PCS 234W: THE PAST AND FUTURE OF OUR FINANCIAL SYSTEM

Fall 2021: Tuesdays 5:00-7:30 p.m.

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This is a seminar in which each student will be asked to write a research paper on a topic related to our financial system. Our readings will be from my book, *Misalignment: The New Financial Order and the Failure of Financial Regulation* (Wolters Kluwer 2020) and Handout Pages. I have put four copies on reserve in Christine Massaro's office, located in Harkness Hall, Room 107. I will post class notes and questions for each session.

Misalignment opens with the financial meltdown of 2007-2009, retraces how our financial system was developed beginning with the Continental Congress, describes the legislative response to the 2007-2009 meltdown, the 2010 Dodd-Frank Act, and then offers an analysis of why the Dodd-Frank Act was inadequate.

In the decade after the Dodd-Frank Act, two new critical events have occurred: (1) the rise of digital assets and cryptocurrency such as Bitcoin and (2) the 2020 Corona Virus Pandemic. Both provide exceptionally interesting paper topics and will in any event be topics during our final substantive class on November 16.

Your final papers can focus on any mutually agreeable topic related to this course. Before choosing a topic, I will ask each of you to submit a two page proposal for your topic by October 19. On November 23 or 30, each student will present her, his or their paper to the seminar. Your final papers may be up to 25 double spaced pages including footnotes. The papers should be prepared in a font of no less than 12. Final papers are due two days before your presentation.

Your grade in the court will be 75 percent based on your final papers and oral presentation, and 25 percent based on class participation.

BACKGROUND

Our financial system today has many players, many products and many regulators. Let me offer a thumbnail of how the system works to help frame the course.

The United States has a large and complex financial system, principally composed of commercial banks and other depository institutions, securities firms, which include broker-dealers and mutual funds, insurance firms, hedge funds, pension plans and real estate finance.

Commercial banks are familiar because of bank accounts, checks and mortgage services. Depository institutions either can charter at the national or state level in the form of banks, savings and loans or credit unions. Most banks and savings and loans are insured by the Federal Deposit Insurance Corporation. As of mid-2018, there were 5542 insured commercial banks and savings institutions with total assets of $17.5 trillion. There also were 5480 federally insured credit unions with aggregate assets of $1.4 trillion.

Banks often are held by a Bank Holding Company such as JP Morgan Chase, Goldman Sachs, Citicorp, Morgan Stanley or Wells Fargo. A holding company also can own a securities or insurance affiliate and be a Financial Holding Company. As of mid-2018, Bank and Financial Holding Companies held $19 trillion in assets.

There were 3800 broker-dealer firms as of June 2018 registered with the Federal Securities and Exchange Commission with total assets of $4.4 trillion. Mutual funds which largely hold stock or debt securities held $16.6 trillion in September 2018. Money market mutual funds compete with banks for passbook accounts and long have been formed by mutual fund complexes. Money market funds have been criticized as "shadow banks" because they are not subject to the same level of regulation as national banks. As of October 2018, money market assets totaled $3.2 trillion.

Hedge funds provide many of the same services that SEC registered mutual funds provide, but with less regulation and can engage in transactions prohibited to mutual funds. Hedge fund customers typically are wealthy individuals or institutional investors. The gross asset value of hedge funds in 2017 was $7.3 trillion.

Pension plans provide retirement income, often by investing in stocks or debt. Pension plans can be public or private and are in addition to Social Security. As of the second quarter of 2018, the combined total assets of pension funds were $23 trillion. There are individual pension plans such as Individual Retirement Accounts which today account for approximately 28 percent of the retirement services market.

Insurance companies insure lives and property and offer retirement plans in the form of annuities which provide annual payments when they vest in competition with pension plans. The insurance industry is highly concentrated. By 2017, 51 percent of life insurance premiums were received by the ten largest firms. Insurance firms such as Prudential, Travelers or Metropolitan invest in a wide range of securities. As of 2017, total assets for the life insurance industry were $7.18 trillion.

As of May 2019, there was $33.9 trillion in residential real estate and $18.4 trillion in commercial real estate, of which $10.3 trillion in mortgage debt was provided for residential real estate and $2.4 trillion in mortgage debt was provided for commercial real estate. Mortgages today are arranged through banks and nonbank mortgage originators for both residences and commercial real estate. Since the 2007-2009 debacle, the nonbank mortgage origination market is dominated by a new generation of Internet firms such as Rocket Mortgage. Mortgage loans often are sold in groups of loans called tranches through a process called securitization which converts them into securities that can be resold to investors, rather than the traditional mortgage loans which were held by the bank or savings and loan.

As of 2016, all financial firms and investors held:

$33 trillion in common and preferred stock or equity. Stock can be held directly or through derivative instruments such as options or futures. Publicly held stock is traded on exchanges such as the New York Stock Exchange or the Nasdaq.

$14 trillion in marketable United States debt, typically through government issued securities called Treasuries. As of June 2019, total United States debt was larger, some $22 trillion.

$3.3 trillion in corporate bonds.

$8.9 trillion in mortgage related securities and $1.3 trillion in other securitized assets.

Finance is regulated by Federal, State and private regulators.

Banks and depository institutions are regulated both at the Federal and State level.

The Federal Reserve System is an independent regulatory agency that regulates Bank and Financial Holding Companies and State banks that receive Federal Deposit Insurance.

The Comptroller of the Currency, which is part of the United States Treasury, regulates national banks.

The Federal Deposit Insurance Corporation administers deposit insurance and bank liquidations.

The National Credit Union Administration oversees nationally chartered credit unions.

Each State also regulates banks and credit unions.

Securities, financial commodities and pension plans respectively are regulated at the Federal level by the Securities and Exchange Commission, the Commodities Futures Trading Commission and the Department of Labor.

Securities regulation also occurs in each state and is buttressed by self-regulatory agencies, the most important of which today is the Financial Industry Regulatory Authority.

Insurance regulation today solely occurs at the state level.

Housing finance is regulated at the federal level by the Federal Housing Administration. The mortgage market long has received key support from two Federal agencies popularly known ad Fannie Mae and Freddie Mac which at times have issued or held a majority of mortgages in this country.

READING ASSIGNMENTS

August 31: Introduction: Framing the Issues: Preface: In a Time of Crisis and Handout 7 - 11.

September 7: The Financial Debacle of 2007-2009: Part 1: The Meltdown: Pages 1-51 and Handout 12 - 16.

September 14: The Financial Debacle of 2007-2009: Part 2: Firefighting and Longer Term Solutions: Pages 51-124 and Handout 17-26.

September 21: Before the New Deal: The National Banks, the Jackson War on the Bank, Comptroller of the Currency, the Federal Reserve System: Pages 141-177, 188-196, 210-261, 277-285, 304-308, 318-327 and Handout 27-37.

September 28: Before the New Deal: Securities Regulation, Insurance, the 1929-1933 Crash and Banking Regulation: Pages 328-362, 377-430 and Handout 38-46.

October 5: The New Deal Revolution: Pages 430-488, 526-548, 560-577 and Handout 47-54.

October 19: The Deterioration of the New Deal Model: World War II, Bretton Woods and the Gold Standard, William McChesney Martin, "Independence" at the Fed, the Bank Holding Company Act of 1956, Keynesianism, Vietnam and the Return of Inflation: Pages 603-678 and Handout 55-63.

October 26: The End of the Gold Standard, Wage and Price Controls, Hyperinflation, the Humphrey-Hawkins Act of 1978, the Age of Volcker: Pages 678-769 and Handout 64-75.

November 2: The S & L Crisis, Deregulation, Alan Greenspan, FIRREA, Clinton and the 1993 Budget Deal: Pages 769-846 and Handout 76-85.

November 9: Gengrichism, the Committee to Save the World, the End of Glass-Steagall, Securities and Insurance Regulation, the New Financial Order: Pages 846-878, 1007-1012, 1016-1024, 1050-1054, 1057-1071 and Handout 86-95.

November 16: Finance Post 2007-2009, Cryptocurrency and the 2020 Pandemic: Pages 1101-1148 and Handout 96-111.

November 23 and November 30: Student Presentations

PSC 234W: Class Notes: August 31, 2021

Our course is a study of a pivotal area of American politics, our system of finance and financial regulation.

Our course in part is a study of crisis reaction. Since the formation of our Nation, we have had financial crises in 1792, 1797, 1819, 1837, 1873, 1893, 1907, 1929-1937, 2007-2009 and 2020.

FRAMEWORK

Financial and Financial Regulation

I. Depository Institutions

A. Banks

- National
- State
- Branches
- FDIC insured
- Bank holding companies
- Financial holding companies

B. Savings and Loans and Thrift Institutions

- National
- State

C. Credit Unions

- National
- State

D. Historical change in function of depository institutions

- Originally circulated own currency

- Today, U.S. Dollar issued by United States Government
- Loans
- Savings
- New functions such as credit cards, ATMs
- In recent years, rival currencies such as Bitcoin have emerged

II. Regulation

A. Banking

- Federal
- Department of Treasury – Office of Comptroller regulates National Banks
- Federal Reserve System regulates bank and financial holding companies, and State Banks that are FDIC insured
- Federal Deposit Insurance Corporation provides deposit insurance
- National Credit Union Administration
- State banking, savings and loan and credit regulation

B. Investment Firms

- Broker-dealers
- Mutual funds and other investment companies
- Money market funds
- Stock and options markets
- Hedge funds
- Financial futures
- Credit rating agencies
- Regulation
    - Securities and Exchange Commission

    - Commodities Futures Trade Commission
    - Securities Investor Protection Corporation (*SIPC*)
    - Financial Industry Regulatory Authority (*FINRA*)
    - State securities regulation, but not commodities regulation

C. Pension Plans

- Defined benefit and defined contribution plans
- Government – Social Security
- Employer plans
- Individual plans – such as IRAs
- Private and individual plans invest in securities
- Social Security invests in government bonds
- Regulation
    - Department of Labor is key regulator of employer plans
    - SEC limited ability to regulate voluntary contributory plans as securities when they have variable returns

D. Insurance

- Life and health includes annuities
- Property and casualty
- State regulation
- NAIC

E. Housing Finance

- Mortgages
- Traditional origination by banks
- Nonbank mortgage originators such as Countrywide
- Internet originators

Regulation today is a conservatorship

- Federal Housing Administration
- Fannie Mae and Freddie Mac

FUNDAMENTAL CHALLENGES

- Misalignment – leading financial firms no longer atomized, industry leaders are financial supermarkets. Regulatory system still based on New Deal atomized model.
- Challenge of change
    - Technology
    - Internationalization
    - Institutionalization
    - Financial products – derivatives such as futures, options, swaps and securitized assets
- Instability of politics – New Deal atomized model, eroded by gaps, omissions over time such as those for hedge funds and swaps and by creation of holding companies without countervailing regulatory response
- Who protects the consumer?
- Regulatory agency turf protection
- Congressional Committee oversight
- Inadequacy of Dodd-Frank Act of 2010 in response to 2007-2009 Meltdown – does not address regulatory structure, adequately empower the Financial Stability Oversight Committee to address systemic risk, eliminate overlaps such as those among bank regulators and SEC/CFTC, or provide for self-funding independent regulatory agencies. Dodd-Frank reduces emergency powers of Treasury, Federal Reserve and FDIC.
- Heightened risk today – looming debt crisis.

CLASS DISCUSSION

Q: What should be the core objectives or values of financial regulation?

Q: Is the financial regulatory system so complicated and fast changing that financial regulation is not really possible?

Q: Is regulation only possible if conducted on an international basis?

PCS 234W: Class Notes: September 7, 2021

The Financial Debacle of 2007-2009:

Part I: The Meltdown

Reading: Misalignment 1-51

I. Baseline: The New Deal Model

  A. 1929 Crash preceded by Great Bull Market of 1920s and Florida real estate collapse

  B. New Deal atomized regulation:

    a. Commercial banks separated from investment banks

    b. Federal Reserve, Comptroller, FDIC, Office of Thrift Supervision and National Credit Union Administration for depository institutions

    c. SEC for securities firms

    d. State insurance regulation continued

II. 2007-2009 – this Model spectacularly failed:

  A. Stock prices fell 54 percent

  B. Global market values declined $35 trillion

  C. Debt markets froze up

  D. Unemployment rose from 4.5 to 10.1 percent

  E. Federal deficit exploded from $459 billion to $1.413 trillion

III. The Meltdown began in housing

  A. Traditional mortgages

  B. The mortgage machine

- Mortgage originators
- Fannie Mae, Freddie Mac – dominant actors: critical advantages over private firms – borrow from Treasury, lower capital requirements, exempt from State and Federal taxes – by 2009, $5.39 trillion mortgages owned or guaranteed – role of shadow banks here meaning mortgage originators, investment banks and Fannie and Freddie – transformed mortgage generation – banks provided 54.4 percent of mortgage assets in 1970; by 2005, banks provided 24.2 percent.
- Securitization – tranches, customized tranches, substantial compensation for originators, securitizers and executives involved.
- Credit Rating Agencies – Moody's, Standard and Poors, Fitch. In 2005-2006 81 percent of subprimes received AAA ratings in part because they were overcollateralized – that is, more mortgages were in tranche than dollar value invested. Credit ratings in retrospect would be criticized for overreliance on historic default rates. In 2008, Moody's would downgrade 94 percent of subprime tranches, credit rating agencies paid for by the issuer. Over half income of Moody's in 2005-2007 was from mortgage related products.
- 1992 – change In Fannie Mae, Freddie Mac mission – affirmative obligation to facilitate lower income and moderate income housing – doubled home ownership purchases by 1995, home ownership grew from 65 to 69.2 percent between 1995 and 2000 – bipartisan support.
- Change in standards: 1992 Act encouraged mortgages with 5 percent downpayment or less (subprime mortgages are those with less than 20 percent down.) Fannie and Freddie worked closely with nonbank originators such as Countrywide. Documentation reduced – Alt-A loans reduced

documentation, allowed interest only payments, low down payment or second mortgage – grew to half of all mortgages by 2008. Adjustable rate mortgages were 31 percent of subprime mortgages in 1999, 69 percent in 2006.

- Delinquency rates on Alt-A or adjustable rate mortgages 13.8 to 45 percent compared to traditional or prime mortgages with 2 to 2.6 percent.
- Investment banks including Bear Stearns, Lehman Brothers and Merrill Lynch and commercial banks such as Citigroup and Wachovia effectively began to compete for the securitization business – investment and commercial banks responsible for 60 percent of all mortgages in 2005 and 2006.
- Credit debt obligations (*CDOs*) were based on mortgage tranches, including those with low ratings such as BBB. CDOs provided collateral for mortgage-backed securities. They appeared to eliminate risk for investors of buying low quality tranches. But CDOs did have risk for issuers such as investment banks. CDOs for investors were a hedging device; for issuers, a speculation or gamble.
- 2001-2007 Real Estate Boom – Interest rates dropped 3 percent, housing start ups 53 percent between 1995 and 2005, home mortgage indebtedness doubled from $5.3 trillion to $10.5 trillion.
- 2006 – on housing bubble burst – home prices declined 9 percent in 2007, 17 percent in 2008
- Fed – lender of last resort – discount window

Chronology of Failures:

- August 6, 2007 – American Home Mortgage Investment Corporation – bankrupt

- August 9, 2007 – BNP Paribas, largest French bank bails out three subsidiaries
- August 10, 2007 – European Central Bank infused 95 billion Euros
- August 2007 – January 2008 – Countrywide saved from bankruptcy by merger with Bank of America
- September 19, 2007 – Bank of England invested 10 billion Pounds in Northern Rock, then nationalized Northern Rock in February 2008
- October 24, 2007 – Merrill Lynch $7.9 billion lost on subprime mortgages
- Early November 2007 – Citigroup subprime exposure $65 billion, $42 billion higher than forecast three weeks earlier
- Fed took several steps to calm markets - $47 billion pumped into banks, interest rate cuts, term auction facility for short term loans. Dow neared 14,000 in October 2007.
- March 2008 – Bear Stearns - $29 billion rescue package from Fed and merger with JP Morgan
- Term securities lending facility for nonbanks too late to help
- Repo market neared collapse – much of Bear Stearns capital short term
- Was saving Bear wise? Moral hazard argument versus systemic risk to economy
- Fed §13(3) authority to lend to nonbanks under “unusual and exigent circumstances” when nonbanks had good collateral
- SEC lost oversight of investment bank holding companies after Bear Stearns
- July 2008 – Housing and Economic Recovery Act
- September 6, 2008 – Fannie Mae and Freddie Mac in conservatorship

- September 15, 2008 – Lehman Brothers bankruptcy – why not save?
- September 15, 2008 – Bank of America acquires Merrill Lynch
- Goldman Sachs and Morgan Stanley convert to bank holding companies
- AIG nears bankruptcy because of financial products division and credit default swaps – no private sector solution. Federal government initially provided $85 billion

And soon, everything gets far worse . . .

CLASS DISCUSSION

Q: If you were czar or czarina of the Universe, what would you have done differently?

Q: Were far reaching pre-2008 solutions politically feasible?

PSC 234W: Class Notes: September 14, 2021

The Financial Debacle of 2007-2009:

Part 2: Firefighting and Longer Term Solutions

Reading: Misalignment 51-124

After Lehman Brothers and AIG, Paulson, Bernanke and Geithner sought a comprehensive solution, which when enacted was termed TARP, the Troubled Assets Relief Program.

Two rival philosophies for emergency relief:

Bernanke and Geithner favored investing money into strong banks. These investments could be leveraged, so a $1 million loan would provide the capital to make $20 million loans at standard loan to capital ratios.

Paulson initially feared direct investment would cause political backlash and be viewed as a form of nationalization or viewed as favoring Wall Street. Paulson sought, and the Bush proposal for TARP was based upon, purchasing troubled assets.

TARP Bill sought $700 billion, a huge amount of money, but later recognized to be inadequate to fully address the crisis. This was believed to be the highest amount then politically possible.

Paulson three-page Bill initially was ridiculed for lack of detail, unbounded powers for Secretary of Treasury and lack of judicial review.

Presidential Candidate John McCain demanded a meeting at the White House on September 25 because of opposition to bailouts. The meeting was a political disaster for McCain, when he did not present a plan or have unified Republican support.

The economic crisis continued to deepen.

September 25: The largest savings and loan, Washington Mutual (*WaMu*), was taken over by the Federal Deposit Insurance Corporation. WaMu had relied upon payment option adjustable rate mortgages which led to its bankruptcy on September 25. JP Morgan acquired WaMu's bank operations for $1.9 billion under a much criticized deal by which WaMu's senior debt holders were asked to take a haircut, that is receive 55 cents on the dollar, and JP Morgan did not stand behind Washington Mutual's other obligations as it did with Bear Stearns.

Wachovia, the fourth largest bank holding company, soon neared collapse. Wachovia had $420 billion in deposits and was twice as large as Washington Mutual. The cause again was adjustable rate mortgages. On September 28, the FDIC voted to provide government support after receiving promises from the Fed to backstop the FDIC under the Systemic Risk Exception in the Federal Reserve Act.

On September 29, the House of Representatives rejected the TARP Bill by a vote of 228-205. The Dow Jones fell 778 points, approximately 7 percent. This meant $1 trillion in stock market value was wiped out.

Congress soon reconsidered TARP. The Bill by then 168 pages in length:

- Retained the Treasury Secretary discretion to buy troubled assets
- Included limits on executive compensation for banks receiving TARP funds – a provision Paulson, Bernanke and Geithner initially opposed, but later accepted as necessary to secure Democratic votes
- Raised deposit insurance from $100,000 to $250,000 per account
- Provided $700 billion, but in two phases - $350 billion immediately; $350 billion held back until President authorized
- Established judicial review

By October 3, both the House and Senate passed TARP.

The enactment of TARP did not end the crisis. In the following week, the Dow Jones Industrial Average fell 1874 points or 18 percent. Credit markets seized up. Most loans then were impossible to secure.

The crisis was now global with similar collapses in Europe, China and Australia.

October 8 – Great Britain invested $87 billion in eight large banks, receiving preferred stock and the opportunity to profit if and when banks turned around.

October 8 – Fed in tandem with European Central Banks, cut interest rates ½ of one percent.

The Fed also increased swap lines to other Central Banks, increased by 600 percent auctions of discount window credit and created commercial paper funding facility to purchase short term debt. This allowed all corporations, not just banks, to borrow and roll over debt. Commercial paper funding facility was revolutionary. The Fed ceased to be banker just to banks.

October 10, 2008 – G-7 meeting agrees to five principles – see pages 66-67.

Shortly later, most significant actions by Bush Administration:

1. Used $250 billion of TARP funds to support leading banks and take advantage of their leverage. Rejection of Paulson initial view. Nine leading financial institutions received up to $25 billion each, equal to 3 percent of each firm's capital. Later, $205 billion provided to 707 other financial institutions.

2. Guaranteed financial firm debt through temporary loan guarantee program in 122 banks and bank holding companies - $346 billion in guarantees.

Stock market reaction and the reaction in Europe initially was very positive.

But tremendous domestic criticism of bailing out leading banks and favoring Wall Street over Main Street.

Short term – TARP politically did not succeed.

Long term – TARP helped save the economy.

AIG by early October had run through $85 billion of support in three weeks. Additional $37.8 billion then provided which also did not work.

November 10 – AIG became first TARP recipient that was not a healthy financial firm. AIG provided $40 billion from commercial paper funding facility in return for warrants for two percent of AIG stock and restrictions on executive compensation. AIG interest rate reduced from 8.5 to 3 percent above LIBOR; repayment extended to five years from initial three years on loans to AIG.

Maiden Lane II and III created to buy bad AIG mortgage securities and CDOs for a total of $52.5 billion.

In long run, AIG would repay $182.3 billion in debt and Treasury would receive $15.1 billion profit selling AIG shares.

In short term, AIG was a public relations disaster. Goldman Sachs would receive $14 billion in payments under Maiden Lane III for credit default swaps. Goldman received 100 percent on the dollar. No haircuts. Saving AIG looked like subsidizing Wall Street.

Citicorp soon also was in critical care. Three times larger than Lehman Brothers, similar leverage ratio of 32 to 1, used off balance sheet transactions through Structured Investment Vehicles (*SIVs*) for borrowing which did not have reserves. Beginning in 2003, Citi, leader in collateralized debt obligations (*CDOs*), often issued with liquidity, puts under which Citi for a fee would buy back the commercial paper if there were no other purchasers. In 2007, this cost Citi $25 billion.

Citi treated as Too Big to Fail – given $25 billion from TARP, $24.3 billion from the Fed, and borrowed $84 billion from Federal home loan banks.

By November, 2008, Citi was in a death spiral, its stock plummeting below $10 for the first time since 1996; by November 19, $3.77. Losing 2 percent of deposits each day in November 2008.

Treasury, Federal Reserve and FDIC agreed to ring fence $306 billion of Citi toxic assets. Citi agreed to first $37 billion of losses and 10 percent of balance. The Fed and Treasury assumed the risk of 90 percent of losses. Citi provided $7 billion of preferred stock to Treasury and FDIC and warrants for 4.5 percent of its common stock.

Ring fence initially appeared to work. Citi stock rose 58 percent on the day of announcement.

As a political reality, saving big banks like Citi meant Treasury and the Bush Administration were expected to support the auto industry, then also deteriorating. Democrats in Congress demanded this. The election of Obama on November 4 strengthened the political need to do so.

President Bush, who had opposed the 1979 bailout of Chrysler, promised Obama "I won't let automakers fail."

On December 19, Bush announced support for $13.4 billion for General Motors and $4 billion for Chrysler.

Stock market continued to sharply deteriorate. In two weeks after the November election, the Dow Jones fell 17 percent. In all, the stock market would drop 40 percent from 2007 peak in 2008.

On December 11, 2008, Bernie Madoff's $65 billion fraud on investors in his investment advisory firm was revealed. SEC in Bush period had allowed securities enforcement to steeply decline. John C. Coffee would later write *Corporate Crime and Punishment: The Crisis of Underdeterrence*.

2008 would be an *annus horribilis* – 3.6 million jobs lost; gross domestic product declined 4 percent in third quarter, 6.8 percent in fourth quarter; $17 trillion of aggregate wealth lost - $5.6 trillion in housing, the rest largely in the stock market. State finances were ravaged. Medicare, unemployment compensation and welfare led to major State and local budget deficits.

Of the 25 financial institutions at the beginning of 2008, 13 failed (Lehman and WaMu), received Government support to avoid failure (Fannie, Freddie, AIG, Citi and Bank of America), merged to avoid failure (Countrywide, Merrill Lynch, Wachivoa), or transformed their business structure to avoid failure (Morgan Stanley, Goldman Sachs).

2009 initially would be worse. 4.7 million jobs would be lost. Stock prices would reach their period low of 6547 on March 9, 2009, dropping 27 percent in the first ten weeks of 2009. Unemployment would reach 10.1 percent in October 2009.

Several major steps were taken.

The American Recovery and reinvestment Act (*ARRA*) of 2009 provided $787 billion in a politically compromised stimulus package - $288 billion in tax reductions, $144 billion for State and local governments, and $355 billion for Federal spending programs, but no job creation program as in the Great Depression Civilian Conservation Corps.

ARRA was dramatically larger than Bush's February 2008 $170 billion tax rebate and tax incentives program.

With TARP and ARRA, the Obama Administration attempted a more far reaching program to prevent or limit housing foreclosures. The default rate on homes was 9 percent in 2009. Home prices fell 32 percent between 2006 and 2009.

The Home Affordable Modification Program and Home Affordable Refinance Program added $200 billion to earlier funds for Fannie and Freddie and allowed 1.3 million mortgages to be refinanced, less than 5 million earlier sought to be refinanced. Banks separately refinanced 3.9 million mortgages. The Federal Housing Authority mitigated the losses of two million other mortgages.

The Housing Programs were pilloried by the political right and inspired creation of the Tea Party. Rich Santelli asked "How many of you people want to pay for your neighbor's mortgage that had an extra bathroom and can't pay their bills?"

The Obama Administration's efforts to support the auto industry, in contrast, were highly successful. Another $81 billion was provided to GM, Chrysler and General Motors Acceptance Corporation on top of $25 billion provided by the Bush Administration. Auto CEOs were fired, GM and Chrysler went through bankruptcy to clean up books, closed plants, and ended lines such as Pontiac. At a cost of $10 billion, by 2011, the auto industry had turned around, with 640,000 jobs saved.

Citi early in 2009 once more was in crisis. Treasury increased its stake from 8 to 36 percent by converting preferred stock into common stock. After a bumpy ride, Citi stabilized, paying off $20 billion of debt to the Federal Government in December 2009.

AIG proved the most embarrassing and astonishingly paid $155 million in bonuses to Financial Products Division executives who had virtually destroyed the company.

The two most serious Obama period initiatives before the 2010 Dodd-Frank Act were:

First, Treasury Secretary Geithner's Stress Test – meant to be realistic appraisal of whether 19 leading financial firms, each with assets over $100 billion, could survive consensus likely losses in 2009 and 2010 and losses under a more adverse scenario. See pages 96-105. Firms were expected to achieve Tier 1 capital of 6 percent under consensus forecast and 4 percent under adverse scenario.

May 7, 2009 results of stress testing was reassuring. Probable losses of $600 billion in 2009 and $400 billion in 2010 were not insurmountable. $75 billion of new capital was needed and could be achieved without TARP funds.

Confidence was restored in banks, but Economist Paul Krugman and others questioned the basic premise of the Stress Test: When you save the banks, the rest of the economy will be helped. Krugman urged: "Banks and markets recovered, but the real economy and the job market didn't."

Krugman and others proposed nationalization of banks as had been done in Sweden.

Second major Obama period initiative was run by the Fed and called Quantitative easing. See pages 105-107. The Fed purchased $1.7 trillion of Fannie Mae, Freddie Mac and other Government debt between September 2008 and October 2010 to bring down interest rates and stimulate the economy. Fed Chair Ben Bernanke believed he helped stimulate a 3000 point rise in the Dow by the end of 2009. GDP increased to 3.9 percent in the fourth quarter of 2009.

In 2009, the Financial Meltdown ended. There would be very little net expense to the Federal Government, but a total of $1.7 trillion was used for QE, $939 billion for FDIC guarantees of senior debt, and $1.354 trillion to support several new Fed lending programs.

Human and political costs were immense:

- Unemployment would remain above 9 percent until 2010.
- Deficit would remain over $1 trillion per year until 2012.
- Massive political backlash would contribute to Republican gains of 63 House and 6 Senate seats in 2010. Congress would flip to Republicans in 2010.
- The crisis would be global and interdependent – European debt crisis was characterized as largest aftershock of 2007-2009.

The big question: Why did the 2007-2009 Meltdown happen?

Proximate causes included:

- Weakness in regulation
- Excessive borrowing
- Excessive leverage
- Fannie Mae and Freddie Mac emphasis on nontraditional mortgages
- New financial instruments such as CDOs backfired
- Credit rating agencies performed miserably
- Low interest rates too long stimulated economy

Ultimate causes:

1. Ideology
    - Bipartisan support for housing
    - Deregulation

2. Misaligned structure

CLASS DISCUSSION

Q: You are again czar or czarina of the Universe. The 2008 elections have created opportunities for new political initiatives. What would be your priorities?

PSC 234W: Class Notes: September 21, 2021

Banking before the New Deal

Reading: Misalignment 141-177, 188-196, 210-261, 277-285, 304-308, 318-327

United States born in financial crisis

Government under the Articles of Confederation was a shambles:

- No plan to repay Revolutionary War debt – then over $200 million
- Direct taxation impracticable
- Reliance on duties
- Paper money near worthless – not worth a Continental – only effective money, gold or silver, called Specie
- Bank of North America in 1781, First National Bank – issued Bank Notes - $2 million in capital after 1786 authorized, only $786,000 in fact. Government owned 5/8th; private investors the rest
- Bank of North America survived because of Robert Morris, Continental Congress Superintendent of Finance
- Never enough money to pay soldiers or buy supplies that Washington believed he needed during Revolutionary War
- Banks in general hated by much of the population which was largely agrarian – Jefferson leading critic: "Banks were devices to fleece the poor, oppress farmers, and insure a taste for luxury that would subvert Republican simplicity."

United States Constitution in 1787 responded to weaknesses of Continental Congress financial system

- Congress granted the powers to collect taxes and duties, borrow money on the credit of the United States, regulate commerce, coin money and regulate its value
- States were prohibited from coining money, impairing contracts, imposing duties and were required to give full faith and credit to other States
- Supremacy clause made United States laws supreme when conflict with State laws

United States Constitution achieved success because of early decisions on finance.

First Secretary of Treasury Hamilton was key actor, especially in first three years, 1789-1792.

Hamilton closely studied the Bank of England then the most successful in the world. As described by Walter Bagehot:

- Private bank based upon stock sales
- Lent money to the Government
- Bank of England had exclusive possession of Government balances and over time depository for many other private banks in England
- After 1844, monopoly in issuing Bank Notes which became England's legal tender
- Could only lend money equal to its capital – by 1790, 11 or 12 million Pounds – but could raise or lower interest rates to attract investors
- Critical role in financial crisis, Bagehot's two rules: (1) Make money available as soon as possible to end the panic, but do so at high interest rates; (2) loan money only to strong Banks with good security – no advance should be made to Banks that will fail

Hamilton in first two years of Washington Presidency would establish a budget system, fund debt, create a tax system, create a National Bank, Customs Service and a Coast Guard. He did so generally with a loyalty to the wealthy in society, especially in New York, his home State and the Northeast. By 1796, when he stepped down as Secretary of Treasury, Treasury had 570 employees, War Department, 12; State Department, 8.

Three influential Reports – two of which are relevant to this class:

Report on Public Credit (1790):

National and State debt $79 million

War veterans had sold securities they received in lieu of cash for their services, often at 15 Cents on the Dollar.

Some States such as Virginia had paid off their Revolutionary War debt; others such as Massachusetts had not.

Hamilton proposed that the National Government assume State debt paying it in full, meaning that speculators who had bought from veterans at a discount and States that had not fully paid off their debt would benefit.

Hamilton justified this as essential to enable the Nation to borrow in the future.

He rejected discrimination in debt payments to benefit veterans and States that earlier had paid off their debts.

Hamilton recommended a loan be approved by Congress for the full amount of all National and State debt – State debt would be assumed in exchange for securities of the United States – loans would be repaid by duties which then accounted for 90 percent of Government revenue and by taxes such as a subsequently enacted Whiskey Tax.

Hamilton was famous for saying that a National debt would be a National blessing, by which he meant a means to bind the Country together.

The Funding Act passed in August 1790, but deeply divisive – Madison, Hamilton's Coauthor of the Federalist Papers, opposed debt assumption. Madison disagreed that State debt should be assumed by the National Government, pointedly criticized unequal impact on States such as his home State of Virginia which had paid off its $3 million debt but would now have to bear a $2 million greater cost. Madison also criticized enriching financial speculators – "Public debt is a public evil." Madison was willing to break up the Union rather than accede to debt assumption.

Jefferson was the peacemaker, at a celebrated dinner persuaded Madison to temper his opposition to debt assumption and Hamilton to agree that the National Capitol would be located in Washington D.C.

August 4, 1790 – An Act for making provision for the payment of the debt of the United States enacted.

Hamilton's second Report, on the National Bank, was published in December 1790. This Report would prove even more divisive and lead in significant part to the formation of rival political parties.

Support for the National Bank came from New England, New York and Pennsylvania, especially financial, manufacturing and trading interests, opposition from Southern States such as Virginia with plantation farming.

Hamilton's case for a National Bank emphasized:

- Money deposited in Banks could be lent out at a multiple of the amount deposited when circulated as paper money at a ratio to deposited gold or silver

- A Bank was essential in emergencies such as war
- A Bank could facilitate collection of taxes

Hamilton sought a National Bank in New York without Branches.

Hamilton opposed loans based on real estate.

Hamilton opposed profits in Bank redounding to the States.

He sought a private Bank, such as the Bank of England, with private individuals as directors, but one required to be key lender to the United States Government. United States Government investment was limited to 20 percent of capital.

Debt would be limited to the amount of capital raised, which Hamilton proposed to be $10 million.

There was a 20 year term.

All debt of the Bank could be paid on demand in gold or silver.

Madison, Jefferson and Attorney General Edmund Randolph opposed the National Bank Act both before and after enactment but before Washington concluded whether to sign or Veto the Act. There were several grounds:

- Paper money would banish gold and silver as a currency
- The Bank would be subject to Bank runs
- The Constitution did not expressly authorize creation of a banking corporation

Washington was initially persuaded and requested a Veto Message from Madison.

Washington also asked Hamilton to respond, which Hamilton persuasively did.

- Hamilton rejected the notion that the National Government was limited in its ability to create a Bank.
- The National Government must be sovereign and able to employ all necessary and proper means to achieve its designated ends – powers to create banking corporation could be implied from the Constitution's powers to tax, borrow money, fund war effort, and regulate trade.
- Linguistic debate with Jefferson over Necessary and Proper Clause Hamilton's position was adopted by the Supreme Court in *McCulloch v. Maryland* in 1819.

Washington signed the Bank Bill on February 25, 1791.

Hamilton won the battle but would lose the War until 1913.

Presidents Jefferson and Madison opposed the National Bank and Maddison did not support extension of its Charter in 1811 – this would prove an economic disaster during the War of 1812 and lead to a dramatic increase in State Banks as well as rampant inflation based on a multitude of State currencies.

In 1816, Second Bank of United States chartered – as with First Bank, the Second was the largest corporation in United States and located in Philadelphia.

$35 million capital – U.S. investment 20 percent.

20 year Charter

Different than First Bank – had 19 Bank Branches

Bank Branches less successful than National Bank

Context in which Second Bank radically different than First – now hundreds of State Banks in competition with the National Bank.

Andrew Jackson would Veto an Act to extend the Charter of the Second Bank of the United States in 1832.

Jackson is the key actor in American finance, 1832-1933. Economic populist, distrusted Banks, distrusted paper money, disagreed with John Marshall on Constitutionality of National Bank, believed in limited Government, proud to repay all National debt in 1835.

Jackson hated Nicholas Biddle, the competent but high handed third President of the Second Bank of the United States.

Jackson opposition to National Bank strongly supported by State Banks and by populist critics such as William Gouge who wrote at length about his opposition to paper money and business corporations.

Jackson Veto message on July 10, 1832 of Act to extend Charter of the Second Bank had five main themes:

- Bank not expressly authorized by Constitution
- Second Bank granted monopoly powers
- National Bank had foreign stockholders
- Election of Bank Directors not subject to democratically elected President and Executive Branch
- New powers such as right of Bank to hold real estate made Bank even more powerful

Jackson ended his Veto message with famous peroration in text at Page 228.

After Jackson's Veto message, banking became a system of *laissez faire*.

Jackson had his Secretary of Treasury Roger Taney remove United States deposits from the Second Bank before its expiration in 1836 and deposit in State Banks.

Biddle overplayed his hand and declined to receive State Bank Notes, which led to widespread inflation and injury to business and labor. The Depression of 1837 was aggravated by weakened banking system.

State Bank mania – 200 new State Banks created between 1834 and 1837 – State loans between 1830 and 1838 grew from $200 million to $525 million – paper Money increased 32 percent between 1835 and 1836. State Banks issued 1500 different kinds of Bank Notes by 1863.

Jackson also harmed economy with 1836 Specie circular requiring gold and silver to be used to pay for public lands. This would lead all Banks in the Country to suspend payment of Specie in 1837.

Government Duties would fall from $51 million in 1836 to $25 million in 1837. Government would run a $12 million deficit in 1837. There were riots in New York and elsewhere.

President Van Buren's response inept – proposed even more fully separating Federal Government from Banking system as was achieved in Independent Treasury Act of 1840.

Subsequent Bank panics in 1853, 1873, 1884, 1890, 1899 and 1907.

Before Federal Reserve Act of 1913, limited Federal steps.

February 1862, at beginning of Civil War, first Paper Currency in United States approved, Greenbacks -- $450 million ultimately created.

Three Federal laws created:

- Office of Comptroller of Currency to regulate new National Banks
- 1864 Banking Act specified minimum capital requirements for National Banks, requirement that one third of capital be deposited

with United States Treasury, limited liabilities to a ratio generally of 10 to 1

- Secretary of Treasury Chase sought to reduce State Currency through tax in 1864 set at 10 percent on Bank Notes and voluntarily convert State Banks into National Banks. State Banks also could not issue National Currency or act as depositories of United States Funds. The intent was to tax the State Banks out of business. It failed. Despite Chase and subsequent Treasury Secretary Sherman's efforts, dual banking system was retained. Many Banks preferred State Charters because they could avoid the Federal tax with new devices such as checks; State minimum capital and examination requirements less onerous than Federal.

Next several decades focused less on Bank structure than Currency Wars – should United States have a gold standard or Bimetallism. Particularly controversial was the "Crime of 1873" when silver barred as basis of Currency. Silver more inflationary than gold, popular with farmers, South and West which were often in debt; gold favored by financial institutions, particularly those that traded with Europe. Key issue in 1896 Election. McKinley and gold standard defeated William Jennings Bryan.

By 1900, economy had grown substantially in size and complexity despite weak banking system.

Giant banking companies such as JP Morgan created; National monopolies such as Standard Oil. Leading Banks both engaged in Commercial Banking and Investment Banking. Stock markets became effective device to fund new corporations.

Repeated financial panics culminated in Panic of 1907 – severe stock market decline, JP Morgan led effort to stem panic leading consortium that invested in New York Stock Exchange, New York City, some key Trust Companies and securities brokers. This was Morgan's last hurrah.

In 1913, after the Election of Woodrow Wilson as President in 1912, Congress enacted the Federal Reserve Act.

The Act was heavily influenced by the ghost of Andrew Jackson.

There was no single Central Bank, but instead a Federal Reserve System with a Federal Reserve Board in Washington D.C. and 12 Regional Federal Reserve Banks throughout the Nation.

The relationship of the Fed in Washington to the Federal Reserve Banks, the Treasury and the Office of the Comptroller was not well defined in 1913.

The Fed Board consisted of seven Members – five were Presidential appointees with ten year terms, the Secretary of Treasury and Comptroller were *ex officio*.

The Fed was empowered to examine each Member Federal Reserve Bank, permit the Federal Reserve Banks to Rediscount Paper of other Banks. The Fed paid a dividend of 6 percent to Member Banks after necessary expenses deducted.

Critically, the Fed was empowered to issue its own Federal Reserve Notes, redeemable in gold. These Notes were to be issued to each Federal Reserve Bank as long as the Fed Bank provided adequate collateral. Each Federal Reserve Bank was required to maintain 35 percent reserve against its deposits.

Reserve requirements for Member National Banks were reduced. Membership in the Federal Reserve System by Member Banks was optional.

The 12 Federal Reserve Banks were given broad powers:

- To discount Notes, Drafts and Bills of Exchange
- To receive from any Member Bank deposits
- To Purchase in the open market from Member Banks Bills of Exchange
- Subject to the Fed Board, to determine local Discount Rates

The 1913 Act fortified a three fold system of financial regulation:

- National Banks who were Members of the Federal Reserve – some 7530 in 1929 with $21.6 billion in total deposits
- State Member Banks of Federal Reserve – 1177 such Banks with $14.3 billion in total deposits
- State Nonmember Banks – 15,797 Banks with $13.2 billion in deposits

Unique system – State and Federal, many Banks, few Branches.

CLASS DISCUSSION

Q: Why by the time of the Federal Reserve Act of 1913 did a consensus develop that we needed a National Bank?

Q: How would Hamilton have designed a National Bank in 1913?

Q: Could the United States economy solely include a National currency such as that created during the Civil War and consistent with Jackson solely rely on State Banks?

PSC 234W: Class Notes: September 28, 2021

Before the New Deal: Securities Regulation, Insurance, the 1929-1933 Crash and Banking Regulation

Reading: Misalignment 328-362, 377-430

I: Securities Regulation Before the New Deal

Largely at State level

Largely derivative of State corporate laws

Corporate governance – Board of Directors senior officers

Corporate finance – stock, debt, balance sheet, income statement

Stock issuance to public through underwriting process

Late 19th Century, State corporate law chartermongering

Par value reduced to law par or no par

Stock issued in exchange for property or services, not just cash

Stock options and stock warrants – Berle conclusion in 1930: "By using them, or a combination of them appropriately, the profits of the enterprise and also in considerable measure the underlying assets, may be shifted from one group of stockholders to another."

State Securities Law effectively began with Kansas Blue Sky Law of 1911.

Merit regulation – Bank Commissioner given broad discretion not to grant a permit to sell stock if stock issue unfair, unjust, inequitable or oppressive to any class of investors

Kansas Blue Sky type law Constitutional Supreme Court held in 1917 – by 1933, every State but Nevada had a Blue Sky Law

Ineffectual with cross border offerings

Riddled with exemptions

Inadequate enforcement

New York Stock Exchange, primary market for securities in U.S. by 1913 according to Pujo Report

Some oversight through Listing Committee

Listing standards voluntary – could be avoided through trading of unlisted stock

Enforcement of listing standards inconsistent – Kreuger & Toll 1929 debenture with substitute collateral

Corporate reporting inadequate compliance – all listed firms provided annual reports by 1933, 60 percent quarterly reports – but only minority reported gross income

Stock trading on floor of Exchange sometimes subject to manipulation through wash sales, touting and other means

Before New Deal, wartime capital controls in World War I – Ended after World War I

1920 Interstate Commerce Act amended to empower the Interstate Commerce Commission to approve new railroad issues

Economy far outgrew primitive State Blue Sky Laws and minimal New York Stock Exchange and Federal regulation

Great merger waves and economic expansion between 1898-1902 and during 1920s booming economy

Led to as many as 250 firms trading securities by 1914 including private banks such as JP Morgan and leading securities firms such as Goldman Sachs

National Banks technically were not permitted to underwrite securities – 1911 National City Bank organized an affiliate that soon underwrote 20 percent of all Bonds in the Country

Pujo Report doubtful that a Federal Securities law could be established except under power of Congress to regulate the Mails

II: Insurance Regulation

Insurance regulation before and after New Deal solely at State level

By 1929, $4.3 billion in aggregate life insurance company assets, 6 percent of banking industry $26.1 billion

Whole life

Term life

Importance of reserves

Stock insurance firms

Mutual insurance firms

Close links to investment banks because life insurance companies reserves were invested in long term securities

Tontine Insurance – whole life with survivor or survivors receiving value of combined savings after a specified period such as 20 years – more expensive than whole life, but attractive because of potential higher return

Supreme Court in *Paul v. Virginia* (1869) held that life insurance sales could not be considered interstate commerce and subject to Federal law

By turn of the Century, life insurance sales practices, particularly among big three Life Insurance Companies, Equitable, New York Like and Metropolitan, often were scandalous

1905 Equitable scandal led to Armstrong Commission – 57 days after public hearings focusing on Big Three Insurers in New York. Charles Evans Hughes served as counsel. The Armstrong Commission found:

- Weak Boards of Directors – Henry Hyde and after Henry Hyde's death, son James Hyde dominated Equitable
- Lavish political contributions
- Excessive salaries
- Excessive expenses
- Irregular accounts at affiliated Trust Companies
- Overstatement of surplus – 20 percent at Equitable
- Failure of Trustees of Equitable to put into place mutualization
- Insider dominance of stock transaction enriched James Hyde and relatives
- Inadequate State insurance regulation

Armstrong recommendations subsequently enacted by New York State established the first effective State Commission on Insurance:

- Policyholder voting in mutual companies

- New election rules for Directors
- Real estate transactions required Insurance Superintendent approval
- Stock investments or securities underwriting prohibited
- Business expansion limited in largest insurance corporations
- Political contributions prohibited for all New York corporations
- Life insurance expenditures regulated including limits on commissions to sales people
- Executive salaries initially above $5000 required Board approval
- Tontine insurance ended
- Reserve requirements increased
- Only four types of life insurance permitted; essentially limited to term and whole life

Armstrong Commission Report and New York legislation increased confidence in life insurance

Life insurance annual sales increased from $1.782 billion in 1907 to $17.755 billion in 1929, including:

- Group insurance
- Annuities

Limits on life insurance firms owning or underwriting securities largely insulated life insurance industry from 1929-1933 Stock Market Crash

III: Before the New Deal

U.S. emerged from World War I strongest economy in the World

Roaring Twenties boom time in U.S.

Wild overoptimism – See President Coolidge Statement on Pages 379-380.

Stock market boom – Dow Jones rose from 72 in 1920 to 381 by September 3, 1929

Everybody ought to be rich enthusiasm throughout American culture even though only 1.5 million Americans invested in stock market

1929-1932 Stock Market Crash

Hoover hesitated to intervene

Stock market hearings

Senator Johnson Finance Committee on Foreign Bonds

Pecora Hearings initiated

Simultaneous banking crisis

Federal Reserve minimal response

Gross National Product decreased from $103.1 billion in 1929 to $55.6 billion in 1933

Unemployment 3 percent in 1929, 25 percent in 1933

IV: The New Deal and Banking Regulation

Roosevelt overwhelmingly elected in 1932; Democrats also controlled Senate and House

Roosevelt began famous One Hundred Day period with a self-declared mandate for action – rejected Stalinist or Hitlerian totalitarianism

36 hours after taking office on March 4, 1933, declared National Bank Holiday after Nationwide Bank runs

March 9, 1933 – Emergency Banking Act:

- Americans required to surrender gold – Roosevelt in 1934 devalued Currency by 40 percent – new Currency created backed by U.S. Full Faith and Credit
- Reopened all sound Banks – U.S. Government could extend advances as necessary
- Comptroller could act as Conservator for unsound Banks

March 12, 1933 – first Roosevelt Fireside Chat built confidence to end Bank Holiday

At same time, some 5000 of 17,800 U.S. Banks reorganized or closed in 1933

Reconstruction Finance Corporation invested $1 billion in Bank Capital, one-third of total capital of U.S. Banks in 1933

Weaknesses in the U.S. Banking System:

- Dual National and State systems
- State Branching not permitted to National Banks
- McFadden Act of 1926 allowed limited in-state National Bank Branching
- Federal Reserve between 1913 and New Deal had confused structure – 12 Federal Reserve Banks often more powerful than Central Federal Reserve Board. Struggle between Central Fed and New York Federal Reserve Bank over interest rates contributed to ineptitude of Fed 1929-1933. Central Bank kept interest rates too high when economy

- Large Bank affiliate system led to subsidiaries by 1933 in securities industry and real estate. One half of all securities issues between 1921 and 1933 came from Bank Holding Companies

June 16, 1933 enactment of the Glass-Steagall Act:

- Separation of Commercial Banks from most Investment Bank or securities activities
- Requirement that private Banks such as JP Morgan be subject to same oversight as National Banks
- Federal Deposit Insurance Corporation established to provide deposit insurance initially to 97 percent of all Commercial Bank deposits. Ended Bank runs.
- Powers of Central Federal Reserve strengthened relative to Regional Federal Reserve Banks by creation of an Open Market Committee to specify Regional Bank interest rates
- National Bank Branches expanded throughout the State in which the Bank was located
- 1935 Banking Act further strengthened Central Fed by reducing Regional Bank membership on Open Market Committee and authorizing the Central Fed to appoint Regional Federal Reserve Presidents
- Deposit insurance increased

CLASS DISCUSSION

Q: Why was National financial regulation so minimal before 1933?

Q: Does it make sense to divide investment banks, that is securities firms, from commercial banks?

Q: Why did Roosevelt require individuals to surrender gold in 1933?

Q: What were the dangers of creating a National currency solely backed by the Full Faith and Credit of the United States? Why didn't this run the same risk as State backed Notes?

PSC 234W: Class Notes: October 5, 2021

The New Deal Revolution

Reading: Misalignment 430-488, 526-548, 560-577

Roosevelt New Deal address three core pillars of financial regulation, banking, securities and housing

The Stock Exchange Practices Hearings (1932-1934) galvanized legislative response:

- Begun under President Hoover in April 1932, led by Progressive Republican Peter Norbeck
- An early highlight was Fiorello LaGuardia presentation of 61 cancelled checks given by corporations to newspaper journalists including journalists from the *New York Times* and *Wall Street Journal* to boost stocks
- Pool operators led by firms such as MJ Meehan disclosed in May 1932 to manipulate RCA stock
- Norbeck selected Ferdinand Pecora to be Committee Counsel as his last significant act before Democratic Majority swept into the Senate in 1933 and Democrat Duncan Fletcher became Committee Chair
- Pecora focused on several key actors in the 1929-1933 collapse
- First, Insull Utility Holding Company, responsible for 10 percent of the Nation's electrical power, dominated in a multi-layer holding company by Samuel Insull and his family. Insull Utility was heavily leveraged and went bankrupt in September 1931, "biggest business failure in history of the World." Securities sales had benefitted Insull and other insiders, excessive bank loans to over

100 separate operating companies circumvented loan limits to any one company in Banking Laws.

- Second, National City Bank led by the Banker of Bankers of the period, Charles Mitchell. 1911 National City Bank created National City *Company*, to circumvent the Comptroller's prohibition on Commercial Banks operating in the securities industry. Mitchell led both the National City Bank and Company. By 1929, the National City Company was the largest security broker in the country with brokerage securities sales of over $1.5 billion a year. Mitchell relied on high pressure sales, advertising, securities sales in the commercial bank.
- Pecora Hearings revealed extraordinarily high compensation paid to Mitchell and others in National City, $1.3 million paid to Mitchell in 1928, at a time when highest paid Federal civil servants earned $1600 a year. The revelation of 1929 wash sales by which Mitchell sold and repurchased stock from his wife to create what appeared to be fraudulent tax savings led to Mitchell's resignation and March 1933 indictment. Further revelations revealed bribery by National and other investment firms including J&W Seligman to secure right to underwrite what became near worthless Peruvian Bonds. See description of Bonds on Page 441. National encouraged flipping of World War I Bonds held by many Americans into Bonds such as the Peruvian Bonds with higher interest rates. There were material omissions in prospectuses. In 1927, National City Company in contravention of National Banking Law began purchasing National City Bank common stock to achieve working control of its market. The stock price of National City Bank soared from $785 per share in January 1928 to the equivalent of $2925 in 1929 before falling to $100. Pecora presented evidence that National City had manipulated its own stock price.

- The most dramatic testimony of Pecora Hearings concerned JP Morgan, the leading news story for 12 Hearing Days. JP Morgan & Co. was a private investment bank with just 24 partners in 1933, but dominant investment bankers of the period. These 24 partners held 126 Directorships in 89 firms with assets of $20 billion and helped issue $6 billion in securities between 1919 and 1933. No high pressure sales such as those in National City Company.
- Pecora undermined Morgan assertion that JP Morgan was a National asset. JP Morgan paid no income taxes in 1931 and 1932, a shocking revelation to public. This was not illegal. Morgan had huge business losses those years. JP Morgan & Co. usually did not publicly underwrite stock but instead gave stock at steep discounts to preferred lists of investors who resold to public. Preferred list was a Who's Who of Government and business figures. Most serious was the organization by Morgan of public utility holding company United Corporation in 1929 – Morgan and Company sold United Corporation stock and options and made $419 million in profits by 1933.
- Fall of the House of Thebes, ultimately symbolized by Morgan and the Midget, Lia Graf.
- The legislative consequence of Pecora Hearings included several Federal securities laws between 1933 and 1940 and the creation of the SEC.

Securities Act of 1933:

Securities Act of 1933 was enacted during the First Hundred Days of Roosevelt Administration.

Roosevelt advisers including top aide Raymond Moley was critical of the Act. Moley because he thought that it would have a negative impact on business; Rexford Tugwell and Adolf Berle of the famed Brains Trust because they favored National planning.

Roosevelt relied on Louis Brandeis and his philosophy, "sunlight is the best disinfectant." Roosevelt sought a Fraud and Disclosure Law for new securities issues – See Roosevelt Message on Page 584.

Several legislative teams involved in drafting of the 1933 Act. Their efforts polarized on many issues, of which the most consequential was merit regulation. Could the Federal Government preclude securities that were "in unsound condition" rather than the full disclosure of the philosophy of the James Landis-Ben Cohen-Tommy Corcoran draft which favored fully informing the market.

Sam Rayburn Chairing the House Commerce Committee like Roosevelt favored rapid enactment of a new Law during the time of the Pecora Hearings publicity. Many of his Committee disfavored the Thompson Draft power of the Federal Trade Commission to preclude securities issues not based upon sound conditions.

Roosevelt turned to Felix Frankfurter who asked Landis-Cohen-Corcoran to draft the new Act.

Frankfurter ultimate policy objective was to help Roosevelt establish a Federal Government led by a fourth Branch of Administrative Agencies to oversee United States economy. Frankfurter was champion of modern regulatory state.

The Securities Act of 1933 was a modest part of the Frankfurtian vision. As enacted:

- Federal Trade Commission empowered to enforce Securities Act – no power to pass on quality of securities
- Mandatory disclosure for firms making a public issue – called Truth in Securities or Full Disclosure Act

- Waiting period to reduce high pressure sales
- Fraud provisions required due diligence on part of issuing firm, executives and underwriters with increased fraud provisions

The Securities Exchange Act of 1934 was far more comprehensive:

- Established SEC to administer the Securities Act of 1933 and Securities Exchange Act. The SEC was an independent regulatory commission led by a five person Commission with no more than three Commissioners from any one party.
- Stock market registration and oversight, but no abolition of floor traders or specialists.
- Margin loan limits established enforced by the Federal Reserve which Roosevelt feared too accommodating to Wall Street.
- Corporate governance provisions regulated proxies, insider trading.
- Broker-dealers had to register. This created a challenge of oversight given over-the-counter market.
- Roosevelt disappointed reformers by appointing Joseph Kennedy, not James Landis, to be first SEC Chair. Landis, Pecora among other four Commissioners.

SEC under first Kennedy, then Landis as Chairs had an extraordinary start. The SEC was the most successful of the New Deal regulatory agencies.

Commission reached its apogee under third Chair, William O. Douglas. Douglas was more assertive than Landis, he sought an SEC that would be the investors' advocate. Douglas was highly critical of investment bankers. But Douglas' ideal was self-regulation under SEC supervision, Douglas' shotgun in the closet philosophy.

Douglas led successful effort to reorganize the New York Stock Exchange. In 1937, he threatened tough trading rules if New York Stock Exchange did not transform governance from a floor member dominance by specialists and floor traders to a new system with a full time President and Board dominated by broker-dealers who dealt with the public and public representatives. Memorably accused the New York Stock Exchange of being like a private club with elements of a casino.

New York Stock Exchange fearing that a fight with the SEC would hurt business appointed the Conway Committee which proposed reconstituting the Exchange Board dominated by broker-dealers and a full time paid President with her or his own staff. New York Stock Exchange withdrew accusation that SEC had caused 1937-1938 recession.

Then the Richard Whitney scandal broke. Whitney, long the face of the Exchange as its President and key witness or public speaker, shockingly had embezzled money from the gratuity (or death benefit) fund of the Exchange and other sources. Whitney claimed sole responsibility. Douglas authorized hearings to demonstrate that others in the leadership of the Exchange and the House of Morgan where Richard Whitney's brother, George, worked, also were involved. Fourteen days of hearings showed that the Exchange had protected its own. The NYSE rejected the recommendation of Public Governor Robert Hutchins that the Exchange conduct a public hearing to determine George Whitney's culpability.

The Exchange elected William McChesney Martin to be its first full time President.

1938 Maloney Act created National Association of Securities Dealers as self-regulatory organization for broker-dealers.

1939 elevation of Douglas to Supreme Court and World War II marked historical zenith of SEC

Two highly compromised laws in 1940:

Investment Company Act regulated mutual funds and other investment companies.

No fairness review such as merit regulation – largely a registration and disclosure act.

Requirements that minority of Investment Company Board be independent.

Limits on Investment Company securities – in the future common stock and investment banker role in investment companies.

The Investment Advisers Act of 1940 was even more limited – required registration and very little else of persons who provided investment advice for compensation, with exceptions for broker-dealers, banks, lawyers, accountants and publishers.

Underlying Roosevelt laws in banking, securities and housing was a revolution in judicial review.

Lochner popularized substantive due process or liberty of contract.

After Supreme Court struck down 12 New Deal laws between 1934 and 1937, "a switch in time saved the nine."

Judicial review subsequently precluded striking down State or Federal economic regulatory law if there was a rational basis.

The Roosevelt Administration created a heavily siloed system of banking, securities, housing and insurance regulation. See Pages 576-577.

This system generally effectively worked until 2007-2009.

CLASS DISCUSSION

Q: Why did no President after Roosevelt ever equal his reform agenda?

Q: What lessons does his New Deal provide for today?

PSC 234W: Class Notes: October 19, 2021

The Deterioration of the New Deal Model

Reading: Misalignment 603-678

History books read faster than history occurs. The New Deal Regulatory Model deteriorated slowly over a 70 year period.

Concomitant with the deterioration was a great economic expansion – see Pages 603-604.

In the post-World War II period, the Fed achieved its prominent role in National monetary and international policy. This too occurred slowly.

1933-1941 – Fed rarely changed Discount Rate:

- 1934 reevaluation of gold empowered Treasury to establish Emergency Stabilization Fund – this permitted Treasury, if it so chose, to engage in open market operations and undercut Fed power over money supply.
- Treasury used this Emergency Fund as a threat and curtailed Fed independence by insisting Fed coordinate open market operations and interest rate changes with the Fed which in effect could Veto them.
- Fed did get new power to set Margin Loan Limits in the 1934 Securities Exchange Act.
- Critically the Fed also was granted power to raise or limit Federal Reserve Bank Reserve Limits to increase or decrease money supply.
- Treasury Secretary Morgenthau blamed the Fed for the 1937-1938 Recession because the Fed increased Reserve Requirements and reduced the money supply.

1940-1945 – World War II:

- U.S. great arsenal of democracy – converted civilian economy to war time economy
- Most expensive War in our history – Page 608
- Financed largely through Roosevelt-Morgenthau Plan: (1) 50 percent taxation; (2) 50 percent bond sales and interest rate reductions that reduced cost of Federal borrowing
- Comprehensive system of controls over prices, wages, supply priorities, rationing
- Fed role largely to purchase Government Securities and keep interest rates low – World War II financing would be at an average cost of 1.94 percent compared to World War I rate of 4.22 percent

1944 Bretton Woods Agreement meant to fix international currency exchange rates by pegging them to the Dollar, set at $35 per ounce.

World War II essentially ended unemployment – less than 2 percent when War ended.

Fear that demobilization would lead to hyper unemployment and destabilize the economy.

When price controls ended, inflation wildly accelerated – in first six months of 1946, inflation increased by annual rate of 28 percent.

Employment Act of 1946 set as goal maximum employment, production and purchasing power (meaning low inflation).

Council of Economic Advisers created to be independent both of Fed and Treasury.

Congress in 1947 rejected Truman proposal for price, wage and credit controls.

1946-1951, Treasury attempted to maintain Fed in subservient role by insisting that interest rates be pegged at lower than market rates – Treasury used its Veto to prevent Fed interest rate increases.

Korean War brought tension between Treasury and Fed to a head – $150 billion would be appropriated to fund that War.

Marriner Eccles characterized inflation as the major economic issue in the Country and sought to end Fed obligations to buy Treasury Securities and to leave interest rate determination to the Treasury.

The tension between the Fed and Treasury widely reported – Truman sided with Treasury and orchestrated false claims that the Fed had agreed to support the Treasury Defense Program and pegged interest rates.

With interest rates rising by 14 percent in late 1950 and early 1951 and Senator Douglas leading bipartisan efforts to fortify Fed control over interest rate levels, Truman and Treasury capitulated and agreed to what became known as the 1951 Accord – see Pages 618-620.

In theory, the Fed gained control over interest rates and ceased to be required to be the residual buyer of all Treasury Securities.

Keynesian v. Friedmanesque monetary theory debate animated much policy discussion. See Page 622.

In fact, limits on Fed powers remained – key to its qualified independence was the talents of its chairs such as William McChesney Martin and Paul Volcker.

Martin named by Truman in 1951 and served for 19 years as Fed Chair.

Early in Chairmanship adopted a Bills Only policy limiting Fed open market purchases to short term Treasury debt, largely freeing Fed from pressure to buy unlimited quantities of Treasury debt.

Martin did succeed in consolidating power of Federal Reserve Board in Washington by diminishing influence of Federal Reserve Bank in New York. This was not an all or nothing proposition. Because of the New York Fed's proximity to the leading commercial banks, it would remain the most influential of the 12 regional Federal Reserve Banks and in 2007-2009 would be a key partner in Bernanke and Paulson's efforts to prevent total disaster in the economy.

Martin understood this freedom was qualified – quote at Pages 622-623, 625-626.

Why? Fed could be controlled by Presidential appointments, wanted a place at the table to encourage Executive Branch to be responsible in its fiscal policy, subject to embarrassment or potentially punitive legislation from Congress.

Effectively coordinated with Eisenhower and Kennedy Administrations through Quadriad meetings and periodic meetings with the President.

For 15 years, Martin achieved great success containing inflation, largely by using the Discount Rates to "take away the punch bowl just when the party gets going."

Remarkable success for 15 years – quote at Pages 626-627.

Subject to criticism for limiting growth:

- Douglas – money growth too slow – 1959 Staff Report of Joint Economic Committee saw 2.7 to 3 percent GDP growth as much less than achievable 3.9 to 4.5 percent growth. Harsh critic of Fed monetary policy – favored ending Bills Only.

- Wright Patman, in effect, sought a return to pegged rates, return of Fed ownership of Treasury Securities for noninterest bearing Treasury Securities.

In contrast, Fed relations with overall Congress largely favorable.

1956 Bank Holding Company Act allowed National Banks to own two or more Banks originally within a State. No authority to purchase nonbanks – initially a way to allow National Banks to engage in Intrastate Branching.

1970 Amendments to Bank Holding Company Act closed loophole that allowed Bank Holding Companies to purchase or engage in nonbank activities initially such as selling commercial paper. Martin supported 1970 Amendments to end Bank ownership of nonbank activities.

Later Bank Holding Companies would become the principle device by which Banks grew to be Financial Supermarkets. Pages 632-633.

Most consequential checks on Fed independence involved the President and Treasury.

Truman appointed Martin in 1951 very shortly after 1951 Accord because he believed that Martin was an ally. He had served as the Treasury Negotiator of the Accord – Truman bitterly disappointed by Martin's commitment to Fed independence – once called Martin a traitor.

Eisenhower commitment to balanced budgets consonant with views of Martin.

Eisenhower generally supported Fed independence – in 1956 after Treasury Secretary Humphrey suggested Martin resign after Fed raised interest rates during election year, Eisenhower – see Page 635 – spoke publicly in favor of Fed independence.

Martin disappointed Presidential candidate Nixon and others in Eisenhower Administration by slowness in responding to the 1960-1961 Recession – Nixon blamed Martin for defeat in 1960.

Kennedy championed Keynesian economics and a pro-growth critique of Eisenhower – he sought growth as fast as 5 percent per year. He paired Keynesians with traditional establishment figures such as Douglas Dillon who became his Secretary of Treasury.

Kennedy appointed Walter Heller to be Chair of Economic Advisors, aided by Paul Samuelson and other prominent Keynesians. Heller, Samuelson and others believed that Fed was too independent, favored expansionary spending and tax cuts when recession began. "Prosperity shrinks budget deficits."

Kennedy embraced full employment and a broad social agenda.

Initially a rocky relationship with Martin who spoke publicly about Kennedy having a chip on his shoulder with respect to Fed independence.

Martin not supported by Kennedy when James Saxon, Comptroller, took initial steps to dismantle the Glass-Steagall Act, opposing the Fed role in approval of one Bank's acquisition of another Bank. Saxon criticized the Fed for blocking the Chase Manhattan Bank's acquisition of 80 percent of the shares of Liberty National Bank.

Martin did achieve a constructive working relationship with the Kennedy Administration. The Fed supported:

- Operation Twist, replacing Bills Only or purchase of short term Treasury Debt with a commitment to purchase medium Treasury Debt and attempt to lower long term debt and raise short term.
- During Operation Twist, the Fed did not cut short rates as it normally would during a recession.
- Worked with the Treasury to purchase foreign currencies, began a major role continuing in international currency.
- In July 1963, the Fed raised the Discount Rate to 3.5 percent to help address the Balance of Payments deficit.

Most important economic initiative of Kennedy Presidency was his case for comprehensive tax reduction to stimulate the economy and achieve Balance of Payments.

Under Eisenhower, Martin had opposed such a tax cut, and Martin was concerned about burgeoning deficits if the tax cut was enacted as initially planned.

Kennedy was unable to secure a tax cut because of the opposition of Senator Harry Byrd, Chair of the Senate Finance Committee who also was alarmed by the deficit.

After Kennedy was assassinated, Johnson termed enactment of the Kennedy Tax Cut as the Nation's first priority. Johnson coupled the Kennedy Tas Cut with substantial budget cuts to win Byrd's support.

The 1964 tax reduction cut the top rate of individual income taxes from 90 to 71 percent and corporate taxes from 52 to 48 percent.

As Kennedy had anticipated, the economy did achieve a 5 percent growth rate, low inflation, declining unemployment and because of greater productivity, greater increased tax receipts – see Page 658.

Martin's relationship with Johnson even more fraught than with Kennedy. Johnson sought guns and butter – a broad social program in his Great Society initiatives and support for the Vietnam War. Johnson used his leverage to appoint a 4-3 Majority ultimately on the Fed of pro growth expansionists.

Johnson very upset in November 1964 when Fed raised its Discount Rate from 4 to 4.5 percent after UK raised its rate to 7 percent.

In 1965, although there were strong unemployment and GNP numbers, inflation began. Normal Fed response was to increase interest rates. Martin instead sought to persuade Johnson to increase taxes to reduce the growing deficit.

In 1965, Johnson working with Defense Secretary McNamara took steps to hide the full costs of the Vietnam War and the rapidly growing deficit. Johnson considered this essential to secure enactment of key Great Society programs.

Martin led a 4-3 Majority on December 4, 1965 raising the Discount Rate from 4 to 4.5 percent – Johnson erupted, summoned Martin to the woodshed at his ranch in Texas and accused Martin of running a rapier through him – Martin refused to back down and defended Fed independence, but there was a heavy price.

Fed and Martin became timid about interest rate increases and increased the money supply significantly. Fed also supported purchases of Treasury Securities to help support the Federal deficit – see Pages 666-667.

Only reluctantly did Johnson agree to a tax increase in 1967, supporting a 10 percent corporate surcharge. In 1968, a combination of the ever increasing inflation, growing deficits, Johnson budget cuts and a crisis in gold led to the Revenue and Economic Control Act with its 10 percent surcharge.

The U.S. economy continued to overheat – see Pages 674-675.

Martin would conclude his Chairmanship believing that he had failed because of the growing inflation.

More fairly, Martin achieved nuanced Fed independence, modernized the structure of the Fed to secure greater power in Washington and significantly expanded the Fed's international role.

CLASS DISCUSSION

Q: What is Keynesian economics?

Q: Is cutting tax rates and interest rates always wise according to Keynes?

Q: What is Milton Friedman's critique of Keynesian economics?

Q: Why was William McChesney Martin neither a Keynesian or Friedmanite?

Q: Did Martin surrender too much independence by seeking a seat at the table to influence Eisenhower, Kennedy and Johnson on fiscal policy?

PSC 234W: Class Notes: October 26, 2021

The End of the Gold Standard, Wage and Price Controls, the Humphrey-Hawkins Act and the Age of Volcker

Reading: Misalignment 678-769

Financial and economic policy is closely entwined with National political events. In the next sessions, we focus on the relationship of the Fed to the Presidencies of Nixon, Ford, Carter, Reagan, Bush I and Clinton.

Nixon was elected in 1968, in a very close race 43.4 percent in popular vote to 42.7 percent for Humphrey and 13.5 percent for George Wallace.

In 1972, Nixon reelected in a landslide with 60.7 percent of the vote, winning 49 states in race against George McGovern.

Congress little changed throughout Nixon Presidency – Democrats in Majority in Senate and House.

Nixon appointed Arthur Burns to be Fed Chair beginning February 1970.

Burns, a scholar of economic cycles from Columbia University, believed that wage and price controls was the preferred way to fight inflation – growth of trade unions and expansion of welfare programs had undermined earlier functioning of free markets.

Nixon preferred economic stimulus in the period before 1972 election. Nixon pressured Burns in ways that the Fed had not seen before.

The other key Economic Adviser was John Connally, Nixon's second Secretary of Treasury beginning in February 1971.

Nixon economic policies would be incoherent and ineffectual, ultimately resulting in stagflation with unemployment rising from 3.5 to 5.6 percent and inflation from 4.7 to 8.7 percent. The ineffectuality of his policies would be aggravated by the first oil spike after OPEC protest against U.S. policy in Six Day War in Middle East with oil jumping from $2.80 to $9.60 a barrel between September 1973 and March 1974.

Three different Nixon policies:

First, announced February 1969, was a policy of gradualism to decrease inflation, Nixon commitment to balanced budget – by 1970 Elections, Nixon and Burns disillusioned with gradualism.

The second economic policy was announced in Nixon's second State of the Union, an expansionary budget, "We are all Keynesians now." This policy drove up Federal deficit to $23 billion in 1971. Money growth 10 percent in first six months of 1971.

One key consequence of this policy was the withdrawal of gold from U.S. In August 1971, Great Britain requested $3 billion in gold, U.S. gold holdings would have fallen below $10 billion. In May 1971, West Germany left Bretton Woods.

The third policy would be the one for which Nixon would be best remembered, an August 15, 1971 nationally televised speech that shocked the world. Three key recommendations:

(1) With unemployment at 6 percent, Nixon proposed several economic stimulants such as 10 percent job development credit that was immediately effective and budget deficit of $25.2 billion.

(2) Wage and price controls – These would be a short term political success, but in longer term would be disastrous after wage and price controls lifted, inflation proceeding at 8 to 9

percent in 1973 would rise to 12 to 14 percent in first three months of 1974. Federal Funds Rate would peak at 13.5 percent in mid 1974. Prices on NYSE would decline 25 percent between January 1973 and December 1973. The U.S. entered a recession. After 6 percent rise in GNP in 1973, inflation adjusted GNP or real GNP would decline 2 percent in 1974. Unemployment would reach 34 year high of 8.2 percent in 1975.

(3) Nixon began process of taking U.S. off gold standard. Treasury Secretary Connally was directed to suspend convertibility of U.S. Dollar into gold. Nixon also added 10 percent temporary tax on goods imported into U.S. Paul Volcker, then a senior official in the Department of Treasury, explained to outraged Europeans that the U.S. sought to transform $4 billion trade deficit into $9 billion surplus in one year. The dollar was devalued to $42.22 per ounce of gold in February 1973, creating an unrealistic value with market price of gold at $89. In March 1973, six leading European nations ended Bretton Woods and agreed to fix their Currencies against the floating value of the Dollar. By Spring of 1974, gold reached a price of $180. In August 1975, IMF eliminated requirement of U.S. gold in transactions with IMF. Ending gold standard freed Fed to pump money into the economy during recession, but also increased probability of inflation and pressures for protectionism.

Nixon Presidency accelerated changes in Bank competition. Fed beginning May 1971 amended Regulation Y to allow Bank Holding Companies to perform functions of a trust company, investment adviser, and with limits, insurance agent.

Interest rate ceilings initially were more consequential. Basic bank accounts were intended to be protected by Regulation Q which placed a ceiling on interest rates to protect Bank and S&L solvency. S&Ls benefited from interest rate differential between 1945-1965, which was narrowed between 1965 and 1970. See Page 699.

The interest rate differential between 1945 and 1965 led to disintermediation. Commercial Bank assets fell from 86 percent to 67 percent, S&L assets rose from 5 to 23 percent.

As interest rate ceilings undercut Bank ability to finance operations, Banks turned to alternative instruments such as short term Certificates of Deposit (*CDs*) and commercial paper, which grew from $8.4 billion in 1964 to $39.7 billion in 1970. Commercial paper was not guaranteed by FDIC, as the 1970 bankruptcy of Penn Central, which held $200 million in commercial paper powerfully illustrated.

Banks also gravitated to new instruments to attract retail savers, notably IRAs in 1975 and Negotiable Orders of Deposit (NOW accounts) beginning in Massachusetts in 1972.

Most significantly, mutual funds created Money Market Accounts which were the equivalent to Bank and checking accounts beginning in 1971. By 1979, Merrill Lynch Money Market Funds would total over $70 billion. In September 2018, Money Market Funds would equal $3.5 trillion and long have been the most popular retail investment in the United States. The percent of private financial assets held by insured Banks and S&Ls declined from 60 percent in 1970 to 35 percent in 2000.

In August 1974, Nixon would resign in the Watergate scandal and be succeeded by Gerald Ford – economic conditions horrible. See Page 704.

Ford emphasized voluntary means to curb inflation with the much ridiculed WIN Campaign in October 1974. See Pages 706-707.

1974 Elections in which Democrats gained 49 seats in the House shocked Ford. By December 1974, 86 percent of Americans had no confidence in Ford's ability to manage the economy.

In January 1975, Ford reoriented his priorities to focus on inflation which was the basis of Tax Reduction Act of 1975 with $22.8 billion in tax cuts including $12 billion in tax rebates.

After long period of high Fed interest rates, Fed interest rates dropped from 7.75 percent in January 1975 to 5.5 percent in 1976. The deficit would increase from $53 billion in 1975 to $73.7 billion in 1976. Unemployment would reach 8.9 percent in May 1975, GDP would decline 7.5 percent in last three months of 1974 and 9.2 percent in first three months of 1976. Dow Jones Industrial Average would fall 45 percent between January 1973 and December 1974.

The Fed would receive considerable blame. The House Concurrent Resolution 133 in May 1975 at Pages 710-711 stressed Congressional preference for the economic goal of maximizing employment.

Ford narrowly defeated by Jimmy Carter in 1976 after surviving an intense primary challenge from Ronald Reagan. Democrats maintained overwhelming Majorities in the House and Senate. Carter ran as anti-Watergate, anti-Washington outsider.

Key Carter policies – balance budget, end pork barrel projects, opposed mandatory wage and price controls, emphasized job creation.

Burns replaced as Fed Chair initially by G. William Miller, former CEO of Textron. Michael Blumenthal initial Secretary of Treasury; Charles Schultze, Chair of Economic Advisers.

Carter economic plans were an abysmal failure, aggravated by second OPEC oil price spike in 1978. GDP declined 5.75 in 1977, rose only 1 percent in 1979; unemployment rose to 7.8 percent in 1980. But worst economic outcome was inflation, which rose to a virtually unimaginable 18 percent in February-March 1980. Carter popularity would deteriorate from 75 percent approval in March 1977 to summer of 1979 when only 23 percent felt economy was going well.

As with Nixon and Ford, Carter policies proceeded in phases.

January 1977, Economic Stimulus proposal with $50 one time rebate for each taxpayer; tax credits for business investment in machinery or equipment; $4 billion additional in emergency public works; dramatic increases in comprehensive Employment and Training Act from 310,000 public jobs to 725,000. The total costs were relatively modest at $20 billion.

Senators scoffed at tax rebates which Carter then dropped.

Labor infuriated no proposed increase in minimum wage.

May 13, 1977, Carter signed Economic Recovery Act with $20 billion in public works programs and later signed 1977 Tax Reduction Act increasing the standard deduction and credits for employers up to $100,000 equal to 50 percent of $4200 of wages for each new employee.

Carter then shifted to anti-inflation policy. But the message was handcuffed. Voluntary wage and price controls, no massive interest rate increases did not end inflation. Voluntary wage and price controls did not work as Carter acknowledged in televised address in October 1978.

Carter opposed further tax cuts and sought to reduce the deficit from $66 billion in 1976 to $30 billion in 1980. Public reaction to new wage and price guidelines was highly negative.

Ongoing deterioration of dollar against international currencies – trade weighted value of dollar against 10 leading currencies declined from 107 to 86 between 1976 and 1978.

U.S. tried to protect the dollar through Special Drawing Rights, increased swap lines with Germany and Japan, and increasing Discount Rate by one point to 9.5 percent in November 1978. Inflation remained out of control, rising to 14.7 percent in May 1978.

Congress formalized House Concurrent Resolution 133 in 1978 with Humphrey-Hawkins Act which set dual mission for Fed: maximum employment and stable prices [meaning noninflationary prices].

In November 1978, Congress enacted Internal Revenue Act with $18.7 billion of new tax cuts, which Carter reluctantly signed. 1978 Midterm Elections, slight set backs for Democrats in Congress. But tax revolt in California Proposition 13 rolled back property taxes and imposed 2 percent cap on yearly increases; Kemp-Roth Bill proposed 10 percent cut in Federal taxes for three years.

January 1979 Budget for 1980 doubled earlier proposed $30 billion deficit to $60 billion, shocking financial community.

Compounding Carter's economic woes was the Energy Crisis. In January 1979, Shah of Iran overthrown by Ayatollah Khomeini, spiritual head of 31 million Shiite Muslims. Iranian oil production declined from 6 million barrels a day to 1.5 million, global oil prices doubled from $22 to $42 per barrel. In 1979, 50 percent of U.S. gas stations closed.

Carter decontrolled oil prices on June 1 to increase U.S. production, but coupled decontrol with windfall oil tax and heated rhetoric criticizing oil companies as profiteers.

In July 1979, Carter delivered Malaise Speech, inspired in part by University of Rochester Professor Christopher Lasch's book, *The Culture of Narcissism*. The title of Carter's speech was *Energy and National Goals – A Crisis of Confidence.* Carter made several specific proposals. See Pages 731-734.

Carter undercut the impression of being an effective leader by asking for the resignations of five Cabinet Secretaries led by Treasury Secretary Michael Blumenthal. G. William Miller, viewed as an ineffective inflation fighter at the Fed, named new Secretary of Treasury.

Most importantly, Paul Volcker, an inflation hawk, was named Chair of Fed. By 1983, Volcker's tight money, high interest rate policy would reduce inflation to 3.7 percent with enormous social costs, most significantly unemployment rising from 5.8 percent to 10.8 percent between first nine months of 1979 and late 1982. But the Fed's policy did result in a dramatic decline in inflation only possible because of Carter and Reagan support.

Volcker rejected gradualism and focused on Federal Funds Rates and instead in October 1979 emphasized restraining monetary growth to reduce bank reserves. Volcker initially supported increasing bank reserve requirements by 8 percent in the marginal reserve requirement simultaneous with a one percent increase in the Discount Rate to 12 percent.

Public and Congressional reaction was furious as Country descended into recession.

Progress towards ending inflation was slow. In March 1980, Carter announced a new economic plan with a balanced budget and credit restraints, which as implemented by Fed required consumer credit card companies such as Mastercard and Visa to maintain noninterest bearing deposits with Fed equal to 15 percent of their growth in assets after March 1980.

The March 14, 1980 Credit Restraint Program hit like a bombshell. Bank loan growth declined from as high as 20 percent to 2.5 percent. Money supply was flat, interest rates declined from 16.5 percent in March 1980 to 6.37 percent in July 1980 with unemployment increasing from 6.3 to 7.8 percent.

Fed backpedaled, ending Credit Restraint Program in two phases by July 1980, prompting a rapid rise in interest rates to 14 percent by Election Day 1980.

Volcker would characterize 1980 as a false start. In 1980, Reagan elected President in landslide, winning 50.7 percent of vote to Carter's 41 percent and John Anderson's 6.6 percent. Reagan was elected because of a sense of ineptitude of Carter symbolized by the Malaise Speech, handling of the Iranian hostages and because of the economy. The best remembered line of the Campaign was Reagan's question in a Presidential debate: "Are you better off than you were four years ago?"

Reagan had long coattails. In 1980, the Senate flipped to Republicans, Democratic Majority in House narrowed.

Volcker relentlessly pursued money supply restraint. Interest rates increased to 14 percent in May 1980, unprecedented increase when unemployment was 7.5 percent.

The Volcker policy worked. By 1983, GDP had increased by 6 percent, unemployment fell to 5.3 percent, down 2.5 percent, stock prices increased by 20 percent, inflation ranged from 2.5 percent in 1986 to 4.5 percent in 1988.

The Reagan policy emphasized tax cuts and deregulation. He was taxed 94 percent as film star at peak of his career. By 1964, Reagan was a leading Conservative spokesman. Reagan sought to put Federal Government on a diet, favored Kemp-Roth 10 percent tax cuts for each of three years, and said in his Inaugural Address: "Government is not the solution to our problem, Government is the problem."

New Economic Team, initially spearheaded by Office of Management and Budget Director David Stockman. Three policy strands in Reagan Economic Team:

- Monetarists favored nondiscretionary rules to reduce money supply
- Supply siders favored marginal tax reductions to stimulate economy
- Traditional market conservatives sought to deregulate Government

Reagan, in contrast, not an economist but favored four "commonsense" fundamentals:

- Reduce growth in Federal spending
- Preserve tax reductions that are stimulative
- Remove Government regulations to spark productivity
- Maintain a health dollar and stable monetary policy

The hallmark of Reagan economic policies were 1981 and 1986 tax cuts coupled with increased defense expenditures:

- Reagan team found themselves boxed in: Not possible to increase defense spending by 7 percent per year, cut taxes and balance budget.
- Nonetheless Reagan Economic Team continued rosy scenario forecasts with magic asterisks.
- 1981 tax cuts reduced top income tax rate from 70 to 50 percent with a version of Kemp-Roth, 5 percent cut followed by two years of 10 percent cuts.

- 1986 Tax Reform Act lowered top rate to 28 percent before being increased three years later to 39.5 percent.
- Cumulative consequences of 1981 and 1986 tax cuts led to average tax reduction of 2.89 percent.
- With deficits growing, 1982 and six other tax increases offset .98 percent of Reagan tax cuts.
- Biggest failure of Reagan Administration would be budget cuts. With defense increases growing, the deficit would grow to $207.8 billion in 1983 and continue at high levels. Total national debt would triple during Reagan's term from $997 billion to $2.85 trillion with massive increase in foreign ownership of United States debt.

But with inflation at 3.22 percent in 1984 and economic growth at 7.4 percent, Reagan won landslide in 1984, winning 49 States and 58.8 percent of popular vote.

CLASS DISCUSSION

Q: If you were an adviser to Richard Nixon in August 1971, what would you recommend as the best way to address stagflation?

Q: What were the benefits and costs of removing interest rate ceilings?

Q: If you were adviser to Jimmy Carter, what economic policy would you have recommended at the beginning of his Presidency in 1977?

Q: Paul Volcker was legendary for dramatic increases in interest rates to end inflation. The policy caused massive unemployment. Was there a better way to proceed or was taking this bitter pill a necessity?

PSC 234W: Class Notes: November 2, 2021

The S&L Crisis, Deregulation, Alan Greenspan, FIRREA, Clinton and the 1993 Budget Deal

Reading: Misalignment Pages 769-846

By the 1980s, the Regulation Q cap on interest rates was playing havoc with S&Ls. With interest rate caps lower than S&L borrowing rates and fixed rate mortgages, S&L profits fell in the early 2000s. 107 S&Ls failed in 1981-1982, risk of failure rose from 43 to 415 by 1982.

In 1979, Circuit Court ruled that Fed lacked power to permit automatic transfer of funds from savings to checking accounts.

Nonmember Banks in the Fed system leaving Fed because they were required to keep reserves in noninterest paying accounts with the 12 Federal Reserve Banks.

The Monetary Control Act of 1980 addressed each of these concerns:

- Fed was given the power to require all depository institutions to maintain reserves. But reserve requirements lowered from 16.25 percent to 12 percent was a major step to attract Member Bank support. Lowering of reserve requirements freed $14.5 billion from reserves and increased Bank lending and profits as well as money supply.
- Lending powers of S&Ls increased to 20 percent of their assets for commercial real estate, S&Ls also given trust powers and power to issue credit cards.
- Interest rate ceilings eliminated over a six year period.
- All depository institutions could use Money Market Funds and ATMs.

Benefits of 1980 Act were overwhelmed by continued spike in interest rates. New mortgages and housing stats declined, S&Ls lost $4.6 billion in 1981 and $4.3 billion in 1982.

S&Ls were required to give up interest rate differential in 1983.

Quite different response to banking by Congress, the Fed, the Reagan Administration and Supreme Court.

In 1982, Congress enacted the Garn-St. Germain Depository Institutions Act:

- Federal Home Loan Bank Board given new powers to prevent closing of S&Ls including purchase of their securities or facilitating mergers
- FDIC given new powers to act as Receiver of a closed insured Bank with $500 million of assets or more and arrange mergers or purchasing Net Worth Certificates
- S&Ls granted power to make commercial real estate loans up to 40 percent of their assets and commercial loans up to 10 percent as well as commercial investments up to 10 percent
- The key change was that S&Ls could offer Adjustable Rate Mortgages. In 1982, $480 billion of $600 billion in S&L assets in mortgages, most in Fixed Rate Mortgages with interest lower than 11 percent borrowing cost of S&Ls
- S&Ls also could create Money Market deposits.

Between 1982-1985, S&Ls went on a buying spree, grew 56 percent compared to 24 percent for Banks.

Federal Home Loan Bank Board decreased required capital to 3 percent while FDIC maintained 5 percent for Banks.

Even 3 percent overstated given latitudinous Regulatory Accounting Principles which reduced number of insolvent S&Ls from 293 under GAAP to 48.

Federal Home Loan Bank Board decreased number of required shareholders from 400 to one. A subsequent Bipartisan Commission on Financial Institution Reform, Recovery and Enforcement called this a license to steal.

Goodwill mergers allowed two insolvent Banks to merge and claim price paid higher than fair market value of acquired S&L was asset.

S&Ls could invest up to 10 percent of assets in junk bonds popularized by Michael Milken and Drexel Burnham.

The Comptroller in 1982 interpreted the Glass-Steagall Act to allow a National Bank to establish a discount broker. By 1983, 1000 bank discount brokers. The Supreme Court approved Bank of America acquisition of leading discount broker Charles Schwab.

In 1987, Supreme Court also affirmed power of National Banks to operate discount broker outside of home State without branch office limits. By 1983, there were 5400 Bank Holding Companies holding more than 80 percent of bank assets.

State law regulation of S&Ls was particularly weak. See Pages 779-780. Seventy percent of all Banks and 50 percent of S&Ls then operated at State level.

By 1983, 50,000 ATMs on way to 100,000 by end of decade.

In 1984, Bush Task Force on Regulation of Financial Services proposed creation of functional regulation to consolidate Federal Bank regulation in Fed, Comptroller and State Member Banks of Fed and their Holding Companies.

Functional regulation proposed in limited way. Other Federal Bank agencies remained.

Bush Task Force was enthusiastic about dual banking system and ignored ongoing S&L crisis.

S&L crisis subsequently reached its climactic phase and was dubbed "greatest scandal in history of U.S. Banking." The number of surviving S&Ls would decline from 3234 in 1986 to 1645 in 1995 – 890 S&Ls with $348 billion in assets went bankrupt. The total cost of cleanup would be $152.6 billion.

S&L losses in at least 10 percent and some estimated 40 percent attributable to fraud. By 1992, 1000 individuals would be charged with crimes.

Highly publicized failures such as Lincoln Savings and Loan led by Charles Keating, whose $1.3 million contributions to five Senators including John McCain would cause three of these Senators not to seek reelection and McCain to be criticized for poor judgment by Senate Ethics Committee. The five had encouraged Federal Home Loan Bank Board to go easy on Keating. Lincoln Savings and Loan in 1989 went bankrupt at cost of $2.6 billion. Keating went to jail.

Beginning in 1983, Edwin Gray, Chair of Federal Home Loan Bank Board reversed weak S&L regulation by, among other things, increasing required capital to 7 percent.

There was a more limited bank crisis. Fed made unprecedented $3.6 billion loan to Continental Illinois, seventh largest Bank in U.S., that popularized phrase "too big to fail." Volcker criticized for being less forceful as Bank Supervisor than other aspects of his Fed Chairmanship.

Volcker was forceful in addressing Mexico meltdown in 1982. Volcker led effort to lend Mexico $1.85 billion in Central Bank credits and persuade Commercial Banks to provide $3.5 billion as stopgap until Mexico devalued Peso. Volcker built on William McChesney Martin leadership in international finance.

Broader international efforts less successful. Treasury Secretary James Baker in 1985 sought $9 billion deposited in World Bank and $20 billion Commercial Bank Fund to support developing country.

With higher interest rates leading to U.S. dollar appreciating as much as 50 percent against currencies of four largest economies and retarding U.S. exports, Plaza Accord in 1985 devalued yen, but other industrial countries deeply concerned about 25 percent increase in dollar against major currencies.

In 1987, Louvre Accord led to agreement that U.S. would reduce its deficit to 2.3 percent of GNP in 1987, less than 3.9 percent in 1987. Not successfully implemented after October 19, 1987 stock market collapse of 22.6 percent.

In August 1987, Alan Greenspan succeeded Volcker as Fed Chair. Greenspan would serve for 19 years as Fed Chair under Presidents Reagan, Bush I, Clinton and Bush II. Would be hailed as Maestro, greatest Central Banker in history in 1985 and excoriated for maintaining easy money policies in 2000s that contributed to 2007-2009 debacle. Greenspan also criticized for light touch approach to regulation. Greenspan favored unfettered marketplace competition, opposed Federal regulation of OTC derivatives in 1998 and aspects of 2002 Sarbanes-Oxley Act for decreasing U.S. competitive flexibility, supported ending Glass-Steagall.

Greenspan was a committed advocate of deregulation and a committed champion of data driven analysis. Notable success before Fed Chairmanship, Chairing 1981-1983 Bipartisan Commission to address potential Social Security funding crisis later in 1980s.

Greenspan had a strong start late in Reagan Presidency. Reagan in 1987 was bogged down by Iran Contra scandal, Democratic party control of Senate and defeat of two Supreme Court nominees, Robert Bork and Douglas Ginsburg.

Greenspan calm reaction to October 1987 Stock Market Crash won him plaudits. Federal Public Statement on October 20, 1987 was one sentence long: "The Federal Reserve, consistent with its responsibilities as the Nation's Central Bank, affirmed today its readiness to support the economic and financial system." Behind the scenes Greenspan worked with Jerry Corrigan, New York Federal Reserve President, to keep Banks operating. The economy soon stabilized, grew 2 percent in first three months of 1988, 5 percent in next three months.

In November 1988, George H.W. Bush elected President. More moderate than Reagan: "I do not hate Government. A Government that remembers that the people are its master is a good and needed thing." Bush sought a Thousand Points of Light, but also highly competitive. Won 1988 Election in part because of racist Willie Horton ads.

Bush very successful in foreign policy including end of Communism in Soviet Union and Operation Desert Storm in Iraq.

Bush Presidency would fail because of economy. In accepting nomination in Summer of 1988, he made a pledge: "Read my lips. No new taxes."

Deficits from Reagan Administration and Senate Democrats led to Bush signing 1990 Omnibus Budget Reconciliation Act that raised income taxes from 28 to 31 percent, among other tax increases.

Federal deficit would continue to soar, reaching $221 billion in 1990, $269 billion in 1991, $290 billion in 1992. Unemployment rose from 5.9 percent in Bush first year to 7.8 percent in July 1992.

Breaking "Read My Lips" pledge caused Republican Minority Leader Gingrich to break with Bush and not support new tax increases.

Bush and Treasury Secretary Nicholas Brady would unsuccessfully push Greenspan to cut interest rates. Bush would blame Greenspan for 1992 reelection defeat.

Bush did lead successful effort to clean up S&L mess. Federal Home Loan Bank Board was out of funds by 1989. Reagan Administration reluctance to directly provide Federal funds to S&Ls had led to inadequate provision of $8.5 billion to Federal Savings and Loan Corporation in 1987 Competitive Equality Bank Act. By year end 1987, 940 S&Ls or 33 percent of industry had less than 3 percent capital with 505 considered by GAO to be insolvent.

In 1989, GAO Report that at least $85 billion would be necessary to stabilize S&L industry.

Bush 1989 Resolution Plan provided $50 billion in Federal money, $20 billion in Direct Federal Funds, $30 billion in Treasury Debt Securities as enacted in 1989 Federal Institution Reform, Recovery and Enforcement Act (*FIRREA*). When $50 billion proved inadequate, Bush Administration in 1991 supported another $55 billion – total ultimate costs of implementing FIRREA would be $87.9 billion on top of earlier $64.7 billion of Federal Savings and Loan Corporation.

FIRREA created funding agency, Resolution Trust Corporation, to manage and resolve all S&L cases – through 1995, 747 failed Thrifts would be resolved with recovery of $397 billion or 86 percent recovery rate.

New Office of Thrift Supervision created subject to Treasury oversight and new statutory limits on commercial loans, consumer loans, loans to single person. Federal Savings and Loan Corporation was abolished.

FIRREA expanded definition of Banking in FDIC Act to include Savings and Loan Institutions and authorized Bank Holding Companies to acquire S&Ls.

In 1991, Federal Deposit Insurance Corporations Improvement Act specified new more demanding regulatory standards. See Pages 817-821.

None of the FIRREA requirements or subsequent new Federal Banking Standards would prove successful in 2007-2009. No attempt to address structure of financial regulation or the banking industry.

In 1992, Bush defeated for reelection by Bill Clinton. Democrats remained in control of Senate and House. Bush subject to determined challenge in primaries by Pat Buchanan who gave Culture War Speech at 1992 Nomination Convention and Third Party Candidacy of Ross Perot, whom Bush thought "crazy." Perot skewered Bush in Presidential defeat by agreeing with him that Perot had no Government experience. "Bush had a point. I don't have any experience in running up a $4 trillion debt."

Clinton was candidate with a lot of baggage including allegations of being Slick Willie for dodging the Draft and allegations of sex scandals. He won because of the economy, the deficit and health care. Character issues were less important to plurality of voters. Famous line in poster outside Campaign Manager Jim Carville's door: "The Economy, Stupid."

Clinton championed new Democrats in South with message that he would be strong on foreign policy, moderate on social policy and disciplined in addressing budgets and deficits. At 1992 convention when Clinton accepted nomination: "What is George Bush doing about America's economic problems? Well, he promised 15 million new jobs by now. And he is over 14 million short. . . . He never balanced a budget. I have. Eleven times."

Clinton faced large potential deficit when he became President. This caused him to trim back several new social programs and delay introduction of Health Care Proposal.

Clinton's early Administration was like the gang that could not shoot straight, including a battle with Joint Chiefs of Staff over gays in the Military, withdrawn nomination of Attorney General, Travelgate.

His great success was on the economy. Working with Alan Greenspan and Treasury Secretary Robert Rubin, Clinton by a hair secured passage of 1993 Omnibus Budget Reconciliation Act. The Act cut the budget, notably Medicare and the Military and raised taxes by a total of $500 billion over a few years.

The deficit would decline from $290 billion in 1992 to an aggregate surplus of $453 billion between 1998 and 2001. The deficit was reduced from $3.77 trillion to $3.32 trillion, "the fiscal equivalent of the fall of the Berlin Wall." Had Clinton's tax laws been left in place, National debt would have been paid off during the first decade of the 2000s.

To secure enactment of 1993 Tax and Budget Bill, Clinton jettisoned environmentally favorable BTU Tax in favor of "pathetic" 4.3 cents increase in Gasoline Tax, but did secure rise in individual tax rates from 31 to 36 percent and corporate tax rate from 34 to 35 percent. There were also modest social investments.

Clinton Budget and Tax Plans ultimately would succeed. Clinton would create 22 million new jobs, GDP would average 4 percent, inflation would decline to 2.6 percent compared to 6.1 percent annually between 1970 and 1992.

A key to Clinton Administration success was odd couple partnership with Greenspan. Federal Reserve did not undercut Clinton early increase in GDP by interest rate hikes. Throughout 1993, Fed left interest rates at 3 percent when GDP increased by 5.75 percent. Greenspan testified in favor of $500 billion Clinton plan and sat with Hillary Clinton at Clinton's first State of the Union Address.

As successful as Clinton Budget and Tax Cut Plan was in his Presidency, the initial response to the Plan was politically disastrous. Next session, the two great failures of Clinton Administration, health care and 1994 Midterm Elections.

CLASS DISCUSSION

Q: If Clinton succeeded in his economic policy, why was it so quickly reversed?

Q: Could interest rate ceilings be justified as a means to reduce inflation?

Q: Should the S&L crisis have led to a unified banking system with just one type of depository institution and one system of regulations?

PSC 234W: Class Notes: November 9, 2021

Gingrichism, the Committee to Save the World, the End of Glass-Stegall Act, Securities and Insurance Regulation, the New Financial Order

Reading: Misalignment 846-878, 1007-1012, 1016-1024, 1050-1054, 1057-1071

Comprehensive health care reform was highest aspiration of Clinton Presidency and greatest failure. In 1993, health care one-seventh of U.S. economy, $1 trillion for hospitals, physicians and health care providers, insurance, education and research.

Clinton sought several objectives simultaneously:

- Universal access including for those with preexisting conditions – everyone covered.
- Cost containment – U.S. then spending 14 percent of income on health care; Canada 10 percent, no other country more than 9 percent. Medical bills growing at twice the rate of inflation.
- Third, politically feasible plan – not single payer or Medicare for all, but a plan that built on existing system of private insurance – 9 out of 10 people then received health insurance through employers.
- Fourth, managed competition with employer mandate. Insurance corporations competed for customers under Government rules. Key new rule – annual payments for health care, not fee for service. Hospitals, insurers would have to compete for patients. Each person given choice of at least three high quality plans each year.
- Fifth, community ratings – Every person in local area paid same amount. Health insurance no longer to be based on risk factors such as age or preexisting conditions. This would increase cost of health care for young and healthy and decrease for older and sicker individuals.

Politically, enactment of plan proved a catastrophe:

- Clinton asked his wife, Hillary, to lead effort. She was highly qualified to do so, but secretiveness of her Task Force's' procedures would be sharply criticized – not involving Congress early in process, only holding one public meeting much derided.
- Hillary wanted to include health care in 1993 Omnibus Budget Reduction Act. This would have meant that health care only needed 51 votes to be enacted. Congressional Budget Office refused to give credit for speculative future savings and to include health care in Budget Act would have meant short term price controls – opposed by several in Clinton Administration.
- Clinton insisted on comprehensive Act and rejected recommendations from Senator Moynihan and others for incremental approach to universal health care.
- Republican party and health industry campaigns against Act, highly effective. The Act was 1342 pages long, TV commercials featuring Harry and Louise at kitchen table being confused by Act proved to be devastatingly effective.
- By April 1994, majority of Americans opposed the Act. Most did not understand it.
- Senator Dole, Senate Minority Leader, led a filibuster against the Act. In September 1994, George Mitchell, Senate Majority Leader, threw in the towel and the Clinton comprehensive health care plan was not enacted.
- In 1997, Hillary Clinton would successfully lead incremental effort to provide health insurance to 7.6 million children, largest expansion of health care since Medicaid in 1965.

Political consequences of failure of health care painful for Clinton. His Administration was characterized as inept, arrogant and inexperienced.

Newt Gingrich, House Republican Minority Leader on September 27, 1994 announced Contract with America, widely credited with gain of 54 Republican House seats and House Majority in 1994 as well as eight new Republican Senators and Republican Senate Majority. Gingrich would be *Time* Magazine Man of the Year, led Gingrich Revolution.

Ten proposed Bills in Contract to be enacted in first 100 days of Congressional Session if Republicans had Majority – see Pages 852-854.

On April 7, 1995, Gingrich gave unprecedented prime time address describing nine of ten Bills enacted or on their way to enactment in first 100 days, including line item veto. But Gingrich emphasized Contract was just the beginning. He sought to replace Welfare System, overly complicated Tax Code, balance budget over seven years without raising taxes by limiting spending increases to 3 percent per year.

Some of Contract items became law, but others did not, such as Constitutional Amendment requiring term limits in Congress, line item veto held to be unconstitutional. Others not approved in Senate such as those limiting the use of U.S. troops in U.N. missions or did not make it to Senate, such as moratorium on new Federal regulation. Others were successfully opposed by Clinton such as loser pay provision in Common Sense Legal Reform Act.

Nonetheless, the practical impact of Gingrich on Clinton Administration caused a fundamental shift by Clinton from moderate liberal to the center of the political spectrum through triangulation, led by long time Clinton outside consultant and then Republican strategist Dick Morris.

Morris urged Clinton to adopt most popular Contract with America planks such as balanced budget, reducing deficit, shrinking Government, pruning burdensome regulation and welfare reform. But oppose social aspects of Republican agenda such as hostility to reproductive rights, environmental protection, and Federal aid to education.

Clinton pursued this strategy.

In second State of the Union Address, Clinton supported line item veto, welfare reform, tax cut for middle class and expansion of IRAs to allow people to pay for education, health care and home purchases. Critically, he proposed to balance budget in ten years. But Clinton refused to compromise on several social programs and loser pays.

Gingrich ultimately would lose battle with Clinton in part because he was so uncompromising. He called Democrats the "Enemy of Normal Americans" and supported appointment of six independent counsel including Ken Starr, who ultimately published lurid details of Clinton's involvement with Monica Lewinsky.

Gingrich attempted to force Clinton to accept massive budget cuts in Medicare, Medicaid, food stamps, student loans, Americorps, environmental protection and 100,000 new police officers Clinton sought by refusing to increase debt limit.

In November 1995, Clinton refused to accept Gingrich conditions and vetoed Republican Continuing Budget Resolution and Debt Ceiling Bills. 800,000 Federal employees were sent home. National parks closed, Social Security and veterans benefits suspended.

Gingrich publicly complained about not being allowed to ride next to Clinton on Air Force One and having to depart plane through rear exit on flights to and from Israel for funeral of Israeli Prime Minister Yizhak Rabin. Gingrich ridiculed for explaining why he toughened stance in Government shutdown in terms of personal grievance. A newspaper labelled him a cry baby in a cartoon.

Clinton in contrast on November 19, 1995 announced he would work for seven year balanced budget which he then believed possible because deficits were dropping faster than expected.

On December 6, 1995, Republicans approved their budget prompting a second shutdown on December 16, 1995 – Gingrich was characterized as "unfeeling and mean-spirited". Large majorities of public blamed Republicans for shutdowns – bond rating agencies threatened to lower AAA rating of United States Bonds, meaning potentially higher interest rates because of greater risk.

Republican Party soon conceded, approved increase in Federal debt ceiling, agreement to fund Federal Government without massive social cuts and accepted Clinton plan for seven year deficit reduction without Republican budget cuts.

Bob Dole, Senate Majority Leader and World War II hero, nominated to run against Clinton in 1996. More moderate than Gingrich and less flamboyant in style. Sought to build a bridge to a time of tranquility, faith and confidence. To secure nomination, he gravitated to the right and nominated Jack Kemp to be V.P., adopting Kemp approach to 15 percent tax cut, flat taxes, school choice and strengthened national defense. Dole sought to end four Cabinet Departments – Housing & Urban Development, Commerce, Education and Energy and privatize legal services and Corporation for Public Broadcasting.

Clinton campaign briefly rocked by sex scandal involving Dick Morris, "Where is the outrage?" Dole repeatedly demanded.

Clinton campaigned as candidate of the vital American center. On August 22, 1996, he signed controversial Welfare Reform Act, negotiated in part with Gingrich. The Act put a five year limit on cash assistance and created a program of block grants to States which had the practical effect of reducing Americans receiving cash assistance from

12.2 million in 1996 to 5.3 million in 2001. Senator Moynihan called the Act "the most brutal act of social policy since reconstruction." Opposed by several Cabinet Officials. Clinton signed Act to end welfare as we know it and to strengthen election prospects.

Clinton won in 1996 because of economy. He would win 49.2 percent of electoral vote to 40.7 for Dole and 8.4 percent for Perot. Congress remained in Republican hands; Republican Majority in Senate increased to 55-45.

By 1996, 10 million new jobs, 4.4 million more Americans owned homes. Clinton had successfully led campaign against Draconian cuts to social programs, tarring Dole as part of Dole-Gingrich Republican Party leadership.

Concord with Fed continued – with economy expanding at 4 percent, unemployment on way to 4 percent or lower, Dow Jones doubling from 3243 on first day Clinton in office to 6448 year end 1996, the Fed did raise interest rates but at a lower rate than growth in economy.

Clinton reappointed Greenspan on February 22, 1996, by then with overwhelming support of his economic advisers.

Clinton would win Greenspan support for ratification of NAFTA, intended to end tariffs among U.S., Mexico and Canada. Labor unions hated this because Mexico in particular could produce goods at lower costs. Clinton supported because of commitment to free trade and belief that NAFTA enactment would increase U.S. market share abroad. Clinton Administration would negotiate 300 treaties including General Agreement on Tariffs and Trade which in 1993 reduced tariffs by $740 billion and created World Trade Organization to support uniform tariff rules.

Clinton and Fed most strikingly aligned with Committee to Save the World – Greenspan, Treasury Secretary Rubin and Deputy Treasury Secretary Summers. The Committee coordinated U.S. responses to financial crises in Mexico, Thailand, Malaysia, South Korea, Indonesia, Russia and Brazil between 1994 and 1998.

Each case was different – Mexico first and most important illustration of coordination. Mexico borrowed with bonds that were convertible into U.S. Dollars at a fixed exchange rate. When Mexican economy collapsed in 1994, Mexico spent $15 billion to prop up Mexican Peso at fixed rate of three Pesos to each Dollar. Peso continued to deteriorate. Mexican President Zedillo allowed Peso to float against Dollar and soon trading at five Pesos to Dollar. Mexico had to pay $30 billion in Dollars in 1995 with only about $6 billion in reserves left. Interest rates on Dollar Bonds, called Tesobonos, reached 20 percent. Private sector unwilling to save Mexican economy even at that rate.

Greenspan and Rubin responded with substantial commitment to Mexico - $25 billion U.S. commitment proposed in January 1995. Clinton explained the basis of his commitment. See Page 865.

This was a very unpopular commitment. One poll had 79 percent opposed to helping Mexico. Even with adjustment to U.S. commitment to reduce to $20 billion from U.S. and $17.8 billion from IMF, Congress refused to approve.

Clinton supported Rubin use of Exchange Stabilization Fund to provide U.S. funds. No vote by Congress, infuriating many in Congress. Tom Friedman called this "the least popular, least understood, but most important foreign policy decision of Clinton Presidency." Mexico repaid U.S. in full in 1997.

U.S. subsequently provided $17.9 billion to IMF and worked on similar support for South Korea ($58.2 billion), Indonesia ($47.7 billion), Thailand ($17.2 billion), Russia ($22.6 billion) and Brazil ($41 billion). The deals involved U.S., IMF and private funds.

Highlight of Clinton second term would be economy translated to high Clinton approval ratings, 70 percent on selected dates in 1998 and 1999 despite Monica Lewinsky sex scandal and impeachment.

1998 Midterm results disappointing for Republicans – House Majority shrank from 226-207 to 223-211. Party not in White House usually gains in Midterms. Three days after the Midterms, Gingrich resigned as Speaker.

Greenspan approach to the economy was different than William McChesney Martin who thought the job of the Fed was to take away the punch bowl when the party got going. Throughout market exuberance of 1997 to 1999 when Dow Jones rose from 7000 to over 11,000 in 27 months, Discount Rate remained relatively low. For example, unchanged throughout 1997 at 5 percent.

Greenspan and Clinton believed that information revolution had transformed economy. Third industrial revolution led by Internet and DOT.com mania. Firms like Microsoft had a market value of more than $500 billion in 1999. Bill Gates then was the richest man in U.S.

Greenspan who had complained about irrational exuberance in 1997 took attitude that Fed would not burst the bubble.

Clinton reappointed Greenspan again in 2000. By then Greenspan was a media star: "Who needs gold when we have Greenspan?" asked *New York Times* Editorial.

In 2000-2001, DOT.com boom burst. Tech heavy Nasdaq market fell from 5049 to 1104 between early 2000 and Fall of 2002. Dow Jones fell 38 percent.

Fed backpedaled on monetary policy, reducing Federal Funds Rate from 6.5 percent to 1 percent between January 2001 and June 2003. Discount Rate declined to .75 percent in 2002.

Greenspan who had championed budget cuts earlier with Clinton in 2001 supported Bush tax cuts, ultimately $1.35 trillion, asserting that Clinton budget plan would lead to surpluses.

After September 11, 2001 terrorist attacks and DOT.com bust, deficits returned beginning with $158 billion deficit in 2002. Bush Presidency would double National Debt.

Greenspan and Clinton also worked closely on deregulation of banking laws.

In 1994, Reigle-Neal Interstate Banking and Efficiency Law had eliminated virtually all limits on interstate banking.

Significantly in 1994, the Fed approved Bank Holding Companies engaging in securities underwriting up to 25 percent of their revenues. This was a decisive erosion of Glass-Steagall.

A bank merger wave followed. In 1998, Citicorp merged with Travelers Insurance, in the largest financial merger in history. The merger was impermissible given Bank statutory restrictions on insurance underwriting. Fed conditionally approved merger for two to five years to give Congress time to change the laws.

Greenspan believed that liberalization of United States financial regulation was long overdue.

Gramm-Leach-Bliley Act of 1999 repealed Glass-Steagall limits on Bank mergers with securities or insurance firms. New Financial Holding Companies could own both. Clinton insisted that mergers only permissible if community credit needs adequately provided.

The path after Gramm-Leach-Bliley was fully clear to a New Financial Order. 1999 began a series of major mergers in financial services industry such as Bank of America merging with Nationsbank to form Nation's largest Bank. The structure of financial regulation and the financial markets largely set by 1999, with key changes involving powers of Bank and Bank Holding Companies to own Banks without Branch limits, ATMs, power to own securities and insurance firms – but generally not commercial firms. Financial regulation remained siloed among Federal and State banking, Federal and State Securities Administrators and State Insurance Regulators. New gaps and omissions had opened in old New Deal model, with largely unregulated hedge funds and swap transactions.

CLASS DISCUSSION

Q: What is the case for financial supermarkets operating simultaneously in banking, securities and insurance across state and international lines without limits on branches, ATMs or capital?

Q: What are the disadvantages of financial supermarkets?

Q: Why were Banking and Financial Holding Companies largely prohibited from owning nonfinancial firms?

Q: What lessons are relevant to today's politics from the failure of the 1993-1994 Clinton Health Care proposal and 1994 election results?

PSC 234W: Class Notes: November 16, 2020

Restructuring Finance Post 2007-2009 and Two New Crises: Cryptocurrency and the 2020 Pandemic

Reading: Misalignment 1101-1148

Background:

New Deal Model:

- Atomized regulation Post 1929-1933 Crash
- Glass-Steagall Act
- Model largely worked for close to 70 years

2077-2009 Model spectacularly failed

- Stock prices fell 54 percent
- Global market values fell $35 trillion
- Debt market froze up
- Unemployment rose from 4.5 to 10.1 percent
- Federal budget deficit exploded from $459 billion to $1.413 trillion.

Why?

- Meltdown in housing
- Mortgage originators
- Fannie Mae, Freddie Mac
- Securitization
- Credit rating agencies
- Investment Banks
- New securities such as credit debt obligations and credit default swaps

- 2001-2007 real estate boom – interest rates dropped 3 percent, housing start ups 53 percent between 1995 and 2005, home mortgage indebtedness doubled from $5.4 trillion to $10.5 trillion
- 2006 – housing bubble burst – home prices declined 9 percent in 2007, 17 percent in 2008
- Bear Stearns near failure in March 2008
- July 2008 – Housing and Economic Recovery Act
- September 6, 2008 – Fannie Mae and Freddie Mac in conservatorship
- September 15, 2008 – Lehman Brothers bankruptcy
- Goldman Sachs and Morgan Stanley convert to Bank Holding Companies, top five Investment Bank Holding Companies end
- AIG rescued ultimately by over $180 billion in Federal support
- TARP - $700 billion in October 2008 initially inadequate – market falls 1874 points in following week – another $787 billion provided in 2009 through American Recovery and Reinvestment Act

What worked?

- Using TARP funds to support leading Banks rather than buy troubled assets – Bagehot Theory
- Guaranteeing financial firm debt
- Ring fencing assets at Citicorp and elsewhere
- Support of auto industry
- Stress test in 2009
- Quantitative easing

Near total meltdown in 2008-2009

- Of top 25 financial institutions at beginning of 2008, 13 failed or transformed their business structure to survive

- 2008 – 3.6 million jobs lost; GDP declined 6 percent in third quarter, 6.8 percent in fourth quarter
- 2009 worse – 4.7 million jobs lost – stock market low of 6547 on March 9, 2009, dropping 27 percent in first ten weeks of 2009, unemployment would reach 10.1 percent in October 2009 and remain over 9 percent until 2010, deficit would remain above $1 trillion until 2012
- Massive political backlash – GOP gained 63 House seats and 6 Senate seats in 2010
- Crisis would be global and interdependent

Ultimate causes:

Ideology

- Bipartisan support for housing
- Deregulation

Structure

Dodd Frank Act enacted in 2010

Purpose:

To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices. . . .

Financial Stability Oversight Council

Treasury Secretary chairs, 11 members

Not command and control, largely monitor and recommend to Members such as Fed, SEC, Comptroller of Currency, FDIC general supervisory priorities and practices

Crisis management in hands of Fed and FDIC

Recommend prudential standards such as risk based capital requirements

Fed directed to require each covered financial company to develop a resolution plan for use in event of material financial distress or failure

Dodd-Frank sought to end "too big to fail" – financial companies put in receivership to be liquidated, no taxpayer funds to prevent liquidation

Fed use of emergency lending programs more limited than before Dodd-Frank – could not use Emergency Stabilization Fund

Many commendable features:

- Each covered Bank Holding Company debt to equity ratio limited to 15-1 when a threat to financial stability
- Volcker Rule to limit Banks from engaging in proprietary trading or acquiring hedge funds or private equity firms
- New Bureau of Consumer Financial Protection
- Credit Rating Agencies subject to new controls – SEC and other agencies could not rely on favorable ratings in regulation
- Asset-backed securities now required issuers to have skin in the game, at least 5 percent of credit risk
- Investment advisers to hedge funds now had to register with SEC
- Gramm-Leach-Bliley Act prohibition on regulation of security based swaps ended but regulation now shared by SEC and CFTC

Greatest deficiencies of Dodd-Frank structure:

- Only one earlier agency eliminated – Office of Thrift Supervision
- Only one new agency created – Bureau of Consumer Financial Protection
- Byzantine structure with multiple Federal bank regulators, investment regulators, no insurance regulation, no new housing finance regulator remained

A different, structured approach to reform:

- Change purpose of Dodd-Frank – do not limit bailouts and subsidies in an emergency
- Replace relatively toothless FSOC with Financial Regulatory Authority
- Reduce membership to an independent Chair, Secretary of Treasury, Fed Chair, National Banking Commission Chair, Investment Commission Chair, Consumer Financial Protection Chair and Chair of National Insurance Commission
- Authorize FRA to impose prudential regulatory standards with 2/3 votes
- FRA with President and White House have command and control powers in financial emergency
- Limit Fed to monetary policy and oversight of Bank and Financial Holding Companies
- Create National Banking Commission to oversee all other Banks, Savings and Loans and Credit Unions at Federal level
- Create Investment Commission to combine current SEC, CFTC, pension investment regulation in Department of Labor and currently unregulated institutions such as hedge funds
- Create National insurance regulation
- Simplify rulebooks, examination and enforcement
- Eliminate regulatory arbitrage

- Create commission self-funding for all independent regulatory agencies
- Unify compensation for all Federal agencies at Fed levels
- Key change – emphasize depoliticized independent regulatory agencies during non-emergency times; create unified response during emergencies

THE 2020 PANDEMIC

On August 31, 2020, the United States Government Accountability Office Report to Congress began:

> The Coronavirus Disease 2019 (*COVID-19*) pandemic has resulted in catastrophic loss of life and substantial damage to the global economy, stability, and security. Worldwide there were 22,256,000 reported cases and 782,000 reported deaths due to COVID-19, as of August 20, 2020; within the United States, there were 5,507,000 cumulative reported cases and 158,000 reported deaths. The United States also continues to experience serious economic repercussions and turmoil. As of July 2020, there were about 16.3 million unemployed individuals, compared to nearly 5.9 million individuals at the beginning of the calendar year.

During 2020, four federal laws added approximately $3 trillion to the National Deficit. See CBO, The Effects of Pandemic-Related Legislation on Output (Sept. 2020). These laws were:

- *Paycheck Protection Program and Related Provisions*. Through the Paycheck Protection Program (*PPP*), the legislation funds loan guarantees for loans to small businesses to help them cover payroll and other costs. CBO expects most PPP loans to be forgiven, so they will effectively become grants. In addition, the legislation allocates funds to the Small Business Administration (*SBA*), which lends them to businesses, provides debt relief, and administers the Economic Injury Disaster Loan (*EIDL*) program. That program provides grants to businesses experiencing a temporary loss in income.

- *Enhanced Unemployment Compensation*. The legislation temporarily increased unemployment benefits by $600 per week through July 31, 2020. In addition, the legislation created a temporary program for people not otherwise eligible for unemployment benefits, such as self-employed workers and independent contractors, and extended the number of weeks of federally funded benefits available to beneficiaries who qualified for regular unemployment insurance in 2020. Finally, the legislation allowed states to waive work-search requirements for people receiving benefits.
- *Recovery Rebates for Individuals*. The legislation provides a refundable tax credit of $1200 per qualifying adult and $500 per dependent child to taxpayers with income below specified limits. The tax credit begins phasing out once the income of individuals and of married couples filing jointly passes $75,000 and $150,000, respectively.
- *Direct Assistance for State and Local Governments*. The legislation provides grants to state and local governments – and to tribal and territorial governments as well – for spending related to the pandemic.

In March 2021, Congress enacted the $1.9 trillion American Rescue Plan Act emphasizing cash first, bringing the direct cost of COVID relief close to $5 trillion.

As of June 10, 2021, the National debt was estimated to be $28.2 trillion. In 2020, total Federal revenues equaled $3.42 trillion; total spending $6.55 trillion.

Richard Clarida, Burcu Duygan-Bump & Chiara Scotti, The COVID-19 Crisis and the Federal Reserve's Policy Response (Fed. Res. Bd. Fin. & Econ. Discussion Series, Div. of Research & Statistics and Monetary Affairs, June 3, 2021) summarized the broad Federal Reserve response:

> At the time of this writing, one year has passed since the COVID-19 pandemic arrived on the shores of the United States. Since then, the virus has caused tremendous human and economic hardship across our country and around the world. The pandemic and the mitigation efforts put in place to contain it delivered the most severe blow to the U.S. economy since the Great Depression. GDP collapsed at an annual rate of over 30 percent in the second quarter of 2020. More than 22 million jobs were lost in just the first two months of the crisis, and the unemployment rate rose from a 50-year low of 3.5 percent in February to a postwar peak of almost 15 percent in April of 2020. A precipitous decline in aggregate demand pummeled the consumer price level. The resulting disruptions to economic activity significantly tightened financial conditions and impaired the flow of credit to U.S. households and businesses.
>
> The fiscal and monetary policy response in the United States to the COVID crisis was unprecedented in its scale, scope, and speed. Legislation passed by the Congress in March 2020, December 2020, and March 2021 provided a total of nearly $5.8 trillion in fiscal support to the U.S. economy – about 28 percent of U.S. GDP.[1]

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[1] This total includes the roughly $3 trillion from the spring 2020 bills – the Coronavirus Preparedness and Response Supplement Appropriations Act, 2020; the Families First Coronavirus Response Act; the Coronavirus Aid, Relief, and Economic Security (*CARES*) Act; and the

The Federal Reserve acted decisively and with dispatch to deploy all the tools in its conventional kit and to design, develop, and launch within weeks a series of innovative facilities to support the flow of credit to households and businesses (Table 1). The Federal Reserve's policy actions in response to the COVID crisis can be grouped into four broad categories. In the first category, we would include conventional monetary policy measures such as cutting interest rates, offering forward guidance, and rescaling and restarting programs to purchase Treasury securities and agency mortgage-backed securities (*MBS*) as well as repurchase agreement (*repo*) operations. In the second group, we would include measures to provide liquidity and funding to support money market functioning. In the third category, we would include a number of facilities the Federal Reserve launched to support more directly the flow of credit to households, businesses, and state and local governments. And in the fourth group, we would include temporary recalibrations the Federal Reserve made to regulations and supervisory practices to encourage and incent banks to support the flow of credit to their household and business customers.[2]

The facilities the Federal Reserve either relaunched or designed and developed anew in response to the COVID crisis

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Paycheck Protection Program and Health Care Enhancement Act – inclusive of the roughly $0.45 trillion in capitalization for the Fed lending facilities in the CARES Act; as well as $0.9 trillion in the stimulus divisions of the Consolidated Appropriations Act, 2021, passed in late December 2020; and $1.9 trillion in the American Rescue Plan Act of 2021, passed in March 2021.

[2] A complete list of the Federal Reserve's actions in response to COVID-19 can be found on the Federal Reserve Board's website at https://www.federalreserve.gov/covid-19-htm. The text included in this paper relies heavily on Board of Governors (2020f, 2020g, 2020h).

were established under the authority of section 13(3) of the Federal Reserve Act; under section 13(3), these facilities can be established only in "unusual and exigent circumstances" and with approval of the Treasury Secretary. The U.S. Treasury provided first-loss equity investments in seven of the nine section 13(3) facilities stood up during the COVID crisis. These Treasury equity investments were funded initially from the traditional Exchange Stabilization Fund (*ESF*) and then later from funds specifically appropriated to the ESF by the Congress for this purpose in title IV of the Coronavirus Aid, Relief, and Economic Security (*CARES*) Act. Another key principle respected in the design of the facilities is that they were structured to be backstops, with pricing and terms set to incent borrowers to obtain credit, if available, from financial markets and financial institutions so as to restore the flow of credit from private lenders through normal channels.

Table 1: Timeline of selected Federal Reserve actions during the COVID-19 pandemic

Date	Action	Objective
Monetary policy actions		
March 3, 2020	FOMC lowers FFTR by 1/2 percentage point, to 1 to 1-1/4 percent	To support achieving its maximum-employment and price-stability goals
March 9, 2020	Updates the monthly schedule of repo operations	To ensure that the supply of reserves remains ample and to mitigate the risk of money market pressures that could adversely affect policy implementation
March 12, 2020	Introduces new weekly recurring one- and three-month term repo operations	To address the disruption in Treasury financing markets
March 15, 2020	FOMC lowers FFTR by 1 percentage point, to 0 to 1/4 percent, and introduces forward guidance	To support achieving its maximum-employment and price-stability goals
March 15, 2020	FOMC to increase its holdings of Treasury and agency mortgage-backed securities by at least $500 billion and $200 billion, respectively, over the coming months	To support the smooth functioning of markets for Treasury securities and agency mortgage-backed securities
March 16, 2020	Introduces a second daily overnight repo operation and increases the amount offered in each to $500 billion	To ensure that the supply of reserves remains ample and to mitigate the risk of money market pressures that could adversely affect policy implementation
March 23, 2020	FOMC announces it will continue to purchase Treasury securities and agency MBS "in the amounts needed." It also includes in the purchases agency CMBS for the first time	To support the smooth functioning of markets for Treasury securities and agency mortgage-backed securities
June 10, 2020	FOMC announces it will increase holdings of Treasury securities and agency mortgage-backed securities at least at the current pace	To sustain smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions
September 16, 2020	FOMC revises forward guidance on rates	To bring FOMC forward guidance into line with the new policy framework, introduced with the approval in August of the new Statement on Longer-Run Goals and Monetary Policy Strategy
December 16, 2020	FOMC introduces guidance on asset purchases	To bring guidance into line with the new policy framework in order to provide accommodation and support the economy
Liquidity and funding operations		
March 15, 2020	Discount window: reduction in primary credit rate by 150 basis points to 0.25 percent, and introduction of term loans up to 90 days. Reserve requirements: reduction to 0 percent, effective on March 26	For depository institutions to meet unexpected funding needs and, in doing so, to help them meet demands for credit from households and businesses
March 15, 2020	FOMC enhances standing U.S. liquidity swap lines with Bank of Canada, Bank of England, Bank of Japan, European Central Bank, and the Swiss National Bank	To lessen strains in global dollar funding markets
March 17, 2020	FRB announces Commercial Paper Funding Facility	To support the flow of credit to households and businesses
March 17, 2020	FRB announces Primary Dealer Credit Facility	To support smooth market functioning and facilitate the availability of credit to businesses and households
March 18, 2020	FRB announces Money Market Mutual Fund Liquidity Facility	To support the flow of credit to households and businesses

Table 1 (*continued*)

Date	Action	Objective
March 19, 2020	FOMC announces temporary swap lines with 9 additional central banks	To lessen strains in global dollar funding markets
March 20, 2020	FOMC increases frequency of 7-day maturity operations of standing swap lines	To lessen strains in global dollar funding markets
March 31, 2020	FOMC announces temporary FIMA Repo Facility	To lessen strains in global dollar funding markets
Tools to provide more direct support for providing credit across the economy		
March 23, 2020	FRB announces Term Asset-Backed Securities Loan Facility	To support the flow of credit to consumers and businesses
March 23, 2020	FRB announces Primary Market Corporate Credit Facility	To allow companies access to credit so that they are better able to maintain business operations and capacity during the period of dislocations related to the pandemic
March 23, 2020	FRB announces Secondary Market Corporate Credit Facility	To provide liquidity for outstanding corporate bonds
March 23, 2020	FRB says it expects to announce Main Street Lending Program soon	To facilitate the flow of credit to small businesses so that they can keep their workers on the payroll during the disruptions caused by the coronavirus
April 9, 2020	FRB announces Municipal Liquidity Facility	To help state and local governments manage cash flow stresses caused by the coronavirus pandemic
April 9, 2020	FRB announces Paycheck Protection Program Liquidity Facility	To bolster the effectiveness of the Small Business Administration's PPP by supplying liquidity to participating financial institutions through term financing backed by PPP loans to small businesses
Banking initiatives		
March 15, 2020	FRB encourages banks to use their capital and liquidity buffers as they lend to households and businesses who are affected by the coronavirus	To support the flow of credit to households and businesses
March 22, 2020	Agencies provide additional information to encourage financial institutions to work with borrowers affected by COVID-19	To help with the challenges that affect banks, credit unions, businesses, borrowers, and the economy, given the unique and evolving situation
April 1, 2020	FRB announces temporary exclusion of U.S. Treasury securities and deposits at Federal Reserve Banks from the supplementary leverage ratio	To help ease strains in the U.S. Treasury market and continue to facilitate the significant inflow of customer deposits at banks
June 25, 2020	FRB announces stress-test results with additional sensitivity analyses	To better identify the potential effects of the pandemic on the capital positions of banks
August 3, 2020	Interagency announcement on loan modification	To provide relief to business and individual borrowers during pandemic
December 18, 2020	FRB announces second round of stress-test results	To better identify the potential effects of the pandemic on the capital positions of banks

Note: On March 23, 2020, the Federal Reserve said it expected to announce soon the establishment of a Main Street Lending Program. The actual announcement of the program came on April 9, 2020. A complete list of the Federal Reserve's actions in response to COVID-19 can be found on the Federal Reserve Board's website at https://www.federalreserve.gov/covid-19.htm. FOMC is Federal Open Market Committee; FFTR is federal funds rate target range; repo is repurchase agreement; CMBS is commercial mortgage-backed securities; FRB is Federal Reserve Board; FIMA is Foreign and International Monetary Authorities; PPP is Paycheck Protection Program.

Source: Federal Reserve Board.

These efforts prevented financial catastrophe. The CBO in its February 2021 Overview of the Economic Outlook: 2021 to 2031 summarized its forecast with the following Table at 2:

CBO's Economic Projections for Calendar Years 2021 to 2031

					Annual Average	
	2020	2021	2022	2023	2024–2025	2026–2031
	Percentage Change From Fourth Quarter to Fourth Quarter					
Gross Domestic Product						
Real	-2.5	3.7	2.4	2.3	2.2	1.6
Nominal	-1.2	5.6	4.5	4.3	4.4	3.8
Inflation						
PCE price index	1.2	1.7	1.9	1.9	2.1	2.1
Core PCE price index	1.4	1.5	1.9	1.9	2.1	2.1
Consumer price index	1.2	1.9	2.2	2.3	2.4	2.4
Core consumer price index	1.6	1.5	2.2	2.3	2.4	2.4
GDP price index	1.3	1.9	2.0	2.0	2.1	2.1
Employment Cost Index	2.8	2.3	2.8	3.0	3.2	3.3
	Fourth-Quarter Level (Percent)					
Unemployment Rate	6.8	5.3	4.9	4.6	4.0[e]	4.3[f]
	Percentage Change From Year to Year					
Gross Domestic Product						
Real	-3.5	4.6	2.9	2.2	2.3	1.7
Nominal	-2.3	6.3	4.9	4.2	4.4	3.8
Inflation						
PCE price index	1.2	1.6	1.8	1.9	2.0	2.1
Core PCE price index	1.4	1.5	1.8	1.9	2.0	2.1
Consumer price index	1.3	1.9	2.1	2.3	2.3	2.4
Core consumer price index	1.7	1.6	2.1	2.3	2.4	2.4
GDP price index	1.2	1.6	1.9	2.0	2.1	2.1
Employment Cost Index	2.9	2.1	2.6	2.9	3.1	3.3
	Annual Average					
Unemployment Rate (Percent)	8.1	5.7	5.0	4.7	4.2	4.1
Labor Force Participation Rate (Percent)	61.7	61.9	62.1	62.0	61.9	61.2
Payroll Employment (Monthly change, in thousands)	-765	521	145	145	135	40
Interest Rates (Percent)						
Three-month Treasury bills	0.4	0.1	0.1	0.2	0.4	1.7
Ten-year Treasury notes	0.9	1.1	1.3	1.5	2.0	3.0
Tax Bases (Percentage of GDP)						
Wages and salaries	44.8	44.0	43.9	43.9	43.9	43.6
Domestic corporate profits	7.6[i]	7.9	7.5	7.7	8.2	8.0
Current Account Balance (Percentage of GDP)	-2.8[i]	-2.9	-2.4	-2.0	-2.0	-2.2

The COVID Relief Programs were lauded for reducing suffering. See COVID Relief Checks Sharply Reduced Suffering: Analysis, *Fiscal Times*, June 2, 2021, or feared because of their long term consequences for social programs as intense costs consume more of the Federal budget.

CLASS DISCUSSION

Q: If you were czar or czarina, what approach would you take short and long term to the pandemic? Why?

CRYPTOCURRENCY

The appeal of Bitcoin and thousands of alt coins is explained in the opening paragraphs of Rebecca Bratspies, Cryptocurrency and the Myth of the Trustless Transaction, 25 Mich. Tech. L. Rev. 1, 2-5 (2018):

> Imaging a globally-accepted virtual currency able to facilitate virtually costless transactions at near lightning speed. Now imagine that this currency is open-source and decentralized. Then add an unalterable, tamper-free recording feature to guarantee that every transaction [is] 100% secure and throw in anonymity to boot. Finally, eliminate the need to trust third parties by making this currency independent of central banks or financial institutions. This is the basic pitch for cryptocurrency – from Bitcoin to the thousands of alt-coins that have followed in its wake. . . .
>
> . . . [T]rue believers posit a world with virtually limitless applications for the block chain – the technology at the core of cryptocurrencies. They suggest that these virtual cryptocurrencies will replace fiat currencies, including the dollar, the yen and the euro. So far, the reality of cryptocurrency has not lived up to its hype. It turns out that cryptocurrency transactions can be slow and expensive, because the core technology, the blockchain, scales poorly. These technological issues may or may not be fixable. However, the most interesting divergence between this marketing pitch and cryptocurrency's actual track record have to do with the purported consequences of decentralization – the claim that Bitcoin obviates the need for trust.
>
> In an increasingly volatile world, cryptocurrencies like Bitcoin purport to replace trust with technology. Indeed, Bitcoin founder, Satoshi Nakamoto described Bitcoin as an "electronic

payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party." In the 2008 whitepaper that launched Bitcoin, Satoshi Nakamoto criticized existing electronic payment systems for requiring a trusted third-party intermediary. Nakamoto wrote the Bitcoin white paper during the depths of the 2008 financial crisis, when trust in the ability of governments and banks to manage the economy was at its nadir. A decade later, the so-called "trustless" nature of cryptocurrency is still a big selling point. For example, the cryptocurrency news site Coindesk offers a Bitcoin 101 which touted that: "You don't need to trust anyone else." Coindesk went on to explain that in the conventional banking system, there are multiple points at which trust comes into play: "You have to trust the bank, for example. You might have to trust a third-party payment processor. You'll often have to trust the merchant too. These organizations demand important, sensitive pieces of information from you." With the blockchain, by contrast, cryptocurrency's boosters claim that trust, along with centralization, is no longer necessary. . . .

. . . [T]here is no question that the touted security of the blockchain has not prevented thieves and scam artists from stealing millions of dollars of cryptocurrency. Indeed, the combination of rapidly rising cryptocurrency values, anonymity, and lack of regulation make cryptocurrency platforms "natural targets" for theft. As of late 2017, Reuters estimated that 980,000 coins, worth up to $15 billion had been stolen between 2011 and 2017. And that was before January 2018, when hackers sole $534 million from Japanese cryptocurrency platforms Coinrail ($42 billion in market value loss) and Bithumb ($30 million in coins stolen).

There have been several recent developments.

The recovery of some or all of the ransom that Colonial Pipeline paid in Bitcoin to criminal ransomware operators has undermined confidence that Bitcoin is untraceable. See, e.g., Perlroth, Griffith & Benner, Cyber Cash is Traceable after All, *N.Y. Times* (June 20, 2021).

The Securities and Exchange Commission has taken the position that Bitcoin involves securities subject to its regulation. SEC v. Ripple Labs, Inc., 2021 U.S. Dist. LEXIS 69,563 (S.D.N.Y. 2021).

See also Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System (2008); Mary Lacity, Crypto and Blockchain Fundamentals, 73 Ark. L. Rev. 363 (2020).

CLASS DISCUSSION

Q: Crypto is the first widely used currently alternative to the dollar created in this country since State bank notes of the 19th century. Should crypto be prohibited, regulated or unregulated?