American Recurring Banking and Financial Crises: The Historical and Regulatory Context

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"All crises have involved debt that, *in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment."* **John K. Galbraith** (1908-2006), Canadian-born American economist, (in 'A Short History of Financial Euphoria' 1994).

"History shows that once an enormous debt *has been incurred by a nation, there are only two ways to solve it: one is simply declare bankruptcy, the other is to inflate the currency and thus destroy the wealth of ordinary citizens."* **Adam Smith** *(1723-1790), Scottish economist, father of modern economics, (in 'The Wealth of Nations', 1776).*

"Inflation is always and everywhere a monetary phenomenon *in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."* **Milton Friedman** (1912-2006), (in 'The Counter-Revolution in Monetary Theory', 1970).

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Some six years from now will be the 100th anniversary of the 1929 stock market crash, marking the onset of the Great Depression (1929-1939).

These were crucial events in the United States and in many other countries. In the U.S., in particular, it heralded a period of nationalism, protectionism and sweeping banking regulations.

The 1929 crash occurred after a period called the "Roaring Twenties", which followed World War I (1914-1918) and the Spanish flu pandemic of 1918-1919. It was a period of general economic prosperity, with many economic innovations and industries (automobile, electricity, telephone, radio, films etc.), being propelled by low interest rates and ongoing speculation.

What turned the stock market crash into a severe economic downturn was the failure of many banks and the credit crunch that followed.

Many American banks had followed the risky banking practice of lending large portions of their deposits for stock market speculation, and they did not survive the crash. Altogether, during the 1930 decade, it is estimated that as many as 9,000 U.S. banks failed, creating an important contraction of the money supply.

Even though the Federal Reserve central bank had been established in 1913, it was somewhat clumsy in designing and in implementing monetary policy. For instance, it did not widely use open market purchases to inject badly needed monetary liquidity in the economy, as money supply was contracting. Instead, in order to meet the requirements of the international Gold standard system of the time, the Fed kept raising its discount rate to prevent an exodus of money and gold from the United States, thus contributing to creating a deflation.

The financial crisis really became an international one when the large Austrian bank Creditanstalt failed, on May 11, 1931. This was a bank that had debts with many other banks. Its failure impacted negatively other international banks, and it contributed to making the financial crisis a truly international one.

All this is to say that a cascade of bank failures is a very dangerous phenomenon in a market economy. That is why there is an obvious need to prevent unduly risky investments by banks, through appropriate public regulation, to protect the public interest.

Why can deposit-financed commercial banks fall victim to a run on the bank?

The answer to the above question lies in the 'fractional reserve banking' system under which banks operate. Essentially, commercial banks borrow short-term funds from depositors and invest most of that money in profitable longer-term loans. For security and liquidity, they are required to maintain a mandatory minimum percentage of their deposits as cash reserves, the so-called fractional reserve, to be available for the withdrawal of deposits. The rest is considered capital to be loaned and invested in loans and in securities.

However, if confidence in a bank comes into question, especially if its loans or investments have lost value for any reason, (as indicated in the section of 'unrealized losses' in its books), people could fear for the safety of their deposits, and they may attempt to withdraw their savings during a panicky run on the bank. Such a panic or a crisis of confidence is bound to deplete a bank's meager reserves, and the lending institution may then face a liquidity crisis, and not be able to reimburse all depositors.

Without outside intervention, this could force a bank to close its doors and declare bankruptcy. If many banks find themselves in the same precarious illiquid situation, the entire banking system could enter into a systemic banking crisis, through a widespread contagion or domino effect.

Two major legislative attempts to regulate and two attempts to deregulate banks in the U.S.

The onslaught of the 1929 Stock market crash and the unfolding of the Great Depression, which translated into 15 million Americans losing their jobs and half of the country's banks failing by 1933, made the adoption of banking reforms a necessity.

In 1933, President Franklin D. Roosevelt (1882-1945) signed into law the famous Glass-Steagall Act of 1933, which forced a clear separation between commercial banks, which rely on deposits from the public, and investment banks, which borrow money by issuing shares or bonds. And, because commercial banks have a fiduciary mandate to protect depositors' money, they also had to follow strict guidelines for their lending in order to avoid making too risky investments, which could jeopardize their solvency.

Moreover, in order to prevent financial panics and destabilizing runs on the bank, the Banking Act of 1933 established the Federal Deposit Insurance Corporation (FDIC), whose purpose was to restore trust in the American banking system. It guaranteed that small depositors would not lose their money if a bank becomes insolvent. On the other hand, insured banks had to follow strict rules of investing.

Even though the Glass-Steagall Act was slightly amended over time, its main features remained the foundation of the stability of the U.S. banking system for some sixty-six years, that is to say until 1999.

The 1999 Gramm-Leach-Billey Act to deregulate the American banking system

American banks had often lobbied Congress and the U.S. government to relax the rules of investing contained in the Glass-Steagall Act. In November 1999, then Democratic President Bill Clinton signed the Gramm-Leach-Billley Act (GLBA) into effect, after Congress had voted overwhelmingly in its favor, with a vote of 90-8 in the Senate and by a vote of 362-57 in the House.

That law repealed important sections of the Glass-Steagall Act. Its main feature was to remove the legal barriers that prevented financial institutions from merging commercial banking, investment banking and insurance services in a single holding entity. The purpose was to permit a consolidation of the American banking industry and create large financial conglomerates deemed to be financially more stable.

Some congressmen and many economists argued that the new law was a step backward in the wrong direction, because it could make banks too large to be managed, and because it could make it easier for them to increase the level of risk-taking in their investments. The end result would be to render such large financial conglomerates "too big to fail". This, in turn, would imply that the government would have no other choice but to bail them out with public money, in case of insolvencies.

The Dobb-Frank Act of 2010 vs. the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018

In 2007-2008, the Subprime Mortgage Crisis broke out in the United States, with three large investment banks failing (Bear Stearns, Merrill Lynch and Lehman Brothers). This time, the culprit was largely unregulated derivative financial products, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO), which lost a lot of their value when the housing bubble burst and widespread mortgage defaults ensued.

The failure of those large investment banks played a central role in the 2008-2009 global recession, dubbed the 'Great Recession'.

A partial rollback of banking regulations in 2018

After the economic debacle of 2008-2009, the Barack Obama administration and the Democratic-controlled Congress came to the conclusion that new banking standards were required if future financial crises were to be avoided. And, President Barak Obama signed the Dodd-Frank Act on July 21, 2010.

That law was designed to prevent the excessive risk-taking behavior that had led to the 2007-2008 financial crisis and cost hundreds of billions of dollars in public bailouts of failed financial institutions. With that objective in mind, the 2010 law intended to eliminate the classification of banks deemed 'too big to fail', by submitting medium size banks to the same stringent regulatory supervision as very large banks.

However, a well-known politico-banking scenario again came into play.

Some bankers began complaining that the new investment rules to prevent excessive risk taking were too strict. Their main demand was that the threshold for the new regulations to apply, i.e. to banks with assets worth $50 billion and above, should be raised to $250 billion and above. In simpler terms, the demands were that the new stricter banking regulations should apply only to very large banks, the so-called 'too-big-to-fail' banks, and not to medium-sized banks with assets and liabilities below $250 billion.

The Republican-dominated U.S. Congress acquiesced to the demands formulated by the banking lobby. —On March 14, 2018, the Senate passed the Economic Growth, Regulatory Relief and Consumer Protection Act, exempting hundreds of U.S. banks that the Dodd-Frank Act's banking regulations had placed in the category of banks having between $50 billion and $250 billion of assets.

The new 2018 regulatory law also weakened the so-called Volcker Rule, which prohibits banking entities from engaging in proprietary trading and forbids banking entities from investing in or sponsoring hedge funds or private equity funds. —Thereafter, on May 24, 2018, President Donald Trump signed the partial repeal of the 2010 Dobb-Frank law.

The onset of a new banking crisis in March 2023

During the fatidic weekend of March 10-12, 2023, three American banks, whose total financial assets were below the $250 billion asset threshold, failed and required immediate intervention by regulators to prevent a wider contagion.

They were the Silicon Valley Bank ($212 billion assets), with significant exposure to the technology sector, the Signature Bank ($110 billion assets) and the smaller Silvergate Bank ($11 billion assets), the last two banks catering partly to cryptocurrencies users and to cryptocurrency-related firms.

The March 19, 2023 shotgun merger of the large Credit Suisse bank with the larger Swiss UBS bank is also indicative that large international banks can be fragile and may require an intervention on the part of regulators.

The U.S. Fed's role in creating monetary conditions leading to banking and financial crises

In the aftermath of the 2006-2009 financial and economic turmoil, the U.S. Fed and other large central banks in Europe embarked upon a nonconventional and risky monetary policy of massive money creation, with the so-called policy of quantitative easing (QE), and of artificially pushing interest rates way down, even to negative nominal interest rates, in some instances.

A clear indication of how the U.S. Federal Reserve central bank has been pumping liquidity into the monetary system can be seen in how fast its balance sheet, part of the monetary base of the economy, increased. It stood at roughly 0.9 trillion U.S. dollars, in 2007, but grew to 8.34 trillion U.S. dollars, as of March 8, 2023, an enlargement of more than 900 per cent.

This has had the consequence of the Fed bringing down nominal interest rates close to zero, just as other central banks in Europe and in Japan have also done.

However, a sure result of keeping interest rates artificially ultra low, for too long, is to create financial bubbles, in the bond market, in the stock market and in the real estate market. Lo and behold, in recent years, these markets have reached price levels that are way above their historical average.

This may have pleased some investors and some traders, but it may also have painted the central bank into a corner, if inflation gets out of hand and the central bank has to raise interest rates to fight it.

For reference: in the mid-summer of 2021, it was obvious that inflation in the U.S. was much above the targeted rate of 2 percent and was rising, but the Fed continued nevertheless its quantitative easing policy of purchasing $140 billion of bonds and mortgage-backed securities, each month.

The Fed's view at the time was that inflation was a 'transitory' phenomenon, not expected to last. Therefore, the Fed kept pushing liquidity into the U.S. economy until March of 2022, when it was obliged to reverse course as inflation was getting up steam. —By then, indeed, the inflation rate was already at 8.5 percent.

The fact of the matter is, when central banks raise interest rates after they have kept them ultra low for too long, it becomes very tricky for them to fight inflation without placing their banking sector in jeopardy.

That is because a sustained rise in interest rates causes the prices of bonds and of other securities already issued to fall, along with the price of real estate and of stock prices. Banks that are saddled with so-called 'unrealized losses', at such a critical time, may find themselves in financial difficulty, when they cannot afford to raise rates on their deposits, or appeal to outside help.

Conclusions

First, we may contrast public regulation of new drugs and public regulation of new financial products.

When it comes to the health of people, and when pharmaceutical companies propose new drugs or medications, such new medical products must be submitted, tested and approved by a public federal agency. In the United States, the Food and Drug Administration (FDA), founded in 1906, is responsible for regulating and approving new drugs and medications, before they can be distributed and sold.

However, when it comes to the health of the economy, it is much easier for the banking industry to invent risky new financial products and sell them to the public. Indeed, there is no statutory testing of the viability of such new financial products before their distribution. It's only after the fact—when it is discovered that they have been toxic for the financial system and the overall economy—that their use is curtailed and may be more strictly regulated.

Maybe the banking industry should be treated more as a public utility infrastructure, essential for the good functioning of the economy, in order to prevent market economies from following a disruptive boom and bust cycle, each 15-20 years.

Second, the recurrent periods of financial and economic instability could be a consequence of the dual mandate given to central banks. Indeed, besides serving as lender of last resort, in times of liquidity crises, a central bank's important role is to supervise the fiduciary money creating process, in order to prevent both inflation and deflation.

However, in 1978, the U.S. Congress adopted the Full Employment and Balanced Growth Act, which gave the Federal Reserve central bank an explicit "dual mandate".

Indeed, not only must the Fed manage and supervise the banking system and the money supply, in order to avoid inflation or deflation, but it must also *"promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates."*

At times, such a dual mandate may enter into contradiction and make monetary policy most difficult to implement. This may also explain the kind of yoyo monetary policy that the Fed has adopted recently, pushing interest rates way down and pushing them way up, when inflation becomes a threat.

Economic growth and employment creation in the long run are primarily a government responsibility through its fiscal, industrial and other economic policies, even though monetary policy may influence economic activity and employment in the short-run.

Especially in times of inflation, a central bank with a dual mandate may find itself in a conundrum. That is because to control inflation, it must slowdown the rate of increase of the money supply and raise interest rates, thus slowing down economic growth and employment.

However, we may point out that the European Central Bank (ECB) does not have an explicit dual mandate. It has only one primary objective and that is price stability, subject to which it may pursue secondary objectives. Similarly for the Bank of Canada, whose primary mandate is to maintain low and stable inflation, while supporting "maximum sustainable employment".

Finally, in general, let us keep in mind that the more private bankers are shielded from their errors and mistakes by generous public bailouts, the more they will be tempted to invent esoteric and risky debt instruments, and the more the economy will be subjected to destabilizing financial crises.

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This article was originally published on the author's blog site, Dr. Rodrigue Tremblay.

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