THE FREEMAN
IDEAS ON LIBERTY

Banking and Freedom in the Fifty Years of FEE

by Steven Horwitz

The regulatory changes undergone by the U.S. banking system in the fifty years since the founding of FEE are a very close reflection of the broader intellectual changes that have taken place during the same period, many of which are due to the effort of people associated with the Foundation. One can plausibly argue that, in several respects, the U.S. banking system is less burdened by regulations than at any time in the past. At the same time, however, the regulations that do remain hamper the operation of profitable banks, harm consumer welfare, and continue to undermine the safety and stability of the U.S. banking system. The grudging removal of some regulations by the federal and state governments has enabled banks to provide a range of products and services (both economically and geographically) that was unheard of just a couple of decades ago. If deregulation of the banking industry continues into the next century, American consumers will more fully reap the benefits of freedom in this most central of industries.

The American banking industry of 1946 would seem odd to someone who has come of age in the 1980s and '90s. Banking institutions were rigidly divided into commercial banks or savings and loans associations; neither was able to operate across state lines, and many states prevented both from operating branches even *within* the state. Options for consumers were extremely limited—for most, simply a choice between a passbook savings account that could earn no more than 5 percent interest, and a checking account that, by law, could earn no interest. Financial institutions were frequently "mom-and-pop" operations, with many observing so-called "bankers' hours" of 10 to 3, and almost all facing relatively little competition from nonbank providers of financial services.[1] There were no ATMs, no mutual funds, very few credit cards, just one kind of mortgage, and virtually no price competition because of price controls on interest payments.[2]

In the intervening decades, the banking industry has undergone numerous changes, many due to investments in advancing technology that has made new kinds of financial services available to consumers. A list of examples would be quite lengthy, but one group should make the point. The development of high-speed computers and the associated communications technology have made possible ATM machines, wire transfers, and a variety of sophisticated financial instruments that depend on computer calculations to figure the riskiness of alternative financial assets in a portfolio. The

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explosion of choices available to consumers of even modest means is tribute to both the market's ability to generate technological innovation through competition (where that freedom is allowed) and the prosperous standard of living in the United States that has enabled consumers to demand more sophisticated financial instruments.

The Push for Change

In addition, many of the industry's changes have been due to genuine deregulation, the push for which has come from three sources. First, the inflation of the 1970s radically changed the banking industry by creating problems it had never faced before. Second, the advances in technology and communications that simplified the moving of money made the existing geographic restrictions on banking seem even more archaic than they already were. Third, the general skepticism toward centralized government solutions that emerged in the 1980s (a result of historical events both here and abroad and changes in the intellectual landscape) generated political support for deregulation.[3]

The inflation of the 1970s was responsible for a number of changes in the banking industry, dealing primarily with the price controls on interest rates. As inflation caused interest rates to rise as high as 20 percent by 1980, consumers and banks faced serious problems. For consumers, the problem was finding a place to put money that could earn rates of interest that would compensate them for the ongoing inflation. If the inflation rate was 10 percent, then money deposited in a standard checking account that paid no interest eroded by 10 percent per year. Passbook savings accounts offered only about 5 percent interest and did not allow checks to be written against them. Neither option was desirable. As a result, consumers wanted to find ways around the price controls to earn competitive interest rates on their bank balances.

One option, buying large denomination financial instruments that were allowed to pay higher rates of return, was frequently out of the reach of small savers. The brilliant entrepreneurial solution to this problem during the mid-1970s was the money market mutual fund. These funds (often operated by nonbank financial institutions) would pool the savings of their customers and, in turn, buy large denomination certificates of deposit (over $10,000), which were not subject to the interest rate controls. After subtracting administrative costs and profits for itself, a money market fund would pay its customers slightly less than what it earned from the CDs, but far more than depositors were receiving from standard checking or savings accounts. The result was a major drain of funds away from conventional banks, toward financial institutions that were offering the new money market instruments.

Of course the banks did not stand idly by while this was happening. They appealed to regulators to allow them to offer special kinds of interest-bearing checking accounts akin to the money market mutual funds. They also lobbied for the removal of the interest rate controls that dated back to the mid-1930s. Both of these efforts were successful and now banks can offer a wide range of mutual fund instruments and are free to pay competitive interest rates on standard checking accounts. In these ways, banks are notably freer than they were fifty, or even twenty-five, years ago.

Often overlooked in the popular press was that the savings and loan failures of the 1980s were rooted in the inflation of the 1970s. As interest rates rose due to inflation, savings and loans who had granted thirty-year mortgage loans at low, fixed rates of interest found themselves in trouble. They were only earning five or six percent on their loans, but had to pay up to 20 percent to bring in new funds. This combination was a recipe for disaster, and sent many savings and loans into a tailspin as early as the middle and late 1970s. In addition, double-digit inflation also spurred the development of adjustable-rate mortgages, as well as the whole secondary market in mortgage-backed securities, as ways for banks to shield themselves against interest rate risks. In so doing, the banks also offered new options to consumers who might prefer adjustable rates if they believed interest rates would fall in the future.

As the troubles of the savings and loans continued on into the early 1980s, the acquisition of failing institutions by stronger banks or savings and loans was seen as a way to avoid some of the most harmful effects of bank failures. However, federal regulations limited such opportunities by restricting interstate mergers and acquisitions, particularly for savings and loans. In 1983, Congress passed the Garn-St Germain Act, which allowed interstate mergers and acquisitions if the acquired institution was in serious trouble. Although brought on by previous government activity (i.e., the inflation), this regulatory change was a step in the right direction, and opened the door to further activity in interstate banking.

Along with the need to address the devastating effects of inflation on the banking system, two other factors were crucial to ending the geographic limitations on banks and savings and loans. As communications technology continued to change, as domestic and international markets expanded, and as the population became more mobile, the limits on interstate banking—cemented in place in the 1920s—became increasingly burdensome. In addition, the high concentration of bank and savings and loan failures in Texas and Oklahoma after the fall in oil prices in the 1980s also suggested that interstate banking was desirable. The oil-state banks had significant limits on their ability to make loans across state lines. As a result, they were heavily tied to oil-related firms. When oil prices fell, the firms collapsed, taking the banks along with them.[4] Both banks and policy makers recognized that increased opportunities for geographic diversification were needed.

From about the mid-1970s forward, some states began to address the interstate banking issue through a loophole in the law. The Douglas Amendment to the Bank Holding Company Act of 1956 allowed individual states to admit banks from other states by a specific legislative act. For example, New York could negotiate an arrangement with New Jersey to allow each other's banks to cross the state line. From the mid-1970s onward, states began to make just these sorts of arrangements, in most cases by forming regional reciprocal agreements.[5] In the last five years or so, most states have opened their borders to any other state that is willing to reciprocate. Moreover, as of September 1995, national legislation went into effect that allows banks from all states to merge with or acquire banks in any other state. These changes in the interstate banking laws are among the most significant deregulatory moves in the recent history of banking. They promise to provide heightened competition and greater safety in the years to come by allowing banks to better diversify their loan portfolios.

Despite these gains, significant problems still exist with the regulatory structure of the banking system, three of which I will briefly discuss. Perhaps the most important is the federal deposit insurance program. Banks are forced to pay premiums into a fund designed to pay the depositors of failed banks. Because premiums are based solely on amounts deposited without regard to portfolio risk, banks are inclined to worry less about risky lending practices.

One factor contributing to the crisis of savings and loans was Congress' allowing them to enter the commercial real estate market in the early 1980s—by itself not a mistake as it allowed diversification—at the same time it raised the maximum amount covered by deposit insurance from $40,000 to $100,000, thereby giving the savings and loans both more ability and more incentive to undertake risky loans. When the real estate market took a tumble later in the 1980s, many banks and savings and loans were taken down with it. Industry analysts have pointed out that 43 percent of the total losses of savings and loans were due to bad real estate investments. Had the deposit insurance ceiling not been raised (or not existed at all) and had savings and loans been able to lend across state lines more easily, the overall riskiness of their loan portfolios would have been lower and the

"Attending FEE seminars, reading the literature, and making great friendships there has meant a remarkable professional life for me. It was a Henry Hazlitt book from FEE, The Failure of the 'New Economics', *that brought me in touch with the Committee for Monetary Research & Education, an organization that has become respected throughout the nation and abroad.*

As FEE moves into the next fifty years, its work is more important than ever and will continue to serve as a vital foundation for a better society and nation."

— Elizabeth B. Currier
President, Committee for Monetary Research & Education, Inc.

number of failures would have been far less. Reforming, abolishing, or privatizing federal deposit insurance remains one of the most important policy issues facing the banking industry as a new century is about to begin.

A second set of regulation still plaguing banks, and, according to a survey of bankers, the single most costly set of regulations they face, are those associated with the Community Reinvestment Act of 1977. This law forces banks to make a certain percentage of their loans to individuals and businesses in their local area, and requires an immense amount of paperwork to document their compliance. Beyond the waste of the paperwork, the CRA increases the riskiness of banks by forcing them to make loans to borrowers to whom they would not otherwise lend. The CRA amounts to a wealth redistribution program with banks as the means. In the end, consumers and taxpayers carry the burden either because banks are forced to forgo making other loans (what economists call an opportunity cost) or government bails out depositors of banks who fail due to too many bad loans. The CRA seems likely to linger on as onerous as ever despite efforts by the Congressional majority to weaken or eliminate it.[6] Ending the CRA would both release needed bank resources and enhance the stability of the U.S. banking system.

The third set of restrictions on banking freedom is a much more fundamental one. The span of FEE's existence is virtually identical with the period during which the Federal Reserve has become the dominant policy-making force in the U.S. economy. It has done so by being insulated from any political or economic constraints on its decision-making power. The wide range of discretion given to the Fed to promote "full employment" reflects the intellectual atmosphere of 1946, also the year in which the full employment mandate was thrust upon the Fed. In the fifty years since, the increased skepticism concerning government in general, and of discretionary monetary policy in particular, has led many economists to challenge the validity of the task assigned to the Fed. In 1996, Congress may consider removing the "full employment" mandate on the Fed, and its concomitant discretionary power, replacing it with a mandate for price stability.[7]

The downside of such a policy change is that the most important and fundamental power of the Fed, its monopoly over the production of currency, would remain undented. This monopoly is what ultimately enables the Fed to change the money supply as it deems appropriate and gives it the power to inflate away the value of the dollar. Binding the Fed to price stability (while arguably better than full employment) is still theoretically controversial among free-market economists and leaves intact the Federal Reserve's *power* to inflate. Challenging the Fed's monopoly over the production of currency and removing the dollar's fiat status will remain important tasks facing free-market thinkers in the next fifty years.

As we have seen from the changes in the former Soviet Union and Eastern Europe, the ruling ideas of the mid-1940s are fading from the scene, being replaced by ideas from scholars who were fortunate enough to have access to the ideas and resources of organizations like FEE who kept alive the classical liberal tradition through its darkest days. The changes that have occurred, and the minor victories that have been won, are surely not enough, and the power of the old ideas lingers on in the existing regulations and government power which shackle the creative energy of the U.S. banking system. The next fifty years hold great promise for building on the changes we have already seen and increasing the level of freedom in the U.S. banking industry. □

1. Bankers' hours were not as much of a problem at a time when most families had only one adult working full-time during the day. Housewives could do the banking during the daytime hours when banks were open. It is also true that the limited hours tended to create lines at banks, especially when drive-up windows and ATMs were not as common as today, creating additional inefficiencies.

2. Of course banks skirted these controls by offering non-monetary forms of interest such as free toasters or clock-radios when you opened a new account. The primary effect of the interest rate ceilings was to divert resources into less efficient forms of interest—an important lesson for the ongoing discussion of price controls in the health-care industry.

3. It is worth mentioning that this was not a Republican Party phenomenon. One of the co-sponsors of the airline deregulation bill was Ted Kennedy, and one of the co-sponsors of the recently enacted interstate banking bill was Don Riegle, both Democrats.

4. This is also one response to those who blame the savings and loan crisis on "deregulation." If that was the case, why were so many failures concentrated in two states, and states that severely limited the ability of their banks to diversify? If it was just "deregulation" we would expect the failures to be more widely distributed.

5. Some states immediately invited banks from any and all other states into theirs.

6. The banking bill passed in the House on September 28, 1995, included several deregulatory moves, but did not touch the CRA. Any moves toward its reform or abolition will probably have to wait until after the 1996 elections.

7. As of October 1995, a bill was pending in Congress to make such a switch. Whether it will come to the floor and get the needed votes remains unclear. Another measure of the change in the intellectual landscape is that a presidential candidate (Steve Forbes) could publically call for a return to the gold standard without threat of ridicule.

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The Economic Foundations of Freedom

by Ludwig von Mises

Animals are driven by instinctive urges. They yield to the impulse which prevails at the moment and peremptorily asks for satisfaction. They are the puppets of their appetites. Man's eminence is to be seen in the fact that he chooses between alternatives. He regulates his behavior deliberatively. He can master his impulses and desires; he has the power to suppress wishes the satisfaction of which would force him to renounce the attainment of more important goals. In short: man acts; he purposively aims at ends chosen. This is what we have in mind in stating that man is a moral person, responsible for his conduct.

Freedom as a Postulate of Morality

All the teachings and precepts of ethics, whether based upon a religious creed or whether based upon a secular doctrine like that of the Stoic philosophers, presuppose this moral autonomy of the individual and therefore appeal to the individual's conscience. They presuppose that the individual is free to choose among various modes of conduct and require him to behave in compliance with definite rules, the rules of morality. Do the right things, shun the bad things.

It is obvious that the exhortations and admonishments of morality make sense only when addressing individuals who are free agents. They are vain when directed to slaves. It is useless to tell a bondsman what is morally good and what is morally bad. He is not free to determine his comportment; he is forced to obey the orders of his master. It is difficult to blame him if he prefers yielding to the commands of his master to the most cruel punishment threatening not only him but also the members of his family.

This is why freedom is not only a political postulate, but no less a postulate of every religious or secular morality.

The Struggle for Freedom

Yet for thousands of years a considerable part of mankind was either entirely or at least in many regards deprived of the faculty to choose between what is right and what is wrong. In the status society of days gone by, the freedom to act according to their own choice was, for the lower strata of society, the great majority of the population, seriously restricted by a rigid system of controls. An outspoken formulation of this principle was the statute of the Holy Roman Empire that conferred upon the princes and counts of the Reich (Empire) the power

Professor Mises (1881–1973), one of the century's pre-eminent economic thinkers, was academic adviser to the Foundation for Economic Education from 1946 until his death.

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