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15. The political economy of financial reform: the origins of the US deregulation of 1980 and 1982

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This paper draws heavily upon the work and wisdom of Howard Sherman. As one of Howard's numerous graduate macroeconomic theory students, I not only committed to memory the components of his Marxian analysis of the profit rate, I also internalized his commitment to an institutional-historical methodology. While Howard is most often associated in macro with his business cycle models, in his classes he also emphasized the institutional-historical foundation on which a political economic analysis is constructed. As the methodology of this paper unfolds, I think it can be easily seen that my analysis of the changing relationships between capitals and the evolution of a new regulatory structure to attend and accommodate capitals' newly emerging needs descends from Howard's methodological approach. While the questions are mine, they are due to him.

15.1 INTRODUCTION

The 1980s usually date the beginning of the US economy's move towards market deregulation and the weakening of the welfare state. In 1980, Ronald Reagan became President; financial market deregulation commenced; income tax rates were reduced; the legitimacy of government's economic role was successfully challenged; and New Classical theory became dominant in economic thinking and policy making circles. These changes indicate the beginning of neoliberalism; they also demarcate the end of liberalism, as we knew it. Rather than springing up *sui generis*, they come at the end of a decade of political debates, economic disruptions, and domestic and international institutional changes. The economic battles of the 1960s and 1970s are the birth site of the 1970s deregulation. Those battles were fought on the terrain of a

accords underpinning the "Golden Age of Capitalism." This shift away from liberalism, toward free market liberalism that proceeded in the 1980s was neither haphazard nor uncontested.

After the ravages of the Great Depression, the US financial sector had been consciously reconstructed to thwart the inherent market instabilities responsible for producing the ten years of economic upheaval. The sector's reconstruction, along with the initiation of governmental programs for housing, social security, minimum wages, and various industrial subsidies, formed the core of the new welfare state. While always subject to Congressional discussion, legislation, and budget debates, these programs weathered attacks and actually grew through the 1960s. By the 1970s, an accumulation of economic problems motivated discussions on and recommendations for change.

In this paper I analyze the initiating events that promoted the financial deregulation implemented in the early 1980s: the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982. These acts were meant to level the playing field on which depository institutions operated and competed. While others have detailed the complementary and equally important fraying of the capital-labor accord (Marglin and Schor 1991; Armstrong *et al.* 1991), this paper focuses on the deconstruction of the New Deal-constructed financial sector.¹

The economic and political transformation that was under way by the 1970s was not only signified by the changes in the financial sector, but it was also amplified by them. The possibility of a capital-labor accord rested on the construction of a financial sector that would not be disruptive and would promote growth by financing industrial production. The labor peace achieved by the capital-labor accord required that financial capital act in a manner that was subservient to industrial capital. The New Deal constructed a regulated financial sector that was the handmaiden to industry. Financial capital was contained by a regulatory structure that constrained its innovative nature and organized its operations to meet the needs and demands of industrial capital. This structure allowed industrial capital and labor the luxury of striking an accord that met only the needs of their relationship. With the domestic financial crises of the 1960s, the breaking down of the Bretton Woods agreement, and the move towards an internationalization of production, the financial sector began to move away from its constrained subordinate position towards one of much greater freedom.

The late 1990s exhibited the results of this economic transformation. Since it is beyond the scope of this paper to detail all the changes and debates that prepared the US economy for financial deregulation, all I can do here is highlight the changes that laid the foundation and structured the debates which

finally resulted in financial deregulation. We start after this introduction in section 15.2 with a historical description of the structure of the US financial sector as it developed after the Great Depression. These post-Great Depression relationships were maintained through the 1950s. In the 1960s the US domestic and world economies as structured by the Bretton Woods Agreement began to deconstruct as new pressures emerged. These international pressures and their domestic counterparts are described in section 15.3. In section 15.4, the instrumental role played by the Hunt Commission and FINE study² in defining the structure that deregulation would eventually take is discussed. The effects of the changing domestic and international pressures as they differentially affected the commercial banks and the savings institutions forms the basis of this discussion. In the final section, the findings are summarized.

15.2 RECONSTRUCTION OF FINANCIAL MARKETS AFTER THE GREAT DEPRESSION

"The ultimate purpose of the framework for financial structure and regulation is to assist financial institutions and markets in performing their economic functions" (D'Arista 1994b: 240). With this dictum in mind, Congress reconfigured the US financial sector while it was still in the midst of the Great Depression. In this New Deal undertaking two ideas dominated: make the new structure stable by learning from the mistakes that brought on the Depression; and satisfy industrial need with appropriate financial institutions and regulators who will oversee their operations within a properly accommodative structure. The promotion of stability was founded on three structures: insurance, fire walls, and regulation. Deposit insurance was made available for the demand and time deposits in each depository institution. Fire walls, as manifested in the Glass-Steagall Act, were inserted between the capital markets – equity and debt – and the depository institutions to isolate the creators, holders, and disseminators of the money supply from the riskier activities of the capital markets. Finally, expanding the number of regulators while linking each one to a particular type of financial institution meant better oversight and promotion of activities that were appropriate to each institution's functions (Eichler 1989). The determination of appropriate activity depended upon the industry the institution served, for each type of institution was linked to an industry or a part of the production process. In this linked relationship, the financial sector was the regulated actor while the industrial sector was, effectively, unregulated. The financial sector's activities were structured to meet the needs of the industrial sector.

The linking of an institutional finance provider with an economic sector effectively carved up financial capital so that there was a financial conduit dedicated to an industrial sector. The New Deal legislation divided finance providers into three basic credit providers: freely functioning financial markets for long-term capital needs – plant and equipment; commercial banks for short-term loans that would primarily provide operating capital; and thrifts for home mortgage lending. These divisions of the capital and money markets defined the asset-side activities of these financial institutions, and their liability-side activities were equally as segmented. Commercial banks were limited to offering non-interest-bearing demand deposits and savings deposits with interest rates limited by Regulation Q. Savings institutions were restricted to only offering savings accounts, but they were able to outbid commercial banks for these funds because their interest rates were not limited.³ The New Deal reformation refrained from making the federal government a centralized planner. Instead it structured the financial market so that specific pools of funds were available for specific industrial needs. This structure limited competition for finance among capitals which damped price competition and quantity volatility, thereby promoting stability.

The evolution of this segmented finance capital structure arose from political debates and disputes between finance and industrial capitalists as well as from discussions about institutional stability. Ferguson (1989) describes the formulation of the Glass-Steagall Act of 1932 as the defeat of J.P. Morgan's investment bank, the House of Morgan, by J.D. Rockefeller's commercial bank, the Chase National Bank. Additionally, it gave industrial capital a financial conduit:

By separating investment from commercial banking, this measure destroyed the unity of the two functions whose combination had been the basis of Morgan hegemony in American finance. It also opened the way to a financial structure crowned by a giant bank with special ties to capital-intensive industry – oil. (Ferguson 1989:16)

While Ferguson detailed the personal and political economics of the separation between the long- and short-term financial markets and the connection to an industry, others (D'Anista 1994a; Dickens 1998; Epstein 1994; Goodhart 1989) have examined the financial-industrial-regulatory connections. These authors have determined that there is a supportive, rather than a hierarchical control relationship that was constructed among the Federal Reserve, large banks, and large manufacturers. Instead of regulators simply acting as guards against banking malfeasance and too-risky behavior, they have tended to act as champions.⁴ These relations also produced a bifurcation in commercial banking: large banks serve large, more capital-intensive industries and small banks serve small

more labor-intensive industries. Dedicated capital conduits for large and small capitalists were also the result of the New Deal structure.

The final piece of the New Deal financial structure was home buyers' finance. Again, the process by which this structure was formulated had as much to do with the political power of economic interests as with the desire to stabilize the financial system (Keith 1973).

To promote stability, legislation initiating the Federal Home Loan Bank Board (FHLBB), the liquidity provider primarily for the savings and loans, was passed. The savings and loans, unlike the commercial banks, held only savings deposits and had to originate mortgages as their primary asset.⁵ This asset-liability mix meant that savings and loans were more easily subject to interest rate risk since their assets were long term and their liabilities were short. They were also subject to disintermediation. To reduce these risks federal deposit insurance, deposit rate ceilings on commercial banks, and the FHLBB were created.

The political struggles that eventually produced federal policy to revive the failed industries of housing and housing finance are detailed by Nathaniel Keith (1973), a strong supporter of the New Deal's commitment to affordable housing and the assistant to the chair of the National Housing Agency, Raymond Foley. He notes that the beginning of the restructuring was in 1933 when a law establishing the Home Owners' Loan Corporation (HOLC), which refinanced the outstanding mortgages of owners who were in or close to default, was passed. The HOLC, however, only helped current owners, not those who wanted to purchase a house. So in 1934 legislation to construct a Home Loan Bank System, a Federal Reserve System for savings and loan associations, was enacted. Now, the private residential construction industry had a stronger financial system through which new home mortgages could be originated.

The agency responsible for coordinating this revival was established by the 1934 National Housing Act which created the Federal Housing Administration (FHA). The FHA was, in effect, an insurance program for lenders. It was mandated to cover any losses that a lender might experience as a result of home buyer default. The FHA's cost of operation was met by a levy – mortgage insurance premium – on the borrower. In return for this insurance protection, lenders extended the maturity of the mortgage and demanded only 20 percent as an initial down payment. Additionally, the National Housing Act created the FSLIC, a deposit insurance program for the savings institutions (ibid.: 25–6).

This public-private institutional arrangement for housing finance was affirmed for the construction of private housing, not for public housing. The housing lobby, formed by the Chamber of Commerce of the U.S., the National

Association of Real Estate Boards, the US Savings and Loan League, the National Association of Retail Lumber Dealers, and later by the National Association of Home Builders, led the opposition to public housing into the 1960s and helped to orchestrate housing policy into the 1980s (Keith 1973: 29; Meyerson 1986).

The federal government's legislation laid the foundation for the housing industry's economic resurrection and validated the effectiveness of this private-public partnership.

While the establishment of each of these programs had been justified in large degree as emergency measures to help overcome the great depression, their basic long-range significance lay in the tacit recognition that solutions to national housing problems required intervention by the Federal Government. (Keith 1973: 26)

The effectiveness of the structure and the continued cooperation of the industrial group assured the continuation of these arrangements with very little adjustment into the 1960s.

Not only did the housing finance arrangements continue into the 1960s, but the commercial bank-industrial link and many of the other New Deal programs that formed the foundation of the US's welfare state also endured. Of the 30 years that separated the initiation of these programs and the beginning of their ends, 15 were spent in depression and war. These were periods in which a massive governmental push was made to save capitalism from both its internal and external foes. After 1945, a new international financial order prevailed which bore an American organizational imprint that insulated the US welfare state and US domestic markets from external financial disruptions. These international and domestic structures successfully supported the operations of international and US domestic markets until the long, strong expansion of the Kennedy-Johnson years was strangled by the tight domestic monetary policy of William McChesney Martin's Federal Reserve and Johnson's inability to finance the Viet Nam war with taxes (Campagna 1987: 332-4).

15.3 THE CONTRADICTIONS IN THE 1960s

The Economic Environment

In the 1960s the US economy experienced the longest and strongest expansion to date since the Great Depression. Spurred by investment expenditures induced by the Kennedy-Johnson investment tax credit and government expenditures on military and Great Society programs, the economy grew at an

average annual rate of over 5 percent between 1963 and 19968. Johnson's dedication to Kennedy's unfinished programs, his own commitment to the Great Society, his reliance on traditional Keynesian fiscal policies, and, until 1966, the Federal Reserve's accommodative monetary policy signaled that the welfare state was both alive and well. This picture of security and well-being dissolved, unfortunately, into one of uncertainty, stagnation, and inflation by the end of the decade.

In 1966, this economic dissolution manifested itself in the first post-Depression credit crunch. The crunch was brought on by the Federal Reserve's switch to a tight monetary policy to combat inflation, which was a rejection of their previously accommodative stance. The Federal Reserve cited as the source of this inflation not the excessive spending by government, consumers, or business, but the rising wages of workers. In order to fight the run-up in wages, the Federal Reserve initially implemented policies that drove up interest rates, expecting the high rates to cause a recession which would push wages back down as unemployment rose. When this policy failed, they tried to constrain the supply of credit, hoping that capital starvation would reduce production and eventually wages (Dickens 1995).

The complication that accompanied this tight monetary policy was its impact on the economic viability of the commercial banks, the protectorate of the Federal Reserve and FDIC, and the thrifts. The regulatory structure that had aided depository institutions' operations over the previous 30 years now fettered their lending and profit-making capacities. Some of the banks implemented a successful adaptation to this new environment which was achieved by innovations that neither small commercial banks nor savings and loans could adopt. They found a unique solution that their regulators validated and that provided them with a competitive advantage over other depository institutions. The thrifts, on the other hand, experienced the beginning of their end.

The Crunch and the Way Out

The credit crunch originated from the Fed's decision in late 1965 to raise the discount rate and its follow-up move in April 1966 to implement a restricted rather than a moderated money supply growth rate. At the FOMC follow-up meetings in May, June, and July their directives became even more adamant about allowing the growth of bank reserves so as to reduce the supply of loans which would eventually induce a reduction in employment and cause wages to fall. Then, in August the big banks raised the prime rate, and the Federal Reserve responded by initiating an increase in reserve requirements, not increasing the discount rate. As a reprisal for the banks' continued expansion of

business credit, legislation that put an interest rate ceiling on three-month certificates of deposit (CDs) was enacted (Dickens 1990, 1995; Wolfson 1994b: 35).

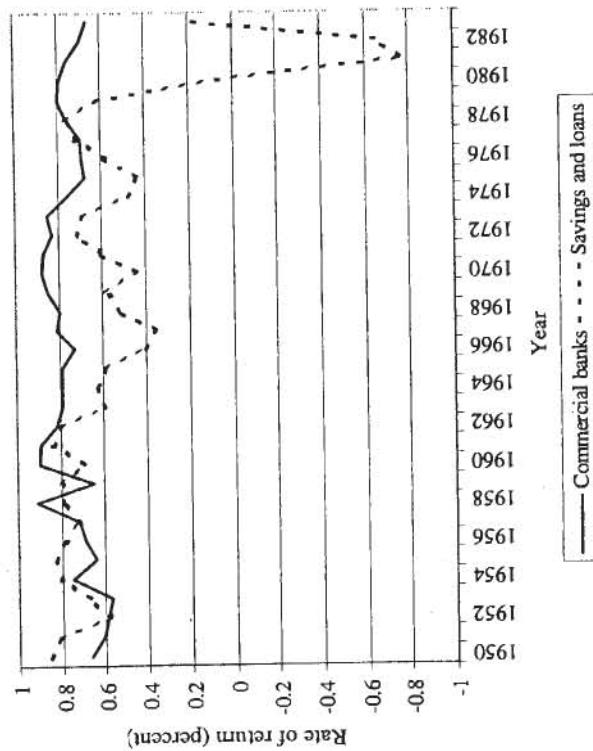
Banks, in an attempt to circumvent the Fed's restrictive credit supply policies had discovered new reserve sources which allowed them to continue to meet their customers' demand for loans. Bankers used two innovations to evade the Fed's restrictive monetary policy in this period: CDs and the Euro-dollar market. CDs had lower reserve requirements, but were more costly than deposits. Commercial banks would have preferred a cheaper supply of reserves for making loans; however, with interest-insensitive loan demand these funds could provide the bank with the reserves they needed (Wolfson 1994b: 35-6). By focusing on credit supply constraints, the Fed had pushed the banks into innovation.

When CDs were slapped with interest rate ceilings, the banks found another reserve source, the Eurodollar market. Initially, the Eurodollar market was an off-shore short-term money market operating out of London. Given the dollar's favored standing as the international currency for trade and reserves, numerous nations had dollar-deposit accounts in their banks and numerous US banks operated overseas. Rather than leaving the dollars as untapped reserves in these banks, financial operatives in Britain conceived of using them to finance trade and other activities without running foul of their capital controls. In the early 1960s, US banks started borrowing in this market and repatriated the reserves as loans. The Fed allowed this circumvention of its domestic policy because it did not disrupt the fixed exchange rate system: it had a positive impact on the US balance of payments; and it opened up the lucrative international market to US banks (Dickens 1995; Helleiner 1994: 86-91).

Financial and Industrial Contests Emerge

These financial innovations serve to emphasize two important points about financial markets and institutions in this period: the commercial banks, while still constrained by regulation, were given more leeway than the thrifts to innovate; and even with their ability to innovate, the political power of the financial institutions was far less than manufacturing's. The implementation of tight monetary policies to stabilize the industrial side of the economy induced high interest rates, a constraint on credit supply. The regulated commercial banks were able to continue their expansionary lending activities and operate in a profitable manner. The thrifts, on the other hand, could not enter the CD or Eurodollar markets. They were subjected without recourse to the high market interest rates which, when they rose above the ceiling, institutionalized their

Figure 15.1 Rate of return on assets



rates, led to massive disintermediation (Wolfson 1994b: 36). The changes in the economic environment were not equally conducive to the well-being of the banks and thrifts.

Prior to the credit crunch, Regulation Q did not cover the savings and loans. In order to attract time deposits their rates were usually between $\frac{1}{4}$ and $\frac{1}{2}$ percent higher than those in a commercial bank, which resulted in 1966 in a savings deposit rate of between 5.5 percent and 5.75 percent. On the asset side, a savings institution's lending "ceiling" was imposed by the structure of the mortgage market or the state.⁶ To maintain their traditional profit levels, savings and loans needed to operate with a 2 percent spread between their mortgage rate and their cost of funds. In 1966, the mortgage rate was 6.25 percent, leaving far less than a 2 percent spread. Unable to compete with the commercial banks on the asset or liability side in this tight money inflation-fighting environment, the savings and loans lost their deposit base and their borrowers. They also lost out in profit-making. Figure 15.1 shows the rate of

return on assets for commercial banks and savings institutions. In 1962 the annual return on assets (ROA) for all savings institutions was 0.80 percent. In 1966, it dropped to 0.41 percent, and in 1967 it touched bottom for the decade at 0.36 percent. The commercial banks in this same time period had an ROA of 0.82, 0.73, and 0.81 percent, respectively. Lacking a regulator that controlled market interest rates and credit conditions and that had the power to help them innovate, the savings institutions, not the commercial banks, bore the brunt of the Federal Reserve's financial tightening.

The disproportionality in power between the financial and the industrial sectors continued into the 1960s. An example of this power differential is seen in the programs that were proposed to stem the flow of capital out of the US. Two programs, voluntary capital controls and an Interest Equalization Tax (IET) on short-term domestic bank loans to foreign borrowers and foreign securities sold in the US, were instituted to slow the financial capital flow out of the country and block the international activities of the big banks (Helleiner 1994: 86). Both programs were enacted and enforced. On the positive side, capital controls signaled that financial liberalization was an improper strategy for coping with trade deficit-induced flow imbalances. Additionally, they reaffirmed a confidence in the government's ability to construct appropriate, effective economic policies. On the negative side for the banks, these programs also demonstrated:

that the interests of US bankers continued to be subordinated, as they had been since 1947, to the priorities of New Deal economics and global strategic objectives ... Further evidence of the bankers' relative political weakness was [that their international activities were controlled more strictly than those of the industrialists. (ibid.: 87-88)]

They contrast with Kennedy's attempt at industrial regulation. In 1962 the Kennedy Administration backed controls on the direct foreign investment of industrial corporations. The controls were never enacted because the corporations forced the administration to back away from them (ibid.: 88).

By the end of the 1960s the New Deal institutions, programs, economic structures, and power relationships were still dominant, but perched on shaky ground. The shaking came from newly mobilizing forces. Douglas Dillion and Robert Roosa, bankers in the Kennedy administration, had been advocating the deregulation of Western European capital markets. They argued that liberalized markets would function more smoothly and efficiently, and thereby produce better information and better decisions. While in the early 1960s their views were not believed to merit further investigation, the Federal Reserve's overt agreement to keep Eurodollars free of reserve requirements

and the Kennedy-Johnson governments' support for using this off-shore market were signs of the nascent push towards financial liberalization (Dickens 1990; Helleiner 1994).

After 1966, as each new financial crisis emerged, the policy alternative of liberalizing financial markets was discussed, but the old ways of copying with the crises still dominated. In 1969-70 the next financial crisis emerged as the Federal Reserve, again, tightened monetary policy. This time, the banks sought relief through a change in their corporate structure and then by using an old market instrument, commercial paper. By converting into a unit bank holding company, the bank's parent company could issue commercial paper and use the proceeds to purchase loans originated by the bank. So, indirectly, the banks were using the commercial paper market as "new" reserves. Additionally, banks were tapping into the fed funds market and using repos (Wolfson 1994b: 42). Banks were not alone in tapping the commercial paper market for funds; non-financial corporations were also turning to this market for their short-term loans. Thus, the expansion in the use of the commercial paper market meant banks could more easily satisfy loan demand when monetary policy was tight, but it also heralded the arrival of the new competitor for non-financial corporate business, a broader and deeper short-term capital market.

The Federal Reserve's tight monetary policy also affected the savings institutions. They suffered disintermediation in 1970 just as they had in 1966. These events prompted members of Congress to propose new non-market-determined methods for satisfying credit needs. In 1970, Senator William Proxmire promoted legislation that would require "the Federal Reserve to lend directly to the housing industry" (Dickens 1996: 120). In 1968 and again in 1973, Representatives Barrett and Sullivan introduced legislation that mandated making 6½ percent federal-funded mortgages directly available to prospective home buyers when the normal sources for these funds, the savings institutions, were inhibited from lending. And Representative Wright Patman proposed the restoration of a Reconstruction Finance Corporation-like institution which could lend to worthy borrowers during tight credit periods (US House of Representatives 1973a: 644-5, 695-6).

In 1973, disintermediation struck again. In July, the Federal Reserve, which was engaging in another round of tight monetary policy, allowed the commercial banks to issue a small investors' CD with a four-year maturity without an interest rate ceiling. The response was immediate. Deposits in the savings institutions, which were still subject to interest rate ceilings, fled. While in August 1972 the net change in deposits at the nation's mutual savings banks had been a positive \$415 million, in August 1973, after the innovation, the net change was a negative \$475 million.

Soon after this third round of savings institution disintermediation, two government-sponsored studies investigating the appropriate changes for the US financial sector were completed. President Nixon had convened a group of industrialists and financiers in 1970 who produced at the end of 1971 *The Report of the President's Commission on Financial Structure and Regulation* (Hunt Commission report). At the end of 1975, the House of Representative's Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance also produced a report, *Financial Institutions in the Nation's Economy* (FINE study).

At the heart of each of these sets of recommendations was the proposal to deregulate the financial sector. This proposal was the foundation of the financial liberalization that was eventually enacted in 1980 and 1982. What had happened to the original industrial and financial forces whose interests had been served by the New Deal structure? What new configuration of political and economic power was emerging to support this market-oriented financial structure for the US?

15.4 THE HUNT COMMISSION REPORT AND THE FINE STUDY: THE MAP TO THE FUTURE

The first of the studies for financial restructuring, the one most instrumental in mapping out the changes that actually transpired in 1980 and 1982, was the Hunt Commission report. The FINE study took its initial outline for restructuring from the Hunt report, so its set of recommendations differ only slightly from its precursor's. The differences that do exist between the two reports appear to arise more from the insights achieved by grappling with the problems in the financial sector that were experienced after the publication of the Hunt report than from any ideological differences between the two committees.

The Recommendations

The essential point made in both reports was that the "protective" regulations responsible for producing the specialized segmented-market depository institutions should be stripped away. The depository institution that would best fit into the economic structure and meet the needs of the post-Bretton Woods global economy was a market-based institution with undifferentiated products and services. Since both the commercial banks and the thrifts had been protected from market competition, the protections that had made each type of institution unique had to be dropped. In concert with this move to unifor-

mity, all institutions with transaction accounts would be subject to the same reserve requirements. Additionally, Regulation Q would be phased out, and markets would determine deposit rates. Suggestions for a new set of universal prudential regulations were made to enhance stability in this openly competitive environment. The homogenization of products and services meant that the protected status accorded to housing finance would no longer exist, so to ensure housing finance availability various incentives were proposed, including a tax credit. Finally, all taxes distinctive to particular types of depository institutions would be replaced by a uniform tax.

Both reports indicated that with more uniform institutions competition could be more easily promoted. This competition may even extend into non-banking areas such as insurance and securities. To foster regulation within this new structure, the dual system of chartering, regulating, and examining depository institutions would be maintained.⁷ And interstate branching needed to be encouraged. As for monetary policy, the Federal Reserve would be removed from its regulatory position and act strictly as the institution that made US monetary policy.

In between the Hunt Commission report and the FINE study, the Nixon administration sent forward to the House of Representatives "A Program for Reform of our Financial System" (August 1973) which made, effectively, the same recommendations for restructuring that the other two studies made. Other proposals for restructuring were also put forward in 1975 and 1976. The responses to these relatively uniform proposals from the different parts of the financial sector provide some insights into who was behind these proposals for change.

The "Pros" and "Cons"

On the "pro" side of the recommendations for financial marketization stood the American Bankers Association, numerous neoclassical economists, and the Federal Reserve (First National City Bank 1972; *Banking* 1972; Schott 1972; Fraser and Rose 1972; and Jackson 1976). On the "con" side stood almost every other financial trade association and regulator (Scott, US Savings & Loan League 1973; National Underwriters Co. 1972; Biemiller-AFL-CIO 1973; Goldfinger, AFL-CIO 1975; Martin, National Association of Home Builders 1973; Bomar, FHLBB 1973; Carlson, Independent Bankers Association of America 1973; and Benda, Independent Bankers Association of America 1975). The attraction to the market that the "pros" experienced was obviously not universal. The common response of some Hunt report critics was that without representation on the committee, a good outcome — one that

embodied a particular economic interest – was unlikely.

The split within the financial sector over these proposals falls primarily along the old lines of the “protected” side of the depository institutions and the “unprotected.” The side taken by the financial markets’ actors, for example, insurance and securities, depended on the recommendations made about non-banking powers. Given that the debates on deregulation usually emphasized greater market-dominated activity for all actors in the financial sector, those financial institutions already operating in the market were not in general support of more competitors; they were not gaining additional powers, just additional competitors. Among the depository institutions, the commercial bankers, the US Treasury, and usually the Federal Reserve were the primary advocates of market liberalization.

In the debates that ensued over the two reports and the first piece of financial reform legislation after the Hunt report, the sides were very clear. The “cons” were composed of those institutions and capitalists that were already losing in terms of the shifting structure of capitalism. If profit rates are an appropriate indicator of success, then Figure 15.1 shows how the savings institutions fell from dominance after the 1950s. In the 1960s, the period in which finance capital again became international and inflation distorted the structured competition of the domestic depository institutions, the commercial banks caught up with and surpassed the savings institutions. The commercial banks’ success continued from the early 1960s through the late 1990s, only being interrupted in 1977 and 1978.⁸ The “pros” had been able to move into new markets and to use new financial instruments. The “cons” were tied to an industry whose massive growth had past. The savings institutions faced a slow-growing market, tight regulation, and high inflation. In response to this situation, they argued to maintain their historical position as a protected financial institution (Scott 1973; Goldfinger 1975) or make the kinds of changes that would keep them in a fairly protected part of the financial market (Crawford, National Association of Mutual Savings Banks 1973, 1975).

The transformation in comparative profit rates arose from the capacity for innovation in each set of depository institutions, the restructuring of industrial capital on a global/international basis, and the particular relationship of the depository institution to industrial capital. While the Eurodollar market was initiated in 1961, domestic depository institutions were still tightly bound to their New Deal-determined industrial capitals. As those capitals began to move geographically and structurally, the depository institutions followed. Finance and industrial capitals were linked as partners in a dance; and, as in a dance, one partner leads while the other follows. But, what happens to the partner

Behind the ‘Pros’

The commercial banks were in solid support of financial liberalization from its very beginning. Looking at this stance from the perspective of a New Deal depository institution, it is easy to see how attractive liberalization would be if it promoted the development of new products to meet the new, changing credit demands of the industrial markets. While the 1966 and 1969–70 credit crunches indicated how banks could use CDs, commercial paper, and Eurodollars to circumvent or weather tight monetary periods, what they failed to show is how financial innovations were also associated with the growth in mergers and with the multinational corporation (MNC) (Isenberg forthcoming).

In the 1960s two changes conspired to produce a greater need for capital: the third wave of US mergers and the move overseas of the merged multinational corporations. Commercial banks, constrained as they were by the Glass-Steagall Act, did not finance mergers, but it was these mergers that produced conglomerate firms that then went abroad to search for markets. Once abroad, these MNCs continued to need short- and long-term finance, but their banking relationships were still with American banks. As stated earlier, the Interest Equalization Tax (IET) had been instituted in 1963 to halt the exodus of US dollars. This barrier pushed domestic banks into opening up foreign branches to meet the borrowing needs of their now overseas customers. Joseph Ablely, the chief financial officer of R.J. Reynolds, explains this need clearly when he says: “Having banks that are structured to operate around the world in much the same way this company does is crucial” (Moffitt 1983: 43).

Initially, this mandate from industrial capital was only possible for a small number of American banks. Moffitt notes that by the mid-1960s three banks, Chase, Bank of America, and Citibank, had over 80 percent of total foreign branches of all US banks (*ibid.*: 45). Then, the imposition of the Voluntary Foreign Credit Restraint program produced a growth spurt in foreign banking that pushed even small banks to open foreign branches. Andrew Brimmer notes: “At the end of 1964, only eleven banks had established branches abroad – although in combination they were operating from 181 locations. By the end of September 1974, there were 129 banks with a total of 737 foreign branches” (*ibid.*: 47). This increase in branch activity was accompanied by a rise in foreign branch net assets from \$52.6 billion to \$127.3 billion between 1970 and 1974 (Mueller 1981). These activities translated into profits. The importance of foreign earnings for the ten largest US banks went from an on-average 17.5 percent of their total earnings in 1970 to 50.8 percent in 1976 (Moffitt 1983:53).

While bank branches were springing up across the world, London was the

heart of American overseas banking activities, especially the Eurodollar market. The creation of this market in London, with its traditional, historical role as an open financial center, meant that America's international banking activities could be conducted without the continuously tighter controls of the US federal government:

Although it had the power, the United States chose not to prevent them [the banks] from participating in the market. In fact, by the mid-1960s, US officials were actively encouraging American banks and corporations to move their operations to the offshore London market. (Helleiner 1994: 82)

As the Eurodollar grew over time, it also expanded its maturity:

The influx of US banks and multinational industrial corporations transformed the Eurodollar market from a short-term money market into a full-fledged international capital market serving needs that had previously been met by the New York market. (*ibid.*: 89)

With the backing of the US government and the continuing domestic demand for business loans, both short and long, the Eurodollar market became the model for the future.

In addition to their activities in the liberalized international markets, in the early 1970s, commercial banks also became interested in the expanding markets of Real Estate Investment Trusts (REIT). Initially, the interest was motivated by the fees-for-service relationship between the commercial banks and the REITs. As the REITs moved into the commercial paper market to finance their risky construction and development loans, the fees-for-service relationship expanded into the extension of guarantees on the REITs' commercial paper. Eventually, some of the large banks even entered this risky market through their own subsidiaries. The high risk of these activities was soon borne out (Wolfson 1994b: 53-5). Neither this foreknowledge of risk nor their regulators' proscriptions - of which there were none - kept the commercial banks out of this growth area. Commercial banks were looking for new areas for lending and new ways to do it. Their experiences in the 1960s and 1970s had shown them that clever innovation was the path they wanted to take and that financial regulation was an obstacle on that path.

Behind the "Cons"

The "cons," the other set of depositor institutions, were not being pushed by their old industries into innovation and neither were they attracted by the siren calls of newly expanded areas for lending. Some of the savings institutions

desired to expand the asset side of their activities, but none of them wanted to exit the mortgage market or change the liability side of their balance sheet. Even if there had been new areas for lending, the regulatory requirements, both asset and liability, for savings institutions were strict and required adherence. As was noted earlier, regulators left little room for savings institution innovation.

In the re-regulation debate, the savings institutions lobbied for expanded asset-side activities while their borrowers argued that the best regulatory change was an effective inflation policy. The savings institutions wanted to maintain their position in mortgage lending, but they also thought they could handle a move into what they called "family finance centers" (Greene/National League of Insured Savings Associations 1973). Effectively, this would have allowed them to make consumer loans, thereby shortening the overall maturity of their total assets, which would have made weathering the tight monetary policy periods easier. The borrowing side of the housing lobby, however, viewed such change as simply reducing the funds available to home buyers (Martin, National Association of Home Builders 1973). Whereas in past debates, the regulators, lenders, and borrowers had maintained a united front, in this set of debates, their interests and arguments failed to perfectly coincide. This imperfect coincidence of wants did not mean war between the lenders and borrowers; it simply signaled change in the economic foundation of this relationship and the unraveling of their united front.

Meyerson (1986) argues that the passage of the Garn-St Germain Act in 1982 is evidence that the solidarity of the housing lobby had broken down. She continues by indicating that it was actually the political power which this solidarity reflected that had shattered. This argument needs, however, to be taken one step further for full clarification. The political power of the lobby resided in the economic power of the housing industry; so it is actually the structural changes in housing industry that drained the lobby's strength.

The decimated housing sector of the 1930s had been rebuilt through the combined efforts of the housing industry, the savings institution trade associations, and the government. In the 1960s as the commercial banks' borrowers merged and went abroad, the savings institutions' borrowers were also experiencing changes that would ultimately alter the extent of their independence on the savings and loan associations.

The US economy's expansion in the 1950s spurred an especially strong growth in the home building industry that resulted in an increase in firm size and spawned a merger movement. By the end of the 1950s, this growth in demand had altered the nature of the industry, the large developer had gained dominance. Checkoway (1986) notes that an estimate in 1939 of the number

of large and medium builders stood at 480. Ten years later that number had risen to 3750. In terms of the number of houses built, "[l]arge builders also accounted for 5 percent of all houses built in 1938, 24 percent in 1949, and 64 percent in 1959" (Checkoway 1986: 122). Then in the 1960s developers began to merge. These mergers produced two major alterations: conglomeratization and vertical integration. Both of these changes affected the way in which housing was financed. Formerly, the small contractor had been dependent on local finance for his/her construction and development (C&D) loans. Now, giants in industry and finance were using national capital markets to float bonds that financed C&D loans (Schlesinger and Erlich 1986).

Not only were C&D loans replaced, but mortgage lending which had been the purview of the savings institutions was also being replaced. As a part of the new industrial form, mortgage services were offered by these full-service developers to provide the customer with "one-stop shopping." Just as the large developer issued bonds for construction loans, s/he also used those bonds to generate mortgage finance. With the development of the secondary mortgage market in the early 1970s, these firms would also "refinance" their credit supply by bundling their originated mortgages into mortgage-backed bonds, selling them off, and replenishing their pool of loanable funds with the proceeds (ibid.:146-51). The growth in builders' size and market structure meant access to a new source of capital and less reliance on the old source - the savings institutions.

In addition to the mortgage broker association with a builder, the independent mortgage banker also entered the financial sector in a big way in the 1970s. The emergence of the secondary mortgage market with the governmental aid of the Federal Home Mortgage Association (FNMA), General Home Mortgage Association (GNMA), and Federal Home Loan Mortgage Corporation (FHLMC) meant that stand-alone mortgage bankers could sell bonds to finance their credit supply, bundle their originated mortgages, sell them, and use the proceeds to resupply their pool of funds. The impact of these mortgage bankers on the mortgage market was fast and big. In 1970 they supplied 2 percent of the market; by 1982 they were responsible for 17 percent of the loans extended.

In 1973 at the start of the debates on financial restructuring, both sides of the housing lobby had seen these changes emerging. The realtor and home builder acknowledged the changes and their roles in them, but they also reaffirmed that access to stable sources of capital was imperative for their industry. Bonds may be the wave of the future, but "more is always better," and a stable "more" is the best. Maintaining the savings institutions as a dedicated

to have a robust system of finance on which to draw. The savings institutions, on the other hand, realized that competition in their niche had arrived. There was no way for them to go back in history to a time when they alone provided finance for home buyers. Their future lay in diversification around the type of lending in which they had been engaged for the past 30 years. So the savings institutions settled on the "family finance center" as their new credit market niche. These innovations in finance and construction signaled to the savings institutions and home building industry that their futures were no longer on the exact same path. In the early 1970s the path had not yet forked, but the lobby could see what was on the horizon.

The housing lobby forged by the two halves of the housing sector had been powerfully successful in shaping the structure and rules of operation of the US financial sector for almost 30 years. In the 1970s when both political and economic changes loomed, even the political power of the commercial banks was insufficient to immediately force a change in the structure of the entire financial sector without the agreement of the housing lobby. The lobby was unwilling to make a complete break with their partners because they knew that many of their interests still overlapped. It took almost ten years, numerous recessions, more periods of disintermediation, and the almost complete failure of the savings institutions before the lobby embraced financial re-regulation.

1.5 CONCLUSION

The US financial market deregulation of 1980 and 1982 actually began much earlier. At the heart of this transformation was the breakdown of the social, economic, political, domestic, and international forces which had forged the social contract that came out of the New Deal. The disintegration of the bonds connecting labor and industrial and financial capital was seen in wildcat strikes, accelerating inflation, and the numerous financial crises that struck in the 1960s and 1970s. Fundamental to the success of the Golden Age of capitalism was the New Deal's regulated financial structure. This structure was necessary, but not sufficient, to produce the capital-labor accord that characterized much of the post-World War II US economy. With its dependence on these cooperative, highly structured relationships, this planned capitalism could not be expected to survive once the behavior of the underlying actors changed. And, indeed, it did not.

When the structure began to collapse, the Nixon administration acted as the Roosevelt administration had: it called the leaders of capital and labor together to strategize about the future. This time, even though wage and price

finance decided that "free" markets were the best way to make economic decisions.⁹ These views on the structure of the financial sector represented the desires of the commercial banks and their borrowers, but not the needs of the housing industry and the savings institutions. The economic and political power as reflected in the savers and borrowers of the different types of depositary institutions had shifted. The supporters of the commercial banks dominated, so they were calling the next tune. Even with their stronger economic and political position, it took almost a decade for the implementation of the new financial order.

The 1980s' deregulation shattered the bonds that had confined the financial sector's activities to those that met the needs of industry. The current regulation has fostered finance's transformation from being an input into the production process to being an independent industry that innovates and sells its own products. Finance no longer functions to serve only the needs of industrial capital. This transformation heralds the passing of the "Golden Age" and the arrival of the "Global Age."

NOTES

1. Wolfson (1994a) presents a macroeconomic view of the forces at work in the "Golden Age" and Meyerson (1986) looks at this restructuring from the perspective of welfare state changes.
2. The Hunt Commission report is the informal name for *The Report of the President's Commission on Financial Structure and Regulation*. The FINE study is the informal name for the study on the *Financial Institutions and the Nation's Economy*.
3. Only in 1966 did the interest rate ceilings limits in Regulation Q get extended to savings institutions.
4. In the neoclassical "capture theory" of regulation, regulators attempt to grow and gain in prestige and power by expanding control over the number of firms regulated or the types of activities they regulate (Kaane 1987).
5. Depending on whether it was a state or federal charter, a savings and loan had to hold over 70 percent of its total assets as mortgages in order to qualify for the bad loan tax credit. The savings banks had a different set of rules for their operation, but they too held mortgages as the majority of their assets and eventually were granted access to the FHLBB system.
6. At the state level, there were often usury laws that limited the amounts that could be charged for a mortgage loan. Given the preponderance of these usury laws, the interest rate ceilings on VA and FHA loans, the long-term nature of the mortgage, and the absence of secondary markets, the mortgage market was not freely flexible. Rates were sticky.
7. The Hunt report recommends one unified regulatory system for both state and federal institutions, while the FINE study suggests having two, one for each set of institutions.
8. In 1978 money market certificates of deposit (MMCD) were authorized for national use. Initially, they were successful in fighting disintermediation and allowing more loan originations, but they quickly metamorphosed into another problem: increased costs of operation (FDIC 1997: 214-21).
9. Lane Kirkland, who was a member of the Hunt Commission and head of the AFL-CIO.

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