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RESEARCH SUMMARY

CENTRAL BANK INTERVENTION AND THE ROLE OF POLITICAL CONNECTIONS

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Among the extraordinary policy responses to the 2007 financial crisis was the emergency lending program by the Federal Reserve to both domestic and foreign banks, eventually totaling $16 trillion. The scope of this intervention means that examining the common characteristics of the banks that received emergency funding from the Fed could greatly increase our understanding for dealing with the next crisis.

According to new analysis from the Mercatus Center at George Mason University, data on political lobbying show that politically connected firms were indeed more likely to receive emergency assistance.

Below is a brief summary of Benjamin M. Blau's study. To read it in its entirety and learn more about the author, see "Central Bank Intervention and the Role of Political Connections."

BACKGROUND

The study uses data from a full-scale audit of the Fed conducted by the General Accounting Office to examine whether banks with political connections were more likely to receive emergency loans during the financial crisis. The Fed is politically independent, and its decision making, including its loans, should be motivated by the best interest of the credit markets and the economy in general. Nonetheless, this study finds a high degree of correlation between political connections and the likelihood of a bank receiving emergency support from the Fed during the financial crisis.

KEY FINDINGS

- Banks receiving emergency loans spent 72 times more on lobbying expenditures in the decade before the crisis than banks that did not receive loans; 15 percent of firms receiving support from the Fed employed politically connected individuals; for banks that did not get a loan from the Fed, only 1.5 percent had a well-connected employee.

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- Banks that lobbied the Fed or employed politically connected individuals were more likely to receive emergency loans. The study still finds a relationship between political connections and the likelihood of receiving an emergency loan from the Fed even after controlling for bank size and eliminating from the sample firms listed as “too big to fail” by the Financial Stability Board.

- When controlling for factors like size and designation as “too big to fail,” politically active firms on average received larger loans than banks without political connections.

- Banks that employed politically connected individuals were generally in debt to the Fed for longer than those that did not have such employees.

CONCLUSION

Explaining why politically connected banks were more likely to receive emergency assistance will require more research, but in view of the Fed’s political independence, there are at least three different possible explanations for the results:

- *Information available to the Fed*: The Fed possibly had more information about politically active banks; therefore, awarding loans to those institutions was an easier decision.

- *Voluntary participation by banks*: Politically active banks are more likely to *seek* Federal Reserve loans.

- *Risk-taking by banks*: Politically connected firms, because of their ties to those in power, might feel emboldened to engage in riskier behavior that will eventually prompt the central bank to take action when the crisis occurs.