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ARTICLES

THE TRANSFORMATION OF U.S. BANKING AND FINANCE: FROM REGULATED COMPETITION TO FREE-MARKET RECEIVERSHIP

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INTRODUCTION

Financial deregulation was justified both before and during the presidency of Ronald Reagan by the premise that reduced government regulation would encourage competition between financial institutions, thereby increasing market choices for large and small savers alike. Regulations limiting

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lending and depository interest rates were seen as the primary obstacle to an unfettered free market despite the fact that such legal restraints on the price of credit were the linchpin in a regulatory regime that had provided stability in banking and finance for almost half a century.

Increased price competition was considered a public good because of its presumed beneficial effects upon consumer choice, economic efficiency, resource allocation and growth. Competitive forces, once unleashed, brought higher returns to depositors as commercial banks, savings and loan associations, and credit unions found themselves in the same environment as previously unregulated money markets such as the Eurodollar and mutual fund markets. According to this free-market blueprint, higher interest rates on deposits would encourage increased private thrift and savings which, guided by an invisible free hand, would flow into investment of new capital, plant and equipment. Americans would become more productive at home and more competitive abroad.

All this was fantasy. In no other major area of policy during the Reagan era did theory depart more from reality. From its start, financial deregulation was a policy based upon logical and ideological contradictions. Increased interest rates to depositors meant more burdensome lending rates for public and private borrowers, particularly at a time when the central monetary authority at the Federal Reserve System (the "Fed") had restricted the total supply of credit. By the end of his first administration, Ronald Reagan had succeeded in ratifying the most radical transformations of American banking since the New Deal: virtually all restrictions on the price of credit were abolished. By the end of President Reagan's second term in office, the advocates of free-market capitalism were quietly relying on massive government interventions and a policy of financial bailout to safeguard the entire monetary payment system.

In analyzing the legislative and regulatory development of U.S. banking and finance policy, this Article considers a range of empirical evidence and realities. Such an empirical methodology has been embraced over the years by widely disparate schools of legal thought.[1] Most recently, this methodology has

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[1] For instance, the "empirically oriented wing" of the critical legal studies

been associated with the "law and economics" school, which explicitly recognizes the importance of using empirical evidence to analyze legislative strategies.[2] This Article considers and evaluates relevant empirical evidence, including indicators of macroeconomic performance[3] and microeconomic performance.[4] As this Article suggests, consideration of such empirical realities requires lawyers and policy-makers to engage seriously with scholars in the disciplines of economics and the various social sciences.

I. THE REGULATORY REGIME: 1933-79

Most Americans are not old enough to remember a time when there was a banking crisis so severe that not a single bank was open for business in the entire country. Such was the reality confronting Americans when President Franklin D. Roosevelt took his first oath of office on March 4, 1933, and issued a proclamation providing for a nationwide bank holiday.[5] Confidence in the banking and credit system had degenerated, resulting at first in isolated runs of depositors and finally mass panic and the brink of financial collapse.

The magnitude of the financial crisis presented Roosevelt with the opportunity for major reform of the banking system. Within days of his inauguration, President Roosevelt signed the Emergency Banking Act of 1933. The Act prohibited the

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movement can be traced back to the "fresh look" methodological approach of Karl Llewellyn and the neo-realists. Note, *'Round and 'Round the Bramble Bush: From Legal Realism to Critical Legal Scholarship*, 95 HARV. L. REV. 1669, 1670 n.5, 1671 n.10 (1981).

[2] RICHARD A. POSNER, OVERCOMING LAW (1995). Judge Posner rightly warns against the tired tendency of legal scholars to produce self-referential scholarship: law review articles that merely cite ad nauseum to other law review articles that fail to consider empirical reality or to develop analytical frameworks for evaluating empirical evidence.

[3] Macroeconomic indicators include rates of interest, inflation and economic growth, changes in the size of the federal deficit and national debt, and changes in the distribution of national wealth and income.

[4] Microeconomic indicators include changes in the profitability of commercial banking, the scope and frequency of financial failure, the magnitude of the collapse of the savings and loan industry, and the scope of government bailouts, rescue packages and market interventions.

[5] Similar proclamations and orders had already been issued by the Governors in every state. LESTER V. CHANDLER, THE ECONOMICS OF MONEY AND BANKING 327 (9th ed. 1969).

payment of interest on demand deposits (checking accounts), raised minimum capital requirements for federally chartered banks,[6] and provided the statutory authority for the Federal Reserve Board to implement Regulation Q, which set maximum interest rates payable on time deposits such as savings accounts.[7]

Underlying the New Deal reform plan was the widespread perception that unrestrained competition had destroyed public confidence in the entire banking industry during the Great Depression. In an effort to attract funds in the 1920s, banks had bid up the rate of depository interest payments to excessive levels. "To cover the cost of these funds, the banks in turn were obliged to invest their resources on terms which sacrificed asset quality for yield."[8] The "competitive escalation of interest rates paid on deposits," which had induced lenders to make riskier loans at higher interest rates, ultimately became a major factor in the 1930-33 wave of business failures, mortgage foreclosures and bank closings.[9]

For nearly half a century, beginning in 1933, American banking was shielded from the most extreme excesses of price competition.[10] The depository interest rate ceilings performed

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[6] EDWARD L. SYMONS, JR. & JAMES J. WHITE, BANKING LAW 41 (2d ed. 1984). The Banking Act of 1935 extended parts of the federal regulatory scheme to state-chartered banks and empowered the Federal Reserve to set reserve requirements on time and savings deposits. *Id.*

[7] Thomas F. Huertas, *The Regulation of Financial Institutions: A Historical Perspective on Current Issues*, *in* FINANCIAL SERVICES 6, 20-22 (George J. Benston ed., 1983). Similarly, the FDIC implemented FDIC Regulation 329 to impose interest rate ceilings on non-Federal Reserve-member banks. CARTER H. GOLEMBE & RAYMOND E. HENGREN, FEDERAL REGULATION OF BANKING 54 (1975). For much of the post-World War II era, the Regulation Q interest rate ceilings on passbook savings accounts were kept low, often between three and five percent, thereby allowing banks to lend at low interest rates while still remaining profitable. The regulatory authority to set depository interest rate ceilings was not made permanent, but was subject to periodic review and extension by Congress. *Id.* at 55.

[8] GOLEMBE & HENGREN, *supra* note 7, at 54. Note the strong similarity between the 1920s and the speculative 1980s, when once again banks (as well as savings and loan associations) "sacrificed asset quality for yield" by lending at high interest rates and dealing in high interest junk bonds. *Id.*

[9] *The Depository Institutions Deregulation Act of 1979: Hearings on S. 1347 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing and Urban Affairs*, 96th Cong., 1st Sess. 130 (1979) (statement of Henry B. Schechter, Director, AFL-CIO Dep't of Urban Affairs) [hereinafter Statement of Henry Schechter].

[10] The "New Economics" of John Maynard Keynes provided the intellectual

a variety of functions that served as the basis of financial stability in the United States. These ceilings provided stability by limiting the degree of price competition between banks and other financial institutions, allowing the banking system to expand credit without raising interest rates on loans,[11] and maintaining the existing distribution of wealth and income between debtors and creditors. The Federal Reserve's Regulation Q was the cornerstone of the federal government's efforts to enforce a stable depository interest rate environment. State usury laws, in turn, limited interest rates on loans while providing banks with a comfortable margin for profit.[12]

During these years, banking became a conservative "3-6-3" business: bankers paid out 3% nominal interest to attract deposits, lent the deposits out at 6%, and headed for the golf course at 3 in the afternoon. Prudence was valued more than risk, and competition for deposits was restricted to the provision of branches and other services, including customary offers of free toasters. Freedom of contract between depositors and bankers took a back seat to considerations of bank safety and financial stability.

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support for much of New Deal banking policy. Keynes himself concluded that "the rate of interest is not self-adjusting at a level best suited to the social advantage but constantly tends to rise too high, so that a wise Government is concerned to curb it by statute [i.e., usury laws] and custom and even by invoking the sanctions of the moral law." JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 351 (1st ed. 1964).

[11] Under Regulation Q, the Federal Reserve was able to slow the expansion of credit by *lowering* the depository interest rate ceilings, thereby limiting the ability of banks to attract funds. *See* CHANDLER, *supra* note 5, at 113-14; WILLIAM GREIDER, SECRETS OF THE TEMPLE 177-78 (1987). The repeal of Regulation Q hampered the Federal Reserve Board's monetary control capabilities by requiring higher interest rates to achieve the Federal Reserve's policy goal of zero inflation. According to Michael Mussa, director of research at the International Monetary Fund, some central banks now have to raise interest rates twice as much as they once had to in order to reduce inflationary pressures. Steven Greenhouse, *Central-Bank Gripes About a New World*, N.Y. TIMES, Aug. 23, 1993, at D1.

[12] In addition, the federal government pursued other policies intended to foster an allocation of credit more favorable to construction of new housing. C. Thomas Long et al., *Enhancing the Value of the Thrift Franchise: A Possible Solution for the Dilemma of the FSLIC*, 37 CATH. U. L. REV. 385, 399 (1988). The Federal Home Loan Bank Act of 1932 provided for the chartering of savings and loan associations and for tax incentives to reward home mortgage finance. *Id.* at 389. The Interest Rate Adjustment Act of 1966 allowed thrift institutions to pay slightly higher rates for deposits than could commercial banks. Richard L. Peterson, *Consumer Finance*, *in* FINANCIAL SERVICES, *supra* note 7, at 199.

While depositors earned less on their savings under this regime, low interest rates on loans fostered investment, employment and income. Banks enjoyed high-quality loan portfolios and far fewer failures. For example, from 1930 to 1933 more than 9000 commercial banks failed, causing devastating effects upon the public's confidence in the entire system of monetary payments. In contrast, from 1934 to 1973 only 641 U.S. banks were closed, an average of less than seventeen a year.[13]

The Federal Reserve Board, in its role as central bank (the banker's bank and lender of last resort) and marketplace regulator, became the institutional focal point for enforcing the New Deal regulatory model. Throughout this long period of banking stability, the Federal Reserve would make periodic adjustments to Regulation Q to achieve the sometimes conflicting policy objectives of "maximum employment, production, and purchasing power."[14] However, the intricate system of regulated depository interest rates depended upon the maintenance of low market interest rates to prevent depositors from shifting funds from banks and thrifts to higher-yielding government securities or money markets. The Federal Reserve achieved this policy initially by "pegging" yields on government securities to levels below the Regulation Q ceilings.[15]

From 1942 to 1951, the Federal Reserve pursued a low interest rate policy by supplying funds to anyone presenting government securities at the pegged prices—ranging from three-eighths of one percent on 90-day maturities to a maximum of 2.5% on 25-year Treasury bonds.[16] The real rate of

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[13] GOLEMBE & HENGREN, *supra* note 7, at 30.

[14] These policy objectives were ultimately embodied in the Employment Act of 1946. CHANDLER, *supra* note 5, at 495. In addition, the Federal Reserve made adjustments to discount rates, reserve requirements (Regulation D), and imposed selective credit controls through Regulation W, which was implemented to impede the growth of consumer credit in an overheated economy by regulating minimum down payments and maximum periods of repayment.

[15] CHANDLER, *supra* note 5, at 527-28.

[16] Such a "pegged" interest rate policy was designed to reduce the costs of financing the federal government's debt while maintaining the price of government securities, thereby sustaining public confidence in the financial institutions that held large amounts of government debt. CHANDLER, *supra* note 5, at 487-88.

The architects of the Federal Reserve's "pegging" policy correctly recognized that a successful war effort meant the full employment and mobilization of society's human and capital resources, requiring the maintenance of low real inter-

interest—the nominal market interest rate minus the inflation rate—was even lower. The Fed actively used its authority to set low interest rates for depositors and marketplace alike, despite a federal deficit almost five times larger and national debt nearly two and one-half times larger, than those of the 1980s (as a percentage of U.S. Gross Domestic Product).[17] The experience clearly demonstrated the Federal Reserve's ability to peg interest rates at levels low enough to discourage efforts to evade Regulation Q through the proliferation of "money substitutes."

A creature of the Wilsonian period of reform, the Federal Reserve System originally was subject to some measure of public democratic control. The Secretary of the Treasury and Comptroller of the Currency were permanent members of the Federal Reserve's seven-member governing board[18] until the

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est rates and strategic controls of credit and prices when markets either became too tight or were inherently non-competitive. Since the Federal Reserve ended its pegging policy, the U.S. economy has experienced a significant secular decline in its capacity utilization rates for human and capital resources. A revival of the regulatory regime—characterized by selective credit controls, interest rate ceilings, low inflation, and full utilization and employment of human and capital resources—is a necessary prerequisite to success on more modern war fronts, such as the nation's unfinished wars on poverty, drugs and violent crime.

[17] In 1943, the federal budget deficit was 31.1% of Gross Domestic Product ("GDP"). By 1946, the gross federal debt was 127.5% of GDP. PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT: 1993, at 438 (1993) (Table B-76) [hereinafter 1993 ECONOMIC REPORT]. Yet during this same period of time interest rates were pegged within the range of three-eighths of one percent to 2.5% on government securities. *Id.* at 428 (Table B-69); CHANDLER, *supra* note 5, at 487-88. In contrast, during the Reagan era the federal budget deficit was never larger than 6.3% of GDP (fiscal year 1983) and the gross federal debt was never larger than 55.4% of GDP (fiscal year 1989), although real and market interest rate yields on government securities were many times higher than during the 1940s. 1993 ECONOMIC REPORT, *supra*, at 438 (Table B-76). Likewise, today the federal budget deficit is down to 3.1% of GDP, while the gross federal debt is 70% of GDP. But both real and market interest rates are far higher than during the 1940s. PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT: 1995, at 366 (1995) (Table B-78). Such empirical data suggests a cause-and-effect relationship that is at odds with the conventional economic wisdom that our present-day deficits are the cause of high interest rates. Rather, high interest rates have generated deficit borrowing to finance both public and private debt. The "passive deficits" of the 1980s and 1990s represent insufficient investment in the real economy, unlike the "active deficits" of the 1940s that financed military campaigns and domestic economic development alike.

[18] President Woodrow Wilson hailed the 1913 Federal Reserve Act as a triumph over the "money trust." GREIDER, *supra* note 11, at 277-78. Wilson declared that control of the banking system must be "public, not private," and "must be

1935 Banking Act stripped both officials of their Federal Reserve Board memberships, effectively leaving the Board under the strong influence of private commercial bankers. Thereafter, to meet the necessities of economic crisis and war-time mobilization, democratic influence on Federal Reserve policy depended almost entirely on President Roosevelt's personal and political alliance with Federal Reserve Board Chairman Marriner Eccles.[19]

The war ended, prosperity returned and eventually the Federal Reserve's ability to set low interest rates was eclipsed by a poverty of institutional will. The accumulation of private factional interests overwhelmed the public policy objectives of the Federal Reserve. Reflecting the position of its commercial banking and bondholding constituencies, the Federal Reserve was anxious to end the low interest rate regime. The Fed was particularly motivated by the mild price escalation which had driven the real interest rate on short-term government securities to low and even negative levels, creating a situation where savers essentially subsidized borrowers. The Federal Reserve-Treasury Accord of 1951 finally freed the Fed from its pegging policy.[20]

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vested in the Government itself, so that the banks must be the instruments, not the masters, of business." AUGUST HECKSCHER, WOODROW WILSON 318 (1991).

[19] GREIDER, *supra* note 11, at 312. The confusing structure of the Federal Reserve System seems designed to provide political accountability in appearance but not in reality. The Federal Reserve System consists of a seven-member Board of Governors and a 12-member Federal Open Market Committee ("FOMC"), which sets interest rates and monetary policy for the nation. While the Board's Chairman and Vice-Chairman are appointed for four-year terms, the remaining board members are appointed to terms of 14 years, longer than three presidential administrations. The FOMC consists of the seven members of the Board of Governors and the presidents of five of the 12 regional Federal Reserve Banks. Unlike board members, the appointment of the regional Federal Reserve Bank presidents are not approved by Congress. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 4-7 (7th ed. 1984) [hereinafter FEDERAL RESERVE SYSTEM].

[20] CHANDLER, *supra* note 5, at 493. The so-called "independence" of the Federal Reserve's decision-making process did not insulate it from politics, but merely dictated an outcome most favorable to certain private banking interests. Unfortunately, such an historic turning point in the nation's monetary policy failed to elicit any significant public debate. Congressional oversight of the Federal Reserve System existed more in form than in substance despite numerous legislative proposals over the years to reorganize the Federal Reserve to make it more accountable to a wider range of interests (i.e., debtor groups such as consumers, farmers and manufacturing businesses).

Over the course of the next three decades, the Federal Reserve allowed real yields on government securities to rise steadily even as federal deficit spending declined as a percentage of Gross Domestic Product.[21] The secular rise in interest rates contributed to higher levels of both unemployment and cost-push inflation.[22] Money became more expensive, and the American dream receded further out of reach for the next generation.

Not surprisingly, as market interest rates rose during the 1960s and 1970s, the banking industry extensively lobbied the Fed to raise Regulation Q. Those ceilings were progressively relaxed as large institutional savers sought higher market yields by purchasing government debt or money market funds. Ironically, the Fed itself had created this situation by abandoning its policy of setting market interest rates at levels below the Regulation Q ceilings. As market interest rates rose above the mandated ceilings, and unregulated offshore money markets began to compete with the regulated domestic environment, political and market pressures to dismantle the New Deal regulatory regime grew steadily.

II. Challenges to Legal Enforcement of the Regulatory Regime

A. *Innovative Responses to Regulation*

Enforcement of the interest rate regulatory regime required the continued vigilance and discipline of banking regulators, particularly since market interest rates began to rise after the 1951 Federal Reserve-Treasury Accord. Time and again, financial institutions tried to get around Regulation Q and exploit legal cracks and loopholes by developing "financial

[21] 1993 Economic Report, *supra* note 17, at 438 (Table B-76). Although real interest rates were much higher in the 1980s than the 1940s, the federal budget deficit was nearly five times larger and the gross federal debt nearly two and one-half times larger (as a percentage of GDP) during the 1940s when compared with the 1980s. *Id.*; *see also supra* text accompanying note 17. From a broad historical perspective, there is no compelling empirical evidence to support the conventional wisdom that public deficit spending must necessarily cause higher interest and inflation rates.

[22] 1993 Economic Report, *supra* note 17, at 384 (Table B-31), 414 (Table B-58).

innovations," i.e., money substitutes.[23] Such efforts directly threatened the system of regulatory supervision and enforcement and the public policy objectives underlying it. Every time banks and non-bank institutions challenged the regulatory scheme through such processes of "financial innovation," the regulatory authorities and the Congress faced renewed pressure either to ratify the innovation or bring the new financial instrument under the domain of Regulation Q.

Financial deregulation became an evolutionary process driven by rising nominal interest rates.[24] Whenever market rates of interest rose above regulated depository interest rate ceilings for a sustained period of time, U.S. commercial banks sought to introduce new financial instruments to compete with the unregulated markets for depository funds. Each crack in the interest rate regime made sustaining the intricate regulatory structure more difficult.

The U.S. legal regime permitted alternative markets, such as markets for commercial paper and short-term Treasury bonds, to exist and flourish.[25] Federal regulation applied only to certain depository institutions. The Bank Holding Company Act regulated "any institution organized under federal or state law which accepted demand deposits and made commercial loans."[26] Corporations avoided this definition, however, by acquiring a bank and then taking the bank out of the commercial loan business. The corporation thereby created what has become known in legal parlance as the "nonbank bank."[27]

Competition from these nonbank financial institutions and unregulated offshore money markets led U.S. commercial banks to advocate the repeal of Regulation Q interest rate

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[23] *See generally* MARTIN MAYER, NIGHTMARE ON WALL STREET: SALOMON BROTHERS AND THE CORRUPTION OF THE MARKETPLACE (1993); MARTIN MAYER, THE MONEY BAZAARS (1984).

[24] Robert A. Eisenbeis, *Bank Holding Companies and Public Policy*, *in* FINANCIAL SERVICES, *supra* note 7, at 124, 133.

[25] In addition, the internationalization of the dollar contributed to the development of the unregulated Eurodollar market, which competed with regulated commercial bank deposit rates. The liquidity crunches of 1966 and 1969-70 revealed that large depositors could evade the interest rate ceilings by turning to the Eurodollar market. Huertas, *supra* note 7, at 23-26.

[26] 12 U.S.C. § 1841(c) (1988).

[27] SYMONS & WHITE, *supra* note 6, at 360. One solution to this enforcement challenge would be to return to a "chartering" rather than an "activities" definition of a bank. *Id.* at 354-55.

ceilings. Banks, which had traditionally served as "intermediaries" between depositors and borrowers, were closed out of evolving sources of funds as market rates rose above the ceilings mandated by Regulation Q.[28] Banks, reacting to the resulting "disintermediation crisis" and liquidity squeeze in 1970, attempted to exploit the holding company organizational form "by issuing nonreservable commercial paper as a liability of the holding company and downstreaming funds to subsidiary banks."[29] In response, Regulation Q was amended to close this loophole. Similarly, when bank holding companies began to issue a series of floating rate notes in 1974, the Federal Reserve, pursuant to congressional authorization, gradually brought the note issues under Regulation Q.[30]

Federal regulators did not impede every attempt at financial innovation, however. For instance, in response to rising interest rates and the resulting "disintermediation crisis" of the late 1950s, the Federal Reserve granted approval of the negotiable certificate of deposit ("CD"), allowing banks to attract corporate funds away from the securities market on the basis of price.[31] This open competition for corporate funds necessarily resulted in greater upward pressure on interest rates. Finally, in 1973, federal regulators removed the ceilings on interest rates on commercial bank CDs of $100,000 or more.[32]

The demise of interest rate regulation, therefore, occurred in stages. First, the Federal Reserve Board abandoned the policy goal of pegging nominal interest rates below the Regulation Q ceilings. This change provided the incentive for regulatory evasion. Large "sophisticated" institutional players then pushed the concept of "financial innovation" ever farther. After regulators ratified such evasions, it was only a matter of time before the cracks developed into a more general breach, justified by spurious arguments of equity and fairness to small

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[28] These alternative sources of funds included repurchase agreements, the Eurodollar market, the federal fund market, and the market for large certificates of deposit ("CDs"). Eisenbeis, *supra* note 24, at 133.

[29] Eisenbeis, *supra* note 24, at 133.

[30] Eisenbeis, *supra* note 24, at 135.

[31] Huertas, *supra* note 7, at 23-26.

[32] Statement of Henry Schechter, *supra* note 9. Nearly nine years after the relaxation of Regulation Q on large CDs, Continental Illinois experienced a hemorrhage of such funds, bringing the bank to the edge of collapse. *See infra* notes 103-15 and accompanying text.

savers.

B. *Transnational Factors: Regulatory Arbitrage Between Competing Jurisdictions*

Since the mid-1950s, the pace of financial deregulation was heavily influenced by transnational factors, particularly the development of offshore markets, which were exempt from U.S. taxation, securities laws, reserve requirements and other regulations. In the early 1990s, the regulatory competition of neighboring jurisdictions continued to pose myriad opportunities for private corporations to engage in a process of "regulatory arbitrage," playing one sovereign jurisdiction off against another to minimize regulatory costs. For instance, through the increasingly popular innovation of offshore incorporation, the Cayman Islands and other peripheral jurisdictions continued to exert inordinate authority over the legal factors affecting market interest rates in the United States.[33]

This process, whereby one jurisdiction undermines the legal regime of a neighboring jurisdiction, has been described as a "race for the bottom."[34] For instance, Delaware has been described as "a pygmy among the fifty states [that] prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders."[35] The result is a legal regime in which basic public policy objectives are ignored in the process of chartering corporations.[36]

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[33] Krysten Jenci, *Fed Gets Grilled on Oversight of Banks' Cayman Island Activity*, THOMSON'S INT'L BANKING REGULATOR, June 28, 1993, at 2 (foreign offshore branches are "'free of any U.S. reserve requirements, FDIC premiums or statistical reporting requirements'" (quoting a Federal Reserve statement); Robert N. McCauley & Rama Seth, *Foreign Bank Credit to U.S. Corporations: The Implications of Offshore Loans*, FED. RESERVE BANK OF N.Y. Q. REV., Spring 1992, at 52.

[34] William J. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 705 (1974).

[35] *Id.* at 701; *see also* THEODORE LOWI, THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES 175 (2d ed. 1979) ("A suburb is ultimately an instrument [a legal fiction] by which the periphery can exploit the center, by which a single unit of the whole can exploit the rest.").

[36] In place of this regulatory arbitrage between states, Congress could legislate a level playing field with minimum legal requirements. Cary, *supra* note 34, at 705 ("A civilizing jurisprudence should import lifting standards."). A federal charter for corporations could provide minimum standards for fiduciary duties, shareholder voting rights on executive compensation, capital structures, and limits on a corporation's debt/equity ratio. WILLIAM F. HIXSON, A MATTER OF INTEREST: REEX-

Over the past century, the same dynamic developed in banking; a "dual banking system" allowed private interests to shop around for the jurisdiction with the most relaxed regulatory environment. Although Congress periodically enacted legislation to encourage state-chartered banks to recharter under federal law, it refused directly to preempt state law. Since "[s]tate bank regulations were often less stringent than Federal regulation," there was no incentive for state-chartered banks to recharter under federal law.[37] State banking regulation undermined the federal regime of regulated interest rates by permitting some of the most significant financial innovations of the 1970s.[38]

Likewise, other "pygmy" jurisdictions, situated beyond the reach of U.S. law, can have profound effects upon the U.S. regulatory regime. E. Gerald Corrigan, former president of the Federal Reserve Bank of New York and head of the Bank for International Settlement's Committee on Global Banking Supervision, has noted that because money flows to those jurisdictions that regulate the least, the result has been a regulatory rush to the "least common denominator."[39] Offshore financing effectively raises the level of depository interest rates and adds competitive pressures to the regulated environment of U.S. banking and finance. U.S. banks find themselves at a competitive disadvantage vis-a-vis offshore banks and offshore mutual funds, both in attracting deposits and booking loans.[40] Periphery jurisdictions such as the Cayman Islands, the

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AMINING MONEY, DEBT, AND REAL ECONOMIC GROWTH 255 (1991); *see also* HENRY C. SIMONS, ECONOMIC POLICY FOR A FREE SOCIETY 58-60 (1948).

[37] PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT: 1984, at 171 (1984) [hereinafter 1984 ECONOMIC REPORT].

[38] *Id.*

[39] Steve Lohr, *Where The Money Washes Up*, N.Y. TIMES, Mar. 29, 1992, § 6 (Magazine), at 26, 28-32. In Georgetown alone (the capital of the Cayman Islands), nearly 600 banking outposts hold over $400 billion. Most of these banks are mere shells or booking centers which traffic in computerized electronic debits and credits to evade U.S. regulations and taxes. *Id.* at 27.

[40] *See supra* note 33. United States banks also argued that they faced a competitive disadvantage vis-a-vis securities firms because of unequal regulation. *See The Bottom Line*, BANKER, June 1993, at 64 (listing proposals to harmonize minimum capital standards for securities firms and banks to ensure a "level playing field" and prevent banks from being priced out of business); Christi Harlan & Thomas T. Vogel, Jr., *SEC Considers Controls on Derivatives*, WALL ST. J., Apr. 29, 1993, at C1 (SEC may extend capital requirements for securities firms to cover exposure to forwards, swaps and other derivatives).

Netherlands Antilles and more than four dozen other offshore banking centers[41] effectively have undermined the regulatory regime of the core jurisdiction, the world's largest industrial economy.

While money has begun to flow more freely between the United States and periphery jurisdictions, particularly since the 1970s, there has been a general failure to develop the institutional mechanisms necessary to harmonize the respective regulatory environments, ensure a level playing field, and minimize the opportunities for regulatory arbitrage. In fact, the regulatory authorities often encouraged this fragmented policy. For instance, in 1981 the Federal Reserve Board authorized the establishment of International Banking Facilities ("IBFs") by certain financial institutions within the United States to act as bookkeeping entities to attract Eurodollar deposits. IBFs were exempt from various federal regulations, including reserve and deposit insurance requirements, and interest rate ceilings. A number of states, including New York, California, Illinois and Florida, added to this regulatory race to the bottom by exempting IBF profits from state and local taxation to encourage the establishment of IBFs within their borders.[42]

The development and financial integration of the European Economic Community ("EEC") during the 1960s and 1970s, which undertook to allow the freer flow of money and capital, should have provided compelling evidence of the increasing need for harmonization between disparate jurisdictions. Such expanded trade and financial payments necessitated closer cooperation in the laws of neighboring countries. Unfortunately, during a critical stage of global financial integration, the vision and energy of American policymakers was diverted elsewhere. The United States expended diplomatic capital on mat-

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[41] By some estimates, nearly half of the world's money now resides or passes through offshore banking centers. Lohr, *supra* note 39, at 28; *see also* INTERNATIONAL FINANCIAL LAW: LENDING, CAPITAL TRANSFERS AND INSTITUTIONS 53 (Robert S. Rendell ed., 1980) (unregulated Eurodollar market in loans and bonds); *id.* at 197 (unregulated, offshore international mutual funds).

[42] FEDERAL RESERVE SYSTEM, *supra* note 19, at 85 & n.3; Bowman Brown & Emmanuel N. Roussakis, *Offshore Banking Centers*, *in* INTERNATIONAL BANKING 84 (Emmanuel N. Roussakis ed., 1983); Howard M. Wachtel, *The Global Funny Money Game*, NATION, Dec. 26, 1987, at 784, 786.

ters unrelated to harmonization on the core economic issues of international banking and high finance.[43]

III. Deregulation in the Carter Era

In the broad policy areas of banking and finance, the similarities between the Carter and Reagan administrations far outweigh the differences. Both presidents accepted basic free-market premises that were often at odds with market realities. The result was a bipartisan dismantling of the New Deal regulatory regime in banking and finance and a relaxation of the regulatory discipline that had contained market interest rates during the period after World War II.

A. *The Inflation-Interest Rate Spiral*

The late 1970s saw profound transformation of several important conditions which had supported the regulatory regime. Until the mid-1960s in particular, low and stable interest rates and the Bretton Woods system of fixed exchange rates had enabled national governments to regulate interest rate ceilings on existing money markets while impeding the development of high interest-bearing financial instruments.[44] But as market interest rates rose above the level of U.S. interest ceilings and cross-border financial flows expanded, large depositors could increasingly shop around for the highest re-

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[43] For instance, the United States and Cayman Islands had signed a narcotics agreement and the Mutual Legal Assistance Treaty in the 1980s to provide for cooperation and the sharing of information in drug, white collar crime and bank fraud cases. The two countries, however, remained at an impasse over a tax-information exchange agreement and other issues related to bank secrecy, and there was virtually no attempt to harmonize more fundamental policies of bank regulation such as reserve requirements and deposit insurance. Lohr, *supra* note 39, at 46, 52.

[44] *See* MAXWELL WATSON ET AL., INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS AND PROSPECTS 40 (1988). In 1944, the World Bank and International Monetary Fund ("IMF") were created at an international conference at Bretton Woods, New Hampshire. Article VI of the IMF's Articles of Agreement gave member nations the right to control capital movements, particularly short-term capital movements which would not restrict trade. *Cooling Down Hot Money*, ECON. JUSTICE REP., June 1994, at 4; *see also* Howard M. Wachtel, *Taming Global Money*, CHALLENGE, Jan.-Feb. 1995, at 36, 39 ("The Bretton Woods arrangements were constructed, in part, to allow nations to follow their own domestic economic policies without having them distorted by foreign-exchange speculation.").

turns. "[T]he more sophisticated of these depositors sought higher returns in the open market from less regulated competitors."[45]

Rather than curbing innovations, U.S. regulators ratified them "by raising interest rate ceilings on close substitutes offered by banks and thrifts."[46] Moreover, the Democratic administration and Congress opted not to extend the scope of regulation to nonbank institutions and failed to harmonize policy with peripheral jurisdictions. Interest rates were allowed to rise at the expense of important national economic objectives and the federal government bowed to the myriad pressures for financial deregulation. Chief among these pressures were the shifting economic landscape and a political environment dominated by the fear of inflation.

Throughout the 1970s, inflation and interest rates became higher and more variable. By the early 1980s, nominal and real interest rates reached postwar peaks. In 1981, the nominal (market) prime interest rate reached 18.87%, and the real prime rate topped 8%. The market rate on long-term government bonds rose to 13.91% in 1981, and the real rate on such bonds peaked at about 8.5% in 1984. Finally, inflation reached 13.5% in 1980.[47] Depositors protested that the Regulation Q interest rate ceilings constrained their returns even as inflation eroded the value of their deposits. In addition, bankers constantly reminded policy makers that escalating price inflation had pushed market interest rates into double digit levels, well above the ceilings imposed by Regulation Q and the various state usury ceilings on loans. The great price inflation of

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[45] WATSON ET AL., *supra* note 44, at 40; *see also* Eisenbeis, *supra* note 24, at 133.

[46] Eisenbeis, *supra* note 24, at 133; WATSON ET AL., *supra* note 44, at 42 ("These ceilings [on interest rates] were progressively relaxed during the 1970s and 1980s. Pressure to relax these interest ceilings increased as savers sought higher market yields by purchasing government debt or money market funds. In addition, with the lifting of exchange controls, large borrowers and lenders turned to the Eurocurrency market to obtain additional funds and to earn a market return on their financial assets.").

[47] PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS, ECONOMIC REPORT OF THE PRESIDENT: 1992, at 366, 378 (1992) (Tables B-60 & B-69) [hereinafter 1992 ECONOMIC REPORT]; WATSON ET AL., *supra* note 44, at 40. What role did U.S. financial institutions play in the corporate pricing decisions which fueled the 1970s inflation? *See generally* DAVID M. KOTZ, BANK CONTROL OF LARGE CORPORATIONS IN THE UNITED STATES (1978).

the 1970s eventually destroyed the support for low interest rates and undermined the regulated regime.

According to the conventional wisdom of the late 1970s, the U.S. price inflation was largely the result of demand-pull forces, i.e., excess demand pulling up prices in tight markets. According to the emerging monetarist dogma, inflation was simply the result of "too much money chasing too few goods."[48] That explanation, however, largely ignored the low-capacity utilization rates for capital and labor and failed to consider that the real money supply was growing at a slower rate than the real Gross National Product.[49]

However flawed, Chicago school "monetarism" did provide the theoretical justification for higher interest rates. Tight money became the policy of choice. At a critical moment in time, perception was more important than reality and the policy makers shared a common enthusiasm for austerity to wring the inflationary fevers out of the economy. President Carter's 1979 appointment of Paul Volcker to head the Federal Reserve Board confirmed this outlook. Under Volcker, the Fed announced that it would ignore the rising level of interest

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[48] MILTON FRIEDMAN & ANNA F. SCHWARTZ, MONETARY TRENDS IN THE UNITED STATES AND THE UNITED KINGDOM 19 (1982) ("Substantial changes in prices and minimal income are almost invariably the result of changes in the nominal supply of money."). For further discussion of monetarism, see JAMES K. GALBRAITH & WILLIAM DARITY, JR., MACROECONOMICS 215-38 (1994).

[49] The real money supply, as measured by deflated M1, has grown more slowly than the real GNP. *See* ALBERT T. SOMMERS, THE U.S. ECONOMY DEMYSTIFIED 117 (1985); LYNN TURGEON, STATE AND DISCRIMINATION: THE OTHER SIDE OF THE COLD WAR 17, 112-13 n.34 (1989).

M1 represents the sum of currency, demand deposits, travelers checks and other checkable deposits. M2 consists of M1 plus overnight repurchase agreements and Eurodollars, money market mutual fund balances, money market deposit accounts, and savings and small time deposits. M3 consists of M2 plus large time deposits, term repurchase agreements, term Eurodollars, and institution-only money market mutual funds. 1992 ECONOMIC REPORT, *supra* note 47, at 373 (Table B-65).

Money is the grease that lubricates the gears of the economy. If the growth of the money supply does not keep up with GNP growth, sooner or later GNP growth may decline. *See* Lacy Hunt, *The Velocity Trap*, STANDARD & POOR'S CREDIT WEEK, Feb. 15, 1993, at 1 (large decelerations in the broad monetary aggregates have historically preceded poor business conditions); Henry B. Gonzalez, Chair, House Banking Committee, N.Y. TIMES, June 13, 1993, § 4, at 18 (Letter to the Editor) (by 1993, for the first time since the end of World War II, the basic money supply defined as M2 was negative for an entire quarter and the real per capita money supply was falling rapidly).

rates. Instead it would try to control the entire supply of money and credit in a $3.5 trillion economy by targeting the growth of volatile monetary aggregates.[50]

Unfortunately, tight money was a particularly inappropriate method of dealing with cost-push inflationary forces such as the rise of marginal costs in a slow market. Moderate increases in interest rates were passed on to consumers in the form of higher prices and the recessionary costs of tight money led to even greater inflationary pressures.[51] To effectively impede price escalation, the Volcker policy therefore required the brutal logic of more "credible" increases in interest rates. Ever tighter money, ever higher nominal interest rates, and eventually higher real interest rates, wrung inflation out of the econ-

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[50] In that way, the Federal Reserve was attempting to keep the volatile monetary aggregates of M1 and M2 at doctrinaire levels. By July 1993, the Federal Reserve had publicly decided to abandon its reliance on money supply growth as a yardstick for its anti-inflation policy. This change in policy reflected the fact that slower money supply growth had failed to achieve the overriding policy goal of zero inflation. By targeting real interest rates instead of monetary growth (and by calculating such rates according to the federal funds rate paid by the most creditworthy banks on overnight borrowings of reserves), Federal Reserve Chairman Alan Greenspan hoped to defuse criticism that the Federal Reserve was keeping interest rates too high by limiting the growth of the money supply to levels below the Federal Reserve's own monetary targets. *See* Steven Greenhouse, *Fed Abandons Policy Tied to Money Supply*, N.Y. TIMES, July 23, 1993, at D1; Steven Greenhouse, *Greenspan Is Upbeat on Growth*, N.Y. TIMES, July 21, 1993, at D1.

Despite the fact that inflation persisted while monetary growth had stagnated, the Federal Reserve still refused to admit the need for a more fundamental reorientation of policy away from tight money and high interest rates and towards a greater focus on other non-monetary factors of inflation. *See infra* note 58 and accompanying text.

[51] While there has been widespread concern over the inflationary effects of regulatory costs, Robert D. Hershey Jr., *Inflation Stays Subdued, With Consumer Prices Climbing 0.2%*, N.Y. TIMES, Apr. 13, 1995, at D1 ("one of the few remaining symptoms of inflation was actually caused by the medicine the Federal Reserve used to fight it"), far too little attention has been paid to the effects of financing costs on the inflation rate. If the costs of regulation ultimately can be pushed on to consumers in the form of higher prices (in itself, a "cost-push" critique of the market), then other costs, such as financing costs, also can be passed along to consumers. *Id.* at D8 (automobile finance charges rose 32.8% over the past year, "a direct reflection of the Fed's efforts to slow the economy" and contain inflation with rising interest rates; the rise in such finance charges represented a "sizable chunk" of the reported increase in consumer price inflation). Increases in interest, in excess of productivity increases, are necessarily inflationary. HIXSON, *supra* note 36, at 207-08. Furthermore, as Keynes himself recognized, the price level depends partly on marginal cost, which will rise during periods of declining output and declining capacity utilization rates. John M. Keynes, *Relative Movements in Real Wages and Output*, ECON. J., Mar. 1939, at 44-45.

omy, by destroying private industry and throwing millions of citizens out of work, thereby adding to both public and private sector deficits.[52]

Monetarism was not socially neutral in its workings. Rather, it reflected a commitment to the rich. After all, those who lend are more affluent than those who borrow. High interest rates single out the most vulnerable segments of the population, while individuals and corporations with good assets are rewarded in the form of increased interest income. Tight money and the high real rate of interest are the most important and least recognized factors fueling a massive redistribution of wealth and income away from working Americans, indebted farmers and small businesses and toward wealthy individuals, creditors, and large corporations.[53]

The advent of monetarism represented, if not the intellectual bankruptcy of alternative methods of fighting inflation, at least a paralysis of the political will required to adopt "income policies." Gone were the days when a Democratic President could "jawbone" big business and big labor to keep the consumer price index stable and wage increases in line with productivity growth.[54] The opportunism and ultimate failure of Rich-

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[52] Tight money, without complementary incomes and fiscal policies, led to an overvalued dollar and artificially high real interest rates. *See generally* ROBERT LEKACHMAN, GREED IS NOT ENOUGH: REAGANOMICS 128-35 (1982); JOHN WILLIAMSON, THE EXCHANGE RATE SYSTEM (2d ed. 1985).

[53] *See* GREIDER, *supra* note 11, at 170, 456-57 (deregulation resulted in several hundred billion dollars of increased interest payments from debtors to creditors); KEVIN PHILLIPS, THE POLITICS OF RICH AND POOR: WEALTH AND THE AMERICAN ELECTORATE IN THE REAGAN AFTERMATH 95 (1990) (wealthy individuals and corporations were the greatest beneficiaries of the high real interest rates); *id.* at 165, 241 (Appendix B) (the share of wealth held by the wealthiest 0.5% of Americans rose sharply, from about 14% in 1976 to more than 26% by 1983); Sylvia Nasar, *The 1980s: A Very Good Time for the Very Rich*, N.Y. TIMES, Mar. 5, 1992, at A1, D24 (Congressional Budget Office data showing that the average *pre-tax* income of the top one percent grew by 77% during the 1980s in large part a result of high interest returns on existing wealth); John Kenneth Galbraith, The State of the World: Can We Hear The Voice of the Poor?, Address at The Burro Club (May 4, 1983).

[54] For example, President Kennedy forced a price roll-back by steel companies by threatening cancellation of Pentagon steel contracts as well as federal antitrust prosecution. His efforts provided vital credibility for the government's commitment to ensuring price and wage restraint and discipline. *See* ARTHUR M. SCHLESINGER, JR., A THOUSAND DAYS: JOHN F. KENNEDY IN THE WHITE HOUSE 634-40 (1965). U.S. steel companies now coordinate their price increases despite stable costs and excess capacity. *See Prices Raised by USX and Bethlehem*, N.Y. TIMES, May 1,

ard Nixon's wage and price controls served to undermine the legitimacy of any active government policy encouraging discipline in protected, non-competitive and oligopolistic markets. The nation's proud democratic heritage of government opposition to marketplace collusion and the anti-competitive pricing practices of trusts, cartels and conglomerates was replaced by a neoliberal accommodation of corporate power. The U.S. government no longer was involved as silent partner, as arbiter between labor and management in the crucial processes of wage bargaining and price determination.

In place of civilized, negotiated restraint, wages and prices would have to be bludgeoned into stability by the effects of tight money, high interest rates, and idle industrial and human capacity. By the end of 1980, tight money had proven largely fatal to the Carter Administration. More importantly, the monetary experiment had made financial deregulation inevitable. Double digit interest rates imperiled the entire structure of regulated interest rates.

B. *Unraveling the Regime: The Legislative Assault*

Throughout 1979 and 1980, U.S. securities dealers took advantage of the environment of high market interest rates and invaded the markets for deposits by introducing the money market mutual fund. The mutual fund became the most important financial innovation and money substitute by offering many of the deposit services of banks without imposing the costs of reserve requirements and federal deposit insurance.[55] Depository institutions, unable to offer market interest rates to depositors, found themselves at a competitive disadvantage. Mutual funds quickly attracted billions of dollars in deposits

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1993, § 1, at 41. Such price increases, while inflationary, are made possible by protectionist measures against competing foreign steel. *See* Steven Greenhouse, *Punitive Tariffs Raised Against Foreign Steel*, N.Y. TIMES, June 23, 1993, at D1. *But see* Keith Bradsher, *U.S. Overturns Tariffs on Many Steel Imports*, N.Y. TIMES, July 28, 1993, at D1 (discussing effect of International Trade Commission's elimination of steel importation tariffs).

[55] *See* Michael Mussa, *Competition, Efficiency, and Fairness in the Financial Services Industry*, *in* DEREGULATING FINANCIAL SERVICES: PUBLIC POLICY IN FLUX 121, 142-43 (George G. Kaufman & Roger C. Kormendi eds., 1986) [hereinafter DEREGULATING FINANCIAL SERVICES].

away from banks and thrifts.[56] As market interest rates rose quickly into double digits, deposits in money market mutual funds grew in tandem, from $5 billion in early 1978 to over $40 billion by the end of 1979.[57] Congress held hearings on the matter but ultimately refused to bring the money market mutual fund under the authority of Regulation Q.[58]

Fueled by the rising market rates of interest, the money market mutual fund became the lightning rod for political opponents to Regulation Q. In late 1979, the President's Inter-Agency Task Force on Regulation Q reported its recommendation that the depository interest rate ceilings be removed.[59] Within months, President Carter had signed into law the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA").[60] This Act ratified the liberalization of depository interest rate ceilings, preempted state usury ceilings on mortgage loans, and allowed depository institutions to offer negotiable order of withdrawal ("NOW") accounts.[61]

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56 *See* Huertas, *supra* note 7, at 25-26.

57 *Money Market Mutual Funds: Hearings on Oversight on the Supervision and Regulation of Money Market Mutual Funds and the Effects of the Funds in Financial Markets before the Subcomm. on Financial Institutions of the Senate Comm. on Banking, Housing and Urban Affairs*, 96th Cong., 2d Sess. 493 (1980) [hereinafter *Hearings on Money Market Mutual Funds*].

58 *Id.* at 394-95 (arguing that reserve requirements should not be extended to money market mutual funds ("MMMFs")); *id.* at 497-98 (viewing MMMFs as the evolving means to circumvent existing depository interest rate restrictions). Banks found themselves at a further competitive disadvantage since MMMFs were not required to follow the Community Reinvestment Act, which requires banks to lend in poor communities. *See* Steven Greenhouse, *Nonbanks' Community Role Will Be Target of U.S. Study*, N.Y. TIMES, June 9, 1993, at D1.

59 PRESIDENT'S INTER-AGENCY TASK FORCE ON REGULATION Q, THE REPORT OF THE PRESIDENT'S INTER-AGENCY TASK FORCE ON REGULATION Q (1979). The task force consisted of members from the Departments of the Treasury and Housing and Urban Development, the Office of Management and Budget, the Council of Economic Advisors, the Office of the Special Assistant to the President for Consumer Affairs, and the White House Domestic Policy Staff. Participating regulatory agencies included the Board of Governors of the Federal Reserve Board, the FDIC, the Federal Home Loan Bank Board, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

60 Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C. and 15 U.S.C. (1988)).

61 *See id.* Essentially an interest-bearing checking account, the NOW account remained subject to interest rate ceilings for several years while the newly created Depository Institutions Deregulation Committee was charged with phasing out these and other existing limitations on depository interest rates. Paul M. Horvitz, *Payments System Developments and Public Policy*, *in* FINANCIAL SERVICES, *supra*

Prior to passage of DIDMCA, Congress had failed to preempt state-chartered banks from undermining the federal regime.[62] The NOW account was a primary example of an innovation first permitted by state banking regulators.[63] Congress decided to preempt state law only in one area of DIDMCA, since its purpose was not to set a more exacting federal standard.[64] Rather, Congress determined that in the area of mortgage usury there would be no effective standard: the race to the bottom would be dictated by neither federal law nor the laws of state jurisdictions, but by the vagaries of the marketplace.[65] The "law of the jungle" would uphold any interest rate agreed upon between borrower and lender, regardless of wide disparities in bargaining power between the parties.

DIDMCA was a stunning victory for private U.S. banking interests, highlighting the deficiencies that can develop in the dual banking system when Congress refuses to legislate a minimum regulatory standard. The complete capitulation of the Democrats, both in Congress and in the White House, made the end of the New Deal framework in money and banking inevitable.[66]

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note 7, at 64, 76; SYMONS & WHITE, *supra* note 6, at 45-46. The authority of individual regulatory agencies to set ceiling rates was transferred to the Depository Institutions Deregulation Committee, comprising the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, and the heads of other agencies that regulate depository institutions. FEDERAL RESERVE SYSTEM, *supra* note 19, at 71; George G. Kaufman et al., *The Future of Commercial Banks in the Financial Services Industry*, *in* FINANCIAL SERVICES, *supra* note 7, at 94, 103.

[62] *See supra* notes 46-50 and accompanying text.

[63] 1984 ECONOMIC REPORT, *supra* note 37, at 171.

[64] *See generally To Authorize a National Usury Ceiling: Hearing Before the Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs*, 97th Cong., 2d Sess. (1982). There was token consideration of proposals for a federal usury ceiling but the idea was easily rejected.

[65] *Id.*

[66] At least two members of President Carter's Inter-Agency Task Force on Regulation Q, Roger C. Altman, Assistant Secretary of Treasury for Domestic Finance, and Donna Shalala, Assistant Secretary of Housing and Urban Development for Policy and Research, were top appointees in the Clinton administration.

As Deputy Treasury Secretary, Altman espoused austerity (confusing the cause-and-effect relationship of federal deficits and high interest rates) and lobbied for the Clinton Administration's head-in-the-sand proposal to ease the credit crunch by relaxing bank rules related to documentation, collateral requirements, appraisal standards and examinations. For a description of the regulations, see

IV. THE REAGAN ERA

It is all too easy to view the presidency of Ronald Reagan in near mythical terms. To this day, few people are neutral about its legacy. To separate the reputation from reality, fiction from fact, may demand an uncomfortable measure of self-scrutiny for critics and supporters alike. Conservative admirers, for instance, remain convinced that Ronald Reagan ushered in a free-market revolution which dramatically changed the nation's course from the failed policies of the Carter Administration. The Reagan Revolution, according to this myth, was compromised and betrayed, at first by an inner White House staff, later by Bush Republicans, and always by the Democrats.

In contrast, liberal detractors offer a counter-myth, characterizing the Reagan Presidency as a period of reaction which ushered in a politics of greed, an apocalypse of self-interest. Under this view, the Democratic Congress, while first humbled by the great teflon communicator and offering only weak resistance, eventually rallied to prevent Reaganomics from wreaking even greater havoc on American society. When the fog had lifted, it was apparent that the Grand Old Party had left the nation with a multi-trillion dollar hangover, effectively tying the hands of future presidents for many years to come.

These two myths—Reagan as revolutionary and Reagan as reactionary—satisfy the conscience. Like most myths, they allow the faithful to sleep a bit better at night, secure in the comfort of their own virtue. But such satisfactions are illusory. A more sober examination of the Reagan Presidency reveals other disquieting truths. Nowhere is the dissonance between myth and reality more troubling than in the strategic heights of banking and finance. Monetary policy became firmly en-

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John H. Cushman Jr., *Clinton Plan Would Soften Banking Rules*, N.Y. TIMES, Mar. 10, 1993, at D1. Appropriately, Altman also was appointed by President Clinton as acting chief of the Resolution Trust Corporation ("RTC"), the government's multi-billion dollar bailout agency for collapsing financial institutions.

Ironically, as Secretary of Health and Human Services, Shalala bemoaned the high interest rates on loans for medical students. Yet according to Shalala, the politics of selfishness and self-interestedness, along with a deregulated economy, were unfortunate "facts of life." *Larry King Live: Interview with Donna Shalala* (CNN television broadcast, Apr. 7, 1993).

trenched during the Reagan years as the nation's most important policy lever and, as a result, quietly affected the prosperity and well-being of the American people, the fortunes of the U.S. economy, and the distribution of national income.

In reality, Ronald Reagan's policies in banking and finance did not represent any dramatic change in direction, whether for good or ill, from those of his predecessor. The Reagan program was a change only in pace and degree, the culmination of a long bipartisan slide into complacency and mediocrity, a self-indulgent rejection of the populist and egalitarian tradition that had animated debate over banking and finance policy at crucial moments throughout the nation's history.[67]

As Ronald Reagan took office, the table already had been set for a decisive assault on the New Deal regulatory framework in banking and finance. The genie of financial speculation may not yet have escaped from its bottle, but a Democratic administration had, at the very least, moved in that direction in response to the same free-market frenzy that had helped propel Ronald Reagan to power. During Reagan's presidency, however, financial speculation was not just encouraged, it was glorified. The cork was twisted off, the smoke appeared, and the genie of speculation was finally out in the open, huge

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[67] The American populist and egalitarian tradition finds its roots in the Constitution, which provides the Congress with the exclusive power to coin and regulate money. U.S CONST. art. I, § 8, cl. 5. Thomas Jefferson's opposition to the First National Bank and Andrew Jackson's historic veto of the re-charter of the Second National Bank—arguably the most important presidential veto in U.S. history—were watershed points.

While the Second National Bank was vested with public powers, its charter provided that 80% of the stock ownership and directors were to be private. The present-day Federal Reserve System has similar characteristics, exercising public functions while largely under private control and direction. Such quasi-governmental institutions were once considered unconstitutional, violating the very first sentence of Article I, section 1 of the U.S. Constitution ("All legislative Powers herein granted shall be vested in a Congress of the United States . . . ."). For example, in 1935 the Supreme Court found that the National Industrial Recovery Act of 1933 had unlawfully delegated legislative power to private trade associations. According to Justice Cardozo, it was "delegation running riot." Schechter Poultry Corp. v. United States, 295 U.S. 495, 553 (1935). Unfortunately, in overturning *Schechter Poultry*, the Supreme Court threw out the healthy baby (the nondelegation doctrine) with the dirty bathwater (the flawed, narrow interpretation of the Commerce Clause). Overly broad delegations of legislative power to semi-autonomous bureaucracies may be the most unfortunate legacy of the New Deal's technocratic impulse. *See* JOHN H. ELY, DEMOCRACY AND DISTRUST: A THEORY OF JUDICIAL REVIEW 132 (1980).

and powerful, dominating industry and enterprise.

A. *Salesman of a Rentier Culture*[68]

The Reagan administration had its first great legislative success, a huge supply-side tax cut, in 1981. This policy, which disproportionately rewarded the highest income tax brackets, was soon overshadowed by deepening recession. Volcker's tight money policy continued to wring price inflation out of the economy at the cost of enormous idle capacity. Before the end of 1982, unemployment reached double digits and contributed to the Republicans' large losses in the congressional elections. An expansionary fiscal program consisting in large part of increases in military expenditures, however, began to revive the economy.[69]

Throughout Ronald Reagan's first term in office, market interest rates and the inflation rate exceeded the Regulation Q depository rate ceilings. By 1982, with a prime lending rate of over 15%, yields on government securities in the double digits, and inflation at around 6%,[70] regulators remained under the

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[68] From his first days in office, Ronald Reagan styled his presidency after the laissez-faire administration of Calvin Coolidge. He chose as his first Secretary of the Treasury, Donald Regan, the top gun at Merrill Lynch, Pierce, Fenner & Smith, a Wall Street giant that had led the way in financial innovations. (Merrill Lynch had developed innovative financial instruments such as its Cash Management Account, essentially a mutual fund that offered market returns along with full transactional payments capabilities not unlike a demand deposit.) *See* Horvitz, *supra* note 61, at 90; SYMONS & WHITE, *supra* note 6, at 434. Donald Regan's parallel figure in the Coolidge administration, Treasury Secretary Andrew W. Mellon, lauded by Wall Street as "the greatest Secretary of the Treasury since Alexander Hamilton," also had played a leading role in the financial speculation of the 1920s. NATHAN MILLER, FDR: AN INTIMATE HISTORY 237 (1983).

[69] Many comparisons have been made between the Kennedy and Reagan administrations. Both presidents were military Keynesians who primed the fiscal pump by cutting tax rates and raising the level of defense spending. ROBERT L. BARTLEY, THE SEVEN FAT YEARS AND HOW TO DO IT AGAIN (1992); PAUL C. ROBERTS, THE SUPPLY SIDE REVOLUTION 76-81 (1984); LYNN TURGEON, BASTARD KEYNESIANISM: THE EVALUATION OF ECONOMIC THINKING IN POLICYMAKING SINCE WORLD WAR II (forthcoming). The Kennedy administration, however, was able to achieve a cheap money, low interest rate environment by relying on a broad social consensus to control inflation. The Reagan administration, on the other hand, relied on high interest rates and social fragmentation to keep inflation in check.

[70] 1984 ECONOMIC REPORT, *supra* note 37, at 283, 299. Note that while these figures show a real rate of interest of nine percent for the most credit-worthy corporate borrowers and more than four percent for the federal government itself,

same pressures that had existed late in the Carter Administration: abolish the depository interest rate ceilings or extend Regulation Q to encompass mutual funds and other proliferating money substitutes.[71] The administration and the Congress chose the former.

With the passage of the Garn-St. Germain Depository Institutions Act of 1982,[72] interest rate deregulation became complete. The Act allowed depository institutions to open money market deposit accounts ("MMDA")[73] and set a timetable under which all depository interest rate limits would expire in 1986. The Garn-St. Germain Act put the country on an irreversible course. It was the first time since 1933 that U.S. banks were completely free from price restrictions, and thus able to compete openly for deposits with commercial banks, savings and loans, and nonbank financial institutions.[74]

While the Garn-St. Germain Act expanded the turf of commercial banks and thrifts, Wall Street was secure in the knowledge that the Federal Reserve Board remained in the hands of the "financial bankers" (as opposed to the "industrial capitalists"). In early 1983, Paul Volcker was reappointed for another term as Fed Chairman and approved by the Senate

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such borrowers were effectively locked in to much higher real rates as inflation declined during the life of longer-term loans. *See* SIDNEY HOMER & RICHARD SYLLA, A HISTORY OF INTEREST RATES 386 (1991) ("One event in the long-term market stands out: at the peak of yields in the fall of 1981, the U.S. government borrowed money for twenty years by issuing 15 3/4% bonds, which sold at just under par to yield 15.78%. This stands as the highest bond yield the government had to pay in the two-century history of the republic.").

[71] Robert A. Eisenbeis, *Risk as a Criterion for Expanding Banking Activities*, *in* DEREGULATING FINANCIAL SERVICES, *supra* note 55, at 169, 173. While not liabilities of commercial banks, these money substitutes were certainly an important part of the medium of financial payments, thereby implicating significant public policy considerations that would require their regulation. *See Hearings on Money Market Mutual Funds*, *supra* note 57, at 475 (money market funds "include features of a deposit system which belong exclusively to the banking business").

[72] Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C. (1988)).

[73] THE WORLD ECONOMY AND FINANCIAL MARKETS IN 1995: JAPAN'S ROLE AND CHALLENGES 19-20 (1986) [hereinafter WORLD ECONOMY]; *see also* Michael Quint, *The Down Side of High Interest: Fallout of Decontrol Is Still Being Felt*, N.Y. TIMES, Dec. 26, 1992, at L37-38 (describing negative effects of interest rate deregulation); Leslie Wayne, *Concern Over Bank Sales of Funds*, N.Y. TIMES, Dec. 31, 1992, at D1 (questioning wisdom of banks' sale of mutual funds in response to low interest rates).

[74] *See* SYMONS & WHITE, *supra* note 6, at 45-46; Huertas, *supra* note 7, at 26.

with strong bipartisan support.[75]

The capture of the Federal Reserve Board foreshadowed a global trend throughout the 1980s in which central banks led the drive for financial deregulation across national borders.[76] Liberalization was justified by free-market principles and technocractic policy prescriptions rather than the mere self-interest of the lending classes. The Mexican debt crisis of 1982, and the dangers it posed to U.S. banks, presented an opportunity for the Fed to expand its influence in the international arena. To regain access to international credit markets, the Mexican leadership was required to adopt a severe austerity program and privatization measures, the preferred solutions of the International Monetary Fund ("IMF").[77]

In 1982, Congress appropriated $8.5 billion to help support the IMF. This allocation was only the first of many Reagan-era public handouts to support the financial system. By 1984, nearly two dozen countries, mostly Latin American, were forced to reschedule their debt, borrowing from the IMF to pay just the interest on their foreign loans. When Anthony Soloman of the New York Federal Reserve Bank suggested a "cap" on interest rates to all such Third World debtors, the proposal was quickly rejected by the commercial banking community and the Federal Reserve.[78]

The U.S. economic expansion picked up steam following the 1982 recession without any significant resurgence of price inflation. The strong dollar, no doubt, contributed to this situa-

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[75] *See* GREIDER, *supra* note 11, at 570-74.

[76] The U.S. Treasury Department also fully supports the program of financial liberalization by regularly pressuring other nations to free their domestic interest rates and divorce central bank policy from democratic and parliamentary political control. For instance, in 1990, Treasury Undersecretary David C. Mulford increased U.S. pressure on Japan's Ministry of Finance to deregulate depository interest rates since the "very low levels of interest Japanese banks [paid] depositors [gave] the institutions a vast source of cheap funding that enable[d] them to lend at interest rates well below those that U.S. and other international banks [could] afford." William Krehm, *Thickening Nightmare*, ECON. REFORM, Aug. 1993, at 7 (quoting a *Wall Street Journal* report); *see also Treasury Official Urges Korea to Reform Its Financial Sector*, 60 BANKING REP. (BNA) 938, 938-39 (June 21, 1993) (Treasury Undersecretary Lawrence Summers urging South Korea to decontrol domestic interest rates and make other major changes to its financial system).

[77] GREIDER, *supra* note 11, 485-86.

[78] Timothy A. Canova, *Banking on the Brink: The Fall of Continental Illinois Is Just the Beginning*, CITY PAPER, Sept. 14-20, 1984, at 1, 9.

tion. Another important consideration, largely ignored by monetary economists, was the administration's systematic assault on organized labor and the collective bargaining system.[79] This attack left U.S. workers in retreat and contributed to the steep fall in real wages throughout the decade.[80] Nevertheless, by the end of Ronald Reagan's first administration, most Americans were convinced by his claim that they were "better off than four years earlier" despite widespread industrial dislocation, economic insecurity and lower real wages. After all, voters were told, inflation and money interest rates were down from their double digit levels.

The truth was a bit more worrisome. Inflation, in fact, was in the low single digits. But the real rate of interest—the nominal market rate minus the inflation rate—remained at remarkably high levels. In 1983, inflation was down to 3.2% while the yields on three-month Treasury bills hovered around 9%, the prime lending rate was at 11%, and interest rates on new home mortgages reached over 12.5%.[81] The real rate of interest, therefore, ranged from nearly 6% for low-risk wealth holders to 8% for prime corporate borrowers, but remained in the double digits for consumer and mortgage borrowers.[82] Throughout the rest of the decade, the real rate of interest remained at its highest sustained level of the century—many times higher than the 0.8% average real interest rate which had prevailed for the previous forty year period.[83]

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[79] *See generally* Richard Edwards & Mlutaez Podgursky, *The Unraveling Accord: American Unions in Crisis*, *in* UNIONS IN CRISIS AND BEYOND (Richard Edwards et al. eds., 1986); Sumner M. Rosen, *Labor: A Movement at Risk?*, *in* WHAT REAGAN IS DOING TO US (Alan Gartner et al. eds., 1982); Timothy A. Canova, *Monologue or Dialogue in Management Decisions: A Comparison of Mandatory Bargaining Duties in the United States and Sweden*, 12 U. PENN. COMP. LAB. L.J. 257-64 (1991) (discussing the changes in labor policy from Roosevelt to Reagan); Paul Weiler, *Promises to Keep: Securing Workers' Right to Self-Organization Under the NLRA*, 96 HARV. L. REV. 1769 (1983).

[80] PHILLIPS, *supra* note 53, at 98.

[81] 1984 ECONOMIC REPORT, *supra* note 37, at 283, 299.

[82] *See* 1984 ECONOMIC REPORT, *supra* note 37, at 299.

[83] *See* Leonard Silk, *The Crucial Issue Politicians Ignore*, N.Y. TIMES, Apr. 24, 1992, at D2. During the period 1951-80, the real interest rate averaged 0.8%. But for the decade of the 1980s, the real rate of interest averaged 4.7%. *Id.*

Over the past 130 years the real interest rate averaged about 3%. From 1940 to 1979 the real rate of interest on Moody's Aaa corporate bond yields averaged about 1.5%. During the 1940s and 1950s, the rate was often negative. This real interest rate averaged more than 4.5% throughout the 1980s, and about 4% today.

In such a high interest rate environment, Americans were attracted to the mutual fund. Money market mutual funds grew tremendously throughout the 1980s; from $45 billion in 1979, to $207 billion by 1982, $1 trillion by the end of the decade, and $1.6 trillion by 1993.[84] Mutual funds invested heavily in low-risk bonds, in government securities, and increasingly in commercial paper.[85] Mutual funds pooled money from thousands of individual investors and reduced risk by spreading such investments over a more diversified portfolio of stocks and bonds. Yet such funds remained vulnerable to a more general downturn in the securities markets since they were not federally insured and not subject to reserve requirements. Despite these risks, by mid-1992, mutual funds supplanted pension funds as the largest buyer of corporate equities, reportedly holding nearly $1 trillion in equities.[86] During

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See HOMER & SYLLA, *supra* note 70, at 430.

Even the figures by Homer and Sylla understate the severity of the present high interest rate environment by relying on the Aaa corporate bond yield as a benchmark. After all, those corporations with Aaa credit ratings actually profit from a tight money/high interest rate environment as their existing assets are rewarded in the form of increased interest income. *See* Galbraith, *supra* note 53. Real interest rates have been significantly higher, for less credit-worthy customers, such as consumers and most businesses, remaining in double digits. *See* Greenhouse, *supra* note 54, at D2 (quoting economist who suggested that the real interest rate on installment credit was 15%).

[84] *See* GREIDER, *supra* note 11, at 134; Carole Gould, *The Economy's $1.6 Trillion Gorilla*, N.Y. TIMES, Jan. 17, 1993, § 3, at 16; Jeffrey M. Laderman & Geoffrey Smith, *The Power of Mutual Funds*, BUS. WEEK, Jan. 18, 1993, at 62 (discussing rapid growth of mutual funds); *see also* Paul Starobin, *Make 'Em Pay*, NAT'L J., July 24, 1993, at 1856 (number of U.S. households investing in mutual funds increased from 6% in 1980 to 27% in 1993).

Note that the tremendous growth in money market mutual funds "damaged the relationship between money supply growth and economic growth" because the Federal Reserve's main measure of the money supply (M2) did not include institutional holdings in money market mutual funds. *See* Greenhouse, *supra* note 54, at D2.

[85] *See* Gould, *supra* note 84, at 16.

[86] *See* ROGER A. ARNOLD, MACROECONOMICS 264 (2d ed. 1992); Gould, *supra* note 84, at 16; *see also* Susan Antilla, *In the Face of a Fund Panic . . .* , N.Y. TIMES, June 27, 1993, § 3, at 13 (discussing options to cash out of mutual funds should their market collapse); Mussa, *supra* note 55, at 142.

Ironically, by the summer of 1993, the inevitable declines in interest rates (a reflection of the weakening real economy) fueled record investment in the stock market, largely through the vehicle of mutual funds. *See* Robert Hurtado, *Dow Hits New High At 3,638.96: Interest Rates' Fall Spurs Broad Gains*, N.Y. TIMES, Aug. 25, 1993, at D1; Laura Jereski, *Risks in Junk Bonds Rise as Mutual Funds Play a Growing Role*, WALL ST. J., Oct. 1, 1993, at A1; Leslie Wayne, *Investment* the 1980s, the relatively wealthy planned for their individual retirements by lending their savings to the money market brokers at high interest rates with little concern that those same funds were often channeled into high-interest lending and speculative investments including the high-risk junk bonds used to finance leveraged buyouts which in turn fueled the stock market's rise.[87]

The Reagan years marked a period in which the United States moved significantly into a post-industrial rentier society. The national work ethic was transformed into an atomized competition for personal advantage. The neoliberal rentier culture had found its voice in Ronald Reagan, the premier cheerleader for the new public ethic, as he urged Americans to indulge in private material gratification. This atomized and hedonistic focus replaced the inter-generational ethic that had bridged differences between races and economic classes throughout the New Deal regulatory era.

Americans now sought to increase their wealth and status primarily through increases in "rentier income"—income derived in the form of interest from the ownership of money. Monetarism's high real interest rates served as the reward, not of effort or risk, but of wealth itself. Millions of people convinced themselves that they could grow rich in their sleep as a result of high interest rates.[88] A "nihilism of the overfed" took over as those with great wealth did in fact grow significantly richer, earning many times the average U.S. income *merely as interest on their holdings.* Those dependent on high interest credit did not share in the windfall.

This system was not socially neutral. It resembled a modern social Darwinist universe in which the strongest were rewarded for simply parting with their wealth, often at little or no risk. The weaker members of society—the borrowers—were locked in a stiff economic struggle for jobs, resources, and ex-

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Soars in Mutual Funds, Causing Concerns, N.Y. TIMES, Sept. 7, 1993, at A1.

[87] *See* Jereski, *supra* note 86, at A1.

[88] The United States quickly became a nation of usurers. Those who profited from the high interest rates encouraged even their debtors to accept rentier values. Television advertising fostered a democratic illusion by encouraging the impression that the high interest rate yields would provide the American Express Dream to everyone, regardless of the fact that for millions of citizens personal debt exceeded personal savings. *See* GREIDER, *supra* note 11, at 36.

pensive credit. Those with wealth and savings took advantage of the opportunity to profit from the high returns. Those dependent on credit found themselves paying the highest sustained real interest rates of the century. As the cost of capital and credit rose, risk-taking and entrepreneurialism suffered. The American dream of home ownership, of business ownership, of directing and managing a productive enterprise, and of creating new wealth was becoming more difficult to fulfill. In its place, the drive to maximize one's interest, dividend and capital gains in the financial sector by the "functionless" holding of titles to already existing wealth continued to develop.

The propaganda attack on Regulation Q effectively convinced Americans that "small savers," those concentrated in the low- and middle-income brackets, would benefit most by the lifting of depository interest rate ceilings.[89] In reality, it was the small saver who was hurt the most by the deregulation of interest rates; small savers were the first to suffer the higher finance charges, bank fees, escalating interest rates on consumer and mortgage loans, higher prices, and greater joblessness.[90] The new public ethic nonetheless appealed to the most cynical nature of human beings by affirming that it was acceptable to look no further than one's own nose in a single-minded pursuit of wealth. This ethic signaled a transformation in the national consciousness. Americans increasingly abdicated responsibility and became unwilling to relinquish a single basis point of private gain, unwilling to incur any sacrifice in favor of the interests of the larger community and the welfare of those younger, weaker and more vulnerable—those whose future was limited by the advent of expensive credit.[91]

Other industrial countries followed the U.S. lead by removing controls on domestic interest rates, credit and capital flows. Throughout the 1980s, financial innovations and off-

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[89] *See* GREIDER, *supra* note 11, at 166.

[90] Statement of Henry Schechter, *supra* note 9, at 135-36.

[91] Altruistic instincts were crushed easily in the emerging dog-eat-dog financial environment. People no longer had time to look after their neighbors. Time was limited, time was money, and if you didn't look after yourself, no one else would. Extreme self-interest, the free-market apostles assured us, was the natural and proper condition of humankind. But the underside of this confident vision of post-modern American society revealed a fragmented and insecure existence, a pathological devotion to the cult of the self.

shore markets were permitted to flourish, as money markets expanded at the expense of domestic interest rate discipline.[92] At a time when the liberalization of capital flows between divergent jurisdictions increased the need to coordinate regulatory activities, each nation instead moved to deregulate its own domestic credit market and currency, once again introducing a "race to the bottom."

President Reagan's eight years in office witnessed a tremendous increase in activity in the international financial markets.[93] The future was marked by greater uncertainty, risk, and financial speculation, reflected not just in higher rates of interest, but in the kind of ruthless competitive revaluations and wide depreciations not seen since the beggar-thy-neighbor days of the Great Depression. In addition, elected officials could pursue expansionary fiscal policies only at the risk of endangering their country's foreign currency value. The 1992 crisis in the European Monetary System would finally demonstrate the awesome power of private international speculation to override the policies of virtually any central bank in the world and the interests of so-called sovereign nations and their democratically elected governments.[94]

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[92] WATSON ET AL., *supra* note 44, at 35-39. The "offshore market" should be viewed as an attack on the very legitimacy and sovereignty of the democratic nation-state, the moral equivalent of a black market.

[93] WATSON ET AL., *supra* note 44, at 35; BANK OF INTERNATIONAL SETTLEMENTS, 61ST ANNUAL REPORT 119-20 (1991); *see also* HOMER & SYLLA, *supra* note 70, at 1 ("The spectacular rise in interest rates during the 1970s and early 1980s pushed many long-term market rates on prime credits up to levels never before approached, much less reached in modern history. A long view, provided by this history, shows that recent peak yields were far above the highest prime long-term rates reported in the United States since 1800, in England since 1700, or in Holland since 1600. In other words, *since modern capital markets came into existence*, there have never been such high long-term rates as we recently have had all over the world." (emphasis added)).

[94] *See* DUDLEY D. DILLARD, THE ECONOMICS OF JOHN MAYNARD KEYNES: THE THEORY OF A MONETARY ECONOMY 228 (1948); *see also* KEYNES, *supra* note 10, at 159 ("Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation."); WATSON ET AL., *supra* note 44, at 40; Roger Cohen, *Europe's Currency Crisis*, N.Y. TIMES, July 31, 1993, at 1 (describing the problems facing the French economy and its effect on France's relationship with Germany due to the probable collaspe of the franc); Louis Uchitelle, *Dollar Sinks Against Yen Despite Fed's Moves*, N.Y. TIMES, May 28, 1993, at D1.

According to billionaire investor and currency speculator George Soros, the European currency crisis was "very reminiscent of what happened during the

B. *Financial Bailout*

The Great Depression revealed the dangers of supplanting real industry and enterprise with a "casino economy"[95] in which high real interest rates impose an intolerable and unsustainable debt burden on private income. All too often during the financial bubble of the late 1920s, interest did not reward real industry, but was obtained by the owners of capital simply by virtue of the scarcity of capital,[96] a scarcity which was artificially imposed by the central monetary authority. The New Deal regulatory framework originally was designed to discourage this overspeculation and to ensure a stable allocation of capital into residential housing. Such regulation, however, ultimately became a target of Reagan administration reformers. For example, the 1982 Garn-St. Germain Act allowed savings and loan associations to take demand deposits and make commercial and industrial loans,[97] removed numerous other lending restrictions on federally chartered depository institutions,[98] and raised the level of federal deposit insurance from $40,000 to $100,000 per account.[99]

As the financial sector became more competitive during the early 1980s, it also became fraught with greater risks. Americans scarcely seemed to notice, however. Leaders of both major political parties failed to mention the dangers, and most Americans were far too preoccupied with the pursuit of their own private interests to notice.[100] By 1984, cracks suddenly appeared in the U.S. financial system.

Just as opponents of deregulation had warned, by the early 1980s, rising depository interest rates spurred high-risk

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interwar period, between World War I and World War II, and it's really amazing how people haven't learned from past experience. It's as if Keynes had never lived. Some of the same mistakes: overvalued currencies, sticking to monetary discipline in a time of recession, you know, very high real interest rates. It's a tragic situation." Gary Weiss et al., *The Man Who Moves Markets*, BUS. WK., Aug. 23, 1993, at 50, 53 (excerpts from interview of George Soros).

95 HIXSON, *supra* note 36, at 213.

96 HIXSON, *supra* note 36, at 231 (quoting John Maynard Keynes).

97 WORLD ECONOMY, *supra* note 73, at 19-20.

98 SYMONS & WHITE, *supra* note 6, at 204 (the statutory restrictions that were lifted included regulations dealing with loan-to-value ratios, amortization, aggregate limits and maturity).

99 Statement of Henry Schechter, *supra* note 9, at 132.

100 Statement of Henry Schechter, *supra* note 9, at 132.

loans.[101] Although interest rate ceilings were not completely abolished until 1986, significant liberalization had already occurred in the wholesale market for large CDs and state usury laws had been preempted. To cover the higher costs of funding, U.S. banks began pursuing more aggressive lending policies in search of higher yields. Competition to make loans to oil, gas and coal producers became so intense during the early 1980s that credit standards began to slip, resulting in a rising rate of loan defaults.[102] For example, the 1982 collapse of a small, but fast growing Oklahoma bank, the Penn Square Bank, was traced to such risky practices.[103] Continental Illinois, a large Chicago-based bank that had participated in these Penn Square loans, was left with huge losses after the Penn Square collapse, and subsequently was forced to pay higher rates to depositors and to rely on a larger percentage of foreign sources for deposits.[104]

Continental's loss on Penn Square loans had widespread effects. In early 1984, rumors of Continental's troubles spread throughout the financial world.[105] By the spring of 1984, large overseas depositors began pulling out of Continental, withdrawing enormous amounts of CDs in an invisible, computerized run on the bank.[106] Continental's stock, as high as $33 a share in January 1982, fell to under $4 by May of 1984.[107] Federal regulators were caught in an ideological dilemma of their own making. They understood the grave danger to financial confidence but were hesitant to intervene in the decisions of the marketplace.[108] A sell-off of bank stocks ensued and the crisis began to spread, threatening Continental's many creditors, including other large U.S. commercial banks.[109] The Keefe Bruyette & Woods Index of twenty-four

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[101] Statement of Henry Schechter, *supra* note 9, at 132.

[102] Statement of Henry Schechter, *supra* note 9, at 132.

[103] GREIDER, *supra* note 11, at 522-27; Canova, *supra* note 78, at 1, 9.

[104] *See* Robert A. Bennett, *Chilling Specter at Continental*, N.Y. TIMES, May 20, 1984, § 3, at 1.

[105] *Id.*

[106] *Id.*

[107] GREIDER, *supra* note 11, at 522-27; Canova, *supra* note 78, at 9.

[108] Peter T. Kilborn, *The High Stakes Scramble to Rescue Continental Bank*, N.Y. TIMES, May 21, 1984, at A1.

[109] *Id.*

money-center and regional banks fell 5% in one week.[110] In one day, the price of stock for Manufacturer's Hanover, the fourth largest U.S. bank, tumbled nearly 10%, driving down the entire market on rumors of the bank's $6.5 billion exposure to Latin American debt.[111]

Initial apprehensions and considerations of ideological consistency ultimately gave way to practical political calculation. To stem the run on Continental Illinois and to restore confidence in the entire system of monetary payments, the FDIC finally announced that it would insure even the uninsured, i.e., deposits in Continental Illinois exceeding the $100,000 limit. The Federal Reserve Board also opened a $7.5 billion line of cheap credit to Continental Illinois.[112] At an initial cost of $4.5 billion, the bailout was the largest in U.S. financial history.[113] The seventh largest bank in the country was simply "too big to fail."

The sudden meltdown and resulting bailout of Continental Illinois highlighted the contradictions and hypocrisy of the free-market policy of deregulation. Though completely ignored in the 1984 presidential election campaign, the bailout of Continental Illinois would foreshadow U.S. policy for years to come. Also ignored during the campaign were predictions that the Federal Savings and Loan Insurance Corporation ("FSLIC") would be insolvent.[114] Debate was stifled, as both major political parties were implicated in the rush to dereg-

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[110] GREIDER, *supra* note 11, at 633; Canova, *supra* note 78, at 9.

[111] *See* GREIDER, *supra* note 11, at 497-501, 522-24, 628-30 (history of the Continental Bailout); Robert A. Bennett, *A Growing Case of Market Jitters*, N.Y. TIMES, May 25, 1984, at D1; Canova, *supra* note 78, at 9; Kilborn, *supra* note 108, at A1; Gary Klott, *Worries on Banks Jar Markets*, N.Y. TIMES, May 25, 1984, at D1.

[112] *See* Bennett, *supra* note 104, at A8.

[113] *See* Bennett, *supra* note 104, at A8; Winston Williams, *U.S. Puts Together $7.5 Billion in Aid for Illinois Bank*, N.Y. TIMES, May 18, 1984, at A1. It has been estimated that the FDIC's total loss stemming from the bailout of Continental Illinois exceeded $1.7 billion. By President Reagan's final year in office, bailout had become routine policy. The FDIC rescued the nation's 13th largest bank holding company, First RepublicBank Corp., in a package totaling $5 billion. Kathleen Day & John M. Berry, *FDIC Rescues Texas Bank With $1 Billion Loan*, WASH. POST, Mar. 18, 1988, at B1.

History repeated itself when the federal government bailed out Continental Illinois in 1984. The Reconstruction Finance Corporation, created during the Great Depression to rescue failing banks and corporations, had bailed out the same Chicago-based bank 51 years before. *See* Canova, *supra* note 78, at 1.

[114] Canova, *supra* note 78, at 9-10.

ulate. The decline in democratic political debate set a dismal standard for the future. Four years later, word of a much larger financial bailout of the S&L industry was greeted by politicians and a compliant media with deafening silence.[115] Voters would wake up after election day with a daunting hangover of tax, debt, and interest burdens.

V. THE REAGAN LEGACY: PASSING THE BUCKET

From 1942 to 1980, only 198 U.S. banks failed, an average of less than 6 failures per year. But in 1987 alone, 184 U.S. banks failed. In 1989 and 1990, another 362 U.S. banks failed.[116] From 1934 to 1973, the FDIC incurred losses of $124.3 million in rescue packages.[117] By the early 1990s, tens of billions of dollars already had been spent to begin the process of bailing out the savings and loan industry. The General Accounting Office estimated the total cost of the bailout to be over $500 billion. With accrued interest burdens stemming from high real interest rates the expected total cost could exceed $1 trillion.[118] By any measure, the resolution of the savings and loan collapse had become the most costly financial bailout and one of the largest spending programs in the

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[115] During the 1992 election campaign, some analysts warned of a similar crisis looming over the commercial banking industry. Jerry Knight, *Buttressing the Big Banks*, WASH. POST, Oct. 27, 1991, at H1 ("America's largest banks are in bigger trouble than government officials and the banks themselves have publicly admitted, and many congressional and private banking experts question whether the industry will be able to solve its problems without direct help from taxpayers."); Leslie Wayne, *Bank Profits: Weakest 2d Quarter Since '87*, N.Y. TIMES, Sept. 11, 1991, at D1 ("A lot of people who look at the banking problems are quick to see another savings-and-loan situation."). The Federal Reserve's subsidization policy (providing banks with a low cost of funds through a low discount rate, while allowing banks to play the spread on higher yielding government securities) apparently has forestalled the crisis for now by artificially propping up bank profits. *See infra* notes 134-35 and accompanying text.

[116] Arnold, *supra* note 86, at 264; AM. BANKER, Jan. 5, 1988, at 1.

[117] GOLEMBE & HENGREN, *supra* note 7, at 30, 38.

[118] HIXSON, *supra* note 36, at 220. As a result over 25% of the federal budget deficit problem had become "off-budget" by 1992. *See* William F. Hixson, *The 1993 Budget Debate*, ECON. REFORM, Sept. 1993, at 8 ("The largest component of the off-budget deficit is money for the bailout of failed banks and savings and loan associations."). Both on-budget and off-budget figures, however, may be revised downward as the method of financing the bailouts shifts from RTC-type resolution of failing financial institutions to the Fed's back-door subsidy of the banking and thrift industries. *See infra* note 134 and accompanying text.

nation's history.

While the process of bank inspection was largely shielded from press and public scrutiny throughout the 1980s and early 1990s,[119] investigative journalists documented a wide range of systematic fraud and corruption,[120] including easy plea bargains and sweetheart deals for the well-connected. It would be an understatement to conclude that two successive Republican presidents, along with the Democratic-controlled congressional oversight committees, fell asleep at the wheel. So many vested interests were tied into the structure of high real interest rates and federal receivership that the entire banking system appeared transmuted, guarding a sacred welfare cow for society's powerful.[121]

In the public's imagination, the "S&L Scandal" came to evoke all that had gone wrong in the American political system. Yet it would be all too easy to sweep the blame of the financial collapse under the rug of fraud and corruption, to exonerate the professional economists and policymakers who had lifted the lid on the Pandora's box. Major legislative re-

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[119] For example, the Freedom of Information Act provides a disclosure exception for the "examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." 5 U.S.C. § 552(b)(8) (1988).

[120] For instance, a Department of Justice investigation into the multi-billion dollar plundering of Texas S&Ls by associates of the Marcello Mafia family of New Orleans was reportedly stopped in its tracks under the pretense of "national security" as a result of intervention by the CIA. *See, e.g.*, STEPHEN PIZZO ET AL., INSIDE JOB: THE LOOTING OF AMERICA'S SAVINGS AND LOANS (1989); *The Great S&L Robbery*, TEX. OBSERVER, Apr. 5, 1991, at 1; Pete Brewton, *S&L Probe Has Possible CIA Links: Authorities Target Houston Developer*, HOUSTON POST, Feb. 4, 1990, at A1; Stephen Pizzo, *Probe into CIA-Thrift Links*, NATIONAL THRIFT & MORTGAGE NEWS, Feb. 12, 1990, at 1.

The secrecy surrounding this alleged CIA-underworld alliance understandably feeds public cynicism as well as conspiracy paranoia: where and when did such an unholy alliance begin and where does it end? *See* JOHN H. DAVIS, MAFIA KINGFISH: CARLOS MARCELLO AND THE ASSASSINATION OF JOHN F. KENNEDY (1988); PETER D. SCOTT, DEEP POLITICS AND THE DEATH OF JFK 208 (1993); *The Men Who Killed Kennedy*, Television Documentary by Investigative Reports (produced by Bill Kurtis, 1992); *see also* Jeff Gerth, *The Business Dealings of the President's Relatives: What the Record Shows*, N.Y. TIMES, Apr. 19, 1992, at 14; Jonathan Kwitny, *The Real S&L Scandal: All the President's Friends*, VILLAGE VOICE, Oct. 20, 1992, at 24.

[121] As the "Keating Five" demonstrated, one hand washes the other. During the 1980s, thrifts made $11 million in direct contributions to elected officials of both major political parties. Commercial banks gave even more. L.J. Davis, *Chronicle of a Debacle Foretold*, HARPER'S MAG., Sept. 1990, at 64.

forms had transformed managed lending behavior into systematic mismanagement simply by raising real interest rates to usurious levels, thereby raising the failure and foreclosure rates for legitimate borrowers.[122] Unfortunately, those lessons have not been learned. Instead, public debate has focused on the pace of future deregulation, such as proposed assaults on the Glass-Steagall "fire-wall" prohibitions between commercial and investment banking.[123] Even as financial deregulation has continued to threaten the free enterprise system by its very excesses, blame has fallen on a regulatory regime largely dismantled and relegated to the past.

From the beginning, financial deregulation was intended to result in increased competition between financial institutions. According to the logic of the marketplace, competition would reward the successful and discipline the inefficient. Experience has shown, however, that the failure of large financial institutions presents grave risks to public confidence in the monetary payments system, particularly in a credit economy. Confidence must be safeguarded zealously. Such were the considerations that led to passage of the New Deal Banking Acts in the first place.

It was during the Reagan years that a new regulatory model finally emerged, replacing the regime that had been erected fifty years earlier. The bailout of Continental Illinois served as the blueprint for government policy in dealing with the biggest marketplace losers. In an incredible display of administrative discretion and political favoritism, the FDIC

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[122] Keith Bradsher, N.Y. TIMES, *Bank Regulators Taking Close Look at Lending Risks*, Apr. 9, 1995, § 1, at 1, 36 ("The regulators' new worries this year follow shifts in bank activities prompted by rising interest rates."). For a graphic depiction of the rise in the volume of real estate repossessed by banks throughout the recessionary 1990 to 1992 period, see *Banks Report Decline in Repossessed Real Estate*, BANK RESOLUTION REP., Mar. 29, 1993, at 2.

In addition, variable rate loans and loans of shorter maturities shifted the risks of rising interest rates from lenders to home-borrowers, thereby increasing the incidence of business failure and foreclosure. Statement of Henry Schechter, *supra* note 9, at 136-38.

[123] Franklin R. Edwards, *Can Regulatory Reform Prevent the Impending Disaster in Financial Markets?*, 73 ECON. REV. 1, 36-37 (Jan. 1988); G. Sellon, Jr., *Restructuring the Financial System: Summary of the Bank's 1987 Symposium*, 73 ECON. REV. 1 (Jan. 1988). The Clinton administration officially has joined in the effort to repeal the Glass-Steagall Act. Keith Bradsher, *Rubin's Plan for Banking Spurs Fight*, N.Y. TIMES, Feb. 28, 1995, at D1.

began to insure even uninsured depositors.[124] Such discretionary power effectively "socialized" the risk and eliminated the costs of failure for those interests that were sufficiently organized to influence and control the bureaucratic agencies.[125]

In his first year in office, President George Bush signed into law the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), which created the Resolution Trust Corporation ("RTC") and empowered it to resolve the savings and loan crisis by assuming the assets and collateral of hundreds of failed thrifts across the country.[126] The RTC quickly became the largest holder of real estate and junk bonds in the country.[127] As a result, it became caught in a

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[124] As recently as 1979, Theodore Lowi referred to the FDIC as an example of a federal agency that was politically-accountable and operating within clearly defined legal parameters. The FDIC's pivotal role in the vast financial bailouts of the 1980s and 1990s, however, breathes renewed life into the analytical construct of Lowi's "state of permanent receivership." *See* LOWI, *supra* note 35, at 281; *see also*, Day & Berry, *supra* note 113; Nathaniel C. Nash, *Large Texas Bank To Get $1 Billion in Federal Rescue*, N.Y. TIMES, Mar. 18, 1988, at A1 (to avert a financial panic, the Federal Home Loan Bank Board guaranteed *all* depositors and creditors of the nation's second largest savings and loan).

Other federal agencies, such as the Federal Reserve Board and the RTC, wield unbounded discretionary power as well, "picking winners and losers" as a routine matter of policy. *See* HIXSON, *supra* note 36, at 165. In the words of Milton Friedman, "no major institution in the United States has so poor a record of performance over so long a period of time yet so high a public reputation as the Federal Reserve," which according to Friedman is guilty of "churning" the government's accounts to generate huge commissions for securities dealers. *Id.* The Federal Reserve's help for its big banking clientele contrasts sharply with its decision to permit Harlem's Freedom National Bank to fail. *See* Stepanie Strom, *Failed Dreams: The Collapse of a Harlem Bank*, N.Y. TIMES, Dec. 3, 1990, at A1.

[125] The Supreme Court has continually upheld broad delegations of discretionary power to the Federal Reserve Board. Board of Governors v. Investment Co. Inst., 450 U.S. 46 (1981); Securities Indus. Ass'n v. Board of Governors, 468 U.S. 207 (1984). Some scholars have advocated the revival of the nondelegation doctrine to ensure accountability in the policymaking process. *See, e.g.*, ELY, *supra* note 67, at 132-33.

[126] Marirose K. Lescher & Merwin A. Mace III, *Financing the Bailout of the Thrift Crisis: Workings of the Financing Corporation and the Resolution Funding Corporation*, 46 BUS. LAW. 507 (1991).

[127] *See* Stephen Labaton, *The Bailout Agency Becomes a Highly Motivated Seller*, N.Y. TIMES, Mar. 31, 1991, § 4, at 4; Nathaniel C. Nash, *U.S. Must Unload 30,000 Properties, And Please Don't Ask How's Business*, N.Y. TIMES, Feb. 25 1990, § 4, at 4. With a caseload of 76,000 legal matters, the RTC also has become the nation's largest consumer of private legal services. It expects to spend more than $800 million on legal fees to seize bankrupt S&Ls and sell their assets. John H. Cushman Jr., *Needed: Minority Lawyers for Big Job*, N.Y. TIMES, Apr. 9, 1993, at

regulatory catch-22: whether to hold on to the foreclosed properties and incur high carrying and maintenance costs or sell quickly, undercut the market, and depress real estate values through fire sales at auction.[128]

Unfortunately, there was no significant discussion of other reform proposals. Alternative proposals such as foreclosure moratoriums, re-capping of interest rates on loans, and other direct assistance to mortgagors, which were adopted in one form or another by federal and state governments during Roosevelt's New Deal, were not considered. Rather than bailout from above for the moneylenders, such alternative measures were designed to bailout from below to prevent asset values from deteriorating in the first place simply by preventing distress foreclosure sales.[129] Instead, the RTC auctions proceeded. Within a year the markets for junk bonds[130] and real estate were depressed and homebuilding began to decline.[131]

The bailout program itself seemed to grow in size and scope with the passage of time. If foreclosure, followed by RTC auctions, had the effect of glutting a depressed real estate market, then the resulting decline in real estate values could depress bank share prices and raise the risk premium banks had to pay in the deposit and bond markets by eroding the

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B16.

[128] *Resolution Trust Corporation's Asset Disposition Policies: Hearings Before the Subcomm. on General Oversight and Investigations of the House Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. (1991).

[129] For instance, in Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), the Supreme Court upheld a Minnesota mortgage moratorium act which extended the period of redemption from foreclosure sales. At the federal level, the Home Owners' Loan Act and the Farm Mortgage Act of 1933 provided loan and mortgage refinancing for tens of thousands of farmers and homeowners facing foreclosure. MILLER, *supra* note 68, at 315-16.

[130] Anise C. Wallace, *The Big Bailout: Federal Holding of Risky 'Junk Bonds' Grows*, N.Y. TIMES, Mar. 13, 1990, at D5; Glenn Yago, *The Regulatory Reign of Terror*, WALL ST. J., Mar. 4, 1992, at A12 (in the Fall of 1989, FIRREA forced thrifts to liquidate their junk bond portfolios, causing prices to plummet and destroying once-healthy S&Ls).

[131] Peter Cary & Stephen J. Hedges, *Can't Anybody Here Sell Some Property?*, U.S. NEWS & WORLD REP., Dec. 10, 1990, at 56; Steve Lohr, *Banking's Real Estate Miseries*, N.Y. TIMES, Jan. 13, 1991, § 3, at 1; Iver Peterson, *Home Builders See Recession and Blame the Savings Crisis*, N.Y. TIMES, July 19, 1990, at A1; Joseph F. Sullivan, *New Boom Hits Suburbs: Evictions and Foreclosures*, N.Y. TIMES, Jan. 16, 1991, at B1.

capital of otherwise solvent banks.[132] In the midst of such market conditions, an unplanned credit crunch developed. Banks became much more hesitant to make loans and were content simply to purchase high-yielding, low-risk government securities.[133] This situation was a fitting outcome for a recession-ridden rentier economy in a state of permanent receivership.

The post-Reagan era has witnessed a significant evolution of this bailout model. By 1992 the largest U.S. commercial banks desperately needed a huge cash infusion to make up for the enormous rise in nonperforming assets—i.e., bad loans—to add to their reserves and to restore capital positions. The authorities apparently determined that the economic and political risks were too great to repeat the S&L bailout blueprint. This time, the banks would not be permitted to get to the RTC resolution stage. Instead, the Federal Reserve Board effectively subsidized U.S. commercial banks with low-cost funds, such as a low discount rate, while allowing the banks to boost their profits and play the artificial spread in interest rates through purchasing higher yielding government securities. Banks virtually stopped lending, bought Treasury bonds, and reported record earnings.[134]

The bailout model was therefore refined to hide its true costs from the American voter. But, of course, someone had to foot the bill. By 1993 U.S. taxpayers were providing more than $200 billion annually as high real interest on the federal government's debt obligations. These congressional appropria-

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[132] BANK FOR INTERNATIONAL SETTLEMENTS, *supra* note 93, at 163; *Rise in Loan Delinquency*, N.Y. TIMES, June 15, 1991, at 42; John M. Berry, *Warning Signs of Death Spiral on Bank Credit*, WASH. POST, Dec. 16, 1990, at H1; Robert Hanley, *After the Heady 1980s, A Hangover of Foreclosure*, N.Y. TIMES, July 30, 1990, at B1; Louis Uchitelle, *3 Big Banks Reporting Loan Woes*, N.Y. TIMES, Dec. 21, 1990, at D1.

[133] *Finance: In Search of Borrowers*, ECONOMIST, Apr. 3, 1993, at 71; Martin Mayer, *Why Lend? Banks Have the Fed*, WALL ST. J., Sept. 9, 1992, at A14.

[134] *See First-Quarter 1993 Bank Earnings Hit New Record High Level Of $10.9 Billion*, 60 BANKING REP. (BNA) 873 (June 14, 1993); Louis Uchitelle, *Slump in Business Lending Has Prime Rate Stuck at 6%*, N.Y. TIMES, Oct. 11, 1993, at D1. For yet another method by which central banks now effectively subsidize the profits of currency traders and speculators and commercial bankers, see Saul Hansell, *Europe's Turmoil Aids U.S. Banks*, N.Y. TIMES, Aug. 4, 1993, at D1; Floyd Norris, *Central Banks Make it Easy to Bet Big on a Sure Thing*, N.Y. TIMES, Aug. 3, 1993, at D1.

tions were routinely attributed to the size of the national debt and excessive spending on social programs unrelated to the huge banking subsidy. In short, they were attributed to any factor but the real culprit—the real market rate of interest. Those characterizations ignored the reality that a reduction in the real rate of interest on the Treasury's debt obligations would result in tremendous reductions in the federal government's annual budget deficit.[135] The hidden subsidy to U.S. commercial banks effectively saddled American consumers and businesses alike with higher relative debt burdens while taking billions of dollars from the backpockets of U.S. taxpayers.

VI. A MATTER OF REAL INTEREST[136]

The American experience in the 1920s demonstrated the practical dangers of structuring an economic system on high interest debt. By enforcing a low interest rate structure, the New Deal reforms successfully restored stability to the private banking system.[137] Beginning in 1951, however, that regula-

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[135] With a national debt exceeding $4 trillion for each reduction of one percent in the federal government's average interest rate burden, the annual federal deficit would be reduced by approximately $40 billion. 1993 ECONOMIC REPORT, *supra* note 13, at 246. A return to low interest rates comparable to the "pegged" rates that prevailed throughout World War II would provide the federal government with an "interest dividend" of many tens of billions of dollars each year. Such funds could be used to stimulate demand, cut taxes, finance military to civilian conversion, invest in infrastructure, finance health insurance reforms, education and training programs, build housing, provide public sector jobs and/or reduce the deficit.

[136] For many centuries, lending at high interest rates has been considered morally indefensible, violating religious dictates and the laws of civil society. *See, e.g., The Bible*: *Exod.* 22:25; *Neh.* 5:7; *Prov.* 28:8; *Lev.* 25:36; *Ps.* 15:5; *Ezek.* 18:08, 18:13, 18:17, 22:12; *Matt.* 6:12, 18:27, 18:30, 18:32; *see also The Koran* (N.J. Dagwood trans., 4th ed. 1974): *Sura* II:276, III:130, XXX:39; THE POLITICS OF ARISTOTLE 29 (Ernest Barker trans., 1978). In acknowledging the primary purpose of money "as a *means* of exchange" Aristotle also recognized that "usury" (the charging of interest) tries to make money increase as though it were an *end* in itself. "The trade of the petty usurer," said Aristotle, "is hated most, and with most reason: it makes a profit from currency itself, instead of making it from the process [i.e. of exchange] which currency was meant to serve." *Id.* at 28-29. To the extent that usury interferes with such exchange of goods or capital, it may conflict with other pseudo-Christian justifications of supply-side (i.e., trickle-down) capitalism. *See* GEORGE GILDER, WEALTH AND POVERTY (1980) (the act of investment is a gift from the investor to the community).

[137] "The acuteness and the peculiarity of our contemporary problem arises, therefore, out of the possibility that the average rate of interest which will allow a

tory regime was successively undermined and ultimately was dismantled during Ronald Reagan's presidency.[138]

A. *Assessing the Financial Battlefield*

The legacy of the Reagan administration's eight years of financial deregulation and speculative cheerleading has only grown with the passage of time, largely because of the unwillingness and inability of policymakers to question the basic underlying premises of deregulation. The liberalization of depository interest rates and the lifting of interest rate prohibitions on demand deposits have necessarily resulted in higher real interest rates, particularly in the tight money environment dictated by the Fed. As a result, U.S. financial institutions have been forced to bid up depository interest rates to attract funds. Banks and thrifts have passed on the costs of higher depository rates to debtors by charging higher interest rates on loans. The result has been a growing interest burden on public and private debt; increased business failures, bankruptcies, and mortgage foreclosures; a steep decline in the level of homeownership; deteriorating loan portfolios for commercial banks and savings and loans; and, finally, a financial bailout of epic proportions in the 1990s.[139]

Ronald Reagan's presidency began with the wholesale deregulation of depository interest rates, which eventually subjected banks to virtually unfettered price competition. By the end of President Reagan's first term, however, the federal

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reasonable average level of employment is one so unacceptable to the wealth-owners that it cannot be readily established by manipulating the quantity of money." KEYNES, *supra* note 10, at 308-09. Statute, custom and moral dictates were, therefore, required to keep interest rates at low enough levels to ensure full employment. *Id.* at 351.

[138] Liberals and conservatives alike auctioned their principles to powerful private interests, throwing both caution and discipline to the wind. While the responsibility for dismantling 50 years of regulatory protections cannot be confined to one party or one branch of government, the fact is that most of the significant developments occurred during Ronald Reagan's watch.

[139] On the declining rate of homeownership and rising homelessness, see PHILLIPS, *supra* note 53, at 22, 183-84, 251 (App. I-1). Should real rates of interest be reduced to appropriately low levels, then total debt burdens on both public and private sectors would be reduced accordingly. Both the public and private sectors would then be able to increase investment spending. HIXSON, *supra* note 36, at 258.

government was forced to interfere with market outcomes by rescuing the nation's seventh largest commercial bank from collapse. Bailout, as the pattern if not the exact blueprint, has dominated to this day. The interest rate structure permits, and even encourages, the failure of those at the bottom of the economic pyramid, while those at the top benefit from a policy of "lemon socialism."[140] The federal government subsidizes the losses of the wealthy by propping up a failing system in which self-interest masquerades as free-market principle and public debate is stifled by the requirements of so-called "expertise." The ultimate irony is that the proponents of unrestricted capitalism gladly have accepted federal bailouts to protect themselves from the same intensified competition that they helped to bring about.

While it has been estimated that only 20% of the wealth and income redistributions that occurred during the Reagan era were the result of changes in the tax code (i.e., 80% resulted from high interest rates and deregulation of various industries),[141] political debate continues to concentrate on fiscal remedies to the top-heavy distribution of wealth and income. Those who advocate raising taxes on the rich are accused of trying to play Robin Hood.[142] Yet it would be more accurate

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[140] If socialism is a system of public ownership of the means of production, "lemon socialism" refers to a system of government purchase and/or subsidy for unproductive or failing sectors of the economy. The government buys a lemon rather than nationalizing a Cadillac.

[141] PHILLIPS, *supra* note 53, at 241 (Appendix B), 101-15 (deregulation, money and debt as powerful redistributive levers); Keith Bradsher, *Gap in Wealth in U.S. Called Widest in West*, N.Y. TIMES, Apr. 17, 1995, at A1, C4; Nasar, *supra* note 53, at D24.

[142] In 1944, President Franklin Roosevelt recognized that full employment was a necessary condition to the attainment of individual freedom. FDR called for a Second American Bill of Rights (an Economic Bill of Rights) to include the right to useful and remunerative employment for all Americans. *Public Papers and Addresses of Franklin D. Roosevelt: 1944-1945*, at 32, 41 (State of the Union Address, Jan. 11, 1944); *see also id.* at 371 (Campaign Address, Oct. 28, 1944) & 503 (State of the Union Address, Jan. 6, 1945).

By settling for far less than full employment, the Democratic Party now finds itself advocating a narrower conception of justice based on group rights and affirmative action, opening itself up to criticism that it has become "the party of quotas." Appropriately, the RTC bailout agency has come under pressure to abide by affirmative action standards. Cushman, *supra* note 127, at B16.

The game of musical chairs provides a useful analogy in the full employment versus affirmative action debate: when the music stops, we may divide up the seats (i.e., jobs) based on divisive criteria such as gender, race, ethnic or national to conclude that the Fed is quietly playing the part of the Sheriff of Nottingham by powerfully redistributing wealth to the haves at the expense of the have-nots by dictating the century's highest sustained real interest rates.

Since the late 1970s, real interest rates for most individuals, businesses, and all levels of government have remained at unprecedented levels, more than triple the historical average.[143] The massive redistributions of wealth and income have continued unabated into the Presidency of Bill Clinton. This consequence may be the most troubling and least recognized effect of financial deregulation and high real interest rates. The vast redistribution of wealth and income from consumers to creditor and rentier groups has constituted a drag on the continued expansion of consumer purchasing power and effective aggregate demand, resulting in an unsustainable "debt overhang."[144] When the rate of interest rises faster

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origin (i.e., minority set-asides, quotas and immigration restrictions) or we may work to expand the number of seats so that all who play will find security and happiness.

[143] *See supra* note 83 and accompanying text. The Fed's interest rate hikes may constitute the largest "unfunded federal mandate" on state and local governments. Rising interest rates add hundreds of millions of dollars to the debt servicing costs of all levels of government. According to Senator Byron Dorgan, the Fed's interest rate increases in 1994 alone increased the cost of the federal government's debt service over the next five years by nearly $125 billion, taking back nearly one-fourth of the Clinton administration's deficit reduction savings. The total cost to the private sector from the Fed's 1994 interest rate increases was about $43.7 billion per year, or a total of at least $218 billion over the next five years. 141 CONG. REC. S755 (daily ed. Jan. 11, 1995) (statement of Sen. Dorgan); Summary of Dorgan Amendment to S. 1, the Unfunded Mandate Reform Act of 1995 (amendment would have required the Federal Reserve Board to report to Congress and the President about the anticipated costs of changes in interest rates on the public and private sectors).

[144] Throughout 1993, much of Wall Street cheered the decline in both real and nominal interest rates. Businesses paying near-prime rates of six or seven percent as well as higher rates on earlier loans, however, were still having difficulty servicing their debts in an economic environment where income and profits were rising by only one or two percent. This suggests that minimally lower interest rates, by themselves, may not spark recovery. Steven Greenhouse, *With Rates This Low, Where's the Boom?*, N.Y. TIMES, Aug. 24, 1993, at D1 (economist Henry Kaufman concludes that a much larger decline in interest rates may be required to stimulate the economy "because we have gone through a great debt explosion that has immobilized many borrowers and financial institutions").

This also explains the on-going need to "restructure," consolidate and layoff workers during a period of slow growth. Cost-cutting is needed to increase revenue to finance the debt overhang. See *infra* note 151. However, the cumulative effect of such cost-cutting is to further reduce aggregate demand, profits and income.

than both consumer prices and wages, it eats into private and public income, leaving us poorer as individuals and as a nation.[145]

The experiment in financial deregulation has been an abject failure in meeting its most important public policy objectives. The multi-billion dollar government interventions, bailouts, and subsidies reveal the failure of deregulation to deliver its promise of greater economic efficiency, while the massive redistributions of wealth and income stemming from high real interest rates demonstrate a policy that fails all tests of equity and fairness.[146]

B. *Reforming Substantive Policy*

Past U.S. experience suggests that it is entirely possible to replace the hypocrisy and illusion of deregulation with a regulatory system that both achieves public policy objectives and makes the bureaucracy more democratically accountable. While debate has been greatly constrained by the mythology of liberalism, it is highly deceptive to characterize the bi-partisan program of financial deregulation as "liberalization." If exercised through democratically accountable political institutions,

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The declines in aggregate income resulting from private restructuring and public budget cuts will of course necessitate even further cuts in interest rates if businesses and individuals are to meet their debt payments.

[145] Rising interest rates contribute to a high level of unemployment. (The official jobless rate grossly underestimates the magnitude of unemployment and underemployment in the U.S. since it does not include millions of part-time and discouraged workers, those who have dropped out of the labor market completely, or those incarcerated in prison.) Rising levels of unemployment are, in turn, correlated with increases in homicide, suicide, admissions to state mental hospitals and deaths from cirrhosis of the liver associated with alcoholism. ROBERT L. LINEBERRY ET AL., GOVERNMENT IN AMERICA: PEOPLE, POLITICS AND POLICY 638 (1993) (citing M. HARVEY BRENNER, ESTIMATING THE SOCIAL COSTS OF NATIONAL ECONOMIC POLICY: IMPLICATIONS FOR MENTAL AND PHYSICAL HEALTH, AND CRIMINAL AGGRESSION (1976)). Lower real interest rates and a return to levels of full employment—i.e., reductions in joblessness from present unofficial double-digit rates to less than three percent—should result in very significant reductions in each of these indices of social pathology.

[146] Some analysts may conclude that there will be no change in policy as long as those with power and influence in American society continue to find financial deregulation to be in their private interest. Indeed, such a shift in the political pendulum may require even harder times and more widespread harm to the public interest and general welfare, a prospect not unlikely, given the magnitude of the Clinton administration's budgetary austerity.

regulation of the marketplace is not incompatible with liberty. Rather, it is the abdication of such responsible self-government that may constrain liberty, shackling individuals to coercive forces completely unresponsive to considerations of the general welfare.[147]

In a political system characterized by interest group pluralism, official government policies all too often reflect the private interests of those individuals and groups that are most organized and most capable of devoting large financial resources to the processes of political lobbying. The public interest, however, is more than the sum of such private interests. It includes the interests of those lacking in such financial resources and organizational capabilities. Public policy should reflect the public interest and promote the general welfare.[148] To that end, the doctrine of usury "deserves rehabilitation and honour."[149] Unfortunately, that doctrine has all but disappeared from the legal lexicon of public administration.[150] Lending at high interest rates is no longer considered to be usury: it is considered natural and normal. But there is nothing natural or predetermined about the present policies in banking and finance, or the institutional relationships that result in protection and bailout for the well-connected and high debt burdens for everyone else.

In the field of finance, the measures necessary to end the massive redistributions of wealth are the same as those required to boost investment and employment: namely, significant and sustained reductions in real depository and lending

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[147] THEODORE ROOSEVELT, THE FREE CITIZEN 139 (1956) ("Individual initiative . . . may be crushed out just as effectively by the unchecked growth of private [power] . . . if the state does not interfere at all."); *see also* VACLAV HAVEL, DISTURBING THE PEACE 16 (Paul Wilson trans., 1990) (concluding that "some degree of minimal regulation is essential").

[148] *See* U.S. CONST. pmbl. (the purpose of constitutional government is the promotion of the general welfare; power emanates from the people and is to be exercised for their benefit); *see also* HAVEL, *supra* note 147, at 16 ("Any eventual central regulation of this variegated economic scene . . . should be based on nothing more than a highly evolved sensitivity to what contributes to the general good of the human being, and what, on the contrary, limits and destroys it.").

[149] KEYNES, *supra* note 10, at 351. For a striking example of the inverse relationship between debt and freedom, see James Brooke, *Slavery on Rise in Brazil As Debt Chains Workers*, N.Y. TIMES, May 23, 1993, at 3.

[150] *See, e.g.*, *Fleet's High-Interest Second Mortgage Lending Upheld By Georgia Supreme Court*, 60 BANKING REP. (BNA) 928 (June 21, 1993).

interest rates. Low real interest rates would have the positive effects of: (1) reducing the federal budget deficit by reducing the servicing charges on the national debt; (2) increasing mortgage lending, homebuilding and productive investment in industry; (3) encouraging consumer borrowing; (4) contributing greatly to the achievement of full employment of capital and human resources;[151] (5) restoring the long-run profitability of balance sheets of commercial banks; and (6) ending the redistribution of wealth and income from consumers and other borrowing groups to lenders and rentiers.

If the United States is to achieve these objectives, interest rates must be reduced for ordinary working Americans and businesses. There is no justifiable macroeconomic reason for double-digit interest rates on credit card, commercial and mortgage loans, particularly in an environment of low inflation.[152] All branches and organs of the government, from Congress to the presidency and the federal bureaucracies, must find the political will to impose limitations on market interest rates while forging a broader social consensus to restrain prices and wages. Such a policy is the only viable and humane alternative to the anti-inflationary policy of tight money and high real interest rates.

The Fed, in coordination with foreign central banks, should enforce market interest rates which straddle the infla-

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[151] While the high real interest rates since 1980 have left the U.S. economy with a huge debt overhang in both the public and private sectors, reductions in real interest rates may ultimately prove insufficient to revive consumer and business confidence. But while high real interest rates are capable of pulling down the economy, reductions in such interest rates will not result in increased borrowing or investment when there has been a collapse in confidence. In such an environment, monetary policy is more akin to "pushing a string through a hole". If the present craze for fiscal austerity results in economic contraction and recession, then the monetary authorities may be unable to reinflate effective demand. *See supra* note 144. This suggests that a looser monetary policy is a necessary, but possibly not sufficient, condition to economic growth and job expansion.

[152] While banks argue that high interest rates and bank fees on consumer loans reflect the higher marginal costs of originating small loans, there are compelling public policy reasons for having large transactions subsidize the mass of smaller transactions. Such cross-subsidization of consumer interest rates would ensure that the default rate on consumer loans remains at manageable levels. Furthermore, in light of the history of massive subsidies granted to lending institutions as well as the market protections afforded to such institutions in the form of licensing and chartering requirements, considerations of justice require that consumers receive more equitable treatment.

tion rate—i.e., a real rate of interest which approaches zero percent or even negative levels.[153] Certainly a private banking system can survive and flourish even with negative real interest rates. This was demonstrated during the hey-day of the New Deal regulatory regime as the higher quality bank assets and greater stability of bank balance sheets were obtainable via a low interest rate regime. As a practical matter, even with low or negative real interest rates, banks could still protect their profitability by charging higher rates on loans than they pay to depositors.[154]

Due to recessionary conditions, by mid-1993 nominal interest rates had declined to their lowest levels in over twenty years. While interest rates on consumer, mortgage and commercial loans had remained significantly above the rate of inflation, money market rates were as low or lower than the inflation rate. Depository interest rates were, in many cases, below the old Regulation Q levels. A window of opportunity has opened to restore minimum legal standards of real decency to relations between lenders and borrowers.[155] That effort

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[153] In mid-1993, Fed Chairman Alan Greenspan expressed concern that real interest rates were below zero. His benchmark for measuring real interest rates, however, was the federal funds rate, the rate at which banks lend reserves to each other overnight. For millions of consumers and thousands of businesses, the real rate of interest remained well into the double digits. Greenhouse, *supra* note 54, at D2.

Nobel-laureate economist Paul Samuelson has recognized that *negative* short-term *real* interest rates are necessary in a time of recession or prolonged weakness in a recovery to induce greater private capital formation. Commenting favorably on the Fed's pre-1951 pegging policy, Samuelson has concluded: "In the years when the price index accelerated to two percent per annum or above, was it a mistake that treasury bills chronically bore yields of half a percent per annum and garnered negative *real* interest returns. According to the new dogma it was a mistake, even though the unemployment rate still hovered around 15 percent!" Paul A. Samuelson, *Leaning Against What Inflationary Wind?*, CHALLENGE, Sept.-Oct. 1993, at 20, 24, 26.

[154] In addition to the spread between depository interest rates and lending interest rates, other factors which support the profitability of the commercial banking industry include: (1) the strict licensing requirements and other artificially high barriers to entry into the banking industry that have been justified by considerations of bank safety and soundness; and (2) the charging of various bank fees, many of which already exceed fair and reasonable levels. *See* U.S. PUBLIC INTEREST RES. GROUP & CONSUMER FED'N OF AM., THE 1993 PIR/CFA NATIONAL BANK FEE SURVEY (June 1993); *Banking Fees Skyrocketing*, 60 BANKING REP. (BNA) 878 (June 14, 1993).

[155] At the dawn of the twentieth century, a famous Austrian economist, Eugen von Bohm Bawerk, declared that the level of a nation's interest rates reflects the

could proceed with a reform of monetary policy and a revival of the law of usury.

C. *Reforming the Policymaking Process*

In banking and finance, as in all areas of public policy, process influences and often dictates substantive outcome. A change in policy therefore requires reform of the policy making process, from the way that we elect our Congressional representatives and Chief Executive to the structures and processes of the Federal Reserve Board and other bureaucratic agencies.

In a democracy, we expect that pivotal issues will be widely debated. Yet, throughout the past two decades, both the Republican and Democratic presidential candidates virtually have ignored the most important legislative and regulatory changes imposed on the nation's financial system.[156] Certainly the 1992 presidential election campaign failed to offer any choices to American voters on such fundamental issues as the structure of the nation's central bank and the formulation of monetary policy.[157]

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cultural level of its civilization: the lower the rate of interest, the higher the people's intelligence, cultural level and moral strength. HOMER & SYLLA, *supra* note 70, at 3-4, 200.

[156] The commercialization of the most important mass medium of information and communication—the television airwaves—has adversely impacted the quality of our public debate. In 1968 the average length of a network sound bite was nearly 45 seconds. By 1988, the average sound bite lasted less than 10 seconds. KIKU ADATTO, SOUND BITE DEMOCRACY: NETWORK EVENING NEWS PRESIDENTIAL CAMPAIGN COVERAGE, 1968 AND 1988, at 4 (Harvard University, John F. Kennedy School of Gov't, Research Paper R-2, June 1990); Daniel Hallin, *Sound Bite News: Television Coverage of Elections, 1968-1988*, J. COMM., Spring 1992, at 12.

It is therefore no small wonder that commercial television was unwilling and/or incapable of presenting discussion of complex issues or that the level of debate degenerated into macho posturing aimed at maximum use of sound-bite coverage (i.e., "Read my lips: no new taxes."). To compare this present-day reality with past reform efforts, see Mary A. Watson, *The New Frontier and the Vast Wasteland*, *in* JOHN F. KENNEDY: THE PROMISE REVISITED 261 (Paul Harper & Joann P. Krieg eds., 1988).

[157] The Clinton Administration's plan to create 100 new community development banks (designed by the President's National Economic Council) to extend low-interest credit to poor neighborhoods could be seen as an attempt to circumvent the Fed's high interest rate grip on the economy and the existing private commercial banking domination of the Federal Reserve System. *HUD Secretary Says Community Development Banks Will Use Banks, Thrifts, and Credit Unions*, WASH. INSIDER (BNA), Mar. 4, 1993; *see also* HYMAN P. MINSKY ET AL., COMMUNITY DEVELOP-

In fact, the similarities between the two major political parties now far outweigh the differences on the most significant issues affecting the economy—monetary, fiscal and regulatory policies. Both parties are increasingly dependent on powerful private interests to raise money for thirty-second television spots to get their simplified messages across to voters.[158] This dependency may explain why administration after administration permits a system in which their central banks subsidize rentiers, creditors, private speculators, currency traders and commercial bankers at the public's expense. Administrations, whether Democratic or Republican, are now less accountable to electorates than to the private interests which finance their increasingly expensive political campaigns.

The Federal Reserve System has become the most important vehicle by which the elected branches of government evade responsibility for the adoption of policies that favor the financial elite at the public's expense. Structural change therefore should begin with the Fed. While the Constitution gives Congress the exclusive right to coin money, that power is effectively farmed out to the private bankers which dominate the Fed.[159] Such broad legislative delegations of power effectively permit bureaucratic agencies such as the Fed to "pick winners and losers" while shielding agency deliberations from the scrutiny of open public debate. The necessities of reform require nothing less than a genuine reinvention of government.[160]

MENT BANKING: A PROPOSAL TO ESTABLISH A NATIONWIDE SYSTEM OF COMMUNITY DEVELOPMENT BANKS 9 (Jerome Levy Economics Inst. of Bard College, Public Pol'y Brief No. 3, 1993). Even under such commendable proposals, however, a network of community development banks could remain at the mercy of general economic conditions dictated by conservative financial forces entrenched at the Fed.

[158] *See* Michael Wines, *Candidates for Congress Spent Record $678 Million, a 52% Jump*, N.Y. TIMES, Mar. 5, 1993, at A12.

[159] According to former Congressman Wright Patman, "Under the Constitution, it is the right and duty of Congress to create money. It is left entirely to Congress. Congress has farmed out this power—has let it out to the banking system." MARTIN MAYER, THE BANKERS 23 (1974); *see also* U.S. CONST., art. I, § 8, cl. 5 ("The Congress shall have Power . . . To coin Money, regulate the Value thereof, and of foreign Coin.").

[160] Steven Greenhouse, *Gonzalez Intensifies Battle With Fed*, N.Y. TIMES, Oct. 8, 1993, at D2 (according to Senator Paul S. Sarbanes, the Federal Reserve System is the only agency in which "actual decision-making power [is] vested in individuals who are formally accountable to private parties instead of to the public"); *Clinton Says No To Gonzalez Federal Reserve Bill*, NAT'L JOURNAL'S CONGRESS DAILY, Sept. 24, 1993 (stating that the Gonzalez bill would increase the number of

Major reform of this institutional structure has been impeded by the broad legislative delegations ironically permitted by a distinctly loose interpretation of the Constitution.[161] Additionally, various cultural factors, such as a deeply embedded "cult of technocratic expertise," increasingly are exported from the United States to justify the "independence" of other central banks around the globe. This fetish for technocratic expertise holds that central banking policy is best left to the policy professionals but ignores the danger that the technicians themselves may be corrupted by the trappings of self-interest. Such concerns are often swept aside by the platitude that the Federal Reserve Board is above politics and the premise that both ordinary citizens and Congress are incapable of exercising informed judgment in all matters dealing with central banking policy.[162]

The quiet dogma of an infallible, privately directed central bank is simply incompatible with democratic theory and practice, and as such, deserves to be relegated to the past. The fact is that the Federal Reserve System, like other modern bureaucratic agencies, has not been insulated from politics merely because of its quasi-independent status. Rather, the autonomy of the Fed merely dictates a substantive outcome most favorable to those private banking interests that have a significant institutional power base within the Federal Reserve System. Widespread market failure, on-going financial bailout, increasingly inequitable distributions of wealth and income, and secular

key Federal Reserve System officials who are accountable to the White House and Congress by requiring that all members of the FOMC be nominated by the President and confirmed by the Senate).

[161] For a discussion of the theoretical permutations required to bring the practice of broad congressional delegations within the requirements of the Constitution, see *supra* note 67.

[162] It is a curious phenomena that so many Americans have remained uninformed and uninterested in hearing, let alone participating in, any public policy debate concerning banking and finance. After all, a great many Americans are quite ready, willing and able to understand and manage the intricacies of their own personal finances, including the complexities of mortgage financing and diversified investment strategies, to minimize their tax liabilities and maximize their personal gains in a wide variety of money market instruments. Yet these same intelligent people are content to let unelected bureaucrats at the Fed decide the larger financial issues that affect their lives and economic interests. *See* Carol M. Dukes, *Evil Science Runs Amok—Again!*, N.Y. TIMES, June 10, 1993, at A27 ("we are all scientists if we allow our minds to inquire and refuse to be intimidated by the unchallenged 'experts'").

economic stagnation are both a lesson and a warning about the dangers of insulating the policy-making process from open politics. Limiting public policy debate to a professional class of self-professed experts, lobbyists and professional politicians entrenched inside the Capitol Beltway has had disastrous results for the American economy.

Public policy should not be dictated by a distant state bureaucracy. It should be made by a democratically accountable body "that relies on a continuing dialogue between public opinion and expert opinion."[163] That, however, requires the restoration of an informed public and a wider civic discussion about central banking policy. Education and debate among ordinary American citizens is a requirement, not a luxury. Deeper public understanding and wider public participation and representation in the policy making process[164] naturally would lead to policy outcomes that are more compatible with the public interest. Public participation also would facilitate the achievement of such objectives as lower real rates of interest, reduced public and private deficits, greater levels of investment and employment, and public support for a more civilized social compact to restrain inflation.

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[163] See HAVEL, *supra* note 147, at 16 ("The referee in [any eventual central regulation], of course, could not be a state bureaucracy but a democratically elected political body that relies on a continuing dialogue between public opinion and expert opinion.").

Others have noted the "democratic deficit" in the emerging European Economic Community, which has required member states to "de-link" their central banks from parliamentary control as a condition of closer monetary union. *See, e.g.*, Ruben Lee, *EC Investment Services Regime: The Case for Reform*, EUROWATCH: ECONOMICS, POLICY, AND LAW IN THE NEW EUROPE, Aug. 23, 1993, at 6-7. While important policy discussions are normally confidential and decisions influenced by informal lobbying and privileged access, it is "critical that wide and formal, rather than discretionary, consultations take place" and that such institutional reform be enshrined in legislation. *Id.*

[164] James K. Galbraith, *Self-Fulfilling Prophets: Inflated Zeal at the Federal Reserve*, AM. PROSPECT, Summer 1994, at 31, 37-39. Among the legislative reform proposals introduced in the 1st Session of the 103d Congress to make the Federal Reserve System more accountable to a wider range of interests in the body politic (i.e., debtor groups such as consumers, farmers, and manufacturing businesses) and to open up the Fed's decision-making process to greater public scrutiny are the following: H.R. 587/S. 219 (introduced by Representative Lee Hamilton and Senator Paul Sarbanes), H.R. 28 (introduced by House Banking Chairman Henry Gonzalez), H.R. 145 (introduced by Representative Phil Crane), and H.R. 586/S. 212 (introduced by Representative Lee Hamilton and Senator Byron Dorgan).

POSTSCRIPT

As this Article goes to print, several late-breaking developments deserve attention and brief analysis as important examples of the continuing failure of the free-market policy approach to banking and finance. The growing speculation in derivative financial instruments has led to stunning losses and hardship internationally. In December 1994, Orange County, California, one of the nation's wealthiest counties, was forced to file for bankruptcy.[165] Its investment fund incurred more than $2 billion in losses on highly leveraged derivative investments after wrongly betting that interest rates would fall.[166] In February 1995, Barings P.L.C., one of the world's oldest investment banks, suddenly collapsed just days after it was reported that a single trader in its Singapore office had lost more than $1 billion of the bank's money in unauthorized financial gambles on the direction of Japanese stock prices and interest rates.[167]

The losses incurred by Barings' shareholders ultimately may be somewhat contained by the sale of the bank's assets to a financial suitor.[168] The bankruptcy of Orange County, however, has already led to real hardship for real people: county workers have been laid off and a wide range of public services for taxpaying residents have been cut.[169] Orange County is not an isolated case. Derivatives have led to mounting losses for government agencies, schools and universities, non-profit organizations, and corporations around the country.[170] The

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165 Sallie Hofmeister, *Orange County, Calif., Makes Bankruptcy Filing*, N.Y. TIMES, Dec. 7, 1994, at A1.

166 Seth Mydans, *Orange County Begins Pain of Cutbacks*, N.Y. TIMES, Mar. 10, 1995, at A19; Leslie Wayne, *Orange County Can Meet Only 60% of Its Budget*, N.Y. TIMES, Jan. 5, 1995, at A1.

167 Richard W. Stevenson, *Young Trader's $29 Billion Bet Brings Down a Venerable Firm*, Feb. 28, 1995, N.Y. TIMES, at A1; Richard W. Stevenson, *Markets Shaken as a British Bank Takes a Big Loss*, N.Y. TIMES, Feb. 27, 1995, at A1 ("[Barings] was left with no choice but to seek bankruptcy protection after a frantic rescue effort by the Bank of England . . . came up short.").

168 Richard W. Stevenson, *Dutch Concern Is Set to Take Over Barings*, N.Y. TIMES, Mar. 6, 1995, § 1, at D5.

169 *Hundreds of Jobs Likely to Go in Cuts by Bankrupt County*, N.Y. TIMES, Dec. 26, 1994, at 14.

170 G. Bruce Knecht, *TV: Derivatives on "60 Minutes"*, WALL ST. J., Mar. 8, 1995, at A18; G. Bruce Knecht, *Hit By Derivatives, Florida County Tries To Decide*

benefits of derivative investments, such as the sharing and hedging of risk, must eventually be weighed against their increasing costs, which include huge losses to seemingly sophisticated, yet unwary investors[171] and significant collateral damage to investors in tangentially related markets.[172] Policymakers and analysts are only beginning to understand the potential magnitude of the risks now inherent in the global casino economy.

These risks were illustrated by the sudden collapse of the Mexican peso in December 1994. A financial meltdown in Mexico, if not quickly contained, could have spread to neighboring currencies and regions, affecting other emerging markets and the value of the U.S. dollar. Rather than face the prospect of protracted debate in Congress, President Clinton ultimately adopted the rescue package by executive order. In February 1995, the Clinton administration committed itself to $20 billion in emergency loans to Mexico as part of a $50 billion international rescue package for the Mexican peso.[173]

Policymakers were forced to rely on arguments of political expediency and financial necessity to justify a rescue package that so flagrantly violated free-market principles. The Clinton administration's authoritarian policy formulation cannot be blamed solely on fears of partisan politics, since the growing revolt in Congress was not confined to Republicans.[174] The overriding perception of a double standard is difficult to dispel.

What To Do, WALL ST. J., Mar. 21, 1995, at A1.

[171] For instance, Proctor & Gamble Co. has joined a growing list of victims of derivative losses. *P. & G. Amends Bankers Trust Suit to Seek More Money*, N.Y. TIMES, Feb. 7, 1995, at D9.

[172] Sheryl WuDunn, *Tokyo Stocks Plunge on British Firm's Collapse*, N.Y. TIMES, Feb. 27, 1995, at D1; *see also* Hofmeister, *supra* note 165, at A1 (the bankruptcy filing of Orange County drove down the market for municipal bonds, and threatens to "cause Wall Street firms to demand higher interest rates or to pull back on lending to local governments").

[173] David E. Sanger, *Clinton Offers $20 Billion to Mexico for Peso Rescue*, N.Y. TIMES, Feb. 1, 1995, at A1. The peso's decline threatened to drive down the value of the U.S. dollar. Paul Lewis, *Dollar Bruised in Stampede of Investors to Yen and Mark*, N.Y. TIMES, Jan. 13, 1995, at D1; Kenneth N. Gilpin, *Far-Reaching Effects Seen if Mexico Rescue Is Halted*, N.Y. TIMES, Jan. 23, 1995, at D1.

[174] David E. Sanger, *With Opposition Rising, Clinton Pleads for Mexico Rescue Package*, N.Y. TIMES, Jan. 19, 1995, at A21. Possibly responding to elite constituencies, many Republican leaders were early supporters of the rescue package. David E. Sanger, *Leaders of G.O.P. in Congress Back Clinton on Mexico*, N.Y. TIMES, Jan. 13, 1995, at A1.

When an ordinary citizen loses his or her house or business because of foreclosure or default, it is considered the legitimate outcome of free-market forces, although the price of credit is not ultimately set by market forces but is administered by central banks. If anything, the loss of a home or business, like the loss of a job, is considered to be a sign of personal failure. In contrast, when wealthy investors stand to lose the principal of their investments, the government is ready and willing to intervene to forestall a "financial crisis."

Since the regulatory regime has been dismantled and replaced with a Darwinian free-market approach, financial crisis has become a regular feature of the financial system.[175] Governments now intervene regularly in the private marketplace to reverse market outcomes with receivership policies when such intervention suits the interests of the financially elite stratum of society—the same elite which enjoys political influence by virtue of its financial ability to contribute to election campaigns. The proclivity of elected officials to depart from free-market principles contrasts sharply with their demonstrated unwillingness to intervene effectively on behalf of debtor interests (representing the broad majority) or to define a coherent public interest to justify rational regulation and market-ordering measures.

The operation of the peso support mechanism confirms criticism that the bailout policy is a welfare program for rich American investors. The so-called "smart money" fled, leaving government agencies and central banks holding a mountain of depreciating pesos. It was reported, for instance, that funds drawn down by the Mexican government from the U.S. Treasury Department's Exchange Stabilization Fund were flowing into Europe and the Far East, thereby depressing the value of the dollar in those markets. As one Morgan Stanley analyst admitted, "There was always a danger the provision of public capital would serve as a cover for private capital to leave the country."[176] The dollar fell to historic lows against the Japa-

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[175] The frequent necessity of huge financial bailouts is not confined to the United States. Richard W. Stevenson, *Bailing Out France's Biggest Bank*, N.Y. TIMES, Jan. 26, 1995, at D1; Timothy A. Canova, *The Swedish Model Betrayed*, 37 CHALLENGE: MAG. ECON. AFF. 36 (May-June 1994).

[176] Paul Lewis, *Dollar Falls On Fears in Peso Crisis*, N.Y. TIMES, Feb. 17, 1995, at D1, D15. For a discussion of the elite financial institutions which have huge

nese yen and German mark (and also slid against the British, French and Swiss currencies), in large part due to speculation that the Federal Reserve would not raise interest rates[177] and that the U.S. government lacked the capability to defend the dollar because it already had committed half of its Exchange Stabilization Fund to Mexico.[178]

For Mexico, the bailout agreement represented a major relinquishment of its economic sovereignty, particularly its ability to implement fundamental policies such as the setting of domestic interest rates, which were raised sharply (to upwards of fifty percent) to appease the markets and the U.S. government.[179] Amidst the panic to fashion the massive government bailout package, a more sensible option was ignored: Mexico could have stabilized the peso by reimposing limited foreign exchange restrictions. The silence of the public debate was deafening. The American media machine paid scant attention to the few voices articulating an alternative vision of a regulatory paradigm to replace the failing free-market mythology.

These events confirm that the liberalization of international capital flows has created a world in which the sovereignty of

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interests at stake in the Mexican financial markets, see Louis Uchitelle, *U.S. Losses in Mexico Assessed: Peso's Fall May Cost Americans Billions*, N.Y. TIMES, Dec. 26, 1994, at 55.

177 Keith Bradsher, *Dollar Falls to New Low and Fed Intervenes*, N.Y. TIMES, Mar. 3, 1995, at D1.

178 Treasury Undersecretary Lawrence Summers tried unsuccessfully to assure skeptical currency speculators that the remaining resources in the Exchange Stabilization Fund were sufficient to support the dollar through effective market intervention. David E. Sanger, *Dollar Continues to Plunge as U.S. Ponders Strategy*, N.Y. TIMES, Mar. 7, 1995, at A1. Summers presumably did not want to risk rattling the foreign exchange markets further by mentioning any variation of his proposed turnover tax on financial transactions (such as applying the tax to currency speculation), a compelling regulatory proposal that Summers had advocated in his pre-Clinton administration days. *See infra* note 186.

179 David E. Sanger, *Mexico Is Facing New Restrictions To Get U.S. Help*, N.Y. TIMES, Feb. 20, 1995, at A1. In compliance with the bailout agreement, the Bank of Mexico promptly raised its short-term interest rates to nearly 50%. Anthony DePalma, *Mexico Initiates An Economic Plan of Extended Pain*, N.Y. TIMES, Mar. 10, 1995, at A1; Anthony DePalma, *Rates Up Sharply in Mexico*, N.Y. TIMES, Feb. 21, 1995, at D1; David E. Sanger, *Peso Rescue Sets New Limits on Mexico*, N.Y TIMES, Feb. 22, 1995, at A1. Consumer interest rates have soared above 115% annually, while salaries are expected to rise only 10 to 17% this year. Sallie Hughes, *Mexico's Middle Class Losing Ground: Soaring Interest Rates Spark Debtors' Rights Groups*, MIAMI HERALD, Mar. 26, 1995, at 22A.

any one nation is surrendered to the forces of private financial speculation. Capital is capable of staging a general political strike against the policies of any nation state, including the United States, by simply voting against that country's currency and bonds in the private marketplace. In the United States, for example, some analysts recognize that even Federal Reserve Board policy is subject to the veto-power of the international capital markets.[180]

While the total volume of U.S. exports and imports has reached about one trillion dollars per year, foreign exchange trading now adds up to roughly one trillion dollars *each day*.[181] When speculators vote against a country's economic policies by selling assets denominated in that country's currency, the country's central bank can respond only by raising the domestic rate of interest.[182] This solution often is ineffective in its intended purpose and always damages the country's domestic economy.[183] More than sixty years ago, the world's premier economic mind, John Maynard Keynes, warned that nothing less than the democratic experiment in self-government was endangered by the threat of global financial market forces.[184]

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180 *See, e.g.*, Keith Bradsher, *Latest Rate Hike by the Fed Makes White House Nervous*, N.Y. TIMES, Nov. 20, 1994, at 26 ("Some officials even fear that public criticisms [of Fed policy]", let alone criticism of the Fed's undemocratic structure, "would prompt the Fed to push interest rates even higher to reassure financial markets of its continued independence.").

181 FEDERAL RESERVE BANK OF NEW YORK, SUMMARY OF RESULTS OF THE U.S. FOREIGN EXCHANGE MARKET TURNOVER SURVEY (Apr. 1992).

182 Sanger, *supra* note 178, at A1 ("But the solution that the markets appeared to be demanding, another increase in [U.S.] interest rates to lure foreign investors to buy dollars again, is fraught with economic and political problems for the Federal Reserve and the White House."); *Plunge in the Dollar Could Spark Upheaval in Markets, Economies*, WALL ST. J., Mar. 8, 1995, at A1 (if the Federal Reserve tries "to rescue the dollar by raising interest rates and fails, financial events could spin out of control"); Keith Bradsher, *Dollar's Four-Day Plunge Halts*, N.Y. TIMES, Mar. 9, 1995, at A1.

183 *See* James D. Robinson III, *Inflation Overkill*, FOREIGN AFF., Sept./Oct. 1994, at 2; Canova, *supra* note 175, at 38-39. Opposition to high interest rates by the U.S. Chamber of Commerce and the National Association of Manufacturers demonstrates the growing split between industrial and financial interests. Louis Uchitelle, *Industry Leaders Warn Against Rise in Interest Rates*, N.Y. TIMES, Sept. 25, 1994, at 1; Jerry J. Jasinowski, *The Case Against Further Money Tightening*, CHALLENGE, Jan.-Feb. 1995, at 9.

184 John M. Keynes, *National Self-Sufficiency*, 22 YALE REV. 755, 762 (1933) (let trade be global, Keynes wrote, but "above all let finance be primarily national").

Any program intended to regain a country's sovereignty over its own money and currency policy requires the regulation of private speculation. A return to fixed exchange rates could provide a framework for controlling wide speculative fluctuations.[185] Alternatively, the implementation of even a modest tax on international currency transactions, similar to the "Tobin tax" proposed by Nobel-laureate economist Dr. James Tobin, could provide a powerful market disincentive to unnecessary speculation in currency trading while raising billions of dollars in revenue.[186] In March 1995, at the World Summit for Social Development, French President Francois Mitterand supported the Tobin tax as a way of raising money, preventing financial speculation, and regaining some degree of economic sovereignty. This was a fitting stance from the first significant victim of the globalization of finance. In the early 1980s, the new Mitterand government surrendered an ambitious Keynesian social agenda when the value of the French franc crumbled in the face of speculative attack.

It is clear that there exists a compelling alternative paradigm to the current free-market approach to banking and finance. This emerging paradigm extols the virtues of a regulatory regime that would reorder the marketplace to achieve a range of crucial policy goals: low real interest rates; price stability; sustained economic growth and job creation; the preven-

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Keynes developed a plan for "financial disarmament," which included proposals for an International Clearing Union and central bank control of foreign exchange transactions. *See also* James Crotty, *On Keynes and Capital Flight*, 21 J. ECON. LITERATURE, Mar. 1983, at 62.

[185] Former Fed Chairman Paul Volcker (an early architect of high real interest rates), recently headed a commission of distinguished scholars that atoned for past transgressions by calling for a return to a Bretton Woods-type system of fixed exchange rates, with wider bands for fluctuations of currency values. Bretton Woods Comm'n, Bretton Woods: Looking to the Future (Wash. D.C., July 1994).

[186] DAVID FELIX, THE TOBIN TAX PROPOSAL: BACKGROUND, ISSUES AND PROSPECTS (U.N. Development Programme for the World Summit for Social Development Policy Paper Mar. 1995) (citing James Tobin, *A Proposal for International Monetary Reform*, Presidential Address Before the Eastern Economic Association, *in* 1978 EASTERN ECON. J. 153); Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax*, 3 J. FIN. SERVS. RES. 261-81 (1989); *see also* James Tobin, *On the Efficiency of the Financial System*, LLOYDS BANK REV. (July 1984); Joseph E. Stiglitz, *Using Tax Policy To Curb Speculative Short-Term Trading*, 3 J. FIN. SERVS. RES., 101-15 (1989) (as a member of the President's Council of Economic Advisers, Stiglitz, like Summers, has been largely silent in public on these issues).

tion and avoidance of financial crisis; and greater political accountability. However, those who favor such a "paradigm shift" are confronted with a systematic political challenge. Alternative voices are not heard precisely when policy options are considered and adopted, most probably because those voices are overwhelmed by the urgency of the moment and the powers of vested interests. Even those who favor the prevailing free-market dogma may well remember that a democracy that lacks effective and informed public debate during times of crisis is no longer master of its own fate, but an organism at the mercy of outside forces.