. Vieira: If you interpreted them correctly, you would see they were tied to the profligacy of the banks but the bankers said:

"Well, this is because we don't have a lender of last resort. If we had someone who could pump in liquidity when we have these panics because the fractional reserve system is collapsing; if we had that kind of system then we could manage the panics. We would never have inflation, we would never have depression."

> That is the exact structure of the Federal Reserve System: It's a delegation of some kind of monetary authority to private parties.
>
> **EDWIN VIEIRA JR.** Constitutional lawyer

All right, the system gets up and running in time for World War I in 1914. But after the end of World War I, you have the first depression under the Federal Reserve in 1921–22.

Then comes the banking crisis after the 1929 stock market collapse. In 1931 and 1932, this was the great collapse of the Federal Reserve System.

Roosevelt comes in in 1933, seizes the gold from the American people, turns Federal Reserve notes into legal tender for the first time, and abrogates all of the gold clause contracts that existed–public or private.

The Epoch Times: Why is all this unconstitutional?
Mr. Vieira: First, if you look at the currency unit, the Constitution requires the currency unit to be a

ALEX WONG/GETTY IMAGES

An honor guard stands next to the original copies of the Declaration of Independence, the Constitution, and the Bill of Rights at the National Archives in Washington in this file photo.

silver unit, the so-called dollar. That was the Spanish mill dollar; it was adopted by the Continental Congress and it was adopted by Congress after the Constitution was ratified.

And gold was to be also in the system in what I would call bi-metallic system. The unit was silver or gold and was to be measured in silver, but both of them were to circulate side-by-side.

But banks were operating under the fractional reserve principle and generating currency based upon debt and not based on actual gold or silver reserves. This was the inherent instability in the system.

They lent out more currency than they had real money in the vault.

The Epoch Times: And once the people wanted to redeem their currency, the banks faced bankruptcy.
Mr. Vieira: That's right. Then the banks turned to the government and the initial step was what they call suspension of specie payments.

The government said, "Well you don't have to pay the notes; you don't have to redeem those currency notes for some period of time while you straighten out your loan portfolio."

Some of them, of course, went bust, some of them didn't. But this was one special instance of the government coming into play here to protect the private bankers.

This was in the 1820s, 1830s, before the U.S. Civil War. Then after the Civil War, the symbiotic relationship had the national banks buy U.S. debt and receive 90 percent of the face value of that debt in currency, which then they could loan out on the fractional reserve principle.

The difficulty in that system was that, at that time, the American people were not willing to tolerate an endless expansion of debt so the bankers weren't able to increase the amount of currency and loans.

The Epoch Times: And the Fed solves that problem for the bankers?
Mr. Vieira: The Federal Reserve solves that problem for them but it still had, in its original formulation, a gold connection.

So they had to get rid of that and they got rid of that on the basis of an emergency that was caused by the failure of the system [The Great Depression].

It's incredible how people would accept this kind of reasoning.

Now if you ask, ultimately, why it's unconstitutional, it's because of that relationship in currency creation.

Congress is supposed to oversee the coinage. The dollar is supposed to be a coin and gold is supposed to circulate in coinage form or in bullion form, not in the credit form; that credit form is tied to the U.S. Treasury.

If you look back historically, the Continental Congress in the War of Independence had the power to, what they call, "emit bills."

When the Constitution was being discussed, that power was in the draft, the power to borrow money and "emit bills." They had a debate and struck it out.

Under our constitutional system, the only powers Congress has are the ones given to it by the Constitution. They struck out this provision from the Articles of Confederation, so it logically follows that the power isn't there. There is no power to create paper currency of the debt-based variety in Congress.

The Epoch Times: But you found out there is another reason.
Mr. Vieira: The Federal Reserve is a cartel structure. You have 12 regional banks, and on top of that is the all-seeing eye of the pyramid, the board of governors, and the Federal Open Market Committee. Then down below in the pyramid you have all of the private member banks.

Now, if you look at that structure with a constitutional eye, where have I seen this before, is in the structure Roosevelt created in 1933 in his first attempt to overcome the depression.

It was called the National Industrial Recovery Act. They created one of those little pyramids in every major industry—for steal, for coal. They had one for poultry. It was a famous case Schechter v. United States called the "sick chicken case."

In that industry, legal code was created by the participants, by the private parties. Under that code, a chicken seller could not sell one chicken individually.

He had to sell them in pairs. When the customer says, "Well I don't like that chicken, it looks sick to me, I only want the one chicken," and you sold him just one chicken, that was a criminal violation of the code.

This goes up the Supreme Court in the Schechter case and unanimously they declare that structure unconstitutional because it amounted to a delegation of legislative authority to private parties.

That is the exact structure of the Federal Reserve System: it's a delegation of some kind of monetary authority to private parties, the 12 regional reserve banks.

Of course, they do have the board of governors at the top but the National Industrial Recovery Act also had the National Recovery Administration as the little agency on the top overseeing everything.

So why is the Federal Reserve still here? Because its statute was enacted in 1913, and it wasn't a part of the National Industrial Recovery Act.

Nobody succeeded in bringing a case to the Supreme Court to challenge the Federal Reserve System on the same basis on which the National Industrial Recovery Act was declared unconstitutional. ■

The interview has been edited for brevity and clarity.

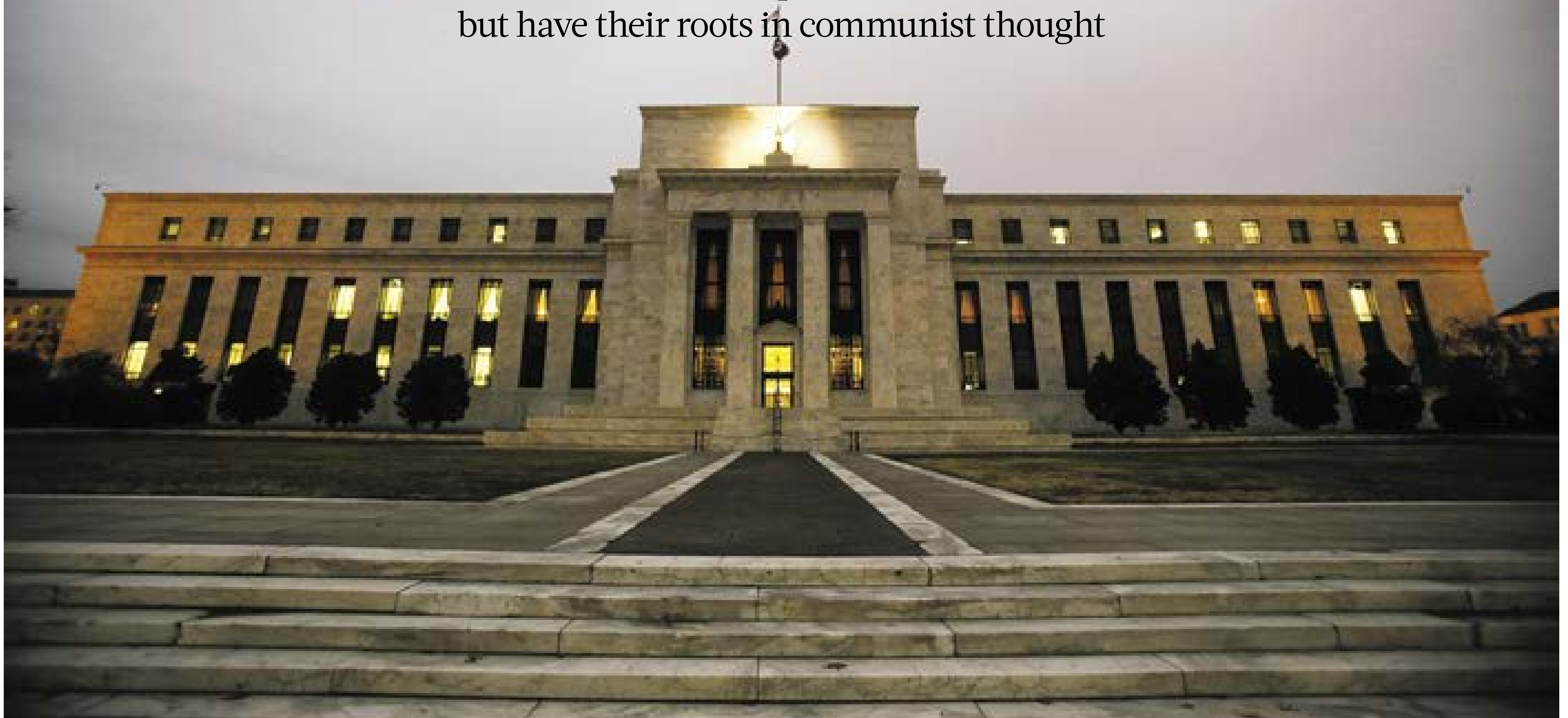
Edwin Vieira Jr. holds four degrees from Harvard, including a doctorate from the Harvard Graduate School of Arts and Sciences and a juris doctor from Harvard Law School. For more than 30 years, he has practiced law, with an emphasis on constitutional issues. He is also one of our country's most eminent constitutional attorneys, having brought four cases accepted by the Supreme Court and won three of them. His two-volume book "Pieces of Eight: The Monetary Powers and Disabilities of the United States Constitution" is the most comprehensive study in existence of American monetary law and history as viewed from a constitutional perspective.

MARK WILSON/GETTY IMAGES

ANALYSIS

IS CENTRAL BANKING A CAPITALIST OR COMMUNIST CONCEPT?

Central banks look capitalist on the surface, but have their roots in communist thought



The Federal Reserve building in Washington on Dec. 16, 2008.

VALENTIN SCHMID

If you visit the Federal Reserve's Facebook page, you will seldom find a positive comment. That's because people who don't care about central banking won't go to the Fed's Facebook page. That leaves only the ones who are positive about it—if they exist—and the ones who don't like central banks.

The right doesn't like central banks because of their centrality. The banks centralize power over interest rates, and the right doesn't like central control over pretty much anything. The left doesn't like central banks because they represent money, capitalism, and "too big to fail" banks.

However, despite the confusion and complicated hybrid setup of the Fed and other central banks, these institutions are more communist and socialist in nature than capitalist.

Contrast these two statements from two important historical documents.

One calls for the "Centralization of credit in the hands of the state, by means of a national bank with State capital and an exclusive monopoly."

The other one gives Congress the power to "coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures."

Karl Marx and Friedrich Engels penned the former statement in 1848 in their infamous "Communist Manifesto."

Alexander Hamilton, John Adams, James Madison, and Thomas Jefferson were responsible for the inclusion of Article 1, Section 8 of the U.S. Constitution, the source of the latter statement.

So which camp is the Federal Reserve in—manifesto or Constitution?

National Monopoly

The Fed is a national banking system and has an exclusive monopoly on issuing the U.S. dollar credit instrument in paper and electronic form.

The Communist Manifesto furthermore calls for "gradually substituting paper money for gold and silver coin." This objective was achieved, gradually, from the beginnings of the Fed in 1914 until the revocation of the Bretton Woods modified gold standard in 1971. Since then, the world has operated on a global paper dollar standard.

The Communist Manifesto calls for 'gradually substituting paper money for gold and silver coin.'

Furthermore, the manifesto wanted the "paper issues [to be] legal tender," a principle dutifully incorporated into the Federal Reserve Act of 1913.

Under the act, "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. They shall be redeemed in lawful money," where "lawful money" means legal tender.

The U.S. Constitution, on the other hand, calls for Congress to "coin money," referring to the issue of gold and silver coins and the standardization of their measurements. The Department of the Treasury

still issues American Gold and Silver Eagles, but the Fed neither coins money nor concerns itself with the standardization of weights and measures.

Hybrid Ownership

What about ownership, capital, supervision, and credit? This is where the Fed does not meet the strict manifesto standard. Legally, the Federal Reserve System is a public/private hybrid, with private banks owning the shares or capital of the system and the government providing some, though not all, of the supervision.

So the Fed does not operate on state capital. However, it shares its profits with the Treasury and most of the important decisions are made by publicly appointed officials. The president appoints seven of the 12 members of the Fed body that decides monetary policy (the Federal Open Market Committee) and they are then confirmed by the Senate. So it does sound like the "centralization of credit in the hands of the state," or at least the power to manipulate credit.

Credit is not centralized in one bank, but rather in the one Federal Reserve System, which includes thousands of privately owned banks that issue credit to their customers. This goes against the call for "suppression of all private banks and bankers," because they still exist. However, the system has central control over credit due to regulation and tinkering with the interest rates.

The Fed can control how many reserves the system banks must hold and how much money (credit) they can lend. The open market operations that determine the interest rate on the reserves also incentivize banks to free up or contract credit.

In fact, setting short-term rates and manipulating long-term rates centrally through large-scale asset purchases, like the Quantitative Easing program, is akin to communist central planning.

In the free market, private banks compete for savings, and the interest rate is set in a competitive bidding process between different economic actors. Not so in a centrally controlled system.

Lastly, Marx and Engels got their wish written in 1848: "In most advanced countries, the following will be pretty generally applicable," with "the following" including centrally controlled credit and other demands of the manifesto.

Today, the only countries without central banks are the micro states of Monaco, Nauru, Kiribati, Tuvalu, Palau, Marshall Islands, and the Federated States of Micronesia. ■

Communism is estimated to have killed around 100 million people, yet its crimes have not been fully compiled and its ideology still persists. Epoch Times seeks to expose the history and beliefs of this movement, which has been a source of tyranny and destruction since it emerged.

PUBLIC DOMAIN

INFLATION THE HIDDEN TAX

Mainstream economics tells you inflation is necessary, when, in fact, it is part of a larger, unfair redistribution mechanism

VALENTIN SCHMID

The Federal Reserve (Fed) targets 2 percent inflation and full employment. While this sounds benign, it is part of an inefficient and unfair economic system that leads to waste, and to boom and bust cycles.

The famous goal of 2 to 3 percent inflation targeted by the Fed is supposed to be a sign of a growing economy and healthy demand by households and businesses. Because both sectors earn more, they can spend more, which leads to higher prices.

This is sometimes true, but most of the time inflation is a hidden tax on productive businesses and households that rewards the government and financial speculators.

Price inflation arises when there is too much money chasing too few goods. For example, the broader money supply figure called M2, which includes most bank deposits, has multiplied 46.5 times since the beginning of 1959, the first time the data was recorded. GDP, not adjusted for inflation, only went up 38.1 times, so the money supply grew faster than productive output.

Over the same time, every dollar spent by the average U.S. consumer lost 88 percent of its purchasing power. This is not a coincidence.

Proponents of inflation economics, mostly followers of the Keynesian school, say that this does not matter, as wages rise in proportion to the loss in purchasing power.

If all prices in the economy indeed rose by the same proportion, then the whole notion of inflation would become meaningless, as relative prices would stay the same. In practice we find that per- →

▲ Children play with stacks of hyperinflated currency during the Weimar Republic in Germany in 1922. Currency became worthless when post-World War I Germany was hit by one of the worst cases of hyperinflation in recent history.

PETR SVAB/THE EPOCH TIMES

The Bergdorf Goodman store in Midtown Manhattan on June 17, 2015.

sistent inflation puts wage earners at a disadvantage; wages have only gone up 33.5 times during the period since 1959.

It also penalizes savers who forgo consumption to prepare for retirement or for the purchases of larger items like a house or a car. Simply putting the money under the mattress or having it in a low yielding deposit at the bank just won't do.

This means that everyone who wants to protect their savings must become a financial speculator, as simply holding U.S. dollars will lead to a guaranteed loss of purchasing power.

Partially due to this incentive, and to the relatively large number of stockholders among the U.S. population, the stock market increased roughly in line with the broad money supply, as the S&P 500 index has gone up 45.5 times since 1959.

Different financial instruments, such as time deposits, bonds, real estate, or stocks, can produce a return higher than that of the inflation rate, but they also involve risk. Inflation, therefore, eliminates riskless saving, an otherwise normal feature of holding monetary instruments such as gold.

How Inflation Works

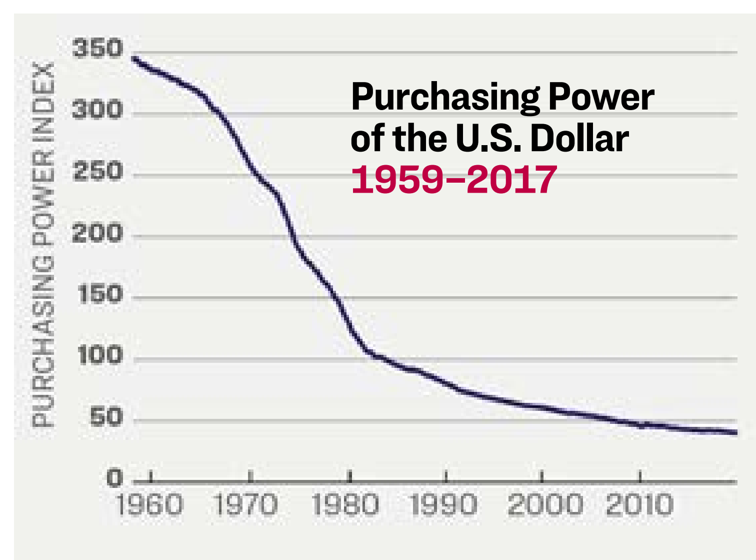
Another winner in this system is the government. This is because the money supply (M2) is often inflated by using government bonds that either the Fed or banks buy with freshly printed money. In fact, government debt has gone up a staggering 70 times since 1959—more than any other metric—in part because foreign entities also hold a large chunk of it.

The government's gains from inflationary policy are manifold. First, inflation erodes the interest the government pays on its debt in real terms. Right now, with inflation ranging between 2 and 3 percent and the 10-year treasury yield between 2 and 3 percent, the actual yield is zero.

The government taxes nominal GDP, which increases with gains in productivity and inflation. Having a higher nominal GDP means higher taxes, which makes it easier to service the debt. So any gain in wages or even capital gains from the stock market, which would reduce the impact of inflation, are reduced by progressive taxation.

Persistent inflation puts wage earners at a disadvantage.

The dollar lost 88 percent of its purchasing power, thanks to inflation.



SOURCES: U.S. BUREAU OF LABOR STATISTICS

The government and financial speculators such as banks benefit from the increase in the money supply because they get the fresh money first.

Once a bank buys a government bond with new money—all it needs to do is expand its balance sheet—the government can use the new money it has on deposit with the commercial bank to fund its operations, like welfare transfers or its massive bureaucracy.

Because it gets to spend the money first, it gets the prevailing prices before the market can adjust for the increase in the money supply. As the money trickles down through the economy, reaching wage earners and businesses who don't supply the government, prices adjust upward.

This is the hidden tax of inflation the private sector doesn't know about. The fact that banks can print fresh money to buy practically risk-free government bonds explains why the government has resorted to increases in debt to fund uneconomical ventures like wars or the welfare state.

It's better than increasing tax rates directly, which would lead to social upheaval. Instead, the government just has to wait until inflation works its way through the economy and increases nominal GDP because of higher prices. Then the existing tax rates bring in more tax revenue without anybody noticing.

Banks also benefit because they can sell the freshly issued government bonds to pension funds and other institutional investors and use the new money to put it into the stock market, real estate, or commodities before anybody else, also getting cheaper prices before other market participants.

Different Forces

In the United States, this erosion of the value of the dollar has been gradual and only noticeable over time because there have been powerful deflationary forces increasing the supply of goods and therefore cushioning the impact of inflation.

The most important factor is gains in productivity through technological advancement. The IT revolution has made it possible to produce more with less, providing us with ever cheaper gadgets, cars, plane tickets, and so on. Where the private sector and competition are allowed to work unabetted, prices usually decline, which is what should happen naturally in a market-based economy with stable money. Non-farm productivity has grown 220 percent since 1959.

So we have innovation and declining prices in sectors with little government interference, countering the inflation

of the sectors where the government is heavily involved, leading to an overall mixed picture.

The second factor leading to goods deflation was the increase in productive capacity in foreign markets, especially China. Cheaper foreign labor and capital enabled the opening of huge industrial capacity and the production of sometimes artificially cheap goods, sold to the U.S. market.

In the absence of these counterbalancing factors, monetary inflation eventually leads to a complete breakdown of the currency, as can be seen in Zimbabwe and Venezuela at the moment. Both countries have a booming stock market, but only in nominal terms.

The Alternative

An economy under a stable monetary regime like the gold standard would display naturally deflationary tendencies that would benefit wage earners and savers.

Capital investment would be financed out of real savings and not via the creation of new money in the banking systems.

This investment would lead to increases in productivity, enabling the economy to produce more with less, thereby lowering commodity input prices and output prices of consumer and capital goods without affecting wages negatively.

The purchasing power of consumers would, therefore, rise every year, and savers could choose to save a share of their disposable income in cash or at a bank without even receiving any interest.

Investors with a higher risk appetite could still choose to deploy their savings in riskier ventures to fund capital investment, but they would not be forced to, as is the case now.

The Fed and other central banks are afraid of deflation because they know it would take the form of forced selling of leveraged assets, as happened during the subprime crisis. But benign deflation in a stable money system originates from gains in productivity higher than the prevailing interest rate for loans.

As for the government, it would have to learn to live within its means, as it could not rely on banks to print money to finance its debt. And with money increasing in purchasing power and being literally risk-free, it would be hard-pressed to find investors to buy its bonds.

With less financial speculation and less government waste, capital could find the most productive uses, leading to higher productivity and, ultimately, cheaper consumer prices. And who wouldn't like that? ■

DREW ANGERER/GETTY IMAGES

President Donald Trump shakes hands with Jerome Powell, nominee for chairman of the Federal Reserve, at the White House on Nov. 2, 2017. Since then, the president has criticized the Fed for raising rates too much.

COMMENTARY

Is the Fed Right About Hiking Rates?

The timing and the rhetoric are strange, but the Fed is thinking about the long term

Commentary

DANIEL LACALLE

President Donald Trump isn't a fan of current Federal Reserve policy, specifically about raising rates too fast or too much.

And it is true: the timing of the rate hikes and the brisk commentary coming out of the Marriner S. Eccles building in Washington seem odd to many who have gotten used to continuous Fed support for financial markets, whether in the form of jawboning or various easing programs.

We all remember how then-Fed Chair Janet Yellen all but suspended the intended tightening policy just before the presidential election in 2016 because of market jitters. So Trump is right to wonder why the current incumbent administration does not get the same treatment from the Fed as the previous one.

However, leaving the political timing aside, current Fed chairman Jerome Powell's policy is the right one for America in the long run.

Lost Opportunity

As Trump noted himself, the mandate of Yellen in the Fed was a lost opportunity. Yellen and the Fed delayed urgent and justified rate increases despite a bull market and high liquidity due to the fear of a negative market reaction ahead of the 2016 election.

And it's not that Powell is acting rashly. His Fed is conducting the rate hikes with months of warnings and detailed communication. Because the economy is growing above 3 percent, wage growth is also at 3 percent and unemployment is at record lows.

The rate hikes so far have not only caused no damage to the economy but have helped strengthen growth while investment returned. →

The rate hikes so far have not only caused no damage to the economy but have helped strengthen growth while investment returned.

DON EMMERT/AFP/GETTY IMAGES

Traders at the New York Stock Exchange in this file photo. Markets briefly entered a bear market last December after the Fed made it clear it would keep raising interest rates.

Years of low rates reduced capital expenditure and fueled a dangerous bubble. Now, real investment is back. Gross fixed capital formation was up 8 percent last year after years of stagnation, and capital repatriation exceeded $300 billion.

The reason why Powell can and should use this period of superior growth to build a buffer for the future is because the Tax Cut and Jobs Act has helped prolong the recovery, which has started to reach the middle class. Savers and workers benefit from a stronger dollar and moderately higher rates. Now, as the interest rates on even the shortest-dated and safest Treasury bills are above 2 percent, conservative savers are starting to see their disposable income and savings improve.

Easy Fed Money

It is important to note that policy remains highly accommodative compared to historical standards. The yield on 30-year U.S. Treasuries discounting inflation is less than 0.08 percent and credit conditions remain robust. Money supply growth continues to be strong and above nominal GDP growth despite the Fed reducing its exposure. The private sector is offsetting the unwinding of the Fed's balance sheet.

More importantly, if the Fed does not build a buffer for an eventual downturn by reducing the balance sheet and raising rates while the economy is strong, the negative consequences will be significant.

We see in Europe how the European Central Bank (ECB) has not raised rates, and now the slowdown of the second half of 2017 has accelerated, leading the central bank to exhaust all its tools to support the economy.

If there is a possible recession, what can the ECB or the Bank of Japan (BoJ) do when rates are at all-time lows and liquidity at all-time highs? Very little.

And while the Fed is getting prepared for an eventual downturn, it is precisely the positive effect of this administration's supply-side measures that keeps jobs, wages, investment, and growth above global trends.

Strong Dollar

The U.S. dollar needs to remain the world reserve currency and the safest asset, and this can only happen if the Fed normalizes its monetary policy as it has announced.

The United States can absorb the rate hikes because the evidence shows it becomes a safer and better investment option compared to the rest of the world. And even though the S&P 500 has recently dropped sharply and is 10 percent off the record highs, European markets trade 20 percent below their 2015 highs, which never reached the 2007 highs, which never reached the 2001 highs.

As the U.S. economy improves and others face the saturation of past stimuli, it is only logical that the United States sees a high inflow of funds from abroad. And that is good. It keeps U.S. Treasury yields low, stimulates demand for bonds and equities—at least relatively speaking—and provides a steady flow of capital investment into the U.S. economy.

The U.S. economy can accept a strong dollar and moderately higher rates.

It only exports around 10 percent of GDP, and less than 30 percent of the profits of S&P 500 companies come from exports. More importantly, the United States exports high added-value goods and services, which don't suffer much from a stronger dollar.

In the past nine years, devaluing the currency and lowering rates has hurt the middle class, savers, workers, and high productivity companies—those that voted for Trump to change the mistakes of the past.

The mandate of Yellen in the Fed was a lost opportunity.

A devaluation policy hurts more Americans than it helps. Devaluation is simply stealing from your citizens' savings and disposable incomes.

A strong U.S. dollar reduces inflationary pressures and keeps interest rates low. With the economy growing as it is today, rates would be much higher in a normalized environment, closer to 4.5–5 percent.

A strong dollar and a prudent monetary policy have those two positive effects for savers, workers, and families as the economy strengthens and wages improve.

Signal Effect

If the Fed did not raise rates as announced, it would send a negative signal to the world—that things are much worse than the economic data shows. Even worse, it would not act as a positive driver for risky assets like stocks and bonds.

These are falling now because of excessive valuations and the slowdown in emerging markets and the eurozone, factors that have nothing to do with the Fed's normalization and everything to do with the excessive fiscal and trade imbalances built by those economies in the period of low rates and high liquidity. As noted above, those markets are down much more than the S&P 500.

The Fed needs to normalize in order to avoid making the mistakes of the ECB and the Bank of Japan, but mostly to maintain the status of the United States as the world reserve currency.

A sound monetary policy and defending a strong currency is good for the clear majority of the economic agents of an economy. No country has collapsed due to a strong currency. Many have fallen due to constant destruction of the purchasing power of their currency.

A moderate rate-hike policy and a strong currency are also essential to keep the world reserve currency status. If a small proportion of the U.S. economy suffers from a strong dollar due to low competitiveness, it is a price worth paying in exchange for being the world's most used currency, a reserve of value, and a worthy investment for the rest of the world.

If Trump wants to strengthen the domestic market, increase disposable income for the middle and lower classes, and end the perverse incentives created by years of excessive demand-side policies, he needs to accept the prudent path outlined by Powell. ■

Daniel Lacalle is chief economist at hedge fund Tressis and author of "Escape From the Central Bank Trap."

MARK WILSON/GETTY IMAGES

FED CHAIRMAN

Who Is Jerome Powell and What Is His Strategy?

DANIEL LACALLE & VALENTIN SCHMID

For decades, the Federal Reserve has run not on a gold standard but on a Ph.D. standard. Academics such as Ben Bernanke and Alan Greenspan thought they could manage the most complex and most important price of the market economy–the interest rate–with a few mathematical equations.

The 64-year-old Jerome Powell could prove to be different, because he has had more practical experience in business and government than Greenspan, Bernanke, and Janet Yellen, who, apart from their time with the Fed, have been academics. Powell is a trained lawyer who made a career in investment banking, private equity, and public service, and has been serving as a Fed governor since 2012.

Unfortunately for Powell, he is now in the hot seat when the next recession or financial crisis hits, and hit it will.

The main difference between him and his predecessor Yellen? He doesn't seem to care what the market does and just follows his policy of rate normalization, based on a strong economy and the Fed's mathematical models.

The first press conference by Powell as chairman of the Fed in March betrayed as much.

Powell was clearly cautious with long-term estimates, an Achilles' heel of a Fed that consistently missed its own inflation and growth expectations. His response to a reporter on his predictions for 2020 was perfect: The Fed has to monitor the changes that are taking place right now and avoid giving optimistic estimates that only make them lose credibility.

And now, credibility is key, as the Fed doesn't have much of it left.

Powell was technical, correctly agnostic to stock-market reactions, and exceptionally aware of the risks in a market extremely oriented toward external stimuli.

For market operators, having a new Fed chair with such an unpolitical and market-agnostic profile may not seem like good news. But it is. Too many investors play the "bad news is good news" game. That is, to expect poor macro data so that monetary stimulus is perpetuated.

This carry trade leads market participants to bet on cyclical assets and inflationary themes, while expecting economic stagnation and more expansionary policies. This is dangerous.

What Powell explained is very important, and the path of rate increases is clear. The "buy anything" party is over. And that's good.

The U.S. economy can absorb a rate-

increase path up to 2.75 to 3 percent in 2019 without a problem. In fact, if the economy couldn't absorb it, we would have to be very concerned about the kind of growth and investments we have.

Will He Blink?

However, with the market down more than 20 percent as of just before Christmas, his resolve will be put to the test.

In 2012, writing on what was then the latest round of easy money (in the form of quantitative easing), fund manager Paul Brodsky said, "After professionally watching Fed chairmen cajole, threaten, persuade, and manage sentiment in the markets since 1982, we argue this latest permutation is understandable, predictable, and, for those willing to bet on the Fed's ultimate success in saving the banking system (as we are), quite exciting."

He argued that the Fed's congressionally mandated objectives of maintaining price stability and full employment are secondary to keeping the banking system solvent.

Given that the Federal Reserve System is owned by its private member banks, this analysis is not too far-fetched, and borne out by history.

Whenever a financial crisis threatened the banking system (that is, the Federal Reserve System), the Fed and its chair would do whatever it took to save it from collapsing.

Greenspan oversaw the bailout of savings and loans in the early 1990s, as well as of hedge fund Long Term Capital Management (LTCM) in 1998, both private-public initiatives greased with Fed liquidity, loan guarantees, and lower rates. The bailouts led to what economists call moral hazard, in which participants think they can take excess risk because they will be bailed out.

"When LTCM was rescued, there was a general thought: 'Hey, these guys are on the job if we screw up. They've got our backs,'" said Barry Ritholtz, chief investment officer at Ritholtz Wealth Management.

Easy financial conditions enabled the tech bubble of the late 1990s, and Greenspan again juiced the markets after the tech bubble popped and the economy suffered a relatively mild recession in 2001.

This led to another round of moral hazard and the subprime bubble, which popped in 2007, and, in turn, led to a real financial crisis and a harsh recession in 2008–2009.

After taking over in 2006, it was Bernanke's job to announce zero interest rates and quantitative easing programs, and to broker various bailouts for insolvent banks by other banks or the federal government.

Contrary to the Fed's narrative, the banking system could have been restructured in a different way, one that would lead to less moral hazard in the future.

"Let's use Bank of America as an example," said Ritholtz. "Bank of America gets nationalized, which really means Uncle Sam provides debtor-in-possession financing. This is really what happens normally with small companies. Someone who takes them out of bankruptcy gives them some operating money to keep functioning. The equity gets down to zero—senior management out the door. There is certainly a layer beneath, which can get promoted without a problem."

In comparison, Yellen's job was relatively easy: She just had to make sure rates didn't rise too quickly as to cause stock and bond markets to crash, and hope there wouldn't be an external shock (for instance, China) on her watch that would push the fragile system over the brink.

Unfortunately for Powell, he's now in the hot seat when the next recession or financial crisis hits, and hit it will. Then, his background in business will cease to matter, and he'll probably continue the unofficial Fed policy of keeping the banking system afloat, just like his predecessors.■

Who Is Jerome Powell?

Powell is a lawyer who made a career in investment banking, private equity, and public service and has been serving as a Fed governor since 2012. He does not have a degree in economics.

SPENCER PLATT/GETTY IMAGES

Traders work on the floor of the New York Stock Exchange as the Federal Reserve Board Chairman Jerome Powell holds a news conference on Dec. 19, 2018.

For market operators, having a new Fed chair with such an unpolitical and market-agnostic profile may not seem like good news. But it is.

Chairmen of the Federal Reserve Board

Paul Volker 1979-1987
American economist (M.A. from Harvard) and chairman under Presidents Jimmy Carter and Ronald Reagan

Alan Greenspan, 1987-2006
American economist (Ph.D. from NYU) and chairman under Presidents Ronald Reagan, George H.W. Bush, Bill Clinton, and George W. Bush

Ben Bernanke 2006-2014
American economist (Ph.D. from Princeton) and chairman under Presidents George W. Bush and Barack Obama

Janet Yellen 2014-2018
American economist (Ph.D. from Yale) and chair under Presidents Barack Obama and Donald Trump

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Tim Newton, chairman and CEO, Salmagundi Club

"It's the only sane newspaper amidst all this insanity."

Stan K., pastor

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COMMENTARY

BANK MONEY

'The Root of All Evil'

Waste and corruption are the result of banks' privilege to create money out of nothing

The seal of the Federal Reserve on a U.S. banknote.

VALENTIN SCHMID

The one force that causes the most harm in our economy also happens to be the least well-known and understood.

While the left blames greedy corporations and individuals, and the right blames the government, it is in fact the collusion between the government and private banks that leads to problems like environmental degradation, unemployment, income inequality, and many more.

In the United States and most other countries, the government grants private banks the right to create money out of nothing and forces individuals to accept said money as legal tender and to use it to pay their taxes.

The Coinage Act of 1965 states, "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."

Today, the "notes" are mostly electronic credits in the form of bank deposits, but the same law applies. So much for legal tender—what about creating money out of nothing? Don't banks take savers' deposits and then loan them out to borrowers?

The short answer is no. Instead of taking in savings from companies and individuals, then waiting for a suitable borrower, banks use a simple accounting trick to create new money whenever someone applies for a loan.

Let's assume you apply for a mortgage of $450,000. Once it's approved, the bank simply credits your account with $450,000 in the form of a deposit, which you can then use to spend on your house. This is the bank's liability. On the bank's asset side, it credits itself with a loan of $450,000 to you, which you will pay back over the course of 30 or so years, plus interest.

For this process, no savings are necessary. The only thing the bank has to do from a regulatory perspective is keep a very low fraction of its assets in cash or balances at the Federal Reserve (Fed), so it can pay out some cash on demand if needed. This is often not more than 1 percent of its assets, hence the term "fractional reserve" banking.

The Root

The popular saying has it that money is the root of all evil. However, the original quote from the Bible would be more accurately applied to the process described above, wherein banks are allowed to create money out of nothing and charge you interest for the trouble: "for the love of money is the root of all evil."

Money itself, of course, cannot be evil. It merely measures the value of goods and services produced and the value of capital saved. However, under the bank money monopoly, the new money created doesn't measure production and savings, but actually changes them.

Instead of taking in savings from companies and individuals and then waiting for a suitable borrower, banks use a simple accounting trick to create new money whenever someone applies for a loan.

The creation of "money," in the form of the loan and deposit, required nothing to be produced and nothing to be saved. The production only begins later, when the contractors start building the house—although even that is not guaranteed, given that many mortgages or other loans are used to buy up existing assets, which drives up prices.

Even loans that finance new construction alter the economy in unnatural ways: bankers' prejudice directs production instead of consumer demand from their own savings. And the bank, which can repossess the collateral unless the loan is repaid, gets something for nothing.

The principle at work here is pure love of money—nothing more. The bank does not need to expend any effort but can "earn" the interest on the loan, which is the same as a private tax on the money supply. It is the equivalent of a few designated individuals being allowed to keep a money press

MANDEL NGAN/AFP/GETTY IMAGES

at home, which they could then use to print cash, make loans, and charge interest against. Meanwhile, everyone else is forced to use those printed loans to make investments. Clearly, this is not fair.

The Problem

The ease with which banks can create money explains the recurring colossal blunders in risk management and loan creation, of which the subprime crisis is only the most recent manifestation. Because money is free, it makes sense for banks to loan out as much as possible. After all, they don't have to do anything to source the funds, but get to reap the interest payments as the loans are repaid.

If the market for money were not completely cartelized by the government for the banks, even this perverse mechanism would have its limit, and would ultimately lead to the demise of the participating banks—just as what played out in the 2008 crisis.

However, because banks, regarded as too big to fail, collude with the government and sponsor politicians with campaign contributions, they can always rely on the government to bail them out when the house of cards collapses. This is not a problem of too little regulation, but instead of the wrong kind of regulations, perpetrating a systematic theft of public resources.

Even this is just the tip of the iceberg. Because the capital allocation process in this system is so flawed, the private sector is encouraged to spend funds on inefficient and unnecessary vanity projects—real estate is the most obvious, along with massive industrial overcapacity.

Because big corporations have better access to big banks, they have better access to this artificial "capital," and they can therefore crowd out smaller players that may be able to service their communities better. Too much real estate development and industrial overcapacity also put the most strain on environmental resources.

The process leads to the centralization and bureaucratization of everything, not just the government. Big corporations, paying lower interest charges than their smaller competitors, end up providing the majority of goods and services. This is why we see the same brands and chains everywhere.

Because the money supply "tax" needs to be paid to private banks, corporations are constantly looking for ways to cut costs, which often means firing people and replacing them with robots.

Workers and ordinary consumers, on the other hand, get trapped. They have no choice but to meet high interest payments on credit card loans and mortgages, while the prices of goods, and anything they might invest in, shoot through the roof.

$63.5 TRILLION

The total amount of credit market debt created by the banking system. It has been growing at an average annual compounded rate of 8 percent since the fourth quarter of 1951.

SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS

The Solution

Of course, it doesn't have to be this way. If banks did not have the privilege of creating money out of nothing, and instead had to source their loans from real savings, their incentives would change immediately. It would also help if there were no government bailouts.

In that case, investment would equal real savings and would by definition be limited, because savings require a reduction in consumption. This is harder to achieve than simply printing money. Resources would, therefore, be economized. Opportunities for accumulating extravagant wealth, while still present, would also be reduced, and there would be a natural tendency toward a more even wealth distribution—not one engineered by a centralized bureaucracy.

If banks and borrowers had skin in the game, capital allocation decisions would be examined not according to the "love for money" principle, but rather according to how productive the investment would be.

More productivity means producing more with less, thus saving natural resources. Less capital investment would mean more room for humans to participate in the economic process. Prices for capital and goods would be more stable.

This is not a dream, nor a vision of Utopia. Honest banking and honest money have existed before in history. The first step to solving this problem is to become aware of the problem. ■

SHUTTERSTOCK

Contrary to popular opinion, the Fed doesn't even create most of the money in our financial system. It merely provides the basis for private banks to create credit money.

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