“The banking and other economic factors of selected U.S. historical events: from the establishment of the Federal Reserve Banking System to the Great Recession”

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Paul Gentle (China)

The banking and other economic factors of selected U.S. historical events: from the establishment of the Federal Reserve Banking System to the Great Recession

Abstract

Knowledge in the economic and banking history of the United States, of the last one hundred years or thereabouts, is necessary in any discussions of even current economic and political policies. This article looks at major economic events in the last century, with some attention also given to surrounding political forces of these events. In 1933, President Franklin Roosevelt, with strong bipartisan support in Congress, was able to pass the Glass-Stegall Act, after taking office in the Great Depression. Politicians in the United States during the approximately twenty-five years prior to the bursting of the housing bubble in 2007 have both used legislation to remove regulations and also made sure that inadequate government personnel were available to audit financial institutions. An important part of confidence is a faith in government regulatory agencies that monitor financial institutions. Lax monetary and regulatory policies can create a real estate bubble. This happened in the most recent economic disaster, the Great Recession. Sometimes the Federal Reserve has pursued reasonable monetary policy and other times inappropriate decreases or increases in the money supply have created havoc in the national economy.

Keywords: banking, Federal Reserve Bank System, financial crisis, Great Depression, Great Recession, Taylor rule for central banks.

JEL Classification: G21, E5, G01, N11, N12.

Introduction

The macroeconomy is influenced by the federal government in three ways. This is through the fiscal policy of spending and taxing. The second way is through monetary policy. And the third is via the regulation of banks and other financial institutions. The way that banks and other financial institutions are regulated has an influence on the outcome of any monetary policy. Often the regulations can have the effect of increasing or decreasing the actual credit that financial institutions extend and the ability of financial institutions to meet their obligations. The United States has gone through a profound economic history of imposing regulations on financial institutions and financial markets and removing some of those regulations, especially in a period from the 1980s through part of the first decade of the 21st century. An attempt to replace some of those discarded regulations has taken place since the worst part of the Great Recession. The article’s first section will explain the most significant political-economic events from the founding of the Fed to the 1950s aftermath of World War II. The second section examines the time of the 1960s through the present. Also this section, starting with the last paragraph of page 23 (left column), states that macroeconomic theory has changed due to the many different events during the time span covered in this paper. Finally, a summary and conclusion will complete this article. Covering a span of over one hundred years of American economic and banking history will enable the reader to have a good foundation in regard to the major economic and political events of contemporary American history.

1. The founding of the Fed, World War I, the new Deal, the Glass-Steagall Act for banks and other financial institutions, World War II, Korean War, and moderate recessions of 1950s

There are two major pieces of banking legislation which became law in the first decades of the twentieth century that have a special significance. One is the Federal Reserve Act of 1913, and the other is the Glass-Steagall Act of 1933, which passed in the early part of the first term of President Franklin Roosevelt. President Woodrow Wilson signed the Federal Reserve Act on December 23, 1913 and on November 16, 1914, the Federal Reserve (also known as the Fed) opened for business (Bordo et al., 2016). The founding of the Fed probably came about due to the Panic of 1907, which led to the 1908 Aldrich-Vreeland Act, which created the National Monetary Commission. This commission was a group of legislators, academics, and bankers and their published 1910 report discussed in detail both the positive and negative features of the financial systems in both the United States and foreign countries. The commission issued a report that provided a “major impetus” to the founding of the Fed (Mankiw et al., 1987). On the front page of The New York Times on November 16, 1914, McAdoo, President Wilson’s U.S. Treasury Secretary prophesized that the founding of the Federal Reserve would help the agricultural economy, which at times lacks the necessary capital to finish the harvesting of crops and marketing distribution cycle. It was prophesized that the financial sector and the general
economy would be improved. McAdoo also pointed out that the banking sector would be more secure, and, thus, the general economy would benefit (Mankiw et al., 1987). President Woodrow Wilson was a strong proponent of passage of the Federal Reserve Act. In the Congressional House and Senate, the Act tended to have broader support by Democrats compared to the Republicans. This is similar to the call for an expanded money supply by Democrats and tighter monetary policy by Republicans, during some of the previous twenty years before the founding of the Fed (Johnson, 2010).

In examining Figure 1, one can see that the debt to GDP ratio was at its maximum during World War II. Yet recent years show a ratio that is second in height. One reason the debt to GDP ratio is important, since it concerns the crowding out effect upon the private sector. According to the Monetarists, there is complete crowding out. Yet the New Keynesians believe in only partial crowding out (Mishkin, 2006).

In examining some countries, Rostow (1959) determines that Great Britain attained a certain “maturity” level, in regard to technological advancement, by 1850, with a comparable level in the United States in 1900, both Germany and France in 1910, Japan in 1940, both Russia and Canada in 1950 and Sweden in 1930. These dates are “rough” and “symbolic”. Rostow thinks these dates are important in understanding such historical events such as World War I, which lasted from summer 1914 to fall 1918. During the war, American farmers produced food for their own country and much of the food for the allies in Europe. Carlos Lozada (2016) states that when World War I began, the U.S. economy was in a recession. However, a forty-four month economic boom ensued from 1914 to 1918. The first part was manifested as Europeans began purchasing United States goods for the war and later as the USA itself joined the battle. The unemployment rate decreased to below two percent in 1918. The USA came out in support of the British and French allies earlier by supplying armaments (Gordon, 2009; Lozada, 2016). The cost of the war to the United States is included in Table 1.

Table 1. Cost of wars from World War I to present, using constant fiscal year 2011 dollars

<table>
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<tr>
<th>Wars</th>
<th>Cost</th>
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<td>World War I</td>
<td>$334 billion</td>
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<tr>
<td>World War II</td>
<td>$4.104 trillion</td>
</tr>
<tr>
<td>Korean War</td>
<td>$341 billion</td>
</tr>
<tr>
<td>Vietnam War</td>
<td>$738 billion</td>
</tr>
<tr>
<td>Persian Gulf War</td>
<td>$102 billion</td>
</tr>
<tr>
<td>Total Post-911, including 2nd Iraq invasion/AfghanistanOther through FY 2011 (unfortunately, since 2011 and in the foreseeable future, this conflict continues)</td>
<td>$1.147 trillion</td>
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Note: The fiscal year 2011 federal budget was implemented in October, 2010 through September, 2011. This is the typical time pattern for each fiscal year budget.

However, the agricultural sector may have been hit the hardest, since some European nations were no longer demanding as many American agricultural products, as they had during World War I. Though, economic prospects improved, notably by 1922, when an economic boom began. (Post-World War I Recession, 2016). In Figure 2, we can see how percentage GDP was affected by the downturn and recovery periods of both the Great Depression and Great Recession. We can see that the low point of the Great Depression was lower than the low point of the Great Recession. The years following the Great Depression were more uneven compared to the years following the Great Recession.
It is important to note the downturn in GDP around 1937 and the cause of the downturn will be examined on page 17, left column, last paragraph. What happened in 1937 will be explained later. During the 1920s, there was a “substantial retail appetite for real estate securities” (Goetzmann et al., 2010). This large buying of real estate securities, due to some people being overly optimistic, resulted in a boom and bust situation in construction (Goetzmann et al., 2010). The resulting precipitous drop in the price, perissuance of more real estate securities. This phenomena may have helped other asset prices to decrease and the result was the stock market crash of 1929 (Goetzmann et al., 2010; Brocker and Hanes, 2013). Both Bernstein (1984, 2001) and John Kenneth Galbraith (1972) note that the American economy was weakening before the stock market crash of October 24, 1929 and that the crash was a symptom of rather than the cause of the Great Depression. Friedman and Schwartz (1963a, 1963b) state that the worse part of the Great Depression may be referred to as the “Great Contraction”. This great Contraction period was from 1929 through 1933. During that period, there was a large reduction in the money supply. The presence of the gold standard in the USA was one of the factors that contributed to deflation, until it was lifted in 1933 (Eichengreen et al., 1985, 1992, 2016; Bernanke et al., 1991). Fisher (1933) points out the deflation makes existing debts greater in real terms. Mishkin (2006) and Blanchard et al (2013) express that during the time there was deflation in the Great Depression, real interest rates were very high. The real rate of interest is very significant to consumption and especially investment levels of economic activity (Chen et al., 2011; Gentle et al., 2005, 2013). The highest point of unemployment in United States history was experienced in 1933, at 25.2% (Gordon, 2009). Bernanke (2010) points out that the Fed since the Great Contraction has most often taken actions to be sure the economy does not fall into a deflationary period. Figures 3 and 4 illustrate the inflation rates and unemployment rates. Note the deflation during part of the late 1920s and the first few years of the 1930s. More recently, we can see that there was deflation in part of 2009, during one of the down times of 2009.
Though by no means automatic, there can be a short term trade-off between the inflation rate and unemployment rate. This temporary relationship is far less apparent in the long run, as economic agents adjust their expectations for any changes in inflation. Also deflationary periods are often characterized by increased unemployment rates (Gentle et al., 2005, 2013). Both Figures 3 and 4 hint at this phenomenon. Franklin Roosevelt took office in March, 1933, before the 20th amendment changed the time of a new presidential term from March 20 to January 20. Two important pieces of legislation became Acts in 1933. The Glass-Steagall Act of 1933 (sponsored by U.S. Senator Carter Glass and U.S. House Representative Henry Steagall) prohibited banks from underwriting or dealing with corporate securities. With this act in force, only investment banks could engage in such activities. Also passed that same year was the FDIC Act of 1933, which insured deposits, increased public confidence in those financial institutions covered by FDIC (Mishkin, 2006). President Franklin Roosevelt signed the Glass-Steagall Act of 1933 and the FDIC Act of 1933, after the legislation received bipartisan support in the House and Senate. Rickards (2012) maintains that this act was greatly effective in limiting bank failures and severe business cycles between the Great Depression and the Great Recession. In 1999, the Glass-Stegall Act was repealed, one causal factor in more bank failures and the Great Recession, bigger than any economic downturn since the Great Depression. The National Recovery Administration led to prices and wages being more inflexible and “sticky”; the program lasted only two years, 1933 – 1935 (Bordo et al., 2000). United States tariffs were raised and this led to retaliatory tariffs, impeding international trade and lowering USA GDP (Gordon, 2009). Cunfer (2010) describes the increased federal government involvement in agricultural, with such programs as price parities on some commodities and efforts to turn over-cultivated land, such as the “dust bowl”, back into grassland (Robertson et al., 1979; Cunfer, 2010; Agricultural Adjustment Act, 2016). In 1936, there was a faulty fear of impending inflation, used as a reason to cut back fiscal and monetary stimulus. An economic downturn was the result in 1937 (Velde, 2009) Figures 5 and 6 portray the money supply and the velocity of that. Both the money supply (M2) and velocity (V2) dropped during part of the Great Depression. Since the Equation of Exchange states that $MV = PQ$, the decreases in M and V had an effect on GDP (Quantity, 2015; Gordon, 2009).

In Figure 6, we have a graph of velocity over time. In Figure 7, we have the corresponding levels of risk during the same time periods. Also there is an interaction between velocity and risk. The greatest point of risk premia in the Great Depression was in 1932 and this velocity was lessened at that time. During periods of economic crises, when there is higher economic risk, velocity falls. Risk we associate with uncertainty and uncertainty lessens business and consumer confidence. Furthermore, economic activity is lessened with any lowering of business or consumer confidence. Periods of great economic activity, such as a period of growth or a significant war, are accompanied by an increase in velocity. The Dodd-Frank Act was created to bring back some regulation of financial institutions, which was lost with the repeal of much of the Glass-Steagall Act. Due to Dodd-Frank, some assets of the shadow banking world shifted in amounts to money or M2. So there was some reduction, for some time length, of velocity because of this Dodd-Frank Act (Mishkin, 2006; Anderson et al., 2015). Throughout the Great Depression, there was a gradual recovery in consumer oriented industries and only a strong recovery in capital intensive industries, once World War II got underway. During 1939, unemployment was at 17.2% and in 1940 it was 14.6% (Gordon, 2009).
We can also see that in the beginning of the 21st century, the Dodd-Frank Act effects, which did not tighten up the shadow banking system, but concentrated more on the traditional banking sector. Thus, the velocity of M2 decreased some. Shadow banking refers to the creation of credit by national and global non-bank financial intermediaries. Dodd-Frank is distinguished by comparatively little regulation. If the Glass-Steagull Act were ever re-adopted, shadow banking would be much more regulated than it has been since the demise of the Glass-Steagull Act (Zaidi, 2016; Investopedia, 2016). More about the Great Recession and its aftermath will be covered in section 2 of this article. Bernstein (1984) states that World War II brought a lessening in the unemployment rate, as the United States manufactured armaments for her allies and even more so during the time the USA officially declared war. Gordon (2009) provides these figures: 1941: 9.9%; 1942: 4.7%; 1943: 1.9%; 1944: 1.2% and 1945: 1.9%. During the time the USA was in World War II, the unemployment rate was clearly below the natural rate of unemployment, stringent price controls had some effect on keeping the inflation from rising as much as it would have without such controls.
With the end of World War II in 1945, the removal of price controls allowed prices to rise. U.S. Treasury bondholders took a loss (Gordon, 2009). After the Korean War ended in 1953, a peace time adjustment incorporated the Fed’s plan to rein in inflation through the raising of interest rates, a process known as disinflation. This was a factor in a recession that lasted in parts of 1953 and 1954 (Holmans, 1958; Robertson et al., 1979; Labonte et al., 2002). See Table 1 for cost of Korean War. Both the U.K. and the United States experienced a short recession during part of 1957 and 1958. The counter U.S. response to this was an expansionary monetary policy (U.S. President, 1959).

2. 1960s, stagflation, recessions in 1980 and 1982, deregulation, repeal of the Glass-Steagall Act for banks and other financial institutions, Great Recession, partial reform

There was a strong reliance on fiscal policies, with differing tax and spending policies, during the Kennedy and Johnson presidential administrations, which ran from January, 1961 to January, 1969 (Finkelstein, 1992). The United States had moderate inflation in the period from the end of World War II and through most of the 1960s. The Bretton Woods agreement was in effect from 1945 until 1971 (Mishkin, 2006). In 1971, the United States was taken off the gold standard, which had been set up in the Bretton Woods agreement (Mishkin, 2006). White (2008) maintains that the Fed’s monetary expansions in the 1960s were too much to pair up with the gold standard. Also he believes that it was the Fed, not the gold standard that caused the problem. White (2008) maintains that the 1971 decision has sometimes contributed to inflation. Sometimes, in the 1970s, OPEC greatly raised oil prices, with resulting supply shocks to the economy. This resulted in increased unemployment during those times. In the 1970s, in order to lessen the impact of the supply shocks, the Fed increased the money supply. However, this resulted in a situation of both high unemployment and high inflation, known as stagflation (Knoopy, 2004). (The Vietnam War ended in 1975. See Table 1 for cost.) The approach to counter inflation in the United States in this time period can be thought of in terms of two stages. In 1979, when Paul Volker became the Chair of the Fed, he pursued a disinflation policy that had the unpleasant effect of creating a recession in 1980. The Fed lowered interest rates some and the inflation returned. Then, Volker showed his credibility as an inflation fighter and stayed the course through a tough recession in 1981 and 1982. Then, inflation had dropped enough to allow for an easier monetary policy in 1983 (Gordon, 2009). An absence of volatility in the economy, in terms of predictable inflation rates and moderate unemployment occurred during part of the 1980s, but some ignorant choices made in chipping away at financial institution regulation had already begun to take its toll. Paul Volker had been appointed Federal Reserve Board Chair by President James Carter in 1979 with Senate approval. Volker was successful in lowering inflation. He was also successful in keeping financial institutions and market properly regulated (Dell, 1996; Carlin and Soskice, 2006; Gordon, 2009; Stiglitz, 2009, 2010). President Ronald Reagan did re-appoint Paul Volker in 1983 with Senate approval. Yet when Volker’s first term was up, Reagan chose a different path. According to Stiglitz (2008, 2009, 2010), Volker was not re-appointed in 1987, since the Reagan Administration wanted to de-regulate financial markets and institutions. However, President Ronald Reagan and his staff thus, chose Alan Greenspan with Senate approval (Andrews, 2008; Stiglitz, 2008). Furthermore, Greenspan was re-appointed by Republican Presidents George H.W. Bush and George W. Bush, as well as Democratic President William J. Clinton. Each time, he was also confirmed by the U.S. Senate (Mishkin, 2006; Andrews, 2008). Horvitz (1995) maintains that financial systems are not inherently stable. Politicians often make policies that are in the interest of private financial institutions (Krozner et al., 1999). Also, there are problems that keep the regulatory agencies in the United States from being allowed to do their job in the interest of the voter-taxpayers. For example, the Savings and Loan (S&L) problem clearly indicates that government regulators have sometimes lessened capital requirements and restrictions on risky asset holdings and pursued holdings and pursued regulatory forbearance. An important motivation for regulators that explains this occurrence is the desire of regulators to escape blame for poor performance by their agency (Niskanen, 1971; Mishkin, 2006). Starbuck et al. (1996) point out that the change in interest polices that took place in the 1980s and enticed S&Ls to take riskier chances with their capital. For one can see that loosening capital requirements and pursuing regulatory forbearance, regulators can conceal the problem of insolvent financial institutions and hope that these situations will improve. Mishkin (2006) states that Edward Kane describes such behavior on the part of regulators as “bureaucratic gambling”. Furthermore, regulation officials often bow to the pressures of those who have a great deal influence over their careers. These are the politicians, who are greatly influenced by lobbyists with campaign donations. “Members of Congress have often lobbied regulators to ease up on a particular S&L, that contributed large sums to their campaigns. Regulatory agencies that have little independence from the political process are more vulnerable to the pressures”. The great cost of running political campaigns in the United States the contributors to such campaigns great access to elected officials, who, then, direct regulatory agents to act in the campaign donor’s interests, rather than the taxpayer-voters (Mishkin, 2006). Moreover, the President and Congress approved banking legislation in 1980 and 1982.
that made it easier for savings and loans to engage in risk-taking activities. Once this legislation passed, the need for monitoring the Savings and Loan (S&L) industry increased because of the expansion of permissible activities (Mishkin, 2006). Although more regulatory agency auditing was necessary due to allowing S&Ls to get into more activities, Congress had been successfully lobbied by the S&L industry. Thus, Congress refused to approve adequate funding for effective auditing (Mishkin, 2006).

See Table 1 for the costs of the Persian Gulf War and post September 11, 2001 military activities spent and budgeted through fiscal year 2011. After a mild, brief recession from the last part of 1990 and through the first part of 1991, the U.S. economy experienced a good economic environment, until the early 2000, when the economy experienced a recession, due to the dot.com boom ending (Gordon, 2009). An economic phenomena occurred towards the end of the millennium and into a brief part of the beginning of the next century. Gordon (2009) is an expert about the so called “New Economy,” and why it could not last. A low inflation rate, coupled with a low unemployment rate, affected the Fed policy of keeping interest rates low. Matters of economic expansion also accelerated in 1995. Computers were coming and more a necessity for both businesses and for home use by consumers. The result was that the prices for computers and related equipment, such as fiber optics, increased due to the increase in demand. Yet this could not last and the ending of the dot.com boom brought a decline in some of the stock prices. There had been too much investment in computers, related equipment, telecommunications, which, in turn, affects apartment and commercial building construction (Gordon, 2009; Bernanke, 2010). Between March and November, 2001, a recession occurred due to these factors: the ending of the dot.com boom, the attacks on the United States on September 11, 2001, the corporate scandals, such as those with Enron and the invasion of Iraq (Graham et al., 2002; Bernanke, 2010). In response, the Fed pursued an expansionary policy that was beyond that recommended by the Taylor Rule (Bernanke, 2010). Here is John Taylor’s (2013) expression of his rule: 
\[ r = p + .5y + .5(p - 2) + 2, \]
where \( r \) is the federal funds rate; \( p \) is the rate of inflation over the previous four quarters; and \( y \) is the percent deviation of real GDP from a target. At one time, the ability to convert money to gold functioned as a rule for monetary policy. However, since economies tend to function with fiat money, they can consider the Taylor Rule. “The Taylor rule synthesized (and provided a compromise between) competing schools of thought in a language devoid of rhetorical passion” (Koenig et al., 2012). By design, the Taylor Rule establishes a compromise solution for monetary policy between y-hawks (output hawks) and p-hawks (price hawks). The Taylor rule is meant to be a formative guide to monetary policy. Furthermore, the prescribed policy in reality describes the conduct of U.S. monetary policy during a period of macroeconomic stability. This trait helped to influence the embrace of the Taylor Rule by policy makers (Koenig et al., 2012). According to Bernanke (2010), a key indicator of monetary policy is the overnight federal funds rate, managed by the Fed, through the Federal Open Market Committee (FOMC). The federal funds rate has an influence over the total economy. Due to the 2001 recession, the federal funds rate was lowered from 6.5 percent in late 2000 to 1.75 percent in December of 2001 and, then, even lower, to 1 percent in June of 2003, where it remained for a year. In June of 2004, the FOMC started to raise the target rate, where it peaked at 5.25 percent in June of 2006 before pausing (Bernanke, 2010). With the recession that the United States has gone into in 2007, the interest rate has been cut again. The Federal Reserve wishes to keep inflation and GDP at reasonable levels (Bernanke, 2010). Both Gordon (2009) and Bernanke (2010) evaluate the cut in the federal funds rate using the Taylor rule. What this rule calls for is to guide a central to “move the real short-term interest rate away from its desired long-term value in response to any deviation of actual inflation from desired inflation and in response to any deviation of real GDP from natural real GDP” (Gordon, 2009).

If using the Taylor Rule as a guidepost for monetary policy, both Gordon (2009) and Bernanke (2010) state that the Fed allowed the federal fund’s rate to be too low during a portion of the first half of the first decade of the 21st century. The combination of lax financial sector regulations and too lax monetary policy led to the Great Recession.

There may have been some efficiency in letting some competition between banks, between states, in some cases (Strioh and Strahan, 2003). Yet that does not mean the wholesale, total de-regulation that took place of financial institutions, whereby conflicts of interest occurred, was a good idea (Stiglitz, 2009, 2010). For example, standard type banks that do standard consumer and small business type banking have been allowed into risky investment banking. Such activity was clearly made illegal by the Glass-Steagall Act. After being chipped away at little by little, the Glass-Steagull Act was repealed in 1999 (Stiglitz, 2009, 2010; Gramm, 2016). Well before the housing bubble burst, with its attendant economic ill effects, articles and books had already been written, which stated that the massive financial deregulation was a case do the United States heading in the wrong direction (Batra, 2005; Hatcher, 2006). Keynes (1936) was a person who believed in the basics of the free enterprise system and thought some government regulation was necessary to preserve that to regulate potential problems in pure capitalism.
In Figure 8, one can see three time periods when the amount of bank financial institutions had a large amount of failures. These times were the during part of the 1930s (in Great Depression), part of the 1980s and early 1990s and again during the Great Recession. The innovative Glass-Steagall Act curtailed bank failures. In the 1980s and 1990s, the financial institution regulations where reduced some; however, the big push for even more deregulation came with the Gramm-Leach-Bliley Act (Sponsored by U.S. Senator Phil Gramm and U.S. representatives Jim Leach and Thomas Bliley), signed by President Bill Clinton in 1999. Their further reduction, as well as irresponsible monetary policy caused the bank failures shown in the third peak, on the right side of Figure 8 (Mishkin, 2006). The government financial institution regulators routinely “were too close to the people they were supposed to be regulating,” and standards were sometimes not upheld. So unless regulations are enforced, they are of little use (Mishkin, 2006).

Former Fed Chair Bernanke (2010) emphasizes the lack of adequate regulations a more important factor, which were already present when the Fed had an expansionary monetary policy. The housing bubble and Great Recession occurred to both and a lack of regulations. Bernanke (2010) points to August 2007 as the time when the current financial crises was already painfully evident. That was a full year before the stock market collapse in October of 2008. Bernanke (2010) agrees with those that say that this financial downturn is the worst since the Great Depression.

Low income people sometimes were affected by the United States real estate bubble. The low interest rates caused many people of many socio-economic levels to refinance their homes and they did that based on a highly appreciated value. Once the housing market bubble burst, the homes depreciated greatly in value. Yet the mortgage was still based on the appreciated value (Gordon, 2009; Bernanke, 2010). Moreover, Gordon (2009) states that since the Federal Reserve had made the interest rates too low from 2001-04, making the situation worse. About three decades ago in the United States, home mortgages were issued by savings institutions and held as assets by those institutions. Conversely, as financial markets have developed over time, the financial institution originating the mortgage loan, “such as the mortgage giants Countrywide Financial and Washington Mutual, rarely holds it in its loan portfolio” (Gordon, 2009). In lieu of that, the individual mortgages are classified by risk and sold as groups to investors in many different countries. Some of those mortgages have a riskier classification than the norm. These include “subprime loans”, which are mortgages made to people at low interest rates in order to attract borrowers, though the interest rate may increase latter on (Gordon, 2009). The more the risk, the higher the interest rate can be expected to be. Some investors “want these higher returns and are willing to take the risk they involve” (Gordon, 2009). Regrettably, this “relatively new system in which mortgages were sold off by the original financial institutions to other investors in the United States and in foreign countries began to unravel in 2007” (Gordon, 2009). A great amount of the lower income and overextended households, “who were in debt with these mortgage contracts defaulted on their obligations to repay, and some of the large investment funds holding these mortgages found their assets worth far less than they assumed”, affecting the well-being of many financial firms (Gordon, 2009).

Financial institution deregulation allowed many more different types of financial institutions to get into the market of mortgages. Furthermore, the removal of interest rate ceilings also had a great effect. Home construction increased greatly and so did mortgage

**Fig. 8. Historical United States bank failures**

issuing (Gordon, 2009). Moreover, the Fed lowered the federal funds rate by a greater than expected amount during 2001-04. The low interest rates brought in more mortgage brokers into the market. Mortgage brokers even offered to refinance mortgages that would have low interest payments in the beginning and increase, as time went on. Some people were tricked into agreeing to the mortgages often did not understand what they were agreeing to (Gordon, 2009). For example, during 2003 and 2004, about one-third of mortgage applications were for adjustable-rate mortgage (ARM) products (Bernanke, 2010). There were more exotic mortgages that included significant reductions in the initial monthly payment than could be obtained through a standard ARM. Clearly, for lenders and borrowers focused on minimizing the initial payment, the choice of mortgage type was far more important than the level of short-term interest rates. These mortgages of exotic types allowed more people to get a mortgage and this contributed to the housing bubble. Amazingly there were even non-documentation loans (Bernanke, 2010). Robert Shiller (2007) states that the beginning of the boom was in 1998, with most rapid price gains were in 2004 and 2005, when the annual rate of house price appreciation was between 15 and 17 percent. Thus, the timing of the housing bubble was due to an expansionary monetary policy (Bernanke, 2010). In tandem, loose regulatory policy and expansive monetary policy contributed to the housing bubble. Yet the Fed Chair after Greenspan was Bernanke and he emphasizes his belief that the lack of regulations may have been just as much or more important than the lax monetary policy. The Fed strongly advocated financial regulatory reforms, and the Great Recession and the crisis showed that financial indicators such as leverage and liquidity must be evaluated in light of both a system-wide perspective, as well as at the level of individual firms (Bernanke, 2010).

The Federal Reserve and other agency efforts to improve mortgages came too late to keep many banks and finance companies from needing bailouts. The U.S. federal government bailed out banks and many financial companies. Among these were firms heavily into credit default swaps. In order to regulate this, auditing capacity has to be there (Bernanke, 2010).

Mishkin (2006) states that both regulators and politicians are to act as agents for the “voter-taxpayers (principals)” in the United States economy, since “taxpayers bear the cost of any losses by the deposit insurance agency”. However, there is a “principal-agent problem”, because the agent, whether that agent is a politician or regulator, “does not have the same incentives to minimize costs to the economy as the principal the taxpayer” (Mishkin, 2006). If regulators of financial institutions are to act in the interest of taxpayers, the regulators should seek to lower the cost of the deposit insurance agency. This can be done by having high capital requirements, having tight restrictions on holding assets that are too risky and not adaptable to any regulatory forbearance, “which allows insolvent institutions to continue to operate” (Mishkin, 2006).

There are different types of regulations for financial institutions, aside from making sure that adequate financial resource requirements are met. At the same time that financial institutions underwent changes in regard to what services that they could provide, there was also a broadening of the areas that some financial institutions could operate in. Not all policy makers and economists agree about the value of allowing banks to cross state lines in their branching out in the United States. However, both Stiroh et al. (2003) and Beck et al. (2010) believe that customers benefit from the competition of regulations that allow interstate competition among banks. Regardless of the merits of such a change, this could make for more necessary auditing, as the kaleidoscope of the landscape of financial institutions in the United States would keep on changing that much more. With the advent of the Obama presidency, the too laissez-faire attitude towards financial institutions was not sufficiently extinguished. For example, the Chair of the U.S. Securities and Exchange Commission (SEC) Mary Shapiro, sided with two Democrats – Luis Aguilar and Elisse Walter in their decision to approve an enforcement case, through a law suit, against Goldman Sachs Group, Inc. The two Republican commissioners, Kathleen Casey and Troy Paredes, did not seek this enforcement (Bookman, 2010). However, the White House stated that it had no influence on the SEC’s action. On April 16, the SEC stated it was filing the lawsuit, because Goldman Sachs’s which “created and sold collateralized debt obligations linked to subprime debt mortgages in early 2007 without disclosing the hedge fund” associated with Treasury Secretary Paulson’s Paulson and company (Brower, 2010).

The adverse effects of the policies of the United States government reached outside to foreign nations. Taylor (2016) and Mishkin et al. (2016) state that the following of monetary policy rules helps not only the United States, but also other countries. There were spillover effects of the United States not following the Taylor rule on all those nations that had become accustomed to the U.S. following the rule. The “Great Moderation” that was started in the United States and was truly international in scope. In the early years of the twentieth-first century, the Great Moderation gave way to a high inflation in the United States, necessitating foreign countries to try to vainly try to predict the capricious monetary policies that had been the result in the United States (Taylor, 2016; Mishkin et al, 2016). Foreigners accurately predicting U.S. inflation is a factor in foreigners accurately predicting real return on investment on U.S. debt instruments, such as U.S. Treasury bonds and mortgage backed securities, as
well as future foreign exchange rates. When there is greatly fluctuating U.S. inflation, there is an adverse effect on the ability of foreign nations to get accurate readings of real return on investment on U.S. debt instruments and future foreign exchange rates. (Mishkin, 2006; Gordon, 2009). The USA is tied in with foreign nations with of the countries are using U.S. dollars. Financial instability in one country can affect others (Cecchetti, 2016).

According to Carney (2008), Christopher Dodd, Connecticut Senator and Chairman of the Senate Banking Committee got a VIP loan, a special deal from Country Wide on his mortgages. When Country Wide started having financial troubles and was going to go under, Dodd was instrumental in making sure that Bank of America was allowed to buy Country Wide. When Country Wide started, the Committee got a VIP loan, a special deal from Country Wide on his mortgages. When Country Wide started having financial troubles and was going to go under, Dodd was instrumental in making sure that Bank of America was allowed to buy Country Wide. Furthermore, Bank of America has made sizeable campaign donations to Dodd, Barack Obama, John McCain and Hillary Clinton (Carney, 2008). These special corrupt deals resulted in a decrease in necessary auditing of financial institution that deal with mortgages and mortgage backed securities. This has effects both nationally and internationally due to the mortgage backed securities being sold internationally. Reich (2010) points out that whether or not Utah U.S. Senator Bennett, New Jersey’s U.S. Senator Corzine or other politicians are caught favoring Wall Street banks and investors over the general American population and duly punished by voters, there will always be other politicians for Wall Street to bankroll, in order to get favorable regulation.

Incomplete attempts to restore regulation, such as the Dodd-Frank Act, fall short of the greatness of the bi-partisan Glass Steagall Act of 1933. Stiglitz had advised American law makers to break the largest banks up so that they would not be of the too-big-to-fail variety. However, in the twentieth first century, as of yet, the American law makers have not addressed the concerns of Stiglitz and others. Prior to the Great Recession, in 1999, Democrats were led by President Bill Clinton and Republican Senator Phil Gramm in the destruction of the Glass-Steagall Act. At the very least, politicians should care enough to keep investment bankers totally separate from the commercial banks. This needed requirement is due to the obvious conflict of interest that arises when investment bankers throw caution to the wind and invest insured deposits in doubtful and often catastrophic bonds, stocks and mortgage backed securities. Until the “leaders” of both parties in Washington care enough to re-instate the Glass-Steagall Act or something very similar, the American citizens are being set up for another fall. Americans need to get informed about the economics and political factors that have caused economists disasters (Rikards, 2012, 2014).

This article traces selected major events, seen through economic and political lenses. Macroeconomic thought has often adjusted to fit the times. In the early 1900s, there existed the Classical School as the main school of economic thought. The Classical School of economics stated the economy was always self-correcting. With the advent of the Great Depression, the Keynesian School called for government intervention, relying primarily on fiscal policy. Friedman and Schwartz (1963a) proved the significance of changes in the money supply in the Great Depression. Then, the New Keynesian synthesis somewhat combined the most relevant of the Keynesians, Monetarists and other schools. The main difference between New Keynesian and New Classical is that New Keynesians believe that even anticipated government policies can have an effect on the economy, though less than unanticipated ones. However, New Classicals think that only unanticipated policies can have such an effect. Views on macroeconomics and economic history will continue to be augmented by future events.

Summary and conclusion

In the United States, in the past century and beginning part of another one, the country has vacillated between responsible regulation of banks and other financial institutions and having too laissez faire an attitude towards the very powerful and rich people on Wall Street. The two biggest economic disasters discussed in this article were the Great Depression and the Great Recession. Irresponsible monetary policy and lack of funded effective regulations of banks and other financial institutions resulted in the needless suffering for many millions of Americans and this also affected other parts of the world. What is more, this suffering could have been avoided and hopefully the more sane and responsible policy makers can make that happen in the future.

End notes:

(1) Meetings between commercial bankers took place on Jekyll Island prior to passage of the Federal Reserve Act (Bagwell, 2016).

(2) The Austrian School of Economics measures money supply, velocity and some other factors, differently than mainstream schools of economics, such as New Keynesian, Monetarist and New Classical. Therefore Thornton and other Austrian school economists do not agree with the mainstream views concerning what happened to the money supply and velocity during the Great Depression. The Austrians also have their view that the gold exchange standard was a factor in the Great Depression. Mainstream economists refer to what was in place in the early 1930s as a gold standard. There are disagreements between Austrian school economics and mainstream economics starting with basic nomenclature, such as what is the money supply. In this way, from the beginning, they disagree with
mainstream macroeconomics, and that fact should be kept in mind in any discussions between mainstream and Austrian School economists. This article employs mainstream macroeconomic thought—such as, New Keynesian, Monetarist and New Classical (Thornton, 2014-15). All the theories, including Austrian and Mainstream ones, can teach us something (Snowden at al, 2005).

(3) A very much less strong and comprehensive act also called Glass-Steagall was passed in 1932. However, the 1933 Act is what people usually mean in referring to the Glass-Steagall Act. Detailed discussions of any partial bail outs of banks, other financial institutions and some consumers are beyond the scope of this paper. Though these bailouts sometimes occurred.

(4) This article is dedicated to Political-Economy Historian, Glenn Feldman, 1962-2015, Alumnus of Auburn University History Graduate program and Professor, University of Alabama at Birmingham.

References


