

## INTRODUCTION

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### Prologue: A Bubble Couple

One of us was unfortunate enough to be caught up in the housing bubble in southern California. He was relocating to the San Diego area in late 2004. He and his wife had owned four homes in three states over the previous twenty-seven years. Typically, the couple would negotiate with sellers over price and then seek financing from a bank. They would also initiate contact with lenders for refinancing.

The couple went house hunting when the North San Diego County real estate market was frenetic. Their agent advised them to carry cell phones at all times because if anything came on the market potential buyers had less than a day to view a property and make an offer. Typically houses drew multiple offers. When they found a house a few days before Christmas, the agent advised making an offer close to the full asking price in hopes that the seller would accept it before an open house scheduled for two days after Christmas. Their offer was accepted.

The couple's real surprise came when they met with a mortgage broker who had an office in the same building as the real estate company. They were offered several different kinds of loans, several of which they had never heard of. The idea of an "interest only" loan seemed bizarre, and they opted for a 5-percent-down thirty-year mortgage. The first mortgage was with Genesis Mortgage Corporation, which resold it within a month to Wells Fargo. The second mortgage was with National City Mortgage of Cleveland, Ohio. Within two months National City, unsolicited, offered to extend more credit on the house.

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A home equity line was provided that could be drawn on to make improvements to the house. Now the lender was throwing money at the borrower rather than the borrower trying to get a loan. Of course, the couple took the line. Owning a house in southern California was one of the best investments you could make. If you held on to a house for ten years or so you could sell at a big profit—so went the local lore. Things did not turn out that way.

National City was the epitome of the financial bubble. At one time a reputable bank dating back to the mid-nineteenth century, it got into subprime mortgages in 1999 by purchasing First Franklin Financial Companies.<sup>1</sup>

National City kept expanding. By 2003 and 2004 it was making \$1 billion per year on its subprime business. In 2006 National City sold First Franklin to Merrill Lynch but had to hold on to \$10 billion in subprime loans that Merrill Lynch did not want.<sup>2</sup> This was the beginning of the end. National City's subprime holdings tanked. The bank lost \$1.8 billion in the second quarter of 2008, and it was forced to sell itself to PNC Bank in October of that year.<sup>3</sup> PNC used government money from the Troubled Asset Relief Program (TARP) to complete the acquisition. (Merrill Lynch was to meet its own end, even without that extra \$10 billion in subprime loans.)

In 2007 the couple switched the second mortgage from National City to Wells Fargo. Wells Fargo let them make further draws on their “equity” to make improvements to the house. The housing bubble, the couple failed to realize, had already popped. The country was about to enter the Great Recession. Tax collections in California collapsed. Something had to give in the erstwhile Golden State, which for years had irreconcilable passions for low taxes, a prison gulag, and generous public-employee pensions. The author's employer, the University of California, cut nominal salaries through furloughs—unpaid vacations without the vacation. Public education, at all levels, became a victim of the collapse of the housing bubble. As for the couple, the salary cut put stress on their mortgage commitments.

The couple was more fortunate than most Americans. One day the phone rang. They were able to move to a much better job and a much bigger house in Georgia. They did lose a great deal of money on the California house. Getting caught up in the bubble set back the author's expected retirement date. But unlike National City, the couple survived, and unlike millions of other borrowers, they still have a home.

### A Nation Bubbles Over

The financial system of the United States was close to collapse by the fall of 2008. On September 15, two of the four largest investment banks failed. One, Lehman Brothers, declared bankruptcy. Lehman failed to find a buyer, and the government decided not to guarantee some of its underperforming assets in order to facilitate a sale. The other, Merrill Lynch, the country's largest brokerage firm, was sold to Bank of America at a rock-bottom price.

The next day the Federal Reserve announced an \$85 billion bailout of the nation's largest insurance company, American International Group (AIG). AIG's troubles were based on billions of dollars in swaps that it underwrote against defaults of mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs).<sup>4</sup> A collapse of AIG would have destroyed the value of these securities and generated even greater sell-offs, losses, and insolvencies throughout the entire financial system. Three days later, on September 18, Secretary of the Treasury Henry Paulson went to Congress to plead for the enactment of the \$700 billion Troubled Asset Relief Program (TARP). This sketchy plan, a virtual blank check from Congress to the U.S. Treasury, sought to reinject capital into the financial system. Government purchases of mortgage-backed securities and other distressed assets would, it was claimed, prop up markets and halt the financial crisis.

The dramatic failures of the week of September 15 capped a string of financial calamities that had begun with the government bailout of Bear Stearns in March 2008. Just a week before the collapse of Lehman and Merrill Lynch, the government took

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over the biggest players in the mortgage market, the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. Before the year was out, the federal government would also control AIG. The ensuing crisis hit an economy already in recession after the collapse of the bubble in housing prices. Unemployment pushed toward levels not seen since the early 1980s. The automobile industry, the traditional symbol of American manufacturing strength, almost collapsed before a government-orchestrated restructuring in which the American taxpayer became the owner of a majority of General Motors' stock. At the beginning of 2012, GM, Ally Financial (the successor to GM's long-time finance subsidiary GMAC), and AIG remained subject to government supervision; the future of Fannie and Freddie remains unresolved.

The financial crisis of 2008 was a truly traumatic event for Americans and affected almost everyone else in the global economy. But the causes of this calamity continue to be hotly debated.

The blame frequently goes to individuals such as investment bankers reaping huge bonuses on Wall Street, go-granny-go subprime mortgage originators in Pasadena, and house flippers in Las Vegas. Others focus on large structural factors such as the explosion of financial innovation and global financial imbalances that showered the United States and much of the industrialized world with cheap credit from China and the Middle East. Still others claim that the crisis was just one more instance of markets gone wild, a mass mania no different from the seventeenth-century bubble in the price of Dutch tulip bulbs.<sup>5</sup> We, however, do not reach a verdict of not guilty by reason of insanity.

We focus on the national government in Washington, D.C. To be precise, we put much of the responsibility for the crisis and the failure to undertake genuine reform of the American financial system squarely on members of Congress, on Presidents Jimmy Carter, Ronald Reagan, George H. W. Bush, Bill Clinton, George W. Bush, and Barack Obama and on those they chose to serve in their cabinets and in the Executive Office in the White House and to run regulatory agencies, including the Federal Reserve and the Securities and Exchange Commission (SEC).

We contrast their actions with those of the private-sector actors who indulged in “infectious greed” and “irrational exuberance.” Political actors failed in their response to the challenges of financial innovation and the global “savings glut.” They allowed the crisis to develop and inhibited response after the crisis was front and center in the public eye.

A notable culprit was Federal Reserve chair Alan Greenspan, the originator of these catchwords, venerated in his initial Senate confirmation vote and four reappointments, two by a Democratic president. Greenspan pumped up the housing bubble with easy credit and failed to exercise his responsibility to investigate and regulate deceptive “teaser loans” and outright fraud in the origination of subprime mortgages. His successor, Ben Bernanke, when appointed by George W. Bush in 2006, presented himself as a Greenspan clone (although one less prone to obtuse pronouncements) and was curiously passive until the September 2008 collapse of the financial sector. Bernanke’s passivity may have reflected a Fed that is less “independent” than many imagine. Congress and the financial and housing sector would have been up in arms had Bernanke attempted to rock the boat.

The malefactors were bipartisan. They included Republican appointees like Greenspan and Republicans in Congress and the White House imbued with the mantras of “free markets” and “the ownership society”; Democrats were eager to have the poor in housing they could not afford. Both Franklin Raines, head of the White House Office of Management and Budget under Bill Clinton, and James Johnson, adviser to Walter Mondale, Al Gore, and Barack Obama, were grossly overcompensated as CEOs of Fannie Mae.<sup>6</sup> Clinton’s chair of the Council of Economic Advisors, Nobel Prize Laureate Joseph Stiglitz, along with future Obama adviser and Citigroup employee Peter Orszag and Clinton adviser Jon Orszag, wrote a 2001 position paper for Fannie Mae claiming that there was only a one in 500,000 chance that Fannie Mae would go bust.

Perhaps of greater importance than the Democratic preoccupation with low income and minority housing, and with Fannie

Mae, was the acquiescence of the Democrats in financial deregulation, most notably by Clinton treasury secretaries Robert Rubin and Larry Summers. Rubin was in a Washington transition between Goldman Sachs and Citicorp; Summers did a stint at the hedge fund D. E. Shaw after his government service.

The financial crisis and the Great Recession it spawned have led to a spate of books on what went wrong. Ours is a late entry. What can we say that has not been said? We are certainly not the first to stress the influence of Wall Street on Washington. Others go so far as to imply that Wall Street has “captured” Washington and always gets what it wants and gets it right away. Such an account is far too simple.

Politicians and policy makers do often behave in ways that are not reducible to carrying water for Wall Street. For example, the Bush administration’s Treasury Department, whose top officials had strong Wall Street ties, was reluctant to ask for congressional authority to address the financial crisis in early 2008. Later that year, perhaps because of congressional opposition to its role in saving the investment bank Bear Stearns, the administration allowed Lehman Brothers to go into bankruptcy rather than risk congressional reaction from a bailout. (It’s worth noting that neither heavy campaign contributions from Lehman nor its CEO Richard Fuld’s service as a director of the New York Fed saved Lehman from bankruptcy.) Possible Treasury Department fears about Congress, even Republican controlled, would have been well founded. Shortly after Lehman failed, the House of Representatives voted down the administration’s first try to pass TARP.

As a second example, consider the difficulty the financial industry faced when it pursued “reform” of personal bankruptcy law. It took Visa, MasterCard, and other creditors seven years to force through the 2005 legislation that made consumer bankruptcy more difficult. The financial services industry is indeed powerful, but it does not always get what it wants. Moreover, the industry is competitive and not perfectly homogeneous. The demise of Bear Stearns, Lehman Brothers, and Merrill Lynch as independent firms may have been welcome news to the survivors, Goldman



**Figure I.1.** Financial collapse. Ben Bernanke, George W. Bush, Henry Paulson, and Christopher Cox after the bankruptcy of Lehman Brothers.  
*Source:* Official White House Photo by Joyce N. Boghosian.

Sachs and Morgan Stanley. So it is important to sharpen our understanding of exactly how financial interests are represented in Washington and when those influences will be the greatest.

Our account provides a more nuanced understanding of the channels through which politics exacerbates financial crises. Whereas much of the discussion of the political underpinnings of the financial crisis has centered on the political interests of the financial sector, we stress the *Three I's*: ideology, institutions, and interests.

The actions of politicians reflect not only pressures from organized interests but also personal beliefs about the proper role of government in regulating the financial sector. As we document throughout this book, these ideological beliefs are rigid and are largely unresponsive to new information. Undoubtedly the

manifest ideologies reflect some mixture of genuine personal belief, constituents' beliefs, and cronyism linked to personal venality.<sup>7</sup> What we hold to be important is not so much the recipe for this mixture but its rigidity. This rigidity, we argue, can impede measures that might prevent bubbles and limit the political response in a bust.

Political institutions such as elections, legislative rules and procedures, and regulatory structures affect the incentives and opportunities of elected politicians to engage in policy making that either exacerbates or mitigates financial crises. Our focus is on how the fragmented and supermajoritarian structure of U.S. political institutions makes it difficult for policy makers to keep up with financial innovation and to reform the financial sector in the bust.<sup>8</sup>

Groups and interests are the final ingredient. Well-organized, resourceful groups such as those in the financial sector are often able to exploit ideological allies and institutional structures to produce policy benefits for themselves. As we will show, powerful groups are able not only to push presidents and legislators for more favorable policies but also to stave off intruding regulators. Weak regulation, in turn, allows certain actors to push the boundaries of legality.

Washington failed to deal with three pillars of the financial crisis. The first pillar was the dramatic increase in risky residential loans known as subprime mortgages in which the borrower has an insufficiently good credit or work history to qualify for a lower-interest prime loan. The originators of these high-interest mortgages would often keep little or no "skin in the game" but instead would sell the mortgages to other financial firms. Some of the nation's largest financial institutions allegedly produced fraudulent documents and resold subprime mortgages as prime quality AAA paper.<sup>9</sup>

The second pillar of the crisis was the securitization of mortgages by bundling them into pools of loans that could be sold to investors. These mortgage securities were in turn sliced into tranches representing various levels of risk. The highest tranches

maintained first claims on interest payments; the lowest tranche owned the lowest-priority claim, and therefore was the first one to feel the effects of defaulting mortgages.

Underwriters sought credit ratings for the various securities and their tranches. Despite the low quality of the underlying loans, credit rating agencies uniformly issued ratings at AAA, as safe as U.S. government debt.<sup>10</sup> (After the crisis, Standard & Poor's downgraded U.S. government debt but continues to give some MBSs AAA ratings.<sup>11</sup>) With the blessings of Standard & Poor's, Moody's, or Fitch, these securities were then marketed by financial institutions and peddled to investors around the world. Investment banks and large commercial banks such as Citigroup not only resold mortgage-backed securities but continued to hold many directly. In order to dramatically increase their leverage in these investments, they financed the purchase of MBSs and other CDOs with low-interest short-term loans in the "shadow" banking system formed by the overnight repo (sale and repurchase) market.

The third pillar was the use of credit default swaps (CDSs) to insure these mortgage-backed securities against default. The seller of a swap agreed to pay the buyer a predetermined sum in the event that the MBS defaulted. These insurance policies were designed to allow the holders of MBSs to hedge against risk. But other investors who did not hold MBSs also bought these swaps to place a casino-like bet against the MBS—the so-called naked credit default swap. The insurer AIG morphed into an investment bank and ran the biggest casino. Although CDSs are theoretically designed to spread risk, AIG's financial services division underwrote so many that a nuclear bomb of concentrated risk was created.

These three pillars, along with the easy-money policies of the Federal Reserve and the huge influx of foreign capital, promoted a housing market bubble. When the bubble popped, the first pillar collapsed with a wave of defaults on subprime loans. This took out the second pillar, as AAA securities based on mortgages began to default and lose value. The bank purchasing an MBS

or CDO would turn around and use it as collateral for a short-term loan. When the housing bubble burst and defaults became probable, there were large increases in the collateral demanded to finance these short-term loans. Consequently, as mortgage defaults increased, holders of MBSs began to have difficulty refinancing their operations through the repo market as lenders feared defaults on these loans. Eventually, a full-fledged run on the shadow banking system started. Owing to a lack of transparency about holdings of “toxic” assets, the run spread through the financial system. Finally, the collapse of the second pillar caused buyers of CDSs to try to collect their insurance claims, taking out the third pillar and bringing AIG into insolvency.

Clearly, all three of these pillars are based on policy errors of commission and omission. Policy makers could have avoided the crisis by closely regulating or even prohibiting the products underlying any one of the three pillars. Subprime mortgages could have been curtailed by any number of regulations: interest rate regulation, restrictions on the types of mortgages available in the market; stricter supervision of lending standards, mortgage originators, and real estate agents; or higher total loan-to-value requirements on loans. The perverse incentives in securitization could have been curtailed by forcing mortgage originators to retain a substantial interest in the mortgages they sold. Both originators and securitizers could have been forced to “cover” the underlying securities and derivatives by retaining liability in the case of default. The conflicts of interest by ratings agencies could have been dealt with. Policy makers could have prohibited accounting gimmicks like special investment vehicles that allowed mortgage market investors to magnify leverage. Credit default swaps could have been restricted to those with “skin in the game,” and issuers could have been required to hold more capital to protect against losses.

That regulatory measures might have avoided or ameliorated the crisis suggests the deep complicity of the White House, Congress, and federal regulatory agencies. The bubble that led to the crisis was stimulated by relaxation of mortgage market regulation

in the 1980s, government pressure on both the GSEs and on private financial institutions to increase lending to low-income and minority borrowers, and by the protection of over-the-counter derivatives from regulation in the Commodity Futures Modernization Act of 2000. All these seeds of crisis were planted before George W. Bush took office and before the explosion of subprime mortgages and private-sector mortgage securitization. Corrective actions were not taken during the Bush administration despite the presence of many warning signals. The Bush administration throttled the SEC with the appointments of Harvey Pitt and Christopher Cox as chairs, while Republicans in Congress prevented action on attempts by Democrats to regulate predatory lending. If mortgages did indeed become Dutch tulips, Washington provided a superbly fertile flower bed.

But there is nothing unique about the recent crisis. The same types of policy failures occurred in both the savings and loan (S&L) crisis and the Great Depression. The S&L crisis was in full swing by 1985 and was ended only by the creation of the Resolution Trust Corporation in 1989. Similarly, the Great Depression was triggered by the stock market crash of October 1929, but major new policies waited for the first hundred days after Franklin Delano Roosevelt's inauguration in March 1933.<sup>12</sup> These policy innovations included the Glass-Steagall Act, signed by the president in June of that year. Glass-Steagall both separated commercial and investment banking and created deposit insurance. Notably, it also maintained restrictions on interstate branch banking that were lifted only with the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Financial market problems in the Great Depression were preceded by those that led to the Panic of 1907. The Panic, which took place in October of that year, drew no response from Washington. The objective of preventing a future crisis did result in the Aldrich-Vreeland Act of May 30, 1908, but a substantial response occurred only with the creation of the Federal Reserve in 1913.<sup>13</sup> Clearly, there is a recurring pattern of closing the barn door after the horses are long gone.

Why do such colossal policy failures and delays occur repeatedly? One argument is that recurrent financial crises are simply a reflection of capitalism, its cyclical nature and capacity for creative destruction. In this view, the lag in policy and regulation has more to do with the unpredictable nature of financial crises than with any political failures. But focusing solely on economic dynamics gives an incomplete picture of financial crises.

Many of the underlying causes of financial disorder were indeed known in advance. Yet attempts at reform were not just ignored but actively opposed. Such examples are easy to come by. We start with the 1990s.

In 1994, Askin Capital Management, a hedge fund heavily invested in MBSs, lost \$600 million.<sup>14</sup> That December, Orange County, California filed for bankruptcy when derivative investments based on interest rates went south after a sudden rise in interest rates. In 1998, Merrill Lynch, which advised the investments, reached a \$400 million settlement with Orange County. Congressional hearings on hedge funds and derivative securities were held in the aftermath, but no legislative correctives were proffered. A decade later, Merrill Lynch failed.<sup>15</sup>

In the late 1990s, a dozen small subprime lenders went bankrupt when, after several years of Ponzi-style lending, many of their outstanding mortgages defaulted.<sup>16</sup> In 1999, the hedge fund Long Term Capital Management (LTCM) failed; the Federal Reserve intervened to avoid further damage to the financial sector. Also in the late 1990s, Brooksley Born, the head of the Commodity Futures Trading Commission (CFTC), sounded the alarm about problems associated with the lack of regulation of derivative contracts including the CDSs that became central to the financial crisis of 2008. Yet her attempt to bring derivatives under the jurisdiction of the CFTC was adamantly opposed by President Clinton's economic team (most notably Robert Rubin and Larry Summers), chairman of the Securities and Exchange Commission Arthur Levitt, and congressional heavyweights such as Senate Banking Committee chair Phil Gramm.

The new century began with the pop of the dot-com bubble in 2001. Much attention was devoted to the role of misleading and fraudulent information that arose from accounting firms and market analysts. Merrill Lynch paid a \$100 million fine for reports issued by its analysts. Citigroup, which later received billions in TARP funds, paid billions in fines and settlements over its role in the Enron and Global Crossing fiascoes. Nonetheless, the reforms of the Sarbanes-Oxley Act failed to prevent widespread accounting misinformation in the financial crisis.<sup>17</sup>

As the housing bubble got under way, concerns about the risky loan portfolios of Fannie Mae and Freddie Mac were repeatedly raised in the early part of the decade, but intense lobbying by these GSEs and their politically connected executives beat back any and all attempts at regulation. In particular, many state attorneys general sought to draw Washington's attention to the risks in the complicated mortgage products being marketed. They further sought to pursue predatory lending charges against banks but were "preempted" from doing so by national regulators.<sup>18</sup>

By 2005 and 2006, the Federal Reserve had collected unmistakable evidence of the mounting foreclosures and defaults on subprime mortgages yet it decided not to use its regulatory powers to raise lending standards. Prominent academics, such as Robert Shiller and Nouriel Roubini, were predicting a national housing crash. Moreover, policy makers simply ignored history: many recent financial crises such as those in Scandinavia, Japan, and Thailand were triggered by a collapsed real estate bubble. But Washington and Wall Street convinced themselves "This Time Is Different."<sup>19</sup>

So financial crises are not simply economic phenomena; they have a very important political dimension. As we argue in this book, behind every financial bubble there is a corresponding political bubble. Just as financial bubbles in markets are a combination of irrational exuberance and greed, political bubbles brew in their own mix of ideology, institutions, and private interest.

## What Is a Political Bubble?

By *political bubble*, we mean a set of policy biases that foster and amplify the market behaviors that generate financial crises. Political bubbles are procyclical. Rather than tilting against risky behavior, the political bubble aids, abets, and amplifies it. During a financial bubble, when regulations should be strengthened, the political bubble relaxes them. When investors should hold more capital and reduce leverage, the political bubble allows the opposite. When monetary policy should tighten, the political bubble promotes easy credit.

In their causes, political bubbles bear a marked similarity to market bubbles. First, both types of bubbles rely on specific sets of beliefs. Economists stress the role of expectations in generating asset bubbles.<sup>20</sup> These beliefs are used to rationalize asset prices that depart strongly from their historical levels. For example, the belief that the excess returns that investors require for holding stocks (the so-called equity risk premium) had permanently declined helped fuel the stock market boom of the late 1990s. At the same time, the notion that a new information economy was emerging led to feverish public offerings. A firm selling dog food over the Internet, Pets.com, whose investment banker was none other than the bubbly, bullish-on-America Merrill Lynch, went to fourteen dollars a share after an eleven-dollar initial public offering in February 2000, only to be liquidated in November of that year.<sup>21</sup> Also in the first decade of the new century, the belief that globalization and a savings glut from the developing world could drive interest rates to permanently low levels fueled housing bubbles from Las Vegas to Latvia. Even investors who were more skeptical of these changes in fundamentals continued to buy inflated assets in hopes of selling them just before the crash.

Just as beliefs fuel a “this dance can go on forever” mentality of investors and speculators, the beliefs and ideologies of politicians and voters sustain political bubbles. First, the fact that politicians and voters may share in the investor’s “irrational exuberance” makes them loath to support corrective policies. If a

savings glut reduces the natural level of interest rates, it would be folly to use monetary policies to keep them artificially high. If the information economy is the wave of the future, it would be Luddism to tighten standards for either the public offerings that would capitalize the firms of the future or the pricing of stock options in accounting statements.

But beyond the beliefs that underpin a particular bubble, basic ideological beliefs about the nature of markets and the role of government also fuel bubbles. The *Oxford English Dictionary* defines *ideology* as a “systematic scheme of ideas, usually relating to politics or society, or to the conduct of a class or group, and regarded as justifying actions, especially one that is held implicitly or adopted as a whole and *maintained regardless of the course of events.*”<sup>22</sup>

Of course, ideological beliefs come in various flavors ranging from left to center to right. But the belief structure most conducive to supporting political bubbles is what we term *free market conservatism*. Like most ideologies, free market conservatism is based on a core set of principles. The absolute simplest form is the belief that government intervention in the economy is bad per se, no matter what. Markets are always better at allocating resources than bureaucracies are. Consequently, government intervention should be extremely limited. Government should engage only in the basic protections of life and property, and it should be specifically restricted to functions that cannot be provided by the marketplace (even free market conservatives disagree about what these are). Because markets allocate resources best, taxes and regulations should be as low as possible.

Beliefs associated with free market conservatism have advocates in both major political parties. Its influence has been especially pronounced in the Republican Party in recent years, serving as an important catalyst in the party’s shift to the right and to the increased polarization of American politics.<sup>23</sup> But free market conservatism is not confined to the right side of the Republican Party. In fact, as we argue later, its adherents include many important Democrats.

Nonetheless, in recent years, some Republicans—especially those who have come to be identified with the Tea Party movement—have engaged in a virulent form of free market conservatism that we can term *fundamentalist free market capitalism*. The fundamentalist version sees no role for government under any circumstance. It can be contrasted with the view of earlier, prominent exponents of capitalism, ranging from the first treasury secretary, Alexander Hamilton, to the famous economist Milton Friedman, and even to Alan Greenspan, all of whom saw the need for government intervention, at least in exceptional circumstances. The fundamentalists severely hindered Treasury Secretary Paulson’s efforts to stabilize financial markets, both in forcing the bankruptcy of Lehman Brothers and in opposing TARP.<sup>24</sup>

Although economic and political beliefs behave quite similarly in the rise of a bubble, there are important differences in the aftermath of the bubble’s pop. Economic expectations can change dramatically and decisively over a short period of time when actors realize that economic fundamentals can no longer sustain the value of appreciated assets. But as the italicized clause of the *Oxford Dictionary* definition reveals, ideologues permit no such correction of their worldview. The rigidity of ideological beliefs inhibits the rational adaptation of policy to the circumstances of a financial crisis. Rather than concede that the old orthodoxy may be to blame, the ideologue searches for ways to blame perceived deviations from that orthodoxy. For adherents of free market conservatism, an apparent market failure is proof positive of government interference with the laws of economics. This suggests that policy making in the pop will exacerbate the crisis. The decisions will be delayed and distorted by ideological rigidity. The new policies are likely to contain the seeds of the next crisis.

The second commonality of financial and political bubbles is that both are strongly influenced by the institutions or the “rules of the game.” These rules generate incentives to engage in social behavior that may be destructive. The incentives of economic

actors are shaped by the structure of financial markets, the state of financial knowledge, and the presence or absence of government oversight and regulation. These factors determine to a large degree whether capital flows to society's most productive uses or, in contrast, feeds speculation and manipulation. Institutions similarly structure political decision making. The electoral system and campaign finance laws affect what policies politicians support. The structure of the federal government—bicameralism, the presidential veto, the filibuster, and the committee system in Congress—poses formidable obstacles to policy making. If these obstacles cannot be overcome, the government most likely will not be able to provide adequate oversight and regulation of financial markets.

In this way the political rules determine the economic rules. This political trump is important for understanding financial crises, as the entire set of hurdles imposes a status quo bias that inhibits governmental responses. The institutional hurdles that lead to gridlock are in turn exacerbated by ideological polarization.<sup>25</sup>

The final common feature of financial and political bubbles is the role of self-interest and greed. As we know from the Scottish economist Adam Smith in *The Wealth of Nations* and the American political scientist David Mayhew in *The Electoral Connection*, a lot of benefits flow from self-interested behavior in both the economic and political realms.<sup>26</sup> But, of course, there are limitations. Markets need a functioning invisible hand. Competition must be present and information must flow freely via the price system. Democracy requires competitive elections, free expression, and informed and engaged voters. When these conditions are not met, the social virtue of self-interest may cease, and opportunities for greed emerge.

Greed and interest are often what links finance to the political side of the bubble. Opportunist financiers will seek political alliances with opportunist politicians and compatible ideologues. Together such coalitions will exploit political opportunities to advance interests. A striking example of such alliances involves

former senator Phil Gramm (R-TX) and his wife Wendy. From 1995 to 2000, Gramm was the chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs. He was an author of the Gramm-Leach-Bliley Act, which repealed Glass-Steagall in 1999. Moreover, Gramm was instrumental in inserting the “Enron loophole” in the Commodity Futures Modernization Act of 2000.<sup>27</sup> Wendy Gramm was head of the CFTC from 1988 to 1993, and while she was head, Enron was granted exemptions pertaining to derivatives trading.<sup>28</sup> In 1993, Wendy Gramm became a member of the board of directors of Enron.<sup>29</sup>

When Phil Gramm retired from the Senate in 2002, he joined the Swiss banking firm UBS as a vice chairman. UBS was clearly troubled; in May 2004, the Federal Reserve fined the firm \$100 million for illegally transferring funds to Iran and Cuba. In 2007, the SEC successfully pursued an insider trading case against a UBS executive.<sup>30</sup> In addition, UBS was in deep trouble in the financial crisis; it received \$5 billion of the funds allocated to the AIG bailout. In 2009, UBS paid a \$780 million fine for holding illegal bank accounts for Americans and agreed to turn over the names of 4,400 account holders.<sup>31</sup> In 2011, UBS lost \$2 billion in a rogue trading scandal in its London office. For UBS, hiring a well-connected politician was an inexpensive investment.

Phil Gramm was known as an ardent advocate of free market conservatism. His ideology and his self-interest clearly overlapped. Phil and Wendy Gramm were beneficiaries not of competitive, but of crony, capitalism.

The UBS connection illustrates, moreover, that crony capitalism runs deep in both the Democratic and Republican Parties. In August 2009, President Obama played golf with one of his major fund-raisers, Robert Wolf, president of UBS North America.<sup>32</sup> The opportunism of the Gramms, Wolf, and Obama is striking. UBS is likely to draw benefits from its bipartisan connections. And these connections, we argue, are important to political bubbles.

Somewhat sadly, it can be difficult to disentangle the political influence of ideology from the influence of venality and greed.

Phil Gramm's free market conservatism was richly compensated. As free market conservatism has become an acceptable ideology to a large enough fraction of the mass electorate, personified in Joe the Plumber, who was hyped by the John McCain campaign in 2008, opportunistic politicians and crony capitalists can exploit this mass acquiescence for gain, contributing to increasing income inequality: Gramm's income increases much faster than Joe the Plumber's.<sup>33</sup> (Samuel Wurzelbacher, aka Joe the Plumber, is a Republican nominee for a House seat in 2012; if he wins, he may well realize the American dream and make his own way into the 1 percent.) Venality and free market ideology are complements in promoting a bubble. As Charles Kindleberger and Robert Aliber put it, "the supply of corruption increases in a procyclical way much like the supply of credit."<sup>34</sup>

Free market ideologies are not the only belief systems that can contribute to a political bubble. Even politicians on the left who subscribed to ideological beliefs rooted in economic and racial equality provided crucial support for policies that exacerbated the housing crisis. Executives of many real estate and financial firms exploited the political push to subsidize homeownership for lower-income and minority groups. In chapter 2, we point to a Fannie Mae annual report that establishes a direct link between Fannie Mae, Countrywide Financial's now discredited CEO Angelo Mozilo, and *redistributive egalitarianism*.

In this book, we show that a political bubble was at the center of the 2008 crisis. We also show that the dynamics of political bubbles played a central role in previous financial crises. Indeed, just as financial bubbles are endemic to capitalism, political bubbles are a permanent feature of capitalist democracy. Neither can be reformed away completely without forsaking the benefits of capitalism, of which there are certainly many.<sup>35</sup>

Nonetheless, American history has shown that some economic and political policies are preferred to others. After the Great Depression, the United States, until 2008, did not suffer any financial or economic dislocation that generated political

pressure for substantial government intervention in the economy. Indeed, over the past thirty years, Washington has deregulated financial markets by law, executive order, budgetary cuts, and deliberate neglect. This contrasts with earlier historical experience. After the “panics” that occurred every twenty years or so during the nineteenth and early twentieth centuries, Washington produced short-run write-offs through bankruptcy laws and reductions in debts owed to the federal government as well as enduring legislation such as the Federal Reserve Act. In the wake of the Depression, institutional change occurred in the enactment of deposit insurance and the regulation of banking, securities markets, and public utilities. In our contemporary globalized, high-tech economy, the regulatory alphabet soup of the 1930s may not be reheated easily as the flows of capital and financial activity require much greater international coordination and cooperation. Nevertheless, a strengthening of government capacity for monitoring and intervention is clearly needed.

In the crises that have arisen since the New Deal, times have indeed been different. The opponents of change succeeded in limiting the legislative response to a crisis. Most notably, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which responded to the savings and loan crisis of the 1980s, created a weak regulator, the Office of Thrift Supervision (OTS), and allowed for regulatory venue shopping by financial firms. AIG chose the OTS as its regulator. In the current crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act passed in July 2010 is a partial and overly complex act. We will see, in part 2, that it leaves ample opportunities for future bubbles.

We end the book by drawing policy conclusions that reflect our understanding of how political and economic bubbles interact. We favor a strong set of simple rules rather than regulatory discretion. The thirty-seven pages of Glass-Steagall are much to be preferred to the nearly three thousand pages of Dodd-Frank. Some may view us as Luddites. But we don’t share their optimism about the benefits of financial innovation. Instead, we

believe that the ever smaller increases in economic efficiency are undermined by ever increasing political risks.

We are skeptical about the unalloyed benefits of financial innovation for several reasons. First, economists do not agree among themselves. For example, Carmen Reinhart and Kenneth Rogoff nicely outline the broad academic disagreement about the seriousness of the U.S. current account deficit as the housing bubble grew.<sup>36</sup> Second, economists, even the smartest of the smart, often do not get it right. Joseph Stiglitz made a wrong call on Fannie Mae. Two other Nobel Prize Laureates, Robert C. Merton and Myron Scholes, were principals in LTCM, whose failure required a private sector bailout organized by the New York Fed. Third, judgment reflects financial incentives. The film *Inside Job* exposed how former Fed governor and current Columbia Business School professor Frederic Mishkin accepted a six-figure fee to coauthor a 2006 report titled *Financial Stability in Iceland*.<sup>37</sup> The Icelandic banking system crashed in 2008. Yale University professor Gary Gorton worked as a consultant to AIG before the crash, only to write a book later explaining how the emergence of a shadow banking system contributed to the crisis. The national and global financial systems are complex social systems. Within these systems, opportunities for economic and political manipulation abound. So it is naive to believe that markets always successfully self-regulate.

More broadly, we distrust arguments made in the name of economic efficiency that do not account for the political risks. Politics and markets alter new “products,” ostensibly efficient, in a way that leads to inefficiency. For example, adjustable-rate mortgages (ARMs), allowed in the United States by the Garn–St. Germain Depository Institutions Act of 1982, make sense in that they allow lenders to avoid the interest rate mismatch involved in accepting short-term deposits but making long-term loans. They also make sense for assistant professors of finance, at the beginning of their life cycle earnings, to make smaller payments in the near term at the risk of making larger payments in the future. But the product quickly got distorted into “teaser” loans with

low introductory interest rates that later reset to usurious levels. These loans were often made without verification of income or assets. Because Congress failed to sharply delimit the new product, the nation might have been better off without any ARMs.

We also argue for strong product regulation with a minimum of regulatory discretion because of Wall Street's ability to lobby on regulatory implementation. Until JPMorgan Chase's \$5.8 billion trading loss in 2012, the implementation of the new Volcker Rule that prohibited commercial banks from speculating on their own account was likely to have been significantly weakened by lobbying by the firm's CEO, Jamie Dimon. Similarly, as the CFTC was deliberating rules for treating client money, Gary Gensler, the head of the CFTC, permitted himself to be lobbied by MF Global head and former Goldman Sachs colleague Jon Corzine. Clients, who are still waiting for their money back, deserved better from the former New Jersey senator and governor. Sharp legislation with severe criminal penalties for misuse of client monies might well have protected MF Global clients.

In theory, regulatory implementation after Dodd-Frank by the "best and the brightest" might lead to more market efficiency than a set of rules set in stone by legislation. But regulatory implementation is hardly a technocratic process that can be divorced from politics. As journalist David Halberstam recounted, "the best and the brightest" were deeply implicated in the American failure in Vietnam.<sup>38</sup> The elites and experts are no less implicated in our recent financial failures. Whether it was the LTCM failure, the Enron scandal, or the subprime crisis, graduates and faculty members of our elite educational institutions were on the scene.<sup>39</sup> The central characters of these debacles serve on the boards of America's leading philanthropies, cultural institutions, and public companies.

The composition of the board of directors of AIG vividly demonstrates the extent to which the American elite is implicated in the crisis. The outside directors between 2005 and 2008 included Obama- and Clinton-appointed diplomat Richard Holbrooke; Clinton defense secretary and former Maine Republican senator

William Cohen; Reagan White House adviser and Harvard University economist Martin Feldstein; Carla Hills, president Gerald R. Ford's Housing and Urban Development secretary and George H. W. Bush's trade representative; Ford "energy czar" Frank Zarb; American Museum of Natural History president Ellen Futter; and public television executive George Miles. Feldstein, Futter, Holbrooke, Miles, and Zarb served on the board for all or part of the years 2005–8. Over that period, their individual compensations as director ranged from \$792,000 to \$1,136,000. Perhaps those directors who served in government at low pay merited a subsequent private sector payout. But the AIG board failed to protect the public interest.

The moral of the story is that efficiency in the financial system has its limits. Efficiency should not be an end in itself because financial firms are inhabited by fallible people. The central goal of financial reform should not be efficiency but increasing the accountability of the financial system to the American public.