The Political-Economic Sources of the Financial Crisis

Executive Summary

This discussion paper sets the stage for research on the Political Economy of Financial Markets (PEFM). It explores political and economic factors that contributed to the global and euro area crises, and suggests where research is needed to develop policy prescriptions for a future ‘steady state’ in managing financial markets. The preliminary findings are as follows:

- A confluence of political and economic factors led to the crisis, including in many cases an exaggerated faith in ‘efficient markets’ and ‘rational expectations’.

- This faith in markets led to ‘light-touch regulation’, excessive reliance on banks’ own risk-assessment systems, and an over-dependency on rating agency assessments.

- A less obvious implication of the efficient market paradigm was that it made monetary and fiscal policy-makers cautious about puncturing credit booms.

- The policy regimes favoured by the IMF and EU assigned instruments such as interest rates to single goals (e.g., inflation), reinforcing the neglect of private sector deficits.

- Policies in China and the US, while more eclectic, also allowed the development of large external surpluses or deficits – and in the US a major credit boom.

- The ‘ideological capture’ of policy was an element in global regulation and in some countries; but there were also more venal examples of capture by vested interests.

- Even with macroprudential tools playing a role, it seems monetary and fiscal policy in future must pay more attention to credit, asset prices, and external surpluses/deficits.

- In future, regulation must be tougher, and bank supervision more intrusive; but it is not sure how well officials will keep pace with banking and shadow banking trends.

- Policies in a steady state could range from (i) ‘tweaking’ past regimes to (ii) a reversal of liberalisation – the latter being a serious risk if pre-emptive policies do not work.

Research under the PEFM Programme will extend this reflection on relations between the state and the financial sector. It will begin with three topics: financial integration in Europe; the role of macro policy anchors; and policy capture. On this basis, it will explore the kind of changes in policy frameworks that may be needed in order to foster financial stability.

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I – Introduction

Research work on financial markets over the past decade failed to sound alarm bells about an impending crisis. Yet the current wave of financial turbulence has deeply damaged the advanced economies – leading to fragile growth, high unemployment, and a rise in public debt that is exceptional by peacetime standards. In the euro area, the associated social and political risks are in many ways more ominous than at any time since the 1930s. Against this backdrop, it is clear that the role of the financial sector in the modern state poses dilemmas that are more complex and long-lasting than previously thought, and deeply political in resonance. Nowhere is this more germane than in Europe, and specifically the euro area.

The severity of the global crisis that began in 2007, and the subsequent euro area banking and sovereign debt crisis, thus raise questions about the conventional wisdom on financial markets and their governance that prevailed in recent years. From the late 1970s on, mainstream academic and official thinking was strongly influenced by the ‘efficient markets’ hypothesis and by the assumption of ‘rational expectations’. The prevailing paradigm held that financial markets were efficient, in the sense of fully incorporating available information. More broadly, markets – once freed from distortive government intervention and adverse policy shocks – would allocate resources well and behave in a stable and stabilising manner.

The influence of these forces was far-reaching in terms of the political economy of government relations with financial markets. Its most obvious outcome was to help foster a philosophy of ‘light-touch’ regulation in some countries (including, among others, the United States, the United Kingdom, and Ireland). It favoured a delegation of credit risk assessment, as far as possible, to market-based entities such as credit rating agencies, and a delegation of risk assessment more generally to banks’ own internal risk appraisal systems. It de-emphasized any need for macroprudential policies to address financial stability risks, and for financial regulation and supervision to address inappropriate market behaviour.

This paradigm also had a pervasive effect on other policies that influence market behaviour. It underpinned a view that macroeconomic policies could best assure stability if oriented to a single goal, such as inflation or debt sustainability. A strong form of this view was that these policies should be set transparently on ‘auto-pilot’ over the medium term, based on numerical targets. This would provide a credible framework in which markets would operate efficiently and stably. Macroeconomic policies should not be subject to discretionary changes in light of credit, asset price or external developments; of competing policy goals; or of issues of policy co-ordination, except in extremis. The view that private sector imbalances can be ignored is sometimes known as the Lawson Doctrine, after the former UK Chancellor of the Exchequer.

This view of the role of macroeconomic policies reflected considerations of a political-economic order. A key goal was to minimise the scope for political interference that could impede the implementation of sound policies or distort the functioning of financial markets. As a policy architecture, this resonated strongly with political views favouring a roll-back of the role of the state. The bias against discretionary policy adjustment reflected a belief that such actions were not effective in dealing with efficiently operating financial markets; but it also reflected a view that politicians and officials could not – and should not be trusted to – outguess markets on the nature and extent of credit, asset price, external financing or liquidity risks. The assessment of such risks was substantially outsourced to the private sector.
In the period before the crisis, academic and official authors ascribed the period of ‘great moderation’ to improved rules and practices in the conduct of macroeconomic policies. It was asserted that the problem of depression prevention had been solved – and without resorting to any discretionary role for fiscal policy. This assertion contrasted sharply with the prior orthodoxy established by Keynes and others in the wake of the Great Depression, which emphasized the need for discretionary intervention at times when the economy was subject to market failures. Indeed, the macroeconomic goal of fiscal policy shifted from the Musgravian role of economic stabilization to that of meeting a set of numbers for debt sustainability that had hitherto been regarded (or all too often ignored) as a constraint.

It also departed from a long-held consensus that firm financial market supervision was needed to address inherent problems of capital markets that included moral hazard, adverse selection and various forms of ‘herd’ behaviour. This helps explain the failure to read the tell-tale signs of an impending crisis, or to listen to those (for example at the Bank for International Settlements) who had joined up the dots and sounded very precise warnings. All-too-often, the views of ‘whistle-blowers’ in international and national policy institutions, who criticised the prevailing orthodoxy, were side-lined or treated in a dismissive manner.

The aftermath of the global crisis has seen a reversal of views concerning banking policy, in favour of more intrusive financial regulation and supervision. But this shift alone may not be sufficient to foster financial stability over the medium term. It is not just that heavy capital and liquidity constraints on the formal banking sector itself may stimulate a rapid growth in ‘shadow banking’. A key question – and the core subject of this paper – is whether the design of monetary and fiscal policies also needs to be rethought in a setting of imperfect financial markets. Closely related to this issue is the extent of the contribution that can be expected from the use of macroprudential instruments to address private sector imbalances.

Questions along these lines implicitly blame the crisis on the inherent instability of markets and on insufficient action by the state. A variant on this view might place substantial blame on the wrong sort of actions by the state. The sources of the crisis may have lain in part in distortive government policies. Is clear that governments in systemically important countries intervened in markets in ways that were destabilising. At issue, for example, are exchange rates across the Pacific region, and banking policies in the US designed to mitigate income inequality. Moreover, some countries clearly failed to follow their fiscal or monetary rule. A related concern is that policy may have been captured by entrenched interests. At one level, the question would be whether policy-makers in some countries failed to tackle commercial interests that were benefiting from a financial sector boom. It can also be asked if some entrenched interests formed common cause with ideological proponents of ‘smaller government’ and ‘efficient markets’, thus hijacking banking policy. More broadly, political elites may benefit from a continuance of boom conditions. Overall, the financial sector and parties benefiting from it can be seen as a powerful interest group in society. The role of specific interests in hijacking policy or impeding ‘whistle-blowing’ deserves exploration.

There are thus competing accounts of what went wrong with policy design and execution, and how far the prevailing free market paradigm bore a responsibility for this. It is important to examine experience so as not to 'throw out the baby with the bathwater' in reassessing the design of policy regimes. Could it be, for example, that the sources of instability over the past decade lay mainly in a confluence of distortive government actions which would have
overwhelmed all but the most intrusive financial regulatory regimes? Or again, has the adoption of single-goal medium-term macroeconomic policy regimes been basically an advance, requiring only flanking support from macroprudential tools?

These questions and issues concerning financial stability policies used to be thought mainly relevant to emerging markets engaged in financial liberalisation. Today, however, it is clear that they are of deep concern also in advanced economies. That may be particularly the case when advanced economies are experiencing large private sector imbalances, undergoing major transformations, such as changes in financial technology or rapid cross-border financial integration, or changing their monetary anchor – as in the shift to monetary union in Europe.

The remainder of this paper is organised as follows. Section II discusses the traditional rationale and channels for government involvement with financial markets. Next, the paper explores interactions between political, economic, and market factors in the main currency areas in the run-up to the crisis (Section III). It goes on to consider exit strategies from the crisis and their spillover effects (Section IV). To make the findings more concrete, the paper explores three scenarios that link possible crisis diagnoses with policy options in a steady state (Section V). Section VI concludes and summarises possible initial research priorities.

II - Government influence over the financial sector: channels and rationale

The influence of the state on the financial sector in a modern economy runs through multiple channels. Moreover, many of these channels turn out to be a two-way street. Governments seek influence markets; and market developments end up by influencing governments.

Financial sector regulation and supervision are the primary channels used to influence financial market governance (as opposed to financial market behaviour as a transmission channel for monetary policy). Even in this domain, the way official influence plays out over time is complex. The financial sector is highly adaptive, and prone to ‘regulatory arbitrage’. Indeed, the capacity of innovation to side-step ‘price and quantity restrictions’ (potentially diverting intermediation to less supervised routes) was one driving force behind the liberalisation/deregulation programmes that were initiated in the 1970s.

Other branches of policy, too, exercise a very strong influence over financial market behaviour. These include monetary and exchange rate policies; tax policies; and general budgetary policies, including importantly their side-effects through the design of government borrowing programmes. The incidence of these policies – as well as the ‘policy mix’ – can play a major role in influencing the stability of the financial sector.

Moreover, structural policies and the business environment can be important. If there are distortions in the real sector of the economy (reflecting, for example, failings in competition policy, corporate governance, or the labour market), these may be amplified by liberalised financial markets. This can be relevant in emerging market economies that are undergoing liberalisation. Depending in part on the sequencing of liberalisation, capital inflows may be allocated to sectors that appear promising at the microeconomic level (participating in a housing boom, for example), but ultimately prove destabilising at the macroeconomic level.
The motivations that may govern state policies towards the financial sector are diverse. There are a number of technical grounds for regulatory and supervisory intervention that find wide support in the literature, even if some proponents of the efficient markets paradigm tended downplay these. They lie in such ‘intrinsic failures’ as moral hazard, adverse selection, myopia, failure to reflect externalities, and herd behaviour. In other words, markets may create distortions as they rely on explicit or implicit guarantees (as in ‘too big to fail’); gamble in selecting very risky projects; fail to see long-run hazards (e.g., macrofinancial risks) or social costs; or derive undue comfort or concerns from peer-group behaviour.

There are, however, less benign reasons for state involvement, with roots of a more political nature. Financial institutions pose obvious temptations to government. They have allocative influence across all economic sectors. To intervene in this allocation is to affect economic outcomes without having to raise taxes (or even pass legislation). One potential beneficiary is the government itself, by forcing institutions to finance its operations on non-market terms (‘financial repression’). Another is disadvantaged groups that lack access to, for instance, mortgage credit. In addition, the state may seek to influence financial stability or economic growth by direct controls over the volume or price of credit, or the level of the exchange rate. A further possibility is the ‘capture’ of policy by entrenched economic interests.

This highlights both the political context and the potential ambiguity in state initiatives vis-a-vis the financial sector. A government decides, say, to peg the exchange rate; or to force banks to hold very sizable reserves against some transactions; or to insist that banks hold higher levels of short-term allegedly low-risk public sector debt; or to urge banks to avoid speculative financing and concentrate on lower value household mortgages, insisting they should use the country’s own money, not foreign currency. Each of these actions could be appropriate – or it could be a stepping stone to a non-market style of economic management. Political-economic context, in other words, is everything. So it is both important and challenging to disentangle which policy channels were used in a problematic manner during the run-up to the financial crisis. This is one of the main topics of the next section.

III - The nature of the problem in the run-up to the global and euro area crises

Rarely is there complete agreement among global policy-makers about the right policy frameworks (still less, the right stance of policy) across the advanced economies. However, the decade between the Asian crisis and the global/euro area crisis saw a high degree of consensus among IFI and academic experts on desirable macrofinancial policy regimes.

There were two main strands in this consensus. The first was to favour policy assignments based on ‘one instrument: one goal’ (such as inflation targeting). This view has a long academic lineage, although one of its most respected advocates, Tinbergen, warned that central banks should not manage policy by concentrating on a single objective. The second, reflecting caution about the wisdom or effectiveness of fine-tuning, was to set policy over the medium term on a transparent and credible path toward a fixed numerical goal, such as the rate of inflation (for monetary policy) or the public debt ratio (for fiscal policy). This, in effect, gave doctrinal cover for ignoring credit, asset prices and the external balance.

This consensus was very influential throughout Eastern and Western Europe. Neither China nor the US adopted these frameworks. However, the Federal Reserve shared the view that
Voluntary policy should not pre-emptively address private sector imbalances, while in China the monetary regime was operated in a way that assured a high external imbalance. The euro area adopted much of this consensus, but of course monetary conditions in member states did not necessarily match local cyclical conditions. Expositionally, it is helpful to consider the ‘ideal’ frameworks favoured at the IMF and in Europe, and then turn to the less tidy task of examining policy in practice in the major blocs – including China, the US and the euro area.

(a) The Political Economy of the ‘Favoured’ Policy Regimes

The policy regimes favoured by the IMF and the EU comprised four main elements:

- Fiscal policy should be set on a medium-term path towards a sustainable public debt ratio. It should take the opportunity for faster progress to that goal during booms. It should, however, avoid discretionary fine-tuning, except during extreme downturns, while letting stabilizers operate (unless risk premia make this inadvisable). Also, in some circumstances a medium-term expenditure rule was seen as a useful adjunct. Over time, fiscal councils were seen as a way of ensuring more credible projections.

- Monetary and exchange regimes should migrate to ‘corner solutions’ – a hard peg or inflation targeting – to minimise vulnerability to speculative attacks. They should be managed in a highly transparent way. In neither case should the policy framework be varied in response to asset prices, credit growth or external imbalances. Central banks should be independent in the implementation of policy. Monetary policy committees including ‘outside experts’ were advised as a support to strengthen policy credibility.

- Banking regulation and supervision should focus mainly on risk-adjusted measures of capital adequacy. The desirable end-state for larger banks would see heavy reliance on banks’ own risk models, incorporating rating agency assessments as useful.

- Financial liberalisation should feature at an early stage in the sequencing of emerging market reforms – because capital controls were seen as ineffective and distortive, and because liberalisation was considered to be an anchor for the irreversibility of reform.

The experience of the crisis period suggests that this set of policy frameworks needs to be re-examined. For example, a hypothetical set of critiques might run along the following lines:

- These frameworks ignored large private sector imbalances, even in circumstances (such rigid wages in a setting of hard pegs) that could suggest large sacrifices of output and employment if losses of competitiveness needed to be reversed. The risks of irrational exuberance creating bubbles were largely forgotten.

- In tying the hands of policy-makers, major reliance was placed on the transparency and accountability inherent in one-instrument/one-goal policy assignments, and also on the discipline of fixed numerical rules as a commitment device: however, these design features also limited the scope for pre-emptive action or policy co-ordination.

- Estimates of fiscal positions used standardised methodologies that had been agreed for cross-country comparison, but which proved quite misleading in the real-time setting of financial booms – with regard to both fiscal elasticity and output gaps.
There was strong concentration on targeting nominal (or roughly adjusted) fiscal deficits as a source of public debt, but the foregoing points meant that this reliance was misplaced both with regard to the true fiscal stance and to contingent liabilities.

In some cases policy makers changed the rules to suit their situation (as in the revision of the SGP), while in others (including the UK) they in effect engaged in regulatory arbitrage, misusing the rules they had set up to influence expectations.

The reliance on market-based risk assessments – from rating agencies and from banks’ own internal risk models – proved dangerously misplaced.

The benefits of financial liberalisation in achieving cross-border risk-sharing and income-smoothing were assumed to apply when integration took place through banking and other debt-based flows, which later research has questioned.

Issues of leverage (total balance sheet versus capital) and liquidity adequacy were ignored or relegated to secondary importance, and this was a major misjudgement.

The political trade-offs underlying these rules as commitment mechanisms proved much more problematic than foreseen: policy-makers hands were tied to some degree, but they were also given reasons or excuses to ignore rather inconvenient trends.

One issue for study in the light of experience is thus the best specification of policy rules and institutions for financial stability – especially in a world where financial markets show significant imperfections. Even if the above critiques are valid, there is a question how far one discards rules, or adapts them, or implements measures to flank and supplement them.

However, an important prior consideration is how the actual policy praxis in major currency areas, which does not fit neatly into the frameworks outlined above, actually affected financial stability in the run-up to the crisis. We turn now to this.

(b) Political Economy Issues in Systemic ‘Leaders’

Life is rarely tidy, and it happens that three of the largest currency entities did not – or did not fully – subscribe to the ‘favoured’ policy frameworks discussed above. The United States, the euro area (at the monetary union level rather than the country level), and China had macroeconomic regimes that were in all or some respects more eclectic and judgemental, both in setting objectives and in calibrating policies (although in the case of the euro area the differences may be to some extent more cosmetic than real). Correspondingly, the financial stability hazards associated with their policies did not fall neatly into the categories suggested above but were much more idiosyncratic in nature.
Proceeding from the least to the most complex, the design of macroeconomic and financial policies in China was not dominated by single goal instrument assignments or fixed medium-term policy rules. The public debt was not high, and fiscal policy was more governed by concerns about demand management and development objectives. The monetary and exchange rate regime was driven very strongly by the concern to build up external reserves – or, put another way, to pursue a growth model that was very strongly export-driven.

This strategy in China was a political choice, and it found echoes elsewhere in Asia. It is widely perceived that the reserve accumulation model was driven by a desire to ensure greater domestic insulation from shocks. More specifically – after the experience of the Asian crisis – it offered protection from the risk of having to submit in the future to highly intrusive IMF conditionality. The financial sector in China – while modernising and subject to a formal supervisory regime – was dominated by state-owned entities; so to that extent concerns about regulation and supervision were somewhat removed from those in advanced economies.

Policy in the United States during the years before the crisis was also sui generis. The spirit of regulation and supervision was influenced by the ‘light touch’ philosophy, and the Federal Reserve took an active view against the pre-emptive use of macrofinancial instruments. The budget was in a strong position and there were at one point even concerns about too little government debt being outstanding; so the design of fiscal policy was influenced more by political debate about the desirable level and structure of taxes and spending.

Monetary policy was at the centre of discussions about macroeconomic management, with the Federal Reserve having a dual mandate to consider full employment as well as inflation. Interest rates were at times held below levels consistent with inflation targeting (ie, Taylor Rule levels). This has been ascribed in part to concern about various shocks (LTCM, Y2K, 9/11, etc). It coincided with a period of high savings in Asia, and allowed a counterbalancing expansion of the non-traded good sector in the United States – in particular the housing market. It found support in assessments that the trend rate of non-inflationary growth in the economy had been moved upwards by an ongoing technology revolution. And it fitted with a doctrine that private sector imbalance, or possible bubbles, could and should mainly be addressed when they popped – a shifting of risks described as the ‘Federal Reserve Put’.

Recent literature on the run-up to the crisis has highlighted a political-economic strand in developments in the United States that is quite distinct than that of a prevailing free-market philosophy. The gist of the argument is that concerns about inequality spilled over into housing finance policy, and this provided a major stimulus in the development of the low-income or no-income mortgage boom. A less concrete set of concerns are that the political influence of a financial elite played a role in fostering policies that were very liberal in their approach to the governance of financial markets. It is fair also to highlight a set of factors that are far from unique to the United States: the credit and housing boom provided a sense of well-being to many economic actors, as well as an expanding tax base; and political-economic expediency probably supported a disinclination to ‘take away the punch bowl’.

This discussion of China and the United States already suggests a complex interplay of political-economic factors in the period when macrofinancial risks were building up. Moreover, influence of financial conditions in these countries contributed to an environment of very low risk premia in global capital markets, which are generally reckoned to have had some pervasive impact on financial conditions in other economies.
In the euro area, the run-up to the global and regional crisis presents a yet more complex picture. Policies at the global, euro area and national levels interacted in unexpected and disastrous ways. They also spilled over to emerging markets linked to the euro area.

Looking ‘top-down’ at euro area policy frameworks, one can identify most of the inherent dilemmas described above under ‘favoured policy regimes’. Monetary policy was conducted on inflation targeting lines. Despite a second pillar incorporating monetary elements, it was not conducted with any strong regard for credit, asset prices, or external imbalances. It is true that the largest economies of the euro area were not experiencing sizable private sector imbalances, and the area as a whole was in current account balance. However, a somewhat tighter monetary stance in light of aggregate credit growth and depressed risk premia would have been helpful. Fiscal policy, meanwhile, was managed at the national level in accordance with common rules (geared to debt sustainability); and in the booming euro area periphery typical analytical errors were made that resulted in an unduly easy fiscal stance. Financial regulation and supervision were conventional in design, with some variation in practice: Spain undertook a degree of pre-emptive macroprudential tightening; while in Ireland the surveillance of the financial system by the authorities (and indeed the IMF) was ineffective.

From a bird’s eye view, this overall macrofinancial set-up might have suggested an outcome of reasonable stability. Monetary policy was appropriately somewhat tighter relative to economic conditions than in the United States, but the world-wide lowering of risk premia was bound to have some effect on stability. One could have anticipated some fall-out from financial exuberance, especially in member states where country-specific booms had been triggered and where interest rates under the common monetary policy were bound to be low in terms of cyclical conditions. The disaster that actually ensued, however, reflected in part problems that were intrinsic to the incomplete political-economic architecture of the union:

- First, there was a strong assertion that within the euro area the national balance of payments had been ‘abolished’, so cross-border financing flows were not of concern. This involved serious self-deception at a time when budgets, labour markets and bank deposit insurance and resolution frameworks were segmented along national lines. It was particularly dangerous when markets perceived the debt of Greece as no more risky than that of Germany. (Indeed the sovereign debt of advanced economies was typically low or zero-risk-weighted for prudential purposes, and euro areas sovereigns were treated similarly by the ECB). In a sense, this mirrored a global faith in market perfection and a neglect of liquidity regulation. Moreover, national politics in the EU on the financing of bank bail-outs had not kept pace with the single banking market, so the fate of nations’ banks and their budgets were inextricably intertwined.

- Second, the dynamics of inter-country adjustment in the euro area were not well understood. Country-specific booms would result in a loss of competitiveness, which over time would bring the economy back to a cyclical position aligned with the common monetary policy. During these cycles the fiscal balance would experience extended swings (when correctly measured), and external imbalances would need to be financed. In countries where wages were rigid, this adjustment process back to external balance could be lengthy, and this was the case in several periphery countries that were experiencing euro convergence booms. Finally, financial integration took loan-based forms that did not result in risk-sharing and ended up fostering contagion.
In addition to these systemic euro area issues, the most seriously affected member states got into such deep trouble in part because of much narrower political considerations. In Ireland, these included, in the account of many observers, unhealthy closeness between commercial interests and the authorities, which may have complicated the task of supervision. In Spain, the central banks was proactive in its supervision of the banks, but failed to come to grips with risks in the property loan portfolios of savings banks – which had close links with politics at the local level. In Greece, the exceptionally serious fiscal misreporting and mismanagement was deeply rooted in political-economic failings of the state.

The interaction between these economic and political elements gave rise to a perfect storm. The triggers were the rise in global risk premia from 2008 and the fiscal debacle in Greece. But close to the heart of the problem lay a political unwillingness in the EU to pool the costs of bank bail-outs, and an ideological view that the national balance of payments had been abolished. The political convenience of country-specific booms also muffled concerns that fiscal positions were much weaker than common methodology suggested. And in the most severe cases, there was an acknowledged political dimension in the genesis of their tensions.

This review of the policy design and implementation in the major currency areas puts the issue of IFI-endorsed policy frameworks in a somewhat different perspective. One could perhaps express the situation as follows. The critical failing in macroeconomic policy conceptions was the lack of attention to destabilizing imbalances at the country level, including overall external surpluses/deficits and the portion of these that arose in the private sector. In the advanced economies at least, the neglect of these imbalances had deep roots in a newly-rediscovered faith in private markets, which in essence went too far. Moreover, the efforts by the IMF and the EU to codify transparent and accountable policy regimes against this backdrop ended up counselling and endorsing policy frameworks throughout Europe that virtually ruled out discretionary adjustment to address private sector imbalances.

Research Box 2

Macroeconomic policies in China and the United States are well-documented, but there is not a consensus on the merits and spillovers of monetary policy actions in the United States in the run-up to the crisis. The significance of US housing policies designed to address inequality has recently been covered more fully. Suggestive new work has been done on financial integration, which deserves following up. The role of entrenched interests is not well-documented.

(c) How Policies and Incentives Interacted

It is helpful to take one or two cases to explore the potential scope for the layers of factors described above to interact in a problematic manner. Ireland and Spain are good examples:

- First, one can view this in purely economic terms. The experience of these economies was set in a global environment of low risk premia and easy liquidity conditions. Within this, the euro area was running a monetary policy that was quite orthodox but did not seek ‘lean against the wind’ of aggregate credit growth and asset price trends. Inevitably, in a monetary union, booming periphery economies experienced monetary conditions too easy for their economies. National fiscal policy in these booming
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economies was mismeasured, and the apparently robust stance in Ireland and Spain was too easy. As property boomed and competitiveness declined, macroprudential measures were adopted in both cases but on a scale that was too little or too late. As private indebtedness rose and was financed across borders, there was no sense of danger that external liquidity availability could be a source of vulnerability.

Second, one can trace a counterpart to these developments that is political in nature. Global liquidity conditions were in some ways the product of very specific political priorities in China and the United States, as the former maximised political-economic autonomy, and the latter embraced free markets but also used housing credit policy to address distributional concerns. In the euro area, political-economic ideology denied the national balance of payments; and politicians were unreceptive to analyses suggesting fiscal policy in booming economies was easier than intended. Finally, at the national level in Ireland and Spain political factors impeded supervision.

Research Box 3

The analysis of political factors in the run-up to the crisis has seen disconnected pieces of research, but no comprehensive treatment. The propagation of the ideas underlying the ‘efficient markets hypothesis’, the ‘light touch’ approach to regulation, and the favoured set of policy frameworks is also a topic that deserves more study.

(d) Financial Market Innovations and Responses to Policy Influences

In the discussion so far, no reference has been made to ‘securitization’. This no doubt reveals an implicit hypothesis in the ordering this paper: that, faced with major upheavals in financial markets, it is worth looking first at the macrofinancial policy setting to identify possibly drivers of market behaviour. However, the massive packaging and risk rating of real estate loans in securitised parcels in the US was a very important and ‘exogenous’ mechanism in the development of vulnerabilities and then the propagation of the crisis.

The process of unbundling and rebundling risks through securitization and through the use of derivates had been underway for 20 years. It was driven by technology, and at times also by forms of regulatory arbitrage or regulation-oriented packaging – including a concern of banks to generate fee income without paying high regulatory ‘taxes’ in the form of capital adequacy requirements. Over time, central banks tended to view these processes as benign, since they could facilitate a diffusion of risks and indeed, it was hoped, a migration of risks to portfolios best place to manage them and absorb any related losses.

Several new factors led to these processes accelerating and becoming more dangerous. One was an intensified search for yield on the side of investors, amid liquid markets and faced with low and compressed risk premia on financial assets over an extended period. Another was the shift of risk assessment approaches to be heavily reliant on rating agency assessments, which as a corollary opened up new avenues for designing rating-friendly instruments. A further element was the interaction of ever more ‘sophisticated’ capital asset pricing models with technology that allowed such pricing to be established instantly through very complex procedures. These approaches to pricing come with strong academic
endorsement, but were not transparent to most market operators and were difficult to judge in terms of common sense views on risk exposure in the event of unanticipated forms of shock.

The regulatory incentives for behaviour by markets operators shifted somewhat in the decade preceding the global crisis. Regulation in many cases was influenced by a more laissez-faire ideology – perhaps especially in the US, the UK and Ireland. And in more political terms, on both sides of the Atlantic, taxation policies towards income and wealth – as well as socially acceptable remuneration practices – generally became more conducive to greater income inequality and higher concentrations of wealth. Indeed financial innovation and leveraging were viewed in many economies – from the US to Ireland and Spain – as major opportunities for growth and employment creation. Moreover, the sea-changes under way in global markets did put pressure on the weakest points in the incentive framework for markets. Rating agencies were paid by, and at a technical level worked closely with, the issuers of the securities they were rating. And managers and owners of financial institutions in many cases plunged after the opportunities to maximise fee income and minimise regulatory costs.

So, in terms of market practices and innovations, one again finds at work in the run-up to the crisis a blend of economic and political trends that proved mutually-reinforcing.

Research Box 4
The development of financial innovations and the role of ratings agencies are quite well covered in the literature. However, factors that accelerated these developments are less well explained.

IV – Crisis Management and its Spillover Effects

As the crisis struck, the policy response mechanisms were largely forced by events and were relatively quickly agreed – notably in the United States, but also in Europe. These involved forceful and at times unconventional action by central banks to support financial markets; a short-run fiscal stimulus in countries that were not facing a sharp rise in their risk premia; the creation of larger firewalls at the global level – notably at the IMF; and a programme of re-regulation in the financial sector. This strategy has been effective in halting and reversing the crisis in the United States and in non-euro area advanced economies in Europe.

The exit strategy from the immediate response phase of the global crisis was defined by mid-2009 and, despite many disagreements about implementation, has proved durable in concept. The core of this was a commitment to continue with easy monetary policies, thus facilitating a parallel process of regulatory and fiscal tightening. This was a policy mix driven mainly by the dictates of balance sheet repair. Its external impact was set to result in a real depreciation of the advanced economies as a group against emerging market economies. Given high degrees of leverage in key sectors (notably households, banks and governments), it was likely to result in a domestic recovery that was at best muted by historical standards.

In the euro area, the crisis response has been less decisive. Seen top-down, monetary, fiscal and regulatory strategies have not been very different from those outlined above – though with a more rule-based and front-loaded approach to fiscal consolidation. However, as in the run-up to the crisis, it is at the level of internal architecture that the euro area experience has been hazardous. Firewalls of middling size have been erected, to provide conditional finance
to countries with impaired market access; but support for banks has been via additional sovereign borrowing, adding to vicious circle effects. The ECB has adopted unconventional polices such as government bond purchases, but this latter policy has at times run into doctrinal obstacles. After pressing banks to build up capital in light of sovereign risk exposures, the euro area strategy has recently included medium-term liquidity injections to banks by the ECB that are visibly channeled in part to support national government bond markets. In the outlier case of Greece, the strategy has included sovereign restructuring – no doubt inevitably, but with some damage in terms of perceived contagion risks.

Seen from the perspective of emerging market countries, the exit strategies of the advanced economies ironically involve some of the same problematic externalities as policies in the run-up to the crisis. Forceful policies of monetary expansion have inevitable spillover effects to these emerging markets, leaving difficult choices concerning the choice of nominal appreciation, inflation and macroprudential barriers. It is possible that this constellation is fostering a further round of macrofinancial tensions in the period ahead, to the extent global monetary conditions are seriously mismatched with the domestic cyclical positions of EMCs. In some cases, it has already probably contributed to the sharpness of boom-bust monetary cycles. A countervailing risk is that the management of the euro area crisis does not foster a successful resolution, and thus damages global growth prospects to an imponderable degree.

Research Box 5

The spillover of effects of the exit strategy have been explored in work by the IMF and others on the scope for specific macroprudential instruments to counter these effects; but this discussion needs to be broadened to a more fundamental review of ‘favoured policy regimes’ in EMCs.

V – Government relations with the financial sector: towards a stable state?

It is far from clear that the full lessons of the crisis have been internalised in terms of a new ‘stable state’ of policy frameworks. Defining the elements of such a steady state is a main motivation) of the PEFM project. One way of attacking this problem is by setting up alternative scenarios of ‘diagnosis’ and ‘cure’. This recognises that the genesis of the crisis was multi-faceted, and that viable remedies must address not single strands in the problem but the problematic dynamics across policy and market areas. More work is needed to develop such hypotheses (and it cannot be assumed that one size fits all across countries), but the following three ‘competing’ scenarios may be useful as an illustration:

Deep surgery scenario

On this view, the crisis was triggered by a confluence of problems that are endemic in a world of liberalised financial markets. The euro area crisis, more specifically, was inevitable in a monetary union with full financial liberalisation but no fiscal superstructure, and where labour markets, as well banking support, remain segmented on national lines. Politicians/policy-makers will never (1) agree on the nature of emerging risks; (2) pre-emptively tighten either macroprudential or macroeconomic and policies; or (3) ensure sufficiently flexible labour and product markets, even under monetary union. Following the crisis, public debts have risen to a point where such risks cannot be tolerated again, because they have already put liberal democracy under serious stress. The crisis signals a reversal of the trend towards
deregulation and liberalisation that began in the 1960s. Banks must be barred from securities and derivatives business; banking (especially cross-border banking) must shrink relative to GDP; and financial churning must be dampened by a Tobin tax. The financial sector must hold more public debt, and real interest rates will remain negative as this debt is eroded.

**Substantial redesign**

A second diagnosis would see serious design flaws in the favoured set of policy regimes, to the extent that the global crisis was an accident waiting to happen. The premise that financial markets were efficient and inherently stable proved at least as dangerous as the foibles of policy-makers (‘deficit bias’, ‘public choice’) that had undermined faith in the discretionary policy adjustment. On that basis, monetary and fiscal policy should take account of more than one set of goals, including through the side-effects of any given policy mix, and both must at times give overwhelming priority to dampening booms or limiting busts. There would still be a strong case for policy transparency (eg, goals for inflation), and more independence from the political cycle (e.g., though fiscal councils). Financial supervision would be intrusive, with some quite strong restrictions on the business lines that banks can engage in. In the EU (or at least the euro area) cross-border bank support and resolution would be introduced. There would be a major rethinking of policy frameworks, but no reversal of liberalisation.

**Enhanced tweaking**

A third diagnosis could be that the crisis showed up practical problems in policy frameworks. But it also reflected an unusual coincidence of political, macroeconomic and financial market factors – against which few regimes could offer full defence. The main error was light touch supervision, and Canada managed to completely avoid contamination from the crisis mainly by being very tough on its banks. Thus regulation and supervision must be more intrusive, with supervisors taking more responsibility for ‘outguessing the market’. Macroeconomic policy regimes need to be supplemented by macroprudential tools, and there could be scope for over-riding medium term-targets at times in the interests of policy co-ordination or other pre-emptive action. Monetary policy should look at a longer time horizon – factoring credit, asset price and external developments into this. Macroeconomic and banking policy should be insulated from entrenched interests and extraneous priorities such as distributional goals. Clearer internal organisation and ‘living wills’ should help cut the fiscal costs of bank resolution. The emphasis would be continuity and improvement of existing policy regimes.

These three scenarios can be viewed, of course, as a continuum. But the basic question is not to make them more granular – that would be somewhat artificial. The concern one must have at heart is how to assess where on this continuum, even very roughly, a future set of ‘stable state policy regimes’ might be positioned. To move towards the ‘deep surgery’ scenario would be hugely costly. History leaves no doubt about the costs and abuses that result from government repression of the financial sector. Yet it is not wholly clear whether policies to pre-empt private sector imbalances can be put into effect. Perhaps macrofinancial diagnostics can be improved; and perhaps policy design and implementation can be better proofed against forms of capture, whether venal or ideological. Otherwise, one must ask whether relations between governments and financial markets may be in an end-game in which a periodic ratcheting-up of the public debt leads, over time, to just such a costly outcome.
VI – Concluding remarks

The goal of this paper has been to assemble in an intelligible pattern the factors that led to the global crisis. It was found that a confluence of political and economic factors lay behind its emergence, as also in the case of the sovereign debt and banking crisis in the euro area. In the advanced economies, an important role was played by the dominant ideology of efficient markets and rational expectations. Along with more traditional problems of regulatory ‘capture’, this encouraged many authorities to embrace a light-touch approach to regulation and supervision, which proved very costly. It also increased the proneness of macroeconomic policy-makers at the country level to neglect what were in fact seriously destabilising imbalances in the private sector, and more generally in the external accounts. Against this backdrop, efforts by the IMF and the EU to codify transparent and accountable policy regimes resulted in their counselling and endorsing policy frameworks throughout Europe that did not leave much place for discretionary actions to address private sector imbalances. Moreover, some conceptions embraced at the launch of EMU, such as the presumed abolition of the national balance of payments, also led to disastrous blind-spots in analysis.

A first attempt has been made, along the way, to identify priority areas for research as the PEFM programme gets underway. Initial priorities could include exploring two sets of issues that may help to shed light on the ‘diagnosis and cure’ scenarios outlines above:

(1) Financial Integration in Europe. The sequencing of this was in tune with Brussels and Washington orthodoxy, but the results proved hazardous. The rapid opening of Eastern Europe to capital inflows fostered an unsustainable pattern of growth. The same pattern emerged in the euro area periphery. There was an expectation that cross-border financial integration would share risks, and smooth incomes. However, the US experience on which such views were based had featured interstate equity flows, while in Europe cross-border flows took the form of bank and bond lending, directed heavily to the non-traded goods sector (which implied also that liabilities were not hedged by export earnings). This episode deserves research to identify what approach to integration may be viable in the future.

(2) Instrument assignment. The orthodoxy of one-instrument-one-goal macroeconomic policy assignments, and of pre-commitment to numerical goals under medium-term policy regimes, depended on a setting where markets were viewed as efficient and stable. Once that is recognised not to be the case, there may be a need for discretion and co-ordination to pre-empt market instability. An assessment of this issue depends in part on the contribution to financial stability that can be expected from macroprudential instruments, which may help contain or dampen market swings. The nature of these tools is well-understood, and there is evidence about their effectiveness. The difficult challenges arise when it comes to the analytical and political hazards in seeking to apply such tools. This topic deserves to be examined, including their potential role in addressing spillover effects of exit strategies.

(3) Policy capture. Lying behind many of these issues is the question to what extent there was a hi-jacking of policy design and execution away from public interest goals. In the run-up to the crisis, such capture seems to have been present in various forms – ranging from the venal to the ideological. There is thus a need to analyse the ways in which ideological views were promulgated, and also the role of vested interests – in the private and the public sector – in hi-jacking policy and silencing potential ‘whistle blowers’. This topic seems an indispensable complement to the two more ‘technical’ research areas defined above.
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