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The Institutional Foundations of Financial Politics in the United States

As the financial crisis of 2008 wound down, economist Willem Buiter quipped, "self-regulation is to regulation as self-importance is to importance."[1] We know intuitively that they are not the same thing. Buiter goes on to comment that if a large corporation such as Airbus or Boeing wants to double its operations, it would need four or five years to assemble the money, build the factories, and ramp up its business. However, a bank can double, triple, or even quadruple its operations with incredible speed under the right circumstances of optimism, trust, and confidence. Unlike a large manufacturing operation that needs a plant and inventory of parts, a bank borrows and re-lends money to increase its operations without the same need for physical infrastructure. The problem is that the speed works in reverse. In the absence of the large fixed costs associated with plants and heavy machinery maintenance, pessimism, mistrust, lack of confidence, and fear or panic can force banks to shrink their operations at an even faster rate than they grow. Given the centrality of the banking system to economic activity and this unique feature of its operations, the industry cannot be left to police its own activities.[2]

Policing the activities of banks poses a unique set of problems in the United States. By world standards, American political culture contains a very antigovernment streak. The early patriots resented taxation by the

[1] See Willem Buiter, "Regulating the New Financial Sector," based on comments delivered on February 20, 2009, at the Center on Capitalism and Society conference "Emerging from the Financial Crisis" held at Columbia University, February 20, 2009, http://www.voxeu.org/index.php?q=node/3232 (accessed April 12, 2012).

[2] Ibid.

British parliament. Unlike many constitutions that detail a role for government, the Bill of Rights in the American Constitution is a list of things the government *cannot* do. The political activities of banks and financial institutions are no exception to this rule. Like the rest of American business, they seek the freedom to conduct their affairs with a minimal amount of government intervention to maximize their profits. The problem is that the failure of a large bank has very different societal effects than the failure of other firms. The entire U.S. economy is dependent on the banking system for money, credit, and a way to make payments. Therefore, it has been compared to the trunk of a tree that feeds the branches and leaves of the broader capitalist system. The loss of a branch or leaves might do serious damage, but the loss of the trunk kills the tree.

When the system fails and banks must be bailed out, ordinary Americans are generally angry. Although they do not understand the details of money, power, banks, and finance, they have an intuitive sense that some groups are benefiting more than others, and that those who cause the problem do not pay the same price as those who must bail them out. At times, they direct their anger solely at bankers. Other times, they direct it both at the banks and the political system that seems unable to respond to the crisis by rewarding those who behaved responsibly while punishing those who behaved irresponsibly. Although the political anger may be justified, it frequently operates in an atmosphere that lacks an understanding of what is really going on.

What makes the politics of finance so difficult to follow? In short, American universities separate the study of economics from political science. Although some political scientists study "political economy," it is generally a field within international relations that concerns the practices of the International Monetary Fund, World Bank, or Basel Committee.[3] While authors are aware of the U.S. power that results from the use of the dollar as the primary currency in most international transactions, they do not examine the governing institutions of the United States.[4] Moreover, they are rarely concerned with the day-to-day practices of the banking and

[3] For a few examples from a very large body of literature, see Jeffrey A. Frieden, *Banking on the World: The Politics of American International Finance* (New York: Harper and Row, 1987); Benjamin J. Cohen, *In Whose Interest? International Banking and American Foreign Policy* (New Haven, CT: Yale University Press, 1986); Louis W. Pauly, *Who Elected the Bankers? Surveillance and Control in the World Economy* (Ithaca, NY: Cornell University Press, 1997); David Andrew Singer, *Regulating Capital: Setting Standards for the International Financial System* (Ithaca, NY: Cornell University Press, 2007); Tony Porter, *Globalization and Finance* (Malden, MA: Polity Press, 2005).

[4] For recent contributions, see Eric Helleiner and Jonathan Kirshner, eds., *The Future of the Dollar* (Ithaca, NY: Cornell University Press, 2009) and Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge:

financial services community. Sophisticated discussions of money, finance, and banking in the American academy are reserved for economics departments and business schools in which political discussions are secondary.

Therefore, for most people, the first of two chief obstacles is that this area requires an understanding of what money and finance are, along with what role they play in a capitalist economy. People need to know how money and credit are created and how they affect the prices of what we buy and sell. *Money* is defined as something accepted as a medium of exchange, a measure of value, or a means of payment, whereas *finance* is generally understood to be the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of funds.[5] These terms, however, are meaningless without operating within some kind of political institution or government. A person cannot spend U.S. dollars in France or yen in the United States. As a medium of exchange or store of value, paper dollars and metallic coins do not have any value once they are taken out of the jurisdiction of the country or countries that created them, unless someone is willing to exchange them for something that can be used locally. Therefore, money and the political institution that issues it are tightly connected; at the same time, political actors and the private sector sing the virtues of the independence of central banks and "keeping politics out" of the regulatory systems that finance needs to exist. These two realities cannot coexist.

The second chief obstacle to understanding why the government does what it does in the financial area comes from the organization of political science departments. Discussions of Congress, the presidency, international organizations, or federal agencies in Washington tend to be fragmented, and work that ties them together is usually conducted in policy-oriented, not

Cambridge University Press, 2002). This type of work on other countries exists within literature on comparative politics; however, oddly, little is written on the United States itself. For some important contributions within a body of literature more numerous than countries in the world, see Sylvia Maxfield, *Governing Capital: International Finance and Mexican Politics* (Ithaca, NY: Cornell University Press, 1990) and *Gatekeepers of Growth: The International Political Economy of Central Banking in Developing Countries* (Princeton, NJ: Princeton University Press, 1997); Jung-en Woo, *Race to the Swift: State and Finance in Korean Industrialization* (New York: Columbia University Press, 1991); Saori N. Katada, *Banking on Stability: Japan and the Cross-Pacific Dynamics of International Financial Crisis Management* (Ann Arbor: University of Michigan Press, 2001); Peter A. Hall and David Soskice, eds., *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (New York: Oxford University Press, 2001); Victor Shih, *Factions and Finance in China: Elite Conflict and Inflation* (New York: Cambridge University Press, 2008).

5 Merriam- Webster, *Webster's New Collegiate Dictionary* (Springfield, MA: G & C Merriam, 1981), 426, 736.

theoretical, settings. Therefore, different agencies and processes surrounding economic policy in the U.S. government are investigated by different bodies of literature in political science, and the research is reported in different academic journals. It is easy to demonstrate that certain industries make large campaign contributions or use high-priced lobbyists. However, to understand why the government has bailed out some banks and not others, or the auto industry and not the housing industry, also requires an understanding of agency capture, the policy process, and bureaucratic politics in a crisis. Many of the seminal books that explore the topic of bureaucratic politics have little to say about money and finance as an issue area.[6] Political scientists who investigate these different topics do not necessarily converse with each other, let alone economists. Nonetheless, these disparate areas of study in political science offer a great deal of insight into the politics behind money and banking in general, and in a crisis in particular.

All political scientists, however, do not have the same understanding of how the political process works. Graham Allison, in his early study of bureaucratic politics in an international crisis, offers three models that could be used to assess the strategic limitations and possibilities of government action.[7] In the first of these, "the government" acts as one coherent unit and does what it does in pursuit of a clear, observable goal. In the second model, the government is a loose alliance among semi-independent organizations, each operating according to its own internal logic or standard procedure. In the third model, the government functions in the bargaining among units, where each sees different aspects of the problem and advantages in different ways of resolving it.

Each of these three models operates within a unique American political culture. Gabriel Almond and Sydney Verba define *political culture* as the "attitudes toward the political system and its various parts, and attitudes toward the rule of the self in the system. It is a set of orientations toward a special set of social objects and processes."[8] Although Americans can be

[6] James Q. Wilson, *Bureaucracy: What Government Agencies Do and Why They Do It* (New York: Basic Books, 1989); Herbert A. Simon, *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organizations* (New York: Macmillan Company, 1957). For some exceptions to the rule that were unfortunately published prior to the 2008 crisis, see Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, and Jeffrey Worsham, *Other People's Money: Policy Change, Congress, and Bank Regulation* (Boulder, CO: Westview Press, 1997).

[7] Graham T. Allison, *Essence of Decision*; Graham T. Allison and Morton H. Halperin, "Bureaucratic Politics: A Paradigm and Some Policy Implications," *World Politics* 24 (Spring 1972), 40–79.

[8] Gabriel A. Almond and Sidney Verba, *The Civic Culture: Political Attitudes and Democracy in Five Nations* (Princeton, NJ: Princeton University Press, 1963), 4. Almond and

deeply divided on some issues, they also share some common views and expectations of government's role in the economy at all levels. Since the Great Depression, they have had high expectations for the federal government to play a role in managing the economy to promote full employment and lower inflation.[9] Yet the mix of public and private interests in the financial services industry reflects a unique political culture that distrusts any concentration of power in government and also distrusts the concentration of economic power in banks. For example, in one poll after the financial crisis in 2008 and prior to the passage of the Dodd-Frank reform bill, more than 40 percent of those polled responded that the government had gone too far in measures to fix the financial industry. At the same time, banks were viewed badly by 54 percent of poll respondents, and 60 percent had a negative opinion of insurance companies.[10]

When Allison's different models of policy analysis are embedded in understandings of American political culture, they reveal that the source of the financial community's political power is not to be found exclusively in its lobbying activities or even campaign contributions. Instead, it is deeply rooted in the historical and cultural way the banking system is woven into the patchwork of government agencies that regulate it, particularly the connection between home ownership and the American dream. Although lobbyists' campaign contributions certainly play a role in the immediate days when the system threatens to collapse or in the final days when a significant piece of legislation is being negotiated, the heads of agencies such as the Treasury Secretary and Federal Reserve Chair, as well as the chief officers of financial services firms such as Citibank and Goldman Sachs, negotiate directly with the president, members of Congress, and each other to protect the interests of their institutions, as well as to secure future profits.[11] At times the goals clash, and at times they are indistinguishable from each other.

Thus at different junctures in American history, distrust of both government and banks, as well as understandings of the appropriate degree of separation between the two, have played out in market and political

Verba referenced in Karen C. O'Connor and Larry J. Sabato, *American Government: Continuity and Change*, Election Update ed. (New York: Longman, 2000), 17.

9 Almond and Verba, *American Government: Continuity and Change*, 30.

10 Poll results available at http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4nQoiYaj2ag&pos=1 (accessed April 7, 2012).

11 See Tom Braithwaite, "Arkansas Sharpens Debate on Bank Risks," *Financial Times*, June 10, 2010, 3. See also Phil Mattingly, "Jamie Dimon Joins Final Round of Lobbying on Financial Bill," *Bloomberg Business Week*, May 27, 2010 (accessed May 28, 2010, site now discontinued).

arrangements surrounding finance. Susan Hoffman makes the point that one of the important contributions of the Populist movement to thinking within the Democratic Party at the end of the nineteenth century was the notion that monetary arrangements should be controlled by public policy, not just banks.[12] Advocates of one or another point of view or public philosophy created political institutions that embodied these philosophies, such as the Federal Reserve System, during those moments in history. Thus Americans constructed the regulatory framework within which the industry operated, infusing it with a particular purpose that can seem to contradict itself when placed alongside preexisting institutions, such as the Office of the Comptroller of the Currency (OCC) in the Treasury. Later ideologies such as monetarism helped to dismantle the regulatory system constructed after the Great Depression and designated a greater role for some existing political institutions that worked to advance monetarist goals, such as the Federal Reserve.

In this way, the interaction of markets, government bureaucracy, and politicians has created niches for all participants. Much of the politics among them has involved efforts to alter or preserve these distinctions.[13] The fragmented nature of the financial services area means that there are many places where policy discussions take place. As Allison's model of bureaucratic politics would predict, conflicting coalitions of regulators and interest groups compete to maintain their turf. Thus there are ample opportunities within the system to stop any radical change.[14]

What we learn from studies of politics complements what we learn from economics because the stakes are different. Economic actors seek profit as a goal. Politicians have electoral incentives to pursue their goals. Bureaucrats compete for governing authority, budgets, and personnel. The American distrust of both concentrated political authority and concentrated economic power has meant that in governing finance, American citizens have made various demands on their government at different historical epochs. In response, the government formed and maintained a dual set of political institutions at both the state and federal levels. The paradox is that the bureaucratic structure allows for industry to innovate in response to technological and other changes in the world economy; at the same time, its complexity opens up channels for industry to evade regulation, even by the agencies that were created to prevent this outcome. Thus the structure that results from history is its own source of instability going forward.

[12] Susan Hoffman, *Politics and Banking*, 111.
[13] Eisner, Worsham, and Ringquist, *Contemporary Regulatory Policy*, 95.
[14] Ibid., 115.

PUBLIC POLICY AND ECONOMICS IN AMERICAN GOVERNMENT

In their seminal study of eight centuries of financial crises, Carmen Reinhart and Kenneth Rogoff find that policymakers inevitably fall victim to the notion that "this-time-is-different," or the thinking that government policy and institutions have improved so much that a highly leveraged economy is not vulnerable to a crisis of confidence.[15] Why haven't government policies and institutions been able to prevent crises when they appear to have? Or, to put it another way, what is it about this government that contributes to financial instability? I find the answer to this question in the political system that interacts with the economic one, or in the arrangement of political institutions that permits the excessive borrowing to occur. Although this *time* may not be different, the American government *is* different insofar as its fragmented regulatory system presents many opportunities for regulatory arbitrage to occur. Fragmentation does not appear to pose an immediate threat to the stability of the system because the market innovation that accompanies it advances the opportunities for greater numbers of Americans to participate in economic activity, when properly applied.

Finance professionals use the term *regulatory arbitrage* to refer to the practice of taking advantage of differences in regulation that exist in two or more markets to earn greater profits. Arbitrage comes in many forms. In some instances, a firm evades regulation through financial engineering that exploits the difference between what is going on in the transaction and how it is treated under the regulations in place. Particularly in the world of banking, such regulatory arbitrage can be used to lower or avoid capital adequacy requirements by selecting safe assets to keep on the books of the financial institutions and riskier ones to transfer off of them. It can also be used to lower the risk that regulators attach to assets by transforming them through various forms of securitization. In other usages, the term can refer to situations in which the firm conducts business in a physical place where the regulations are lighter, albeit this latter use is sometimes distinguished as "regulator shopping."[16] When these practices are compounded, they can restructure the risk inherent in the entire banking system.

In examining the sources of financial instability that emanate from the political system, I demonstrate how the fragmentation of regulators in the United States offers endless opportunities for regulatory arbitrage of all types to occur. However, regulatory fragmentation and arbitrage are not

[15] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).
[16] See, for example, http://moneyterms.co.uk/regulatory-arbitrage/ (accessed November 14, 2011).

the only sources of instability from the political system; they both derive from the broader policy process among institutions that determine what the government does in this area, particularly in a crisis. As the process works, new financial instruments enter the marketplace and generate new winners and losers who, in turn, constitute new potential political pressure groups. The old institutional arrangements that created the regulations in the first place must respond. Rather than romanticizing previous arrangements that might have achieved a degree of stability for a given number of years, yet might have also excluded large segments of the population from access to credit, I attempt to show how the interaction of financial markets, regulations, and the political institutions that created them are in a constant state of flux.

This book's comprehensive examination of both markets and the agencies that make policies allows readers a view of the political playing field that encompasses the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Treasury, congressional committees, and presidential administrations – all of which are commonly left unexamined in economic treatments in any systematic way. Most economists are far from oblivious to the political world in which the market economy functions. However, those that take it into account either abstract away the institutional structure and bureaucratic politics among agencies or include it in parts.

For example, Hyman Minsky argues that the source of instability lies within the banking and regulatory system; he terms *banking* to be an "endogenous destabilizer."[17] Regulation is meant to control the destabilizing forces of banking and finance; however, regulation cannot prevent destabilization because banks adjust the composition of their portfolios in response to it. Although Minsky acknowledges that there are political, organizational, and competence reasons for separating the Federal Reserve System and the FDIC (in particular), he does not elaborate on them.[18] Likewise, Simon Johnson and James Kwak pay particular attention to the role of campaign contributions and agency capture in creating an environment where profits and bonuses in the industry are transformed into political power. They posit a "new American oligarchy," which is their term for a group that gains political power from economic power and then uses it for its own benefit.[19] Beyond the existence of large campaign contributions and regulatory capture, however, they do not offer any systemic analysis for

[17] Hyman P. Minsky, *Stabilizing an Unstable Economy* (New Haven, CT: Yale University Press, 1986), 250–53.
[18] Ibid., 57.
[19] Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon Books, 2010), 6.

how these activities play into politics in Washington, nor do they answer critics of such approaches in political science literature.[20]

I posit that the evolution of institutional arrangements among financial markets and the government have provided both a source of instability and innovation as each responds to developments in the other. Regulations channel competition in the industry that gives rise to interest groups representing market participants in distinct compartments within an industry. The interest groups feed back into the federal and state legislatures that provided the statutory justification for the regulation in the first place. Therefore, the paradox of bank regulation is not limited to the size of the financial sector relative to the rest of the economy or its disproportionate lobbying budgets and campaign contributions. The policy process, and thus the rewriting of regulation and assignment of tasks among political institutions, is in constant motion and subject to revision.

The Study of Public Policy

Policy is usually defined as the output of government institutions, or what the government does in any given area. In the financial area, that includes what the government spends to support financial institutions and how it taxes them. Policy also includes how the government regulates the activities of the banking, securities, and insurance industries, thus influencing their costs of doing business. The government's management of the macroeconomy to promote full employment and low inflation also affects the activities of these industries, because government spending and the size of the money supply have important consequences for interest rates. With the exception of monetary policy, each of the other domains explored in this book – fiscal and regulatory – operates at both the national and state level in the United States. In fact, state and local budgets constitute about 40 percent of total government spending.[21]

Although the policymaking process in any one of these three domains does not have clear boundaries or beginning and endpoints, in most areas it begins when individuals identify a problem and seek government action to resolve it. Identification of a problem in the financial system is somewhat different from other areas, however, because the problems are not immediately apparent to nonexperts. Knowing where, or how, the government

[20] See, for example, David Vogel, "The Power of Business in America: A Reappraisal," in *Kindred Strangers: The Uneasy Relationship between Politics and Business in America* (Princeton, NJ: Princeton University Press, 1996), 268–97.

[21] C. Randall Henning and Martin Kessler, "Fiscal Federalism: US History for Architects of Europe's Fiscal Union, Working Paper 12–1," in *Working Paper Series* (Washington, DC: Peterson Institute for International Economics, 2012), 22.

might be able to intervene is even more difficult without knowledge of how monetary and fiscal policy is spread across institutions of rule in the United States. As with other areas such as health care or the environment, policy can seem to progress incrementally or as a variation on what the government has done in the past. It can also emerge from political compromise among policymakers, from the actions of elites that flow downward, from new opportunities, or from individual preferences that get translated into collective outcomes that are not preferred by any individual.[22]

Most observers of the American policy process note that benefits accrue to the same group of elites with little change over time despite the existence of many interest groups. These areas of limited interference and deference to the judgment of experts have been called "policy monopolies," "iron triangles," "policy whirlpools," and "subsystem politics" at different times, depending on the author.[23] Initially, iron triangles were defined as the administrative agencies, legislative committees, and interest groups at a single level of government that formulated policy in a consensual manner.[24] Later, the concept was broadened to include journalists, researchers, and policy analysts who play an active role in disseminating policy ideas, as well as actors at all levels of government who are active in policy formation and implementation.[25] Analysts have pointed out that various degrees of conflict are inherent within advocacy coalitions. Moreover, a political actor's organizational affiliation (e.g., interest group, government agency, research institution, media outlet, etc.) does not always dictate that actor's position on an issue. Rather, Sabatier and Jenkins-Smith propose that agency officials, researchers, and journalists are all potential members of an advocacy coalition who may engage in some degree of coordinated activity in pursuit of their common policy objectives.[26]

[22] Charles E. Lindblom, *The Policy-Making Process* (Englewood Cliffs, NJ: Prentice-Hall, 1968). See also David B. Truman, *The Governmental Process: Political Interests and Public Opinion* (New York: Alfred A. Knopf, 1968). For more recent studies, see Thomas R. Dye, *Top Down Policymaking* (New York: Chatham House Publishers 2001); James E. Anderson, *Public Policymaking* (New York: Houghton Mifflin, 2000); Kenneth N. Bickers and John T. Williams, *Public Policy Analysis: A Political Economy Approach* (New York: Houghton Mifflin Company, 2001).

[23] Frank R. Baumgartner and Bryan D. Jones, *Agendas and Instability in American Politics* (Chicago: University of Chicago Press, 1993), 7. For an early statement of subsystem politics, see J. Leiper Freeman, *The Political Process: Executive, Bureau-Legislative Committee Relations*, rev. ed. (New York: Random House, 1965).

[24] Jeffrey M. Berry, *The New Liberalism: The Changing Power of Citizen Groups* (Washington, DC: Brookings, 1999), 80.

[25] Paul A. Sabatier and Hank C. Jenkins-Smith, "The Advocacy Coalition Framework: An Assessment," in *Theories of the Policy Process*, ed. Paul A. Sabatier (Boulder, CO: Westview Press, 1999), 119.

[26] Ibid., 127.