If he were alive today and realized the service he had rendered his compatriots as, first of all, an uncommonly effective catalyst for their yearning for liberty and then as being instrumental in accelerating the downfall of the oppressive regime, he could take pride in the prominent role he played in those momentous pre-revolutionary events in his country's history. Voltaire did much to destroy the old regime, the abuses of which he so hated.

***Alexander J. Nemeth, PhD, JD**, a specialist in Clinical Psychology, Neuro-Psychology, and Forensic Psychology, who also trained as an attorney, retired as Director of Training in the Department of Psychology of the Kaiser Medical Center in Vallejo California, in part to devote more time to psychobiographical scholarship. His book Voltaire's Tormented Soul: A Psychobiographic Inquiry was published in 2008 by Leigh University Press and reviewed in this journal. Dr. Nemeth can be contacted at anemeth9@gmail.com.*
❑

Psychoeconomics Revisited

How the Actions of Central Bankers Are Shaped by Past Currency Trauma

Robert W. Dimand and Robert H. Koehn—
Brock University

The leaders of the world's major central banks responded very differently to the credit crunch that began in August 2007. Ben Bernanke, chair of the Board of Governors of the Federal Reserve System (the Fed), acted promptly to commit the Fed to maintaining the liquidity and functioning of the U.S. system of financial intermediation, and began a series of reductions in the target rate for overnight lending

of federal funds. Bernanke gave the Fed's function as a lender of last resort priority over defending the exchange rate of the U.S. dollar or avoiding the moral hazard risk of bailing out private and semi-private financial institutions.

In contrast, the European Central Bank (ECB) kept the prevention of inflation as its main priority, and left its overnight lending rate unchanged for more than a year—and then raised it (although the ECB subsequently followed other central banks in reducing interest rates). Mervyn King, Governor of the Bank of England since 1993, emphasized the problem of moral hazard (that banks and other institutions would adopt riskier behavior if they thought they could rely on being bailed out), and, until sandbagged by the collapse of the Northern Rock Bank, did not follow the Fed in subordinating macroeconomic goals to preserving the functioning of the system of financial intermediation. Their reactions differed in ways that reflected the lessons they had drawn from past traumas that had affected central bankers in their countries (Robert W. Dimand and Robert H. Koehn "Central Bank Responses to Financial Crises: Lenders of Last Resort in Interesting Times," Conference presentation at "The Political Economy of Central Banking," Ryerson University, Toronto, 5/28/2009, pp. 27).

As a 2008 headline in *The Economist* puts it, "The lessons of German history haunt the single currency." As may be seen in the writings of Otmar Issing, who became the European Central Bank's first chief economist after serving as chief economist of the Bundesbank, the ECB has continued the Bundesbank's traumatic memory of the hyperinflation that increased the German price level in 1923 to one trillion times its level in 1914 ("Leader: The Bank that Failed: The Governor of the Bank of England is the Biggest Casualty of a Financial Fiasco," *The Economist*, 9/22/2007, p. 16). One U.S. dollar exchanged for 4.2 marks in 1914, and for 4.2 trillion marks in 1923. Because money was losing its value,

people wished to avoid holding money, so the price level (P) rose faster than the money supply (M), even though the excessive printing of money was the cause of the rising prices. John Maynard Keynes calculated in 1923 that the real quantity of money (M/P) in Germany had declined by 92%. But, notoriously, Dr Rudolf Havenstein, the long-serving president of the Reichsbank (the predecessor of the Bundesbank), misunderstood the cause of the soaring prices, and promised that with 38 new high-speed printing presses, the Reichsbank would be able to print money fast enough to catch up with the rising prices, telling the Reichstag on August 7, 1923, that "in a few days we shall be able to issue in one day two-thirds of the total circulation" (Irving Fisher, *The Money Illusion*, 1928, p. 66).

The hyperinflation of the 1920s provides a more painful memory for German central bankers (and for other European central bankers at the ECB, influenced by Bundesbank traditions even though the first two ECB heads have been Dutch and French) than does the mass unemployment of the Great Depression of the 1930s, because German central bankers are not blamed for causing the Great Depression. The resulting attitude is illustrated by a machine in the Bundesbank's Money Museum, where:

> museum-goers are…invited to grab a lever, and choose how much money to supply to a slowing economy…The machine shows prices running out of control, warning lights come on, and the game ends. 'Sorry, but you've failed,' reads an illuminated rebuke. 'Go back and review the basics of money again.' The real-life costs are spelled out, a few meters away, by somber displays and newsreels describing the misery of currency instability. They show Germany's hyperinflation in 1923, when it became cheaper to burn banknotes than to buy fuel…A display marked 'conflicts' describes how politicians from Konrad Adenauer to Helmut Schmidt all failed to browbeat the bank into bending the rules on inflation. Each

> time, visitors are told, the bank was ultimately proved right ("Don't Play Politics with the Euro: The Lessons of German History Haunt the Single Currency," *The Economist*, 3/8/2008, p. 62).

Ben Bernanke is haunted by another historical trauma, which was the subject of his doctoral dissertation: the scramble for liquidity in the United States in the early 1930s that led to the temporary complete closing of the U.S. banking system in the "Bank Holiday" of March 1933 (Bernanke, *Essays on the Great Depression*, 2000). More than 4,000 banks never reopened, and, according to Bernanke's research, the U.S. banking system was unable to function effectively as a system of financial intermediation between savers and borrowers for the rest of the decade (Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960*, 1963). The trauma of such a meltdown of the financial system, due to the rising risk of bankruptcy and default as deflation raises the real value of debts, is shown by the representation of the credit crunch of the early 1930s as "It" in the title of Hyman Minsky's *Can "It" Happen Again? Essays on Instability and Finance* (1982).

In 2002, shortly after becoming a member of the Board of Governors of the Federal Reserve System, Bernanke spoke at Milton Friedman's 90th birthday party, and delighted the audience by wittily remarking, "Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve System. Regarding the Great Depression…we did it. We're very sorry…we won't do it again" ("Leader," *The Economist*, p. 16). Today's financial crisis resembles one that happened three-quarters of a century ago ("1929 and All That: How Today's Financial Crisis Resembles One That Happened Three-quarters of a Century Ago, and How It Does Not," *The Economist*, 10/4/2008, p. 83). When the credit crunch began in August 2007, Ber-

nanke, by then chair of the Board of Governors, had no doubt who was responsible for ensuring that "it" did not happen again, and who would be blamed if it did.

Mervyn King also studied the debt-deflation of the early 1930s, devoting his presidential address to the European Economic Association to the topic. But Britain never experienced waves of bank failures and a freezing of the system of financial intermediation, such as the United States did in the early 1930s, any more than it ever experienced a hyperinflation, as Germany did in the early 1920s. The crucial traumatic experience for a British central banker was the stagnation and unemployment that followed Britain's return to the gold exchange standard in 1925 at the prewar parity of $4.86 to the pound sterling, known as "Norman conquest of $4.86" because of the central role of Montagu Norman, Governor of the Bank of England from 1920 to 1944 (D. E. Moggridge, *British Monetary Policy, 1924-1931: The Norman Conquest of $4.86*, 1972).

The thoughts of King and his colleagues have not been as overwhelmingly focused on avoiding inflation as has been the case with Issing and the ECB, nor were they as concerned as Bernanke with the role of the central bank in keeping the system of financial intermediation from grinding to a halt—until events forced them to be so concerned, belatedly and at some cost to their reputation ("Leader," *The Economist*, p. 16). The leadership of the ECB does not wish to be remembered like Rudolf Havenstein, who unleashed spiraling inflation. The Federal Reserve's Board of Directors wishes to avoid following the example of Eugene Meyer (Fed chair from 1930 to 1933), who allowed the implosion of the banking system. Their colleagues at the Bank of England worry about the precedent of Montagu Norman, who made the wrong choice about how to set a key monetary policy variable (in his case, overvaluing the exchange rate).

In each case, their mindset is shaped by the past experience of their own central bank (or its predecessors), experiences that were traumatic for their national economies but also were traumatic for the central bankers involved.

Robert W. Dimand, PhD, *a graduate of McGill and Yale Universities, is a Professor of Economics at Brock University, St. Catharines, Ontario, Canada, and Adjunct Professor of Economics at McMaster University, Hamilton, Ontario, Canada. His teaching and research fields are macroeconomics, game theory, and the history of economic thought. He is the author of The Origins of the Keynesian Revolution, co-author of A History of Game Theory, Volume 1, and co-editor of A Biographical Dictionary of Women Economists. Dr. Dimand can be contacted at rdimand@brocku.ca.* ***Robert H. Koehn****, a graduate of McMaster University, is a Lecturer in Economics at Brock University, St. Catharines, Ontario, Canada, where he teaches public finance, managerial economics, and the economics of unions. He has published in the Atlantic Economic Journal, the Journal of Economic Asymmetries, the Journal of Economic Issues, and the International Journal of Applied Economics and Econometrics. Professor Koehn can be contacted at rkoehn@brocku.ca.* ❑

International Views of Health Care

Canadians Watch the American Health Care Struggle

Andrew and Helen Brink—Psychohistorian and Nurse/Potter

Canadians watch with incredulity and a degree of smugness as Americans take extreme positions on the issue