Macroprudential Ideas and Contested Social Purpose: A Response to Terrence Casey

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In his *Policy Matters* piece in this issue of BJPIR, Terrence Casey (Casey 2015) has performed two services to the political science community trying to make sense of the political economy emerging from the financial crash of 2008. First, he has made a forceful interpretation of what macroprudential regulation as a whole new post-crash policy field (Baker, 2013, Borio, 2011, Haldane, 2013), actually amounts to. Few have been so bold. Casey is clear, macroprudential will evolve as a set of technologies and instruments to fix the primary weakness (financial instability) in what he calls neoliberalism, but what might more accurately be referred to as Anglo-Liberal financialized capitalism (ALFC)[1]. Others writing about this new emerging policy field (and there will be many), will undoubtedly have to take this contentious and forceful argument seriously and respond and even position themselves in relation to the empirical accuracy of Casey's interpretation. Second, Casey has drawn attention to what is undoubtedly the most important question facing macroprudential regulation that has so far been overlooked in technical policy debates and in the emerging social science literature on macroprudential, - the question of social purpose. Although Casey never uses the term, he is effectively making an argument about the purpose for which state power (and intervention) will and should be employed in the economy and the resulting normative frameworks of macroprudential governance (Ruggie, 1982, p.384). This is one of the big, central questions of our age. It speaks broadly to the theme of whether post-crash reform efforts should be aiming to bring about a significant transformation in the Anglo Liberal model of political economy, in terms of the institutional relationships, market forms and the state-society bargains on which it rests, or whether these efforts should be directed towards preserving the existing system. In this sense, Casey is making an argument not only about the desirable normative purpose of macroprudential as the saviour of ALFC, but also the normative content and stance of its constituent ideas and concepts concerning the desirability and optimality of financialized capitalism of the 21st Century. By doing this Casey is reminding us that the macroprudential regulatory project will not be normatively neutral and is therefore highlighting just how much is at stake in this emerging field of public policy.

However, in this response we want to highlight five inconsistencies or short comings in Casey's argument and analysis that should cause us to question its overall veracity. The first problem is that Casey sets up two hypotheses that he presents as oppositional, or mutually exclusive, but which are just as likely to be compatible and complementary. What Casey terms the debt driven growth hypothesis (DDG) and the financial instability hypothesis (FIH) are presented as rival explanations for the financial crash of 2008 that academics and policy makers have to choose between. This rather stark and artificial separation is made to do the majority of the work in Casey's argument, because Casey essentially sides with FIH, against DDG, which is seen to be less hostile and even neutral towards 'neoliberalism' because it applies to all economies with relatively liberalised financial systems. DDG on the other hand provides a focused critique of ALFC and its limited capacity to generate growth without a resort to dangerously high levels of debt financing that ultimately prove unsustainable. The classification of DDG and FIH into separate and oppositional perspectives is however inherently problematic. Casey's argument revolves around the claim that FIH reverses the causation of DDG, because under the FIH perspective finance creates instabilities which undermine productive growth, whereas under DDG poor productive performance results in a turn to debt financing resulting in financial instability (p.7). The causation here is assumed to be one way, or linear, – either excessive debt and credit causes poor productive performance (FIH), or poor productive performance and restricted growth results in a turn to credit and debt which proves unsustainable (DDG). Such a formulation is simplistically reductive and is not reflective of complex adaptive economic and financial systems that often display non-linear dynamics, which is in turn a fundamental insight of the emerging macroprudential perspective (Haldane and Nelson, 2012, Blyth, 2010.) The notion that DDG and FIH are connected and feed into one another is not considered. For example, it is possible to accept the proposition that financial markets are procyclical, characterised by herding and inherent instability, as per FIH, without necessarily rejecting the claims of DDG that debt has become integral to growth in the Anglo Liberal world (private sector debt was over 400% of GDP in the UK in 2011, Thompson, 2013). In this respect, the form, course and size of any given financial cycle will not be unrelated to the wider structures of a given political economy, but will interact with those structures dynamically, yet Casey rather side steps this issue with a very static analysis, that simply looks at the correlation between equity withdrawal and overall growth in the US and the UK over three decades. The macroprudential perspective itself, holds that the financial cycle, financial risk and financial instability are endogenous and dynamic features of the economic system as a whole (Persuad, 2009, Borio, 2009). The logical extension of this position is that the creation of debt, credit and leverage, and the associated outgrowth in shadow banking trading in exotic derivatives and securities products, became part of the Anglo Liberal growth model and were not separate from the growth dynamics and social settlements, or everyday lived experiences of consumers and citizens (Langley, 2010, Seabrooke, 2006, Crouch, 2009), but very much an integral part of them. The fact that Casey acknowledges that the crisis of 2008, was a crisis of debt on the final page of his analysis, might suggest that Anglo Liberal economies not only have a propensity to generate debt (which has been growing in Casey's own admission), but also that rather than being competing explanations, DDG and FIH are in fact intimately intertwined and complementary explanations. That debt and credit become central to a growth model, does not invalidate the financial instability hypothesis, but can exacerbate financial instability and make FIH more salient. Likewise accepting FIH does not mean we have to reject the notion that debt can become integral to a particular growth model. In this sense, we do not have to choose between DDG and FIH. We can accept both, or elements of both, and many macroprudentialists do, yet it is precisely because Casey portrays DDG and FIG as oppositional, that he is able to make the case for FIG at the expense of DDG, and thereby suggest that FIH is supportive of and can save neoliberalism.

Second in relation to the empirics and the implicit conception of ALFC employed, we also have cause to question Casey's analysis. Casey's defence of ALFC (or neoliberalism) and his assertion that it is worth saving, is essentially based on two empirical claims that tell us a lot about his static conception of this model. The first is that it was only after 2000 that equity withdrawal actually boosted consumption. Prior to this, during the 1980s and 1990s, productivity and growth rose in the United States and the United Kingdom without a reliance on debt financing. The problem with this argument is that it neglects to view ALFC as an evolving and complex adaptive system. Anglo Liberal capitalism in other words has continued to evolve and change its form. For example, financial innovation and engineering, driven by policies of deregulation, evolved throughout the 1990s, increasing the share of financial activities, expanding debt levels so that debt and credit became a major engine of growth in the 2000s, even in the terms of Casey's limited empirics. Likewise two decades of structural reform and 'flexible labour market policies', *have* resulted in real wage stagnation and downward wage pressure for large sections of the population, with financialization and credit filling the void. Raghan Rajan's book *Faultlines* demonstrates how levels of debt among households rose pretty much exactly in line with levels of inequality in the US (Rajan, 2010). The Anglo Liberal capitalism of the 21st Century has continued to evolve. It is not the same system, set of social relations and growth model that existed in the 1980s and 1990s that Casey wishes to defend. Therefore, we have to at least consider the possibility that financialized Anglo Liberal capitalism has evolved past a threshold point of pathology, generating financial instability and inequality that has begun to erode its own productive capacity. Casey's analysis does not entertain this possibility, but the most extensive historical study to date certainly generates substantial data in support of such a scenario (Piketty, 2014).

Casey's second empirical point is that financial cycles and instability are not specific to ALFC. All economies with liberalised financial systems suffer from them. In historical terms, this is indisputable. However, as Casey concedes ALFC appears to exacerbate the size of financial cycles. Not only was the financial cycle and subsequent crash in 2008 the largest ever recorded, imposing huge costs, including over a year's lost output and severe fiscal damage due to socialized losses, leading to questions as to whether sovereigns could ever again afford a crash on such a scale (Alessandri and Haldane 2009, Haldane 2012,) but it was also clear the crash itself emanated from Anglo-American financial centres and practices. The question raised by this is whether these growing costs are worth it, are sustainable, and how these will be judged by populations and politicians. On this basis, it is far from clear that ALFC is either sustainable, or worth saving. Can the model's apparent propensity to generate financial cycles on a scale never seen before, really be offset by relatively modest growth during the 1980s and 1990s that did not appear to depend on debt financing?

A third problem with Casey's analysis relates to how he treats the relationship between the financial sector and macroeconomic performance, which is also a central focus of macroprudential regulation. Casey invokes a fairly simple correlation between equity withdrawal and growth, to argue that Anglo liberal capitalism managed to grow over two decades during the 1980s and 1990s. However, he largely overlooks the complex, dynamic and evolving nature of the relationship between financial sector activities and macroeconomic performance. This is a significant oversight. For example, Andrew Haldane a leading macroprudential advocate at the Bank of England, refers to a ‘vacuum cleaner’ effect in which monies and people were drawn into banking. Haldane argues that this process had silent costs for other areas of the economy, as resources and personnel were drawn away from other sectors starving them of sunlight. Research intensive businesses and those reliant on substantial external funds such as infrastructure projects suffered most, as scarce skilled labour and funds were sucked into finance (Haldane, 2012, p.4). The Bank for International Settlements (BIS), which has a claim to being the spiritual and intellectual home of macroprudential regulation, has recently published research to suggest that once a Bank goes over 100 per cent of GDP it starts to act as a drag on growth (Cecchetti and Kharroubi, 2012). Notably, the balance sheets of the UK’s three largest banks were still over 400 per cent of GDP in 2012. Even before we consider the subsidy to banking that Haldane puts at several hundred billion dollars a year on a global basis (Haldane, 2012), and the problem of too big to fail, that results in implicit public bail out guarantees for large banks, it is clear that large heavily leveraged banks are not necessarily efficient, but can impose significant costs on the wider economy. Haldane has also pointed out how banking became a transactional, sales driven business, which was accompanied by and fed into a process of shortening of time horizons in capital markets, so that even long term investment is now very short. These trends mean that those infrastructure and hi-tech projects that do most to boost growth, but are usually long duration projects, suffer most (Haldane and Davies, 2011). Picking up on some of these themes, a recent contribution from civil society, has suggested that heavily financialized societies such as the US and the UK, suffer from a developed country version of the resource curse, - the finance curse (Shaxson and Christensen, 2013). In other words, there is a growing evidence to suggest that once financialization and financial activities go beyond a certain size and volume, as an organic outgrowth of ALFC, they start to prove detrimental to the wider economy and macroeconomic performance. Such analyses are now preoccupying many working within a macroprudential perspective. Yet Casey's case in defence of ALFC, almost entirely overlooks these issues and debates, even though they are emerging as the most powerful critique of unfettered financialization. If we take these views seriously it suggests that macroprudential regulation should also deal with issues relating to the size and structure of the financial sector, which would potentially involve interventions that would in all likelihood gradually changed the growth model of ALFC. Such debates are not yet settled, but remain contested.

A fourth problem is that the macroprudential perspective is a very uncomfortable intellectual bed fellow for neoliberalism as described by Casey. By presenting the FIH perspective as the saviour of neoliberalism, Casey is essentially claiming that the ideational and normative content of contemporary macroprudential ideas are favourable and sympathetic to the core ideas of neoliberalism, but there are substantial grounds for believing they are not. As Casey recounts, "neoliberals assume market competition produces varied risk assessment. Miscalculation is punished and accuracy rewarded, the market thus endorsing winning strategies." (p.7.) Yet the macroprudential perspective adopts a view of financial markets that is antithetical to the one outlined by above. As described by Paul Tucker formerly of the Bank of England, a macroprudential perspective involves thinking "of markets as inefficient, riddled with preferred habitats, imperfect information, regulatory arbitrage, herding and inhabited by agents with less than idealised rationality" (Tucker, 2011, pp.3-4). Neoliberalism is more than just a growth model. As Casey indicates it has an important ideational component consisting of beliefs about how economies and markets function and behave, that in turn becomes constitutive of reality by creating institutional blue prints for appropriate and desirable governance arrangements and practices (Blyth, 2002). Ideas are *prior* in the sense that they are constitutive of particular sets of economic and social relations by generating institutional blue prints and future policy possibilities (Blyth, 2002).

Neoliberalism by this reading is a state-society complex of social practices and relations that are at least partly created, rationalised and legitimated by conceptions of markets (ideas) that are simultaneously analytically descriptive and explanatory, as well as normative. The claims and internal constitution of ideas, how they relate to one another, and the claims they make about appropriate forms of state intervention and market practice, are therefore integral to any socio economic order.

When we think in these terms the most fundamental tension in Casey's argument is revealed: that some decidedly non neoliberal ideas, about the inherent malfunctioning and pathologies of financial markets, are required to save neoliberalism. The financialized neoliberalism that has become synonymous with the Anglo Liberal world over the last thirty years saw simplified versions of Eugene Fama's efficient markets theory became part of the institutional DNA at regulatory agencies such as the UK's Financial Services Authority (Turner, 2011). These beliefs in the self-equilibriating properties of financial markets and the benefits of financial innovation and market completion, were the intellectual rationale for an approach to financial governance based on light touch supervision and assessments of private sector risk management models (Persaud, 2009, Tsingou, 2008). In contrast, the macroprudential perspective, essentially argues that the state (whether through central banks, or other agencies) has a duty to minimize the inherent instability of the financial cycle and the socially suboptimal outcomes that result, by using prudential measures for macroeconomic ends (Haldane, 2014c). On a more practical level, many of the policy instruments that fit under the macroprudential umbrella, such as countercyclical capital ratios, time varying liquidity buffers, and maximum leverage ratios, all intervene directly and set parameters to private institution's business models. They involve regulators adopting positions and seeking to limit and trammel private investment strategies at key moments, - a decidedly non neoliberal proposition.

Philosophically the justification for such countercyclical policy interventions is similar to the one Keynes made regarding states needing to manage the instabilities of the business cycle, socializing the conditions of investment to limit unemployment. Notably, Casey partially recognises the tension that arises from this when he notes that the ideas of Hyman Minsky - an opponent of the free market, are the potential saviour of the neoliberal growth model (p.10). Both Minsky and Keynes had normative views that run contrary to the neoliberal premises outlined by Casey. The final chapter of Minsky's biographical study revisits Keynes final chapter in *The General Theory* on social philosophy, adopting a critical and negative view of rentier activities and arguing in favour of interventionist and activist policies, including taxation to achieve a more equitable distribution of income (Minsky, 1975, p.158.) Minsky himself advocated regulating the debt financing of investment for large scale organizations to reduce the tendency for capitalism to generate serious financial crises, and to combine this with concerted efforts to increase the income of the poor (Minsky, 1975, p.165).

There also deeper ontological tensions between macroprudential thinking and the rational expectations micro foundations of much of the economic theory that has driven neoliberal policy prescription. Most notably, macroprudential's key conceptual foundation is a recognition of the need to avoid fallacies of composition (Borio, 2011, p4). The idea of a fallacy of composition holds that individual rational self interested actors seemingly following their interests will not necessarily cohere to produce stable and efficient systemic outcomes, but will result in systemic risks resulting from collective rather than individual behaviours. As Keynes noted, "it is not a correct deduction from the principles of economics that enlightened self interest always operates in the public interest. Nor is it true that self interest generally is enlightened, more often individuals acting separately to promote their own ends are too ignorant, or too weak to attain even these" (Keynes, 1931, pp.287-88). In this sense, a macroprudential approach through its acknowledgement of ‘fallacies of compostion’ is invoking a public ethics and based on macro moralities around the need for systemic financial regulators, with implications for the social purpose of economic policy interventions (Best and Widmaier, 2006). While notions like the public or the common good do not disappear completely in microclassical analyses that have provided one of the primary intellectual foundations for neoliberalism, they do become merely additive. In contrast, a macroprudential perspective, does not see the world as being just made up of atomistic individuals, but also includes social entities and forces that possess an autonomous standing, as the aggregate is more than just the sum of its individual parts. From a macro perspective therefore an individual’s responsibility for his or her wealth is always complicated by broader systemic forces (Best and Widmaier, 2006, p.617). Because of this public forms of economic action become necessary to stabilize macro-level processes with the state having a moral obligation to its citizens to pursue their economic welfare. In this moral and economic universe, responsibility for economic success or failure is not borne alone by individuals but instead is shared by the social collective, and rests on the legitimacy of a public authority pursuing interventions to protect a wider public interest, or social purpose. In this regard, ethical overtones cannot be dismissed as ‘merely normative’ preferences, but rather are rooted in deeper ontological assumptions. Macro perspectives with their conception of the economy as a social whole, seek to pursue policies in order to achieve a social good which ultimately exceeds the sum of any individual gains. Microclassical (neoliberal) pessimism about public officials in general and public economic interventions in particular is rooted an individualist moral vision (neoliberalism) that is not shared by the macroprudential perspective. The shift to a macroprudential perspective therefore opens a different range of moral and ethical possibilities and articulations of social purpose that markedly differ to those evident in neoliberal assumptions about markets.

The emergence of macroprudential thinking raises the question of what is its social purpose? Casey's argument is that this social purpose should be to patch up and maintain what he calls neoliberalism, but as the discussion here has indicated macroprudential ideas challenge many of the conceptual and intellectual foundations of neoliberalism. At the very least, ideas about markets and accompanying justifications for public policy interventions have been modified and heavily revised by the macroprudential turn. If the ideational base of neoliberalism is being subverted by opposing premises this raises two questions: whether macroprudential regulation is compatible with neoliberalism as a state-society complex and whether we can still meaningfully talk of neoliberalism if some of its core ideas are being questioned and overturned?

If the ideational content of macroprudential is potentially incompatible with neoliberalism's own premises, the final weakness in Casey's argument is that some of the biggest champions of the macroprudential perspective, within the UK, have also indicated that they view the move towards macroprudential as part of a deeper transformation. Such views have also been highly critical of ALFC in its existing form. In other words, many from within the macroprudential perspective contest Casey's vision of the most suitable social purpose for macroprudential. This in turn might suggest that macroprudential is just as likely to challenge and change ALFC as it is to protect and reinforce it. In the UK, for example Adair Turner's remarks about socially useless finance echoed the earlier stance against rentierism adopted by Keynes and Minsky. He has also called for policy action to address rising inequality alongside countercyclical policies, as a cause of financial instability and to address global imbalances (Turner, 2010, p.24). Turner also favours a more expansive and ambitious form of macroprudential regulation including measures to tax debt pollution, much closer management of the quantity and the mix of categories of credit, including diverting credit away from property towards businesses to fund new capital investment by specially public licensed banks whose sole function is to finance such activities, thereby leaning against identifiable biases arising from free market dynamics (Turner, 2010, p.30). Such policies would result in a much more interventionist public policy regime, that would seek to restructure financial activities and target some of the diagnosed root causes of rising debt, reducing the scale of financial transacting therefore potentially modifying ALFC (Turner, 2011). Andy Haldane has suggested that macroprudential regulation is about making finance 'the servant rather than the master' (Haldane, 2014). Such a notion speaks about re-structuring some of the power relations at the core of ALFC. Haldane has also talked about the need for the greatest and most radical financial reformation for over 80 years, which he also believes is underway (Haldane, 2012). In his latest speech, Haldane suggests that the shareholder model of ALFC has resulted in 'unfair shares' that have undermined productive capacity (Haldane, 2014b). In short, many macroprudential pioneers view it as a regulatory project that can make a more far reaching contribution to a fundamental restructuring in social and economic relations, including as the basis for a reduced reliance on financialization, which in turn would surely fundamentally alter the character of ALFC and its constituent social and political relations. In other words, the sense of social purpose that macroprudential is supposed to serve is far from settled. It is a contested and contingent public policy question that will be settled by the interaction of evidence led technical debate and the moods, pressures and impulses of the political process. The danger of Casey's analysis is that it risks obscuring that many of the key debates within macroprudential regulation are not yet settled and that it has much potential beyond patching up the status quo. The task for political economists and political scientists analysing emerging macroprudential regimes is to offer up interpretations and prescriptions concerning the social purpose of these regimes. Terrence Casey's analysis has provided a start to that process, albeit a highly contentious one.

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[1] Anglo Liberal Financialised Capitalism can be defined here as the common feature of US and UK political economy: the centrality of a large internationally active financial centre as a service point for global financial flows and products; a form of credit fuelled asset based prosperity and welfare (Finlyason, 2009), usually connected to property; company law that is generally highly favourable to dispersed (and often short term) shareholders; a framework of generally flexible labour market regulation; and at least a rhetorical commitment to notions of efficient markets, minimal state intervention and provisioning, and relatively low taxes.