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Special Independence Day Issue: California Declares Monetary Independence

On July 1, 2009, the State of California declared its independence from the Federal Reserve System, announcing that it is issuing its own currency. Governor Schwarzenegger framed the announcement in less-inflammatory terms but the substance of California's action is that the State will no longer pay its obligations in the legal tender of the United States, being Federal Reserve notes, but instead issue its own "notes", being "promises to pay" at a future date.

For public relations purposes, these notes are described to, and by, the mainstream media as "IOU's", a term which has no legal meaning and therefore may be interpreted by the listener as whatever the listener imagines. The intention expressed by the Governor that these notes will be accepted by "the banks" so that the folks to whom California issues these notes may be able to get some spendable currency, is much like the hopeful pronouncement of a third-world nation that their pesos or zlotys or baht will be accepted by the international banking community. It is significant that California will continue to pay its bond obligations to "the banks" in United States dollars, "hard currency", exactly as a debtor nation is required to repay its loans from the World Bank in U. S. dollars, while paying its obligations to its private citizens in local currency of indeterminate value.

"The banks" are put in a difficult position. Banks are under close scrutiny as to the valuation of the assets they hold. Will a bank policy committee gamble that California will redeem its notes at full face value? Is the bank violating Federal Reserve liquidity requirements if the bank buys California notes from its depositors and carries those notes on its books to the stated due date at some arbitrary valuation? Bank policy committees should rightly be wary enough that they may await direction from the Federal Reserve before having anything to do with the California State Instruments.

California may have turned its pawnbrokers into currency speculators. Assuming that commercial banks will prudently delay a decision on accepting CASI's, one anticipates that Los Angeles pawnshops will post today's rate of exchange outside their doors, "California State Instruments accepted at 75 cents U. S.", much like the signs posted in the cambios in Tijuana. One speculates that these instruments will acquire a suitable street designation, as "CASI pesos" or "Schwarzenegger pesos" or perhaps "Arnolds", leading to signs in the neighborhood bodega stating "CA\$1.00 = US\$0.75".

The critical indicator that California has withdrawn from the Federal Reserve currency system on a long-term basis, rather than merely as an emergency measure for the temporary duration of the State budget negotiations, will be when California begins issuing CASI's in standardized denominations rather than issuing an individual instrument in an exact amount for each individual obligation

the State pays, that is, issuing twelve CA\$100.00 notes and six CA\$1.00 notes rather than a particularized "promise to pay the amount of \$1,206.00".

The policy decision facing the Federal Reserve is whether to encourage or discourage this conduct. This conduct is encouraged if the Fed advises banks that they may carry CASI's on their books at full face value, and discouraged if the Fed refrains from giving an advisory, suggesting to the bank policy committees that the individual bank will face the consequences of the policy committee's decision. The policy question for the Fed to decide: "Does the Fed want to retain all the responsibility to managing the money supply of the United States, or does the Fed take advantage of this opportunity to shift the blame for any future financial disaster to the State government of the second largest economy?"

To remind Americans who the important Jackson was, this column respectfully closes this Independence Day edition with a quote from the late President Andrew Jackson, February, 1834:

"I have had men watching you for a long time, and am convinced that you have used the funds of the bank to speculate in the breadstuffs of the country. When you won, you divided the profits amongst you, and when you lost, you charged it to the Bank. You tell me that if I take the deposits from the Bank and annul its charter I shall ruin ten thousand families. That may be true, gentlemen, but that is your sin! Should I let you go on, you will ruin fifty thousand families, and that would be my sin! You are a den of vipers and thieves. I have determined to rout you out and, by the Eternal, I will rout you out."

Happy Independence Day.

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