Oracles, Heroes or Villains

IMF Managing Director Christine Lagarde declared central bankers and finance ministers to be the heroes of recent economic crises for taking corrective action while national politicians squabbled. What enabled them to do so? In the wake of Brexit, chaotic trade policies in the United States, and resurgent nationalism around the world, national politicians are quarrelling again, meanwhile the markets are roiling. Can we again depend on economic technocrats to save the day for these national politicians and the rest of us? What happens if they fail or, perhaps worse, go too far? In this timely book, Shambaugh answers these question using recent economic crises in Argentina, the United States and Europe as case studies for analysing the intersections of power, politics and markets. By specifying the interactions between political uncertainty, market intervention, and investor risk, Shambaugh predicts how economic technocrats manage market behaviour by shifting expectations regarding what national politicians will do and whether their policies will be effective.

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Economic Policymakers, National Politicians and the Power to Shape Markets

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I dedicate this book to Jacqui, Emily and Natalie.

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Adults in the Room

In September of 2018, reports that senior appointees in the White House were attempting to shape the content of national policy provoked "volcanic" reactions by President Trump including accusations of "treason" and an internal hunt for disloyal personnel in the West Wing.[1] The accounts detailed by Bob Woodward in *Fear: Trump in the White House*[2] and by an unknown senior member of the president's staff in an editorial provocatively titled, "I Am Part of the Resistance Inside the Trump Administration," describe a chaotic policy environment in which a president demands complete deference from his staff yet is surrounded by many "senior officials in his own administration [who] are working diligently from within to frustrate parts of his agenda and his worst inclinations."[3] The anonymous editorial writer describes efforts by senior members of President Trump's staff to make sure that Russian President Vladimir Putin is held accountable for poisoning a former Russian spy in Great Britain and for offenses committed against the United States despite President Trump's reluctance to do so.[4] Woodward, in turn, recounts an instance when, following a phone call in which President Trump raised the possibility of assassinating Syrian President Bashar al-Assad, US Secretary of Defense James Mattis told a senior aide, "We're not going to do any of that. We're going to be much more measured."[5]

[1] H. Jackson, K. Welker & P. Alexander (2018). "On the hunt for a betrayer, a 'volcanic' Trump lashes out." *NBC News*, September 6. www.nbcnews.com/politics/donald-trump/hunt-betrayer-volcanic-trump-lashes-out-n906941.
[2] B. Woodward (2018). *Fear: Trump in the White House*. New York: Simon & Schuster.
[3] "I am part of the resistance inside the Trump administration" (2018). *New York Times*, September 5. www.nytimes.com/2018/09/05/opinion/trump-white-house-anonymous-resistance.html.
[4] Ibid.
[5] P. Rucker & R. Costa (2018). "Bob Woodward's new book reveals a 'nervous breakdown' of Trump's presidency." *The Washington Post*. September 4. www.washingtonpost.com/politics/

Some of the actions described appear truly extraordinary – such as removing a piece of legislation from the President's desk so that it remained unsigned – yet interventions by "adults in the room" who take advantage of their positions to constrain the policies of overly exuberant politicians are not specific to the Trump administration or to the United States.[6] He is neither the first nor will he be the last leader of a democratic country who demands deference from his advisors, appoints loyalists and fires critics, interprets his authority broadly and attempts to bypass or disrupt institutional constraints on his actions. Nor is his administration the only one in which appointees and senior civil servants actively seek to constrain as well as bolster the executive's agenda, even when doing so involves taking actions that extend beyond the traditional bounds of their authority.[7]

The key issue raised by these revelations is not that senior appointees are trying to shape the policy-making process or that they occasionally take extraordinary actions to do so. These behaviors are relatively common.[8] Rather, the essential unanswered questions are about their impact: When and under what circumstances can unelected senior policymakers affect the contents and consequences of national policy decisions?

Economic Crises as Laboratories

Contemporary commentators offer immediate responses to these questions, but their assessments are often limited by a focus on current policies whose consequences cannot yet be fully known.[9] To better

bob-woodwards-new-book-reveals-a-nervous-breakdown-of-trumps-presidency/2018/09/04/b27a389e-ac60-11e8-a8d7-0f63ab8b1370_story.html?utm_term=.c94e2b6578e5.

6 Examples include the Madisonian division of authority among the executive, legislative and judicial branches of the US government.

7 G. Shambaugh & P. Weinstein (2016). *The Art of Policymaking: Tools, Techniques, and Processes in the Modern Executive Branch*. Washington, DC: CQ Press.

8 Unapproved leaks like those to Bob Woodward and *The New York Times*, defined as information that is provided to people outside of the formal decision-making apparatus without the knowledge or consent of the executive, are relatively common across US administrations when members of the policy-making community feel that their view or concern is not being presented to or considered by the President. Shambaugh & Weinstein, *Art of Policymaking*, p. 270.

9 Examples include: P. Musgrave (2017). "President Trump should stop tweeting. Now." *Washington Post*, June 8. www.washingtonpost.com/posteverything/wp/2017/06/08/president-trump-should-stop-tweeting-now/?utm_term=.937145a1c67f; K. Vanden Heuvel (2018). "Forget the Trump circus. Focus on his ruinous policies." *Washington Post*, September 11. www.washingtonpost.com/opinions/forget-the-trump-circus-focus-instead-on-his-ruinous-policies/2018/09/11/d8dcfed2-b51a-11e8-94eb-3bd52dfe917b_story.html?utm_term=.0132a2ee869d; J. Scarborough (2018). "Woodward's '*Fear*' is

understand these dynamics, I examine the role of senior unelected policy experts in the formulation and implementation of economic policy in Argentina, the United States and Europe over the past thirty years. Their collective experiences provide a laboratory for analyzing how changing power dynamics among national politicians and senior technocrats affect the contents and consequences of economic policy in different contexts.

The US Federal Reserve Chairs Alan Greenspan, Ben Bernanke and Janet Yellen, European Central Bank Presidents Jean-Claude Trichet and Mario Draghi, and Argentine Ministers of the Economy Domingo Cavallo and Roberto Lavagna are widely acknowledged as having played key roles in shaping economic policy and taming market behavior before, during and after the economic crises that hit Argentina in the 1990s, the United States in 2007, and Europe in 2010. Some of these technocrats interpreted their mandates narrowly and remained deferential to political leaders, while others took a broader view and were willing to do "whatever it takes" to manage market expectations and achieve broader policy goals. Some succeeded in securing the authority, deference and political support necessary to shape national economic policy. Others had their authority curtailed and their policies ignored. Still others were left without sufficient political backing to generate or sustain supporting legislation. Consequently, as is playing out in the Trump administration today, some technocrats succeeded in reducing policy uncertainty and changing market behavior with mere words, while others manipulated extraordinary incentives and threats to little avail.

Managing Director of the International Monetary Fund Christine Lagarde proclaimed central bankers to be the heroes of the recent crises because they took corrective action while political leaders squabbled.[10] I argue that under the right conditions, central bankers, treasury secretaries and finance ministers (a group that I will refer to as "economic technocrats" or "economic policymakers") can manage market expectations and behavior by reducing uncertainty about how national governments are likely to respond to changing circumstances and whether their chosen policies will be effective.

The adage that "markets abhor uncertainty" is suggestive, but not very informative. I increase its utility by specifying the relationships among

depressing – and heartening." *Washington Post*, September 5. www.washingtonpost.com/opinions/woodwards-fear-is-damning-depressing–and-heartening/2018/09/05/0a7ee502-b149-11e8-aed9-001309990777_story.html?utm_term=.9473a8accbfc.

10 C. Lagarde (2012). "Promises to keep: the policy actions needed to secure global recovery," interview with K. Ryssdal. *American Public Media*, *Marketplace*, September 24. www.marketplace.org/topics/world/european-debt-crisis/imfs-christine-lagarde-urges-action-fiscal-cliff-euro-crisis.

investor risk, political uncertainty and different types of government intervention in the economy using what I call the Risk Intervention Curve (RIC). Economic policymakers can reduce political uncertainty by altering the economic policy options available to national politicians. They can also increase expectations that desired outcomes will be achieved by validating the chosen policies (i.e., reducing policy risk), altering general market conditions (i.e., reducing market risk), and assisting financial institutions and countries in distress or compelling them to alter their behavior (i.e., reducing specific actor risk).

The ability of economic technocrats to reduce these uncertainties and risks varies with their ability to assert authority over economic policy, to generate deference from national politicians to their policies and to standing institutional obligations, and to secure supporting legislation as needed. The constitutive power dynamics among economic technocrats and national politicians are reflected in (1) the degree to which the locus of authority over economic policy is accepted or contested, (2) the degree to which national politicians defer to or demand deference from economic policymakers and conform to or shirk their responsibilities to extant agreements, and (3) the degree to which political leaders have the will and capacity to implement supporting legislation. Variations in authority, deference and implementation capacity generate six distinct patterns of political and market behavior that have reoccurred repeatedly in Argentina, the United States and Europe over the past thirty years.

Oracles, Heroes or Villains?

In the 1990s and early 2000s, Federal Reserve Chairman Alan Greenspan was lauded as an oracle who understood the complex dynamics of modern financial markets. Federal Reserve Chairman Paul Volcker is renowned as the hero who slayed inflation and brought the United States out of the economic doldrums of the 1970s; in parallel, Argentine Finance Minister Domingo Cavallo is the hero who slayed inflation and transformed Argentina from a basket case into a poster child of economic development in the 1990s. European Central Bank President Mario Draghi is the hero who restored investors' confidence in Europe in 2012 by asserting he would do "everything it takes" to preserve the euro. Federal Reserve Chairman Ben Bernanke was anointed by *Time* magazine as the "Person of the Year" in 2009 for using his mastery to minimize its severity.

At the same time, many would-be oracles and heroes have failed. Some central bankers, finance ministers and treasury secretaries secured the power to shape policy, yet made poor decisions. In April and July of 2011, for example, Jean-Claude Trichet infamously misread market expectations and raised interest rates despite high levels of policy uncertainty generated by Moody's decision to downgrade Portugal's debt to junk status and the stalled negotiations regarding a bailout for Greece.[11] Trichet's authority to raise rates was not questioned, but raising interest rates unsettled markets by compounding growing uncertainties across Europe about the ECB's willingness to recognize and respond to economic downturns in member countries. This likely, stalled growth and worsened the debt crisis.[12] Other technocrats had compelling policy ideas yet failed to acquire the right balance of authority, deference and political support needed to shape, validate or sustain desired economic policies. Consequently, they were unable to reduce political or policy uncertainty and failed to reduce investors' perceptions of risk. Misguided and failed interventions have generated asset bubbles and exuberant spending; they have also stalled economic growth, triggered bank runs and sparked capital flight.

Furthermore, even when central bankers and other economic policymakers achieve their objectives, the benefits of their actions are often not evenly distributed across society. Monetary policy is a blunt instrument. It can reinvigorate economic systems, but it is a poor substitute for legislative policy when it comes to allocating benefits. Aggregate indicators of economic recovery and the successful recapitalization of the financial sector are little solace to those who remain unemployed or feel like they have been left behind. Consequently, even some technocrats who were once lauded as oracles and heroes – including both Alan Greenspan[13] and Domingo Cavallo – have fallen from grace. Some were summarily dismissed by disgruntled politicians. Others had their authorities reduced or were simply ignored or not given the supporting legislation needed for their policies to succeed. Still others have become reviled as villains who are blamed for the crises and the inequities of the post-crisis recoveries. In addition, seemingly impervious institutions – like the Argentine currency board, the euro, the European Union, and the Federal Reserve – have been chastised. Rather than being all-powerful, their impacts on political behavior and market expectations have been

[11] J. Kollewe (2011). "ECB raises interest rates despite debt crisis." *The Guardian*, July 7. www.theguardian.com/business/2011/jul/07/ebc-raise-interest-rates-debt-crisis; "ECB raises interest rates to 1.5%" (2011). *The Financial Times*, July 7. www.ft.com/content/a4f92816-a87f-11e0-8a97-00144feabdc0.

[12] J. Surowiecki (2011). "Europe's big mistake." *The New Yorker*, September 5. www.newyorker.com/magazine/2011/09/05/europes-big-mistake.

[13] S. Mallaby (2010). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York: Bloomsbury Publishing.

revealed to be highly contingent on shifts in the degrees of authority, deference and political support they command.

Today, in the face of continued economic policy uncertainty generated by bickering among national politicians and the rise of nationalist leaders who are threatening to tear down long-standing economic agreements and institutions, a growing number of us – political leaders, investors and citizens alike – have put our trust in economic technocrats – central bankers, finance ministers, treasury secretaries and other regulators – to reduce uncertainty and manage the economy. We hope they will reinvigorate growth, create jobs and protect us from inflation and other dangers. Many of us join Managing Director Lagarde in hoping that they will keep us happy, healthy and wealthy when our intricately interconnected markets go awry.

Twenty years after the financial crisis hit Argentina and ten years after the crises hit the United States and Europe, the global financial system has been rebuilt and economic growth is returning for many. Yet, despite this apparent success, national politicians continue to squabble, and our hopes often turn to angst because the abilities of these technocrats to exercise power in an age of political upheaval and economic interdependence, though great, do not match our expectations.[14] This sentiment is reflected in Neil Irwin's aptly named article, "The Policymakers Saved the Financial System. And America Never Forgave Them."[15] This paradox persists in much of the world because neither people on the street nor the politicians nor the technocrats themselves fully understand the nature of this power or the consequences of its use. The experiences of Argentina, the United States and Europe can help resolve this paradox by providing a laboratory for enriching our understanding of the nature and consequences of exercising power in politically turbulent and highly interdependent times.

[14] Just two years after her declaration of central bankers as heroes, Ms. Lagarde described the global economy as covered by clouds of the "new mediocre," with economic challenges (e.g., low levels of growth, investment and inflation in many countries and resurgent inflation in others), financial challenges (e.g., high interest-rate spreads, volatility and the resurgence of under-regulated shadow banking), social challenges (e.g., persistently high unemployment and growing income inequality in many countries), institutional challenges (e.g., widespread distrust and rejection of long-standing norms and institutions at the core of the liberal democratic order) and political challenges (e.g., rising polarization, stalemating political opposition and extremism on the left and right around the world) fueled by public backlashes against austerity and the lack of recovery for many. C. Lagarde (2014). "World financial growth still falling short," speech delivered at Georgetown University on October 2. www.georgetown.edu/news/christine-lagarde-imf-director-speaks-2014.html.

[15] N. Irwin (2018). "The policymakers saved the financial system. And America never forgave them." *New York Times*. September 12. www.nytimes.com/2018/09/12/upshot/financial-crisis-recession-recovery.html.

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Abbreviations

ABSPP	Asset-Backed Securities Purchase Programme
AIG	American International Group
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
APP	Asset Purchase Program
BCRA	Central Bank of the Argentina Republic
Brexit	British Exit from the European Union
CBPP	Covered Bond Purchase Programme
CEO	Chief Executive Officer
CFTC	Commodities Futures Trading Commission
CGT	*Confederación General del Trabajo*
CIFS	Credit Institutions Financial Support Scheme
CJEU	Court of Justice of the European Union
CONADEP	*Comisión Nacional sobre la Desaparición de Personas*
CPFF	Commercial Paper Funding Facility
CSPP	Corporate-Sector Purchase Programme
DF	Deposit Facility
EC	European Commission
ECB	European Central Bank
EFSF	European Financial Stability Facility
ELA	Emergency Liquidity Assistance
EONIA	Euro Overnight Index Average
ESF	Exchange Stabilization Fund
ESM	European Stability Mechanism
EU	European Union
FCC	Federal Constitutional Court of Germany
FDIC	Federal Deposit Insurance Company
FED	Federal Reserve Bank of the United States
FOMC	Federal Open Market Committee
FPV	Progressive Front Alliance
FrePaSo	Front for a Country in Solidarity
GDP	Gross Domestic Product

G-Fund	Government Securities Investment Fund
GIPSI	Greece, Ireland, Portugal, Spain and Italy
Grexit	Greek Exit from the European Union
GSP	Generalized System of Preferences
ICSID	International Centre for the Settlement of Investment Disputes
IMF	International Monetary Fund
INDEC	*Instituto Nacional de Estadística y Censos*
LEBAC	Letters of the Central Bank of Argentina
LIBOR	London Interbank Offer Rate
LTCM	Long-Term Capital Management
LTRO	Longer-Term Refinancing Operations
M3	Money Supply
MMIFF	Money Market Investor Funding Facility
MRO	Main Refinancing Operations
NCUA	National Credit Union Administration
NEC	National Economic Council
OAS	Organization of American States
OCC	Office of the Comptroller of the Currency
OMT	Outright Monetary Transactions
OTC	Over-the-Counter Derivatives
OTS	Office of Thrift Supervision
PJ	Justicialist Party
PSI	Private-Sector Involvement
PSPP	Public-Sector Purchase Programme
QE	Quantitative Easing
REPO	Repurchase Contract
RIC	Risk Intervention Curve
RUFO	Rights upon Future Offers
SEC	Securities and Exchange Commission
SGP	Stability and Growth Pact
SMP	Securities Markets Programme
TARP	Troubled Asset Relief Program
TED	Treasury–EuroDollar Rate
TLTRO	Targeted Longer-Term Refinancing Operation
TROIKA	European Commission, European Central Bank and International Monetary Fund
UCR	*Unión Cívica Radical*
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
VLTRO	Very-Long-Term Refinancing Operation
YPF S.A.	*Yacimientos Petrolíferos Fiscales*