Constitutional System of Money and Finance

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ABSTRACT[1]

This paper shows that the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Security and Exchange Commission have embraced an unconstitutional system of money and finance. This system is designed to deprive the principals (citizens) of their hard earned wealth. It is prone to cause continual decimation of general welfare and domestic tranquility. The monetary system currently transfers a staggering $150 billion per year from principals to the banks whose shenanigans have wiped out trillions of dollars from principals' hard earned capital. This paper proposes a constitutional system of money and finance with (a) direct lending of savings from principals to their government by eliminating a riskless transfer of the interest spread to middlemen banks, (b) removal of the speculative short selling practice and (c) the independence of market making and clearing from traders. The proposed system is urgently necessary to any country that seeks to promote general welfare, domestic tranquility and citizenship rights like those mandated by the U.S. constitution.

[1] This paper is based on an economic theory for first-best efficient system of governance to resolve moral hazard in banking and finance, which was first written in 1994 and currently revised in Acharya (2012). This theory uses standard pricing of assets in a free market economy, minimization of the cost of governance, application of the current bankruptcy rules, standard methods of valuation of debt and equity, etc., which are very consistent with the constitution and freedom of enterprise for innovation and prosperity. The implications of this research are profoundly important for governance of financial institutions and economy, though they seem antithetic to the current market self-discipline literature. I believe that true and desirable self-discipline of markets will be fostered under the proposed constitutional economic theory.

Constitutional tenets

The system of money and finance in an economy can be visualized through a classic principal-agent model, which is formally developed in Acharya (2012a), as a dynamic game among stakeholders of leveraged firms maximizing their net-worth and a not-for-profit government minimizing the cost to taxpayers while the financial markets price assets by the principle of arbitrage. The shareholders of firms are better informed agents who control the risk borne by the principals - debt holders of firms and principals (citizens) protected by constitutional governance. The value of net-worth (capitals) earned by principals and agents translate into their financial credits expressed in units of fiat money circulated in the economy.

The above system of money and finance is assumed to be governed by a constitution. The U.S. constitution has granted individual rights that prohibit the government or any of its agencies or any non-government entity acting in its behalf to adopt any rule, procedure or practice to "deprive any person of life, liberty, or property, without due process of law." The constitution also mandates steps to "insure domestic Tranquility" or "promote the general Welfare." In this section, we specify these constitutional provisions as three generic tenets, which are commonly longed by principals in every country around the world.

Tenet 1
The constitution forbids the government or any of its agencies to adopt any rule, procedure or practice to deprive any person of life, liberty, or property; or to deny to any person within its jurisdiction the equal protection of the laws. This tenet is specified in Amendment 14 of the U.S. constitution.

Tenet 2
The constitution specifies (at least implicitly) a free market economy in which people can enterprise and exchange their merchandize, service or capital without any restriction imposed by the government, any government agency and any non-government enterprise or individual. This tenet is implied by Tenet 1.

Tenet 3
The constitution ensures promotion of general welfare and domestic tranquility in a nation. This means the government, any of its agencies, any non-government enterprise, or any individual will not engage in any activity to stifle the general welfare or incite domestic tranquility of the nation. This tenet is consistent with the preamble of the constitution of the U.S.

Such constitutional tenets have been adopted by most major nations worldwide.

Unconstitutionality of current monetary system

The current monetary system adopted by Central Banks in most countries grants banks the privilege to earn a significant interest spread on money channeled from savings of principals to their government. The banks bear no risk for such channeling. Neither do they toil or serve anyone for the privilege. But they extract from government a significantly higher interest rate than that they pay on deposits saved by principals through enterprise, creativity, innovation and service to enhance national prosperity and security. The banks bear no risk or perform no service to earn the significant spread between the rates they pay on the deposits and earn from the government.

Bankers are also among principals, but they have a valuable privilege that the rest does not have.[2] This privilege is underwritten by the bankers in behalf of principals, without full knowledge of the rest. The privilege is designed for

[2] After submission of several memos on ending privilege to the US Congress and Presidents Bush and Obama, an agreement seems to have emerged: Republican presidential candidate Governor Mitt Romney in his first presidential debate on October 3, 2012 to end the privilege of writing blank checks to mega banks and President Obama did not contest. See Acharya, S. (2012b), "Legality, Morality, Constitutionality and Economic Efficiency," memo submitted to Presidents of USA and India with copies to leaders of US Congress, available at http://pro-prosperity.com/Legality,%20Morality,%20Constitutionality%20and%20Economic%20Efficiency.html

indolent bankers and their proxy Federal Reserve Board to usurp the hard earned wealth created by principals. The following proposition establishes that the current monetary system practiced by the Federal Reserve Board is unconstitutional.

Proposition 1
The current monetary system practiced by the Federal Reserve Board (Central Bank in the U.S.) as well as by Central Banks in other Western nations violates the constitutional Tenets 1, 2and 3.

Proof of Proposition 1
The current monetary system restricts the principals from earning the highest interest rate possible if they were to lend to the government directly. At the same time, the effective interest rate paid to banks by the government is higher than that feasible if the principals were allowed to lend directly to the government. The current monetary system thus lets banks to take away the principals' liberty of earning the highest rate of interest on their hard earned capital. This violates Tenet 1.The current monetary system also violates the principle of free market (capitalistic) economy. In a free market economy, those who earn their capital (expressed in monetary units) have the right to exchange the same freely for the highest price (interest rate) that is possible through negotiation with the borrower. The current monetary system takes away this freedom of negotiation between principals and the government to fetch the highest interest rate on the hard earned capital. The current monetary system thus violates Tenets 1 and 2 by imposing middlemen banks, who neither take risk nor toil, to earn from principals or the government a spread on the capital created by principals through hard work.

The current monetary system does not promote general welfare or domestic tranquility and thus violates constitutional Tenet 3. How? In this system, middlemen banks systemically force principals to accept a significantly lower interest than that feasible through direct lending of their capital to the government. The banks and their patron, the Central Bank, have secretly underwritten this unconstitutional wealth transfer mechanism in behalf of principals without the full knowledge of the latter. They have done so in spite of the constitutional power of the principals to form the government to rule their nation. As stated earlier, the bankers too are among the principals. But granting the privilege of Central Banking only to the bankers, not to non-bankers, violates the constitutional mandate of equal treatment of everyone under the law (Tenet 1). If fully informed, the non-bankers among principals will never grant the few bankers the privilege to cream hard earned wealth. General welfare and tranquility will erode when the non-bankers among principals recognize and agitate about the transfer of their hard earned wealth to indolent bankers. Widespread erosion of general welfare led to dramatic loss of tranquility during the Great Depression. Principals have already turned apprehensive and angry about the unconstitutional usurpation of hard earned wealth by indolent bankers in the wake of the recent Great Recession of 2008. The Central Banking privilege granted only to the bankers thus violates constitutional Tenet 3.

The quantum of wealth transfer from the persevering principals to the indolent bankers is staggering, for example, when the rate of interest on deposits is 1.5% and the rate paid by the government is 4% on a total of $6 trillion in bank deposits. The spread is 2.5%. The transfer is .025 x 6,000,000,000,000 =150,000,000,000. In this example, the current monetary system recklessly transfers a staggering quantum of wealth of $150 billion, per year, from the hard earned savings of principals to a few indolent bankers who continually cause depressions and recessions to jeopardize national tranquility and general welfare. This is unconstitutional. It can and should be stopped immediately by adopting a constitutional monetary system presented below.

Safe Central Bank:

Corollary to Proposition 1
The current system of Federal Deposit Insurance violates the constitutional Tenets 1 and 2.

Proof of Corollary to Proposition 1
Under the current system of money and finance, principals will earn lower interest rate on their deposits in the FDIC-insured banks and face greater risk than if they were allowed to lend to the government through a Central Banking facility (defined as Safe Central Bank). This is not consistent with constitutional Tenets 1 and 2.

A constitutional monetary system

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In this section, a constitutional monetary system is proposed to earn the highest rate of interest on the hard earned capital of principals that the current system deliberately does not offer. It is simply a direct lending mechanism: it permits the principals to earn as high a rate of interest as possible by lending the portion of their credits they wish to keep safe to the government directly without the middlemen banks. The interest rate (price of capital) obtained by direct negotiation (equilibrium) between Principals and the government is the essence of a free market or capitalist economy specified by constitutional Tenet 2.

Proposition 2
The Central Bank (the U.S. Federal Reserve) is currently maintaining the accounts of foreign central banks and domestic commercial banks. Consider a proposed monetary system which simply extends this Central Bank facility (called Safe Central Banking) to individuals and businesses. This system is constitutional.

Proof of Proposition 2
The monetary system proposed in Proposition 2 is constitutional because it will grant the same freedom to business enterprises and individuals as currently available to commercial banks and foreign central banks. The proposed system dovetails constitutional Tenets 1and 2. This system will no longer grant the middlemen banks the spread between the interest rates paid by the government and received on hard earned savings of principals. Absent the spread, the proposed system will fetch a significantly higher rate of interest on the hard earned savings of individuals and businesses than possible within the current system. The proposed system will no longer violate constitutional Tenet 1 because it will stop the transfer of hard earned wealth from persevering individuals and businesses to indolent bankers.

In the proposed monetary system, persevering individuals will preserve and enhance their wealth as per the constitution. Inducing perseverance and not rewarding indolence in society will enhance prosperity, security and stability of the nation. The proposed system will thus reduce the chances of financial depression, and promote general welfare and domestic tranquility. The proposed monetary system, thus, ensures constitutional Tenet 3.

In the proposed monetary system, indolent bankers can no longer act as middlemen to pocket a significant interest spread without risk or toil. The proposed system will preclude the windfall transfer of wealth from principals and from their public exchequer to a few indolent bankers. The prevailing wealth transfer system amounts to an unconstitutional deprivation of individual property. This leads to an unsustainable surreptitious (financial) subjugation by a few indolent bankers of principals, who enterprise, produce, create, innovate and serve to make the nation prosperous and secure. Principals in democratic countries like the U.S. and India got their independence from colonial rules. But the colonials left behind a monetary system that surreptitiously subjugates principals.

The proposed monetary system will ensure true independence without surreptitious subjugation of principals. The proposed constitutional monetary system will minimize the systemic risk, reward perseverance, discourage indolence and enhance the long run prosperity, security and stability of a nation.

In the proposed monetary system mirrors the Safe Banking proposal first made in Acharya (2003)[3] which was submitted to the U.S. Congress in 2003. In the proposed monetary system, the Central Bank (the U.S. Federal Reserve) serves as the Safe Central Bank to maintain and manage safe accounts for willing individuals and businesses. The Safe Central Banking policy represents a unique equilibrium within the economic theory of constitutional governance,4 which originally written in 1994 and revised as of March 2012a. This theory is based on a continuous time dynamic model in which profit making enterprises (banks and nonbanks)make their choices for risky assets and the government minimizes its costs to ensure free markets for pricing and trading and for bankruptcy of firms that fail.

Under the proposed constitutional monetary system, the current Federal Reserve's board of advisors and the boards of directors of its regional banks will include bankers as well as non-bankers nominated by the President and

[3]See Acharya (2003), Acharya (2008a) and Acharya (2012a).

confirmed by the Congress. The proposed monetary system, if enacted, will usher in a new era which will eliminate most monetary problems currently faced by the U.S. and the rest of the world:

1. The Great Recession of 2008 revealed the considerable uncertainty about operation and stability of the money market funds. The government has to insure the money market funds. This is consistent with the proposed constitutional monetary system, except that the U.S. under this proposal will no longer need to insure money market funds or bank deposits (and thus render the FDIC redundant) because almost all current money market account holders and bank depositors will have an option to transfer their funds to the Safe Central Bank at the Federal Reserve.

2. Commercial banks now pay a lower interest on insured deposits to recover the cost of deposit insurance to them. The Safe Central Bank at the Fed, under the proposed monetary system, can offer a higher interest rate because (i) deposits switched to the Fed will not need to be insured and (ii) the systemic cost due to moral hazard associated with the inefficiency of the FDIC will be eliminated.

3. The proposed constitutional monetary system will directly facilitate lending of the hard earned savings of individuals and businesses (banks and nonbanks), deposited within the Safe Central Bank at the Fed, to the government at almost the same interest rate as the Fed will pay the depositors. This will dramatically reduce the cost of borrowing to the government, fetch a higher interest rate on hard earned deposits of individuals and businesses, and prevent an undue windfall transfer of hard earned wealth of individuals and businesses to indolent bankers.

4. The proposed constitutional monetary system will eliminate the source of systemic risk, which currently originates from inducement of indolence though the tacit systemic regulatory permission to wangle away of the wealth earned by persevering individuals and businesses. Rewarding perseverance, not indolence, is the founding ethos of America. This should be the guiding principle of every nation willing to thrive and remain stable. The proposed monetary system will rejuvenate such ethos to enhance national prosperity and stability worldwide. There is no other alternative for nations willing to thrive amid internal stability. This proposed constitutional monetary system is the truth that will prevail ultimately. This truth is like the standard equilibrium concept in game theory and economics.

5. The proposed constitutional monetary system will curtail, if not eliminate, the continual boom and bust cycles persistent in the current system. When capitalists (individuals and businesses) deem prudent to take greater risk, they will transfer money from their Safe Central Bank account at the Fed operating with the proposed system, for investment in risky projects, mutual funds, hedge-funds or banks. A decrease in the supply of safe capital at the Safe Central Bank will prompt the Fed to raise the interest rate appropriately to contain inflation potentially caused by such transfers to risky ventures. When the capitalists fear losing in risky investments or get attracted towards a higher Safe Central Bank rate, they will choose to balance their risky and safe bets. The amount of Safe Central Banking deposits will allow the Fed to learn directly about the level of systemic risk within the economy. This will let the Fed closely calibrate its interest rate policy depending on supply and demand for its money at its Safe Central Bank. The Fed is currently basing its interest rate policy on the total reserves of commercial banks, as well as on its inference of systemic risk based on judgment of individual bank portfolios, and inflation. The constitutional monetary system will give the Fed the most accurate direct assessment of the systemic risk without having to infer it imprecisely through middlemen banks steeped in moral hazard and other uncontrollable activities.

6. The proposed constitutional monetary system will prevent banking panics, runs and bailouts and obviate the federal deposit insurance, which is source of moral hazard in banks and regulatory agencies that cause sporadic depressions and recessions, as discussed below.

Proposition 3
The proposed constitutional monetary system will obviate federal deposit guarantee and, hence, avert moral hazard in banking and regulation.

Proof of Proposition 3

Why did the U.S. Congress start federal guarantee of bank deposits? The banking panics and runs of 1907 created a deep mistrust among principals in the banking system. Principals held their hard earned savings in the form of gold, tangible assets and cash instead of bank deposits. This caused serious problems in channeling savings to businesses for creation of jobs. Mass unemployment ensued, leading to the Great Depression. The surviving top bankers faced a catastrophe because of the instability in their amassed credits extended as debt to individuals, businesses and governments. The top bankers then had a secret conclave to devise a strategy of advising the U.S. Congress for institution of the federal deposit guarantee by creating a new government body, the Federal Deposit Insurance Corporation. This deposit guarantee thus protected the credits amassed by the bankers.

It is widely accepted that credit crunch exacerbated and prolonged pain and suffering of principals during the Great Depression. But no economic theory existed to explain why the banking panics and runs occurred in the wake of path breaking scientific inventions and innovations in early 20th century. My research starting 1994 has discovered that moral hazard in the financial system and regulation leads to an erosion of trust of principals in the system. Principals then liquidate their positions to purchase the most trustworthy assets available, namely, gold, silver and U.S. government securities. This was vivid during the 2008 Great Recession when investors liquidated their money market funds to purchase safest U.S. government securities. But regulatory agencies fell into the moral hazard trap to raise the limit on bank deposit insurance, and to guarantee money market funds as well as all bank debt. The latent moral hazard in banking is now exacerbated with more of the banks' risks transferred to principals via the new, virtually unlimited guarantees extended by the government.

Acharya (2012a) shows that moral hazard in banking and bank regulation can be dissipated efficiently if the government simply ensures that the constitutionally mandated free market economy runs without any restriction in trading. Unrestricted trading means that individuals and businesses are free (without government dictation) to purchase, for example, the failed banks at free market prices. An unrestricted free market did not exist during the Great Recession of 2008 because the government-created agencies like the Federal Reserve, the Treasury Department and the FDIC told principals that they would bail out some failing banks to acquire assets of the other failing banks by zeroing out principals' savings invested in securities of the latter. Such ad hoc government restrictions on markets are obviously unconstitutional. Restrictions on freedom of markets have perpetuated moral hazard in banking and regulation. The ability of banks to privatize profits by piling risks on principals is moral hazard. As the principals observe risks piling on them, their trust in banking erodes. Eroding trust leads to panics and runs on financial institutions. Granting federal insurance of bank deposits and debts will only exacerbate the bankers' tendency to privatize larger profits by transferring greater risks to the principals as observed during the Great Recession of 2008.

Unflinching trust in banking is essential for prosperity amid stability in a nation. To preserve trust in banking, it is necessary to simultaneously enact the following policies:

i. Repeal government insurance of bank deposits and debts.
ii. Remove moral hazard with an unequivocal resolve by principals to not bail out any failing financial institution.
iii. Institute the proposed constitutional monetary system by creating a Safe Bank at the Federal Reserve with a depository facility open to everyone among principals, namely, every individual and business, not just financial institutions.[4]

We can now see that the Safe Central Banking policy proposal, submitted to the Congress in2003, is the same as the currently proposed constitutional monetary system. Here are some profoundly beneficial implications of this proposal:

1. The too-big-to-fail bankers and their cronies will no longer be able to play moral hazard unconstitutionally for self-aggrandizement by depriving principals.

2. The Glass-Steagall Act, repealed in 1999, will not need reinstatement.

[4]The concept of *Safe Banking* also obtains in a general equilibrium mathematical model on the economic theory of constitutional governance, in Acharya (2012a).

3. No new regulation on trading within banking firms or hedge funds will be needed as long as they follow the constitutional system of operation of financial markets described in the next section.

4. It will naturally result in heavily capitalized and unregulated Universal Banks with freedom to take risky investments, because investors will no longer trust thinly capitalized banks unprotected by the government. Absent taxpayer bailout, thinly capitalized Universal Banks will not survive to create havoc to the economy. Bank Holding Companies will not have the incentive to fudge their capital through multi-tier leveraging.[5]

5. Bankers can no longer use the federally-insured deposits for unconstitutional moral hazard gambling which costs taxpayers enormously, hurts the economy badly and erodes the national competitiveness irreparably. Recall that the banking panics of1907 led to runs on banks. People thereafter did not trust banks. Their savings could not be channeled to businesses to create jobs in the economy. This led to the Great Depression. Bankers then drafted legislation for the U.S. Congress to enact to have the government insure bank deposits. This legislation allowed a formal perpetuation of the same unconstitutional game of moral hazard with tacit collusion of the Federal Reserve.

6. Elimination of deposit insurance will cease the virtual control that a few bankers have wielded over the U.S. Congress and principals. The new policies will ensure that bankers establish their trustworthiness and creditworthiness by investing sufficiently their own equity capitals to attract depositors to their Universal Banks. In the current system of federal deposit insurance and debt guarantees, bankers are eager to siphon off bank earnings directly as bonuses and underhandedly through unconstitutional moral hazard lending to private equity and hedge funds owned by them. The current system has enervated banks as shells. Safe Central Banking will serve those who may distrust even the highly capitalized Universal Banks. There will thus be no panics.

Unconstitutionality of speculative short selling

This section shows how the Security and Exchange Commission has transgressed constitutional Tenets 1, 2, and 3 by permitting the practice of speculative short selling in financial markets. We then present the case of how an old, stable and well capitalized bank, Washington Mutual, could be easily acquired by another bank, J.P. Morgan and Chase, through speculative short selling. We argue that speculative short selling should be illegalized, according to constitutional Tenets 1, 2, and 3. Economic inefficiency of short selling is proved in Acharya (2012d).

A short seller sells a stock he does not own and promises to deliver the stock to the buyer by borrowing the same from a lender, an existing owner. If the price falls, the short seller can buy the stock at the lower price to return it to the lender. The profit of the short seller is the difference between the short selling price and the buying price. If the security is not borrowed for delivery to the buyer, the short sale remains naked. The Security and Exchange Commission allows naked short sales for 3 days, does not penalize such naked positions for 13 days, and simply prohibits an increase in the naked positions if a broker-dealer fails to deliver in 13 days.

Proposition 4: (i) Short selling amounts to unconstitutional usurpation of private property, violating constitutional Tenet 1. (ii) Short selling can trigger financial meltdowns, depressions and unemployment, violating constitutional Tenet 3. (iii) Short selling can lead to control of the Congress and Principals. (iv) Short selling can destroy the home mortgage market. (v) Short selling can destroy the housing sector. (vi) Short selling can destroy international relations. (vii) Non-speculative short selling should remain legal.

Proof of Proposition 4 (i)
An ordinary short seller can speculate and may lose or gain because he cannot control the price move. But a mega short seller can strategically speculate by trading a very large number of shares of a stock to rig its price downward in order to profit from the falling price. A mega short seller can be a market making bank holding company or a private hedge fund run by the bank's executives with easy access to federally insured deposits and FDIC guaranteed

[5] See Acharya, S. (2008b).

debts. Speculative short selling can significantly increase the supply and lower the price of a security. This is unconstitutional because the true owners are forced to take an artificially lower value of their holdings than possible without the increased supply of the security triggered by short selling. Speculative short selling thus amounts to surreptitious, unconstitutional usurpation of private property. This violates Tenet 1. Creation of unauthorized shares through short selling also violates the prevailing company act that rigorously stipulates the outstanding shares of a company.

Proof of Proposition 4 (ii)
Short selling can cause depressions, massive unemployment and even anarchy. For example, JP Morgan and Chase could, as permitted by the SEC, short sell one billion shares of Washington Mutual (WaMu) in 2008. By massively increasing the supply of outstanding shares, without authorization by the Board of Directors of WaMu, JPMC could (a) decimate the market price of WaMu common shares, (b) force the rating agencies to downgrade WaMu, (c)make it impossible for WaMu to raise more capital, (d) scare the FDIC to seize WaMu to transfer$300 billion of WaMu assets to JPMC for $1.9 billion in a weekend, even if WaMu (i) was solvent and well capitalized according to its primary regulator, the Office of Thrift Supervision and vouched by the FDIC until the seizure, and (ii) could have received funds within days under the Troubled Assets Relief Program and from discount windows of the Federal Reserve.

The SEC imposed a ban on short selling of most financial firms except WaMu during those dark days before WaMu fell. This raises a question about whether the SEC is at the beck and call of mega short sellers, or whether it devises market rules constitutionally to serve the best interest of principals.

Whether or not JPMC did anything illegal under the current SEC regime is for the system of justice to determine. The point is that the SEC's permission of short selling is unconstitutional because it deprives thousands of legitimate owners of property (stocks, bonds and preferred stocks) of their possessions, violating Tenet 1. Such deprivation also leads to massive unemployment and financial depression. Unfair seizure of property leads to mistrust in banking, financial markets and governance. This demotes general welfare and domestic tranquility, violating constitutional Tenet 3.

Proof of Proposition 4 (iii)
Short selling can lead to control of the Congress and principals. Mega short selling can facilitate a bank to use its FDIC guaranteed debt and federally insured deposits to take over or eliminate rival banks. It can thus allow a few banking firms to take control of the economy, Principals and Congress, as happened during the Great Depression. Short selling has exacerbated the Great Recession and can still lead the economy to Great Depression II. Looking forward, mega short selling must have piled massive short positions in most market making bank holding companies and made them too big to fail because the taxpayers have to cover those positions at huge losses at the time of bail out.

Proof of Proposition 4 (iv)
Short selling could destroy the home mortgage debt market during the Great Recession. For example, a large bank like Goldman Sachs could buy the best rated mortgage debts from several mortgage banks to securitize as mortgage backed securities (MBS). Goldman Sachs could then sell the MBS to other investors like Bear Stern and Merrill Lynch. JPM could then short sell massive quantities of the same category of MBS without being required to borrow the securities under the SEC rule. The market could then have an artificially increased quantity of outstanding MBS without actually being backed by real mortgage loans. This could drive down the MBS values of all real mortgage loan pools held, for example, at Bear Sterns, Merrill Lynch, and Lehman Brothers, making these investment banks insolvent and then fall. Such failures could scare the regulators and Congress to offer inducements in terms of billions of dollars of fresh taxpayer funds to the mega short sellers that caused the failure to rescue the failed investment banks. The mega short sellers could thus acquire the best rated mortgage loans cheaply by depriving the owners of Bear Sterns, Merrill Lynch and Lehman Brothers. Consolidation could then allow the short sellers to resort to predatory lending.

A numerical example

Suppose that JPM acquires at par $100 worth of mortgage loans, made by loan originators to borrowers with no risk of repayment. JPM then creates mortgage backed securities (MBS) based on these loans, gets the MBS rated as AAA and then short sells the same at par to Bear Sterns. This should be enticing to Bear Sterns because it buys the MBS at no premium. Now JPM short sells another $100 of the same AAA-rated MBS to Merrill Lynch.

JPM thus makes $200 from the MBS short sold to the two investment banks. Neither Bear Sterns nor Merrill Lynch holds the original mortgage loan pool underlying the short sold MBS. Only JPM holds the original mortgage loans and receives monthly payments (say 6% per year)from the borrowers of those loans. JPM has paid $100 to the mortgage borrowers, but makes$200 upfront from two investment banks or a net of $100 upfront. JPM pays yearly $12 to the investment banks and receives from the mortgage borrowers $6. This amounts to a net yearly payment of $6 by JPM. The short sale thus generates for JPM a net cash inflow of $100 upfront and a net yearly cash outflow of $6. This appears fair and unproblematic.

But then JPM short sells the same AAA-rated MBS for $90 with a promise to make the same yearly payment of $6 to other investors buying these pools. This looks unprofitable to JPM and attractive to the buyers. But it can be strategic for JPM and devastating to others including the economy. The short sale at reduced price depresses the equity capital of both Bear Sterns and Merrill Lynch by 10% of all their MBS holdings. If Bear Sterns borrows from JPM to buy the MBS, it is doomed by JPM. This is possible due to short selling permitted by the SEC.

Speculative short selling thus allows JPM to take over Bear Sterns to control the mortgage market and unleash predatory lending. Such developments during the Great Depression led the Congress to create Fannie Mae and Freddie Mac to contain predatory lending. Speculative short selling facilitates predatory lending.

The short selling practice permitted by the SEC makes JPM’s actions in the above example permissible. But this practice is unconstitutional because it facilitates usurpation of (a) property that belongs to owners of Bear Sterns and (b) incomes of home mortgage holders through usurious interest rates that a consolidated bank can set predatorily. This violates constitutional Tenets 1, 2 and 3.

The name of JPM in the above example is incidental. JPM can be replaced by any other market making bank holding company in this example to arrive at the same conclusion that the short selling practice permitted by the SEC is unconstitutional and should be banned.

Proof of Proposition 4 (v)

Short selling can destroy the housing sector. Speculators can buy huge quantities of Credit Default Swaps (CDS)-which are put options on MBS and simultaneously sell short MBS and other debt and equity securities issued by mortgage banks. This can lead to a rapid decline in prices of mortgage bank securities. It will then prompt the rating agencies to lower their ratings. Rating downgrades can curtail the availability of funds to many mortgage banks. This can destroy the ability of mortgage banks to finance homes. Many mortgage banks indeed failed during the Great Recession of 2008 and the home prices fell precipitously.

Despite near zero rate of interest set by the Federal Reserve since 2008, many top rated home mortgage borrowers are paying their mortgage payments at significantly higher rates of interests, artificially set by the shenanigans of the banks and hedge funds. Banks and hedge funds used federally insured deposits to bid up commodity prices to force the Federal Reserve to raise the interest rate before the crash. Now, the high rated home owners cannot avail of the lower rates of interest on the new money created on their back by the Federal Reserve because of drops in their home values. The Fed’s newly created cheap money injected to banks have perhaps gone to private hedge funds and trusts. Many home owners with decimated prices of their homes are resorting to strategic defaults. It is so eerie that the replacement cost of many homes, as quoted by home insurers, is often significantly higher (sometimes 200% more) than the assessed values based on declining prices caused by strategic defaults. Speculative short selling of MBS has thus exacerbated the home mortgage crisis.

Proof of Proposition 4 (vi)

Short selling can destroy international relations. Speculative short selling led to bitter relations with China and Russia in 2008. A top strategist, advising the Chinese government, warned on September 5, 2008 about an end to the international financial system, if not the world, should the US government not honor the tacitly guaranteed Fannie and Freddie debt. The Chinese warning followed their worries about a sudden spurt in the speculative short positions on Fannie and Freddie common stock. Speculative short selling thus pushed the U.S. to the brink of a financial war with China and Russia. It then forced the Treasury Secretary to the White House bunker to push Fannie and Freddie into conservatorship. The Federal Reserve had to swap the Chinese and Russian debt holdings for guaranteed deposits in the Federal Reserve Bank of New York for about $600 billion.

The speculative short sellers were the same mega banks who first short sold the taxpayers by originating subprime mortgage loans including liar loans and transferring the loans to Fannie and Freddie. They then short sold Fannie and Freddie securities and lobbied for dismantling the two government sponsored enterprises, which were created to alleviate the woes of the Great Depression and were critical during the Great Recession. The speculative short selling is still potentially poised to create anarchy domestically should the economy recede towards Great Depression II. It can strain relations with the developing world that has amassed dollar reserves.

Every firm serves its self interest while selling securities short. The speculative short selling practice permitted by the SEC appears to help the firm boost its profits temporarily. But the mutual short selling of each other's holdings will eventually force the short sellers to face collective ruin of their capitals. This pushes the fate of a great nation to the brink of disaster, due to uncontrollable destruction of accumulated capital, created through hard work. Speculative short selling thus strikes the very heart of the nation as well as society, in addition to causing unconstitutional plunder and destruction of hard earned savings of Principals.[6]

Proof of Proposition 4 (vii)

Non-speculative short selling should remain legal. Short selling is not always speculative. Non-speculative short selling does not artificially raise the supply of securities and is thus constitutional. It is needed for hedging.

For example, farmers short sell forward contracts at the time of plantation to deliver their crop at the time of harvest for a forward price set at the time of plantation. Farmers will plant only if the forward price exceeds the cost of plantation and harvest. If the forward price is less than the cost of production, a farmer can avoid plantation and avert a potential agony of becoming bankrupt.

We have similar examples of exporters who need to short sell forward foreign exchange contracts to hedge their future foreign currency earnings. Oil exporting countries often short sell forward contracts to deliver crude oil to the importing countries.

Portfolio managers often buy put options to hedge their portfolios. Option specialists write(short sell) options and hedge their risk exposure by trading in the common stock on which the options are written. This is necessary to run their brokerage business that earns them commission. Short selling of securities for such hedging is non-speculative and should not be banned.

Non-speculative short selling is needed to protect/hedge basic business operations. Non-speculative short selling does not artificially increase the supply of securities because the short positions are usually covered. It is the speculative short selling that destroys many a needy hedgers.

Rampant speculative short selling devastated the economy during the Great Depression. The SEC learnt nothing from it or is simply pretending ignorance. Speculative short selling made most financial firms vulnerable during the Great Recession of 2008, as it did during the Great Depression. The SEC went haywire during 2009 about short selling that it first banned for financial firms, selectively, and then lifted.

The academic studies based on data during the SEC ban and after the ban argue that speculative short selling does not increase price volatility. But the SEC ban was not extended to all firms (especially the nonfinancial firms) and it excluded specific financial firms like the Washington Mutual that may have fallen due to rampant speculative short selling. The academic study obviously does not consider stock prices of specific companies like Washington Mutual, Bear Sterns, Merrill Lynch and Lehman Brothers that had perished by the time SEC introduced its ban on short selling. No study is necessary to establish that the stock prices of these firms were wildly swinging during 2008 and

[6]After discovering its deadly force in 2001, the author has articulated it in memos and papers since 2003 to plead with the US Congress for a universal ban on speculative short selling.

2009. It was due to speculative short selling. Professional short sellers were creating buzz in the media about some positives like takeover of failing firms to entice buyers of shorted securities. Otherwise, the prices of failing firms would have fallen to the ground instantly. The professional speculative short sellers can be formally discovered by examining the confidential trading books of the market makers and clearing houses.

Constitutional market making

The proposed U.S. Senate banking reform bill may not prevent future market failures and depressions because the unconstitutional practice within the system of money and finance will continue even after enactment of the bill. This section argues for a constitutional system of market making and clearing to prevent future crises.

Unconstitutionality of the current system of market making

Market Making Law: The current U.S. law makes trading for profits illegal for the MMs-the market makers in NASDAQ, specialists in NYSE or CBOE and dealers in CME and CBOT. The law permits MMs to earn stipulated fees or commissions to match the true sellers and buyers in the market. The MMs are prohibited by law from trading ahead of the buyers and sellers. This law is based on Tenets 1, 2 and 3 stated in Section I. The Federal Bureau of Investigation website[7] in Chicago states: "[August 1989] The Attorney General announced the indictment of46 current and former traders and brokers on the Chicago Mercantile Exchange and the Chicago Board of Trade. The indictments were the result of a two-year FBI Chicago investigation in which four Agents posed as traders."

Proposition 5
The current system of market making is effectively illegal and unconstitutional.

Proof of Proposition 5
Government regulators currently permit a bank holding company(BHC) to form a bankruptcy remote, fire-walled subsidiary (sub) for market making. The MM sub, per se, may not be trading illegally. But a market making BHC that uses its non-MM subs to trade based on valuable information obtained from order flows at its MM sub flouts the spirit of the law on a consolidated basis, backed fully by the regulators. This is effectively illegal and unconstitutional because it facilitates wangling of wealth of MM clients (buyers and sellers) based on full information obtained from orders already placed by both the buyers and sellers of securities.

This effective illegality and unconstitutionality of market making is exactly like the violation of the minimum bank capital required by the Federal Deposit Insurance Corporation Improvement Act of 1991 via formation of the BHC structures that has caused the Great Recession.[8] A banker can, for example, increase return on equity ten-fold through a BHC structure by effectively diluting its consolidated capital to one-tenth of the FDICIA-1991 minimum capital requirement.[9]

That such deep leverage effectively piles huge risk on taxpayers and households was clear from the events that unfolded just before the Great Recession: The regulators had explicitly permitted such effective transgression of the minimum bank capital requirement law until the end of 2007.

In late 2007, I submitted memos and a research paper to the Congress illustrating how the taxpayers were committing financial suicide by unknowingly underwriting such regulatory transgression of FDICIA-1991.[10] Consciousness must have dawned on the regulators only after the Congress pressured in early 2008 for banks to raise capital to meet the minimum requirement on a consolidated basis, as I had appealed for. Frequent public

[7]See http://chicago.fbi.gov/history.htm
[8]See Acharya, S. (2010), "Mythology of Market Discipline Unraveled by Market Crash: A New Philosophy of Governance," available on the Internet at
http://pro-prosperity.com/Mythology%20of%20Market%20Discipline%20Unraveled%20by%20Market%20Crash.html
[9] See Acharya (2012a).
[10] See Acharya (2007).

statements by the Treasury Secretary in early 2008 to persuade banks to deleverage and to raise capital for survival shows that banks across the board were not sufficiently capitalized by the end of 2007, when the asset prices were sufficiently stable. It is the new requirement imposed in early 2008 on banks to have the regulatory minimum capital on a consolidated basis that exposed most BHCs that had fudged the law through firewalled subsidiaries. The banks that could not raise sufficient capital and that the government did not want to bail out failed. Regulators infused capital to some failing banks through backdoor, during the Great Recession of 2008, basically to suppress the truth about their failure to enforce the minimum capital requirement on a consolidated basis. But principals from the Left, Right and Center have vividly seen the picture of regulatory failure and the patch-up.

Principals should now appreciate the public admission of regulatory failure by heads of the Federal Reserve Board and other government agencies. But will this lead to a catharsis of a regulatory-backed, effectively illegal financial system? It will not, even if the banks and BHCs are recapitalized massively by some magic wand and the proposed banking reforms are passed as new laws. I see vividly the truth that the market making BHCs have abused their MM subs as fronts to gather information from order flows to trade from their non-MM subs. Such regulatory-backed trading is illegal on a consolidated basis because the BHCs use their MM subs, legally barred from trading, as fronts to trade within their non-MM subs with valuable information gained from order flows unavailable to individual traders. As a result, both the buyers and the sellers of securities lose, with gains flowing to the BHCs and their proxy private hedge funds and trusts, thanks to the current regulatory-backed, effectively illegal financial system.

The unconstitutional shenanigans of the market making BHCs produce significant profits, but they are miniscule as compared to the foregone profits on the household investments. Such shenanigans thus generate significantly less tax for the Treasury than possible if the MM shenanigans were disallowed. Empirical studies show that more than 90 percent of the mutual funds underperform as compared to the market. The recent meltdown has wiped out many hedge funds. University endowments have been decimated. People have lost an estimated $50 trillion worldwide. A recent news report shows that most Americans did not benefit from the 70% rise in the stock market indexes. The report does not say if the Tea Party activists and their strong sponsors are angry because of losses from short selling. The powerful supporters of the current market making system in any party may have gained from time to time, but most are now poised to lose, if they have not already lost a bundle.

Risks hereon

In this subsection, I argue that the current financial system (even after the new Senate Bill is passed) is going to be financially suicidal for taxpayers and households hereon. How?

The market making BHCs are not discriminating in their strategy of rigging the prices of their long positions upwards and of their short positions downwards. This increases the value of their marked-to-market portfolios and capitals needed to survive. That the market making BHCs failed to foresee the true values of their holdings was vivid during the Great Recession, as the Treasury Secretary stated repeatedly that banks were filled with toxic assets with no buyers. The market broke down and the government had to step in with the Federal Reserve owning many portfolios with overpriced long positions and underpriced short positions. Selling of the overpriced long positions and covering of underpriced short positions will only result in losses to the Fed. Merging BHCs will only let the losses accumulate in a bigger scale within the consolidated BHCs. That the government regulators and academic thinkers failed to see the market meltdown and are failing to see the massive accumulation of risks simply illustrate a failure of their philosophy of self-disciplined market making. See Acharya (2012a and 2010).

Market making BHCs do not make money by strategies which may be considered rational for the truly productive household investors, ordinary hedge funds and mutual funds. A market making BHC's portfolio comprises overpriced long positions and underpriced short positions. If liquidated, these portfolios will produce only losses. The Federal Reserve has direct experience about such losses as the values of all the seized collaterals during the Great Recession have shrunk. That is why the managers of the market making BHCs take away as bonus whatever hey can from the profits schemed in the markets as long as no one is complaining. This is why I rang an alarm bell about banking executive compensation in my Safe Banking paper (Acharya 2003) and appraised the Congress about it.[11]

[11]http://pro-prosperity.com/Global%20Economy%20Chatterbox/Warning-USCongress-In-2003-

At the end of this super economic cycle, potentially leading to another Great Depression, a supermarket making BHC (if not a few such BHCs) will emerge like we had in early twentieth century. The surviving super BHC emerging with government facilitated mergers will have a gigantic portfolio of mostly overpriced long positions and underpriced short positions. This super BHC will then control the principals, the indebted households, banks, hedge funds and non-financial firms because it can and will thrive only by rigging downwards the prices all assets held by debtors. The profit maximizing super BHC will rationally liquidate or seize the debtors' assets by selling the assets short and then by covering at fire-sale prices at will.

For example, when the prices of a mortgage bank's securities (its assets) are rigged downwards by its lender (the super BHC), the mortgage bank loses its equity and control. The super BHC then acquires the mortgage bank for pittance to control all mortgage loans made to households. Through many such concocted acquisitions of mortgage banks, the super BHC then artificially chokes credit to households leading to a collapse of the housing prices. The scared households then surrender their homes for nothing. The super BHC then acts benevolent by claiming that it has written off the mortgage loans (acquired by rigging the system) and rented the repossessed properties (seized through an unconstitutional market making system) for affordable amounts.

The super BHC will seize homes only after the households have lost jobs and savings. Such rigging will thus result in losses of all savings and investments of most households with the proceeds and controls of their businesses and homes transferring to the super BHC. The Principals, the Congress and the President will then have little power as in the Great Depression.

Capital is destroyed continually by the current market making system

We are at the brink of a potential Great Depression. We need to preemptively exorcise the evil process of mutual capital destruction. I continue to "pray" that the calamity does not unfold. But "prayer" within my Universal Religion means searching for the truth through research about how Principals should govern themselves (see in Acharya (2012c))

An understanding of the capital destruction process can make the needed reform for a constitutional system of market making transparent. The market making BHCs make money because of a lopsided financial system instituted by a conniving regulatory regime. The system helps the market making BHCs wangle away hard earned savings of the households by piling losses on taxpayers: A market making BHC irrationally raises the price of a security it holds long to entice ordinary short sellers to sell the security short at rising prices. The BHC then raises the price further to scare the ordinary short sellers to buy back the security at a fictitiously high price from the BHC.

By inducing ordinary short sellers to sell a security short through media blitz about the security being overvalued and then by rigging the price artificially upwards using block bids based on taxpayer-insured funds, a market making BHC can scare even the large professional hedge fund short sellers to force the latter to buy a short-sold security at a fictitiously higher price to cover short positions at losses. This tactic transfers enormous wealth from households, hedge funds and mutual funds to the market making BHC and their managed private hedge funds and trusts in addition to raising the value of the BHC's portfolio to keep the operation afloat. A market making BHC can likewise gain from ordinary holders of securities (pension funds and household investors) by irrationally dropping the prices to scare the buy-and-hold passive investors to sell their holdings at substantial losses.

The market making BHCs can thus rob the hard-earned savings of the households, hedge funds, mutual funds and even large investment banks. The taxable profits of the market making BHCs may be significant, but they are miniscule as compared to the foregone profits of the rest. The current unconstitutional system thus generates lower taxes for the government than feasible if itis reformed constitutionally. Furthermore, market making BHCs use taxpayer-insured deposits, FDIC-insured debt and regulatory support to impose massive losses on taxpayers as well as investors.

Many banks have already failed during the Great Recession. The large investment banks that had survived the wrenching Great Depression fell one by one during the Great Recession, until the government stepped in to save Goldman Sachs and Morgan Stanley.

How trading by market making BHCs is financially suicidal to taxpayers

As concluded in the previous section, a market making BHC's portfolio comprises overpriced long positions and underpriced short positions. If liquidated, these portfolios will produce only losses. Underpriced means a lower market price than the true value and overpriced means a higher market price than the true value. Market price is the price determined in the current market with the market making BHCs playing their noosing games described earlier. True value is the price determined in a constitutionally free market economy, i.e., after the proposed constitutional reforms are implemented to unshackle the market from the unconstitutional noose of the current market making BHCs.[12]

A numerical example

An ailing market making BHC has 100 shares of IBM long and 500 shares of Intel short. The current price of IBM is $130 per share and of Intel is $22 per share. The current market value of this portfolio is 100 x 130 – 500 x 22 = $2000. If this portfolio really comprises overpriced long positions and underpriced short positions under the current unconstitutional market environment, it would mean that the true value of an IBM share will be less than $130 (say $120) and the true value of an Intel share will be more than $22 (say $25). The true values will prevail if the proposed constitutional reforms are implemented to free the market of the noose imposed by the current market making BHCs. The true value is approximately equal to the liquidation value that the government can fetch by seizing the portfolio and closing the positions. The true value of the BHC portfolio is 100 x 120 – 500 x 25 = –$500. Seizing and liquidation of this BHC portfolio will result in only losses for taxpayers. The net cash flow to taxpayers on liquidation of this ailing BHC portfolio is its true value, –$500, minus the amount to be paid for acquisition based on the current market value, $2000: –500 – 2000 = –$2500. The net cash flow to taxpayers foreclosing out the BHC is thus a huge unnecessary loss. The loss is due to the overpriced long positions and underpriced short positions held by the ailing BHC bailed out by taxpayers.

The market making BHC executives thus game to transfer wealth from households, pension plans, mutual funds and smaller hedge funds and banks. They can transfer the proceeds to private trusts and hedge funds or pay themselves in unseemly bonuses, as long as the system does not collapse and no one objects. When the system collapses, taxpayers discover only junk in the portfolios of the market making BHCs. The wealth transferred to indolent bankers and their private trusts from households, mutual funds, pension plans, smaller hedge funds and banks is nothing but the value of hard work of the effective producers among Principals. The effective producers simply discover, after losing their savings and jobs, that they were engaged to toil for the schemers and that they have no option but to line for breads distributed by the schemers during a depression.

Without an access to the private trading books of market making BHCs, one cannot claim for sure that the BHC portfolios indeed comprise overpriced long positions and underpriced short positions. But this is my rational inference based on how the market making BHCs make trading profits while the rest lose on average.

Regulatory agencies can easily test my rational inference based on their privileged access to the private trading data of the market making BHCs. I had implored the SEC to let me have such data for research in 2001. I was too naïve to harbor cooperation from the SEC. The Federal Reserve has firsthand experience about the values of portfolios it acquired in 2008 as collateral to lend money.

A constitutional market making system

Pointing fingers at some banks or individuals does not exorcise the real evil from the system: the regulatory-backed, effectively illegal market making process which results in unconstitutional transfer of hard-earned wealth of the productive households, who prop a nation, to a few indolent schemers who tend to weaken the nation.

[12]The basic ideas of this memo are from my book, Acharya (2005).

Many households lost heavily during 2000-2001. They then stopped playing in the financial casino. They invested in homes. The schemers then followed a concerted strategy to rig the household wealth by short trading on synthetic mortgage backed securities, credit default swaps and debt and equity issued by mortgage banks. Many mortgage banks then failed. Capital became too scarce for mortgage banks to fund housing. This resulted in the Great Recession in2008. The schemers seized many mortgage banks illicitly. This Great Recession also ruined many mega investment banks, millions of jobs and trillions of dollars of wealth worldwide. It has taken the economy to a more precarious predicament with the consolidated mega BHCs that destroyed others' wealth and jobs commanding greater power over the deprived, Principals.

The path we are in now is obviously reminiscent of the one traversed from the point when banking panics occurred in 1907 to a subsequent consolidation in the banking sector and then the Great Depression. The new regulatory power, proposed in the reform bill, to limit the size of mega BHCs or to dismantle the ones that flounder seems quite superfluous and specious. The proposed bill seems eerily silent on how the regulators have willy-nilly connived in the current process of formation of mega BHCs and supported the unconstitutional market making. We have no option but to reform the prevailing, effectively illegal and unconstitutional system of market making, clearing and trading:

1. Follow effectively and aggressively the current law on illegality of trading by market makers. This means holding companies that trade from subsidiaries or parent company must not be market makers, directly or indirectly through affiliated proxies or subs. Every market maker must be independent, directly and indirectly, of the traders.

2. Allow no trading house to control or own, partially or fully, the market clearing operation for any security. This means that the government must set up an independent market clearing agency answerable to the public and Congress. The independent market clearing agency must be chartered to guarantee a smooth transfer of traded securities from the sellers to the buyers at the time of transactions or as soon as possible, electronically or physically. The independent market clearing agency must compile trading data to facilitate monitoring of any abuse of the prevailing law on illegality of trading by the market makers.

3. Do not contravene the current law on market making even through specious regulatory means, for example, to permit a market maker to trade via affiliated non-MM offshore holding companies or proxy subs for exploiting valuable information garnered from the flow of orders at MM subs.

Moral hazard free markets and regulation

The market clearing institution is a network through which millions of trades crisscross to effect transfers of securities from sellers to buyers. It is like the network of highways through which hundreds of vehicles ply from various origins to their destinations. If the network of highways is controlled privately, there will be so much robbery that the government will be unable to control. The market clearing houses (for all securities) must be brought under the domain of a new government clearing house to monitor rampant short selling by the current private clearinghouses.

In a constitutional monetary system (Safe Banking Policy regime) sans federal deposit insurance, bank regulators will have limited roles due to unneeded interference in banks. The bank regulators from the current FDIC should then merge with their counterparts from the OCC, OTS and Federal Reserve Board and the nonbank regulators of SEC and CFTC. This will consolidate all the bank and nonbank regulators into a single agency to effectively coordinate monitoring of all firms for their (i) accounting statements, (ii) security and derivative trades, and (iii) mutually annihilating speculative short selling of each other's securities.

Without a consolidated regulatory agency, any coordinated authoritative analysis and monitoring will be impossible. The currently floated idea of a consortium of the current regulators-who have badly failed to perform their duties by willy-nilly pandering to the wishes of the firms they regulated and thus caused the Great Recession-is bound to fail because it defies the first principle of management, which advocates that one can discharge one's responsibility only by having the authority to do so. The consortium idea cannot duly vest the absolute authority in the Treasury Department, over the currently independent regulators, to make it responsible or answerable to the Congress and the principals. If such absolute authority is vested in the Treasury Department, it will be the effectively consolidated regulator that I am proposing. The Treasury Department should obviously be the consolidated regulator answerable to the president and Congress. The constitutional system of U.S. behooves the elected leaders, not appointed regulators or bureaucrats, to be answerable to the people.

The Federal Reserve should remain responsible for administration of the proposed constitutional monetary system with Safe Banking facility open to all and conduct independent research to (a)enhance national competitiveness, (b) raise the value of dollar, (c) reduce the cost of capital for businesses and households, (d) preserve a free market economy with the least possible interference of government in businesses, (f) maintain low price volatility in commodities, assets and financial securities, and (e) measure and enhance prosperity of American households. Growth in net assets is a measure of prosperity that appears to be the common longing of the principals. Federal Reserve's research and policy should be consistent with the common longing of people. This will ensure consistency with the goals of the newly proposed Consumer Finance Oversight Agency. All the voting governors of the Federal Reserve should be nominated by the President and confirmed by the Congress.

The Congress should prohibit running of hedge funds by the CEOs and Directors of bank and mutual fund companies or by their proxy relatives or trusts. This is necessary to avert an unconstitutional usurpation of savings of mutual fund investors, to reinforce trust in mutual fund investment and in capital markets. Such trust is necessary to enhance prosperity and stability of principals.

The Congress is already considering a law to have shareholders' say on bank and non bank executive pays and perquisites. The proposed law calls for the say on pay as advisory. The say on pay must, however, be mandatory. This is necessary to align executives' interests with the long term value and survival of firms. This is necessary to enhance prosperity of investors and to preserve stable jobs for households.

Dodd-Frank bill preserves unconstitutional system

Policymakers are feeling helpless[13] after the Federal Reserve infused $2.5 trillion of new money to banks in 2008, the Congress gave away $700 billion in TARP funds to banks and the Administration spent $850 billion to stimulate the economy, and after the Fed decree made the bank deposits available to banks at nearly zero rate of interest. The Fed can still pump more new money to the economy by buying up U.S. Treasuries and bank assets backed by auto and credit card loans. Printing money has become a double edged sword the faltering economy cannot be primed and the dollar may potentially crash to precipitate inflation.

Why did the Keynesian doctrine of new money injection to lift a recessing or depressing economy falter? This is discussed in Acharya (2008c). It is because money, under the current system, flows disproportionately to a small fraction of people who control the system but not produce globally competitive goods, services and ideas. In this system, the Keynesian dogma loses its potency.

It is true that many of these controllers lost some of their unseemly aggrandizement due to the Great Recession. But they successfully lobbied for creation of new money to make up their losses, without enhancing production. They also succeeded in ensuring that the current unconstitutional system of money and finance is preserved despite the Financial Regulatory Bill signed into law in July 2010.

The Great Depression had painfully led to a partial reform of the unconstitutional system through the passage of the Glass-Steagall Act, though it also introduced moral hazard due to the Federal deposit insurance. After the Glass Steagall Act was repealed in 1999, the unconstitutional moral hazard plagued system turned virulently monstrous with no effective checks on robbing the hard earned savings of persevering and productive households. This led to a partial depression, euphemistically branded as the Great Recession of 2008.

The Financial Regulation Bill of 2010 still preserves the virulently monstrous unconstitutional system, as if to guarantee a recurrence of the Great Depression.

[13]See Goodman, Peter S., (August 28, 2010), "Policy Options Dwindle as Economic Fears Grow," New York Times available at http://www.nytimes.com/2010/08/29/weekinreview/29goodman.html?pagewanted=1&_r=1&hp

The U.S. economy would have been stable, sans depressions, if the unconstitutional system of money and finance were replaced with a constitutional system, discovered by selfless research of the author. Denial of the truth about the necessity of the constitutional system has only increased the economic pain for the vast majority of households and made the national economy unstable. Can a nation perpetuate a system of financial shenanigans that allow a few to usurp, unseemly and unconstitutionally, the hard-earned fruits of labor of the vast majority of persevering and productive households? No.

The robustness of the process of my discovery/research leaves no doubt that the truth will ultimately triumph and prevail, though through considerable pain to the economy and society. What is the process of my discovery of the truth about the system of money and finance? It is multi-pronged:

1. A mathematical-theoretical model seeking general equilibrium among (i) a not-for-profit government that minimizes its cost of service, (ii) firms that seek to maximize profits with debt, equity and potential bankruptcy, and (iii) a constitutionally mandated free trading economy in which, for example, toxic bank assets will be traded freely, not exchanged by government fiat for exorbitant amounts of public funds. A unique equilibrium of this model is **Safe Central Banking without Federal deposit insurance**. See Acharya (2012a).

2. When the profession rejected the model because it was too complicated, I wrote a verbal model (devoid of math) to prove that Safe Banking sans Federal deposit insurance is optimal for a not-for-profit government seeking to minimize the cost to taxpayers. See Acharya (2003) and Acharya (2008a).

3. I have also proved that Safe Banking without Federal deposit insurance (not the current system of money and finance) is constitutional, in a general equilibrium mathematical model. See Acharya (2012a).

A truncated fuzzy model that depends on sunspot or invisible hand to “prove” the necessity of Federal deposit insurance cannot succeed in suppressing the profound truth discovered through the robust procedure employed in my research. The premise of my general equilibrium model is constitutionally mandated free trading which essentially precludes government protection of too big to fail institutions. That the premise was violated during the Great Recession is obvious: the government did not permit free trading of the toxic bank assets and rather bought them by paying fiat-driven fictitious book values to save banks selectively.

The Financial Regulation bill passed in July 2010 promises to dismantle too big banks that were not allowed to fail earlier. This promise is consistent with the premise of my general equilibrium model of free trading of assets of even the too big to fail firms.

The government cannot possibly keep its promise when the largest banks are lined for rescue during a future crisis. An economic crisis, still looming in the horizon, is turning graver under the veneer of growth because the Financial Regulation bill preserves the unconstitutional system of money and finance which was responsible for the Great Recession and the Great Depression.

The Financial Regulation bill of 2010 adopts another result of my research, namely, to require the bank holding companies to hold the minimum regulatory capital on a consolidated basis. But how will the zombie banks generate the extra needed capital?

Well, if the government can preserve the unconstitutional system for a long enough time going forward, banks may accumulate capitals through unconstitutional usurpation as they have done thus far. This will not pan out, however, when the vast majority of households (especially the rich including many university endowment funds) have been rudely woken up by the current unconstitutional system. The Federal Reserve and the Financial Clearing House recently lost their appeal in the Court to suppress the right to information on the names of banks that received$2.5 trillion of largesse granted by the Fed in 2008.

The truth about the constitutional system of money and finance is very profound, robust and irrepressible. The truth will ultimately triumph and prevail. The custodians of the current system will ultimately have to concede defeat to pave the way for the proposed constitutional system of money and finance. Adopting the proposed system now will cause substantial pain to the beneficiaries of the current system. But the pain will be far greater and unacceptable if the Great Depression recurs.

Policy needed to create jobs in the U.S.

As the biggest financial institutions tottered in 2008, did the regulators have an overriding common principle, maybe tacit, to pick the ones that deserved to survive to absorb the others?

The Financial Crisis Inquiry Commission posed this profound question on September 1, 2010 to the prominent witnesses from J.P. Morgan & Chase, Lehman Brothers, Federal Reserve Bank of New York, and Law Firms. The FCIC could not arrive at a common principle that underlay the regulatory rescue effort in 2008.

Here is a rational inference about the common principle behind the regulatory choice, and a method of further testing the hypothesis using confidential trading data that can be subpoenaed from market making financial institutions and the market Clearing House: The institutions picked as the saviors like JPMC and Goldman Sachs were prominently present in the advisory boards of the regulatory agencies (FDIC, FRB-NY and BOG-FRS, and Treasury) and held enormously large net short interests in the very securities that were held long by the other financial institutions that were sacrificed(Lehman Brothers, AIG, Fannie Mae, Freddie Mac, Washington Mutual, Lehman Brothers, Wachovia and Merrill Lynch).

Lehman, Merrill, Bear Stearns, Wachovia and Washington Mutual had accumulated large portfolios of mortgage loans and mortgage backed securities by borrowing, notably, from Bank of America, Citigroup and JPMC. The borrowers had submitted collaterals and so had collateralized debt obligations (CDOs) with their lenders. The lenders had short-sold the same mortgage backed securities that the borrowers were holding to lower the marked-to-market equity values of the borrowers. The lenders could then issue margin calls like JPMC acknowledged on September 1, 2010FCIC hearings that it did to Lehman Brothers which collapsed as a result.

Whether or not JPMC tacitly influenced the FRB-NY’s decision to not rescue Lehman Brothers can be tested by looking at JPMC’s short interests on Lehman securities including common stock.

Similarly, whether Washington Mutual and Bear Stearns collapsed because of the vested short interests of the lending institutions can be tested with the private trading data.

The private trading books of the large financial institutions may not tell the whole truth. It is because such an institution can sell securities short through a wholly owned, leveraged subsidiary and then shut down the subsidiary through a prearranged bankruptcy with the lender-parent, thus wiping out the short positions. The Clearing House should, however, have all the data including the details of the extinguished subsidiaries. This is the valuable information that can be used to establish a profound truth that the FCIC is seeking about whether the banks chosen by the regulators as saviors during the Great Recession did indeed have vested short interests in the securities held or issued by the others that were sacrificed or simply usurped through FDIC or cajoling with regulatory pressure.

In the case of Washington Mutual, the total number of shares held by investors soon after its seizure by the FDIC was one billion more than the shares issued by the company. In the case of Freddie and Fannie, the shares held by investors were approximately 20% higher than the outstanding.

A large financial institution can create billions of shares of a highly solvent rival bank and sell the virtually created shares in the open market and at the same time tacitly advice the FRB-NY to not rescue the rival by rigging a liquidity crisis. This is government-supported unconstitutional usurpation of hard earned capital of persevering and productive households who have rightly invested in the solvent bank that is artificially taken down. See Acharya (2012a). Whether or not such things really happened should be rigorously tested with private trading data obtained from the market Clearing House.

Fannie and Freddie could not be literally sacrificed due to the Chinese threat at the time. But they were depressed to the ground through conservatorship and a lethal funding of preferred stock at 10%annual dividend. The Federal

Reserve could have lent this money to Fannie and Freddie at the same rate of .125% as it does to banks. But the regulators made a convoluted arrangement to wipe out the profits of Fannie and Freddie forever. The government borrows money from banks at 4% while the Fed creates the same money for banks at 0.125%. Fannie and Freddie pay 10% dividend on the same virtually free money. Fannie and Freddie were taken to conservatorship after they were forced to buy about $400 billion of toxic bank assets. Whether or not the bank "advisors" like, for example, JPMC and Goldman Sachs, tacitly nudged the regulators to ensure that Fannie and Freddie never show any profits can be tested if the same advisors or their affiliate subsidiaries were short insecurities issued by these two institutions.

Finding the truth that the FCIC is seeking will help develop the single most job-creating bill: close the FDIC and provide Safe Banking. See Acharya (2003, 2008).

After listening to the testimonies before the FCIC from the FDIC and other regulatory agencies on September 1, 2010, it is very obvious that the primary goal of the FDIC is to minimize the cost to the Deposit Insurance Fund (DIF).

So, what is the best policy for the FDIC to achieve its goal of minimizing the cost to the DIF? The answer is to pick one bank to acquire the rest. The DIF will then have no cost as long as the single existing gigantic bank remains solvent. The FDIC goal will then lead to a recommendation to the Congress to close this gigantic bank while it remains solvent!

The FDIC goal is thus unsustainable, if not very weird. It simply ignores the antitrust laws, the panic it spreads, and the systemic risk it creates while unconstitutionally usurping (indeed destroying) the hard-earned private capital invested in the closed rival banks.

Indeed, the FDIC goal since its existence has led to fewer large banks that are growing still larger overtime with arranged acquisitions of rival banks (big and small). Extrapolating this current reality into the future should show that the U.S. will ultimately have one gigantic bank after it takes over the rest, as almost happened during the Great Depression.

The Congress cannot obviously follow the FDIC advice of just reducing the cost to DIF by first creating a large bank while closing the rest and then by shutting down the last remaining largest bank.

The Congress will rather follow the anti-trust laws to break the largest remaining bank. The Congress will even contemplate closing down the FDIC that pursues an undesirable goal reaching a nightmarish predicament for the nation.

Given the above potential reality in the future, what is optimal policy for the Congress now? The answer is to close the FDIC now and to provide Safe Banking to investors at the lowest possible cost to taxpayers and highest possible growth in capital.

Closing the FDIC now will obviate the ongoing unconstitutional usurpation of the hard-earned private capital invested in banks being closed by the FDIC to accomplish its unsustainable goal. Closing the FDIC now will also prevent formation of a few unwanted gigantic banks with little competition.

The above argument should make it clear that the FDIC goal is a primary source of unconstitutional usurpation (destruction) of hard earned private capital, cause of investor panics and systemic risk leading to flow of funds to government bonds and decimation of investments in the risky real projects that generate employment.

So the single most compelling job-creating bill feasible now is to have Safe Banking without Federal deposit insurance. This bill should be enacted urgently to rejuvenate the trust in U.S. banking and financial markets, which had once made the nation the most favored destination of private capital for economic growth and prosperity.

Conclusion

The current system (rules) of money and finance grants the mega banks the privilege of controlling the hard-earned deposits of the principals. This system insures the deposits, de jure up to 250000 dollars per account, but de facto without any limit. During the financial catastrophe of 2008, the US government insured $3.5 trillion of the previously uninsured money market funds and $7.8 trillion of the previously uninsured bank debt to stem the domino of crashing markets. The current system permits the privileged mega banks to use the federally insured deposits for highly leveraged trading bets against the mutual funds and pension funds of principals. The system also allows the mega banks to use valuable privileged information which only they can obtain from their market making operations. The unprivileged principals face guaranteed losses due to double jeopardy as (i) their deposits are deployed (by mega banks) to trade with their less informed mutual funds and pension plans, and (ii) new money is printed by the Federal Reserve to rescue mega banks when their bets fail. The system also permits mega banks to deploy the insured deposits for trading at privately-held hedge funds. This system this allows a guaranteed privatization of profits by piling enormous risk on principals. Mega banks have arrogated such privilege by foisting on the principals the scheme of federal deposit insurance, Federal Reserve Act of 1913 and an SEC to allow trading shenanigans like short selling for guaranteed (riskless) usurpation by mega banks and their proxies of the principals' hard-earned savings. This paper showed that the current asymmetrically privileged system of money and finance is unconstitutional.

The concluding argument can be made with a question: Will the principals (citizens) vote for a system that guarantees the best health care, the best food and the best housing as long as they live, but with a condition that they will have nothing left to bequeath to their posterity? The answer is that no American will vote for such a system because it amounts to a sophisticated form of slavery that transcends race, color, religion and origin. The principals have abandoned slavery, legislatively. But the dramatic rise in the percent of people with little savings proves that the current system fosters slavery in a sophisticated way, despite the legislations (see Acharya 2012d). It is due to the pre-independence capital market rules and practices that have continued thus far. These rules facilitate usurpation of most of the savings of the vast majority of principals by those who control the repertoires of American wealth-the banks, brokerages and the clearinghouses. This is why the principals (rich and poor alike) must cease the unconstitutional rules and practices to reform the rules constitutionally for governance of banks and capital markets.

The current unconstitutional system of money and finance is also economically inefficient, which means it is poised to destroy the hard-earned capital of even the usurpers (see Acharya 2012a,b,d). The bankers and hedge funds are now locked in mutually opposing short and long positions in financial securities, which are like financial bombs aimed at annihilating capitals of each other.

This paper has argued that the only way to extricate the economy from the mutually destructive shenanigans is an economically efficient and constitutional system of money and finance, which is characterized by a withdrawal of the riskless privilege now being enjoyed by a few mega banks. Perhaps as a result of several memos written by the author to the U.S. Congress, Presidents and presidential candidates, a bi-partisan agreement seems to have emerged on ending the mega bank privilege (see Acharya 2012d).

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