

Financial Markets are Not *Inherently* Unstable

By

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Abstract

While it is true that over the last two centuries financial markets have been unstable, they are not *inherently* unstable. Misrepresentations and nondisclosure by banks, which enable them to over-leverage, are the root cause of financial instability. Remedies being put forth, such as a global lender of last resort, will be counterproductive and will result in greater instability. The solution is to change the *structure* of the world's monetary systems to remove the *cause* of such instability: the ability of banks to create money out of nothing.

Why are financial markets unstable?

In the U.S. during the 19th and 20th centuries, there were numerous boom/bust periods in which financial markets soared and then collapsed. Question: how come this malady wasn't common to other markets, such as the ice cream market or the automobile market? What is it about financial markets that they tend to boom and bust? Also, it is crucial to understand that because financial markets are interrelated with other markets, a financial market collapse can also result in a systemic collapse.

A distinguishing characteristic of financial markets that is absent from other markets is *excessive* leverage. On the futures exchanges, various commodities are leveraged, but no one would suggest that the markets for, say, copper or soybeans are *inherently* unstable. Clearly there is something different about financial markets. That difference is inadequate counterparty surveillance. And that inadequacy is the result of misrepresentations and nondisclosure, which is the indicia of fraud, on the part of key financial players: banks.

Fraud in the Basic Banking Relationship

From inception, banks made fundamental misrepresentations to their customers regarding the basic banking relationship in two areas. First, banks told customers that they were "depositors." At best, this was misleading. In fact and in law, depositors were, and continue to be, unsecured creditors of banks. Most depositors, especially small ones, however, put their money in banks for safe keeping; they were not heedful of the risks they were taking.

Second, banks told customers that they could get "their" money back "on demand." However, in fact and in law, when people "deposit" money in a bank, it becomes the *bank's* money to do with as the bank pleases. The bank may loan that money to someone else, invest it in whatever, including illiquid investments, or gamble with it. Further, what banks should have told depositors was that they could get their money back on demand *provided*: not too many of them wanted to do so at the same time; the money had not been invested in something that was illiquid and that could not quickly, and without much loss, be converted back into cash; and, finally, that the bank had not lost the money in some venture.

These misrepresentations lulled depositors into acquiescing to nondisclosure on the part of banks as to what they were doing with depositors' money and the amount of leverage banks were employing. If banks told depositors the truth about the basic relationship, depositors would have then exerted more counterparty surveillance over banks, excessive leverage would never have occurred, and there would certainly never have been anything approaching systemic failure, as almost occurred in 1907 and as did occur in 1932.

Regulation is a signal that something is wrong with the system

In his book, *Soros on Soros*, Mr. George Soros correctly observes that a lender of last resort and the gold standard are incompatible. But, the only thing that made the lender of last resort bailout facility necessary were banking misrepresentations and nondisclosures.

By abandoning the gold standard, banks enhanced their ability to, in effect, create money out of nothing. Whereas under the gold standard they were able to create money, called "fractional reserve lending," there were some (clearly inadequate) limitations on the amount of money they could create. First and foremost, since all of the newly created money, called banknotes, which were legally promissory notes, were redeemable on demand in gold, there was a physical limit beyond which market forces would close a bank that created money greatly in excess of its capital and its reserves, thereby curtailing further money creation.

Further, with some limitations, bank officers and directors were personally liable to depositors. These two factors led many banks to keep something on the order of 40% of their reserves in gold, just in case. If those reserves could be reduced, then banks could garner more profits, and first some, and then many banks sought to do so. The notion that banks were acting improperly was well understood by some market participants.

"Perhaps Hugh McCulloch, our first Comptroller of the Currency, may have been somewhat over the edge, in this regard, when in 1863 he proposed that the National Bank Act 'be so amended that the failure of a national bank be declared *prima facie* fraudulent, and that the officers and directors, under whose administration such insolvency shall occur, be made personally liable for the debts of the bank, and be punished criminally, unless it shall appear, upon investigation, that its affairs were honestly administered.' So much for moral hazard. And surely, here we observe the intellectual origins of prompt corrective action." [Speech by Federal Reserve Chairman Alan Greenspan Before the American Bankers Association, Washington, D.C., September 18, 2000]

Unintended consequences of regulation and the "lender of last resort" facility

After the Panic of 1907, which J. P. Morgan alleviated with a \$100 million gold loan to banks so that they could meet the demands of depositors who were then withdrawing their funds, there were four words that terrified the banking community: "What if he [Morgan] dies.?" The answer was a government entity that would provide "liquidity" when the banks got caught short. Further, the formation of the Federal Reserve enabled bank reserves to be aggregated so that there would be a need for less of them, and the banks could leverage even more than before.

The banking system was thus able to finance World War I. Without such financing, and had there been full disclosure at that time about the causes of bank panics, the War would have been over in just a couple of months. There would have been no Treaty of Versailles, no destruction of the German and Austrian currencies, no Hitler, no Lenin, no Stalin, no World War II, and the murder of 170 million, *excluding* those who died during wars during the Twentieth Century, would not have occurred.

No amount of regulation will eliminate the moral hazard issue. Further, the system, with moral hazard is inherently unstable, and the moral hazard issue means that there will necessarily be wealth transfer from ordinary working people to those who benefit from the moral hazard: the financial sector. Not only is this unfair, it will not stand the light of day if ordinary people come to understand what is transpiring.

The solution

The solution is gold-as-money. There are compelling reasons, too lengthy to describe here, why free men and free markets choose precious metals as money. In a nutshell, precious metals as money is the most efficient medium of exchange—in terms of minimizing transaction costs—for transmitting value over space and over time.

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