Political economy of the US financial crisis 2007-2009

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Abstract

The emphasis of this paper is on the political economy of the subprime mortgage crisis in the United States and how the policy makers contributed to it through their legislation and regulations, made under the rising influence of interest groups and the lobbying activities of the finance industry. The "Great Recession" of 2007-2009 began as a bubble-burst in the mortgage market in the United States that spilled over to the entire financial market of the US, and afterwards to the integrated world financial market. The crisis sprang up over the US real sector and, due to the decline in US aggregate demand, spread consequently to the real economy of the rest of the World. No sound evidence has been given for the publicly proclaimed idea that the causes of the crisis lie within the self-regulating free market. The causes of the crisis lie primarily in the activities of political power, i.e. in the extensive government regulation which has, under the strong influence of interest groups and the lobbying power of financial corporations, led to favouritism in macroeconomic policies and inefficient resource allocation. Regulation was enforced by stimulating affordable housing through government sponsored enterprises, oligopoly of the rating agencies, banking regulation and an increasing connection between government and the finance industry.

Keywords: United States financial crisis, political economy, government regulation, lobbying, political power

1 INTRODUCTION

Since September 2008 the main emphasis of the public, the business world, politicians and economists has been on the global financial crisis[1]. This crisis by now called the "Great Recession" due to its strong and long-lasting effects resulted in social and political instability in various parts of the world. Claims were made that it would outmatch the Great Depression of the 1930s in its profound and lasting consequences. Governments throughout the world are using the panic as an excuse to increase their relative size in the economy and strengthen their regulatory power and the interventionist redistribution of income. Influential economic analysts, populist politicians and anti-globalists are warning of the failure of the free market system, the end of the "neoliberal" economy and are calling for the end of globalization while contributing to the rising protectionism.

This paper will question the notion that the causes of the crisis lie within increasing deregulation and an unconstrained free market. Through analyzing the causes of the global financial crisis the paper will focus on the political economy of the crisis seen through the increasing impact of lobbyists and interest groups on political and regulatory decisions. It is not a question of for or against intervention; it

[1] According to NBER the crisis in the US started in December 2007 and finished in June 2009, but with bankruptcy of Lehman Brothers and the rising danger of further bank crashes the crisis culminated and became widely focused in September 2008. Its consequences are still present in many countries.

is a matter of political decisions that caused a distortion of the market that led to accumulation of systemic risk.

The reasons of banks' risky behaviour do not lie in the deregulation of the banking sector, rather they originate from overregulation and the artificially created demand for housing and mortgages created by those same politicians who now seek for answers to why and how the system got so corrupt and risk-laden. The free and efficient market is being constrained by regulations aimed at punishing those who made inefficient and risky decisions. The central government regulators induced the policies of affordable housing and mortgage investments. Extensive debt accumulation and risk-taking combined with house inflation upon which the growth of the financial sector was fuelled were all consequences of government policies. The banks and other financial institutions caught up in the downward spiral were only following the decisions the government regulations were guiding them into.

The main argument of this paper revolves around that point. The desire of regulators to eliminate risk from the system by determining what kind of decisions businesses should make or by guiding their investment incentives led to the creation of a high level of systemic risk that became inherent to the society.

The paper begins by introducing an international perspective on the current crisis. It focuses around the United States in particular because of its central role in the inception of the crisis which spilled over onto the rest of the world's financial markets and so bringing about the worldwide recession. Subsequently it endeavours to explain opposing views about the causes of the crisis. It continues with a description of the mechanism of adjustable rate mortgages and offers a perspective on increasing bank risk-taking, the burst of the housing bubble and the spill-over effect to the real sector of the economy. In chapter four the paper examines the political and regulatory inducements of the crisis. It covers the impact each of them had on the economy and possible reasons why the policymakers instituted them. These causes include the general regulatory enhancement of systemic risk by the policymakers with the unintended consequences on the bolstering of the crisis, the role of government-sponsored enterprises and the legislative solutions in housing policies as well as the function of rating agencies and intensified banking regulation. An assessment on whether monetary policy had implications in creating the crisis and the housing bubble is given in chapter five with help of the Taylor rule. Finally the role of the rising influence of the political power of the financial industry as possibly the decisive factor of the crisis is portrayed in chapter six.

2 INTERNATIONAL BACKGROUND OF THE CRISIS

The international environment preceding the crisis was characterized by globally stable economic growth, growth of productivity and a low level of inflation – which was a primary result of policy changes by central banks focused on inflation targeting. Short term interest rates were at historically low levels both in the US and

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worldwide (figure 1 and 2). Due to the recession in 2001 the US Federal Reserve Board (Fed) introduced a sharp decrease in its target interest rate. Even though this resulted in the recovery of the economy, figures remained weak, not showing signs did not of a substantial GDP growth or growth of employment, at least until 2005. In addition to this "jobless recovery" there were threats of a decrease in inflation, which was already at very low levels (figure 3) and a serious concern that the US might experience a recession decade, like that endured in Japan in the 90s. Even after tightening of the monetary policy in 2004 real rates still remained rather low (figure 2).

Figure 1
Nominal short-term interest rates (%)

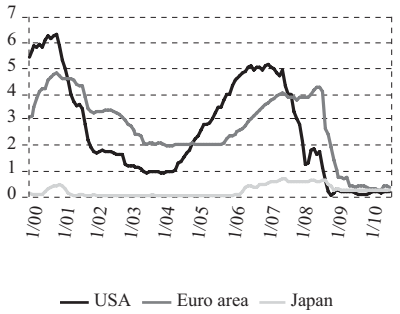


Figure 2
Real short-term interest rates (%)

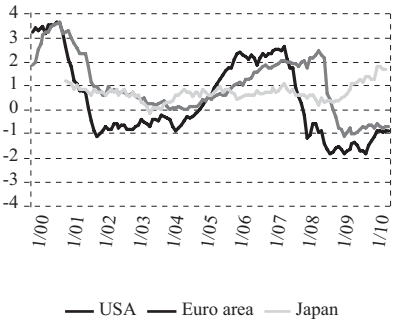


Figure 3
Historically low inflation rates worldwide, average inflation, annual % change

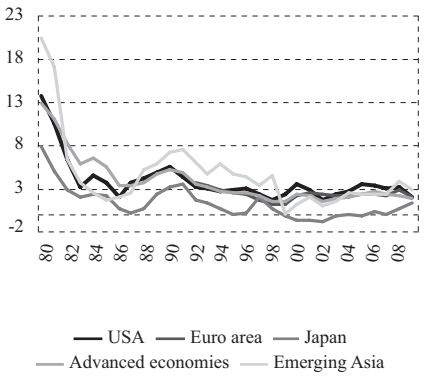
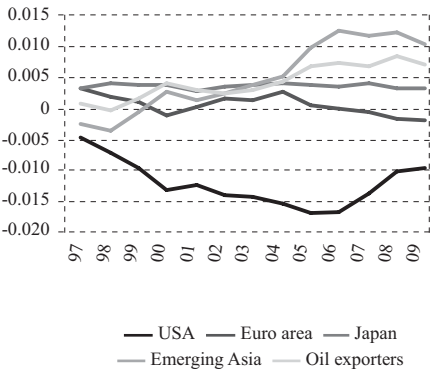


Figure 4
Current account balances as shares of World GDP



Source: IMF (2010).

The European Central Bank (ECB) was less aggressive than the Fed due to the fact that ECB has to deal with differing inflation rates among its member countries whereas the Fed does not. The ECB monetary policy rate generated different effects across the countries of the eurozone. Those countries that had negative real

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policy rates, such as Ireland or Spain, experienced housing booms, while countries with low inflation and higher real policy rates such as Germany, did not experience an asset price bubble.[2] An empirical investigation of monetary policy as a possible cause of the crisis will be addressed later in chapter five.

Low real interest rates reflected high world savings. There was strong demand for safe assets from Asian and oil exporting countries that contributed to depress the yield on long term government securities issued by advanced economies, the US in particular. A low US savings rate also contributed in steering assets from current account surplus countries into financing US investments and consumption. However, capital inflows were used to finance current consumption rather than investment into productive assets. The US current account deficit started to grow uncontrollably by the end of 1998 and reached its highest level around 2006, while at the same time oil exporting countries and emerging Asian countries experienced high surpluses in their current accounts (figure 4). This period is matched by the likewise high growth in the US housing market. There is no proof that the current account deficit itself caused the housing boom, but there is evidence that the inflow of foreign capital was mainly used at the time being for the purchase of real-estate, adding to the housing bubble[3]. Excess savings in Asia were being invested into safe assets such as US government securities, which contributed to a high level of capital inflows into the US. High inflows into the US brought about excessive risk taking and exposed domestic financial institutions, companies and households to exchange rate risk. Pushing excess savings towards assets increases the demand for these assets which resulted in an appreciation of asset prices. This put additional pressure on demand as well as on total output. An inflow of foreign savings, combined with low interest rates and expectations of constantly increasing asset prices resulted in the creation of an asset bubble in both houses and securities. An increasing demand for assets motivated the financial market in developing new instruments and securities (derivatives) whose main purpose was to diversify risks.

3 ORIGINS OF THE CRISIS ON THE HOUSING AND FINANCIAL MARKET

There have been many disagreements as to the causes of the Great Recession. Opposing views have been defined in two main categories; one, the (New) Keynesian, which states that the crisis is to be blamed on deregulation and profit seeking in Wall Street and the other, the free-market approach, blaming lax monetary policy leading to the housing bubble and extensive regulation that curtailed and sustained growth. The basic distinction is in the response to the crisis where the (New) Keynesians urge for more intervention, financial regulation and government stimuli as the drivers of growth. On the other hand the free-marketers try

[2] Low inflation resulting in higher real interest rates was not the only reason why Germany did not experience an asset price boom, but it was nonetheless one of the factors.
[3] For detailed information concerning this issue, see Shiller (2008), chapters 3 and 4.

to prove that more government and regulation are not the answer and can only lead to further stunting of growth.

Those who urge for tightening of regulatory standards such as Akerlof and Shiller (2009), Krugman (2009, 2010), Stiglitz (2010) and Bernanke (2010) point out that banks and Wall Street in general behaved in such a way because they were not submissive enough to controls from the government institutions. Banks were allowed to take too many risks and the market did not (and by some means could not) punish them. Deregulation brought the system down as it was responsible for allowing government enterprises to focus more on profits and less on their social goals, which led them to behave like predatory lenders. Monetary policy is dismissed as a cause because their low-rate policy was justified by a jobless recovery in the post-2001 recession period, accompanied with fears of a deflationary trap.

The bubble on the housing market was due to large capital inflows into the US that lowered interest rates and increased incentives for mortgage lending and home ownership. The bubble started to inflate as financial innovation through the securitization of mortgages and their repackaging into new types of securities made this possible. As more and more securities were being underwritten, the bubble grew even larger. This led to further greed on the financial market where the investors were led by "animal spirits", instead of rational expectations and were investing more than they should have. This psychological category was even more visible when the downturn occurred, as it added to the instability of the markets. The only mistake of the monetary authorities was a lack of regulatory oversight that could have prevented the recessionary effects.

From this standpoint it is obvious that this crisis and the bubble-burst of the housing market are inevitable in the economy as it moves in cycles, in which, after long periods of economic success, a period of economic downturn arises. The causes are in the market itself and its participants who become too greedy and who seek extraordinary profits in good times. This is why government intervention is needed as the government alone is powerful enough to stimulate the economy out of a recession and bring it back to its pre-crisis high growth levels. Without its intervention unemployment would rise and demand would plummet, public unrest causing the system to be even more vulnerable than it already is.

The free-marketers such as Cochrane (2009), Taylor (2009), Friedman (2009), Roberts (2010), Wallison (2010) claim the opposite. The market was being constrained from punishing those who were inefficient, too risky and irresponsible. The regulators imposed housing policies, tax cuts and bank capital restrictions that gave incentives to the banks to fill up their assets with mortgage-based securities. Increasing leverage and risk-taking followed by an increase in home values which sustained the high growth of the financial sector are all a consequence of government guided policies. The banks were making the decisions that the gover-

nment institutions were guiding them into. The area in which the free market could function was constrained.

According to them, the idea of a global savings glut that led to low interest rates and fuelled the housing bubble does not provide a full explanation. Irrational exuberance and animal spirits were present on the market, but they were not crucial in explaining what contributed to bubble growth and herd behaviour. Monetary policy played a crucial role as the interest rates were down to historically low levels and remained this way for too long.

Although both of these views offer an interesting examination of why the system got filled up with risk and how it was possible that the policymakers could not find a proper response, the focus of this paper is not in explaining various views as to what created the recession. Rather, its main purpose is to provide a political economy view on why the market crashed and on the nature of the policies responsible for the state in which the market found itself. It has no intention to explain or analyse the complete American financial sector. The intention is to identify and demonstrate the correlation between political decisions that guided market participants and the causes of the recession.

3.1 BANK RISK TAKING

Until the 2000s the subprime mortgage market was relatively small in size and it was carried mostly by commercial and investment banks whose goal was to buy these mortgages from underwriters, repackage them into mortgage-backed securities (MBSs) and sell them further while backed by the payment of principal and interest on the mortgages. These MBSs were structured by classes with the same collateral but a different level of risk. They were later bought by investors whose interest was the return in the form of interest payments on the mortgages paid by the mortgage owners.

The crisis originated in the United States in the housing and mortgage market where people were buying and selling houses in the hope of making a profit. They invested mostly borrowed money into buying real-estate as the safest possible investment whose price was constantly increasing. As an answer to this increased demand on the housing market the financial institutions increased their credit expansion, lowered lending standards and decreased their interest rates. This resulted in two effects: it increased the debt of households[4] and it increased the banks' demand for other sources of financing. The lack of own sources was compensated for by borrowing from other institutions until the amount of debt became unsustainable, i.e. when it could not be paid out of its own capital[5].

[4] The trend of lagging growth of real wages compared to the real GDP growth added to this increasing household debt and a decrease of domestic savings.

[5] Lehman Brothers borrowed 30 times more than the amount of its own capital. This was impossible to return in the case of a credit crunch in the housing market (SEC – Lehman Annual Report, pg. 29).

This lethal combination of easy credit and rising debt accumulation accompanied by large inflows of foreign funds fuelled a housing construction boom which led to the rise of the US housing bubble. Based on these rising prices and financial innovation[6] many investors, both from the US and worldwide, invested into the US housing market. As the prices went down, those who had invested in the boom started reporting losses. In parallel, ordinary investors, due to their home values now being worth less than mortgage loans contracted, started to be affected by foreclosures, and thus a downward spiral was created.

Banks and investment financial institutions who seem to be traditionally conservative and cautious and who tend to act within their legal boundaries that suppress irresponsible behaviour, went into risk taking and acted quite the opposite to their previous practices. The main cause of such willingness to engage in risk taking was the new regulatory framework for their activities. They had a "safety net" in case something went wrong. By issuing home loans the banks took out insurance for their credit portfolio in terms of credit default swaps (CDSs). These instruments acted as insurance policies (although they formally were not insurance contracts) that guaranteed down payment to the banks in the case of foreclosure or an inability to repay interest. The CDSs were obtained in insurance companies such as American International Group (AIG). In the case of rising housing prices the safety net functioned well. Having a back-up in insurance instruments the banks started offering home loans to people who did not meet the usual criteria, people with low and irregular incomes. The system was based on a never-ending growth in housing prices notwithstanding the risk of potentially negative effects if the prices suddenly started falling. The overheating in the system led to the fall of real-estate prices, i.e. to a burst bubble on the housing market and the inability to service the loans. The banks were not able to pay back the money borrowed from other institutions. Insurance companies could not afford to compensate the losses and the safety net proved to be an illusion.

3.2 THE HOUSING BUBBLE

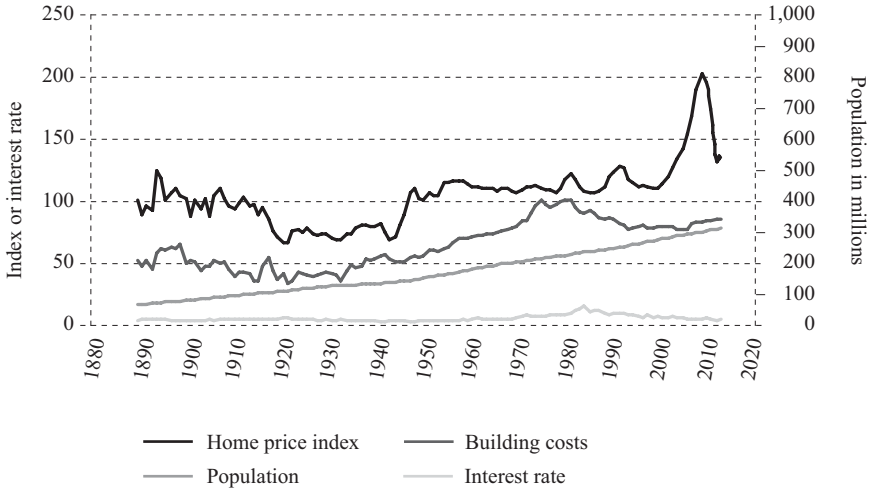
Official policies of the Bush and Clinton administrations gave support to rising household debt accumulation by their policies of making sure every citizen had a home. Lack of financial and credit strength of households was compensated by the government through its specific measures (such as the Tax Relief Act or the Community Reinvestment Act). The government was encouraging commercial and investment banks to give out mortgage loans by guaranteeing them through its government entities. This increased the scope of investing into real-estate; it affected the growth of real-estate prices and led to a loosening of lending standards for new subprime mortgages. This, in turn, opened space for financial innovation of securities and derivatives. The assumption for an asset bubble growth was created. Speculative bubbles are defined as "increases of asset prices that have no

[6] Recognized through the creation of various new financial derivatives such as mortgage-based securities (MBSs), credit default swaps (CDSs) and collateralized debt obligations (CDOs).

rational economic explanation in which the market prices move quite the opposite than when determined by market conditions. The high prices are only temporary and they act as an effect of the enthusiasm of investors, rather than a consistent evaluation of their real asset value" (Shiller, 2006). The bursting of the bubble on the market in real terms means changing the direction of price movements, which are readjusted to their real value. On the housing market in the US there existed an irrational growth of real estate prices, which had deviated from the "equilibrium" path determined by market forces.

Figure 5

S&P Case-Shiller relative home price index



Source: Shiller, 2006.

Robert Shiller created an index of relative housing prices[7] in the United States with a basis year being set as 1890, which shows the movement of house prices up until today (figure 5). The highest growth in housing prices in the given 120 year period took place between 1998 (right after the official decision of the government that everyone should have a home, no matter what the price) and 2006. A house that was worth $110,000 by the end of 1998 was worth $200,000 by the middle of 2006, presenting an 85% increase in prices. The prices were increasing up until the point when the demand for housing could not keep track of its high prices leading to a downward pressure on the prices, which started to fall by the end of 2006.

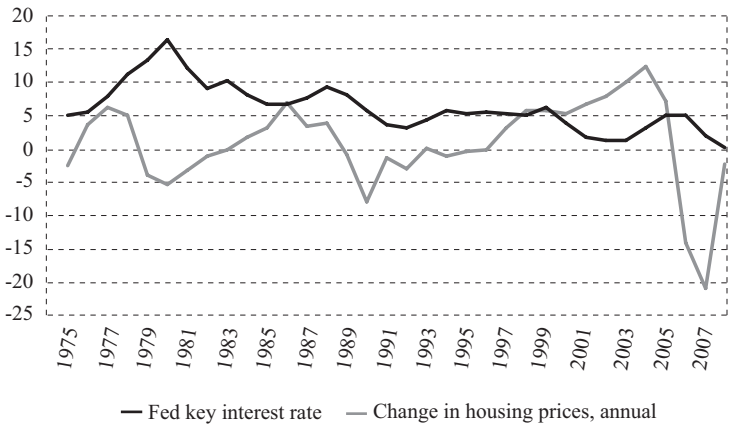
[7] The S&P Case-Shiller U.S. Home Price Index measures the values of single-family housing within the United States. The index measures changes in housing market prices given a constant level of quality. It uses the "repeat sales method" of index calculation which uses the data on properties that have sold at least twice, in order to capture the true appreciated value of each specific sales unit (Standard & Poor's indices).

The financial industry was interlinked with these price movements by issuing MBSs and other derivatives whose returns were based on the strong growth of housing prices. It was common sense at the time that MBSs could diversify risk because they were protected from local misbalances due to their geographical diversification. If one part of the country were to experience a decline in prices, their returns wouldn't be jeopardized because the rise in prices would be continued in other parts of the country. The expectations did not take into account what would happen if the entire country experienced a housing market crash.

Figure 6 offers a closer look at the link between housing prices and the Fed key interest rate in the last 35 year period. It shows that changes in housing prices are negatively related with the level of the Fed interest rate. When interest rates were high, housing prices declined, and as soon as the interest rates started to fall the housing prices would rise, although they did so with a certain lag, as the change in interest rates would always precede the change in housing prices by roughly a one to two year period. In the last decade, the housing prices started to rise rapidly around 2001, followed by a gradual decrease of the interest rate. When the interest rate hit its lowest levels the housing price increases were closing in on their peak. The Fed's decision to raise interest rates in 2004 again resulted in a lag on the housing market as the prices did not decrease until 2006. However, this sharp decrease was not all due to a rising interest rate. If it had been, the fall would not have been so severe; rather it would have had the same scope as the interest rate movement as it did in previous years. This latest drop in housing prices was not a complete consequence of the interest rate movement, although the interest rate movement could have been the trigger that led to a decline in home prices. The answer to what caused the drop to be so rapid and robust lies in out-of-the-model factors, such as political decisions that created incentives to invest into housing, which will be dealt with later in the text.

FIGURE 6

Comparison of housing price changes and the Fed interest rate (%)



Source: Author's own calculations; Federal Reserve Board, 2010; and Standard & Poor's Indices, 2010.

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3.3 CRISIS SPILL-OVER TO THE REAL SECTOR

Political intervention to stabilize the financial market is intensified by negative spill-over effects on the real sector. This is especially evident in the rising unemployment, which jeopardizes social and political stability. In the integrated market, on which spill-over effects act fast, the risk on the financial sector is rapidly spread around to other sectors. In a banking crisis the amount of loans decline and become more expensive resulting in difficulties for the private sector. The crisis on the financial market caused by a credit contraction (due to risk increases and the strengthening of lending criteria) tends to lead to a real sector activity drop and consequently a fall in production and employment. A decrease in demand on the world's largest market brings about a decline of imports in the US, a decrease of other countries' exports to the US and consequently a fall in production, growth of unemployment and a GDP decrease in most countries of the globalized world. The fall of sales and profits in the real sector is reflected in decreasing private sector net present value which is reflected in the stock market. And vice versa, a decline in the stock market decreases the amount of money available, offers more expensive loans, meaning fewer loans for the private sector, a fall in production and profits and a loss of jobs.

A fall in employment levels increases political pressures, and governments try to find an answer in fiscal stimuli to bolster demand, revive production and turn around the unemployment trend. This increases budget expenditures and therefore the budget deficit, which cannot be balanced by levying extra taxes but only by additional debt accumulation. The growing public debt in the US has already reached unprecedented levels, which increase the risk of future instability and crises. The reaction of governments to breakdowns in the financial market, a decrease of exports, decrease of home and foreign demand, growth of unemployment and consequently social turmoil often consists of protectionist measures that can only deepen the crisis. Social turmoil and further instability can result in the strengthening of populism and authoritarian solutions and to further endangering of democratic orders.

The crisis has strengthened the interventionist and regulatory powers of the government, which in the short run, in order to maintain political stability, may prove to be simulative of economic recovery. However, in the long run this may prove to be a risky orientation. It is unlikely that substituting government for the market can prove to be an efficient answer, at least not in the long run. Empirical testing is needed to prove the riskiness of such a trend on future economic growth. It is essential to restore the faith in the market as the most efficient way of creating wealth.

4 REGULATORY AND POLITICAL CAUSES OF THE CRISES

4.1 REGULATION AND SYSTEMIC RISK

Greed and corruption seem to be the most popular two causes that are being blamed for the risky behaviour of banks and other financial institutions. While no one

denies the existence of these motives, as they are always present, there is no evidence that they culminated in 2007-2008 and caused the crisis. The financial institutions invested into only the safest securities with an AAA rating, as determined by the authorised rating agencies and rated as securities with the minimum risk and therefore the lowest return. It is questionable to link investing into low-risk AAA securities with greed for extra profits. Investors were behaving rationally in this case. The reasons for increasing investments into MBSs and hence bolstering the housing bubble should be seen in regulatory policy decisions. The policies of the legislative and executive government were made for the political goals of gaining voters. Combined with an increasing influence of lobbyists and various interest groups this resulted in the gradual creation of systemic risk for the financial system. Systemic risk was built in by regulatory decisions such as affordable housing policies, granting an oligopoly to rating agencies, activities of government sponsored enterprises on the mortgage market and by additional regulations imposed on banks' capital. Systemic risk created in this way was not a consequence of bad intentions; it was concealed behind desires to reform business activity by diminishing or even eliminating risk and uncertainty. The origin of increased risk-taking lies in the informational and cognitive basis of regulatory decisions which have a much narrower effect than when they are spontaneously created by market regulations. Even in the case of public good provision where market failures do exist, the acquisition of public goods by the government is much more efficient in a market environment than in a collectivistic economy. The efficiency of the financial market is being decreased with growing regulation bestowed upon it, thus increasing its systemic risk.

4.2 FANNIE MAE AND FREDDIE MAC: GOVERNMENT SPONSORED ENTERPRISES

Government sponsored enterprises (GSEs), the Federal National Mortgage Association (*Fannie Mae*) and the Federal Home Loan Mortgage Corporation (*Freddie Mac*) both had a crucial role in creating the bubble on the housing market. Their main goal was to purchase loans from banks on the subprime mortgage market. Once in ownership of the loan they take full responsibility for it, receiving interests on a monthly basis and taking over the risks of default on the loan. Fannie and Freddie have the option of either keeping these loans as a source of monthly revenue or repackaging them and selling them as mortgage-backed securities to investors. The banks use the money from selling their loans to acquire new mortgage loans and the entire cycle is continued. Mortgage prices rise as a source of additional mortgage loan creation from the banks selling them to the GSEs. "By increasing the demand for mortgages in the secondary market, the GSEs can reduce the interest rates the homebuyers pay on the mortgages in the primary market, fostering home ownership" (Levine, 2010) which was their main purpose created by the government.

Securities issued by the GSEs were marked as government issued securities and were considered to be of a substantially low risk and hence low return. This was

due to the general notion that they would be bailed out by the government if they experienced any solvency or liquidity problems.

By the end of 1990s as the real estate market expanded, so did the influence of the GSEs on that market. By the time the government took over their business in 2008 they had acquired half of all American MBSs and three quarters of newly issued mortgages (HUD, 2008). Since 1999 Fannie Mae had been lowering standards for buying mortgages from banks who were favoured to "expand the MBS business to those individuals whose credit rating is not good enough to even get an ordinary loan" (Friedman, 2009). The total amount of mortgage loans with a low down payment that Fannie and Freddie bought had quadrupled in the period between 1998 and 2003 (table 1). By 2007 Fannie and Freddie were the owners of a quarter of all mortgage loans issued with an interest rate less than 5%.

Table 1

Total purchases of mortgage loans by Fannie Mae and Freddie Mac with low interest payments

Year	Total amount of mortgage loans with a repayment lower than 5% owned by Fannie Mae and Freddie Mac (in thousands of mortgage loans)	Percentage of mortgage loans with a repayment lower than 5% in total mortgage loans owned by Fannie Mae and Freddie Mac
1998	75.6	4
1999	91.9	5
2000	106.3	5
2001	162.4	7
2002	214.4	8
2003	311.3	12
2004	268.7	11
2005	306.1	12
2006	390.0	15
2007	608.6	23

Source: U.S. Department of Housing and Urban Development (HUD), 2008b; and Roberts, 2010:29.

The Housing and Urban Department (HUD) instituted a set of housing policy goals as a part of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. The most interesting one concerned the Low-and Moderate-Income Goal that transferred the authority to the GSEs to purchase as many as these mor-

tgage loans from low and moderate income borrowers as the goal determined (HUD, 2008). Table 2 shows how these goals were being overachieved by Fannie and Freddie. The Congress set a policy through the HUD that the GSEs must buy a pre-determined amount of these mortgage loans and made unlimited funding available to them in order to attain the political goal. This in turn resulted in Fannie and Freddie's high involvement in the mortgage market.

Table 2

Low-and moderate-income:[a] mortgage loans owned by Fannie and Freddie with respect to HUD's goals (% of total low-and moderate-income mortgage loans)

Year	2000	2001	2002	2003	2004	2005	2006	2007
Fannie Mae	49.5	51.5	51.8	52.3	53.4	55.1	56.9	55.5
Freddie Mac	49.9	53.2	50.3	51.2	51.6	54	55.9	56.1
HUD goals	42	50	50	50	50	52	53	55

[a] *Households with income less than or equal to median income.*
Source: U.S. Department of Housing and Urban Development (HUD), 2008a.

However, certain claims say that the growth of the subprime mortgage market was primarily underwritten by private mortgage lenders like Countrywide, not by Fannie and Freddie. "Fannie and Freddie accounted for a sharply reduced share of the home lending market as a whole during the peak years of the bubble. To the extent that they did purchase dubious home loans, they were in pursuit of profit, not social objectives – in effect; they were trying to catch up with private lenders" (Krugman, 2010).

According to the Housing and Urban Department (HUD) the GSEs had acquired more subprime mortgages than rest of the market altogether (HUD, 2008). Their advantage was funding at a very low cost which meant that they had "no competition for any asset they were willing to buy" (Wallison, 2009). Their entrance into the subprime mortgage market justified by reaching the government targets resulted in their rapidly achieving the dominant position on that market.

The impact of the GSEs on the mortgage market meant that more and more originators of mortgage loans would strive to extend them to dubious borrowers, as they now had an artificially created market for these kinds of securities. "There was a huge frenzy at the originator level to produce the subprime and Alt-A loans that would then be sold to the GSEs" (Wallison, 2009). Because of their impact the market was growing. And the only way the GSEs were able to make profits was for the market to keep on growing. They were therefore benefiting from economies of scale. The Fed also made a study on this matter that showed that "the GSEs were not even successful in reducing interest rates for middle-class home

buyers – the central justification they always claimed for their existence" (Greenspan, 2010). In addition to this Alan Greenspan warned the Congress in his testimony before the US Senate of the potential hazardous effects Fannie and Freddie could have upon the system. He warned of increasing mortgage securitization and a threat of creating systemic risk for the US financial system if the GSEs were to become too large and gain a huge share of the home mortgage market (Greenspan, 2005). The Congress neglected many warnings and did nothing.

The behaviour, however, did not go unnoticed in the political arena. The opposition Republicans (before 2001) were calling for additional regulation and supervision of Fannie and Freddie, while the Democrats responded accusing the Republicans of being against "affordable housing" for all Americans, preserving the *status quo*. In addition to that both Fannie and Freddie were reliable sources of campaign donations for mostly Democrats (table 3). Democratic candidates received twice as many contributions as the Republicans in the twenty year period. Political elites and Fannie and Freddie were mutually benefiting from their lobbying and campaign donations creating thus a privileged position for the GSEs on the market. This resulted in the previously mentioned lack of competition for the government-protected companies as well as their ease of financing.

The political implication in the story behind Fannie and Freddie is worth noticing, as for some reason the need to reform Fannie and Freddie has been neglected by the new regulatory bill in Congress. The GSEs influence among Congress members, especially on those who wrote the bill (Senator Dodd and Congressman Frank in particular) is still intact as the funds are "flowing" from the GSEs to the Congress members [8].

Fannie Mae and Freddie Mac were included in the political decisions of the American government for obtaining its political goal of expanding the availability of loans for buying houses to all social groups, especially to low-income minorities. The risk was becoming inherent to them by the dictate made by government policies, which was to escalate in the case of a recession or falling housing prices. The first to be hit by this possible recession were the social groups with low and unstable incomes. The regulatory decisions demanded from Fannie and Freddie a repurchase of mortgage loans and securities from those who could not have made regular down payments. This was all due to the pursuit of a populist government policy – that everyone is entitled to a home, with no regard to their income, as the fight against homelessness and poverty leads to election success, disregarding the long run effect.

[8] Both of the companies were strategically giving large donations to those politicians who were sitting in the boards regulating their industry. Fifteen of the 25 listed members of the House and the Senate that gained the most campaign funds were either members of the House Financial Services Committee, the Senate Banking, Housing & Urban Affairs Committee or the Senate Finance Committee. Senator Dodd, with the most granted campaign funds, is the chairman of the Senate Banking Committee, while Congressman Kanjorski is the Chairman of the Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (Center for Responsive Politics, 2009).

TABLE 3

Fannie Mae and Freddie Mac political campaign donations from 1989 to 2008

Representative	Party/State	Funds (thousands USD)	Representative	Party/State	Funds (thousands USD)
1) Dodd, Christopher	Democratic-CT	133.9	6) Bennett, Robert F.	Republican-UT	61.4
2) Kerry, John	Democratic-MA	111.0	9) Davis, Tom	Republican-VA	55.4
3) Obama, Barack	Democratic-IL	105.8	10) Bond, Christo-pher	Republican-MO	55.4
4) Clinton, Hillary	Democratic-NY	75.5	11) Bachus, Spencer	Republican-AL	55.3
5) Kanjorski, Paul	Democratic-PA	65.5	12) Shelby, Richard	Republican-AL	55.0
7) Johnson, Tim	Democratic-SD	61.0	19) Blunt, Roy	Republican-MO	36.5
8) Conrad, Kent	Democratic-ND	58.9	20) Pryce, Deborah	Republican-OH	34.7
13) Emanuel, Rahm	Democratic-IL	51.7	21) Miller, Gary	Republican-CA	33.0
14) Reed, Jack	Democratic-RI	50.7	23) Reynolds, Tom	Republican-NY	32.7
15) Carper, Tom	Democratic-DE	44.3			
16) Frank, Barney	Democratic-MA	40.1			
17) Maloney, Carolyn	Democratic-NY	38.7			
18) Bean, Melissa	Democratic-IL	37.2			
22) Pelosi, Nancy	Democratic-CA	32.7			
24) Hoyer, Steny	Democratic-MD	30.5			
25) Hooley, Darlene	Democratic-OR	28.7			
Total	**Democrats**	**966.7**	**Total**	**Republicans**	**419.6**

*Annotation: The numbers by the names of the representatives mark the rank of the amount of funds given for their campaign by Fannie Mae and/or Freddie Mac.

Source: Center for responsive politics, 2010a.

4.3 COMMUNITY REINVESTMENT ACT AND POLITICAL ENCOURAGEMENT OF AFFORDABLE HOUSING

One of the pressures on Fannie and Freddie to enter the subprime mortgage market was the Community Reinvestment Act (CRA). Although it was legislated back in 1977 it was revised several times since, the most important revision arriving in 1995 when the government changed the Act so as to "force the banks who issue mortgage loans to prove a more active contribution to lending towards unprivileged social groups within their communities such as minorities" (Niskanen, 1995).

The regulator was even threatening law suits against those banks who do not lend to minorities in the legally proscribed amounts.

Stan Liebowitz from the University of Texas was investigating the policies regarding the housing market from 1990 to 2006. He pointed out that "perhaps these weaker lending standards that every government agency involved with housing tried to advance, that the Congress tried to advance, that the presidency tried to advance, that the GSEs tried to advance – and with which the penitent banks initially went along and eventually supported with enthusiasm – might lead to high defaults, particularly if housing prices should stop rising" (Woods, 2009).

The banks, along with the GSEs were following the government's instructions. They weren't deliberately lowering interest rates or their lending standards thus making them more available to riskier borrowers. The reasons behind the banks giving loans to people who simply could not afford to become homeowners lies primary in politically governed decisions which only resulted in increasing the risk of the banking sector in dealing with real estates and MBSs.

The government, through encouraging homeownership, created an artificial demand on the housing market, leading to its further distortion. This was visible through a series of policy Acts instituted in the 90s the effects of which were not visible until 2006. The constructers also received outstanding privileges, benefits and reliefs for building a house (which continued to when the supply shrunk and the people stopped buying houses). Due to rising social injustice and due to their policies of resource redistribution, government regulation led to even riskier loans and poor investment decisions resulting in an even bigger misallocation of the very resources they were to reallocate. Loan requirements were softened due to the short run interests of politicians thinking only of how to win the next election and remain in power. The affordable housing idea proved to be a political trick with costly unintended consequences.

4.4 THE RATING AGENCY OLIGOPOLY

The rating agencies were, like Fannie and Freddie, privately owned companies that enjoyed large government benefits. A large amount of institutional investors such as retirement funds, insurance companies and banks were forbidden to purchase securities with a lower rating than BBB as determined by the recognized rating agencies. The regulator in certain cases allowed only the purchase of highest AAA rated securities creating thus a favourable market for credit rating agencies. In 1975 a government regulating agency, Securities and Exchange Commission (SEC), gave an oligopoly status to three rating agencies in the US. Standard & Poor's, Moody's and Fitch became the only agencies that had the right to give out official ratings to various market securities. They were set as NRSROs (*Nationally Recognized Statistical Rating Organizations*) and they were the only

ones good enough to comply with SECs regulatory requirements in order to evaluate the riskiness of a security.

Such a decision brought about a large distortion of the financial market as the impact of the decision had severe consequences on financial stability. The regulators restricted the supply of ratings, empowering only the NRSROs to provide ratings to which the rest of the financial industry needed to comply. They also increased the demand for rating agencies services as the entire financial industry that was under regulatory supervision had to use the NRSROs ratings in order to determine their capital requirements. The government was also using the same ratings, as all the securities issued by the government, including its GSEs, were rated with the highest investment grade. Companies that would not use the NRSROs ratings faced a limited market for their securities. The system became much too dependent on the role of the rating agencies.

"The rating agencies faced little market discipline, had no significant regulatory oversight, were protected from competition by regulators and enjoyed a burgeoning market for their services" (Levine, 2010). In a situation with limited competition due to a restricted access of entry to the market the agencies had no incentive to use up-to-date methods and no incentive to reveal their credit making process creating thus a lack of transparency. There was no market-correcting mechanism to ensure accuracy. In addition, the agencies operated in a particular business model where the "issuer pays" for the rating. Before the 1970s the agencies were operating in an "investor pays" model where if one agency was giving out bad ratings the customer would simply buy the rating from one of its competitors. The new model of "issuer pays" automatically implies the problem of a conflict of interest. Companies prefer favourable ratings as this can lower their costs of capital. They care less about the accuracy of the rating. Since the rating agencies depend on revenue from the securities issuers, who wish for the best ratings possible, the desire of the agencies to please their customers may result in sub-optimal ratings.

The rating agencies dismissed the idea that they were in conflict of interest as they rely on "reputational capital" meaning that if investors figure out that a certain rating agency is giving out bad ratings (meaning that they are too high with respect to the risk of an asset or company) this agency would soon start losing reputation. The loss of reputation would result in loss of clients as the issuers would now turn to different agencies for rating evaluation not wanting to lose potential investors in their securities because of the link to the bad rating agency. Issuers would reduce their demand for this agency and this would result in the reduction of the agency's future profits and would cause problems in the long-run. However, in order for the reputational capital argument to stand, there needs to exist a wide variety of competitors to which the issuers can turn to. The NRSRO concept implies that all those financial institutions that need to serve the capital regulation standards of the SEC have to use the nationally recognized rating agencies. In

addition to that there is not much competition in the ratings market especially when all three agencies use similar methods and have similar incentives.

The effect of the condition the rating agencies found themselves in is that, although private, due to their oligopoly position, they could use any techniques they wished for evaluating the riskiness of a company or an asset, "while their financial success did not depend on the outcomes of these techniques to produce a certain something that someone is willing to buy" (Friedman, 2009). If the rating agencies are making bad decisions and therefore sending wrong signals to investors they can't be held account for their actions as they are protected by their NRSRO status. In addition to that the rating agencies cannot be sued due to wrong or misjudged ratings as they only provide opinions and are therefore protected by the First Amendment of the US Constitution. Their imprecision and bad evaluations could not have hurt their profits, because they did not have any competition to punish them for doing a poor job. For example, according to Friedman (2009) "Moody's hasn't updated its main statistical assumptions on the American mortgage-backed securities market since 2002. This means that the dynamics of an unprecedented growth on the housing and the mortgage market wasn't taken into account at all". Rating agencies took full advantage of working in such a distorted environment. This was obvious in the cases of Enron and Lehman Brothers whose ratings held high up to only a couple of days before bankruptcy. Also academic research concluded that rating agencies "lag stock price movements by about 18 months" (Levine, 2010). Such behaviour could have been prevented in an open competition credit ratings market in which imprecision and neglect in estimates would have been punished by the loss of reputation, clients and money. The regulator did not allow this as it favoured private agencies and allowed them to be ineffective and corruptive.

4.5 INCREASING FINANCIAL REGULATION: THE RECOURSE RULE

Rating agencies errors are important because of the link they have with existing banking regulation standards that demanded from banks to fill up their assets with AAA rated securities. "Securities rated AA or better qualified for a lower capital requirement. Normally, banks are required to have capital equal to 4 percent of the value of mortgages held. But those with an implicit government guarantee, such as securities issued by Fannie Mae, only required capital equal to 1.6 percent of asset value. Once AA rated, CDOs qualified for the same lower capital requirement that applied to quasi-government securities, putting even more pressure on the credit rating agencies to inflate ratings. That would free up bank capital for additional profit-making investments." (Bartlett, 2010). The reason why investment and commercial banks engaged in buying MBSs instead of, for example Treasury Bills, considered to be the safest possible investment, lies in another regulatory decision – the recourse rule enforced by the Federal Reserve, Federal Deposit Insurance Corporation and the Office of Thrift Supervision in 2001 as an American amendment of the Basel regulations.

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According to this rule American banks were required to spend more capital on commercial and corporate loans and less capital for investing into asset-backed securities, such as MBSs, as long as these securities were rated AAA or were issued by the GSEs. Basically, this rule implies that for every $100 investment into mortgage-based securities, $2 in capital was required, compared to $5 for the same amount in mortgage loans and $10 for the same amount in commercial loans[9] (Friedman and Kraus, 2010). This rule was designed to guide the banks funds into allegedly less risky assets, such as AAA MBSs issued by Fannie or Freddie. "The fact that 93 percent of the banks' mortgage-backed securities were either AAA rated or were issued by a GSE shows that this is exactly what the rule accomplished" (ibid, 2010). It filled the banks' balances with what later proved to be toxic and high risk assets.

In addition to steering bank investments, the recourse rule may have been one of the causes of increasing housing prices throughout the US. The more MBSs were bought and packaged by the banks that were following the capital standards, the more mortgages had to be written so as to cope with the rising demand. This created an artificial demand for AAA mortgage-based securities. In order to satisfy the demand there was an increasing need to underwrite asset-backed securities, of which the safest were mortgage-backed, as housing prices always increase. The artificially created demand for MBSs could prove to be one of the explanations behind lower lending standards that made mortgage loans more available to low-income borrowers.

Regarding the fact that bank investments, government policies and government sponsored enterprises were guiding the decisions of market participants, it could be inferred that the global financial crisis was caused by regulation, or better yet by failed government intervention on the market. It would be wrong to accuse the banks of taking too much risk or being too greedy in this case. They were simply exploiting the given profit opportunity. Their investments and incentives were guided into wrong assets by the policies set by regulators in order to avoid risk taking. The regulators tried to change the behaviour of market participants in a way that seemed optimal. By doing so they negatively influenced the subprime mortgage market, sending wrong signals to investors that led to the distortion of the financial and housing market.

It is not realistic that a central regulator can make better decisions on which types of assets to invest in than a private investor. Every market participant is best left alone in assessing its investment decisions as well as the riskiness of an investment. When investment decisions are proscribed by law this brings about a distortion of the market, as potentially efficient investments are being substituted with those determined by the legislator. This means that successful projects are being left out for the purpose of achieving politically determined goals. Regulatory de-

[9] Meaning that by investing into MBSs they could use more money for further credit and deposit creation.

cisions adopted preceding the crisis created an artificial demand for mortgage-based securities which further led to an increase of the demand for mortgage loans, loosening of lending standards and an increase of the risk of default on the loans. The consequence was an inflated housing bubble. Every artificially created demand which is based on political rather than market decisions leads to artificial price growth and to privileging certain interest groups, assets or investments.

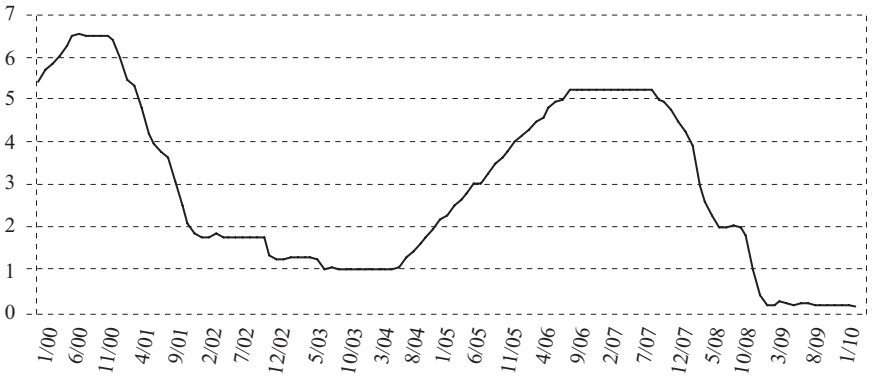
5 MONETARY POLICY OF THE FEDERAL RESERVE

At the beginning of the decade the American Federal Reserve Board was leading a highly expansionary monetary policy in order to alleviate the shocks that had hit the US economy at the beginning of the decade (such as the dot-com boom, the 9/11 attacks followed by an invasion of first Afghanistan and then Iraq, and a series of corporate scandals throughout 2002). By increasing the money supply and lowering its reference interest rate to historically low levels the Fed prevented the possible recession threatening the economy at the time. However, the easy money policy had a contrary effect as it created a favourable environment for further mortgage expansion.

The key indicator of a central banks' monetary policy is its reference interest rate. In the US this refers to the federal funds rate determined by the Federal Open Market Committee (FOMC). It presents the overnight rate by which the banks lend funds to one another.

Figure 7

The Fed key interest rate: FOMC overnight federal funds rate (%)



Source: Federal Reserve Board, 2010.

The overnight federal funds rate classifies as an open market operation maintained by central banks as one of the key instruments of monetary policy. Open market operations became the main instrument of developed nations' central banks as through the movement of key interest rates one can draw conclusions on what is the reaction or direction of a central banks' monetary policy. As a response to the 2001

recession, the rate decreased from 6.5% at the end of 2000 to 1.75% in December 2001 and eventually to a record low 1% in June 2003 where it remained for almost a year (figure 7). The reason behind such an expansionary monetary policy was a slow recovery with rising unemployment (peaking at 6% in the first half of 2003) and a slow GDP growth rate (an average of less than 2%) combined with fears of deflation and the possibility of experiencing a depression decade such as Japan in the 1990s (Bernanke, 2010).

One of the crucial questions on the current crisis has been concerning the Fed's monetary policy and whether it had an effect on housing prices. One way of examining the scope of monetary policy effects is by using the Taylor rule. This popular policy guidance rule was created by John Taylor (1993) of the University of Stanford. The Taylor rule examines monetary policy by relating the overnight federal funds interest rate to tradeoffs in inflation (difference between the real and target inflation rate) and output (difference of current output from the potential output):

$$i_t = r_t^* + \pi_t + a\left(\pi_t - \pi_t^*\right) + b\left(y_t - \bar{y}_t\right). \quad (1)$$

Where:

i_t; recommended key interest rate for a given period in time, t

r_t^*; long-run key interest rate, estimate $r_t^* = 2$

π_t; real rate of inflation in a given period of time, t

$(\pi_t - \pi_t^*)$; difference between real and target inflation rate in a given period of time

$(y_t - \bar{y}_t)$; output gap, difference between real and potential output in a given period of time

$a, b > 0$, $a, b \in \langle 0,1 \rangle =$, $a+b = 1$; parameters which describe how the interest rate reacts on inflation and output deviations from their target and potential levels.

According to the Taylor rule the federal funds interest rates should be higher when inflation is above its target level $(\pi - \pi^*) > 0$ or when real output is higher than potential output $(y - y^*) > 0$. Taylor estimated a long-term value of the federal funds rate to be around 2%. His rule basically shows that when output and inflation are equal to their potential rates, the federal funds rate should be 2 plus the level of inflation.

An important thing to determine while calculating the Taylor rule rate are the values of a and b parameters for inflation and output gaps. Both of the parameters should be positive and have a value of 0.5 giving therefore the same weight to both inflation and output. The same weight given to output and inflation is justified by the fact that a stable price level and economic growth represented two main goals of central banks, an assumption that will be questioned later on. The Taylor rule anticipates a high interest rate (and therefore a restrictive monetary

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policy) when the inflation is above its target rate or when output is above its full employment level. This would result in a decrease of inflationary pressures. In the opposite scenario it anticipates a low interest rate so as to stimulate output. According to the Taylor rule an increase of inflation by 1 basis point should result in an increase of the nominal interest rate by more than one basis point[10] (Taylor, 1993).

The long-run Fed target inflation rate for the US, used in the calculation, revolved around 2%. The data used for calculating the potential output were taken from the Congressional Budget Office (CBO, the institution that officially measures the potential output for the US). By inserting the mentioned variables in the Taylor model the next equation is obtained:

$$i_t = 2 + \pi_t + 0.5(\pi_t + \pi_t^*) + 0.5(y_t - \bar{y}_t) \quad (2)$$

The data for inflation and output gaps are given in table A in the appendix. By putting in the given values of the variables in equation (2) the quarter rates for the suggested Taylor rule interest rate were obtained. Between the first quarters of 2002 up until the first quarter of 2006 the Fed was conducting a restrictive monetary policy and the interest rate was too low in comparison with the real economic conditions at the time (figure 8). The Taylor interest rate did not fall below 3% in the period when the federal funds rate was locked down at 1%. The Taylor rate even rose to 4 and more percent suggesting an increase of the federal funds rate. The market was sending signals of an increasing economic activity at the time, to which the Fed should have replied by increasing its interest rate. According to this analysis the Fed disregarded the market signals and continued with an expansionary monetary policy giving an additional boost to the growth of the housing bubble.

The main assumption of the Taylor rule is that output and inflation are the main policy goals of the Fed. However, the Fed's main policy goals are stable prices, maximum employment and moderate long-run interest rates, which should eventually lead to a stable output and growth levels. Up until the 1990s the levels of high employment were highly correlated with output growth, but in the recent recession employment levels started to lag behind economic recovery, hence the term "jobless growth". The once interrelated Fed goals are now slightly detached as the Fed experiences political pressures if employment is not at its maximum level, even if output and inflation are at their expected levels. The voters often see unemployment as the best yardstick to conclude whether the current government is doing a good job or not. This creates additional political pressure on the ruling party in Congress as they need to satisfy voters before the election making them

[10] John Taylor explains his rule in the following way: if inflation rises by 1% the proper answer would be a raise of the interest rate by 1.5%. This increase doesn't always have to be 1.5% but it is crucial that it were above 1%. If the GDP would drop by 1% with respect to its potential growth level, then the right answer would be to lower the interest rate by 0.5%. For more see [http://www.econtalk.org/archives/2008/08/john_taylor_on.html].

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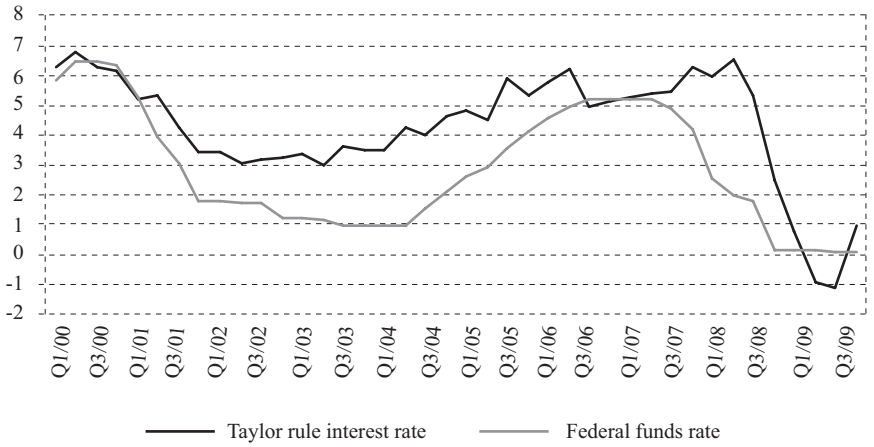
believe that they indeed can handle the economy. The Fed doesn't answer to the public on how it is governing the monetary policy or whether it maintains a stable level of employment, but it does to the Congress. Thus Congress can create political pressure on the Fed, despite the Fed's huge independence, to focus on one goal in particular.

FIGURE 8

Comparison of the federal funds rate determined by FOMC and the suggested interest rate as determined by the Taylor rule (%)



Source: Federal Reserve Board, 2010 (appendix table A).

This may influence the justifiability of using the Taylor rule in assessing monetary policy, as the employment level and the deviation from its potential level rather than output have to be taken into account while determining whether the Fed was making the right policy decisions or not. If the Fed was following the full employment level goal which caused it to alter its policy rates from the market determined ones, one could presume that this was due to political pressure. Due to the jobless recovery in the post-2001 recession the reason behind low policy rates could have been the fact that employment was not following the output growth.

The Taylor rule suggested that output and inflation were at stable levels and that there was no need for low interest rates (at least not for so long). From this perspective the low rates might have been justified. However, it remains a fact that low rates contributed to the expansion of the housing bubble. Therefore, although low rates had an effect on rising housing prices (as was seen in figure 6 in chapter 3.2) they cannot be construed as the only cause of the bubble bursting (as is also shown on figure 6). From this it can be inferred that the Fed did not have a crucial role in the crisis as its rates were justifiable at the time. Nonetheless the rates were low enough to create a favourable environment for the bubble growth, but had little to

do with its rapid bursting and the fact that the demand on the housing market rose so rapidly. The cause of increasing demand lies in other areas of policy decision-making, such as the ones already presented in this paper.

6 POLITICAL POWER OF THE FINANCIAL SECTOR

With regulatory oversights a scene was set for even bigger investments into riskier deals, asset bubble inflation and bursting. The process that preceded the crisis was the expansion of the finance industry and its lobbyist and political power in the 80s and the 90s.

The enormous wealth accumulated by the financial sector gave the bankers great political power – the biggest since J.P. Morgan. During his time (1907) a banking panic could have been stopped only by a coordination of all the bankers in the private sector, because there wasn't any government body strong enough to provide an effective solution. The age of banking oligarchs has been suspended by the establishment of various new regulatory measures following the Great Depression of 1933 (such as the Glass-Steagall Act). In the period between the 1980s and 2002 there was an increasing trend toward profitability of the financial sector whilst the real sector experienced a decrease of its profits in relation to GDP (figure 9). In the years preceding the crisis the financial sector growth was even more impulsive and due to rising amount of credit available in the system it is possible that the real sector growth in profitability at the time was fuelled by the financial sector growth. A trend in which there is a decrease of investment into the real sector as against an increase of investments into the financial sector is known as a process of *financialization* – a rise of the share of the financial sector as part of the GDP. In the 1970s the financial sector had a share in total US profits of around 17%, in the 1990s this grew to in-between 21 and 30% whilst just before the Great Recession it reached a level of 41%. Parallel to this increase of the scope of the financial sector there was a growing gap between the real economy and the total value of all financial transactions concerning derivatives and other securities. This gap developed to a ratio of 1:4 in favour of the financial industry (the World GDP being around 50 trillion dollars and the value of all financial transactions reaching around 200 trillion dollars) (IMF, 2009).

FIGURE 9

US private sector profits as share od GDP (%), annual

Source: Government Printing Office, 2010.

6.1 LOBBYING AND POLITICAL POWER

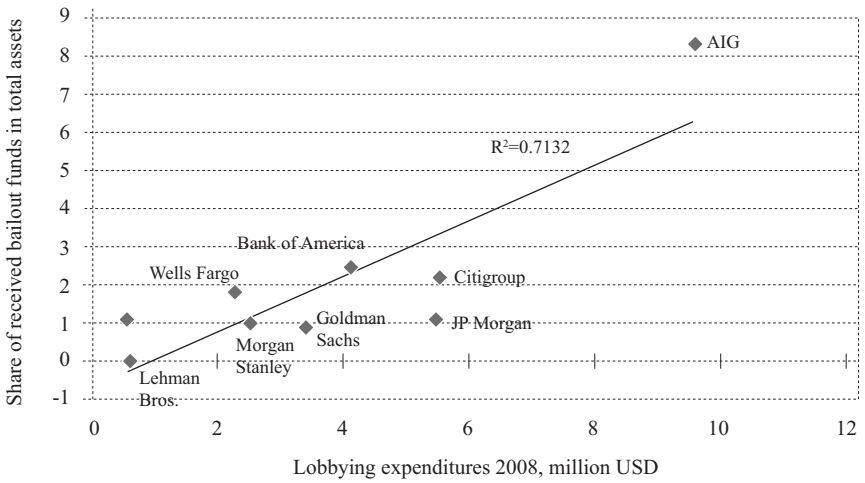
The US financial industry gained more and more support and trust at the national level, which matched the support the real sector industries had had before. "Once what was good for General Motors was good for the country. Over the past decade, the attitude took hold that what was good for Wall Street was good for the country" (Johnson, 2009). The bankers had gained political power due to their rising economic power and developed into much more than mere interest groups as their interests became identical with those of the government.

Simon Johnson draws attention to the flow of individuals between Wall Street and Washington that only emphasises the linkage between newly empowered bankers and the government. Robert Rubin, the co-chairman of Goldman Sachs was the Treasury Secretary in the Clinton administration and after his political career ended up in Citigroup. Henry Paulson, the CEO of Goldman Sachs, was appointed the Treasury Secretary in the Bush administration. Paulson's predecessor John Snow later became the chairman of a large private equity firm Cerberus Capital Management, while Alan Greenspan, a long-time Chairman of the Fed became a consultant in Pimco, one of the strongest international bond market companies. Such connections are even bigger at lower bureaucratic levels in the last three presidential administrations which have further increased the strong bonds between Washington and Wall Street. For Goldman Sachs employees it was almost a tradition to find jobs in public services after they leave the firm, and vice versa – after a career in the public sector they were always welcome back to their position on Wall Street (Johnson, 2009).

The system of power accumulated by the financial institutions becomes more evident when looking at bailout funds and by what principles were they redistributed. According to figure 10 there is a correlation between the amount of bailout funds and the company's lobbying expenditures and campaign donations. For example, although the bailout was supposed to be redistributed according to the size of assets of a certain company it is clear that AIG, although not the biggest in the size of its assets got arguably the most money from the bailout. The reason for that could be the fact that AIG had the most lobbying expenditures in 2008 as well as throughout the decade. Perhaps allowing AIG to declare bankruptcy would have proven to be highly destabilizing for the financial system, but it still doesn't justify the disproportion in the bailout funds received by AIG and all other banks, where the bailout funds were approximately 8% of AIG asset values. No other bank received bailout funds of more than 2.5% of its total assets (table 4).

Figure 10

Bailout funds and lobbying expenditures in 2008



Source: Author's own calculations (data – see table 4).

Banks such as Citigroup, JP Morgan Chase or Bank of America spent a lot of money on lobbying activities so as to avoid bankruptcy and acquire additional benefits for further business activities (such as acquisitions of Bear Sterns and Washington Mutual by JP Morgan Chase or Merrill Lynch by Bank of America). Their lobbying activities did not allow the Lehman Brothers scenario. Although they were also companies full of "toxic" assets they ended up acquiring new banks and expanding their business activity. The first five banks by the size of assets are at the same time the five banks with the most lobbying expenditures, taking into account the last 10 years as well as 2008 (table 4). In both cases the only one that stands out is AIG which has in the last 10 years, as well as in 2008,

spent the most money on lobbying. The lobbying policies of AIG correspond with its bailout funds. AIG was given two times more funds than any other financial company. Lehman Brothers, the only big bank that was left to fail did not invest as much into lobbying and political campaigns as other financial institutions that found themselves in similar problems[11].

TABLE 4

Bailout funds, total assets and lobbying and political campaign expenditures of the recipients of the bailout funds

Financial institution	Received bailout funds (billion USD)[a]	Total assets (billion USD)[b]	Bailouts as share of total assets (%)	Lobbying expenditures 2008 (million USD)[c]	Campaign donations 2007-08 (million USD)	Lobbying expenditures 1998-2008 (million USD)
AIG[d]	85	1,022	8.32	9.57	0.33	90.9
Citigroup[e]	45	2,050	2.20	5.52	0.95	84.5
Bank of America[f]	45	1,817	2.48	4.10	2.66	26.7
JP Morgan Chase	25	2,251	1.11	5.46	0.80	52.8
Wells Fargo	25	1,371[g]	1.82[h]	2.27	1.10	15.5
Morgan Stanley	10	987	1.01	2.50	0.80	25.9
Goldman Sachs	10	1,082	0.92	3.39	0.94	19.8
Bank of New York	3	268	1.12	0.55	0.62	1.9
Lehman Brothers	-	691	-	0.60	0.55	8.6

a – Bailout funds are taken as the amount of preferred stock purchases received through the Troubled Asset Relief Program (TARP) in 2008. JP Morgan, Wells Fargo, Morgan Stanley, Goldman Sachs and Bank of New York received funds only through the TARP. AIG, Citi and Bank of America had additional sources.
Source: U. S. Department of the Treasury, 2008.

b – Measured as total assets in 2008, i.e. at the time the bailouts were given.
Source: Federal Reserve Board, 2010.

c – Source for lobbying expenditures and campaign donations (final three columns).
Source: Center for responsive politics, 2010b.

d – AIG was initially given $40 billion by the Treasury through the Systematically Significant Failing Institution Program. This was expanded by the $43.5 billion AIG got from the Federal Reserve Credit Facility (from which they are allowed to take up to $60 billion, reduced from the initially $85 billion) and a $1.5 billion from the Treasury credit line (from which they are

[11] Perhaps the fact that Lehman Brothers borrowed significant amounts to fund its investing into MBSs in the years preceding the crisis raising its leverage ratio to 30:1 (SEC, Lehman Annual Report, 2007) made it too vulnerable to the housing market downturn thus making it impossible for the government to bail them out. However, other big banks also found themselves in problems having their assets filled with MBSs, but were bailed out nonetheless. A broader analysis of each company's exposure to bankruptcy risk is needed so as to make a stronger conclusion. The Treasury conducted a stress test in February 2009, almost 6 months after the Lehman bankruptcy to determine how much more money was needed to salvage the biggest bank holding companies. Maybe this test came too late for Lehman, but it would be interesting to view the results of further bailout funds and compare them to lobbying expenditures in the coming years.

allowed to take $30 billion). AIG received a further $49.5 billion later in 2009 through Federal Reserve Securities Purchases, but these weren't taken into account as only the bailout funds resulting from lobbying expenditures in 2008 were considered, as well as bank assets. Source: Federal Reserve Board, 2010.

e – Citigroup received $25 billion through the TARP (more precisely through the Capital Purchase Program, CIP) in September 2008. It received an additional $20 billion on December 31st 2008 as a part of the Targeted Investment Program (TIP). Both programs were governed by the US Treasury Department.

f – Bank of America received initially $15 billion through the TARP (i.e. through the CIP) in September 2008 followed by an additional $10 billion (again through the CEP) and $20 billion through the TIP in January 2009.

g – Wells Fargo before the purchase of Wachovia (December 31st, 2008) had assets worth $662 billion.

h – The share of bailouts in total assets would be 3.78%, if the original asset size of Wells Fargo before the purchase of Wachovia was taken into account.

Wells Fargo is another example of buying political influence. Before the purchase of Wachovia Bank, the size of the Wells Fargo assets was approximately the same as that of Lehman Brothers. Nonetheless, Wells Fargo was given more than or the same amount of bailout money as much larger banks. However Wells Fargo's clever investments in political campaigns during the crisis left them in an even better position than before. In 2008 this bank spent over a million dollars to finance Congressmen's political campaigns[12]. In 2009 they spent 2.9 million dollars, while in 2010 the amount was 2.3 million dollars. As the purchase of Wachovia was closed on December 31st 2008, the further outflow of funds is most likely an act of appreciation to the politicians that made this deal possible (Center for Responsive Politics, 2010). Due to the previously mentioned fact that the bailout funds were to be assigned by the TARP (*Troubled Asset Relief Program*) based on the size and value of a bank's assets (the bigger the assets the bigger the bailout funds), 25 billion dollars for Wells Fargo in comparison to zero dollars for Lehman Brothers increases the possibility that non-economic and/or political criteria were determining the allocation of the bailout funds. A further examination of bankruptcy risk of both of these companies as well as the relative size of MBSs in total assets is needed so as to reach a complete conclusion as to how the bailout funds were allocated.

The American financial industry has shown substantial lobbyist power in the redistribution of TARP funds and for now it is threatening to repel or distort any recovery act or fiscal stimulus as well as a financial reform that doesn't match its selective criteria. The increased power of the financial industry basically gives it a right of veto on public decision making, even in the times when they have lost public support. Simon Johnson emphasizes that in March 2009 a group of CEOs from the nation's thirteen most prominent banking and financial institutions met

[12] Among which the recipients were mostly the in-office Democrats holding key positions in the Congress. One example is the House Speaker Nancy Pelosi, a second in line of presidential succession, following Vice-president Joe Biden. Another example is Democratic House Representative Carolyn Maloney, member of a series of Committees on Financial Services and Oversight and Government Reform as well as the Chairwomen of the Joint Economic Committee of the US Congress (U. S. House of Representatives, 2010).

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with President Obama in hopes to get the government on their side and insure even more of taxpayers' money and government guarantees for themselves (Johnson and Kwak, 2010). It seems as though the banks accumulated even more political power since the onset of the crisis, and power was generated from a built-in belief that further bankruptcies of large financial institutions (Lehman was rather small compared to Bank of America, Citigroup or JP Morgan) would cause irreparable damage (bringing in the "too big to fail" concept). The banks are likely to use this fear to grasp even more taxpayer money and favourable contracts with Washington. For example, Bank of America received new bailout funds as soon as it declared that it would not be able to purchase Merrill Lynch. As soon as they were granted the funds (through TIP) the acquisition was possible. "Campaign contributions and the revolving door between the private sector and government service gave Wall Street banks influence in Washington, but their ultimate victory lay in shifting the conventional wisdom in their favour, to the point where their lobbyists' talking points seemed self-evident to congressmen and administration officials... In the aftermath of the financial crisis, the banks could still roll out their conventional weaponry – campaign money and lobbyists; but because of their ideological power many of their battles were won in advance" (Johnson and Kwak, 2010).

6.2 THE IMPLICATION OF POLITICAL INFLUENCE ON BAILOUTS

Many voted in favour of the stimulus however, hoping that this would bring about to a more stable system returning to it its much needed confidence. The bailouts combined with a fiscal stimulus have indeed provided the system with more confidence and were crucial in restoring the short-run stabilization and liquidity. In a system of rising systemic risk and lack of public confidence towards the banks triggering a possible bank run and an even bigger loss of jobs and production, fiscal stimuli and bailouts could prove to be more than welcome. Deutsche Bank Research has pointed out that the costs (in terms of direct fiscal costs) of a large government intervention may turn out to be much smaller than anticipated and much smaller than in previous financial crises. They estimate them to be only a small fraction of the GDP unlikely to exceed 2% even in countries most hit by the crisis (DB, 2010). Many others have also pointed out the benefits of bailouts and stimuli in a sense that the recession would have been much more severe and that unemployment would have reached even higher levels. The system, if it were left to self-correct would lead the entire world into a long lasting recession. The comparison was somewhat reminiscent of the Great Depression of the 1930s.

The threat of a further stimulus to the banks which they would use to distort its effects still stands. Bailouts can prove to have huge indirect costs that transcend mere fiscal costs. Banks can very likely misuse them so as to make the system far more dependent on them than it already is. Also, little attention has been given to all those firms that did not receive any bailout funds at all. The stimulus package is given either to large, over-sized, too-big-to-fail private enterprises, while a

spending increase to fund social security or infrastructural programs benefits either the public sector or the large companies who lobby their way into getting the job for a certain government-funded project. Through a stimulus plan "a large portion of the allocated funds will go to state governments, local governments and non-profit organizations: entities that have no market-driven test of whether they are creating or destroying value via the rationalization of invested capital" (Grant, 2009). The small and medium-sized businesses are left without stimulus resources. The result of a bailout or any kind of government favouritism of certain private companies (that is always a result of that company's high lobbying activity and/or political campaign financing) is the shattering of the competition. If one company gets money from the government while its competition doesn't, it has clear advantage over the others.

Small and medium sized businesses have often been recognized as the drivers of growth. Even when the data indicate that there are a lot of small businesses that fail every year, even more businesses survive and grow on a yearly basis as well. Entrepreneurs will continue to invest into various business projects until they find a project that will result in success. This process of constant dynamics of entrepreneurship that eventually yields the best possible solution for them as well as for the entire economy is known as the process of *creative destruction* as defined by Schumpeter (1975). Shattering this process with favouritism of certain companies is not likely to be a way out of a recession.

The bailouts, despite their short-run stabilization effect, complete the picture of a growing partnership between the largest financial institutions and the government. The government stands to protect the institutions from failure as the stability of the system is far too dependent on them, thus increasing moral hazard and encouraging lack of responsibility. Such actions by the government will certainly not decrease the accumulated power of the financial industry. It is more likely that they will enhance it, creating conditions for further instability and dependence of the finance industry on the government. In the light of what this paper has presented so far, this can only result in yet another financial crisis in which the decisions of the banks will again be steered by regulatory policies and credible promises of future bailouts thus furthering the moral hazard problem and creating a new asset bubble and a new dose of uncertainty and instability.

7 CONCLUSION

The very existence of a recession does not justify the enormous subsidies to various financial institutions nor does it justify the increasing spread of government intervention all over the financial markets. Although some of the biggest financial institutions were close to bankruptcy, overall the data at the time were not suggestive of a worldwide crisis, rather of a process of creative destruction – the driving force of capitalism. These financial giants do not leave a black hole in the credit market; rather they are being quickly replaced by other, smaller and healthier companies who offer a more conservative form of financing.

The political power of government institutions and its connection with the corporate world of finance generated the current financial crisis. The government was involved through a series of impulses through which it guided the behaviour of businesses. The financial industry on the other hand created the dependency of the system on them resulting in rising cohesion with government officials. This created a system in which the banks acquired political protection resulting in a rising moral hazard problem where systemic risk was thus increasing. The regulators encouraged the banks to invest into non-standard home loans thus contributing to the growth of the housing bubble. Through an expansive monetary policy further impulses were created and liquidity was drawn into the asset market contributing to housing and securities bubbles. Through Fannie Mae and Freddie Mac the regulators were reaching the HUD's housing objectives thus contributing to the creation of adverse selection. The increase of MBSs in banks' balances because the required capital standards had been reached was yet another effect of misplaced regulatory decisions. Finally, the government failures will be paid for by the taxpayers. If the taxpayers or better yet the voters were able to learn an important lesson from this it would present a substantial limitation to further misconduct of political institutions.

This crisis does not present a failure of capitalism because the success of capitalism is not based on unregulated markets. It is based on free markets. Economic growth and wealth accumulation are highly correlated with market freedoms. The crisis therefore doesn't present a failure of capitalism or free markets but the failure of overregulated markets, or better yet markets regulated by narrow interest groups with a substantial level of political power.

The biggest risk that could occur as an outcome of the crisis is the possibility that even more politicians, economists and the public in general start to believe that the free market is to be blamed for causing the crisis, diverting thus the public opinion against the market economy. This would result in not only a decrease of economic freedom and economic growth but also an endangerment of the fundamental principle on which a society can succeed – individual freedom.

Appendix

Table A

Data used to obtain the Taylor interest rate compared with the federal funds rate

Year/ quarter	Long-run int. rate[a] (r_t^*)	Rate of inflation[b] (π_t)	Par *a*	Inflation gap[c] ($\pi_t - \pi_t^*$)	Par *b*	Output gap[d] ($y_t - \bar{y}_t$)	Taylor rate[e] (i_t)	FOMC rate[f]
2000/1	2	3.8	0.5	-1.8	0.5	2.9	6.35	5.85
2000/2	2	3.7	0.5	-1.7	0.5	4.0	6.85	6.53
2000/3	2	3.5	0.5	-1.5	0.5	3.2	6.35	6.52
2000/4	2	3.4	0.5	-1.4	0.5	3.0	6.20	6.40
2001/1	2	2.9	0.5	-0.9	0.5	1.6	5.25	5.31
2001/2	2	3.2	0.5	-1.2	0.5	1.5	5.35	3.97
2001/3	2	2.6	0.5	-0.6	0.5	0.0	4.31	3.07
2001/4	2	1.6	0.5	0.4	0.5	-0.7	3.45	1.82
2002/1	2	1.5	0.5	0.5	0.5	-0.6	3.45	1.82
2002/2	2	1.1	0.5	0.9	0.5	-1.0	3.07	1.75
2002/3	2	1.5	0.5	0.5	0.5	-1.1	3.20	1.75
2002/4	2	2.4	0.5	-0.4	0.5	-1.8	3.30	1.24
2003/1	2	3.0	0.5	-1.0	0.5	-2.2	3.40	1.25
2003/2	2	2.1	0.5	-0.1	0.5	-2.0	3.05	1.22
2003/3	2	2.3	0.5	-0.3	0.5	-1.0	3.65	1.01
2003/4	2	1.9	0.5	0.1	0.5	-0.8	3.55	1.00
2004/1	2	1.7	0.5	0.3	0.5	-0.7	3.52	1.00
2004/2	2	3.3	0.5	-1.3	0.5	-0.7	4.31	1.00
2004/3	2	2.5	0.5	-0.5	0.5	-0.4	4.07	1.61
2004/4	2	3.3	0.5	-1.3	0.5	0.0	4.65	2.16
2005/1	2	3.1	0.5	-1.1	0.5	0.6	4.85	2.63
2005/2	2	2.5	0.5	-0.5	0.5	0.6	4.55	3.00
2005/3	2	4.7	0.5	-2.7	0.5	1.2	5.95	3.62
2005/4	2	3.4	0.5	-1.4	0.5	1.4	5.37	4.16

Year/ quarter	Long-run int. rate[a] (r_t^*)	Rate of inflation[b] (π_t)	Par *a*	Inflation gap[c] ($\pi_t - \pi_t^*$)	Par *b*	Output gap[d] ($y_t - \bar{y}_t$)	Taylor rate[e] (i_t)	FOMC rate[f]
2006/1	2	3.4	0.5	-1.4	0.5	2.2	5.80	4.59
2006/2	2	4.3	0.5	-2.3	0.5	2.2	6.25	4.99
2006/3	2	2.1	0.5	-0.1	0.5	1.9	4.99	5.25
2006/4	2	2.5	0.5	-0.5	0.5	1.8	5.17	5.25
2007/1	2	2.8	0.5	-0.8	0.5	1.9	5.33	5.25
2007/2	2	2.7	0.5	-0.7	0.5	2.1	5.42	5.25
2007/3	2	2.8	0.5	-0.8	0.5	2.2	5.51	4.94
2007/4	2	4.1	0.5	-2.1	0.5	2.6	6.30	4.24
2008/1	2	4.0	0.5	-2.0	0.5	2.0	6.00	2.61
2008/2	2	5.0	0.5	-3.0	0.5	2.2	6.60	2.00
2008/3	2	4.9	0.5	-2.9	0.5	-0.2	5.30	1.81
2008/4	2	1.1	0.5	0.9	0.5	-2.0	2.50	0.16
2009/1	2	-0.4	0.5	2.4	0.5	-4.0	0.80	0.16
2009/2	2	-1.4	0.5	3.4	0.5	-6.4	-0.90	0.25
2009/3	2	-1.3	0.5	3.3	0.5	-6.9	-1.10	0.15
2009/4	2	2.0	0.5	0	0.5	-6.0	1.00	0.12

a – Long-run interest rate estimated by John Taylor to be 2% (Taylor, 1993).

b – Measured as the headline CPI inflation (Federal Reserve Board, 2010).

c – Inflation gap determined by the difference between real inflation and its target level of 2% as set by the Federal Reserve Board.

d – Output gap as determined by the difference between real and potential output. According to Taylor (1993) this is calculated as: $\frac{y_t - \bar{y}_t}{\bar{y}_t} \cdot 100$. *Real output data available at Economic Report of the President: 2010 [online] www.gpoaccess.gov/eop/tables10.html. Potential output data available: Government Printing Office, 2010; and potential output data available at Congressional Budget Office, 2001.*

e – Suggested Taylor rule interest rate; $i_t = r_t^* + \pi_t + a(\pi_t - \pi_t^*) + b(y_t - \bar{y}_t)$.

f – Official federal funds rate as determined by the FOMC (Federal Reserve Board, 2010).

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