

# The FreeMarket

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## The Root of Economic Evil

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Four in five Americans opposed the \$50 billion Mexican bailout, but they were powerless to stop it. When the central bank says it's in charge—as it does in every financial upheaval of this magnitude—we are supposed to hold our tongues and leave it to the experts, even if their actions generate only uncertainty and volatility.

Washington's most powerful "expert" is Alan Greenspan, chairman of the Federal Reserve Board. With a wave of his hand, and some well-placed phone calls, he can order credit extension and money creation at will. While Congress and the White House must contend for public approval, Greenspan runs the Fed without effective political or economic accountability.

Greenspan doesn't allow philosophical consistency to interfere with the running of his government-supported banking empire. Bailing out Chrysler is a "bad idea," he told the House Banking Committee in 1979, because it violates the "principles of the free enterprise system." He was a private economist then, with no personal stake in the nation's car industry. As Fed chairman, his loyalties are to the largest banks. We can't have free enterprise here, he said of letting Mexican banks fail, because that "could halt or reverse the global trend toward market-oriented reform."

Greenspan's seemingly contradictory remarks sum up the Fed's central doctrine. The Fed should socialize all risks to the nation's largest banks and protect them from the vagaries of the free market, especially financial losses. And then the Fed must back the debt and projects of the banks' largest customers to enhance their profits. Meanwhile you're a public menace if

and thus cannot be subject to competitive pressure or to changes in consumer demand. Butchers and bakers can go belly up because that's how the market works. But big bankers should be coddled by the government.

The myth of the indispensable bank is consistent with the Fed's original purpose. It was conceived in the unholy alliance of government and business, born of corrupt politicians and special interests, and midwived by intellectuals and elite media propaganda. And like other regulatory agencies before and since, the Fed was conceived as a cartelization device to benefit the leading firms in the industry it

The Federal Reserve is responsible for inflation, business cycles, wars, welfarism, and statism.

you "hoard" your money (keep it out of bank vaults) or stage a "run on a bank" (want to get your money out). Everyone should simply roll with the Fed's monetary punches of inflation and business cycles.

Why? The banking industry is not supposed to work like any other. Banks, we're told, are the very foundation of the economy

regulates.

As Murray N. Rothbard shows in his latest book, *The Case Against the Fed*, banking-reform agitation began in the 1890s at the behest of a Morgan-Rockefeller alliance, with the goal of replacing the National Banking System with a central bank. The model was the Bank of England as modi-

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# The Root of Economic Evil

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fied by the Peel Act of 1844, which gave the bank a legal monopoly on banknote issue and thereby centralized and standardized all commercial bank reserves.

For almost two decades, well-connected businessmen, journalists, economists, and, of course, government officials and bankers held monetary conferences, issued commission reports, published journal articles, and wrote editorials favoring modest and then increasingly centralized monetary reforms. This agitation led to congressional enactment of more and more centralized policies, culminating in passage of the Federal Reserve Act in 1913.

Modeled after the prototype of all such government-business partnerships — the Interstate Commerce Commission—the Fed eliminated “cutthroat” banking competition, often denounced as “wild-cat banking.” This way the larger, more bureaucratic banks reined in the smaller, more entrepreneurial banks by requiring uniform “rules of conduct.”

No private cartel can maintain itself indefinitely, lacking as it does the legal power of coercion. But the Fed, like the ICC, enforced the cartel’s rules. No longer could the more entrepreneurial banks offer better prices and services. Nor could the more financially sound banks engage in competitive practices detrimental to less-sound banks. The Fed became guarantor of all banks: the Lender of Last Resort. This allowed the banks to extend fractional-reserve lending with impunity.

Crucial to a successful cartel is a central decision maker to apportion the spoils. The Fed does this by expanding reserves of the banks when it purchases assets with newly created money. Typically, the Fed will

purchase securities from the large, politically connected banking houses, conferring on them the greatest share of the spoils. Smaller banks must wait for the effects of money and loan expansion to trickle down to them.

Like other regulatory agencies, the Fed confers benefits on government officials as well as its clients. However, the scope of the power granted to government by the Fed far exceeds that bestowed by other regulatory agencies. The Fed is an engine of government spending and thus an instrument able to control and manipulate economic activity.

Without the Fed’s backing, the U.S. government could not have become the biggest welfare-warfare state in the history of the world. It could not have entered World War I, either as a belligerent or provider of material and financial backing. Thanks to the Fed, the money stock doubled during the war. Without that ability, the US would have stayed out, there would have been a negotiated settlement, and quite possibly, neither Lenin nor Hitler would have come to power.

The second major event made possible by the Fed—or more correctly caused by it—was the Great Depression. Benjamin Strong, the Governor of the New York Fed, collaborated during the 1920s with Montagu Norman, Governor of the Bank of England, to reestablish British financial prominence. But the reckless U.S. inflation of the 1920s set in motion the boom-bust of the business cycle.

Once the Fed backed off its inflation in the late 1920s, the depression phase of the cycle, precipitated by sharply rising interest rates, resulted in collapsed capital values (particularly stock prices). The size of the collapse overwhelmed

the Fed’s frantic efforts to re-inflate.

Our economy would be much freer had the Fed not brought on the Great Depression. The horrible consequences could not have been used as an excuse to supplant the relatively free pre-Crash economy with Hoover-Roosevelt interventionism.

The Fed was the key to government expansion through the 1930s and 1940s. The nascent welfare-warfare state in the New Deal social programs and the armaments industry was nurtured by the Fed. The American economy and culture would be far healthier without the massive wartime intervention system still largely fastened on us.

Fed inflation made possible the Great Society and U.S. participation in the Vietnam War. Without the Fed, we would not have the dependent welfare class, massive transfers of wealth, nor rampant crime and cultural collapse.

The 20th century’s business cycles, erosions and transfers of wealth, and distortions in resource allocations are products of Fed inflation. Government debt itself would be self-reversing if there were no central bank conducting open-market operations to monetize the debt.

The Fed stimulates the demand for government debt by standing ready to buy it. By providing an artificial lift in loanable funds to the banking system, the Fed offsets the effects of high levels of government demand for loanable funds: high rates of interest and displacement of private capital accumulation.

The Fed has caused unnecessary world-wide financial instability. The stock market crashes of 1929, 1987 and 1989, the dollar devaluations of the early 1970s and the 1990s, the collapses of financial institutions during the Great Depres-

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sion and the 1980s, are all products of the Fed. The default on Orange County bonds may have involved local crookery, but it was the Fed, with its distorted interest-rate signals, that misled city managers into thinking rates would not rise.

The Fed's ability to create such instability was greatly enhanced by the Monetary Control Act of 1980, which empowered the Fed to purchase the debt of any institution in the world. This made the Fed the "Buyer of Last Resort," thereby permitting debt issuers to crank out more and more debt without consequence, making the eventual collapse much more severe.

As international capital markets become more efficient, the Fed's attempts to manipulate interest rates become all the more destructive. It was the artificially low interest rates of 1992 and 1993 that led large banks and mutual fund managers to sink money into "emerging markets" (itself a silly euphemism). The artificially low rates threatened to bring inflation, as they always do, and the Fed raised rates in 1994, leading investors to pull out and Mexico's financial sector to virtually collapse.

Today the Fed attempts to coordinate world-wide inflation as the major banks once attempted to coordinate nationwide inflation. The major banks once agreed among themselves to bail out bankrupt banks to prop up the domestic financial system; now the Fed bails out central banks of other countries to prop up the entire international financial system. The logical end of this monetary interventionism is a single world-wide central bank with unlimited, coordinated inflation: in short, the dream of John Maynard Keynes.

But why would anyone desire this, especially after a century of Fed-caused inflation, business cycles, world wars, welfarism, statism, financial uncertainty, and cultural collapse? Government and its connected interests do, but for everyone else, it would be a disaster, no matter what Alan Greenspan says.

The alternative to a world central bank is not floating fiat currencies, nor fixed-exchange-rate fiat currencies, but world-wide sound money guaranteed by market competition. The gold standard is the only monetary regime that confers the benefits of trade and the division of labor without the detrimental effects of inflation

and business cycles.

Short of a gold standard, we must take away, or at least limit, the power of the central bank. Current proposals offered by the Republican Congress, such as the balanced budget amendment, are mere posturing. The BBA will not stop the Treasury from issuing government debt or prevent the Fed from engaging in open market operations, the key to Leviathan's strength. Therefore it cannot stop the welfare-warfare state from growing.

We don't need new amendments to the U.S. Constitution. We need only repeal the Federal Reserve Act, liquidate the central bank's assets, define the dollar in terms of gold, and let the market take over. The government would lose its present ability to expand indefinitely.

If this happened, it would matter much less who was President, who was Speaker of the House, and who was Secretary of the Treasury, and the American people could live their lives without the looming presence of Leviathan. Alan Greenspan would be back in the private sector, where he could once again denounce government bailouts on principle. ♦

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