Edited by Terrence Casey

THE LEGACY OF THE CRASH

How the Financial Crisis Changed America and Britain

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Terrence Casey
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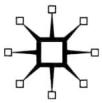

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To my wife Allison and our greatest legacies – Maria, Jack, and Oliver

Preface and Acknowledgments

This volume was born of a conference organized by the British Politics Group of the American Political Science Association in September 2010 entitled 'The UK and US in 2010: Transition and Transformation'. The worst financial crisis since the Great Depression slammed both the British and American economies full force in September 2008, obliterating the political and economic verities of the previous three decades. By 2010 the aftershocks still resonated. The moment was thus opportune for a collective assessment of how these events were transforming these polities – whether this represented a critical juncture in which political and economic relationships and institutions would be remade. That both states were then governed by relatively new administrations rendered these questions even more intriguing. The result was a lively one-day conference with 14 panels and over 90 participants. Given the size of the event it was not possible to include everyone in the volume that follows. Many a worthy paper had to be left by the wayside, hopefully to be picked up by other venues. My thanks go out to all who made it such a wonderful event.

No one can pull off something like this without the support and assistance of numerous colleagues. First and foremost I would like to thank Susan Sell of George Washington University. I pursued my graduate studies at GW and Susan was one of my professors and mentors. In her current role as Director of the Institute for Global and International Studies in the Elliott School of International Affairs, she offered to host the event. Without her willing support neither the conference nor this volume would have come to fruition. Special thanks also to her assistant, Mike Salamon, who saw to our every need leading up to and during the day of the event. Thanks also to the faculty in the GWU Department of Political Science, from which I earned my doctorate, and the Elliott School of International Affairs, for whom I worked as both a teaching assistant and visiting instructor. I want to extend my personal gratitude to Harvey Feigenbaum – who taught me how to be a great researcher – and Henry Nau – who taught me how to be a great teacher. To the extent that I do not live up to their standards, the fault is entirely my own.

This volume is not only a product of its contributors, but also of the larger British Politics Group. The BPG is full of many wonderful people

who are also exceptional scholars, and my personal and professional life has been greatly enriched by being a member. I am particularly privileged that they have entrusted me with the role of Executive Director. Everyone in the BPG is thus deserving of thanks. I would like to single out Janet Laible, who served as the co-chair of the conference and beyond that has always been unselfish in giving her time to the group. Thanks are also warranted for Justin Fisher, our president at the time of the conference, who was not only a very able executive, but retains an uncanny ability to locate the best breakfast spot in any city on earth. Graham Wilson has proven a worthy successor, although he has yet to prove himself on the dining front. Thanks also go out to our APSA program chair, Florence Faucher-King; our newsletter editor, Tom Wolf; our webmaster (and emergency sommelier), Alistair Howard; and to all who serve or have served on the BPG executive

This is the second volume that I have edited for Palgrave Macmillan, an exceptionally supportive and professional organization. My special thanks to Amber Stone-Galilee, who marshaled the project from the conference through completion, and to Liz Blackmore for her tireless work in moving the book from manuscript through production – and especially for not giving me too much grief that my contributions were the last ones submitted!

A nod of appreciation also to my colleagues in the Department of Humanities and Social Science at the Rose-Hulman Institute of Technology. Teaching politics at a small engineering school in western Indiana where I am the sole political scientist was not perhaps my 'dream job' coming out of grad school. Yet I reside in a world of outstanding students and colleagues who are both incomparable teachers and first-rate scholars. I am lucky to be part of such a fine academic family. I am also doubly blessed at home. I could never have achieved as much as I have without the loving support of my wife Allison (who had the stamina and perseverance to get her nursing degree with three kids and a husband occupied by teaching and editing books) and our children Maria, Jack, and Oliver – excellent legacies indeed! Thanks for everything.

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Introduction: The Political Challenges of Hard Times

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They called it the 'Great Moderation'. While this specifically referred to a trend of reduced macro-economic volatility among the major advanced economies since the late 1980s, it encapsulated a wider political and economic meaning. It marked the extended period of economic growth from the early 1990s into the 2000s, growth that was attributed to an encouraging combination of free market economic policies at home and globalization abroad. In this view, post-war economic history began with the 'Long Boom', 30 years of full employment and unparalleled economic growth. The period also coincided with the widespread adoption of Keynesian macro-economic policies, intended to smooth the business cycle, and the social welfare state, serving to protect vulnerable workers and allowing them to become stable mass consumers. Yet by the late 1960s the model was already showing its contradictions, particularly a 'spending ratchet' (Crouch, 2009). Keynes called for the state to spend when the economy was in recession, but democratically elected governments found it difficult to take away the goodies when the boom years returned, as Keynes also advised. This fed into rising spending and higher prices, hindering productivity and profitability. Add in the cost-push of oil prices and the result was the rampant inflation and stagnant growth ('stagflation') of the 1970s. Attempts to restore the balance through even more spending only fed the inflationary spiral. Keynesianism was tested and found wanting, offering a political opening for leaders advocating a return to liberal economics; hence the label 'neoliberalism'.

Both Margaret Thatcher's Conservatives and Ronald Reagan's Republicans rejected the verities of the 'post-war consensus'. Rather than continuing state-centered economic governance, Reagan declared that

'government was the problem'. The solution was simple: get the state out of the way. Although varied in application across governments, the basic rationale was that by shifting resources out of the government's control – where political pressures led to economically inefficient decision-making – and into the private sector – where competition and market forces provided appropriate signals – these policies would remove the barriers to (private) investment, spur entrepreneurialism and innovation, and increase the trend growth rate of the economy. The initial shock therapy of extremely tight monetary policy and slashed budgets, intended to combat (as they saw it) the greater evil of inflation, produced sharp recessions in both economies. By the mid 1980s, however, prices were tamed and robust growth returned. Both leaders were rewarded for the economic turnaround with re-election, twice in Thatcher's case (Reagan, of course, being constitutionally limited to two terms). Boom turned to bust, however, as overheating markets required the reapplication of monetary brakes, producing another recession in the early 1990s. For critics of neoliberalism, this was evidence that the program was a failure, unable to deliver stable growth. Yet the critics were premature, for that very moment saw a confluence of positive trends: the end of the Cold War, which provided not only a fiscal 'peace dividend' but the opening up of vast new capitalist markets; the expansion of other major developing markets, especially China and India; the realization of full cost advantages of globalized production; and development of a new wave of information technology, both creating new markets (such as mobile phones) and greatly enhancing productivity in existing industries (such as retail). The result in the 1990s was a heady period of strong economic growth, improved fiscal balances, and relative international stability, for Britain and America at least. To be sure, there were economic crises during this period, most notably in East Asia in 1997 and Russia in 1998. Yet all were contained without major impacts on global growth. In the minds of policymakers these were thus isolated and manageable events in countries on the periphery of the global economy.[1] Problems hit home at the end of the decade when the overinflated expectations of new internet-based enterprises led to the 'dot com bust'. Yet rapid action by the Federal Reserve limited the damage to a relatively short recession. Even with 9/11 and the two wars that followed, both America and Britain continued with strong growth and low unemployment – economic records envied by many of their competitors – into the middle of the 2000s. The Anglophone economies had been buffeted by recession and war, but with flexible financial markets and adroit monetary authorities,

the business cycle was tamed. The Great Moderation appeared to be here to stay.

It all came crashing down in 2008, punctuated by one dramatic weekend in mid-September. Economic conditions had started to slip by the end of 2007. The Fed had pursued an expansionary monetary policy for most of the decade which, along with other incentives, fed especially into a booming housing market in the United States. With credit flowing freely and inflationary pressures building up, the Fed began to raise rates. With that the housing bubble began to deflate. Those who had taken out minimum down payment mortgages with high variable interest rates (the so-called 'subprime mortgages') now found themselves with huge debt on declining value assets. The economic damage of this might have been contained in the most overheated regional American markets except that these mortgages had been bundled together, securitized, and sold off to other investors all over the world. A dramatic downturn in the US housing market would thus send seismic shocks throughout the global financial system. (The details are examined in Chapters 3 and 4.)

That major financial firms were in crisis was evident in late 2007. Northern Rock first sought emergency cash from the Bank of England in September 2007. Gordon Brown's government then spent the next four months seeking a private sector buyer for the bank until finally nationalizing Northern Rock in February 2008. In the same month the giant Swiss bank UBS announced $11.3 billion in losses for the fourth quarter, mainly from writing off US mortgages (James, 2009, p. 103). In March 2008 the Federal Reserve provided $29 billion in financing to allow JP Morgan to buy the struggling Bear Stearns, a deal quickly thrown together over a weekend of negotiations. The 'conservatorship' (effectively nationalization) of two major government-sponsored mortgage enterprises – Fannie Mae (short for the Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corporation) followed in early September. Throughout the summer Lehman Brothers saw its profits and share value continue to slip. On 10 September they announced a $3.9 billion loss. By the evening of Friday 12 September Secretary of the Treasury Henry Paulson and Federal Reserve Bank of New York President Timothy Geithner called an emergency meeting of the leading financial figures on Wall Street to try and find a buyer for Lehman over that weekend, the same approach taken to deal with Bear Stearns. Both the Bank of America and Barclays emerged as potential buyers. Barclays took the lead, but British regulators raised objections and the British government was not willing to underwrite the sale unless matched by similar action from their US counterparts (James,

2009, p. 112). Whether by choice or by necessity – and this is still a point of controversy[2] – no US government money was forthcoming. Lehman Brothers filed for bankruptcy on 15 September 2008.

The news exploded on the markets on that Monday morning and investors, already skittish, went into full-fledged panic. The financial dominoes started to fall quickly. Bank of America bought Merrill Lynch that day. American International Group (AIG) received an $85 billion bailout the following day from the Treasury in exchange for a roughly 80 percent equity stake in the company. Uncertainty fed the contagion. The international financial system was flooded with derivatives and securities sold by these failing institutions, obscuring any estimate of their real value and vastly enhancing the risks of counterparty default. The logical response was to stop lending, producing a 'credit crunch' that would be devastating to the real economy if not resolved quickly. Bernanke and Paulson thus sought more comprehensive legal authority to bail out banks for fear that inaction would lead to complete financial collapse and economic depression. The result was a $700 billion proposal to Congress for a Troubled Asset Relief Program (TARP), albeit without any clear guidelines as to how the program would work,[3] submitted on 20 September. The government seemed to be flailing, throwing around hundreds of billions of dollars but offering no clear indication of who would or would not be protected (Taylor, 2009, p. 29). Members of Congress, mainly Republican members in the House of Representatives, balked, expressing concerns with the size of the program, the means of implementation, and fundamentally whether the government should be providing such a massive bailout of the banks, a point which rankled their free market principles and raised problems of moral hazard. Days of tense negotiations followed between Congressional leaders, the White House, and Treasury officials, descending to the tragic-comic incident of Secretary Paulson getting down on one knee and begging Speaker of the House Nancy Pelosi to keep her Democratic members in support of TARP. Faced with the legislation being blocked, President Bush is said to have declared in private, 'If money isn't loosened up, this sucker could go down' (*New York Times*, online edition, 26 September 2008). Despite the President's urging, TARP was initially defeated in the House 205–228, with 133 Republicans and 95 Democrats voting against it. The market response was forceful and negative, with the Dow Jones Industrial Average experiencing its largest single-day point drop ever. Fear of economic Armageddon focused Congress' attention. On 1 October the bill easily passed the Senate and was sent back to the House, where it passed on 3 October with a comfortable majority.[4] Armageddon may have been