

Bryan's Revenge: Easy Credit and the American Welfare State

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“...it isn't even past yet.”

Many analysts have argued that one factor behind the economic crisis of 2009 was financial deregulation: starting in the 1970s, and extending well into the administration of George W. Bush, the American state revised its manner of regulating the match between those who had capital and wished to invest it, and those who needed capital. Although financial deregulation can be said to have started as far back as the administration of Richard Nixon, and gained speed throughout the 1980s, many analysts identify two specific acts as particularly consequential: the Gramm-Leach Bliley Act of 1999, which finally repealed once and for all the restrictions that had been put in place in 1933 with the Glass-Steagall Act; and the Commodity Futures Modernization Act of 2000, which ensured that trade in over the counter derivatives would not be regulated as standard futures contracts are regulated.

Glass-Steagall had been in place since the Great Depression. Faced with nationwide bank failures the administration of Franklin Roosevelt had decided that banks had been speculating in the stock market with the deposits of their everyday customers. Consequently Glass-Steagall forced banks to choose either investment banking, or consumer lending, but restrained banks wishing to engage in both. Throughout the 1980s the Federal Reserve Board under Alan Greenspan supported efforts to loosen the interpretation of the Act. At issue was a clause in Glass-Steagall that stated that commercial banks could not be “engaged principally” in investment banking. The Federal Reserve progressively raised the amount of business in securities commercial banks could pursue and still be considered to not be “engaged principally” in investment

banking. Success with these ever-greater proportions convinced many members of the financial community that the Glass-Steagall restrictions were no longer necessary, and by 1999 Congress was prepared to repeal the restriction with the Gramm-Leach-Bliley Act, with overwhelming support from members of both parties.

The second episode was a non-regulation rather than a deregulation. In 1998 the market in over-the-counter derivatives had been growing exponentially and was worth nearly \$30 trillion, and Brooksley Born, head of the Commodity Futures Trading Commission, proposed discussing their regulation. But Alan Greenspan and Robert Rubin united to shout her down, arguing that even the specter of governmental intrusion into the market would create uncertainty and cast trillions of dollars' worth of contracts into doubt: "There was a legitimate and widely held view that this aggravated that very question of legal certainty," said Gary Gensler, assistant secretary of the Treasury at the time. "All it took was one judge in some jurisdiction to determine this and it would throw a great deal of uncertainty into this interconnected world." (Coutts and Bernstein). The Commodity Futures Modernization Act ensured that the government would not regulate OTC derivatives like futures contracts.

Much work remains to be done to measure the specific effect of these acts, but the general outline of the consequences is evident. First, the repeal of Glass-Steagall seems to have increased the sheer size of these financial institutions, allowing their health to affect larger and larger parts of the economy; second, the mixing of investment and commercial lending made each vulnerable to the other, in that new financial instruments for commercial lending were developed that were ultimately derived from consumer lending; and third, new and unregulated financial innovations that attempted to mitigate

risks by diversifying into both sectors of finance, but whose complexities confused analysts and distorted ratings processes, created non-transparency and uncertainty in the financial system. These two acts were not the only policies important in the events, but they were two key episodes in the changes in regulatory governance that collectively reduced the ability of the state to constrain finance.

But this sequence of events leads to a puzzle that has not been widely discussed. One reason that many proponents of deregulation gave for wanting deregulation in the 1990s is that at that point, the U.S. financial system was more severely regulated than the financial systems of any other country. No European country has ever had regulations akin to Glass-Steagall (see e.g. Canals, 1997; Herring and Litan, 1995). The U.S. was an outlier in this respect, as it was in financial regulation in general, and many observers complained that this put American firms at a competitive disadvantage against their foreign counterparts. A comparison with the U.K.—presumably the nation with the closest traditions of state regulation of the market--highlights the difference:

“U.K.-style prudential supervision has resulted in levels of enforcement that are orders of magnitude lower than those of the U.S. The [British] FSA levied fines totaling £5.3 million in 2007 and £13.3 million in 2006. In the U.S., a single financial regulator – the SEC – collected disgorgements and penalties of \$496.4 million in fiscal year 2007 and \$1.804 billion in fiscal 2006. The CFTC, in the five years to December 2007, levied more than \$1.8 billion in total monetary sanctions. According to the FSA, 40% of the SEC’s staff works on enforcement, compared with 10% of the FSA’s staff. The foregoing statistics understate the

difference in enforcement intensities, once one considers the vast differences in the levels of private enforcement activities of the two legal environments. In particular, there are no securities class actions in the U.K. In the U.S., for the period 2002-2004, class actions resulted in sanctions of \$3.3 billion – more than the monetary sanctions obtained by the SEC and the Department of Justice combined.” (Duffie and Hu, 2008)

These differences in regulatory environments were often given as reasons for the American deregulations. New York Democrat Chuck Schumer, in explaining his support for repeal of Glass-Steagall, said “If we don’t pass this bill, we could find London or Frankfurt or years down the road Shanghai becoming the financial capital of the world...There are many reasons for this bill, but first and foremost is to ensure that U.S. financial firms remain competitive.” Indeed, the ability of foreign financial markets to function just fine without American-style financial regulations was a key factor in the belief that such regulations were not necessary. European banks eventually got pulled into the crisis stemming from the U.S., of course, because they were exposed to American financial instruments; but on their own, they had functioned for several decades without American-style financial regulations.

The puzzle, then, is this: why did the U.S. attempts to imitate European-style financial regulation seem to have such negative consequences? Why does European-style financial regulation not work in the U.S.?

An answer to this question is important intellectually because it sheds light on aspects of American and European political economy that remain poorly understood: for

all of their differences, all our theories of comparative political economy, from “varieties of capitalism” to neo-Marxist theories, converge on the argument that the U.S. is a more “liberal” political economy, with minimal state interventions or with state interventions only where necessary to ensure the free flow of the liberal market. Consequently, none of these theories has much to say when faced with instances of greater intervention in the market in the U.S., or with interventions that impede the free flow of the liberal market. These theories are particularly unhelpful in tracing the origins of these American regulations, as they would predict that such regulations were put in place to aid the creation of a liberal market. But the origins of the US regime of financial regulation shows that these acts were passed over the opposition of capitalists and defenders of liberal markets, and usually against loud protests of the impediments these regulations created to the free flow of the liberal market.

An answer to this question is also politically important, because without an answer the need for strong financial regulation in the U.S. will not be understood. The argument will always be that if looser regulation works in other countries, it should work in the U.S. President Obama in a recent interview made just this argument when he said: “You know, I’ve looked at the evidence so far that indicates that other countries that have not seen some of the problems in their financial markets that we have nevertheless don’t separate between investment banks and commercial banks, for example.”

In this paper, I will attempt to show that the President’s understanding—which is the common wisdom—glosses over some important differences in the way that credit functions in the U.S. compared to other countries. In the absence of a mature welfare state, easy credit and loose bankruptcy regulations served the function of a de facto

welfare state in the U.S., with citizens borrowing to finance education (including the purchase of homes adjacent to good schools), health care, and retirement—purchases that would have been financed out of general taxation in the European countries. This led to a much higher demand for credit in the U.S. Consequently, loosening regulations on credit had a much more dramatic effect in the U.S. than in Europe, in that European-style financial deregulation in the absence of a European-style welfare state led to much higher levels of borrowing, which ultimately set the stage for crisis. Attempts to reform the financial regulatory regime should keep in mind the distinct role that credit plays in the U.S. Conversely, advocates of tighter regulation must keep in mind that, in the absence of a mature welfare state in the U.S., tighter credit regulation means decreasing ability of citizens to finance the welfare needs that were being met by easy credit in the era of deregulation.

Debt and the Crisis

Before exploring the factors that led to the rise of borrowing, it is necessary to understand the role that borrowing played in the crisis. There are three main factors that led to the slowdown in the growth of credit, and consequently to the bankruptcy of some key financial institutions in the U.S. in 2008-2009¹: (1) The economic growth of many developing countries, and especially China, led to a dramatic increase in savings worldwide, which led to a much larger number of investors looking for things to invest in. (2) Expectations of stable returns in the U.S. drew that money into this country, a process that accelerated when financial market deregulation allowed an explosion of experimentation and innovation for new ways to make money. One of these innovations

¹ Monica Prasad, “Three Theories of the Crisis,” Economic Sociology Newsletter, April 2009.

was to divide streams of income (such as from home mortgages) into more and less risky parts; package together the parts of different reliability; and sell the different packages at different rates of interest corresponding to their different levels of risk. This process (“securitization”) had begun in the 1970s but intensified in the next decades. One consequence of securitization was that if the bad debts could be sold to someone else, then the original investor had no interest in actually ensuring that the debt was honored, leading to more and more hazardous loans being made. Another important change was looser regulations on the debt that firms were allowed to take on to finance investment, leading to extraordinary rates of leveraging. Credit rating agencies were caught short by all the changes (and perhaps didn’t want to ask too many questions because they were getting paid by the firms they were rating) and continued to base their ratings on assumptions that were no longer true for the new schemes. Consequently many investments that were actually quite risky were rated as not being so, and the investors looking for things to invest in rushed into them. (3) The home mortgage bubble, itself caused by a separate set of regulations and deregulations, led to a larger number of people buying homes, including some who were the victims of predatory lenders; and stagnant wages led to rising levels of indebtedness in general. As long as property values kept rising, homeowners and debtors could borrow against the value of their homes to pay off mortgages and other debts. But when prices began to decline this was no longer possible, leading to foreclosures and further declines in homes and, finally, a popping of the bubble. When this happened all those securities that had been built on top of home mortgages collapsed, and all the investors from all over the world who had put their money in the financial products based on those debts lost their money. Some financial

firms lost so much money that they went bankrupt, or were only prevented from doing so by infusions of taxpayer money. All financial institutions became much more cautious in their lending—partly because of lack of clarity in how much any institution was exposed to speculative derivatives--leading to a slowdown in the growth of credit which has led to a general cycle of reduced spending, unemployment, and disinvestment.

One of the triggers for this sequence was that financial deregulations led to rising levels of debt. The financial deregulations allowed new, riskier financial products to be marketed. These new products allowed loans to be made that would not have been made before, such as the infamous “liars’ loans” that required no documentation of income. It was because of these rising levels of debt that problems with the derivatives built on top of consumer debts did not become apparent, as consumers could borrow and refinance again and again to cover their debt payments. And it was because of rising levels of debt that credit rating models went awry, as the models assumed a level of foreclosure that had been correct in the past, but that were not accurate for the new, riskier loans.

What is often ignored in this picture is the micro-level mechanism at the heart of these macro-level trends. The generic picture is of a debtor “lying” about financial circumstances, or of a creditor “preying” on vulnerable populations with loans with ballooning interest rates hidden in the fine print. Both of these scenarios account for some fraction of the debtors and creditors [cites]. But another possibility is simply greater need combined with opportunity. A householder borrowing to cover a financial catastrophe, who is not explicitly asked to document income, is not a liar; similarly, *absence* of the opportunity to borrow in that situation is not necessarily an improvement

over a loan at high interest rates. Instead, the debtor and the creditor in this situation have pieced together a patchwork welfare state.

...to come: causes of rise in debt