

# Partisan Financial Cycles

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**Abstract:** Little attention has been given to the partisan character of government as a cause--or a consequence--of financial crises. I argue that policies and regulations vary predictably with the partisan character of the government, creating a *partisan-policy financial cycle* in which right-wing, pro-market governments preside over financial booms while left-wing governments are elected to office after crashes. My sample consists of all bank-centered financial crises to hit advanced countries since the end of the Bretton Woods system in 1973, including the recent “subprime” crises—a total of 27 cases. I find that governments in power prior to major financial crises are more likely than the OECD average to be right-of-center in political orientation. I also find that these governments are more likely than average to be associated with policies that precipitate crises: large fiscal and current account deficits, heavy borrowing from abroad, and lax bank regulation. However, once a major financial crisis occurs, the causal arrow flips and government partisanship becomes a *consequence* of crises. I find that the electorate moves to the Left after a major financial crisis, and this leftward shift is associated with changes in government partisanship in that direction.

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## 1. Introduction

Surprisingly little attention has been given to the partisan character of government policies as causes (or consequences) of financial crises. While the subprime mortgage crisis that began in 2007 has been attributed to lax regulation in the context of a surge in capital inflows from abroad, neither the level of regulatory oversight nor the policies that fueled the capital inflow have been linked to government partisanship in the run-up to the crisis. When this crisis ends, there will likely be major reforms to the financial regulatory framework, just as reforms followed every other major financial crisis in U.S. history (Bordo 2008). Here again, scholarship has ignored the link between financial crisis, regulatory reform, and government partisanship.

I explore the relationship between government partisanship, public policies, and banking crises in the industrialized countries since the end of the Bretton Woods system. My working hypothesis is that a *partisan-policy financial cycle* exists in which right-wing governments preside over financial booms, funding budget deficits with foreign borrowing and deregulating financial activities in line with their pro-market ideology. When the crash ultimately occurs, voters reassess their support for right-leaning governments, making it more likely that left-wing governments will be in office after financial crashes. Once in power, left-wing governments pursue policies to unwind the financial excesses of their predecessors and oversee the broad re-regulation of financial activities. In short, the political orientation of the government is both a “cause” of pre-crisis policies and a “consequence” of financial crises.

I evaluate this argument on data from all bank-centered financial crises to hit developed countries from the end of the Bretton Woods regime in 1973 through the recent “subprime” crises—a total of 27 cases. My primary source for these crisis cases is Reinhart and Rogoff (2008, 2009). Like Reinhart and Rogoff, I give particular attention to the most severe “systemic”

banking crises, the Big Five: Spain (1977), Norway (1987), Finland (1991), Sweden (1991), and Japan (1992). Since the subprime crises must be considered as severe as a Big Five crisis by any metric, I add these nine systemic crisis cases to the sample: United Kingdom (2007), United States (2007), Germany (2007), Switzerland (2007), Iceland (2008), Ireland (2008), Japan (2008), Netherlands (2008), and Spain (2008).<sup>1</sup> While partisan financial cycles are most likely to occur in systemic crises, I also consider lesser banking crisis, using Reinhart and Rogoff's sample of 13 "milder" banking crises: United Kingdom (1974), Germany (1977), Canada (1983), United States (1984), Iceland (1985), Denmark (1987), New Zealand (1987), Australia (1989), Italy (1990), Greece (1991), United Kingdom (1991), France (1994), and United Kingdom (1995).

My argument applies to industrial (OECD) economies in the post-Bretton Woods period. It is limited to OECD economies because political partisanship does not hew to the left-right dimension in many developing countries, which is to say that data on the political orientation of developing-country governments is limited. It is restricted to the post-Bretton Woods period because banking crises almost always occur in an environment of financial globalization, where free capital mobility fuels asset booms (Bordo and Landon-Lane 2010). While banking crises have been common since the early 1970s, they were nonexistent in industrialized economies during the Bretton Woods era (Jordà, Schularick, and Taylor 2010; Bordo and Landon-Lane 2010). This is no coincidence. Bretton Woods was characterized by widespread capital controls and extensive financial regulations, which insulated countries from financial booms and busts. By contrast, the post-Bretton Woods period saw the removal of capital controls, the liberalization of domestic financial markets, and the return of banking crises. To quote Jordà et al, (2010; 2),

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<sup>1</sup> Subprime crisis observations are from Cecchetti, Kohler, and Upper (2009).

“...it is striking from the data that no financial crises happened during the Bretton Woods years of tight financial regulation and capital controls in the years from WW2 until the mid 1970s.”

**Figure 1** plots the frequency of banking crises over time, verifying that banking crisis go hand-in-hand with financial globalization. Only two banking crisis occurred anywhere in the world during the Bretton Woods period, and these crises were in developing countries: India in 1947 and Brazil in 1963. While banking crises were common during the gold standard era and the interwar period, my argument does not extend to these earlier epochs of international capital mobility because political partisanship had not yet come to reflect the dominant Left-Right cleavage that it does today. Prior to the Great Depression, the role of the state in the economy was small and other issues--religion, constitutional reform, suffrage, protectionism, and imperialism--shaped partisan competition in industrial countries. Furthermore, it was only after Bretton Woods ended that right-wing parties like the Republican Party in the United States moved away from their traditional policy of balanced budgets and fiscal rectitude to embrace the idea that “deficits do not matter” (Bartlett 2007; Cusack 1999). International capital mobility was the enabling condition behind this policy shift because large fiscal deficits would have produced much sharper declines in private domestic investment had foreign capital not been available to finance the dissaving (Friedman 1992). In short, my argument applies to OECD countries in the context of large-scale cross-border capital flows. **Table 1** contains the crisis episodes employed in my comparisons.

In terms of research design, this paper is more exploratory than explanatory. By focusing on cases where banking crises occurred, I am selecting on the dependent variable which precludes drawing causal inferences about the relationship between partisanship and crises. Whenever possible, however, I include an “OECD baseline” to assess whether political trends

observed in the crises cases are distinct from general trends among advanced countries. Even still, this research design is not suited to causal inference. But it can help *rule out* partisanship as a cause of whether a country experiences a financial crisis. It can also help *rule out* whether government partisanship is a consequence of financial crises. This is because partisanship cannot “explain” financial crises—or post-crisis partisanship—if it varies widely over the crises cases.

With this research design, it is crucial to select observations without regard to values of the explanatory variables. That is, the sample should be as representative of the population as possible and should never be chosen to “fit” a particular hypothesis (King, Keohane, and Verba 1994, p. 141). As mentioned above, I use the entire population of advanced-country banking crises as identified by Reinhart and Rogoff (2009) and Cecchetti, Kohler, and Upper (2009). These authors, and the sources they reference, never mention “government partisanship” as a criterion for selecting crises observations.

Several themes set this paper apart from previous work on financial crises. First, I treat financial crises as endogenous events originating in the policy choices of governments. While the triggering event may vary from crisis to crisis, the preconditions are rooted in the tendency of governments to combine large fiscal and current account deficits with lax bank regulation. Second, I associate these pre-crisis policies with the partisan orientation of the government in office: in countries that experience a major financial crisis, right-of-center parties are more likely to be in power during the boom, overseeing policies that precipitate crises. It thus appears that partisan electoral competition is a source of pre-crisis booms by way of the macroeconomic and regulatory choices of right-leaning governments. I suggest that right-wing parties, enabled by international capital mobility, run fiscal and current account deficits to reward their high-income

constituents with asset booms. Third, I argue that financial crises also have consequences for partisan electoral competition. I show that after a major financial crisis, the electorate tends to move to the Left and this leftward shift is associated with subsequent changes in government partisanship to the Left. Thus, financial crises appear to affect the partisan orientation of electorates and governments.

In the next section, I present comparisons of the partisanship orientation of government across cases of financial crises. In Section 3, I overlay these partisan patterns on the government policies that have been associated with financial crises: fiscal deficits, current account deficits, and financial deregulation. In Section 4, I spotlight the U.S. subprime crisis and the Savings and Loan crisis of the 1980s, with an eye for evidence that would disprove the partisan-policy cycle hypothesis. In Section 5, I conclude and consider future research.

## **2. Government Partisanship and Financial Crises**

**Figure 2** compares the political orientation of government across the Big Five cases of financial crisis. Following the convention in Reinhart and Rogoff (2009), period  $T$  represents the year when the banking crisis began, period  $t - 5$  is five years prior to the onset of the crisis, and the graph continues to  $t + 5$ , the period five years after the crisis began. Political orientation data in this figure is from the World Bank's *Database of Political Institutions* (DPI), which records the Left-right orientation of the party heading the executive branch (Beck et al 2001).<sup>2</sup> Governments

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<sup>2</sup> Later, I use an alternative partisan specification based on the share of cabinet posts held by different parties. But there are limitations to both partisan measures. First, these measures are based on a time-invariant classification of parties on the Left-Right spectrum, which is problematic if parties have repositioned themselves on this spectrum over time. Second, these measures fail to capture the complexities of presidential and semi-presidential systems. In the United States, for example, neither the party of the chief executive nor the partisan composition

headed by Right parties are coded 0, governments headed by Center parties are coded 1, and governments of the Left are coded 2. As a baseline for these comparisons, the figure also includes the “OECD mean,” which is the average political orientation of the chief executive for all OECD countries (minus the country in crisis) during equivalent time periods. I include the OECD baseline to assess whether partisan political patterns are specific to crisis countries, as I am suggesting, or whether they reflect more general trends in advanced countries during equivalent time periods.

**Figure 2** shows that governments moved sharply to the Right in the run-up to the Big Five crises, moving from center to right-of-center orientations by the  $t-4$  period. A turning point in political orientation begins with the onset of the crisis and this leftward shift continues, after a partial three-year retrenchment, with another large movement to the Left. The change in government partisanship is most extreme between the  $t-4$  and  $t+4$  periods, during which governments moved from Right to Left by 0.9 points on average. As the political orientation variables (DPI) ranges from 0-2, this represents a 33 percent shift from Right to Left. Since the plot of the OECD mean indicates that no similar movements in political partisanship were occurring across the OECD during these time periods, we can be fairly certain that the observed partisan turning points in crisis countries were not part of larger trends in other advanced countries.

**Figure 3** displays the partisan orientation of government in countries hit by the subprime crisis that began in 2007. Here, the data extend only to  $t + 2$  since, as of this analysis, partisan electoral outcomes have yet to be determined beyond that point. However, the emerging political pattern is similar to the pattern evident in the Big Five crises: in the periods before the

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of the cabinet distinguishes between a situation in which the president’s party controls Congress and divided government.

subprime crisis, government political orientation was trending to the Right. Indeed, in two pre-crisis periods ( $t-4$  and  $t-1$ ), subprime countries had governments headed by parties that were sharply more right-of-center than the OECD average. More generally, the figure reveals that the rest of the OECD experienced little change, on average, in government partisanship over this eleven-year period. Hence, the sharp swing to the Left in subprime countries after the crisis is evident—an indication of a partisan turning point.

**Figure 4** continues comparisons of the orientation of the political party in power using all 18 crisis countries in the Reinhart and Rogoff (2009) sample. The sample includes the Big Five cases plus the 13 milder banking crisis cases listed in **Table 1**. The partisan pattern found in **Figures 2** and **3** is weaker here, as might be expected. Unlike the Big Five and subprime crises, minor banking crises affect isolated banks and are not systemic in nature. For example, the minor crisis in Australia in 1989 involved two large banks that received capital from the government to cover losses (Reinhart and Rogoff 2009, p. 350). Minor crises are less likely to have been “caused” by government policies because policies that make a crisis more likely—large current account deficits and financial deregulation—affect all or most financial firms and activities. Furthermore, minor bank crises do not generate the political-partisan “consequences” of a systemic crisis either, since they do not spawn deep recessions, high unemployment, and asset price crashes that can push the electorate to the Left. Nevertheless, the figure reveals a slight tendency for Right governments to give way to Left governments even when we “dilute” the sample with crises of lesser magnitudes.

An alternative measure of partisanship reveals similar patterns. In **Figure 5**, I calculate government partisanship as the share of cabinet portfolios held by Left and Center parties, weighted by the number of days the government was in office in a given year. These data are



from the Comparative Political Data Set (Armingeon et al. 2010). Left parties are defined as Labor parties, Social Democratic parties and parties to the Left of these mainstream Left parties, while Center parties include most Christian Democratic parties. **Figure 5** shows that the percentage of total cabinet posts held by Left and Center parties declined in the run-up to the crisis in each of the three crises samples and then increased as the crisis approached. Left and Center parties continued to increase their share of cabinet portfolios in the year of the crisis and made gains through the  $T+4$  period. This is consistent with the patterns observed in **Figures 1-4**.

Returning to the systemic banking crises, we can break out the averages into individual cases and look at the *change* in government partisanship that occurred after each major crisis. **Figure 6** plots the “Change in Partisanship,” indicating the change in the mean value of the DPI political orientation indicator between the pre-crisis ( $t-5$  to  $t-1$ ) and the post-crisis ( $T$  to  $t+5$ ) periods.<sup>3</sup> “OECD change” indicates the change in the OECD average of DPI, minus the country in crisis, over the same interval. Positive values indicate a shift to the Left. Given that much larger partisanship changes occurred in crisis countries than in the OECD as a whole, it is fair to conclude that governments of *all* political orientations were punished at the polls for presiding over a systemic financial crisis. Systemic crises provoke turnover in the chief executive.

Beyond punishing incumbents, **Figure 6** also provides support for the existence of a partisan financial cycle. Governments moved to the Left in 9 of 13 cases (69%) after the onset of a major financial crisis. By contrast, governments moved to the Right in four cases (31%). That

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<sup>3</sup> The post-crisis mean for the subprime cases is constrained to the  $T$  to  $t+2$  periods. Orientation values for subprime cases after 2009—the latest year of the DPI database—were gleaned from recent election outcomes. The Japan 2008 case represents a judgment call since the Democratic Party of Japan (DPJ), which displaced the Liberal Democratic Party in 2009, does not define its policy mandate only along the Left-Right dimension.

a strong majority of countries moved from Right to Left after a systemic crisis tends to support the contention that right-wing governments are more likely to preside over pre-crisis booms than left-wing governments. Hence, we cannot rule out partisanship as a *cause* of major banking crises. That a strong majority of countries had governments that were more left-of-center after a crisis than before a crisis also suggests that we cannot reject the hypothesis that government partisanship is a *consequence* of financial crises.

We can explore this possibility further. If elected governments have a tendency to move to the Left after a financial crisis, then presumably the electorate in crisis countries is moving to the Left as well. While electoral results are an indirect measure of this shift, **Figure 7** provides information on the change in mass political attitudes that follows a financial crisis. The data are from the World Values Survey (WVS), which has carried out representative national surveys of political and social attitudes in five “waves” from 1981 to 2007. The series allows me to measure the change in individual political attitudes that followed a banking crisis. However, data are not available for all crisis cases. No observations from the subprime cases are possible since the most recent WVS wave was in 2007, and I can only calculate the change in mass political attitudes for 10 of the 18 crisis cases in the Rogoff and Reinhart (2009) sample of major and minor crises. In these cases, a financial crisis occurred between two waves of the WVS.

I measure the change in “mass political orientation” as the change in the country average of individual responses to the WVS query: “In political matters, people talk of “the Left” and “the Right.” How would you place your views on this scale, generally speaking?” Responses range from 1 = Far Left to 10 = Far Right. In **Figure 7**, crisis countries are indicated on the left axis, with the onset year of the banking crisis in parenthesis. An asterisk indicates a Big Five

crisis. Next to the bars are the years of the two WVS surveys used to calculate the change (delta), in national attitudes. Negative changes indicate a shift to the Left.

The largest change in political attitudes occurred in the Big Five case of Finland, where average political orientation shifted to the Left by over half a point (0.54) between 1990 and 1996 (the crisis occurred in 1991 but took several years to unwind). In England, two mild banking crises took place in the interval between WVS surveys, and national political attitudes moved leftward by a third of a point. In Norway, another Big Five case, attitudes shifted by almost a quarter of a point to the Left (0.24). By contrast, the Big Five crisis in Japan is associated with a shift to the Right, albeit a small one (0.05).

These are small changes in public political attitudes, to be sure, and factors other than financial crisis may have contributed to them. But the figures do suggest that it is not just swing voters choosing Left parties over Right parties after a crisis. They show fewer people identifying as right-wing and *more* identifying as left-wing. Hence, we cannot rule out the possibility that mass political attitudes are affected by financial crises—especially systemic financial crises—and that a post-crises shift to the Left in the electorate may be the source of leftward shifts in government orientation.

### **3. Partisan Policies and Banking Crisis**

In a study completed over 30 years ago, Edward R. Tufte found that the “single most important determinant of variations in macroeconomic performance from one industrialized democracy to another is the location on the left-right spectrum of the governing political party” (Tufte 1978, p. 104). While Tufte’s path breaking analysis generated mountains of research on the links between government partisanship and various macroeconomic outcomes—unemployment rates,

inflation rates, income equalization, and the size and rate of expansion of the government budget—no one to my knowledge has looked at whether the orientation of the governing political party is also related to financial cycles of boom and bust.

In the previous section, I showed that financial crises appear to have political *consequences*. Crises affect political attitudes within the electorate which lead to shifts in government partisanship. In this section, I develop the argument that government partisanship might also be a *cause* of financial crises. Like Tufte, I assume that political parties represent different constituencies and make policy choices that reflect the interests of their core constituents when in government. But unlike Tufte, I focus on government policies that make boom-bust financial cycles more likely: large fiscal and current account deficits combined with financial deregulation. I suggest that right-of-center governments run these policies in order to reward their high-income constituents with sharp--yet transient--increases in wealth.

### *3a. Current Account Deficits*

Reinhart and Rogoff (2009) establish policy similarities between the U.S. subprime crisis and prior banking crisis episodes. They pay particular attention to the massive U.S. current account deficit that preceded the crisis—and the foreign borrowing binge that it precipitated—and they show that such “capital flow bonanzas” are a common precursor of financial crises in both advanced and emerging economies.<sup>4</sup> Likewise, Chinn and Frieden (2009: 2) argue that the subprime crisis is “...merely the most recent example of a “capital flow cycle,” in which foreign

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<sup>4</sup> The term, “capital flow bonanza” is from Reinhart and Reinhart (2009) and signifies a period of abnormally large capital inflows (i.e., above-average foreign borrowing).

capital floods a country, stimulates an economic boom, encourages financial leveraging and risk taking, and eventually culminates in a crash.”

At the most fundamental level, the current account balance is the difference between a country's savings and its investment. If the current account balance is positive, it measures the portion of a country's saving invested abroad; if negative, it is the portion of domestic investment financed by foreign savings. Since any excess of national spending over income must be financed by foreigners, the current account deficit is equivalent to the net inflow of capital from abroad.

**Figure 8** provides dramatic evidence of the association between the current account balance and financial cycles. In each sample average, the figure shows that countries amassed seriously large current account deficits in advance of a crisis, reaching 4 percent of GDP on average for the subprime sample. Several subprime cases are particularly noteworthy in this respect. For example, the current account deficit of the United States reached an all-time record high of 6 percent of GDP in 2006. But this was trivial in comparison to Iceland's deficit, which hit 41 percent of GDP in 2008. The current account to GDP ratio was also very large for Spain (- 10 percent), Ireland (- 5.3 percent) and the U.K (- 3.3 percent) prior to their respective crises. More generally, the pattern is one of increasing deterioration in the current account balance before crises followed by sharp improvements afterwards. In fact, the current account balance average goes into surplus for the Big Five and the subprime samples by the  $t+2$  period.

There can be a link between the current account and the fiscal deficit, which is known as the “twin deficits” relationship. When a government increases its fiscal deficit, domestic residents may use the additional income to boost consumption, causing total national saving to decline. Unless domestic investment decreases to offset the saving shortfall, the country must

borrow from abroad, i.e., it must run a current account deficit. Chinn and Ito (2007) show that the budget balance is an important determinant of the current account balance for industrial countries. In the next section, I examine the fiscal accounts of OECD governments that presided over financial crises and find evidence that suggests a twin deficits policy.

### *3b. Fiscal Balances*

With respect to financial crises, the relationship between the twin deficits appears very strong. **Figure 9** plots the average structural budget balance for my crises samples.<sup>5</sup> In each sample, the structural budget balance turned sharply negative in the period before a crisis hit. This suggests that governments were, on average, running a policy of heavy deficit spending in the run-up to their crises. As Reinhart and Rogoff (2009, p. 220) note, “increasing public debt has been a nearly universal precursor” of postwar financial crises. They also find that the budget balance typically worsens after a banking crisis, which they attribute to large stimulus programs during post-crisis recessions.

But are budget deficits preferred by the Right? Connecting the fiscal component of the “twin deficits” relationship to right-wing governments may run counter to conventional wisdom since Right governments are supposed to favor a low level of public consumption (Hibbs 1977, Alesina, Cohen, and Roubini 1993). However, the conventional view finds little empirical support in the post-Bretton Woods period (Cusack 1999). In fact, a number of studies conclude that the partisan impact on fiscal policy is just the opposite of the conventional wisdom.

Cameron (1985), for example, finds that leftist governments in the OECD are usually *less* likely

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<sup>5</sup> The structural budget balance is the fiscal deficit that would be incurred if the economy was at full employment. Since the structural balance is cyclically adjusted, it captures the central government’s fiscal policy stance.

to incur large budget deficits than governments controlled by centrist, Christian Democratic or conservative parties. Similarly, Garrett and Lange (1991) found that OECD countries with Left governments and strong labor parties tend to run smaller budget deficits than do right-leaning parties.

These findings suggest a partisan fiscal pattern in which the Left is more likely to adopt a conservative stance than the Right. While unconventional, this is consistent with Persson and Svensson (1989) and Pettersson-Lidbom (2001), who theorize that right-wing governments strategically run fiscal deficits in order to force their left-wing successors to curtail public spending—a strategy known as “Starve the Beast” (Bartlett 2007). This also echoes a similar argument by Alesina and Tabellini (1990) in the context of Reagan administration deficits. The “Starve the Beast” strategy can be effective because, by lowering taxes and issuing debt, right-wing governments constrain future spending.

In addition to strategically limiting the fiscal choices of successors, deficits have another attraction for the Right: they favor high-income constituents by cutting taxes more than spending. For example, Ohlsson and Vedrin (1996) examined Swedish fiscal policy between 1968 and 1993 and found that right-wing governments cut taxes more than spending, thereby generating greater deficits than social democratic governments.

These arguments suggest an electoral mechanism for the partisan financial cycle in which right-wing governments preside over fiscal deficits. But are current account deficits that generate risky capital inflows a policy of the Right? Begin with the assumption that Right parties disproportionately represent homeowners and other asset-owners, as in Ansell (2007, 2009). Since current account deficits fuel asset booms in housing and equities markets, right-wing parties may derive electoral benefits from this policy, even if the wealth effects that asset-holders

experience turn out to be temporary. Moreover, when capital inflows are available to finance budget deficits, right parties can generate asset booms via large fiscal deficits without crowding-out private investment and thereby antagonizing their high-income business constituents. This is because capital inflows prevent domestic interest rates from rising above the world interest rate, so that the crowding out of investment that usually takes place in a closed economy doesn't occur.

While he doesn't consider capital flows, Ansell (2007, 2009) argues that asset booms generate feedback effects that reinforce these patterns. He shows that when housing and other asset prices rise rapidly, asset-owning voters respond by demanding lower tax rates and less publicly provided social insurance. The tax rate effect has two sources: first, asset-owners become more sensitive to taxation as their assets appreciate, via capital gains or property taxes. Second, as assets appreciate, their owners feel wealthier so they adopt the anti-tax preferences of high-income citizens. The social insurance effect occurs because asset-owners have self-insured against income loss in the event of unemployment or old age. With their assets, especially housing, serving as a "nest egg," they respond to asset booms by demanding less public insurance.

Ansell (2007, 2009) finds evidence that public policy in OECD countries is responsive to changes in asset-holders' fiscal policy preferences. He shows that when right-wing parties are in power, rising asset prices have particularly strong negative effects on social spending and taxes. More generally, Ansell (2007) argues that volatility in OECD housing prices since the 1980s has caused a fundamental shift in the politics of macroeconomic policy, wherein changes in macroeconomic policies now have a larger effect on the value of assets than on product prices, wages, or employment.



These arguments suggest that right-wing parties can derive electoral benefits from pursuing macroeconomic policies that risk provoking a financial crisis. Furthermore, when capital is internationally mobile, right parties can generate wealth gains for their constituents via a twin deficits policy without crowding out private investment. But is that all they do? The next section considers the impact of partisanship on financial regulation.

### *3c. Financial Regulation*

In party manifestos, Right parties generally champion free enterprise capitalism and the superiority of markets over government regulation and allocation (Budge et al. 2001). They tend to support personal initiative and markets free of all but the most essential government involvement. In general, right-or-center parties are less concerned with market failure than with “government failure” and moral hazard problems created by government intervention. Is there evidence to suggest that right-of-center governments acted on these prior beliefs and deregulated financial markets in the run-up to financial crises?

Measuring the extent and the effectiveness of financial supervision involves more than the sum of the formal rules and regulations established by law. This is because governments may use their executive powers over regulatory agencies to interpret and implement the law, creating a gap between *de jure* bank regulation and *de facto* bank regulation. Since I am interested in the effect of government partisanship on the actual level and quality of bank regulation, I need a measure that captures the legal rules as well as the actual implementation and enforcement of those rules.

My data on banking regulation come from Abiad et al. (2008) who rely on a mix of *de jure* and *de facto* criteria to code this dimension of government financial policy. On the *de jure*

side, they consider whether (1) a country has adopted the Basle Accord risk-based capital adequacy ratios, and (2) whether the chief banking supervisory agency is formally independent of the executive's influence. On the *de facto* side they consider whether (3) the main banking supervisory agency conducts "effective" supervisions through on-site and off-site examinations and (4) whether the country's banking supervisory agency covers all financial institutions without exception. Conducting on-site and off-site examinations is how regulators monitor banks' balance sheets, but gauging the "effectiveness" of examinations is a judgment call that the authors' relied on experts to make. Similarly, banking regulations are compromised if some financial institutions are exempt from supervisory oversight, but knowing when some banks are exempt from supervision usually cannot be deduced from the formal rules.

From these criteria, Abiad et al. (2008) create an index of bank regulation and supervision that ranges from 0 to 3, with higher values representing more (or better) regulation. I use this index to explore the argument that right-wing governments tend to deregulate the financial sector prior to crashes and their left-wing successors tend to re-regulate after the crash occurs. I am aware that the subjective aspects of the data may bias results in the direction of my argument: upon observing a crisis, for example, coders may have inferred that regulation was lax or ineffectual.

**Figure 10** plots the average value of the Abiad et al. (2008) measure of bank regulation for the Big Five crises. It also includes the OECD baseline, which is the average level of bank regulation across the OECD during equivalent time periods. The figure suggests that bank regulation is much weaker (in extent or quality) on average in Big Five crisis countries prior to a crisis. Bank regulation then increases sharply once a crisis has occurred. But note that bank regulation is improving across the OECD during the same time periods. This suggests the Big

Five crisis countries are part of a more general trend among industrial country governments to increase their regulation over time. Part of the reason for this general upward trend lies in the coding of the Basle capital adequacy criteria: Abiad et al. (2008) assigned a value of 0 to all cases on criteria prior to 1993—that is, before Basle regulations were in place internationally. This ensures that bank regulation is increasing over time in all samples of the data. Nevertheless, **Figure 10** indicates that the Big Five crisis countries had less (weaker) bank regulation and supervision on average than the average OECD country in the run-up to their crisis. This is consistent with my argument that the governments of these countries—which tended to be more right-wing than average—made a partisan policy choice to have less regulation.

The evidence in this section is not sufficient to rule out the possibility that financial cycles have origins in partisan policy choices. The evidence is stronger with respect to macroeconomic policy. Prior to the onset of a major financial crisis, governments presided over rapidly deteriorating current account deficits (a.k.a., capital inflow bonanzas), and these external deficits appear related to a policy of government dissaving (a.k.a., budget deficits). The data also suggest that regulation of the financial sector was weaker than average before crises in the countries that experienced a major financial crisis. However, this may reflect measurement error since retrospective coding of bank regulation is subjective and may reflect the coders' inference that a crisis is evidence of less regulation.

In order to provide more empirical leverage on the politics of financial cycles, the next section briefly reviews two U.S. banking crises: the Savings and Loan (S&L) crisis of the 1980s and the subprime crisis that began in 2007.

#### **4. Partisanship and Banking Crises in the United States**

The United States has experienced two financial crises since 1973: the S&L crisis and the subprime crisis. Although Reinhart and Rogoff (2009) classify the S&L crisis as a “milder” crisis, over 1,400 savings and loan institutions and 1,300 banks failed as a result of the crisis. However, the fiscal costs of cleaning-up the S&L crisis were substantially lower than the clean-up costs of the Big Five crisis.

The U.S. case provides partial support for the argument that right-of-center political parties enact policies that help fuel booms while left-of-center parties are elected as a consequence of crashes. Republican administrations were in office in the years immediately ahead of each crisis, pursuing “twin deficit” policies and reducing the level of financial regulation. However, the deregulation of the S&L industry began prior to the election of Ronald Reagan, under a Democratic administration, and a Democrat displaced a Republican president only after the subprime crisis.

#### *4a. “Twin Deficits” under George Bush and Ronald Reagan*

Prior to the subprime crisis, the U.S. current account deficit ballooned to over 6 percent of GDP, an all-time record for the United States. Chinn and Frieden (2009) and Chinn (2005) attribute the burgeoning current account deficit to Bush administration fiscal policies; the emphasis after 2001 on cutting taxes while increasing spending on national security produced a large federal budget deficit that had to be financed. The huge pool of foreign savings available from surplus countries like China, Japan, and Germany provided the Bush administration with a cheap way to finance its fiscal deficits. In other words, the cause of this capital flow cycle was rooted in Bush administration policies, not in the willingness of foreigners to lend to the United States. The administration had promised its right-wing constituents that it would reduce taxes

while increasing spending on national defense; the globalization of financial markets allowed it to finance the resulting fiscal imbalances without crowding out domestic private investment.

The Bush administration's policies recall an earlier episode of twin deficits in the United States. Indeed, the term "twin deficits" originated during the Reagan administration, when taxes were reduced and the budget deficit increased markedly. During the early 1980s, the current account also moved into sizable deficit as the U.S. economy grew faster than that of its major trade partners in Europe and Asia. As with the subprime crisis, the S&L crisis also occurred in the context of Republican tax cuts, increased military spending, ballooning current account deficits and borrowing from abroad to make ends meet (Destler and Henning 1989). Japan, in particular, became a major lender to the United States in the 1980s. More generally, U.S. deficits were easier to finance after the Latin American debt crisis led to a reversal of capital flows to developing countries, freeing up funds to pursue the high interest rate environment in the United States.

It may seem unconventional to argue that it is the right-of-center party that lacks fiscal restraint. But this is easy to confirm in the U.S. case. **Figure 11** displays the size of the federal budget deficit as a share of gross domestic product (GDP) by presidential administration. Since 1973, Republican presidents have run substantially larger budget deficits than Democratic presidents. On average, budget deficits were more than twice as large under Republicans as under Democrats: 3.2 percent vs. 1.3 percent of GDP. In fact, the Clinton administration registered substantial budget surpluses, and surpluses were projected well into the future (Congressional Budget Office 1999). However, the Bush administration's tax cuts and the recession of 2001 erased the surplus and the budget balance fell into a large deficit of 1.5 percent of GDP by 2002. Military and homeland security expenditures after September 11, 2001 further

increased the deficit in 2004. However, the Bush administration had no trouble financing these fiscal deficits because it could borrow cheaply in international capital markets.

#### *4b. Financial Regulation under Bush and Reagan*

There is anecdotal evidence that Republican administrations deregulated in advance of the two banking crisis in the United States. In the run-up to the subprime crisis, the Bush administration deregulated financial activities just as capital inflows fueled the domestic expansion. Among the most important changes was the April 2004 decision by the Securities and Exchange Commission (SEC) to relax capital requirements on investment banks and put these firms on a regime of self-regulation (Labaton 2008a). This ruling enabled investment banks to triple their leverage ratios, fueling the growth in mortgage-backed securities supporting subprime mortgages. In retrospect, the SEC conceded that self-regulation of investment banks contributed to the subprime crisis (Labaton 2008b). So, just as budget deficits induced current account deficits, and capital inflows pushed up housing prices, financial deregulation encouraged the use of mortgage-backed securities and other risky financial instruments. The stage was set for the subprime crisis.

The evidence is less supportive of partisan regulatory policy prior to the S&L crisis. This is because one of the principal deregulatory laws of the era—the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)—was passed by a Democratic president, albeit with support of the Republican majority in Congress. The DIDMCA phased out deposit interest-rate ceilings, allowed S&Ls and credit unions to offer checkable deposits, and increased the limit for deposit insurance to \$100,000 from \$40,000. However, the Reagan administration was squarely behind the second key legislative act deregulating financial markets:

the Garn-St. Germain Depository Institutions Act of 1982 (Garn-St. Germain). According to the Federal Deposit Insurance Corporation's official history of the S&L crisis, the Reagan administration aimed to fully deregulate the S&L industry with the Garn-St. Germain Act (FDIC 1997). The Act expanded the nonresidential lending powers of S&Ls, allowing them to move aggressively into commercial real estate lending. For commercial banks, it removed restrictions on real estate lending and relaxed restrictions on loans to a single borrower. In line with its small government ideology, the Reagan administration also used its executive authority to pressure the Federal Home Loan Bank Board and other thrift regulatory agencies to reduce the size of their examination staffs (FDIC 1997, p. 177). Overall, the administration's deregulatory zeal set the stage for a rapid expansion of commercial real estate lending, overbuilding, and the subsequent commercial real estate market collapse. In short, this appears to be another instance in which a conservative U.S. executive presided over financial deregulation in advance of a crisis.

Despite inconsistencies in government partisanship, a regulatory cycle still emerges: at the beginning of the 1980s, with passage of both DIDMCA and Garn-St Germain, deregulation of the financial services industry, especially of S&Ls, was dominant. As the S&L crisis deepened and the banking crisis evolved, the emphasis turned to reregulation. More stringent rules and oversight were reestablished in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). By the late-1990s, with the banking industry's apparent return to stability, deregulation returned to the agenda, and reached fruition during the Bush administration (FDIC 1997).

## **5. Conclusion**

Were the bank-centered financial crises that hit advanced economies after 1973 related to “politics” by way of the ideological orientation of the governing political party? The evidence presented here is not sufficient to rule out the existence of a *partisan-policy financial cycle* that takes the following form: governments in power prior to a systemic financial crisis are more likely than average to be right-of-center in political orientation. Inasmuch as right-leaning governments are more likely to be in office prior to a major crisis, they are therefore more likely than average to be associated with policies that predict crises: twin deficits, capital inflow bonanzas, and deregulation of the financial sector. However, once a financial major crisis occurs, causing widespread macroeconomic distress, the causal arrow flips and government partisanship becomes a *consequence* of crises. The evidence suggests that the electorate moves to the Left after a major financial crisis, and this leftward shift is associated with changes in government partisanship to the Left.

The two American financial crises, the S&L crisis and the subprime crisis, are roughly consistent with these cross-country partisan patterns. In the 1980s and the 2000s, Republican administrations launched massive tax cuts without imposing discipline on the rate of growth of government spending. In both decades, the result was record budget deficits and record current account deficits, which is to say that foreign capital financed the twin deficits and fueled expansions in real estate. Furthermore, in both decades deregulation allowed housing booms to continue unchecked until a financial crisis occurred. As with the cross-country results, these parallels suggest that we cannot rule out the existence of partisan financial cycles.

The source of these patterns may be partisan electoral competition, which has taken new forms with the onset of international capital mobility. Prior to the early 1970s, Right parties championed fiscal discipline and balanced budgets. This made electoral sense since, in the

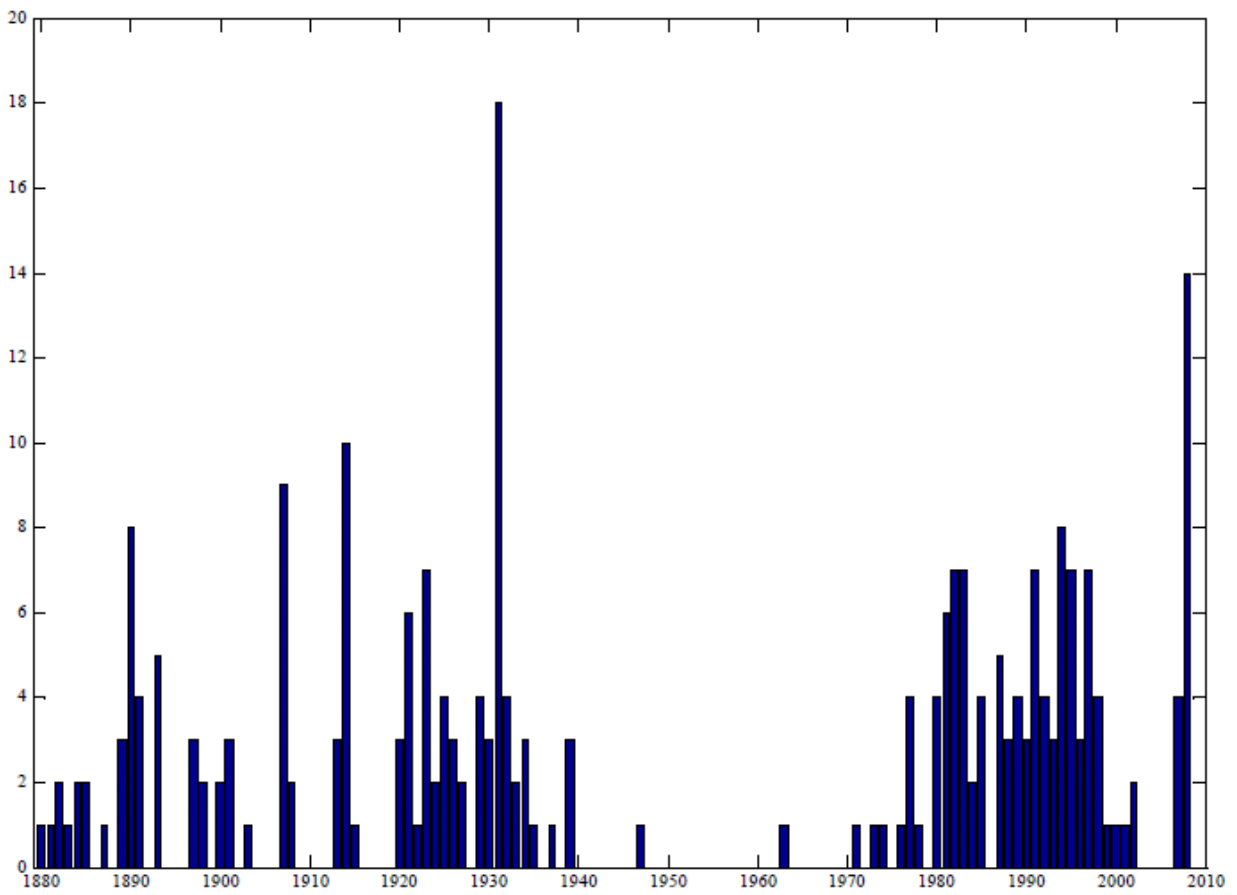


absence of large-scale capital flows, budget deficits crowded-out domestic investment to the detriment of right-parties' business constituents. But with the free flow of international capital, Right parties obtained greater scope to run fiscal deficits without generating increases in domestic interest rates. Yet deficits have another appeal for Right parties when capital is internationally mobile. Deficits (financed by capital inflows) tend to raise asset prices, and the gains of asset price appreciation go disproportionately to Right-party constituents, namely homeowners and older asset-holders. In short, by undermining the appeal of balanced budgets and providing an easy way to generate short-run wealth effects for asset-owning constituents, international capital mobility may have caused a fundamental shift in the Right's electoral strategy. Unfortunately, this shift has exposed OECD economies to a higher risk of financial crisis.

**Table 1: Bank-Centered Financial Crises in OECD Economies since 1973**

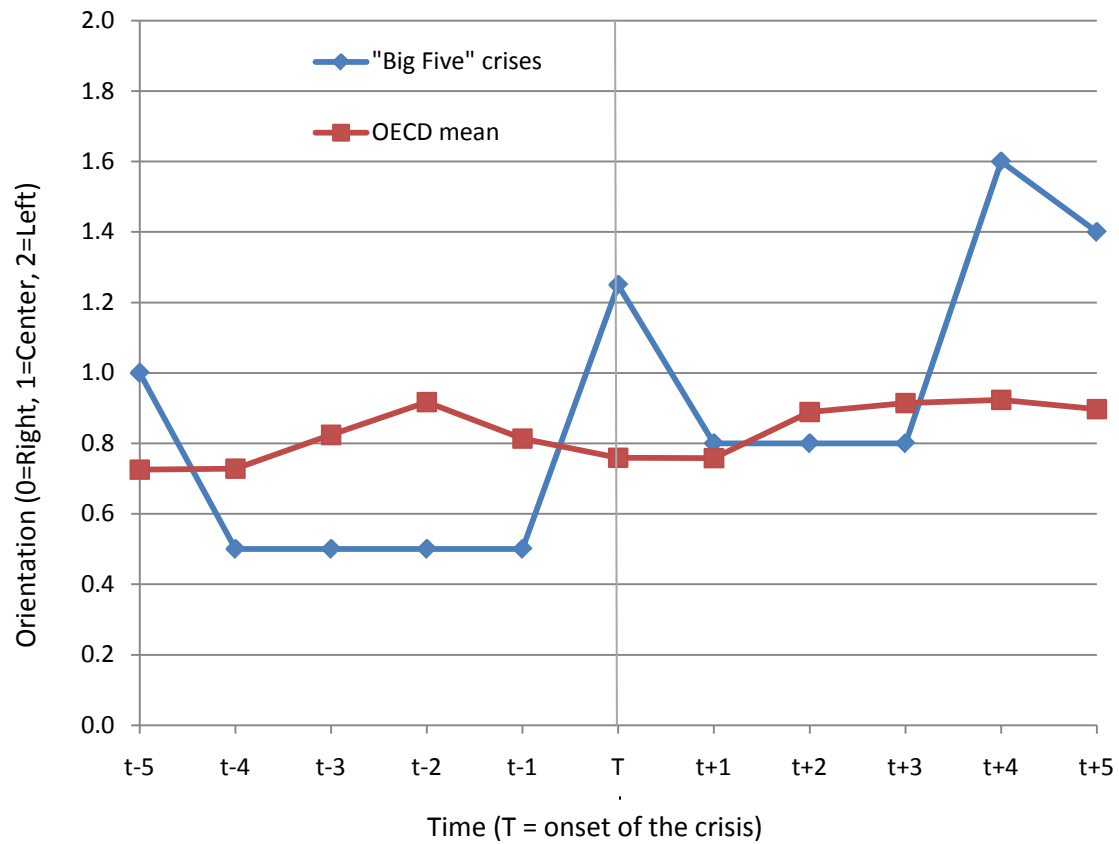
| Country                          | Onset of crisis |
|----------------------------------|-----------------|
| <i>The Big Five</i>              |                 |
| Spain                            | 1977            |
| Norway                           | 1987            |
| Finland                          | 1991            |
| Sweden                           | 1991            |
| Japan                            | 1992            |
| <i>Subprime Crises</i>           |                 |
| United Kingdom                   | 2007            |
| United States                    | 2007            |
| Germany                          | 2007            |
| Switzerland                      | 2007            |
| Iceland                          | 2008            |
| Ireland                          | 2008            |
| Japan                            | 2008            |
| Netherlands                      | 2008            |
| Spain                            | 2008            |
| <i>Milder Crises</i>             |                 |
| United Kingdom                   | 1974            |
| Germany                          | 1977            |
| Canada                           | 1983            |
| United States (savings and loan) | 1984            |
| Iceland                          | 1985            |
| Denmark                          | 1987            |
| New Zealand                      | 1987            |
| Australia                        | 1989            |
| Italy                            | 1990            |
| Greece                           | 1991            |
| United Kingdom                   | 1991            |
| France                           | 1994            |
| United Kingdom                   | 1995            |

**Figure 1: Frequency of Banking Crisis, 1880-2010**



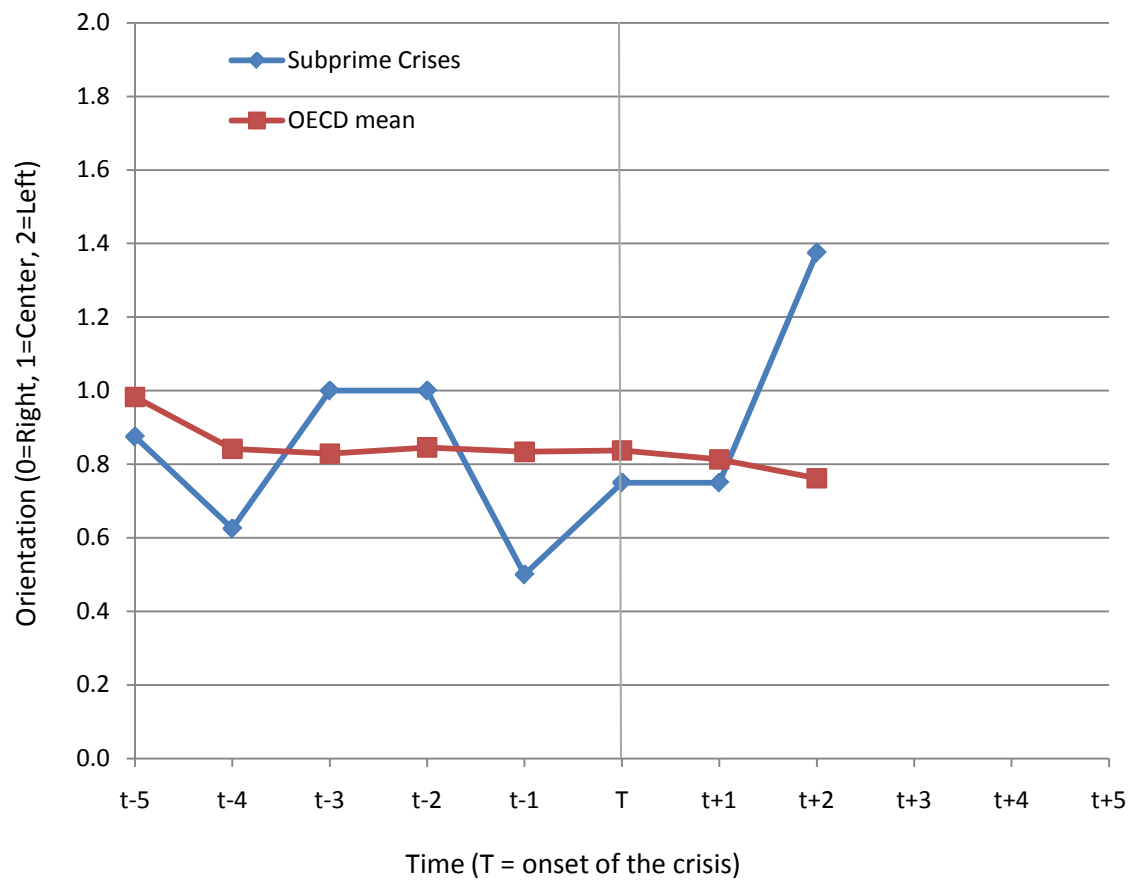
*Source:* Bordo and Landon-Lane (2010, Figure A.4, p. 53).

**Figure 2: Political Orientation of the Chief Executive before and after the Big Five Banking Crises**



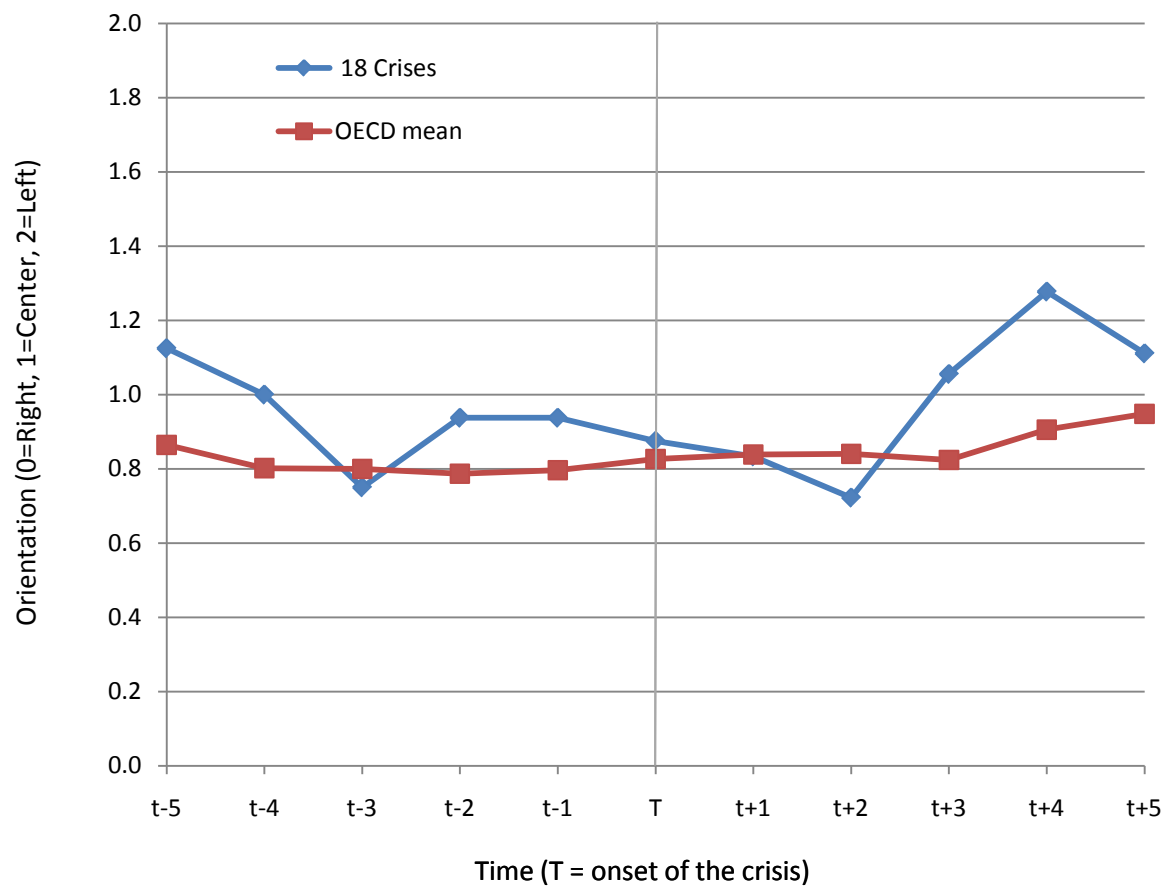
*Notes:* Missing data for Spain 1977 ( $t-5$  to  $T$ ).

**Figure 3: Political Orientation of the Chief Executive before and after the Subprime Crises**



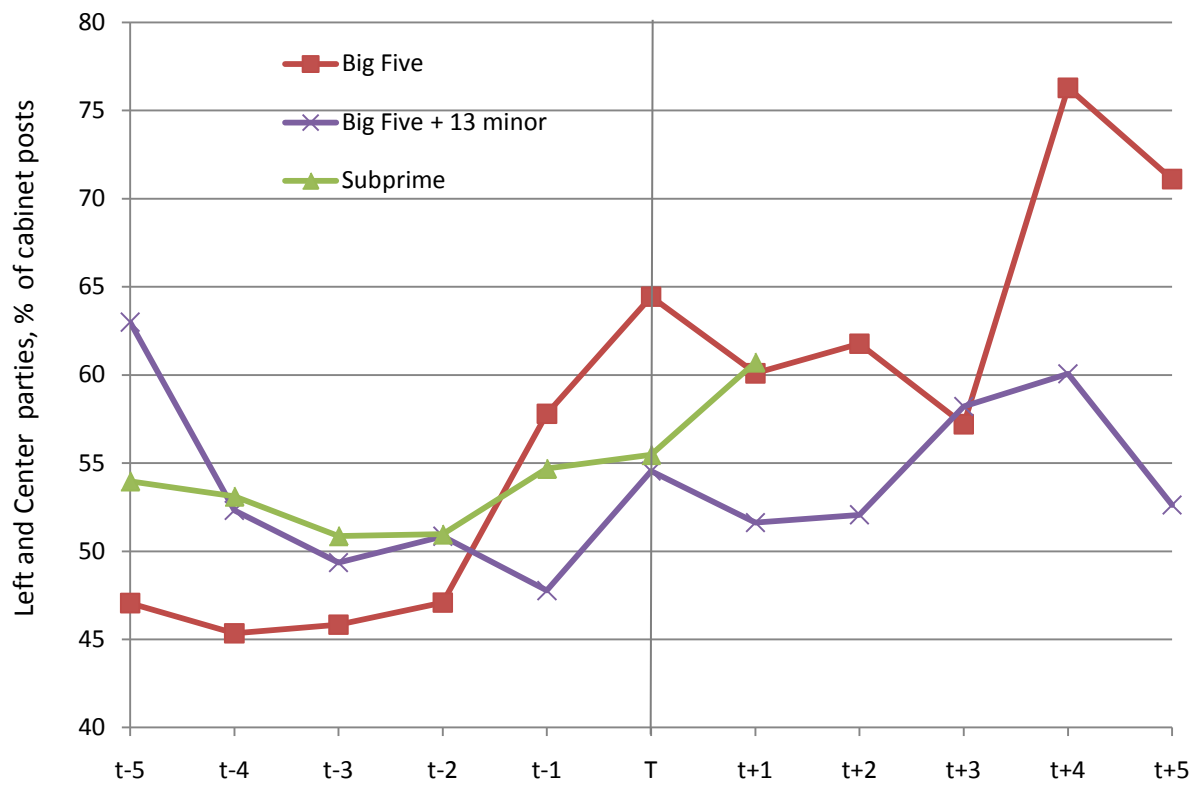
**Notes:** Missing data for Switzerland 2007 ( $t-5$  to  $t+2$ ).

**Figure 4: Political Orientation of the Chief Executive before and after a Major or a Minor Banking Crisis (18 cases)**



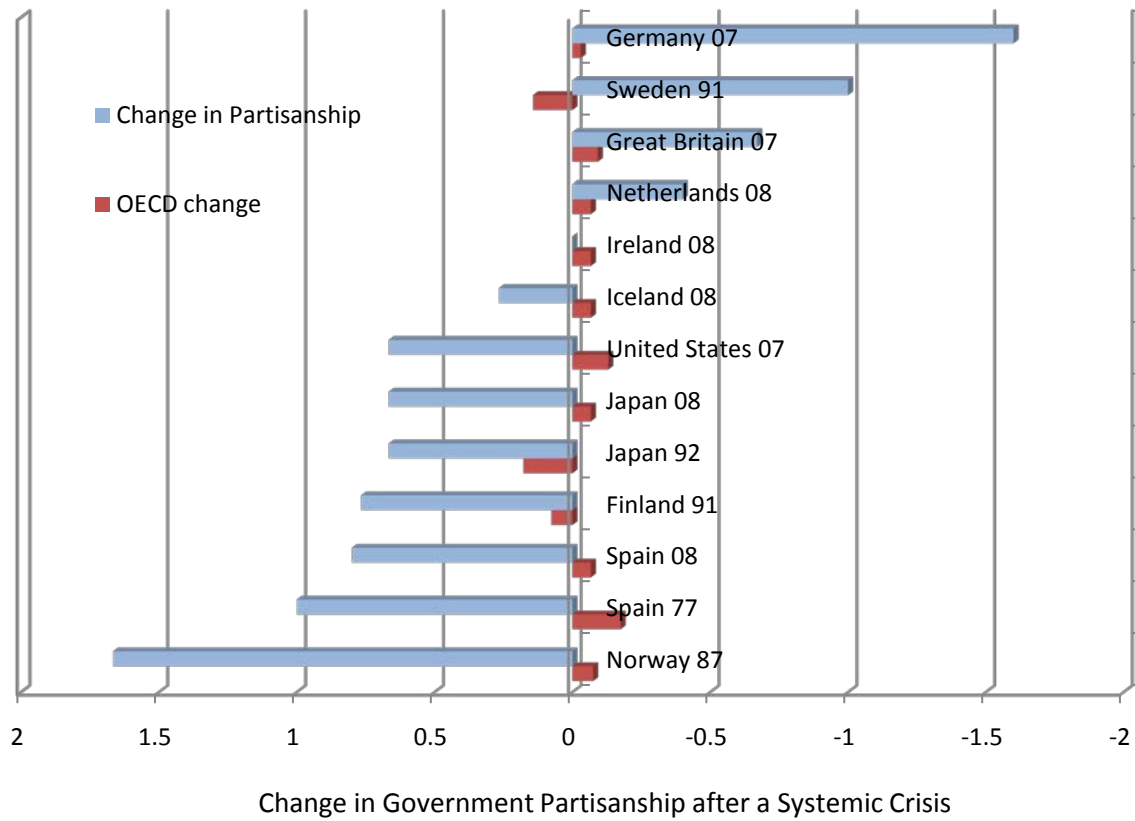
*Notes:* Missing data for United Kingdom 1974 ( $t-5$  to  $T$ ), and Spain 1977 ( $t-5$  to  $T$ ).

**Figure 5: Partisan Composition of the Cabinet before and after a Financial Crisis**



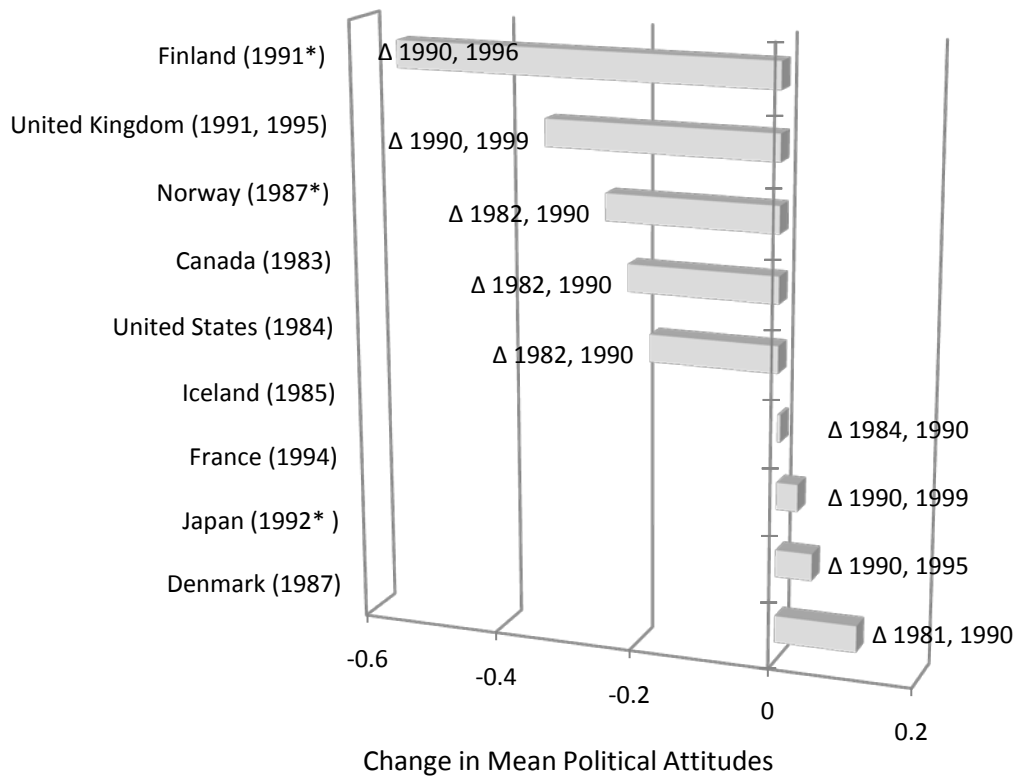
*Notes:* Missing data for Spain 1977 ( $t-5$  to  $T$ ).

**Figure 6: Change in the Orientation of the Chief Executive after a Systemic Crisis (Big Five plus Subprime cases)**



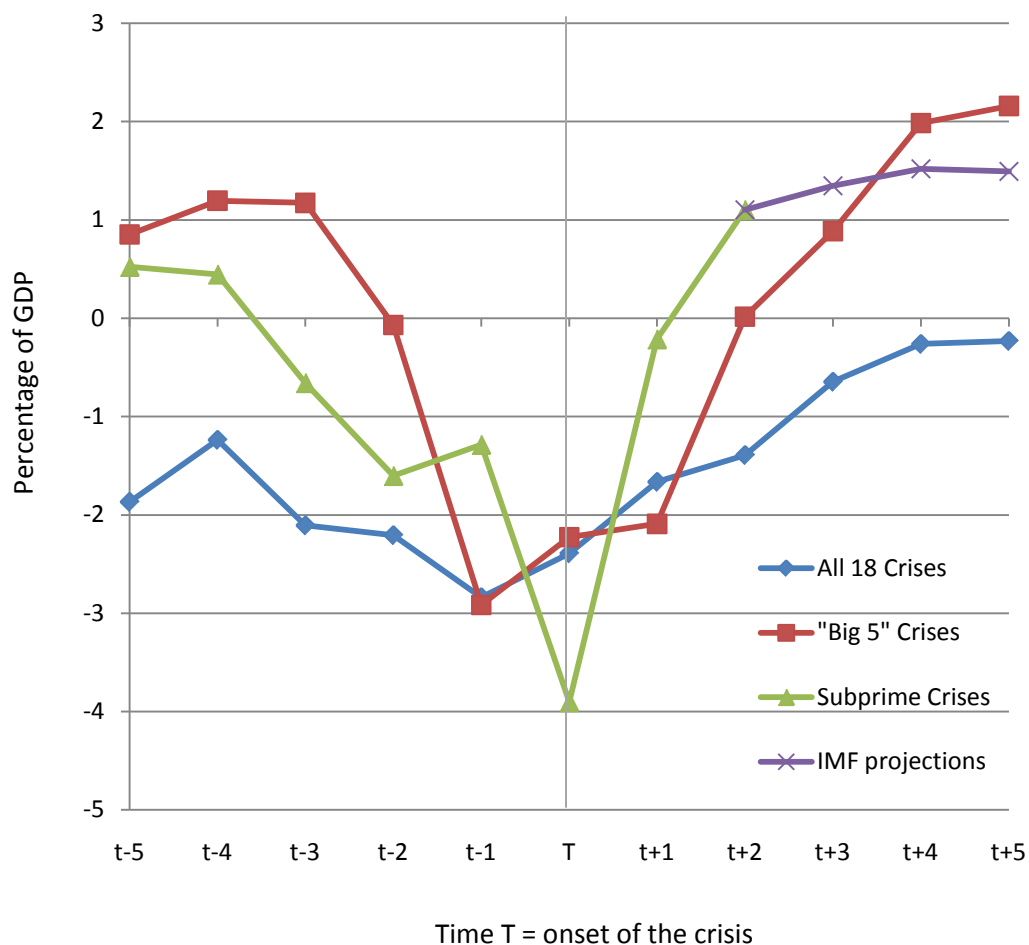


**Figure 7: Change in Mass Political Orientation after a Banking Crisis, by Country**



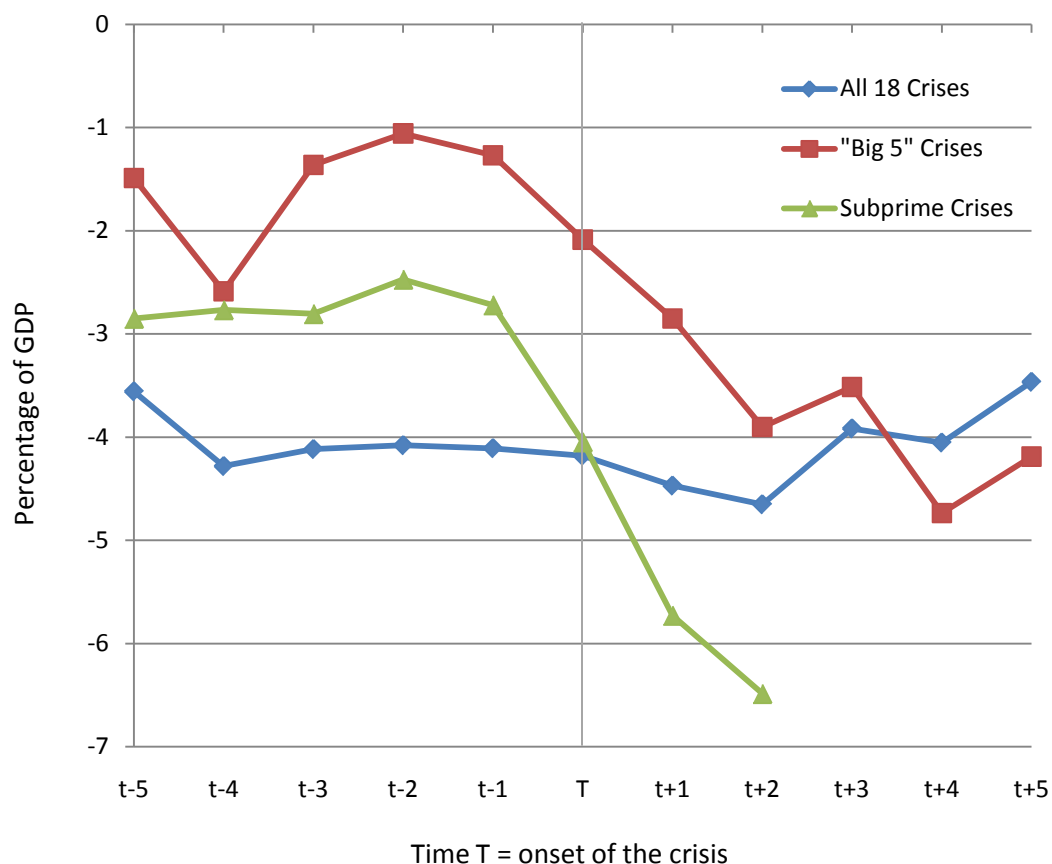
*Note:* Negative values indicate a shift to the Left.

**Figure 8: Current Account Balance before and after a Banking Crisis**



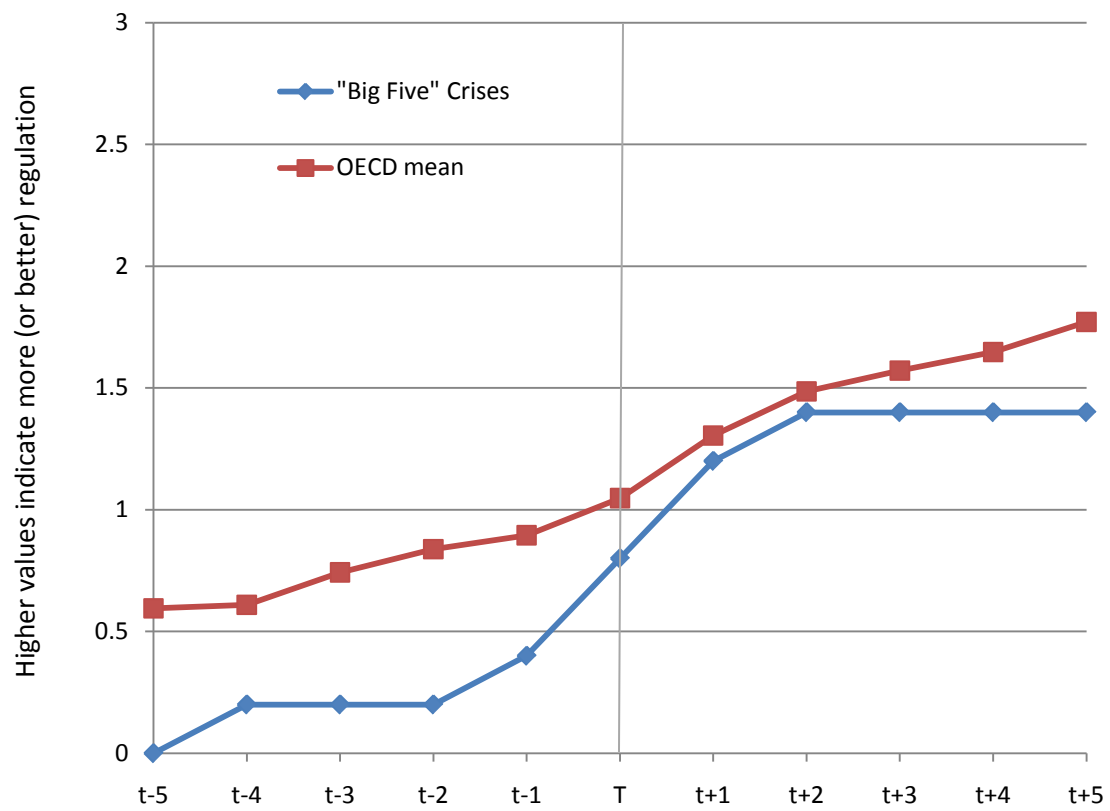
*Notes:* Current account data are from the IMF's *World Economic Outlook* (WEO) database. Subprime projections to 2012 are IMF estimates. Missing data for Canada 1983 ( $t-5$  to  $t-4$ ), Germany 1977 ( $t-5$  to  $t+2$ ), Spain 1974 ( $t-5$  to  $t+2$ ), and United Kingdom 1974 ( $t-5$  to  $t+5$ ).

**Figure 9: Central Government Structural Budget Balance before and after Bank Crises**

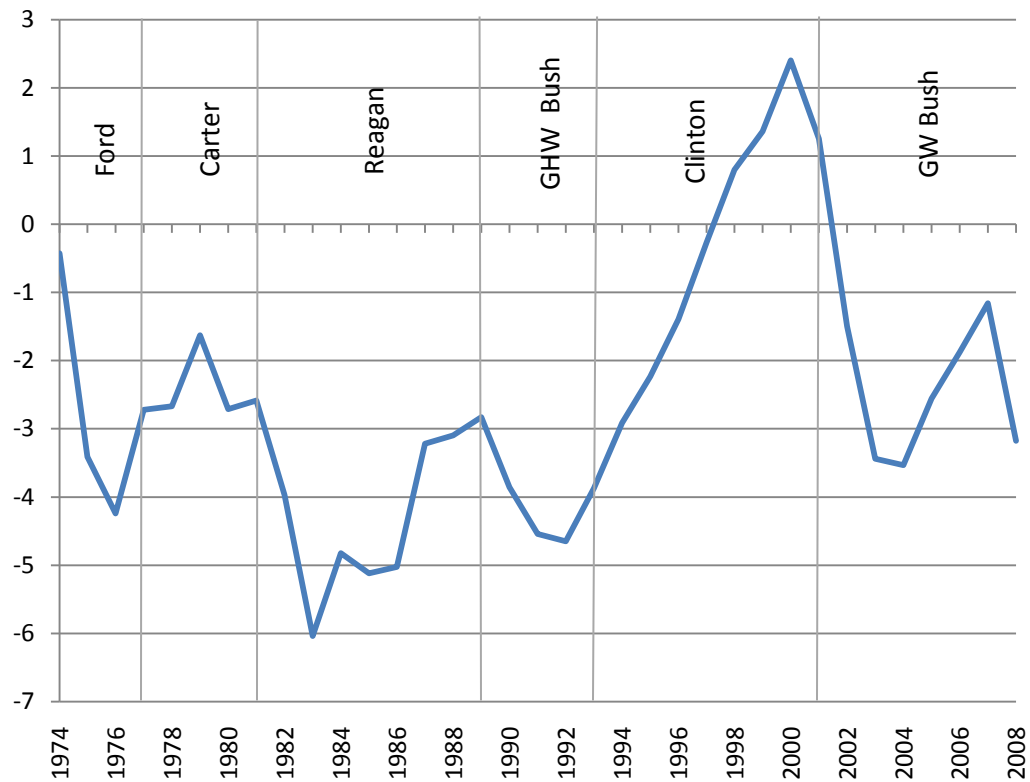


*Notes:* Fiscal data are from the IMF's *World Economic Outlook* (WEO). Missing data for Canada 1983 ( $t-5$  to  $t-4$ ), Denmark 1987 ( $t-5$  to  $t-2$ ), Germany 1977 ( $t-5$  to  $t+2$ ), Greece ( $t-5$  to  $t-4$ ), Iceland 1985 ( $t-5$  to  $t+5$ ), Iceland 2008 ( $t-5$  to  $t+2$ ), Spain 1977 ( $t-5$  to  $t+5$ ), Sweden 1991 ( $t-5$  to  $t+5$ ), and Switzerland 2007 ( $t-5$  to  $t+2$ ).

**Figure 10: Bank Regulation and Supervision before and after the Big Five Crises**



**Figure 11: U.S. Federal Budget Deficit as Share of GDP, by Presidential Term**



*Notes:* Data are from the Congressional Budget Office.

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