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978-1-009-23313-2 — Taming the Cycles of Finance?
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Excerpt
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1 Introduction

How do policy frameworks change as a result of crises and policy failures? Are societies able to learn from these failures and modify regulatory ideas, incorporating these lessons into policies that allow us to address the main policy shortcomings? Or are we doomed to keep repeating the same mistakes, barred by vested interests and policy inertia from reforming the system? In our current era, characterized by the "poly-crisis" of environmental degradation, financial market turmoil and political unrest, such questions gain increasing prominence (Tooze 2022). One cannot help feeling that such inertia is indeed one of the reasons why such policy problems fester and become entrenched, in turn aggravating problems in other areas. Engaged in permanent emergency measures for crisis fighting, policymakers seem largely incapable of addressing the underlying trends (Tooze 2022).

In few areas do such problems manifest themselves more glaringly than in the realm of financial markets and their regulation. Despite massive policy interventions since the Global Financial Crisis of 2007–8, these markets continue to be a permanent source of instability and concern for policymakers, leading to one emergency liquidity intervention by central banks after another. As central banks continue to act as firefighters, seeking to quell any financial instability before it threatens to turn into a systemic crisis (Bernanke et al. 2019b), the question is whether the regulatory interventions in the aftermath of the last financial cataclysm have been futile.

After all, in the crisis aftermath of 2008, G20 leaders formulated the hope that central banks would in the future intervene ex ante, addressing financial fragilities before they require interventions (G20 2009a). They asked central banks and financial regulators to develop a forward-looking systemic approach to financial regulation, widely known as macro-prudential regulation. In contrast to the pre-crisis micro-prudential approach, which focused on safeguarding the stability of individual banks, this new approach was supposed to take developments within the financial system as a whole into account, intervening to remove and attenuate the fragilities that might cause systemic financial distress. In particular, macro-prudential regulation was supposed to mitigate and reduce the impact of cyclical developments in financial markets, which moved from booms to busts to new booms (Blyth 2008). These new tasks required central banks to manage and foresee financial market developments and intervene in them if they were deemed to threaten financial stability. These new responsibilities challenged the non-political status of central banks, which had already come under pressure because of their persistent crisis-fighting role. In a sense, this new task set was challenging the role of central banks in contemporary financial systems.

The Role of Central Banks in Contemporary Financial Systems

> The evolution of financial practices must be guided to reduce the likelihood that fragile situations conducive to financial instability will develop. Central banks are the institutions that are responsible for containing and offsetting financial instability and, by extension, they have a responsibility to prevent it.
>
> (Minsky 1986, 358)

With these simple words the eminent economist of financial instability Hyman Minsky summed up the position and tasks of central banks. As the main institutions capable of ending financial panics, based on their ability to provide emergency funding to financial markets and institutions, central banks have taken on a pivotal role in today's financialized capitalism, stabilizing financial markets that seem ever more volatile and fragile. Their role as the final liquidity backstop of the system came to the fore during the tumultuous years of the Global Financial Crisis (2007–8), when Western central banks, with the Federal Reserve at its helm, injected trillions of dollars to stabilize a financial system. At that moment, the system was essentially facing a systemic bank-run on the shadow banking system after a financial boom in the 2000s had led to the accumulation of bad mortgage debt in an increasingly interconnected and fragile financial system.

Since then, central banks have been at the forefront of stabilizing financialized capitalism (Langley 2014) and permitting a return to economic growth. They have used their balance sheets as a tool to meet their inflation targets and stimulate asset growth through quantitative easing[1] and to stabilize financial markets whenever liquidity dried up and turbulences in financial markets threatened to impact the real economy (see Figures 1.1 and 1.2). By intervening in money markets during the financial crisis in 2007–8 and in short-term secured

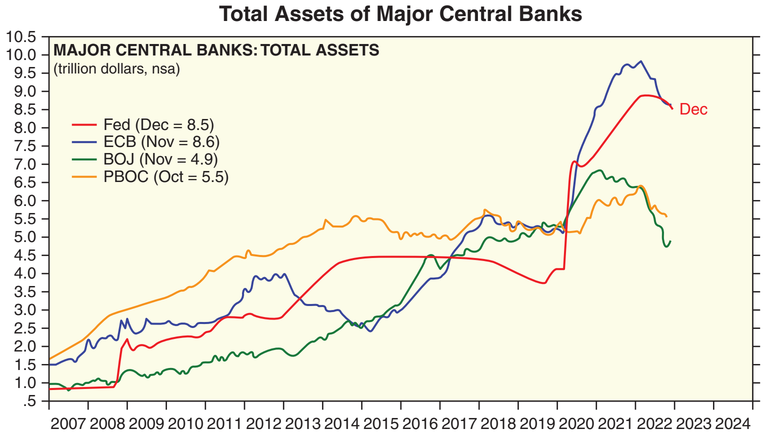

Figure 1.1 Growth of major central banks' total assets (Yardeni 2023, 1, monthly balance sheets [yardeni.com]).

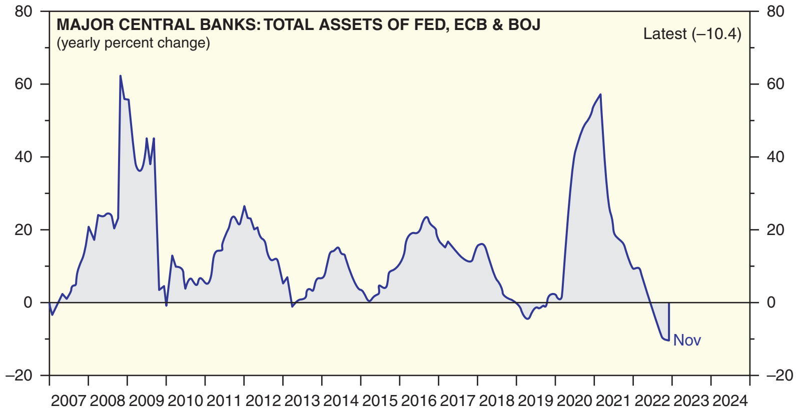

Figure 1.2 Annual growth of major central banks' balance sheets (Yardeni 2023, 2, monthly balance sheets [yardeni.com]).

[1] Quantitative easing is the name for a transaction by a central bank using freshly created central bank money to buy up assets in financial markets.

repo-markets[2] and bond markets in 2019 and 2020, central banks have taken on a much more active role in offsetting and containing financial instability. This trend to an increasingly present role of central banks to contain and offset financial instability is universal among Western central banks. As these figures demonstrate, central banks in the last fifteen years have been engaged in a system-stabilizing role of historical proportions (Tucker and Cecchetti 2021).

In the context of this new historic function, the question arises as to how far central banks have been empowered to intervene ex ante in the structure of financial markets in order to prevent such episodes of financial instability, guiding financial practices "to reduce the likelihood that fragile situations conducive to financial instability will develop" (Minsky 1986, 358). This question poses itself in the context of a secular growth of financial markets, which since the financial crisis of 2007–8 has continued unabated rather than reversing itself, growing from 150 trillion dollars in

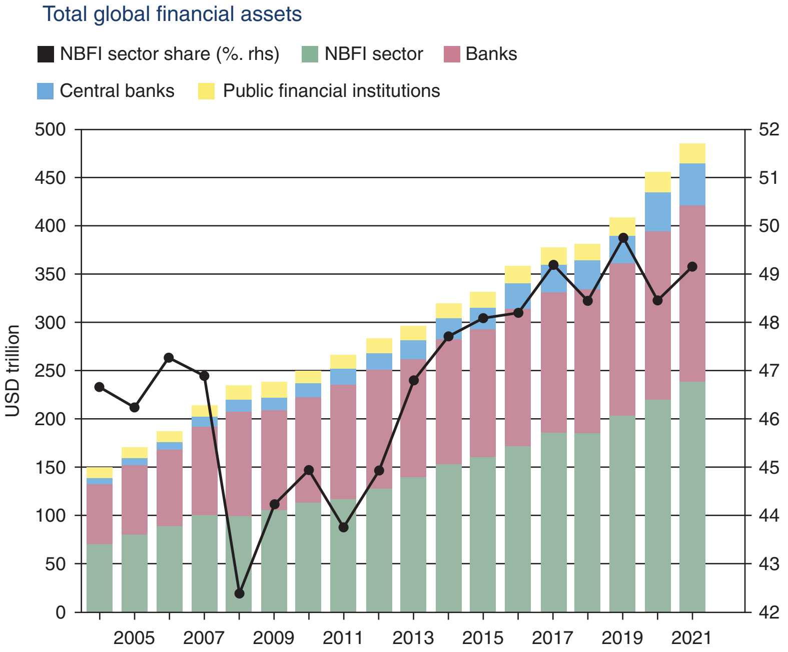

Figure 1.3 Growth of total global financial assets by sector (FSB 2022, 7).

[2] The repo-market is a secured short-term market for loans, mainly between banks, but also hedge funds and other financial market players (see Chapter 7).

2004 to 450 trillion dollars in 2021 (see Figure 1.3). And not only have total global financial assets tripled in the last eighteen years, they have also done so in a manner that has seen non-bank financial institutions grow more rapidly than the banking sector. Formerly known as the "shadow banking sector," these non-bank financial institutions that engage in bank-like activity are particularly prone to "bank-run dynamics" and hence financial instability. These developments hence make the capacity for such a preventive approach a crucial issue of our time.

The Rise of Macro-Prudential Policy

A policy program for such preventive action was introduced in the wake of the 2007–8 financial crisis, charging central banks and prudential authorities around the world with taking a systemic view on the financial system and installing macro-prudential regulation capable of preventing financial imbalances from rising to such a degree as to threaten financial instability (G20 2009a). Developing largely outside of the mainstream of Western regulatory thinking before the crisis (Borio 2003b), macro-prudential thinking experienced a sudden and unexpected rise after the failure of Lehman and the ensuing recession (Baker 2013a). Rhetorically embraced by the G20 at the 2009 summit as the political answer to the crisis (Lombardi and Moschella 2017), macro-prudential thinking was to complement the focus on the risk management of individual institutions of the micro-prudential approach. Employing a systemic view, it aimed to increase the resilience of the system as a whole and to lean against the wind as credit booms accelerate (Baker 2013a, b, 2014; IMF, FSB and BIS 2016), empowering macro-prudential central bankers to act as "a risk manager to the financial system" as a whole (Persaud 2014, 161).

Once agreed upon in 2009, this macro-prudential shift was presented by the G20 as the answer to the financial crisis, a necessary correction to a micro-prudential focus on banking institutions alone, which had failed to consider the larger changes in the financial system that had led to greater interconnectedness and hence greater fragilities. It furthermore had ignored the procyclical character of the financial system, which amplified a boom-and-bust cycle. In this vein, the prescriptions, much like the analysis of the financial crisis according to the official G20 discourse, were in line with Minsky's recommendations. In 1986 Minsky had already insisted that such preventive central bank action could no longer only be limited to banks and the setting of interest rates, but needed to include the money markets, which by then had taken on a large role in US financial capitalism (Minsky 1986, 359).

Macro-prudential regulation was hence supposed to extend beyond the realm of banking regulation and include the shadow banking sector, seeking to preventively reduce financial fragilities before they could threaten a systemic financial crisis. These actions were to limit the cross-sectoral fragilities, which had emerged from the increasing interlinkages of banks and non-bank financial institutions. They were also to limit the endogenous buildup of systemic risks over time, which in turn gave rise to the boom-and-bust cycles: the acceleration of asset prices in the boom phase followed by the quick deceleration of such prices in the bust (Borio 2009). Both tasks required a massive expansion of supervisory capabilities at central banks to enable them to analyze and capture the buildup of systemic risks that required macro-prudential intervention. They also required an increase in the coordination of supervisory tasks between central banks and market regulators to expand these macro-prudential regulations to shadow banks in capital markets, thus establishing, if possible, "prudential market regulation" (Tarullo 2015) that would limit the fragilities in that sector.

In short, what was required was nothing less than the buildup of an entirely new analytical and bureaucratic policy apparatus, implying a massive expansion of discretionary interventions by central banks to preventively ensure financial stability. To enact this, central banks had to not only generate a commonly agreed definition of systemic risks and the indicators to measure them but also agree on the macro-prudential policy goals they were to pursue and the macro-prudential toolkit best able to achieve them. Furthermore, they needed to set up monitoring frameworks in line with these decisions and decide if and under which conditions they were to activate the tools they had newly installed. All this occurred in the context of little academic guidance on these issues (Adrian 2018) and with little to no prior experience by Western central banks as to how such interventions should be calibrated (CGFS 2010b). The challenging tasks related to the set-up of macro-prudential regulation regarding concepts, measures, interventions and monitoring are depicted in Figure 1.4.

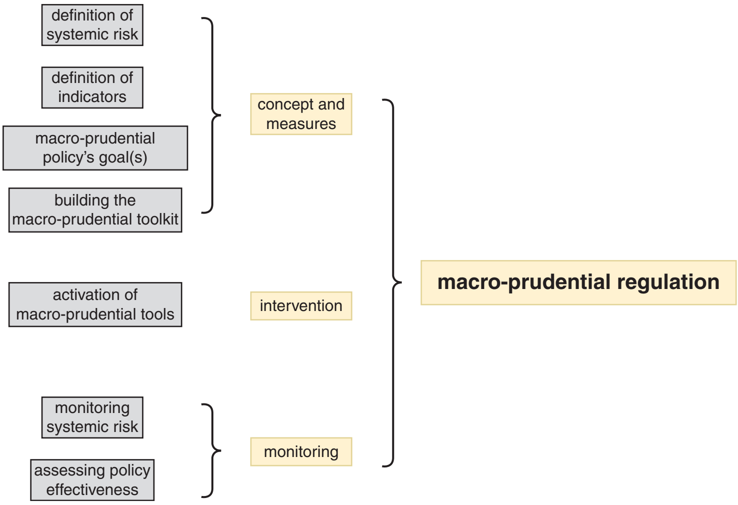

Figure 1.4 The components of the macro-prudential regulatory framework.

The Status Quo Crisis?

How far has this policy program, initiated after the 2007–8 financial crisis, transformed the financial system and its impact on capitalist economies? In particular, how far have post-crisis reforms reduced the procyclical character of the financial system, which has been characterized as a system of compounding bubbles, moving from boom to bust to the next boom (Blyth 2008)? Rarely if ever have the conditions for policy change been more favorable than after the complete failure of the pre-crisis policy paradigm governing financial markets (see, e.g., FSA 2009), as the huge costs of bail-outs and recessions caused by the crisis (Woll 2014) spurred a radical rhetoric by policymakers and politicians at the global level. Diagnosing the need for fundamental change to financial regulation, they were pledging to install the new macro-prudential paradigm to tame the financial cycles shaking the world economy (Moschella and Lombardi 2017).

And yet, despite the evident failure of the reigning policy paradigm (Langley 2014) and its subsequent disavowal by policymakers, the political science literature comes to a sobering assessment: rather than the radical transformation some had hoped for or expected

(Baker 2013a, b), the regulatory developments post-crisis are largely seen as incremental, engaging in paradigm repair rather than fundamental change (Kessler 2012; Mirowski 2013; Moschella and Tsingou 2013; Muegge 2013; Eichengreen 2014; Helleiner 2014; Gabor 2015, 2016a; Baker 2018; for an outlier, see Wilf 2016).

Categorizing the occurring regulatory changes post-crisis as a "status quo crisis" some identified the macro-prudential shift as a largely discursive branding exercise (Helleiner 2014) that led to little meaningful change. Even more optimistic observers, who acknowledged the potential for paradigmatic change inherent in macro-prudential regulation (Baker 2013a, b), were sobered by the limited institutional change following the "grandiose" announcements by the G20 (Baker 2013c). They soon came to see the actually implemented measures as too weak to actively manage the cyclical tendencies of the system (Baker 2018). Whereas initial discussions were structured around the question whether macro-prudential regulation could save the "neoliberal growth model" of Anglo-Saxon capitalism (Casey 2015) or whether it fundamentally contradicted it (Baker and Widmaier 2015), subsequent research saw little in terms of path-breaking regulatory changes (Baker 2018), a finding that was linked to the adverse selection of radical ideas in a context that favored the interests of financial capital (Underhill 2015). Based on a binary logic of either a full paradigm shift or no paradigm shift at all, the political science literature largely sided with the no-paradigm-shift interpretation, thus seemingly closing the subject.

This stance, I argue, is premature as it pays insufficient attention to the different temporalities inherent in the maturation process of new regulatory frameworks (cf. Braun 2014). Meaningful policy change requires a translation from ideas to new policy devices to policy frameworks in action, and this takes time (see also Kaya and Reay 2019). By treating the macro-prudential framework as a full-fledged policy paradigm from its inception, these analyses overlook the immense efforts of applied central bank economists necessary to transform a set of loose discursive commitments into a viable policy framework. The central dynamics of this process remain hidden to date as most analyses have focused on the discursive commitments to the new macro-prudential approach at the top of the political and technocratic levels (Baker 2013a, b, 2015) and their limited translation into new policies (Stellinga and Muegge 2017; Stellinga 2019).

These analyses, however, neglect the substantiation of these discursive commitments through the practical work of applied economists over time and its effects.

Fragmented Policy Change: Actionable Knowledge and the Enactment of a Policy Program

This book seeks to provide a more nuanced understanding of the effects of macro-prudential reform efforts by "following the practical life of ideas – the messy and material process of their production and circulation" (Best 2020, 596). It emphasizes that a central pillar in the strength of policy paradigms resides in the socio-technical policy devices that policymakers use to perceive the issues they want to govern and that help them choose their preferred way to act (Hirschman and Popp-Berman 2014). It is these models, systems of risk measurements and their metrics (such as early warning systems) – embedded in the routine of policymaking – that have undergone tremendous development over the last fifteen years. The binary approach to policy change risks missing these substantive changes, not in the least in the outlook of central banks on financial markets, as encapsulated in the newly installed macro-prudential monitoring frameworks. In contrast to the pre-crisis period, these metrics now clearly signal the buildup of cyclical systemic risks in financial markets, standing in potential contradiction to existing regulatory measures and pushing for anti-cyclical regulatory measures for central banks and others to enact.

In order to capture these tensions and provide a more detailed view of the macro-prudential regulatory movement and its effects, the book employs the concept of "fragmented policy change" (Kaya and Reay 2019). This allows us to see substantial and rapid changes in some areas, such as the ideational underpinnings or institutional set-ups of regulation, whereas other areas see limited or no change (Kaya and Reay 2019, 386). It thereby pays attention to the different spatial and temporal dynamics inherent in the maturation process of new regulatory frameworks in different jurisdictions (cf. Braun 2014), from ideas to new policy devices to policy frameworks in action (see Kaya and Reay 2019). Such a different perspective allows us to identify the changes that have occurred without dismissing them ex ante as nonimportant, pointing to the potential buildup of contradictions between the knowledge base of regulation on the one hand and the regulatory action it incites on the other. It also allows for an identification of the structural obstacles that prevent the macro-prudential approach from coming fully into its own. Such an assessment of change thus acknowledges the analytical and operational work by central banks over the course of the last fifteen years in making such a macro-prudential framework work, all the while remaining alert to its current shortcomings in terms of policy implementation.

To provide such an assessment, the book is based on the viability framework of economic ideas as developed by Hall (1989b). He distinguishes between the economic, bureaucratic and political viability of economic ideas to understand how such "new ideas acquire influence over policy-making" (Hall 1989b, 362) and why their spread and implementation differ across jurisdictions. Based on a careful study of the spread and ascendancy of Keynesian macroeconomic ideas in the wake of World War II, Hall maintained that economic ideas do not only need to be seen to convincingly address the contemporary economic problems in order to become politically powerful (economic viability). They also need to be in line with the "long-standing administrative biases of the officials responsible for implementing [policy]" (Hall 1989b, 371), as well as the structural capacities for implementation (bureaucratic viability). Lastly, they need to be politically viable, appealing to the "interests of the political entrepreneurs who would have to put them into action" (Hall 1989b, 375) and potential coalition partners, which could forge an alliance strong enough to implement these ideas (political viability).

This book enriches this approach with social-constructivist understandings of the role and power of economic ideas. These understandings point to the hidden "politics" of economic ideas within technocratic institutions (Clift 2018, 2019) and the preconditions that such ideas need to fulfill in order to be accepted and used in policymaking. Most importantly, to be turned into practice, such ideas needed to be translated into actionable knowledge and take the shape of "policy devices," which allow policymakers to see, observe and intervene in economic affairs (Hirschman and Popp-Berman 2014). Before such ideas could be acted upon, they needed to be hardened by the epistemological assurances technocratic policymaking requires, generating credible "risk objects" whose behavior is sufficiently understood in order to justify technocratic intervention. It is at this level that this book identifies the greatest change, observing the work of applied economists within central