

**Capitalism,
Government,
Money,
and the
Future of
the World**

*Finding
and Keeping
the Right Balance
in
Market-Capitalist
Democracies*

Total amount of **goods and services offered for sale** at a given time

SUPPLY

Equilibrium among these THREE things determines price levels

Total **desire to buy those goods and services** at a given time

DEMAND

~~CHANGE ANY OF ONE OF THESE THREE THINGS, AND PRICE LEVELS WILL MOVE...~~

Total amount of **'money' in circulation** at a given time

MONEY SUPPLY

ALL THREE OF THESE THINGS ARE ALWAYS IN MOTION, SHIFTING

- **Currency in circulation** (or, units of a specified commodity)
- **Bank deposits ++** (money created by banks, through lending)

What role does a central bank play, in all this?

Total amount of **goods and services offered for sale** at a given time

SUPPLY

Equilibrium
among these **THREE** things determines price levels

Total **desire to buy those goods and services** at a given time

DEMAND

Total amount of **'money' in circulation** at a given time

MONEY SUPPLY

CHANGE ANY OF THESE THREE THINGS AT JUST A DIFFERENT PACE THAN THE OTHER TWO, AND PRICES WILL MOVE

ALL THREE OF THESE THINGS ARE ALWAYS IN MOTION, SHIFTING

- **Currency in circulation** (or, units of a specified commodity)
- **Bank deposits ++** (money created by banks, through lending)

Inflation is BAD

- Erodes the value of everyone's savings
- Messes with the value of debts, transferring value from lenders to borrowers: fixed-interest-rate debts become easier to pay, because future payments will be made in dollars that are worth less
- Makes it harder to plan for the future, and to make long-term contracts
- Tends to feed on itself and worsen, if it gets going, as people start to expect more inflation, and act on that

Deflation is MUCH WORSE

- Virtually shuts down whole sectors of the economy, forcing a severe recession or even a depression
- Messes with the value of debts, transferring value from borrowers to lenders: fixed-interest-rate debts become more painful to pay, because future payments must be made in dollars that are worth more
- Makes it harder to plan for the future, and to make long-term contracts
- Causes layoffs, due to the problem of 'sticky wages'
- Tends to feed on itself and worsen, if it gets going, as people start to expect more deflation, and act on that

Hyperinflation is a CATASTROPHE

- Wipes out the value of everyone's savings
- Makes it nearly impossible for the economy to function: at some point, people ditch the hyperinflated currency and switch to some other form of money

Inflation is BAD

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- Messes with the value of debts, transferring value from lenders to borrowers
- Makes it harder to save and to make long-term investments
- Tends to feed on itself as people start to expect inflation

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If inflation, deflation, and hyperinflation are all BAD, then what's the one condition that would qualify as GOOD?

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MONEY SUPPLY

ALL THREE OF THESE ARE ALWAYS CHANGING, DAY BY DAY

Central banks continuously monitor *supply, demand, and the size of the money supply*, and manage the size of the money supply, with the aim of maintaining a stable currency value – i.e., **stable prices**

- **Currency in circulation** (or, units of a specified commodity)
- **Bank deposits ++** (money created by banks, through lending)

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at a given time

SUPPLY

Generally, over the
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Generally, therefore, most
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Total
require to buy those goods and services
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MONEY SUPPLY

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Total **require to buy those goods and services** at a given time

DEMAND

Central banks do this primarily by setting short-term interest rates (i.e., the cost of borrowing money), thereby affecting the pace of lending, and influencing the quantity of money created by banks, as well as the total amount of leverage present in the economy

Total amount of **'money' in circulation** at a given time

MONEY SUPPLY

Central banks also do this through feeding new money directly into the economy via 'open market activities', mainly (but not exclusively) via the purchase of government debt

- **Currency in circulation** (or, units of a specified commodity)
- **Bank deposits** ++ (money created by banks, through lending)

Generally, central banks try to aim for continuous *low, but not zero*, inflation: 1% to 2% per year is considered ideal

- Managing the money supply to keep it in perfect sync with economic growth is a challenging and inexact task, with feedback loops and time lags; there's a limit to how precisely you can expect to manage outcomes
- Because even a little bit of deflation can be so destructive (due to how it causes a slowdown in economic activity that starts in real estate and durable goods, and because of sticky wages), it is prudent to err just a bit on the side of *inflation*
- Interest rates, which are the powerful central-bank tool for controlling *inflation*, are almost *useless against deflation* – which is another good reason to give yourself a margin for error, to avoid the risk of ever slipping even slightly into deflation
- Inflation under 2% is low enough that people generally don't bother to worry about it in planning their economic activities: they treat it as if it was essentially zero
- To the extent that a little bit of inflation has any economic effect at all, it is probably slightly stimulative: “*go ahead and buy it... prices only tend to go up over time*”

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The actions the Fed takes – both in setting interest rates, and in feeding money into the economy directly, itself – also affect the overall levels of demand and supply present in the economy... All this is therefore a tricky process, with feedback loops, and lags between when an action is taken, and when its full impact may be felt

Bottom line: the Federal Reserve – and every other central bank – is really in the business of managing expectations around the effects of its actions on all these moving parts – rather than just managing the money supply, as a single dimension...

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Perennial dangers, in the execution of monetary policy by any central bank

- The officials responsible for maintaining price stability, and the overall stability of capitalism, may make serious, honest **mistakes**: mistakes that **cause either inflation or deflation**, or that **fail to mitigate macroeconomic instability**, or that **make a bout of instability worse**
- The officials responsible for monetary policy might be **corrupt**
- The **independence** of the central bank as an institution – and the single-minded policy goals of **price stability** and **economic stability** that it needs to be *unfailingly focused on* – might be violated / overruled

Two perennial threats to the independence of the Federal Reserve, in the US

- A **president** who is determined to override / overrule the Fed's critical policy goals of price stability and macroeconomic stability, in order to **force it to serve some other priority, instead**
 - *Easy to imagine: a president who demands that interest rates be reduced (or stay low) during the run-up to an election, in order to assist in his re-election... despite the fact that doing this may allow inflation to ultimately spiral out of control*

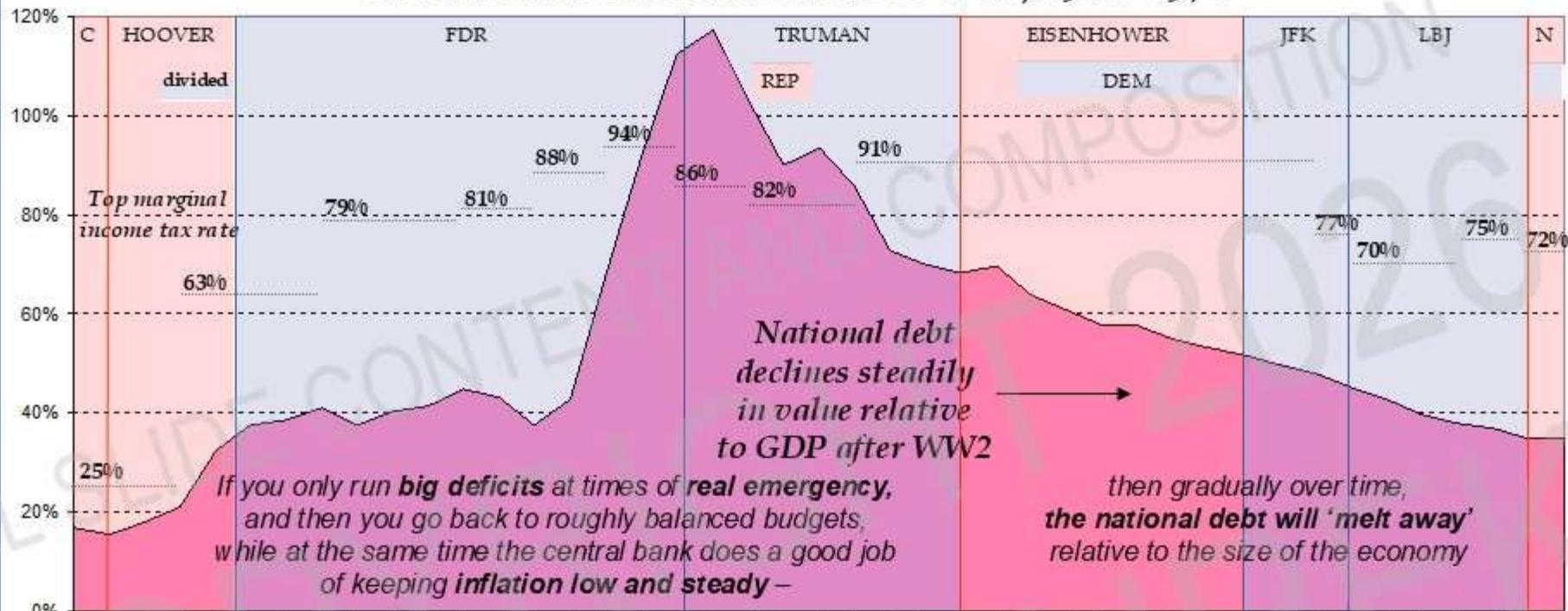
Two perennial threats to the independence of the Federal Reserve, in the US

- The possibility that **Congress** (perhaps acting in consort with the President) might force the Fed to prioritize **some other goal**, over price stability and macroeconomic stability
 - *Easy to imagine: if the country experiences a bout of **high inflation**, that requires **very high interest rates** for a time, in order to restore price stability*
 - > ***but Congress nonetheless demands that interest rates be lowered prematurely**, because the high rates are causing a serious recession and too much economic pain and displacement for its constituents*
 - *despite the fact that **this will cause inflation to spiral out of control***

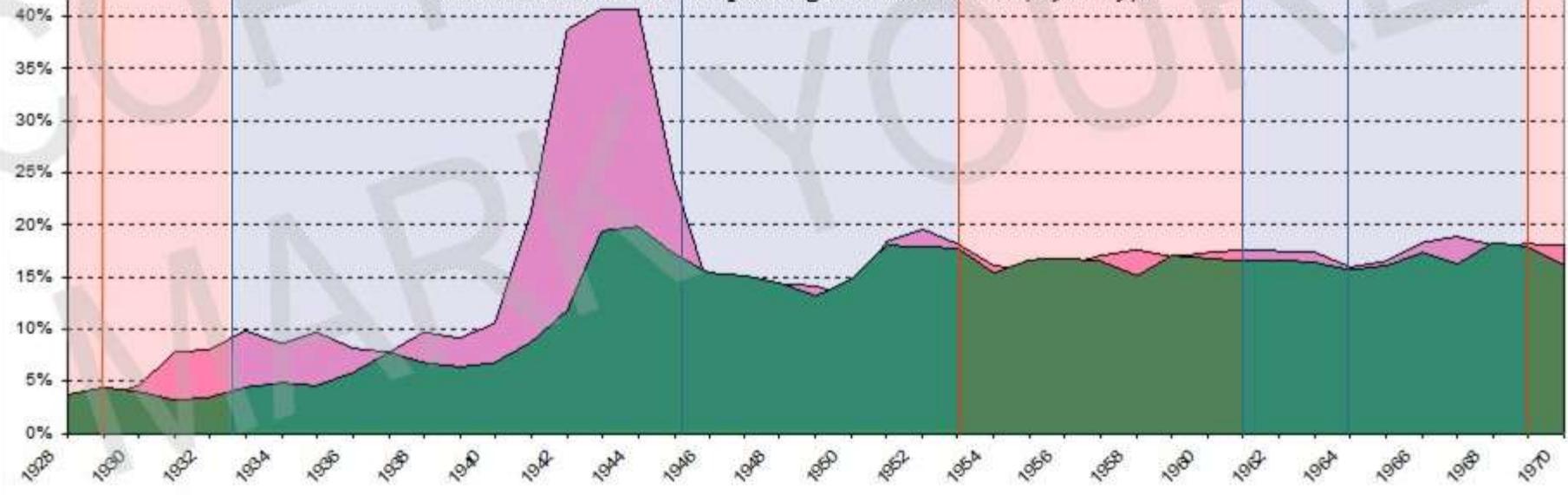
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- The possibility that **Congress** (perhaps acting in consort with the President) might force the Fed to prioritize **some other goal**, over price stability and macroeconomic stability
 - *Another easy-to-imagine possibility: **if the national debt gets very big, and interest payments on it therefore become very burdensome, Congress might pressure the Fed to keep interest rates artificially low, just to make servicing the debt cheaper...** despite the fact that **this will cause inflation to spiral out of control** And / or: **Congress might demand that the Fed buy up massive quantities of Treasury debt**, to effectively 'cancel' that debt...*

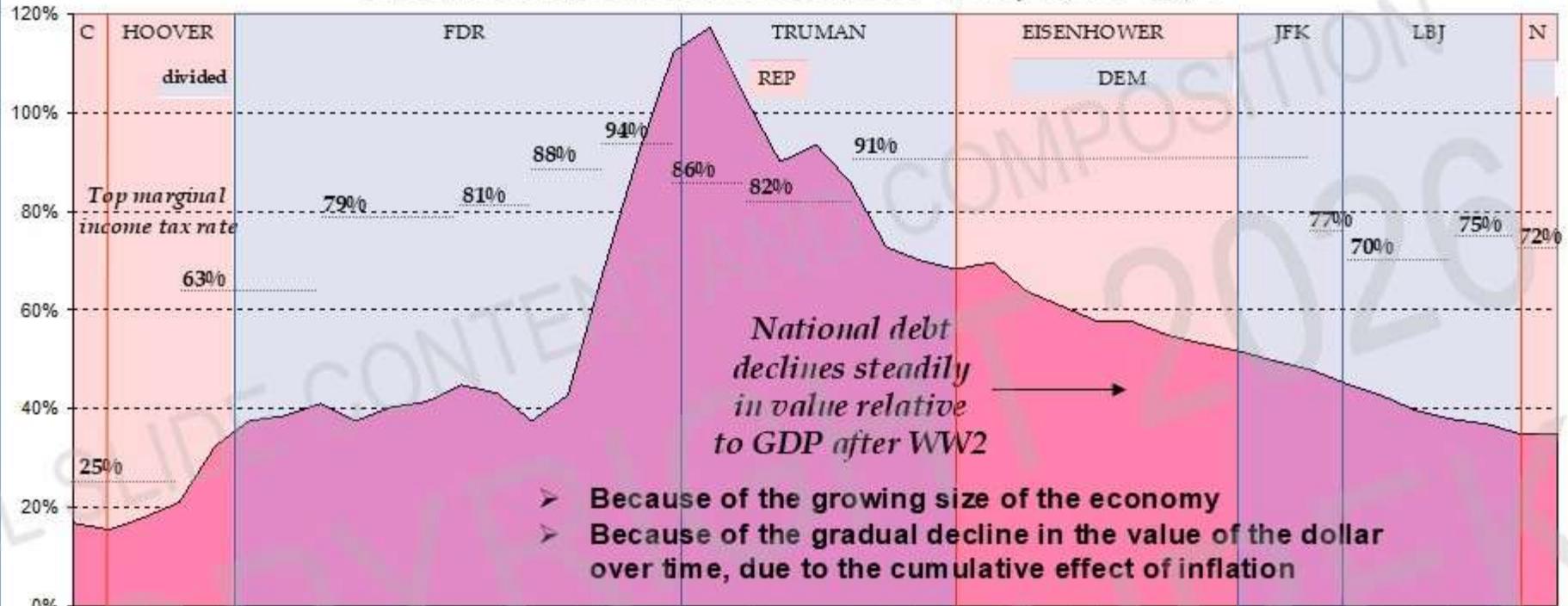
US National Debt as a Share of GDP, 1928-1970



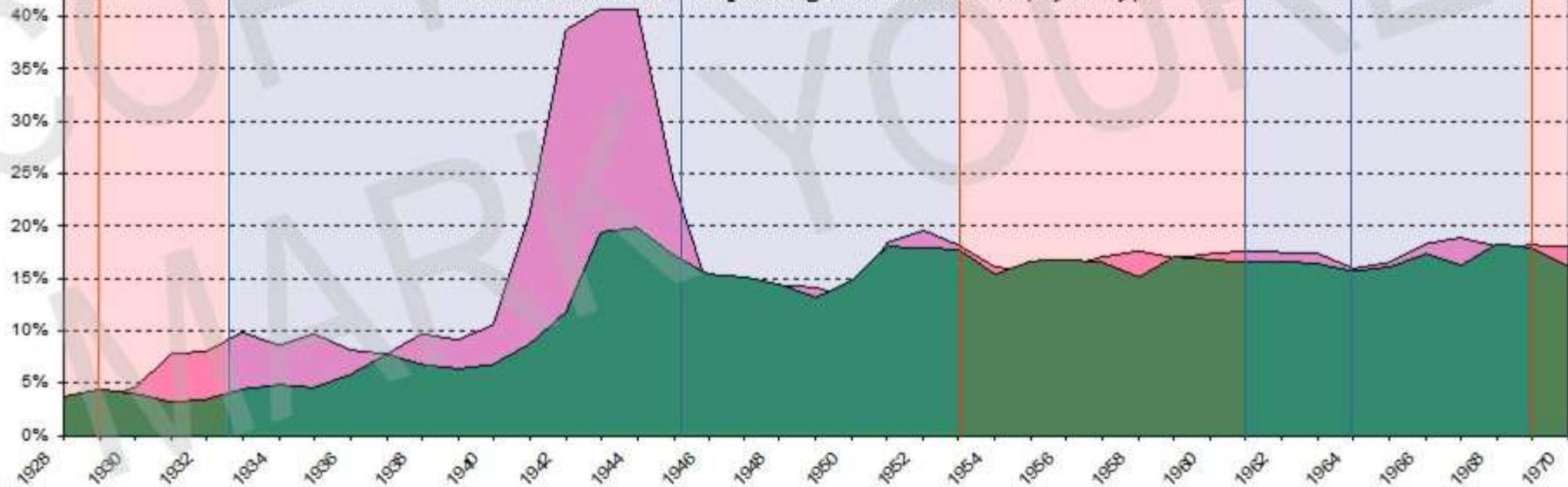
US Federal Revenue and Spending as a Share of GDP, 1928-1970



US National Debt as a Share of GDP, 1928-1970



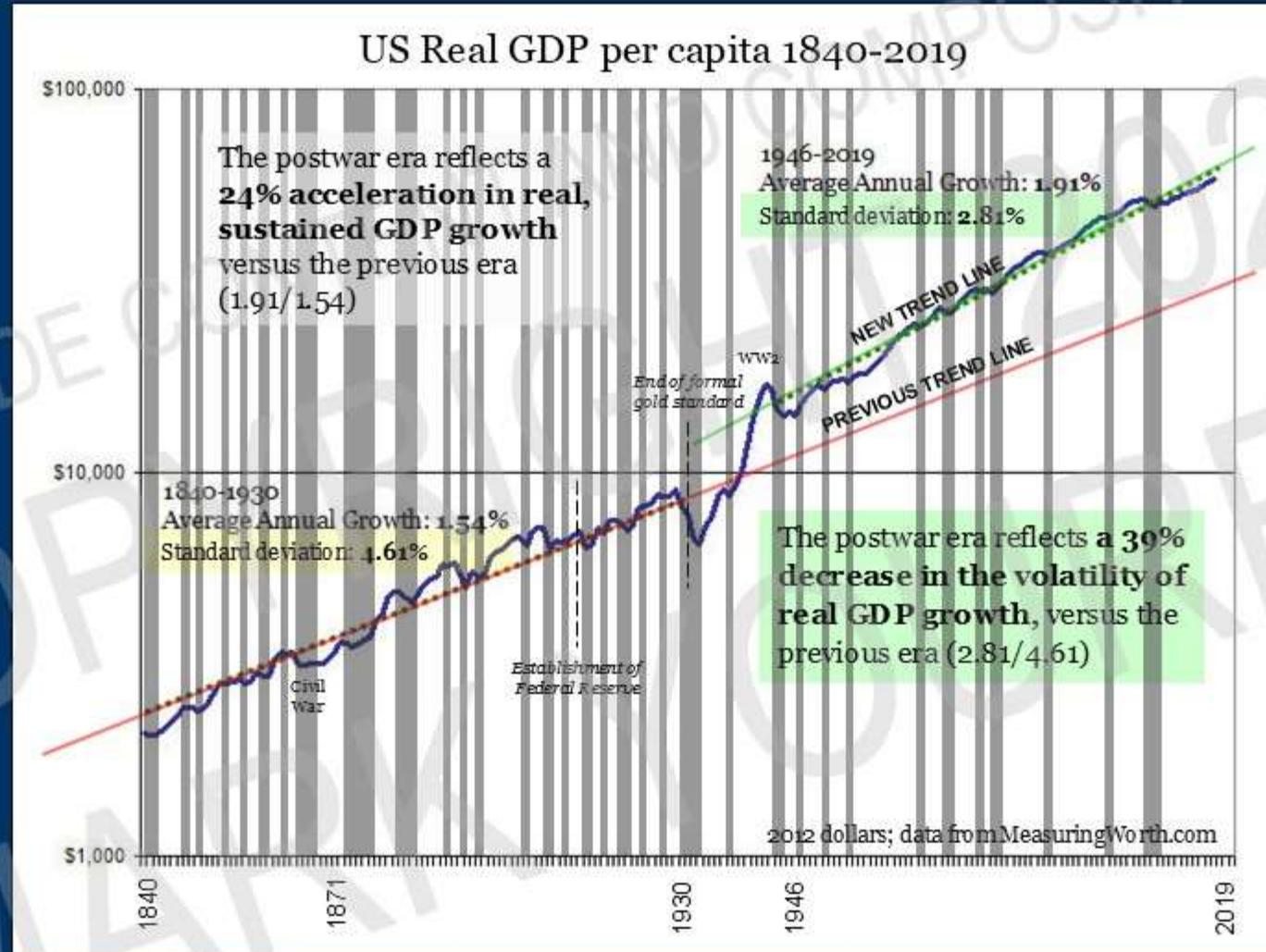
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“The Postwar Era can be viewed as a relative long-term success in the use of government to steady the economy as a whole, and the banking sector as a special focus...”



... punctuated by occasions of lapse and misjudgment... while capitalism's resilient instability is always looking for new ways to manifest”

Postwar Era: The Evolution of Economic Theory and Practice

- Use of **government fiscal policy (deficit spending)** to employ unused capacity and stimulate the economy during recessions, to reduce the depth and severity of downturns (Keynes, 1930s; but acknowledged use begins in 21st Century)
 - Also, with the increased size of government, more inherent economic stability, as well as a growing factor of **automatic stabilization**, via income and corporate taxation
- Use of **monetary policy as a counterbalance to the instability of the economy**
 - The need for the central bank to move aggressively to provide liquidity in a banking crisis
 - Understanding that collapse of the money supply with mass bank failures in the early 1930s contributed significantly to the severity of the crisis, and that the Fed did not respond effectively: monetary policy of the time did not reflect sufficient awareness of this (Friedman, 1960s)
- Recognition that **higher employment cannot be ‘bought’ with inflation**
 - In the 1960s, monetary theory held that there was a stable, exploitable relationship between unemployment and inflation: i.e., that permanently lower rates of unemployment could be ‘bought’ with modestly higher rates of inflation (the ‘Phillips curve’)
 - Friedman and others warned that the theory was mistaken: a false bargain that would require ever-higher rates of inflation to sustain

Postwar Era: The Evolution of Economic Theory and Practice

- Recognition that **inflationary expectations can themselves cause self-perpetuating inflation** (Bernanke, 1970s)
 - Consensus that **stable, low inflation** should be the primary ongoing goal of monetary policy: 1-2% seen as optimal, to avoid the risk of deflation (1990s-2000s)
- Recognition of the **persistently-resistant instability of market-capitalist economies**
 - As central banks get better at maintaining low inflation and steady growth, a prolonged period of such **'success'** can itself foster **complacency and overconfidence on the part of investors**, fostering the formation of **price bubbles**, and then **new bouts of instability**
 - Growing awareness that **markets cannot be counted on to be self-correcting in the case of pricing in risks to the economy as a whole**, that are nonetheless **external to each individual enterprise**, *i.e.*, **systemic risks** (2010s, Posner et al)

'Greenspan put' may be encouraging complacency

'Moral hazard' may be created by the interventions of the Fed, says Peronet Despeignes

Some stock traders now call it "the Greenspan put". It is a label borrowed from the world of options trading for a widely held view: when financial markets unravel, count on the Federal Reserve and its chairman Alan Greenspan (eventually) to come to the rescue.

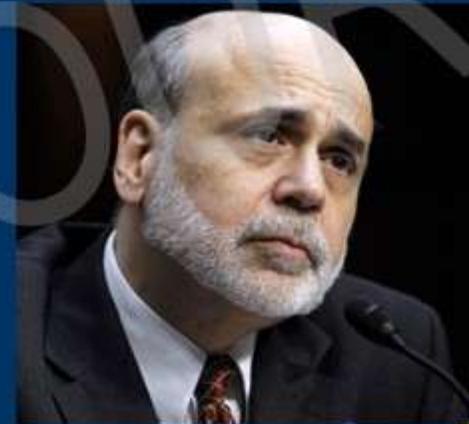
"Investors are worried about a hard landing. I am less con-



Postwar Era: The Evolution of Economic Theory and Practice

Economic crises of this era, so far:

- **1970s-1980s – Surging inflation**, caused in part by bad monetary policy, ultimately requires harsh monetary intervention to extinguish
- **1980s-1990s – Destabilization of the S&L industry**, requiring eventual costly government intervention
- **2000s** – Introduction of financial innovations which, in conjunction with the rise of an uninsured ‘shadow banking’ sector, fueled a nationwide **housing bubble** and subsequent **economic collapse**
- **Early 2020s** – Shock **Covid-19** downturn, then an **inflation surge** as the pandemic wanes



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... punctuated by occasions of lapse and misjudgment...

while capitalism’s resilient instability is always looking for new ways to manifest”

late 1960s to early 1970s

- Since 1951, William McChesney Martin has served as chairman of the Fed, and has presided over an era of relative economic stability and growth, having established the principle of **Fed independence**, and the key responsibilities of the central bank: to **control inflation**, and to **stabilize capitalism’s mood swings**



Address to the Investment Bankers Association of America, October 1955:

In the field of monetary and credit policy, precautionary action to prevent inflationary excesses is bound to have some onerous effects...

Those [of us] who have the task of making such policy don't expect you to applaud.

The Federal Reserve is in the position of a chaperone who has [to order] the punch bowl removed just when the party is really warming up.

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- The banking sector has been largely free from panics since the 1930s, under a system of deposit insurance, bank supervision and regulation that has been remarkably successful, until now
 - The S&L industry dominates the issuance and holding of home mortgages, during an era of relatively low and stable inflation
 - Their business model depends on the elements of regulated interest on deposits (3%) and mortgages that pay around 5.5 – 6.0%; they are largely shielded from competition from commercial banks
- But trouble is brewing:
 - Inflation has been ticking up very gradually since the early 1960s, and is beginning to raise worries
 - The Bretton Woods structure of fixed exchange rates between the dollar and other major currencies has begun to come apart; starting sometime soon, it may be necessary to just let currencies float
 - (In retrospect), it is clear that there has been a large asset price bubble in the US stock market that began back in the late 1950s, and that might pop or start deflating at any time

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late 1960s to early 1970s

- Fed chair Martin is worried about rising inflation. In 1967, 1968 and 1969, the Fed gradually raises interest rates; by mid-1969 the discount rate is at **8-9%**
- The new president, Richard Nixon, forcefully pressures Martin to reverse course and *loosen* monetary policy, regardless of rising inflation. Martin refuses, but his term ends in Jan 1970. Nixon appoints Arthur Burns as the next Fed chair
- Burns moves to lower rates aggressively; by late 1970, the discount rate is below **4%**, despite the fact that inflation is still at **>6%**. In private, Nixon makes clear that he is adamantly opposed to any rate increase prior to the 1972 election
- In a surprise move on August 15, 1971, Nixon imposes broad wage and price controls, ostensibly to curtail inflation without raising interest rates, and also to support the value of the dollar, as he simultaneously announces the end of the Bretton Woods fixed-exchange-rate regime
- As could be expected, wage and price controls prove to be a very poor substitute for responsible monetary policy. They momentarily hold back inflation, but at the expense of all kinds of economic distortions, including supply shortages, the expansion of black markets, and product-quality deterioration



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mid-1970s to early 1980s

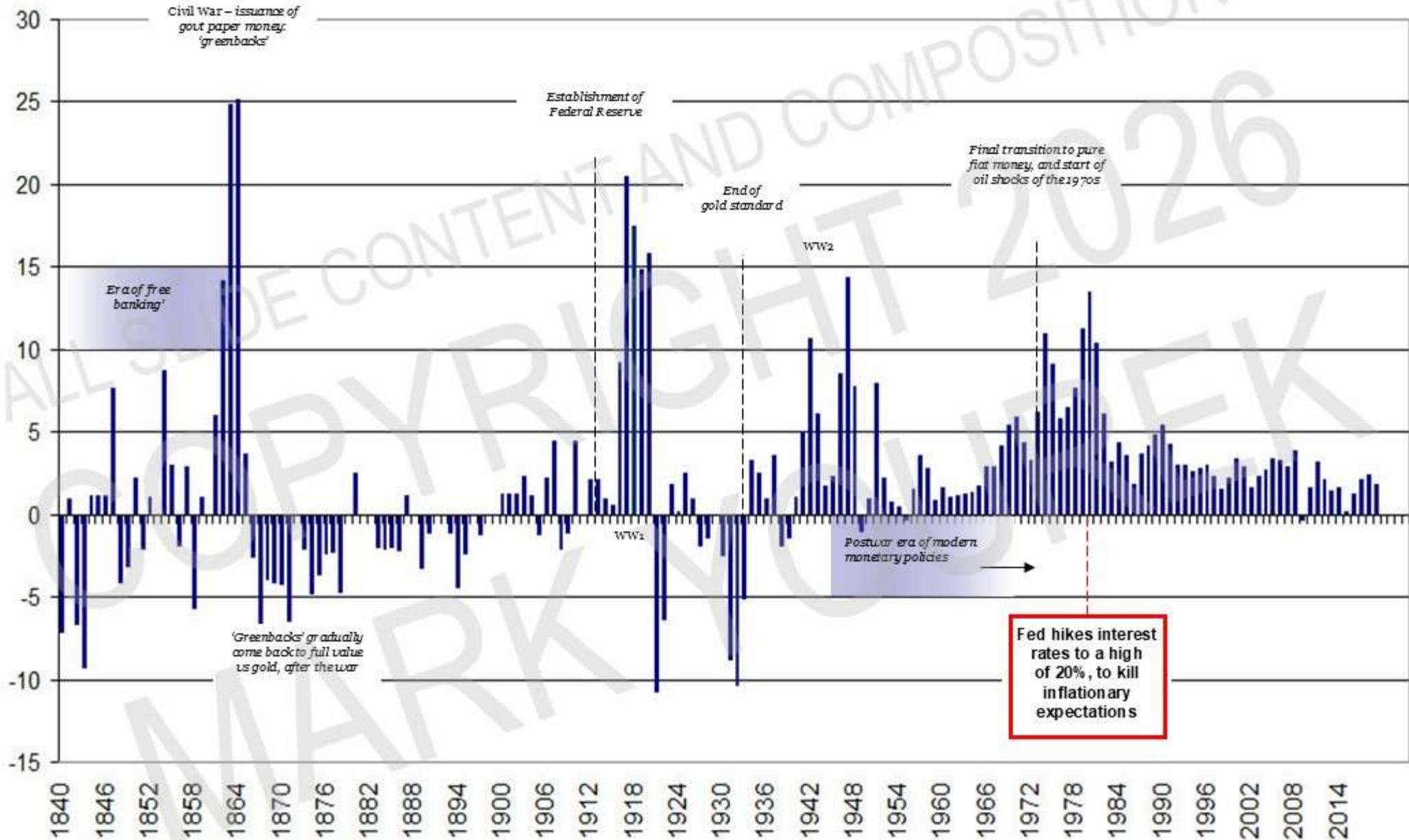
- When price controls are lifted, inflation surges, and continues rising. In 1973, the Fed starts raising interest rates sharply: the rate is at **10%** by late '73, and at **11%** by the summer of 1974. The momentum of inflation would call for such rates to remain in place for an extended time, but...
- **The oil shock of 1973** begins a vast removal of wealth from the US economy. Conditions begin to weaken immediately, and country drops into the **1974-75 recession, even as high inflation continues**
- The Fed, faced with the dilemma of **stagflation**, opts to move back to relatively low interest rates, in hope of supporting a recovery; the discount rate is back to **5 - 5.5%** by mid-1975
- The low interest rates allow **inflationary expectations** to take even deeper root, with prices surging upwards all through the 1970s, largely on the growing momentum of expectations
- **In 1979, President Carter appoints Paul Volcker** as Fed chair, with the assignment of raising rates as high as necessary, for as long as necessary, to kill the persistent expectation of inflation
- **Record interest rates of 20%** as set by the Fed in the early 1980s are ultimately successful at extinguishing inflation – and inflationary expectations – at the cost of another **deep recession in 1981-82**, with the housing and durable goods sectors all but shutting down



The maturation of monetary functions in the United States

ESTABLISHMENT OF GOVERNMENT-ISSUED CURRENCY 1860s	ESTABLISHMENT OF INSTITUTION TO MONITOR ECONOMY AND COUNTER INSTABILITY 1913	PREVENTION OF BANK PANICS: DEPOSIT INSURANCE and FED AS LENDER OF LAST RESORT 1934	FULL CENTRAL BANK OPERATIONS BEGIN 1934-35	FED ASSERTS INDEPENDENCE TO SET INTEREST RATES 1951	CRISIS-TESTED ABILITY TO SET INTEREST RATES INDEPENDENTLY early 1980s
Civil War need to raise huge amounts of money to prosecute war	Panic of 1907 need to be able to react strongly to stabilize during bank panics	Great Depression need to end bank runs and enforce banking stability	Great Depression need to end severe deflation	Korean War inflation need to end subordination to Treasury	1970s inflation need to definitively kill inflation expectations
Elimination of private bank notes Currency issued on gold standard	Federal Reserve established as new entity distinct from Treasury, with technocratic governance. But a significant part of the political establishment disagrees with the need for such an institution, and with the idea that govt should ever intervene in the economy	Deposit insurance established after banking industry is devastated by runs and panics. Fed begins to act as lender of last resort to banks, with much closer bank supervision and regulation	Convertibility to gold is ended, effectively ending the gold standard. The US dollar is devalued from \$20.67 to \$35, to stop deflation. Everyone required to sell their monetary gold to the government, to prevent hoarding, and to get money to start circulating more freely	Until 1951, interest rates were held artificially low, to limit servicing costs on the massive WW2 national debt. But the outbreak of heavy inflation causes the need for the Fed to start setting interest rates so as to actively stabilize the currency value	Due to too-loose monetary policy and oil shocks, inflation surges and begins to self-perpetuate. Paul Volcker leads effort to crush inflation expectations. Very costly to economy in short run (bad recession), with heavy political criticism, but the Fed succeeds in killing inflation

US Annual Inflation Rate 1840-2019



	1980	1981	1982
30-year home mortgage	14%	17%	16%
3-year new-car loan	13%	17%	16%



sales of homes dropped by 50%, during this period

housing starts dropped by 50%

new-car sales dropped by 33%

unemployment climbed to almost 11%

**tens of thousands of businesses went bankrupt:
more than at any time since the Great Depression**

DUMP
REAGAN



This house

**Bought
1964**

**\$93
house payment**

**5.5%
interest rate**

**\$16,000
mortgage**

**\$20,000
price**

**Similar house in
the neighborhood**

**Bought
1980**

**\$570
house payment**

**14%
interest rate**

**\$48,000
mortgage**

**\$60,000
price**



This house

**Bought
1964**

\$93

house payment

5.5%

interest rate

\$16,000

mortgage

\$20,000

price

**Over just 16 years,
cumulative inflation
reduced the effective
cost of my parents'
mortgage
payments
by >60%**

**'Inflation messes with the value
of existing debts, transferring value
from lenders, to borrowers'**

**Similar house in
the neighborhood**

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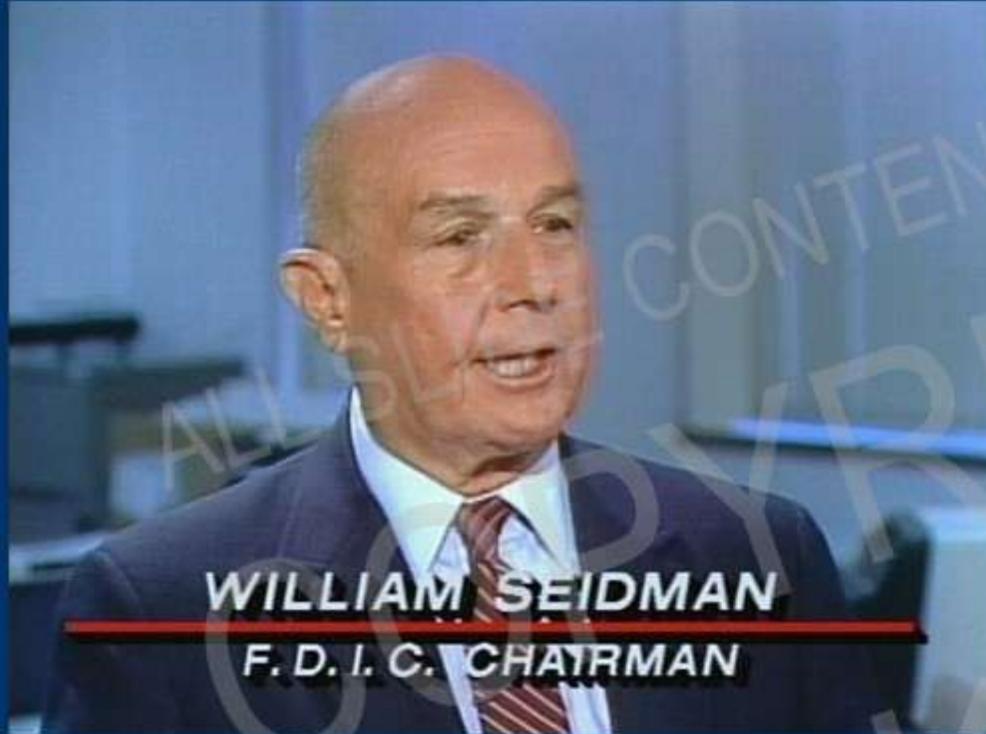
1980s

- The **S&L industry** is in deep trouble, stuck holding portfolios of long-term low-interest home mortgages, and with new mortgage initiation at a historic low, due to high interest rates. Attracting deposits requires offering high short-term rates, which is unprofitable, given the need for a positive interest-rate spread between borrowing and lending
- By 1982, the industry loses \$4 billion, with more and more S&Ls becoming insolvent. At the time, the FSLIC held reserves of \$6 billion, while the cost of paying off depositors at insolvent institutions was estimated at \$25 billion. Congress and regulators seek out other options
- A bipartisan Congress passes and President Reagan signs the **Garn-St. Germain act**, which pulls back strict regulatory supervision (**‘forbearance’**) and allows S&Ls to use government-insured deposits to invest far beyond home mortgages, to fund (and own directly) more speculative projects and enterprises. The hope was that the industry could ‘grow out of’ its problems
- By 1985, S&L assets had jumped by 50% in just three years, as the industry grew aggressively. But owners of the many **‘zombie’ S&Ls had none of their own capital at risk**. This condition of **moral hazard** motivated them to take wild risks in hopes of winning big, with no downside risk – except to the taxpayer. Insolvency spread widely, as losses accumulated
- By 1989, it was clear that many S&Ls were hopeless. A growing number of flamboyant cases of **outright fraud** helped prompt belated government action. One-third of all S&Ls fail and must be resolved by government, with the cost to the taxpayer ultimately coming to **\$140-150 billion**



The special thing about banks

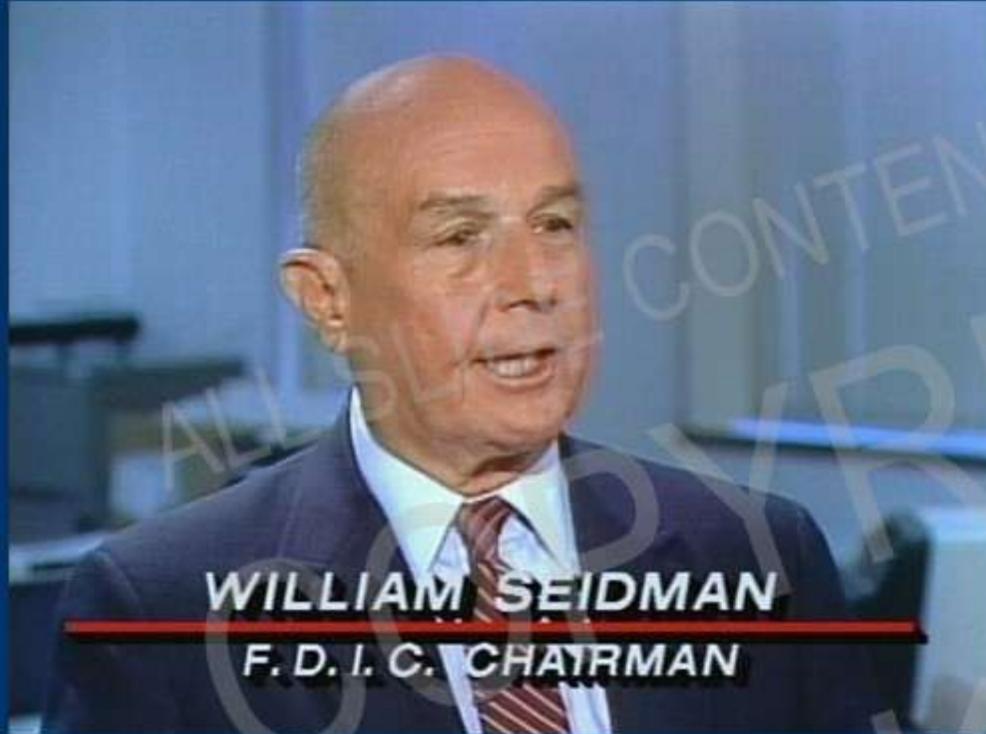
William Seidman, Chairman of the FDIC 1985-1991



A bank is a very special kind of company, chartered by a state, or by the federal government, to do something no other business can do: collect, hold and lend out other people's money at a profit.

The special thing about banks

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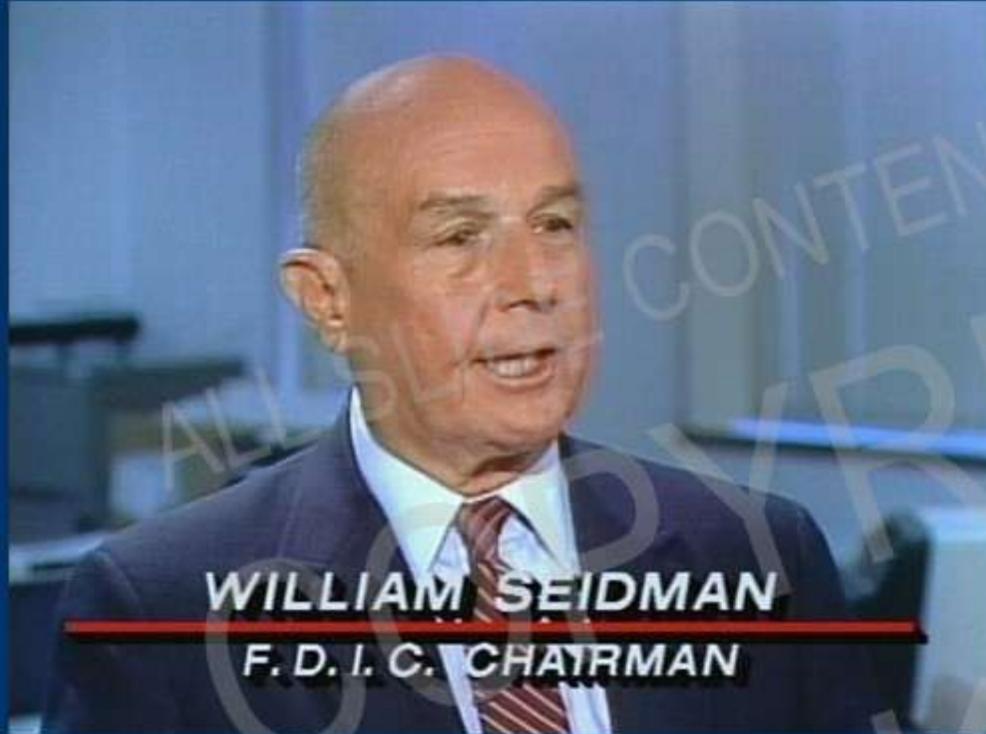


Only banks have their deposits insured by the government, and for that reason, only banks have as their full business partner the US taxpayer – because the US taxpayer is on the hook for up to 90% or more of the loss, if the bank makes too many bad bets.

For that reason, effective bank regulation and examination is absolutely essential.

The special thing about banks

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In the late 1970s the FDIC reached its peak staff of almost 2500 bank examiners.

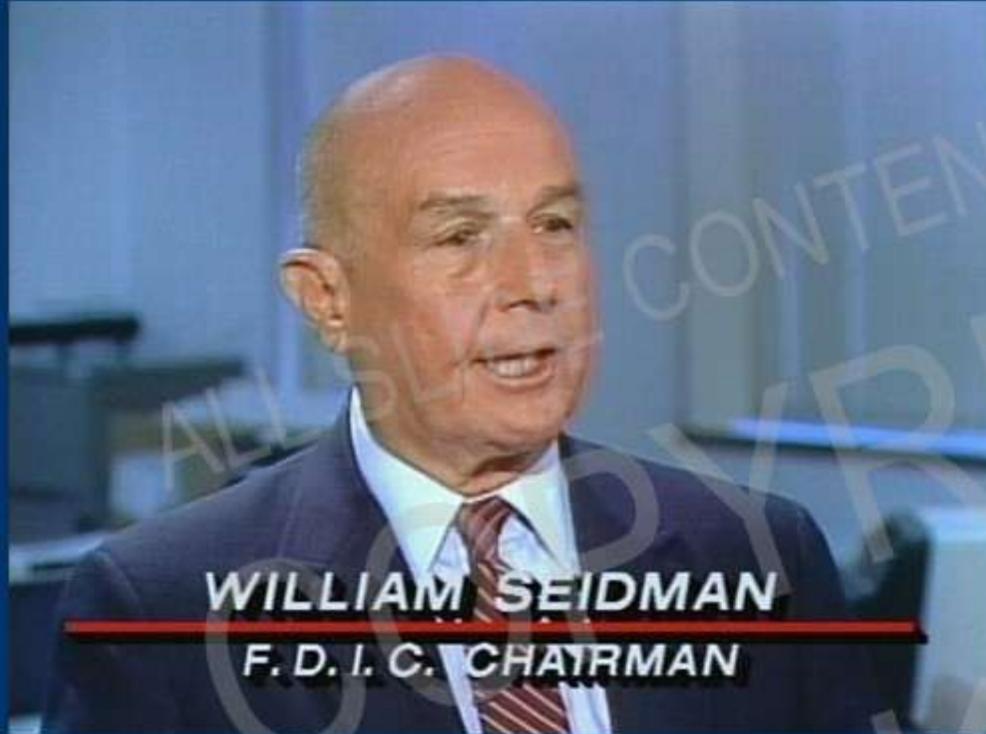
By 1983 our number of supervisors had shrunk to about 1400.

The number shrank because the Reagan Administration held the view that fewer supervisors would be needed, as financial institutions were deregulated.

They thought that fewer people would be needed, to look over the shoulders of the banks.

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WILLIAM SEIDMAN

F. D. I. C. CHAIRMAN

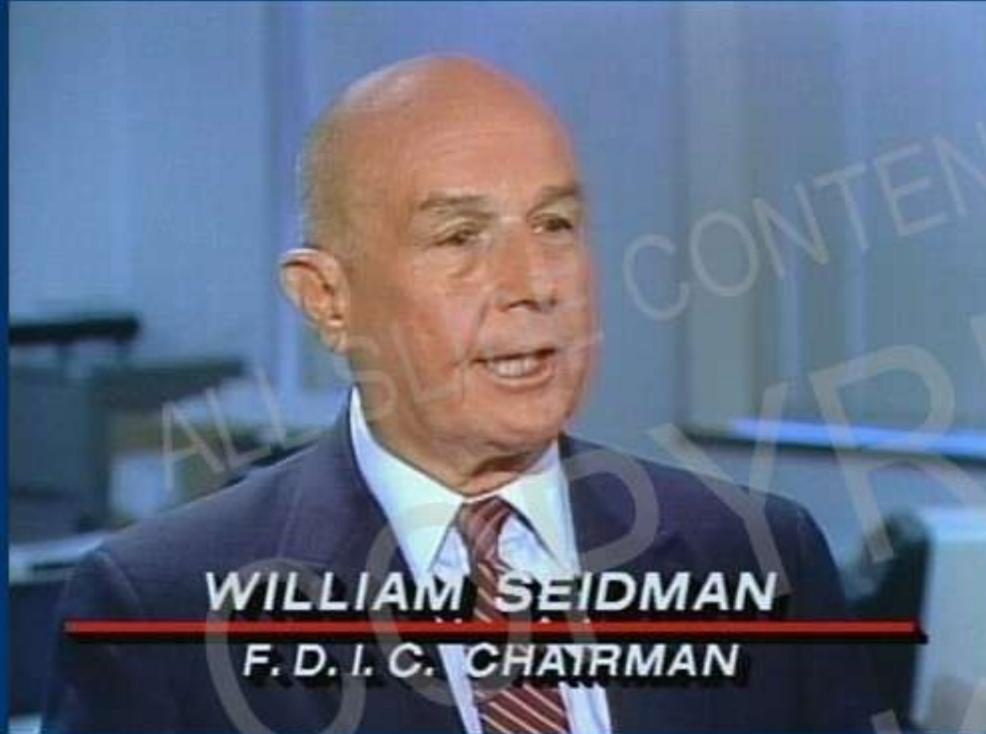
In fact, the *opposite* is true –

The more freedom you give bankers to undertake various kinds of risk, *the more you have to watch them* –

especially if your agency is the one that is offering the government's full faith and credit guarantee, by insuring [bank] deposits, in case risky loans go sour.

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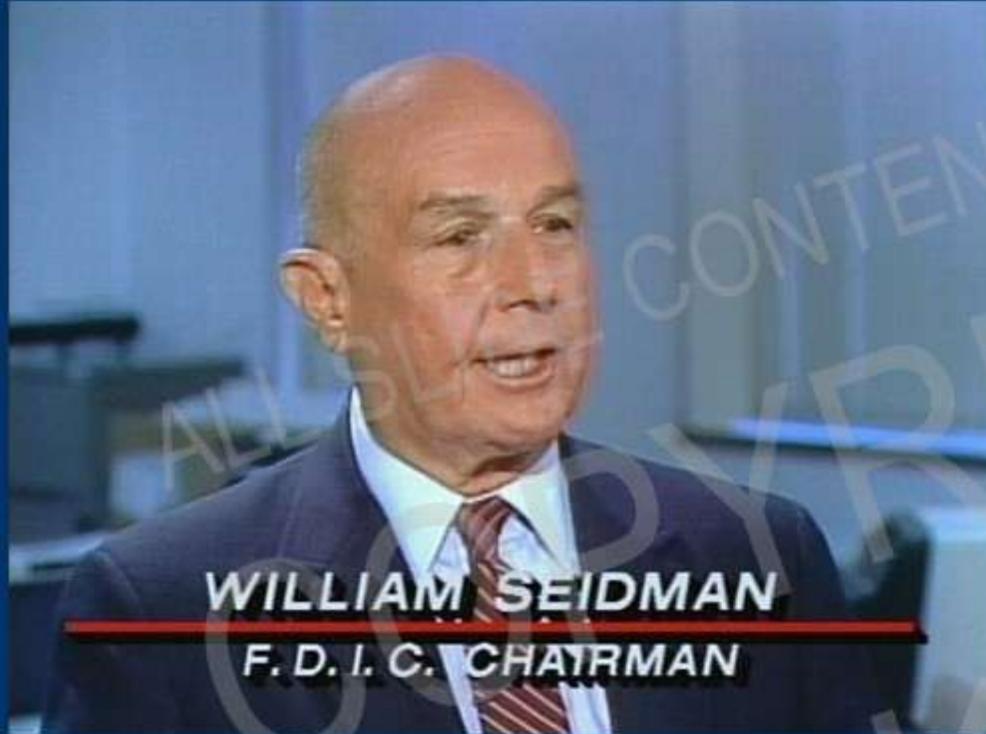


Bank deregulation is unusual in that it requires *more*, not less, supervision.

This was not a message that was easily received in the Reagan White House.

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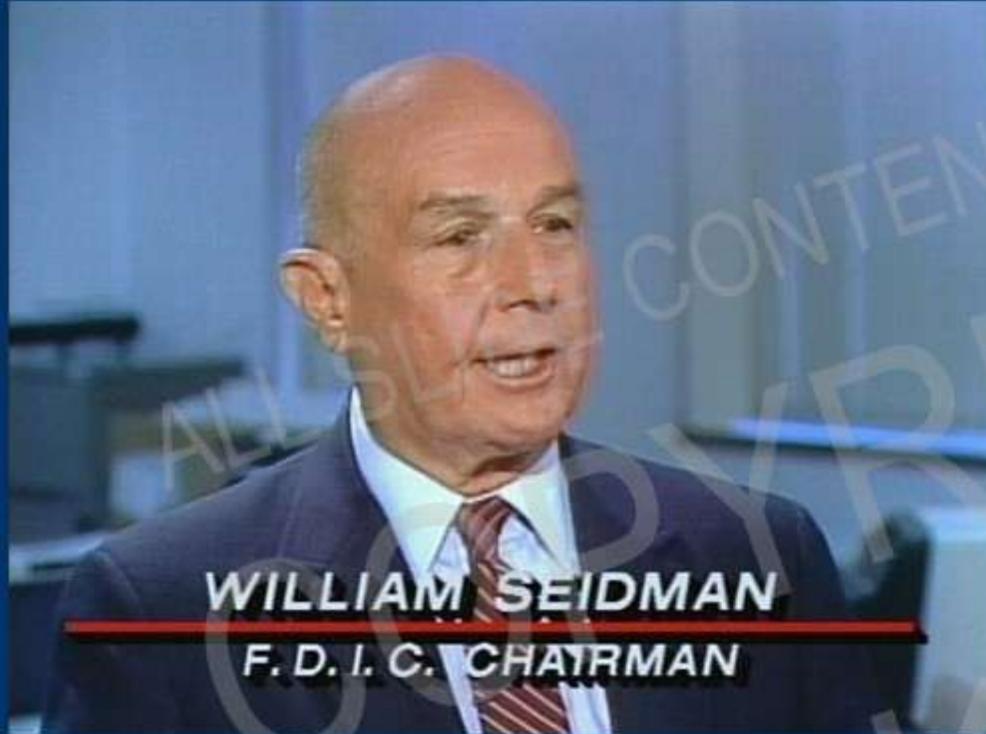


Much of the Reagan Administration's efforts at deregulation was of great economic benefit, but applying that doctrine to the banking industry, specifically the thrift industry, was a **colossal error.**

*Full Faith and Credit:
The Great S&L Debacle and
Other Washington Sagas, 1993*

The special thing about banks

William Seidman, Chairman of the FDIC 1985-1991



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Postscript:

Until 2016-2017, the
FDIC employed around
2500 bank examiners

In 2018-2019, this
declined to 2300

As of late 2021
it was back to 2500

In 2025, it was cut
aggressively, once again

“The Postwar Era can be viewed as a relative long-term success in the use of government to steady the economy as a whole, and the banking sector as a special focus...

... punctuated by occasions of lapse and misjudgment...

while capitalism’s resilient instability is always looking for new ways to manifest”

Aside:

Another section of the **Garn-St. Germain Act of 1982** legalized a range of products beyond the industry-standard fixed-term, fixed-rate amortizing mortgage:

- **Adjustable-rate mortgages**, in which the interest rate is fixed for a number of years and then rises to a floating rate for the remainder of the loan term
- **Interest-only mortgages**, that have the borrower pay interest alone during the first years of the loan, with principal payments beginning thereafter
- **Balloon-payment mortgages** that have a single large amount, often the bulk of the original loan principal, as the final payment at the end of the term

Each of these constitutes a way of enabling borrowers to **increase the amount they can be loaned** towards a house purchase, while also **adding risk regarding their future ability to pay**, given that the terms call for payments to rise, and often to **rise significantly**, at a defined point in the future

folios of long-term low-interest home loans, which were now too low, due to high interest rates. Attracting deposits was unprofitable, given the need for a positive

return on assets, and many S&Ls becoming insolvent. At the time, banks were driving off depositors at insolvent institutions and were looking out other options

the **Garn-St. Germain act** which pulls in deposits and allows S&Ls to use government-insured deposits (and own directly) more speculative projects to pull them out of its problems

and, as the industry grew aggressively.

their own capital at risk. This condition was a recipe for types of winning big, with no downside risk – and as losses accumulated

growing number of flamboyant cases of insolvency. One-third of all S&Ls fail and must be liquidated, ultimately coming to **\$140-150 billion**

**Capitalism,
Government,
Money,
and the
Future of
the World**

*Finding
and Keeping
the Right Balance
in
Market-Capitalist
Democracies*