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Excerpt
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Part I

BANKING CRISES AND THE RISE OF GREAT EXPECTATIONS

1 INTRODUCTION

The financial crises that began in the United States and Europe in 2007 have had dramatic political consequences that have almost certainly not yet fully played out. In their aftermath, some affected Western societies have experienced levels of political instability and polarization that may be unprecedented in the post-war period. Many incumbent governments lost office after extensive and costly interventions that continue to shape public finances and expenditure, as well as public perceptions of the responsibilities and limits of government.

Increasingly, commentators point to worrying parallels with events in earlier, less stable times. Mainstream centre-right and centre-left parties are under pressure from 'populist' parties and candidates that have made substantial electoral inroads in some of the most consolidated democracies by selling a message of elite betrayal (Inglehart and Norris, 2016; Roth, 2017). Economic recovery from these crises has been relatively anaemic by historical standards and many voters are said to remain angry, distrustful of elites and, most alarmingly, of democratic political institutions more generally (Diamond, Plattner and Walker, 2016; Foa and Mounk, 2016, 2017).

In this book, we adopt a long historical perspective so as to consider whether some of these possible consequences of major banking crises are typical or unusual – and whether they are likely to be sustained. At present, we lack systematic knowledge of this kind. Economists and economic historians have provided long-run empirical analyses but have often largely ignored the politics of crises (Cassis, 2013; Jordà, Schularick and Taylor, 2016, 2015; Reinhart and Rogoff, 2009; Turner, 2014). Where they have addressed this topic, we show that they have generally overlooked how and why so much has changed over the course of a century and more (Funke, Schularick and Trebesch, 2016; Mian, Sufi and Trebbi, 2013). Political scientists, meanwhile, have mostly tended to focus on understanding the politics of recent banking crises or on the historical experiences of particular countries and regions (Bartels and Bermeo, 2014; Bermeo and Pontusson, 2012; Crespo-Tenorio, Jensen and Rosas, 2014; Haggard, 2000; Hellwig and Coffey, 2011; Kahler and Lake, 2013; MacIntyre, 2003; Pepinsky, 2012). What is lacking is a systematic assessment of how and why the politics of banking crises has evolved over the long run, and what this means for the ability of governments to manage such crises and their political consequences. This book seeks to fill some of this gap.

Our key message is that the policy and political aftermaths of crises have been transformed over the course of the past two centuries. In the last half-century, financial and political instability have become mutually reinforcing in a way they were not previously. Modern democracies, we argue, have generated powerful tendencies towards increasingly extensive and costly policy interventions. This policy trend is driven primarily by what we term ‘great expectations’: the heightened demand by large segments of contemporary society – roughly, the middle class – for policies that protect their wealth and incomes from the damage that banking crises can inflict. We focus in particular on the consequences of the rising material stake of this group in wealth protection – or what we call ‘the wealth effect’. As Atkinson and Brandolini have noted, much contemporary analysis of inequality focuses on the very rich and the very poor rather than ‘the forgotten middle’ (Atkinson and Brandolini, 2013, 75). This middle class plays a large part in our story because of its overwhelming political importance. As we discuss in Chapter 3, we view the middle class as ‘those [households] “comfortably” clear of being at-risk-of-poverty’ but not those households who have sufficient wealth not to need to work (Atkinson and Brandolini, 2013, 79). This now constitutes a majority of potential voters in many democracies with full adult enfranchisement.[1] Cross-country evidence also suggests that

[1] Atkinson and Brandolini offer various alternative measures of the middle class, including households with income between 75 per cent and 200 per cent of the national median income, which would include over 70 per cent of Nordic households, over half of British and American households, but under half of Mexican households (Atkinson and Brandolini, 2013, 78–81).

individuals in these households are significantly more likely than their poorer counterparts to vote in elections, maintaining pressure on governments to provide policies that broadly reflect their preferences.[2]

To be sure, the political science literature has a long tradition reaching back to Aristotle of arguing that the emergence of a middle class has been an important driver of democratization and of the effective functioning of democracy (Acemoglu and Robinson, 2006; Glassman, 1995; B. J. Moore, 1966; Mounk, 2018; North and Thomas, 1973). We emphasize a different causal mechanism, with less positive consequences. As middle-class demands for wealth stabilization policies have risen over time, they have tended to generate perverse consequences: increasing financial instability, more and deeper crises, and rising political disruption and dissatisfaction. As in Charles Dickens's famous novel of 1861, great expectations have generated great disappointments – with ongoing consequences for the nature and stability of democratic politics.

Our argument has four main novel elements. First, we underline the central importance of changing societal norms regarding government policy responsibilities, identifying a rising and effective societal demand 'from below' for the protection of relatively recently accumulated at-risk wealth. We contrast this with alternative though generally complementary accounts of how financial elites have captured policy 'from above'. Second, we show how mechanisms of democratic accountability have proven ineffective in limiting the propensity of governments to undertake bailouts during banking crises; indeed, they have increasingly done the opposite. Third, we argue that domestic political institutions have acquired increased importance for voters by shaping how governments intervene in crises. And fourth, we show that great expectations have ultimately fed both financial fragility and voter disappointment in government policy. In this way, our argument points to the macro-level consequences of what others have referred to as the 'financialization of everyday life' (e.g., Finlayson, 2009; Langley, 2009; Seabrooke, 2007).

2 Mahler, for example, finds that there is 'class bias' in voter turnout in most developed democracies (i.e., turnout increases as income rises). The average difference in turnout in thirteen countries in the late 1990s between the 1st and the 3rd–4th (averaged) income quintiles is −8.8 and −3.8 per cent respectively, confirming that middle-class voters are a large group between the relatively pro-redistribution poor and anti-redistribution rich (Mahler, 2008, 175–8). See also Franko, Kelly and Witko (2016); Mahler, Jesuit and Paradowski (2014).

Our analysis also points to a new possible 'policy trilemma'. The classical monetary policy trilemma highlighting the incompatibility of monetary policy autonomy, international financial integration, and exchange rate stability is well known. More recently, some have proposed a financial policy trilemma positing the incompatibility of national responsibility for financial policy, international financial integration and financial stability (Schoenmaker, 2013). Others have suggested a political trilemma for the global economy consisting of democracy, global economic integration and national sovereignty (Rodrik, 2012). We believe that our analysis identifies another trilemma by raising serious concerns about the ability of contemporary societies simultaneously to sustain democratic politics, rising financialization and financial stability over time.

This challenge is not primarily, or merely, driven by what many suggest is the central problem: the increasing political influence of the very wealthiest groups, especially in the United States (Bartels, 2008; Gilens, 2012; Hacker and Pierson, 2010; Johnson and Kwak, 2010). While we do not deny the importance of such 'elite capture' in some cases, large variations in its extent among countries and over time mean that it is unlikely to explain the systematic trends we identify. Instead, we argue, the challenge is arguably even more fundamental because the pressures we identify are rooted in the preferences of a much broader segment of contemporary society than the very wealthiest groups. Nevertheless, our argument has important implications for economic policy and for political strategies that might ameliorate both the damage that democracy is doing to financial stability and the damage that financial instability is doing to democracy.

In the rest of this chapter we proceed as follows. In the first section, we outline our claims about the rise of great expectations regarding the protection of middle-class wealth. In the second section, we preview our argument about its consequences for policy and politics during and after severe banking crises. We end by providing an outline of the remainder of this book.

1.1 The Rise of Great Expectations: From the Nineteenth Century to Today

To clarify our argument about the rise of great expectations, here we divide the period since the early nineteenth century in a very stylized manner into three main eras. This periodization links the evolution of societal wealth, and specifically that of the middle class, to changing household and voter expectations of policy and political outcomes. It is in the third of these eras that great expectations intensify.

In the first era, from the early nineteenth century until the Great Depression, there was a low level of effective societal demand for economic protection in general in most democracies. This expectation was reflected, for example, in the very low levels of social welfare provision by most states compared to the post-1945 era (Briggs, 1961). When banking crises struck in this period, a narrow group of elites connected to insolvent financial firms often requested government rescues, but, with little mass pressure to support this elite demand, elected governments for the most part could avoid bailouts of insolvent banks and their creditors without substantial political risk. Instead, as we explain below, during this period governments and central banks (where these existed) for the most part adopted policies that we describe as largely 'market-conforming', allowing many distressed banks and customers to fail. The disastrous consequences of such policies, notably in the United States and parts of Continental Europe, were demonstrated in the Great Depression. In the political aftermath of this economic calamity, political populism and extremism flourished, a number of democracies collapsed and the world descended into a decade-long spasm of extreme violence.

The second era, roughly dated from 1945 to 1970, was very much a response to the economic and political havoc wrought by the Great Depression and the wars that followed it. These events generated a much more widespread demand for economic stabilization and the establishment of welfare safety nets to provide social stability and thereby to underpin democratic politics. This demand is often summarized by the idea of 'embedded liberalism', which was supported by new Keynesian and social democratic ideas that explained the flaws of the economic orthodoxy of the previous era and provided new policy solutions (Blyth, 2002; Ikenberry, 1992; Polanyi, 1957; Ruggie, 1982). The priority given during this era to national economic stabilization, welfare transfers and the Bretton Woods pegged exchange rate system also required a substantial degree of financial repression in the form of regulatory controls on banking and capital flows. This had the important additional effect of avoiding the deep banking crises of the previous era. For many countries now commonly referred to as ‘advanced’, this system ensured approximately full employment, stable growth and underpinned the consolidation of democracy. For much of today’s emerging and developing world, this system permitted the pursuit of industrial development and nation-building, though with much less commitment to democratic norms.

The third and most recent era began around the mid-1970s and has been strongly associated with extensive financial liberalization and sharply rising societal wealth. Like the second era, it too emerged in part in response to the perceived problems generated by the dominant policy mix of the preceding era. New pro-market policy ideas expounded the benefits of moving away from macroeconomic activism and state-led development and towards the liberalization of markets, including for finance (Frieden, 2006; Helleiner, 1994). In part as a consequence of the financial liberalization that followed, banking crises re-emerged as an important policy challenge and as a growing threat to accumulating societal wealth from the mid-1970s.

It is important to recognize that wealth protection only became a clear policy priority in this third era. During the Bretton Woods era, governments were more strongly committed to the protection of employment income and development promotion than to the protection of wealth. Although, as noted above, financial stability was largely assured in practice during the early post-war decades, most democracies engaged to a substantial degree in the suppression and redistribution of wealth in this period. Post-war marginal tax rates on the very wealthiest peaked after the war and remained high until the 1970s (Scheve and Stasavage, 2016). High levels of wealth expropriation and redistribution in some early post-war banking crises in Western Europe by democratic governments also indicated the low priority given to wealth protection in this era (Scheidel, 2017, 126–73; Tribe, 2001). In most democracies, wealth inequality declined markedly until this time, in part because of these redistributive policies (Piketty and Zucman, 2015).

The shift towards more market-oriented financial policies from the 1970s would, it was hoped, restore more rapid growth. It certainly produced a marked and sustained rise in the value of housing and financial assets in many countries, as well as higher volatility of asset prices. Figure 1.1 shows how rapidly net private real wealth per adult increased in many advanced countries after 1970. As we show in more

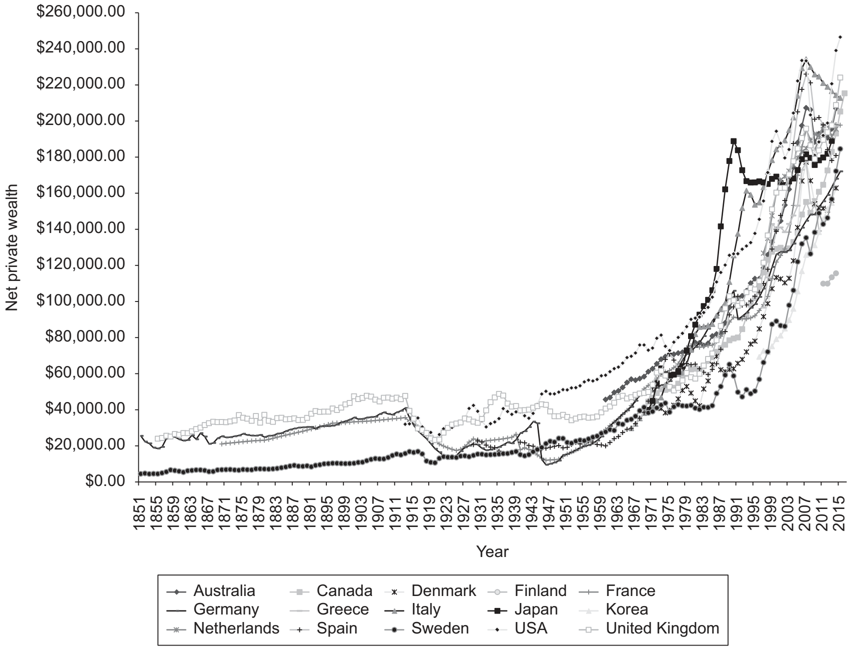

Figure 1.1: Real net private wealth per adult in selected countries, PPP exchange rates and constant 2016 US dollars, 1850–2016.
Source: World Wealth & Income Database (2017).

detail in later chapters, much of this wealth accumulation has been in the form of housing equity and pension assets.

For the middle classes in these countries in particular, this wealth has also been subject to rising market risk. This is because housing assets have become both more important and increasingly leveraged for this large group, and because in a number of countries there has been a shift from defined benefit pensions towards defined contribution schemes (Jordà, Schularick and Taylor, 2017; Piketty and Zucman, 2015). For this reason, and because in some countries this wealth may be needed to purchase increasingly marketized and more expensive services such as education and healthcare, wealth accumulation can be associated with rising anxiety for many households (Langley, 2009). As we show in Chapter 4, this rising anxiety has substantially increased the level of effective demand for government policies that protect this wealth.

We also highlight in later chapters similar trends occurring among households in emerging markets and developing countries, though at lower levels than those observed in more advanced democracies. As economic development and financial inclusion have progressed, a wider segment of the population in emerging markets and developing countries has become linked to the financial system. Bank deposits account for much of this exposure, and thus much household concern in these countries focuses on the limited fiscal capacity of governments to protect this form of wealth. Yet in a number of these countries the wealth portfolios of households of the upper middle class increasingly resemble those of average households in advanced economies. In addition to leveraged housing assets, pension assets held in defined contribution schemes are now prevalent in many parts of the emerging and developing world, most notably in Latin America and Eastern Europe (Brooks, 2005, 2007). Thus, we suggest, the expansion of financial inclusion and the growth in exposure to market-traded assets have also elevated the level of effective demand for wealth protection in emerging market and developing country democracies.

1.2 The Consequences of Great Expectations

This rising demand 'from below' for wealth protection has had crucial policy and political consequences in democracies that largely distinguish the third era from the first two. In policy terms, it has meant that when banking crises occur, governments are now subject to much stronger pressure from a wider political coalition to provide bailouts that prevent extensive wealth destruction. In political terms, it has meant that governments that fail to provide such bailouts, or that do so in a manner that is delayed or perceived as substantially redistributive, experience greater voter dissatisfaction and are thus more prone to lose office than in the past. We discuss both of these below.

1.2.1 The New Bailout Constituency and its Policy Impact

In a low-expectations world, such as that of our first era, the political constituency favouring minimal public intervention in crises generally prevailed over the constituency favouring public sector support of failing banks. This does not mean that governments and central banks never intervened in banking crises that occurred in the pre-1945 period. However, when they did, on average they did so in limited ways that can be described as roughly 'market-conforming'. The key policy recommendation in this tradition is often associated with Walter Bagehot, the famous nineteenth-century author and editor of *The Economist*, who argued that central banks should provide temporary loans at market interest rates in panics only to those banks deemed solvent and that would survive in normal circumstances (Bagehot, 1962 [1873]; Rosas, 2009, 6–7).

In the era of great expectations, more voters will expect governments to go well beyond such a minimalist policy stance during banking crises. As we elaborate in the next chapter, large parts of the middle class now favour intra-crisis policy interventions that minimize potential damage to their employment and their wealth. This is for three main reasons. The first two, following other scholars, we summarize as the financialization of wealth and the democratization of leverage. The third is what we identify as a growing *ex ante* government policy commitment to financial stabilization.

Financialization can be described as 'the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies' (Epstein, 2005, 3). A burgeoning literature has explored its wider social, economic and political implications.[3] The trading of assets in financial markets includes those associated with the pensions and other portfolio financial assets of most middle-class households in modern economies. This process has fostered a highly interdependent, networked financial system in which the level of 'systemic risk' – the risk that failure in one part of the system will propagate failure throughout the system – is substantially elevated. This financialization of wealth not only pertains to pensions and other financial investments; as we note below, financial risk also increasingly shapes housing markets and associated wealth. Although interconnections among banks were also present before the 1970s, their scope and magnitude were of a much smaller scale than in recent decades. Financialization increases the risk that allowing any significant financial firm to fail will generate a system-wide crisis that puts the value of a wide range of assets – and thus the interests of a large number of voters – in jeopardy.

The democratization of leverage, as Jordà, Schularick and Taylor explain, is associated with a long boom in mortgage lending to

[3] For one review, see van der Zwan (2014).