The Economic Consequences of the Bank Bailouts:
Parallels and Discontinuities between the 1920s and Today

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ABSTRACT

This paper uses Polanyi's *The Great Transformation* and Keynes' *Economic Consequences of the Peace* (*ECP*) to examine the role of banking relations in periods of severe cross-border economic imbalances such as the 1920s and the 2000s. Navigating the challenges that arise in such periods requires what we term here a global monetary order – that is, a set of financial intermediaries that maintains orderly relations among counterparties and reduces cross-border risks (or at least, does not amplify them). There are remarkable parallels between the 1920s and the contemporary era: severe cross-border economic imbalances, the build-up of unpayable financial obligations, and speculative bank practices. In both the 1920s and 2000s, these banking systems were disabled and/or dysfunctional at precisely the time when they were most needed. This exploration of parallels, however, exposes a key disjuncture between these two historical eras: the earlier one ended with forceful reforms that restored domestic functionality in banking, if not global monetary order; but in the current period, banks' economic functionality has not been restored at either the global or domestic level. The reasons for this asymmetry are explored.

Keywords: John Maynard Keynes, Karl Polanyi, *Economic Consequences of the Peace*, *haute finance*, investment banking, megabanks, subprime crisis, global monetary order

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1. Introduction

This paper uses Polanyi's *The Great Transformation* and Keynes' *Economic Consequences of the Peace* (*ECP*) to examine the role of banking relations, and especially of the international-banking system, in periods of severe cross-border economic imbalances such as the 1920s and the 2000s. Navigating the challenges that arise in such periods requires what we term here a global monetary order – that is, a set of financial intermediaries that maintains orderly relations among counterparties and reduces cross-border risks (or at least, does not amplify them). We then use Keynes' writings on banking, in the *ECP* and into the early 1930s, as a point of departure for understanding how global monetary order broke down and fed the rise of speculative and unsustainable banking relations in the latter 1920s and early 1930s.

There are remarkable parallels between the 1920s and the contemporary era. The period from 1982 forward also involved severe cross-border economic imbalances, as had the years leading up to the Conference of Versailles. Until the year 2000, large investment banks helped to maintain a level of global monetary order. What unbalanced this quasi-order was not global war and the reparations demands to which it led, but two other factors: first, deregulation of US and European finance, which led large investment banks to change their strategic positioning and their planning time-horizons; second, the magnitude and viability of financial obligations, due to the subprime lending bubble. These two factors decimated the US banking system and then launched the European banking system into chaos as well. As in the 1920s, these banking systems were disabled and/or dysfunctional at precisely the time when they were most needed.

This exploration of parallels, however, exposes a key disjuncture between these two historical eras: the earlier one ended with forceful reforms that restored domestic functionality in banking, if not global monetary order; but in the current period, banks' economic functionality has not been restored at either the global or domestic level. This asymmetry is attributed here to global financial institutions' relatively greater economic and political power in the current age; it is also due to the impossibility of disembedding these institutions from the interstices of global financial practices, where they now hold a central place, without comprehensively undoing the logic of banking service provision as these institutions have themselves reinvented it in the past two decades. The Neoliberal period has given rise to mechanisms that bind the power of the nation state, as is evident now in the case of the Eurozone. By contrast, the 1930s period saw nation states seize control of their economic destinies, albeit with consequences that were disastrous on a human and global scale.

2. *Haute Finance* and Global Monetary Order

In the first pages of *The Great Transformation*, Karl Polanyi describes how the nineteenth century a hundred years' peace: the "powerful social instrumentality which could play the role of dynasties and episcopacies under the old [system], and make the peace interest effective … was *haute finance*" (Polanyi, *ibid*., page 10). During that 'long century', government stood aside while "capitalistic companies were invading whole continents. ... The home government was not supposed to intervene in private trade; ... Foreign investments were still deemed a gamble" (*ibid*., page 222). In this context, then, private banking, that is, *haute finance* disciplined the financial dynamics of the global economy:

> "*Haute finance*, an institution *sui generis*, peculiar to the last third of the nineteenth and the first third of the twentieth century, functioned as the main link between the political and the economic organization of the world. … Independent of single governments, even of the most powerful, it was in touch with all. … the secret of the successful maintenance of general peace lay undoubtedly in the position, organization, and technique of international finance" (*ibid*., page 10).

Polanyi argued that the prosperity of these global bankers depended on peaceful, contract-fulfilling exchanges of value across borders. So these financiers prevented a "general conflagration. … Every war, almost, was organized by financiers; but peace also was organized by them… [T]his strictly pragmatic system .. guarded with extreme rigor against a general war while providing for peaceful business amid an endless sequence of minor ones" (*ibid*., page 16). Polanyi cites the Rothschilds as an example: "their business would be impaired if a general war between the Great Powers should interfere with the monetary foundations of the system… it fell to them to maintain the requisites of general peace in the midst of the revolutionary transformation to which the peoples of the planet were subject" (*ibid*., page 11)

Polanyi's account of banking relations in the hundred years preceding 1920 conveys more of a sense of stability than was felt in the occasionally warring nations or by those providing "*haute finance*." International banking was unstable during this period (Burk 1989).[1] Barings, the respected British merchant bank, almost failed (and brought down the entire private banking system with it) in 1890, due to its excessive risk-taking in Argentine investments (Zeigler 1988). The ranks of private banks, including Rothschild's and Baring, Peabody and Morgan after 1853, the Drexels, and others, were comprised of "merchant bankers," often former merchants involved in Anglo-American trade; these firms' partnership configurations were unstable, as their founders took whatever measures were necessary to survive the many intense financial crises of that era. Polanyi's observation about the role of *haute finance* in that epoch builds on the fact that establishing and maintaining dependable merchant banking relations – and using these relations to finance everything from commodities to war expenditures – required bi-lateral bill-acceptance/clearing arrangements which were ultimately trust-based.

Polanyi is proposing an idea that we will term *global monetary order*: that is, a set of institutions whose power and positioning within the global economy permit them to initiate, maintain, and discipline financial flows across borders. By 'order' here is meant the assurance for participants in cross-border relations that obligations be made only with a secure prospect of repayment. Establishing this assurance requires that institutions initiating financial contracts not extract immediate gains from a transaction – say, from the fees available from creating a new set of

[1] Polanyi's term contrasts with the French expression *haute banque*. Cassis (2006, pp. 104) observes, "There is no official list of the members of the *haute banque* – membership of the group was a matter of status rather than of functions." Eight French banking houses, all private bankers, were members of this list at the end of the nineteenth century, according to this author. *Haute finance* was clearly a way of denoting the broader list of private banks that would have met these criteria for a broader set of nations.

securities – if that transaction will generate payment obligations that have a high probability of failure, or if it may require excessive short-term financing in markets where affordable liquidity is not always available. In effect, the institutions maintaining this order must have the means to limit the overall systemic flow of finance (especially of credit obligations), synchronizing it with available cash-flows; and they must be willing and able to consider the systemic spillover implications of the decisions they make individually. In effect, a functioning monetary order must consider and capture spillovers and guard against (or eliminate) free riding.

A global monetary order resided, in the 'hundred years' peace' period, in a set of large investment banks, connected by ties of tradition and trust.[2] This order was linked to the gold standard, which provided a secure reference point – if not a set of automatic adjustment mechanisms – for monetary transactions. The global investment banks constituted the nerve center of cross-border finance: "international banking was not restricted to the financing of governments … [but also] comprised foreign investment in industry, public utilities, and banks, as well as long-term loans to public and private corporations abroad. National finance again was a microcosm" (page 11). These banks' oligopolistic grip on external finance permitted them to keep an "iron grip" on smaller nations seeking finance for infrastructure projects. The relatively small number of these banks and their close historical (and even family) ties necessitated that they consider the longer-term, systemic consequences of every short-term decision to authorize or deny flows of credit. Larger nations posed their own problems, as Polanyi observes via the example of the Franco-Prussian War of 1870:

> "International Finance had to cope with the conflicting ambitions and intrigues of the great and small Powers; its plans were thwarted by diplomatic maneuvers, its long-term investments jeopardized, its constructive efforts hampered by political sabotage and backstairs obstruction." (13)

Such geo-political conflicts could be cooled only by a counterforce which had both an interest in avoiding war, and the leverage to cool hot heads. As Polanyi puts it:

> "the peace interest became effective only because it was able to make the balance-of-power system serve its cause by providing that system with social organs capable of dealing directly with the internal forces active in the area of peace. Under the Holy Alliance these organs were feudalism and the thrones…; under the Concert of Europe they were international finance and the national banking systems allied to it" (*ibid*., page 17-18).

So in the 'hundred years' peace,' "Trade had become linked with peace" (*ibid*., page 15). But even while he acknowledges the gains from that 'peace,' his narrative is motivated by the breakdown of these arrangements. This global monetary order proved fragile, in that it depended on the existence of an international gold standard whose maintenance, in turn, eventually became too costly for Great Britain, the nation responsible for maintaining it.

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[2] Plentiful evidence of the close bonds among investment banks operating in the UK, Europe, and America is provided in Burk (1989) and in Cassis (1994).

Polanyi's text does not offer a formula for a global monetary order. But his argument suggests the elements needed: a hegemonic nation-state able to maintain currency regularity, plus a set of responsible, long-term oriented financial firms that govern the flows of finance among nation-states. Polanyi unfolds an argument for a new international monetary hegemon that begins by recognizing the failure of the international gold standard as a key step in the economic disintegration and growing barbarism of the interwar period:

> "… The only alternative to this disastrous condition of affairs was the establishment of an international order endowed with an organized power which would transcend national sovereignty. Such a course, however, was entirely beyond the horizon of the time. No country in Europe, not to mention the United States, would have submitted to such a system." (*ibid*., page 23)

In this interim period, "the world relied as never before on *haute finance*, now represented by JP Morgan instead of N.M. Rothschild" (*ibid*., page 23), capital flight emerged for the first time, and cataclysmic changes ensued, as "The snapping of the golden thread was the signal for a world revolution" (*ibid*., page 29). The "scourge of unemployment" and "[d]efeat created highly artificial conditions," which led to "new mechanisms" (*ibid*., pages 224, 225, 228), including fascism, which "now emerged as an alternative solution to the problem of industrial society" (*ibid.,* page 252).

3. Keynes on banking in the *Economic Consequences of the Peace* and in the 1920s

In prose influenced by his "Stracheyan side" (Clarke 2009, p. 48), Keynes' *Economic Consequences of the Peace* unfolds like a contemporary Greek tragedy. Its starring characters are doomed to the loss of all they hold dear by the actions they feel compelled to take against the backdrop of an unresolved tit-for-tat national and industrial competition between Germany and France. Chief among the dramatis personae are United States President Woodrow Wilson, deluded by his design for a peace among the nations involved in the Great War, and French President Clemenceau, who apparently concedes to Wilson's purposes but in fact undercuts them, to France's immediate (if not longer-term) advantage. In the end, Wilson's triumph sets in motion forces that will bring a yet greater disaster to all of Europe – precisely the opposite of his intention.[3]

The Versailles Treaty Conference of 1919 mandated significant cross-border reparations and debt-repayment flows in the wake of both the war damages laid at Germany's feet and the international debts accrued during the war years. Keynes protested this in his *ECP*, Keynes focused on the negotiations over the level and financing of post-War reparation and debts, mentioning banking and finance only in two brief passages. It is not that Keynes had not written about this topic, nor than he had no experience of *haute finance* in Polanyi's sense. He had written scathingly about the "lack of courage .. on the part of our joint-stock bankers" (Keynes 1914, p. 461) – the consequence was the closure of the London stock market and a period of

[3] Choosing to celebrate Wilson's idealism rather than to expose its limits, Karl Polanyi wrote in these terms about the 28th US President: "First among the statesmen of the time, Woodrow Wilson appears to have realized the interdependence of peace and trade, not only as a guarantee of trade, *but also of peace*." (Polanyi, 1944, p. 23)

extreme financial distress at the onset of World War I - in an article published in September 1914 (Moggridge 1992, Chapter 10). And he had worked at the British Treasury to secure the finance needed for Britain's war effort (Moggridge, *ibid*., Chapter 11). As we shall see, Keynes would soon renew his accusation that banks' self-seeking behavior can prevent their performing needed roles in economic processes. But the inattention to finance in *ECP* is not surprising when put into historical context.

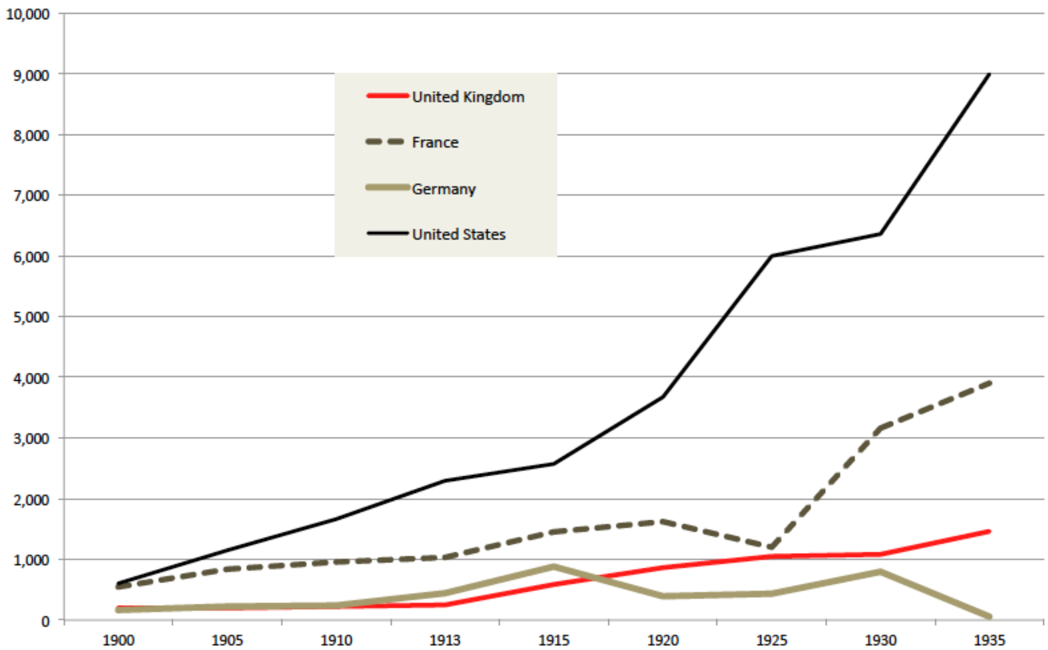
Generally speaking, the two decades prior to World War I found banking systems in the midst of an industrial transition. As noted above, recurrent financial crises in the nineteenth century led to numerous coalitional and ownership shifts by international banks. Further, these crises and the increasing scale of industrial activity (and hence of investment projects) led many privately-held regional banks to mergers with larger banks such as Barclays (Ackrill and Hannah 2001, chapters 1-2). During World War I, national governments reined in their banking and financial markets, and closely controlled interest rates and financial flows.

These measures, together with the industrial output shifts due to war-time conditions, created many distortions. Keynes reflects in *ECP* on "inflationism of the currency systems of Europe" (p. 170), which had redistributed wealth wildly and nearly erased the line between entrepreneurship and speculation. Keynes remarks on "the popular indignation against the more obvious consequences of [the] vicious methods [of t]hese 'profiteers,' [who] are, broadly speaking the entrepreneur class of capitalists" (pp. 168-9). He notes that as one consequence of the turbulent conditions of the post-war, Europe is presented with "the spectacle of an extraordinary weakness on the part of the great capitalist class, which has emerged from the industrial triumphs of the nineteenth century, and seemed a very few years ago our all-powerful master" (p. 169).

The end of the war did not uniformly weaken the banks. As Cassis (2006, chapter 4) recounts, the postwar found national banking systems in very different circumstances: the French banks generally were weakened by war and inflation, as were the German banks; the City banks of London and the internationally active US banks generally prospered. But the Versailles conference set in motion forces that would destabilize banking generally and *haute finance* specifically. Prior to the War, the practitioners of *haute finance* could manage cross-border payments obligations before and after the conflicts whose financing they arranged – including the obligations of defeated powers. Polanyi's "one hundred years' peace" vision of *haute finance* was based precisely on the national budgetary restraint required for this rebalancing.

However, the Great War set in motion demands not only for repayment of war-time borrowing, but for reparations on a scale that dwarfed the defeated powers' repayment capacity. Keynes' text anticipates the disastrous consequences of these required flows in *ECP*. His other significant passage on finance therein warns of the distortions in financial relations that the Treaty conference had set in train. Keynes rails against the "vast paper entanglements which are our legacy from war finance both at home and abroad. The war has ended with every one owing every one else vast sums of money." To "free our limbs from these paper shackles," Keynes recommends a "bonfire" or, for "internal debt, .. a capital levy for the extinction of debt" as an "absolute prerequisite of sound finance." (p. 197)

Figure 1: National holdings of gold (in tons), 1900-45
IMF Intl Financial Statistics



Keynes' suggestion on burning War-related debt was not heeded; nor were his admonitions about the social implications of fluctuations in monetary value (as Keynes (1931) put it) heeded, nor his suggestion for modified reparations that would permit Germany the possibility of an economic recovery (Ritschl 2012, pp. 2-3). Instead, global finance in the 1920s was characterized by deepening instability: gold stocks were steadily transferred to France and to the United States, as Figure 1 shows; Britain's return to the gold standard, while France's franc struggled (Cassis 2006, chapter 4), and Germany remained able to access international capital markets under the Dawes plan (Ritschl 2012), even while unable to service its reparations.

UK banks benefited from the perceived stability benefits of the gold-linked pound sterling; these benefits were fragile, though, as gold stocks steadily shifted toward the US (Figure 1). Meanwhile, the unsustainable cross-border commitments, accompanied by unbalanced species flows, encouraged the growth of shorter-term speculation among banks. Keynes' observations about banking and finance during the remainder of the 1920s indicates his increasing recognition that global financial arrangements and domestic banking practices were increasingly dysfunctional. Keynes' lecture to the Institute of Bankers on December 5, 1922, includes the observation that "The course of sterling .. has been under the control of our financiers, … and I think the policy they have actually adopted, although I understand the honourable motives which have prompted it, has prolonged the trade depression."[4]

In 1925, Keynes shifted this critique from financiers to the Ministry of Finance in his essay, "The Economic Consequences of Mr. Churchill." Over the course of this decade, Keynes came to

[4] Keynes (1981, I, p. 65). Keynes' observation goes to the point that the rise in the rate of sterling has compromised the potential for British gains from trade associated with the rise of prices in America.

regard international financial practices as a component of a misconceived British commitment to the Gold standard. In a letter to Sir Richard Hopkins on April 19, 1928, he wrote:

> "The more I think about it, the more I am impressed with the extreme rashness and folly of carrying on an international banking business .. when we are no longer the only international centre, with a free gold reserve not only of trifling magnitude in itself but a very small fraction of the free reserves of the rival financial centre, the United States."[5]

Keynes' views of domestic banking underwent a similar transformation. In an address to the League of Nations Union in March 1924, Keynes had rhapsodized the economic role of banking in Schumpeterian terms:[6]

> "there is the kind of banking undertaken by the ordinary banker as the public thinks of him, who deals with his customers, whose main business is to see that his customers are solvent and suitable to lend money to, and who directs the deposits of the community into the most advantageous channels. That is a business in itself, a business which bankers, I think, carry on in this country with great efficiency."[7]

But just a month later, Keynes described speculative investment behavior linked to German reparations that point to the opposite assessment:

> "What Germany has appeared to pay in reparations is nearly equal to what the foreign world has subscribed in return for worthless marks. The same illusion, the same ill-calculating ignorance, which generated oppressive and impossible demands, have brought forth also these vast losses, before which the losses of all previous bubbles are nothing. A million foreigners .. have acquired bank balances in Germany, and each .. has cost its owner on the average about £400. … These are the rich ones – the bankers, the financial experts. Beyond them are the many millions, the housemaids and the hairdressers, who have bought a few shillings' worth .. of crisp Reichsbank emissions…"[8]

A year later, in a March 21 (1925) essay in *The Nation and Atheneum*, Keynes called for controls over such rash and destructive practices:

> "Where most of the business of a country is carried on by means of a credit system of the modern type, central management of the currency becomes a necessity. The best example of an attempt under modern conditions to reduce the element of central management to a minimum was to be found in the United States under their pre-war organization prior to the establishment of the Federal Reserve System. This state of affairs proved so

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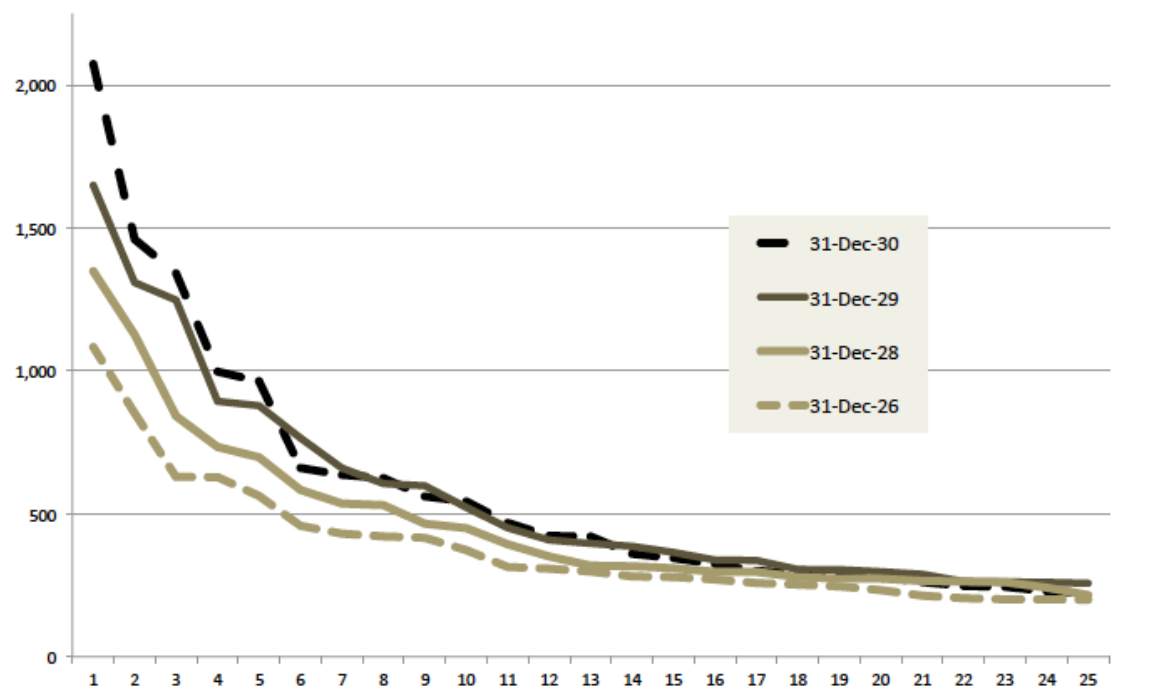
[5] Keynes (1981, II, p. XX).
[6] Chapter 3 ("Credit and Capital") of Schumpeter (1934) sets out a vision of financial markets in which bank credit provides the finance that permits entrepreneurs, who often lack adequate resources, to go forward with their plans.
[7] Keynes (1981, I, p. 187).
[8] Keynes (1978, p. 245).

disastrous, particularly in the crisis of 907, that it became the preoccupation of all thinking American bankers to evolve a managed system."[9]

Figure 2: The 25 Largest US Commercial Banks, 1926-1930, rank ordered by deposit totals on December 31



4. Large US banks' rise in the 1920s, and the New Deal banking reforms

US banks grew rapidly in the 1920s. According to Goldsmith (1958, Appendix A), commercial bank assets in the United States grew by 39 percent between 1922 and 1929. The very largest banks grew faster than even other large banks.[10] Figure 2 arrays the 25 largest commercial banks, by deposit size, from largest to smallest, for year-end 1926, 1928, 1929, and 1930.[11] This figure shows that while the deposit-size of banks below the 10th position remained approximately constant, the larger banks grew significantly in relative (and absolute) terms.

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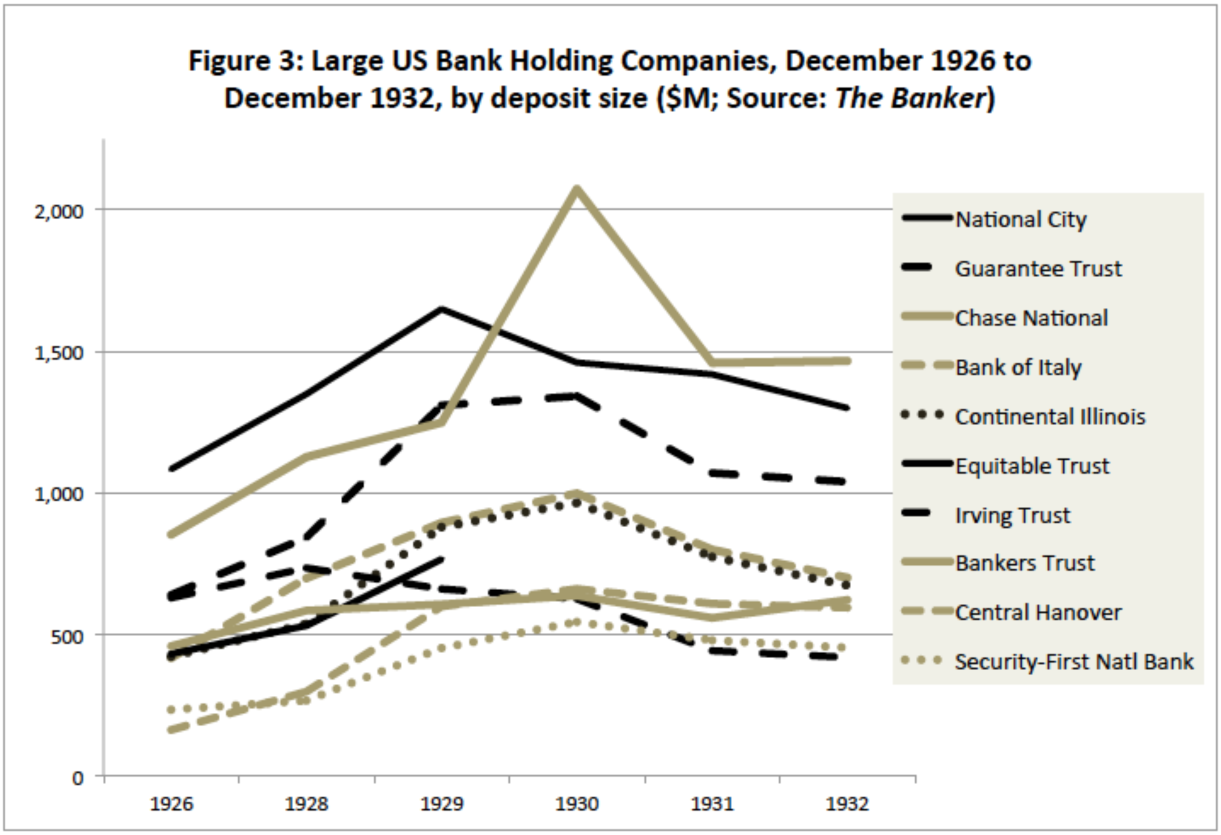
[9] Keynes (1981, II, pp. 338-9).

[10] This section draws on United States experience. The situation in the United Kingdom was similar in key respects. The consolidation and merger of US banks described here is paralleled, in Britain, by consolidation during the shift, noted above, from private to joint-stock banking. The much larger number of small depositories in the United States reflects that nation's peculiar circumstances of building capitalist relations spanning a continent by steady expansion of its borders (Cameron 1960).

[11] US federal regulators do not maintain systematic records on banking firms' asset size (or their other balance-sheet entries) extending back to the 1920s and 1930s. However, fragmentary data on bank size for these years were obtained from contemporary news sources. The figures shown here for the 1920s and 1930s are drawn from *New York Times* articles reporting on bank-size rankings posted by *The Banker* magazine. Note that these figures encompass total deposits and not total assets.



In New York, the largest banks competed for primacy through active acquisitions strategies involving large competitors: City National merged with Corn Exchange in 1929, Chase with the Equitable Trust and Interstate Trust companies in 1930, and so on. A *New York Times* article published in 1926 pronounced that "banking is now America's 'biggest' business" and then analyzed the merger wave in banking, as well as considering whether permitting more widespread branching would even the playing field between large and small institutions.[12] A *New York Times* article published on September 29, 1929 about the City National merger with Corn Exchange, entitled "The Ruler of the World's Largest Bank," substituted adulation of City chairman Charles E. Mitchell for analysis.[13] Figure 3 illustrates the rapid rise in the leading US banks in the 1926-29 period, with City National in the lead.

These years saw the British and American banking systems caught up in a swirl of speculation (Kennedy 1973, Galbraith 1955). Banks operated as both sellers of speculative stocks and bonds, financiers of speculative financial positions, and bankers for the households and businesses tempted into position-taking in an unhinged and unregulated financial environment. As in the

[12]Foster (1926).

[13] Wamsley (1929). The article begins, "Early risers strolling along Fifth Avenue almost any pleasant morning may see a brawny figure of a man, striding briskly along at a pace that covers the ground between his town home in the upper reaches of the avenue and his office in lower Wall Street in little more than an hour. Sometimes he is alone, frequently with a business companion, but the constitutional is taken every day he is in the city, and in the same vigorous fashion, shoulders back, chest out and at a pace that exhausts less vigorous companions."

subprime lending boom of the 2000s, both large and small financial institutions, banks and non-banks alike, were involved in financing and taking positions in stock-market speculation. Regulators were slow to impose margin requirements on investors and unable to manage the financial institutions feeding these "investors." A mania of 'getting in on the kill' evolved. The giddy rise in stock prices encouraged mergers and acquisitions, especially in the financial sector.

The September 1929 and October 1929 stock-market crashes in the UK and US, followed by the 1931 failure of Austria's Creditanstalt tumbled the overleveraged house of cards. This was the context for Keynes' pointed and angry indictment of bankers in the August 1931 paper included in his *Essays in Persuasion*:

> "Today … it is the serious embarrassment of the banks which is our gravest concern. The shattering German crisis of July 1931, which took the world more by surprise than it should, was in its essence a banking crisis, though precipitated, no doubt, by political events and political fears. That the top-heavy position which ultimately crumbled to the ground should have been built up at all was, in my judgement, a sin against the principles of sound banking. One watched its erection with amazement and terror."[14]

Keynes then predicted that the banks' weakness had to be addressed if the economy was to recover:

> "And over a great part of the world, and not least in the United States, the position of the banks, though partly concealed from the public eye, may be in fact the weakest element in the whole situation. It is obvious that the present trend of events cannot go much further without something breaking. If nothing is done, it will be amongst the world's banks that the really critical breakages will occur." Keynes (1931, p. 173)

Irving Fisher (1933) described the debt-deflation processes of these years in excruciating detail. Panic (Kindleberger 1973) overtook global financial markets, and fear spread among the populations of the few remaining democratic nations (Katznelson 2013). This destructive self-reinforcing cycle of bank and business collapse compelled action. Congress passed the Reconstruction Finance Corporation (RFC) in January 1932; it provided loans to state and local governments, banks, and businesses. And in March 1932, the Senate Committee on Banking and Currency launched an investigation into the causes of the 1929 Wall Street crash.

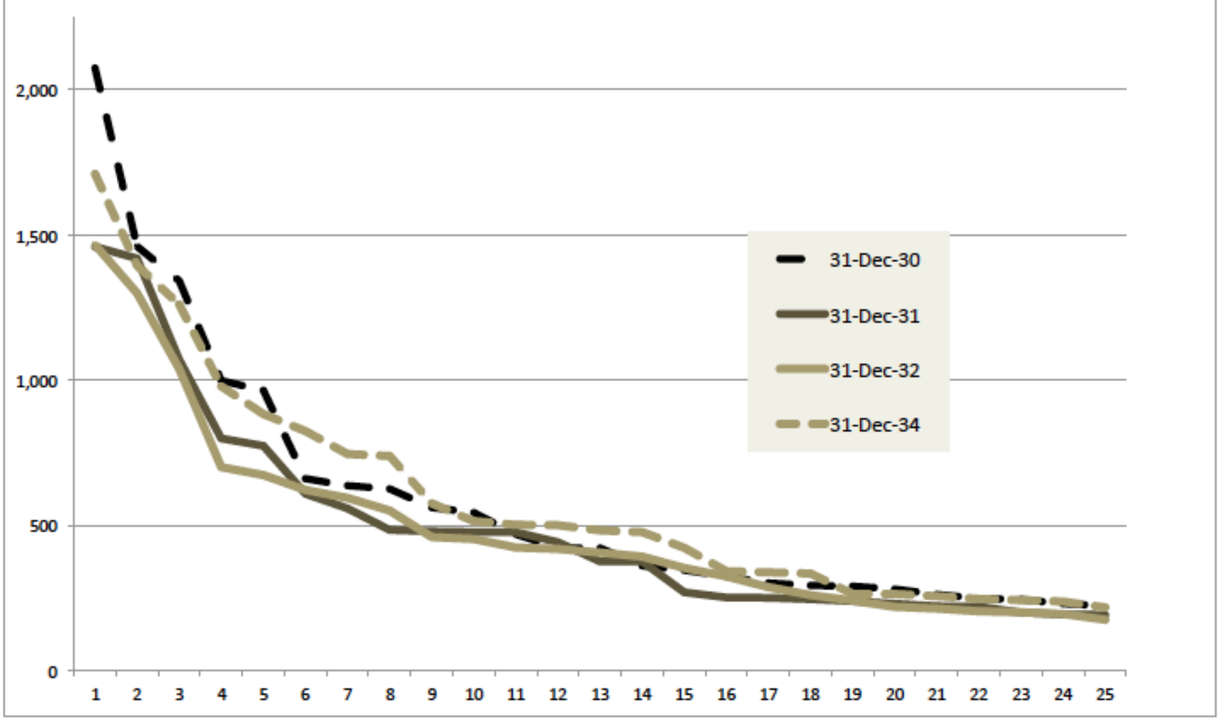
The RFC did not stop the collapse. Figure 4 shows how the largest US banks' balance sheets began shrinking after 1930. A bank run preceded the inauguration of Franklin Delano Roosevelt on March 4, 1933. Taking executive powers into his hands, the new President authorized a bank holiday on the same day, and asserted in his inaugural address, that "the only thing we have to fear is fear itself." He went on:

> "Plenty is at our doorstep, but a generous use of it languishes in the very sight of supply. Primarily this is because the rulers of the exchanges of mankind's goods have failed… Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men. … stripped of the lure of profit, … they

[14] Keynes (1931, p. 150).

have resorted to exhortations, pleading tearfully for restored confidence. They know only the rules of a generation of self-seekers. They have no vision, and when there is no vision the people perish." (Roosevelt 1933)

Figure 4: The 25 Largest US Commercial Banks, 1930-1934, rank ordered by deposit totals on December 31



Five days later, Congress passed the Emergency Banking Act, which assured Federal Reserve support for bank deposits. In the following weeks, a wave of legislation put a floor on the downward economic spiral by providing unemployment insurance, jobs programs, and mortgage underwriting. Meanwhile, the Banking Act was working its way through Congress. The fourth chief council of the Senate Committee investigation on the 1929 crash, Ferdinand Pecora, had been appointed in January 1933. Given the investigation's unsatisfactory results, Pecora had begun a new round of hearings in February 1933. President Roosevelt encouraged Pecora to call J.P. Morgan as a witness. On May 23, 1933, Morgan commenced his testimony with a statement fully consistent with Polanyi's view of how private banking was a vehicle for achieving both domestic prosperity and global monetary order:

> "The bank must at all times so conduct himself as to justify the confidence of his clients in him and thus preserve it for his successors… and so [to] maintain the credit and reputation which has been handed down to us from our predecessors in the firm. … knowing as he does that none of the aids provided by the Government for incorporated banks, such as the Federal Reserve System or the Reconstruction Finance Corporation, are at his disposal.
>
> "The private banker has at least one other duty; he must be ready and willing at all times to give disinterested advice to his clients to the best of his ability. … The belief in the

> integrity of his advice is a great part of the credit .. which [constitutes] … the best possession of any firm" (United States Senate, 1933, page 4).

Morgan goes on to set forth the arguments that justifies permitting large investment banks, in particular, to operate with a large scope of action and minimal constraints: first, in taking risks they do not put other people's money in play, but only their own; second, they can finance entrepreneurial initiatives that would not otherwise be feasible;[15] and third, their size and their prudence (due to depending on their own resources) positions them to backstop the overall financial system when panics or crises ensue:

> "… I will now pass on to the uses of private bankers. These seem to me to be closely related to the fact that, as they are risking their own money and doing their own work, they may properly undertake certain responsibilities and businesses which the management of an incorporated bank might not be justified in dealing with. … [T]hey can in a very prompt and effective way assist in the development of the industries and production of this largely industrialized world. They can also come to the aid of a general situation … in times of panic and distress, to an extent that an incorporated bank might well feel it had not a right to do with its stockholders' money.
>
> Another very important use of the private banker is to serve as a channel whereby industry may be provided with capital to meet its needs for expansion and development" (United States Senate, *ibid*., page 4).

Morgan's reference to his role in the 1907 banking crisis did not deter Pecora and his team, who explored J.P. Morgan's stock-market price manipulation and non-payment of taxes.[16] And Morgan's denial of wrong-doing in a June 9 statement did not forestall the passage of the 1933 Glass-Steagall Act a week later. That Act made federal deposit insurance permanent, and addressed the issues of bank market-manipulation and speculation through several provisions. Its key feature was the separation of commercial and investment banking; existing banks had to choose which side of their operations to maintain, and which to jettison.

Whether bank speculation was indeed responsible for the crash of the banking system, has become the subject of a lively economic debate.[17] The key point here is that large banks were sufficiently weak that a forceful set of laws restricting the ambit of their activities, and specifically their access to the 'safety-net' provisions written into banking law, could be – and was – approved by Congress and passed into law by the President. One reason this picket-fencing of banking succeeded was banks' loss of political leverage in the new Administration. It is not that banks had lacked political influence. Chernow (1993) demonstrates their extensive contacts in the US. And Cassis (1994) notes that elite bankers and national political leaders

[15] This is Morgan's own recitation of Schumpeter's view of banking.

[16] Galbraith (1955, pp. 50 et seq.) shows how the Great Crash arose in part because investment banks did not restrict themselves to the virtuous role that J.P. Morgan describes here: instead, investment banks engaged actively in establishing and financing investment trusts and other vehicles for financial speculation that fed the unsustainable asset-price appreciation of the pre-Crash years.

[17] Galbraith (1955, p. 179) cites "bad banking structure" as one of the causes of the Great Crash of 1929, and describes several systemic weaknesses in the pre-Crash US banking structure. Temin (1991) presents a balanced account of differing views about the causes of the Depression, Galbraith's text among them.

moved together in "the most select high society of the time" (p. 295). But circumstances forced these prior political ties to the sideline.

A second reason an aggressive banking reform was passed is that banks were no longer able to manage international global imbalances, as they had previously done.[18] Third, government underwriting was sufficient to restore "normality" in the markets for liquidity and credit. Fourth, the global context – the rise of fascism and of Stalinism, in particular – gave Roosevelt a temporary window for undertaking decisive executive action with legislative concurrence (Katznelson 2013).[19]

In effect, while global monetary order had been destroyed, the national state was capable of stepping in so as to restore national monetary order. This suggests an explanation for one peculiarity in the structure of the *General Theory* (1936): the near-inattention to banking. Financial dimensions of capitalist fluctuations, such as liquidity preference and speculation motives, constitute a central theme of that volume. But banking does not; its only mention occurs in a short subsection on how banking structures tend to accelerate upturns or downturns in economic activity. We can hypothesize that the dog didn't bark – that banking occupies such a secondary place in Keynes' *magnum opus* – because by the mid-1930s, banking had been tamed.

5. Global Imbalances and US Banking Evolution: the 1980s through 2008

There are striking parallels between the period between the 1919 Versailles treaty and the 1933 US banking reforms, and the situation in the US as it unfolded from the 1980s to the subprime crisis. We argue in this section that large US banks did play a role similar in some ways to *haute finance* in the years before 2000, by helping to manage cross-border imbalances. But some key differences make it impossible to regard the US banks involved in cross-border finance as a club whose claim on economic surplus depended, as in the 19th-century world, on private bankers maintaining gentleman's agreements.

The key differences are these: first, the nature of the cross-border imbalances in the post-War period were significantly different than in the pre-War era; second, large banks' evolution in this period increased rivalry at the commanding heights of finance, instead of enhancing cooperation; third, when the system entered into the severest phase of crisis, political leaders were no longer willing or even able to make a distinction between a part of the banking system that clearly provides needed functions for the broader (non-financial) economy, and that part whose behavior can be more clearly labeled as speculation-driven. We consider each of these differences in turn, using the idea of global monetary order to organize our discussion.

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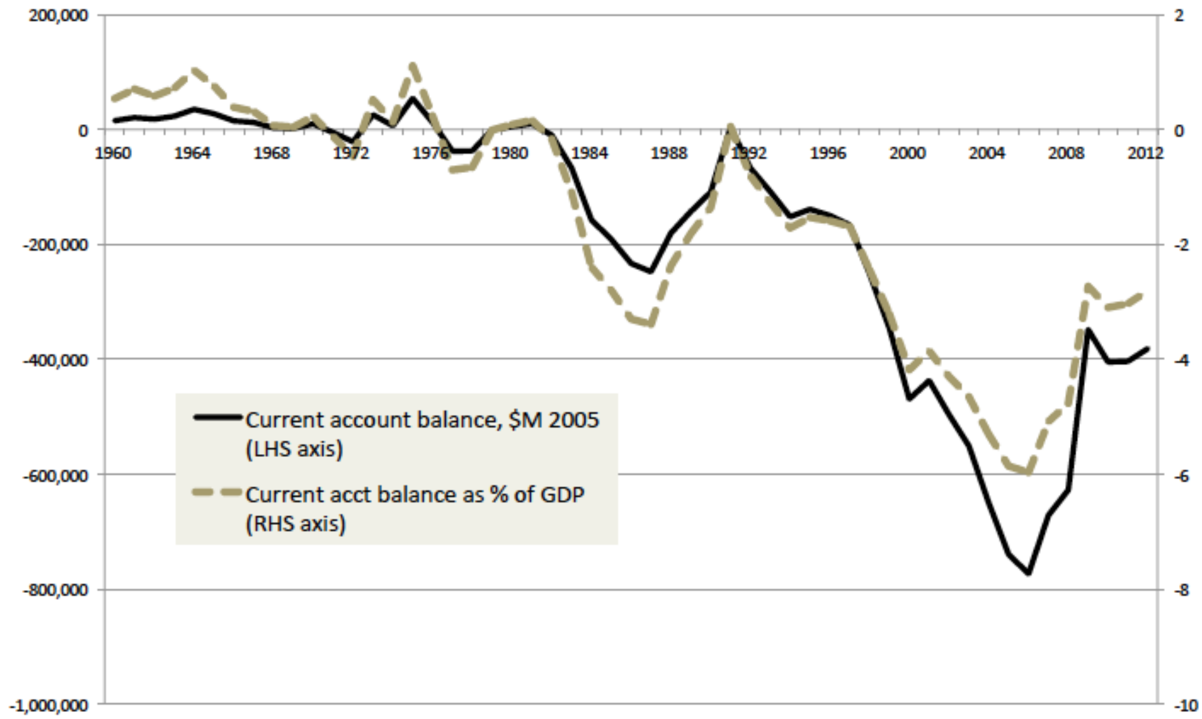
[18] It is worth noting that Polanyi's analysis in *The Great Transformation* does not cover the history reviewed here. It pays no attention to why the gold standard collapsed, and does not explore the role of international finance as the gold standard came apart. He also pays no attention to the role of banking, and indeed of these same investment banks, in undermining domestic economies in this period.

[19] Ross (1996) notes that Great Britain's banking structure had, like the US, become one in which different banking functions (commercial banking, investment banking, and so on) were carried out by separate institutions. This was achieved by reorganizing activities and government directives, not by a single piece of legislation as far-reaching in its consequences as the Glass-Steagall Act.

We focus, as above, on the US case. This US-centric approach embodies a central theme of this narrative: that is, the US economy's systematic capital-account surpluses in the post-1980 period, and the US's bank and thrift crises of those years, explain the shift of the US system to a securitization-centered approach that became increasingly speculative. These shifts led both money-center banks and investment banks toward ever-more-predatory competitive practices, and, at the same time, transformed core banking – and repositioned it within the nexus of financial markets – in such a way that policy-makers attempting to rescue the US banking system at its moment of crisis perceived their options very differently than Franklin Delano Roosevelt had understood his.

Figure 5: US Current Account balance, in $M 2005.
Source: US Bureau of Economic Analysis



US post-War cross-border imbalances. Figure 5 presents summary statistics about the trajectory of the net US current-account position from 1960 to 2012. Until 1981, the scenario is one of relatively minor deviations from zero. Thereafter, two plunges into net deficit position are observed: one from 1983 to 1991; and a second and deeper plunge from 1993 to the present. This net negative position accounts for a remarkably high percentage of the US GDP. The 1970s imbalances were associated with petro-dollar recycling: a period in which oil-exporting countries' surpluses were channeled via global-North banks to borrowers in resource-rich global-South countries. These imbalances were unstable, since they were linked to commodity prices. The institutions involved in the lending part of this recycling were large commercial banks in the US and Japan, primarily; the loans were channeled primarily to resource-rich Latin American countries. This lending, of course, resulted in debt crisis as interest rates were driven skyward in the Volcker era and as global commodity prices crashed.

From 1983 forward – with the exception of 1991 – the US current account has been consistently in deficit. These systematic net deficits imply systematic capital-account inflows: and these inflows have made the US a global liquidity sink. This trend's principal implication is that the US financial system consistently receives inflows of funds seeking investment opportunities.

The uneven evolution of financial-industry competition. As the US economy entered the post-War period, there was nothing like a gentleman's club with unbroken relationships over time. For one thing, the ranks of investment bankers were riddled by unsettled rivalries that went back to the early 20th Century. The 1900s saw the rise in the US of Jewish-owned investment banks – Goldman Sachs, Lehman Brothers, and others – who helped finance Germany's war effort, and who thus came out on the opposite side from the bankers that had nurtured the Anglo-American alliance (Chernow, 1994, Chapter 10).[20] The Glass-Steagall Act, in turn, had unsettled the competitive terrain further. Some banks that had formerly been universal (combining investment and commercial banking operations) shifted to commercial banking (e.g., Citibank), and others to investment banking (Lehman). But things were not so simple: Morgan Stanley/J.P. Morgan/Morgan Guaranty, for example, continued to straddle the Act's binary definitions in their US operations (Chernow 1994, Chapter 24); Citibank, in turn, continued to offer a full line of corporate underwriting and investment banking services, as well as commercial banking services, throughout its global network – the one exception being the United States itself (Baron and Besanko 2001).

At the commanding heights of US banking after the War, then, was a combination of money-center commercial banks and large investment banks. Both undertook a stream of innovations and shifts of organizational form which eventually met in the middle when the Glass-Steagall Act was repealed in 1999. Old-line investment banks such as Morgan Stanley, First Boston, and Dillon, Read were pushed to expand their activities in the 1960s by the success of smaller competitors such as Goldman Sachs and Salomon Brothers that excelled at trading (Chernow 1994, Chapter 29). From the 1950s to the 1970s, US banks invaded European markets, as Sylla (2001) put it, so as to "escape" from strict US regulations. In 1974, Morgan Stanley engineered the first hostile takeover in memory on Wall Street, breaking the "gentleman's code." (*ibid*., pp. 598-99). In the early 1970s, futures markets and derivatives made their first appearance, followed by the first hedge and institutionalized private-equity funds in the early 1980s (Cassis 2006, Chapter 6). In effect, the investment pools and instruments needed to support a shadow banking industry came into existence – if not maturity – in these years.

Large commercial banks' evolution was, if anything, even more radical than investment banks'. These banks – and in particular, the money-center banks involved in cross-border and money-market operations - were working continually to undermine the tight regulatory limits established in 1930s banking legislation. They sought first to free up borrowing markets, so as to take more aggressive asset positions. Examples are Citibank's creation of a secondary market in certificates of deposit in 1961, then money-center banks' opening of Eurodollar deposit accounts, their expanded use of the commercial paper market, and so on. This led to occasional liquidity crises,

[20] The Rothschild's, of course, were a Jewish family as well. The sensitivity this provoked in the broader world of finance is evident in the 1887 book, *The Rothschilds: The Financial Rulers of Nations* (Reeves 1887), which celebrates the family's predominance in business affairs but also justifies it by emphasizing the family's historical links to European commerce and family members' civility and capability.

as when a default on commercial paper issued by Goldman Sachs for Penn Central led to a run on the commercial-paper market (Stojanovic and Vaughan 1998).

The circumstances of US commercial banks became more precarious as of the late 1970s, as high interest rates spurred disintermediation, larger businesses began turning more aggressively to direct (instead of intermediated) credit, and new non-bank investment outlets were emerging for middle-market clients. The result was a series of banking reform acts, beginning in 1980, and the launching of a regulatorily-encouraged bank merger wave (Dymski 1999). So from the 1980s on, large banks' search for liabilities was increasingly accomplished by merging with – or acquiring – other banking firms. This was facilitated by the deep recession of the early 1980s and by the insolvency and collapse of many savings-and-loan associations. Meanwhile, large commercial banks compensated for the loss of blue-chip borrowers (who were turning to the commercial paper and bond markets) and instead focused loan growth on Latin America and oil-rich American states. When, as noted above, this resulted in crisis – and in particular, the collective balance-sheet insolvency of US money-center banks (Dymski 2011), regulators did not rein in or shut these institutions; instead, they emerged largely intact, buttressed by the idea that the very largest banks were "too-big-to-fail" because of their central position in US money and credit markets.

Further, the Federal Reserve encouraged the drift toward universal banking by steadily loosening regulations under the Bank Holding Company Act. Especially important was its 1987 approval for commercial banks to underwrite equities and bonds via "Section 20" subsidiaries. Since investment banks already had that turf covered, the result was that the commercial banks' underwriting involved riskier securities.[21] In 1994, federal legislation removed barriers to banks' inter-state expansion. Analyses of banking in this era treated bank consolidation and activity deregulation as a given (for example, Summers 1991, Boyd and Gertler 1993, Meyer 1998); if anything, even more deregulation was needed (Calomiris 2002). Dymski (2011) shows that this acceptance of further deregulation and consolidation as inevitable reflected the agenda-shaping of the Shadow Financial Regulatory Committee, which had been formed officially in 1986. When analysts did raise concerns, they were dismissed.[22]

Glass-Steagall was on borrowed time. Citibank reorganized its global operations on a customer, not geographic basis, in the mid-1990s (Baron and Besanko 2001), preparing for the transition. It then precipitated that transition with its announcement in April 1998 of its plan to merge with Travelers Group. At the time, insurance was one activity that did not qualify as "closely related to" banking under the 1956 Bank Holding Company Act. The Federal Reserve tentatively approved the merger, subject to a change in the enabling law within an 18-month window. The Financial Services Modernization Act, which replaced the Bank Holding Company law with a permissive, post-regulatory framework, was duly passed in November 1999. The former money-center banks, who had already grown by combining and by absorbing regional banks, had a

[21]Focarelli *et al.* 2011 demonstrate this empirically for securities underwritten in the period 1985-1999.
[22] For example, a banking survey article by Boyd and Gertler (1993) highlighted large banks' overly risky loans and weak results and linked it to these banks' too-big-to-fail status; they also noted, perceptively, that "financial stability in a contemporary environment hinges mainly on the sound operation of the money market" (p. 363). Fischer Black, then working for Goldman Sachs, struck back at this critique of the money-center banks, blaming "the luck of the draw" (Black 1993, p. 369) and "an accident of the period" (*ibid.*, p. 371) for big banks' unhappy 1980s outcomes.

license to build out extensive universal banking organizations. Meanwhile, those investment banks that had not already shifted their ownership basis from the partnership to the joint-stock ownership form – a move that signaled their readiness to increase their leverage and take on riskier assets, and to increase the volume of trading on their own account.

Figure 6: The 25 Largest US Commercial Banks, December 1981 to June 2008, rank-ordered by asset totals ($B; Source: FFIEC)

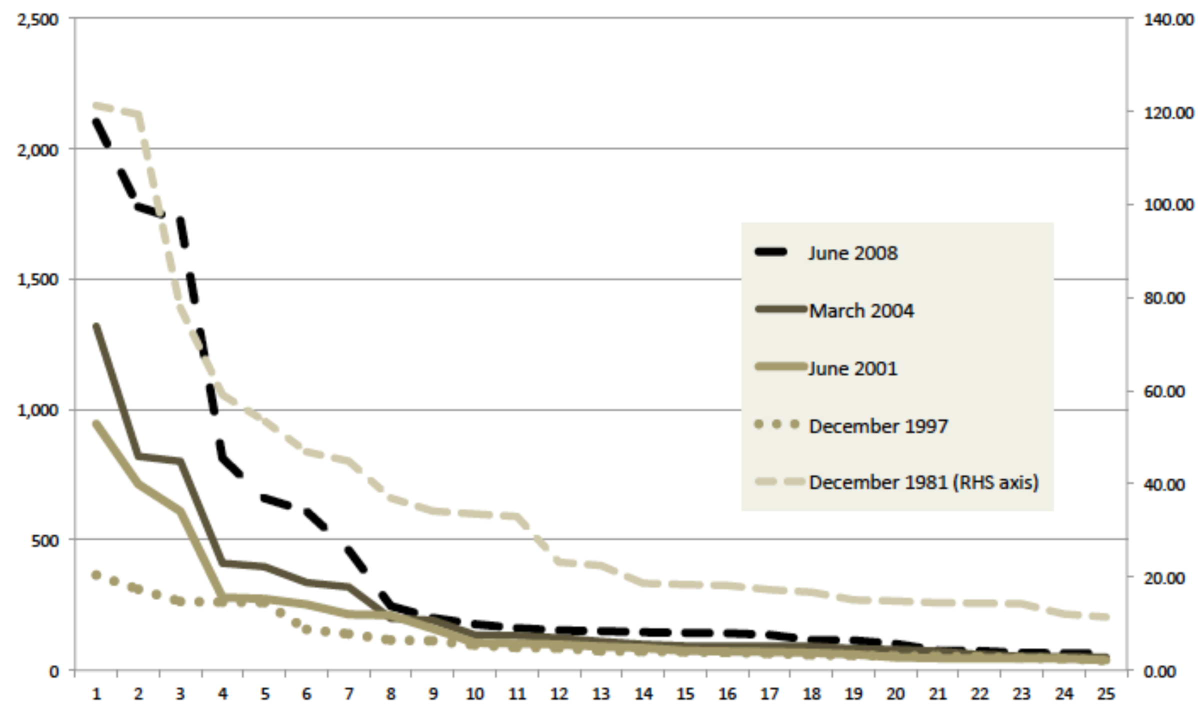


Figure 6 tells the story of these years for large bank holding companies by depicting the relative asset size of the 25 largest banks. It first depicts the rank-ordering just before December 1981, just before the Latin American debt crisis and savings-and-loan crisis hit home; the largest banks in that year are considerably bigger than their rivals further down the list. By 1997, after years of crisis and underperformance, Figure 6 shows that the very largest banks are very little larger than their regional competitors. But this steadily changes, until by June 2008 – just before the subprime crisis – the largest banks again dominate the competitive landscape.

These decades of unsettled rivalry and market positions clearly do not reflect institutions that are capable of maintaining global financial order. To the contrary, as noted, these institutions began to regularly engage in excessive risk-taking as a means of taking market-share from one another. The last gesture toward global monetary order was the September 1998 bailout of Long Term Capital Management (LTCM). LTCM, whose board of directors included the originators of the Black-Scholes formula, and which had specialized in highly-leveraged arbitrage plays based on mean reversion, lost $4.6 billion in the four months after the Russian financial crisis. The Federal Reserve coordinated the emergency provision of $3.6 billion by 14 money-center and investment banks. In effect, the Federal Reserve turned to the largest institutions on Wall Street to use their resources – and their reputation for probity – to block a global loss of confidence and a run on the Street's money market. The 1999 LTCM episode was somehow a reply of the Barings crisis of 1890. It was also a final fleeting moment for a reality that was being swept away. Thereafter, large globally active banks would not be available to restore order in crises; they would be principals in generating new crises.

Policy forcing and megabanks' repositioning of the institutional nexus of banking. In any event, by 2000 the US megabanks – the money-center banks and leading investment banks – were well along the way to creating that next crisis. They had since the mid-1990s been originating subprime loans, either directly or through subsidiaries or affiliates, then bundling, and selling these loans off as securities – often bundled together with plain vanilla mortgages, predatory non-mortgage loans, or other credits. They had been offloading risk onto AIG and other entities, using credit-default swaps; they had taken massive positions in derivatives markets linked to subprime markets, and had created synthetic instruments on which more zero-sum bets could be registered. An increasing share of the commercial-paper market was locked up in supporting the financial vehicles to which subprime paper had been directed. The details of these events have been recorded elsewhere and need not detain us.[23]

There are two key aspects of the buildup of subprime debt and securities during the 2000s, for our purpose. The first is that the "originate-to-distribute" lending model that was used to generate subprime mortgages and transfer their risks became the new institutional standard for lending and borrowing for large banks. This new model required an entire phalanx of components – loan brokers, insurers and underwriters, credit-raters, servicers, investors, and so on. It was financed through money markets; and as the volume of these mortgages and other credit contracts – and bets on these contracts – grew, the strategic use of leverage and the potential need for liquidity in the event of a housing-price shock grew even more rapidly.

The second is that the banking industry never lost its grip on US political leadership, even in the midst of system collapse. As Dymski (2011) notes, a huge number of lobbyists work for financial interests in Washington, many of them former regulators or members of Congress. Further, these interests have been pushing the same reform agenda, under the watchful eye of he Shadow Open Market Committee, since the 1980s. This political influence not only accommodated the concentrated power of US megabanks as key elements of national banking markets; the creation of this concentrated power had itself been an objective of federal policy for as many years. Wall Street insiders held leadership positions in the administrations of Presidents Clinton, George W. Bush, and of Barack Obama.

As the crisis gathered force – the peaking of housing prices in 2006, the run on Northern Rock in 2007, the collapse of the commercial-paper market – President Bush attempted to deter it with a precision tax cut in Fall 2008. This ruse failed. In March 2008, JP Morgan Chase bought Bear Stearns after its meltdown; in the ensuing six months, however, rapid adverse shifts in market conditions and housing prices made it impossible for any of the megabanks to purchase the failing Lehman Brothers (Sorkin 2009). When the moment of ultimate crisis came in late September 2008, decisions on how failing institutions should be resolved were handled by Treasury secretary and former Goldman Sachs executive Hank Paulson. President George Bush, in his speech of 24 September 2008, made it seem that banks had been victims of the subprime crisis, not its progenitors. The President explained,

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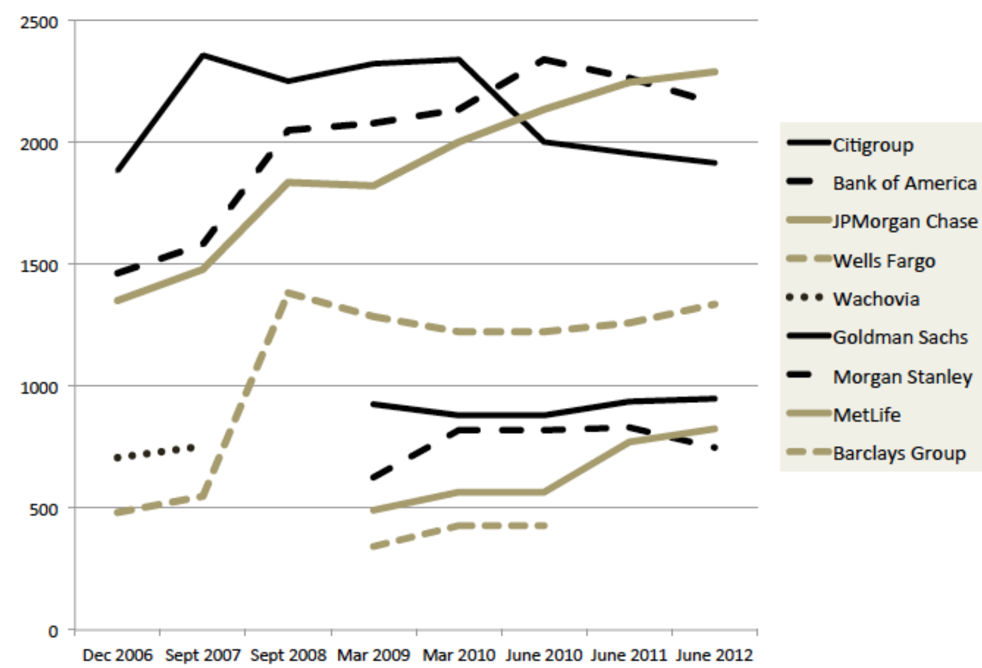
[23] These details are contained, among other sources, in Dymski (2009) and FCIC (2010).

“the problems we're witnessing today developed over a long period of time. For more than a decade, a massive amount of money flowed into the United States from investors abroad because our country is an attractive and secure place to do business.

“This large influx of money … led to excesses and bad decisions. … As a result, many mortgage-holders began to default. … Two of the leading purchasers of mortgage-backed securities were Fannie Mae and Freddie Mac. Because these companies were chartered by Congress, many believed they were guaranteed by the federal government. This allowed them to borrow enormous sums of money, fuel the market for questionable investments, and put our financial system at risk.

“The decline in the housing market set off a domino effect across our economy. … and the gears of the American financial system began grinding to a halt. … I'm a strong believer in free enterprise, so my natural instinct is to oppose government intervention. … But these are not normal circumstances. The market is not functioning properly. There has been a widespread loss of confidence, and major sectors of America's financial system are at risk of shutting down.”

Figure 7: Largest US Bank Holding Companies, December 2006 to June 2012, by asset size ($B, FFIEC)



Pres. Obama’s first inaugural speech five months later did blame banks, but only indirectly; and it remained vague about what, if anything, should be done to generate reform:

“Nor is the question before us whether the market is a force for good or ill. Its power to generate wealth and expand freedom is unmatched. But this crisis has reminded us that without a watchful eye, the market can spin out of control. The nation cannot prosper long when it favors only the prosperous." (January 20, 2009)

A month later, the President was similarly mild in announcing his bailout program in Arizona: "Banks and lenders must be held accountable for ending the practices that got us into this crisis in the first place." Against this background, it is not surprising that none of the four elements that facilitated aggressive 1930s banking reforms were present: the banks had retained their political influence; cross-border capital flows were more under banks' control than under federal regulators; government underwriting could not restore market "normality"; and there was no salient external geo-political threat, as there had been in the 1930s. Figure 7 shows that the largest banks did not shrink; instead, they maintained their size or even have grown since the crisis. Crisis-related mergers by the four largest US commercial banks pushed their market share in US credit markets to just under half.

7. Conclusion

Today, two unresolved competitions haunt the global economy: a struggle for dominance among financial centers and large financial firms; and a contest over the extent of financial markets' freedom of action between megabanks and nation-states. These have, as in the 1920s, involved massive global imbalances. Distortions in the markets for liquidity and risk-taking led to a global financial crisis with two phases – the US subprime crisis and the Eurozone crisis. Responses to this crisis have drawn heavily on public goods – central banks' lender of last resort capacity and national governments' capacity to spend – but without restoring economic growth and without fully recognizing or reining in megabanks' excessive power. The role of President Wilson in the *ECP* is played in our time by Presidents Bush and Obama, and that of Clemenceau by three habitués of Wall Street: Henry Paulson, Timothy Geithner, and Lawrence Summers. These advisors maintained that saving these banks – making them too big to fail and providing them with needed subsidies – would, together with a modest fiscal stimulus, reverse the US downturn. Instead, the consequences of the US response to the subprime crisis, and of the subprime assets held by European banks, was to set up a European stage of the great crisis, in which nation-states have been incapacitated precisely when their actions are most needed.

We have noted the remarkable parallels between the 1920s and the contemporary era. The years leading up to these eras' crises were characterized by severe cross-border economic imbalances and by and large investment banks' central role in maintaining global monetary order. Then, in both epochs, deregulation and speculative lending overwhelmed the system as it was. But whereas the 1930s episode was snapped to a halt with a banking holiday, the 2008 crisis did little to undo the excessive power and size of US megabanks, and nothing to restore their economic functionality. Megabanks' economic and political power remains unchecked in the current age, in part because it seems impossible to extract these institutions and the innovative borrowing-lending methods they pioneered from credit markets without severely compromising those markets' operation. So whereas the 1930s crisis ended with nation states in control (for better or worse) of their national destinies and of their banking relations, the current post-crisis period finds nation states today unable to insure effective banking relations. Further, the current regime of overleveraged, hyper-competing global megabanks do not constitute the basis of a new global monetary order.

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