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## REDUCING THE NATIONAL DEBT: WHY THE FEDERAL RESERVE BANK SHOULD REFUSE RECEIPT OF \$4.26 TRILLION IN BOND INTEREST AND PRINCIPAL PAYMENTS FROM THE UNITED STATES TREASURY AND GOVERNMENT SPONSORED ENTERPRISES (GSEs)

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### Abstract

The national debt of the United States stands at \$19.7 trillion.<sup>2</sup> Prospects are poor for federal tax revenues reaching a point where this debt can ever be repaid or successfully managed. Because of extended wars and the financial crisis of 2008, extraordinary measures were taken to fund governmental entities, inject liquidity into the economy, and drive down interest rates to stimulate the economy. The semi-independent Federal Reserve Bank (“the Fed”), operating as the central bank of the United States, purchased approximately \$4.26 trillion of United States Treasury bonds and government sponsored enterprises (GSEs) obligations to help in this effort in what is known as

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<sup>2</sup> See TreasuryDirect, *The Debt to the Penny and Who Holds It*, U.S. DEP’T OF THE TREASURY <https://www.treasurydirect.gov/NP/debt/current> (last updated Feb. 03, 2017).

“quantitative easing.”<sup>3</sup> These securities were purchased in the private or secondary marketplace through primary dealers. The Fed did not pay for these Large Scale Asset Purchases (LSAPs) with paper money, but instead credited each bond seller’s bank “using newly created electronic funds.”<sup>4</sup> The banks then added those funds to the bond sellers’ accounts, and these sellers elected to spend those funds or leave them in the bank. If the funds stayed in the banks, then the banks could increase lending, purchase more assets or build up reserves on deposit at the Fed.

More broadly, the Fed’s securities’ purchases increased the total amount of reserves that the banking system keeps at the Fed.<sup>5</sup> The Federal Reserve Act provided for these indirect purchases of U.S. Treasury securities to implement monetary policy. However, the extent of these purchases after 2008 was unprecedented.<sup>6</sup> The Fed’s balance sheet has exponentially expanded, leaving the Fed the owner of a ladder of bonds of differing maturities at no cost. To date, the Federal Reserve has been returning interest it earns on these securities to the Department of Treasury, thus allowing the federal government to earn interest on its own deficit generating bonds. Also, as payment of principal on these bonds becomes due, the Federal Reserve has up until now taken this money and rolled it over into more treasury obligations. At a future date, this practice will stop, and the Fed will either sell these bonds back to private parties to drain excess liquidity from the economy or force the U.S. Treasury to repay the principal on these bonds to the Fed.

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<sup>3</sup> See Norbert Michel, *Quantitative Easing, The Fed’s Balance Sheet, and Central Bank Insolvency*, THE HERITAGE FOUNDATION (Aug. 14, 2014), <http://www.heritage.org/monetary-policy/report/quantitative-easing-the-feds-balance-sheet-and-central-bank-insolvency>.

<sup>4</sup> See Steve Meyer, *Recent Federal Reserve Monetary Policy Presentation*, FEDERAL RESERVE (Jan. 14, 2011), <https://www.federalreserve.gov/mediacenter/files/meyer20110228.pdf>.

<sup>5</sup> See *id.*

<sup>6</sup> See *Open Market Operations*, BD. OF GOVERNORS OF THE FED. RES. SYST. (Dec. 14, 2016) <http://www.federalreserve.gov/monetarypolicy/openmarket.htm> (“The Federal Reserve’s approach to the implementation of monetary policy has *evolved considerably* since the financial crisis and particularly so since late 2008 ....” (emphasis added)).

This article proposes a “workout” wherein the Federal Reserve heads off this long delayed repayment crisis by simply canceling the obligation of the Department of the Treasury to repay it. The financially beleaguered GSEs could also have portions of their debt obligations canceled with restructuring conditions. The Fed could turn over the remaining agency and GSE bonds to the U.S. Treasury to hold as an asset. This workout would reduce the federal debt by 21.6%, and allow the GSEs to recapitalize. Combined with responsible fiscal measures and structural reform, such a course would go a long way towards reducing the national debt and avoiding federal bankruptcy. Legal hurdles would have to be surmounted to implement this proposal. This includes Section 4 of the 14<sup>th</sup> Amendment to the U.S. Constitution which states that the validity of the public debt of the United States shall not be questioned. Section 4 was enacted in 1868 out of the Civil War context, although limited case precedent from 1935 interpreted it generally. Nevertheless, because one semi-public entity (the Fed) purchased from private parties a large amount of the debt of the United States (another public entity--the U.S. Treasury), this debt has effectively been retired. The Federal Reserve should simply return these bonds unpaid to the U.S. Treasury. No private parties or contracts would be effected. One entity operating as the central bank of the United States has paid off debt obligations of the U.S. Treasury. No default or repudiation by the debtor would occur. Public policy considerations also come into play, such as sustaining confidence in the financial system and setting precedents for future government activity in the United States and abroad regarding overarching debt. However, canceling out the debt owed between public oriented institutions, while seeing to it that all private parties are repaid in full for their bond purchases, would actually increase confidence in the soundness of the U.S. government and Treasury obligations.

Further, since the Federal Reserve is starting to increase interest rates in a “normalization” process that tightens the money supply, the Fed can counterbalance this restrictive policy, in a slow growth period, by refusing debt repayments in a systematic way so as to increase the money available

to the U.S. treasury for fiscal stimulus and structural reform of the economy. If this proposal works well, other countries may emulate this idea to stave off their own insolvency and economic problems. In summation, fairness and fiscal necessity require that large scale obligations purchased with devised money be extinguished in a final phase of return to a reality based economic system.

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## I. THE SCOPE OF THE PROBLEM: THE NATIONAL DEBT AND HOW THE FEDERAL RESERVE BANK PURCHASED TREASURY BONDS AND FUNDED GOVERNMENT SPONSORED ENTITIES (GSEs)

The national debt of the United States stands at \$19.7 trillion dollars.<sup>7</sup> After years of war spending and financial deregulation, the American economy collapsed in 2008.<sup>8</sup> In response, the Federal Reserve Bank (known as “The Fed”) converted a traditional mechanism for managing monetary policy and interest rates into a large scale operation of buying massive amounts of U.S Treasury bonds and Government Sponsored Entity (GSE) debt.<sup>9</sup> In fact, the Federal Reserve Bank purchased \$4.26 trillion of these obligations in Large Scale Asset Purchases (known as LSAPs).<sup>10</sup>

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<sup>7</sup>*The Debt to the Penny and Who Holds It*, TREASURYDIRECT, <http://www.TreasuryDirect.gov/NP/debt/current> (last visited Jan. 30, 2017) (\$19,720,830,822,303.49 to be exact.) *See also Frequently Asked Questions About the Public Debt*, TREASURYDIRECT, [https://www.treasurydirect.gov/govt/resources/faq/faq\\_publicdebt.htm#DebtOwner](https://www.treasurydirect.gov/govt/resources/faq/faq_publicdebt.htm#DebtOwner) (last visited Jan. 30, 2017) (Of this figure “Intragovernmental holdings” defined as “Governmental Account Series securities held by Government trust funds, revolving funds, and ‘special funds’; and Federal Financing Bank securities” are \$5,495,822,314,247.37. Debt “held by the public” which is defined as “all federal debt held by individuals, corporations, state or local governments, **Federal Reserve Banks [emphasis added]**, foreign governments, and other entities outside the United States Government less Federal Financing Bank securities,” is \$14,225,008,508,056.12. The treasury direct website defines the “deficit” as being the fiscal year difference between what the government takes in from taxes and other revenues, called receipts, and the amount of money the Government spends. On the other hand, the total national “debt” is accumulated deficits plus accumulated off-budget surpluses. “The on-budget deficits require the U.S. Treasury to borrow money to raise cash needed to keep the Government operating. We borrow the money by selling securities like Treasury bills, notes, bonds and savings bonds to the public.”).

<sup>8</sup> NEVA GOODWIN ET AL., *MACROECONOMICS IN CONTEXT*, 337 (Routledge, 2<sup>nd</sup> Ed 2009), [http://www.ase.tufts.edu/gdae/Pubs/te/MAC/2e/MAC\\_2e\\_Chapter\\_15.pdf](http://www.ase.tufts.edu/gdae/Pubs/te/MAC/2e/MAC_2e_Chapter_15.pdf); Matthew Sherman, *A Short History of Financial Deregulation in the United States*, CEPR, 1, 13 (2009), <http://www.cepr.net/documents/publications/dereg-timeline-2009-07.pdf>, (“Since the Spring of 2008, financial markets have experienced turmoil not seen since the Great Depression.”).

<sup>9</sup> From late 2010 to the end of June 2011, “\$600 billion of long term Treasuries were added to the System Open Market Account (SOMA) portfolio...” *See Domestic Open Market. Operations During 2011*, FED. RESERVE BANK OF N.Y., 1 (2012) [hereinafter *Fed 2011 Operations*] <https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2011.pdf>. Author note: The word “SOMA” brings to mind the ideal hangoverless drug “soma” in Aldous Huxley’s novel *Brave New World* (1932) used to control the masses. *See SOMA*, BLTC RESEARCH, <https://www.huxley.net/soma/meaning.html> (last visited Feb. 22, 2017) The acronym SOMA used in the Fed sense of the word bears a peculiar resemblance as a palliative used to cure the world’s economic ills by filling the markets with electronically created money.

<sup>10</sup> *See Domestic Open Mkt. Operations During 2015*, FED. RESERVE BANK OF N.Y. (2016), <https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2015-pdf.pdf>. Regarding the System Open Market Account (SOMA) holding a \$4.26 trillion par value portfolio during the year. \$2.46 trillion of this is Treasury securities, \$1.77 trillion is agency Mortgage Backed Securities (MBS) holdings, and \$33 billion in face value agency debt securities. *See id.* at 22-23. Public debt securities held by Federal Reserve Banks as of June, 2016 total \$2,819,062 (categorized “In millions of dollars”, making for a total of \$2,819,062,000,000). *See Ownership of Federal Securities, Table OFS-1*, BUREAU OF THE FISCAL SERV. U.S. DEPT. OF THE TREASURY, [https://www.fiscal.treasury.gov/fsreports/rpt.treasBulletin/b2016\\_3of1.doc](https://www.fiscal.treasury.gov/fsreports/rpt.treasBulletin/b2016_3of1.doc). However, Table OFS-2 provides that “SOMA [acronym for open market purchase holding by the Federal Reserve]and Intragovernmental Holdings” total

Incredibly, the Fed has purchased up to 70% of the outstanding available obligations in the marketplace of some kinds of bonds.<sup>11</sup> This unprecedented policy has lowered interest rates to near zero, stimulated the economy, expanded asset prices, and provided liquidity to banks and the government.<sup>12</sup> It has backstopped Government Sponsored Entities to allow for stability in the home mortgage market.<sup>13</sup> Today, the economy has finally reached a modicum of recovery to where the Fed has started to raise interest rates from the zero bound.

When the bonds purchased by the Fed give off interest and principal, the Fed has been treating the interest and principal differently. When the U.S. Treasury pays interest to the Fed, this interest is turned back over the U.S. Treasury.<sup>14</sup> When principal on these bonds held by the Fed become due

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\$7,911.2 (categorized “In billions of dollars”, making the total \$7,911,200,000,000) as of June, 2016. This amount excludes Treasury securities “held under repurchase agreements.” The Federal Reserve statistical release dated October 13, 2016, in Table 1 called “Factors Affecting Reserve Balance of Depository Institutions and Condition Statement of Federal Reserve Banks lists Reserve Bank credit of \$4,417,421 (in “Millions of dollars,” making for a total of \$4,417,421,000,000) with Securities held outright totaling \$4,220,858,000,000 (many of these securities are have listed values of “face value” thus undervaluing them). Of this \$4.2 trillion in Securities held outright, \$2.5 trillion are U.S. Treasury Securities, \$1.7 trillion are Mortgage Backed Securities, and \$20.5 billion are Federal Agency debt securities. Some of these securities are listed at face value, not the actual price at which they were purchased, or the price for which they could be sold. *See also* Alvin C. Harrell, *Commentary: Reflections on the Mortgage, Housing, and Financial Crisis*, 68 CONSUMER FIN. L.Q. REP. 123, n.13 (2014). (stating that the “The Federal Reserve will borrow \$1.1 trillion in 2013 alone to buy bonds—and it reserves the right to borrow unlimited amounts for future bond purchases without congressional or presidential permission...”).”

<sup>11</sup> *See Fed 2011 Operations, supra* note 9, at 9, 10. Limits were raised in November, 2010, “in consultation with the FMOC” allowing the New York Fed desk to increase limits on holdings of individual issues of specific securities from 35 percent to 70 percent. I note that without these limits, theoretically the Fed could purchase every bond security of every issue available in the marketplace in the United States, thus severely impacting the functioning of the law of supply and demand and the availability of bonds to anyone other than the government.

<sup>12</sup> Ben S. Bernanke, Chairman, Monetary Policy Since the Onset of the Crisis, Speech at the Federal Reserve Bank of Kansas City Economic Symposium (August 31, 2012). <http://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm>. (referring to the benefits of lower yields in long term Treasuries, corporate bonds and MBS, reductions in retail mortgage rates, boosting of stock prices, easing of broader financial conditions.; Janet L. Yellen, Vice Chair, Speech at the Brimmer Policy Forum, Allied Social Science Annual Meeting.; The Federal Reserve’s Asset Purchase Program (Jan. 8, 2011) <http://www.federalreserve.gov/newsevents/speech/yellen20110108a.htm>. (stating “these purchases tend to influence aggregate demand, including a reduced cost of credit to consumers and businesses, a rise in asset prices that boosts household wealth and spending, and a moderate change in the foreign exchange value of the dollar that provides support for net exports).”

<sup>13</sup> “The decision to redirect those reinvestments from longer term Treasuries into MBS was intended to support conditions in mortgage markets.” *See Fed 2011 Operations, supra* note 9, at 1.

<sup>14</sup> Press Release, Federal Reserve Board Announces Reserve Bank income and expense data and transfers to the Treasury for 2015, (Jan. 11, 2016) (on record with Board of Governors of the Federal Reserve system), <https://www.federalreserve.gov/newsevents/press/other/20160111a.htm>. The Fed paid \$97.7 billion of their

and payable, the Treasury pays these amounts, but the Fed has had a policy of buying more U.S. Treasury obligations to take their place.<sup>15</sup> Similarly, when principal payments are made on agency or GSE bonds, these funds were reinvested in U.S. Treasury obligations or later dated Mortgage Backed Securities (MBS).<sup>16</sup> In the near to intermediate future, the Fed will no longer be reinvesting these principal payments into more U.S. Treasury bonds and GSE bonds.<sup>17</sup> The issue thereby arises as to whether the U.S. Treasury, the financially beleaguered GSEs, and others, should fully pay back to the Federal Reserve the \$4.26 trillion owing, when the creditor Federal Reserve “created” or “invented” money through reserve expansion to buy this debt. This article proposes that this debt, purchased so cheaply, should now be used as an instrument of public policy change.

An extensive search of Federal Reserve Bank statements and official publications indicates how these asset purchases were initially accomplished. On August 26, 2016, the Chair of the Fed,

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estimated 2015 net income to the U.S. Treasury. “The Federal Reserve Banks’ 2015 estimated income of \$100.2 billion was derived primarily from \$113.6 billion in interest income on securities acquired through open market operations (U.S. Treasury securities, federal agency and government-sponsored enterprise (GSE) mortgage-backed securities (MBS), and GSE debt securities).” The statement also said, “The FAST Act [Fixing America’s Surface Transportation Act] enacted on December 4, 2015, requires that aggregate Federal Reserve Bank capital surplus not exceed \$10 billion.” \$19.8 billion was transferred to the Treasury on December 28, 2015, “which was the amount necessary to reduce aggregate Federal Reserve surplus to the \$10 billion surplus limitation” in the FAST Act.

“Primarily as a result of the income from the SOMA portfolio, remittances to the Treasury were \$75 billion in 2011, well above the \$25 billion per year observed over the ten years through 2007.” See *Fed 2011 Operations*, *supra* note 9, at 18.

<sup>15</sup> *Supra* note 9, “Throughout 2015, ongoing rollovers of maturing Treasury securities kept the size of the portfolio fairly steady at \$2.46 trillion. Securities in the portfolio continued to age, with the weighted average maturity of the portfolio declining from 9.6 years to 8.6 over the course of the year.”

<sup>16</sup> The FOMC (Federal Open Market Committee) made a “decision in 2010 to continue to reinvest principal payments received from agency debt and MBS [agency mortgage backed securities] into Treasury securities.” This decision was then reversed in September, 2011, “to shift reinvestments of maturing agency debt and agency mortgage-backed securities (MBS) into MBS...”, See *Fed 2011 Operations*, *supra* note 9, at 1, 3. See also *FAQs: MBS Purchase Program*, FED. RES. BANK OF N.Y, 2, [https://www.newyorkfed.org/markets/mbs\\_faq.html](https://www.newyorkfed.org/markets/mbs_faq.html). (last visited Feb 22, 2017). “On August 10, 2010, the FOMC directed the Desk to keep constant the Federal Reserve’s holdings of securities at their current level by reinvesting principal payments from agency debt and agency MBS in longer-term Treasury securities.”

<sup>17</sup> Janet L. Yellen, Vice Chair, *The Federal Reserve’s Asset Purchase Program*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (Jan. 8, 2011), <https://www.federalreserve.gov/newsevents/speech/yellen20110108a.htm>. Ms. Yellen stated: “We recognize that the FOMC must withdraw monetary stimulus once the recovery has taken hold and the economy is improving at a healthy pace.”; See also *Is the Federal Reserve Printing Money in Order to Buy Treasury Securities?*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (August 25, 2016), [http://www.federalreserve.gov/faqs/money\\_12853.htm](http://www.federalreserve.gov/faqs/money_12853.htm). This “Current FAQs” section of the Fed’s release states in part, “...the Federal Reserve has indicated that it will return its securities holdings to a more normal level over time, as the economy recovers and the current monetary accommodation is unwound.”

Janet L. Yellen, at a symposium entitled “Designing Resilient Monetary Policy Frameworks for the Future”, stated “we fund our asset purchases through the creation of reserves.”<sup>18</sup> The Fed thereby expands its balance sheet in a non-reserve neutral way.<sup>19</sup> The most elaborate explanation publicly available is from Steven Meyer, Senior Advisor to the Federal Reserve Board of Governors. On January 14, 2011, Mr. Meyer stated:

“You may wonder how the Fed pays for the bonds and other securities it buys. The Fed does not pay with paper money, instead the Fed pays the seller’s bank using newly created electronic funds and the bank adds those funds to the seller’s account. The seller can spend the funds or can simply leave them in the bank. If the funds stay in the bank then the bank can increase its lending, purchase more assets or build up the reserves it holds on deposit at the Fed. More broadly, the Fed’s securities purchases increase the total amount of reserves that the banking system keeps at the Fed. Whether the Fed’s purchases lead to an increase of the money circulating in the economy depends on what banks do with the new reserves and on what sellers do with the funds they receive. As it happens the money supply has not grown unusually rapidly since the Fed began its first round of asset purchases, if anything the money supply has been growing more slowly than normal and as I noted earlier inflation declined while the Fed was conducting its first round of purchase and is now quite low. Still if the Fed were to continue buying securities even as banks eventually expand their lending then the money supply could increase too rapidly and inflation could become high, Fed policy makers are determined to avoid that outcome. The Fed will not keep buying large amounts of securities on an ongoing basis. Its purchases are a temporary measure to help the economy recover. When the economy has recovered sufficiently the Fed will reduce its holdings of Treasury debt and other securities. That reduction will avoid a large permanent increase in the money supply. The Fed also has other tools it can use to decrease bank reserves and prevent a large expansion of the money supply, those tools have been tested and are ready to be used if needed. The bottom line is that the Fed’s asset purchases are an extension of standard monetary policy, right now at the beginning of 2011 monetary policy is helping foster a stronger economic recovery and job creation while keeping

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<sup>18</sup> Janet L. Yellen, Chair, *The Federal Reserve’s Monetary Policy Toolkit: Past, Present, and Future*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (Aug. 26, 2016), <https://www.federalreserve.gov/newsevents/speech/yellen20160826a.htm>.

<sup>19</sup> *FAQs: Purchasing Direct Obligations of Housing-Related GSEs*, FED. RESERVE BANK OF N.Y. (Aug. 20, 2010), [https://www.newyorkfed.org/markets/gses\\_faq.html](https://www.newyorkfed.org/markets/gses_faq.html). The Federal Reserve Bank of New York, which implements these asset purchases, stated in a question and answer publication about the program to purchase \$175 billion in GSE direct obligations through the end of the first quarter of 2010, “Are these operations reserve neutral? No, these operations are financed through the creation of additional bank reserves.”



the risk of deflation low, later when appropriate the Fed will tighten monetary policy to avoid future inflation...’’<sup>20</sup>

Furthermore, since under the Federal Reserve Act, the Fed is not allowed to purchase these bonds and securities directly from the U.S. Treasury, third party “sellers” were used to facilitate these transactions.<sup>21</sup> The Federal Reserve Bank of New York, under direction from the Federal Open Market Committee, buys U.S. Treasury securities as well as GSE debt in the secondary market through “primary dealers” over a proprietary trading platform which accepts propositions simultaneously from all dealers using a multiple-price auction format.<sup>22</sup> The legality of the GSE purchases have been questioned.<sup>23</sup> As of December 31, 2014, the Federal Reserve System held over \$1.7 trillion of agency MBS.<sup>24</sup>

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<sup>20</sup> Steven Meyer, Senior Advisor, Presentation on Recent Federal Reserve Monetary Policy, FED. RES. BD. OF GOVERNORS (Jan. 14, 2011), <https://www.youtube.com/watch?v=0PmXbTcOVhU>. Meyer, an economist with the Federal Reserve in Washington which he calls “the central bank of the United States” explained the then need for the start of large scale asset purchases: “Unfortunately, the recovery slowed in the middle of 2010, unemployment was near 10 percent and the economy’s expansion became too sluggish to bring unemployment down. Meanwhile inflation continued to trend lower and there was a growing risk of deflation. So, in November of 2010, after several months of public discussion, Fed officials decided to start a second round of securities purchases, they announced they intended to buy an additional \$600 billion dollars of longer term U.S. Treasury securities, about one-third as much as in the first round.”

<sup>21</sup> Timothy C. Harker, *Bailment Ailment: An Analysis of the Legal Status of Ordinary Demand Deposits in the Shadow of the Financial Crisis of 2008*, 19 FORDHAM J. CORP. & FIN. L. 543, 581 n.126 (2014), (“Technically, the Federal Reserve Act prohibits the Federal Reserve from purchasing Treasury securities directly from the Treasury.”) Mr. Harker goes on to explain: “Today the primary willing buyer is the Federal Reserve, which owns now a record \$2.2 trillion in Treasury securities—the Federal Reserve created \$2.2 trillion dollars in order to purchase Treasury securities on the secondary market...” *Id.* at 581; *see also* 12 U.S.C. § 355(2) (2012).

<sup>22</sup> *Fed 2011 Operations*, *supra* note 9, 8-9, 13 (2012).

<sup>23</sup> *See* Chad Emerson, *More Illegal Actions of the Federal Reserve: How the Federal Reserve Acted Outside the Scope of Its Legal Authority in Purchasing Securities from Fannie Mae and Freddie Mac*, 29 NO. 10 BANKING & FIN. SERVICES POLY REP. 11 (Oct. 2010). This article argues there is “no express provision in the Federal Reserve Act for the Federal Reserve to use its open market authority to purchase private sector promissory notes such as mortgages or corporate bonds or to purchase equities.... Conversely, the plain meaning of Section 14 reveals that the Federal Reserve may not purchase private assets because they lack the requisite ‘full guarantee’ element required by the Federal Reserve Act.”; *see also* Chad Emerson, *The Illegal Actions of the Federal Reserve: An Analysis of How the Nation’s Central Bank Has Acted Outside the Law in Responding to the Current Financial Crisis*, 1 WM & MARY BUS. L. REV. 109 (2010).

<sup>24</sup> *See* Eric S. Anderson, *Maintaining Capital in the Secondary Mortgage Market: Housing Finance Reform and the Liquidity Coverage Ratio*, 19 N.C. BANKING INST. 53 (2015).

## II. THE LEGAL PARAMETERS OF LARGE SCALE ASSET PURCHASES (LSAPs)

Unlike many other central banks in the world, the Federal Reserve is legally limited on the kinds of assets it may buy<sup>25</sup> and the manner of purchase of those assets<sup>26</sup> in order to propagate monetary policy. The Fed is authorized by the Federal Reserve Act to purchase U.S. Treasury obligations indirectly through private dealers in the open market.<sup>27</sup> 12 U.S.C. section 355(2) states “Every Federal Reserve bank shall have power: ... (2) To buy and sell in the open market, under the direction and regulation of the Federal Open Market Committee, any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States.” U.S. Treasury obligations fall squarely within this definition. Less clear is the authority to purchase government sponsored entity (GSE) obligations. However, the Federal Reserve takes the position that Congress gave it the authority in 1966 to purchase the debt of agencies guaranteed or owned by the federal government, thus allowing it to purchase mortgage backed securities (MBS) and the debt of government sponsored enterprises such as Freddie Mac and Fannie Mae.<sup>28</sup> The U.S. Treasury was also given authority under the Housing and Economic Recovery Act (HERA) signed into law on July 30, 2008, to temporarily invest in Freddie Mac and Fannie Mae. It ultimately injected \$187.5 billion into these two entities after the Federal Housing Finance Agency (FHFA) took Fannie and Freddie

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<sup>25</sup> For instance, the Bank of Japan (BOJ) has purchased Exchange Trade Funds (ETFs, which includes stock funds) and J-REITs (Japanese Real Estate Investment Trusts), whereas the Federal Reserve has purchased only U.S. Treasuries, Mortgage Backed Securities (MBS) and Agency paper. See GABRIEL AGOSTINI, ET AL., *COMPARATIVE STUDY OF CENTRAL BANK QUANTITATIVE EASING PROGRAMS*, COLUMBIA UNIVERSITY, 138 (2016).

<sup>26</sup> Treasury obligations must be bought indirectly from private parties or dealers. See *Fed 2011 Operations*, *supra* note 9.

<sup>27</sup> 12 U.S.C. § 355(2) (2012).

<sup>28</sup> See RENEE HALTON & ROBERT SHARP, *The First Time the Fed Bought GSE Debt*, RICHMONDFED.ORG (2014) [https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic\\_brief/2014/pdf/eb\\_14-04.pdf](https://www.richmondfed.org/~media/richmondfedorg/publications/research/economic_brief/2014/pdf/eb_14-04.pdf).

into conservatorship.<sup>29</sup> On November 25, 2008, the Federal Reserve announced it would buy up to \$500 billion of agency mortgage backed securities and up to \$100 billion of agency debt.<sup>30</sup>

The large scale asset purchases of U.S. Treasury obligations have been controversial due to the quantitatively different manner in which the Fed has taken a traditional device to manage interest rates, and mushroomed bond purchases into the trillions of dollars. The GSE purchases have been controversial since “[t]he FOMC’s guidelines for agency purchases, established in 1968, indicate that purchases ‘are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.’”<sup>31</sup> In the December 2008 Federal Open Market Committee meeting, Richmond Fed President Jeffrey Lacker noted that these guidelines seemed “inconsistent” with the stated purpose of the large scale purchase of agency debt to “reduce the cost..of credit for houses...fostering improved financial conditions more generally.” In January 2009, the FOMC voted to suspend the guidelines indefinitely,<sup>32</sup> to which Lacker dissented.

Other scholarly articles further describe the limits the Federal Reserve Act places on the monetary actions of the Federal Reserve.<sup>33</sup>

### III. PAYBACK AND ALTERNATIVES IN UNWINDING

In December of 2015, Congress passed and President Obama signed, almost unnoticeably, a provision effecting what may ultimately happen to the \$4.26 trillion in bonds the Fed purchased through quantitative easing. The “Fixing America’s Surface Transportation Act” or “FAST Act” was

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<sup>29</sup> See W. Scott Frame et al. THE RESCUE OF FANNIE MAE AND FREDDIE MAC, N.Y. Fed. Reserve Staff Report No. 719, (March 2015), [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr719.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr719.pdf). The U.S. Government became a preferred stockholder in the entities.

<sup>30</sup> *Id.*

<sup>31</sup> HALTON & SHARP, *supra* note 28, at 6.

<sup>32</sup> *Id.*

<sup>33</sup> *The Limits the Federal Reserve Act Places on the Monetary Actions of the Federal Reserve*, 19 ANN. REV. BANKING L. 553 (2000); Stephen G. Cecchetti, *Crisis and Responses: The Federal Reserve in the Early Stages of the Financial Crisis*, 23 JOURNAL OF ECONOMIC PERSPECTIVES 51 (Winter 2009).

enacted ostensibly to repair and reconstruct this countries' roadways, bridges, and rail systems.<sup>34</sup> Section 32202 of the FAST Act (of sections starting at 1001 and going all the way up to Section 89003), essentially requires surplus funds of the Fed to be transferred to the general fund of the United State Treasury.<sup>35</sup> Section 32202 states:

Section 7(a) of the Federal Reserve Act (12 U.S.C. 289(a)) is amended by adding at the end the following:

“(3) LIMITATION ON SURPLUS FUNDS.—

“(A) IN GENERAL.—The aggregate amount of the surplus funds of the Federal reserve banks may not exceed \$10,000,000,000.

“(B) TRANSFER TO THE GENERAL FUND.—Any amounts of the surplus funds of the Federal reserve banks that exceed, or would exceed, the limitation under subparagraph (A) shall be transferred to the Board of Governors of the Federal Reserve System for transfer to the Secretary of the Treasury for deposit in the general fund of the Treasury.”<sup>36</sup>

This innocuous wording, hidden in the midst of a transportation bill, would mandate that not only interest collected on U.S. Treasury bonds be returned to the Treasury, but principal payments also to the extent they exceed \$10 billion of surplus funds. Should the Fed start selling some or all of its \$2.46 trillion in Treasury bonds, \$1.77 trillion in MBS bonds, and \$33 billion in agency debt, all this money in excess of a mere \$10 billion would go to the United States Treasury. However, the FAST Act carves out for itself a fraction of this money—\$53.3 billion per year for five years to go to the “Highway Trust Fund” for a five year total of \$266.5 billion. Thus, assuming the Fed generates enough income to support itself in other respects, and that it sells all the securities it bought during quantitative

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<sup>34</sup> FAST Act, Pub. L. No. 114-94, 129 Stat. 1312 (2015).

<sup>35</sup> *Id.* at §§ 32202-89003, 129 Stat. 1739-1800.

<sup>36</sup> *Id.* at § 32202, 129 Stat. 1739. A second provision in the FAST Act, section 32203, would change the amount of dividends paid to stockholders of the bank which hold total consolidated assets of more than \$10,000,000,000, to the smaller of the market rate of yield of a Treasury note, or 6%. *Id.* at § 32203, 129 Stat. 1739. Under current rates, this would substantially lower the amount of the dividend to large stockholders.

easing, it would be giving to the U.S. Treasury \$3.98 trillion (4.26 trillion minus \$10 billion minus \$266.5 billion). This exceeds the amount of money needed to run the entire U.S. government for one whole year,<sup>37</sup> and the periodic ritual of raising the debt ceiling would not be necessary for years with this supplemental fund for extra federal spending. The Treasury would have \$3.98 trillion in new cash to spend on priority items to get the economy growing at a greater rate, and restructure the economic system. However, selling all of these securities could rapidly decrease the money supply, or what the Fed calls “draining liquidity” from the system.<sup>38</sup> Furthermore, United States Treasury would still eventually be responsible for paying principal plus interest to the new private owners of these bonds in the amount of \$2.46 trillion, and the MBS agency complex would have to pay back \$1.77 trillion.

A second alternative, which the Federal Reserve undoubtedly contemplates, would be the Fed slowly and systematically selling these bonds on its own monetary time table. Instead of quickly ending the unprecedented experiment with quantitative easing, the Fed would maintain its grip on the monetary fate of the country by transferring these securities to the private sector at opportune moments of its own making. The U.S. Treasury in turn would slowly obtain this money by these sales when the Fed remits it to the Treasury, assuming principal payments would not become due first. Moreover, the Treasury, at the discretion of the Secretary, would then reduce the national debt by paying the new private owners and others the principal and interest on the bonds sold by the Fed (which had turned the proceeds over to the Treasury), or supplement the gold reserve held against

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<sup>37</sup> See *Federal Budget of 2015: An Infographic*, CONGRESSIONAL BUDGET OFFICE (January 6, 2016), <https://www.cbo.gov/publication/51110>. The Federal Budget of 2015 shows spending of \$3.7 trillion and revenues of \$3.2 trillion for 2015. Assuming half a trillion dollars budget deficits going forward each year, this extra \$3.98 trillion could make up for all budget deficits for 8 years into the future.

<sup>38</sup> *Credit and Liquidity Programs and the Balance Sheet*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (January 5, 2017), [https://www.federalreserve.gov/monetarypolicy/bst\\_frlabilities.htm](https://www.federalreserve.gov/monetarypolicy/bst_frlabilities.htm).

outstanding U.S. notes.<sup>39</sup> This option gives the Fed flexibility, but just moves the money around between the parties.

The third alternative, the one proposed by this article, would simply have the Fed cancel or refuse repayment on these bonds from the U.S. Treasury and a limited amount of bonds from MBS agencies,<sup>40</sup> thus reducing a huge portion of the overhanging debt crippling the future functioning of government and these mortgage generating agencies. This proposal would be swift and involve a squaring of accounts between government and quasi-governmental agencies. The liquidity currently in the banking system would stay, with the Fed not withdrawing this funding in the face of the current slowing in the global economy.<sup>41</sup> Equally important, the U.S. Treasury and mortgage generating agencies would not have to pay third parties in years to come on these bonds obtained through quantitative easing, thus leaving more flexibility for funding future public construction and infrastructure projects. This proposal would be a way for the Federal Reserve to exit from the corner it has painted itself into, with the economy slowing<sup>42</sup> at the same time the Fed wishes to normalize interest rates.<sup>43</sup> The letting go of this debt through a Federal Reserve write off, in tandem with the

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<sup>39</sup> See Federal Reserve Act, Section 7(b) (2016), which provides for what is to happen to Federal Reserve Banks earnings transferred to the U.S. Treasury. This section also provides that should a Federal Reserve Bank be dissolved or go into liquidation, any surplus remaining [*which would include bonds owned by the bank*] would be paid to and become the property of the United States. Thus all U.S. Treasury bonds owned by the Fed would go to the U.S. Treasury and be extinguished. Should Congress decide to form a U.S. National Bank controlled by the executive branch and liquidate the Fed, the assets of the Fed would therefore go to the U.S. Treasury, substantially reducing the national debt.

<sup>40</sup> And turn over the rest of the agency and GSE bonds to the U.S. Treasury to own, collect payments upon, or sell, to help reduce the national debt.

<sup>41</sup> Peter Coy, *Global Markets Stumble Into High Debt, Low Investment 2017, Next year will be mediocre at best*, BLOOMBERGBUSINESSWEEK, (October 19, 2016), <https://www.bloomberg.com/news/features/2016-10-20-/global-markets-stumble-into-a-high-debt-low-investment-2017>. This article quotes Columbia Business School Dean Glenn Hubbard as saying, “[w]e run the risk of slow growth turning into a crisis.”; see also Heather Long, *The Next President Will Likely Face A Recession*, CNN (June 19, 2016), [money.cnn.com/2016/06/19/news/economy/Donald-trump-hillary-clinton-recession/](http://money.cnn.com/2016/06/19/news/economy/Donald-trump-hillary-clinton-recession/); Jeffrey Sparshott, *U.S. Growth Starts Year in Familiar Rut; Global Headwinds, Weak Business Spending Could Continue to Weigh in GDP in Coming Quarters*, WALL STREET JOURNAL (April 28, 2016), <https://www.wsj.com/amp/articles/U.S.-first-quarter-gdp-advances-ay-0-5-pace-client>. This article states that “[s]low first quarters followed by a rebound have been common in recent years....”

<sup>42</sup> See Coy, *supra*.

<sup>43</sup> However, the Heritage Foundation takes a different view, believing that losing money on these assets would cause the Fed to become insolvent. See Norbert J. Michel, Ph.D. and Stephen Moore, *Quantitative Easing, the Fed's Balance Sheet, and*

raising of interest rates, would counteract any unwanted inflationary impact. The Federal Reserve could even test this bold proposal by raising rates while at the same time writing off portions of its bond portfolio, watching to see market reaction. This third alternative would be a huge net gain for the U.S. Treasury.

Should the Federal Reserve refuse to extricate itself from quantitative easing by adopting this proposal, Congress may want to consider legislation changing the Federal Reserve Act.<sup>44</sup> This could include expanding the number of persons on the Federal Reserve Board of Governors from seven<sup>45</sup> to fifteen, as well as on the Federal Open Market Committee<sup>46</sup>, thus allowing the President of the United States to appoint a majority of new persons in favor of eliminating this episode of quantitative easing from our recent economic history.<sup>47</sup> A bigger change would be replacing the Federal Reserve

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*Central Bank Insolvency*, HERITAGE.ORG, [www.heritage.org/research/reports/2014/08/quantitative-easing-the-feds-balance-sheet-and-central-bank-insolvency](http://www.heritage.org/research/reports/2014/08/quantitative-easing-the-feds-balance-sheet-and-central-bank-insolvency) (Aug. 14, 2014). The article, however, admits: “the Fed can withstand balance sheet insolvency indefinitely...” and “Even if the Fed were to suffer such large losses on its MBS holdings that it could no longer use those securities to meet its obligations, it could still create more base money to meet its obligations. The main limiting factor to this solution—printing more money to meet its obligations—is the (unknown) level of inflation the public will tolerate. Ultimately, if the Fed’s excessive money creation causes too much inflation, people would not want to use the U.S. dollar.” See section entitled, “The Fed’s ‘Failure’ Hinges on Its Special Government Status”.

<sup>44</sup> Changes to the Federal Reserve Act are not unusual. For example, before enactment of the Banking Act of 1935, the Treasury Secretary and the Comptroller of the Currency sat on the Fed’s governing board. The Federal Open Market Committee was also formed at that time as a separate legal entity. See *History of the Federal Reserve*, FEDERALRESERVEEDUCATION.ORG, <https://www.federalreserveeducation.org/about-the-fed/history> (last visited July 23, 2016).

<sup>45</sup> See Federal Reserve Act § 10(1), 12 U.S.C. § 241 (2015) (stating the Board of Governors of the Federal Reserve System is comprised of seven members appointed by the President by and with the advice and consent of the Senate for terms of fourteen years. See also *Who are the members of the Federal Reserve Board, and how are they selected?* BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (Jan. 11, 2017), [https://www.federalreserve.gov/faqs/about\\_12591.htm](https://www.federalreserve.gov/faqs/about_12591.htm).

<sup>46</sup> The Federal Open Market Committee, which is responsible for monetary policy through open market operations, consists of twelve members—the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four of the remaining eleven Reserve bank presidents who serve one-year terms on a rotating basis. See 12 U.S.C. § 263 (2016); *Federal Open Market Committee*, BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM (Jan. 26, 2016), <https://federalreserve.gov/monetarypolicy/fomc.htm>. The President of the United States appoints the Chair and Vice Chair of the FOMC from among the members of the Board of Governors. *Id.* The Chair is appointed for a four-year term and may serve consecutive terms. *Id.* The current Chair, Janet Yellen, began her four-year term on February 1, 2014. See Annie Lowrey, *Yellen Wins Backing of Senators to Lead Fed*, N.Y. TIMES (Jan. 6, 2014), [mobile.nytimes.com/2014/01/07/business/economy/Yellen-Senate-Vote.html?\\_r=1&referer=](http://mobile.nytimes.com/2014/01/07/business/economy/Yellen-Senate-Vote.html?_r=1&referer=)

<sup>47</sup> This would be similar to President Franklin Roosevelt’s proposal to expand the number of Judges on the Supreme Court when that August body was opposing his agenda to revitalize the economy. Shortly thereafter, the Supreme Court stopped holding New Deal enactments unconstitutional. Simply the threat of having the President appoint a majority on the Court made that Court come to its senses. The Fed perhaps would react in the same way should it realize that its institutional integrity was about to be changed.

Bank altogether with a United States National Bank as the new central bank of the United States.<sup>48</sup> Since this new central bank would be part of the U.S. Treasury Department, it would be controlled by the U.S. President. This merger of interests would also result in the bond debt owed from the U.S. Treasury being held side by side with the actual corresponding bonds held by the new United States National Bank, thus effectively canceling these bonds through “restructuring” this \$2.46 Trillion in debt obligations. Creditor and debtor would thus become one, effectuating a merger or accord, where the assets and liabilities of each would be absorbed into one debt extinguishing entity.

The Federal Reserve or the new United States National Bank should also consider not requiring the financially troubled government sponsored enterprises (GSEs) to pay it back for some of the obligations purchased by the Fed in the wake of the financial crisis of 2008. These GSEs include Freddie Mac and Fannie Mae which are de facto under government conservatorship. Congress has had to fund these entities for a while after the financial crisis, but has been unable to decide what new structure Freddie and Fannie should assume. In recent years, these GSEs have become profitable again, actually returning money to the U.S. Treasury.<sup>49</sup> Relief from paying back some bonds owned by the Fed may allow these entities to re-capitalize themselves<sup>50</sup> without periodically asking Congress for money in the future.<sup>51</sup> However, checks and balances on future activities would need to be

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<sup>48</sup> This process may not be necessary if powers of the Treasury are legislatively expanded into areas the Fed now controls, as the Federal Reserve Act, Section 10(6), reserves powers to the Secretary of the Treasury over those of the Federal Reserve where the powers appear to “conflict” 12 U.S.C.S. § 246 (2016). The Federal Reserve would thus have powers in specific areas transferred to the Treasury Department by enumerating those powers as residing with the Secretary of the Treasury, leaving the Fed with a more limited jurisdiction and role to play in U.S. economic life.

<sup>49</sup> Matt Levine, *Fannie and Freddie Will Be Profitable After Their Next Bailouts, Too*, BLOOMBERGVIEW, Aug. 8, 2016, <https://www.bloomberg.com/view/articles/2016-08-08/fannie-and-freddie-will-be-profitable-after-their-next-bailouts-too>

<sup>50</sup> Levine recommends that these GSEs keep their profits, rather than turning them over to the U.S. Treasury, allowing Fannie and Freddie to capitalize themselves and become viable entities again. He believes all downturns are temporary. Assuming regulations were put in place to prevent speculative lending standards such as those prevalent in 2006 and 2007, these organizations could be salvaged and perform the necessary service of supporting viable home ownership. *Id.*

<sup>51</sup> It may also allow the GSEs to pay back the U.S. Treasury for \$187 billion in bail out money the government invested in the GSEs, thus allowing the GSEs to go private again. Alternatively, an offset could be made in the amount of GSE



enacted, as well as settling litigation with past shareholders in exchange for this forgiveness of debt.<sup>52</sup> Such a course could permanently eliminate a future source of liability to the U.S. Treasury, resolving one more loose end left over from the financial crisis of 2008.

#### **IV. SURMOUNTING BARRIERS SO AS TO RESTRUCTURE DEBT (OR REORGANIZE INSTITUTIONS)**

The primary legal barrier to the Federal Reserve writing-off U.S. Treasury debt it purchased in the aftermath of the financial crisis is Section 4 of Article XIV of the U.S. Constitution. This section of the 14<sup>th</sup> Amendment, ratified on July 9, 1868, states,

“The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned. But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations and claims shall be held illegal and void.”<sup>53</sup>

Strict construction of Section 4 of the 14<sup>th</sup> Amendment would look to the historical context of the enactment regarding debts incurred in prosecuting the civil war against the insurrection, which were to be honored (or at least not questioned). Further, the United States or any State could not assume or pay any debt which supported the rebels or the Confederacy, or pay any claims made because of the emancipation of slaves in the South.<sup>54</sup> All such debts were “illegal and void.”<sup>55</sup>

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bonds given to the U.S. Treasury directly by the Fed to repay the U.S. Treasury for its ownership position in the GSEs of preferred stock and warrants.

<sup>52</sup> Levine suggests,

creating “... some privately owned mortgage companies, either from scratch or from the bones of Fannie and Freddie, to buy or guarantee mortgages. Raise capital for those companies from investors, perhaps giving existing Fannie/Freddie investors some credit for their existing holdings, perhaps not. Regulate those companies, and make sure they’re well enough capitalized to absorb any reasonable credit risk in the mortgage market. Let those companies buy some sort of backstop from the government, at a fair price, to further socialize the credit risk of mortgages.” *Id.*

<sup>53</sup> U.S. CONST. art. XIV, § 4

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

Therefore, this appears to be a typical post war enactment, rewarding one side and punishing the other. An analysis of the historical circumstances of the passage of the “securing the public debt”<sup>56</sup> clause of the 14<sup>th</sup> Amendment speaks to how it was necessary to combine all the clauses in Section 4 to obtain its passage.<sup>57</sup> Another scholar ventures his opinion that “[t]his provision was originally included in the Constitution to prevent a southern Democratic majority from repudiating Civil War debts.”<sup>58</sup> This same scholar elaborates further that “[d]espite this provision’s history, most believe—and in 1935, in *Perry v. United States*, the Supreme Court concluded—that it applies generally, not just to Civil War debts.”<sup>59</sup>

Thus until now the beginning language of Section 4 has been construed as general in scope concerning the unquestioned validity of public debt.<sup>60</sup> However, a future court may read the language of Section 4 more literally, as there is a phrase inserted in the middle: “including debts incurred for payment of pensions and bounties for services in suppressing insurrection and rebellion.” The placement of this passage squarely between “authorized by law” and “shall not be questioned” narrows Section 4 to a post-civil war world. This militates against universal applicability of the “validity of the public debt” clause into the future in every situation. It is true that much of the United States public debt in the 21<sup>st</sup> century comes from Middle Eastern war debts, however, this was not a civil war within our own country. Further, ostensibly, the purchase of several trillion dollars of public debt by the Fed was in response to a financial crisis involving unwise lending for home mortgages, and the selling of these bad mortgages to others who were stuck with increasing defaults on these instruments. In both

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<sup>56</sup> *Id.*

<sup>57</sup> Richard L. Aynes, *Unintended Consequences of the Fourteenth Amendment and What They Tell Us About Its Interpretation*, 39 AKRON L. REV. 289,316-321 (2006).

<sup>58</sup> Steven L. Schwarz, *Rollover Risk: Ideating a U.S. Debt Default*, 55 B.C. L. REV. 1, 19 (2014).

<sup>59</sup> *Perry v. United States*, 294 U.S. 330, 354 (1935).

<sup>60</sup> See Neil H. Buchanan & Michael C. Dorf, *How to Choose the Least Unconstitutional Option: Lessons for the President (And Others) from the Debt Ceiling Standoff*, 112 COLOM. L. REV. 1175, 1180 (2012).

these instances—the Middle Eastern wars and the encouragement of speculative lending activity—the federal government had a not so virtuous role in fomenting these activities.<sup>61</sup>

Aside from the origins of our current public debt, and historical background of Section 4 of the 14<sup>th</sup> Amendment, a further look at the language of this Constitutional provision and how the debt has been factually treated since its creation, is important to resolving its legal validity. The language of Section 4 stating that the validity of the public debt “shall not be questioned” is peculiar phraseology. The provision could have emphatically stated “the public debt of the United States shall be paid,” or “the public debt shall not be repudiated,” or similar words, but it does not.<sup>62</sup> The words “shall not be questioned” would seem to apply to private party creditor confidence in the financial condition of the U.S. government. Private parties or outsiders who hold current government bonds should not have reason to “question” the security of the public debt they hold. However, to the extent the Federal Reserve has purchased government bonds from private parties, giving these private parties full value, there should be no such concern. The taking bonds out of circulation and into retirement if you will, actually strengthens the financial wherewithal of the U.S. government. No private party can complain they have not been paid, as there has been no default. Private or foreign government bondholders actually have a more secure and valuable asset because there are less bonds in circulation to be purchased.<sup>63</sup> The only “question” left, concerns what the status of the bonds are that were purchased by the Fed through quantitative easing.

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<sup>61</sup> Thus arises the doctrine of “odious debt,” whereby it seems “morally repugnant to saddle the population of a country, down unto generations yet unborn, with the obligation to repay debts that are truly odious...Most people instinctively believe that the consequences of reprehensible acts should be visited exclusively on the malefactors [for instance a] corrupt regime and complaisant creditors. . . .The question is whether this moral imperative can be translated into a workable legal theory.” Lee C. Buchheit, G. Mitu Gulati, & Robert B. Thompson, *The Dilemma of Odious Debts*, 56 Duke L. J. 1201, 1224 (2007).

<sup>62</sup> Michael Stern, “*Arrest Me. I Question the Validity of the Public Debt.*”, POINT OF ORDER (June 2, 2011, 7:00 am), <http://perma.cc/OZx6HQ6yRk5>.

<sup>63</sup> The treasury market is \$13.6 trillion. Taking a several trillion-dollar supply of treasuries out of this market will make the remaining treasuries scarcer and more valuable. See Lisa Abramowicz, *Beware the Foreign Exodus From Treasuries, Many*

The reality of the situation is that this public debt, issued by the U.S. Treasury, has been bought up by a brother institution, the Federal Reserve Bank *operating as the central bank of the United States*.<sup>64</sup> Historically the Fed and the Treasury have worked closely together on a whole host of issues and the Chair of the Fed meets regularly with the Secretary of Treasury. During the Korean War a “Treasury-Fed Accord” was established which “eliminated the obligation of the Fed to monetize the debt of the Treasury at a fixed rate and became essential to the independence of central banking and how monetary policy is pursued by the Federal Reserve today.”<sup>65</sup> These two agencies also coordinate policies to support the stability of the U.S. currency. The Fed further fosters a payment and settlement system through services to the banking system and the U.S. Treasury that facilitates U.S. dollar transactions and payments.<sup>66</sup> Recently, the U.S. Treasury and Fed helped establish a plan to address volatility in the U.S. Treasury market experienced on October 15, 2014.<sup>67</sup> In a similar manner, the Fed’s Large Scale Asset Purchase program has involved mainly the purchase of U.S. Treasury obligations, using “primary dealers over a proprietary trading platform, accepting propositions simultaneously from all dealers using a multiple-price auction format.”<sup>68</sup> Interest and principal from these bonds is returned by the U.S. Treasury under the FAST Act, which “requires that aggregate Federal Reserve capital surplus not exceed \$10 billion.”<sup>69</sup> This debt, and its payment and repayment

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*Countries Need the Money and Are Cashing Out*, BLOOMBERGGADFLY (Dec. 30, 2016, 7:00 am), <https://www.bloomberg.com/gadfly/articles/2016-12-30/foreign-exodus-from-treasuries-puts-damper-on-any-rally>

<sup>64</sup> PURPOSES AND FUNCTIONS: OVERVIEW OF THE FEDERAL RESERVE SYSTEM, FED. RES. SYS (last updated Dec. 14, 2016), [https://www.federalreserve.gov/pf/pdf/pf\\_1.pdf](https://www.federalreserve.gov/pf/pdf/pf_1.pdf).

<sup>65</sup> *History of the Federal Reserve*, FED. RES. SYS., <https://www.federalreserveeducation.org/about-the-fed/history> (last visited Feb. 6, 2017).

<sup>66</sup> *Structure of the Federal Reserve System: About the Federal Reserve System*, FED. RES.SYS.

<https://www.federalreserve.gov/aboutthefed/structure-federal-reserve-system.htm> (last updated Jan. 19, 2017); *See also* R. Bhala, *The Inverted Pyramid of Wire Transfer Law*, 82 KY. L.J. 347, 386 n. 164 (1993) (“The Federal Reserve’s book entry system is the clearing, settlement, and custodial facility for U.S. Treasury Obligations...”)

<sup>67</sup> *See* Joint Press Release, Bd. of Governors of the Fed. Res. Syst., Statement Regarding Progress on the Review of the U.S. Treasury Market Structure Since the July 2015 Joint Staff Report (Aug. 2, 2016), <https://www.federalreserve.gov/newsevents/press/other/20160802a.htm>.

<sup>68</sup> *See Domestic Open Market Operations During 2011*, *supra*, note 8, pp. 8-9.

<sup>69</sup> *See* Press Release, Bd. of Governors of the Fed. Res. Syst., (Jan. 11, 2016), <https://www.federalreserve.gov/newsevents/press/other/20160111a.htm>.

back and forth between these two agencies, is therefore no longer part of the public marketplace. This public debt cannot therefore be brought into question.

For all practical purposes, the public debt obligations purchased under the Large-Scale Asset Purchase program have been taken out of the hands of outsiders and been brought back in-house to the Fed and U.S. Treasury. Some confusion, however, enters the picture because of past statements from former Fed Chair Ben S. Bernanke about intentions to bring these bonds forth into the public marketplace by selling these obligations once again to private parties. He called these future sales from the Federal Reserve's portfolio "reserve-draining tools" to put upward pressure on interest rates when the time comes [but the time has never arrived]. He indicated the Fed spent considerable effort planning and testing this "exit strategy." He believed the expansion of the Fed's balance sheet through the LSAPs had not raised inflationary expectations "in part because of the great emphasis the Federal Reserve has placed on developing tools to ensure that we can normalize monetary policy when appropriate."<sup>70</sup> But in the four years ensuing since Chair Bernanke's 2012 speech, inflationary pressures have not arisen (and not because of extensive efforts by the Fed to reassure the public it could conceivably exit quickly from quantitative easing). Slow growth<sup>71</sup> and international deflation have, on the contrary, been the problem, and many analysts have now concluded that the low interest rates brought about by LSAPs have actually produced the low growth world-wide economic environment.<sup>72</sup> Or at the least, these analysts believe LSAPs have lost their effectiveness. Amid this

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<sup>70</sup> Ben S. Bernanke, Chairman, Speech at the Fed. Res. Bank of Kansas City Symposium: Monetary Policy since the Onset of the Crisis (Aug. 31, 2012) <https://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm>

<sup>71</sup> See Coy, *supra* note 40.

<sup>72</sup> Robert Fry, *Low Interest Rates are Hurting Growth*, FORBES (Oct. 4, 2016), <http://www.forbes.com/sites/realspin/2016/10/04/low-interest-rates-are-hurting-growth/#3fd69af43a2b>. Fry argues that low interest rates boosted economic growth at the first part of the economic recovery, but that holding rates too low for too long eventually hurts growth. He states that his 32 years' experience in the private sector taught him that investment in plant and equipment are made for reasons other than low interest rates. He states that low interest rates also hurt consumer spending by forcing people to save more money for their retirements once they realize the low rates will last a long time and leave less interest (and thereafter principal) on which retired people can live. He cites Kurt Karl of Swiss Re who told him because of the aging of the population in Italy, interest rate cuts were bad for economic

backdrop, it is time for the Federal Reserve to announce its intention to never sell these U.S. Treasury obligations, and simply return them to the U.S. Treasury.

Moreover, an argument can be made that the moment these quantitative easing bonds were first purchased by the Federal Reserve Bank (regardless of statements of “intention”), they no longer constituted “public debt” at all. These bonds became credits and debits between two public institutions, the Fed and the Treasury. The Federal Reserve should now restate its true intentions regarding these “obligations.” As a marketplace phenomenon, this debt has in reality been extinguished. The Fed’s actions since the QE purchases speak louder than its words from 2012. It has not been able to sell these bonds because of market conditions, and because of failure of its program. It holds the debt saying it intends to sell it someday to drain liquidity, but does something else—keeping it forever, and rolling it over indefinitely.<sup>73</sup> The Federal Reserve should now acknowledge honestly that it really never expected nor now wants repayment on this paper, meaning that it will not accept money from the U.S. Treasury for these bonds, at least money that it will keep on the Fed’s balance sheet.<sup>74</sup> The words debt cancellation, repudiation or forgiveness in this context

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growth in Italy. “Too many years of excessively low interest rates have raised the savings rate of young and middle class people saving for retirement and have severely cut the income and spending of old people who **had** money in the bank... economic growth will be stronger if savers can get a decent return.”; A strategist at UBS Wealth Management, Christopher Swann, is referred to in the article as stating that the strategy could backfire if it cuts bank profits by narrowing the difference between the rates banks charge borrowers and the rates banks pay to get cash for loans. “If profits suffer too much, banks may even scale back lending.” *Will Negative Interest Rates Stimulate Growth—or Backfire?*, U. OF PA. WHARTON SCHOOL (March 1, 2016), <http://knowledge.wharton.upenn.edu/article/the-wild-west-of-negative-interest-rates/>.

<sup>73</sup> Rolling over the debt indefinitely provides a sure source of funding for the government into the future. It is like the government having a multi-trillion-dollar endowment fund that moves forward as old bonds expire and new ones are purchased. Particularly when interest rates are rising, this provides the U.S. Treasury with automatic funding regardless of whether or not private parties are interested in buying government bonds. Should the Fed alter the composition of its portfolio of government bonds to shorter maturities by rolling over longer maturities into shorter ones, the government would cycle money through its coffers even faster. This would not be monetary policy as the Fed maintains, but the providing of a perpetual government funding mechanism.

<sup>74</sup> Fed Chair Janet Yellen at a press conference on December 16, 2015, was asked about the Fed’s large balance sheet of purchased bonds and the stated policy of keeping a large balance sheet until interest rate normalization “is well under way.” Her response was: “... we eventually want to operate with a much smaller balance sheet of—than we have at present. The—we would reduce the size of the balance sheet to essentially whatever size we needed to manage monetary policy effectively—in an effective and efficient way... It might be somewhat larger than the very tiny quantity of

are really meaningless. This debt, purchased with devised money, has long ago been monetized and extinguished. The Treasury has not “renounced” the debt nor defaulted, but a companion bank to the Treasury has paid off the debt and will not seek payment.

The new American President should strongly encourage a normalization of economic processes by insisting that the Fed acknowledge this de facto reduction in the national debt, and return these bonds to the U.S. Treasury unpaid.<sup>75</sup> The President should also appoint a new Fed chair along with more Fed Governors, or perhaps push Congress to enact laws for a new National Bank of the United States that would replace the Fed to bring monetary stability back to the United States and indeed the world.<sup>76</sup> The graft in the financial system, and the institutional delays to reform,<sup>77</sup> should be brought to an end.

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reserves that we had in pre-crisis... we expect to reduce our balance sheet over time by cease—diminishing or ceasing entirely reinvestments. And, beyond that, we haven’t given additional guidance other than to say that the timing of reductions in reinvestment will depend on economic and financial conditions.” See Bd. of Governors of the Fed. Res. Syst., Transcript of Chair Yellen’s Press Conference December 16, 2015, 16-17, (Dec. 16, 2015), <https://www.federalreserve.gov/mediacenter/files/fomcpresconf20151216.pdf>; Almost a year later, Chair Yellen spoke at yet another press conference on December 14, 2016 (and four years after Chairman Bernanke’s speech about future draining of liquidity or selling securities from the Federal Reserve’s Portfolio). In the last part of Chair Yellen’s latest prepared remarks, she said “[f]inally, we will continue to reinvest proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities. As our statement says, we anticipate continuing this policy ‘until normalization of the level of the federal funds rate is well under way.’” When asked about the over \$4 trillion Fed balance sheet, Yellen stated, “So we’ve indicated in our normalization principles that we expect to diminish the size of our portfolio over time largely by ceasing reinvestments of principal rather than by selling securities. We’ve indicated that once the process of normalization of the federal funds rate is well under way, we would probably begin to allow our portfolio to run off. We’ve not yet made any precise decisions about when that will occur.” See Bd. of Governors of the Fed. Res. Syst Transcript of Chair Yellen’s Press Conference, December 14, 2016, 18-19, (Dec. 14, 2016), <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20161214.pdf>.

<sup>75</sup> The Treasury could simply destroy these bonds returned to its possession thus lowering the national debt, or in the alternative, hold on to them and resell them into the private marketplace. The debt ceiling would not have to be raised to resell these bonds because they were previously authorized by Congress. More funding would therefore be available to rebuild the country as the executive sees fit, or as Congress authorizes. The federal debt would remain the same under this second scenario.

<sup>76</sup> If the Fed refuses to return these bonds to the U.S. Treasury, the President should engineer a merger of the Fed with the U.S. Treasury, making a new United States National Bank an appendage of the U.S. Treasury. Such a merger would resolve any lingering doubt about the legality of extinguishing quantitative easing bonds, as the credits and debits of the Fed and Treasury would be united in one organizational structure, canceling each other out. This organizational structure would also give the President control over future activities of the central bank that could include forcing financially stressed entities to be bought out and restructured.

<sup>77</sup>See “Board Members” of the Board of Governors of the Federal Reserve System, regarding their 14 year terms. *Board Members*, BD. OF GOVERNORS OF THE FED. RES. SYST. (Sept. 12, 2014), <https://www.federalreserve.gov/aboutthefed/bios/board/default.htm>.

## V. PUBLIC POLICY AND FUTURE IMPLICATIONS OF DEBT RESTRUCTURING

The current organizational structure of monetary and fiscal policy in the United States is divided, thus impeding constructive, coordinated change. The Federal Reserve independently conducts monetary policy, while weak Presidents and members of Congress struggle to enact spending measures that make a difference in ordinary peoples' lives. Restructuring of governmental entities within the executive branch is hampered because of lack of financial flexibility, while the Federal Reserve has its hands on the levers of the power to expand or contract the private economy. The raising or lowering of interest rates by the Fed has a huge impact on the ability of government to finance national priorities. Presidents are elected and replaced based on the quality of the job the Fed does, not how the President performs. True structural reform of the economic system is the responsibility of no one with this divided structure. A realignment of power at the national level is needed to have these dispersed policy makers work together on the country's goals.

Only the President can be the agent of change in this situation, as significant innovation rarely originates out of large legislative groups of people in committees with segmented and defined areas of responsibility. An essential structural reform would be to bring the central bank of the United States under control of the Department of Treasury (which reports to the President). This would entail creating the United States National Bank. Under such a system, the President would have the ability to manage the debt of the United States, while working with the new central bank to restructure debt and financially distressed entities. The President then, through the Secretary of the Treasury, could oversee the cash flow and the currency of the United States in accordance with his trade policies, and make small early executive branch adjustments to organizations before they later go off course requiring large bailouts. The economy would thereby run more smoothly,<sup>78</sup> instead of reeling from

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<sup>78</sup> Assuming the President and his advisors have financial and business talent.



one crisis to another. The President could then promote new kinds of business and manufacturing within the United States. Funding would be available for his national priorities with the cooperation of Congress. In order for any chief executive officer to forge a different direction for his company or country, he must hold the purse strings funding the new endeavor.

Under the auspices of the President, a newly organized United States National Bank would concentrate on regulating<sup>79</sup> the financial system in such a way that “no-doc” loans and financial excess is never allowed to be perpetrated again. Focus would be made on simple rules, easy to understand and implement so that smaller financial institutions can compete with the too big to fail banks (these rules would be similar in form to those created during the great depression of the 1930s). This way is preferable to the Fed’s track record of monetary instability, quantitative gridlock, and fiscal obligations that cannot be foreseeably repaid. The new central bank under the control of the executive would better realize the Federal Reserve’s mandate of maximizing employment, stabilizing prices, and moderating long-term interest rates.<sup>80</sup>

Future structural and debt problems also loom, such as the massive student loan debt hindering young people’s progress, underemployment caused by the technological (and robotic) elimination of employment in the United States, and the burgeoning cost of health care. Using debt as a means to accomplish the people’s goals, not as a coping mechanism to just get by, through the executive branch proactively managing the nation’s financial affairs would be a sensible way to proceed. Greater thought, synchronization, and creativity must be put into reaching these higher

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<sup>79</sup> The Federal Reserve’s “Mission” includes “supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers.” See *Mission*, BD. OF GOVERNORS OF THE FED. RES. SYST., (Feb. 6, 2009) <https://www.federalreserve.gov/aboutthefed/mission.htm>.

<sup>80</sup> *Id.*; See also 12 U.S.C. Section 225a

goals, moving past the current disorganized, haphazard, and negative prospects the nation has currently settled into.

## **VI. THE ARGUMENT FOR FAIRNESS AND FISCAL SOUNDNESS**

Extinguishment of national debt by bringing it under the control of the President is morally justified. These debts were brought into being by a dysfunctional organizational structure within government that was unaccountable. The taxpayer should not be held responsible for paying the bill for those in government who were unresponsive to the ordinary citizen. The Federal Reserve Bank purchased a large portion of this debt with an accounting entry upon the books of the Fed in order to financially help the country. The money to fund this purchase was created out of nothing. The debt overhang which is left should be electronically uncreated, as this grand experiment with Federal Reserve quantitative easing comes to an end. The financial crisis of 2008 jeopardized the global economic system.<sup>81</sup> The debt purchased during this crisis should not now hamstring the world economic system from making further progress by creating a solvency crisis. The next stage of this scenario must be the lessening of national debt so as to pave the way for healthy public and private sectors.

A final issue arises as to whether this proposed cancelation of debt, if done, will thereafter discourage the central bank of the United States from ever again using quantitative easing. After all, we are still involved in expensive wars in the Middle East, the lengths of which are unpredictable. Also, some government spenders advocate running permanent government deficits, funded by waves of quantitative easing followed by monetization of the purchased debt. They say this is the only way to take care of vast populations of underemployed citizens. But this is all conjecture about the future. With the right mixture of reorganization and revitalization, permanent or even episodic quantitative

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<sup>81</sup> See Goodwin, *supra* note 8.

easing may not be necessary. We can only proceed one step at a time, considering the realities of the moment. Cancellation of the debt from the last round of quantitative easing—\$4.26 trillion dollars—needs to happen now for us to take the next step forward.