Cornelia Woll*

A Rejoinder by the Author

DOI 10.1515/ael-2016-0005

In order to respond to the insightful and detailed discussion, I find it helpful to group the authors according to the most relevant issues they have identified. First, I will return to the notion of power in business-government relations, which Wilmarth and Barnes discuss at length and which Reinke finds problematic. Second, I will clarify the use of the game-theoretical framing, which has certain heuristic limitations. It does, however, address the governments' strategy, contrary to the criticism of Reinke and Jensen. Third, I dive into the empirical study to address other factors that help to explain bailout arrangements. I show why I disagree firmly with Jensen, who believes that healthy banks alone are sufficient to analyze the six cases, suggesting that my argument is over-determined. I do concede, however, that additional elements help to provide a richer analysis, in particular the institutional and legal settings highlighted by Moutot and Thiemann.

Symposium on 'The Power of Inaction. Bank Bailouts in Comparison' by Cornelia Woll

- 1 Cornelia, Woll (2016) 'A Symposium on Financial Power', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2016-0001.
- 2 Kelsey M. Barnes and Arthur E. Wilmarth (2016) 'Explaining Variations in Bailout Policies: A Review of Cornelia Woll's The Power of Inaction', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0012.
- 3 Matthias Thiemann (2016) 'The Power of Inaction or Elite Failure? A Comment on Woll' "The Power of Inaction", Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0011.
- 4 Philippe Moutot (2016) 'Power of Inaction or Ability to Learn in Action within a Political Process? Comments on "The Power of Inaction" by Cornelia Woll', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0009.
- 5 Raphael Reinke (2016) 'The Power of Banks and Governments', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2016-0003.
- 6 Jason O. Jensen (2016) 'Comment on *The Power of Inaction* by Cornelia Woll', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0010.

*Corresponding author: Cornelia Woll, Sciences Po, Paris, France, E-mail: cornelia.woll@sciencespo.fr

- 7 Yuri Biondi (2016) 'Empowering Market-Based Finance: A Note on Bank Bailouts in the Aftermath of the North Atlantic Financial Crisis of 2007', *Accounting, Economics and Law: A Convivium*, DOI 10.1515/ael-2016-0004.
- 8 Cornelia Woll (2016) 'A Rejoinder by the Author', *Accounting, Economics and Law: A Convivium*, DOI 10.1515/ael-2016-0005.

1 Studying power

The academic literature on power already provides a rich perspective on the ways through which the financial industry shapes the fate of politics and society. Two dimensions of power are particularly relevant: structural power – the positional capacity to control the range of choices available to others – and productive power – the capacity to produce subjects through systems of knowledge and discourse. I argue that both of these provide much greater insights than instrumental power, the exchange of resources typically highlighted by the lobbying literature. However, structural power and productive power both refer to social processes that are not controlled by specific actors. They therefore provide a very poor sense of agency, which limits their use for the analysis of crisis management. To get a closer look at political strategies and individual responsibility, I propose to consider the collective action of the financial industry, suggesting that collective inaction is in fact an exercise of power.

I therefore do not share Wilmarth and Barnes' assessment that "productive power (political clout) of the financial industry is even more important in affecting the industry's ability to refuse the government's call for collective action." To begin with, my definition of productive power, taken from Barnett and Duvall (2005), is different from Wilmarth and Barnes, who equate productive power to "political clout". Political clout, in fact, is the ability to shape outcomes within a political relationship, so it is actually a synonym for all forms of power. I do not, as the authors claim, "assign less importance to the financial industry's political clout as a factor". Rather, I seek to explore exactly how political clout is exercised.

I do agree with the authors that the anticipation of future sanctions and the fiscal capacity of the state play a major role in the negotiation strategies, even if I have a less optimistic vision of the certainty of such anticipations.¹ However, in the empirical discussion of differences in the US and the UK, the authors narrow their discussion down to two factors explaining the superior influence of the

¹ For example, I am surprised to read that Wilmarth and Barnes find "the confidence of the Irish banks" to be "well-placed" given the fact that the country went bankrupt and all Irish banks had to be propped up by the government, including the effective nationalization of Allied Irish.

financial industry in the US, which I both disagree with. They argue that public outrage in the UK was “significantly more intense than in the US” and, second, that “political influence in the US was particularly strong due to massive campaign contributions and revolving doors.” Public outrage in the US was massive after the financial crisis, and cannot be negated by the fact that financial reform efforts were unsuccessful. Policy outcomes should not be used to gauge the size of the supposed causes without an explicit theory. I am unconvinced of the role of campaign contributions simply because the absence of campaign contributions did not keep German financial institutions from wielding comparable influence and the presence of revolving doors in France do not correspond to similar outcomes in the US. Put differently, I do not deny that financial contributions and revolving doors are a major feature of US politics and go a long way to explain evolutions over time (see Wilmarth 2013), but they are of little comparative interest since other countries display different pathways to similar outcomes.

Reinke, in turn, is confused about the “power of inaction”, which implies a certain “powerlessness of action”. He finds it difficult to imagine that financial institutions organize a collective response purely because they are motivated by the public good. I agree and do not suggest such heir motives. Since the negotiations imply powering by the state, at least in the four cases where the government pushed for a coordinated industry response, the business contributions are the result of a coercive or non-coercive struggle, not the intrinsic motivations of the financial institutions.

Moutot, Thiemann and Reinke criticize the epistemological stance of the argument, which does not allow determining whether collective action fails due to the unwillingness or the incapacity of the industry to cooperate. I admit this limitation, which is rooted in game theoretical metaphor as well. The whole point of the struggle is for each player to convince the opponent that no action is imaginable, to make a credible case by ideally throwing the steering wheel out of the car. The analyst is in no better position to judge the foundation of these claims than the opposing player. In hindsight, we only have anecdotal evidence to make our own judgment.

2 A game of chicken?

The “game of chicken” framework allows zooming in on the most intense moment of crisis management in the fall of 2008. Despite its heuristic value, it is only a partial contribution to the analysis of bailout politics. The book’s empirical analysis therefore goes far beyond the crisis moment, discussing

both the period leading up to it and the discussion of the aftermath, which need to be included in a full account of the management of the financial crisis.

Moutot, Thiemann, Reinke, and Jensen have underlined that the government and their financial industries are engaged in repeated games, with the ability to learn from past decisions. This is certainly true. I have shown, for example, that the Danish government and industry negotiated a total of eight bank packages in the empirical discussion, and I also indicate that policy choices after 2009 were strongly affected by the lessons of the 2008 negotiations. Governments that had felt overpowered by their financial industry earlier on often imposed more constraining regulation in the aftermath, for example in Germany.

Moutot suggests that the dynamic of these repeated interactions should be theorized as a learning process, and I believe this is a useful direction. For the discussion in the book, I have chosen to underline that learning is necessary only for those that were unable to dominate the negotiations. As Karl Deutsch remarked, “power is the ability to afford not to learn” (cited in Woll 2014, 44).

A second criticism put forward by Reinke and Jensen is the government strategy in the game is missing or ambiguous. I am surprised to read this assertion, since the government strategy is the necessary counterpart to the industry strategy, and I feel that I have discussed it at great length. Collective action by the financial industry is a response to the government’s solicitation. When the government does not push for it, like in the UK or Ireland, it will not arise spontaneously. Moreover, financial institutions certainly evaluate their own dependence on the government as well as the government’s fiscal capacity, as Thiemann and Wilmarth and Barnes underline. I believe the confusion arises because I have not underlined clearly enough in the theoretical discussion that power is always a relational concept. Nobody holds power in absolute terms, independent of the person he or she interacts with. The financial industry is always only as powerful as the government is weak, or vice versa. If they are in a mutually beneficial symbiosis, then it will have to be at the expense of somebody else (consumers, the taxpayer, foreign financial institutions, etc.).

Once the initial round of negotiations produces no outcome, it is indeed helpful to consider what conditions government choices. When the financial industry failed to contribute fully to a national scheme (as has been the case in the US, Germany, but also the UK and Ireland), I indicate that three countries have “yielded” and proposed bailout schemes that were favorable to industry demands: the US by providing “cheap” money and initial recapitalization, Ireland by bailing out individual institutions at very high costs and Germany by making its rescue scheme non-mandatory. The UK plan also spared health institutions and thus resembled the German one, but the conditions for additional liquidity and recapitalization were particularly harsh. The UK also did not

attempt to negotiate with the banking sector, but imposed its plan from very early on. When we compare the actual rescue scheme of Germany and the UK, one can thus argue with Culpepper and Reinke (2014) that the UK was just as biased towards failing institutions as Germany, but the fact that the initial round of negotiations did not take place in the UK make me set it apart.

I do agree that the chicken game metaphor is limited when thinking about the repeated rounds of interactions and the ultimate policy choice, and should thus not be taken too far. In the end, the economic and political constraints that both players try to judge in their interactions matter of course profoundly. This implies that not all negotiations were equal: the fiscal capacity of Ireland was so poor that the initial dominance of the financial sector eventually led to their downfall, together with the collapse of the Irish economy. The negotiation game in the US was quite different, and a chicken-game framework does not allow addressing the size of the stakes.

However, I am rather doubtful of the revised payoff matrix proposed by Jensen. First, I disagree that banks are unable to save themselves, which is precisely the point I tried to demonstrate through the case studies and in chapter 4. They are unable to provide private-sector take-overs, yes, but even ailing banks can pool their resources to create additional liquidity by creating more market confidence, as has been shown in France, or by paying fees and accepting collective public recapitalization, which they then monitor jointly with the government.

Second, I would be very careful not to extrapolate from the supposedly positive return on rescue schemes I show for countries such as France or Denmark. Neither banks nor the government ever profit in any meaningful way from a banking crisis or the ensuing bailouts. For banks, the benefits have to be weighted against the costs of normal business being brought to a grinding halt for a considerable period. For the government, additional costs that do not enter into the numbers I have quoted in table 2.1. include all monetary policy tools, but also certain stabilization measures and the costs of policy coordination. The profits of bailout schemes are comparable to the economic upturns after war periods: they have to be evaluated against the destruction of assets that preceded them.

3 The financial health of individual institutions

I refer to the rich literature on collective action to indicate when collective action will or will not take place. Since financial sectors resemble small groups, the entrepreneurship of individual actors and the intensity of individual preferences matter. In particular, I suggest that the financial health of the largest institutions

is decisive. If the big financial institutions are in good shape and have no interest in participating, other banks or the government will have a hard time enticing them.

Jensen suggests that this makes my argument over-determined: it would be sufficient to know the health of the largest institutions to know bailout patterns, without analyzing collective action. I disagree theoretically and empirically. Theoretically, it is impossible to determine what size of an institution would be sufficient to give it such “go-it-alone” power.² In many cases, we may have several large institutions, some in stable health, others somewhat ailing. What yardstick should we use to determine which side the case will fall? The answer is that it depends precisely on the social entrepreneurship of the financial institutions in each group, where some may take leadership and convince others of a collective interest.

Empirically, I have a different reading of several cases he cites as proof. Contrary to what he suggests, I do not consider the US as a case where a coordinated bailout was possible, since the mandatory recapitalization in the early phases of TARP was very short-lived and based only on the fact that the government conditions were very favorable to the industry. If one considers only financial health, it is thus a puzzle why a country where all of the major banks were affected to some degree did not see a coordinated industry response that was more durable. Concerning the UK, it is rather telling that Jensen needs to define the size of RBS away by indicating that it was due to the take-over of ABN Amro, which he considers too recent. I also think it is a stretch to consider Allied Irish and Bank of Ireland as healthy, even if it is true that Anglo-Irish was in even worse shape.

To be sure, it is difficult to know with certainty how dire the situation of individual banks was, but I would even counter Thiemann’s reading of the French case. Thiemann wonders why BNP Paribas supported a collective scheme, arguing that it was less affected by the crisis than its peers. I believe the apparent good health of BNP Paribas is a direct consequence of the collective action of the French industry and the subsequent takeover of Fortis, but I do not have sufficient scientific evidence to construct a counterfactual argument. In sum, the health of individual institutions is an important element to help us understand how likely they are to cooperate and contribute to a public-private scheme, but health alone does not determine the success or failure of inter-bank negotiations, especially in mixed cases.

² I borrow this term from Gruber (2000).

4 Conclusion

Theorizing crisis management in an area as complex as financial regulation and discussing six country experiences is bound to leave several questions unanswered. Despite a wealth of information and evidence, I do not provide a precise blueprint that would help to design optimal bailout arrangements in the future; I merely indicate how to avoid the worst. I show when and how financial institutions were able to win the upper hand in negotiations with their government, but I do not spell out theoretically how governments can win back control over finance. Much of this discussion is done empirically, illustrating the range of options governments have available. Some countries employed harsh rescue conditions to avoid moral hazard and discourage risky behavior in the future. Other countries followed up on bailouts with financial regulation that is much more stringent. Again others seek to reduce the size of their financial institutions or increase their capital ratios to reduce the risk of “too big to fail”.

The range of options available to governments in the long run is crucial and deserves a book-length discussion of its own. Apart from policy tool kits, such a discussion should entail the legal and institutional setting that governments have to operate in, and which financial institutions necessarily anticipate in their negotiation strategies. Moutot and Thiemann rightly point to the constraints and opportunities enshrined in existing regulatory frameworks and in the rules of the democratic process in each country. For reasons of scope, I have only dealt with these questions in the empirical narrative. However, I believe that my perspective is compatible with a more institutional account that would lead us to understand the conditions for repeated “elite failure” as Thiemann suggests. In my terminology, I would argue that institutional settings contribute substantially to providing the conditions for collective action or its failure. This is not only true at the evident, organizational level, but also by defining the room for manoeuvre of each player, shaping their self-understanding and giving meaning to their operation.

Finally, it is important to mention that banking crises are likely to have a systematic effect on political processes. Several recent studies now look at the consequences of crises on electoral dynamics, such as right party success or the defeat of incumbent governments (e.g. Chwioroth & Walter, 2015; Funke, Schularick, & Trebesch, 2015). For a long-run perspective on the politics of financial crises, these political dynamics and their anticipation will have to be taken into account. We have only just begun to explore the tight connections between economic stability and democratic governance in the light of this recent evidence.

References

- Barnett, M., & Duvall, R. (2005). Power in international politics. *International Organization*, 59(01), 39–75.
- Chwieroth, J. M., & Walter, A. 2015. *Financial crises and political turnover: A long-run panoramic view* (Unpublished manuscript). <http://personal.lse.ac.uk/chwierot/images/Panoramic.pdf>.
- Culpepper, P. D., & Reinke, R. (2014). Structural power and bank bailouts in the United Kingdom and the United States. *Politics & Society*, 42(4), 427–454.
- Funke, M., Schularick, M., & Trebesch, C. 2015. *Going to extremes: Politics after financial crises, 1870–2014*. CEPR Discussion Paper No. 10884. <https://dl.dropboxusercontent.com/u/75787447/CEPR-DP10884.pdf>.
- Gruber, L. (2000). *Ruling the world: Power politics and rise of supranational institutions*. Princeton, NJ: Princeton University Press.
- Wilmarth, A. E. (2013). Turning a blind eye: Why Washington keeps giving in to wall street. *University of Cincinnati Law Review*, 81(4), 1283–1446.
- Woll, C. (2014). *The power of inaction: bank bailouts in comparison*. Ithaca, NY: Cornell University Press.