

The Tapestry Of Monetary Collapse

by
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The view here at Capital & Crisis is that the patterns of economic boom and bust emerge from an unstable loam, too saturated with the oils of monetary intervention. Interest rates and money no longer manifest the natural underlying demand of consumers and business, nor do they provide accurate signals regarding the core supply of capital. What emerges is a distorted pattern of production, a mishmash of mis-priced capital, too soft to harden into a sound and sturdy foundation. The beacon, which the market uses to allocate capital, has become errant, and is leading the market onto the rocks.

The threads of this story form a grand tapestry that will one day tell a sorry tale of monetary collapse. For the time being, one can explore the tapestry in bits and pieces, as one might examine the shards left in the trail of a twister, wondering how it came to be and where it will strike next. Today, we start at the beginning.

The granddaddy of central banks was probably the Swedish Riksbank. Originally chartered as a private bank in 1656, it collapsed eight years later due to bad loans, at least some of which were due from the government. After no buyers could be found for the decrepit floundering institution, the Riksbank was reorganized in 1668 under the authority of Parliament.

As the only bank in Sweden, it enjoyed special privileges as the only issuer of paper money (banknotes), but it was still required to redeem those notes in gold. It paid for its charter, though, with an agreement to lend money to the government.

After decades of practicing its leechcraft upon the Swedish people, it again ran into grave trouble in 1720. The government of Sweden had once again failed to make good on its obligations, and the Riksbank was unable to meet its requirements for redemption from a nervous citizenry.

This time Parliament came to the rescue, with what would be a key and defining characteristic of central banks—it granted the Riksbank's notes the legal tender status. This meant that the Swedes had to accept its notes to satisfy any claims of payment at par value, even though in the market the notes traded at heavy discounts to face value, since it was rather well known that the bank's treasury was light on gold.

The Riksbank was an early creaky prototype for what would become, in countries all over the world, “the modern central bank.” It resembles the Federal Reserve in that it was created by an act of the legislature and that its notes enjoyed legal tender status. Monopoly and privilege defined central banks from the beginning, as various steely-eyed historians and clear-seeing economists have pointed out.

The scholar Vera Smith was one of these, as well as being a sharp critic of central banking dogma in general. She wrote her doctoral dissertation under the supervision of Friedrich von Hayek at the London School of Economics. This work was published in 1936 as *The Rational of Central Banking*. Despite the fact that the book is now nearly seventy years old, it remains an interesting and critical account of the formative years of central banking. As Smith surveyed the development of central banking in a number of western countries, she convincingly made the point that central banks emerged from “a combination of political motives and historical accident,” as opposed to emerging from sound economic principles or theoretical foundations. As she wrote, “A central bank is

not a natural product of banking development...[it] comes into being as a result of government favours.”

Central banking has always been tied to, enmeshed with, and a part of, the exigencies of state finance. Its power emanates from its status as a legal and protected monopoly issuer of legal tender notes, which as Smith pointed out, was a very welcome weapon in the armory of the state.

It was for later generations to adorn it with the tinsel of necessity, and adorn it they did. The arguments for central banking have grown more sophisticated, as central banks themselves have become tightly woven into the fabric of accepted, and even desirable, social institutions. As Smith noted in 1936, (and it still holds today), “in the present century centralized banking systems have come to be regarded as the usual concomitant, if not one of the conditions of the attainment, of economic development.” The central bank of today enjoys a prominent place in world finance that would have shocked even the early advocates of central banking.

Smith noted, too, the irony that when laissez-faire thinking was at its apogee in other industries, banking was still carved out as a special business, even by otherwise ardent free-traders and thinkers. It was from the beginning given an exempt status, which the principles of free trade seemed unable to penetrate from a public policy point of view. This was one of the unfortunate turns of history, where one can only imagine what might have been had banking been able to develop along more natural lines.

For example, as Smith observed, the accumulation of privilege by favored proto-central banks had the effect of squeezing out competitive banks. In England, the Bank of England enjoyed such a special position that private note issue was abandoned circa 1780. Moreover, smaller banks began keeping balances at the Bank of England, thereby giving it even more the characteristic look of a central bank. Though Bank of England notes were not declared legal tender until 1812, its notes were, for practical purposes, accepted as such for many years prior.

In America, a series of crises—Smith listed 1873, 1884, 1890, 1893, and 1907—fueled debate about America’s haphazard banking network, which involved a two-tiered system of national and state banks. The serial crises put the spotlight on the nation’s banking system, which was criticized for being inflexible and slow to issue notes, i.e., lend money, in times of need. As Smith noted, “Its failings were summarized under the term ‘inelasticity.’ This is a term which has frequently had a dangerous connotation, being more often than not a cloak for the advocacy of inflation.”

The problems, of course, stemmed not from the banks being too slow or inflexible, as Smith alluded to, but from the fact that they were too loose and liberal to begin with. Fractional-reserve banking assures that, at times, some banks will be over-extended and unable to make good on their promise to note holders to redeem in specie. In the panic of 1907, suspensions of payments lasted over two months in some cases, which led to, as one might imagine, some angry depositors.

Smith also pointed out that the role of providing relief in times of crisis was often taken up by the Treasury, a principle that had been established as early as 1846. Smith documented the Treasury’s actions in 1873, 1884, and again in 1907, which largely consisted of the Treasury providing funds to national banks either by purchasing bonds or prepaying interest on the national debt. So one sees here the beginnings of today’s open market operations, which are carried out by the Fed.

The point here is to show that by 1913, the birth year of the Federal Reserve, central banking was not a novel idea. It was a very old idea, borrowed from Europe, without

logical or well thought out principles guiding its creation, but political ambition, expediency and exigency at the helm. Central banks enable concerted inflating of bank credit, which is a source of great profits for banks as well as terrific fertilizer for the growth of future crises. Central banks also make it possible for banks to enjoy the special privilege that the government will cover their backsides in the event that they cannot meet their obligations timely.

The modern sheathing of central banking in fine-spun theoretical regalia occurred after the fact by self-important bureaucrats and ambitious courtesans. Today, the central bank has put itself at the center of every discussion regarding the economy. Widely held as the key steward of the nation's interest rates and economic health, the Fed Chairman enjoys prominence near the level of the President of the United States, with his every whisper subject to endless interpretation by pundits and others.

And yet, despite its position of power, prestige and privilege, the economy lies still beyond the grasp of the central bank. A central bank can influence, but it cannot control. It can turn on the hose, but it can't aim it. The real danger arises when it thinks it can.

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