The Contemporary American Banking Crisis in Historical Perspective
Author(s): Michael A. Bernstein
Source: *The Journal of American History*, Vol. 80, No. 4 (Mar., 1994), pp. 1382-1396
Published by: Organization of American Historians
Stable URL: http://www.jstor.org/stable/2080605
Accessed: 25/01/2010 21:19

The Contemporary American Banking Crisis in Historical Perspective

Michael A. Bernstein

The Big Fix: Inside the S&L Scandal: How an Unholy Alliance of Politics and Money Destroyed America's Banking System. Revised edition. By James Ring Adams. (New York: Wiley, 1991. xii, 340 pp. Paper, $12.95, ISBN 0-471-53844-2.)

The Great Savings and Loan Debacle. By James R. Barth. (Washington: AEI, 1991. x, 170 pp. Paper, $7.95, ISBN 0-8447-7008-6.)

Banks, Borrowers, and the Establishment: A Revisionist Account of the International Debt Crisis. By Karin Lissakers. (New York: BasicBooks, 1991. xii, 308 pp. $23.00, ISBN 0-465-00605-1.)

High Rollers: Inside the Savings and Loan Debacle. By Martin Lowy. (New York: Praeger, 1991. xii, 321 pp. $24.95, ISBN 0-275-93988-X.)

The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry. By Martin Mayer. (New York: Collier, 1990. xiv, 366 pp. Paper, $12.95, ISBN 0-02-012620-4.)

The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation. By Lawrence J. White. (New York: Oxford University Press, 1991. xiv, 287 pp. Cloth, $24.95, ISBN 0-19-506733-9. Paper, $13.95, ISBN 0-19-507484-X.)

Depositing funds in a bank is in many respects an act of faith—an expression of the belief that a run or panic will not ensue, eviscerating the bank's holdings or leading to its closure. For this reason there are few sights more appalling in modern society than that of a mob outside the doors of the local savings and loan (S&L) or commercial bank. Unfortunately, precisely that sight has assaulted our senses

Michael A. Bernstein is associate professor and chair of the Department of History and an associated faculty member in the Department of Economics at the University of California, San Diego, where he teaches economic and political history.

For initial guidance concerning the contours of this essay, and for many helpful criticisms and suggestions, he is grateful to Casey Blake, Rachel Klein, Jane Knodell, Michael Meranze, David Thelen, and Eugene White.

with distressing frequency since the late 1970s, conjuring memories and images of a half century ago when an oft-repeated quip went: "What's that . . . a breadline or a bank?" Even so, we are, at least we believe we are, smarter than the unfortunates of the Great Depression. With deposit insurance and other schemes of financial control, it is believed, bank failures need never lead to such wholesale financial slaughter and crisis as was the nation's lot in the early 1930s. If ever there was enlightened and inspired government regulation in the public interest, it was found, we assumed, in the workings of the Federal Reserve System and the Federal Deposit Insurance Corporation. Almost, but not quite.

In fact, since the latter half of the seventies, the American banking industry has teetered on the verge of systemic bankruptcy. While the crisis has taken its greatest toll in the savings and loan division of the industry, even commercial institutions have begun to weaken. Amid this financial distemper, federal institutions have indeed been called upon. The problem, however, is one both of magnitude and of kind. Conservative estimates place the direct monetary cost of bailing out the bankrupt thrifts at approximately $140 billion. But if this burden cannot be defrayed by direct taxation, and there is no reason to believe it can, the additional costs of borrowing the bailout funds (the interest charges on the loan itself) raise the estimate as high as $500 billion by early in the next decade. This translates into roughly $2,000 for every woman, man, and child in the United States.[1]

There is also the matter of reform. In this, the worst crisis in the nation's commercial and thrift banking sectors since the 1930s, both the American public and their elected representatives face the prospect of virtually repeating history, while grasping few of its lessons. What steps can we take to avoid the kind of financial chaos and loss that have characterized the past decade and that will be part of the economic history of the turn of this century? An adequate answer clearly depends on our ability to understand the causes of the current crisis—and on our willingness to attribute blame where blame is due.

While the history of the contemporary American banking crisis has more than its share of scoundrels, stupidity, and sheer bloody-mindedness, it also may delineate lessons for future policy formulation that should prove discomfiting to both the Left and the Right. Some of the worst irritants in the operations of the banking industry have resulted from the deregulation zealously pursued, in the past three decades, by conservative proponents of free market mechanisms. Other serious problems in the nation's financial corporations have resulted from regulatory practices often advocated by liberal interventionists. As Charles Keating, Michael Milken, and other exemplars of the criminal mind in American finance pay their debts to society, their prison terms and periods of probation will not solve the banking crisis nor prevent future eruptions—at least not under present institutional and regulatory arrangements.

[1] For the projections, see Martin Mayer, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* (New York, 1990), 2. For other projections, see *Los Angeles Times*, Aug. 5, 1992, p. D2; *ibid.*, March 17, 1993, pp. A1, A18; *ibid.*, March 31, 1993, pp. D1–2; *ibid.*, April 22, 1993, p. D2.

Financial crises occur when depositors lose confidence in the security of the assets they have placed in banks. Fractional-reserve banking, which permits rapid and efficient deployment of loanable funds for both consumption and investment, is premised on the assumption that not all demand deposits will be drawn upon at the same time.[2] Yet if depositors sense weakness in the banking system, a run can develop in which all deposits are drawn down at once. Individual banks then have little choice but to lock out their customers. Of course, as individual banks pursue this strategy, they supply the ingredients of total panic. Governmental institutions that establish a lender of last resort, in the form of a central or national bank, or insurance systems that secure the value of deposits (up to some minimum) can compensate for such inherent fragility in the private banking system.

In the 1890s, for example (indeed, in much of the nineteenth century), the practice of fractional-reserve banking in the context of a decentralized network periodically resulted in panics and bank runs. In the face of these interruptions in the financial circulation, banks often suspended cash payments to depositors. In some cases, banks continued payments only up to some specified maximum daily sum. During the panic of 1907, payment suspension was frighteningly common throughout the nation, and many banks suspended payment for over two months. Scrip and other collateral instruments were used in many regions to try to make up for the widespread hemorrhage of the monetary system. The United States was unusual in its experience of financial unsteadiness in the late nineteenth century. Other industrialized (and industrializing) nations at the time, most strikingly France, Germany, and Great Britain, had far more centralized banking networks, which enjoyed stability as a result of fairly systematic (though variegated) links with government agencies and the public purse.

In an effort to cure a sickly financial system, in 1908 a divided Congress established the National Monetary Commission. Inspired by the commission's recommendations, President Woodrow Wilson created the Federal Reserve System five years later, in the wake of long and bitter debates over the creation and administration of such a system. Radical Democrats and members of both major parties with vocal agrarian constituencies, while eager to avoid laissez-faire banking structures, wanted all economic interests represented in the leadership of a more centralized financial and monetary apparatus. Business-oriented Republicans, less worried about democratization of the system's hierarchy, often split between those anxious to utilize monetary policy to stimulate export trade and those more focused on the needs of the domestic market. Certain unorthodox Progressives even recommended the creation of a government-owned central bank, but their proposals never became part of focused discussion.

[2] The phrase *fractional-reserve* banking refers to the practice by which financial institutions hold in reserve only a portion of the deposits with which they have been entrusted. Bankers loan out funds accumulated in deposit accounts, thereby earning interest and stimulating investment and spending in the economy at large. Banks can thus maximize profitable loan activity by holding only as much money in reserve as they need to meet daily demands for withdrawals. A *demand deposit* is a bank account on which a depositor may draw without delay or advance notice.

Created with a permanent charter, the Federal Reserve System was based on twelve regional reserve banks that oversaw the growth and circulation of the national money supply. A Federal Reserve Board whose members were the secretary of the treasury, the comptroller of the currency, and five governors appointed by the president supervised the new system. Each bank had directors, some of whom were chosen by the board, others by the member banks in its region.[3]

It was the task of the Federal Reserve System to control the reserves of member banks and thereby to modulate the supply of money circulating in the economy. The system, by periodically altering (through various regulatory mechanisms) the amount of cash member banks had on hand to loan out, could decisively alter the pace of economic activity by loosening or tightening credit. In emergencies, the system could also act as lender of last resort in order to prevent the bank payment suspensions and panics that had plagued the national economy in the previous century.

The creation of the Federal Reserve System apparently solved some of the problems responsible for the intermittent cycles of economic performance during the half century after the Civil War. It eliminated the regional and seasonal interruptions in financial circulation that had caused so much adversity. It afforded the federal government greater control over, and awareness of, the growth of monetary instruments. Yet, as future events would demonstrate, it could not provide sufficient safeguards against collapses in the level of effective demand and unambiguous lines of authority during a general deterioration in the soundness of member institutions.

The Great Depression of the 1930s demonstrated beyond doubt the inadequacies of the national banking network created earlier in the century. A series of bank failures in late 1930 and early 1931 exacerbated the dangerous situation that had emerged following the New York stock market collapse in the fall of 1929. Many banks, trying to benefit from the remarkable bull market of the twenties, had tied up funds in the stock exchange. With the collapse of that market, as brokers called in their margin accounts, many banks found themselves pushed into bankruptcy, forced to close their doors to depositors as liquid assets dwindled. Individual bank failures then began to generate runs on other banks, as depositors became nervous about the security of their accounts.

From late 1930 until Franklin D. Roosevelt's inauguration in March 1933, an escalating rate of insolvencies beset the banking industry, and the nation's supply of money in circulation plummeted. These developments prompted the rapid and deep tumble of gross domestic product that defined the Great Depression. Not surprisingly, one of the first acts of New Deal intervention was the implementation of the Glass-Steagall Act in the spring of 1933. The banking crisis had left the public worried and angry, and members of Congress were eager both to discipline and to reform the financial sector.[4]

[3] Perhaps the best recent history of the founding and early evolution of the Federal Reserve System is Eugene Nelson White, *The Regulation and Reform of the American Banking System, 1900–1929* (Princeton, 1983), 63–188.

[4] On the history of early New Deal reforms in the banking industry, see Morton Keller, *Regulating a New Economy: Public Policy and Economic Change in America, 1900–1933* (Cambridge, Mass., 1990), 192–228; Albert

Glass-Steagall passed the Senate unanimously; in the House there was spirited but ultimately limited debate. The act separated commercial and investment banking activities, provided for the more rapid use of the Federal Reserve as lender of last resort in liquidity crises, and created the Federal Deposit Insurance Corporation (FDIC) to guard individual depositors against losses. In fact, the latter provision sparked some House debate between politicians with links to large banks (who tended to oppose deposit insurance as an unwarranted intervention in their industry) and those with ties to smaller banks (who tended to support such insurance as a means of protecting small-scale operations). Such reforms, proponents believed, could forestall any future collapse of the financial and economic systems.

A half century later, a movement for regulatory reform began to have a major influence on public policy making. Inspired by new corporate interests hoping to gain entry into markets closed by statutory limits on the number of competitors in them, deregulatory initiatives by both Congress and the executive branch often emerged on a bipartisan basis. Presidents Richard M. Nixon, Gerald R. Ford, Jimmy Carter, and Ronald Reagan (and later George Bush) all actively furthered a reduction in the federal regulation of enterprise. Premised on the notion that regulation imposed excessive costs on industry and resulted in inefficiency and resource misallocation due to the (usually unintended) creation of obstacles to competition, deregulation ultimately became the norm for many activities including commercial aviation, telecommunications, railroading, and trucking.

In several areas, the reform movement yielded apparently beneficial results: lower prices, expanded services, and greater competitive entry. Even so, in some cases, the airlines affording perhaps the most striking example, deregulation in time tended to result in a reconcentration of ownership with concomitant negative impacts on pricing, employment, and service delivery. And the deregulatory movement had little in common with more populist efforts (perhaps best exemplified by the work of Ralph Nader) to secure government regulation of such things as pollution, occupational threats to health, and dangers to consumers—let alone with struggles to make the leadership rosters in existing regulatory agencies more representative of American society.

The deregulation movement probably had its profoundest consequences in the nation's banking and financial sectors. Beginning with the Ford and Carter administrations, rules about the operations of banks, brokerage houses, and savings and loan institutions were relaxed. Among brokerages, deregulation resulted in a proliferation of discount offices that allowed investors to avoid the expenses and commissions associated with more traditional houses. Among banks, the elimination of many restrictions on the geographic range of their operations stimulated competitive entry throughout many states—although by the early 1990s a concentration of assets through bank mergers was under way. In the savings and loan industry, however, deregulation contributed to a crisis of mammoth proportions.

U. Romasco, *The Politics of Recovery: Roosevelt's New Deal* (New York, 1983), 29–33, 56–57, 218, 224; and, of course, William E. Leuchtenburg, *Franklin D. Roosevelt and the New Deal: 1932–1940* (New York, 1963), 60–62.

The savings and loan crisis had its roots in the period before deregulation, when rising interest rates and the proliferation of money market investment funds made it increasingly difficult for savings banks to offer depositors competitive rates of return. As the rates paid on such alternative investments as money market funds dramatically increased, Regulation Q, a federal rule limiting the maximum rate of interest that could be paid on savings and other demand deposits, made it virtually impossible for savings and loan institutions to attract funds. Ironically, interest rate regulation had begun in 1933 when the Federal Reserve Board implemented the first version of Regulation Q. The goal had been precisely to prevent the competitive shopping around for interest returns and to encourage depositors to place their funds in institutions selected on the basis of reputations for solvency and safety, not simply levels of offered interest.

Banking industry lobbyists, not surprisingly, wished to eliminate Regulation Q. In 1980, the Carter administration, ostensibly seeking to aid a troubled industry, eased interest rate restrictions by means of the Depository Institutions Deregulation and Monetary Control Act (known as the Diddymac). The new law abolished geographic restrictions on the investment activities of S&Ls, thereby bringing a national market within the purview of individual institutions that had operated locally for decades. It also provided for deposit insurance of up to $100,000 for every savings account in the system—tendered by the Federal Savings and Loan Insurance Corporation (FSLIC), a derivative of the FDIC. (The $100,000 insurance figure was never openly debated in the Senate or the House.) S&Ls were no longer tied to deposits generated in their immediate communities but could attract deposits from far away by offering through brokers the high rates of interest made possible by deregulation itself.

Geographic deregulation created a national market in unregulated savings deposits—as, for the first time, S&Ls were allowed to offer account and credit privileges and other banking services nationwide. FSLIC insurance simultaneously created a false sense of security within the S&L industry itself. The thrifts responded by investing in speculative commercial ventures in the hopes of shoring up their profitability. That profitability had been compromised for over a decade by the inability of savings institutions to raise interest rates (beyond the constraints set by Regulation Q) in order to attract depositors away from money market funds and other novel interest-bearing assets. Thrifts' net income, as a share of their total assets, had averaged only 0.5 percent throughout the late 1970s; it fell to 0.1 percent by 1980 and turned negative in 1981 and 1982.[5] Home mortgage business, the mainstay of the industry since the Great Depression, dropped off. Indeed, it became increasingly (and uncharacteristically) common for the S&Ls to provide full financing for a broad spectrum of investments with little or no down payment.

[5] The figures on thrifts' income are based on data generated by the Federal Home Loan Bank Board and the Office of Thrift Supervision. See Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* (New York, 1991), 19.

A further difficulty emerged in this "reform" environment. Thrifts found that the interest they earned on traditional mortgages provided insufficient funds to pay the higher interest they were now legally allowed to offer on newer financial instruments. Some institutions began to use up their own capital funds (or liquid reserves) to make good the difference. By 1982, fifty thrifts nationwide failed—a rate unprecedented since World War II. Congress, reflecting bipartisan concern for the S&L sector, responded with another revision of law. The Garn–St. Germain bill, signed into law by President Ronald Reagan in 1982, further loosened restrictions on the kinds of investments S&Ls could make.[6] The Federal Home Loan Bank Board (FHLBB), later the Office of Thrift Supervision (OTS), also participated in this deregulation strategy by reducing, virtually to zero, the minimum amount of capital that a bank was required to have on hand in order to undertake certain investments.

In the savings and loan industry, the deregulation of the seventies and eighties generated hasty, at times foolish, and even corrupt decision making. Operating in unrestricted and almost unknown territory, S&Ls became involved in questionable investment schemes, many of them unsecured, some very risky. Moreover, in the late eighties, as the real estate market softened in several regions (especially in the South and Southwest due to the continuing troubles of the oil and mining industries), thrifts found even their traditional avenues of investment encumbered. Thus began a series of savings and loan failures that had no equal since the 1930s.

Widespread bankruptcy in the thrift industry quickly became a major public concern. Unable to make good their obligations to depositors, S&Ls exhausted their deposit insurance and approached Congress for relief. But the FSLIC lacked sufficient funds to make good the mounting losses in the thrift industry. With little debate, Congress created a new federal agency in 1989 to deal with the problem. No serious contention over the merits of a "bailout" took place in Washington. As if haunted by the specter of the 1930s, each major political party was determined to beat the other to the punch by using public funds to protect private banking from losses. Added to this, of course, was the complicity of various senators and members of Congress in protecting certain bankers and their investors from ruin. Whether such links involved criminal conduct, as suggested in a flurry of publicity concerning the so-called Keating Five (Senators Alan Cranston of California, Dennis DeConcini of Arizona, John Glenn of Ohio, John McCain of Arizona, and Donald Riegle of Michigan), who, some allege, supported bailout efforts in exchange for campaign contributions and other emoluments, has never been thoroughly investigated.

Federal buyouts and reorganizations of bankrupt institutions (under the auspices of the new Resolution Trust Corporation, or RTC—which to this day runs newspaper advertisements for its operations with the slogans "Resolving the Crisis" and "Restoring the Confidence") began at the end of the 1980s and continue. The pres-

[6] The Garn–St. Germain bill was introduced in Congress late in 1981 and, in the words of Martin Mayer, "went through Congress like a dose of salts, with virtually no hearings in either Senate or House Banking committees." See Mayer, *Greatest-Ever Bank Robbery,* 61.

sures of the resolution process on the federal budget contribute to an unprecedented general fiscal crisis facing the American state. Small wonder then that the contemporary American banking crisis has called forth numerous articles and books—as well as accusations, prescriptions, and warnings.

We might usefully divide the volumes under review, which represent a good sampling of the best among the many publications on this topic, into those that stress structural determinants and causes of the crisis and those that focus on malfeasance and criminal behavior as proximate causes. Even so, this division should not be drawn too forcibly, since some works, such as Martin Mayer's admirable volume, *The Greatest-Ever Bank Robbery,* link structural assessments with an unstinting focus on felonious behavior.

James Ring Adams, in *The Big Fix* (a title that perhaps says it all), interprets the S&L crisis almost solely in conspiratorial terms. A free-lance business journalist who often writes for the *Wall Street Journal* and *Barron's,* Adams offers an exceedingly well written and impassioned argument that the crisis occurred because banks were "infiltrated by crooks and con artists." As a consequence, there emerged, in the financial sector of the American economy, "an epidemic of fraud, a coordinated wave of white-collar crime unlike anything in history. . . . a political betrayal of the public as heinous in its way as the crimes of Laval and Quisling."[7] Ironically, however, Adams offers other insights that undercut his "bad men" theory of banking history.

The Big Fix shows, perhaps despite the author's inclinations, that the "reform" of deposit insurance, raising the minimum coverage to $100,000, unleashed a torrent of hazardous and ill-considered investments by thrifts. The book quite rightly argues that the repeal of Regulation Q also set the stage for the destruction of the S&Ls. It goes so far as to claim that deregulation eliminated the kinds of financial practice essential to maintaining the integrity and solidity of the banking system. All this suggests an agenda for re-regulation and new policy reform—at least in principle. But this Adams does not wish to pursue. Instead his book provides copious detail on the criminal conduct of individuals—detail that is both luridly interesting and shocking. Yet it is information that leaves us lacking any coherent program for revision of the nation's disordered financial affairs.[8]

All this is in plain contrast with Lawrence J. White's sensible *The S&L Debacle.* This volume seeks to focus on the economic conditions of the 1980s and the peculiar incentives thrown up by deregulation and the policies of Reagan's first presidential term as explanations for the past decade's turmoil in the thrift industry. It emphasizes policy analysis as distinct from personalities and anecdotes.[9] Not surprisingly, therefore, White stresses the significance of such events as the repeal of Regulation Q and the increase in deposit insurance coverage mandated by the Diddymac.

[7] James Ring Adams, *The Big Fix: Inside the S&L Scandal: How an Unholy Alliance of Politics and Money Destroyed America's Banking System* (New York, 1991), vii–viii, esp. viii.

[8] James Ring Adams reserves particular scorn for Democratic congressman Fernand St. Germain of Rhode Island, then chair of the House Banking Committee, who led the move to raise deposit insurance minimums. Adams, *Big Fix,* for example, 17–19, 23–25, 269 ff.

[9] White, *S&L Debacle,* vii.

But White, a former member of the Federal Home Loan Bank Board and now a professor of economics at New York University's Leonard N. Stern Business School, has further impressions to offer regarding the S&L crisis. He finds fault with accounting conventions that track the past cost of investments rather than their current (not to mention future) market value. The problem is that the assets and liabilities of a thrift are usually measured in historical cost terms. Should market values fall, as they did in many real estate markets during the 1980s, outmoded accounting conventions fail to give bank managers (and regulators) accurate and useful information regarding a thrift's health. White believes this is the essential reason why the deposit insurance system was so quickly exhausted as thrifts failed in increasing numbers by the mid-eighties. Reformed accounting techniques would, much earlier on, have alerted the industry, the public, and the federal government that all was not well with the savings and loans—nor with the FSLIC.[10]

White also suspects that the very structure of deposit insurance has exacerbated an already bad situation. The current deposit insurance system is a flat-rate scheme. Premiums paid by participating banks are fixed without regard to the uncertainty of their investments and funds. Neither Congress nor banking regulators have ever attempted to reform the system by introducing risk-based premiums. White finds this most unfortunate. For a true *insurance* system to work, he argues, premiums must be indexed to levels of hazard. In the 1980s, as thrifts began to invest funds in increasingly risky and even questionable projects, deposit insurance premiums should have risen to compensate. They did not, and the insurance fund was quickly depleted as losses accrued. A federal bailout was then the politically expedient (if not fiscally sober) consequence. White's reasonable suggestions remind us of an argument made by one of this century's most eminent economists. "Speculators may do no harm as bubbles on a steady stream of enterprise," John Maynard Keynes wrote in 1935. "But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."[11]

Other aspects of "Reaganomics" helped gut the thrift industry, claims White. The Economic Recovery Tax Act of 1981, one of the first supply-side initiatives of the Reagan presidency, shortened real estate investment depreciation periods. This was done to lower tax liabilities for investors in real estate. The change greatly enhanced the profitability of real estate investment. Such increased yields further encouraged the high-risk and aggressive investment policies of many thrifts under the new regime. Deregulation and such new policies as the 1981 tax act combined to create a set of almost irresistible and dangerous incentives for the S&L industry.

James R. Barth, in his *The Great Savings and Loan Debacle,* and Martin Lowy, in his *High Rollers,* both take views similar to White's concerning the causes of the thrift crisis. Barth, a former chief economist with the Federal Home Loan Bank

[10] See, in particular, *ibid.*, 25–51.

[11] *Ibid.*, 205–65; John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York, 1964), 159.

Board and later with the Office of Thrift Supervision, focuses mainly on the problem of undercapitalization. In this regard, he lays blame at the feet of the FDIC, for that agency, in its revised regulations, allowed S&Ls to work with increasingly inadequate amounts of capital as they expanded their investment operations. Compounding this problem, and here his argument is much like White's, was the "moral hazard" embedded within the deposit insurance structure that allowed member banks and thrifts to pay fixed premiums independent of the extent of the gamble assumed in their commitments. But his main emphasis is on capitalization rules. With regard to the future functioning of the thrifts, Barth concludes that it "is owner-contributed equity capital, not activity and ownership restrictions, that ultimately [will protect] taxpayers."[12]

High Rollers, although badly written in places, offers fine summaries of the events leading up to the disaster of the eighties in the thrift industry. Lowy, an attorney, former bank officer, and S&L director, agrees with White and Barth in finding fault with the structure of the FDIC and the consequences of the pernicious Garn–St. Germain bill. He is at his best when he explains where all the money went. It accumulated in the hands of those who, thanks to the repeal of Regulation Q, had fixed-rate (below market) mortgages during the sixties and seventies and of those who took out preferred savings accounts (certificates of deposit) in the S&Ls during the same period. The distortions of the thrift industry also clearly benefited developers, their employees, and their retainers—construction workers and the suppliers of building materials, in particular—as they rushed to exploit the rapidly and, we now know, inappropriately expanding real estate markets of the past two and a half decades. Some monies went into the pockets of the speculators—some legitimate, others not. And a great deal of money evaporated in the collapse of the real estate markets (especially in the South and Southwest) during the late seventies and eighties. Overall, Lowy, like several of our other authors, stresses that market forces and policy errors, not corruption and ineptitude per se, destroyed the thrift industry.[13]

Perhaps the best of the books under review here is Martin Mayer's *The Greatest-Ever Bank Robbery.* An accomplished business journalist, Mayer succeeds in providing the reader both a comprehensive narrative of events and a compelling point of view. Although the title of the work and its opening lines suggest that Mayer views the thrift crisis as the work of criminals and con artists, he also interprets the debacle in structural terms. He makes clear, for example, that outright theft and fraud can account for only a fifth of the losses currently sustained in the thrift industry. And the entire volume continually refocuses our attention on the role of deregulation and policy revision.[14]

[12] James R. Barth, *The Great Savings and Loan Debacle* (Washington, 1991), esp. 37, 100 ff.

[13] Martin Lowy, *High Rollers: Inside the Savings and Loan Debacle* (New York, 1991), 4–5, 229–39. Lowy does powerfully condemn, however, the appointments of Ed Gray (a notorious incompetent) as chair and Lee H. Henkel, Jr. (ultimately forced out of government service due to suspected malfeasance), as member of the Federal Home Loan Bank Board by President Ronald Reagan in May 1983. See *Los Angeles Times,* Nov. 19, 1992, pp. D1, D4.

[14] For Mayer's attitude toward fraud, and his estimate of fraud accounting for 20% of all losses, see Mayer, *Greatest-Ever Bank Robbery,* 1, 53.

Deposit insurance, for Mayer, is a crucial part of the story of the S&L crisis. Insurance rated independently of risk became, in Mayer's words, the "crack cocaine of American finance" during the seventies. At best, it attracted incompetents and, at worst, shady characters into an industry known for its judiciousness and honesty, and it stimulated not only poor decision making but also the implementation of veritable Ponzi schemes in what had been, almost literally, mom-and-pop financial operations. Combined with the relaxation of the minimums required for capitalization, these regulations made a thrift collapse inevitable. Mayer is particularly upset that the capitalization requirements were eased—for this resulted in a severe form of moral hazard where S&L owners could play fast and furious with money that was not their own.[15]

Mayer also criticizes the 1980 Diddymac for the deformations it created in the thrift sector. Mayer reminds us that this law, an initiative of the Carter administration, demonstrates that both the Democratic and the Republican parties must share the blame for the policy errors of recent decades. Put in its most abstract terms, Mayer believes that the bipartisan failures of the past three presidential administrations had to do with their inability to recognize that "if deregulation [was] to work, there [had to] be increased supervision" of actual banking conduct and behavior.[16]

In the final analysis, Mayer's volume is most useful because it gives the lie to the claim that deregulation and decontrol of economic and financial activities can generate optimal welfare results. The efforts to eliminate governmental supervision and control of economic life, under five successive presidential administrations of both major parties, have generated only modest positive results, and in many cases, such as that of the S&Ls, they have caused great hardship, dislocation, and waste. Indeed, as Mayer reminds us toward the end of his book, financial deregulation has weakened American banks in the world market—and not simply with respect to investment in real estate and construction. The contemporary American banking crisis also has powerful implications for the position of the American economy in the global marketplace. For all these reasons, one "hopes historians will give more than a footnote to the S&L disaster of the 1980s, for it is a story rich with evocation of what went wrong . . . as the sun began sinking on the American Century."[17]

The chaos and bad consequences of financial deregulation, economic instability during the seventies and eighties, and unfortunate policy revision seriously distorted not only domestic but also international banking. In this regard, Karin Lissakers's well-written and useful *Banks, Borrowers, and the Establishment* offers readers a fine introduction to the global dimensions of the contemporary banking problem. Formerly an official in the Policy and Planning Staff of the Department of State and a staff member of the Subcommittee on Multinational Corporations of the Senate Foreign Relations Committee, Lissakers brings an informed and engaged perspective to problems of international finance.

[15] *Ibid.*, esp. 20, 291–92.
[16] *Ibid.*, 144.
[17] *Ibid.*, 314, esp. 323.

Much like the binge in domestic real estate lending that .characterized the deregulated thrift industry beginning in the 1970s, a virtual orgy of international lending by private American banks to various nation-states emerged at the same time. By the mid-seventies, many American banks were besotted with deposits from the Organization of Petroleum Exporting Countries (OPEC)—the accumulations generated by the explosion in oil prices dating from the 1973 Yom Kippur War in the Middle East. Flush with such deposits (known colloquially as "petrodollars"), such banks increasingly looked toward overseas investment outlets given the recession in American economic activity that began in the late 1970s. A Federal Reserve Board survey showed, for example, that in 1975 the twenty-one largest banks in the United States held $14.5 billion on deposit from OPEC members in North Africa and the Middle East and $3.7 billion from other OPEC nations. Of this $18.2 billion, some $12.35 billion were loaned to Latin American nations. Indeed, OPEC deposits during the seventies, in banks in the major industrialized states, were sufficient "to finance all the net lending [by these banks] . . . to borrowers outside their own area."[18]

Ironically, the flow of petrodollars was perverse; it initially siphoned funds from OPEC nations to those least in need of capital inflows, namely developed nations like the United States. The central banks of the OPEC states found American financial assets (not to mention the dollar itself) much more appealing as a store of value than those of other, poorer nations, which were viewed as risky and insecure. This served to break the typical link between nations with current account surpluses, such as the OPEC members, and nations in deficit, such as the so-called less developed countries (LDCs). American banks thus embarked on a rush to "recycle" the petrodollars with which they had become engrossed, often skipping traditional steps to assess the credit-worthiness of potential borrowers. Risk management thus suffered—much as in the deregulated thrift industry. "The willingness of the market to lend," writes Lissakers, "not the borrower's ability to pay, became the accepted measure of credit-worthiness."[19]

The result of this strange financial ballet was predictable. Loaned resources were often squandered. The projects in which they were invested met unfortunate or simply unlucky ends. In some cases, as in Argentina and Brazil, petrodollars were used predominantly to purchase weapons and other military hardware. By 1979 Brazil's foreign debt, for example, was growing 23 percent per year. In Mexico, the ruling Partido Revolucionario Institucional poured borrowed funds into programs to benefit its constituency (this predominantly under President Luis Echeverría's government) or into social programs (this under Echeverría's successor José López Portillo) on the promise of future oil revenues. When world oil prices softened, the strategy came to naught. In many Latin American nations, foreign savings began

[18] Karin Lissakers, *Banks, Borrowers, and the Establishment: A Revisionist Account of the International Debt Crisis* (New York, 1991), esp. 22, 27.
[19] *Ibid.*, 7–8, esp. 12, 37.

to substitute for falling domestic reserves — the ratio of domestic investment to gross domestic product consequently fell.[20]

By 1980, another increase in world oil prices, a worldwide recession, and higher interest rates in the United States (pursued by the Carter government, under the aegis of Paul Volcker, chair of the Federal Reserve Board) — all conspired to initiate a flight of capital from the LDCs to "safer havens" (that offered higher returns) such as the United States. Some economic analysts and observers have wondered if the high interest rate policies pursued during the Carter and Reagan years did not, therefore, have an ulterior motive. Although publicly declared a necessary anti-inflation measure (as high interest rates tend to lower investment, expansion, and growth), if the policy is viewed within an international financial context, it emerges as one of protecting the profit margins of American banks — many of whom had overextended themselves in international lending at excessive risk. Indebted nations had to borrow yet more money simply to make the interest payments on their outstanding debts. Shortly after Ronald Reagan took office for the first time, Brazil and Mexico owed foreign banks $70 billion each; Argentina and Venezuela $30 billion each; Chile and the Philippines $10 billion each; Nigeria $7 billion; and Poland $14 billion. In total, the LDCs and several East European countries together owed half a trillion dollars.[21]

Lissakers provides other vivid examples of how domestic American economic and fiscal policy has dramatically affected other nations and the general network of international finance. Prior to 1986, the United States tax code allowed withholding taxes assessed in borrowing countries to be credited against source banks' income taxes in countries in which banks managed their operations (or, in particular, "booked a loan"). In other words, when a United States bank made a loan abroad, the foreign country's withholding tax on the interest paid on the loan (to be assessed before that interest income was repatriated to the United States) could be used as a tax credit for the bank back in the States. This tax policy only made the dangerous pattern of foreign lending in which American banks indulged more attractive.[22]

Another example of how United States policy made things worse was a 1984 revision of the tax code that eliminated the automatic withholding of taxes owed to the United States government on interest payments to foreigners. The idea was to make the United States an even more attractive venue for international investment by increasing short-term yields. For the Reagan government, this was especially desirable given the need to attract foreign funds to finance the nation's burgeoning debt. This policy hamstrung other national governments, which were then further deprived of their own domestic sources of finance. The sheer avarice represented by the policy prompted the renowned international economist Rudiger Dornbusch of the Massachusetts Institute of Technology to declare in 1987 that the Reagan government "in an effort to fund our own deficits at low cost . . . has promoted tax fraud on an unprecedented scale."[23]

[20] *Ibid.*, 49–51, 65, 77–78.
[21] *Ibid.*, 84.
[22] *Ibid.*, 118–19.
[23] *Ibid.*, 153.

Not surprisingly, an international debt crisis (paralleling the collapse of thrifts within the United States) emerged in the mid- to late 1980s. Pressed to the wall, borrowing nations ultimately had to consider the outright repudiation of their debts. For many, the alternative was economic chaos, political instability, and social disorder. Some major United States banks, for example Citibank, began to increase their liquid reserves as early as 1987 in order to prepare for possible repudiation. This got the attention of Washington, as such action by American banks might itself become a stimulus for foreign repudiation. By 1988, massive rescheduling of debt payments began. All this set the stage for the 1989 Brady Plan.[24]

Building upon the initiative of James Baker, his predecessor as United States secretary of the treasury (who in a 1985 meeting of the International Monetary Fund at Seoul, South Korea, proposed aid for borrowing nations premised on their efforts to privatize state enterprises and eliminate trade protection and subsidies), Nicholas Brady advanced a new international lending proposal in 1989. Banks would undertake debt relief and even debt forgiveness at a measured pace, as the United States government supported banks' efforts to convert remaining debt into marketable assets (such as bonds) for trading in the international market. As some loans carried restrictions that prevented banks from selling them without the debtors' approval, banks offered liberalized terms to debtors in return for the chance either to purge themselves of poorly performing loans or to sell high-quality loans at a profit. Moreover, Washington would provide either guarantees for the remaining (reduced) debt or negotiate collateral of some sort.

Although the Brady Plan, now implemented with a variety of borrowing nations, has seemingly dealt with the worst stages of the international debt crisis, major problems remain. In particular, the debt rescheduling that the Brady Plan has inspired worldwide has drastically raised the total interest charges that borrowers will ultimately pay. Coupled with astounding reductions in the real incomes of peoples throughout the Third World, the debt burden may yet be as awesome and brutal as ever. As Luiz Carlos Bresser Pereira, Brazil's former economics minister, recently put it, "there [have been] two debt crises, one for the debtors and one for the creditors, and only the latter has been solved."[25]

The foreign debt crisis has had a profound impact on the domestic banking industry. Many major United States banks, who had grown addicted to the international lending spree of the seventies and eighties, now find themselves "institutions in search of a mission." It is perhaps not coincidental that in 1986 the Morgan Guaranty International Bank's Miami office had a crowded room of foreign lending executives and traders, while the room previously used for domestic corporate lending stood empty. It is not surprising that foreign banks now account for close to half of the *domestic* corporate lending in the United States. In general, American banks either are out of touch with the domestic market or (because of a relatively fragile position relative to foreign competitors) are able to offer domestic corporate loans

[24] *Ibid.*, 212 ff.

[25] *Ibid.*, 228–29, 241 ff.; Luiz Carlos Bresser Pereira quoted by Alexander Cockburn, *Los Angeles Times*, Aug. 17, 1992, p. B7. Borrower nations and the United States media generally have tended to be enthusiastic about the consequences of the Brady Plan. See, for example, *ibid.*, June 2, 1992, pp. D2, D4; *ibid.*, July 10, 1992, p. D2.

only at rates substantially higher than those of foreign banks. American banks not infrequently ask for interest payments some three to five points higher than their foreign competitors.[26] For a nation now facing the prospect of substantial debt reduction itself, as well as major infrastructural and social spending commitments, the relative dormancy of the American domestic financial sector is problematic and disturbing.

The domestic banking crisis remains unresolved and festering. Even the RTC has generated potentially counterproductive results. As the corporation sells off the assets of bankrupt thrifts, it recoups, on average, about fifty-five cents for every dollar in book value. A weak real estate market continues to be the main culprit. But these properties are now being acquired, at fire-sale rates, by a handful of large banks and investment companies that, in essence, privilege themselves at the public's expense. BankAmerica Corporation of San Francisco, for example, has purchased nearly 20 percent of all the consumer deposits held by the RTC. The concentration of assets within the financial sectors that such data demonstrate contributes to a general perception that the thrift crisis, even in its resolution, has been a recipe for unwarranted aggrandizement and empowerment.[27]

The ultimate lessons of the contemporary banking crisis have yet to be learned—and even if understood, what impact they will have upon public policy formulation and implementation is unclear. Deregulation, at least in the financial sector, appears to have failed its proponents. Undertaken at the behest of an energetic and vocal academic and civil service constituency, it has created, in several cases, far more costs than benefits. Regulatory reform, as conceived of by the Nixon, Ford, Carter, Reagan, and Bush administrations, responded far less to the lobbying of public-interest groups than to the efforts of cadres of new entrepreneurs (such as the Carl Icahns and, yes, the Charles Keatings and Michael Milkens of the world) and academic practitioners (such as Alfred Kahn, the Cornell University economist who was one of the original architects of airline deregulation) to gain access to particular economic markets and to enjoy and exploit new levels of statist influence and visibility. There were no mass demonstrations on Pennsylvania Avenue to deregulate the airlines or the thrifts or the telecommunications industry.

A thorough resolution of the national and international financial crisis is still in the making. In sheer magnitude, the fiscal demands that the S&L bailout will impose on the national budget make it unlikely that complete financial reform can be achieved without further tax burdens being imposed on the general public. The cause of this public mismanagement, according to our authors, has been the cupidity of some combined with the ignorance, shortsightedness, and political connivance of many elected and appointed officials. Linked with all this has been the baleful influence of academic economists and other policy analysts who encouraged financial deregulation without proper anticipation and assessment of its consequences.

[26] Lissakers, *Banks, Borrowers, and the Establishment,* 140, esp. 254; *Los Angeles Times,* June 16, 1992, p. D3.
[27] *Los Angeles Times,* Sept. 9, 1992, p. D3; *ibid.,* Oct. 30, 1992, p. D2.