POLITICAL AND INSTITUTIONAL CONSTRAINTS ON POLICY RESPONSES TO THE FINANCIAL CRISIS IN THE UNITED STATES AND THE EUROPEAN UNION

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Abstract

CHRISTOPHER A. THOMPSON: Political and Institutional Constraints on Policy Responses to the Financial Crisis in the United States and the European Union
(Under the direction of Liesbet Hooghe)

This essay will attempt to explain what caused the variation in policy outputs in response to the financial and economic crisis in the United States and the European Union which began in 2007. Specifically, it will examine the design of fiscal and monetary stimulus in both regions, as well as the development of financial supervisory and regulatory legislation. Ultimately it will be shown that the variation in policy outputs was the result of differing constitutional mandates, relation to public opinion, and dominant policy paradigms at the respective central banks; evolving contemporary political trends; and differing concentrations of legislative power, understood from the perspectives of federalism and multi-level governance.

Table of Contents

I. Introduction

Since Fall 2007, the world economy has been upset by the economic crisis which began in that year. The consequences of what began as a private sector crisis have been mitigated by public action, although there has been little consensus on the best way forward within the countries most affected, much less internationally. Indeed, in the United States and in Europe, similar policy actions have been undertaken, but there have also been dramatically different approaches to re-stabilizing their respective economies and reigniting growth, and they have come at different times and with varying degrees of political difficulty. This paper will seek to analyze the governmental response to the economic crisis in the United States and European Union from a political and institutional perspective by focusing on economic stimulus and the introduction of legislation to regulate the financial industry. Although the resulting policies and their effects are important and will be mentioned, the investigative focus of this essay will be more concerned with how and why such policies came to fruition. In particular, the following questions will be addressed. First, why was the US able to enact comprehensive and detailed financial regulatory reform, while the EU approached the issue by establishing a variety of new regulatory agencies? Second, why was US fiscal stimulus so large and centrally-administered while fiscal stimulus in the EU was relatively small and established unevenly by the member states? Third, why is the Federal Reserve still engaging in expansionary monetary policy nearly six years after the beginning of the crisis while the European Central Bank has engaged in relatively tight monetary policy? In this paper I argue that the speed and content of economic policy response can be understood as a function of: 1. Central bank mandates and perceptions of central bank legitimacy, 2. Contemporary political trends and parties in power, 3. The extent to which legislative power was concentrated (in the US) or dispersed (in the EU), drawing on studies of federalism and multi-level governance. I will explore each of these elements in subsequent sections, but before proceeding through the analytical meat of the essay, I will spend some time providing a relatively straightforward account of the economic crisis and manner of response in the United States and European Union by their respective central banks and state and federal governments.

II. Policy Timeline

A brief review of the unfolding crisis may be useful before a full discussion of the policies in question. Strong economic growth starting in the mid 1990s contributed to overoptimism regarding permanent growth levels, which was accompanied by low interest rates in the US, low inflation, and a glut of liquidity and credit. Although commodity prices remained stable, asset prices increased dramatically. The ensuing real estate bubble in the US was matched by an increase in the use of highly complex financial derivatives and securitization financing techniques as investors armed with high levels of liquidity sought greater yields than those offered by modest government bonds. Major consequences of this activity were dangerously leveraged financial institutions and irresponsible lending and borrowing (European Commission 2009, 7-8).

The growing potential crisis was exacerbated by inadequate risk management, both by firms in the financial sector as well as the regulatory agencies responsible for their supervision, and increasing opacity of complex financial instruments; underestimation of default risk by credit ratings agencies and the perverse conflicts of interest between the CRAs and the financial sector; and failures in corporate governance driven by irresponsible executive compensation schemes and outright misunderstanding of their own products (European Commission 2009, 8-11).

In the fall of 2007, credit markets were disrupted as a rash of failing subprime mortgages triggered a succession of dropping asset values, spiking capital requirements at banks, and a domino effect throughout the financial system, culminating most dramatically with the failure of Lehman Brothers in September 2008. As investors around the world had been channeling money into the failing mortgage-backed securities, the crisis reverberated far beyond the US. This banking crisis and evaporation of liquidity spurred the Fed and ECB into action to maintain liquidity in the interbank market. It was not long before the effects of the crisis in the financial sector were felt in the economy more broadly, causing a severe drop in employment and economic output in the United States and European Union. This economic downturn, along with the use of sovereign funds to bail out national banks, led investors to fear the possibility of a sovereign debt crisis in the EU, the reverberations of which are still being felt. Drudi has separated the various phases of crisis as follows: "the financial turmoil (9 August 2007–14 September 2008), the global financial crisis (15 September 2008–7 May 2010) and the eurozone sovereign debt crisis (8 May 2010–the present)" (2012, 881).

Considering the general lack of coordination, divergent policy prescriptions, and disparate growth rates of today, it is odd to think of the collaborative efforts that came in the immediate aftermath of the financial crisis. Regardless, there was indeed substantial transatlantic policy coordination and political congruency in 2008 and 2009. This should be expected to some degree, as in these early months the crisis was primarily financial in nature (before evolving into a broader economic crisis, and even later into a sovereign debt crisis in Europe). Accordingly, the necessary steps were fairly clear in the early days to solve the rapidly developing problems of the financial industry. Later it would become apparent that financial regulation would be necessary, but at first it was primarily a matter of logistics.

We will see that in the immediate wake of the crisis, the European Union and United States acted quickly and similarly to stabilize their respective private sectors by providing liquidity and state support to the financial industry, as well as through targeted spending to sustain and revive their economies. Initially, both cut interest rates through their central banks, extended deposit guarantees, provided liquidity to the financial industry, and initiated fiscal stimulus (Pisani-Ferry 2012, 9). However, it was in the months and years that followed that their paths diverged. International discord and lack of consensus on the way forward resulted in a policy push for austerity in suffering EU countries, while federally directed stimulus was used on a much larger scale to support and revive the flagging economy in the US. Additionally, the Federal Reserve in the United States has engaged in stimulative monetary policy in the years since the crisis by not only keeping interest rates low but also continuing to inject cash into the economy. The ECB, on the other hand, has supported national banks but mostly stayed true to its mandate by keeping inflation in check (regardless of what effects this does or does not have), and fiscal support has been rather limited. Both the US and EU also passed legislation reforming their respective financial sectors at a certain point, but took substantially different approaches to the issue.

Today, more than five years beyond the beginning of the crisis, the recovery in the US has been tepid but steady, while some parts of the EU have experienced a double-dip recession and the crisis seems far from resolved. (Indeed, the Cyprus bailout drama is playing out at the time of this writing.) Later I will elaborate on my hypothesis for why a similar crisis developed down such divergent paths.

A. Stimulus

Fiscal Stimulus

European Union. Targeted fiscal stimulus was undertaken in the EU, but in contrast to the United States, execution was only nominally guided by the European Commission. Rather the responsibility for funding and carrying out the stimulus was primarily the domain of member states. The Commission released a stimulus plan proposal on November 26, 2008, suggesting a package of measures to be undertaken primarily at the level of the member states (European Commission 2008, 6). One reason for stimulus spending at the member state level is that the budget of the EU, while substantial, does not have a comparable macroeconomic impact as the US federal budget or of the budgets of the EU member states. Specifically, the budget of the EU is equivalent to 1.05% of GDP for the period of 2007-2013 (European Union 2006). This is in contrast to the US budget, which for FY2013 is estimated to be equivalent to 19.4% of GDP (Office of Management and Budget 2013, 25).

The European Economic Recovery Plan, as envisioned by the Commission, was comprised of two pillars, supported by one underlying principle. The first pillar of the plan was a direct spending injection of €200 billion (1.5% of GDP) which would boost demand and confidence within the guidelines of the Stability and Growth Pact (European Commission 2008, 2). If the first pillar is seen as focused on near-term objectives, the second pillar is more concerned with the long-term outlook. The second pillar was comprised of a series of steps to ensure Europe's future competitiveness through measures such as investments in clean and efficient energy technologies, investments in workforce skills development, and investments in infrastructure. This also included steps toward lowering administrative burdens, and providing capital for small and medium enterprises (SMEs). Underlying these pillars was the fundamental principle of facilitating solidarity and ensuring social justice. This cited the duty to help the most needy and to focus on social change in times of crisis, and to utilize the European Globalization Adjustment Fund and European Social Fund (European Commission 2008, 11).

A credit squeeze, falling house prices, and troubled stock markets all caused loss of consumer confidence, consumption, and investment. The European stimulus was introduced when growth was predicted to be 0% for 2009, with some member states having already slipped into recession (European Commission 2008, 4). The introduction to the plan made explicitly clear that the risk was for a self-perpetuating economic spiral in which a negative feedback loop is created among "falling demand, downsized business plans, reduced innovation, and job cuts" (European Commission 2008, 4). The plan encouraged member states to rely on the strengths of the EU of coordination and stability frameworks as designed by the SGP and Lisbon strategy, along with the scale of the euro and single market as they formulated measures to emerge from the economic crisis. The plan cites the legitimacy of the independent ECB as key to supporting the euro, which in turn has lent stability to the macroeconomic situation and ability to coordinate national crisis responses. However, while emphasizing that all the economic policy levers available needed to be utilized to handle a problem of this magnitude, the Commission acknowledged that the most effective policy levers (especially those to stimulate short-term consumer demand) are those utilized at the member state level. But since all member states were operating under fiscal constraints this required committed coordination. The role of the EU, in the Commission's view, would mainly be to catalyze "smart action" (European Commission 2008, 5).

The strategic aims of the plan, to stimulate demand and confidence and to lessen the impact of the downturn on the most vulnerable primarily through the mitigation of job loss and avoidance of long-term unemployment, were in line with the goals of the Lisbon

Strategy for Jobs and Growth, and would help position Europe to take a leading role when economic prosperity returned. This would be achieved by structural reforms and investments in the development of the knowledge economy. Investments towards a low-carbon economy would have positive economic effects by encouraging technological innovation, increasing "green-collar" employment, reducing energy cost, and decreasing dependence on foreign energy.

Put succinctly, the plan consisted of immediate budgetary expansion amounting to 1.5% of EU GDP, consisting of €30 billion spent by the EU and €170 billion by the member states, as well as a variety of reforms for the future (European Commission 2008, 6). The European Investment Bank and European Bank for Reconstruction and Development were also to increase their budgets over the coming years. There is reference to the need for easy monetary policy consisting of liberal lending by the ECB to stabilize markets and contribute to liquidity.

In laying out qualifications for the budgetary stimulus, the Commission said that it must be "timely, temporary, targeted, and coordinated;" comprised of a mix of both spending and revenue measures; within the guidelines of the SGP; include structural reforms to promote resilience; improve market function; improve competitiveness problems; support employment and workers who are transitioning in and out of the labor market; and reduce regulatory and administrative burdens on business (European Commission 2008, 8-10). The fiscal stimulus of the Recovery Plan was to be closely connected to the four priority areas of the Lisbon Strategy, i.e. people, business, infrastructure and energy, research and innovation. It was also suggested to invest heavily in the maintenance of the active labor force through skills upgrading and career counseling. Member states should use the leverage they have on financial institutions by encouraging them to provide credit to consumers and businesses. Investments in infrastructure were encouraged to soften the blow to the disproportionately weakened construction sector, as well as to poise member states for future success.

The plan also encouraged member states to maintain their trade links and export edge through engagement at the WTO, development of free trade agreements, supporting Eastern European markets, and building a close relationship with the new US administration.

The European Union stimulus plan was administered in varying degrees by member states. Consequently, the poorest Southern European states and/or those that had been most devastated by the crisis were often those which were unable to implement the vigorous stimulative spending programs that were needed. Indeed, spending over $100 billion, or about 3% of GDP, Germany was a leading domestic spender on stimulus, but of course is one of the wealthiest and largest member states (OECD 2009, 20). Portugal, on the other hand, spent approximately 0.4% of GDP on fiscal stimulus between 2008 and 2010 (OECD 2009, 20).

In addition to discretionary fiscal stimulus, the EU was equipped with automatic fiscal stabilizers, such as stringent employment protection programs to absorb economic shock and keep consumers spending (Kulish 2009, A1). Stabilizers are beneficial in that they are not politically constrained, do not suffer from implementation lags, and do not run the risk of remaining in place after a crisis has been resolved (Baunsgaard 2009, 5). Of course, since automatic stabilizers are a matter of fiscal policy, they are handled at the member state level, and there is variety to their implementation. Such policies do exist in the United States to a limited extent (unemployment insurance being one example), although are generally used much more narrowly, being considered both costly and incompatible with a free-market ethos.

At a certain point, as the economic crisis slid into a sovereign debt crisis, austerity measures became the more widely used policy response in Europe.

United States. In the United States, stimulus through deficit spending came in the form of the American Recovery and Reinvestment Act of 2009, signed into law shortly after the inauguration of President Barack Obama. To date, the act has injected $840 billion into the US economy by means of tax benefits; contracts, grants, and loans; and entitlements (Congressional Budget Office 2012, 1). The statement of purpose for ARRA included the following objectives:

1. "To preserve and create jobs and promote economic recovery.
2. To assist those most impacted by the recession.

3. To provide investments needed to increase economic efficiency by spurring technological advances in science and health.
4. To invest in transportation, environmental protection, and other infrastructure that will provide long-term economic benefits.
5. To stabilize State and local government budgets, in order to minimize and avoid reductions in essential services and counterproductive state and local tax increases (American Recovery and Reinvestment Act of 2009)."

ARRA was funded directly from US Treasury holdings, meaning it added dramatically to the US federal deficit. Approximately $290.7 billion have been spent on tax benefits; $250.4 billion on contracts, grants, and loans; and $244.2 billion on entitlements. Expenditures began upon enactment of the Act in February 2009, and will essentially run through 2019 (Congressional Budget Office 2012, 1). The ARRA was fully administered and funded at the federal level, and widely served as a stopgap for state and local funding shortages. States and municipalities do not have the ability to leverage debt to the same extent as the federal government, so the federal financial assistance was crucial to many states (many of which were, and some of which continue to be, in dire fiscal straits - some to the point of bankruptcy).

The stimulus act in the United States proved to be highly politically contentious, with arguments in both directions arguing that it was either too expensive for the nation to afford or too small to be as effective as it needed to be. Political developments, largely spurred by backlash to the ARRA, would have dramatic implications for the possibility for further stimulus spending in the future. This will be discussed later in this paper.

Monetary Stimulus

Monetary policy was also employed for its stimulus effects in both the United States and European Union. In both areas, interest rates were effectively lowered to zero in the wake of the financial crisis, where they have remained since. Both banks also utilized a variety of mechanisms for increasing liquidity in the economy. In the United States, the controversial policy of quantitative easing involved the Federal Reserve buying large amounts of mortgage backed securities and other assets to take toxic assets off private bank balance sheets and inject liquidity into the economy. The ECB also bought assets, though in the form of sovereign bonds, and made liquidity available to banks. These policies will be detailed below.

With the onset of the financial crisis in 2007 and 2008, Ben Bernanke (who had become chairman of the Federal Reserve Board of Governors in early 2006) began to dramatically slash the federal funds rate to accommodate the liquidity crisis which was wracking the financial sector. Over the following months and years, the Fed continued to engage in expansionary monetary policy, lending to banks at near-zero interest rates, as well as exploring unconventional monetary actions such as large-scale asset purchases. The overall effect of Fed monetary policy has been to inject roughly $4 trillion into the economy since the outset of the crisis (Zumbrun and Saralva 2012).

The Fed used three varieties of monetary tools in addition to Federal funds interest rate cuts to support the economy through the early months and years of the crisis, some of which are still in use five years on. The first group of tools were for lending to traditional banks and other financial institutions. This was perhaps the most immediately effective action it took as the crisis unfolded, as without substantial liquid support, major financial institutions would have been insolvent early in the crisis. The second group of tools was also for lending but directly to borrowers and investors. The final group of monetary policy tools were beyond the traditional scope of the Fed's activities and as such were the most controversial. These were the asset purchases, as referenced before, of Treasury securities and mortgage-backed securities. This practice continued in the years following the crisis, and as recently as September 2012 the Fed announced its intention to purchase mortgage-backed securities at the rate of $40 billion per month through mid-2015 (Federal Reserve Board 2012).

In the European Union, monetary policy executed by the ECB has been somewhat similar to that of the Federal Reserve, in that conventional interest rate cuts were put in place at the outset of the crisis, and a variety of non-standard measures followed. Additionally, clear communication of policy actions and their rationale were key for managing private sector expectations, with the hope of promoting stability (ECB 2011, 90). Similarly to the

Federal Reserve, the ECB lowered its interest rates to 1% between October 2008 and May 2009. Additional nonstandard measures adopted were intended to facilitate credit flows and financing conditions despite the liquidity crisis and beyond what would be possible with interest adjustments only. These measures are referred to as Enhanced Credit Support (ECB 2011, 124). It was not until substantially later, in May 2010, that the ECB introduced its Securities Markets Programme, in which the ECB announced it would buy unlimited amounts of sovereign bonds contingent upon fiscal conditions (ECB 2011, 128). In a sense, SMP was similar to the Federal Reserve practice of purchasing large quantities of MBS, although that was a strategy to ensure financial sector liquidity and stability, while SMP was in response to the sovereign debt crisis, intended to keep member states solvent and prevent the risk of contagion.

B. Legislative Reform

Financial regulation was clearly a necessary step in the aftermath of the financial crisis as well, although it was enacted substantially later than stimulus actions were undertaken. In the United States, regulation came in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Signed by President Obama on July 21, 2010, the law contained a broad array of reforms aimed at curbing abusive lending practices and strengthening oversight of financial institutions in the hope of averting future crises on the magnitude of the most recent one. Among the major reforms and initiatives contained in the act were those to restore the Glass-Steagall era restriction on proprietary trading by banking entities, establish minimum capital requirements for financial companies, establish the Bureau of Consumer Financial Protection, and more comprehensively regulate derivatives (DavisPolk 2010, iii-vi). The effects of this act will be felt in just about every corner of the US financial industry and the US regulatory system, ranging from the SEC to the newly created CFPB.

Financial reform in the European Union arrived slightly later. Although the framework for suggested reform was outlined by the European Commission in the De Larosiere report in 2009, legislation was ultimately passed by the European Council on

November 10, 2010. In contrast to the Dodd-Frank act, which in itself provided a comprehensive catalogue of detailed reforms to be enacted, legislation in the EU served primarily to establish an array of new supervisory bodies, for both macro-prudential and micro-prudential supervision. They were the European Systemic Risk Board (ESRB), European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA), and European Securities and Markets Authority (ESMA) (Council of the European Union 2010, 1).

Policy Outputs			
	Fiscal Stimulus	*Monetary Stimulus*	*Legislative reform*
United States	American Recovery and Reinvestment Act	Cut interest rates, quantitative easing through purchase of Treasury securities and mortgage-backed securities	Dodd-Frank Wall Street Reform and Consumer Protection Act
European Union	Automatic stabilizers, European Economic Recovery Plan	Cut interest rates, Enhanced Credit Support, Securities Markets Programme	ESRB, EBA, EIOPA, ESMA established

III. Explanations

Substantial research has been done to analyze points of divergence for policy outputs in the United States and European Union. Pisani-Ferry and Posen, for example, suggest that divergence has been a product of the limited scope of the ECB and lack of a fiscal authority in the EU. More broadly, though, they stress that policymakers in the US believed that permanent output capacity was not diminished by the crisis, and that further governmental activism would be necessary and capable of nourishing the steady recovery to achieve full pre-crisis output (as well as the fact that low employment is generally less politically palatable in the US than in the EU) (Pisani-Ferry 2012, 36-37). Shelkle, on the other hand, suggests that in some instances traditional characteristics of "good governance" were discarded in the US response to the crisis, but were employed on the EU side, and vice versa in others. For example, she argues that central bank independence was compromised on the part of the US but enforced vigorously in the EU, while fiscal rules on state budgets were followed closely in the US but relaxed in the EU (Shelkle 2010, 35).

For my analysis of such divergent policy responses on each side of the Atlantic I will focus on the three major factors, institutional and political, which influenced the possibility of such responses. They are: the respective mandates and perceived legitimacy of the Federal Reserve and the European Central Bank, contemporary political trends in the United States and European Union, and the differing implications of federalism and multilevel governance in the United States and European Union.

A. Central Banks

Constitutional Mandates

The central banks of the United States and the European Union, the Federal Reserve and the European Central Bank, respectively, serve similar functions although they are subject to substantially different power dynamics and operate under differing mandates. The

Federal Reserve in the United States has a dual mandate to maintain price stability and maximize employment. The European Central Bank, on the other hand, is only mandated to maintain price stability, as defined by the Maastricht Treaty, or Treaty on European Union. TEU assigns price stability as the primary objective of the ECB. This reflects a "broad consensus" that price stability is the best contribution that the bank can make toward economic growth and social cohesion (Executive Board of the ECB 2011, 7). Thus, as referenced before, the ECB *has* fulfilled its mandate in recent years, although such singular focus on price stability does tend to constrain countercyclical policy options in times of crisis, potentially even causing pro-cyclical effects. On the other hand, the Fed has engaged in an easy-money policy with what would traditionally be considered inflationary measures intended to bolster growth instead of simply stabilizing prices. Although the crux of my argument indeed lies in the result of the differing mandates of the Federal Reserve and the ECB, we should keep in mind that central banks do increase or stray from the confines of their mandate in time of crisis (and both of these banks did just that during 2008 and 2009) (Pisani-Ferry 2010, 20).

Since the introduction of the euro in 1999, the ECB has valued price stability above all things, despite the fluctuations of the global political economy. The Fed, it seems, is more willing to go beyond the scope of its mandate to react to the political and economic context. Indeed, the scope of its activities is a living dynamic, as some of the measures seen today as extraordinary, such as asset purchases and direct lending, were common practice in the early twentieth century. Perhaps the ECB has been less willing to expand its scope as it worked to establish its identity over the first decade of the common currency, although the crisis certainly forced it to adapt to new realities. If financial systems have historically been vehicles for economic and national growth, which has also been the primary motivation for economic integration and strength of the EU, regulation may, on the face of it, seem counter to the purpose of the EU, which would explain the ECB's reluctance to engage directly in regulation, leading instead to the establishment of new oversight bodies. In fact, a system designed around the purpose of economic liberalization inherently limits the capacity for public intervention (Jachtenfuchs 2004, 110). It should also be noted that the institutional mechanisms for banking unity and regulation have been in place for significantly longer periods in the United States than in the EU. The National Banking Act took regulation out of state hands 1865, giving competence to the federal level, and the Federal Reserve was established in 1913 (Snider 2011, 124). Compare this to the 2011 establishment of the European Banking Authority and 1998 establishment of the European Central Bank, and the ongoing debate over central bank activity and regulation becomes understandable.

Relation to public opinion

We should also think of the banks' mandates as they relate to their relative distance from the voting population and perceptions of their political independence. The strident political independence of the ECB, due to its exclusive focus on price stability, certainly contributes to its constrained policy portfolio. It seems intent on staying true to its narrowly defined mission and unwilling to expand very much beyond its relatively constrained mandate, even in the context of systemic crisis. A slew of empirical research has shown that central bank political independence is key to maintaining low inflation (Mishkin 2011, 8). On one hand, it has been shown that monetary policy is time-inconsistent, in that ad-hoc policy changes made in frequent response to short-term economic changes can tend to result in worse overall economic performance than if a commitment was made to a long-term strategy (Mishkin 2011, 8). Without central bank independence, it would be likely that central bankers could fall under the sway of popular opinion, pursuing low inflation at the expense of employment or vice versa.

However, in democracies, central banks must be accountable to the people because they are public institutions. It is necessary for banks and legislatures to have a collaborative and constructive dialogue in which the bank is aware of the objectives of the elected officials but free to pursue its own agenda due to its unique position to judge the efficacy of a given policy. The regularly scheduled testimony given to Congress by the Fed chairman, Ben Bernanke, is an example.

In this vein, the decision of the ECB to reject quantitative easing was a political one. Provision of liquidity to banks was acceptable, because it was within spirit of the Maastricht treaty, but the wholesale purchase of government bonds (i.e. quantitative easing) was not, because it could be considered to violate the separation of monetary and budgetary policy (Pisani-Ferry 2012, 26). The European Council has EU budgetary authority, and the ECB is diligent and demonstrative about its determination to stay independent. Encouragement by the European Council for the ECB to exceed its mandate could be seen to compromise the political independence of the bank (Pisani-Ferry 2012, 27). Furthermore, exceedingly loose monetary policy would have been highly politically unpopular with the Germans, for example, who were reluctant to introduce a common currency in the first place.

If the central banks are to take losses as a result of nonconventional asset purchases such as monetary easing, they may come under congressional or parliamentary scrutiny, which could compromise their political independence and lead to the problems described earlier. Additionally, the purchase of private securities can be considered within the realm of fiscal policy, i.e. legislative territory, also compromising its independence (Mishkin 2011, 29).

The ECB responds to the European Council, a supranational governing body, while the Fed responds to the US Congress, a directly elected body. The Fed's closer and less problematic connection to the voting populace, despite its political independence, enabled it take a more interventionist approach than the ECB, which is another level removed from the people. This probably also influenced the approach that the respective banks took toward regulation. Due to the Fed's relatively greater institutional proximity to the citizenry, a detail-oriented legislative regulatory overhaul was appropriate, while the ECB's distance lent merit to the creation of new oversight bodies instead.

Dominant Policy Paradigms

As for the technical details of the Fed's monetary policy, these also reflect contemporary trends, if not in political views, per se, but in the evolution of consensus on the most effective economic action that a central bank can take, as well as what the appropriate role of a central bank is in the first place. Opinions on the best course of action for a central bank evolve as well. Although this reflects the evolving understanding of the science of monetary policy, the ideological position of monetary policy shifts as well, and this is often revealed in the political debate. Monetary policy as a remedy for recession was not a large part of macroeconomic theory in the 1950s and 1960s, as the Keynesian focus on demand as a driver of economic fluctuation was more in vogue. However, the literature that Milton Friedman produced in the 1960s was extremely influential in the development of economic consensus, as central bankers came to believe that inflation was always a product of monetary policy, and as such their central task would be to control inflation (Mishkin 2011, 4). Robert Lucas published a series of influential papers in the 1970s describing rational expectation theory, positing that the public and markets will act in response to what they view to be the most likely future policy action. That is, economic activity will be driven not only by present policy, but expectations about future policy. As such, "the management of expectations about future policy" are now central to the formation of monetary policy (Mishkin 2011, 6).

Optimal monetary policy theory before the crisis was based on the new neoclassical synthesis, which stressed the importance of monetary policy for inflation, the importance of price stability, the compatibility of employment and price stability, and the need for monetary policy that is not concerned with short-term objectives, as well as the importance of an independent and credible central bank (Mishkin 2011, 3-12). This monetary policy is referred to as "flexible inflation targeting" (Mishkin 2011, 14). Before the crisis, the Fed and ECB behaved as did most all central banks with independent monetary policy power, by setting a credible long-term inflation target while taking short-term steps to enhance output. One difference, though, is the ECB's willingness to set a concrete target, but unwillingness to refer to it as such - perhaps due to the aversion to missing that target. The Fed, on the other hand, was unwilling to even announce an official inflation target, rather suggesting that "appropriate monetary policy" would be carried out (Mishkin 2011, 14). Spring 2010 marked a major point of departure as the ECB generally saw it unnecessary to continue exceptional support, while the Fed continued to employ activist monetary policy.

B. Contemporary Political Trends

In the United States the political winds during the tempest years of the crisis were decidedly under the sails of Keynesian politicians with the election of Barack Obama and the Democratic congress (even the administration of George W. Bush before, while not explicitly Keynesian, certainly engaged in stimulative fiscal and monetary policy), resulting in the American Recovery and Reinvestment Act of 2009 and continual stimulative efforts by the Fed. However, in the two years after his election, a large contingent of the American populace organized in opposition to what they viewed as federal overreach, with substantial electoral consequences for the 2010 midterm elections. In the EU, on the other hand, as the financial crisis evolved into a sovereign debt crisis, political favor in wealthier countries such as Britain, Germany, and the Netherlands turned against collaborative efforts to bolster national finances of other member states such as Greece, Portugal, and Spain. Net donor countries generally favored austerity for net recipient countries, under the guise that it would help alleviate the economic downturn. Unfortunately, such prescriptions did not appear to work, and revealed what may be charged as protectionist impulses in the donor states. Voters in recipient states, on the other hand, clearly let their displeasure be known. Far-right parties gained support in Greece, for example, and Mario Monti was faced with broad unpopularity in Italy, viewed as an illegitimate technocrat. This chronic tension between those prescribing austerity and those chafing under its constraints slowed the political process. The lack of European solidarity was exacerbated by the lingering effects and debates of the crisis.

United States

The onset of the crisis coincided with the general election campaign for president, in which Barack Obama won a resounding victory, apparently winning broad public support for Democratic programming. Upon taking office, Obama was greeted by a political balance which was amenable to his policy preferences. Propelled by a decisive electoral victory, and enabled by Democratic control of both chambers of Congress, the Obama administration was able to work relatively swiftly to implement its agenda in response to the crisis. Moreover, the US federal government did not believe that the crisis indicated a permanent reduction in economic output capacity, lending more faith to expansionary fiscal and monetary policies by Congress and the Fed (Pisani-Ferry 2012, 14).

The Dodd-Frank act was the most ambitious overhaul of the financial regulatory regime in the United States since the wake of the Great Depression, and followed several decades of particularly fervent deregulation, epitomized perhaps most famously by the repeal of the Glass-Steagall Act in the late 1990s. The possibility for such an ambitious reform bill to be implemented was a clear indication of a changed political environment after the previous decades of deregulation (Snider 2011, 125).

However, another major political shift would reroute the legislative course of the recovery. The congressional midterm elections of 2010 had a further destabilizing effect as Democrats lost control of the House of Representatives, largely due to public disapproval of the state of the economy and the handling of the crisis by the legislative and executive branches, and fueled by the rise of the fervently small-government Tea Party. This fringe group quickly gained a somewhat mainstream status, expressing distaste for what they viewed as expensive and intrusive federal legislative achievements, including bailouts of the financial and auto industries, the recovery act, healthcare reform, and the Dodd-Frank financial regulatory reform. Following these elections, after which the House was Republican-led and Senate Democrats no longer held a supermajority, one would expect a less activist US government in the crisis. Indeed, it was extremely difficult for the administration to address lingering issues from the crisis. The midterm elections derailed the ambition for a second stimulus package, and no no major legislative actions stimulating or regulating the economy were passed. Hence the responsibility to tackle the crisis was left primarily to the Fed by means of subsequent rounds of monetary easing.

Following the 2012 presidential election, Obama has shown signs of assertiveness and combativeness, although he is still faced with a divided Congress. However, economic growth has generally been positive, and absent some major shock, it is unlikely that further legislative action will be necessary for the crisis.

European Union

The Commission is a non-political technocratic body, the Council can be thought of as an all-party government, and the European Parliament requires broad consensus due to qualified majority voting. All of these factors, in the opinion of Jachtenfuchs and Kohler-Koch, are institutional arrangements that blunt the effect of party politics (105). The Commission is bound to take a "scientific" approach to solving problems, i.e. leave normative arguments to national politics (Jachtenfuchs, 105). However, despite the technocratic nature of the European institutions, national politics are still highly influential as there has been little consensus among various member states, particularly along the north-south axis, about what the best policy is moving forward. It is inevitable that normative, nationally-biased political opinions influence the formation of system-wide policy. In the case of the economic crisis, these policy positions can be seen as a result of both ideological alignment and territorial alignment, which will now be examined in turn.

As in the United States, the economic crisis has had dramatic implications for domestic member state politics and national governance in Europe. And, similar to the United States, enthusiasm for stimulus faded as the crisis wore on. The text of the recovery plan proposal, which explicitly labels its policy steps as "a counter-cyclical macroeconomic response" (European Commission 2008, 6), reflected the prevailing willingness for bold governmental action in the early phase of the crisis. In subsequent years, language reflecting support for state intervention would have been more controversial. Indeed, austerity became the policy mode of choice promoted principally by the Germans, along with other wealthy member states such as the Netherlands and Denmark. For much of the sovereign debt crisis, there was a clear ideological divergence between those states advocating fiscal stimulus and those advocating austerity. However, the presidential election in France was a significant turning point for the strength of ideological solidarity, for example, as it was largely a rejection of fiscal coordination with center-right Nicolas Sarkozy being ousted by the Socialist Francois Hollande (Dinan 2012, 85). Hollande's campaign explicitly rejected the politics of austerity (Donahue 2012). Likewise, elections in Greece affirmatively rejected EU-imposed technocratic austerity (Dinan 2012, 85). Much of the response to the eurozone crisis has been intergovernmental in nature, emphasizing the prerogative of states and the lengths to which they will attempt to protect their interests.

In addition to evolving consensus based on ideological alignments, there has clearly been consensus based around territorial position (which frequently paralleled economic strength). Decision-making at the European level is bound to a great degree by territorial interests. The Council of Ministers and European Council are comprised of heads of state and national ministers. Accordingly, much of the action undertaken at the European level resembles the politics of current member state governments, and is not necessarily a reflection of broader political coalitions or interest groups. Furthermore, the formal veto power of these representatives often precludes change away from arrangements which favor current dominant interests. This vertical axis favors the states, so it should be no surprise when the larger, wealthier, and more powerful states are able to have outsized influence on the policy of the EU (Moravcsik 2001, 175). The practical implications of this dynamic have been seen in the policy responses to the crisis. That is to say, beyond an ideological divergence, richer countries of the North were generally less willing to financially support the struggling countries of the South, such as Spain and Greece. There is a major disconnect between core Europe and peripheral Europe, both geographically and financially. The wealthier countries of Europe, with competitive economies which have effectively been subsidizing the Mediterranean countries' emergence from the crisis, fear further loss of wealth not only if the debtor countries are unable to pay them back, but also from the potential losses entailed in a proposed banking union. Furthermore, there is a fundamental lack of trust on the part of the northern countries regarding the institutional functioning of southern countries like Italy and Greece, where corruption, electoral turnover, and general financial mismanagement have plagued those societies for years.

C. Governance Structures

Federal Theory

Considering the federal nature of both the United States and the European Union is a good starting point as an understanding of how the dispersion of power throughout the two unions affects political processes in each. Federal democracy relies on constituents to distribute power as they see fit. Being that the EU has been constituted in a confederal fashion, with sovereign states ceding limited amounts of authority to the supranational level, it is understandable that tension comes from below. The power in the United States has been concentrated more centrally at the federal level.

The historical development of the EU and US had major implications for how the polity saw themselves in relation to the union, and how the individual states were situated in the federal context. The federal United States developed to reconcile the two goals of self-government and political integration over a vast area. This federal structure was intended to achieve a government that would dynamically respond to the will of the governed, would facilitate interaction between the governed and the government, balance liberty and order, and secure moral and civil order. As Elazar points out, the American federal structure was designed to be a comprehensive government (2001, 39). Clearly, the EU was conceived in a significantly different fashion, in that a collection of comprehensive governments were already in existence, and these governments agreed to transfer a limited portion of their power to the supranational level. In this way, politics were largely left as an internal domestic affair, and the development of a federal political culture was impeded. Furthermore, popular trust of the European Union is currently substantially lower now (33% in Autumn 2012) than just before the onset of the crisis (57% in Spring 2007). The percentage of citizens reporting positive feelings toward the EU have declined and those feeling negatively have increased in that time as well, converging at about 30% each (Directorate General for Communication 2012, 14-15).

Many theorists of European integration appeared to view the integration process itself as the goal to pursue, rather than a tool for achieving some practical ends. In the event of the economic crisis, it was revealed how "European integration has tended to be seen as a valued end in itself, often confusing means with ends. It is only once the process started to produce results, that the question of the form of government and indeed the nature of the political enterprise was raised. In the United States, on the other hand, the federal form of government was conceived to embody the fundamental republican and democratic principles which inhered in American civil society" (Elazar 2001, 32).

It is perhaps ironic that the economic crisis has proven to be by far the biggest threat to European unity of the past fifty years considering that the primary goal of the project was to consolidate economic progress. Europe is founded on economic liberalism but limited partnership, an apparent contradiction in the event of systemic economic crisis (Elazar 2001, 40).

The spillover effect, described by functionalists as the process by which the competences of the EU expand, has been incremental and the crisis hit before the process was truly complete, with the capabilities in place to be able to respond appropriately. "Appropriate and substantial if not complete powers for each function were given first to a specific functional authority and then to the EC, which was the multipurpose expression of those functional authorities. Only after the number of functions increased to the point that more general institutions were required were such institutions constituted, in different ways for each class of powers" (Elazar 2001, 37). A comprehensive constitution was made through a formal convention in the United States, while the European process has been piecemeal through several successive treaties.

The differing federal structures of the EU and US also have implications with respect to the authority to engage in fiscal stimulus. The US budget is crafted at federal level and is relatively quite large. In the EU, only national level budgets have macroeconomic impact, as EU-level budget is relatively insignificant. "The traditional Musgravian allocation of responsibilities, which assigns stabilization to the central level, therefore does not apply to Europe, where the EU budget plays no macroeconomic role whatsoever" (Pisani-Ferry 2010, 30). The relatively insignificant budget of the EU makes it unable to effectively leverage stimulative spending at the European level (or carry out many other programs normally executed by other federal governments, for that matter), leaving it as a primarily regulatory body. It is for this reason that fiscal stimulus was mostly forced to be undertaken by the member states' own governments, and why it relied on regulatory action for other remedies, i.e. monetary policy and reform of financial oversight (Moravcsik 2001, 170).

US budgetary policy allows for more discretion, allowing it to work counter-cyclically, while EU budgetary policy relies more on automatic stabilizers, and since the macroeconomic-effective budgets are at the state level, they are constrained by the SGP and less able to respond in times of crisis (Pisani-Ferry 2010, 30).

There is a moral commitment which is a significant aspect of the federal union project. That is, it has generally been agreed that decisions will be made for the common good, and that no individual state would take an action harmful to the rest. This union was meant to transcend ethnicity, as well as cultural and territorial differences. It might be jarring, then, for some observers to witness the political repercussions of the crisis, and the division which has come as a result of it. The decentralized power distribution of the EU puts member states into an uneasy partnership at times of crisis. On one hand, crisis reveals the true extent to which the various member states have not integrated into one larger European identity and to which the member states prioritize their own national interests. On the other hand, there is a clear reluctance to completely shun cooperation as member states recognize the degree to which they are economically integrated; not only will the failure of a member state have substantial repercussions for its peers, but others are aware that they could very well require such assistance in the future and would not be served to burn bridges in the present. Furthermore, of course, is the fact that a union-wide solution may be vastly more efficient than a collection of member-state level solutions. This may be a normative aspect of the federal ideal: the spirit of collective action and support. Where such an ideal becomes complicated in practice, as evidenced by the comparative cases of the United States and European Union, is in the level of power concentration. Jachtenfuchs and Kohler-Koch refer to the way in which the transgovernmentalism of the EU institutionalizes autonomy, thus complicating cooperation (102).

Multilevel Governance

The concept of multilevel governance may be key to a comprehensive understanding of the course of policy responses in the United States and European Union to the different phases of the crisis as well. Explained most simply, the concept of multilevel governance analyzes how power is concentrated at various levels of government and how it can facilitate or prevent decision-making at a given level. In the United States the most relevant interplay is between state and federal legislatures, while, similarly yet differently, the dynamic is between national and European level governing bodies in the European Union.

Multilevel governance is a relatively new concept in the field of political science, being first developed by Hooghe and Marks in the wake of the Maastricht Treaty of 1992, and used to analyze how authority was shifted among the subnational, national, and supranational levels. In the intervening years this concept has been widely debated and analyzed. Hooghe and Marks claim that power has been shifted to supranational institutions and to the regional and local governments. In this way, policy can be tailored to the relevant scale, increasing efficiency (2010, 17). I would say that this certainly characterizes the ideals of the institutional architecture of the EU, including EMU, although the project of EMU had not been thoroughly developed in time to effectively sustain the Eurosystem and European System of Central Banks more broadly through such a major crisis. The EU is characteristic of what Hooghe and Marks have labeled Type I governance, for which the intellectual foundation is federalism. This contains a limited number of jurisdictional levels, which are each general purpose (2010, 18).

This is clearly relevant to the legislative decisions made regarding the crisis in the European Union, as well as the tensions which accompanied those decisions and which have delayed others. Approaching financial regulatory reform is difficult, regardless of whether it is being enacted by a national legislative body, as in the US, or by a supranational body, as in the EU. This is because financial regulation is not only a technical but a normative subject. Seeking consensus among such a broad array of opinions and interests is exceedingly difficult.

Many eurosceptics or critics are suspicious of an overly powerful or extensive European superstate (although similar criticism and paranoia abound in the US as well), which delayed the development of appropriate crisis resolution tools before the recent economic upheavals, and certainly have not facilitated progress recently either. The perception of distance and illegitimacy of technocracy abounds in Europe, particularly in the

Southern states that have come under the stewardship of wealthier northern states in recent years.

Levels of governance also have implications for the perceived legitimacy of the central banks and their perceived responsiveness to the needs and desires of the polity. The Fed is subject to the oversight of the US Congress, which is a body of directly elected representatives who were (in the case of the House, which constitutes the vast majority of Congress) elected in proportion to the represented constituency. The ECB, on the other hand is subject to Commission oversight, the Commission being a body of political appointees who are in turn answerable to the European Parliament, which is itself a proportionally elected body.

The increasing specialization of policy areas such as international finance has necessitated the development of a highly trained technocratic elite operating at the supranational level and more or less insulated from the pressures of national politics. This sort of autonomy may have the effect of leaving few, if any, of the interest groups affected by their policy outputs satisfied, as has been the case throughout the course of the crisis. Additionally the internal deliberations and processes of the Council and its committees enable legislators to evade close public scrutiny. All of these things add to the democratic deficit and spur feelings of euroscepticism among many of the populace.

With regards to the most democratic of the EU institutions, the European Parliament, there is often a knowledge deficit among the voting populace as to the functioning of the EP and how their MEPs can effect change or how they fit into the policy-making process (Jachtenfuchs 2004, 111). This can create an unfortunate feedback in which national party members are punished electorally for action taken at the European level, simply because their fellow party members were associated with an unpopular European legislative action, and not necessarily for a substantive reason. This has contributed to the political flux in the EU and the delay in reaching a satisfying resolution to the crisis.

IV. Conclusion

The elements identified in the preceding sections collectively explain why the response in the EU to the financial crisis of the past five years has been considerably less impactful and more piecemeal, not to mention politically fraught, than that of the United States. In particular they have been used to explain economic stimulus (monetary policy employed by their respective central banks, as well as direct stimulative spending) and the process towards reform of financial regulation in each area.

We first examined the respective central banks of the United States and European Union. While serving essentially similar functions, these banks operate in remarkably distinct political and structural environments and are driven by different mandates. The Federal Reserve is a politically independent institution, guided by a dual mandate to maintain inflation at a healthy level and to minimize unemployment. However, the action of the Fed does implicitly respond to political winds, and may deviate from its mandate in times of crisis. The European Central Bank, on the other hand, typically stays quite close to its strict and limited mandate, keeping a small portfolio of policy options and stridently avoiding entering the fiscal fray, which is beyond its mandate and could expose it to charges of illegitimacy or political partiality. Its position is particularly complicated due to the ten EU member states which do not operate on the euro currency.

Next we examined the contemporary political environment throughout the various stages of response to the economic crisis. In the United States, a rush of enthusiasm for expansionist monetary and fiscal policies coincided with the most critical period of the crisis as Barack Obama was elected president of the United States and took office. With a clear mandate for action, he was able to sign into law the American Recovery and Reinvestment Act shortly after his inauguration, and the Federal Reserve, technically independent of political influence (although certainly aware of prevailing opinion) was able to proceed with stimulative monetary policy through the sharp reduction of interest rates and repeated rounds of monetary easing. Furthermore, the Dodd-Frank Wall Street Reform and Consumer Protection act was signed into law in the Summer of 2010, shortly before congressional midterm elections gave control of the House to Republicans and ended the unitary control of government by Democrats, effectively stalling further decision action towards crisis resolution. In the European Union, ideological division was more relevant to policy outputs in response to the sovereign debt crisis. Rigid ideological alignments among those member states advocating austerity and those advocating stimulus, a division which paralleled the alignment of wealthier northern states against recipient southern states until the election of French president Hollande in 2012, prevented the smooth resolution of the crisis.

Finally was an analysis of the way that governance structures have affected the ability of policy-makers in the United States and European Union to respond to the crises. In particular, emphasis was given to the concepts of federalism and multi-level governance. In the United States, the strong federal system effectively prevents any one state or group of states from impeding legislative action at the national level, which had major implications for the ability of the federal government to pass stimulus and regulatory legislation, as well as for the speed with which it was able to do so. On the other hand, the legislative action at the European level required much more laborious, halting progress toward action. Political divisions, both ideologically and territorially driven, impeded progress as member states jealously guarded their own prerogatives and domestic recovery.

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