

# GLBA and Financial Deregulation: The Forgotten Cause of the Financial Crisis

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*NICHOLAS FREILING*

*AUSTRIAN STUDENT SCHOLARS CONFERENCE*

*GROVE CITY COLLEGE*

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*“The financial deregulations have sped up the erosion of the real-wealth-generation process. Consequently, instead of having a severe crisis in 20 years' time, we have it now.”*

– Frank Shostak

Since the collapse of financial markets almost five years ago, various pundits have sought a scapegoat to blame for what is becoming a very long recession. Among the more popular positions is that the financial deregulation of the late twentieth century—specifically the Gramm-Leach-Bliley Act—facilitated excessive speculation and disturbed what had been a relatively stable financial sector. While such a position seems to contradict what Austrian school economists believe about coercive regulation, many of them actually advance such a thesis. Deregulation of an inherently inflationary banking system, they argue, only leads to further credit expansion and inevitably results in boom and bust. Considering the nature of market competition, the instability of fractional-reserve banking, and the aftermath of the regulatory rollback, this thesis is found to be entirely true.

### **Competition and Coordination**

In *Man, Economy, and State*, Murray Rothbard lays the foundation of Austrian cartel theory by demonstrating that the market process renders the dichotomy between “cartel” and partnership or cooperation to exist only in terms of the formal arrangement and extent of participating firms’ coordination and not in terms of such arrangements’

compliance with those conditions that constitute “competitive behavior”. Cartels or mergers, he argues, will come into existence if a coordinated effort to limit or coordinate production by various firms in a single industry is found to be more profitable for each individual firm than if they were to make production decisions independently. This implies that the coordinated arrangement of resources must be more value-productive (Rothbard, 2009, p. 638). Even if a cartel or merger leads to less production of the cartelized firms’ goods, the increase in value-productivity implies increased total production across the economy—the capital once employed to produce the old, increased levels of a good are bid away to other lines of production where they will be more efficiently employed (Rothbard, 2009, p. 638).

Rothbard’s theory was presented in response to the theory advanced by proponents of the *perfect competition* model—the standard neoclassical conception of market competition. This model states that pure competition requires “*economic negligibility* and, in a set of traders with *many* equally powerful economic agents, the related notion of *numerical negligibility*” (Khan, 2008). In other words, the model requires that one single buyer or seller cannot affect price—that the allocation of resources throughout the relevant industry or economy are insensitive to the actions of any single agent (Khan, 2008). Further, perfect competition requires that all agents maintain full independence from one another (as George Stigler writes, perfect competition prevails “when there are indefinitely many traders...acting independently in a perfect market”) (Stigler, 1957, p. 14). This is the standard neoclassical definition of competition. Advocates of this view also argue that an efficient allocation of resources is impossible

with a market that is “competitively structured” to allow for free entry and exit, small firm size and homogenous products (Armentano, 1999, xii).

In this light, it is understandable why advocates of the perfect competition model have a generally negative view of cartels and mergers. By restricting production to increase profits, they are allegedly “anti-competitive” or “collusive,” and are often the victim of state intervention designed to prevent their existence.

But the perfect competition model is fundamentally flawed in such a way as to undermine theory based on that model. As D.T. Armentano shows, the model is not a description of competition at all. “Pure competition,” he writes, “is a static, equilibrium condition whose very assumptions are such that competitive process is ruled out by definition...it does not describe the competitive process that produced that particular outcome” (Armentano, 1978, p. 2). Additionally, Block, Barnett II and Wood show that if the neoclassical perfect competition model were an accurate portrayal of reality, “there would be no need for advertising, marketing, brokering, or, indeed, any other institution which addresses itself to the lack of knowledge about goods and services on the part of producers and consumers” (Block, Barnett II, Wood, 2002, p. 51). This is because all economic agents in the model are assumed to have “complete information” about the number of buyers and sellers and price levels. This is obviously an unrealistic model. Not only does the profession of marketer exist in the real world, but no economic agent has the sort of complete information available to agents in the model.

Predictably, Rothbard’s rebuttal of neoclassical cartel theory has led to the rejection of competition law among proponents of the Austrian school as a means to

preserve market competition and facilitate maximum economic growth. The implication of Rothbard's analysis is that the effect of competition law is always the opposite their creators' state intent—laws that prohibit inter-firm coordination of any type actually *inhibits* economic growth and enforces a sub-optimal allocation of resources across the economy.

In this light, such measures as the Sherman Antitrust Act, the Clayton Act, and the *structure-conduct-performance* paradigm have been almost universally condemned by the proponents of the Austrian school. Rather than help to preserve market competition, critics argue, such measures serve only to prevent entrepreneurs from maximizing profits, and therefore decrease the total efficiency with which producers across the economy are able to satisfy consumer demand. Ludwig von Mises writes,

“The concept of competition does not include the requirement that there should be a multitude of competing units. Competing is always the competition of one man or firm against another man or firm, no matter how many others are striving after the same prize.” (Mises, 1996, p. 362)

Measures to remove such coercive interventions, therefore, are endorsed by many Austrian theorists. Murray Rothbard writes regarding US antitrust law,

“The effects of these arbitrary rules and *ex post facto* findings of "crime" are manifold: business initiative is hampered; businessmen are fearful and subservient to the arbitrary rulings of government officials; and business is not permitted to be efficient in serving the consumer. Since business always tends to adopt those practices and that scale of activity which maximize profits and income and serve the consumers best, any harassment of business practice by government can only hamper business efficiency and reward inefficiency.” (Rothbard, 2006, p. 72)

So when Congress repealed the Glass-Steagall Act in 1999, it would seem to follow that proponents of the Austrian school would regard the deregulative measure as a step toward economic liberty and further economic progress. The Glass-Steagall Act was a

form of triangular intervention that forbade the merging of commercial and investment banking, and repeal would once again allow commercial banks to purchase and hold securities.<sup>1</sup>

Yet the response was largely the opposite. Rather than embrace the repeal, mainstream Austrian economists largely condemned it. Frank Shostak writes in regard to the Act,

“The present banking system has nothing to do with a true free-market economy...more controls in the framework of central banking can only slow down the pace of the erosion of real-wealth formation. They cannot prevent the erosion...More controls will simply suppress banks’ ability to amplify the Fed’s pumping. In this sense, controls are preferable to a so-called deregulated banking sector.” (Shostak, 2010).

Shostak’s concerns are echoed by various other Austrian scholars, including Jesus Huerta de Soto and Mark Thornton (de Soto, 2012; Thornton, 2008). This is because the unique nature of fractional-reserve banking throws a wrench into the analysis of competition law according to the Rothbardian lens. Whereas Rothbard shows that cartels and mergers occur because they increase efficiency, banking firms today are different in that they engage in fractional-reserve lending—a form of banking based on an illegitimate property contract that inevitably results in inflation and destructive business cycles. Therefore, competition law that prevents fractional-reserve banks from engaging in “profit-maximizing” coordination serves to slow the deterioration of real-wealth brought about by fractional-reserve lending, which in turn supports the notion that fractional-reserve banking is inherently inflationary.

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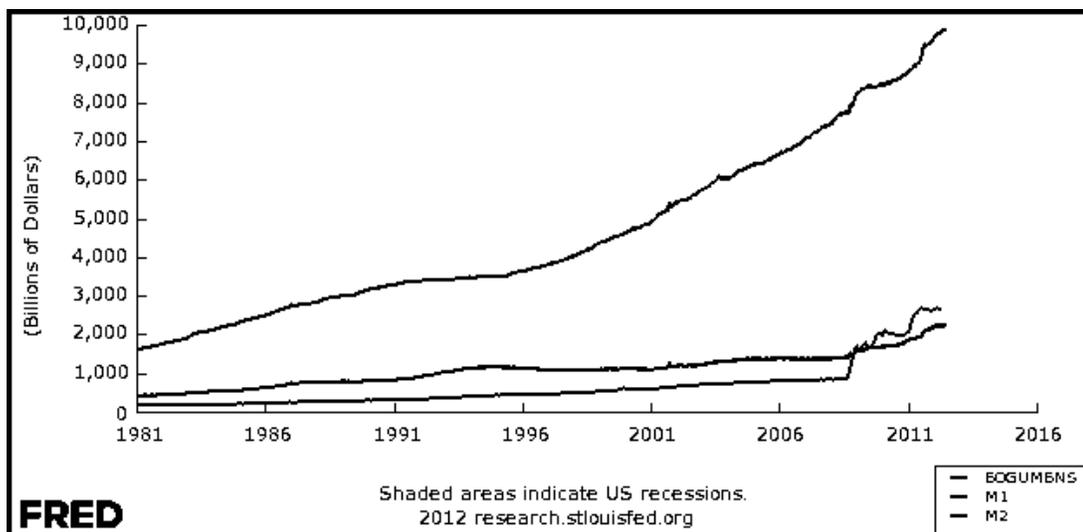
<sup>1</sup> It is understood that Glass-Steagall was not pitched as a form of antitrust or competition law. However, the law was *in effect* an instance of competition law, as it forbade the merging (vertical integration) of investment banking and commercial banking into one firm.

## **Critique of Fractional-Reserve Banking**

Fractional-reserve banking is a form of banking whereby total cash reserves are lower, by some fraction, than outstanding warehouse receipts—“where more than one warehouse receipt is backed by the same amount of gold or other cash in the bank’s vaults” (Rothbard, 2008, p. 96). This happens when banks choose to lend out deposited funds at interest in order to increase their profits. The implication of such an arrangement is that, while full redemption is “guaranteed” to all depositors, banks cannot possibly redeem all possible claims at all times. Thus, fractional-reserve banks face a higher risk of default and are subject to panic if customers fear that their redemption claims may not be fulfilled (White, 2012, p. 3).

According to Gordon Tullock, fractional-reserve banks have existed at least since as early as 1000 A.D. (Tullock, 1957, p. 396). Early bankers likely discovered the profits to be had by issuing more credit on interest than the available funds in their vaults. Today, this form of banking is extremely prevalent. Joe Salerno claims that all commercial banks and thrift institutions in the United States today engage in fractional-reserve banking (Salerno, 2012). Evidence of the extent of fractional-reserve banking in the United States can be seen in the difference between the monetary base and the M1 and M2 money supplies (see chart below).

## US Money Supply



As seen above, the monetary base (measured by BOGUMBNS) is significantly lower than the M2 money supply, which is due to pyramiding of funds by fractional-reserve banks.

Though the alleged benefits of fractional-reserve banking with regards to economic growth are often accepted largely without question, the practice is not without serious criticism. The traditional Rothbardian position holds that fractional-reserve banking is based on an illegitimate form of deposit contract and leads to an inherently fluctuating and unstable money stock. Murray Rothbard summarizes,

“In my view, issuing promises to pay on demand in excess of the amount of goods on hand is simply fraud, and should be so considered by the legal system. For this means that a bank issues “fake” warehouse receipts—warehouse receipts, for example, for ounces of gold that do not actually exist in the vaults. This is legalized counterfeiting; this is the creation of money without the necessity for production, to compete for resources against those who have produced. In short, I believe that fractional-reserve banking is disastrous both for the morality and for the fundamental bases and institutions of the market economy” (Rothbard, 2006, p. 44).

This “counterfeiting” is only possible because of a bank’s initial violation of the traditional obligation of *custody* (de Soto, 2006, p. 29). Fractional-reserve lenders, by definition, hold less than the full amount of their deposits. Instead, they maintain a reserve-ratio of reserves to warehouse receipts (credit) just large enough to cover their liquidity needs—that is, day-to-day redemption claims and clearing balances it owes to other banks (Selgin, 1988, p. 37). But de Soto shows that this practice was traditionally condemned under Roman law. Summarizing Roman legal tradition relating to deposit contract, de Soto writes, “The essential obligation of depositaries is to maintain the *tantundem* constantly available to depositors. If for some reason the depositary goes bankrupt, the depositors have absolute privilege over any other claimants” (de Soto, 2006, p. 32).

The feature of fractional-reserve banking relevant for this paper is not the legitimacy of its deposit contract, however, but its propensity toward inflation and recurrent liquidity crises. Indeed, many argue that fractional-reserve banking is inherently inflationary and—ethically justifiable or not—leads inevitably to economic instability.

This process begins when banks attempt to meet increased demand for money by printing and lending banknotes backed by less than 100 percent reserve. These notes begin circulating throughout the economy in exchange for goods, repayment of debt, and (most dangerously) as lent funds. Ultimately, consumer prices adjust to the new money stock, and the demand for money increases in response, giving rise to more fractional-reserve issue. Salerno writes,

“...fractional-reserve banking is inherently inflationary. When a bank lends out its clients' deposits, it inevitably expands the money supply ... for when the borrowers spend the borrowed cash to buy goods or to pay wages, the recipients of these dollars redeposit some or all of these dollars in their own banks, which in turn lend out a proportion of these new deposits. Through this process, bank-deposit dollars are created and multiplied far beyond the amount of the initial cash deposits ... As the additional deposit dollars are spent, prices in the economy progressively rise, and the inevitable result is inflation, with all its associated deleterious effects on the economy.” (Salerno, 2012)

This inflation culminates in liquidity crisis when, as Guido Hulsmann explains, confusion between money titles (redemption guaranteed) and fractional-reserve IOUs (redemption not guaranteed) bring Gresham’s Law into operation and the fractional-reserve IOUs crowd out the money titles. The entire monetary system, then, turns into a fractional-reserve system (Hulsmann, 2003, p. 400). Coupled with the fact that banks always retain the incentive to issue more notes (thereby decreasing their reserve-ratios) and can learn only from trial-and-error when their note issue has undermined their customers’ confidence, it is easy to see why repeated boom and bust is the inevitable outcome.

While there is more to be said about this process, suffice it to say—for the purposes of this paper—that the mainstream Austrian view of fractional-reserve banking is that such a system inevitably gives rise to unsustainable boom and subsequent bust.<sup>2</sup>

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<sup>2</sup> It is important to note that not all Austrian scholars share the Rothbardian view of fractional-reserve banking. Lawrence White, George Selgin, Steve Horwitz, and Pascal Salin—self-proclaimed adherents to the Austrian school—find fractional-reserve banking to be neither inherently inflationary nor morally dubious. It is not the object of this paper to pick sides, however. Rather, we examine the effect of competition law on fractional-reserve banking assuming the validity of the Rothbardian view.

### **Competition Law in the Banking Industry**

Because of the massive impact banking has on the economy at large, it should be no surprise that the banking industry has long been subjected to regulations stemming from various antitrust and competition laws. Rebecca Craft identifies three major pieces of legislation—the McFadden Act, Glass-Steagall, and the Bank Holding Company Act—that comprise the structure of the commercial banking regulatory system by which we can judge the effect of competition law on fractional-reserve banks (Craft, 1983, p. 92-95).

The McFadden Act (1927)—an explicit form of competition law applied to the banking industry—was designed by its proponents as a means to strengthen national banks with respect to their state-chartered counterparts. Whereas previous attempts by Congressman and former bank president Louis T. McFadden to allow national banks to establish branches had totally failed, the Federal Reserve Board of Governors found recourse in the notion of restricting branch banking altogether as a way to ease national banks' competitive disadvantage (branch banking was, in many states, permitted for state banks). Speaking before Congress, Federal Reserve Board member Henry Dawes asserted that “branch banking, unless curbed, will mean the destruction of the national banks and thereby the destruction of the Federal Reserve System” (Johnston, 1983, p. 1).

Such sentiments were held by a majority of the Federal Reserve Board of Governors, and they adopted a resolution in November, 1923 designed to stop the spread of intercity branching. This resolution was codified into law by President Coolidge on February 25, 1927. In its final form, the bill forbade intercity branching by state banks,

thereby reducing state banks' competitive edge over national banks (the notion of branch banking as a hedge against bank failure was increasingly evident in the 1920s, as the vast majority of the many bank failures in that decade were unit banks) (Johnston, 1983, p. 2).

Five years after the passage of the McFadden Act, Congress passed the Banking Act of 1933. Sections 16, 20, 21 and 32 of this bill are collectively and famously known as the Glass-Steagall Act. These provisions separate deposit and investment banking by prohibiting investment banks from taking deposits and banning interlocking directorates for commercial and investment banks (Meltzer, 2003, p. 432). In addition, one provision in the Banking Act amended the McFadden Act to allow national banks to operate branches wherever permitted state banks by law (Johnston, 1983, p. 3).

While the Glass-Steagall Act was not explicitly designed as a form of competition law designed to preserve market competition according to the neoclassical model (indeed, such a model would have been unknown to policymakers), the law was *in effect* an instance of competition law regulating the banking industry: it forbade the horizontal integration of commercial and investment banking activities into one firm.<sup>3</sup>

Finally, Congress passed the Bank Holding Company Act in 1956. This bill authorized the Federal Reserve Board of Governors to determine permissible activities for bank holding companies (of which most banks were a member). Effectively, this law limited bank holding company activities to those activities that can be properly defined as or are related to banking—the activity must be “so closely related to banking, or

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<sup>3</sup> It is the view of J.W. Markham that the reasoning of legislators in passing Glass-Steagall was an underlying belief that the stock market crash of 1929 came about due to the excessive use of bank credit to speculate in the stock market.

managing, or controlling banks as to be proper incident thereto” one that “can reasonably be expected to produce benefits to the public such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices.” (Craft, 1983, p. 94-95).

The Bank Holding Company Act, like the Glass-Steagall Act, was a form of competition law by implication and not by explicit intention. Its advocates believed the expansion of banks into non-banking activities—such as buying securities—represented a threat to economic stability. In essence, this act simply applied the stipulations of Glass-Steagall to bank holding companies, a form of incorporation which had become a loophole for banks trying to avoid the Glass-Steagall prohibitions.

As Craft notes, the sum purpose of the above laws is an attempt to “completely isolate commercial banking from investment banking and commerce by regulating product offerings and geographic expansion” (Craft, 1983, p. 95). Understandably, such regulation would have a profound effect on the banking industry, the supply of credit, and ultimately the business cycle. Such an effect, however, is difficult to identify, as banking and credit expansion are influenced by many factors. But the immediate aftermath of the laws’ eventual repeal in the 1990s provides a natural experiment by which to discern the effect of competition law on credit expansion in the fractional-reserve system.<sup>4</sup>

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<sup>4</sup> Examining the effect of the laws’ initial passage is more difficult than examining the effect of their repeal in the 1990s, as two-thirds of the regulatory structure was passed just prior to or in the midst of the New Deal, during which time the entire US banking industry was subjected to various new and expansive regulations.

### **Fractional-Reserve and Competition Law**

In 1994, President Clinton signed the Riegle-Neal Interstate Branching and Banking Efficiency Act (IBBEA) into law. This bill effectively repealed all federal regulatory barriers to interstate banking and branching that had been enacted through various pieces of legislation throughout the past decades. It is important to note, however, that the key effect of the IBBEA was in the area of interstate *branching*, as interstate banking was already permitted by most states prior to the passage of the IBBEA in 1994 (Hendrickson and Nichols, 2011, p. 11).

Five years later, Clinton signed the Gramm-Leach-Bliley Act (GLBA) into law. This bill effectively repealed the major provisions of Glass-Steagall: it repealed restrictions on banks affiliating with securities firms and authorized financial holding companies to engage in “complementary” financial activities, such as securities underwriting, merchant banking, commercial paper dealings, and insurance company portfolio investment (Financial Services Modernization Act; Markham, 2009, p. 29).

These two pieces of legislation combined constituted a massive rollback of competition law that had regulated the U.S. banking industry for decades. Whereas geographical expansion and integration of commercial and investment banking had been forbidden for the majority of the twentieth century, the barrier between investment and commercial banking was now effectively removed, and interstate branching became legal.

Among the most immediate effects of this deregulation was the rapid increase in the size of the nation's largest banks. As Albert DePrince shows, Congress was accurate in its prediction that increased national concentration of banking firms would result from the IBBEA—thus, they included an amendment to the Bank Holding Company Act that prohibited the Federal Reserve from authorizing an acquisition that would give the merging institutions control of more than 10 percent of the deposits in the U.S. (DePrince, 2005, p. 5). But concentration occurred below the limit nevertheless, and by 2003, the distribution of assets had completely changed (see chart below).

**Table 4**  
**Summarizing Concentration Trends 1993-2003**

Asset Class	1993				
	Asset Threshold Levels (\$,000)	Number of Banks In Asset Class	Total Assets in Asset Class (\$,000)	Average Assets per Bank by Class (\$,000)	Assets in Class as Percent of Total Assets
Mega Banks (Minimum Assets)	63,287	6	667,965,612	111,327,602	17.8
Large Banks	63,287	62	1,020,372,501	16,457,621	27.2
Regional Banks	8,438	394	1,017,269,633	2,581,903	27.1
Large Community Banks	844	351	207,374,823	590,811	5.5
Community Financial Institutions	422	10750	838,490,521	77,999	22.4
		11563	3,751,473,090	324,438	100.0

\* Maximum Asset Level for the Class

Asset Class	2003					2003 over 1993 <sup>®</sup>			
	Asset Threshold Levels (\$,000)	Number of Banks In Asset Class	Total Assets in Asset Class (\$,000)	Average Assets per Bank by Class (\$,000)	Assets in Class as Percent of Total Assets	Asset Threshold Levels	Number of Banks In Asset Class	Total Assets in Asset Class	Average Assets per Bank by Class
Mega Banks (Minimum Assets)	80,762	11	3,238,720,920	294,429,175	42.4	2.47	6.25	17.10	10.21
Large Banks*	80,762	71	2,141,686,703	30,164,601	28.0	2.47	1.36	7.70	6.25
Regional Banks*	10,768	334	1,030,294,322	3,084,714	13.5	2.47	-1.64	0.13	1.80
Large Community Banks*	1,077	398	297,836,229	748,332	3.9	2.47	1.26	3.69	2.39
Community Financial Institutions*	538	7440	934,486,762	125,603	12.2	2.47	-3.61	1.09	4.88
		8254	7,643,024,936	925,978	100.0		-3.31	7.38	11.06

\* Maximum Asset Level for the Class

<sup>®</sup> At Compound Annual Rates

(DePrince, 2005, p. 17)

DePrince attributes this paradigm shift in banking concentration trends directly to the repeals made by the IBBEA. This is entirely plausible and coincides with Rothbardian cartel theory: prohibitions on bank mergers and expansion prevent coordination (cartels, mergers, etc.) that would otherwise result in higher profits. Thus,

once these prohibitions are rescinded, profit-seeking firms coordinate production through various forms of consolidation, resulting in fewer and larger firms. In summary, Federal Reserve scholars writing in 1997 assert that “more large banks controlling a greater share of uninsured deposits have resulted from recent bank consolidation” (Feldman and Rolnick, 1997).

Such trends were also seen following the passage of GLBA. The merging of Citibank and major insurance underwriter Travelers Group—one of the biggest financial mergers in history—was only possible because of GLBA (Markham, 2009, p. 28). According to Tyler Cowen, GLBA is also the reason why JP Morgan and Bank of America were able to buy Bear Stearns and Merrill Lynch, respectively (Cowen, 2008). Further cross-industry consolidation was seen in 2000 when two major foreign banks acquired U.S. securities firms, another leading foreign bank purchased a U.S. insurance company, and Charles Schwab and MetLife acquired banks (Wilmarth, 2002, p. 4).

While it would seem natural that these mergers would be welcomed by Austrian scholars as conducive to profit-maximization, increased value-productivity, and general economic growth, Austrian scholars Jesus Huerta de Soto, Frank Shostak, and Mark Thornton argue that the deregulatory rollback opened the floodgates for the creation of various “creative” and unsound financial instruments—only possible under a fiat monetary system—that ultimately contributed to the 2008 financial crisis (de Soto, 2012; Shostak, 2010; Thornton, 2008). Thornton writes,

“With Glass-Steagall, Congress put its finger on and mitigated the tendency and temptations of banks to create massive costly externalities to society, in this case, by holding bundled mortgage-backed securities which were deemed safe by rating agencies but which ultimately failed the market test. [GLBA] would make perfect

sense in a world regulated by a gold standard, 100% reserve banking, and no FDIC deposit insurance; but in the world as it is, this "deregulation" amounts to corporate welfare for financial institutions and a moral hazard that will make taxpayers pay dearly." (Thornton, 2008)

Instead of a step toward economic growth, then, these scholars argue that the GLBA crippled the U.S. economy by allowing the harms of fiat money—discussed above—to run their course unchecked. Shostak in particular argues that this deregulation required banks to increase their volume of lending in order to maintain the level of profits they enjoyed under the previous regulated system “where banks profit margins were nearly predetermined, because the Fed imposed interest-rate ceilings and controlled short-term interest rates” (Shostak, 2010). De Soto argues that, in a fractional-reserve environment, regulations like Glass-Steagall help create a monetary environment that more closely mimics the conditions that would exist in a totally free market which, for de Soto, a system marked by 100 percent reserves (de Soto, 2012).

Further evidence in favor of the de Soto-Shostak-Thornton view comes from Wilmarth, who convincingly argues that the “too big to fail” (TBTF) policy whereby the federal government insures the solvency of the country’s largest financial institutions undermined what benefits were allegedly supposed to come out of the GLBA’s deregulatory measures. Citing Feldman and Rolnick, Wilmarth shows that TBTF confers an implicit subsidy on banks that allows them to pay below-average rates and shields them from market discipline that would otherwise be the result of their high-risk behavior (Wilmarth, 2002, p. 14). This view of TBTF is also advanced by Lawrence White, who argues that TBTF leads to an unnaturally large share of deposits flowing into the largest banks, thereby concentrating more capital into single firms which are no less—if not

more—prone to risky practices than smaller banks (White, 2012, p. 5-6). Coupled with the fact that more and more banks were enabled by GLBA to grow large enough to warrant TBTF protection, this meant that high risk behavior was more widespread and magnified than if GLBA had not been passed (of course, it was the high-risk behavior of sub-prime lending that triggered the 2008 collapse).

One prominent argument against the notion of deregulation and increased diversification as contributive to increased risk and ultimate financial crisis is that diversification and expanding banks' securities powers actually decreases risk of default (Kwan and Laderman, cited in Barth, 2000, p. 199). Such a thesis is commonly leveled when analyzing the effect of U.S. banking regulation—specifically the McFadden Act's partial ban of geographical expansion—on the banking industry during the Great Depression compared to that of Canada, where regulation was much less stringent and bank failures were far less common. Indeed, this has become a near-universal view about why Canadian banks fared so much better than their American counterparts in the 1930s (Strahan, 2006, p. 1-2).

But Demetz and Strahan show that larger bank holding companies use their diversification advantage to operate with greater leverage and to pursue riskier (though potentially more profitable) lending (Demetz and Strahan, 1997, p. 312). With regard to our topic, this means that the GLBA, by facilitating increased bank size, also contributed to riskier lending (e.g. subprime lending). Additionally, much commentary that asserts the unilateral benefits of diversification does not account for the inflation and instability inherent in fractional-reserve banking. In reality, this is the thrust of Austrian arguments

against the benefits of GLBA—the existence of fractional-reserve banking convolutes traditional economic analysis of various banking regulations, even rendering the alleged benefits of increased bank diversification to be moot.

To further illustrate this point, de Soto provides a chart that shows why the absence of an “Ideal Monetary Model”—that which would come about in a free market—renders some regulation beneficial toward the end of economic stability (de Soto, 2011).

<i>Ideal Monetary Model</i>	<i>(Very) Timid Measures in the Right Direction</i>
A pure gold standard (Growth in the world's stock of gold $\leq$ 2% per year)	Rigorous compliance with a limit of 2% per year to growth in the money supply, M. Fixed exchange rates. Euro.
A 100 percent reserve requirement (Bank crises are not possible.) The abolition of the central bank.	The central bank limits itself to providing liquidity to banks in trouble to avoid bank crises.
What is deposited is not lent, and there is a proper matching of the flows of savings and investment. The business of providing liquidity is separate from that of financial intermediation.	A radical separation between commercial banking and investment banking. (Glass-Steagall Act of 1933)

(de Soto, 2011)

With the chart above, de Soto argues that certain regulations can be used to slow the inflation of artificial credit. Among the policy suggestions is a clear defense of Glass-Steagall as a means toward matching the flows of savings and investment, i.e. separating the business of providing liquidity and of financial intermediation. He writes,

“In many areas of the controlled market, which must be reformed (the privatization of streets, liberal immigration, etc.), it is a grave error to believe it

necessary to eliminate all regulation until the ideal reform takes place. Quite the opposite is true. Until the reform occurs, a minimum of regulation is needed to simulate, as far as possible, the results of the ideal system.” (de Soto, 2011).

Again, it is important to note that the reason for opposing the repeal of Glass-Steagall leveled by these Austrian theorists is not because such banking regulation is needed to correct for market failures that the free market cannot solve. Rather, it is precisely because the conditions of free market do not exist that such financial regulation is defensible as conducive to economic stability.

### **Conclusion**

Under normal circumstances, competition law like the McFadden Act, Glass-Steagall, and the Bank Holding Company Act would impose detrimental limitations to the efficiency with which the affected firms can satisfy consumer demand, and would thereby inhibit economic progress. Such insight is the contribution of Rothbard’s discussion of competition and coordinated production. But the fact that the US banking industry was (and remains) built upon a system of fractional-reserve lending throws a twist into the analysis of regulation in the banking industry. If it is the case, as Rothbardians argue, that fractional-reserve banking is inherently inflationary and unstable, then regulation that prohibits banks from investing deposited funds in securities markets and forbids the merging of commercial and investment banking actually serves to limit the harmful expansion of artificial credit that culminates in boom and bust. Conversely, deregulation in the banking industry that allows for more and bigger mergers between financial institutions of various types allows for a more rapid expansion of artificial credit, and entices recession sooner than if the deregulation had not occurred.

In conclusion, the GLBA itself—while not the sole cause of the 2008 financial crisis—represented a significant part of a larger deregulatory trend that only encouraged unsustainable lending practices. Ironically, this is known because of Rothbardian insights into the nature of competition—that coordinated production and mergers are undertaken because they increase efficiency and value-productivity. However, if efficiency involves increasing levels of fractional-reserve lending and speculation, such coordination can only stifle long-term economic stability.

If economic growth is the goal, policymakers would have done well to heed the warning of those who argued that deregulation—while a noble end—is counterproductive toward achieving greater financial stability as long as banks continue lending on fractional-reserve.

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