

10. The national origin of financial liberalization: the case of the United States

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INTRODUCTION: WHY EXCHANGE FINANCIAL STABILITY FOR INSTABILITY?

The post-World War II United States through the end of the 1960s was characterized by an economy on a relatively stable, non-inflationary growth path which was not disrupted by a financial event until close to the end of the 1960s. This economy has been characterized as having well-organized oligopolized markets and functionally regulated financial institutions and markets fine-tuned to industries' financial needs. After 1966, this set of relationships started to change. Non-financial industrial profits peaked, and then the financial sector experienced the first of many credit crunches that would follow. It was the ending of an era – the Golden Age.

The Golden Age has now been succeeded by the Global Age. Unlike its predecessor, the Global Age has been characterized by an erratic economic growth path, increased financial fragility and bankruptcy, periods of high inflation rates, and increasingly volatile activity in asset markets. Even the periods of strong growth have been marred by an increased disparity in the income distribution which has led to growth in poverty levels. It has been a period in which a greater reliance on markets was supposed to have brought increased efficiency along with stable growth, but the results, so far, have been quite mixed.

The signature relationship of the Golden Age – a functionally regulated financial sector organized to meet industry's financial needs – gets turned on its head in the Global Age. Financial institutions and markets that were tuned to non-financial needs still met them, but the new 'exotic' assets introduced an independence to financial sector activity which had not been seen since before the New Deal. The institutional changes that produced this new economic hierarchy and the economic outcomes associated with it were fostered

in the United States. Now finance, not industry, calls the economic tune, but the tune is off-key. Given that increased market reliance was supposed to deliver increased efficiency and stability, but has delivered at best unevenly distributed gains and losses and only an increase in private efficiency, the question that must be answered is 'Who championed financial deregulation and why?'

This period of US history has received much well-deserved attention (Smithin, 1996; Wray, 1998; Wolfson, 1994; Marglin and Schor, 1991; Bowles et al., 1984, and Armstrong et al., 1991). Most analysts, however, have tended to focus on one side or the other of a falsely bifurcated economy: the financial sector vs. the production sector.¹ This chapter, however, examines the process of change as one that evolves out of both the productive and financial sectors.

The rationale for analysing the United States' financial liberalization rests on its role as the model for the rest of the world. This model has been presented as universal and correct for all countries. Yet, as this chapter will show, it is a model that evolved out of very particular historical and institutional structures. US financial deregulation occurred at a particular historical moment in response to particular sectoral demands.

Ahn (2002) argues that in Korea's financial deregulation there were sectors that provided internal support for the International Monetary Fund's (IMF) externally mandated move to deregulate its financial sector. But not all countries that seek help from global institutions like the IMF want to restructure their economies. Currently, however, they must, if they expect to receive aid (Mehmet, 1999).

Since this chapter focuses on the process that produced the US financial deregulation, it is the period that predates the actual legislation that is of interest. In detailing the changing structure of the post-World War II economy which includes the changes in the hierarchy of economic relationships, the dynamic alteration in the relationships between financial institutions and markets, the government, the industrial sector, and the citizen can be seen and separated so that the supporters and detractors of deregulation emerge.

The process of US deregulation continued for 20 more years after the initial liberalizing legislation in 1980. In 1999, with the passage of the Financial Modernization Act, which repealed the 1933 Glass-Steagall Act, the last of the major structures created by the New Deal in response to the Great Depression was toppled. The continuation of the liberalization process is equally as interesting as it stretches through time as it was at its inception. There is, however, only space to detail the beginning of the process in this chapter.

The structure of the chapter will be as follows: in Section 1 the analytical frameworks that inform this investigation are each introduced and their inter-

post-World War II US economy, 1950–70. It focuses on the important financial and industrial relations and structures that were responsible for this long period of strong growth and financial stability. Then, the third section details the sectoral problems that emerged after 1966 to plague the financial and industrial structure and were responsible for initiating structural change. Finally, the concluding section lays out the political and economic forces responsible for initiating the process of financial liberalization.

1. ANALYTICAL APPROACH

This chapter draws on two theoretical approaches that usually are not linked, yet both develop cyclical views of the market economy. The first, Hyman Minsky's Financial Instability Hypothesis (FIH) (1982a and 1982b), presents a view of a developed market economy that is subject to short-term cyclical economic activity and an internally generated transition from financial stability to instability. Effectively, it looks at the operation of the economy from an almost purely financial position. The second, Samuel Bowles, David Gordon, and Thomas Weisskopf's Social Structure of Accumulation (SSA) (1984) offers a vision of a developed market economy that is subject to long waves of economic activity that are motivated by the changing class relationships between industrial capital and labor. This approach, effectively, assumes that finance is always available and neutral.

The accumulation structure, social contract, that Bowles et al. (1989) present for the postwar United States is comprised of 'four institutional relationships affecting the relative power of the capitalist class: the *capital-labor accord* ... *Pax Americana* ... *capital-citizen accord* ... and the *moderation of inter-capitalist rivalry*' (italics in original) (p. 114). Each of these relationships represents an institutional structure that was a determinant in the evolution of postwar US economy.²

- The capital-labor accord gave management control over the production process in exchange for assuring labor that its real wages would be tied to productivity growth which would continue to grow. This part of the social contract grew out of a period that had seen increasing discord. The capital-labor accord set the ground rules for the disputes between firms and unions and for the settlement of these disputes.
- The Pax Americana indicated the entire set of international agreements that had been forged at the end of World War II. These institutional

the fixed relationship to gold, and a set of fixed exchange rates were instituted.

- The capital-citizen accord legitimated the capitalist's right to accumulate profits while validating the right of citizens to having basic needs met, if necessary, by governmental programs.
- The final relationship, moderation of inter-capitalist rivalry, limited foreign capitals' competition with US businesses and maintained the oligopolistic division of the domestic market. This set of institutional relationships organized the interactions of production and exchange to produce a stable rate of accumulation.

All four of these institutional arrangements were important elements in the organizational structure that produced the 1950s and early 1960s US economy which was characterized by mild recessions, stable growth, low inflation, relatively high employment, and a rising real wage level. At this historical moment, the production sector depended upon the financial sector to provide it with funds and the financial sector responded. They were their clients. The regulation also operated to keep financial risk low and financial institutions insulated from highly speculative assets and deals.

In Minsky's FIH most of the focus is on the dynamic that produces the run up in debt which produces financial instability (1982b; 1986). Minsky's ideas on financial instability emerge out of his vision of the cyclical nature of the market-based economy. In his view the expansion phase of the cycle takes place after the last bout of instability has washed out the debt overhang from the previous expansion. While not exactly starting with a clean slate, the firms and households have reduced their expansion-induced heavy indebtedness to a level that fosters their productive activity. The economy is then ready to restart the process of productive lending. Lending is necessary at the start of an expansion because expectations for the growth of the economy are high, but the funds necessary for making the investment expenditures that will fuel the economy's growth are low.

So, in the beginning, firms have newly emerged from an economic downturn, and they need to borrow money to finance their investments. If the investments are successful, then the debt is reduced as the expansion proceeds. If the expansion is an extended one, then firms, convinced of its ongoing nature, continue to invest using debt finance. Then, instead of a decline in debt as the expansion continues, the firms experience a run-up in debt and rise in their debt service commitments.

Assuming that the expansion continues and the firms' level of confidence in the continuation of the expansion remains high, debt levels will continue to rise. As long as the firms can finance their current and future debt service

firm is considered conservatively financed – hedge financed – and no additional risk accrues to the economy.³ Once the firms turn to less conservative forms of finance – speculative and Ponzi – then, the financial structure of the economy becomes vulnerable to unrealized expectations and market disruptions.⁴

The economic impact from this increased financial instability will depend upon the preponderance of the differently financed firms, their integration with other parts of the economy, and the government's policies. If the government decides that a bailout is necessary, then the immediate economic impact may be minimized, but the financial activity of the firms is legitimated. In the future it will be emulated by other firms which may induce even greater financial instability. If the government is unable to act or decides not to act, then the financial instability turns into an economic downturn as firms shed their debt and productive activities (Minsky, 1982b).

Minsky's description of the period of hedge finance corresponds to a description of the 1950s and early 1960s US economy. It had weathered the Great Depression and World War II so it was financially ready to begin the privately-led accumulation process again. In the 1970s and 1980s, the US financial experiences reflected a more heavily-leveraged economy – one that is financially unstable.

It may first appear that the SSA and the FIH are mutually exclusive, but they are not. Each approach assumes that the other aspects of the economy exist, so by linking the two approaches a more comprehensive analysis of the market economy is produced.⁵ Also, each approach depends upon historical context as the frame for its analysis. In the SSA historical context allows the various sets of capital, labor, citizen relationships to vary through time. The path of economic change then, depends upon the interaction of the current institutional structures with the prevailing capital–labor–citizen relations. Minsky's FIH uses historical context to allow financial institutions and firms to alter their financing activities in the different phases of the accumulation process. At any particular historical moment firms and financial institutions have attained a level of financial stability that is reflective of their analysis of borrowers' and lenders' risk and the current phase of the business cycle. As the expansion phase of the business cycle extends, risk assessments are reduced and the level of financial instability is increased. How quickly the economy moves to a financially unstable position depends upon the economic growth rate and the economy's institutional structure. Therefore, by linking these two approaches through their dependence on historical context and cyclical economic activity, the pivotal role played by institutional structure in each analysis also emerges.

In both of these analyses the evolutionary nature resulting from changes

unpacking this evolutionary process in the next section, we can understand how the US economy progressed from its position of economic strength and stability to one characterized by financial instability and economic volatility. Additionally, we will explore how the institutional structures, in particular the hierarchical relationship between the financial sector and the production sector, were responsible for shaping the accumulation process that characterized the Golden Age, and when that relationship was changed how it produced the Global Age.

2. THE US POST-WORLD WAR II ECONOMY

The United States experienced some mild recessions in the years right after World War II ended, but overall the period from 1945 to 1973 is called the Golden Age because of its effectively high and stable rates of growth. The annual growth rate averaged 4.3 per cent while the rate of investment averaged 4.7 per cent. These growth rates were accompanied by an average unemployment rate of 4.3 per cent and an annual inflation rate of about 2.0 per cent. The process of converting from a war- to 'peace' time economy did not produce the expected postwar recession. The transition was smoothed by wartime savings that financed 'pent-up' consumer demand, by the governmental expenditures on the Korean War, which perpetuated the war economy, and by Europe's Marshall Plan-financed expenditures.

Using only the SSA arguments, the continuation of the high and stable growth rates, which characterized the Golden Age, resulted from the institutional arrangements between capitals, labor, the citizen, and the state. The major manufacturing sectors were provided with a set of contracted international relationships, that is fixed exchange rates, that stabilized trade and a set of agreements with organized labor that produced a manageable labor force, a procedure to 'set' wages and, therefore, the distribution of income. Additionally, the state committed to new foreign and domestic roles. It assumed responsibility for maintaining a level of aggregate demand sufficient to avoid anything but mild business cycles, a military presence that would sustain the *Pax Americana*, and a set of domestic policies that advocated for the poor and promoted a readjustment to the skewed US income distribution.

These institutional arrangements were important in coordinating the activities of industrial capital, labor, and the state in this period. As has already been noted, this traditional SSA representation of the production sector glosses over the important institutional arrangements in the financial sector. The financial sector did have a lower profile than the production sector during this period, but it was no less important. The regulated financial structure, which

and gave industry control of the leash. This hierarchical relationship was tolerated by the commercial banks because they bore a large share of the blame for the depth and duration of the Great Depression. To keep this type of economic devastation from ever happening again, the financial sector was made a subordinate partner to production. Laws enacted in the 1930s segmented the money and capital markets and linked specific financial institutions, especially depository institutions, to particular industrial clients and market segments. It was the subordinated nature of this relationship – in SSA language, the moderation of inter-capitalist rivalry – that was responsible for the stability of the financial sector which characterized the US economy between 1945 and 1970. Widespread financial fragility did not emerge until the 1980s because of the particular nature of these institutional relationships.

The process that sets the economy up for its financial crisis takes time to develop.⁶ Minsky (1986) has indicated that the United States in the 1950s still lived with the financial imprint and fear of the Great Depression. Banks had large holdings of US Treasury securities, consumers were relatively free of debt, and so were firms. Debt use was conservative and levels remained low until into the 1960s when the first postwar credit crunch occurred. As Minsky notes, 'During the 1950s and early 1960s – a period of mainly tranquil expansion – a cumulative change in the financial structure took place that undermined the conditions that had made the tranquil expansion possible' (1986, p. 286). To understand the nature of this tranquil expansion and how, as well as why, it was short-lived, the relationship between the financial and production sectors need to be analysed.

The Financial Sector's Regulation

The Great Depression financial legislation passed by Congress aimed at reintroducing confidence in the depository system so that it could concentrate on fulfilling its goal: financing economic growth. An integral part of confidence-building in the sector was functional as well as prudential regulation. First, functional regulation took the form of segmented markets that distributed funds to depository institutions and also formed a conduit by which credit was allocated to various industries. Price competition for deposit funds between like depository institutions was dampened through the use of deposit rate ceilings. These price ceilings also acted to keep borrowers' rates low. Finally, 'firewalls' between depository and non-depository institutions were installed to separate the highly speculative activity of non-depository institutions from the credit apparatus that was fundamental to the growth of the economy (Dymski, 1990). Functional regulation, more than prudential regulation, sculpted the industrial shape of the financial sector. The creation of the

financial sector into regulated markets that made credit decisions based on an understanding that the success of their borrowers, the industrial sector and home buyers, was fundamental to the success of the lenders, the commercial banks and savings and loan associations.

The functional financial structure also addressed the fear of financial collapse and contagion that was fostered by the Great Depression. The segmentation of deposits and loans by type of institution isolated a problem originating one type of institution from being communicated to another. Neither the liability nor the asset side of each type of depository institution had much overlap with any another type of depository institution, so a crisis in one institution or asset was not easily communicated to any of the other institutions.

The result of this functional structure was a segmented financial market in which lenders were constrained to work with particular borrowers in a symbiotic relationship. The borrowers were not mandated to obtain loans from the depository institutions. Their other possibilities included internal finance or trade credit. Lenders, on the other hand, had nowhere else to turn for their assets. They operated within prescribed credit markets; their borrowers were, in effect, legislated. So while both borrowers and lenders were linked together, the lender was even more dependent upon the borrower than the reverse. This set of relationships continued to be a mutually beneficial symbiotic structure as long as each side remained mutually dependent.

The prudential regulation enacted because of the Great Depression included depositors' insurance and an enhanced interventionary role for the Federal Reserve. The insurance limited depositors' risk. All depository institutions regardless of their charter status had to be insured. Not all depository institutions, however, could be or were members of the Federal Reserve, but all of them did have some Fed-like regulator and insurer. The regulator was responsible for implementing and maintaining a regular examination schedule of its institutions to assure the proper operation of the depository institutions and to guard against fraudulent activities. The final line of defense was assigning the Federal Reserve to be the lender-of-last-resort.

Results from the Financial and Nonfinancial Interaction

The successful growth of the US economy was already detailed at the beginning of this section. Now we turn to an analysis of the finance–production relationship to determine its success. For this we turn to the standard indicator, profits. But, first, we need to look at the generator of those profits in the financial sector, loans.

After the end of World War II, banks moved quickly into commercial and

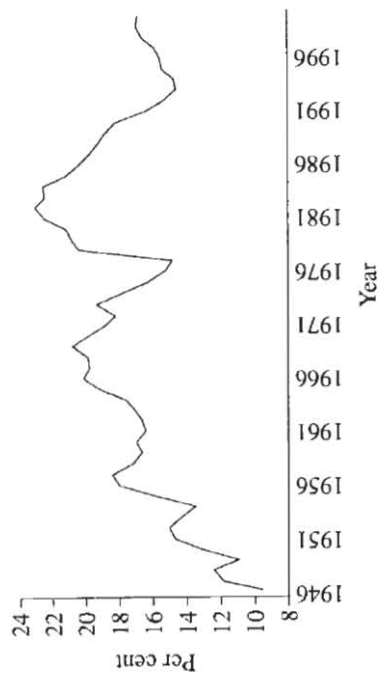


Figure 10.1 Commercial banks: commercial and industrial loans

our period of investigation, these loans as a proportion of assets peaked in 1968. They rose from a low of 9 per cent in 1946 to the 1968 high of almost 21 per cent. Additionally, the importance of C&I loans is seen by comparing asset growth rates. The average annual growth rate of C&I loans in the 1950s was 9.5 per cent while banks' total assets grew at less than half that rate, 4.2 per cent. In the 1960s C&I loans were still very important to banks, but the gap between the growth rates was no longer as wide. By the end of the 1960s, C&I loans were no longer the engine of growth that they had once been. This slowdown will be especially important in later years, but as the data indicate, C&I loans were at the core of bank activity throughout the 1950s and 1960s.

Bank profit rates (Figure 10.2) were quite volatile in the 1950s.⁸ They reached their peak in 1958 and then, starting in 1960, experienced less volatile, but still cyclical movement throughout the rest of the period of investigation. While their global peak was in 1958, the peak that signaled the end of their positive secular trend was in 1970. The cyclical activity in the 1950s is very similar to that seen in C&I lending. This connection is not surprising given the banks' assets strong dependence on loans. Once the banks entered the 1960s, however, the financial innovations that became a part of their everyday operations helped to smooth out profits' volatility. Regardless of whether the cyclical activity was volatile or not, the functional and prudential regulation appeared to have been successful at reducing bank failures. In the 1950s, the average number of failed banks per year was three

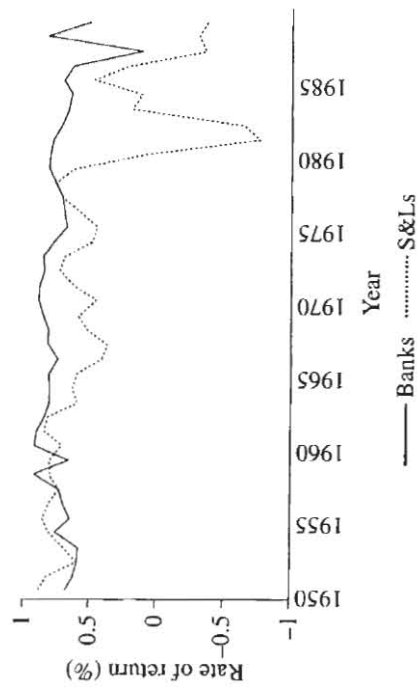
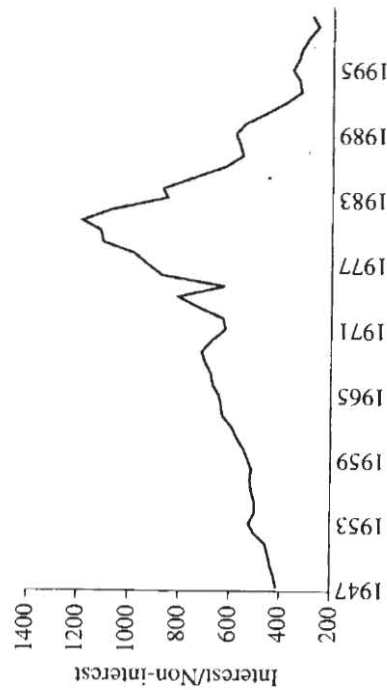


Figure 10.2 Depository institutions: rate of return on assets

Just as C&I lending became an important bank asset, it would be expected that interest income would play a dominant role in the banks' income statement. Figure 10.3 presents the results of a comparison of interest income to non-interest income.⁹ Until 1981, the year in between the first and second rounds of deregulating legislation, interest income grew compared to non-interest income. The break in this secular growth trend comes in 1968, like the C&I loans' break. The profits data indicate that the bank had some other assets that helped to offset the decline in C&I lending, but the interest income



data verifies that most of the banks' interest income came from their C&I loans. The patterns of the two series are almost identical in terms of their peaks and troughs.

The importance of C&I loans in banks' portfolios and for profits indicates that the health of business was important to banks. Figures 10.4 and 10.5 show businesses' profit rates. In Figure 10.4 the profit rates for non-farm non-financial corporate business – large firms – show a strong positive trend punctuated by highly volatile cyclical activity from the 1950s into the 1960s.¹⁰

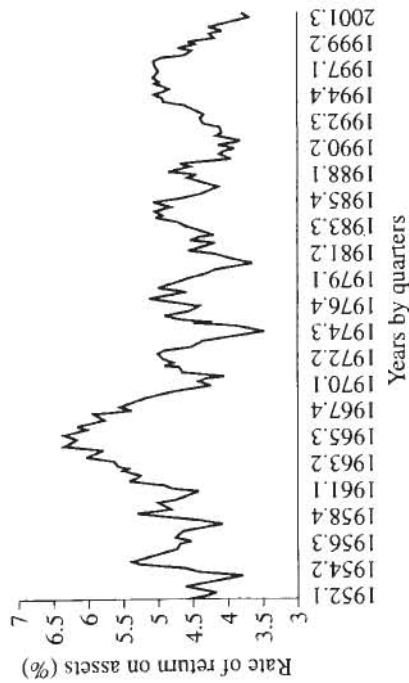
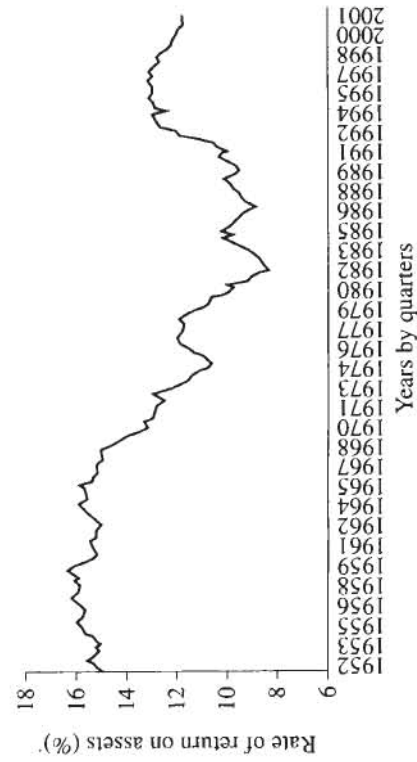


Figure 10.4 Non-farm, non-financial, corporate business



The profit rate turned down in 1966 just as the SSA proponents indicated it would.¹¹ The banks' profit rate peaked a little later and did not experience the same sharp decline and strong volatility of the firms. Figure 10.5 shows that the non-farm non-financial non-corporate business sector – small and medium-sized firms – experienced less dramatic cyclical activity than the corporate sector, and it had a different trend.¹² The non-corporate sector's profit rates rose gradually throughout the 1950s achieving their global peak in 1959. After this peak, the small- and medium-sized firms, like the large corporate firms, reached a peak in 1966 that signaled the beginning of a secular decline which lasted until 1976.

Both sub-sectors of business were important to the commercial banks. The non-corporate firms were the bread and butter of the commercial banks. Small firms, usually because of their size, were unable to secure finance through the capital markets, so their borrowing was confined to trade and bank credit. The large firms used the equity markets for their long-term finance, but commercial banks were an important source of short-term funds through the 1960s. This profit picture of the business sector is of obvious importance to the banks. These firms are their business. If they enter a period of decline, or if they find other sources of finance, then the ramifications are obvious for the lenders.

The picture presented by this data when linked to the regulated financial sector indicates the important connection that existed between business and commercial banks. Funds flowed from savers to depository institutions and then to borrowers. The stability of this flow was due in large part to the set of functional and prudential regulations that shaped the financial institutions in this period. The 1950s United States experienced cyclical economic activity, but the overall experience was one of strong stable financial institutions. When there was a spike in inflation or an increase in credit demand during a business cycle expansion, the financial institutions never experienced duress. The structures of financial institutions and of the organization and institutions of production were well suited to interact with each other. The financial sector promoted the flow of finance and the social structure of production turned it into economic growth.

3. THE SPLINTERING OF THE STRUCTURES

While the 1960s opened with a recession, its defining economic experience was its long expansion. The US economic expansion that began in 1961 did not peak until 1969. Even as this expansion was underway, producing in-

ration brought the question of its interaction with the financial sector to the foreground. Would a changed SSA change the banking system? Could they still work together to produce strong economic growth? Along with the SSA's problems came troubles for the financial sector. The extended growth of the 1960s produced a situation where credit demand outstripped supply. These sectoral tensions formed the economic foundation of the argument to implement financial deregulation. The last section will argue, however, that the decision to deregulate arose from political, as well as economic, pressures.

The Dissolving SSA

Bowles et al. (1984, 1989) have argued that the four pieces of the SSA came under pressure by the end of the 1960s. The Pax Americana, which they exemplify with terms of trade figures, had turned against the United States. Instead of the ratio of the import deflator to the export deflator remaining less than one, the figure it had been throughout the 1950s, it rose to over one in the early 1960s (1984, p. 83). Along with the decline in the terms of trade other important factors, like the Bretton Woods institutions and arrangements, that underpinned the strength of the US dollar were disintegrating. Additionally, the Viet Nam war was eating away at the government's budget and the nation's conscience.

The capital-labor accord had been constructed at a point in time when unions reflected a power structure that admitted primarily white men into their halls. The overlooked groups were now raising their arms and knocking to either get in and get even. Additionally, the power of the corporation over the workforce was in decline. The unemployment rate by the end of the 1960s hovered just above 3 per cent, and it had been in decline throughout the expansion. The fear of job loss was on the wane (1984, 90-91). The capital-citizen accord came under pressure to address the civil rights of groups of Americans that previously had been dismissed. Additionally, the poor and their advocates pushed for a redistribution of the national income via governmental programs since even the 'fully employed' economy failed to eradicate poverty. Along with wanting more butter, some groups in the United States wanted more guns. The Viet Nam war produced an increase in the government's expenditures but, given its unpopularity, it had to be deficit financed. The government's deficit finance in hand with the strong expansion's demand for debt finance fueled domestic inflation and increased interest rates.

Finally, the inter-capitalist rivalry that had been moderated through functional regulation in the financial sector and the United States' commanding role in international trade began to heat up. Changes in the operations of

demand resulted in dysfunctional regulation. The dominant role of US producers for the domestic market was contested as the countries that had been decimated after World War II became economically viable competitors. The solidity of the SSA by the end of the 1960s could be compared to a tightly knit fabric in which the threads had started to unravel.

The Financial Sector

The credit demands of the 1950s had been met without strain for most of the decade. Regardless of the sufficiency of the credit supply in this period, banks, corporations, and securities dealers quietly angled for innovations that would circumvent aspects of their regulation (Dymski, 1990). Securities dealers developed the repurchase agreement (RPs) market and large banks soon became active participants. Corporations looking for a return on their transaction accounts moved out of demand deposits and through their banks into interest-bearing RPs. Also in search of cheaper short-term finance they moved into corporate paper (CP). Additionally, banks, both large and small, formed correspondent relationships. Large banks borrowed the surplus Fed funds that the smaller banks usually had on hand.

These innovations indicated the capacity of the financial institutions, even in their most heavily regulated phase, to finesse the rules. Since some of them were direct responses to tight money, they also showed how innovative banks could be when responding to the pressures that resulted from heavy credit demand. These innovations, however, were very limited in their impact when compared to the innovations that emerged in the 1960s, the era of 'liability management'.

The heavy credit demand of the 1961-69 expansion set the tone for what has been called the 'go-go banking' decade. During this expansion the economy grew on average at an annual rate of over 5 per cent. To maintain this pace of activity, firms increasingly relied on debt finance. The commercial banks, pushed by this demand to create more credit, were unable to attract more deposits through price incentives, so they innovated. Concurrently, banks' borrowers were seeking other lenders and cheaper ways to finance their expenditures. Banks' responses to excess demand, possible loss of borrowers and, by the end of the decade, the Fed's tight monetary policy were based on these immediate problems, but also on a longer view that saw fundamental changes in their markets. A new dynamic was underway in which the banks' response to these changes drove its innovative activities.

Innovations: Products and Processes

The first set of banks

deposit rates and required reserves – the banks could not simply raise the interest rate that they would pay on deposits. The development of negotiable certificate of deposits (CDs), the Eurodollar market, and bank holding company commercial paper (CP) were the most important deposit innovations of the period. Unlike their 1950s innovations, CDs, which were created in 1961, were a deposit, so there was no limitation on their size. Also, unlike their regulated deposits, CDs' interest rates were allowed to be competitive (Dymski, 1990; Wolfson, 1994b). This competitiveness meant that Regulation Q could no longer guarantee the competitive advantage that had been established for the savings and loan associations. Now, the commercial banks could compete against the S&Ls for savers' deposits. They could also attract funds that might have gone to non-depository institutions. The lifting of this guarantee also meant that segmented markets which had damped the depository institutions' intra-market competition were bridged.

Along with CDs came the Eurodollar market. The interbank lending market in the United States was constrained by the level of excess reserves in the system, so by repatriating foreign dollar-deposits, Eurodollars, as liabilities, the US banking system was able to expand its supply of credit.¹³

In 1969 another important 'new' source of banks funds emerged, bank holding company-issued CP. The 1956 Bank Holding Company Act had limited multi-bank holding companies' activities, but not one-bank holding companies'. In 1969 when a 10 per cent required reserve was applied to Eurodollar liabilities, the one-bank holding companies moved to supplant those lost reserves with CP. The holding company did this by issuing CP and then using the funds to purchase a loan portfolio from its affiliated bank. Banks received an infusion of new reserves in exchange for their loans (Dymski, 1990, p. 11).

The second set of changes in this period affected the banks' designated borrowers. Large corporations with access to capital markets were increasingly issuing their own short-term debt to finance working capital (Federal Reserve, 1969). Given the excess demand for credit, the spread between the interest rate on CP and the prime rate had grown.¹⁴ The cost advantage that CP offered was not surprisingly attractive to the corporations. The impact of this change on the commercial banks during the late 1960s when credit demand was high was minimal. The banks, however, understood that the industrial sector – their legislated market – was finding and using other lenders. This change, unlike the previous ones, was not orchestrated by the commercial banks, and it meant a reduction in the demand for credit from them. Given their regulated status, which meant their prescribed borrowers, the banks understood the potential impact of this move on their market.

bank to another bank. Rather than lending directly to an industrial borrower who would purchase working capital, this was a loan that was internal to the set of depository institutions. It was a finance to finance relationship that added another layer of debt – increased leverage – to the credit creation process. Eurodollars increased the efficiency of the now internationalizing financial system, for unused reserves were recycled. In addition to this efficiency, however, more risk was also added to the financial system. Now, two layers – the deposit and the Eurodollar loan – rather than one, formed the foundation for the retail loan. This innovation in banking activity was pushing at the edge of the New Deal regulations.

The change in the financial market conditions produced by the lengthy expansion which consumed most of the 1960s and by the pesky inflation which had emerged at the end of the 1960s pushed bankers to innovate. The success of these innovations meant that they continued to make loans and the loans were profitable as indicated in Figure 10.2. The overall effect of these innovations was an introduction of price competition for deposits among commercial banks, an increase in the level of risk in the depository system, and a reshaping of the customer base for bank activities. These changes put the banks on a path leading away from the ethos of the New Deal functional regulation.

International Banking

As some of the innovations detailed in the previous section indicate, international financial markets and banks were a source of new banking ideas for the operation of US banks. In the 1950s a few large banks followed their multinational borrowers abroad so that they could continue to meet the needs of these clients. In 1950, the seven U.S. banks operating abroad had 95 foreign branches. By 1965, 13 U.S. banks had 211 branches overseas with nearly \$9 billion in assets, up from \$3.5 billion five years earlier' (Moffitt, 1983, p. 44). Overseas, the operation of commercial banks stood in strong contrast to the prescribed activities of US banks at home. They had no reserve requirements, no Regulation Q, no deposit insurance premiums, and a broader array of financial activities from which to choose – investment banking being most prominent. US banks moved into this new structure eagerly and found that it enhanced their bottom line. Given these positive foreign experiences, this private cost-reducing and asset expanding financial structure figured largely in the industrial and regulatory changes that large commercial banks promoted in the 1970s.

The banks moved gradually at first, and then in droves to Europe. Along with evading the 1963 interest equalization tax, US banks operating abroad

banks could directly purchase shares in foreign banks (D' Arista, 1976, p. 868). US banks now had a choice: move abroad and participate in this broader market or stay home and just purchase shares. Either way, the new risks came with it.¹⁵

Another aspect of international banking was the opening of numerous 'shell' banks in the Caribbean. Unlike the London branches, these were banks in name only. They were created for an address which would allow US banks the same circumvention of regulations as a London branch would, but at far less cost. Loans were booked out of these offices, but their real use was for the Eurocurrency market and foreign exchange trades. With the fixed exchange rate system of Bretton Woods, banks rarely lost on currency speculation (D' Arista, 1976, p. 924). After the introduction of flexible exchange rates in 1973, the commercial banks' insulation from loss was no longer guaranteed.¹⁶

Just as commercial banks' engagement in the foreign exchange market increased the risk in the financial sector, it also signaled a change in the banks' relationship to its traditional activities. Unlike a loan, which generates income from the interest rate charged, foreign exchange trades generate income from the fees charged on each transaction and from any gains made by capital appreciation. This was not an activity that fostered economic growth by connecting lenders and borrowers. Instead, it downplayed the banks' role as a depository institution and as an intermediary between savers and borrowers. It developed a new role for the bank, intermediary between buyers and sellers of financial assets – foreign currencies. Given the transformations that the commercial banks would undergo in the future, this change was prescient.

4. THE PUSH FOR CHANGE

The commercial banks weathered the 1960s in fine shape. The same cannot be said for the savings and loan associations. The S&Ls depended upon savings accounts for their funds and the tight monetary policy of the Fed in 1966 and 1969 wrecked havoc with their rates of return. As Figure 10.2 shows, the S&Ls throughout the 1950s had achieved returns that were usually equal to or greater than the commercial banks', but this relationship changed in the 1960s. From then on, the S&Ls were plagued by inflation, disintermediation, increasing competition from the banks, usury laws, and changes in the structure of mortgage and housing markets which showed up as declining rates of return (Isenberg, 2000).

processes, and markets so the S&Ls' regulators continued to essentially promote the existing regulatory structure. The Federal Reserve, the major regulator of the large commercial banks, was pushed to grant greater innovative latitude, and they did (Epstein and Schor, 1991; Dickens, 1996; Isenberg, 2000). In addition to allowing the banks to be more innovative, the Federal Reserve was also more likely to fashion its monetary policies so that the banks would experience less of its negative effect.¹⁷

As the United States moved into the 1970s, facing persistent inflation, an unpopular war outside its borders, social dissent within its borders, and a collapsing international monetary framework which mirrored a rearrangement of international economic and political power, the first of two important bodies for analysing financial restructuring was being formed. In June 1970, President Richard Nixon announced the formation of his Commission on Financial Structure and Regulation (informally known as the Hunt Commission).

The ostensible reason for this commission was the 'saving' of the S&Ls; and they were experiencing financial trouble. The more likely reason for this commission was to begin the process of financial liberalization which the commercial banks strongly supported. The mandate of the commission and its composition would argue that the latter reason is more supportable.¹⁸ Unfortunately, he was right. The commission's mandate was to

focus primarily on problems relating to commercial banks, mutual savings banks, savings and loan associations, credit unions, private pension plans and reserve life insurance companies. For these institutions, the Commission elected to study in detail their functional specialization, the effects of deposit rate regulations, chartering and branching, problems of deposit insurance, reserves and taxation, the effects of regulations on mortgage markets and residential construction, competitive problems and the framework of the financial regulatory agencies. (Report of the President's Commission on Financial Structure and Regulation, 1971, p. 2)

After this report from the commission was issued and legislation based on its proposals was introduced to the Congress, the Congress initiated a study of its own. Its set of recommendations, the Financial Institutions and the Nation's Economy study (FINE study), was very similar to those in the Hunt Commission Report.

These government-sponsored studies laid the foundation for the financial liberalization program that was initiated in 1980. The changes proposed in the Hunt Report and the FINE study supported the creation of a financial sector in which participants would be subject to greater reliance on market-based competition rather than a functionally regulated market. The two reports

reserve requirements be eliminated, so that all depository institutions could compete against each other using both price and products. They further proposed that deposit rates should be market-determined which means flexible and able to distribute the savings flows among the competing institutions. The differentiated taxes that had subsidized the savings and loans and the credit unions should be harmonized with the other depository institutions. And, the array of depository institution specific regulators should be rationalized. Most important in this context was the desire to separate the Fed from its regulatory functions so that its sole responsibility was to make US monetary policy.

In 1973, still President Richard Nixon, submitted to the House of Representatives 'A Program for Reform of our Financial System'. This was the legislation that kicked off the drive for financial liberalization. Nixon opened his program by stating that

Our country depends on a strong, efficient and flexible financial system to promote sound economic growth, including the provision of adequate funds for housing. Such a system is one which allows financial institutions to adapt to the changing needs of borrowers and lenders, large and small, and is free to make full use of technological innovations. ... Events during the last decade, however, have revealed significant defects in the operations of our financial institutions. ... The inflexibility of our financial system can be directly attributed to the methods used by the Government to direct credit flows - methods designed to meet the depressed economic conditions of the 1930s but poorly suited to cope with the expansionary conditions of the past decade. (p. 1)

The opening sentence in President Nixon's message focuses on two goals of the financial system: (1) promoting sound economic growth and (2) providing an adequate level of finance for housing. At this point in time, the US economy was still experiencing a modest positive growth rate (though it was on the cusp of a major recession), but housing finance was experiencing numerous periods of negative growth. Disintermediation at S&Ls had become a common occurrence when market interest rates topped savings deposit rates. Equally as problematic were the reduced inflows of savings deposits that the S&Ls had been experiencing throughout the 1960s when bank-issued CD rates approached or surpassed savings deposit rates. On average, the total interest-bearing deposits of banks rose at the rate of 15 per cent between 1962 and 1965. This compares unfavorably to the rise in nonbank deposits - funds in S&Ls, and mutual savings banks - which reached 11.9 per cent in 1963, fell to 10.9 per cent in 1964, dropped to 8 per cent in 1965 and at the end of the third quarter in 1966 had fallen to 3.1

some regions the banks' rates exceeded the savings' rates in 1965 and 1966 (ibid.: p. 1745).

The savings and loan associations were being beaten up badly by the commercial banks who fostered the assumption that the proposed legislation was to support the S&Ls, the mainstay of housing finance. This assumption, however, was false. The S&Ls never supported any of the legislation that proposed a 'leveling of the playing field' approach to financial re-regulation (Camp, 1973; Scott; 1973; Isenberg, 2000). The S&Ls supported a re-regulation that would have maintained their special status - compartmentalized markets - but expanded the assets in which they could invest. Their idea was to construct a 'family finance' center in which consumer and housing loans were made available. By including consumer finance in their portfolio, they could enter the short end of the market thereby diversifying their holdings. Additionally, the FHLBB proposed mortgage pooling to provide a stabilized flow of long term funds to the S&Ls (Carlson, 1973).

The major supporter of financial liberalization was the large commercial banks (Adams, 1973; First National City Bank, 1972; Schott, 1972; Smith, 1973). They had already shown how successfully they could innovate when it was allowed, and they were chafing at the regulatory bit that continued to subjugate them to industry. Under the warm smile of the Fed, the large commercial banks had been given the freedom, unlike all other depository institutions, to innovate. As detailed in Section 2, during the 1960s the commercial banks altered their sources of funds, expanded their operations both geographically and through new products and services, and they reshaped the contours of their competitive terrain. The large commercial banks were able to prevail over the usually negative impact of inflation through innovation while the S&Ls were held to their traditional financial roles by their regulators and their powerful borrowers. The result was their demise. As Figure 10.2 shows a comparative analysis of rates of return puts the S&Ls in a very negative position.

These large corporations did not need the banks in the same way that the housing industry needed the S&Ls. It was the home builders and home buyers groups that supported the regulated market for S&Ls. The corporations had other choices, whereas the home builders and buyers in the 1960s and 1970s did not. And even when in the late 1970s changes in housing finance occurred - in both home buyer and construction loans - the housing industry wanted to hold on to all of the financial resources that it had (Beasley, 1973; Isenberg, 2000).

By 1974, the large commercial banks were trammeling the path for finan-

and 1975, their earnings from foreign activities made up an increasing amount of their total income: 1971, 22.7 per cent; 1972, 33.9 per cent; 1973, 41.5 per cent; 1974, 42.6 per cent; and 1975, 63 per cent. So, international activities were becoming increasingly important. Along with their international operations came the Eurodollar market, the development of the foreign exchange market, opaque lending arrangements – guarantees and lines of credit – and the new borrowers, real estate investment trusts. The banks saw their future and it had very little to do with traditional corporate lending and everything to do with making their own decisions about new products and additional risk. The banks and their regulators pushed for the new world of deregulation because they had already entered it. Financial liberalization would legitimate what they were already doing and make it easier to do.

CONCLUSION

The reasons behind the US decision to deregulate its financial sector were just as national as when during the New Deal it decided to regulate it. The passing of the Depository Institutions and De-regulation Act of 1980 and the Garn-St. Germain Act of 1982, which implemented many of the recommendations in the Hunt Report and FINE study, showed the superior political power of the commercial banks and their supporters. The recommendations made by the S&Ls and their supporters, which never made it into legislation, failed to win the necessary political backing. These different economic approaches to financial market structure masked the struggle for markets, market power, and commercial bank independence from the industrial sector. The end result of the move to a competitive market structure, ultimately, meant the death of the savings and loan industry and the move to market dominance as well as self-determination of the commercial banks. The decision to liberalize the financial markets which is usually seen in a global and ideological context as the decision to adopt a market decision-making process is, instead, shown here to be a contest between the two most important US depository institutions for the path for their future. The death of the savings and loans associations and the prosperous growth of the commercial banks would argue that competitive markets do not work equally well in all places, at all times, and for all institutions and services. They are highly specific, not general and universal as they are most often depicted.

NOTES

1. Wolfson (1994b), Crotty (1986), and Epstein and Schor (1991) stand out as mavericks from this group.
2. The description of the US postwar Social Structure of Accumulation used throughout this chapter is taken from Bowles et al. (1984, 1989).
3. Minsky defines gross capital income as total receipts from operations minus current labor and material costs (1982b, p. 24).
4. Minsky's taxonomy of financial leverage starts with the least heavily indebted, hedge, moves to the next most heavily indebted, speculative, and ends with the most heavily indebted, Ponzi. Each category is defined by its loan market exposure due to the need to refinance, the term to maturity matching of assets and liabilities, and the firm's current and future ability to pay its debt service in full as contracted. Speculative financing means that the debt service exceeds the either current or future gross capital income for a short time period and for this period, refinancing is available (Minsky, 1982b, p. 26). Ponzi financing means that the debt service exceeds the gross capital income for at least the near term and new borrowing is necessary to finance this short fall (*ibid.*, p. 28).
5. Crotty (1986) argues that both of these analyses can be linked by situating them in the overarching framework provided by Marx. Crotty wrote his article soon after the SSA theorists first presented their work, so he sees it as less developed than Minsky's mature work. Nonetheless, he sees both of them grappling with the fundamental contradictions of a capitalist system in a manner that can be linked through Marx's ideas on class relations and financial instability.
6. Crotty (1986) emphasizes both aspects of Minsky's FIH. The crisis phase in the hypothesis, the phase which receives the most attention, emerges after there has been a run-up in debt; financial innovation has extended the credit-creation process; and the firm's ability to pay back their debt is in question. There is no regularity in this process, so length of time in a phase is indeterminate.
The hedge finance period comes before the crisis and receives little attention in the FIH literature. This is a period in which a lot of debt has been cleared off firms' balance sheets because the financial crisis resulted in financial failures and bankruptcies. This cleansing has left the financial system in a position to take on new debt which it does with trepidation, initially.
7. The data for Figure 10.1 come from the Federal Deposit Insurance Corporation (FDIC). The data for Figure 10.2 come from the FDIC, <http://www2.fdic.gov/hsobRpt.asp>. They are taken from Table CB11, Loans and Leases.
8. The data for Figure 10.2 come from the FDIC, <http://www.fdic.gov/databank/quarterlybankingprofile/graphbook/annual/>.
9. The data for Figure 10.3 come from FDIC, <http://www2.fdic.gov/hsobRpt.asp>. They are taken from Table CB04.
10. The profit rates for non-farm non-financial corporate businesses were produced from the Federal Reserve's Flow of Funds data. To construct a figure that reflected domestic profit activity, foreign earnings retained abroad were subtracted from total internal funds plus IVA. That figure was divided by total assets and multiplied by 100.
11. Bowles et al. (1989) present a rate of capital accumulation and a two year lagged rate of profitability. The lag refers not to the profit rate construction, but to profits' relationship to investment (p. 109). The turning points in their figure are very close to points in Figure 10.4 even though they use after-tax profits in the construction of their profit rate.
12. The profit rates for non-farm non-financial non-corporate businesses were produced from the Federal Reserve's Flow of Funds data. Profit data was not available for this sector, so net income with IVA and CCA has been substituted. This difference accounts for the major difference in profit rate levels between this business sector, the non-corporates, and the corporate sector.
13. In 1969 when the Fed implemented a tight monetary policy to combat inflation, market

- their pool of total purchased fund, and therefore, their ability to supply credit was retained (Wolfson, 1994b, p. 179).
14. In 1959, the spread between prime and the six month CP rate was 0.51. In 1960, the gap increased to 0.97. On average, between 1955 and 1959, the spread was 0.742, while between 1960 and 1964, it was 0.846 (Council of Economic Advisors, 2001).
 15. Given the regulatory role of the Federal Reserve, it could be argued that the Fed would want US banks to stick to the activities and risk levels prescribed in the New Deal legislation. The Fed, however, took the stand that it did not "want to impose restrictions which would put the [US] branches at a disadvantage with banks in the host country ..." (D'Arista, 1976, p. 870).
 16. How much exposure did US banks have in this market? It was unknown. Congress had asked in 1973 that foreign exchange transactions be reported to the US Treasury. In 1976, they were still perfecting the form on which these transactions were to be recorded (D'Arista, 1976, p. 877).
 17. Dickens (1996) in discussing the Fed's monetary policy between 1970 and 1972 argues that the restrictive actions by the Fed in 1968 and 1969 – the implementation of reserve requirements and interest rate ceilings on CDs and Eurodollars – were 'compelled by Congress' (p. 119). In January 1970, the Fed, still pursuing its tight monetary policies, allowed the interest rate ceiling on CDs to rise. Democrats in the House of Representatives saw this as a partisan attack on the S&Ls. Resolutions and amendments flew, and the Fed, in order to sustain the liquidity of the banks in the face of the House's opposition to their action, eased monetary policy (p. 119).
 18. The members of the Hunt Commission came from the academy, the home building industry, the industrial sector, a union, and from a cross-section of the financial sector. The weighting of this representation is, however, interesting. There is one representative from home building, three from industry, two from the savings and loans, one from a savings bank, three from commercial banking, one from an investment bank, one from the unions, two from insurance, one from a finance company, two from the academy, and Alan Greenspan. The commercial banks and their industrial borrowers are more heavily represented than the savings and loans and the home builders. Lane Kirkland, representative from the A.F.L.C.I.O., refused to sign the Commission's report and wrote in his dissenting statement:

Besides avoiding the social priority area, it would appear that the net effect of the Commission recommendations would be to channel funds out of the housing market as well as to raise the cost of mortgage money – especially during a tight credit market.

The Commission recommendations that would eliminate interest rate ceilings on deposits, widen the functions of thrift institutions and allow interest rates on mortgages to escalate would have a harmful effect on the housing market.

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11. Saving is the accounting record of investment

Basil Moore

In real life, research is dependent on the human capacity for making predictions that are wrong, and on the even more human gift for bouncing back to try again. This is the way the work goes. The predictions, especially the really important ones that turn out, from time to time, to be correct, are pure guesses. Error is the mode. ... We all know this in our bones, whether engaged in science or in the ordinary business of life. (Lewis Thomas, 1983, p. 82)

The extent to which one sees one's destination before one discovers the route is the most obscure problem of all in the psychology of original work ... It is the destination which one sees first, [though] a good many of the destinations so seen turn out to be mirages. (John Maynard Keynes, quoted in Moggridge, 1992, p. 552)

The accounting identities equating aggregate expenditures to production and of both to incomes at market prices are inescapable, no matter which variety of Keynesian or classical economics you espouse. I tell students that respect for identities is the first piece of wisdom that distinguishes economists from others who expiate on economics. The second? ... Identities say nothing about causation. (James Tobin)

I. INTRODUCTION

Economists view saving and investment as if they were independent behavioral relationships. Business firms, the administrators of the economy's capital stock, are responsible for most investment spending. Households, the ultimate owners of the economy's net worth, undertake most of the economy's saving. Yet *ex post* saving and investment are identical as a national income identity. The key question becomes: what is the mechanism that brings these two largely independent magnitudes, undertaken by different economic groups, into equality? The dilemma conventionally has been resolved by distinguishing *ex ante* saving and investment, which in general are not identical, from *ex*

