Housing and the New Financial Markets

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4

The Origins of Financial Deregulation: The CMC, Heller Committee, and the Friend Study

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Introduction

Recent changes in financial policy have made deregulation and the restructuring of housing finance central realities of the 1980s. The old regulatory rules of the New Deal–interest rate ceilings on savings deposits, clear lines of demarcation between banks and thrifts, and restrictions on interstate branching–have either been eliminated or are on their way toward being overturned.

This chapter explores the origins of financial deregulation. The first section examines the early deregulatory efforts of the Commission on Money and Credit (CMC). Established by financial executives on the Committee for Economic Development, the CMC essentially set the agenda for much of the ensuing debate over financial deregulation. The second section outlines the activities of the Heller and Dillon Committees, which were established under the Kennedy Administration. The third section explores the credit crunch of 1966 and some responses to it. The fourth section then turns to the Friend Study. This was set up by the Federal Home Loan Bank Board in the wake of the devastating credit crunch of 1966 and addressed the distinct problems experienced by the

housing finance system. While it too reinforced many of the broad recommendations handed down by the CMC, it made a host of specific suggestions for reorganizing the thrift industry, mortgage markets and federal credit policy. In doing so, the Friend Study informed much of the ensuing debate on deregulation as it applies to housing finance. Finally, a short summary of findings along with some brief thoughts on the determinants of regulatory policy change are presented in the concluding section.

The Commission on Money and Credit

The first serious attempt to reorganize the New Deal financial system came almost immediately after World War II. This early effort at deregulation was pioneered by the Committee for Economic Development (CED) and culminated in the publication of the report of the CED's privately funded Commission on Money and Credit (CMC) in the early 1960s. Before reviewing the specific recommendations of the CMC, a brief discussion of the origins and composition of its sponsoring organization, the CED, is in order.

Origins and Composition of the CED

The CED was founded in 1942 by top level business elites concerned with the shape of the post-war economy.[1] Its expressed purpose was to give a business-oriented direction to the enlarged scope of government economic intervention. The CED's roots harken back to the Great Depression. Many of its original members were drawn from the Business Advisory Council (BAC)–a group of high corporate executives who were for a long time formally part of the Commerce Department.[2] Linking the Roosevelt Administration firmly to the big business community, the BAC provided a pool of corporate talent charged with devising the best ways to reinvigorate a sagging American economy.

The links between these two organizations were clear from the outset. Of the CED's original twenty trustees, fourteen were active members of the Council; of the remaining six, three quickly became BAC members. The most prominent figure in this BAC-CED nexus was doubtless Paul Hoffman, the president of Studebaker, a BAC vice-chair, CED chair, Marshall Plan officer, and board director of New York Life. Another key figure was Ralph Flanders, a high ranking member of the BAC and chairman of the CED's important research division–where most of its policy-making activities were focused. Joining Flanders at the top of the research division were GE's president, Charlie Wilson, who was also a BAC executive committee member and went on to become secretary of defense

under Eisenhower; Beardsley Ruml, dean of the University of Chicago's Social Science School, who later become chairman of the New York Federal Reserve; Donald K. David of Harvard and Chester Davis among others.[3]

There was one crucial difference, however, between BAC and CED. Unlike the BAC, a substantial portion of the CED's membership came from the banking and financial communities. These included luminaries from commercial banks such as Bank America, Bankers Trust, Chase Manhattan, Chemical Bank, Citicorp, Manufacturers Hanover, Morgan Guaranty, Continental Illinois, and First National Bank of Chicago as well as big insurance firms such as Prudential, New York Life, Equitable Life and Metropolitan Life.[4] The reasons for the CED's interest in financial regulation should thus be obvious.

Early CED Initiatives on Financial Regulation

The CED made its initial moves on financial policy in the late 1940s. In its now famous report on the post-war economy, *Monetary and Fiscal Policy for Greater Economic Stability*, the CED first broached the idea for a government-sponsored monetary commission. This was envisioned as a publicly-appointed group of high financial executives charged with making policy recommendations to the president. Such a commission would take a comprehensive look at a wide variety of banking and monetary issues: the structure of the Federal Reserve system, the stability of capital flows, the supply of credit, international monetary arrangements, and, of course, the structure and regulation of the domestic banking systems.[5]

Shortly thereafter, members of the Senate Banking and Currency Committee introduced a measure calling for the creation of such a commission. While this measure quickly passed through the Senate, it met formidable opposition in the House–long a bastion for small bank, thrift, and real estate interests. Much of this opposition was organized by maverick Congressman Wright Patman of Texas.[6] In 1948 and again in 1951, Patman countered the CED proposals for a commission of private bankers with recommendations for a congressional review of the financial system. This was completely unacceptable to CED financial elites, who were well aware of the substantial clout possessed by small banks, and realty interests in the House.

By the early 1950s, then, very salient splits had occurred within the financial community over how best to approach regulation, and the contours of a long term political battle over financial regulation were already coming into focus. Large banks sought wholesale deregulation, which included the elimination of interest rate ceilings on savings accounts and

the liberalization of interstate branching laws. These resource-rich firms were organized within the CED and found considerable support for their positions in the Senate and in the Executive Branch. In the face of this onslaught, smaller financial firms—both banks and thrifts—remained virulent in their opposition to the elimination of the New Deal's regulatory protections. These small business interests continued to hold substantial political clout in the House.[7]

By the mid-1950s, however, two developments bode well for the CED's financial agenda. The Eisenhower Administration was very closely linked to the CED. The president was a former CED trustee and committee members dominated his administration. Indeed, both Treasury secretaries to serve under Eisenhower—George Humphrey and Robert Anderson—were CED trustees and BAC members, the latter being a high-ranking official of the Ford Foundation as well. Marion Folsom, who headed the CED's Field Development Division, became an undersecretary in the Treasury Department.[8] On the other hand, the financial system was just embarking upon a period of swift evolution characterized by intensifying competition among rival firms. The dominant market position once held by commercial banks was starting to erode, as life insurance companies, pension funds, and federal credit agencies expanded rapidly. More importantly, the suburban building boom dramatically increased the role of the thrifts in the financial system. In the years immediately following the war, residential finance became extremely profitable because of the sizable spread between mortgage and deposit interest rates. Throughout this period, the thrifts grew at a phenomenal pace, doubling their total assets about once every five years and increasing their market share from less than one-fifth to almost half of all savings deposits. Unencumbered by ceilings on deposit interest rates, the thrifts were indeed growing at the expense of commercial banks who had seen their share of the market for savings deposits decline from 48 percent to 38 percent.[9] By the mid-1950s, this system of specialized mortgage finance institutions had become a second "banking system" of sorts—controlling a huge pool of resources and operating under the jurisdiction of its own central bank.

In 1956, financial interests in and around CED launched their frontal attack. Heads of large banks began speaking out publicly on the disarray that characterized the banking system. Reports on the dismal shape of the financial landscape hit the business and popular press. According to one historian of the CED:

> As one goes over the financial pages of newspapers and grinds his way through the dreary prose of corporate speech writers of late 1956, it becomes obvious that all manner of special interests were lining up behind the idea of a national [financial] commission.[10]

During that year, a special advisory body on financial institutions was set up in the Senate. The Committee for the Study of Federal Statutes Governing Financial Institutions and Credits strongly recommended establishment of the CED's Monetary Commission. In 1957, the Eisenhower administration began pushing for the CED's proposal. The economic report of the president recommended a presidentially appointed financial commission. Somewhat more boldly, the president's State of the Union message called for a national monetary and financial commission that would not only make recommendations but essentially draft new financial legislation.[11]

While the president's suggestion was favorably received in the Senate, crucial opposition again surfaced in the House. Working both through the House Rules Committee and the Joint Economic Committee, Representative Patman led the opposition, reintroducing his proposal for a congressionally sponsored financial commission. The Eisenhower administration then attempted to forge a compromise. The administration put forward a new proposal for a "mixed" commission, consisting of sixteen members with eight appointed by the president, four by the Speaker of the House, and four by the president of the Senate—namely, Vice-President Richard Nixon. This too was soundly defeated in the House. By 1958, at the latest, it was abundantly clear that the direct financial policy-making power sought by the CED's financial elites was not forthcoming.

Establishment of the Commission on Money and Credit

Faced with such a dilemma, the CED set out to establish its own financial commission. Negotiations between key CED officials and Eisenhower administration officials were quickly set in motion. A series of meetings between the CED, Treasury Secretary Anderson (also a CED member), and Eisenhower aide, Gabriel Hague (a CED trustee, member of the Council on Foreign Relations [CFR] and president of Manufacturers Hanover) ensured the administration's total cooperation. Senator Ralph Flanders (the former chairman of the CED's Research Division whose political allies included Lyndon B. Johnson and Senator Byrd) began to mobilize forces in the Upper House, while CED Chairman Donald David used his position as a Ford Foundation trustee to attract over $1 million in Ford money.[12]

By early 1958, the CED's Commission on Money and Credit (CMC) began its operations with a membership roster thoroughly dominated by financial elites. Frazar Wilde of Connecticut General Life, who was also chairman of the CED's influential Research and Policy Committee, became the CMC's chairman. H. Christian Sonne, a New York investment banker and executive director of the National Planning Association,

assumed vice-chairmanship. Other top-ranking financial executives on the CMC included David Rockefeller of Chase Manhattan, J. Cameron Thomson of Northwest Bank Corporation, Joseph Dodge of Detroit Bank and Trust, Gaylord Freeman of First National Bank of Chicago, and Joseph Tapp of Bank of America, among other high-ranking corporate figures.[13]

The Report of the Commission on Money and Credit

The CMC's work lasted two and one-half years. During that time, it commissioned approximately one hundred staff papers from which ten full-length monographs were culled. In 1961, its final report entitled *Money and Credit: Their Influence on Jobs, Prices and Growth* was published. The breadth and coverage of the CMC report was quite encompassing. It made recommendations concerning international banking, tax policy, federal intervention in credit markets, Federal Reserve policy and urban renewal, as well as financial structure and regulation.

An issue of primary concern to the CMC was determining what types of boundaries should separate the different types of financial institutions. This became even more pressing as non-banking firms began taking advantage of loopholes in the Bank Holding Company Act of 1956 in order to enter the banking business. The main thrust of the CED's recommendations thus emphasized eliminating the differences in regulatory treatment for the various kinds of financial firms. This essentially boiled down to establishing what today is referred to as a "level playing field" for rival financial institutions. CMC staff member Robert Aliber has summarized the thrust of this view as follows:

> The Commission's theory was that controls on financial intermediaries in the allocation of credit led to resource misallocation. The recommendations were directed toward achieving greater economic efficiency, both by removing the constraints on the selection of assets and liabilities that each class of institutions might acquire and by reducing the differences in the regulations applied to different classes of institutions.[14]

The CMC thus made the case for deregulation. Its specific recommendations included the following:[15]

1. Elimination of the prevailing ceilings limiting the interest payable on time and savings deposits
2. Expansion of thrift operations to include real estate related consumer lending as well as mortgage finance
3. Liberalization of restrictions on interstate branching by banks and thrifts

4. Equalization of tax and reserve treatment for financial institutions
5. Elimination of interest rate ceilings on government-insured mortgages
6. Transfer of federally subsidized secondary mortgage market operations to the private sector
7. Consolidation of the prevailing network of regulatory agencies.

Taken together, these recommendations stipulated nothing less than the total dismantling of the New Deal regulatory framework. Designed to bolster the position of large commercial banks vis-à-vis small banks and thrifts, they would serve to define the agenda of regulatory policy for the next twenty years.

Financial Reform in the Early 1960s

When the CMC report was made public in June 1961, there had been a change in the presidential administration. The new Kennedy administration was quite favorably disposed to the CMC report, an indication of the bipartisan influence possessed by the CED. There were two reasons for this. During the election campaign of 1960, JFK had developed some close ties to financial elites.[16] Upon assuming office, one of his key behind-the-scenes policy advisors became Robert Lovett of Brown Brothers Harriman, who was a CED trustee and Rockefeller Foundation official, as well as a director of CBS and of New York Life. When Lovett turned down Kennedy's offer to become Treasury secretary, he recommended C. Douglas Dillon for the post. Although Dillon was not a CED member, he possessed very close ties to the elite financial community in general and the Rockefeller family in particular. Dillon was a senior partner in the New York investment banking firm of Dillon Read and Company and head of the related U.S. Foreign and Securities Corporation.[17]

The economics of the period also affected the administration's views. By the late 1950s and early 1960s, signs of stress were already emerging in the New Deal financial system. Inflation had begun to push up interest rates. In 1957, the Federal Reserve raised the interest rate ceiling on commercial bank deposits from 2.5 to 3.0 percent. Two years later, the Treasury Department issued its "magic fives," government securities carrying a 5.0 percent yield.[18] For the first time, a small wave of disintermediation hit depository institutions, as savings flowed to higher-yielding

investments. In this fast-changing financial environment, large commercial banks acted quickly to bolster their competitive positions. In 1962, First National City Bank (now Citibank) pioneered the Certificate of Deposit (CD)—a savings instrument which paid high rates to business customers. Commercial banks had devised a way to circumvent prevailing deposit ceilings in order to attract new funds.

The Heller and Dillon Committees

As competition among banks, thrifts, and other types of financial institutions accelerated, the Kennedy administration looked to financial elites and especially to the CMC for ways to bolster the financial system. Indeed, the administration established three presidential commissions to review and make policy recommendations based on the CMC report. One committee, headed by Walter Heller, chairman of the Council of Economic Advisors, examined financial regulation; a second, headed by Treasury Secretary C. Douglas Dillon, focused on federal credit policy; and a third looked at the rise of private pension funds. The first and, to a lesser extent, the second, are especially important for our purposes.

Taken together, the policy recommendations of the Heller and Dillon Committees essentially reinforced the CMC's conclusions. First, the Heller Committee, like the CMC, recommended that ceilings on time and savings deposits be eliminated, with regulatory authority placed on a standby basis to be invoked only during periods of financial turmoil. It recommended that ceilings on demand deposits be retained.[19] Second, the Heller Committee called for a significant expansion of thrift asset and liability powers. While this recommendation reflected the spirit of the CMC report, the Heller Committee was significantly more detailed in distinguishing what new powers should be assumed by thrifts. It specifically suggested that thrifts be empowered to make multifamily mortgages, issue home improvement loans, and invest in state and municipal securities. Federal chartering of savings banks was also recommended.[20] Third, on the issue of interestate branching, the Heller Committee did not go quite as far as the CMC. While it suggested that prevailing restrictions against branching were inefficient, it made no specific policy recommendations, leaving the question open for further study.[21] Finally, the Dillon Committee strongly supported the CMC's recommendation for limiting government participation in credit markets. It called for a reorganization of existing secondary mortgage market operations. Unlike the CMC, however, it stressed the need to retain rate ceilings on government insured FHA/VA mortgage loans.[22]

The Credit Crunch of 1966

After a period of relative quiescence,[23] the devastating credit crunch of 1966 refocused attention on the financial system, especially on its housing finance component. In its wake, a new dimension—regarding the role of the thrifts in the financial system—would be added to the long-standing debate on financial policy.

The differences which distinguished the financial environment of the 1950s from that of the mid-1960s were quite striking. Even in the rapidly changing financial environment of the early 1960s, thrift institutions continued to prosper. Housing cycles remained short in duration and relatively mild in impact.[24] There were some basic reasons for this. Steady economic expansion meant that savings were plentiful with the demand for mortgages constantly increasing. Limited inflation kept rates paid on savings deposits substantially beneath the going mortgage rate. In 1960, thrifts still offered a significantly higher rate of return on their deposits than did commercial banks, 3.86 percent versus 2.56 percent.[25] So long as this situation persisted, the potentially troublesome tension of borrowing short and lending long could be kept at bay.

By the mid-1960s, however, some fundamental changes were occurring. As inflation started to rise, the competition for funds heated up. Following First National City's lead, large commercial banks began offering smaller CDs designed to attract individual savers as well as business customers. In 1964, the Federal Reserve Board hiked the interest rate ceiling on commercial bank deposits to 4.5 percent, and the rate differential between thrifts and commercial banks dwindled to a mere 0.5 percent. As inflation continued to climb—fueled in no small measure by burgeoning military outlays—the Federal Reserve clamped down on the money supply initiating a severe credit crunch. During 1966, interest rates jumped; and the Federal Reserve, under pressure from big banks, raised the ceilings on time and savings deposits to 5.15 percent.[26] Disintermediation wracked the thrifts, where new savings inflows fell from $8.4 billion in 1965 to just $3.6 billion in 1966. As the pool of available housing credit shrunk, mortgage-lending activity was curtailed. New housing starts plummeted from approximately 1,500,000 to 700,000 units. The severe mismatch between the long-term lending position and short-term borrowing capacity of the thrifts became a blatant problem.

Responses to the 1966 Credit Crunch

The 1966 debacle brought the political and economic tensions operating within the financial structure to a head. The broad contours of these

tensions broke down along the following lines. Big commercial banks, by far the most active interests, sought to increase their markets by eliminating prevailing deposit ceilings and existing restrictions on branching. This was vehemently opposed by small banks and thrifts wary of increased competition. As small financial institutions and large banks squared off, small banks and thrifts became locked in a potentially devastating struggle over issues concerning thrift exemption from Regulation Q and the possible expansion of thrift powers. In this battle for position, each side attempted to gain leverage by influencing the decisions of regulatory bodies and, when possible, by motivating the policy process. Ultimately, government responded to these myriad conflicts by enacting or attempting to enact a series of contradictory policies. Here, a brief cataloging is in order.

In September 1966, Congress passed the Interest Rate Control Act which brought the thrifts under the umbrella of Regulation Q establishing a rate differential in their favor. This bill had the strong support of small thrifts and real estate interests, but was fought by commercial banks. By late 1967, the House Banking and Currency Committee–long a bastion of thrifts and realty influence–reported a second bill, the Federal Savings Institutions Act, which called for broadened powers for savings and loans and for mutual savings banks. This bill was the product of forceful lobbying by large thrifts, but it provoked the ire of commercial banks, especially small ones. Under their tremendous pressure, it was narrowly defeated in the Rules Committee in 1968.[27]

The Friend Study

Faced with a seriously troubled financial system and with political pressures mounting on all sides, Congress decided to launch a full-scale examination of the housing finance system. In 1967, the Federal Home Loan Bank Board was authorized to commission such a study. The study was directed by Professor Irwin Friend and carried out by the faculty of the Wharton School. It took approximately two years to complete, during which time over twenty papers covering all aspects of the housing finance system were produced. The final report entitled *A Study of the Savings and Loan Industry*, commonly referred to as the Friend Study, was issued in July 1969.

From a political point of view, the Friend Study was a very interesting document. It basically operated on two levels. It sought to remedy the short-run problems of the thrifts, especially their extreme vulnerability to tight money, and to do so in a way that would build some level of support

among thrifts and housing interests for broader financial reorganization. Implicit throughout the study were the same types of bias that characterized the CMC report. Once again, regulatory restrictions like those on deposit rates, on branching, or on the activities of different types of depository institutions were seen as producing distortions and inefficiencies in the operations of the financial markets. Even though it was armed with this basic thrust, the Friend Study made its recommendation wholly in favor of retaining a specialized system of housing finance intermediaries. Here, it veered decidedly away from strict economic logic and into the hoary seas of political considerations. The Friend Study ultimately rested its case for specialized mortgage finance institutions on the high fixed costs associated with the prevailing housing finance system. The twists, turns, and logical jumps of this argument are so interesting that it is worth reproducing at length.

> The essential question here is what is to be gained by continuing to give incentives to specialized institutions which devote the bulk of their resources to providing home financing credit as against other policy alternatives. . . . The main justification in directing any subsidy to a specific intermediary. . . is the belief that this provides greater control over the implementation of housing policy than leaving the investment decision in the hands of a diversified lender though, even with specialized intermediaries, the past effectiveness of housing policy leaves much to be desired. . . . [Since] we are not starting from scratch and with the uncertain benefits directing housing subsidies to [all institutions involved in mortgage lending], it is probably undesirable to extend further the area of housing subsidies. Finally, the viability of specialized savings intermediaries is important not only in view of their potential for facilitating housing policy but also to make optimum use of available facilities for providing desired services to depositors.[28]

Recommendations of the Friend Study

The recommendations of the Friend Study reflected its contradictory perspective. These recommendations were comprised of three basic components: (1) the elimination of ceilings on deposit interest rates, (2) the expansion of thrift asset and liability powers, and (3) the nature and scope of government intervention in the mortgage market. All three merit particularly close examination.

The issue of deposit rate ceilings had long been a politically volatile one–pitting large banks against small ones, thrifts and banks against one another. It would be an understatement to charge that the Friend Study approached this issue cautiously. After stating that restrictions on interest rate payments were both inefficient and inequitable, the Friend Study expressly noted that their elimination might jeopardize "those interests

that have grown up under them," as well as the broader economy.[29] It suggested the following:

> Interest rate ceilings should neither be retained indefinitely nor abolished immediately. The level of ceilings should gradually be raised relative to free market rates, preferably when credit is easing and market interest rates are declining appreciably. This would mean that ceilings would normally be inoperative. However, the power to reinstate effective ceilings should be maintained on a standby basis though reserved for emergency use.[30]

The Friend Study thus accepted the deregulation alternative spearheaded by large banks and handed down from CMC to the Heller Committee–an alternative which was vehemently opposed by small banks and thrifts.

The Friend Study made a second recommendation for introducing greater flexibility into the asset/liability structure of thrifts. On the asset side, this included granting mortgages on multifamily residences and making consumer loans up to ten percent of total assets. On the liability side, it meant granting checking accounts, issuing long-term savings accounts, and establishing CDs.[31] The Friend Study took into account the two major caveats against such diversification. One, it noted that such diversification, when combined with the existing tax advantages for thrifts, might confer windfall profits to them. If this turned out to be the case, it suggested that an equalization in tax treatment for banks and thrifts might be in order. Two, the Friend Study considered the potential reductions in housing credit that might stem from diversification. Here, it contended that even with expanded lending powers, thrifts would "continue to perform a useful function in implementing housing policy."[32] Needless to say, the diversification alternative proposed by the Friend Study provoked a sharp split within the thrift industry. While large thrifts mostly supported it, small ones were opposed, especially if it came as part of a package which included the elimination of existing rate ceilings.

The Friend Study then made a series of recommendations concerning the nature and scope of government intervention in the mortgage market. While it concluded that there was no need for a direct government lending function in conventional mortgage finance, it did recognize that a market for government-insured mortgage-backed securities was necessary to increase the efficiency of the secondary market. Government participation was also needed to develop new mortgage instruments such as gradual payment mortgages, variable-rate mortgages and reverse equity instruments, which would permit elderly households to draw on the equity built up in their homes.[33]

Moreover, the Friend Study strongly recommended that the FHLBB take a more active role in the restructuring of the housing finance system. Consequently, the FHLBB would utilize its wide range of policy instruments to promote economies of scale in the thrift industry. Some of the policy directives suggested by the Friend Study included the following:

> The FHLBB should place more stress on the importance of economies of scale in its chartering and branching policies. The geographic limits on branching should be widened, and the 100-mile mortgage-lending limit relaxed, to spur competition and to permit greater scope for economies of scale. . . . Mergers on a selective basis among smaller institutions might be encouraged. . . . The FHLBB should review existing credit policy on expansion advances to ensure that such advances are not made available to associations engaged in unsound operations.[34]

Needless to say, the policy to promote consolidation generated widespread opposition among small thrifts.

The Friend Study ultimately addressed a number of political agendas.[35] It came out in favor of the deposit decontrol alternative pressed for by big banks. On issues related to the thrift industry, it reflected the interests of large firms almost exclusively. Although it made overtures for enhancing residential finance, its program was widely opposed by small thrifts that comprised the bulk of the industry and by the real estate lobby as well.

Conclusions

The recent revolution in financial policy and the attendant restructuring of housing finance find their roots in the late 1950s and early 1960s. The Commission on Money and Credit essentially created the agenda for financial deregulation. The Heller and Dillon Committees reinforced its basic conclusions and provided a gloss of public legitimacy for this privately conducted study. The Friend Study addressed the specific problems of the housing finance system and did so in a way which supported the basic deregulatory recommendations of the CMC.

These findings reinforce a number of more general conclusions regarding the political economy of financial policy.[36] Basically, large financial firms exert considerable influence at the high levels of American politics. These firms are well connected to presidential administrations, key bureaucrats, congressional officials, and regulators. There is a steady circulation of their personnel into the major financial regulatory bodies as well as the Treasury Department. It is perhaps most notable that top banking officials are significantly overrepresented on the numerous advisory bodies

and commissions, such as the CMC (or in later years the Hunt Commission) which concretely set the agenda of financial policy. Small financial firms have very little influence at the pinnacles of American politics. Instead, they are active in the Congress, especially the House, where the bulk of their political investments are concentrated. Not surprisingly, this is where most of the opposition to deregulation has emerged.

Such a distinct "political division of labor" over financial policy has a number of important implications for thinking about the determinants of financial deregulation. The most widely accepted approach points to the linkages between innovation and regulatory policy change.[37] Here, regulatory restrictions–which constrain profit-maximizing behavior–create incentives for financial innovation. By circumventing old regulatory rules, the innovations undertaken by private firms lead to a regulatory collapse and thus set the context for deregulation. While this approach sheds a great deal of light on the economic causes of financial innovation, it misses the crucial interactions among economic trends, coalition-building, and business influence over politics as they shape the policy process. As such, the concrete politics of financial deregulation remain a mystery. The direct actions taken by commercial banks in setting the agenda of deregulatory policy are overlooked.

Notes

[1] Excellent historical discussions of the CED are found in Robert M. Collins, "Positive Business Responses the New Deal: The Roots of the Committee for Economic Development, 1933-1942," *Business History Review* (Autumn 1978): 368-91; Kim McQuaid, *Big Business and Presidential Power: From FDR to Reagan* (New York: William Morrow, 1982); Phillip Burch, Jr., *Elites in American History, Volume 3: The New Deal to the Carter Administration* (New York: Holmes and Meier Publishers, 1980); and Burch, "The American Establishment: Its Historical Development and Major Economic Components," in Paul Zarembka, ed., *Research in Political Economy, Volume 6* (Greenwich, CT: JAI Press, 1983): 83-156.

[2] On the linkages between the CED and the BAC, see Burch (1980, 1983); McQuaid (1982); McQuaid, "The Business Advisory Council of the Department of Commerce: A Study of Corporate/Government Relations" in Paul Uselding, ed., *Research in Economic History, Volume 1* (Greenwich, CT: JAI Press, 1976): 171-97; McQuaid, "Corporate Liberalism in the American Business Community, 1920-1940," *Business History Review* (Autumn 1978): 342-680. A brilliant discussion of shifting elite coalitions during the New Deal is presented in Thomas Ferguson, "From Normalcy to New Deal: Industrial Structure, Party Competition and American Public Policy in the Great Depression," *International Organization* 38, 1 (Winter 1984): 41-94.

[3] Marion Folsom of Eastman Kodak originally headed the CED's Field Development Division and later became the CED vice-chair, BAC vice-chair, a member of the board of directors of the Chamber of Commerce, and undersecretary of treasury under Eisenhower. Other prominent CED trustees who were BAC members included: William Benton (Texas cotton merchant, CED vice-chair), Chester Davis (president of the Federal Reserve Bank of St. Louis), Clarence Francis (General Foods), Charles Hook (American Rolling Mill), Harrison Jones (Coca-Cola), Thomas McCabe (Scott Paper), and Reuben Robertson

(Champion Paper, Proctor and Gamble, and B.F. Goodrich). Another original trustee, John Stuart (Quaker Oats) had a brother, R. Douglas Stuart, who was an active BAC member. In addition to its twenty original trustees, the CED had an initial membership of sixty high-level corporate executives. This later expanded to around two hundred. See Burch (1980, 1983); McQuaid (1976, 1978).

[4] See Burch (1983).

[5] See Karl Schriftgeisser, *The Commission on Money and Credit: An Adventure in Policy-Making* (Englewood Cliffs, NJ: Prentice-Hall, 1974).

[6] It should be noted that Patman's motives were not entirely altruistic. A detailed study of Congress and financial institutions points to Patman's close relationship with the thrift industry. According to Patman himself: "The savings and loans are the underdogs of the financial world; the commercial banks are brutal to them." According to John Gunther of the United States Conference of Mayors: "Mr. Patman hates banks, but he loves S & Ls. He thinks there's a difference and there probably was in the 1940s. But with regard to urban policy, banks and S & Ls are virtually identical. Their policy is to channel all urban programs through the existing banking system." Both quotes from Lester Salamon, *The Money Committees* (Washington, DC: Nader Congress Project, 1975). Data on business contributions to Patman reinforce this point. Of the $8,600 in PAC contributions to him in 1980, $7,000 came from savings and loan associations and credit unions; the rest came from a variety of real estate and construction organizations. He received just $500 from the trade association of small banks, the Independent Bankers Association of America. In sharp contrast to most other members of his influential committee, he obtained nothing from the trade associations of the big banks.

[7] An enlightening discussion of some of the political-economic reasons for such a "division of labor" in the Congress is presented in Samuel Huntington, "Congressional Responses to the Twentieth Century" in David Truman, ed., *The Congress and America's Future* (Englewood Cliffs, NJ: Prentice-Hall, 1965): 6-38. Also, see Richard L. Florida, "The Political Economy of Financial Deregulation and the Reorganization of the Housing Finance System in the U.S." *International Journal of Urban and Regional Research* (1985, forthcoming), for an elaboration of these points in the context of the financial deregulation debate.

[8] On Eisenhower's links to the CED, see Burch (1980): 127-67; McQuaid (1982): 169-98.

[9] See Patric Hendershott and Kevin Villani, *Regulation and Reform of the Housing Finance System* (Washington, DC: American Enterprise Institute, 1977): 7-9.

[10] Schriftgeisser (1974): 8.

[11] See *Ibid.*, 10-11.

[12] For more background on these points, see Schriftgeisser (1974): 17-23.

[13] Other prominent members of the CMC included: Earl Schwulst (Bowery Savings Bank), Marriner Eccles, the famous New Dealer (First Security Corporation), James Black (Pacific Gas and Electric), J. Irwin Miller (Cummins Engine Company), Fred Lazarus, Jr. (Federated Department Stores), Theodore Yntema (Ford), Beardsley Ruml, and H. Christian Sonne (New York investment banker and president of the National Planning Association) along with ten additional members drawn from business, labor and academia. The research staff of the CMC was directed by Bertrand Fox of the Harvard Business School and Eli Shapiro of MIT; its advisory board included prominent economists such as Paul Samuelson, Raymond Goldsmith, and Richard Musgrave among others, as well as noted bankers Alan Temple (Citibank) and Gaylord Freeman.

[14] Robert Aliber, "The Commission on Money and Credit: Ten Years Later," *Journal of Money, Credit and Banking* 7, 4 (November 1972): 915-30.

[15] See Commission on Money and Credit, *Money and Credit: Their Influence on Jobs, Prices, and Growth* (Englewood Cliffs, NJ: Prentice Hall, 1961). This was excerpted in a special section of *The New York Times* (June 26, 1961). Also, Karl Brunner, "The Report of the Commission on Money and Credit," *Journal of Political Economy* 64, 6 (December 1961).

[16] For more on the Kennedy administration's links to the financial community, see Burch (1980): 170-230. Also, McQuaid (1982): 200-22. Additionally, major Kennedy administration directives on tax and fiscal policy were developed based on CED/CMC recommendations. See Schriftgeisser (1974): 45-68.

[17] This is documented in Burch (1980): 177.

[18] For more on these developments, see Sidney Jones, *The Development of Economic Policy: Financial Institutions and Government Policy* (Ann Arbor: University of Michigan Press, 1979): 28-30.

[19] President's Committee on Financial Institutions (Heller Committee), *Report of the President's Committee on Financial Institutions* (Washington, DC: 1963): 19-24.

[20] *Ibid.*, 25-36.

[21] *Ibid.*, 25-36.

[22] President's Committee on Federal Credit Programs (Dillon Committee), *Report of the President's Committee on Federal Credit Programs* (Washington, DC: 1963).

[23] The tragic Kennedy assassination in November 1963 brought Lyndon B. Johnson to the presidency. Johnson–the consummate politician–quickly began evolving some close ties to key financial elites in the BAC and the CED. A key Johnson reelection vehicle, the National Independent Committee for President Johnson and Vice-President Humphrey, was dominated by financial figures such as ex-Treasury Secretary Robert Anderson (a partner at Loeb Rhoades and Company, CED trustee, and BAC member); Thomas Lamont (vice-president of Morgan Guaranty); Sidney Weinberg (a partner at Goldman Sachs, CED trustee, and vice chairman of the BAC); John Loeb (of Loeb Rhoades and Company); and Robert Lehman (of Lehman Brothers) as well as CED activists Marion Folsom, Henry Fowler and Ralph Lazarus. With his landslide victory in 1964, Johnson moved to formalize his ties with high corporate figures. When Treasury Secretary Dillon resigned to pursue private business, former CMC member Henry Fowler was elevated to that post. Fowler initiated regular strategy sessions between the business council and the treasury department. In early 1965, he unsuccessfully attempted to get the president to establish an interagency coordinating committee on bank regulation–comprised of the heads of the Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC), Federal Home Loan Bank Board (FHLBB), and the comptroller of the currency–to formally settle differences on regulatory policy. While the Johnson administration was clearly interested in financial reorganization, more serious matters, like the Vietnam War and burgeoning political unrest at home, diverted its time and energy from such matters.

[24] A good discussion of housing cycles in the post-war era is contained in Jack Guttentag, "The Short Cycle in Residential Construction: 1946-1959," *American Economic Review* 51 (June 1961): 275-98. See also the excellent paper by Leo Grebler, "Housing Credit Versus Monetary Policy" in United States Congress, Joint Economic Committee, *The Business Cycle and Public Policy* (Washington, DC, 1981).

[25] See Jones (1979): 28.

[26] See Irwin Friend, *A Study of the Savings and Loan Industry: Summary and Recommendations* (Washington, DC: Federal Home Loan Bank Board, 1969): 6.

[27] For more information on both of these bills, see Jones (1979).

[28] Friend (1969): 22-23.

[29] *Ibid.*, 27.

[30] *Ibid.*, 28, 35.

[31] *Ibid.*, 19-23, 33.

[32] *Ibid.*, 23.

[33] *Ibid.*, 23-28, 40.

[34] *Ibid.*, 36-38.

[35] The apparently contradictory policy recommendations of the Friend Study did not simply fall from the sky, but were reflective of a particular pattern of political-economic relations. Here, some clues can be ascertained by exploring the membership roster of its advisory board. Only one individual, Dr. Harry Schwartz of the FHLBB, was tightly linked to the thrift industry. Two others were academic economists, Frederick Balderston of Berkeley and John Linter of Harvard. The most influential and prestigious member of the panel, however, was Dr. Kermit Gordon, an academic economist, who was also president of The Brookings Institution and a CED trustee. In addition, Gordon had served on the Council of Economic Advisors during the Kennedy administration and was director of Johnson's Bureau of the Budget. He was thus likely to be very amenable to the deregulation agenda promoted by big commercial banks.

[36] See Florida (1985).

[37] See especially Edward Kane, "Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Bank Regulation," *Journal of Finance* (May 1981), and Robert Eisenbeis, "Regulation on a Financial Innovation," *Issues in Bank Regulation* (Winter 1981). For further elaboration of these conceptual issues, see Richard L. Florida, *Banking on Housing: The Political Economy of Financial Deregulation and the Reorganization of Housing Finance* (unpublished doctoral dissertation, Columbia University, 1985).