Taming the Cycles of Finance?

Macro-prudential regulation is a set of economic and policy tools that aim to mitigate risk in the financial and banking systems. It was largely developed in response to the financial crisis of 2007–8, turning central banks into de facto financial police officers. *Taming the Cycles of Finance?* traces the post-crisis rise of macro-prudential regulation and argues that, despite its original aims, it typically supports finance in times of crisis but fails to curb it in times of booms. Investigating how different macro-prudential frameworks developed in the UK, the USA and the Eurozone, the book explains how central bank economists went about building early warning systems to identify fragilities in the financial system. It then shows how administrative and political constraints limited the effects of this shift, as central banks were wary of intervening in a discretionary manner and policymakers were opposed to measures to limit credit growth.

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Central Banks and the Macro-prudential Shift in Financial Regulation

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Contents

Figures

Tables

Prologue

In the last fifteen years, Western societies have learned about the fragility of finance the hard way.[1] Few if any today would doubt the statement that financial markets are inherently fragile and that stability might give way to sudden and unexpected fluctuations, which in turn might lead to bank-runs and panics. And few if any would doubt that such ructions in the financial system could spill over into the "real economy" of production, employment and income. In that sense, the transatlantic financial crisis of 2008 and the subsequent reverberations have generated a deep public distrust in financial markets, leaving us to ask policymakers to protect us from financial instability. And, indeed, central banks around the world today hold a more or less explicit financial stability mandate, pledging to intervene should such dynamics threaten to unfold.

At the same time that we have become convinced of the dangers inherent in finance, every year we observe the expansion of finance – of debt obligations both traded in financial markets and held on the balance sheets of financial institutions. And not only that; from 2015 onwards we have observed the continued rise of house prices, the increase of mortgage volumes, the increase in indebtedness of both private households and corporations – in other words, an increase in the same debt obligations we have become convinced carry with them the possible grains of future destruction. How, in such a world of ever-rising debt and fragile finance, one might ask, could we argue that we have learned anything at all from the events of 2008? What, if anything, did we learn? And if we learned something, what measures did we take and why do they translate into such an unhemmed expansion of finance?

1 These lessons were already learned several decades ago in developing countries, with the frequency of financial crises increasing markedly from the 1980s onwards (Kaminsky and Reinhart 1999).

These are the questions this book sets out to explore. It does so by following the policymakers that were charged with learning the lessons of the crisis and their attempt to translate a new idea set into practical policy devices, which could allow for "taming the cycles of finance." Localized mostly within central banks, these technocrats aimed to reconfigure the financial system and to build the early warning systems that could allow discretionary intervention ahead of disaster unfolding, limiting the damages finance could generate in the downswing. Tracing and telling this story, this book brings into relief the creative practical agency of these groups, which belie the accusation of the "nothing has happened" and "nothing has changed" accounts one so often hears. Yet, while showcasing the production of a set of policy devices in central banks these applied economists generated, the book at the same time tells a story of mostly political defeat, incremental change and limited regulatory successes, which seem so disproportionate to the growing volume of financial assets circulating in the global financial system.

So, then, has all this activity been in vain? Were all the conferences on financial stability, all the hard work on assembling large-scale data sets and "making the data speak," conducted for little purpose other than to keep technocrats busy in their pursuit of careers within central banks? Such a statement seems unjust and also very much contradicts our understanding of knowledge production and its effects. Today's world has a much clearer, better-documented and better-theorized understanding of financial instability, which will make claims of surprise the next time disaster strikes largely non-credible attempts at cover-ups, hence easily discerned as efforts to protect the status quo from increasing regulatory interventions.

Yet, if such knowledge exists within technocratic circles in central banks, then what is holding this knowledge back from becoming performative, actively curtailing the expansion of fragile finance? As this book will seek to show, it is the manner in which this knowledge is applied in the realm of regulatory debates, where concerns over the buildup of risks requiring action are separated from mere hypothetical yet unproven dangers, that is limiting its potential. In this realm of "regulatory science," regulators are facing a very high burden of proof to show the dangers inherent in finance before any regulatory action is taken. What I will show is that during these debates, again and again, their concerns based on the causal understandings of inherent financial fragilities are transformed from programs of action into programs of research, asking for definite evidence before any action can be undertaken. It is this modus operandi of financial regulation, which is sustaining and sustained by the power of finance, that is holding back the translation of new knowledge into action. Evidence-based policies have become a mainstay of our democracies, seeking to protect citizens from unwarranted statist interventions, yet the manner in which this form of policymaking plays out currently is protecting finance and its expansion. Such a burden of proof is required both to convince skeptical regulators, adherent to different understandings of the world, and to overcome the resistance by finance, entrenched as these understandings are in the circles of policymakers.

At the same time that these technocrats face this daunting task of overcoming the power of finance to resist regulation, their newly gained understanding of the dangers of finance and the policy devices created to showcase pending dangers become tools in the emergency lending operations of central banks, enacted to prevent these deleterious dynamics of finance from unfolding. In this way, the technocrats of financial stability with very limited capabilities and mandate to intervene in the procyclical upswings of finance have become the guardians of financial stability in the downswing, cushioning any disruptive developments that might transpire in the financial system.

Through these now seemingly perennial actions of market-makers of last resort, which provide financial systems with a liquidity backstop, central banks in their interventions validate the fragile financial structures responsible for the threat of systemic illiquidity, furthering the expansion of finance rather than limiting it. In this sense, the technocrats of financial stability, much to the contrary of what they might have desired, become stabilizing agents of the ever-continuing expansion of finance. Rather than taming the cycles of finance, they install an asymmetric regime in which the procyclical dynamics of finance are mitigated in the downswing but are largely left unchecked in the upswing.

For this state of affairs, we cannot solely blame them, given the structural situation they were facing since 2008. Seeking to bring about change based on their new macro-prudential mandate, they were confronted with skeptical market regulators and financial market operations departments in central banks busy with nothing else but keeping the financial system afloat (in particular in the Eurozone). They hence often found their efforts hemmed in by the need for coordination with other actors less willing and convinced of the need to act, by the lack of data to prove their point and by the dependence of political systems on the ever-flowing production of credit. These context conditions made their proposed constraints based on their newly won economic expertise hardly viable in terms of bureaucratic and political action. The goal of this book is not to decry their failure but instead to depict their work and point to the situation within which the expertise they developed over the last fifteen years cannot but largely be impotent. If anything, it is an attempt to contribute to a change in this situation by politicizing the status quo and empowering these agents seeking to act upon the excesses of finance and to reduce the systemic risks central banks have to face in their daily work.

Acknowledgments

This book is the outcome of a ten-year journey. I had finished my dissertation about the growth of shadow banking in Europe in 2012 when I was struck by the importance of economic concepts such as the notion of liquidity for the configuration of financial regulation post-crisis. I hence decided to embark on a study almost in real time of the ideational changes the financial crisis brought about and their impact on actual regulation. I could not have begun this journey at a better place than Frankfurt, with the Bundesbank and European Central Bank around the corner and the Center for Sustainable Architecture for Finance in Europe on-campus at Goethe University Frankfurt. It was there that I encountered many of the financial economists working on the topic who took the time to talk to me about their research, most notably Jan-Pieter Krahnen and Loriana Pellizon. There were also (former) practitioners, such as former Vice President of the Bundesbank Hans Helmut Kotz, responsible for financial stability at the Bundesbank, who was central in orienting my first steps. I would like to thank them very much for the deep insights they provided, as well as the more than eighty practitioners of financial regulation, central bankers and economists who shared with me their time and understanding of contemporary regulatory dynamics.

Equally important were the exchanges and engagement with academic colleagues, first at Goethe University Frankfurt and then in the broader context of the German scene working on the sociology of economics and financial regulation. Here, the deeply insightful Mohamed Aldegwy, humble and erudite, was a great inspiration. Colleagues such as Daniel Mertens, Andreas Noelke and Patrick Sachweh always had an open ear, willing to listen and engage. Most important, though, was a group of young MA and doctoral students, willing to engage this vast topic with me and nurturing the effort with their enthusiasm and curiosity: Marius Birk, Vanessa Endrejat, Jan Friedrich, Edin Ibrocevic, Max Nagel and Slavek Sivagrakau (now Roller), many of whom became my coauthors and good friends. Without their tireless work, much of this book could not have been written.

The project moved to a new level thanks to a semester stay in spring 2017 at the Institute for Advanced Studies in Paris, a setting that provided the calm for contemplation as well as the pleasure of intellectual engagement with other fellows from disciplines far from my own. From there, I moved to Sciences Po, Paris in fall 2017 where I encountered a group of colleagues who were both supportive and challenging. Cyril Benoit, Patrick Le Gales, Colin Hay, Laura Morales, Bruno Palier and Cornelia Woll were always listening and providing thoughtful feedback, while also pushing me to finish the project. A first version of this book was defended as my habilitation in June 2020, in the midst of COVID-19 via Zoom, with internationally renowned colleagues Ben Clift as well as Bruce Carruthers providing additional feedback. Further feedback was provided by Cornel Ban, Nathan Coombs, Len Seabrooke and in particular Bart Stellinga, who has proven to be an indefatigable conversation partner on these issues.

In addition, I would like to thank the anonymous reviewers who commented on the manuscript and on papers that provided an initial foundation for this book. Their insightful, often challenging feedback has helped me to further sharpen my arguments. Chapter 5 draws on ideas first presented in "Is Resilience Enough? The Macroprudential Reform Agenda and the Lack of Smoothing of the Cycle," which appeared in *Public Administration* 97 (2019) (pp. 561–575), while Chapter 7 draws on joint work with Marius Birk and Jan Friedrich, which was published in 2018 as "Much Ado about Nothing? Macro-Prudential Ideas and the Post-Crisis Regulation of Shadow Banking," in *Koelner Zeitschrift fuer Soziologie und Sozialpsychologie* 70 (pp. 259–286). Chapter 10 draws on a paper that appeared in 2021 under the title "The Asymmetric Relationship of Central Banks to Market-Based Finance: Weighing Financial Stability Implications in the Light of Covid Events" in *Revue d'economie financiere* 144 (4) (pp. 191–201).

Lastly, my thanks go to my family. In particular during the COVID-19 lockdowns, my family more than ever became the backbone of my work, keeping me sane in somewhat frightening circumstances. My parents Martina and Wolfgang, my brothers André and Stephan and in particular my sister Anna allowed me to maintain a notion of normalcy, even if we were only connected via Zoom. Alina, my wife, was my rock during this time and provided me with the calm and determination to see the project through, and without her understanding and encouragement this book would not have seen the light of day. At the same time, my kids Karl and Katharina adapted as well as possible to the new situation and showed understanding for my leaves of absence in my office. I dedicate this book to them, hoping that the next years of this decade will be less tumultuous than the first three.