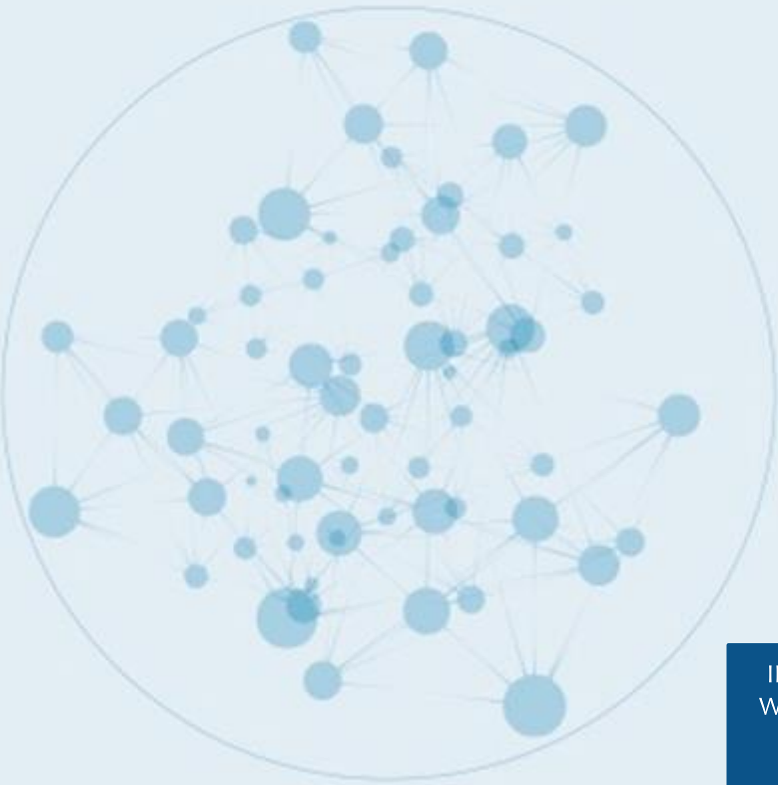
Inquiry: Design of a Sustainable Financial System

UNEP

MAKING THE JUMP

How Crises Affect Policy Consensus and Can Trigger Paradigm Shift



INQUIRY WORKING PAPER

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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it published its final report, *The Financial System We Need*, in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

The Centre for International Governance Innovation (CIGI)

CIGI is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

For more information, please visit *www.cigionline.org.details*.

About this report

This paper draws on material from 34 anonymized interviews with principals who were present during the financial crisis, and who were active in the international institutional and policy response that it triggered.

It results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

Comments are welcome and should be sent to *simon.zadek@unep.org* and *mackintoshs@group30.org*.

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Introduction

The scientific worldview undergoes relatively rare paradigm shifts (Kuhn, 1962), such as the move from the Aristotelean, geocentric view to the Copernican, heliocentric view in 1543. Such major shifts can also occur in the economic, financial, or regulatory world view that is dominant in a particular era. Economic events, and in particular severe national (Gamble, 1988; Hall, 1993) or global crises, can cause an increase in anomalies that cannot be explained by the current consensus. Eventually, a tipping point is reached, which signals the beginning of a paradigm shift in world view among leaders, expert communities, and in the policies they adopt and champion. This type of shift is what has occurred since the 2007-2008 financial crisis and in the response it engendered.

The dynamics of paradigm shift and rapid policy evolution

This paper outlines the dynamics behind the financial regulatory paradigm shift that began in 2008-2009. It seeks to identify parallels with and differences from the slower moving, even more consequential, global climate change crisis, and the fitful, still under way, policy paradigm shift that the United Nations Environment Programme (UNEP) and other stakeholders are trying to support and facilitate linking economic sustainability, financial regulation, markets, and climate change. The following ten observations are developed in this paper:

1. Crises matter for financial system design and reform
2. Crises can enable leaps from one policy narrative to another
3. The abandonment of prior policy norms is possible
4. Not all policies are equally strong within a paradigm shift
5. Dominant expert communities matter to paradigm shifts and policy outcomes
6. The creation of policy consensus between communities also matters
7. Paradigm shift is not a smooth process, but a lumpy one
8. Using soft-law mechanisms is a viable second option
9. There are multiple pressure points for change
10. Emerging countries are important to the paradigm shift.

Some of the lessons from the financial crisis response and policy shift are potentially useful and positive. Others are more mixed. Some are negative. Nonetheless, these observations from the financial crisis have utility as policymakers and actors consider how to impact the speed at which broad new policy approaches can be adopted, and can begin to integrate climate change risks within financial decision-making and policies.

The pre-crisis period

The period leading up to a paradigm shift sees increasing anomalies, observations, and events that cannot be explained with an existing model. Proponents of the model defend the status quo, but ultimately, either suddenly or eventually, the consensus shifts in favour of a new model or theory.

A tipping point and shift in world view was seen in response to the financial and economic crisis of 2007-2008. Initially, there was denial or a refusal to see what was unfolding. This rapidly transitioned into a realization among an increasing number of actors that the neoliberal economic and regulatory models had failed. The totemic myths of self-correcting, self-stabilizing markets, based on rational actors and decision-makers, were exposed as naïve and false. The great moderation was over. Credit and trade had ground to a halt. Panic was endemic. The US and other economies rapidly contracted. Trillions of dollars in assets, in both housing and personal wealth, were wiped out. Action was needed to arrest the crisis.

Collective state action—a reassertion of state power and authority—was the only remaining option. Policymakers confronted "the limits of unrestricted globalization [and] … the intrinsic tension between global financial markets and sovereign states" (Subaachi, 2010). Leaders were faced "not only with the collapse of a financial system, but also with the collapse of a worldview" (Ferguson *et al.*, 2010). Laissez-faire neoliberalism confronted a legitimacy crisis (Chorev and Babb, 2009; Helleiner, 2010), and the spell of the "mystical Anglo-Saxon model of liberalization and deregulation" was broken (El-Erian, 2009). Pressed by the nature of the crisis, a change in the paradigm of regulatory and economic governance began (Constancio, 2010).

In the case of climate change we may be (finally) nearing the end of a long drawn-out pre-crisis period characterized by increasing anomalies, severe and inexplicable – at least to certain sections of the political elite in key countries – climate events and long-term trends. The consensus has shifted inside some communities. But it has yet to do so within other communities that are central to tipping the policy narrative from resistance to a new mindset and ideational worldview. When that occurs, the paradigm and narrative will shift faster and can strengthen and solidify.

1 Crises matter for financial system design and reform

Crises matter for financial system design and reform. When all parties face disaster, new narratives can emerge to guide policy. Petty national differences dissipate. Issues are clarified. The menu of possible solutions enlarges. Domestic interests are quiescent. Decision-making is hastened.

The 2007-2008 crisis created dynamics that helped clarify issues, highlighted failures, forced actors together, allowed consideration of a broader array of policy options that would otherwise be ruled out, and provided a window of opportunity that permitted major policy shifts that, absent a crisis, would be considered highly unlikely or impossible to achieve. There is also a rhythm to crisis response. First, we see immediate crisis management—the firefighting phase. Then, there is an effort to identify the reasons for the crisis and design reforms: the concrete reform phase. Finally, there is a return to business based on the "new normal." As this happens, dissension reappears and the centripetal forces of the crisis are replaced by centrifugal forces of normal international diplomacy. This cycle of crisis management, reform, and gradual relapse is seen in the financial crisis.

In the financial crisis response, we are well into phase three: a gradual return to a new normal based on the altered policy consensus. In the climate change response we are still in a prolonged firefighting phase, and perhaps at the start of the reform phase. But matters are much more complicated and the policy consensus is weak or lacking among key constituencies, in the economic and financial sectors, and certain key governmental ministries. So the coalescence of a new climate change paradigm is still being disputed.

2 Crises can enable leaps from one policy narrative to another

Facing crises, policymakers can leap from one theory to another if the prior beliefs prove incapable of explaining anomalies, and fail to provide a solid basis for future financial sustainability and stability.

The economic and financial crisis of 2007-2008 precipitated a collective jump among political leaders, especially among their experts in the central banking community. The crisis caused political leaders and policymakers to make a pronounced shift away from the previously dominant neoliberal laissez-faire "market fundamentalist" (Stiglitz, 2008) viewpoint, towards the collective reassertion of state power (Padoa-Schioppa, 2010), made actual through the reregulation of global financial markets and firms, using new forums and institutions (principally the G20 Leaders' Summits and the Financial Stability Board [FSB]). The paradigm shift in regulatory worldview that began as a result of this narrative shift is not yet complete; it is the subject of dispute, and defence; it is stronger in some areas than in others. But the shift constitutes a significant and potentially durable new worldview.

Senior political leaders and officials present during the crisis response use similar language. They speak of having no alternative, of needing to act, of looking into the abyss, of needing to step back. Participants identified a "real convergence," and describe it as the formulation of a "new consensus" by various sources (Blanchard *et al.*, 2012; Constancio, 2010; Smaghi, 2008).

The 2007-2008 crisis demonstrated that the creation of a new policy consensus can be quite rapid—a sudden shift in stance precipitated by a crisis and a common consensus about its causes and possible solutions. Alternatively, the build-up of anomalies, crises, and the process of paradigm shift and consensus creation may be a multi-year exercise in deliberation and dispute. In other words, changing the policy consensus can be fast or slow.

The financial and economic crisis was clearly visible, as were the obvious policy failings. The crisis had widespread and immediate effects globally that resulted in public demands for swift action. The financial crisis also had antecedents in the more minor financial crises of the 1990s and 2000s. Not all central bankers had left Galbraith (1954), Kindlberger (1986), or Minsky (2008) mouldering on their bookshelves, although many did. Former Fed Chairman Ben Bernanke, in particular, was acutely aware of the lessons from 1929, the parallels, and the need to act, and what he believed those actions should be. Other policymakers made rapid U-turns, such as Mervyn King, former Governor of the Bank of England and Chairman of its Monetary Policy Committee. Still others, such as Adair Turner, former Chairman of the Financial Services Authority, led the post-crisis dissection, self-analysis, and policy response. Policymakers had models to reach for and could check and compare their responses to other historical events.

This is not the case for the major—arguably even more important—climate change crisis confronting global political leaders and financial policymaking communities. The wave of the crisis in this case is higher, broader, and envelops us all. Because of this, it is harder to grasp and see as individuals, policymakers, and political leaders, since there is a natural tendency to focus repeatedly on the more immediate troubles rather than something ongoing, amorphous, and difficult to fully grasp. The sense of imminent crisis is less keenly felt. From a policymaking standpoint, climate change is more intractable. The costs are higher but more diffuse. The timetable for action is both urgent and yet distant. And the tragedy of the commons can result in delayed action by individual actors and states.

The climate change crisis also has a frequency of one. That is, no one in human memory has experienced what is today under way. It is therefore potentially harder to shift the public consensus and policymaking communities to the tipping point of a new consensus, because of the lack of evidentiary parallels outside those understood by scientists looking closely at ice cores, which capture events on geological timescales. Shifting the public and policymaking consensus permanently to one that more fully captures the environmental and societal risks, which are already unfolding, is a huge task.

But once the tipping point is reached within the consensus narratives used by key policymaking communities that control economic and financial policy levers, significant rapid change should be possible and faster than perhaps looks possible before a paradigm shift is triggered.

3 The abandonment of prior policy norms is possible

In crisis-altered circumstances, what are considered "settled agreed norms" can suddenly be jettisoned by political leadership and a policy community in favour of a new narrative, a new perspective, and a new set of policy tools.

In the financial crisis, we saw the rapid design and agreement of a new, quantifiably stronger approach to the coordinated macroprudential supervision and regulation of global financial markets, and firms emerged rapidly out of the crisis response.

The approach "seeks to develop, oversee, and deliver appropriate policy response to the financial system as a whole rather than focusing on individual institutions or certain economic measures in isolation. Macroprudential policy aims to enhance the resilience of the financial system and to dampen systemic risks that spread through the financial system" (Group of Thirty, 2010). This policy shift signals a major narrative and policy change in the central banking supervisory approach of developed countries (it had been used in China and Japan previously), from one predominantly focused on the stability of *individual* institutions (microprudential oversight) towards a focus on the stability of the financial system *as a whole*. Post-crisis, the central banking community consensus swiftly adopted this macroprudential policy viewpoint. The FSB, and the Basel Committee on Banking Supervision below it, designed and agreed macroprudential tools that would be applied consistently throughout the economic cycle (such as higher capital, liquidity, and leverage standards), and variable tools that could be triggered during the cycle as asset bubbles begin to develop (such as countercyclical buffers). The policy is a multifaceted reregulatory stance and series of interlinked policy solutions. It is a rejection of the past neoliberal laissez-faire approach to financial markets, firms, and adds the maintenance of financial stability explicitly to collectively applied central bank goals.

The Basel III Accord is the keystone of this policy worldview. Agreed in little more than a year from 2009 to 2010, it increased by an order of magnitude the level of core equity and risk-adjusted capital to approximately 10 per cent, required by the world's largest and most systemically important firms. This accord was and is the central policy element in the new approach.

The strength of the accord is being further buttressed with a 2014 proposal to increase risk-adjusted capital for the world's largest banks even further, through the adoption of a new measure, Total Loss Absorbing Capital (TLAC), which would require the largest firms to hold up to 20 per cent risk-adjusted capital. Both this new measure and national actions underscore that the new normal is not static but is still being built and strengthened.

National Basel-plus "gold plating" is seen in major jurisdictions. This, and the proposed TLAC, are important leading indicators of the robustness of the underlying new normal. They demonstrate that the paradigm is progressively improved and added to rather than weakening. The paradigm of progressive improvement is what one would expect of a paradigm becoming more durable—incremental additions to the new normal.

To conclude, central bankers abandoned prior positions and adopted a new macroprudential consensus in response to the global financial crisis. The community then applied this worldview to banking supervision resulting in a large material increase in coordinated regulation and required capital for the world's largest financial institutions. Basel III, its application and national implementation, indicates the strengthening of the new worldview during the last six years, signalling a reassertion of state power and authority over financial markets and firms. Just such a shift in the policy consensus is also possible (but not certain) in the climate change space.

4 Not all policies are equally strong within a paradigm shift

In any new worldview, not all polices are equally strong. But this is to be expected. Some are large jumps (such as macroprudential policy), others are less momentous, but still additive to the new policy