1 Reaching for the Bazooka

1.1 Misfiring the Economic Bazooka

Speaking before the Senate Banking Committee on July 15, 2008, US Treasury Secretary Henry Paulson petitioned Congress for the authority to use taxpayer funds to prevent America's mortgage giants Fannie Mae and Freddie Mac from collapsing.[1] The hearing addressed widespread homeowner mortgage defaults that had sent stock prices plummeting and investors fleeing.[2] Paulson argued that if investors came to understand that the government would not allow Fannie and Freddie to go under, stock prices would stabilize and a larger crisis could be averted. In a statement that would be repeated in news stories for years to come, Paulson speculated, "If you have a bazooka in your pocket and people know it, you probably won't have to use it."[3] In this instance, the "bazooka theory" failed: Paulson not only had to fire his bazooka shortly after acquiring it, but its blast proved grossly inadequate to calm market uncertainty and forestall what became the worst financial crisis to hit the United States since the Great Depression.[4] In spite of Paulson's newly acquired money and authority, investors dumped Fannie and Freddie shares, both organizations fell into government conservatorship, political

[1] Fannie Mae and Freddie Mac are privately held corporations created by the US Congress known as government-sponsored enterprises. Their purpose is to encourage credit in agriculture, home finance and education by reducing the risk of capital losses to investors. www.freddiemac.com.

[2] US Senate Committee on Banking, Housing and Urban Affairs Hearings (2008). "Recent Developments in U.S. Financial Markets and Regulatory Responses to Them," July 15. www.banking.senate.gov/hearings/recent-developments-in-us-financial-markets-and-regulatory-responses-to-them.

[3] C. Isidore (2008). "Paulson in hot seat over Fannie, Freddie," *CNN Money*, July 15. https://money.cnn.com/2008/07/15/news/economy/Freddie_Fannie_Senate.

[4] C. Barr (2008). "Fortune special report: Paulson readies the 'bazooka.'" *CNNMoney*, September 6. https://money.cnn.com/2008/09/06/news/economy/fannie_freddie_paulson.fortune/index.htm.

criticisms of bailouts grew louder and the whirlpool of uncertainty swirled ever faster.[5]

Given the very high-profile failure of Paulson's bazooka theory, one might have reasonably imagined that this crisis management strategy would have been discarded permanently. Quite to the contrary, central bankers in Argentina, Japan, the United Kingdom and continental Europe have all tried to shape market expectations by wielding their own economic bazookas.[6] Just four years after Paulson's metaphorical weapon failed to stop the oncoming economic crisis in the United States, European Central Bank (ECB) Chairman Mario Draghi cocked his own economic bazooka to fight a crisis in Europe. At the time, banking and sovereign debt crises had made it prohibitively expensive for several countries to raise revenue on international markets, and fears that contagion could threaten the integrity of the Eurozone and its common currency, the euro, were rising. The growing levels of perceived risk can be seen in the dramatic increases in interest rates that investors demanded from Greece, Ireland, Portugal, Spain and Italy (i.e., GIPSI countries) in order to buy their bonds. The differences in their rates relative to "safe" countries like Germany also reflect the relative cost of raising money (see Figure 1.1). To calm market expectations, reduce this risk premium for GIPSI countries and forestall further contagion, Draghi declared boldly, "The ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[7]

Draghi's bazooka consisted of the newly created Outright Monetary Transactions (OMT).[8] Under the OMT, the ECB can purchase limitless amounts of government-issued bonds from countries who are pursuing European Union (EU) economic adjustment programs and agree to pursue specified domestic economic policies.

Several factors suggest that Draghi's bazooka was less likely to succeed in calming market fears than Paulson's had been. Paulson had congressional approval and had put his money on the table; in short, he

[5] "Fire the bazooka: it's time to nationalize America's mortgage giants – and then to dismantle them" (2008). *The Economist*, August 28. www.economist.com/node/12009702; "America's mortgage giants: suffering a seizure" (2008). *The Economist*, September 8. www.economist.com/node/12078933.

[6] The capacity of central bankers to generate large amounts of official liquidity quickly makes this tool attractive.

[7] M. Draghi (2012). "Verbatim of the remarks made by Mario Draghi at the Global Investment Conference in London." *European Central Bank*, July 26. www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.

[8] "Press release: technical features of outright monetary transactions" (2012). *European Central Bank*, September 6. www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html.

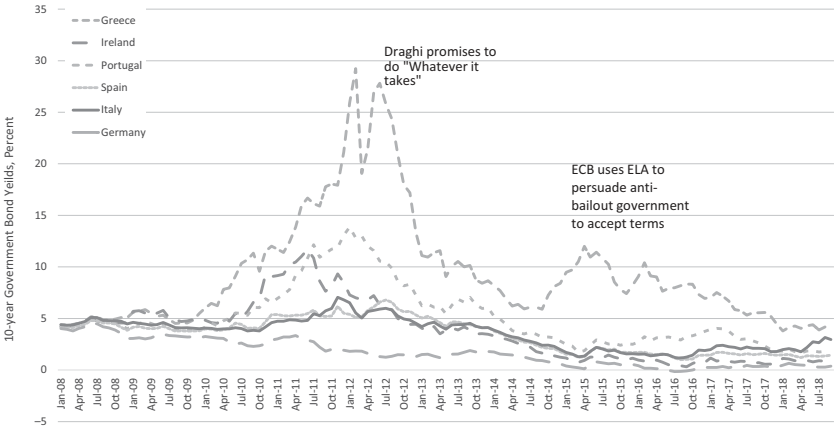

Figure 1.1 Intervention and investor risk in Europe.
Source: Organization for Economic Co-operation and Development, Long-Term Government Bond Yields: 10-year: Main (Including Benchmark) for Germany, Italy, Spain, Portugal, Ireland and Greece, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/, December 17, 2018.

had both the authority and the capacity to act. Draghi, on the other hand, faced political opposition and his authority to act was being challenged by Europe's principal financier, Germany. Draghi also kept his bazooka in his pocket. Indeed, to date, no one has taken any money from the OMT. Yet, Draghi's contested and untested promise worked while Paulson's bazooka failed. As shown in Figure 1.1, Draghi's announcement was followed by a significant drop in interest rates in Greece and across Europe. By 2014, countries that had been "bailed out" were once again able to raise money on international financial markets at affordable rates. With their return to global financial markets, the second phase of the European economic crisis came to a successful – if fleeting – end.

Uncertainty returned to Europe in 2015 when a newly elected, anti-austerity government in Greece challenged the repayment terms for its debt and raised the prospect of exiting from the EU. The ECB responded with a two-part strategy designed to bolster market activity in the Euro-zone and reduce specific-actor risk. First, it instituted a broad-based monetary stimulus program that included the use of negative interest rates in its deposit facility, expanded targeted longer-term refinancing operations designed to promote bank lending, and an asset purchase

program that was similar to the quantitative easing (QE) programs adopted by Japan, the United States and the United Kingdom.[9] It also committed to communicating its intentions about these and other initiatives through a forward guidance program. Second, the ECB reduced specific-actor risk by compelling wayward states countries to change their behavior. For example, the ECB governing council manipulated collateral requirements and the amount of funding available to Greek banks through the emergency liquidity assistance (ELA) program to persuade Greece's anti-austerity government to accept the terms of a third bailout.[10] The ECB used a similar strategy to compel Ireland, Spain, Italy and Cyprus to alter their economic policies. The US Treasury and Federal Reserve similarly sought to restore market confidence by targeting particular companies they deemed to be "too big to fail." These actions generated significant backlashes from the private sector (many of whom interpreted bailouts as indicators of failure rather than as safety nets) private citizens (many of whom considered bailouts to be illegitimate), and national politicians. Consequently, many governments and firms only accepted the bailouts under duress.

This activism by the Federal Reserve, ECB and other economic policymakers and the varying levels of their effectiveness are difficult to explain using prominent theories of political economy which, before the crises, idealized central banks as apolitical, autonomous entities whose principal task was to fight inflation. From this traditional perspective, the primary political role of an independent central bank is to increase the credibility of a country's inflation-fighting commitments by limiting the ability of national politicians to forsake their inflation-fighting promises when political or economic circumstances change (e.g., to solve a time-inconsistency problem).[11] With a few exceptions, debates about the politics of central banking focused on the degree of central bank autonomy from political influence, the effects of transparency in central bank decision-making, or the ability of

[9] "Monetary policy decisions" (2018). *European Central Bank*. www.ecb.europa.eu/mopo/decisions/html/index.en.html; B. Fawley & C. Neely (2013). "Four Stories of Quantitative Easing." *Federal Reserve Bank of St. Louis Review* 95(1), 51–88; "Japan's quantitative easing: a bigger bazooka" (2014). *The Economist*, October 31. www.economist.com/blogs/banyan/2014/10/japans-quantitative-easing.

[10] J. Kanter & N. Kitsantons (2015). "E.C.B. agrees to extend lifeline to Athens." *New York Times*, June 19. www.nytimes.com/2015/06/20/business/international/ecb-greece-debt-meeting.html; "Greece's creditors allow a bit more money to flow" (2015). *The Economist*, July 16. www.economist.com/blogs/freeexchange/2015/07/ecb-and-greek-banks.

[11] For a review of central bank independence literature before the 2008 financial crisis, see: M. Arnone, B. J. Laurens, J.-F. Segalotto & M. Sommer (2007). "Central Bank Autonomy: Lessons from Global Trends." IMF Working Paper, WP/07/88.

independent central banks and fixed-exchange-rate regimes to serve as complements or substitutes in the fight against inflation.[12] The varying successes and failures of national governments in shaping market behavior are also puzzling for theories of international political economy which emphasize the disciplining effects of markets on economic policy and argue that dependence on foreign capital should lead to a convergence of economic policies that reflect the preferences of investors.[13]

In the aftermath of the recent crisis, political economy debates have swung from idealizing central bankers as apolitical technocrats to recasting them as strategic political actors. An increasing number of memoires and personal accounts provide vivid details of the roles that specific individuals have played in shaping economic policy.[14] Other research emphasizes the capacity of central bankers to alter the rules of the game

[12] C. Crowe & E. Meade (2008). "Central Bank Independence and Transparency: Evolution and Effectiveness." IMF Working Paper, 08/119; P. Keefer & D. Stasavage (2003). "The Limits of Delegation: Veto Players, Central Bank Independence, and the Credibility of Monetary Policy." *American Political Science Review* 97(3), 407–423.

[13] W. R. Clark & M. Hallerberg (2000). "Mobile Capital, Domestic Institutions, and Electorally Inducted Monetary and Fiscal Policy." *American Political Science Review* 94 (2), 323–346; W. R. Clark, U. N. Reichert, S. L. Lomas & K. L. Parker (1998). "International and Domestic Constraints on Political Business Cycles in OECD Economies." *International Organization* 52(1), 87–120; W. R. Clark (2002). "Partisan and Electoral Motivations and the Choice of Monetary Institutions under Fully Mobile Capital." *International Organization* 52(1), 725–749; D. Andrews (1994). "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations." *International Studies Quarterly* 38(2), 193–218; B. Cohen (2000). *The Geography of Money*. Ithaca: Cornel University Press; J. Frieden & R. Rogowski (1996). "The Impact of the International Political Economy on National Policies: An Analytical Overview." In *International Organization and Domestic Politics*, eds. R. Keohane & H. Milner. New York: Cambridge University Press, pp. 25–47; S. Maxfield (1998). "Effects of International Portfolio Flows on Government Policy Choice." In *Capital Flows and Financial Crises*, ed. M. Kahler. Ithaca: Cornell University Press, pp. 69–92; B. Stallings (1992). "International Influence on Economic Policy: Debt, Stabilization, and Structural Reform." In *The Politics of Economic Adjustment: International Constraints, Distributive Conflicts and the State*, eds. S. Haggard & R. Kaufman. Princeton: Princeton University Press, pp. 41–88; G. Shambaugh (2004). "The Power of Money: Private Capital and Policy Preferences in Newly Emerging Market Economies." *American Journal of Political Science* 48(2), 281–295; G. Shambaugh & E. Shen (2018). "A Clear Advantage: The Benefits of Transparency to Crisis Recovery." *European Journal of Political Economy* 55, 391–416.

[14] L. Ahamed (2009). *Lords of Finance: The Bankers Who Broke the World*. New York: Penguin Group; C. Bastasin (2015). *Saving Europe: Anatomy of a Dream*. Washington, DC: Brookings Institution; B. Bernanke (2015). *The Courage to Act: A Memoir of a Crisis and Its Aftermath*. New York: W. W. Norton; N. Irwin (2014). *The Alchemists: Three Central Bankers and a World on Fire*. New York: Penguin Group; T. Geithner (2014). *Stress Test: Reflections on Financial Crises*. New York: Crown Publishers; A. Greenspan (2007). *The Age of Turbulence: Adventures in a New World*. New York: Penguin Group; H. Paulson (2010). *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*. New York: Hachette Book Group.

in domestic and international finance.[15] Scholars like Bruce Hall emphasize the extraordinary power that central bankers derive from their status functions. These include the authority to create and destroy money and to delineate the roles and functions that individual actors play in the global economy.[16] Some blame these unelected technocrats for pursuing policies that enabled the crises to take place. Others criticize them for the inequities generated by their crisis-response and post-crisis policies.[17]

The recent financial crises have inspired a wide range of productive research on the roles that central bankers and other senior economic policymakers play in shaping economic policy, yet even today central bankers chafe at the suggestion that they may not be apolitical. Perhaps as a result, we often fail to appreciate their responsiveness to changing political as well as economic circumstances. As reflected in the chapters to follow, many politicians and citizens alike express surprise when "politically independent" central bankers promote particular policy agendas and help national leaders circumvent their critics. Many are also angered when these unelected technocrats compel national governments to accept conditional assistance, impose austerity or shift the burden of bad investment decisions to taxpayers.

At the same time, many place undue confidence in the ability of these technocrats and the economic institutions they manage to shield them from risk. They mistakenly conflate the delegation of economic policymaking authority and declarations of fidelity to experts and institutions with actual changes in political and market behaviors. Many continue to assume these technocrats and the institutions they manage are all-powerful and discount the frequency with which their authorities are contested or rescinded. Many also continue to underestimate the extent to which the power that these economic policymakers and institutions exert over market behavior is contingent on the degree to which national politicians are willing to defer to their recommendations and are willing and able to implement supporting legislation. Consequently, many of us are often uncertain about their motives, yet are perplexed by their failures and concerned about the inequities of their successes.

[15] B. Hall (2010). *Central Banking as Global Governance: Constructing Financial Credibility*. Cambridge: Cambridge University Press.
[16] Ibid.
[17] A. Bowman et al. (2013). "Central Bank-Led Capitalism?" *Seattle University Library Review* 36, 455; L. Jacobs & D. King (2016). *Fed Power: How Finance Wins*. Oxford: Oxford University Press; J. Kirchner (2002). *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*. Ithaca: Cornell University Press.

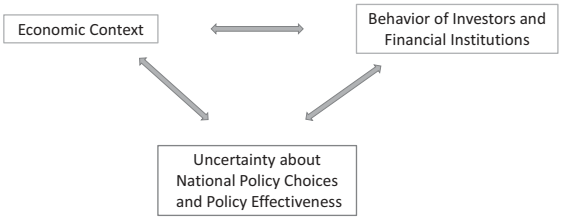

Figure 1.2 The dynamics of intervention.

Lessons from Argentina, the United States and Europe suggest that we need not be perplexed. Variations in the degree to which authority over economic policy is accepted or contested, policy deference is granted or demanded, and the capacity to implement and sustain supporting legislation is high or low generate distinct patterns of political behavior and market outcomes that persist over time in different contexts across Argentina, the United States and Europe. Understanding these patterns enables us to understand the roles these actors play and the impacts they are likely to have on policy and markets in the future.

1.2 The Argument in Brief

The rise of private-sector liquidity as a dominant component in global liquidity markets has created a web of financial interdependence that links the fates of investors, financial institutions and national governments to one another.[18] As demonstrated by the recent crises, the behaviors of each of these actors can generate uncertainties that motivate shifts in capital flows, alter the availability and cost of credit, and motivate changes in financial asset and property prices with significant consequences for all. I argue that this connectivity creates opportunities for the exercise of second-order power because it means that the behaviors of investors, financial institutions and governments are mediated by their expectations about what the others will do and what the consequences of their actions will be (see Figure 1.2).[19]

[18] As defined in Chapter 2, private-sector liquidity is generated by investors engaged in processes that include cross-border banking, interbank and interfirm lending, portfolio flows and investment funds, trading in primary and secondary bond and security markets and the exchange of over-the-counter derivatives and other financial instruments. See: J. P. Landau, ed. (2011). "Global Liquidity – Concept, Measurement and Policy Implications." *Committee on the Global Financial System (CGFS) Papers, No. 45: Bank of France, Bank for International Settlements*.

[19] R. Keohane & J. Nye (1977). *Power and Interdependence*. New York: Longman.

Under the right conditions, economic policymakers can alter the behaviors of investors and financial institutions by reducing political and policy uncertainties. They can reduce uncertainty about how national governments are likely to act (i.e., political uncertainty) by increasing or decreasing policy-making flexibility and by supplementing or limiting policy options. They can reduce uncertainty about policy outcomes (i.e., policy uncertainty) by validating specific policies or policy agendas, altering market conditions and mitigating specific-actor risks. I define this as the exercise of second-order power because the ability of economic policymakers to change market behavior is a second-order effect of their power to reduce political and policy uncertainty.

The relationships among political uncertainty, policy uncertainty and risk under different economic conditions can be represented in stylized form by the Risk Intervention Curve (RIC). The level of political and policy uncertainty in a particular country is a function of the pulling and hauling among national politicians and economic policymakers over economic policy. It varies based on the degree to which authority over economic policy is contested, the degree to which national politicians defer to economic policymakers and extant policy agreements, and the degree to which these politicians have the will and capacity to implement supporting legislation as needed. The ability of central bankers and other economic policymakers to alter these uncertainties and shift their countries' positions along the RIC (e.g., thereby to lower investor risk, attract or retain capital, increase the availability and lower the cost of credit, and manage inflation) varies with their ability to secure the authority, deference and implementation capacity needed to shape economic policy. As discussed in detail in Chapter 2, variations in authority, deference and implementation capacity generate six patterns of political behavior and market outcomes. These patterns reappear consistently over the past thirty years of economic policymaking in Argentina, the United States and Europe.

The interaction among markets, national governments and market actors is dynamic. Changes in market conditions can alter the ability of economic policymakers to secure the authority, deference and implementation capacity needed to shape economic policy. At the same time, economic policymakers often attempt to loosen or tighten general market conditions to incentivize investors and financial institutions to alter their behaviors. They also often attempt to change market uncertainties by assisting firms and countries in distress or by compelling them to change undesirable behaviors.

I analyze these interactions through a three-step process of: (1) specifying the relationships among political uncertainty, policy uncertainty and investor risk under different economic conditions; (2) specifying

strategies for reducing risk by managing political and policy uncertainties; and (3) specifying conditions under which economic policymakers are likely to succeed in implementing these policies and shaping market behavior.

1.2.1 Political Uncertainty, Policy Uncertainty and Risk

I begin by developing a model of investor risk based on political uncertainty under different economic conditions that I call the Risk Intervention Curve (RIC). The RIC builds on insights from recent research by Andrew MacIntyre who posits that the policy preferences of investors reflect a trade-off between policy constraint and policy flexibility.[20] *Ceteris paribus*, policy constraint – resulting from checks and balances in the policy-making process, institutional commitments and other factors that limit the discretion of national politicians to shape economic policy – improves policy predictability and the credibility of policy commitments. Yet, if these constraints are too severe, they can limit the ability of national governments to adapt and respond to changing economic conditions. Alternatively, giving national politicians a freer hand to manage economic policy by reducing the number of veto players and institutional constraints in the policy-making process increases policy adaptability. Yet, if policy flexibility is too high, it could reduce the predictability of future policy decisions and decrease the reliability of policy commitments. Consequently, the relationship between policy flexibility and risk is expected to be concave upward. High levels of risk are associated with both high levels of policy constraint and high levels of policy flexibility; lower levels of risk are associated with a midrange between the two extremes (see Figure 1.3). With the caveat that the risk tolerance of investors can vary widely, the comfort level of a stylized investor can be included to suggest a comfort zone of policy flexibility for a generic investor.

The RIC adds dynamism to existing models that link policy flexibility and investor risk by recognizing that this relationship is context specific. The RIC presumes, for example, that risk and policy constraint will be negatively correlated in inflationary environments in which investors place a premium on the credibility of politicians' commitments to fiscal discipline. In such circumstances, the trade-off between flexibility and risk will become skewed, with a relatively higher level of risk associated with policy flexibility and a relatively lower level of risk associated with

[20] See Chapter 2 for a discussion of MacIntyre's veto player model of investor preferences. A. MacIntyre (2001). "Institutions and Investors: The Politics of the Economic Crisis in South East Asia." *International Organization* 55(1), 81–122.

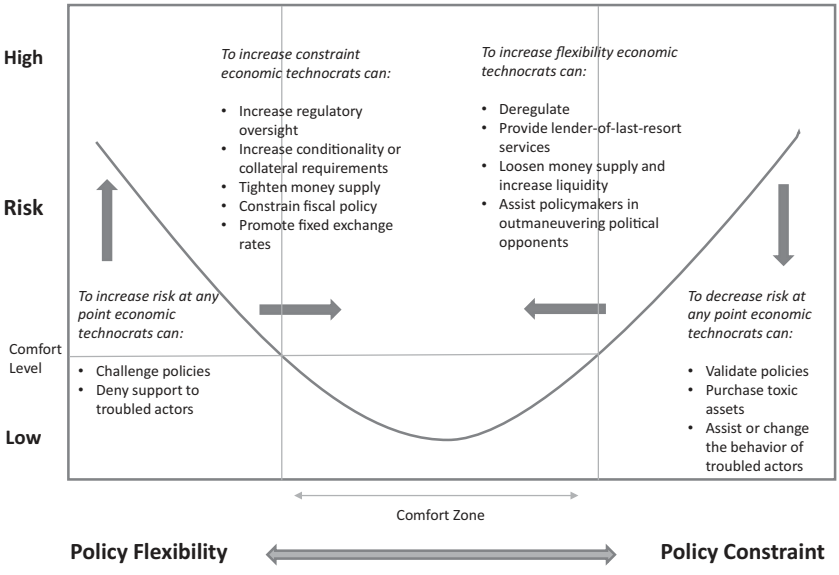

Figure 1.3 The risk intervention curve.

policy constraint. In contrast, risk and policy constraint are expected to be positively correlated in circumstances where private capital is scarce or prohibitively expensive and investors are uncertain about whether the government will step in as a lender of last resort. Consequently, in periods of capital scarcity or other phenomena in which government intervention is desired, the RIC will be skewed in the opposite direction, with a relatively lower level of risk associated with policy flexibility and a relatively higher level of risk associated with policy constraint.

1.2.2 Strategies for Reducing Risk by Managing Political and Policy Uncertainties

The RIC also adds agency to existing models that link policy flexibility and investor risk by treating economic policymakers and national politicians as strategic actors who often attempt to anticipate, respond to and shape investor expectations. I specify two dominant strategies that economic policymakers can use to reduce investor risk. The first involves reducing political uncertainty by increasing or decreasing the likelihood of government intervention, expanding or limiting available policy options, or enabling or constraining the policy discretion of national politicians over economic policy. Economic policymakers can increase