Financial Deregulation, Monetary Tightening, Oil Crises and Transnational Capital Flows: The United States and the Origins of Neoliberal Financial Policies

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Abstract

This article pinpoints the anti inflationary measures and financial deregulation policies passed by the Congress and the White House since early 1980 to establish a linkage between such soaring cost of financing the U.S. economy, a declining competitive edge of U.S. manufacturing during the 1970s, and the deregulation of the financial system by the turn-of-the-decade. It is suggested that such deregulation was an instrument to recast the competitive position of American manufacturing and trading companies. Furthermore, unlike the literature on financialisation of corporate America, this study argues that deregulating the American banking and financial system was not only a way to compensate the shortfall in profits caused by highs in interest rates through the promotion of unregulated financial activities by corporations and other non-banking companies. Rather, the Reagan administration deregulated the financial system to favour the outflow of money from the United States: by unleashing the American banking system the White House promoted an increase in the foreign investments of U.S. banks as an instrument to compensate the decline in banks' profits caused by rising interest rates and the effect it had in terms of decreasing domestic borrowing by companies and consumers. Such decrease also hit hard the domestic profits of U.S. banks. The Reagan administration-turn to introduce a legislation to deregulate the financial sector was intended to let the American financial system increase their overseas investments in European money markets to restructure its banking profits.

At the same time Reagan advanced deregulation policies to restore domestic money stock in combination with a foreign economic policy aimed at favouring capital-seeking strategies for U.S. corporations.

Keywords: financial deregulation, U.S. banks, inflation, Eurodollar, Corporate America, U.S depository institutions, money market mutual funds, anti-inflationary policies

1. Introduction: High Cost of Money, Monetary Stringency and Deregulation of Financial Markets in the United States as an Instrument to Finance the U.S. Economy in the Age of Inflation

The history of deregulation in the United States during the Reagan years is a chapter in contemporary American history that proved to be very popular among historians (Miners and Yandle, 1989; Feldstein, 2007; Friedman, 1995; Sabin, 2021). The abrupt and sudden end of Welfare provisions, Keynesian macroeconomic policies, and postwar compromise between capital and labour that had served as the engine for the long cycle of economic growth and material well-being following the post-WWII reconstruction has traditionally been associated with the coming to power of Ms. Thatcher and Mr. Reagan in the United Kingdom and the United States. In the Social Sciences it is a widely-accepted view to consider this turning point a watershed in the history of social policies and a major divide in the rise of neoliberal economic policies that came to centerstage in national and international economic relations throughout the following thirty years up to at least the outbreak of the 2008 global financial crisis. Accordingly, this approach to the early 1980s as a watershed in national and global economic policies has by and large focused on the political, industrial and labour relations dimension, as well as the social implications of economic deregulations introduced under the Reagan administration and the Thatcher government (King & Wood, 1999; Harvey, 2005; Coates, 2018; Pierson, 1994). Therefore, most studies focused on the fierce commitment by these two governments to eradicate the class conflict from American and British societies (Cooper, 2012; Harvey, 1989). Along this line of reasoning a wave of scholarly works researched the tangle of political actions pursued and the manifold legislative

measures introduced at the time to tame resistance by labor movements and citizens either to the introduction of market-oriented labour relations or to the early onset of industrial privatisations and market liberalisations. The most striking examples mentioned or reconstructed in the literature are opposition to deregulation of labour relations by British miners or by air traffic controllers and pilots in the United States (McCartin, 2011; Seldon, 2014). Likewise, the literature has paid much attention to the conservative and market-prone constituency at the hearth of Donald Reagan's electoral success at the dawn of the new decade (Prasad, 2006). Accordingly, an array of studies have researched the fiscal policies and public spending cuts passed under Reagan (Rasmus, 2020, chapter 3), as well as his cultural connections to supply-side macroeconomic theory and literature (Stedman Jones, 2012; Crouse, 2018). Some more recent fine scholarships pointed attention to the failure of tax cut policies and of full control on money in circulation as a tool to wipe out inflation and to eradicate the depreciation of the American economy that jeopardised the stability and cohesion of U.S. society (Best, 2020).

Invariably, all of these studies missed to consider the issue of financial deregulation as a key component of this historical turn in the history of British and American societies. Not coincidentally, the most authoritative scholarly works in the history of banking deregulation in the United States have by and large either focused attention on an earlier set of political and monetary initiatives to regulate or deregulate the American financial system, or placed the issue of deregulation of financial systems in historical perspective (Calomiris, 2009; White, 1983; Battilossi, 2010). A few studies have made exception to this perspective (Drach & Cassis, 2021: Cuhna, 2021; Chaudhuri, 2014). More recently, a number of studies have lucidly focused on the issue of financialisation of American manufacturing and commercial activities as a key chapter in the history of that historical turn. This article focuses on the concept of financialisation of firms and companies in the next sections: in short, by this expression the authors of this literature refer to a fundamental shift from profits made out of trading and producing goods to money made from speculative investments. This literature has connected such turn to earlier studies in economics aimed at tackling the history of interest rates in modern America (Hendershott, 1989). More specifically, Greta Krippner has made the argument that a fundamental shift from corporate profits made out of fixed-capital investments to profits deriving from speculative investment activities occurred since the early 1980s. According to her and other studies this shift should be interpreted as a specific corporate strategy to make up for a loss in profits caused by the overheating of interest rates unleashed by the Volcker monetary revolution inaugurated in the fall of 1979 (Krippner, 2012). The overheating in the cost of money dwarfed borrowing from the banking system by corporations: this process might have prompted corporations to such a shift from fixed-capital investments to speculative activities in the realm of finance.

This contribution first tries to fill a gap in the history of turn-of-the-1970s origins of neoliberal economic policies concerning the financial side of deregulatory policies and the market-prone turn that featured in the transition to neoliberalism: the economic dimension of deregulation has been left unfixed in the aforementioned scholarship on the labour and social dimensions of the economic policies enacted by Reagan and Thatcher. In second instance, and more importantly, it aims to advance knowledge on the linkage between the effects of newly appointed president of the Federal Reserve System Paul Volcker's historic move since the end of 1979 to go for an unprecedented increase in interest rates to tame the inflation of the 1970s and the implications it had on the cost of borrowing money by companies, and the origins in the early 1980s of global financial capitalism. The birth and ascendancy of financial capitalism since the start of the 1980s lies at the origins of financial market developments from the 1980s through to the collapse of investment banks like Lehman Brothers with the outbreak of the 2008 financial crash.

Compared to the extant literature, this contribution brings into focus the policies and legislative measures implemented under the Reagan Administration to deregulate financial markets. In so doing it makes a case for a process of financial deregulation, whose history has so far been overlooked in the literature, interpreted here as a pivot in the origins of the global financial capitalism that rose to centerstage in world economic affairs over the last 40 years.

With specific respect to the impact of Volcker's monetary shock on the cost of financing the real economy in the United States, this article focuses on the implications of Volcker's monetary tightening on the cost of financing non financial firms through well-established traditional financial instruments such as the stock market and the bond market. It tackles the combined instability and depreciation of U.S. dollar against all major foreign currencies in exchange markets following the second oil crisis and the effects of such depreciation on the cost of borrowing money by companies and corporations. To put it another way, the rise in the cost of money and interest rates caused by Volcker's monetary stringency made traditional sources of funding corporations like the bond and stock markets too much expensive to the large-company borrowers. Likewise, this article focuses attention on the soaring cost of money lent by commercial banks as a result of Volcker's monetary policy and their declining profits. This generalised contraction in banks' profits suggests that the origins of highly-expensive loan rates to manufacturers and

other industrial and commercial borrowers that featured the 1980s began as early as the beginning of that decade. Therefore, the article pinpoints the anti inflationary measures and financial deregulation policies passed by the Congress and the White House since early 1980 to establish a linkage between such soaring costs of financing the U.S. economy, a declining competitive edge of U.S. manufacturing, and the deregulation of the financial system. It is suggested that such deregulation was an instrument to recast the competitive position of American manufacturing and trading companies. Furthermore, unlike the literature on financialisation just mentioned, this study argues that deregulating the American banking and financial system was not only a way to compensate the shortfall in profits caused by highs in interest rates through the promotion of unregulated financial activities by corporations and other non-banking companies. Rather, the Reagan administration deregulated the financial system to favour the outflow of money from the United States: by deregulating the American banking system the White House promoted an increase in the foreign investments of U.S. banks as an instrument to compensate the decline in banks' profits caused by rising interest rates and the effect it had in terms of decreasing domestic borrowing by companies and consumers. Such decrease also hit hard the domestic profits of U.S. banks. The Reagan administration-turn to introduce a legislation to deregulate the financial sector was intended to let the American financial system increase their overseas investments in European money markets to restructure banking profits. By money markets here reference is made to dollar-denominated short-term financial outlets traded on the European financial centers, first London but also Paris, Frankfurt and Zurich.

In third instance, financial deregulation also aimed at favouring overseas corporate borrowing by U.S. banks, financial institutions and consumers, and more generally at restoring credit conditions for U.S. domestic borrowers. Finally, the article ventures on making the argument, subject to further archival and statistical research worth conducting in the future, that in so far as neoliberal deregulation of financial sectors made way for the ascendancy of new financial players such as investment banks and money market mutual funds, as well as new financial products as securitising, asset backed commercial papers, and repurchasing operations (repo operations), all tackled in the last section, a link can be established between high interest rates, the U.S. economic recession of the early 1980s with consequences on lending and borrowing terms, the crisis that hit hard the American corporation and its competitive edge on the one side; and, on the other side, the appearance of a brand-new, derivative-oriented financial environment based on the so called derivative products. This new financial world was -this is the interpretation offered here- the specific response created by neoliberal deregulation of financial markets under Reagan. In other words, when the rise of inflation triggered by the second oil price hike and the tottering of the dollar's value against all major world currencies, either dynamics caused by the combined second oil shock and the the painful effects of soaring interest rates on corporate profits, hit the American economy, the legislative measures undertaken in the past to shield the profits of American bankers from the effects of rising cost of money became ineffective or insufficient. In the past, the American lawmaker had for instance permitted American bankers to make investments in competitive and lucrative overseas Eurodollar markets. The Eurodollar markets were non-resident assets denominated in dollar and traded on the London and other West European financial markets. These financial assets were very lucrative for investors and very affordable to borrowers. This because as non resident assets they were free from legislative constraints such as interest rates ceilings and reserve requirements imposed on the national capital markets in the UK as anywhere else. Therefore, the Eurodollars were dollar-denominated short-term assets traded on the London financial center that helped financial investors and borrowers on the real economy to skip the inflationary environment of the 1970s.

In the new inflationary scenario of the early 1980s the Eurodollar rates spiked and these assets could no longer serve that purpose. At the time, the appearance of new financial players as investment banks and institutional investors, and new financial products as securitisation, became the new inflation-fighting strategy to restore corporate profits through better credit conditions provided by money market mutual funds and new institutional investors. Therefore, this new financial galaxy came to partially replace short-term Eurodollar and other non-resident eurocurrency markets in light of the soaring cost of these short-term money markets. During the 1970s the eurocurrency markets have been a much-wanted investment outlets to U.S. banks and borrowing markets for U.S. and other western companies.

The first section traces the linkage between the impact of the oil crisis on the international investments of OPEC oil producers (which were financial assets denominated in U.S. dollar), the tottering of the dollar's value against most major western currencies and declining investors' confidence in the U.S. currency from 1974 to 1979, and the parallel ups-and-down dynamics that marked interest rates on the Eurodollar market. In so doing the article suggests that during that timeframe the Eurodollar market and other unregulated markets be safe market outlets that let U.S. banks, financial investors and corporate American borrowers skip the implication of inflation and the declining

posture of U.S. dollar in the foreign exchange markets. Such interconnectedness between the trajectory of OPEC's international investments, the value of the dollar against major foreign currencies and the cost of borrowing money came once more to centerstage in U.S and world financial markets by the time the second oil shock combined with highs in interest rates spurred by the monetary revolution inaugurated by Paul Volcker since the fall of 1979.

The second section outlines the macroeconomic consequences of Volcker's monetary shock: after providing an outline of this historic rise in the cost of money, it will pay particular attention to a few indicators: the rate of the dollar against all major foreign currencies; the Eurodollar rate and the rate of other traditional overseas investment outlets; the stock and bond markets, the trajectory of investment flows of U.S. banks and financial institutions in a wide array of classical investment and borrowing markets. All of these indicators are considered in comparison with the 1975 recession and their trend during the 1970s.

The third section, based on the effects on credit conditions outlined in section two, aims to explore the early anti inflationary program set in motion under the Reagan administration. It outlines measures to deregulate the banking and financial sectors, as well as trade liberalisation policies promoted by the White House. All these measures combined represented a political response to the American recession that followed Volcker's shock and to the ensuing declining competitive edge of corporations and shortfall in profits of financial firms.

Finally, in establishing a connection between the onset of new financial products and the coming to centerstage in domestic credit markets of new financial players as a way to replace traditional instruments to finance non financial firms such as the stock market and the bond markets, this article also aims to fine-tuning a correlation between the subject of the literature on neoliberal deregulation in the early 1980s and the few studies that have so far worked on the new financial environment based on derivatives and securitisation that dominated the following two decades (Tooze, 2018). In so doing the fourth and final section maintains that by the start of the 1980s, when the Eurodollar and other unregulated markets no longer sheltered U.S. investors and borrowers from the uptick in prices and lending rates, securitisation, money markets mutual funds and other financial instruments born out of the financial revolution of the early 1980s came to the rescue of American corporations and financial institutions.

2. Tottering U.S. Dollar, Inflation, Recession, Eurodollar Market Developments: The Search for Financial Venues to Protect the American Economy From Rising Cost of Money in the 1970s

It is widely-known that highs in inflation rates rigged the western economies and the United States throughout the 1970s, and combined with mounting unemployment rates. Between the two oil crises of 1974 and 1979 across the OECD countries inflation averaged at almost 10 percent, compared to 4 percent during the previous ten years. Unemployment run at about 5 percent, compared to 3.2 percent during the period from 1963 to 1971 (Solomon, 1999). During the same crucial period, the value of U.S. dollar against most major foreign currencies experienced an extreme volatility. Such volatility was by and large caused by the international investments of OPEC's dollar-denominated oil revenues. The literature on the recycling of petrodollars by the oil producers has tracked and explained this dynamics: as an effect of the uptick in crude petroleum prices the oil producers increased their dollar-denominated assets and their international investments in dollar financial instruments (Spiro, 1999; Gray, 2016, pp. 172-197; Selva, 2017). A substantial amount of these oil revenues went to finance U.S. Treasury securities; however, the OPEC countries also invested on the real economy and in private financial assets (Wallich, 1974, p. 757-763). This transnational flow of dollar-denominated assets contributed to depreciating the dollar in the foreign exchange markets. Thereafter, this weakening of the dollar decelerated as a result of the 1975 recession that rocked the western world: the oil price hikes of 1973-74 reduced world consumption and as a result of this the recession triggered a contraction in international demand for oil and other hydrocarbon compounds. In turn this economic recession, which contracted the U.S. GNP by 4.9 percent (Note 1), reduced the exchange of commodities sold and purchased in U.S. dollar. This trend eased pressure on the American currency and led to a temporary increase of U.S. dollar against other currencies (Board of Governors of the Federal Reserve System, 1978). However, as soon as the western world bottomed out of this mid-decade recession, international demand for oil and the OPEC countries' profits surged again: this expansion in oil revenues traded in U.S. dollar prompted once more the oil producers to invest their dollar assets abroad, or to increase their import of instrumental and consumer goods from the dollar area. This trajectory had deteriorating effects on confidence in the U.S. currency by American and international investors. Both international banks and nations lost their trust in the dollar. Therefore, the weakening of the dollar against all major currencies began once again since 1976 and was well onset by the time the second oil shock of 1979 gave a further blow to the instability of the U.S. currency (Figure 1).

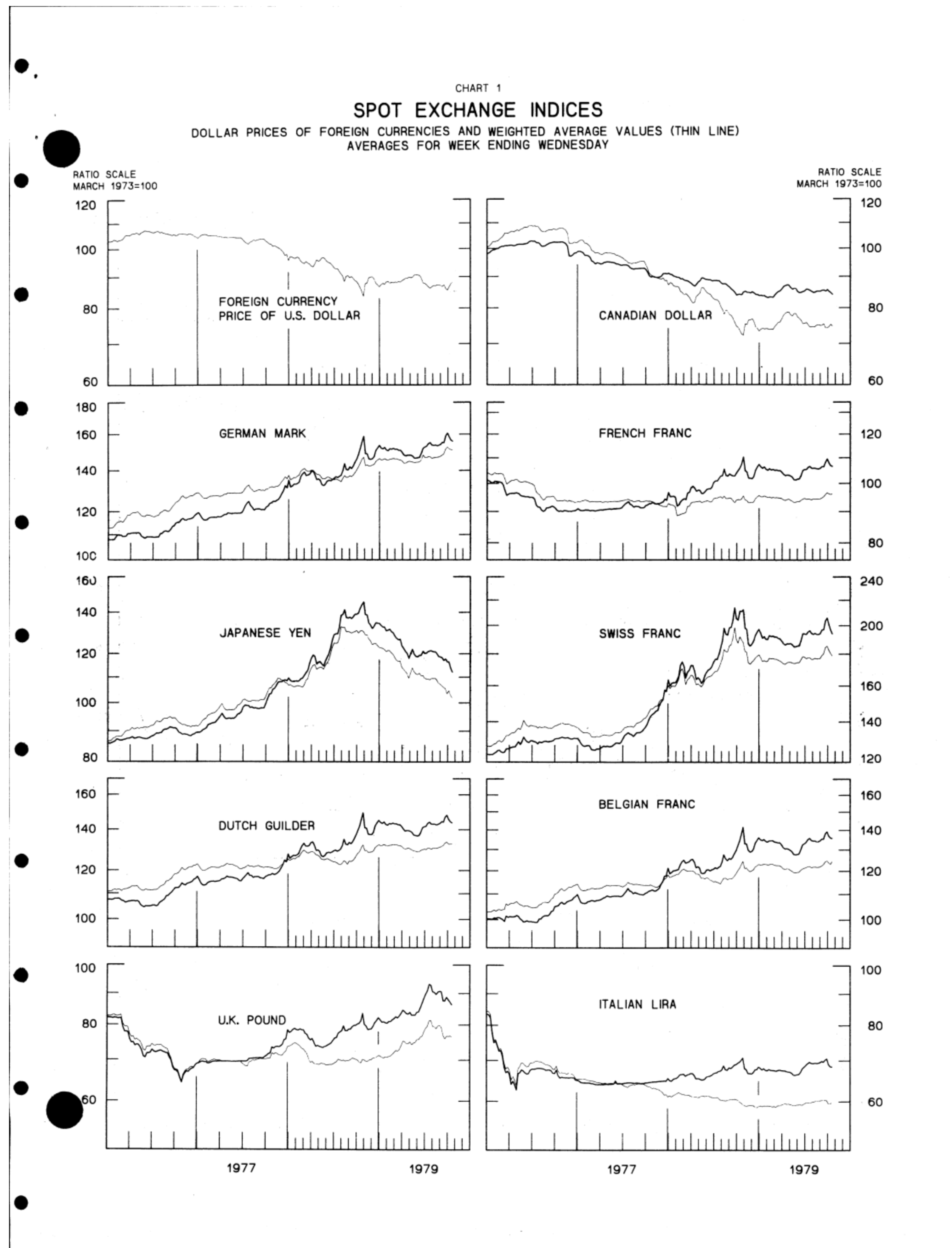


Figure 1. Dollar Prices of foreign currencies and weighted average values, 1974-1979

Source: Board of Governors of the Federal Reserve System, Division of International Finance, Financial Market Section, Selected Interest and Exchange Rates. Weekly Series of Charts, 29 October 1979

The most crucible side effect of such combined short-circuit between the energy crises of the decade and the volatility of the dollar against other currencies was a deep-seated disaffection by the oil producers towards the dollar: since 1977-78 they began threatening the Carter administration of disinvesting their oil revenues out of dollar assets. As over the past few years they had financed the U.S. Treasury debt this threat represented a real danger to Washington (Note 2). These effects of the energy crises on the value of the dollar had a wide range of consequences during the 1970s and still played out in the context of the rise in the cost of money and interest rates in the early 1980s. In first instance, the weakening of the dollar deeply affected the economic relations between the OPEC countries and the oil producing nations on the one side and Washington on the other: the Iranian revolution of 1979,

which further destabilised the value of the dollar, added to these deteriorating economic relations (Note 3). This development is crucial to account for the failure of Carter's international economic policy. Throughout the second half of the 1970s the U.S. democratic president had exerted pressure on leading partner economies like the Federal Republic of Germany and Japan to turn away from export-oriented policies pursued by both Bonn and Tokyo to bottom out of the decade's recession and inflation. Washington struggled to make the two partner countries adopt domestic expansionary policies (Selva, 2017). Carter planned to finance domestic investments by combining national resources and investments from the OPEC oil producers: for this reason the alliance between the United States and Saudi Arabia, the most important partner of Washington among the Middle East oil producers (McFarland, 2020), was as important as never before. As soon as it was clear that the Saudis could not perorate the interests of Washington before the major oil producers in the context of the depreciation of the dollar during the second half of the decade, it became straightforward that the OPEC countries were about to reduce their investments in the United States debt. This threat represented a fundamental blow to Carter's expansionary policies. Secondly, and more importantly from the view point of this contribution, the plummeting of the dollar and its instability throughout the decade jeopardised the financial investments of U.S. banks in unregulated overseas money markets. Spurred by the credit restraints policies enacted in the United States in the early 1960s, since that decade U.S. investors flew the American capital market to place an increasing amount of dollar financial assets with the Eurodollar and other non-resident Eurocurrency markets based in London and other European financial centres such as Paris and Frankfurt (Note 4). As anticipated in the introduction, the Eurocurrency markets were short term money markets denominated in a currency other than the official currency of the financial centres in which they were traded (Burn, 2006). As such they were exempt from a wide array of national regulations imposed on the national banking systems as reserve requirements or ceilings on interest rates. For this reason these markets were highly lucrative to investors and relatively cheap to borrowers. During the 1960s they were one out of many instruments used by U.S. banks to sidetrack the credit restraint programs imposed on the American banking system: by investing money in overseas Eurodollar assets the U.S. financial institutions could flee capital from the United States and make up for a loss in profits any time the business cycle contracted.

During the 1970s the Eurodollar markets became not only an important instrument to sustain the volume of investments by U.S. commercial banks and investors, but also an engine to finance domestic investments on the real economy. One can trace a correlation between soaring oil prices, the international investment of dollar-denominated oil revenues by the OPEC countries and the decline of the dollar against all major foreign currencies in 1974. Likewise, it is worth pointing out an inverted correlation between international demand for oil and oil price hikes, and the value of the dollar during the 1975 recession and later on in the decade. Moreover, it is worth noticing that from 1974 to 1979 the increase in borrowing from the Eurodollar markets by U.S. international corporations and investments by U.S. banks was proportional to the weakening of the U.S. currency (Kidwell, Wayne Marr, & Thompson, 1985, pp. 18-27). As the dollar proved to be volatile and such volatility reduced confidence by financial investors, the overseas Eurodollar markets became an important source of relatively low-rate market to borrow from for the U.S. and other western corporations: in 1975 private corporations increased their borrowing out of total Eurocurrency credit to developed nations (World Bank, 1975, p. 5). Likewise, as the 1975 recession contracted the profits of U.S. banks, American investors placed further funds with the overseas Eurodollar markets. This mixture of borrowing and lending dynamics accounts for a surge in Eurodollar rate during the two years that, after a short recovery in 1975, marked a new era of plummeting dollar rate against all major foreign currencies from mid-1976 to the outbreak of the second oil crisis (Figure 2).

Therefore, every time the dollar got weaker and the value of dollar-denominated investments made by U.S. and international investors (the OPEC countries) was about to decrease, American investors and borrowers rushed to the Eurodollar markets to protect the value of their investments and to avoid the rise in the cost of borrowing money from the U.S. domestic credit market.

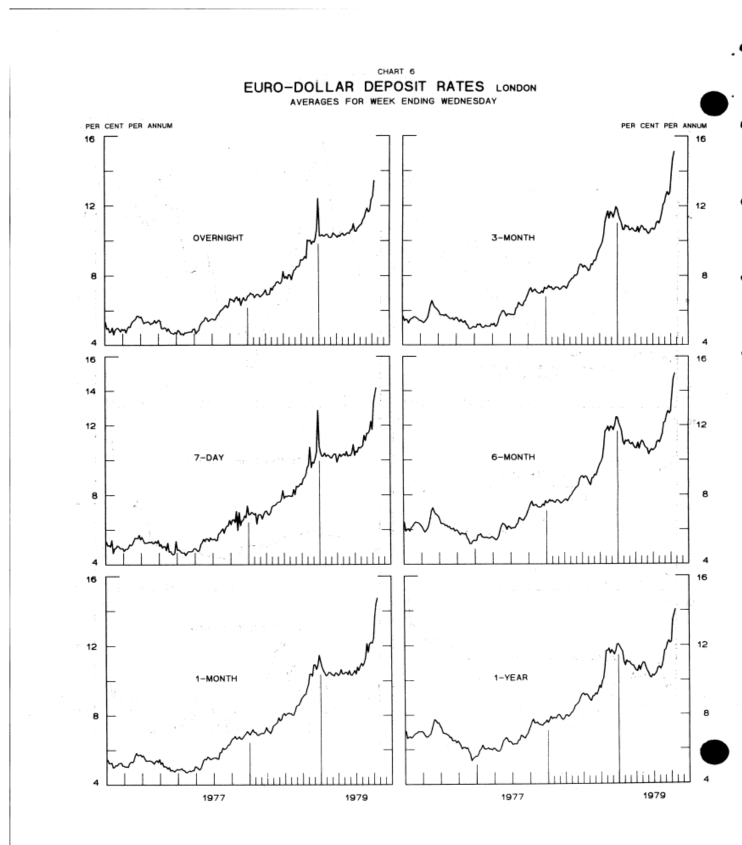


Figure 2. Eurodollar Deposit Rates, 1976-1979

Source: Board of Governors of the Federal Reserve System, Division of International Finance, Financial Market Section, Selected Interest and Exchange Rates. Weekly Series of Charts, 29 October 1979

This trend to borrow from the Eurodollar markets as an exist strategy out of a weakening dollar involved both large commercial banks and corporations. Since about 1978 the growing amount of dollar-denominated loans traded by the five largest U.S. commercial banks, which raised funds in the Eurocurrency markets to finance debtor nations and corporations, as well as the aggressiveness that pushed American banks to extend direct credit to low-creditworthy Latin American and East European nations during the same period, took place against this international financial scenario (Note 5). An intensive debate developed at the turn of the decade within the U.S. economic policymaking elites about whether or not the Eurodollar assets should be considered to measure the total amount of currency in circulation in the U.S. economy (money supply) (Note 6). Finally, not only it was decided to make it a vital component of money supply as much as demand deposits at commercial and saving banks and other traditional components of M1: rather, in 1980 a resolution was taken according to which in order to measure total money supply U.S. authorities should count both <<overnight Eurodollars held by U.S. residents other than bank at Caribbean branches of member banks>>, and <<Eurodollars held by U.S. residents other than banks>>, as well as <<money market mutual funds shares>>(Board of Governors of the Federal Reserve System, 1980). The importance placed on the Eurodollar and money market mutual funds to measure the total amount of money in the U.S. economy clearly signals the relevance of overseas Eurodollar assets in financing the U.S. economy at the start of Volcker's monetary stringency. The Eurodollar markets became vital either to finance the financialisation of U.S. economy described by Krippner, or to pump money into the real economy through the borrowing of Eurodollar assets by U.S. corporations. To American companies and corporations, borrowing from the Eurodollar markets became an alternative to raising money from U.S. domestic capital markets shaken by rising interest rates and the volatility in the value of the dollar stressed in this section. Furthermore, the relevance given by U.S. authorities not only to the Eurodollar markets but

also to the money market mutual funds (MMMF) in order to measure the total amount of money in the U.S. economy sheds light on the role of new financial players and products such as the MMMF in safeguarding the U.S. economy from the wobbling of the American currency in foreign exchange markets and from the sticky effects of the inflation of the 1970s. By the turn-of-the-decade the inflationary strains got worse owing to the combined second oil crisis and the effects on the posted price of barrels of the Iranian Revolution. The relevance of MMMF will be tackled more in details in the last section of this article.

3. Falling Prices and Soaring Cost of Money: The Macroeconomic and Financial Consequences of Volcker's Monetary Revolution

As early as over one year before the historic decision adopted by Paul Volcker to increase interest rates at unprecedented level, the inflation of the decade proved to be not only a plague to the American society but also a further blow to depress the dollar. In March 1978, in his memorandum to the White House about the unfinished inflationary strains, Secretary of the Treasury Blumenthal stressed that <<rising inflation and inflationary expectations are already working on financial markets, domestic and international. They are contributing to the continued weakness of the dollar and the stock market>>. He added that rising prices were likely to push up interest rates: as a response to this dynamics he made a case for tightening financial markets as the very pillar of a soon-to-be-implemented anti-inflationary program (Note 7).

Against this inflationary backdrop what is usually called the Volcker's monetary revolution was the historic decision by the newly appointed chair of the Board of Governors of the Federal Reserve System (henceforth "the Fed") to hollow out of the inflation that plagued the U.S. economy throughout the 1970s through the launching of an unprecedented increase in the cost of money and interest rates. This monetarist approach to fight inflation took place in two steps: first the Fed went for pegging the total amount of money in circulation available for investments; then it pegged the official interest rate at which banks and financial institutions charge each other for loans of (overnight) funds (the Federal Fund rate). As an effect of this move, in the following two years inflation dropped and unemployment surged: from 1980 to 1982 the consumer price index declined from 12 percent to 4 percent (Feldstein, 1990, p. 4). At the same time the surge in lending rates, which by June 1981 had led the rate that large commercial banks charge to the highest creditworthy borrowers like corporations (the prime lending rate) to touch 21 percent (Tooze, 2018, p. 44), since the fall of 1979 made total credit demand to plummet. As a result of Volcker's revolution and the credit restrain program inaugurated during that same period, a few months after the inauguration of Fed's new monetary policy bond yields (the return an investor gets on a bond) went up to 14 percent and business demand dropped by 17 percent: on the whole, credit demand from financial borrowers dropped by 35 percent.

This economic meltdown was a result not only of that credit tightening but also of the second oil crisis. The oil crisis favoured for the second time in less than a decade the weakening of the U.S. dollar against all major foreign currencies and depressed confidence of investors. Though later on Volcker's monetary shock became useful in attracting foreign investors, the combining of the depreciation of the dollar with soaring domestic interest rates accounts for the beginning of the American recession that plagued the U.S. economy at the start of the new decade. On the other hand, the rise in interest rates depressed consumer's deposits at commercial banks and propped up lending by the American households to investment banks. In that context the investment banks could attract households savings. This occurred because by definition an investment bank can offer easier rate to borrowers as it borrows money to lend funds instead of accepting deposits. As it does not need to accept deposits but can borrow to lend, an investment bank enjoys transaction costs cheaper than a commercial bank or a regional bank.

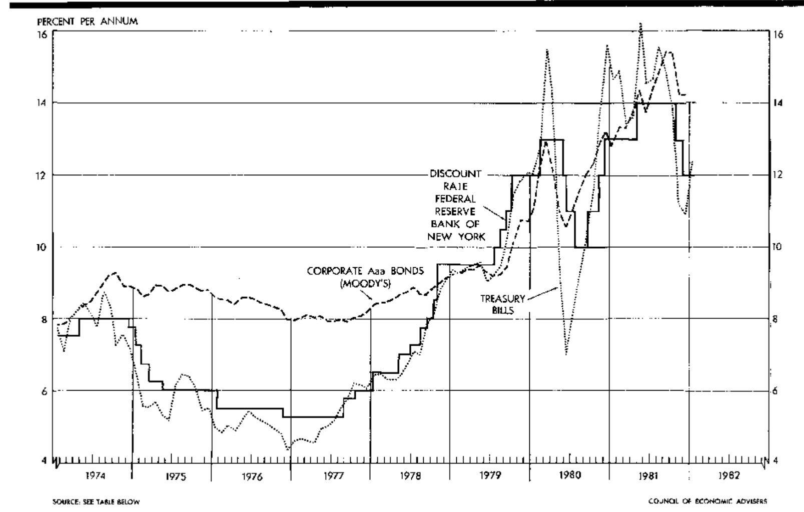
Therefore, the tightening of credit conditions had a direct and immediate impact on the business cycle and triggered mid-term effects on traditional financial instruments to finance manufacturing and trading companies as the stock market and the bond market. If one compares the first three quarters of 1980 to the first three quarters of 1979, both gross domestic product of manufacturing and service companies (non financial corporate business) at current dollars and at 1972 dollars, as well as profits after taxes of these non financial companies, declined (U.S. Department of Commerce, December 1980).

Furthermore, from the inception of Volcker's monetary revolution throughout 1980 it occurred a decline in rates on corporate stock and bonds until the second half of the year, followed by a robust recovery (Figure 3). The early plummeting was an indirect effects of Volcker's tightening, which depressed industrial production and consumer's demand. This dynamics induced financial investors to disinvest from corporate bonds and stocks, thus damaging the financing and the balance-sheet of American corporations. The later rebounding was, in our research hypothesis, a direct effect of the ascendancy of new financial products and investment actors such as the money market mutual funds and the investment banks: owing to the easier credit conditions they could offer, these new financial

institutions could sustain the recovery of the American economy. As said, these institutions and financial devices could take advantage from a very competitive position compared to commercial banks on which this contribution will turn back in the last section.

INTEREST RATES AND BOND YIELDS

Interest rates rose in January.



[Percent per annum]

Period	U.S. Treasury security yields			High-grade municipal bonds (Standard & Poor's) [3]	Corporate Aaa bonds (Moody's)	Prime commercial paper, 6 months [4]	Discount rate (N.Y. F.R. Bank) [5]	Prime rate charged by banks [5]	New-home mortgage yields (FHLBB) [6]
	3-month bills [1]	Constant maturities [2]							
		3-year	10-year						
1976	4.989	6.77	7.61	6.49	8.43	[4] 5.35	5.50	6.84	8.99
1977	5.265	6.69	7.42	5.56	8.02	[4] 5.60	5.46	6.83	9.01
1978	7.221	8.29	8.41	5.90	8.73	[4] 7.99	7.46	9.06	9.54
1979	10.041	9.71	9.44	6.39	9.63	10.91	10.28	12.67	10.77
1980	11.506	11.55	11.46	8.51	11.94	12.29	11.77	15.27	12.65
1981	14.077	14.44	13.91	11.23	14.17	14.76	13.41	18.87	14.75
1980: Dec	15.661	13.65	12.84	10.09	13.21	16.49	12–13	17¾–21½	13.28
1981: Jan	14.724	13.01	12.57	9.65	12.81	15.10	13–13	21½–20	13.26
Feb	14.905	13.65	13.19	10.03	13.35	14.87	13–13	20–19	13.54
Mar	13.478	13.51	13.12	10.12	13.33	13.59	13–13	19–17½	14.02
Apr	13.635	14.09	13.68	10.55	13.88	14.17	13–13	17½–18	14.15
May	16.295	15.08	14.10	10.73	14.32	16.66	13–14	18–20½	14.10
June	14.557	14.29	13.47	10.56	13.75	15.22	14–14	20½–20	14.67
July	14.699	15.15	14.28	11.03	14.38	16.09	14–14	20–20½	14.72
Aug	15.612	16.00	14.94	12.13	14.89	16.62	14–14	20½–20½	15.27
Sept	14.951	16.22	15.32	12.86	15.49	15.93	14–14	20½–19½	15.29
Oct	13.873	15.50	15.15	12.67	15.40	14.72	14–14	19½–18	15.65
Nov	11.269	13.11	13.39	11.71	14.22	11.96	14–13	18–16	16.38
Dec	10.926	13.66	13.72	12.77	14.23	12.14	13–12	15¾–15¾	15.89
1982: Jan	12.412	------	------	------	------	------	12–	15¾–	------
Week ended:									
1981: Dec 12	10.404	13.46	13.66	12.85	14.16	11.60	12–12	15¾–15¾	------
19	11.101	13.56	13.58	12.88	14.11	12.34	12–12	15¾–15¾	------
26	11.037	14.15	14.00	13.03	14.36	12.71	12–12	15¾–15¾	------
1982: Jan 2	11.690	14.09	14.07	13.09	14.50	12.78	12–12	15¾–15¾	------
9	11.658	14.32	14.47	13.27	14.81	12.81	12–12	15¾–15¾	------
16	12.121	14.73	14.76	13.34	15.29	13.18	12–12	15¾–15¾	------
23	12.505	14.92	14.73	13.02	15.36	13.56	12–12	15¾–15¾	------
30	13.364	------	------	------	------	------	12–	15¾–	------

[1] Rate on new issues within period; bank-discount basis.
[2] Yields on the more actively traded issues adjusted to constant maturities by the Treasury Department.
[3] Weekly data are Wednesday figures.
[4] Prior to November 1, 1979, data are for 4–6 months paper.
[5] Average effective rate for year; opening and closing rate for month and week.
[6] Effective rate (in the primary market) on conventional mortgages, reflecting fees and charges as well as contract rate and assumed, on the average, repayment at end of 10 years. Rates beginning January 1973 not strictly comparable with prior rates.

Sources: Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Home Loan Bank Board, Moody's Investors Service, and Standard & Poor's Corporation.

30

Figure 3. Interest rates and bond yields, 1974-1982

Source: 97th Congress, 2nd Session, Economic Indicators, January 1982, Prepared for the Joint Economic Committee by the Council of Economic Advisers, GPO, Washington DC, 1982, Table 30.

Against the framework of this looming crisis that gripped stock market and bond market prices it was not recorded a surge in Eurodollar borrowing by non financial corporations. Neither did deposits in Eurodollar outlets increase at

the start of the new decade. If one measures the share of Eurodollar deposits in total currency in circulation in the United States it is noticeable that both short-term and very short (overnight) Eurodollar deposits slightly declined during the year 1980. By contrast, very interestingly, during the same period shortly after the Volcker shock it was experienced a surge in money market mutual fund shares (97th Congress, 1st Session, 1981, p. 26). At the same time, during the first few months since the onset of Volcker's decision into the year 1980, the Eurodollar rate suffered a setback: afterward they revamped and soared to all-time peak (Figure 4).

The early decline in the cost of Eurodollar loans (Eurodollar rate) was paired by a decrease in borrowing from the Eurocurrency markets by 33 percent from the amount raised during the second half of 1979 (World Bank, 1980). Such decline can be considered a consequence of the effect of the second oil price shock on confidence in the dollar and international demand for loans, even short-term loans. The following surge directly came from the effects of the rise in U.S. federal fund rates on the investment attitude of American banks and on the borrowing patterns of American corporations. The rise in the cost of money within the U.S. pushed the American financial institutions and corporations to flee the United States: this dynamics triggered a rise in deposits and demands in the Eurodollar markets that pushed up the cost of Eurodollar and other Eurocurrency loans. The outflow of assets from U.S. banks and the investments in the Eurocurrency markets through their overseas branches based in Europe let the largest American banks safely avoid the U.S. recession. Likewise, such uptick in the cost of loans on the Eurodollar markets also descended from the attitude of corporations and other non-financial companies to borrow from abroad to skip the rise in the cost of borrowing money within the United States caused by the Volcker revolution.

Therefore, since the combined second oil shock it was recorded a dynamics comparable to the mid-1970s: the more the dollar dropped against all major foreign currencies, the more U.S. investors and borrowers flew the U.S. capital market to seek better lending and borrowing rates, as well as a more dynamics business cycle. However, unlike what had happened from 1975 to 1979, Volcker's inflation-fighting monetary policy triggered a run-up of activities on the Eurodollar market that made the cost of borrowing from that market too much expensive to borrowers. In other words, the combined declining value of the dollar and monetary tightening prevented the unregulated overseas markets (Eurodollar and other Eurocurrency markets) to protect borrowers and investors from the rise of lending rates and declining banking profits.

The question to answer is how the newly-elected Reagan administration reacted to this strand of pressing macroeconomic issues and which measures it approved against this framework. From the view point of this contribution the issue is to better grasp how the political system used economic policy and soon-to-be-implemented financial deregulation policies to face up to these problems that hit both the real economy and the financial system.

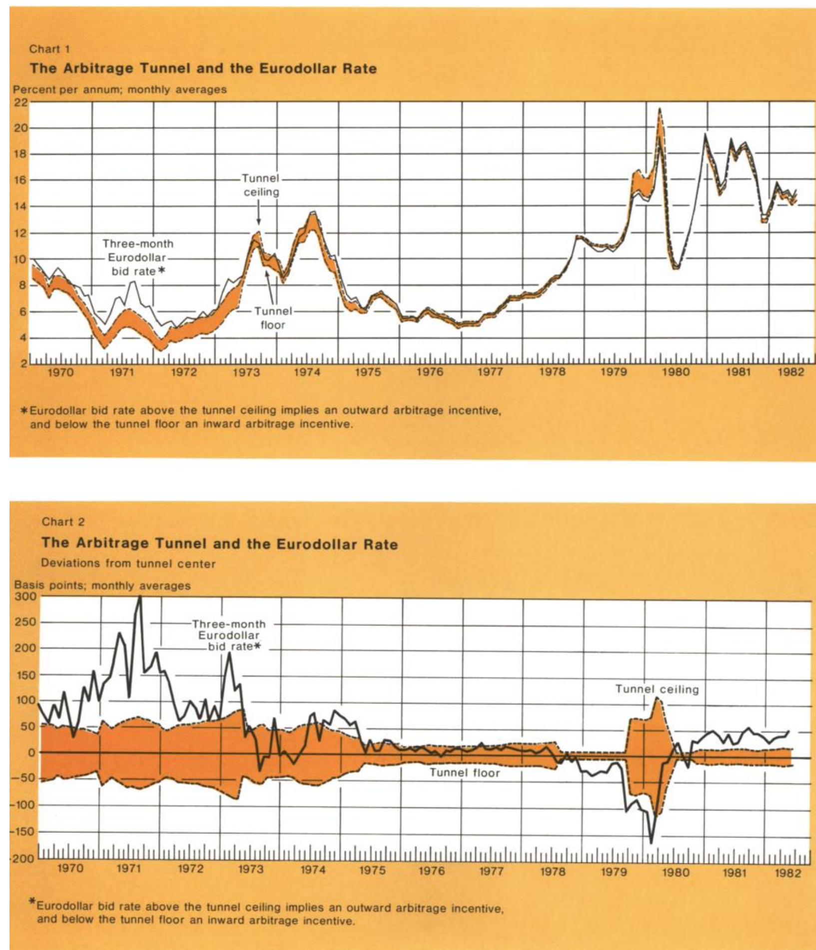


Figure 4. The Arbitrage Tunnel and the Eurodollar Rate, 1970-1982

Source: *Federal Reserve Bank of New York Quarterly Review,* Summer 1982

4. Financial Deregulation and the American Economy: How to Sort Out of High Interest Rates and Recession

The standard account of the Reagan administration's economic policy in the economics and historical literature has persistently made the argument that the new administration made a bet on a combination of massive tax cuts, curtailing of social spending and credit restraint programs to stimulate economic activity while at the same time holding on a strict control on monetary aggregates consistent with all-time peaking interest rates adopted by the Fed as the two cornerstones of an inflation-fighting macroeconomic policy. Substantial tax cuts were supposed to stimulate economic activity and restore the competitive edge of American manufacturing and other non financial companies. This article has suggested that monetary stringency adopted by the Fed turmoiled both domestic credit conditions and the cost of borrowing, and the profits of banks on investments in international bond and Eurodollar markets.

Through the research perspective of financial deregulation it is worth addressing a set of measures that associated American economic recovery not only with easier domestic credit conditions already mentioned in the literature, but also with a perspective of higher commercial and capital market integration between the U.S. economy and the foreign goods and capital markets. Unlike studies as Krippner's (Krippner, 2012), this contribution maintains that the financialisation of corporate America not only served the purpose of compensating the loss of profits caused by control on monetary aggregates and high interest rates; rather, it also aimed to promote the outflow of capital from

the U.S. and increased borrowing by non financial U.S. firms into cheaper overseas money markets, both Eurocurrency markets and, as far as they overheated, newly established money market mutual funds through the intermediation of investment banks. In fact, it is possible to establish a correlation, subject to further archival and statistical research, between deregulation of financial markets inaugurated under Reagan and the birth of new financial products and players as a new financial environment. This creative financial move was to establish new financial products useful in curbing the rise in the cost of financing corporations and the decline in banking profits that not even the offshore Eurodollar rates proved to be able to overcome.

Certainly at the start of its appointment the Reagan administration favoured policies aimed at restraining monetary aggregates consistent with Volcker's monetary policy and based on a deep-seated conviction that financial markets could determine interest rates out of the Federal fund rate. In the framework of overheating cost of money reflecting Volcker's turn, which by late Winter 1980 led long-term interest rates to an early surge (FOMC, 1980), the White House passed a set of measures to restrain credit conditions: by imposing a surge in taxes on consumer credit, and by extending similar conditions to money markets, the new administration aimed at restraining credit within the framework of an inflation-fighting policy based on restraining credit by all means. This policy came at variance with the Department of the Treasury's firm stand on tax cuts and curtailing of welfare spending. This issue was the source of conflicts between the Treasury and the White House.

However very soon, with the beginning of a recession that dipped the U.S. economy, the new administration came to the rescue of domestic borrowers and financial institutions' profits through the combination of two strategies: by deregulating financial markets it made easier lending on the domestic market; on the other hand, by pressurising international economic partners to undertake a process of full trade liberalisation it stimulated export credit. The objective was to devise investment markets for U.S. banks and credit markets for U.S. corporate borrowers alternative to the Eurodollar and other off-shore markets whose capability to offer easy credit went for the worse, particularly in the second half of the year (Figure 4).

From the view point of U.S. regulation of domestic capital markets, the Volcker revolution came to centerstage in monetary policy against the backdrop of earlier deregulation of financial markets initiated since the turn of the 1960s. In particular, deregulation of interest rates ceilings on a variety of credit markets began as early as 1970, when limits on large corporate certificate of deposits were removed in response to the failure of Penn Central Railroad. In 1980 the Reagan administration took a steep turn in that direction by removing ceilings on consumers' saving deposits. While the literature has interpreted this decision as a pivotal legislative measure to fuel the financialization of the U.S. economy as it increased credit to finance the financial activities of financial and non financial firms (Krippner, 2012), from the perspective of this contribution it attracted deposits useful to finance fixed capital investments so as to balance the impact on the costs of borrowing triggered by the uptick in interest rates that Volcker's monetary stringency unleashed. Therefore, such measure added to the capacity of high interest rates to attract foreign capital. Furthermore, it is worth considering such measure one out of many provisions aimed to cope with the impact of monetary stringency on capital supply and credit. In light of declining consumer demand and demand for credit to finance the real economy, the removal of limits to interest rates on consumer deposits was thought to pair the inflow of foreign capital triggered by the exponential rise of interest rates to boost the domestic economy. Therefore, it was a deregulation of credit aimed to restore investment confidence in domestic growth and lending. The second piece of legislation bound to this objective was certainly a remodulation of capital standard for commercial banks aimed at preventing the rise in short-term loan rates from causing a maturity imbalance on the banks' sheets. The Reagan administration passed a lowering of capital standard based on the free market-oriented idea that by this measure all financial institutions could grow themselves out of trouble: without easing reserve standard many banks, not only the Saving and Loans (S&L), would suffer from a maturity mismatch between their short term borrowing and refinancing, and their return on fixed-rate loans or mortgages issued many years before. As many authors have stressed, this was particularly the case of the S&L (Brine & Poovey, 2017, chapter 10; Tooze, 2018, pp. 44-45). However, this deregulation of capital standard of banks and financial institutions had positive effects only on the largest commercial banks. In the new high interest rates environment the largest banks suffered from the crisis that began gripping on the financial instruments they used to trade as the bond markets or the equity markets. Likewise, as already mentioned, the U.S. commercial banks also suffered growing competitiveness from the investment banks. Such competition accounts for the sharp contraction in their deposits. This set of deregulation measures partially helped commercial banks to weather this storm. However, the vast majority of S&L either merged or failed (Curry & Shibut, 2000, pp. 26-35). In third instance, the repealing of anti-trust legislation should restore the competitive position of non-financial corporations hit hardest by control on monetary aggregates and soaring interest rates. The non-financial companies had to face up to a difficult position all the more so as the volatility of the

American stock market and decreasing stock prices made harder for U.S. corporations (the example of Chrysler in the early 1980s is worthwhile) even to offer their stocks as collateral against federal or state lending (Note 8). In the field of trust legislation, though the Department of Justice promoted the liberalisation of telecommunication sector to favour AT&T against Bell's monopoly, indeed that Federal Ministry and the Federal Trade Commission began supporting industrial merging in many sectors to prop up the competitive position of corporate America in the global economy (Galambos, 1999).

In the framework of these multiple issues and considering the limits to all of these deregulation measures in the pursuit of restoring credit to non financial companies and their competitive position by attracting funds and deposits, it was passed the Depository Institutions Deregulation and Monetary Control Act of 1980. It followed through on an earlier move by former President Carter in 1978, when Georgia-born President called for removal of prohibition to bear interests on demand deposits (Miller, 1979). The Deregulation and Monetary Control Act, which was the major reform of capital markets since the 1930s, expanded the Nation's monetary central apparatus by establishing universal reserve requirements for all depository institutions. Furthermore, it adopted a program to remove Federal Deposits interest rates ceilings (U.S. Secretary of the Treasury, 1981).

All of these and other measures passed between 1980 and 1982 converged in propping up investors' confidence and investments in U.S. depository institutions. Such renewed confidence helped restoring capital supply to finance domestic fixed capital investments. This deregulation package became part of a two-fold strategy to recast the competitive position of the American economy based on opening the American economy to world markets competition. This policy pivoted on both the real economy and the financial sectors, either the inflow of capital and goods or the outflows of financial assets, goods and services. In striking contrast with a widespread call across the American capitalism to raise protectionist policies as a cure to the economic recession caused by disinflationary policies, Reagan advanced deregulation policies to restore domestic money stock in combination with a foreign economic policy aimed at favouring market-seeking strategies for U.S. banks and capital-seeking strategies for U.S. corporations. The pillar of this two-fold strategy was a foreign trade policy that pushed Washington's allies to further open their consumer markets and capital markets notwithstanding the looming recession. In the pursuit of this foreign trade policy, the Reagan administration conceived the outflow of money from the U.S. capital markets to overseas short-term money markets as an export-promoting measure. In other words, the investments by U.S. commercial and investment banks in off-shore dollar markets and other short-term overseas markets was a Reagan administration's international trade financing policy (Note 9).

5. When Financial Deregulation and Door-opening Economic Policies Are Not Enough: Toward the Ascendancy of Money Market Mutual Funds and Securitisation to Finance Corporate America

Notwithstanding all of these measures, by the Spring of 1983 the American stock market still showed signs of volatility, with lows in long term bonds and high corporate stock volatility (Note 10). In light of this financial market picture the limited American recovery was by and large based on the easing of monetary tightening passed in mid-1982. Furthermore, the Eurodollar and other Eurocurrency markets, as already stressed, had turned to an upward trend since the second half of 1980. It was against this backdrop that finding out new and competitive financial outlets became a pressing need. Starting in 1980 security dealers engulfed markets with money market mutual funds. Mutual funds could offer many of the deposit services of banks without imposing on borrowers the cost of reserve requirements and federal deposit insurance. In the context of high interest rates, depository institutions found themselves at disadvantage and investments in MMMF, spurred by the intermediary activity of investment banks and other institutional investors, grew exponentially. In 1980 the Congress took a historic turn on the way to favour investments in MMMF that would made these new financial outlet the pillar of money supply for the future. The Congress refused to keep these financial instruments under control by opposing to place them under Regulation Q (U.S. Congress. Senate. Committee on Banking, Housing and Urban Affairs. Subcommittee on Financial Institutions, 96th Congress, second Session, 493, 1980). This act by the Congress further favoured investments in MMMF and at the same time reduced the competitive position of commercial banks, hit hard by Volcker's monetary stringency and credit restraints. A further blow in this direction was given by exempting the MMMF from the Community Reinvestment Act, which required banks to land in poor communities (Greenhouse, 1993).

The final step in this direction was the Garn St. Germain Act passed into law in 1982. This law at the same time allowed depository institutions to open money market deposit accounts, and removed any kind of depository interest rates limits (Canova, 1995, p. 1320). In so doing this law combined earlier attempts to bolster confidence of investors and the inflow of assets in the U.S. economy with a later U.S. strategy of restoring stock money and capital supply to resurrect the American economy through the MMMF. These financial instruments were thought to become a valid

alternative to the unfinished crisis of confidence in the bond and stock markets unleashed by Volcker's monetary stringency.

As a result of this legislative architecture the MMMF grew staggeringly throughout the 1980s: from $ 45 billion in 1979 to $ 207 billion by 1982, to $ 1 trillion by the end of the decade (Laderman & Smith, 1993).

This trend was well on set during the monetary stringency of the early 1980s: by 1983 it was recorded a stunning surge not only of capital outflows and overseas investments in off-shore dollar markets by U.S. banks, as well as a rise in interbank lending, but also a steep increase of investments in MMMF.

As Adam Tooze has lucidly demonstrated, the development of MMMF soon became linked to the growth of securitisation, by definition the attitude of financial institutions to purchase an asset, a mortgage or another type of asset through the immediate selling of it for a fixed-time. As early as the 1970s American investment banks had started securitising on the mortgage market and other certificates on behalf of commercial banks: this was for instance the case of Salomon Brothers, which traded through securities on the market some assets on behalf of Bank of America as early as 1977. (Davis, 2009; McLean & Nocera, 2010). The two most important financial devices of securitisation were the Asset-backed Commercial papers (ABCP), and the Repurchasing operations (Repos): without going into the technicalities of these instruments, they both raised money in financial markets for a fixed term period by offering mortgages or other commercial papers as collaterals. The MMMF became a vital source of funding to pump money into ABCP and Repos. This new financial environment, which wiped out deposits, reserve requirements, federal deposit insurance and other financial regulation-induced costs of financing the real estate markets or fixed-capital investments by non financial corporations, became, as a final research hypothesis subject to further archival exploration and data analysis, the end-point answer to the issue of peaking cost of financing the business cycle germane to the early 1980s. It accounted for different strategies to fix this problem from the early volatility of the dollar in exchange markets after the first oil shock to the surge in Eurodollar rates against the framework of combined dollar depreciation and the following rise in interest rates after the second oil shock. A dynamic that plagued the economy as a result of the second oil crisis and the Volcker's monetary revolution combined. If the Eurodollar and other off-shore markets offered a plausible answer to the rise in the cost of financing the business cycle during the 1970s, in the early 1980s the unpick in Eurodollar rates pushed the Reagan administration to remove any interest rate limits on depository institutions as a new policy to fix the same problem, as well as to promote capital outflows under the form of export credit. The possibility for the depository institutions to open money market accounts and full removal of interest rate ceilings signalled a pressing need to make a few steps further in support of the American economy. Therefore, a final research hypothesis of this contribution is that the rampant ascendancy of MMMF became the new frontier to fix a long-standing problem dating back to the first oil crisis: how to finance the non-financial U.S. companies and corporations in a high interest rates environment from the 1970s to the 1980s.

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Notes

Note 1. Executive Office of the President, Office of Management Budget, Memorandum for the President "Underestimation of Economic Strength in Q1/1983", 6 May 1983, in Ronald Reagan Presidential Library, Simi Valley, CA, James A. Baker Collection, White House Staff Memoranda - Cabinet Affairs, b. 3.

Note 2. Memorandum of conversation Reuber (Canada Deputy Secretary of Finance)- Solomon (U.S. Undersecretary of Treasury), 15 February 1980, in National Archives and Records Management, College Park, MD (Hereafter NARA), Records of the Department of the Treasury (Hereafter RG56), Office of the Undersecretary for Monetary Affairs, Subject Files of Anthony Solomon Undersecretary for Monetary Affairs 1977-1980, b.2, fold. G5.

Note 3. on this see documentation in Carter Presidential Library and Archive, Atlanta, GA, Anthony Solomon papers, Chronological File, b. 7.

Note 4. two excellent archival sources to track the early development of the Eurodollar and other Eurocurrency markets across the European financial centres and the prominent role of U.S. banks in the process are the records of the Economic Intelligence Unit held at the Bank of England Historical Archive (London), and documentation held at the Rockefeller Archive Center (Tarrytown, New York).

Note 5. On either of these lending dynamics see Federal Reserve Bank of New York Historical Archive, New York, NY (hereafter FRBNYA), Central Files, Meeting with New York Bankers. On the size of Syndicated loans before 1980 see also Inoue (1980), table 1.

Note 6. See for instance documentation in NARA, RG56.

Note 7. Michael Bloomenthal and Charles Schultze, Memorandum for the President, "Price Prospects and Anti-Inflation Initiatives", 15 March 1978, in Carter Presidential Library, Papers of Charles L. Schultze, b. A96-018.

Note 8. On this see documentation on Chrysler in Ronald Reagan Presidential Library, James A.Baker Collection, White House Memoranda -Cabinet Affairs, b. 3.

Note 9. Kate Moore (White House), Memorandum for Frank Hodsoll, "Treasury Transition Report: Key International Economics/Finance Issues", 23 March 1983, in Ronald Reagan Presidential Library, Jame A. Baker Collection, File Department of the Treasury, b. 2

Note 10. Executive Office of the President, Office of Management and Budget, "Memorandum Economic Meeting with the President of 9 May 1983", 6 May 1983, in Ronald Reagan Presidential Library, James A. Baker Collection, White House Staff Memoranda- Cabinet Affairs, b. 3.

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