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Published in:
British Journal of Politics and International Relations

Document Version:
Peer reviewed version

Queen's University Belfast - Research Portal:
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Economic Ideas and the Political Construction of the Financial Crash of 2008

Andrew Baker and Geoffrey R.D. Underhill

Abstract

This article is a short introduction to a special section on economic ideas and the political construction of the financial crash. It begins by explaining why economic ideas and the politics of appeals to certain ideas are so integral to the historical significance of the crash of 2008 and the question of whether it can be considered a crash at all. The first section covers the literature on ideas and economic crisis. The second section highlights that the contribution of the special section is to engage in a stock taking exercise of the empirical and conceptual patterns concerning the politics of ideational change underway in the areas of: comparative fiscal policy; monetary policy and Euro zone debt management; capital controls; and financial and securities market regulation and standard setting. The final section outlines the structure of this special section and content of the individual articles.

Economic crises are social and political events, as much as they are economic or financial ones. For both empirical and conceptual reasons, the fields of political science and political economy have come to associate periods of financial and economic distress with far reaching change in salient economic ideas (Hall, 1993, Blyth, 2002, Hay, 1996). For example, ideational change during the 1930s laid the foundations for the emergence of the Keynesian welfare state and what came to be known as the Bretton Woods order of embedded liberalism (Blyth, 2002, Helleiner, 1996, Ruggie, 1982, Kirshner, 2014). In the 1970s more market-based policy ideas began to dislodge Keynesian approaches to macroeconomic policy, as monetarism became the first iteration of neoliberalism (Hall, 1993). Ideational change and the appeals to and the use of economic ideas by policy makers are integral to how periods of crises are politically constructed and socially understood. This is the fundamental question of how we define and understand a period of crisis and indeed whether a period of economic and financial distress can be considered a crisis at all (Hay, 2011). Such a question relates to
the etymological origins of crisis as a critical turning point, producing a trajectory change, in accordance with the original ancient Greek medical meaning of the term, where a patient either recovers from a condition, or withers to death (Widmaier, Blyth and Seabrooke, 2007, Gamble, 2009, Hay 2011). For a crisis to be considered and classified as crisis by this reading therefore, far reaching ideational change which changes both the trajectory of state intervention in and engagement with markets and the whole mental context of governing and imagining the economy, would appear to be a necessity.

Economic ideas represent systems of thought consisting of a series of interconnected claims and assumptions about how economies function, how their constituent parts should and do relate to one another, and the most appropriate objectives and settings of government economic policy. Changes in these systems of thought make a major difference in terms of policy and distributional outcomes. Economic openness and the organization of markets come in many forms and their impact is far from politically or socially neutral. Economic ideas can thus be conceived of as intellectual blue prints for sets of actually institutionalised economic relationships and as such they are both a political resource and the subject of political contestation (Blyth, 2002). Consequently, economic ideas should be acknowledged as being heavily normative, even if often only implicitly so. They carry with them implications for growth, wealth distribution, social inequalities, and for the broader policy framework that accompanies economic adjustment processes such as welfare compensation. Economic ideas require political underpinnings and thus often herald new coalitions of socio-economic constituencies as well as new forms of policy legitimation (Hall, 1993, Schmidt, 2008, 2014). Economic ideas are thus crucial in shaping and defining the architecture, parameters and infrastructure of politics, informing political identity and a sense of the politically possible and appropriate.
Earlier instances of ideational change shaped the parameters of politics itself and reconfigured the role the state played in the economy and society more broadly (Blyth, 2002). Crises may therefore give rise to processes of change and periodic reconfigurations of capitalism, driven by changes in the ideas policy makers employ in understanding the economy and in illuminating and justifying appropriate courses of action. An important task for political science in advancing analysis of the financial and economic distress that has unfolded since 2008 is to examine the political and institutional use of economic ideas in constructing those events and in changing the range of available appropriate policy options, as well as the politics this entails.

Few doubted the need for policy reform in the immediate aftermath of the crisis, and major change would seem a natural expectation for the public and policy-makers alike. Yet far reaching reform implies the redefinition of both the goals and instruments of economic governance. To what extent has the crisis disturbed ‘old’ ways of addressing economic policy problems and goals? Are genuine new departures observable, and based on what sorts of new ideational configurations? For whom and for what purpose? These questions and how and whether the use of economic ideas has changed since the crisis, including how we explain these patterns, are the focus of the following special section.

**Economic Crisis, the Politics of Ideational Change and the Existing Literature**

Previous crisis periods reveal that established understandings and ideas are vulnerable to the claim that they have failed and need to be replaced with new understandings (Hall, 1993). This is the Bayesian reading of ideational change based on a dynamic of the need for rational information updating, learning and error correction (Blyth, 2013). Recently, this has been counter posed against a more constructivist reading in which the primary dynamic is a social process relating to the realignment of authority relations and social standing, in which new
groups and advocates enjoy growing prominence as a result of ongoing performance, reputation and positioning in social networks (Blyth, 2013, Baker, 2013, Chwieroth, 2010). The different political dynamics of ideational change are an area of enquiry for this special section.

Crisis periods often involve the breakdown of apparently established, taken for granted economic relationships and policy frameworks, engendering radical Knightian uncertainty as a series of unique phenomenon that have not been experienced or encountered before by existing policy makers (Blyth, 2002). In such a context, a range of political actors search for new ideas to help navigate this uncertainty and to explain the particular set of circumstances they find themselves in. This can create a window of opportunity for norm entrepreneurs as expert or professional purveyors of ideas to affect change (Finnemore and Sikkink, 1998, Widmaier, Blyth and Seabrooke, 2007, Chwieroth, 2010). Crucially however such a process is inherently political and will be determined by norm entrepreneurs’ capacity to cultivate political support and constituencies for their arguments and interpretations. A process of inter elite – mass public persuasion concerning the nature of economic problems and what that necessitates in terms of policy action and reform is therefore the very essence of crisis politics, as a series of public arguments about the meaning of events ensues (Widmaier, Blyth and Seabrooke, 2007). As Peter Hall recently put it, ideational and paradigm change requires a motivation, a means and a motor. The last of these refers to the electoral and coalitional politics with which different sets of ideas are associated with and appeal to (Hall, 2013).

One wave of post-crash literature has resulted in a broad ‘no change’ thesis, pointing to a pattern of ideational inertia and the absence of change since the crash. In this respect, we have variously heard references to: the strange non-death of neoliberalism (Crouch, 2012); pathology without crisis, (equating a lack of ideational change with an absence of crisis as a critical turning point Hay, 2011); the status quo crisis (Helleiner, 2014); zombie economic
ideas that refuse to die (Quiggins, 2012); and cognitive locks and the stickiness of economic ideas in the current conjuncture (Blyth, 2013, 2013b). While there has been no spectacular paradigm collapse and shift following the crash, several of the contributions in this special section all suggest the picture is rather more differentiated and complicated than a simple inertia or ‘no change’ story. Differences, sometimes apparently subtle, are observable across various policy domains and institutional frameworks. These differences may appear initially slight but may take on momentum as the political and social shake-out of the 2008 crash continues. This brings into view the incremental dynamics of ideational change as opposed to the dynamics of dramatic and sudden paradigm shifts (Carstensen, 2011, 2015). The primary aim of the selection of articles that follows is to provide a better sense of the empirical picture concerning how economic ideas have been used in different economic policy areas and in different institutional settings since the crash.

What all the papers have in common is a concern with how institutions and institutional settings shape the parameters and possibilities of ideational emergence. In this regard, all of the contributions at least take heed of Stephen Bell’s observation that existing ideas scholarship has paid insufficient attention to institutional context, how institutions and ideas interact and crucially how institutions mediate processes of ideational change (Bell, 2011). New ideas are born by existing institutional contexts that shape their emergence. They also imply shifts in underlying preferences across the range of socio-political constituencies in the political economy. The papers in this special section are therefore concerned with how social learning has proceeded amongst policy makers within political and institutional constraints/opportunities since the crash and the sets of dynamic interactions between ideas, institutions, political coalitions and authority relations this consequently gives rise to. In this respect, the question of what kind of ‘learning moment’ (Kirshner, 2014,) the 2008 crash has
given rise to is both an empirical and a conceptual one, and the articles here explore both aspects of these ongoing processes.

The recent financial crash opened up a window of opportunity for agents of change and norm entrepreneurs to push new ideas, but these forces for change have had to interact with a pattern of ‘path dependency’ underpinned by vested interests. Where prior knowledge and expertise informs institutional responses and where these same institutions are populated by coherent insider coalitions, there is often a durable quality to pre-existing ideas. This may hold even when ‘insiders’ clearly and indeed publically recognize the need for change. Long-shared ways of thinking may trump a genuine search for radically better outcomes, due to the latent habitual patterns of various political and institutional actors. In this sense policy entrepreneurs have to shake off a crisis of understanding as much as a crisis of policy.

The Contribution of the Section

The analyses in this special section are intended not only to help us to better understand how ideas relate to interests and vice versa in the current epoch, but also how the dynamics of change and continuity are interacting in the context of the persistence of chronic economic problems and underperformance, recently referred to as secular stagnation (Summers, 2014). In this regard, all of the papers tell us something about the potential political and historical significance of the crash and its response as a transformational moment or sequence of events. Ideas in this sense have a crucial place in the political construction of this crisis and of responses to it: they provide coalitions with resources for change or inertia, because they help agents to visualize how the economy works and how best to respond with policy; ideas provide agents with alibis to allocate blame and to discredit existing institutions or practices; and they provide institutional blueprints for the future, indicating potential solutions and remedies that can reorder social and political relations and instigate institutional
transformations (Blyth, 2002). However, translating ideas into practice, including those that challenge or refute elements of an existing orthodoxy, can be a protracted or incremental process that can take a decade or more to transpire and work through (Helleiner, 2010, Baker, 2013b, 2014, Moschella this issue, Carstensen, 2011, 2015). At the same time, the risk of political derailment and veto-player resistance is omnipresent (Tsingou, 2015). If we are to make sense of the politics of the recent financial crisis and its ongoing fallout, it is important to engage in stock-taking exercises that enhance our understanding of the range of political conditions required for new ideas to succeed, how those conditions in turn shape the evolution of ideas, as well as how economic ideas in turn shape the process of constructing and reforming institutional and political orders. This is the primary contribution of this special section and it involves understanding how path dependency and ‘cognitive locking’ can give a durable quality to pre-existing ideas (Pierson 2000, Hall, 1986, Underhill this issue), creating a barrier to pressures for change from agents pushing new ideas and seeking to cultivate support for those ideas amongst the wider public, resulting in a dynamic interplay between forces of change and inertia.

The special section also explores how far understanding of the politics of the crisis, its construction and meaning, can be furthered by treating ‘crisis politics’ as a series of arguments and persuasive struggles over the meaning of events (Widmaier, Blyth, Seabrooke, 2007). In this sense it considers how elites develop strategies for communicating with electorates and the extent to which they draw on economic ideas for this purpose and how and whether are used somewhat strategically and instrumentally for this purpose (Dellepiane-Avellendea this issue, Schmidt, 2014).

The section explores post-crisis ideational and policy responses and the extent of change in relation to five crucial policy domains: fiscal adjustment as a policy response to crisis (Dellepiane-Avellaneda); thinking on monetary policy and debt management in the Euro-
area and in particular the role of the ECB – which was undergoing its first major test in crisis circumstances (Braun); global rules on macroeconomic adjustment and in particular the management of capital flows (Moschella); and banking supervision and securities market regulation (Underhill). Each of these policy domains has an important element of international or indeed transnational governance with deeper roots in older systems of national economic governance. International institutions and policy processes thus interact with domestic level political economies and the complex patterns of interests and constituencies one might expect. Each of these institutions and policy domains was also closely associated with the institutionalization of the post-Keynesian consensus on a market-based approach to economic governance that emerged in the 1980s and was consolidated in the 1990s (McNamara, 1998, Baker, 2006). Many of these institutions and policy domains were also the post-crisis target for virulent accusations of capture by special interests, of systematic ideational bias, of domination by the policy elites of their strongest economies (the IMF) and their core corporate interests, and of course of massive policy failure (Johnson and Kwak, 2011, Baker, 2010, Underhill and Zhang, 2008, Chwieroth, 2009, Claessens, Underhill and Zhang, 2008, Mattli and Woods, 2009). One might reasonably expect much post-crisis debate and soul-searching. There is little doubt that policy elites, who are after all responsible to democratic processes at the national level wherein domestic electorates have become more radicalised than before the crisis, have felt the heat of criticism and expressed openly the need for change and a better future for the global economy (Thirkell-White, 2009). These same elites also managed to avoid the sort of meltdown that happened in the 1930s, a source of potential complacency. The record of post-crisis policy and ideational change thus remains nuanced, and at best we can only see the outlines, or seeds, of significant ideational change that may or may not emerge in the future.
Structure of the Section

Sebastien Dellepiane-Avellaneda begins this section with probably the best known and well-versed area of pre-crisis ideational debate and consensus – the rise of fiscal austerity as a political and policy agenda (Blyth, 2013b; Stanley, 2014). Dellepiane-Avellaneda explores the origins of the notion of ‘expansionary fiscal contractions’ tracing it to the 1990s and the work of Francesco Giavazzi and Marco Pagano. The idea identified national fiscal deficits as a key ingredient of financial and macroeconomic instability, and thus fiscal adjustment as a key element of adjustment and crisis resolution. This policy mechanism advocating severe and rapid fiscal adjustment as a key ingredient of re-establishing growth in a crisis ran strongly counter to the ‘old-now-new’ Keynesian idea of pursuing fiscal stimulus in bad times, above all in a severe crisis wherein national governments should co-ordinate support for growth across borders. Initially, the G20 process – led by the US – appeared to herald the ‘return triumph’ of the fiscal stimulus and co-ordination position and its ‘new’ ideational underpinnings. As time went on and the recession worsened, a period in which we would expect the consolidation of new ideas, fiscal austerity became more the norm, above all in the Euro-area but also in the UK, in the US Congress, and across a range of other countries hit by the crisis and subsequent recession. This controversial ideational framework has proven more robust than the depth and length of crisis might lead one to expect. Dellepiane-Avellaneda explores the idea of expansionary contractions on actual policy choices by examining the politics of austerity in Ireland, Spain and the UK. He finds evidence that outside of a small group of hard liners, few key policy actors actually believed that fiscal contraction would be expansionary and beneficial, and rather took the view that this time it would hurt. The important contribution here, is the demonstration of how the ascendancy of fiscal contraction as a primary policy priority has depended upon a process of ideational screening and
intellectual repression, suggesting social construction has been a more prevalent policy
dynamic than Bayesian learning in the politics of fiscal policy.

Benjamin Braun focuses on the governance of the Euro-area and in particular the role of
the European Central Bank (ECB). Braun’s contribution is to emphasise crisis preparedness
and crisis management are very distinct phases that create path dependencies that subsequent
efforts at institution building find difficult to escape from. Braun argues that the lack of
preparedness for crisis in the existing policy paradigm (both systemic banking crisis and
sovereign debt crisis), inadvertently resulted in ECB empowerment. Emergency responses
Braun argues set precedents that have left their imprint on the institutional and ideational
landscape in the Euro zone, which purposeful institutional entrepreneurs will find difficult to
escape from. Consequently, the existing crisis as critical juncture literature, has, over
emphasised the capacity for strategic and voluntaristic policy learning and institutional re-
design. This point is important: if the standard rulebook proves inapplicable or irrelevant to
the real-time events of crisis, rapid innovation can result. The lack of a bank resolution
mechanism meant the ECB had to act as lender of last resort fashioning a new role for itself,
thereby demonstrating a capacity for policy and institutional innovation. Braun shows how
this challenged existing ideas about monetary governance in the euro zone that the ECB as an
independent central bank should focus solely on inflation targeting. The lack of existing
institutional mechanisms to deal with financial distress, meant that the no bail out and no
monetisation of debt clauses as main stays of euro zone design effectively had to be
abandoned. In this context the ECB, has begun to recognise that in future monetary policy
will have to play a role in financial stability by curbing asset price rises, moving the ECB
away from the pre-crash Jackson Hole central banking consensus. The dynamic at work here
appears to closer to Bayesian learning and updating. The ideational change that has resulted
from a more dominant ECB, Braun concludes, is closer to a form of paradigm maintenance
and adjustment than paradigm change, not least because the ECB’s enhanced powerful central post-crash institutional position enables it to defend the existing paradigm if it so chooses. This has been evident in a more orthodox approach to the management of the Euro-area debt crisis, with small movements towards limited quantitative easing only emerging in 2015. The Bank has effectively used its new position to reinforce ‘old ideas’ on fiscal consolidation, so central to the analysis of Dellepiane-Avellaneda. Some change has therefore materialised, but it has been of much less importance for the citizen-taxpayers whose resources guaranteed the banks in the first place.

Manuella Moschella then presents a clear case of policy and ideational change, and one that was long run in terms of incubation. Her article focuses on the International Monetary Fund (IMF) and its policy approach to capital flows in the post-crisis period. The roots of this important ideational shift lie in the pre-crisis years when episodes of financial instability affected emerging market economies. When the great financial crisis hit the core financial centres, the ongoing institutional debate shifted definitively in favour of a new policy consensus and new advice to members. The ideational underpinnings of this change are scepticism about the capacity of global capital markets to consistently yield acceptable or indeed workable outcomes for a wide range of IMF members and their societies. A new consensus was also required to legitimate and stabilise a highly-integrated global economy including more prominent rising emerging market economies, that did so much to rescue the international system. In this case, institutional dynamics were very much part of a new ideational consensus that evolved incrementally and took several shocks to solidify. In the case of the Fund and capital controls, Moschella finds that institutional frictions acted as enabling factors, rather than closing down reform, as existing IMF institutional mandates enabled staff the space to gradually and creatively reinterpret the desirable approach to controls. Again a Bayesian dynamic appears evident in this policy area to date.
Finally, Geoffrey Underhill examines post-crisis policy change in international banking and securities market supervision and regulation. He focuses on the post-crisis debate and reform measures promulgated by two prominent international organisations responsible for developing and enforcing international standards for financial stability and the regulation of cross-border financial markets and institutions. The norms of global financial supervision were in the front line of the attack mounted by pre-crisis critics and post-crisis reformers alike. As the crisis emerged and the evidence piled up, volume after volume detailed the extent of policy capture, the dominance of the financial sector over regulators, the weakness of implementation and enforcement, and thus the dramatic failure of the policy framework and its ideational underpinnings of ‘market-based governance’ to prevent crisis and deliver financial stability. Citizens and their elected representatives reeled and fumed at the cost of bank rescues, of hedge fund failures, and at Ponzi fraud like that of the Madoff investment empire. While few bankers hung their heads in shame, official sector supervisors and regulators promised better - a lot better. Yet Underhill argues that fundamental change, despite seeming apposite conditions, has not materialised, at least not yet. The ideational underpinnings of market-based financial governance remain largely intact and interest-based and institutional reflexes die hard. This may change. The ideational ingredients of a major shift are in place, and some national central banks such as the Bank of England appear resolute in developing a new policy agenda. Yet so far, path-dependency and vested interests are holding out, delaying and diluting change where earlier they had to concede in the post-crisis deluge.

The political and policy fall out from the crash of 2008 is still unfolding, so definitive conclusions remain premature, but these four articles cast some crucial new light on the ideas-interests-institutions debate in relation to policy change, as well as the contemporary patterns of change in different policy areas. Path-dependency and its forms in different
institutional contexts are a repeated theme, but also how different policy areas have different political dynamics. Fiscal policy has emerged as the most politicised of these policy areas, where authority relations appear most important. The pace of change has moved slowly in all of our policy areas, due to a combination of political and institutional factors, but crisis generated ideational and political tensions have been evident in all policy areas, and have not as yet been fully and finally resolved. The situation of post-crash change both generally and in the policy areas covered here remains dynamic and politically fluid. That makes the articles included here both interesting and important for political scientists.

**Bibliography**


1 All of the papers in this special section were originally presented in an ECPR joint sessions workshop directed by Andrew Baker and Geoffrey Underhill hosted in Antwerp, 10th-15th April 2012, entitled “Economic Ideas and the Political Construction of Financial Crisis and Reform.” The four papers were selected by the workshop directors to form this special section from the contributions and have since been subjected to a double blind peer review process.