# Glass-Steagall, Then and Now: How to Fix a Bankrupt Economy

*Paul Gallagher, Economics Intelligence Co-Director at EIR, gave this interview to LaRouchePAC's John Ascher on Jan. 10, during a conference call with LPAC activists.*

Paul Gallagher

**LaRouchePAC:** You are familiar with the original Glass-Steagall bill which was passed in 1933 in the Franklin Roosevelt era, and you are also familiar with the bill Rep. Marcy Kaptur (D-Ohio) introduced last year, H.R. 1489, and this year, H.R. 129. Are these bills actually the same?

**Gallagher:** In terms of the substance, they are essentially the same, with one addition which I'll indicate. But it would be worth making clear what the subtance is in four general points.

### What is Glass-Steagall?

First of all, what is most universally known about Glass-Steagall, is that it gives bank holding corporations and bank conglomerates and those other financial firms which have been calling themselves banks, it gives the commercial banking core of those holding companies one year in which they must divest themselves of all non-commercial banking units. And no crossmanagement can remain between the commercial banking unit and those other units, and no crossownership can remain.

Secondly, the original Glass-Steagall, having created, so to speak, "clean" commercial banks again, set a limit through each of the Federal Reserve banks, which were charged to enforce this in their districts. Each commercial bank so separated could not use more than 2% of its capital and surplus at any time for the creation or sale or distribution of securities. There were certain kinds of bank-qualified securities exempted from this, but basically, it was a 2% limit. If you imagine 98% loans and 2% investment in securities, that gives you what was actually being enforced for more than 60 years as the practice across the country, why this worked, and why there were not bank panics.

Thirdly, the law, through a series of regulations, prevented commercial banks and bank holding companies from making loans of their depositors' assets or their own liabilities, their depositors' money, into such vehicles as would support the creation and circulation of securities. You might think in terms of a bank creating a hedge fund, which is nearly a universal practice in the last 20 years. That kind of use of bank loans to support securities was forbidden.

Lastly, and very importantly, no securities of low, or potentially low value, could be placed by a bank in its insured commercial bank units. This later became known as Section 23a of the Federal Reserve Act, because it was orphaned when Glass-Steagall was repealed. But it is part of the Glass-Steagall Act. It is essentially the anti-bailout core of the Glass-Steagall provisions that would have prevented the movement of huge derivatives portfolios of the major banks now—in the case of Morgan Stanley, for one example, a $55 trillion derivatives book.

It prohibits the placing of those derivatives books onto the books of the federally ensured commercial banking unit, under the holding company, in order to get them bailed out by the back door, or get them the promise of a bailout, and in many cases, the fact of a bailout.

So, in those core regulations on the reorganization of banking, this bill, the Kaptur-Jones bill is the same as the original Glass-Steagall bill.

It adds one notable feature, and that is, there was a Supreme Court decision in 1971, known as *Investment Company Institute v. Camp*. In that decision, the Supreme Court affirmed that Glass-Steagall was the primary banking regulations of U.S. Code 12 of national banking law; that it was the preeminent regulator of the banks. And it affirmed that the Glass-Steagall Act could be enforced in such a way as to, in effect, protect commercial banks from themselves, by limiting their ability to plunge into apparently seductive high yield securities transactions, and actually putting the bank and its shareholders and its depositors at risk.

The Supreme Court affirmed that that was a proper use of government power, to regulate commercial banks.

And in the Kaptur-Jones bill, it is consistently stated that the standards set out in that Supreme Court decision of *Camp* would now be the minimum standards for regulation of commercial banking. So, it has that one additional feature, to prevent, in particular the Federal Reserve, which is the primary regulator here, from retracing the steps of Alan Greenspan, who progressively destroyed the main regulations of Glass-Steagall, before he destroyed the law itself.

### Ringfencing is not Glass-Steagall

**LPAC:** Many of the people on the phone may have heard that there is a movement for Glass-Steagall in Great Britain. There has been discussion in Great Britain and some other countries, also in the United States, of a revised form of what they sometimes call Glass-Steagall, which is referred to as ring-fencing. This, in Britain, was the Vickers Commission. Could you please explain the difference between what we are proposing in fighting for Glass-Steagall, and what is known as ring-fencing?

**Gallagher:** Well in the United Kingdom, it is like a war of the commissions—the Vickers Commission vs. the Tyree Commission, which has come very close to demanding replacing it [ring-fencing] with the full Glass-Steagall regulations. The reason for the war, as one Federal regulator told me at the time that this Vickers Commission came up, in Washington, this ring-fence is a very low fence indeed, and the holding companies will have no trouble jumping right over it.

What is Vickers Commission proposal? For example, if you consider the changes that have taken place in the large bank holding companies in the last 15 years—the Federal Reserve itself studied this, and made it clear in a report this past August—where you once typically had, before

Glass-Steagall, about a hundred subsidiaries in an average large bank holding company, you now have two or three thousand so-called subsidiaries, little securities units spread all over the world, in a large bank holding company.

The Vickers Commission ring-fencing proposal essentially says that some of the larger of these very complicated, globally spread securities units will have to raise additional capital on their own, while remaining units of the same "universal bank,"[1] remaining speculative vehicles for those banks. But they will have to raise additional capital themselves, so that they will appear to be independently capitalized, and they will also have to have more of a management team of their own. There is not supposed to be movement of the management "over the fence," and movement of capital back and forth.

But, as my friend involved in regulation put it, the holding companies will leap over this low fence with ease, because they are allowed to make unlimited loans to the various units that have supposedly been fenced off from one another, and therefore quite freely move capital.

So it's a thing which clearly doesn't work. It's very similar to aspects of the Dodd-Frank Act, and there has been a real revolt against it among British bankers. And, as I'm sure people on this call know, polls show that 60-plus members of the Parliament want full Glass-Steagall instead, and it's being very strongly challenged in the United Kingdom.

The New York Times

NEW YORK, SATURDAY, JUNE 17, 1933.

PRESIDENT STARTS RECOVERY PROGRAM, SIGNS BANK, RAIL AND INDUSTRY BILLS; WHEAT GROWERS WILL GET $150,000,000

AIDS FARMERS THIS YEAR

Powers Granted to the President

ROOSEVELT HAILS GOAL

He Calls Recovery Act Most Sweeping Law in Nation's History.

JOHNSON ADMINISTRATOR

Col. Sawyer Is Named to Direct Public Works, Eastman as Railway Coordinator.

'MILLION JOBS BY OCT. 1'

Employers Urged to Hire More Men With Government Stopping Unfair Competition.

*Text of President's statement on recovery policies, Page 2.*

Special to THE NEW YORK TIMES.

WASHINGTON, June 16.—Assuming unprecedented peacetime control over the nation's economic life, President Roosevelt placed in operation today his sweeping program for recovery from the depression.

Within two hours he signed acts of Congress giving him control over industry, power to coordinate the railroads, and authority to start work on a $3,300,000,000 public works program, and then began the active administration of these and other major measures.

In signing the National Industrial Recovery Act the President declared that it was "the most important and far-reaching legislation ever enacted by the American Congress," and said that it "represents a supreme effort to stabilize for all time the many factors which make for the prosperity of the nation and the preservation of American standards."

The Glass-Steagall Banking Re-

WIDE WORK SPREAD ASKED BY JOHNSON

TREASURY TO ORDER $25,000,000 WORK

President Roosevelt's policy to deal with the Great Depression, announced here on June 17, 1933, included the passage of the Glass-Steagall law (inset) and other programs. H.R. 129, currently before the House of Representatives, is the same in all major respects.

### The Fiscal Cliff

**LPAC:** The next phase of the fiscal cliff discussion is coming up. How does pushing Glass-Steagall right now actually deal with this question of the so-called fiscal cliff?

**Gallagher:** Well, this is really the biggest question.

We had some very good discussions of this in meetings in Washington today. It's the crucial question. [Look at] the IMF making its feeble defence of its previous errors and its inability to correct them, with regard to Greece.[2] Not saying it would change policy in any way, but just offering a defence of itself: "I didn't know what I was doing when I imposed the crushing austerity on Greece and Portugal." What they are actually saying, is they don't know what is the multiple between how much you cut, in austerity against government programs, and how much the economy contracts.

They started trying to claim that their models show that the multiple was less than one. They wound up acknowledging in this report that it could be considerably more than one, particularly in economies that are in recession, in economies in which there is contraction already going on. That is where they now acknowledge that studies show that the multiple can be very large—as large as a 6% contraction, for every 1% of cut made by an austerity program at the government level. And one of those studied showed that in the United States, in the 1930s, the ratio was 3 to 1.

So this is what the Congress of the United States is facing from the White House; and the so-called big deals that are being put forward to it right now, are an austerity policy which has been proven, in each of these European countries, to be a disaster when applied in a condition of recession, in particular. In other words, the condition of the whole world has shown, since the collapse of 2007-08, that these policies not only don't work, they are disasters! And this is the policy of the Obama Administration. And the Democrats in Congress who have some experience are quite frank in acknowledging that they know it, that it is their party's President who is pushing this austerity policy.

So what does it come from? It comes from the fact that government revenue has fallen to 15% of GDP, whereas for the last 60 years it has always been about 18.5% of GDP. Five hundred billion dollars gone missing! Gone missing in government revenue because of what we were hit with in the bank panic and collapse 5-6 years ago. And in addition, tremendous impacts from $80 billion a year now in food stamps, $150 billion a year now required for unemployment insurance, Medicaid having jumped up. All of these having smacked the economy because of that collapse of 2007-08. Not repaired.

And if you impose an austerity policy on that, then you have a potential disaster at the same time that the Federal Reserve is printing a trillion dollars a year, and has been doing so since the collapse hit—straight money-printing, and purchases of securities from the major banks. At

The Telegraph

HOME » FINANCE » COMMENT » LIAM HALLIGAN

At last, question time for the money printers

'Ring-fencing" and "quantitative easing". When it comes to the Western world's response to the sub-prime crisis, these two policies quickly established themselves, and remain, as the conventional wisdom.

6:36PM GMT 12 Jan 2013

FINANCIAL TIMES

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Opinion

Why I was won over by Glass-Steagall

By Luigi Zingales

The act can combat the excessive power of banks, writes Luigi Zingales

I have to admit that I was not a big fan of the forced separation between investment banking and commercial banking along the lines of the Glass-

Forbes

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Rethinking Capitalism: Sandy Weill Says Bring Back Glass-Steagall

Oh dear! What's happening to capitalism? First, Jack Welch, the patron saint of maximizing shareholder value, says that maximizing shareholder value is "the dumbest idea in the world."

Now Sandy Weill, legendary banker and creator or the Citigroup [C] in an interview on CNBC's SquawkBox calls for splitting up the commercial banks from the

Support for Glass-Steagall has been building since last Summer in the United Kingdom and the United States.

some point, that will trigger hyperinflation. Some of the members of Congress are beginning to have an awareness of that threat.

So you have to have a policy that attacks this as a whole. That is, you have to have a complete policy, which 1) stops the Federal Reserve from doing what it is doing—printing a trillion dollars or more a year, for a closed circle with the major banks; and 2) discovers and provides a major form for new credit into the economy, which can, at the same time, coax the banks to invest the money that they've been holding on the sidelines. And this new form of credit has to replace the tremendous loss in government revenue.

Everyone knows that this is an economy very heavily based on consumer spending. That's unfortunate; that's the result of bad policies, but that's a fact. These studies that the IMF now acknowledges made it clear that the more an economy is based on consumer spending, the consumer sector, the more it is contracting, the worse the impact of any austerity will be. So you must reverse the austerity policy, and also change that 30-year drift toward the economy being totally dominated by the consumer sector, and not by productivity, infrastructure investment, industrialization. You have to change that at the same time.

### Only the First Step

Glass-Steagall merely does the first thing, it is the most effective way to do the first thing, which is to stop the Federal Reserve from printing this money. It's printing this money solely because of the condition that the banks are in: to circulate it into the banks as liquidity, and keep them going in their current condition of being loaded with toxic assets.

You have to first stop that process, and that's what Glass-Steagall reorganization is for; but at the same time, you have to initiate a Reconstruction Finance Corporation [as in the Great Depression] or a National Banking-type government capitalization of investments in infrastructure, drawing in as leverage a lot of private capital. And where is that private investment going to come from? It's going to come from commercial banks, if those banks are made clean, and separated under Glass-Steagall. They will be investing in a National Bank, or a Reconstruction Finance Corporation, as they did before, in order to put this really productive credit into new infrastructure platforms in the economy.

And we have to discuss NAWAPA and similar urgent infrastructure needs on Capitol Hill. "Glass-Steagall plus plus," as Lyndon LaRouche puts it, has to be a single policy, which attacks the deadly policy of austerity, which they know is coming from the White House, and from the International Monetary Fund.

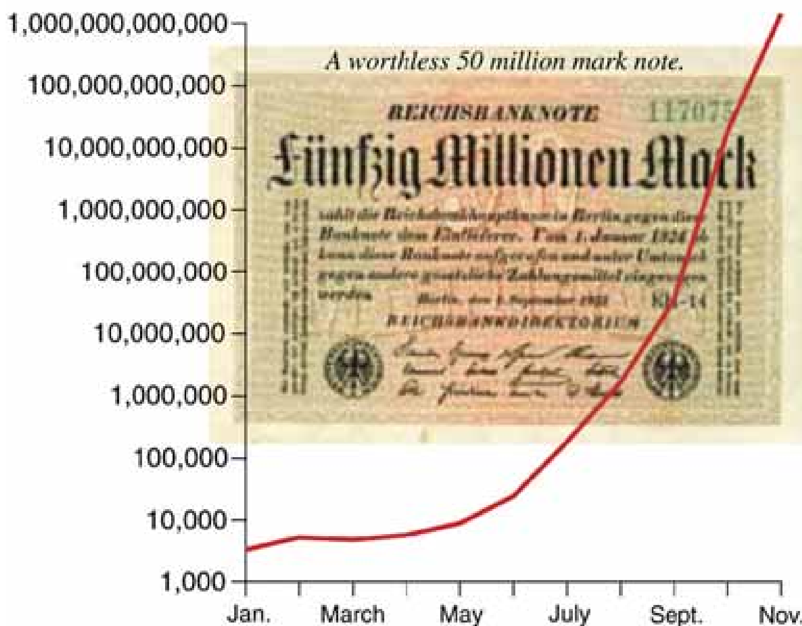
### Threat of Hyperinflation

**LPAC:** At what point does the hyperinflation hit? And why precisely do we need to get Glass-Steagall immediately now?

There was an article that came out this week in Bloomberg from a guy named Red Jahncke, some type of investment counsellor in Connecticut, who indicated that the best time to bring about Glass-Steagall is actually *before* there is a banking collapse, when this can be done in a more transitional kind of way. And he spelled out the method by which these banks could be broken apart.

**Gallagher:** To take the first question first, the Federal Reserve has printed, in the last four and a half years, since the crash of 2007-08, more than $2.5 trillion. That's not all of the many tens of trillions of short-term liquidity loans it made to everything from hedge funds to banks; I'm talking about what it printed, what it used to buy securities from these banks on a permanent basis, to put that money into them. The other major central banks have done the same thing: the British, the ECB of Europe, the Swiss, and the Japanese have done the same thing, and they have combined for something like $11 trillion in that period of time. The Federal Reserve has the policy now which will bring it to about $4 trillion printed by the end of 2013. With a contracting real economy, and the collapse of government revenue, and the austerity policy that I've indicated, this essentially looks *deflationary*, until it suddenly turns *hyperinflationary*.

There will be a trigger; there might very well be a takeoff, all of the a sudden, in the price of food, because of the declines in the production of food under conditions of drought, and under conditions of very rapid price fluctuations of all the inputs to food, and of the food commodities themselves. This could very well trigger it. But the basic



Weimar hyperinflation: Germany printed money for more than two years without any apparent inflationary impact, but suddenly hyperinflation took off and the economy was destroyed. Money became so worthless that children could play with stacks of it. People's savings were wiped out causing widespread discontent and civil unrest.

mechanism that you are looking at, is that the central banks, led by the Federal Reserve and the European Central Bank, are printing trillions and trillions of new currency, putting it into circulation directly through the major national and international bank holding companies.

And they claim this is not an inflationary policy because the vast bulk of that new capital and new liquidity is then being put right back into the Federal Reserve, and the other major central banks. The banks are puting it right back into the central banks, as what are called "excess bank reserves." And they are being paid interest by the central banks on those reserves for the first time.

The Federal Reserve has never done this before. It's the first time in its 100-year history that it has paid interest to get banks to put this money right back into the Federal Reserve. The ECB is doing the same thing.

At a certain point, when a sudden speculative bubble starts to escalate, as for example, with a trigger escalation in the price of food, watch those unused trillions come pouring out into commodity speculation, for example, and suddenly set off hyperinflation. So it's not something that can be predicted at a given time. After all, in Weimar Germany, the worst and most infamous case, they did this kind of money printing to pay unpayable government debts for more than two years, with no apparent inflationary impact, until all of a sudden, it exploded and consumed the currency, and the entire economy. So we can't say when, but we *can* say it will happen.

**Do It Now!**

As to what Mr. Jahncke was saying, he is a strong advocate of Glass-Steagall restoration, and he was saying, now is the time to do it; essentially we're between banking collapses. His article is titled, "Breaking Up the Banks Is Easy When They Aren't Failing." Pass Glass-Steagall, give these large bank holding companies one year to break themselves up, and they'll be able to do it, or at least there is a chance they'll be able to do it, because currently they can sell off their units.

On the other hand, he says that if you wait until these banks, some of them, or even one of them faces failure, and then try to resolve it, try to break it up because it is about to go under, and you will suddenly find that you're unable to sell any of its units or any of its assets in the atmosphere of panic that will be spreading everywhere, and therefore, the whole business of breaking up the bank will fail.

In a broader sense we might say, that if we can make clean commercial banks, a clean commercial banking sector, not loaded down with securities, and at the same time, start to issue national credit for really important productive investments in new infrastructure platforms, then you would see some money which has been placed on the sidelines of the banks, come into this kind of real investment in national banking. He's finding a kind of homespun way of saying, do Glass-Steagall now, because we're between banking collapses, and you won't be able to do it, once the next one hits.

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Footnotes

[1] A universal bank combines commercial banking with investment activities—i.e., a bank that is not operating under the Glass-Steagall system.

[2] See "IMF Nuremberg Defence on Greece: We Had No Idea What It Would Lead To," EIR, Jan. 11, 2013.