Special Banking

Expanding credit through a new Federal Reserve

by Kathy Burdman

The National Democratic Policy Committee announced this week the release of a draft "Federal Reserve Reform Act of 1981," reshaping the nation's central bank in order to halt the current inflationary expansion of money supply. The act would redirect expanded credit instead to high-technology capital-goods investment and a general expansion of production of real industrial and agricutural wealth.

The legislation is based on proposals by policy committee advisory board chairman Lyndon H. LaRouche, Jr. to return the United States to the form of central banking originally intended by Treasury Secretary Alexander Hamilton and embodied in the Constitution. The current Federal Reserve open-market creation of bank reserves is unconstitutional, states LaRouche, because it leaves "the power to create fiat credit in the hands of a powerful cartel of private bankers" led by Citibank and Chase Manhattan, "who dominate the federal funds market." Mr. LaRouche, a 1980 conservative Democratic presidential candidate, called instead for a return to "the constitutional obligation of the federal government" to ensure that the nation's credit goes directly to productive manufactures and agriculture.

The National Democratic Policy Committee is an organization of conservative Democrats formed after the August 1980 Democratic Party National Convention in opposition to the party's nomination of Jimmy Carter. The committee, which accurately predicted the disastrous loss by the Democrats on Nov. 4 under a Carter candidacy, rejects the no-growth economics of the Carter administration, and seeks to revitalize the party through the promotion of high-technology industrial development.

The legislative agenda

The Federal Reserve Reform Act of 1981 would amend the Federal Reserve Act of 1913 which created the Fed system.

The aim of the amendments is: 1) to forbid the Federal Reserve from creation of new fiat credit through its current mechanism of *open-market operations,* commonly known as creation of net new money supply; 2) to provide the banking system instead with unlimited new credit through the Fed *discount window,* provided that all loans to the economy presented to discount by banks to the Fed are earmarked for new real capital investment, production, or transport of tangible wealth; and 3) to raise *reserve requirements charges* on the deposits of those banks whose total loans and other assets outstanding show an inadequate proportion of lending for purposes of tangible real production.

Modification of open market operations. "The core of the problem," the supporting brief to the new act asserts, "is to be found in the way that the Federal Reserve System creates money." The Fed currently adds net new money supply to the banking system each week by printing of fresh new Federal Reserve Notes, the familiar bills which circulate as currency, to buy a certain portion of U.S. Treasury bills or notes, the government's debt, which would not otherwise be purchased by money already in circulation in the banking system. This is known as "monetizing the government debt," printing fiat money to finance the government's deficit.

Even worse than this inflationary problem of "How much money supply?" the brief continues, "is the question 'Whose?' " In practice, the Fed does not purchase Treasury bills directly from the Treasury, but from the two dozen leading Wall Street government securities houses such as Salomon Brothers and Goldman, Sachs, who have bought the debt from the Treasury in anticipation. These big security dealers then deposit the proceeds of their Treasury debt sale—the new fiat-money of the Federal Reserve—into accounts at the top 20 commercial banks, led by New York's

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Citibank and Chase Manhattan.

"The banks then have additional deposits, created out of thin air," the National Democratic Policy Committee brief points out. "They then create more money out of thin air: they loan their deposits to a customer; the customer's loan is redeposited and becomes a new deposit; and so forth." Current reserve requirements limit the "money multiplier" to about 2.5 times the original creation of new money by the Federal Reserve System.

The control of the nation's credit thus rests with a private banking cartel, not the federal government, the legislative brief states.

"In effect, the Fed shares its monopoly powers over money creation with a handful of big money-center banks. If these institutions made most of their loans to the goods-producing sector of the American economy, there would be no problem. They do precisely the opposite. Half the profits of the top 10 commercial banks accrue from the highly speculative Eurodollar market. The large banks are as likely to lend out the newly created money they received from the Federal Reserve into the Eurodollar sinkhole as they are to the American economy.

"That explains why the majority of the nation's 14,700 commercial banks have suffered a deposit shortage during the past two years, even while money supply rose sharply. What the Federal Reserve pumps in does not reach the capillary system of the economy, because the aorta has a leak."

The Federal Reserve Reform Act of 1981 therefore proposes to modify the Fed's open-market operations such that net new fiat money is no longer created through money supply expansion, which the act accomplishes in Section 3 by setting a statutory limit to the amount of U.S. government debt the Fed may hold. The Fed may continue to perform the other functions of open-market operations, such as the short-term buying and selling of Treasury debt to stabilize the markets, but may not buy net new debt.

A new, expanded discount window. The new act then proposes that large amounts of new credit be issued to the economy, rather, by the reformed Fed's getting back total constitutional federal government control over its new fiat money and directing it specifically to productive enterprise. "The Federal Reserve System may create new money indefinitely as long as the new money serves to create new wealth," the supporting brief states.

The new act therefore proposes that the Fed open wide its discount window, which currently provides, by custom, only marginal amounts of credit for emergencies to the banks, for general productive lending. The advantage of the discount window is that it discounts, via the banks, bills of trade which represent chits in effect on tangible goods or services, so that the central bank is assured new money goes to create real wealth.

Criteria for borrowing

For example, U.S. Steel will be able to get a loan from the Pittsburgh National Bank if it can prove the funds will be used to build a new steel plant. In that case, the banker will be able to take the loan agreement to the Fed discount window under the new act and borrow cash up to 50 percent of the value of the loan. The 50 percent requirement is to make sure the banker continues to bear his share of the loan's risk, to ensure sound lending.

If U.S. Steel wants to borrow, however, to diversify into real-estate speculation or casino gambling, Pittsburgh National will advise them that the Fed wouldn't discount such a loan and that the bank cannot make it, except perhaps at exorbitant rates.

The new Act states in Section 4:

> "Upon the endorsement of any of its member banks . . . any Federal Reserve bank may discount up to 50 percent of the face value of notes, drafts, and bills of exchange rising out of the production of actual tangible wealth or capital improvements. . . . This shall be defined as the purchase of raw and intermediate materials and capital goods, construction of facilities, or employment of labor to produce or transport manufactured goods, agricultural commodities, and construction materials; to work mines; to build manufacturing, transportation, and mining facilities or dwellings; to produce and deliver energy in all forms; and to provide public utilities."

Preventive reserve requirements. To prevent banks generally from lending new Federal Reserve discount window credits, which may be redeposited by the borrowers or among banks many times, for nonproductive purposes thereafter, the new act further adds a safety reserve requirement.

The Federal Reserve now requires all banks to keep on deposit with the Fed a reserve against bad loans, calculated at an average rate of 16 percent of the bank's total deposits. This in effect costs the bank money, since the funds are immobilized, and cannot be loaned out.

Under the new act, as long as banks maintain at least 60 percent of their loans in the real productive activities listed above, they will be subject to normal reserve requirements. However: "For every 1 percent by which the member bank's proportion of tangible wealth-creating assets falls below 60 percent of total assets," the new act states, "the Federal Reserve shall require" an additional 1 percent reserve-requirement charge. This should greatly discourage any bank from falling below the 60 percent productive-asset limit.

The Federal Reserve Reform Act of 1981

The following are excerpts from the National Democratic Policy Committee draft legislation:

Sec. 3. Sec. 14 of the Federal Reserve Act of 1913 as amended is hereby amended to include the following new paragraph:

Sec. 2. Sec. 14 of the Federal Reserve Act of 1913 as amended is hereby amended to include the following new paragraph:

"The power of the Federal Reserve banks to purchase or sell bills, notes, and bonds of the United States shall be limited to these functions;

"a) the anticipation of tax revenues accruing not more than one year from the date of purchase of said bills, notes, and bonds, in order to help maintain an orderly flow of disbursements by the United States Treasury;

"b) to maintain an orderly market in the bills, notes, and bonds of the United States, and to meet the temporary liquidity needs of members of the Federal Reserve System;

"c) the purchase of such liabilities of the United States as may be presented by foreign governments for sale to the Federal Reserve System by said governments;

"However, the total holdings of the Federal Reserve banks of bills, notes, and bonds of the United States shall be set as an annual ceiling as of the date of enactment of this Act. Said holdings may vary in size in the course of each year, but may not increase in size at the end of the year, following enactment of this Act and at annual intervals thereafter, except as a result of purchases of official liabilities of the United States from foreign governments, i.e., the Federal government may not create money supply by monetizing United States government debt;"

Sec. 4. Section 13 of the Federal Reserve Act is hereby amended to read:

"Any Federal Reserve bank may receive from any of its member banks, and from the United States, deposits of current funds in lawful money, national-bank notes, Federal Reserve notes, or checks and drafts upon solvent member banks, payable upon presentation; or, solely for exchange purposes, may receive from other Federal Reserve banks deposits of current funds in lawful money, or checks and drafts upon solvent member or other Federal Reserve banks, payable upon presentation.

"Upon the endorsement of any of its member banks, with a waiver of demand, notice, and protest by such bank, any Federal Reserve bank may discount up to 50 percent of the face value of notes, drafts, and bills of exchange arising out of the production of actual tangible wealth or capital improvements for the production of tangible wealth. Any Federal Reserve bank may also pay in 50 percent of the value of any loan made by any member bank for the purpose of furthering the production of tangible wealth. This shall be defined as the purchase of raw and intermediate materials and capital goods, construction of facilities, or employment of labor to produce or transport manufactured goods, agricultural commodities, and construction materials; to work mines; to build manufacturing, transportation, and mining facilities or dwellings; to produce and deliver energy in all forms; and to provide public utilities for communications. Such definition shall not include notes, drafts, bills, or loans issued or drawn for the purpose of conducting business except in the areas so defined, or for carrying or trading in stocks, bonds, or other investment securities.

"Any Federal Reserve bank may discount the full value of acceptances which are based on the exportation of goods, or 50 percent of the value of acceptances which are based on the importation of goods, provided that such goods conform to the restrictions set forth in the preceding paragraph.

"All Federal Reserve banks shall meet all such requests for discount of or participation in notes, drafts, bills, and loans made by member banks, once the Federal Reserve bank has determined that the purpose of such credit conforms to the restrictions set forth above. There shall be no restrictions applied to such discounts in furtherance of tangible wealth creation on the basis of member banks' capital positions. . . .

"This Section shall stand as amended in Public Law No. 302, enacted July 21, 1932 (H.R. 9642 Sec. 210)."

Sec. 5. Section 19 of the Federal Reserve Act of 1913 shall be amended to include the following:

"The above reserve requirements shall apply in the case that member banks maintain 60 percent of their total assets in the form of loans, bills, drafts, and advances to tangible wealth-creating borrowers, of a type eligible for discount under Sec. 4 of the Federal Reserve Reform Act. For every one percent by which the member bank's proportion of tangible wealth-creating assets falls below 50 percent of total assets, the Federal Reserve banks shall require that member bank to place an additional one percent of demand deposits in reserve with the Federal Reserve banks. However, to permit an orderly transition to this reserve rule, this formula shall apply only to new assets appearing on the balance sheets of member banks after the date of enactment of this Act."