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Is It Possible to Re-Privatize the U.S. Financial System? R. Christopher Whalen

Abstract: Since the 1930s, when the U.S. Congress interposed government regulation of banks for market discipline, the role of the state in the American financial system has steadily grown. While politicians and executives from the financial services industry characterize the relationship as a “partnership,” the degree of control exercised by state and federal government over banks and other financial intermediaries has grown enormously over the years – even as the influence exercised over Washington by the largest banks has increased to the same degree. The growth of government involvement in finance, coupled with the growing federal debt and the rising political sway of the large, “too big to fail” banks that act as dealers in U.S. government debt, raise troubling questions about the future of American democracy. This paper briefly reviews the growth in the role of the government in regulating and supporting the operations of banks and other financial intermediaries since the Great Depression and before. The paper concludes by asking whether this socialization of the risks taken by financial institutions and risk in general, and the growing political power of some of the largest financial services corporations in the world, can be reversed or even should be if consolidation and ever larger banks are the norm.

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Is It Possible to Re-Privatize the U.S. Financial System?

R. Christopher Whalen

I do not think it is an exaggeration to say that it is wholly impossible for a central bank subject to political control, or even exposed to serious political pressure, to regulate the quantity of money in a way conducive to a smoothly functioning market order. A good money, like good law, must operate without regard to the effect that decisions of the issuer will have on known groups or individuals. A benevolent dictator might conceivably disregard these effects; no democratic government dependent on a number of special interests can possibly do so.

F. A. Hayek

Denationalisation of Money—The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies

3rd ed., Institute of Economic Affairs (1990)

The Free Banking Era

It is difficult for most Americans to understand how tenuous was the economic position of our nation at its inception. When the U.S. gained its physical independence from Great Britain in the late 1700s, the colonies had no banking system and no common currency. European banks and governments met the capital needs of the young nation and even provided what limited means of exchange were available besides pure barter. While foreign coins and some colonial paper money was in circulation, bartering was the most common means of payment for at least the first half century of the nation's existence.¹

In 1782, the Bank of North America was established by the Continental Congress, and became the first chartered bank in the U.S. Like many previous governments in Europe, the first American government was dependent upon private banks for financing, so creating a new bank under government control was an effort to gain some independence from private banks and also from foreign governments. The bank's charter lapsed in 1790 and two years later, the state of New York chartered The Bank of New York, which

¹ In this paper, I have relied on the banking time line published by the FDIC and other sources, as noted.

is the corporate predecessor of the company now known as Bank of New York/Mellon (NYSE:BK).

By 1791, under the signature of President George Washington, the U.S. chartered the First Bank of the United States, which represented the government's first attempt at creating a permanent central bank of issue for the infant nation's currency.² The First Bank of the United States had just a 20-year charter and it was not renewed due to the intense attacks by the advocates of Jeffersonian principles, who, taking the lesson of King George III and his taxes, feared a central bank of issue would be dominated by the central government. This decision left the U.S. to fight the War of 1812 with no means to finance the military struggle, much less the general operations of the federal government. In 1811, the bank was recreated by the New York merchants who controlled it and chartered anew by the state of New York. Today, the successor to that NY corporation is known as Citibank NA, a unit of Citigroup Inc. (NYSE:C).

After the War of 1812, President James Madison chartered the Second Bank of the United States, but with very limited powers. Between 1815-1819, the U.S. economy grew rapidly and more private banks were created, but the federal government provided virtually no finance to support this growth via public improvements and infrastructure such as roads and canals, leaving this task instead to the cities and states. By 1840, the total debt of the states amounted to some \$200 million, most of which was held by foreigners. Many states fell into default on their obligations.³ As a heavily indebted, rapidly developing country with no organized financial markets or even a currency, the U.S. eventually gained a well-deserved reputation in Europe for not repaying loans. Many European banks refused to lend to the U.S. government or the various states, putting intense pressure on the small nation's liquidity and political unity – stress that is relieved via the issuance of various types of fiat currency and securities.

² When the Bank of England (BOE) was created in 1694, it was the first modern central bank of issue empowered by government. In the U.S., efforts such as the Bank of North America chartered by William Morris, predated the First Bank of the United States. In the UK, the Bank of England was independent of government from its commissioning in 1694 until its nationalization in 1946. Between 1797 and 1821, however, the BOE did suspend the gold convertibility of its notes by order of the government.

³ Margaret G. Myers, *A Financial History of the United States*, NY: Columbia University Press, 1970, p. 143.

In 1809, the Farmer's Exchange Bank in Gloucester, RI, failed—the first U.S. bank failure, but there was no Federal Deposit Insurance Corporation (FDIC) or Federal Reserve System (Fed) to provide support or even organize the orderly liquidation of the bank. The collapse of the Farmers Exchange Bank illustrated the types of financial schemes and public panics that would trouble the U.S. for decades to come. Financial-pioneer-turned-confidence-man Andrew Dexter, Jr., writes James Kamensky,

challenged the notions of his Puritan ancestors by embarking on a wild career in real estate speculation, all financed by the string of banks he commandeered and the millions of dollars they freely printed. Upon this paper pyramid he built the tallest building in the United States, the Exchange Coffee House, a seven-story colossus in downtown Boston. But in early 1809, just as the exchange was ready for unveiling, the scheme collapsed. In Boston, the exchange became an opulent but largely vacant building, a symbol of monumental ambition and failure.⁴

But, needless to say, a democratic society and a free market economy cannot exist without both great ambition and equally great failure.

Reeling from the financial disaster of the War of 1812, a heated debate continued in the Congress regarding the need for a common currency and a new bank of issue. Notes issued by banks in New York, for example, could not be used in other states to settle debts, at least not at face value. By 1814, the federal government was unable to pay its bills and Treasury Secretary Alexander Dallas suspended payments on the national debt in New England due to a lack of hard currency. Following the capture of Washington by the British and the suspension of payments on the national debt, the U.S. was on the verge of dissolution.⁵

The creation of the Second Bank of the United States was the U.S. government's next attempt at establishing a central bank, an effort that came only after significant political debate and negotiation. Many Republicans fought the re-creation of the Bank of the United States, fearing that its size and ability to do business across state lines would give

⁴ James Kamensky, *The Exchange Artist: A Tale of High-Flying Speculation and America's First Banking Collapse*, NY: Viking Penguin, 2008.

⁵ Ralph Charles Henry Catteral, *The Second Bank of the United States*, Chicago: University of Chicago Press (1903), p. 9.

it monstrous power that would prove uncontrollable. The Congress finally passed the legislation to create the Second Bank in 1816 and President James Madison approved the bill, but its 20-year charter would not be renewed after a political battle led by President Andrew Jackson.

By the mid-1830s, the U.S. was in the midst of an economic boom characterized by inflation and speculation in public land sales, as well as road and canal projects. Bank paper generally traded at a steep discount, especially when issued by banks outside of the state or local market where it was presented. When President Andrew Jackson retired the national debt and distributed the surplus accumulated in the Treasury, he almost immediately created a banking crisis. Then, as one of his last official acts, Jackson issued the Specie Circular,⁶ another hard money and anti-paper initiative which required that purchases of government land be paid in coin rather than bank paper. But by requiring that payments for taxes, duties and/or the purchase of land be made in specie, in practical terms the Treasury was draining reserves from the banking system and causing it to shrink.

Done in the midst of a growing national financial predicament, the Jacksonian fiscal measures helped to reduce liquidity in banks and worsen the lack of credit in an already cash strapped society. This third action by Jackson, which was implemented by his successor, President Martin Van Buren, further exacerbated the liquidity crisis in the U.S. As Jackson travelled home to Nashville in the spring of 1837, he noted that bank notes were trading at a steep discount to face value and farmers were paying 30% for credit – all the results of his earlier executive orders.

Yet even with what amounted to a tight money policy from Washington, the speculative fever that had gripped the nation during the early part of the 1830s was coming to a boil and the actions by Jackson would only make matters worse. Some bankers, traders and particularly land speculators clamored for President Van Buren to “strike down the

⁶ Specie refers to metal coins, bullion coins, hard money, commodity metals and other hard stores of value that are also used as a means of exchange.

iniquitous Specie Circular” requiring hard currency payment for purchases of federal land or payment of federal taxes. But Jackson wrote to Van Buren:

My dear sir, the Treasury order is popular with the people everywhere I have passed. But all the speculators, and those largely indebted, want more paper. The more it depreciates the easier they can pay their debts... Check the paper mania *and the republic is safe and your administration must end in triumph.*⁷

Unfortunately for President Van Buren, Jackson’s devotion to hard money was at odds with the needs of a growing nation and the dysfunction in the currency and banking system. With the drain of currency caused by Jackson’s Treasury order, as he called the Specie Circular, and the resultant increased stress on the economy, a lack of confidence in the state banks was widespread around the U.S. The resulting bank panic in 1837 caused many banks to fail over a period of several years. This panic was followed by a sharp economic contraction tied to a general downturn in the business environment that would last until 1841. By no surprise, President Van Buren was defeated in the general election of that same year.

The U.S. would go nearly three quarters of a century without a central bank until the Congress established the Federal Reserve System in 1913. There was no central provider of liquidity nor any deposit insurance, only the bank’s shareholders and capital to support the bank’s liquidity, and safety and soundness. This lack of a currency system and banks had been felt earlier when the Second Bank of the United States called in its loans in 1819, triggering a panic that swept the U.S. and caused many depositories to fail in the ensuing scramble for liquidity. But as with most things, the national Congress was largely indifferent to the needs of the nation, preferring instead to defend regional and states’ rights from threats, real and imagined.

More important, by the 1840s, hundreds of banks existed in America and all of them were printing private bank notes and making loans based solely on their own resources,

⁷ Marquis James, *The Life of Andrew Jackson*, Camden, NJ: Haddon Craftsmen (1938), p. 729.

mostly gold and foreign currency held as reserves. With the demise of the Second Bank of the United States in 1837, only state-chartered banks existed and the U.S. remained dependent upon foreign currency and barter as a means of exchange. During this period, known as the Free Banking Era, state bank chartering standards were not very stringent, and many new banks were formed and failed, but the free banking era was also a period of great expansion in the U.S. economy. The Federal Reserve Bank of San Francisco describes the period:

State Bank notes of various sizes, shapes, and designs were in circulation. Some of them were relatively safe and exchanged for par value and others were relatively worthless as speculators and counterfeiters flourished. By 1860, an estimated 8,000 different state banks were circulating "wildcat" or "broken" bank notes in denominations from ½ cent to \$20,000. The nickname "wildcat" referred to banks in mountainous and other remote regions that were said to be more accessible to wildcats than customers, making it difficult for people to redeem these notes. The "broken" bank notes took their name from the frequency with which some of the banks failed, or went broke.⁸

In reaction to the collapse of the Second Bank of the United States, New York became the first state to adopt an insurance plan for bank obligations. Between 1829 and 1866, five other states adopted similar deposit insurance schemes. But these modest early attempts at enhancing bank safety and soundness were not effective in controlling the emission of paper currency and forestalling crises such as the great panic of 1837. And Washington remained largely oblivious to the chaos in the nation's economy until after the Civil War.⁹ The government received taxes and paid interest in specie, but the rest of the economy was fueled by the rapid growth in paper currency that was, to one degree or another, convertible into specie. Indeed, the Civil War was the first time that Washington used a wholesale issuance of paper money, or "greenbacks," to finance federal spending.

⁸ Federal Reserve Bank of San Francisco, "1995 Annual Report: A Brief History of Our Nation's Paper Money," <http://www.frbsf.org/publications/federalreserve/annual/1995/history.html>.

⁹ Myers, p. 97.

The free banking era officially ended with the passage of the National Currency Act in 1863 and the National Bank Act in 1865, but only after three decades of currency crises, securities fraud and bank failures. The history of the period prepared by the Office of the Comptroller of the Currency (OCC) notes: “By 1860 more than 10,000 different bank notes circulated throughout the country. Commerce suffered as a result. Counterfeiting was epidemic. Hundreds of banks failed. Throughout the country there was an insistent demand for a uniform national currency acceptable anywhere without risk.”

With the adoption of a single currency and the creation of a two-tiered, state and federal chartering system for banks, the die was then set for the evolution of these two separate types of banking business models well into the 20th Century. But this very early model for a national currency did not solve the basic issues when it came to liquidity for banks, whether they were national or state chartered banks. Because the national currency remained based on a private banking system with no effective rules for soundness or liquidity, the U.S. economy would swing from boom to bust for decades after 1865. In a national political economic framework where Washington was still, as the framers intended, lacking in financial resources and the political will to cause great trouble, the shortcomings of the banking system were overlooked.

The financial needs of the federal government during the Civil War would force the government itself to rely on the issuance of non-convertible fiat currency such as greenbacks to support the military effort. At the end of the Civil War, the general assumption was that Washington would contract the supply of paper money allowed during the conflict and resume the use of specie for all payments. The total supply of currency in circulation had doubled from 1860 to 1867, mostly by printing greenbacks and withdrawing gold from circulation. But the advocates of cheap money, many of whom had benefitted from the stiff inflation during the Civil War, “opposed any action which would reduce the amount of currency in order to bring the greenbacks back to the level of gold.”¹⁰

¹⁰ Myers, p. 175.

Ultimately, politics prevailed and resumption of free exchange of specie for paper dollars was delayed for decades, providing plentiful monetary fuel for one of the greatest periods of speculation and outright larceny in American history. Led by characters such as Daniel Drew, Jim Fisk and Jay Gould, the expansion of the American railroads and the related speculation on Wall Street as to the financing for these endeavors created huge opportunities for gain and loss by investors. With the passage of the National Bank Act, the connection between specie and paper money had in theory been stabilized. But because of the vast amount of fraud still associated with bank deposits and claims against other financial entities, and the lack of a system for helping banks adjust to demands for liquidity, the U.S. economy and financial system remained extremely fragile and vulnerable to sudden shifts in public mood.

By 1873, the inherent instability of a fiat money system in the U.S. again resurfaced with the great panic of that year. The collapse of Jay Cooke and various other high flying speculators associated with the railroads set the stage for a financial crisis in the northeast. Banks were drained of reserves and the public was left without access to cash or credit. Banks, stockbrokers, and businesses failed in large numbers, stock prices collapsed, consumer and commodity prices declined, and unemployment increased nationwide in a wave of economic instability that lasted for more than two decades. Cooke, who was an intimate friend of President Ulysses Grant, could not tap bailouts from the Federal Reserve System and Treasury to save his enterprise from eventual ruin, which came on the 17th of September, 1873. Matthew Josephson wrote in *The Robber Barons*, “[t]he seven years of plenty after the war must now make way for the seven years of dearth in a land literally ‘flowing with milk and honey’.”¹¹

Before the creation of the Federal Reserve System in 1913, major banking panics would occur in the United States in 1873, 1884, 1890, 1893, and 1907. Whereas even Canadian banks had the flexibility to issue additional banknotes when currency demand increased, in the U.S. no such facility existed for national banks and, indeed, was forbidden by law. When bank deposits grew out of favor with the public and, more important, foreign

¹¹ Matthew Josephson, *The Robber Barons*, NY: Harcourt Brace & Co., 1934, p. 167.

creditors, bank balance sheets shrank and, with them, the money supply of the entire nation.

This period of growth and great excess was arguably as “pure” a banking model as ever existed in the U.S., with equal measures of exuberance and loathing found in financial markets as the ebb and flow of human action confronted the limited legal and practical boundaries placed upon commerce and finance. The academic community seems to fall into two camps in describing these ancient financial tumults, “those who see these panics as essentially a problem of illiquidity and those who base their explanations on insolvency,”¹² but the more general observation to make about the period between the Civil War and 1900 is that this is the normal behavior of a free market economy with limited government intervention.

With the collapse of the free banking model, the New York banks controlled by J. P. Morgan and other robber barons grew in influence and power, in part because there was no national government to counterbalance their ascendance. Morgan, who as Josephson notes “won respect by force of arms as well as business acumen,” assumed the role of statesman along with the likes of John D. Rockefeller. Together with William Rockefeller, and partners, Rockefeller created Standard Oil, the largest oil refining business in the world and the first great American trust. The founding partners of Standard Oil financed their initial capital from the large New York bankers. In 1877, the Rockefellers founded the Chase National Bank, whose successor operates today as JPMorgan Chase Bank (NYSE:JPM).

By 1885, there were 1,015 state banks and 2,689 national banks, according to the FDIC timeline, which notes that “starting in 1886 and continuing until 1933, Congress considers 150 proposals to create deposit insurance plans.” But it took nearly thirty years longer for the Congress to exert federal authority over the money supply and end the

¹² Kathleen M. McDill and Kevin P. Sheehan, “Sources of Historical Banking Panics: A Markov Switching Approach,” FDIC Working Paper 2006-01, p. 4. The authors provide a good review of scholarship regarding the causes and attributes of financial crises. Available at: http://www.fdic.gov/bank/analytical/working/wp2006_01/wp2006_01.pdf.

system of national banks serving as banks of issue. As severe economic weaknesses began to appear in the U.S. during the late 1880s and early 1890s, the resulting panic led to the collapse of railroads and banks, and the increased power of the great money trusts. “The economy slows, manufacturing and agricultural sectors operate at a fraction of capacity, and foreign investment declines. The result: banking panic. For the first time, bank runs occur outside of New York City, in Kansas City, Louisville, Milwaukee, Denver, and Portland.”¹³

The political reaction against the robber barons and the trusts in the early 1900s set the stage for one of the most conservative pieces of monetary legislation in modern U.S. history, namely the Gold Standard Act of 1900. This legislation established gold as the only standard for redeeming paper money and prohibited the exchange of silver for gold, at least for the moment reassuring the public as to the value of paper money issued by private national banks. But the legislation did not prevent the panic of 1901 or subsequent swings in public confidence in banks or the currency they issued. The aversion among Americans to a strong central government and especially a central bank was too strong and thus still left the U.S. economy in chaos. The author John Steele Gordon summarizes the situation:

We paid a heavy price for the Jeffersonian aversion to central banking. Without a central bank there was no way to inject liquidity into the banking system to stem a panic. As a result, the panics of the 19th century were far worse here than in Europe and precipitated longer and deeper depressions. In 1907, J.P. Morgan, probably the most powerful private banker who ever lived, acted as the central bank to end the panic that year.¹⁴

Between 1907 and 1917, eight states adopted an insurance plan for bank obligations, but such moves did not address the more basic public unease with private banks. The panic

¹³ Federal Deposit Insurance Corporation, “FDIC: Learning Bank.” <http://www.fdic.gov/about/learn/learning/when/1700s.html>.

¹⁴ John Steele Gordon, “A Short Banking History of the United States,” *The Wall Street Journal*, October 10, 2008.

of 1907 was one of the sharpest economic contractions in U.S. history and finally would prompt the national Congress to start to take action and eventually enact of the Federal Reserve Act in 1913. The crisis started with the New York Stock Exchange going into drastic decline, leading to public panic and runs on banks. These bank runs, in turn, led to large-scale liquidations of call loans, or loans used to finance stock market purchases, causing further declines in stock prices and widespread insolvency for businesses and individuals.

Perhaps the most notable event during the crisis of 1907 was when depositors "run" on the Knickerbocker Bank in New York, which was only rescued by J.P. Morgan and James Stillman of First National City Bank acting as a *de facto* central bank and specifically a lender of last resort. The Knickerbocker Trust was chartered in 1884 by Frederick G. Eldridge, a friend and classmate of financier J.P. Morgan, and became one of the largest banks of its day. But the crisis of 1907 caused a fatal deposit run on the bank. More important, the failure of Knickerbocker and other banks featured the role of J.P. Morgan as the *de facto* central bank and receiver of failed banks. The FDIC timeline notes:

President Theodore Roosevelt provides Morgan with \$25 million in government funds to use to control the panic. Morgan, acting as a one-man central bank, decides which firms will fail and which firms will survive. He organizes a rescue of banks and trusts, averting a shutdown of the New York Stock Exchange, and engineers a financial bailout of New York City. Morgan is a strong adherent of a central bank like the Bank of England, which is controlled by private bankers.

In a precursor to the Federal Reserve Act, Congress enacted the Aldrich-Vreeland Act of 1908, which was an immediate response to the horrible social and economic effects of the panic of 1907 and provided for emergency currency issues during economic crises. The legislation also established the National Monetary Commission to propose a banking reform plan. Chaired by Senator Nelson W. Aldrich (R-RI), the commission examined

both the financial and political issues that caused the various crises of the previous decades – but from a decidedly Republican, big city bank perspective.

Under the leadership of Aldrich, the commission developed a plan favorable to the large banks, but William Jennings Bryan and other progressives fiercely counterattacked. Bryan and the progressives want a central bank under public, not banker, control. The 1912 election of Democrat Woodrow Wilson killed the Republican Aldrich plan, but the stage was set for the emergence of a decentralized central bank under at least the nominal control of Washington.

None of the Commission's proposals made it to the floor of Congress in that year, but the report was comprehensive and the Congress spent several years afterward studying its proposals for a central bank and other banking issues. The chief obstacle to monetary reform was uncertainty as to whether it was possible to create a central bank that would not fall under the influence and control of the large New York banks. Paul M. Warburg noted in his book, *The Federal Reserve System: Its Origin and Growth*, that, in 1910, most Americans were in favor of a central bank, but only if “not controlled by ‘Wall Street’ or any other monopolistic interest.”¹⁵ The concerns of the turn of the 20th Century echo the concerns of 2009 regarding the tendency of the political powerful large banks to undermine the independence of a central bank of issue.

While most Americans were not expert in finance, they understood that the financial power of large New York banks would threaten both the value of money and the political independence of the national government. In 1913, following the election of Woodrow Wilson, the Congress passed three key pieces of legislation: the Underwood Tariff, the Federal Trade Act and the Federal Reserve Act (FRA). Of all three pieces of legislation, however, the FRA was at the top of the agenda because of the clear need for banking and

¹⁵ Paul M. Warburg, *The Federal Reserve System Its Origin and Growth: Reflections and Recollections* (Vol. II), NY: The MacMillan Company, 1930, p. 117.

currency reform. Most Americans agreed that change was needed, but there was far from any agreement on the nature of the change that should occur.¹⁶

Bankers and business interests were in favor of legislation sponsored by Democrats like Carter Glass of Virginia, who envisioned a decentralized system of Federal Reserve Banks to provide liquidity to the banking system and serve as the banks of issue for currency. Southern agrarians in the Democratic Party, however, wanted more radical change and feared a central bank controlled by the New York banks. But that result was precisely what finally occurred. In 1910, Warburg and a small group representing the chiefs of the largest banks and corporations in the U.S. travelled by rail to Jekyll Island, GA, to privately discuss the proposal for a central bank.

The Jekyll Island meeting was kept secret because any hint that Aldrich was consulting the large banks would have doomed his efforts and also would have badly damaged Wilson's own political interests. Murray Rothbard described the scene in his classic book, *The Case Against the Fed*:

The conferees worked for a solid week at the plush Jekyll Island retreat, and hammered out the draft of the bill for the Federal Reserve System. Only six people attended this super-secret week-long meeting, and these six reflected the power structure within the bankers' alliance within the central banking movement. The conferees were, in addition to Aldrich (Rockefeller kinsman); Henry P. Davidson, Morgan Partner; Paul Warburg, Kuhn Loeb partner; Frank A. Vanderlip, vice-president of Rockefeller's National City Bank of New York; Charles D. Norton, president of Morgan's First National Bank of New York; and Professor A. Piatt Andrew, head of the NMC staff, who had recently been made an Assistant Secretary of the Treasury under Taft, and who was a technician with a foot in both the Rockefeller and Morgan camps.¹⁷

¹⁶ Robert C. Byrd, *The Senate 1789-1989*, Washington, DC: U.S. Government Printing Office, 1988, p. 411.

¹⁷ Murray Rothbard, *The Case Against the Fed*, Auburn, AL: Ludwig von Mises Institute, 1994. p. 116.

Woodrow Wilson was elected two years later and the leading light of the progressive movement made monetary reform one of his top priorities. Following his inauguration in March of 1913, Wilson's administration worked through the summer of that year to win passage of the FRA, but each time they reached agreement with either the banks or the progressive agrarian interests, the other side would bolt, seeking even more concessions. After several more months of delay, the Senate passed the FRA in December of 1913 and President Wilson signed it into law on Christmas Eve.¹⁸ Senator Robert Byrd (D-VA) summed up the generally accepted version of the event in his history of the Senate:

The creation of the Federal Reserve System was the crowning achievement of the Sixty-third Congress and, indeed, of the first Wilson administration. Despite the conservative attack in the Senate, its basic structure – the twelve Federal Reserve Banks, privately controlled, regulated and supervised by the Federal Reserve Board – still remains. It proved to be a significant reform of the very heart of the American economy. It destroyed the control of money and credit by a few banks on Wall Street, created a more flexible and sound currency, and permitted a planned supervision of banking reserves to meet the country's needs.

Given the current debate in Washington about modernizing the bank regulatory system, it must be noted that Byrd's quotation above is somewhat misleading and reflects a modern-day view. The Fed's Board of Governors in Washington was not part of the original FRA. The number and location of the Federal Reserve Banks was actually determined by the National Monetary Commission. Indeed, Glass and the other exponents of a decentralized "central bank" deliberately avoided a Washington presence for the central bank.

Carter Glass would become Chairman of the House Banking Committee and is frequently credited as the author of the FRA, but he was hardly the champion of the legislation on the floor of the Senate in that tumultuous year. All three pieces of Wilson's key legislative reforms were guided through the Congress and to final enactment by Senator

¹⁸ Byrd, p. 412.

John Worth Kern (D-IN), the first member of the Senate to be referred to as the “leader” of the majority and a key ally of Wilson. Kern would be defeated in 1917 after only one term in office.

The FRA created the nation’s third central bank with a 20-year charter, but without the Washington bureaucracy that today is known as the Board of Governors. Over a decade would elapse before the Congress would pass the McFadden Act of 1927, creating the Board as an agency of the federal government to supervise the autonomous reserve banks. Treasury Secretary William McAdoo, Secretary of Agriculture David Houston, and Comptroller of the Currency John Skelton Williams took up the task of organizing the 12 Federal Reserve Banks, which were just barely operational by the time that WWI began. Because of the emergency authority to issue currency under the Aldrich-Vreeland Act of 1908 and the more important power to discount bankers’ acceptances conferred by the FRA, the new central bank was able to provide liquidity to the nation’s economy and, indirectly, helped to finance the allied war effort against Germany until the U.S. officially entered the conflict in 1917. During the war, the financial center of the world would shift from London to New York.

When the FRA was created by the Congress, it contained a number of superficially populist, decentralized features that provided substantial autonomy from Washington and also provided the banking industry with the ability to influence the central bank. Indeed, some of the revisionist accounts of the era suggest that far from losing the battle with the forces of populism, the New York bankers led by J.P. Morgan & Co. actually won the day. In his classic 1933 book *The Mirrors of Wall Street*, Clinton Gilbert described the scene as the Congress passed the FRA and the subsequent two decades:

It is now almost twenty years since J.P. Morgan and Company, its associates and its satellites attempted to induce Congress to create a central bank of issue instead of the Federal Reserve System. They were determined that control of the national purse should remain in New York. The theory underlying the proposed system that the several sections of the country should control their own finances was

preposterous. To them it was anathema. Ten short years later the same group, represented by the same agent who had led their lost cause in Washington, took charge of the Federal Reserve System. For practical purposes the system was transformed into a central bank, and was manipulated to the very ends that its authors had sought to guard against.¹⁹

Gilbert notes that while the first Board of Governors of the Fed was comprised of people “distinguished by ability and character,” by the time that President Warren Harding had succeeded Woodrow Wilson in the White House, the New York bankers, led by the House of Morgan, largely captured the Federal Reserve Board, which was comprised of the Governors of the Reserve Banks. Benjamin Strong had left the Bankers Trust Company to preside as Governor of the Federal Reserve Bank of New York. The slogan “Return to Normalcy” had succeeded the cries of war and the nation was, once again, more interested in ways to “turn the wheels of commerce and accelerate the movements of trade.”²⁰

By the time WWI ended, there were almost 20,000 state chartered banks in the U.S. and over 7,000 national banks, and most of these institutions had very little contact or transactions with other banks. The FRA gave the central bank authority to regulate and supervise state-member banks, allowed state-member banks and national banks to borrow money from Federal Reserve Banks when they experienced liquidity problems and permitted national banks to open branches overseas. But the American financial system was still remarkably fragmented and local, reflecting the needs of a largely rural population that was only just on the verge of an industrial and social revolution.

The Growing Role of Government in American Finance

With the creation of the Federal Reserve System in 1913, the infrastructure for a national monetary system and also an expanded government role in the nation’s financial and

¹⁹ Clinton Gilbert, *The Mirrors of Wall Street*, NY: Putnam & Sons, 1933, p. 9-10.

²⁰ *Ibid.*, p. 15.

monetary life was established – and just in time to address the financial needs of the nation during WWI. But once the conflict was over and control of the federal government swung back into Republican hands under Warren Harding in 1921, the cautious attitudes toward monetary expansion and the increase of speculation in the financial markets were discarded in favor of economic growth.

The roaring twenties was a time of innovation and rising expectations in America that witnessed an increase in production and productivity that lessened the need for skilled labor needed to generate goods. The age was symbolized by industrialists such as Henry Ford, who was widely seen as a revolutionary figure even though the truth is far less clear cut.²¹ F. Scott Fitzgerald documented the opulence and excess of the era in works such as *The Great Gatsby*, showing both the great wealth of the era and the widening disparity in income distribution that would see have of the wealth of the entire nation held by less than one percent of the population.

Within this time of seemingly endless economic possibility, consumers purchased all manner of products and began to use consumer credit to further enhance their ability to satiate their demand for goods. The financial services industry expanded dramatically and banks began to offer mortgages, installment credit and even margin loans to individuals to fund securities purchases. Consumers began to buy bonds and equity securities, and Wall Street expanded capacity to meet and encourage the new demand. Banks began to offer various types of structured assets to consumers and even participated directly in land speculation.

The political power of the banks grew with the speculative frenzy that gripped the U.S. population. Ron Chernow noted in *The House of Morgan*: “By 1924, the House of Morgan was so influential in American politics that conspiracy buffs could not tell which

²¹ For example, Henry Ford is credited not only with using mass production methods to make his products less expensive, but with instituting the \$5 per day wage at a time when many Americans could barely survive. More recent research suggests that, in fact, James Couzens, the Senator from Michigan was the man who turned Ford Motor Co from an idea into an enterprise and actually pressed Ford to increase wages for Ford’s workers. See Harry Bernard, *Independent Man: The Life of James Couzens*, Detroit: Wayne State University Press, 2002.

presidential candidate was more beholden to the bank... The bank's peerless renown in the Roaring Twenties was such that the Democratic candidate was the chief Morgan lawyer, John W. Davis."²²

With the election in 1924 of Calvin Coolidge, a close friend of the great Morgan banker Dwight Morrow, the financial markets began to truly roar, fed by the greatest speculative fever since the Great Gold Rush and ample credit from the Federal Reserve. Coolidge was "distinguished for character more than for heroic achievement," wrote a Democratic admirer, Alfred E. Smith. "His great task was to restore the dignity and prestige of the Presidency when it had reached the lowest ebb in our history ... in a time of extravagance and waste." Unfortunately, Coolidge was no more inclined to limit the growth and excesses of the banking industry than was his predecessor Harding.

In 1927, the Congress passed the McFadden Act, which established the Federal Reserve Board as a permanent oversight agency of the central bank and, more important, prohibited interstate banking, a limitation that remained until 1994. The McFadden Act also authorized hometown branches for national banks, if allowed by the state, a change that put national banks on a more even footing with state banks. National banks still could not establish branches outside of the city in which they were headquartered, however, but the legislation gave national banks the authority to buy and sell marketable debt obligations.

There seemed no limit to the innovation of the American people or their financial intermediaries. And yet among the Washington political class there was as yet no hint that an economic crisis lay directly in the path of the nation, a catastrophe that would change permanently the nature of the relationship between private banks and the U.S. government from implicit support to explicit regulation and oversight. John Kenneth Galbraith described the problem beautifully in his book *The Great Crash 1929*:

²² Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance*, NY: Grove Press, 1990, p. 254.

No one can doubt that the American people remain susceptible to the speculative mood – to the conviction that enterprise can be attended by unlimited rewards in which they, individually, were meant to share. A rising market can bring the reality of riches. This, in turn, can draw more and more people to participate. The government preventatives and controls are ready. In the hands of a determined government their efficacy cannot be doubted. There are, however, a hundred reasons why a government will determine not to use them.²³

Galbraith writes in *The Great Crash 1929* about how the real economy in the U.S. had been deteriorating for months before, starting with the collapse of commodity prices and land speculation in Florida. Finally, in the autumn of 1929, the financial markets turned down sharply and sent the entire nation into what is now known as the Great Depression. In the space of a week, the Dow Jones Industrial Average dropped 30 percent and the previously exuberant business environment was dashed as both consumer and business confidence plummeted. President Hoover, the Republican successor to President Coolidge and one of the greatest technocrats to ever hold the highest elective office in the U.S., declared after only a week of market upheavals that the worst of the crisis was past.

But by July 1932, the Dow closed at 41.22, an 89% drop from the pre-crash high and a level that would not be reached again until 1954. By March 1933, about half the banks in many states were closed, the nation's economy was imploding under 25% unemployment and a decline of 50% in gross domestic product (GDP), and barter re-emerged as bank runs and company closings drained cash from the economy. Many banks that failed did so as a result of margin lending on stocks, one of the enduring lessons of the period leading up to the Great Crash.

In his final months in office after the election of Franklin D. Roosevelt (FDR), Hoover attempted to enlist the help of Henry Ford to support several insolvent banks in Detroit. These were banks in which the Ford family kept much of its wealth, all in cash deposits, and which Edsel Ford had already assisted despite his father's opposition. On the Sunday

²³ John K. Galbraith, *The Great Crash 1929*, NY: Houghton Mifflin, 1997, p. VII.

before Lincoln's Birthday in 1933, Treasury Undersecretary Arthur Ballantine attempted to convince Ford to put more financial support behind the Detroit banks. Hoover even telephoned Ford on February 12th and spoke with the auto king for almost an hour. He went to bed believing that he had turned Ford around, but awoke the next day to learn that a banking holiday had been declared in Michigan.²⁴

The day before Ford's meeting with Ballantine, the *Detroit Free Press* had carried an interview with James Couzens, Ford's estranged former business partner who became Senator from Michigan after leaving Ford Motor Co. Couzens stated that the weak banks should be allowed to go under and, after a general moratorium, the stronger banks would be allowed to re-open. When Clifford Longley, the Ford Company's counsel and a director of Guardian Trust Company reported Couzens's remarks, Henry Ford replied: "For once in his life, Jim Couzens is right." Ford would ultimately refuse to help Hoover and the Detroit banks, and even threatened to withdraw his money, setting the stage for the bank holiday in Michigan that would ripple across the U.S. in the weeks leading up to FDR's inauguration.²⁵

On February 14, 1933, all banks in the state of Michigan were closed for eight days by order of Governor William A. Comstock. This began a domino-effect that would lead to the final collapse of the nation's banking and financial system three weeks later. Michigan was forced to default on its bonds and the state government was crippled, an event which rippled through the savings and balance sheets of individuals and companies around the world. The home mortgages of many workers from the automobile factories went unpaid, taxes were unpaid, and the local economy began a forced contraction as businesses large and small shriveled without access to cash. Auto traffic on the streets of Detroit dwindled as horses reappeared in large numbers, and the stock prices of the major automobile makers and other companies tumbled. As the historians of the era have documented, more value was destroyed in the early 1930s than in the 1929 market crash.

²⁴ Ibid., p. 65

²⁵ Jesse Jones and Edward Angly, *Fifty Billion Dollars: My Thirteen Years at the RFC*, NY: Macmillan, 1951, pp. 64-65.

On March 4, 1933, President Franklin Roosevelt took office. Most of the nation's banks were closed and panic ruled the streets of American cities and towns. New York, which held out almost a month after the bank crisis began in Michigan, declared a bank holiday on the morning of Inauguration Day. Terrified citizens were lined up outside New York banks as the new president took his oath of office. Ten days after FDR's inaugural, he then ordered an extended bank holiday. Even as the stronger banks in the nation gradually were allowed to re-open, the banks in Detroit remained closed. Almost a million individuals and businesses in Michigan were cut off from their funds for over a month and the larger depositors of the banks – including Henry Ford – were compelled to wait for the liquidation of the insolvent banks.

Jesse Jones, Chairman of the Reconstruction Finance Corporation, laid the blame for exacerbating the Banking Crisis of 1933 at the feet of Ford and Couzens:

Detroit's banking collapse may have been inevitable, the situation in the sorely stricken automobile industry being what it was, and the laws being what there were at the time; but the circumstances would have been less painful, the personal tragedies fewer, had not insurmountable difficulties been created by personal, industrial, and political hostilities at almost every step of our approach to the problem in February 1933.²⁶

Malcolm Bingay, editor of the *Detroit Free Press*, interviewed Couzens several times following the crisis of 1933. He concluded that far from being a matter of hard money principle, Couzens' chief reason for opposing the bank bailout was "pure spite and vindictiveness" directed at Henry Ford and others in the Detroit business community. In fact, Couzens had told President Hoover before the bank holiday was declared in Michigan that he would gladly come up with a further \$1 million for the bailout if it would prevent suffering for "800,000 small depositors of the Detroit banks," but subsequently reneged on the commitment. Hoover's memoirs suggest that Couzens

²⁶ Jones and Angly, p. 55.

ultimately could not bring himself to assist the “old club” of Detroit bankers who had previously shunned him because of his concern for the common man.²⁷

It is often overlooked by popular accounts of the Great Depression that President Hoover, and not FDR, created the Reconstruction Finance Corporation (RFC) and the Federal Home Loan Banks, two of the most significant and interventionist initiatives ever taken by Washington up to that time. The RFC operating under Jesse Jones was empowered to make loans to banks, insurers and industrial companies. It was initially set up with the idea of repaying the government and then some on its investment.

The Federal Home Loan Bank Board was authorized by Congress to charter and supervise federal savings and loans (S&Ls) and establishes the Federal Home Loan Banks (FHLBs), which were given the authority to lend to S&Ls to finance home mortgages. Whereas the Fed merely provided facilities to discount acceptances and made available short-term liquidity, the FHLBs provided government-subsidized term liquidity to thrifts to support mortgage loans.

Upon taking office, President Franklin D. Roosevelt declared a banking holiday and temporarily closed all U.S. banks. Some 4,000 commercial banks and 1,700 S&Ls would ultimately fail during 1933 alone. Some 10,000 banks would fail between 1929 and 1933, with a loss to depositors of \$1.3 billion. The Congress responded to this calamity with some of the most interventionist legislation to date, laws that created the quasi-government system of heavily regulated “private” banks that survives in the U.S. to this day.

The Banking Act of 1933 created the Federal Deposit Insurance Corporation, which immediately examined nearly 8,000 state-chartered banks that were not members of the Federal Reserve System and allowed only solvent banks to re-open. Also known as “Glass Steagall,” the Banking Act separates traditional banking from commerce, including securities dealing and underwriting. Of interest, neither Senator Glass nor

²⁷ Herbert Hoover, *The Great Depression*, NY: Macmillan, 1952, p. 207.

Congressman Henry Steagall envisioned the FDIC becoming a government guarantee for bank deposits, but that is precisely what has happened over the years. Here is what the two main sponsors of the Banking Act of 1933 said about their creation:

- Senator Carter Glass: “This is not a government guaranty of deposits.” He continued, “The Government is only involved in an initial subscription to the capital of a corporation that we think will pay a dividend to the Government on its investment. It is not a Government guaranty.”
- Congressman Henry Steagall: “I do not mean to be understood as favoring the Government guaranty of bank deposits. I do not. I have never favored such a plan.”²⁸

The Emergency Bank Act gives the OCC power to appoint a conservator to act as receiver for national banks. After FDR took office, the Congress created the Federal Housing Administration and the Securities and Exchange Commission, authorized Federal Credit Unions (1935) and made the FDIC permanent. By 1935, there were about 10,000 state-chartered banks and 5,000 national banks, a level that would remain remarkably stable into the 1980s. And through those years the government was regulating and supporting these institutions with a variety of government programs and liquidity mechanisms meant to restore the banking sector, housing and many other aspects of the U.S. economy.

The FDIC records 26 bank failures in 1935, but by 1938 the number of failures rose to 74 as the recession of 1937-1938 took Americans back into the worst years of the Great Depression. The damage done to the U.S. economy and the banking industry was so profound that many of the Depression era-institutions created to support bank lending or to create new channels for home mortgage lending such as the government-sponsored enterprises (GSEs) and the Federal Housing Administration (FHA), as well as

²⁸ Both quotations come from a paper by Alex Pollock, “Reprivatizing Credit: Remarks at a Federalist Society Conference on ‘The Financial Services Bailout’,” Washington, D.C, March 19, 2009.

agricultural lending via the Farm Credit Banks, became permanent features, even after WWII and the resulting surge in economic activity. GDP, bank lending and consumer activity all grow rapidly with government war spending.

There were many other changes and innovations that would spur the use of credit to boost economic activity. Shortly after the war in 1950, Frank McNamara and his partner Ralph Schneider invented Diners Club, the first third party credit card. Through the 1950s, Bank of America and American Express launched credit cards. The former eventually was spun-off as Visa and became an independent franchiser of credit cards to all banks.

In 1950, the Congress passed the Federal Deposit Insurance Act, which:

- Revised and consolidated earlier FDIC legislation into one act, increased the FDIC insurance limit from \$5,000 to \$10,000 and thereby further binds the industry to government insurance.
- Gave the FDIC the authority to lend to any insured bank in danger of closing, if the operation of the bank is essential to the local community; and
- Authorized the FDIC to examine national and state-member banks to determine their insurance risk.²⁹

In 1956, the Congress also passed the Bank Holding Company Act (BHCA), which even today remains as the last remnant of the Depression-era regulatory framework. It prohibited the expansion of bank holding companies into "non-banking" activities through affiliates and prohibited interstate acquisitions unless the laws of a given state explicitly allow such expansion. These prohibitions would be repealed by the Gramm-Leach-Bliley legislation in 1999 and the Reigle-Neal amendment in 1994, respectively. The BHCA turned banks and, in particular, the companies which own banks into a protected monopoly under the aegis of the central bank, an aspect of the BHCA that

²⁹ FDIC Timeline, "1950s".

remains to this day. For the next half century, banks are treated as a special, protected industry even as technology worked to render both assumptions moot. Veteran Washington observer Robert Feinberg noted in a 2008 interview with the author:

To accomplish anything, one has to get beyond the idea that banks are different from other types of companies. That's where the Congress fails miserably. Congress has bolstered this myth that banks are special over the years. No matter how many times that this issue is examined on Capitol Hill, we never seem to get clarity on just what it is within the business model of a bank that deserves 'special' treatment under the law.³⁰

In 1970, the Congress passed amendments to the BHCA that require Federal Reserve Board approval for the establishment of a bank holding company and began to liberalize non-bank activity restrictions. This latter point is most significant because it marks the beginning of the legal recognition that the Glass Steagall-era restrictions on banking vs. commerce were coming undone. Even though the increase in permissible bank activities allowed by the Fed were modest by today's standards, the BHCA amendments of 1970 marked the start of the liberalization of bank activities from the draconian standards of the 1930s, but this did not necessarily mean a reduction in state-involvement in banking.

With the 1971 decision by President Richard Nixon to end gold convertibility of the dollar, banks and dollar-based investors were irrevocably tied to the greenback as a means of exchange and store of value. The end of convertibility also cleared the way for deficit spending by the Congress and monetary expansion by the Federal Reserve to accommodate it. Then Fed Chairman Arthur Burns opposed the move and also Nixon's demands to stimulate the economy, but ultimately the political pressure for growth prevailed. Chairman Burns would later tell my father, Richard Whalen, that the decision to end gold convertibility was a "terrible decision" that should never have happened, but had to happen.

³⁰ Chris Whalen, "GSE Nation: Interview with Robert Feinberg," *The Institutional Risk Analyst*, March 17, 2008.

As the U.S. economy grew through the 1970s and 1980s, the government expanded the role of existing GSEs such as Fannie Mae and the FHLBs, and created another housing GSE, Freddie Mac, to bolster bank lending to support the housing market even further. Legislation such as the Home Mortgage Disclosure Act of 1975 (HMDA) and Community Reinvestment Act (CRA) of 1977 imposed mandates for lending in underserved communities, further tying banks to public policy in areas such as housing and economic development. Each of the housing GSEs that provide liquidity support for banks became a key component of the bank's revenue stream and business model. Both the liquidity management facility of loan securitization and the transaction fees generated by securitization activities became important revenue sources for many banks.

With the creation of the first money market fund, the Reserve Fund, in 1971, the banking industry was under increasing competitive strain due to innovation and new technology. The oil shocks of the 1970s and a sluggish economy drove the Congress to respond in 1980 with the Depository Institutions Deregulation and Monetary Control Act. The law began the process of phasing out Regulation Q—or Reg Q (the Federal Reserve's regulation that dictates what banks and S&Ls can pay on deposits) —and allowed financial institutions to offer negotiable order of withdrawal (NOW) accounts (interest-bearing checking accounts). It also allowed S&Ls to offer checking-type accounts, established loan-loss-reserve requirements, allowed S&Ls to issue credit cards and increased FDIC deposit insurance coverage from \$40,000 to \$100,000.³¹

A decade later in 1982, Congress enacted the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St Germain), a law that further loosened activity restrictions on thrifts and allowed banks to stick their noses into insurance sales and even underwriting. But by 1984, the FDIC was handling the failure of Continental Illinois National Bank in Chicago, Illinois, with \$34 billion in assets, at that time the largest bank to fail in the FDIC's history. The FDIC promises to protect all of Continental's depositors and other

³¹ FDIC Timeline, "1970s".

creditors, regardless of the \$100,000 limit on deposit insurance and Continental receives assistance from the FDIC because it was deemed too big to fail (TBTF).³²

In 1989, the Congresses passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which at the time was hailed as a landmark piece of legislation and created the vehicle for cleaning up the S&L crisis; specifically, FIRREA established the Resolution Trust Corporation (RTC) to resolve S&L failures from August 9, 1989, to July 1, 1995 and made other changes to the regulation of S&Ls. Most significant, the law gave the FDIC the right to seize all of the banks of a BHC in the event that the losses of one insolvent unit would cause a loss to the deposit insurance agency.

In 1991, Congress responded to another economic crisis by passing the Federal Deposit Insurance Corporation Improvement Act (FDICIA). The legislation authorized the FDIC to borrow from the Treasury and put significant legal restrictions on the concept of TBTF. FDICIA mandated a least-cost resolution method and prompt resolution approach to problem and failing banks and ordered the creation of a risk-based deposit insurance assessment scheme, but also contained amendments to the FRA that would eventually allow the bailout loans to banks and non-banks made by the Fed in 2008.

Since FDICIA also mandated that the FDIC must close banks in a way that is “least costly” to the agency, the effective regime when it comes to large banks is to argue that systemic risk concerns make the extension of a bailout the desired outcome. While some observers argue that FDICIA bought the U.S. 17 years without a TBTF bailout, the legislation did lay the groundwork for the biggest ever bailout of U.S. financial institutions starting in 2008. As Walker Todd wrote in a research paper published by the Cleveland Federal Reserve Bank in 1993:

In a comparatively little-noticed amendment of the Reserve Banks' lending authority, FDICIA made potentially significant revisions to the emergency

³² FDIC Timeline, “1980s”.

liquidity provisions of the Federal Reserve Act. In particular, the Act now permits all nonbank firms - financial or otherwise (called "nonbanks" here for simplicity) - to borrow at the discount window for emergency purposes under the same collateral terms afforded to banks. Ironically, while the principal thrust of FDICIA was to limit or reduce the size and scope of the federal financial safety net, at least as applied to insured depository institutions, this provision effectively expanded the safety net.³³

The Financial Modernization Act of 1999, also known as the Gramm-Leach Bliley Act (GLBA), represented the zenith of financial deregulation efforts in the 1990s, at least in a rhetorical sense of the word. The Congress rolled back most of the remaining Glass Steagall-era financial reform legislation and created a new definition for a financial holding company that was authorized to:

- Underwrite and sell insurance and securities;
- Conduct both commercial and merchant banking; and
- Invest in and developing real estate activities.

But the underlying reality was a complete liberalization of bank securities dealer activities and the removal of common-sense restrictions on speculation by both customers and banks. GLBA provided a completely clear field for the larger Wall Street banks to take cash and derivative securities to new levels of complexity and opacity, fueling a boom in housing prices. As Wall Street demanded ever more mortgage loans to feed the loan securitization machine, banks lessened the criteria for underwriting new mortgages and thereby increased the rate of homeownership in the U.S. from the low 60s in percentage terms to over 70% by the peak of the housing boom in 2006. Institutional broker dealers such as Lehman Brothers and Bear, Stearns actually entered the mortgage origination business directly. And as in the 1930s, the expansion of commercial banks into securities underwriting was at the heart of the crisis that would follow.

³³ Walker F. Todd, "FDICIA's Emergency Liquidity Provisions," *Economic Review*, Federal Reserve Bank of Cleveland, 3rd quarter 1993, pp. 16-23.

Citicorp would combine with Travelers in 1998 in anticipation of the passage of GLBA and, by 2000, JPMorgan was merging with Chase Manhattan Bank, just as the Internet market bubble burst and Enron was surging towards an eventual collapse in 2001. The political and business leaders of the time talked about innovation and growth in financial services, but beneath the surface profound problems were being created that would, starting with the collapse of New Century Financial early in 2007, eventually fester and cause the most serious banking crisis since the 1930s. Between 1999 and the passage of GLBA and 2009, nothing was done to slow the use of off-balance sheet vehicles by banks, even after Enron and WorldCom. And the Fed provided all of the liquidity required and more to keep the party rolling along – until it could not roll along any longer.

Between 2007 and 2009, Bear Stearns and Lehman Brothers collapsed, Citigroup was subject to multiple rescues, American International Group was nationalized via an illegal bailout engineered by then-New York Fed President Timothy Geithner, and Washington Mutual Inc. filed bankruptcy after its subsidiary banks were seized by the FDIC in the largest bank resolution to date. Other significant failures such as IndyMac in July 2008 and Wachovia in November 2008 would follow. The Fed and the federal government injected hundreds of billions of dollars into the financial system to bailout the largest banks and prevent further market failures. Thousands more commercial and private companies were restructured by the courts, including General Motors Chrysler, both of which received government assistance and effectively became GSEs along with Fannie Mae and Freddie Mac. As of this writing, it is unclear whether any of these GSEs will ever reach true profitability.

Conclusion: The Current Crisis and Free Market Solutions

The progression of the U.S. from a chaotic, free-market society to a regulated and largely socialist formulation where public funds are used to offset private losses realized by ostensibly private banks is well illustrated by the history of money and banking in

America. While modern day policymakers want the public to believe that the recent crises were random unpredictable Black Swan-type events,³⁴ the history seems to indicate otherwise, namely that the confluence of bad public policy and equal measures of private avarice created the circumstances for the crisis. Two threads seem most important in this respect: first, the reduction and/or evasion of regulatory limits on banks and non-bank financial firms; and second, the progressive expansion of the federal guarantees for private debt generally and in particular the concept of TBTF and the related political influence of the largest banks, which have combined to bring about the socialization of much of the U.S. banking industry.

As James Grant wrote in *Money of the Mind*:

With the partial socialization of the banking business, a process materially and ironically advanced during the Reagan years, the element of speculation was not removed, but its costs were shifted. The public sector's credit increasingly supplanted the private sector's. Government guarantees – of bank deposits, residential mortgages, farm loans, student loans, became widespread, and thereby expanded the volume of borrowing. As the marginal debtor received the marginal loan, the extra car (or house, boat or corporation) was sold. All this worked to enlarge the national income.³⁵

Most modern financial crises had observable antecedents, e.g. increased use of leverage, maturity mismatches, near zero default rates, and spikes in housing price to rental rates and housing price to income ratios driven by public policy. Why did policymakers not connect the dots, attach significant higher than normal probabilities to the occurrence of severe financial disturbances, and fashion policies accordingly? Because these same policy makers were too busy responding to the political demands of banks and society for

³⁴ A “Black Swan” type event is an unanticipated, rare event that is not easily predicted by contemporary statistical measures.

³⁵ James Grant, *Money on the Mind*, NY: Macmillan, 1992, p. 5.

liberalization of the very same rules that were meant to protect against crises in order to promote short-term economic growth.

The history of the ebb and flow of financial regulation in the U.S. suggests that politics is the short-term factor governing the probability of crises, but this evolution is set against the backdrop of an increased role for the state in money and banking generally. The degree of regulatory capture or better, cooperation, between the various parts of the financial community, the housing industry, and the Congress and the regulators, seems to have made the crisis of 2008 inevitable. But even as the Congress now responds with legislation to reform the financial services sector, the growing role of the public sector in all aspects of private banking and finance seems to be growing. For example, as of this writing, the FHA now guarantees 35 million residential mortgages originated by private banks. Large originators of loans such as Wells Fargo and Bank of America have created and sold to investors literally trillions of dollars worth of residential mortgages that are guaranteed by the FHA or one of the housing GSEs, and therefore do not show these assets in their financial statements filed with the SEC.

Would the crisis even have been possible without the active facilitation and encouragement of financial “innovation” by regulators? Ultimately, that is a question that Ben Bernanke and the rest of the federal financial regulatory community have yet to answer. And despite all of the past efforts by the Congress to prevent the public from being forced to bailout out the largest banks, the *de facto* claims by private banks and investors on the public purse have never been stronger. It seems, at least, in terms of public practice, that the distinction between public and private claims on banks is growing less clear as the 21st century completes its first decade. But rather than ask whether the banks can be privatized, the better question seems to be how to insulate the public sector institutions and taxpayers from the periodic financial mishaps of the quasi-public commercial banks and explicit GSEs. Speaking at a meeting at American Institute for Economic Research in June 2009, Martin Mayer recalled that the origins of instruments like the credit default swap began in Washington:

We make bad policy in this country because we do not inquire about how we got to where we are. There are very few second acts in American finance. Not one in a thousand of the people now commenting on the future of regulation of the [credit default swap] knows where the instrument comes from. The truth is that the CDS is one of many of what I shall call GSIs – "Government Supported Instruments" -- that would never have come into existence without dumb ideas from on high. The Collateralized Debt Obligation or CDO, which came into existence in the late 1990s, is a single instrument expressing a garbage pail of loans and notes and bonds. It is all but impossible to value because it mixes together many disparate risks. Most people who think about it at all come to the conclusion that it's not very useful for trading or for investing. In short, it is an excrescence that ought not to exist. The CDO came about because Bill Seidman, when he was given control of the S&L workout in the late 1980s, wanted to sell whole banks rather than gather the tainted assets in FDIC control and auction them off in the usual FDIC procedure. Instead of taking, say, the real estate loans of six failed S&Ls and lumping them together as an offering on which real estate experts could paste a price, he wanted to take the entire portfolio of one or more failed thrifts and sell it off for what it would bring. Note that this multiplied the amount of business Wall Street would get from the workout. The way you got people to bid on this sort of package was to give them the right to substitute other assets for assets in the package, or to guarantee the cash flow from the package.

Mayer's comment not only describes the Washington origins of complex structured finance, but also the practice of substitution in a securitization. But more even than that, he illustrates the incestuous role between the dealers and the political world such that even in times of crisis, the banks are able to generate fees. This active connivance between the largest banks and the political class in Washington suggests that in the case of the former, privatization may no longer be an issue.

The government-sponsored entity is now the model of choice in Washington, for both parties. In addition to Fannie Mae and Freddie Mac, the GSEs include American

International Group, GM, Chrysler, GMAC and Citigroup, which together have cost the Fed and Treasury in excess of half of trillion dollars in subsidies to date – and the number is growing. The Congress does not disturb the arrangement because by keeping these GSEs alive and operational, Fannie and Freddie provide a relatively easy way for the Treasury to intervene in and support the U.S. housing market. And the banking industry is very supportive of Fannie and Freddie because keeping the housing GSEs operational is vital for their liquidity as well – at least until new private alternatives are created.

So while one could argue that a great deal has changed when it comes to money and banking in the U.S. over the past two centuries, the one constant seems to be the tendency of people to seek shelter and subsidy from the public while taking full advantage of opportunities for profit in between crises. The evolution of American history could be viewed as the gradual encroachment of the state into the financial services industry, but just as valid is a corporate view, whereby the largest of the banks are, in fact, GSEs, with implicit call upon the state in the form of a policy known as TBTF. This policy is enforced via the political sway of the TBTF banks, which in turn, play an essential role for the Congress by serving as dealers for the Treasury's debt.

This writer has described the relationship between the banks, the political class and the Treasury as an "Alliance of Convenience" in study of the crisis to be published by Vince Reinhart of American Enterprise Institute:

I submit that our spendthrift government, the Federal Reserve System and the TBTF banks together now comprise the paramount political tendency in America today. This tripartite "Alliance of Convenience," let's not call it a conspiracy, fits beautifully into the corporatist mold that seems to be America in the 21st century – but only viewed by the elites in cities like New York and Washington. Many Americans of all political descriptions oppose this corrupt and unaccountable political formulation. I hope and expect that these differences will become even more pronounced as the election approaches next November. The difference that separates the United States from the rest of the world is the difference which has

always divided us, namely our at least theoretical devotion to individual liberty and free markets. Until we break the Alliance of Convenience between the Congress, the Fed and the large, TBTF banks and force our public officials to embrace core American values regarding transparency, insolvency and accountability, we will not in my view find a way out of the crisis.³⁶

In such an alternative worldview, a corporate worldview, it is the taxpaying public that is being preyed upon by the TBTF banks and their allies in the political class, both of whom are now the chief advocates for inflation and currency debasement. The Fed is the facilitator of this arrangement, balancing subsidies for the TBTF banks with at least a semblance of fighting inflation and promoting economic growth, at least for public consumption. Perhaps an inquiry into the nature of the relationships between the largest banks is where future academic research should focus rather than wondering if the banking industry can be “privatized” or can ever disentangle itself from the political arena and the government’s monopoly on money. Clearly the answer to those questions seems to be a resounding no.

³⁶ Chris Whalen, “Are the Fed, the Congress and the Primary Dealers an Alliance of Convenience?,” *The Institutional Risk Analyst*, October 20, 2009.

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