

Political Bubbles:

Financial Crises and the Failure of American Democracy

Nolan McCarty
Princeton Univ.

Keith T. Poole
Univ. of Georgia

Howard Rosenthal
New York Univ.

Forthcoming, Princeton University Press

©Nolan McCarty, Keith T. Poole, and Howard Rosenthal, 2012

Introduction

The financial system of the United States was close to collapse in the fall of 2008. On September 15, two of the four largest investment banks failed. One, Lehman Brothers, declared bankruptcy. Lehman failed to find a buyer, and the government decided not to guarantee some of its underperforming assets in order to facilitate a sale. The other, Merrill Lynch, the country's largest brokerage firm, was sold to Bank of America at a rock bottom price.

The next day the Federal Reserve announced an \$85 billion bailout of the nation's largest insurance company, American International Group (AIG). AIG's troubles were based on billions of dollars worth of swaps that it underwrote against defaults of mortgage-backed securities (MBS).¹ A collapse of AIG would have destroyed the value of these securities and generated even greater sell offs, losses, and insolvencies throughout the entire financial system. Three days later on September 18th, Secretary of Treasury Henry Paulson went to Congress to plead for the enactment of the \$700 billion Troubled Assets Relief Program (TARP). This sketchy plan, a virtual blank check from Congress to the Treasury, sought to re-inject capital into the financial system. Government purchases of mortgage-backed securities and other distressed assets would, it was claimed, prop up those markets and halt the financial crisis.

The dramatic failures of the week of September 15th capped a string of financial calamities that began with the government bailout of Bear Stearns in March. Just a week before the collapse of Lehman and Merrill, the government took over the biggest players

¹ An asset-backed security is one whose value is based on returns from some underlying asset. In the case of mortgage-backed securities, the value is derived from cash flows generated by interest payments on an underlying pool of mortgages.

in the mortgage market, the government-sponsored enterprises Fannie Mae and Freddie Mac. Before the year was out, the federal government would also control AIG. The ensuing crisis hit an economy already in recession after the collapse of the bubble in housing prices. Unemployment pushed towards levels not seen since the early 1980s. The automobile industry, the traditional symbol of American manufacturing strength, almost collapsed before a government-orchestrated restructuring where the American taxpayer became the owner of a majority of General Motors stock. At the beginning of 2012, GM, Ally Financial, the successor to GM's long-time finance subsidiary GMAC, and AIG remained subject to government supervision; the future of Fannie and Freddie remains unresolved.

The financial crisis of 2008 was a truly traumatic event for Americans and affected almost everyone else in the global economy. But the causes of this calamity continue to be hotly debated.

Many commentators and analysts attribute blame to specific individuals such as investment bankers reaping huge bonuses on Wall Street, go-granny-go subprime mortgage originators in Pasadena, and house flippers in Las Vegas. Others focus on large structural factors such as the explosion of financial innovation and global financial imbalances which showered the U.S. and much of the industrialized world with cheap credit from China and the Middle East.

Our focus, however, is on the national government in Washington. To be precise, we put much of the responsibility for the crisis and the failure to undertake genuine reform of the American financial system on members of Congress, on Presidents Carter, Reagan, George H. W. Bush, Clinton, George W. Bush, and Obama, and on those they

chose to serve in the Cabinet and in the Executive Office in the White House, and to run regulatory agencies, including the Federal Reserve and the Securities and Exchange Commission. We contrast their actions with those of the private sector actors who indulged in “infectious greed” and “irrational exuberance”. Political actors failed in their response to the challenges of financial innovation and the global “savings glut.” They allowed the crisis to develop and inhibited response after the crisis was front and center in the public eye.

A major culprit was Fed chair Alan Greenspan, the originator of these catch words, venerated in his initial Senate confirmation vote and two reappointments, one by a Democratic president. Greenspan pumped up the housing bubble with easy credit and failed to exercise his responsibility to investigate and regulate deceptive “teaser loans” and outright fraud in the origination of sub-prime mortgages. His successor, Ben Bernanke, when appointed by George W. Bush in 2006, presented himself as a Greenspan clone (although one less prone to obtuse pronouncements) and was curiously passive until the September, 2008 collapse of the financial sector. Bernanke’s passivity may have reflected a Fed that is less “independent” than many imagine. Congress and the financial and housing sector would have been up in arms had Bernanke attempted to rock the boat.

The malefactors were bipartisan. They included not only Republican appointees like Greenspan and Republicans in Congress and the White House imbued with the mantras of ‘free markets’ and ‘the ownership society’. Democrats were eager to have the poor in housing they could not afford. Franklin Raines, head of the White House Office of Management and Budget under Bill Clinton and James Johnson, advisor to Walter

Mondale, Al Gore and Barack Obama were grossly over compensated as CEOs of Fannie Mae.² Clinton chair of the Council of Economic Advisors, Nobel laureate Joseph Stiglitz, wrote, in 2001, along with future Obama advisor and Citicorp employee Peter Orszag and Clinton advisor Jon Orszag, a position paper for Fannie Mae claiming there was only a one in 500,000 chance that Fannie Mae would go bust.

Perhaps of greater importance than the Democratic preoccupation with low income and minority housing and with the government sponsored enterprise (GSE) Fannie Mae, was the acquiescence of the Democrats in financial deregulation, most notably by Clinton Treasury secretaries Robert Rubin and Larry Summers. Rubin was in a Washington transition between Goldman, Sachs and Citicorp. Summers did a stint at the hedge fund D. B. Shaw after his government service.

The financial crisis and the Great Recession it spawned have led to a spate of books on what went wrong. Ours is a late entry. So, what can we say that has not been said? We are certainly not the first to stress the influence Wall Street has in Washington. But many authors go so far as to imply that Wall Street has “captured” Washington and always gets what it wants and gets it right away. Such an account is far too simple. Politicians and policymakers do often behave in ways that are not always reducible to carrying water for Wall Street. For example, the Bush Treasury department, whose top officials had strong Wall Street ties, was reluctant to ask for congressional authority to address the financial crisis in early 2008. But perhaps due to congressional opposition to its role in saving the investment bank Bear Stearns, the administration allowed Lehman

² On Raines’s compensation, see Bebchuk and Fried (2005). Lucien A. Bebchuk and Jesse M. Fried. 2005. “Executive Compensation at Fannie Mae: A Case Study of Perverse Incentives, Nonperformance Pay and Camouflage.” *The Journal of Corporation Law*, 30: 807-822.

Brothers to go into bankruptcy rather than risk another congressional reaction from a bailout. (It's worth noting that neither heavy campaign contributions from Lehman nor its CEO Richard Fuld's serving as a director of the New York Fed saved Lehman from bankruptcy.) Possible Treasury fears about Congress, even Republican controlled, would have been well founded. Shortly after Lehman failed, Congress rebuffed the administration in its first try to pass the Troubled Asset Relief Program (TARP).

As a second example, consider the difficulty the financial industry faced when it pursued "reform" of personal bankruptcy law. It took Visa, MasterCard, and other creditors seven years to force through the 2005 legislation that made consumer bankruptcy more difficult. While the financial services industry is indeed powerful, it does not always get what it wants. Moreover, the industry is competitive and not homogeneous. The demise of Bear, Lehman, and Merrill as independent firms may have been welcome news to the survivors, Goldman and Morgan Stanley. So it is important to sharpen our understanding as to exactly how financial interests are represented in Washington and when those influences will be the greatest.

Our account provides a more nuanced understanding of the channels through which politics exacerbates financial crises. Whereas much of the discussion of the political underpinnings of the financial crisis has centered on the political interests of the financial sector, our approach stresses three *I*'s: ideology, institutions, and interests.

The actions of politicians not only reflect pressures from organized interests but also personal beliefs about the proper role of government in regulating the financial sector. As we document throughout this book, such ideological beliefs are quite rigid and are largely unresponsive to new information. Undoubtedly the manifest ideologies

reflect some mixture of genuine personal belief, fit to constituency beliefs, and cronyism linked to personal venality. What we hold to be important is not so much the recipe for this mixture but its rigidity.³ This rigidity, we argue, can impede measures that might prevent bubbles and limit the political response during the bust.

Political institutions such as elections, legislative rules and procedures, and regulatory structures affect the incentives and opportunities of elected politicians to engage in policymaking that either exacerbates or mitigates financial crises. Our focus is on how the fragmented and supermajoritarian structure of U.S. political institutions makes it difficult for policymakers to keep up with financial innovation and to reform the financial sector in the bust.⁴

Groups and interests are the final ingredient. Well organized, resourceful groups such as those in the financial sector are often able to exploit ideological allies and institutional structures to produce policy benefits for themselves. As we show, such powerful groups are not only able to push presidents and legislators for more favorable policies, but also to stave off intruding regulators allowing certain actors to push the boundaries of legality.

With specific reference to the financial crisis, Washington failed to deal with three pillars of the financial crisis. The first pillar was the dramatic increase in risky residential loans known as sub-prime mortgages. Subprime mortgages are those where the borrower has an insufficiently good credit or work history to qualify for a lower interest prime loan. The originators of these high-interest mortgages would often keep no

³ In a research article, Steven Levitt (co-author of *Freakonomics*) estimates that personal ideology represented about 50 percent of the mix. Levitt (1996).

⁴ Our focus will be on U.S. financial crises so that we are concerned primarily with the particular structure of U.S. policymaking institutions.

“skin in the game” but instead sell the mortgages to other financial firms. To add insult to injury, some originators produced fraudulent documents and resold sub-prime mortgages as prime quality AAA paper.⁵

The second pillar of the crisis was the securitization of mortgages by bundling them into pools of loans that could be sold to investors. But because the underlying mortgages were risky, these mortgage securities contained various tranches. The highest tranches maintained first claims on interest payments while the lowest tranche owned the lowest priority claim, and therefore was the first one to feel the effects of defaulting mortgages. Thus, these various tranches were designed to reflect different levels of risk.

Underwriters of these securities sought credit ratings for the various tranches. Despite the low quality of the underlying loans, credit rating agencies uniformly rated the highest tranches at AAA, as safe as U.S. government debt. (After the crisis, Standard and Poor’s has downgraded U.S. government debt by continues to give some MBS’s AAA ratings.⁶) With the blessings of Standard and Poor’s, Moody’s or Fitch, these securities were then marketed by financial institutions and pushed to investors around the world. Investment banks and large commercial banks such as Citicorp not only resold mortgage-backed securities but continued to hold many directly. In order to dramatically increase their leverage in these investments, they financed the purchase of MBS and other

⁵ See “In the Court of Common Pleas of Allegheny County, Pennsylvania, Federal Home Loan Bank of Pittsburgh v. J.P. Morgan Securities Inc., J.P. Morgan Chase & Co., Moody’s Corporation, Moody’s Investor Services, Inc., ant the McGaw-Hill Companies, Inc.”, Complaint No. GD 09-016593, filed Oct. 23, 2009 ; In the State Court of Fulton County, State of George, Federal Home Loan Bank of Atlanta v. Countrywide Financial Corporation (n/k/a Bank of America Home Loans, Inc.; Bank of America Corporation (as successor to the Countrywide Defendants); J.P. Morgan Securities, LLC (f/k/a J.P. Morgan Securities, Inc. and Bear Stearns & Co., Inc.); UBS Securities, LLC; and John Doe defendants 1-50, no date.

⁶ See <http://www.bloomberg.com/news/2011-08-31/subprime-mortgage-bonds-getting-aaa-rating-s-p-denies-to-u-s-treasuries.html>, accessed May 25, 2012.

collateralized debt obligations (CDO) with low-interest short-term loans in the “shadow” banking system formed by the overnight repo (sale and repurchase) market.

The third pillar was the use of credit default swaps (CDS) to insure these mortgage-backed securities against default. The seller of such a swap agreed to pay the buyer a predetermined sum in the event that the MBS defaulted. These insurance policies were designed to allow the holders of MBS to hedge against risk. But other investors who did not hold MBS also bought these swaps to place a casino-like bet against--the so called “naked” credit default swap. The insurer AIG ran the biggest casino. Although credit default swaps are theoretically designed to spread risk, AIG’s financial services division underwrote so many that a nuclear bomb of concentrated risk was created.

These three pillars, (along with the easy money policies of the Federal Reserve and the huge influx of foreign capital) promoted a housing market bubble. When the bubble popped, the first pillar collapsed with a wave of defaults on the sub-prime loans. This took out the second pillar as “AAA” mortgage backed securities began to default and lose value. As these defaults increased, holders of MBS began to have difficulty in refinancing their operations through the repo market as lenders feared defaults on these loans. Eventually, there was a full-fledged run on the shadow banking system. Due to a lack of transparency about holdings of “toxic” assets, this run spread through the financial system. Finally, the collapse of the second pillar caused buyers of credit default swaps to try to collect their insurance claims, taking out the third pillar and bringing AIG into insolvency.

Clearly, all three of these pillars are based on policy errors of commission and omission. Policymakers could have avoided the crisis by closely regulating or even

prohibiting the products underlying any one of the three pillars. Sub-prime mortgages could have been curtailed by any number of regulations: interest rate regulation, restrictions on the types of mortgages available in the market, stricter supervision of lending standards, mortgage originators, and real estate agents, or higher total loan-to-value requirements on loans. The perverse incentives in securitization could have been curtailed by forcing mortgage originators to retain a substantial interest in the mortgages they sold. Both originators and securitizers could have been forced to “cover” the underlying securities and derivatives by retaining liability in the case of default. The conflicts of interest by ratings agencies could have been addressed. Policymakers could have addressed accounting gimmicks like special investment vehicles that allowed MBS investors to magnify leverage. Credit default swaps involving the MBS could have been restricted to those with “skin in the game”, and issuers could have been required to hold more capital against losses.

That regulatory measures might have avoided or ameliorated the crisis suggests the deep complicity of the White House, Congress, and federal regulatory agencies. The bubble that led to the crisis was stimulated by relaxation of mortgage market regulation in the 1980s, government pressure on financial institutions, notably Fannie and Freddie, to increase lending to low income and minority borrowers, and by the protection of over-the-counter derivatives from regulation in the Commodity Futures Modernization Act of 2000. All these seeds of crisis were planted before George W. Bush took office and before the explosion of sub-prime mortgages and private sector mortgage securitization. Corrective actions were not taken during the Bush administration despite the presence of many warning signals. The Bush administration throttled the SEC with the appointments

of Harvey Pitt and Christopher Cox as chairs, while the Republicans prevented action on attempts by Congressional Democrats to regulate predatory lending.

But there is nothing unique about the recent crisis. The same types of policy failures occurred in both the Savings and Loan (S&L) crisis and the Great Depression. The S&L crisis was in full swing by 1985 and was ended only by the creation of the Resolution Trust Corporation in 1989. Similarly, the Great Depression was triggered by the stock market crash of October, 1929, but major new policies waited for the first 100 days after Franklin Delano Roosevelt's inauguration in March, 1933.⁷ These policy innovations included the Glass-Steagall Act, signed by the president in June, 1933. Glass-Steagall both separated commercial and investment banking and created deposit insurance. Financial market problems in the Great Depression were preceded by those that led to the Panic of 1907. The Panic, which took place in October of that year, drew no response from Washington. The objective of preventing a future crisis did result in the Aldrich-Vreeland Act of May 30, 1908 but a substantial response occurred only with the creation of the Federal Reserve in 1913.⁸ Clearly, there is a long standing pattern of closing the barn door after the horses are long gone.

Why do such colossal policy failures and delays repeatedly occur? One argument is that recurrent financial crises are simply a reflection of capitalism, its cyclical nature and capacity for creative destruction. By this view, the lag in policy and regulation has more to do with the unpredictable nature of financial crises rather than with any political

⁷ The 20th Amendment changed the Presidential inauguration date to January 20th and the starting date of the new Congress to January 3rd. The amendment was ratified 23 January 1933 but did not take effect until October of 1933.

⁸ See Bruner and Carr 2007.

failures. But focusing solely on economic dynamics gives an incomplete picture of financial crises.

Many of the underlying causes of financial disorder were indeed known in advance. Yet attempts at reform were not just ignored but actively opposed. Such examples are easy to come by. We start with the 1990s. In 1994, Askin Capital Management, a hedge fund heavily invested in mortgage-backed securities, lost \$600 million.⁹ That December, Orange County, California filed for bankruptcy when derivative investments based on interest rates went south after a sudden rise in interest rates. In 1998, Merrill Lynch, which advised the investments, reached a \$400 million settlement with Orange County. Congressional hearings on hedge funds and derivative securities were held in the aftermath, but no legislative correctives were proffered. A decade later, Merrill failed.¹⁰ In the late 1990s, a dozen small subprime lenders went bankrupt when, after several years of Ponzi style lending, many of their outstanding mortgages defaulted.¹¹ In 1999, the hedge fund Long Term Capital Management failed; the Federal Reserve intervened to avoid further damage to the financial sector. Also, in the late 1990s, Brooksley Born, the head of the Commodity Futures Trading Commission (CFTC), sounded the alarm about problems associated with the lack of regulation of derivatives contracts including the credit default swaps that became central to the Crisis of 2008. Yet her attempt to bring derivatives under the jurisdiction of the CFTC was adamantly opposed by President Clinton's economic team (most notably Robert Rubin and Larry Summers), the chairman of the Securities and Exchange Commission Arthur

⁹ See Hansell (1994), Mallaby (2010) and Partnoy (2009)

¹⁰ In another securitization scandal of 1994, Procter and Gamble and other companies successfully sued Banker's Trust for providing customers with inaccurate information about their exposure in interest rate swaps.

¹¹ See Lewis (2010)

Levitt, and congressional heavyweights such as Senate Banking Committee chair Phil Gramm.

The new century began with the pop of the dot.com bubble in 2001. Much attention was devoted to the role of misleading and fraudulent information that arose from accounting firms and market analysts. Merrill Lynch paid a \$100 million fine for reports issued by analysts. Citigroup, which later received billions in TARP funds, paid billions in fines and settlements over its role in the Enron and Global Crossing fiascoes. Nonetheless, the reforms of the Sarbanes-Oxley Act failed to prevent widespread accounting misinformation in the financial crisis.¹² As the housing bubble was underway, concerns about the risky loan portfolios of Fannie Mae and Freddie Mac were repeatedly raised in the early part of the decade, but intense lobbying by these Government Sponsored Enterprises (GSEs) and their politically-connected executives beat back any and all attempts at regulation. By 2005 and 2006, the Federal Reserve had collected unmistakable evidence of the mounting foreclosures and defaults on sub-prime mortgages yet decided not to use its regulatory powers to raise lending standards. Prominent academics such as Robert Schiller and Nouriel Roubini were predicting a national housing crash. Moreover, policymakers simply ignored history as many recent financial crises such as those in Scandinavia, Japan, and Thailand were triggered by a collapsed real estate bubble. But Washington and Wall Street convinced themselves “This Time is Different.”¹³

¹² For example, in the lead up to the crisis Lehman Brothers used a questionable accounting practice known as Repo 105 to goose its balance sheet just in time for quarterly earnings reports. Using Repo 105 transactions, Lehman loaned assets collateralized at 105% in the overnight Repo market. These loans were counted as sales on the firm’s balance sheet. <http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/>

¹³ See Reinhart and Rogoff (2009)

So financial crises are not simply economic phenomena, they have a very important political dimension. As we argue in this book, behind every financial bubble there is a corresponding “political bubble.” Just as financial bubbles in markets are a combination of irrational exuberance and greed, political bubbles brew in their own mix of ideology, institutions, and private interest.

What is a Political Bubble?

By political bubble, we mean a set of policy biases that help foster and amplify the market behaviors that generate financial crises. Political bubbles are pro-cyclical. Rather than tilting against risky behavior, the political bubble aids, abets, and amplifies it. During a financial bubble when regulations should be strengthened, the political bubble relaxes them. When investors should hold more capital and reduce leverage, the political bubble allows the opposite. When monetary policy should tighten, the political bubble promotes easy credit.

In terms of their causes, political bubbles bear a marked similarity to market bubbles. First, both types of bubbles rely on specific sets of beliefs. Economists stress the role of expectations in generating asset bubbles.¹⁴ These beliefs are used to rationalize asset prices that depart strongly from their historical levels. For example, the belief that the excess returns that investors require for holding stocks (the so-called “equity risk premia”) had permanently declined helped fuel the stock market boom of the late 1990s. At the same time, the notion that a new information economy was emerging led to feverish public offerings of firms selling dog food over the internet. Pets.com, whose investment banker was none other than the bubbly, bullish on America, Merrill Lynch,

¹⁴ We provide detail on the views of economists later in this chapter.

went to \$14 a share after an \$11 IPO in February, 2000 only to be liquidated in November of that year.¹⁵ Also in the 2000s, the belief that globalization and a savings glut from the developing world could drive interest rates to permanently low levels fueled housing bubbles from Las Vegas to Latvia. Even investors who were more skeptical of these changes in fundamentals may have continued to buy inflated assets in hopes of selling them just before the crash.

Just as beliefs fuel the “this dance can go on forever” mentality of investors and speculators, the beliefs and ideologies of politicians and voters sustain political bubbles. First, the fact that politicians and voters may share in the investor’s “irrational exuberance” makes them loath to support corrective policies. If a savings glut reduces the natural level of interest rates, it would be a folly to use monetary policies to keep them artificially high. If the information economy is the way of the future, it would be Luddism to tighten standards for either the public offerings that would capitalize the firms of the future or for the pricing of stock options in accounting statements.

But beyond the beliefs that underpin a particular bubble, basic ideological beliefs about the nature of markets and the role of government also help to fuel bubbles. The Oxford English dictionary defines *ideology* as

A systematic scheme of ideas, usually relating to politics or society, or to the conduct of a class or group, and regarded as justifying actions, especially one that is held implicitly or adopted as a whole and *maintained regardless of the course of events*.¹⁶

¹⁵ See Reed Abelson, *New York Times*, Nov, 8, 2000. <http://www.nytimes.com/2000/11/08/business/technology-petscom-sock-puppet-s-home-will-close.html?scp=1&sq=pets.com&st=nyt&pagewanted=print>, Accessed July 3, 2011.

¹⁶ See Oxford English Dictionary 2007.

Of course, ideological beliefs come in various flavors ranging from left to center to right. But the belief structure most conducive to supporting political bubbles is what we term *free market conservatism*. Like most ideologies, free market conservatism is based on a core set of principles. The absolute simplest form is the belief that government intervention in the economy is per se bad, no matter what. Markets are always better at allocating resources than bureaucracies. Consequently, government intervention should be extremely limited. Government should only engage in the basic protections of life and property, and should be specifically restricted to functions that cannot be provided by the marketplace (but even free-market conservatives disagree about what these are). Because markets allocate resources best, taxes and regulations should be as low as possible.

Beliefs associated with free market conservatism have influenced politicians of both major political parties, but its influence has been especially pronounced in the Republican Party in recent years, playing an important role in the party's shift to the right and to the increased polarization of American politics.¹⁷ But free market conservatism is not confined to the right side of the Republican Party. In fact, as we argue later, its adherents include many important Democrats.

Nonetheless, in recent years, some Republicans especially those that have come to be identified with the Tea Party movement have engaged in a virulent form of free market conservatism, which we can term fundamentalist free market capitalism. The fundamentalist version sees no role for government under any circumstance. It can be contrasted with the view of earlier, prominent exponents of capitalism, ranging from the first Treasury Secretary, Alexander Hamilton, to the famous economist Milton Friedman, and even to Alan Greenspan, all of whom saw the need for government intervention, at

¹⁷ See McCarty, Poole, and Rosenthal (2006)

least in exceptional circumstances. The fundamentalists severely hindered Treasury Secretary Paulson's efforts to stabilize financial markets, both in forcing the bankruptcy of Lehman Brothers and in opposing TARP.¹⁸

While economic and political beliefs behave quite similarly in the rise of a bubble, there are important differences in the aftermath of the bubble's pop. Economic expectations can change dramatically and decisively over a short period of time when actors realize that economic fundamentals can no longer sustain the value of appreciated assets. But as the italicized clause of the Oxford definition reveals, ideologues permit no such correction of their world view. The rigidity of ideological beliefs inhibits the rational adaption of policy to the circumstances of a financial crisis. Rather than concede that the old orthodoxy may be to blame, the ideologue searches for ways to blame perceived deviations from that orthodoxy. For adherents of free market conservatism, an apparent market failure is proof positive of government interference with the laws of economics. This suggests that policymaking in the pop will also be countercyclical. Policy decisions may be made or delayed in ways that exacerbate the crisis.

The second commonality between financial and political bubbles is that both are strongly influenced by the institutions or the "rules of the game." These rules generate the incentives to engage in social behavior that may be productive as well as destructive. The incentives of economic actors are shaped by the structure of financial markets, the state of financial knowledge, and the presence or absence of government oversight and regulation. These factors determine to a large degree whether capital flows to society's most productive uses or, in contrast, feeds speculation and manipulation. Institutions similarly structure political decision making. The electoral system and campaign finance

¹⁸ See Sorkin (2009) and Paulson (2010, p. 152-153, 285-286).

laws affect what policies politicians support. The structure of the federal government such as bicameralism, the presidential veto, the filibuster, and the committee system in Congress pose formidable obstacles to policymaking. If these obstacles cannot be overcome, the government most likely will not be able to provide adequate oversight and regulation of financial markets. In this way, the political rules determine the economic rules. This political trump is very important for understanding financial crises as the entire set of hurdles imposes a status quo bias that inhibits responses to the crisis. The institutional hurdles that lead to gridlock are in turn exacerbated by ideological polarization.¹⁹

The final common feature of financial and political bubbles is the role of self-interest and greed. As we know from the Scottish economist Adam Smith in *The Wealth of Nations* and the American political scientist David Mayhew in *The Electoral Connection*, a lot of benefits flow from self-interested behavior in both the economic and the political realm.²⁰ But of course there are limitations. Markets need a functioning invisible hand. Competition must be present and information must flow freely via the price system. Democracy requires competitive elections, free expression, and informed and engaged voters. When these conditions are not met, the social virtue of self-interest may cease, and opportunities for greed emerge.

Greed and interest are often what links finance to the political side of the bubble. Opportunist financiers will seek political alliances with opportunist politicians and compatible ideologues. Together such coalitions will exploit political opportunities to advance these interests. A striking example of such alliances involves former senator

¹⁹ See McCarty, Poole and Rosenthal (2006), chapter 6

²⁰ See Smith (1904) and Mayhew (1974)

Phil Gramm (R-TX) and his wife Wendy. From 1995 to 2000, Phil Gramm was the chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. He was an author of the Gramm-Leach-Bliley Act which repealed Glass-Steagall in 1996. Moreover, Gramm was instrumental in inserting the “Enron loophole” in the Commodities Future Trading Act of 2000.²¹ Wendy Gramm was head of the Commodity Futures Trading Commission from 1988 to 1993. While she was at the CFTC, Enron was granted exemptions pertaining to derivatives trading.²² In 1993, Wendy Gramm became a member of the board of directors of Enron.²³

When Phil Gramm retired from the Senate in 2002, he joined the Swiss banking firm UBS as a vice-chairman. UBS was clearly a troubled firm. In May 2004, the Federal Reserve fined UBS \$100 million for illegally transferring funds to Iran and Cuba. In 2007, the SEC successfully pursued an insider trading case against a UBS executive.²⁴ In addition, UBS was in deep trouble in the financial crisis; it received \$5 billion of the funds allocated to the AIG bailout. In 2009, UBS paid a \$780 million fine for holding illegal bank accounts for Americans and agreed to turn over the names of 4,400 account holders.²⁵ In 2011, UBS lost \$2 billion in a rogue trading scandal in its London office. For UBS, hiring a well-connected politician was an inexpensive investment.

Phil Gramm was known as an ardent advocate of free market conservatism. When Glass-Steagall was repealed, Gramm declared “we have learned that government is not

²¹ This provision exempted all over-the-counter electronic trading of energy securities from government regulation. The primary beneficiary of the restriction on regulatory jurisdiction was Enron who operated the main trading platform for these securities. See Lipton, *New York Times*, Nov. 14, 2008. <http://www.nytimes.com/2008/11/17/business/17grammside.html>. Accessed July 4, 2011.

²² <http://www.pbs.org/wgbh/pages/frontline/president/players/gramm.html>. Accessed July, 2011.

²³ Ibid.

²⁴ See Gretchen Morgenson, “Is Insider Trading Part of the Fabric?” *NY Times*, May 20, 2012, page BU1.

²⁵ See Browning (2010), p. B3

the answer”. His ideology and his self-interest clearly overlapped. Phil and Wendy Gramm were beneficiaries not of competitive, but of crony capitalism.

The UBS connection illustrates, moreover, that crony capitalism runs deep into the Democratic as well as the Republican Party. In August, 2009, President Obama played golf with one of his major fund raisers, Robert Wolf, president of UBS North America.²⁶ The opportunism of the Gramms, Wolf, and Obama is striking. UBS is likely to draw benefits from its bipartisan connections. Such connections, we argue, are important to political bubbles.

Somewhat sadly, it can be difficult to disentangle the political influence of ideology from the influence of venality and greed. Phil Gramm’s free market conservatism was richly compensated. As free market conservatism has become an acceptable ideology to a large enough fraction of the mass electorate, such as the Joe the Plumbers hyped by the McCain campaign in 2008, opportunistic politicians and crony capitalists can exploit this mass acquiescence for gain, contributing to increasing income inequality where Phil Gramm’s income increases much faster than that of Joe the Plumber.²⁷ (Samuel Wurzelbacher, aka Joe the Plumber, is a Republican nominee for a House seat in 2012; if he wins, he may well realize the American dream and make his own way into the 1%.). So venality and free-market ideology are complements in

²⁶ See Shear (2009)

²⁷ To complicate our distinction between ideology and greed a bit more, few advocates of FMC are pure Libertarians of the Ron Paul mode. Most are willing to tolerate or support government interventions that benefit business or higher-income voters even when they violate free market or small government principles. For example, many voters who identify with the Tea Party and its support for FMC oppose reductions of Social Security or Medicare benefits for high income beneficiaries (see chapter 8). So while ideology is more than simply a mask for private interest, the belief systems of politicians and citizens may be shaped by private interest.

promoting a bubble. As Charles Kindleberger and Robert Aliber put it “the supply of corruption increases in a procyclical way much like the supply of credit.”²⁸

Free market ideologies are not the only belief systems that can contribute to a political bubble. Even politicians on the left who subscribed to ideological beliefs rooted in economic and racial equality provided crucial support for policies that exacerbated the housing crisis. Executives of many real estate and financial firms exploited their desire to subsidize homeownership for lower income and minority groups. In chapter 2, we point to a Fannie Mae annual report that establishes a direct link between Fannie Mae, Countrywide’s now discredited CEO Angelo Mozilo, and redistributive egalitarianism.

In this book, we show how a political bubble was at the center of the 2008 crisis. We also show that the dynamics of political bubbles played a central role in many previous financial crises. Indeed, just as financial bubbles are endemic to capitalism, political bubbles are a permanent feature of capitalist democracy. Neither can be reformed away completely without forsaking the benefits of capitalism, for which there are certainly many.²⁹ Nonetheless, American history has shown that some economic and political policies are preferred to others. After the Great Depression, the United States, until 2008, did not have any financial or economic dislocation that generated political pressure for substantial government intervention in the economy. Indeed, over the past thirty years, Washington has deregulated financial markets by law, executive order, budgetary cuts and deliberate neglect. This contrasts with earlier historical experience. After the “panics” that occurred every twenty years or so during the 19th and early 20th centuries, Washington produced short-run write offs through bankruptcy laws and

²⁸ Kindleberger and Aliber (2005, p. 165).

²⁹ Even democracies where the government is far more engaged in the economy have suffered significant financial crises. Sweden and Japan are notable examples from the 1990s.

reductions in debts owed to the federal government as well as enduring legislation such as the Federal Reserve Act. In the wake of the Depression, institutional change occurred in the enactment of deposit insurance and the regulation of banking, securities markets, and public utilities. In the contemporary globalized, high tech economy the regulatory alphabet soup of the 1930s may not be reheated easily as the flows of capital and financial activity require much greater international coordination and cooperation. However, a strengthening of government capacity for monitoring and intervention is clearly needed.

In the crises that have arisen since the New Deal, times have indeed been different. The opponents of change have succeeded in limiting the legislative response to crisis. Most notably, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which responded to the Savings and Loan crisis of the 1980s, created a weak regulator, the Office of Thrift Supervision (OTS) and allowed for regulatory venue shopping by financial firms. AIG chose OTS as its regulator. In the current crisis, the Dodd-Frank bill, passed in July, 2010 is a partial and overly complex act. We will see, in part II, that it leaves ample opportunities for future bubbles.

After part II, we draw policy conclusions that reflect our understanding of how political and economic bubbles interact. We favor a strong set of simple rules as against regulatory discretion. The thirty-seven pages of Glass-Steagall are much preferred to the nearly 3000 pages in Dodd-Frank. Some may view us as Luddites. But we don't share their optimism about the benefits of financial innovation. Instead, we believe that the ever smaller increases in economic efficiency are undermined by ever increasing political risks.

First, economists do not agree among themselves. For example, Carmen Reinhart and Kenneth Rogoff nicely outline the broad academic disagreement about the seriousness of the US current account deficit as the housing bubble grew.³⁰ Second, economists, even the smartest of the smart, often do not get it right. Joseph Stiglitz made a wrong call on Fannie Mae. Two other Nobel laureates, Robert Merton and Myron Scholes were principals in Long Term Capital Management, which failed in 1999, requiring a private sector bailout organized by the New York Fed. Third, judgment reflects financial incentives. The film *Inside Job* exposed how former Fed governor and current Columbia professor Frederic Mishkin accepted a six figure fee to co-author a 2006 report titled “Financial Stability in Iceland.”³¹ The Icelandic banking system crashed in 2008. Yale professor Gary Gorton worked as a consultant to AIG before the crash; only to later write a book explaining how the emergence of a shadow banking system contributed to the crisis. The national and global financial systems are complex social systems. Within these systems, opportunities for economic and political manipulation abound. So it is naïve to believe that markets will successfully self-regulate.

More broadly, we have a distrust of arguments made in the name of economic efficiency that do not account for the political risks. Politics and markets alter new “products”, ostensibly efficient, in a way that leads to inefficiency. For example, adjustable rate mortgages (ARMs), allowed in the United States by the Garn–St. Germain Depository Institutions Act of 1982, make sense in that they allow lenders to avoid the interest rate mismatch involved in accepting short-term deposits but making long-term loans. They also make sense for assistant professors of finance, at the beginning of their

³⁰ Reinhart and Rogoff (2009), pp. 210-213.

³¹ Frederic S. Mishkin and Tryggvi Thor Herbertsson. 2006. “Financial Stability in Iceland.” Iceland Chamber of Commerce, Reykjavik, Iceland.

life-cycle earnings, to make smaller payments in the near term at the risk of making larger payments in the future. But the product quickly got distorted into “teaser” loans, often made without verification of income or assets. Because Congress failed to sharply delimit the new product, the nation may have been better off without any ARMs.

We also argue for strong product regulation with a minimum of regulatory discretion because of the ability of Wall Street to lobby on regulatory implementation. Until JP Morgan Chase’s \$3 billion trading loss in 2012, the implementation of the new Volcker rule that prohibited commercial banks from speculating on their own account was likely to have been significantly weakened by lobbying by the firm’s CEO, Jamie Dimon. As the CFTC was deliberating rules for treating client money, Gary Gensler, the head of the CFTC, permitted himself to be lobbied by MF Global head and former Goldman Sachs colleague Jon Corzine. Clients, still waiting for their money back, deserved better from a former New Jersey senator and governor. Sharp legislation with severe criminal penalties for misuse of client monies might well have protected MF Global clients. In theory, post-Dodd Frank regulatory implementation by the “best and the brightest” might lead to more market efficiency than a set of rules set in stone by legislation. But regulatory implementation is hardly a technocratic process that can be divorced from politics. As journalist David Halberstram recounted, “the best and the brightest” were deeply implicated in the American failure in Vietnam.³² The elites and experts are no less implicated in the financial failures and scandals of the last generation. Whether it was the LCTM failure, the Enron scandal, or the subprime crisis, graduates

³² One of us experienced this failure first-hand. However, the GI Bill may have made him one of “the best and the brightest” after the fact.

and faculty of our elite educational institutions were on the scene.³³ The central characters of these debacles serve on the boards of America's leading philanthropies, cultural institutions, and public companies. Thus, the central goal of financial reform should not be efficiency, but in increasing the accountability of the financial system to the American public.

³³ LTCM was truly elite. Its CEO was a Chicago MBA; its partners included two Nobel laureates, six MIT economics Ph.D.'s, and three Harvard professors.