

THE BANKS VERSUS THE CONSTITUTION

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Some people say we are heading for socialism. I can see why they might think that: Since October 2008, the U.S. Treasury Department and the Federal Reserve have taken majority stakes in the country's largest commercial insurer (AIG), largest auto manufacturer (General Motors), and largest mortgage lenders (Fannie Mae and Freddie Mac, which were already government-sponsored). The bailouts that began under President Bush and Treasury Secretary Henry Paulson, and which have continued under President Obama and Treasury Secretary Timothy Geithner, have also seen the federal government take shares in banks like Citigroup and Bank of America. This is not capitalism, and it is not the kind of economy the Framers of the Constitution envisioned.

The truth is that we have been drifting away from the Framers' vision for a very long time. Even before the economic crash of 2008, we did not have anything resembling a truly free economy. One of the most important sectors of the economy, the banking sector, was already quasi-socialist or corporatist.¹ The Federal Reserve, with its monopoly powers and its chairman and governors appointed by the President, has been an extra-constitutional branch of government since its creation in 1913. The bailouts, and the government ownership that has come with them, are a direct result of the Federal Reserve's policies. At the same time, this government body has been eroding Americans' capacity for self-government by forcing them to

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1. See Lucio Baccaro, *What is Alive and What is Dead in the Theory of Corporatism*, 41 BRIT. J. INDUS. REL. 683, 683 (2003) (employing as one definition of corporatism "a particular structure of the interest representation system, characterized by monopolistic, centralized and internally non-democratic associations"); see also Michael Graff, *Financial Development and Economic Growth in Corporatist and Liberal Market Economies*, EMERGING MARKETS FIN. & TRADE, Mar.-Apr. 2003, at 47, 58 (denoting corporatism as "deliberate attempts to address undesirable outcomes of market solutions . . . by coordination").

adjust their lives to an overall inflationary economy. This is a vicious cycle: The central bank creates a series of booms and busts that makes business planning very difficult. As a result, more and more businesses fail and turn to government for bail-outs. The public is told that capitalism is to blame and becomes accustomed to the idea that only government is capable of long-term planning. When the next bust hits, the cycle repeats.

The Constitution does not provide for the creation of a central bank. The Framers were well acquainted with the powers and practices of the Bank of England, and under the Articles of Confederation there had been a short-lived experiment in central banking.² Yet the Framers chose not to include a provision in the Constitution to create a central bank. Even if they had wanted to include such a provision, doing so might have jeopardized ratification. Americans were very suspicious of central banks, seeing them as a source of official corruption.³

The British government relied on the Bank of England to finance its national debt, and the debt was used to finance bigger armies and more wars. The debt had to be repaid eventually, which meant higher taxes for British subjects, including, before the Revolution, the American colonists. Historian John Remington Graham explains:

The British people groaned under heavy taxes to pay the interest on the national debt without ever touching the principal due. Each war nudged the King and Parliament into an increasingly servile condition, ever more obliged to the huge financial network behind the East India Company and the Bank of England. So it was that these interests were able to demand and obtain the legislation which ignited the American Revolution.⁴

Despite the lack of constitutional authorization for a national bank, the idea of central banking still appeals to politicians because central banks make financing wars and government growth much easier. Thus, Alexander Hamilton proposed the

2. See Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 223 (2000) (discussing the role played by the Bank of North America and suggesting that Hamilton used the Bank of England as a model for the creation of the first national bank).

3. For the historical roots of Americans' aversion to central banking, see GORDON S. WOOD, *THE AMERICAN REVOLUTION: A HISTORY* 57–60 (2002).

4. JOHN REMINGTON GRAHAM, *A CONSTITUTIONAL HISTORY OF SECESSION* 85 (2002) (footnote omitted).

creation of such a bank to the first Congress, even though the Framers of the Constitution and the ratifying conventions would never have agreed to create one.⁵ He got his wish, and the first Bank of the United States was chartered in 1791. Like the Federal Reserve, Hamilton's bank was in theory private, but the federal government provided its initial capital and from the outset owned one-fifth of the bank's stock.

Thomas Jefferson recognized the danger that the Bank of the United States posed to the Constitution. He wrote to President Washington in 1791 to state the case that "[t]he incorporation of a bank, and other powers assumed by this bill, have not, in my opinion, been delegated to the United States by the constitution. . . . They are not among the powers specially enumerated."⁶ And although the bank's defenders said it would be a convenience for helping government to collect taxes, Jefferson noted that "the constitution allows only the means which are '*necessary*,' not those which are merely *convenient* for effecting the enumerated powers."⁷ If the federal government could do anything it deemed convenient, the Constitution would be a dead letter.

Congress, controlled by Jefferson's Democratic-Republican party at the time, let the bank's charter expire in 1811. But just five years later, President Madison signed on to the creation of the Second Bank of the United States, in part to pay off debts from the War of 1812. Economic historian Murray Rothbard described the result:

Prices rose greatly in real estate, land, farm improvement projects, and slaves, much of it fueled by the use of bank credit for speculation in urban and rural real estate. There was a boom in turnpike construction, furthered by vast federal expenditures on turnpikes. Freight rates rose on steamboats, and shipbuilding shared in the general prosperity.

5. See Alexander Hamilton, *Opinion of Alexander Hamilton, on the Constitutionality of a National Bank*, reprinted in LEGISLATIVE AND DOCUMENTARY HISTORY OF THE BANK OF THE UNITED STATES 95 (M. St. Clair Clarke & D.A. Hall eds., Washington, Gaes & Seaton 1832) [hereinafter LEGISLATIVE AND DOCUMENTARY HISTORY]. But see Paul Finkelman, *Thomas Jefferson, Original Intent, and the Shaping of American Law: Learning Constitutional Law from the Writings of Jefferson*, 62 N.Y.U. ANN. SURV. AM. L. 45, 60 (2006) (footnote omitted) (suggesting that opposition came from James Madison and the House of Representatives, rather than from former delegates to the Constitutional Convention).

6. Thomas Jefferson, *Opinion of Thomas Jefferson, Secretary of State, on the Same Subject*, reprinted in LEGISLATIVE AND DOCUMENTARY HISTORY, *supra* note 5, at 91–92.

7. *Id.* at 93 (emphasis added).

Also, general boom conditions expanded stock trading so rapidly that traders, who had been buying and selling stocks on the curbs on Wall Street for nearly a century, found it necessary to open the first indoor stock exchange in the country, the New York Stock Exchange, in March 1817. Also, investment banking began in the United States during this boom period.⁸

This was America's first great bubble economy, created by bad loans and easy money. The bubble burst in the Panic of 1819, which saw a massive credit contraction and the failure of seventy-four banks, a shocking number considering that at the time the country only had 341 legally incorporated banks.⁹ "The result of the contraction was a massive rash of defaults, bankruptcies of business and manufacturers, and liquidation of unsound investments during the boom," as well as "a vast drop in real estate values and rents."¹⁰

President Andrew Jackson vetoed the bill to renew the Second Bank's charter in 1831, calling the bank "unauthorized by the Constitution, subversive of the rights of the States, and dangerous to the liberties of the people."¹¹ The idea of centralized banking continued to appeal to politicians, however, and in 1913 Congress created the Federal Reserve System. It is not a coincidence that the Federal Reserve was planned and launched at the height of the Progressive Era and not long before Woodrow Wilson took the country into World War I. The Federal Reserve, which is essentially the Third Bank of the United States, was necessary to underwrite the Progressives' dreams of a more activist federal government.¹² Central bank financing also enabled intervention in World War I, just as the Bank of England had been indispensable to Britain's wars and

8. MURRAY N. ROTHBARD, *A HISTORY OF MONEY AND BANKING IN THE UNITED STATES: THE COLONIAL ERA TO WORLD WAR II* 88 (2002).

9. *Id.* at 89.

10. *Id.*

11. Andrew Jackson, Veto Message of July 10, 1832, reprinted in 2 *COMPILATION OF THE MESSAGES AND PAPERS OF THE PRESIDENTS 1789-1897*, at 576 (James D. Richardson ed., Washington, Gov't prtg. office 1897).

12. Plenty of big businesses also wanted to see the Progressives get their wish because more regulation would impose disproportionate costs on their smaller competitors. See generally GABRIEL KOLKO, *THE TRIUMPH OF CONSERVATISM* (1963) (discussing the role of big business in the Progressive Era).

the Second Bank of the United States helped pay off debts from the War of 1812.

Almost everyone in Washington has forgotten the lessons of the Panic of 1819 and Jackson's fight with the Second Bank of the United States. Banks and governments can print money and expand credit, but they cannot create real wealth. Unsurprisingly, in the decade after the Federal Reserve was instituted, we saw another classic boom followed in the 1930s by the worst bust until the present day. Austrian School economists such as Ludwig von Mises and Friedrich Hayek have explained why central banking always leads to this cycle.¹³ When money and credit are available more readily from a central bank than they would be in a free market, other banks will make loans that otherwise would seem too risky. Why play it safe, if you can gamble with somebody else's money borrowed at a low interest rate? More loans are made, more fiat currency circulates, and businesses, just like banks, have an incentive to take more risks than they otherwise would. They start building new factories or retail outlets, or maybe they start to speculate in financial derivatives. The apparent boom employs more people, which leads to more consumption.

For a little while this lending seems like a virtuous cycle, as low interest rates and easy money lead to apparent prosperity for businesses and consumers. In reality, however, a lot more risks are being taken, and eventually those risks lead to failures. When businesses fail they cannot pay back their bank loans. Then the banks fail because they are not getting repaid. People are thrown out of work, and consumer spending shrinks. Then even more businesses fail, and what looked like a virtuous cycle turns out to be vicious.

Banks and businesses make mistakes all the time, of course. A central bank, however, encourages everyone to make mistakes in the same direction—toward taking more risks—all at the same time. Instead of occasional bank and business failures, we get a string of them at once. This widespread failure is what happened in 1819 and 1929, and it is happening again today.

13. See, e.g., LUDWIG VON MISES, *THE THEORY OF MONEY AND CREDIT* (1953). For a good introduction to the Austrian School of economics, see generally THOMAS E. WOODS JR., *MELTDOWN: A FREE MARKET LOOK AT WHY THE STOCK MARKET COLLAPSED, THE ECONOMY TANKED, & GOVERNMENT BAILOUTS WILL MAKE THINGS WORSE* (2009).

Some specific bad policy decisions by Congress led to real estate becoming especially vulnerable to the boom-and-bust cycle. The Community Reinvestment Act,¹⁴ for example, forced banks to make even more bad loans than they otherwise would have made. The fundamental source of the boom-and-bust cycle, however, lies with the Federal Reserve System. As long as we have it, we will continue to ride the rollercoaster of the business cycle, until finally the dollar is destroyed.

The dollar is put at risk by everything that Washington likes to do to get out of recessions: stimulus packages, near-zero interest rates, increases in base money, and issuance of more debt. President Obama, Secretary Geithner, and Chairman Bernanke have pushed these policies into overdrive since January 2009.¹⁵ We have seen the results as our currency tumbles and foreign investors such as the BRIC¹⁶ nations rethink their dollar holdings. The dollar is already getting pummeled,¹⁷ but once banks and businesses begin to think the crisis is over—not because of real recovery, but because of the false sense of prosperity created by government spending—we will see a massive inflationary boom followed by an even bigger bust. This final chapter will be catastrophic for the dollar.

It is painful to see your business fail or to lose your job, but the damage to our economy was actually done during the boom times, when too many financially unsound projects were started. Propping up failing enterprises now will only do more harm by encouraging additional malinvestment. Unfortunately, the damage that central banking has done to our country is not limited to the economy. Not only are individuals being thrown out of work as jobs that were never sustainable now disappear, but central banking and Keynesian economics have even changed the way Americans think about society and government. They have encouraged us to think only about the short term and to look to Washington for long-term planning.

14. Pub. L. No. 95-128, 91 Stat. 1147 (codified at 12 U.S.C. §§ 2901–2908).

15. For an account of the economic policies of President Obama, his Treasury secretary, and the Federal Reserve chairman, see generally TIMOTHY P. CARNEY, *OBAMANOMICS: HOW BARACK OBAMA IS BANKRUPTING YOU AND ENRICHING HIS WALL STREET FRIENDS, CORPORATE LOBBYISTS, AND UNION BOSSES* (2009).

16. Brazil, Russia, India, and China, amongst other rapidly developing nations.

17. David J. Lynch, *Weak dollar raises talk of alternative world currency*, USA TODAY, Oct. 22, 2009, at B1.

An explanation for this change can be found in the work of economist Hans-Hermann Hoppe, who has called attention to the importance of “time preference” in relation to civil society.¹⁸ Time preference is an economic concept: People with a high time preference prefer instant gratification; people with a low time preference are willing to defer satisfaction.¹⁹ The inflationary conditions created by central banking and Keynesian stimulus efforts encourage a high time preference. Money is better spent now rather than saved, we are told, because consumer spending props up the economy. And if you try to save, you will only find your savings eaten away by inflation over time. The message that Washington and the Federal Reserve send is, “Don’t think too much about the future, just live for today.”²⁰

The raising of Americans’ time preference has encouraged the idea that only government can plan for the long term. If you try to save for your retirement, for your children’s education, or for unexpected medical expenses, your savings might not have much purchasing power left by the time you need it. So why not let Washington take responsibility for your retirement, your children’s education, and your family’s health? In a long-term inflationary economy where saving is discouraged, people are virtually compelled to invest in stocks, bonds, and other financial instruments in the hope of earning returns that will beat inflation.²¹ Of course, these investments are subject to the boom-and-bust cycle just like other areas of the economy, and when the bust hits, people who might have been reluctant investors in the first place will naturally welcome a bailout rather than lose their savings. At the political level, the will to resist bigger government weakens, and at the personal level short-term decision making prevails. The British writer Theodore Dalrymple has described this situation well:

[A]sset inflation—ultimately, the debasement of the currency—as the principal source of wealth corrodes the character of people. It not only undermines the traditional bour-

18. HANS-HERMANN HOPPE, *DEMOCRACY: THE GOD THAT FAILED: THE ECONOMICS AND POLITICS OF MONARCHY, DEMOCRACY, AND NATURAL ORDER* (2001).

19. LUDWIG VON MISES, *HUMAN ACTION: A TREATISE ON ECONOMICS* 483–90 (4th ed. 1996).

20. See HOPPE, *supra* note 18.

21. See Frank Shostak, *Obama’s Stock Market Mini-Bubble*, MISES DAILY, May 12, 2009, <http://mises.org/daily/3460>.

geous virtues but makes them ridiculous and even reverses them. Prudence becomes imprudence, thrift becomes improvidence, sobriety becomes mean-spiritedness, modesty becomes lack of ambition, self-control becomes betrayal of the inner self, patience becomes lack of foresight, steadiness becomes inflexibility: all that was wisdom becomes foolishness. And circumstances force almost everyone to join in the dance.

Except in one circumstance, that is: the possession of a salary and a pension that the government promises, implicitly or explicitly, to index against inflation.²²

We have a financial system that pretends to be capitalism but which actually encourages dependence on Washington. By undermining the long-term economic thinking that goes into building strong marriages, families, churches, and voluntary organizations, as well as businesses, the economy of easy money and bigger government uproots the institutions that have defined American life. Through this process it is not only the Constitution that is endangered, but also the social order that fosters self-responsible men and women who want to follow the Constitution in the first place. The corruption in our national economic structure goes very deep, right to the heart of the banking system. In one way, this corruption of capitalism is worse than socialism, because at least under socialism people understand that government is to blame for the miserable condition of their economy. Under the system we have, people are encouraged to blame bad economic conditions on too much freedom and demand more government as the solution.

Luckily, many Americans are waking up to the danger Washington and the Federal Reserve have created. When I speak on college campuses, students often greet me with chants of "End the Fed!" Books like Thomas Woods's *Meltdown* that explain the Austrian theory of the business cycle and apply it to our current crisis are selling very well. And legislation I have proposed to audit the Federal Reserve has picked up overwhelming support in Congress because the public is demanding accountability. A December 2009 poll showed that 79% of Americans want the Federal Reserve to open its books to Congress.²³

22. Theodore Dalrymple, *Inflation's Moral Hazard*, CITYJ, Summer 2009, at 120, 124.

23. 79% Now Favor Auditing the Fed, RASMUSSEN REP., Dec. 4, 2009, http://www.rasmussenreports.com/public_content/business/general_business/november_2009/79_now_favor_auditing_the_fed.

The Framers were very concerned about the monetary stability of the republic, which is why the Constitution prohibits the states from coining money or emitting bills of credit.²⁴ Americans had suffered the consequences of runaway inflation during the Revolutionary War, when the Continental Congress printed fiat currency with abandon. What would they think of a Federal Reserve System that steadily inflates the currency and has caused the dollar to lose 96% of its value since 1913?²⁵ The only thing that might have shocked them more is that politicians have been allowed to get away with creating such a system. Over the course of the twentieth century, the welfare state, Keynesian economics, and the effects of inflation have worn away many citizens' vigilance for their liberties.

It is not too late to reverse course, however, as Americans become increasingly discontent with the Federal Reserve System and discover what this unconstitutional fourth branch of government has done to their money. With this latest financial crisis, the damage to our economy has been so great that many people are looking for a better explanation than the idea that we just did not have enough regulation or that businessmen became uncontrollably greedy. In a free market, the check on greed is that you lose your own money, or that of willing investors, if you make bad decisions. By contrast, the bailouts and the Federal Reserve's efforts to increase lending again have created perverse incentives: They reward the banks and businesses that made bad decisions and punish their competitors who made sound decisions—while taxpayers get to foot the bill. This response is meant to distract us from the source of the trouble, which is that our banking and monetary system is not free. There are grave legal and constitutional questions involved in what Washington has done in response to this crisis. But the first and most serious question we have to address is how central banking guarantees that these crises will keep repeating and keep getting worse.

24. U.S. CONST. art. I, § 10.

25. See Richard Daughy, *Thank the Fed For Your Lack of Purchasing Power*, DAILY RECKONING, Sept. 22, 2009, www.dailyreckoning.com/thank-the-fed-for-your-lack-of-purchasing-power/.