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Source: *Journal of Economic Issues*, Vol. 46, No. 2, PAPERS FROM THE 2012 ANNUAL AFEE MEETING (JUNE 2012), pp. 531-539
Published by: Taylor & Francis, Ltd.
Stable URL: https://www.jstor.org/stable/23265033
Accessed: 23-04-2020 20:04 UTC

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JEI
JOURNAL OF ECONOMIC ISSUES
Vol. XLV I No. 2 June 2012
ISSN 0021–3624/2012 $9.50 + 0.00
DOI 10.2753/JEI0021-3624460228

The Pre-1980 Roots of Neoliberal Financial Deregulation

Al Campbell and Erdogan Bakir

Abstract: U.S. financial deregulation is often popularly presented as a fundamental attack on financial regulation that began with neoliberalism's Big Bang in 1980. This paper argues this position is wrong in two ways. First, it is a process that stretches back decades before 1980. Textbook mentions of 1970s precursor "financial innovations" fall far short of presenting the breadth and duration of the pre-1980 attack on the system of regulation. Second, it has not been an across-the-board attack on financial regulation in the name of market efficiency as required by its ideology and claimed by its advocates, but rather a focused attack on only one of the five pillars of the system of regulation. This paper develops both of these assertions through a presentation of the five central pillars of the pre-1980 system of financial regulation, and the four major attacks on the three different aspects of the restrictions on financial competition.

Keywords: financial competition, financial deregulation, financial regulation, neoliberalism

JEL Classification Codes: N22, G21, G28

Financial deregulation in the United States, as a particularly important aspect of economic deregulation there in general, sharply accelerated following the election of Ronald Reagan in 1980 and the associated adoption by the overwhelming majority of U.S. capital of a commitment to carrying out a neoliberal economic transformation. The two large legal cannonades that announced the acceleration of financial deregulation were the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980 and the Depository Institutions Act (DIA) in 1982. The 1980s legal changes, associated changed practices and their effects in the financial sector from the 1980s to the 2000s have been written about extensively by authors

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across the entire spectrum from mainstream to radical. These changes, together with the process of their continual deepening in the 1990s and early 2000s, are seen by almost all heterodox economists as a fundamental element in both allowing and causing the current financial and economic crisis.

This short paper on neoliberal financial deregulation will focus on two aspects of it that we maintain have been under-discussed. The first is that neoliberal financial deregulation in fact was almost entirely focused on only one of five pillars of the pre-neoliberal financial regulatory structure. This paper will indicate the other four pillars of the pre-neoliberal financial regulatory structure that neoliberal finance did not attempt to deregulate, some of which it even strengthened. The implication of this behavior is that neoliberal deregulation has not been driven by an honest commitment to the ideology that unregulated markets are always socially best (most efficient) as finance asserts. The second is that "the birth of neoliberalism [was] a process extended over time."[1] We argue that the cannonade referred to above must be understood only as an important acceleration of a process already unfolding, not as it is too often incorrectly presented as the "beginning" of neoliberal financial deregulation. This paper will discuss four important prior financial deregulatory efforts.

The Pre-Neoliberal Financial Regulatory Structure

To avoid the common current misunderstanding of neoliberal financial deregulation as a drive to eliminate all regulation of financial markets, it is important to understand that pre-neoliberal financial regulation consisted centrally of five pillars: 1) federal deposit insurance, 2) measures that directly regulate what various financial institutions are allowed to do, 3) measures that require financial institutions to greatly increase publically available financial information ("increase transparency"), 4) measures to limit competition between financial institutions, and 5) measures to allow (and corresponding practices to actually effect) the government's active intervention as a participant into financial markets. We will see that contrary to neoliberal ideology, neoliberal deregulation has consisted of a sustained attack on only one of these pillars, the restrictions on competition.

1) Federal Deposit Insurance. Among many other key aspects of the pre-neoliberal financial regulatory frame, the Glass-Steagall Act[2] established the Federal Deposit Insurance Corporation (FDIC) to start operations January 1, 1934, and mandated all member banks of the Federal Reserve System join it.[3] All small and medium deposits at all member banks were 100% insured[4] in case of bank failure. Notwithstanding the academic writings of some archconservative "markets über alles" advocates and a few sympathetic Congress people from the 1980s onward, this provision, which is arguably the most stabilizing single component of the entire regulatory frame,[5] was never seriously politically challenged.

2) Measures that directly regulate what various financial institutions are allowed to do. While the establishment of the Fed in 1913 and its subsequent activities involved some bank regulation, the banking industry could be said to be largely

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(though not entirely) unregulated before the Great Depression. The 1933 Glass-Steagall Act and the Banking Act of 1935 strengthened the regulatory power of the Fed over both member and most non member banks, and created regulatory powers for the new FDIC.[6] To re-establish the credibility of the highly discredited stock market, the 1934 Securities Exchange Act set up the powerful Securities and Exchange Commission to enforce the regulatory provisions of that act and those of the1933 Securities Act.

3) Measures that require financial institutions to greatly increase publically available financial information above what they would provide if this was left voluntary ("increase transparency"), both to improve market efficiency and to reduce outright fraud. These measures were very extensive for the important stock and bond markets, beginning with the 1933 and 1934 securities acts and supplemented by additional acts from the end of the 1930s onward. Most other sections of the financial industry, such as banking and insurance, were treated as typical corporations, with only the standard public disclosure requirements for corporations, which are strongly limited by "business secrecy" arguments.

The point we want to underline before turning to the regulatory pillar that was the target of neoliberal deregulation is that financial regulation itself was not under attack. None of the above three pillars were subjected to significant legal assaults. Deposit insurance was not eliminated, the Fed's and other regulatory bodies' legal powers were not significantly reduced, and there was no drive to eliminate the basics of public disclosure of information on stocks and bonds.

4) Neoliberal financial deregulation has been a prolonged attack on pillar 4 of the system of financial regulation, measures to limit competition between financial institutions. The three main legal restrictions against unrestricted competition between financial institutions were:

i) Geographical restrictions on banks, on branching. For historical/technological/cultural reasons less that 2% of banks had branch offices in 1900 (Litan 1987, 24). But by the early twentieth century, states were generally encouraging banks to branch intrastate to provide banking services to their populations outside their main cities.[7] The McFadden Act of 1927 then reversed this trend by restricting any new branching outside the city where a bank had its head office, but to get this anti-branching provision passed it had to grandfather in all existing state-bank intercity branch networks (Vietor 1987, 14). Despite this, multi-office banks of various types (branches, "chains," bank holding companies) had more than 50% of all deposits just before the Depression (Litan 1987, 25). The Glass-Steagall and 1935 Banking Acts then reinforced the legal proscription of interstate, and tried to further reduce intrastate, branching.[8]

ii) Restrictions on what banks could pay for what was then their main source of funds to make profits from, deposits. Section 11 of the Glass-Steagall Act caused the modification of the Federal Reserve Act to prohibit the payment of interest on any demand deposits ("checking accounts"),[9] and empowered the Fed to set limits on payments on time deposits ("savings accounts"). While it was arguably the central target of effective deregulation by "financial innovation"

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from the 1950s to the 1970s, it is important to understand that the restrictions on competition were actually significantly broader than just this.

iii) Compartmentalizing of especially the product markets, and to a lesser extent the sources of funds ("segmented liability and asset markets"). In the first instance there was the issue of separation of finance from non-financial production ("commerce"), to protect national production from being subordinated to the interests of finance. Then within finance itself the same issue of separation showed up broadly in the debate about the separation of the major branches of finance such as commercial banking, investment banking and insurance, and again within the deposit-taking sector in debates on the separation of banking for businesses, for consumer credit and for mortgages. By the 1920s the most powerful financial institutions were largely universal,[10] but that was sharply reversed after the 1929 crash with the financial collapse of the vertically integrated trusts and the legislation prohibiting such structures that followed. By far the best known and most discussed aspect of such regulatory separation was the separation of commercial from investment banking by the Glass-Steagall Act, but this was actually just one aspect of the important much broader compartmentalization. "Until the 1970s, each major field of the financial services industry — banks, thrifts, security firms, insurance companies — was almost entirely specialized to itself and supervised mainly by its own regulatory institution" (D'Arista 1994, 186).

5) Measures to allow (and corresponding practices to actually effect) the government's active intervention. This aspect of financial regulation which today is nearly universally accepted and practiced by neoliberal governments around the world is of course directly contrary to the their claimed ideology of self-regulating financial markets. These measures have in fact been extended legally or in practice (more extensive or more frequent use) under neoliberal "deregulation" in parallel with the process of the reduction of the restrictions on financial competition just discussed. The logic for the necessity of this increased financial regulation as part of neoliberal financial deregulation is that the reduced restrictions on financial competition tend to cause an increased systemic financial instability, which can only be prevented from causing problematic or disastrous crises if the government has strong powers to actively intervene in financial markets when crises begin to develop. The most common form of active intervention is through interest rate manipulation, but the government's role as lender in times of crises (linked to the former) is ultimately more important for the survival of the system.[11]

The Roots of Deregulation before the Neoliberal Era

It is extremely important for understanding the successful neoliberal assault on the restrictions on financial competition to recognize the change in the attitude toward competition in finance by the economics profession, and especially by political policy makers as part of their overall changed ideology leading up to neoliberalism. Earlier many members of both of these groups had felt that "excessive" financial competition

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had made a significant contribution to causing the Great Depression. By the 1970s almost all government studies[12] on financial reform held that the system was crippled by "needless barriers to competition" and "serious . . . anticompetitive situations" (U.S. Congress 1973, 1). The recommendations were to reduce or eliminate all three types of the important restrictions on financial competition discussed in the last section – geographic (branch restrictions), price competition for deposits (regulation Q) and compartmentalization.[13] In this section we will briefly consider the four most important such pre-neoliberal attacks.

1) The first major attack on the regulations against financial competition came immediately after the first such major restriction was enacted, the 1927 McFadden Act branching restrictions on geographic competition among banks. The banking industry rapidly effected a (partially, temporarily) successful circumvention of this restriction via bank holding companies (BHCs).[14] In the face of this breakdown of geographic competition restrictions, the government responded a quarter of a century later, (largely) successfully re-imposing the interstate restrictions and forcing (some) established interstate banking networks such as Bank of America to dismantle. The Douglas Amendment to the 1956 Bank Holding Company Act established that BHCs could have subsidiary banks in states other than where their headquarters were only with the permission of that state. Given the attitude of state banking authorities at the time, this effectively meant they could not have multistate banking subsidiaries.[15]

While the banking industry's drive for expanding national networks was largely checked, its competitive drive for increased branching continued to be perused within states, which was to continue up to and into neoliberalism. In the 1950s and 1960s the large majority of the slightly more than 14,000 banks were single unit. Hence there was a great potential for increased branching where allowed through mergers and acquisitions. Many of the 2,200 bank mergers from 1950–1965[16] contributed to this process (U.S. Congress 1973, 17). Then from the beginning of the 1970s, technical changes, legal rulings and changed state attitudes[17] promoted first intrastate and then interstate (effective) increased branching.

2) NCDs, MMMFs and NOWs. Faced in 1961 with inadequate funds for their desired level of business, the New York banks decided among other things to try to win back short term corporate funds that because of regulation Q had migrated into money market instruments, particularly treasury bills. By not only making them negotiable (a small amount of Negotiable Certificates of Deposit (NCDs) existed before this), but more importantly by consciously organizing for the first time a very liquid secondary market, corporate customers could be effectively offered a demand account, which since it was technically a time deposit they could receive interest on. At the time these remained subject to Q interest rate ceilings on time accounts (which increased over the 1960s), but NCDs nevertheless contributed significantly to undermining one aspect of regulation Q's goal of reducing price competition between banks by reducing (not eliminating) what had been their cheapest source of funds, large corporate demand accounts.[18]

In 1971 the first vehicle in the United States to act as an alternative to checkable deposits that completely circumvented regulation Q (since they were not any type of

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bank deposits) was introduced, Money Market Mutual Funds (MMMFs). Again, the key to making these alternatives to checkable deposits was their extremely liquid secondary market. These grew from $3 billion in 1976 to $80 billion in 1980 to $230 billion in 1982, with the money mostly coming out of checking and savings accounts at banks (Markham 2002b, 7).

Money and banking textbooks often lump Negotiable Order of Withdrawal (NOW) accounts in with MMMFs as "financial innovations" from the beginning of the 1970s that undermined regulation Q, but their role was actually significantly different. They were basically checkable accounts for which banks could (but did not) require prior notification for withdrawals, and thus were not classified as checkable accounts, and so could pay interest. Unlike MMMFs they remained, however, subject to regulation Q interest ceilings on saving accounts. The most important difference, however, is that they played a vastly smaller role in the Q-caused disintermediation in the 1970s that was the ultimate cause of regulation Q's subsequent elimination.[19]

Much more important and much less discussed concerning the pre-neoliberal undermining of regulation Q's restriction on price competition for funds was the 1973 decision by the Fed to suspend interest rate ceilings on large (over $100,000) CDs.

3) Euromarkets. The third major assault on the restrictions on U.S. financial competition unfolded over the 1960s through an expanded participation in the Euromarkets. While these markets were not originally developed in order to evade these U.S. domestic restrictions, banks "soon discovered that the Euromarket also enabled them to evade *domestic* New Deal financial regulations such as reserve requirements and interest rate ceilings" (Helleiner 1994, 88). The importance to the banks of the Euromarket's potential to provide money free from Q-restrictions became particularly apparent with the credit contractions of 1966 and 1969–1970, during which large amounts of domestic money was "round-tripped" through the Euromarkets to avoid the Q-restrictions. The number of foreign branches of U.S. Fed-member commercial banks exploded from 211 in 1965 (177 belonging to one bank) to 375 in 1968 and 627 (belonging to 107 different banks) in 1972 (Hester 1981, 153). Euromarket loans which were still insignificant in 1958, had climbed to $25 billion by 1968 and $130 billion by 1975, indicating the importance that evading the Q-restrictions came to have in pre-neoliberal U.S. finance.[20]

4) The breakdown of financial compartmentalization. While the 1956 Bank Holding Company Act successfully largely ended the use of BHCs to try to undermine the regulations against expanding branching, it did not end the use of BHCs to try to undermine financial regulation. In particular, they continued to be an important early vehicle for the attack on the compartmentalization of financial functions, both between finance and other commerce, and within finance. The act exempted from coverage BHCs that had only one bank (OBHC), almost all small banks.[21] The credit squeeze in 1966, however, caused a number of large banks to create OBHCs to avoid the Q-restrictions (Hester 1981, 181), after which they realized how this structure could also be used to avoid the compartmentalization restrictions.

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An explosion of new OBHCs followed in the next three years.[22] The 1970 Amendments to the Bank Holding Company Act closed this exception for OBHCs, but continued to allow BHCs to engage in activities "closely related to banking." A government report three years later concluded that this possible exemption was being widely abused, resulting in allowing BHCs to "act as investment advisors to real estate investment trusts and mutual funds, the leasing of personal and real property, providing bookkeeping and data processing services, operating insurance agencies and permitting bank holding companies to carry out other nonbank activities" (U.S. Congress 1973, 16-17). It is again important to understand that the breakdown of the stabilizing separation of banking from nonbanking functions occurred not only in the neoliberal 1980s and 1990s, but was a process that had occurred from the establishment of the separation, first through BHCs, then after 1956 through OBHCs and then after 1970 through extensive "closely related" exemptions.

In regards to the separation of functions within the banking industry, while right into neoliberalism specialized independent institutions (excepting property-casualty insurers) still dominated the different major components of the finance industry, the trend over the 1970s was already clearly toward the large financial firms in each sector beginning to branch out more and more into other sectors. "[T]he largest financial institutions were gaining footholds in major financial sectors outside their area of specialization at the same time as large nonfinancial firms were becoming important providers of financial services" (D'Arista 1994, 187).

Notes

1. Bakir and Campbell (2010, 339). Although that paper's topic was the difference between the partially restored rate of profit and the less responsive rate of accumulation under neoliberalism, it is referenced here because the empirical data in it on the indebtedness of the non-financial business sector, the increased share of its after-tax profits paid to the financial sector and its decline in size relative to the financial business sector (among other measures) support the thesis that this paper argues, that many of the changes that were to become part of the new neoliberal structure were well underway decades before 1980.
2. While far from establishing the pre-neoliberal financial regulatory frame by itself, a strong case can be made that the most important single piece of legislation in that frame was the Banking Act of 1933 ("Glass-Steagall Act"), signed into law on June 16, 1933.
3. This initial coverage of Fed member banks was then extended. Any bank determined to be healthy by both state regulators and the FDIC could receive this coverage, and given people's fears of losing their deposits most, though not all, banks opted for this. Then in 1934 similar though separate deposit insurance was set up for Savings and Loans, Mutuals and Credit Unions, thus extending such insurance to essentially all depository institutions.
4. The initial level was 100% coverage for the first $2,500 of any deposit, hence fully covering small and medium deposits, and that threshold was then continually raised over the years.
5. Bank runs have historically been the greatest, though certainly not only, destabilizing threat for a banking system. A large part of the 9,000 bank closures from 1930 to 1933 resulted from runs, especially in the two months before Roosevelt took office and declared the first national "bank holiday" (there were many previous state bank holidays), the only tool which was available for trying to stop bank runs before deposit insurance largely eliminated them.
6. Member banks now had to report on all investments transactions and loans. Non-member banks had to be reviewed for "soundness" to enter the FDIC program, which at that time the majority of banks felt compelled to do. The Banking Act of 1935 gave important additional powers to the Fed,

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among others the particularly important new power to establish credit controls and margin requirements for buying stocks and bonds. It gave the FDIC the authority to intervene to protect a failing bank's deposits and capital by either facilitating the merger of the failing bank with a still healthy one, or by carrying out purchase and assumption actions.

7. To prevent defections the Fed in 1918 even passed a regulation allowing its members (including national banks) to branch, though two years later the Supreme Court ruled states could prohibit national banks from branching.
8. It is less often noted that the intent of the McFadden Act was actually to help the national banks by giving them the same intrastate branching rights allowed to state-chartered banks in those states where it was allowed to branch intrastate. While the Glass-Steagall and the 1935 Banking acts made minor further extensions of this equality, at the same time they further restricted intrastate branching by causing the Federal Reserve Act to be extended to subject all member state-chartered banks to the same branching requirements as national banks, and requiring approval for any new branch from the FDIC for any insured bank.
9. The Fed then passed its famous Regulation Q (which became Title 12, part 217, of the United States Code of Federal Regulations) to this effect on August 29, 1933 (which was only formally rescinded on July 21, 2011).
10. Sixty-two commercial banks dealt with investment banking by 1922, and by 1927 such affiliates of banks were responsible for the issue of 13% of new debt and participated in the issue of an additional 7%. It is not widely appreciated that in addition to its well-known branching restrictions, the McFadden Act specifically allowed national banks to have such investment affiliates. Hence by 1931 there were 285 national bank affiliates of this type in addition to the many state ones, and these had raised their share of debt issue to 40% and participation in issue to 61%, and the presidents of the Investment Bankers Association of America from 1931 to 1933 were elected from securities affiliates of commercial banks (Vietor 1987, 15).
11. The Glass-Steagall and 1935 Banking Acts established the basic structure of today's Federal Open Market Committee that executes the former, while the Fed executes the latter through a number of channels under various provisions of the Federal Reserve Act.
12. And in particular the most important two were the recommendations of the Hunt commission (President's Commission on Financial Structure and Regulation 1971) and the FINE Study (U.S. Congress 1976).
13. "[A]ll federally chartered institutions – S&Ls, credit unions, and newly established federal mutual savings banks (MSBs) – be allowed to function with full powers for asset and liability diversification. In essence they could engage in any activity allowed of a commercial bank except direct commercial lending. They could, however, purchase corporate debt on the open market. If S&Ls or MSBs desired to get into the business of direct commercial lending, they would be allowed easy conversion to commercial bank status" (Pierce 1977, 607).
14. Already in 1928 the president of Bank of America organized the Transamerica Corporation as a holding company (not covered by the bank restrictions) to take over the stock of Bank of America and begin to build a (mostly) banking and financial services empire. By 1953 its banking component, located in California and a number of western states, constituted the largest banking structure in the world, and had effectively overcome the branching restrictions intentions of the McFadden and Glass-Steagall acts (Markham 2002a, 307). It planned to increase its size dramatically and go national. A small number of other BHCs had similarly circumvented the interstate branching restrictions in other regions of the country, although not yet on as large a scale.
15. Only full service banking offices that both accepted deposits and extended loans were prohibited. Banks could and did establish offices interstate to only extend loans, to only accept deposits, or to support international transactions (Edge Act corporations). Foreign banks were exempt from any of these restrictions until 1978. Only the banking operations of BHCs faced interstate restrictions (in line with the original banking legislation that was being circumvented), not their other financial services. And while the interstate banking operations of most BHCs were dismantled leading up to or following the act, nine were grandfathered in (Litan 1987, 35). All this notwithstanding, the 1956 act did significantly limit the growth of the evasion of interstate bank branching via BHCs.
16. Until 1963 banks were exempt from the standard antitrust anti-merger provisions (U.S. Congress 1973, 17).

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17. Specifically, improved and lower cost communication networks and ATMs, court rulings that ATMs (especially if leased) were not branches, and increased state acceptance of more extensive intrastate branching. These were followed later in the 1970s by interstate branching agreements, which had always been allowed under the Douglas Amendment but not previously exercised.
18. Sixty percent of bank liabilities were interest free checkable deposits in 1960.
19. As NOW accounts were only allowed outside New England/New York by the same DIDMCA in 1980 that phased out Q ceilings (except the zero rate on demand deposits) and so were relatively small until then, it would be hard to argue that NOW accounts were a major cause of DIDMCA's elimination of regulation Q.
20. From the *Palgrave Dictionary of Transnational History* as reported on the Paris School of Economics Web site, www.parisschoolofeconomics.com/hautcoeur-pierre-cyrille/euromarkets.html, accessed December 1, 2011. Figures on the size of the Euromarket vary between authors because there is no universally agreed on measure for its size (Clendenning 1970, 35), but all measures qualitatively give this same indication of explosive growth in the 1960s and 1970s.
21. The exemption was in fact a concession to the many small banks that operated alone as banks, but in a holding company with several nonbanking businesses. Congress considered these to pose no threat to the banking system, and to be important for the local productive economies of many places in the country (Markham 2002a, 308).
22. "By the mid-1960's many of the nation's major commercial banks . . . discovered a new avenue by which to enter and possibly dominate non-banking areas of the nation's economy –the so-called one bank holding company loophole. [B]efore the end of the decade . . . the public policy of separating commercial banking from nonbanking business was seriously threatened with destruction" (U.S. Congress 1973, 16). In 1966 there were roughly 600 OBHCs, with about 15% of total bank deposits. In the next three years an additional 210 OBHCs were formed, but these now held about 35% of all bank deposits. Twenty-seven conglomerates now ran banks and OBHCs were involved in 20 different financial and 99 different nonfinancial activities. Regulated multibank holding companies were by this time down to 100, with 15% of total deposits (D'Arista 1994, 69-70).

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