Bank Run or Stealth Bailout: Global Credit Crisis hits Main Street

By Ellen Brown
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Theme: Global Economy

In July 2007, the global credit crisis hit Wall Street. In September 2007, it hit Main Street, in what has been called the worst bank run since the 1970s.

Northern Rock, Britain's fifth-largest mortgage lender, was besieged at branches across the country, as thousands of worried customers queued for hours in hopes of getting their money out before the doors closed. Bank officials feared that as much as half the bank's deposit base could be withdrawn before the run was over. By September 14, 2007, Northern Rock's share price had dropped 30 percent, and on September 17 it dropped another 35 percent. According to one official, "If the run on deposits looks out of control, Northern Rock would effectively be nationalised and put into administration so it could be wound down."1i The bloodletting slowed after the government issued an emergency pledge to Northern Rock's worried savers that their money was safe, but analysts said the credit crisis was here to stay.

As BBC News explained the problem: "Northern Rock has struggled since money markets seized up over the summer. The bank is not short of assets, but they are tied up in loans to home owners. Because of the global credit crunch it has found it difficult to borrow the cash to run its day-to-day operations."2 The problem reflects a fundamental flaw in the modern banking system: it is built on a confidence trick. The same money that is supposedly being "saved" by depositors is also being "lent" many times over in the form of long-term mortgage commitments. As the late Murray Rothbard observed:

> [Depositors] think of their checking account as equivalent to a warehouse receipt. If they put a chair in a warehouse before going on a trip, they expect to get the chair back whenever they present the receipt. Unfortunately, while banks depend on the warehouse analogy, the depositors are systematically deluded. Their money ain't there.
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> An honest warehouse makes sure that the goods entrusted to its care are there, in its storeroom or vault. But banks operate very differently . . . Banks make money by literally creating money out of thin air, nowadays exclusively deposits rather than bank notes. This sort of swindling or counterfeiting is dignified by the term "fractional-reserve banking," which means that bank deposits are backed by only a small fraction of the cash they promise to have at hand and redeem.3

While Northern Rock was being stampeded by angry depositors, Countrywide Financial, the largest U.S. mortgage lender, managed to fend off bankruptcy, at least for the time being, with $12 billion in new-found financing. Financing found where? It is an interesting question. Peter Ralter observed in *LeMetropoleCafe.com* on September 16, 2007:

> [W]hy is it that the $2 billion investment by Bank of America in Countrywide was front page news in August while the company's new $12 billion financing is buried on the business pages? Isn't it funny, too, that Countrywide didn't specify who is providing all that money, saying only that it comes from "new or existing credit lines." There was no comment, either, on the credit or interest terms—this for $12 billion! It makes me suspect that Countrywide's new angel isn't the B of A, but rather the B of B; the Bank of Bernanke.4

John Hoefle, writing in *EIR* in 2002, observed, "Major financial crises are never announced in the newspapers but are instead treated as a form of national security secret, so that various bailouts and market-manipulation activities can be performed behind the scenes." At least that is true in the United States, where bailouts are primarily conducted by the Federal Reserve, a *private* corporation answerable to the private banks that are its real owners. In England, by contrast, the Bank of England is actually owned by the British government. Hoefle argues that Congress delegated the money-creating power to the private Federal Reserve in violation of its Constitutional mandate, making the Fed's activities illegal.5

Murray Rothbard would no doubt have agreed. Before 1913, he observed, whenever a bank's depositors demanded more cash than the bank had on hand, the bank would have had to close its doors. The Federal Reserve Act of 1913 shored up the system by allowing troubled banks to "borrow" from the Federal Reserve, which created the money essentially by counterfeiting it on its books. By rights, said Rothbard, the banks should be put into bankruptcy and the bankers should be jailed as embezzlers, just as they would have been before they succeeded in getting laws passed that protected their swindling. But instead, banks considered "too big to fail" are routinely bailed out from their folly, in a form of social welfare reserved only for the rich. The result is "moral hazard": profligate risk-takers are rewarded and encouraged to take even more risks.

At one time, bank bailouts were done openly by the Federal Deposit Insurance Corporation (FDIC) under the auspices of Congress, with the burden falling on more solvent banks or the taxpayers; but that solution cost votes and was politically unpopular. The failure of President George Bush Sr. to win a second term in office was blamed in part on the bailout of the banking system engineered after the savings and loan association debacle of the 1980s.

In a 2005 statement arguing against the imposition of new "insurance premiums" on the banks, Congressman Ron Paul said:

> These "premiums," which are actually taxes, are the primary source of funds for the Deposit Insurance Fund. This fund is used to bail out banks that experience difficulties meeting commitments to their depositors. Thus, the deposit insurance system transfers liability for poor management decisions from those who made the decisions to their competitors. This system punishes those financial institutions that follow sound practices, as they are forced to absorb the losses of their competitors. This also compounds the moral hazard problem created whenever government socializes business losses. In the event of a severe banking crisis, Congress likely will transfer funds from general revenues into the Deposit Insurance Fund, which would make all taxpayers liable for the mistakes of a few.6

The Federal Reserve's new approach to rescuing failed banks is evidently to avoid political objection by doing it behind the scenes, using fiat money created for the purpose. Rather than taxing other banks or the taxpayers at large, the Federal Reserve imposes an indirect tax in the form of inflation. Like other central banks, the Federal Reserve is a "lender of last resort," which means it can create money out of nothing with accounting entries.7 Adding new money to the economy without adding new goods or services, however, is not without cost. It shifts the cost to the public, driving prices up, taxing us at the grocery store and the pump. Meanwhile, errant bank managers are rewarded by being allowed to keep their winnings and continue in their risky ventures.

The system is clearly flawed, but what is the alternative – thousands of people queuing to get their money back as in England? That was the nineteenth century solution. In an article titled "Anatomy of a Bank Run", Murray Rothbard wrote:

> [I]t was precisely bank runs, as severe as they were that, before 1933, kept the banking system under check, and prevented any substantial amount of inflation. But now bank runs – at least for the overwhelming majority of banks under federal deposit insurance – are over, and we have been paying and will continue to pay the horrendous price of saving the banks: chronic and unlimited inflation. Putting an end to inflation requires not only the abolition of the Fed but also the abolition of the FDIC and FSLIC. At long last, banks would be treated like any firm in any other industry. In short, if they can't meet their contractual obligations they will be required to go under and liquidate. It would be instructive to see how many banks would survive if the massive governmental props were finally taken away.8

The obvious problem with that solution is that it would penalize the prudent savers who wound up losing their savings, and the banks' shareholders who invested under different rules. There is really no good solution under the current debt-based banking system, because it is basically a pyramid scheme. Collapse is built into the system, because there is never enough money to meet the cumulative debt burden. Virtually the entire money supply originates as a debt to private banks; and since banks create the principal but not the interest necessary to pay back their loans, new loans must continually be taken out to come up with this interest. When no more borrowers can be found, the pyramid must and will collapse. It will collapse either in those painful increments called the recessions and depressions of the "business cycle," or all at once.

(See E. Brown, "Market Meltdown: The End of a 300 Year Ponzi Scheme,"
September 3, 2007, http://www.webofdebt.com/articles.)

The only way to get off this endless wheel of inflation and depression is to change the way money is created. Rather than coming into existence as an interest-bearing debt to private banks, our national currency needs to be issued as "legal tender" by the people themselves, following the innovative system of debt-free money devised by the American colonists before the private central banking scheme was imposed on the world.

(For more on this, see E. Brown,"Captured by the Debt Spider,"
http://www.webofdebt.com/excerpts/introduction.php.)

NOTES

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2
“Fears Over Rock’s Online Accounts,” *BBC News*, http://newsvote.bbc.co.uk (September 16, 2007).

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Murray Rothbard, “Fractional Reserve Banking,” *The Freeman* (October 1995), reprinted on *www.LewRockwell.com*.

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Peter Ralter, “News of the Day,” *LeMetropoleCafe.com* (September 16, 2007).

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John Hoefle, “The Federal Reserve Vs. The United States,” *Executive Intelligence Review*, April 12, 2002.

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Ron Paul, “Reject Taxpayer Bank Bailouts,” *LewRockwell.com* (May 4, 2005).

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James Barth, et al., “Financial Crises and the Role of the Lender of Last Resort,” *Federal Reserve of Atlanta Economic Review* (January 1984), pages 58-67. See E. Brown, “Financial Meltdown,” September 3, 2007, http://www.webofdebt/articles.com .

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Murray Rothbard, “Anatomy of the Bank Run,” *Free Market* (September 1985), reprinted on *www.LewRockwell.com*.

Ellen Brown, J.D., developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and “the money trust.” She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Brown’s eleven books include the bestselling Nature’s Pharmacy, co-authored with Dr. Lynne Walker, which has sold 285,000 copies.