THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

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Decision-making and Policy Change in the Global Financial Crisis

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LEQS Paper No. 04/2009

May 2009

LSE Europe in Question
Discussion Paper Series

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Crisis: . . . 3. A vitally important or decisive stage in the progress of anything; a turning point; also, a state of affairs in which a decisive change for better or worse is imminent; now applied esp. in times of difficulty, insecurity, and suspense in politics or commerce.

Oxford English Dictionary (1971: 1178)

Is the identification of a situation as one of crisis an objective, analytical, or even empirical claim or does it necessarily imply a subjective and hence normative judgement? Should we define crisis in terms of objective factors such as the 'weight' of contradictions within a given system or in more subjective terms such as the perception of the need for rapid and decisive intervention in the context of widely experienced political and economic contradiction?

Colin Hay (2001: 203)

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1. Introduction

The cluster of economic problems that emerged from and surrounded the growing defaults in United States sub-prime and Alt-A mortgage lending markets is widely regarded as a 'crisis'. Some have even gone so far as to say that this is the worst economic crisis since the 1930s. But is it a crisis because in some real-world sense it threatens to take down the global financial system, or is it a crisis because policymakers in the United States and elsewhere finally decided it is time to make a 'decisive intervention' in the markets?

The distinction here is important. If we side with the real-world interpretation, then the timing of events is exogenous and the policy response is endogenous. Policymakers really have to do something to stop the situation from getting out of hand or else all hell will break loose. If we come down on the 'crisis as narrative' side of the question, then the policy response is exogenous and the timing endogenous. Some clever policy entrepreneur finally succeeded in convincing policymakers to accept her view of the situation and so convinced them that now is the time to act.

In general terms, Colin Hay argues for the crisis-as-narrative view (Hay 1994, 1996, 1999, 2001). Although he acknowledges that actual events may make it more likely for a crisis narrative to emerge, he regards material conditions as 'at best a necessary but *insufficient* condition for such an intervention' (Hay 2001: 203, emphasis in original). His stated objective is to force us to re-examine the importance of policy ideas and ideational contestation to the process of institutional change. In turn, this should move us away from an historical institutionalist view of change that seems to imply that policy paradigms or ideologies are introduced instantaneously and fully-formed (Hay 2001: 212-213).

There is obvious merit to Hay's general concern to underscore that 'the institutionalization of a paradigm within the state apparatus and the translation of that paradigm into policy are protracted, unpredictable, and often contested processes' (Hay 2001: 213). What is less obvious is how this justifies the elevation of narrative over material concerns. On the contrary, it is far easier to understand the protracted, unpredictable, and often contested process of policy development as part and parcel of the struggle to assert control over events in the material world.

The struggle to master events in the real world is particularly obvious when looking at the financial crisis that has been unfolding since August 2007. There are many narratives that surround why this is happening but their influence on policy has been at best inconsistent. The narratives used by policymakers have been determined by events rather than the other way around. Consider Alan Greenspan's testimony before the Congressional Committee on Government Oversight and Reform:

> It was the failure to properly price such risky assets that precipitated the crisis. In recent decades, a vast risk management and pricing system has evolved, combining the best theoretical insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize was awarded for the discovery of the pricing model that underpins much of the advance in derivatives markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year . . . (Greenspan 2008: 3).

If we take Greenspan at his word, the crisis is material and not narrative – events have shaped the story rather than the other way around. Moreover, the distinction is non-trivial. Greenspan's implied emphasis on the empirical basis of the current crisis is important for at least two reasons. First, it underscores the relationship between policy actions and real world outcomes. Politicians and policymakers can have important normative debates about where the priorities for action should lie. But before they can go down that road (and even in the absence of political conflict) there is a real-world question to be answered about what will be the effect of a policy action – and, by extension, whether that effect will be sufficient in material terms to bring the crisis to an end. By placing too much emphasis on narrative over material conditions we run the risk of losing sight of the fact that policies should work – meaning have some material impact – and yet often do not. Even Nobel-prize winning stories about how markets function can suddenly come up short.

The second reason for stressing material rather than narrative forces is to avoid the fallacies and anachronisms associated with what Herbert Butterfield (1931) has immortalized as *The Whig Interpretation of History* – reading the past in light of the present. For example, Hay takes the future of the past as given when he asserts that:

> Crisis can thus be seen as a *process*; a process in which the tendential unity of the state is discursively renegotiated and potentially (re-)-achieved as a developmental trajectory is imposed upon the apparatuses and institutions which comprise it. Crisis is a process in which the site of political decision-making shifts from the disaggregated institutions, policy communities, networks and practices of the state apparatus to the state as a centralised and dynamic agent. The state is constituted anew through crisis (Hay 1999: 338).

It is hard to see how contemporary actors would recognize themselves in this process or whether they would agree with his characterization of its inner meaning. More likely, they would see themselves as struggling to keep their fingers in the dike while looking around to find something more permanent to plug the holes. As United States (U.S.) Treasury Secretary Hank Paulson (2008) put it when forced to explain his changing position on the use of funds under the Troubled Asset Relief Program (TARP): 'We adjusted our strategy to reflect the facts of a severe market crisis, always keeping focused on our goal: to stabilize a financial system that is integral to the everyday lives of all Americans.' Writing amidst a major crisis – when the past is the present, so to speak – it is easier to recognize how much the narrative of crisis, and the authors of that narrative, are driven by events on the ground.

This paper develops an argument about the material basis for the ongoing financial crisis in three sections. The first sets out different models for policy change and sketches a procedure for telling them apart. The second applies the procedure for choosing between the models using the information we have available about the ongoing financial crisis. The third section extends the argument to more general claims about the importance of experiential learning for the policy process.

2. Characterizing Policy Change

Like any analytic concept, it is possible to assign many specialized meanings to the word 'crisis'. All such assignments have their uses, none constitutes the essential characteristic or 'true' meaning of the word. For my purposes, I adopt a common-use definition similar to the one provided by the Oxford English Dictionary and given at the outset of this paper. The crux lies in the notion that change is imminent. If things can continue as they are, there is no crisis. If they must change, there is. Of course since we have human agency involved, we could also add a layer of perception – meaning narrative, probability or intuition. If policymakers think, estimate, or believe that things cannot continue as they are, then there is a crisis. If they do not think, estimate, or believe that change is imminent, then there is not.

That addition of human agency is where the problem begins. Once we start to define crisis in terms of thoughts, estimates, or beliefs, we expose ourselves to the central role of ideas. Human agents cannot think without ideas, they cannot estimate without models, and they cannot believe without conviction. On a basic level, we have to admit that ideas are central to human agency. If human agency is essential to our understanding of crisis then ideas – narratives, stories, what have you – are central to that understanding as well.

This leaves us in a chicken-and-egg situation. Do we focus on the ideas and endogenize human agency or do we focus on our human agency and endogenize ideas? Is the argument that any political leader would have responded in that fashion given the state of the art in policymaking at the time, the advice that was available, or the ideational entrepreneurs who dominated the scene? Or is the argument that these particular leaders were instrumental in promoting this specific policy response and without their presence the outcome would have been very different?

The literature contains examples to suit any response. Although I doubt he would agree with my characterization of his work, Andrew Moravcsik's (1998) *Choice for Europe* would set one end of the spectrum, where policymakers are bound to a course of action dictated by prevailing perceptions of the national interest. By contrast, Craig Parson's (2003) *A Certain Idea of Europe* would lie at the other end of the spectrum, where policy makers are essentially ideational entrepreneurs. Kathleen McNamara's (1998) *Currency of Ideas* fits somewhere in between the two; circumstances conspire to constrain the scope for policy alternatives, but there is still room for individual choice.

The symmetry of this array is beguiling – not least because it omits the possibility that the material conditions underlying perceptions are actually running the show. Despite the weight of professional opinion, the lobbying of vested interests, the skill and access of ideational entrepreneurs, and the pre-commitments of the flesh-and-blood agents in power, the policy adopted in a given context is determined by what actually works to change the otherwise unsustainable situation in the real world. Obviously, this possibility is fraught with difficulties. Someone has to recognize that the situation is unsustainable, someone has to propose the new policy, someone has to approve it, someone has to implement it, and someone has to assess (and accept) the results. Like it or not, there is bound to be a communication of ideas taking place. Nevertheless, it should be possible to distinguish between different causal trajectories where ideas have differing levels of importance.

At this point it is useful to pull together assumptions into ideal types as a first step in the construction of characterizations for different patterns of crisis-response. Since the goal is to model policy change, the two questions to consider are: Is the stimulus for action material or is it ideational? Is the response mechanical or is it deliberate?

- **Cybernetic** – If the stimulus is material and the response is automatic, then the pattern for policy change is cybernetic and ideas are only important insofar as they relate to the design of the switching mechanism (Steinbruner 1974).

- **Empirical** – If the stimulus is material and the response is deliberate, then the pattern for policymaking is empirical. Policy change takes place because the automatic warning lights flashing in the real world indicate that something is wrong and it continues until the change in material conditions is such that those lights stop flashing. Here ideas are important in the design of the warning mechanism (as in the cybernetic model) and also in the efforts of policymakers to make sense of what is happening in the real world. This is the classical scientific world of Kuhn (1970) as described by Hall (1993).

- **Narrative** – If the stimulus is ideational and the response is deliberate, then the pattern for policymaking is narrative in the sense that policy change is optional and takes place only once human agents are committed to a particular course of action. Moreover, policy change continues so long as the new course of action promises to address the reasons for change and to provide advantages over the plausible alternatives. Here ideas play a vital role in the commitment of human agents that change is necessary and that a particular course of action is the most desirable (Blyth 2001, 2002).

- **Ideological** – If the stimulus is ideational and the response is automatic, then the pattern for policymaking is ideological (or tautological) in the same way that a computer program can simulate the behavior of complex systems according to predetermined rules. Here ideas permeate every aspect of the policymaking process because they constitute the socially constructed reality (or simulcra) within which policymaking takes place. In methodological terms, this pattern hews closely to the neo-Gramscian approach (Bruff 2008).

Figure 1: Four Models for Decision-making under Crisis

		Response Mode	
		Mechanical	Rational
Cause or Stimulus	Material	*Cybernetic*	*Empirical*
		Ideological	*Narrative*

The cybernetic and ideological models for policymaking are interesting, but less obviously relevant to the contemporary debate. We have seen cybernetic systems for economic policymaking in the past – as in the classical Gold Standard or the Bretton Woods System – but the cybernetic approach seems less applicable today. Indeed, what is striking about the present situation is the extent to which the policy apparatus has frozen up rather than swinging into action. The ideological model is also not relevant. Rigidly ideological communism has all but vanished, at least in the policy domain. As for ideological market liberalism, most observers agree that is now to a greater or lesser extent socially embedded (Ruggie 1982). Where it does exist, there is less reliance on market liberalism for policy guidance than there is conviction that something about market liberalism must have failed. Here again it is useful to cite Alan Greenspan's recent testimony before the U.S. Congress:

> I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such is [sic] that they were best capable of protecting their own shareholders and their equity in firms . . . . So the problem here is something which looked to be a very solid edifice, and, indeed a critical pillar to market competition and free markets, did break down. And I think that, as I said, shocked me. I still do not fully understand why it happened and, obviously, to the extent that I figure out where it happened and why, I will change my views. If the facts change, I will change. (Hearings 2008: 34-35 [lines 768-772 and 780-786]).

We can set aside the cybernetic and ideological patterns in the current context, but that does not make it any easier to distinguish between the empirical and narrative alternatives. Both models involve choices made by sentient (or thinking) individuals who operate in some kind of institutional or social context. Ideas and human agency are inseparable in this regard and so it is as likely that the facts changed and so Greenspan changed his mind, as it is that Greenspan changed his mind and so went out in search of different facts. Indeed, he may not have changed his mind as much as we might think (or he might suggest). Completing the sentence from the first Greenspan citation given above:

> The whole intellectual edifice, however, collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Had instead the models been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today, in my judgment (Greenspan 2008: 4-5).

3. Fitting the Evidence

We need a testing strategy for recognizing meaningful distinctions between the different models. I propose to focus on four characteristics, each of which can assume one of two possible values. These characteristics relate to the nature of the triggering event, the timing of the response, the strategy for policy evaluation and the structure of any resulting evolution over time. Specifically, my interest is:

- whether the trigger is objective or subjective – does the event require perception to have an impact?;
- whether the response timing is automatic or deliberate – do policymakers have to decide on a response?;
- whether the evaluation is end-based or rule based – do results matter more than process?; and,
- whether the policy is adaptive or pre-determined – what is the balance between discretion and path dependence once a particular response is in train?

In focusing on these questions about characteristic features, my prior is that all of the patterns or models have elements in common but each is distinct in its combination of features. For example, the cybernetic and empirical models have objective triggers while the triggers for the narrative and ideological models are subjective. By contrast, where the response timing in the cybernetic and ideological models is automatic, the response timing in the empirical and narrative models is deliberate. Evaluation in the cybernetic and empirical models is based on outcomes; evaluation of the narrative and ideological models are based on adherence to process or rules. Finally, while policy evolution in the cybernetic and ideological models is strongly process-driven (and therefore predetermined or path dependent), the empirical and narrative models are adaptive and the solutions they offer can change significantly over time.

Figure 2: Four Characteristics for Decision-making Models

Characteristics	**Models**			
	Cybernetic	*Empirical*	*Narrative*	*Ideological*
Trigger (objective / subjective)	Objective	Objective	Subjective	Subjective
Timing (automatic / deliberate)	Automatic	Deliberate	Deliberate	Automatic
Evaluation (end-based/ rule-based)	End-based	End-based	Rule-based	Rule-based
Evolution (predetermined / adaptive)	Predetermined	Adaptive	Adaptive	Predetermined

By organizing characteristics in this way, we can generate possible tests about how crisis-response models will manifest in terms of the historical record. For the present case, we should focus on those points of difference between the empirical and narrative models – the nature of the trigger and the basis for policy evaluation. Two questions are relevant:

- Can we find evidence to suggest that something bad would have happened even if none of our policymakers recognized its significance?

- Do we have reason to believe that the situation could worsen no matter how confidently, convincingly, or consistently our politicians claim to have mastered events?

The only way to answer these questions is to introduce some economic data and to connect that data to the record of events.

3.1. The Trigger – Objective or Subjective?

Most analysts agree that the root cause of the current financial crisis can be found in a combination of three factors.

- The first factor was the large-scale creation (origination) of sub-prime and alt-A mortgages in the United States that were in turn chopped up and repackaged in the form of collateralized debt obligations and other asset backed securities to be sold on to investors who were unconnected to the mortgage origination process, thus providing more cash for new mortgages.

- The second factor was the inappropriate risk-rating of these mortgage backed securities and the growing availability of over-the-counter quasi-insurance cover against default risk in the form of credit default swaps. The poorly rated securities looked like good deals for large investors with access to cheap credit and the ready availability of credit default swap protection made it more attractive for banks to provide cheap credit to large investors.

- The third factor behind the financial crisis was the fact that the compensation schemes used across the industry – from the bounties given to mortgage brokers, to the haircuts earned by the people who repackaged the mortgages into securities, to the fees charged by rating agencies and asset portfolio managers, to the bonuses paid to bank executives – created perverse incentives for each of these different sets of actors to disregard or downplay the risks they faced. Meanwhile, the risks continued to mount as more sub-prime and alt-A mortgages were originated and pushed into the wider financial system.

Borrowing again from Hay, this was a heavy 'weight of contradictions'. It was not, however, a crisis. The crisis came when people started to default on their mortgages. These defaults were most evident in the sub-prime category as a percentage of value. But they were also important among alt-A and prime mortgages, which were less likely to go under in percentage terms but which were much larger in terms of absolute values (IMF 2008: 12).

This rise in defaults across all mortgage types presented a number of different problems given each of the three factors listed above.

- First, as mortgage defaults and delinquencies start to rise, this put downward pressure on house prices – because repossessed homes sell at a deep discount and because homeowners who default on their mortgages drop out of the housing market. The effect tended to be localized. It was nevertheless important because the distribution of sub-prime mortgages was localized as well. As a general rule, sub-prime mortgage lending concentrates either in areas where household incomes are universally low (which makes sub-prime mortgages the only route to home-ownership) or in areas where house prices rise quickly enough that the appreciation in nominal home values makes the high cost of borrowing at sub-prime seem worthwhile. When house prices start to fall in those areas where mortgages are most risky, homeowners who are already stretched financially face the prospect that they will not be able to refinance their mortgages or sell out without finding themselves with negative equity, meaning they would owe money to the bank at the end of the process. Hence they become more likely to default as well.

- Second, the rise in mortgage delinquencies and defaults cut into the value of the mortgage backed securities and so their prices fell. This happened initially in those securities that were most dependent upon sub-prime mortgages and then spread to other instruments (IMF 2008: 13). In turn, investors who held those securities found themselves short of collateral relative to the loans they had taken out to buy them in the first place and so faced bank-initiated margin calls. This forced them to sell some or all of their investments in a declining market, further pushing down prices – not just for mortgage backed securities but for other financial instruments as well.

- Third, the combination of mortgage write-downs and margin calls began to put downward pressure on market prices across the board. Shares in financial industries were particularly vulnerable. To begin with, these industries were themselves large investors and so faced direct losses related to the decline in value of mortgage backed securities. Even if they were not directly exposed, they were indirectly vulnerable because they were the ones who made the loans – either to large investors who were taking direct losses or to other financial firms that were losing directly, indirectly, or both. Finally, financial firms were the ones who held most of the instruments used to swap protection against credit default. As the crisis worsened, these instruments not only lost value but also made the firms liable to pay default protection, given up their own cash to cover the loses incurred by someone else.

The crisis emerged when all these forces combined to cause a seizure in the interbank lending market in August 2007 (IMF 2008: 3, 78). As a result, the cost of borrowing on the interbank market suddenly shot up and the possibility of borrowing in any quantity was not guaranteed. Indeed, many banks simply stopped lending to some other banks altogether. This played havoc with those banks that depended upon the interbank market to meet their day-to-day liquidity requirements – like the British regional bank, Northern Rock. Once it became known that the Northern Rock would have to depend upon the Bank of England for its liquidity, depositors queued up to withdraw their funds and the government had no choice but to step in.

From this description, it is hard to come to the conclusion that the financial crisis is more about perceptions (and narratives) than reality – at least insofar as the perceptions of policymakers are concerned. Market perceptions may be a different matter. To be sure, banks stopped lending to one another for a reason. Depositors staged a run on the Northern Rock for a reason as well. Ideas about solvency and loss clearly played a role in the sudden tightening of the interbank lending market. But these ideas had less to do with any deep understanding of the crisis than with the fear that events were moving outside understanding altogether. The freeze in interbank lending had less to do with credit constraints (the lack of money in the system) than with counter-party risk (the fear that you would not get your money back). Banks simply did not know what was on the balance sheets of potential borrowers and so could not assess their creditworthiness. Rather than gamble on the outcome, they choose to hold onto their cash.

The August/September 2007 crisis was a classic moment of Knightian uncertainty – where probabilities could not be calculated because the data did not fit with the available models (Knight 1964). This uncertainty was not read into the situation. It emerged from the confluence of material forces at play. The crisis was not part of a narrative. As the Greenspan quote above suggests, the crisis came when the narrative broke down.

3.2. Evaluation – End-based or Rule-based?

At this point it is reasonable to agree with writers like Blyth (2002: 35-37) that only ideas can lead you out of a situation of Knightian uncertainty. If you do not have any idea what is happening and someone tells you to do something, your first consideration would be 'why?'. But that would be the case under any circumstance. Purposive action requires a purpose and – to be meaningful – that purpose has to be understood. The more interesting question concerns how long the link between action and purpose can be maintained. Fool me once, shame on you. Fool me twice, and you have to consider why I am so easily fooled.

Blyth (2002: 34-44) has a five-part theory for how the link between purpose and action can be maintained. First, ideas help to create certainty in crisis – they tell you what to do when the old formulas for policymaking no longer seem to apply.

Second, these same ideas become the focal points for collective action by helping individuals to understand their role in any division of labor as well as their stake in the final outcome. Third, these ideas go on to provide a blueprint for the transformation of the prevailing (or pre-existing) institutional environment, telling actors how to make existing endowments conform to new circumstances. Fourth, ideas stimulate the creation of institutional arrangements that are entirely innovative. Finally, ideas can ensure that interests and expectations conform to the new (and newly reformed) institutional framework.

There are two ways to read Blyth's argument – one trivial, the other novel. The trivial reading is as a description of human agency at work. If humans can only act purposively with some idea in mind, then Blyth's framework is just a litany of the different types or manifestations of human action. The novel interpretation is that Blyth reveals the extent to which human agency is guided by ideas – ideas which possess autonomous causal significance insofar as they not only tell us what to do, but why it is in our interests to do so and, indeed, what those interests are in the first place. Here it is useful to quote at length from another of Blyth's works on the subject:

> Such ideas ['causal stories' about the economy that provide agents with an interpretive framework within which they can define, diagnose, and explain a crisis as an event which necessitates a particular set of actions] do more than alter preferences; they reconstitute agents' *interests* by providing alternative frameworks through which uncertain situations, and the place of agents within them, can be understood. . . . By defining how the economy works, and the place of the individual within the economy, crisis-defining ideas both diagnose the disjuncture and in doing so set limits upon the institutional form that will supposedly solve it (Blyth 2007: 762, emphasis in original).

For this novel interpretation to make sense, the essential benchmark for evaluating the causal chain effected through human agency has to be 'the idea' itself, no matter how complicated or contested that idea may be. The certainty traces back to the idea.

So do the collective action, role conceptualization, and even perception of self-interest. Existing institutions must adapt to the idea and new institutions must emerge from it. Finally, any stability must derive from the interaction of idea, certainty, action, concept, perception, and institutions taken as a whole. Moreover, it is not just economic or institutional stability that is at stake here; social legitimacy depends upon the resonance of the idea with popular understanding as well (Seabrooke 2007). The idea cannot be 'wrong' in any absolute or material sense; it can only be weak as a framework for problem recognition, collective action, and subsequent institutionalization. Political might makes the idea 'right'.

The self-referential character of ideas in this interpretation of Blyth is novel in the sense that it departs from how we usually understand human agency – because the solutions define the people and the problem, rather than the other way around. Indeed, it is hard to imagine that policymakers would recognize themselves in the process or even that they would self-consciously embrace ideational consistency as the most useful frame of reference for evaluating policy choices. This leaves two possibilities. One is that policymakers are unaware of the guiding influence of ideas, much as Keynes complained at the end of his *General Theory*. In this case, ideational consistency should reveal itself in the pattern of policy action. The other possibility is that ideational consistency never reveals itself because policymakers jump from one set of ideas to another. Policymaking stops following a narrative pattern and becomes an empirical concern. To illustrate this point it is useful to consider ongoing debates about a range of different policy instruments: collateral rules for central bank credit, government-sponsored bailouts for the financial industry, and deposit insurance for commercial banks and money market accounts. In each case, ideational consistency gives way to events on the ground.

The debate about collateral rules dates back to the Northern Rock crisis. The Northern Rock required special liquidity from the Bank of England for two reasons. The first was that it could not get sufficient liquidity from the interbank market. The second was that it did not have adequate collateral to borrow from the Bank of England under the existing rules for central bank lending. Prior to the crisis, the Bank of England would not accept mortgages (or mortgage-backed securities) as collateral for central bank lending because it did not want the risk that such instruments implied on its books. By contrast, the European Central Bank (ECB) had looser collateral rules and so – given enough time to organize the paperwork through its Irish subsidiaries – the Northern Rock could have gotten liquidity there. The time simply did not exist and so the chairman of the Northern Rock went to the Bank of England for exceptional support. Once the Bank of England made that known, the Northern Rock's fate was sealed.

With the collapse of the Northern Rock, the Bank of England changed its collateral rules to accept mortgages and related instruments. This brought it more in line with ECB practice. That does not mean, however, that the debate over collateral rules was settled. On the contrary, the ECB began to notice that market participants were (potentially) taking advantage of its willingness to accept relatively risky assets. During the summer of 2008, the ECB worked to tighten its collateral rules to prevent such abuse. This tightening was announced on 4 September 2008, just days before the U.S. Treasury allowed Lehman Brothers to collapse. As interbank lending seized up again, the ECB had to put its changes into reverse. The U.S. Federal Reserve loosened its collateral rules as well.

The Lehman Brothers story underscores the confusion about bank bailouts and defaults. In March 2008, the Federal Reserve Bank of New York opened a special lending facility for the investment bank Bear Stearns and then orchestrated a private sector buyout of Bear Stearns by J.P. Morgan Chase. These actions were intended to shield the market from the consequences of a Bear Stearns collapse. The problem was that they were widely interpreted as nurturing moral hazard. Therefore when another investment bank, Lehman Brothers, threatened to become insolvent in September 2008, U.S. Treasury Secretary Hank Paulson declined to intervene. Instead he tried to orchestrate a wholly private sector solution and when that failed he pivoted in order to prepare the markets for Lehman's inevitable demise.

The consequences of Lehman's default were much greater than foreseen. Although Paulson may have thought he could prepare the markets, he underestimated the challenge that such preparation implied. Not only was Lehman an important counter-party in a number of relationships ranging in terms of complexity from interbank lending to complex over-the-counter derivatives contracts, but it was also subject to a huge volume of credit default protection. Far from acting as a brake on moral hazard, the Lehman default revealed the uncertainty surrounding how big a bank has to be in order to be too big to fail. When Lehman's credit instruments went to auction on 10 October 2008 – a key step in the settlement of credit default swap contracts – the New York Stock Exchange went into a rout. In the aftermath, few policymakers were eager to experiment with another banking collapse.

The remaining illustrations all concern near-misses or policy flips. The extension of deposit insurance to commercial banks and money market accounts illustrates both points. The money market accounts were a near miss. The U.S. Treasury hoped to stop depositors from fleeing their existing money market funds by offering to guarantee them for up to a year. What they did not take into account was that this would make money market funds just as safe as regular deposits, despite the fact that money market accounts pay a higher rate of return. Although it would secure money market accounts, the effect might be to trigger a run on regular deposits. The American Bankers Association intervened and the Treasury included a restriction that it would cover only pre-existing accounts in its policy announcement.

The policy flip comes not from the United States but from Ireland, Britain and Germany. On Tuesday, 30 September 2008, the Irish government announced that it would guarantee all deposits in Irish banks. This action drew fire from the British Prime Minister and the German Chancellor. Despite their opposition, however, first one then the other had to increase deposit protection in order to offset the flow of funds from their own institutions into Irish banks and to stave off the prospect of a bank panic at home.

It would be possible to extend this list of illustrations to include central bank term-specific liquidity injections, interest rate reductions, bank recapitalization, fiscal stimulus, and a host of other policy instruments. The common theme is experimentation. Not everything works; nothing so far has worked for good.

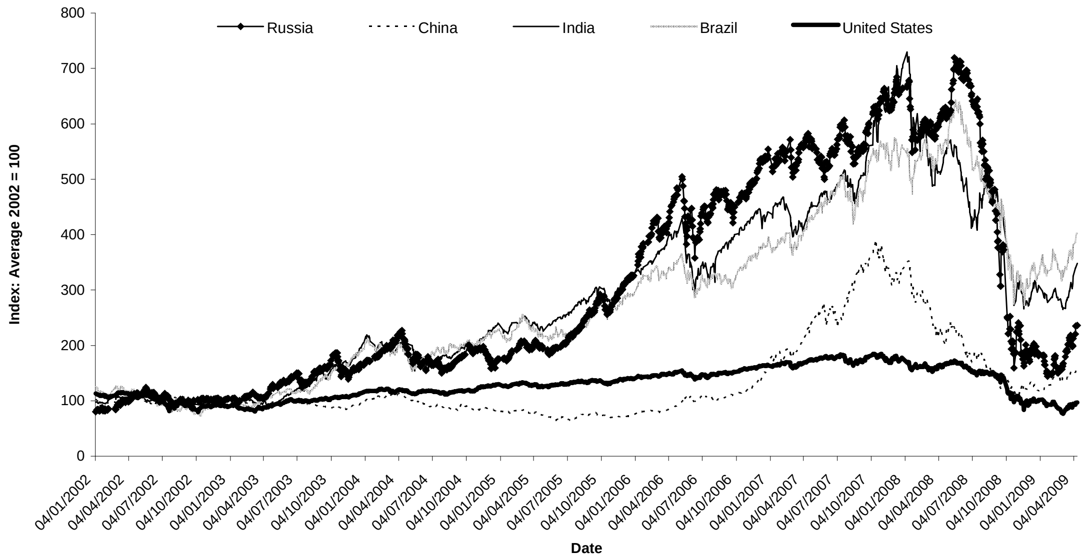
Meanwhile, the economic situation continues to worsen as financial turmoil has undermined real economic performance. Whether we recognized it or not, the August 2007 financial crisis constituted an initial turning point. Failure to respond adequately led to further crises in March and September of 2008. By that time what started as a financial crisis transformed into a crisis of the real economy as well. If we evaluate what has happened so far in material terms, we have to regret that the situation is not better (even if we find comfort in the possibility that it could also be worse). That seems to be what policymakers are saying. They do not have a narrative or a bold idea to get us out of this mess. But they remain determined to do whatever they can until they find something that works.

4. From Bad to Worse

The shift from financial crisis to a crisis of the real economy was only a single step in a longer chain. At each stage, policymakers have found themselves at a turning point at which the current situation is unsustainable and a failure to act is likely to make matters worse. The point to note, however, is that this worsening of the crisis is not a narrative condition – instead it plays out in the material conditions of the real world. To illustrate this point, I focus on three sets of variables: stock market indexes, long-term sovereign debt yields, and exchange rates. In all three cases, the point I want to make is the same. Since the deepening of the crisis in the Autumn of 2008, conditions in the real economy have infected performance at the international level. As a result, countries that were not exposed to sub-prime lending have seen their markets jolted; investment instruments that operate outside the interbank lending market have seen their yields diverge; and exchange rates between the major currencies have shifted dramatically. Of course each of these events can be traced back to the perceptions of market makers – although how consistently or convincingly is a very different concern. The point is that none of these events can be connected to the perceptions of policymakers (at least not ex ante) and yet each is important to how policymakers ultimately will respond.

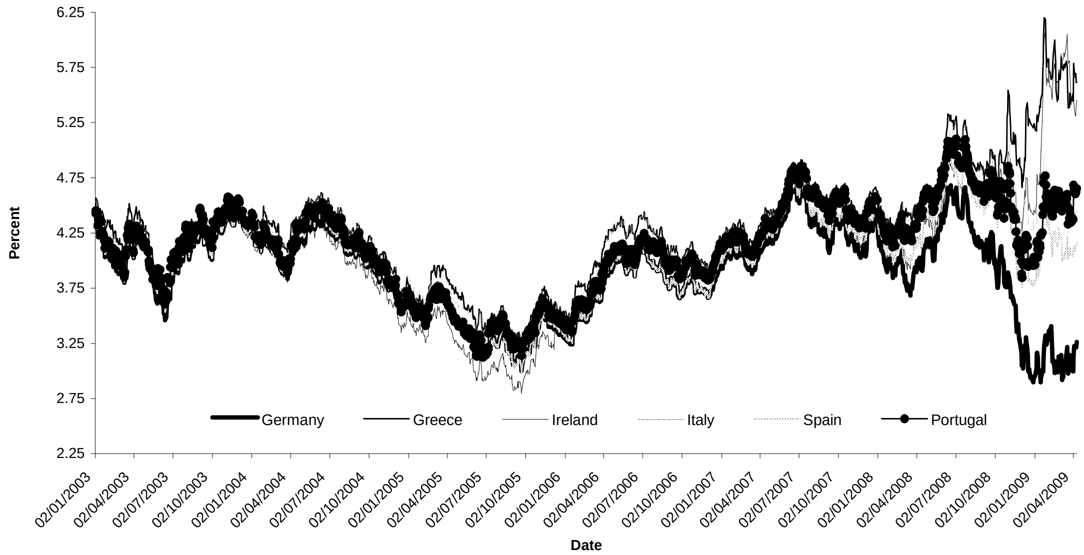
The first illustration concerns the stock market performance in Brazil, Russia, India, and China – known collectively as the BRICs – as compared to the United States. These countries are not closely tied to the securitization markets that have been at the root of the financial problem in the United States and Europe. Nevertheless, they are tied through exports to the real performance of the advanced economies. As that performance has deteriorated, the stock markets of these emerging economies have collapsed – in some cases losing more than three-quarters of their market capitalization. This can be seen in Figure 3, which provides comparable indexes for stock market performance in each of the BRICs that are normalized by setting the average for 2002 equal to 100. As these markets have lost value, this has not only wiped out the investments of a large number of actors in the development world, but it has also exposed investors from Europe and the United States to major loses both directly, where they invested in the market, and indirectly, were they provided loans for local investors to buy stocks on the margin.

Figure 3: Stock Market Performance



The second illustration concerns the yield spreads on long-term sovereign debt issues among highly indebted countries within the eurozone. As governments across Europe attempted to respond to the sudden economic downturn, they confronted a bond market still confused by the global financial crisis. Within this market, some sovereign debt instruments – like those belonging to Germany – are suddenly very attractive while others – like Ireland or Greece – are the subject of intense speculation. The concern has centred on whether a sovereign state in the eurozone could actually default on its public debt. And while the probability of such an event is low, the pricing implications in the bond market have been significant. Where 10-year long bonds used to with differences of less than one-half of one percent, suddenly that spread increased by more than a factor of five. This can be seen in Figure 4.

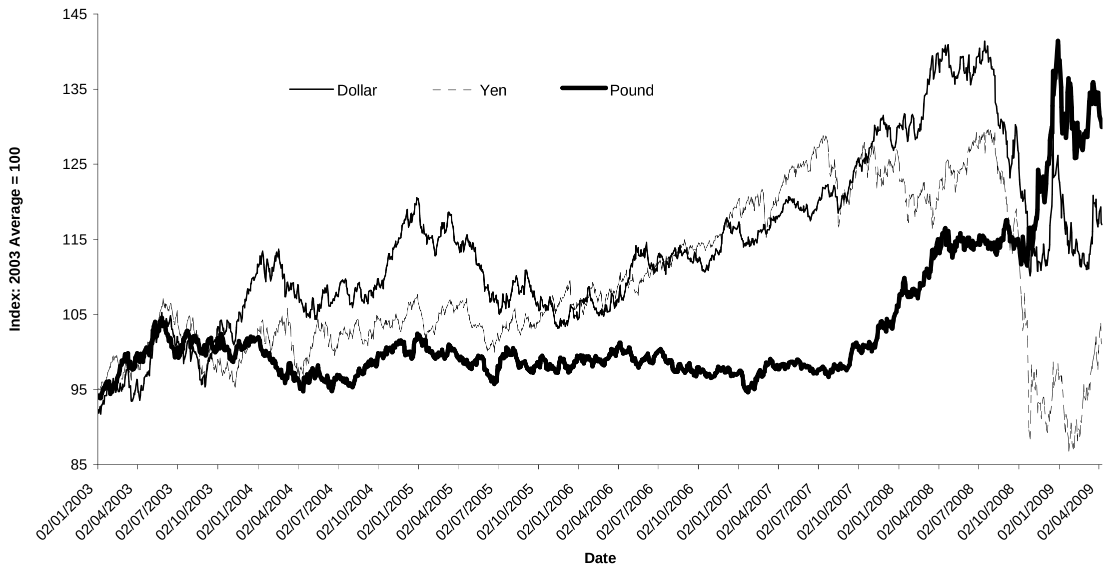
Figure 4: Long-term Sovereign Bond Yields



The third illustration points to the movement of the dollar, yen, and pound against the euro. Exchange rates between the dollar and the euro have long-since departed from anything resembling purchasing power parity and the peak-to-trough movements in that relationship are impossible to explain using macroeconomic 'fundamentals'. Even so, nothing in the first decade of the eurozone can compare to the wild volatility that erupted during the global financial crisis. Not only did the euro and the dollar move sharply against one-another, but the pound-euro and yen-euro exchange rates deviated sharply as well. Explanations for these movements range from portfolio consolidation to an unwinding of the global carry trade.

Whatever the cause, however, it is hard to imagine that anyone anticipated these movements before the fact; and it is easy to suggest that policymakers as yet have no idea how best to respond. This exchange rate volatility can be seen in Figure 5.

Figure 5: Euro Exchange Rates



This high degree of exchange-rate volatility has a significant impact not only across bilateral currency relationships but across the ensemble of global currency and commodity markets taken as a as a whole. Once again policymakers face a bout of uncertainty. The situation cannot continue as it is. The question is how they should respond. So far their efforts have been ineffective. Increasingly, their people have begun to vent their frustration. The international phase of the crisis is only its most recent manifestation. A political phase may be the next in the round.

5. What Does It Mean?

If we were going to characterize the pattern of policymaking in the present crisis, the best fit would be that it is empirical rather than narrative. Although real human beings are deliberating about how best to respond and (hopefully) drawing upon the best ideas that the policy and academic communities have to offer, the underlying reality is that the problem they face is a material one and the standards for evaluating policy performance are material as well. Moreover, I think policymakers would easily identify with this characterization.

For social scientists, the implications are more difficult to accept. They not only need to understand how the policy apparatus operates in generating a response to the crisis, but they also need to know how the resulting policies are supposed to work and actually work as well. This means they need to take ideas seriously – not just as the source of policy, but also as the product of interaction between policymakers, policy analysts, academics, and the material world.

Of course life would be easier if social scientists only had to take the first element into account. If they could take ideas as exogenous, independent variables, then all they would need to do is show how these ideas penetrate into the political system. Much of the criticism directed at the 'Washington Consensus' in international development seems to go down this route, as does criticism of international responses to the Asian financial crisis. Consider, for example, the contrast between Hall (2003) and Liao (2001).

If ideas really matter, though, they should be treated with greater respect. The burden of proof for those who wish to cast ideas as exogenous variables should be to demonstrate a persistent disconnect from the underlying material reality. This is not an insurmountable obstacle and Blyth (2002), for example, moves at least part way in the right direction. The key is that the tests should be made more explicit. Those who would advocate the causal significance of ideas should claim that material forces were not the trigger for a given crisis only if they can demonstrate their insufficiency. Equally, they should be able to demonstrate that material effects do not form an integral part of policy evaluation as well. No-one is denying that politicians are capable of narrating us into crisis. But that is not the same as saying all crisis is narrative, full stop.

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