The Wealth Effect

The politics of major banking crises have been transformed since the nineteenth century. Analysing extensive historical and contemporary evidence, Chwieroth and Walter demonstrate that the rising wealth of the middle class has generated 'great expectations' among voters that the government is responsible for the protection of this wealth. Crisis policy interventions have become more extensive and costly – and their political aftermaths far more fraught – because of democratic governance, not in spite of it. Using data from numerous democracies over two centuries, and detailed studies of Brazil, the United Kingdom and the United States, this book breaks new ground in exploring the consequences of the emerging mass political demand for financial stabilization. It shows why great expectations have induced rising financial fragility, more financial sector bailouts and rising political instability and discontent in contemporary democracies, providing new insight to anyone concerned with contemporary policy and politics.

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The Wealth Effect

How the Great Expectations of the Middle Class Have Changed the Politics of Banking Crises

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PREFACE

We began this project in the wake of the most severe financial crisis in advanced democracies since the Great Depression. We took inspiration from the pioneering work of economists and economic historians who had started to delve deeply into the economic consequences of financial crises over a long stretch of history. They demonstrated the benefits of taking a panoramic historical perspective, identifying systematic patterns in the run-ups and aftermaths of crises. Yet this work largely set aside questions about the political aftermaths of such crises and how politics and institutions shaped the nature of the government policy response.

As scholars of international political economy, these questions were naturally of great interest to us. Theoretically, we wanted to gain a deeper understanding of the importance of time and time-dependent processes in shaping policy and political outcomes after banking crises, as it seemed to us that much economic work emphasized continuity rather than change. Why, for instance, had the policy interventions during and after banking crises in democracies apparently undergone a profound transformation over the course of the previous two centuries? In the nineteenth and early twentieth century democratic governments largely either stood aside or adopted minimalist policy responses to systemic banking crises, but after the 2007–8 crisis we saw governments adopting increasingly extensive and costly publicly funded bailouts.

The observation that many governments in crisis-hit countries lost office in the aftermath of the 2007–8 crisis also motivated us to consider the electoral impact of financial instability. Indeed, politics in many democracies hitherto seen as stable and consolidated became noticeably more fractious, polarized and unpredictable. Had these political aftermaths, like the policy aftermaths, also changed over time? If so, why? Perhaps most interestingly and importantly, this prompted us to think about how the policy and political aftermaths might be related and whether this relationship might itself change over time.

We found that existing accounts did not address these questions in a fully satisfying way. Some scholars explored the relationship between economic crises and political outcomes but gave little attention to financial crises. Other work – both qualitative and quantitative – largely ignored questions related to long-run processes and instead focused on financial crises in narrow time periods or particular regions. In short, surprisingly little was known about how polities themselves might be affected by crises over the long run.

The policy interventions that followed the 2007–8 crisis also made us increasingly sceptical about arguments that democratic institutions could constrain the propensity of governments to implement taxpayer-funded rescues of the financial system. On the contrary, we came increasingly to view democratic institutions as potentially linked to recurrent bouts of financial instability followed by bailouts in a modern age where ‘financialization’ since the 1970s has increasingly connected middle-class households to the financial system as both investors and borrowers. In contrast to an earlier era when financialization was more limited and wealth more highly concentrated, these processes – often encouraged by successive governments – have given middle-class households in modern democracies ‘great expectations’ that governments will protect their wealth and access to credit. During major crises, the ‘wealth effect’ has increasingly entailed governments committing sizeable public resources to stabilize financial markets and bailing out the large, complex financial institutions that have become so pivotal in financial networks.

By focusing on the evolving nature of middle-class household interests and policy preferences, thus far largely overlooked, we developed an account of mass pressure ‘from below’. This thesis points to quite different and arguably even more deep-seated causes than the popular post-2007 accounts that attributed bailouts mainly to elite pressure and capture from above by large financial institutions and connected corporate interests.

It also gave us new insight into the electoral impact of financial crises. If the effective demand from middle-class voters for financial stability had risen, then so too should have the political costs of failing to meet this demand. With great expectations, we have seen the preferences of middle-class voters becoming more aligned, albeit still imperfectly, with elites who share similar interests. This has considerably enlarged the constituency supportive of bailouts, placing elected governments facing crises under much greater pressure than in the past to respond quickly and forcibly to protect at-risk wealth. Careful consideration of the importance of time and time-dependent processes thus led us to the view that it was the evolution of these mass preferences that was crucial in understanding why modern governments might suffer greater electoral punishment than those in the past.

At the same time, we noticed that conflicts of interest within this much-enlarged 'bailout constituency' can be acute. Most voters want governments to protect their at-risk wealth in crises, but this is not precisely the same as what the managers, major shareholders and creditors of large complex financial institutions want. Distributional struggles over the allocation of costs and benefits in bailouts continue and, as the size and extent of interventions have increased, in some cases have become more intense. As we conducted the research for this book, we witnessed conflict of this kind taking various forms: between older voters in much of Europe and the United States with defined benefit pensions and negligible mortgages on their homes, and younger voters who had neither; between middle- and upper-income investors in countries who benefited from government protection of 'uninsured' money market funds during the crisis and sustained quantitative easing, and those whose highly leveraged housing wealth evaporated after 2007; and between many comfortable middle-class voters in northern Europe and Greek citizens who faced large pension losses. We also noticed how the preferences of voters could be unrealistic, inconsistent and riddled with conflict, making crisis management exceptionally difficult for governments to navigate. At various points over 2007–8, many voters in crisis-hit countries who initially favoured extensive financial stabilization measures soon complained that politicians had 'bailed out the bankers'.

The intensity and potential inconsistency of these middle-class voter preferences also led us to consider how voters might respond to policy failures and delays that are themselves, in part, due to institutional obstacles. We developed an account that differs from a standard one in the literature that stresses how divided political authority might enable incumbents to avoid political responsibility. In our view, the emergence of great expectations among a large bloc of middle-class voters means that governments facing more severe political constraints – mainly in the form of polarized 'veto players' – will tend to find it harder to retain office following a banking crisis. Modern crises generate particularly acute problems for incumbents because they often increase polarization and gridlock that can produce policy delays and wealth-destroying market contagion. Due to the uneven effects these delays can have on different asset markets, this can exacerbate the distributional conflicts mentioned above.

Our analysis reveals that modern governments now face an unprecedented, harsh dilemma. Simply responding to voters' great expectations for wealth protection does not ensure electoral success. Voter dissatisfaction and electoral punishment is still likely if governments respond in a delayed and limited manner, or in ways perceived as highly costly and redistributive. Such outcomes, we suggest, are more likely to be present in circumstances where political constraints are severe. Managing crises is a fraught business for contemporary governments: escaping punishment is difficult, though not impossible. Doing so depends in large part on delivering prompt, effective interventions that protect most middle-class wealth and that are widely perceived as spreading the burden reasonably fairly across different groups. Such interventions, however, tend to be the exception rather than the rule. And even successful interventions are still far more costly than in the past.

In the end, our analysis has led us to be doubtful about the prospects for sustaining democratic politics, rising financialization and financial stability over time. Great expectations increasingly compel democratic governments to intervene to protect voter wealth. But this in turn has fostered greater financialization, leverage and financial fragility, as well as contributing to larger public sector deficits. The risk, as we may now be observing in some advanced and emerging democracies, is growing disenchantment with democratic institutions. We remain hopeful that political parties of the moderate centre will mobilize sufficient political courage and conviction to convince voters of the need to change course in the interest of preserving not just their wealth, but possibly also democracy itself.

After eight years and several trips from London to Melbourne and many places more or less in-between, we completed this book. Along the way, we incurred a number of intellectual debts. We are indebted to many colleagues at institutions around the world who shared data or offered comments on various parts of the manuscript including, at the risk of omitting some, Christopher J. Anderson, David Andrews, Ben Ansell, Leonardo Baccini, Erik Baekkeskov, Ken Benoit, Leslie Bethell, Sarah Binder, Frederick Boehmke, Carles Boix, Janet Box-Steffensmeier, Mark Buntaine, Richard Carney, Jon Danielsson, Keith Dowding, Zachary Elkins, Manfred Elsig, Lawrence Ezrow, Christopher Gandrud, Lucy Goodhart, Julia Gray, Stephen Haber, Mark Hallerberg, Dominik Hangartner, Jakob de Hann, Eric Helleiner, Philip Keefer, Luke Keele, Jouni Kuha, Katie Lavelle, David Leblang, Amanda Licht, Johannes Lindvall, Abe Lowenthal, Christopher Meissner, James Melton, Daniel Mügge, Abe Newman, Stefano Pagliari, Elliot Posner, Paul Preston, Dennis Quinn, Raphael Reinke, Thomas Sattler, Moritz Schularick, Stephen Topik, Stephanie Walter, Cornelia Woll and Geoffrey Wood. Our research assistants – Chirag Agarwal, Rodrigo Alves-Jafet, Erika Arnold, Hortense Badarani, Bruno Baisch, Pedro Barros, Jeremiah Brown, Noemie Chomet, Andrew Gibbons, Shunran Hu, Alexia Leckie, Pei Xuan Lin, Lukas Linsi, Orian Mahlow, Michael O'Keefe, Alexander Parsons, Victor Pons Pilz, Mike Pottenger, Richard Reid, Bill Roosman, Mike Seiferling, Suzanna Sobolewska, Brenda van-Coppenolle, Kohei Watanabe, Sam Wilkins and Jack Winterton – helped us to gather the data and identify references vital to completing the project.

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Finally, and most importantly, we dedicate this book to our families, whose even greater patience and support was essential to its completion. We hope that they will continue to fulfil their greatest of expectations.

ABBREVIATIONS

AIG	American International Group
AMC	asset management company
AMLF	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
APF	Asset Purchase Facility
APS	Asset Protection Scheme
ARM	Adjustable Rate Mortgage
ATM	automated teller machine
BACEN	Central Bank of Brazil
BB	Banco do Brasil
BEUB	Banco dos Estados Unidos do Brasil
BHCs	bank holding companies
BIS	Bank for International Settlements
BNDES	National Bank for Economic Development [Brazil]
BNH	National Housing Bank
BRB	Banco da República do Brasil
BREUB	Banco da República dos Estados Unidos do Brasil
BRRD	Bank Recovery and Resolution Directive
CAP	Comparative Agendas Project
CDOs	Collateralized debt obligations
CDU	Christian Democratic Union
CDS	credit default swap
CEF	Caixa Econômica Federal
CEO	chief executive officer
CPFF	Commercial Paper Funding Facility

CPS	complementary pension system
CRA	Community Reinvestment Act
DB	defined benefit
DC	defined contribution
DSR	debt service ratio
EBA	Emergency Banking Act
ECB	European Central Bank
EESA	Emergency Economic Stabilization Act
EMGEA	Empresa Gestora de Ativos
Fannie Mae	Federal National Mortgage Association
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FGTS	Fundo de Garantia do Tempo e Serviço
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
FHLBB	Federal Home Loan Bank Board
FOMC	Federal Open Market Committee
FSA	Financial Services Authority
FSLIC	Federal Savings and Loan Insurance Corporation
FSOC	Financial Stability Oversight Council
GDP	gross domestic product
GSE	government-sponsored enterprise
HAMP	Home Affordable Modification Program
HARP	Home Affordable Refinance Program
HERA	Housing and Economic Recovery Act
HOLC	Home Owners' Loan Corporation
HUD	Department of Housing and Urban Affairs
IMF	International Monetary Fund
IOF	Imposto sobre Operações Financeiras
IOPS	International Organisation of Pension Supervisors
IRA	Individual Retirement Account
L&V	Laeven and Valencia
LBG	Lloyds Banking Group
LOLR	lender of last resort
LTV	loan-to-market value
MBS	mortgage-backed securities
MMIFF	Money Market Investor Funding Facility

MPC	Monetary Policy Committee
NCC	National Credit Corporation
NMC	National Monetary Council
NPL	non-performing loan
NYCH	New York Clearing House
OCC	Office of the Comptroller of the Currency
OECD	Organization for Economic Cooperation and Development
OFHEO	Office of Federal Housing Enterprise Oversight
OLS	ordinary least squares
OTS	Office of Thrift Supervision
P&A	purchase and assumption
PC	Partido Concentração
PDCF	Primary Dealer Credit Facility
PFL	Liberal Front Party
PMDB	Brazilian Democratic Movement Party
PPP	purchasing power parity
PR	Republican Party [Brazil]
PRA	Principal Reduction Alternative
PRF	Federal Republican Party
PRN	Party of National Reconstruction
PROER	Program of Incentives for the Restructuring and Strengthening of the National Financial System
PRP	Republican Party of São Paulo
PSDB	Social Democratic Party of Brazil
PT	Workers' Party
QE	quantitative easing
RAET	Temporary Special Administration Regime
R&R	Reinhart and Rogoff
RBS	Royal Bank of Scotland
RFC	Reconstruction Finance Corporation
S&Ls	small unit banks, or 'savings and loans'
SBCs	systemic banking crises
SCAP	Supervisory Capital Assessment Program
SEC	Securities and Exchange Commission
SIFIs	systemically important financial institutions
SLS	Special Liquidity Scheme
SPV	special purpose vehicle

SUMOC	Superintendency of Money and Credit
SWIID	Standardized World Income Inequality Database
TAF	Term Auction Facility
TALF	Term Asset-Backed Securities Loan Facility
TARP	Troubled Asset Relief Program
TCI	Tennessee Coal and Iron
TR	Reference Rate
TSLF	Term Securities Lending Facility
TUC	Trades Union Congress
VC	variable contribution
WaMu	Washington Mutual
WVS	World Values Survey