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Diagnosing and Explaining the Global Financial Crisis: Central Banks, Epistemic Authority and Sense-Making

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Diagnosing and Explaining the Global Financial Crisis: Central Banks, Epistemic Authority and Sense-Making

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Abstract

This article explores a key facet of the ideational dynamic underlying the politics of the global financial crisis, examining the interpretative and communicative practices through which the two most powerful central banks in the world – the Fed and the ECB – made sense of the events. Drawing on a constructivist neoinstitutional perspective, the study traces and analyzes the diagnoses and causal accounts of the global financial crisis formulated and voiced by these two actors, mapping and examining their evolution from the beginning of the events in the American subprime market in mid-2007 through the peak of the crisis in global financial markets in mid-2009. The analysis assesses the extent to which the two central banks diagnosed and explained the crisis in ways that challenged dominant notions and conceptual assumptions regarding the economic field, particularly the financial realm, or rather in ways that served to ratify them.

While in the first stages of the crisis the diagnoses and causal accounts tended to ratify dominant notions and understandings of the financial field, they later evolved as involving a partial, but still significant, reassessment of established truths. These coherent and detailed sense-making plots touched upon some of the most basic attributes of global financial capitalism, carrying with them the potential for helping to open up the political space for a reevaluation of some of its ideational underpinnings.

The profound global financial crisis that erupted in 2007 can be considered as posing a fundamental challenge to the mode of governance of current capitalism and to its underlying understandings of the nature and functioning of the economic field. Particularly important in this respect are the possible effects of the crisis upon fundamental notions and assumptions underpinning established institutional arrangements and rules. Changes in the ways in which markets and economic actors are conceived, and in the definition of the proper patterns of interaction between them and the state, can function as a key factor contributing to concrete institutional change. Yet one should not assume that crises necessarily lead to ideational transformations of this magnitude in a straightforward manner.

Dynamics of institutional change, including their ideational dimension, are complex and multifaceted political processes, involving various facets and numerous actors that articulate and promote diverse interests, institutional logics and ideational formulas. Hence, such processes are generally gradual and incremental, and their outcomes are highly contingent on many and varied contextual factors. A fundamental facet in these processes is the ways in which influential actors make sense of the situation, formulating diagnoses of current conditions and causal accounts for explaining them. This is particularly important in highly uncertain and volatile times of crisis, when the taken-for-granted status of dominant institutional blueprints, as well as of their ideational foundations, is potentially jeopardized. In these cases, explicit interpretative and communicative practices of crisis sense-making, through which actors diagnose and explain the current state of things, constitute a basic dimension of the politics of institutional change. The extent to which powerful actors articulate their diagnoses and causal explanations of the crisis in ways that differ from conventional reasoning and challenge established tenets, fundamentally affects the chances for the occurrence of deep institutional change. Since these diagnoses and causal accounts are neither an undisputed given nor completely determined by "objective" conditions, but rather are the product of interpretative processes, and since they feed into the dynamics of actors' preference formation and course of action, they constitute fundamental political practices.

Drawing on a constructivist neoinstitutional perspective, this article traces and analyzes the diagnoses and causal accounts of the global financial crisis formulated and voiced by the two most powerful central banks in the world: the American Federal Reserve System (the Fed) and the European Central Bank (ECB). In light of the epistemic authority enjoyed by central banks and the key role they have played in the management of the current global financial crisis, the ways in which they have assessed its character and identified its causes constitute a crucial dimension of the politics of the crisis. I map and examine how these sense-making practices evolved from the beginning of the events in the American subprime market in mid-2007 through the peak of the crisis in global financial markets in mid-2009, assessing the extent to which the two central banks diagnosed and explained the crisis in ways that challenged dominant notions and conceptual assumptions regarding the economic field, particularly the financial realm, or rather in ways that served to ratify them. The analysis is based on the examination of the main arguments, themes and notions appearing in public statements and speeches by members of the Fed's Board of Governors and the ECB's Executive Board between July 2007 and June 2009.[1]

In the following section I introduce the analytical framework of the study, elaborating on the significance of ideational practices of sense-making as a key dimension in the politics of crises, particularly concerning the variable relationships between different diagnoses and causal accounts to established understandings and institutional rules. Then I address the epistemic authority accumulated by central banks over the last two decades, and its implications for the importance of their sense-making practices during the financial crisis. In the following two empirical sections, I examine the varied diagnoses and causal accounts offered by the two central banks and how they evolved as the situation became more uncertain and volatile, showing that they moved from ratifying to increasingly differing from dominant notions and understandings. I conclude by discussing the implications of the study for a constructivist neoinstitutional analysis of the politics of the crisis.

Diagnoses, Causal Accounts and Crisis Sense-Making

The important effects of deep crises in the political economy as inducing fundamental institutional change have been long and widely acknowledged in the neoinstitutional literature. Crisis situations which influential actors see as threatening the balance of power in the field and their own ability to control their environment tend to undermine the stability of the institutional order (Campbell 2004; Keeler 1993). The two most salient instances of this dynamics in modern capitalism are the Great Depression of the 1930s and the stagflation

1 The data examined comprises 137 items for the Fed and 195 for the ECB. They were all retrieved from the website of the Bank for International Settlements (http://www.bis.org/list/cbspeeches/index.htm).

crisis of the 1970s, which have been considered as fundamental factors that stimulated the formulation and institutionalization of the Keynesian and neoliberal policy paradigms respectively. In both cases, the serious conditions of the economy discredited existing policy formulas and institutional arrangements, providing initial impetus for policy paradigm shifts (Blyth 2002; Hall 1992). As the economic crises turned into broader legitimation crises, they opened up the political space for the formulation and institutionalization of alternative models of state-economy relations (Campbell and Pedersen 2001; Fourcade-Gourinchas and Babb 2002).

Yet, the connection between severe economic conditions and the opening up of opportunities for institutional change is neither automatic nor deterministic, but politically constituted by ideational dynamics (Hay 2011b). It is the result of contentious processes in which specific political actors actively engage in interpretative and communicative practices of sense-making. As Vivien Schmidt (2009) has suggested, the discursive strategies deployed by actors while generating and offering authoritative interpretations of the state of things, constitute a key dimension of the political foundations of institutional change. Though processes of sense-making are a fundamental constitutive dimension of social and political life in any situation, they become far more visible and crucial in conditions of high uncertainty, when the state of things appears to challenge dominant understandings and expectations concerning the normal course of events. In these cases, when taken-for-granted and routine reasoning is shaken, explicit interpretative practices are necessary to make sense of volatile environments that defy established notions and beliefs. These interpretations allow actors to form their policy and institutional preferences, and communicate them to others as proper and necessary responses to uncertain and threatening events (Abolafia 2005; 2010).

From a constructivist neoinstitutional perspective (see Hay 2011a), therefore, rather than assuming a straightforward causal link between crisis and profound institutional change, a fundamental issue to be examined is the ways in which influential actors make sense of the situation, characterizing and explaining it to themselves and to others. These interpretations might or might not conduce to the delegitimization of established institutional arrangements and their ideational underpinnings, and to the formulation of alternative understandings of the economic sphere and its relation with the social and the political realms (Abdelal, Blyth and Parsons 2010).

Processes of sense-making can be understood as composed of two distinct, albeit interrelated, interpretative facets: diagnosis and causal accounts. Diagnosing a situation involves the selection and interpretation of information, focusing on particular events, and ordering them into relatively coherent and plausible plots that define the state of things in a certain way, providing an answer to the basic question “What is going on?” This is especially salient under conditions of extremely high uncertainty, like in the case of the global financial crisis, when established and taken-for-granted ideational frameworks for characterizing and understanding events and processes in financial markets appeared to have lost their validity and relevance. Hence, the very definition of a particular set of conditions as a crisis is not given, as it depends not only on the “objective” state of things, but also on the interpretative practices conducted by influential actors (Brandstrom and Kuipers 2003). A key dimension of variation in situation diagnoses is the extent to which it is defined as severe, as posing a tangible and urgent threat to the established order. A particular situation can be characterized as a relatively isolated and circumscribed incident or a temporary disturbance with limited broad implications, a confined episode or accident after which it will be possible and proper to restore the status quo ante, or as a normal and even healthy readjustment of the system that remedies past deficiencies. Alternatively, the same situation can be diagnosed as a momentous event that puts under threat the orderly functioning and continuity of the entire system. Whereas the first types of diagnoses can assist in restoring the legitimacy of the ideational foundations of established institutional rules and arrangements, the last type has a greater potential of reinforcing its loss of credibility, contributing to a broad reconsideration of basic understandings, notions, rules and patterns of action (Hart and Tindall 2009a), and the formulation of more or less comprehensive alternatives.

The analytically next phase in processes of crisis sense-making is the formulation of causal accounts. This comprises the specification of factors that have caused the crisis, their ranking according to their relative importance, the formulation of interactions among them, and the more or less explicit identification of mechanisms linking cause and effect. Like diagnoses, causal accounts can also take varied forms, ranging from focusing on circumstantial, even accidental, factors to focusing on systemic factors seen as inherent to the inner logic of the system. Crises can be explained as resulting from the misbehavior and/or misjudgment of particular actors, such as the greediness and unscrupulous conduct of financiers, which were often emphasized in the media as having led to the global financial crisis. Alternative causal accounts would focus on more or less fundamental deficiencies in the design and implementation of specific institutional arrangements. More comprehensive causal accounts would address basic dimensions of the political economic regime, highlighting the ways in which systemic elements in the established mode of governance has led to the crisis.

Particular crisis diagnoses and causal accounts can play an important role in reaffirming, or alternatively undermining, core assumptions and notions that serve as the basis for established institutional arrangements and policies. Hence, from a neoinstitutional perspective they can be considered as a particular form of "institutional work"; a concept entailing practices of varying types that are directed at maintaining, disrupting or creating institutional formulas and rules (Lawrence, Suddaby and Leca 2009). In this sense, crisis diagnoses and causal accounts are fundamental political acts that can encourage, or alternatively preclude, deep institutional change, mediating the connection between crises and institutional reconfiguration (Abdelal, Blyth and Parsons 2010).

Like any other political resource, the ability to formulate authoritative diagnoses and causal accounts is not evenly distributed among actors. Due to their privileged institutional locations, certain actors are more likely to impact on processes of crisis sense-making by providing interpretative frameworks with higher chances of being seen as thoughtful and valid. This is the case for central banks. As elaborated in the next section, central banks, particularly the most powerful among them, emerged in the last decades as pivotal actors in the global political economy with the epistemic authority to interpret and explain the state of things in financial markets and in the economy at large.

Central Banks, Epistemic Authority and Crisis Sense-making

As noted, processes of crisis sense-making are complex processes in which many and varied actors participate. In the case of the global financial crisis, incumbent and opposition politicians, different state agencies, international economic organizations and forums, the general and economic media, and the economics epistemic community took part in the efforts to formulate relatively coherent and convincing diagnoses and causal explanations that could make sense of the breakdown of what was believed to be the normal course of events (see Brassett and Clarke 2012; Hart and Tindall 2009a; Riaz, Buchanan and Bapuji 2011). Actors with recognized epistemic authority, those who have the socially recognized knowledge considered necessary to define what something is (Abdelal, Blyth and Parsons 2010), have the highest chances of having the most significant impact on these processes. Furthermore, the authority of knowledge-based experts to elucidate the situation is of exceptional importance in cases of crisis in institutional fields regarded as highly complex and requiring highly sophisticated knowledge, such as the financial realm (Mugge 2011; Seabrooke 2010).

In the case of the global financial crisis, central banks have played a particularly prominent role in the process of crisis sense-making, for two interrelated reasons. First, in recent decades, as part of broad processes of liberalization and financialization of the economy, central banks all over the world accumulated a great deal of institutional power as autonomous agencies. The notion and practice of independent and powerful central banks became a globally accepted standard of proper state institutional architecture (Jayasuriya 2001; Polillo and Guillen 2005), constituting a fundamental instrument in the neoliberal system of global financial governance (Hall 2008). Central banks gained the power not only to autonomously determine and implement policies with enormous effects on the economy, but also to provide authoritative judgments about the current and prospective state of the economy. Within this context, an important power resource of central banks is their privileged positioning as state agencies that appear to be external to the political sphere (Goodman 1992; Johnson 1998; Lebaron 2000). Based on this institutional location, central banks, more than any other state agency, are able to make the argument that, in contrast to political actors and their narrow interests, their actions derive from undisputed economic expertise (Kirshner 2003; Maman and Rosenhek 2011; Watson 2002). In this regard, Martin Marcussen (2006a) has noted that the domain of central banking has lately been undergoing a process of scientization. By this he means that, on the basis of dense institutional connections with the epistemic community of academic economists, and the use of scientific knowledge, and even its production and dissemination, central banks have been able to consolidate their power as the carriers of unquestionable expertise. Central banks, therefore, have become pivotal actors in transnational networks in which policy-relevant knowledge is produced and disseminated. In other words, they have accumulated a great deal of recognized epistemic authority for assessing, evaluating and explaining economic and financial processes.

The second reason for the importance of central banks as sense-makers of the global financial meltdown is related to the role they have played in the management of the crisis. As key state agencies whose fields of action are intimately related to the functioning of the financial sphere, central banks have played an essential role at the level of the formulation and implementation of concrete measures to manage the crisis. The enormous injection of liquidity by various means, unprecedented drastic monetary easing, exceptional intensive intervention in financial markets, and recapitalization of financial institutions by central banks have been the major measures employed in the attempts to contain and resolve the crisis. Tellingly, all these emergency measures deviate to a large extent from the principles of the hitherto dominant institutional model defining the proper roles and patterns of action of central banks, especially the tenet of minimal intervention in financial and money markets, and the rule that monetary policy can and should only be used to control inflation levels (Leijonhufvud 2009). As a result of this substantial and highly visible intervention, as the crisis evolved the public salience of central banks increased significantly, and they came to be broadly seen as crucial actors in the management of the crisis. This intensive and extensive involvement, in turn, further strengthened the positioning of central banks – particularly of the two most powerful central banks in the world, the Fed and the ECB – in the global political-economic field, as leading players with the necessary epistemic authority to interpret, explain and act upon the economic world. Therefore, the ways in which they diagnosed and explained the crisis are of major significance for the broad politics of potential institutional change, whether by discrediting established assumptions and institutional blueprints or, alternatively, by restoring their credibility.

Diagnosing the State of Things: From Market Readjustment to Collapse

A primary facet in processes of sense-making concerns the ways in which the state of things is interpreted and characterized by relevant actors. A particularly important question in this regard is the extent to which the situation is diagnosed as connoting an acute threat to the established order. The diagnoses of the financial and economic conditions formulated by the Fed and the ECB along the crisis followed a rather similar course, which proceeded from characterizing the events in financial markets as temporary disturbances and a normal instance of market readjustment, to defining the condition of the global economy as representing a massive and profound crisis threatening the whole global economic system.

During the first months of the events that would rapidly turn into the financial crisis, the two central banks described the situation mainly using terms that connote passing and confined incidents, although worrying and deserving of close attention. Most likely deliberately aimed at calming players in financial markets and restoring confidence, this diagnosis characterized the incipient market stress as essentially temporary and controllable. The most commonly used expressions were market volatility, turbulence, turmoil and nervousness. Though it was noted that these conditions were not confined solely to the American subprime mortgage market but were affecting other financial markets as well, the diagnosis implied that this was a circumstantial and quite normal situation well known in financial markets.[2]

Simultaneously, a more elaborate diagnosis begun to be voiced, according to which the financial markets were in fact experiencing an unsurprising and healthy process of correction and readjustment through reassessment and repricing of risk. While this diagnosis pointed to past excesses and exuberances in the financial sphere that needed to be corrected, particularly concerning the under-appreciation of risk, it essentially reaffirmed the fundamental notion of efficient self-regulating markets: market forces were just accomplishing the necessary and unavoidable price correction that would bring the market to a new, more efficient, equilibrium.[3] As put by Ben Bernanke while referring to the financial stress in September 2007, "[M]arkets do tend to self-correct".[4] The natural and basically positive character of the events as an expression of the efficient functioning of self-correcting financial markets was underlined also by the President of the ECB, Jean-Claude Trichet, who in October 2007 remarked:

> It is important to note that the present significant market correction is not an event that should surprise us. […] In many respects the present episode can be interpreted as correcting those anomalies and paving the way – once the turbulences would have dissipated – for a more sustainable structure of global finance.[5]

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2 For instance, "Housing, housing finance, and monetary policy", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyoming, 31 August 2007; "The financial market turmoil, the European economy, and the role of the European Central Bank", Lucas Papademos, Vice-President of the European Central Bank, at an event organized by The European Institute, New York, 27 September 2007; "Reflections on the global financial system", Jean-Claude Trichet, President of the European Central Bank, at the 2007 IIF Annual Membership Meeting, Washington DC, 20 October 2007.

3 For instance, "Financial markets and central banking", Donald Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Peter McColough Series on International Economics, Council on Foreign Relations, New York, 28 November 2007; Jean-Claude Trichet, President of the European Central Bank, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 9 October 2007.

4 "Subprime mortgage lending and mitigating foreclosures", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 20 September 2007.

5 "Reflections on the global financial system", Jean-Claude Trichet, President of the European Central Bank, at the IIF Annual Membership Meeting, Washington DC, 20 October 2007.

The great emphasis put on the notions of repricing and reassessment of risks is highly significant for illuminating the connection of this diagnosis to the established understandings of the financial field that developed over the last two decades. With the processes of financial innovation that started in the 1980s and accelerated enormously in the 1990s, the basic notion that risk can be correctly measured and valuated, and hence efficiently managed through sophisticated financial instruments based on precise mathematical models and techniques, turned into a crucial constitutive element of global finance (Langley 2010; MacKenzie 2006). The diagnosis of the events as conducing to a more accurate and realistic pricing of risk ratified therefore the fundamental epistemic assumption that financial risk can indeed be calculated. It expressed and reaffirmed the belief that, even if there were some mistakes in the past, financial risks are in principle commensurable, and that market pricing is the effective mechanism to evaluate and manage them (Best 2010; Wigan 2010). Hence, this diagnosis reenacted the deep-seated conception of risk that underlies contemporary finance: a reified object that can and should be unproblematically and naturally commodified, and traded efficiently in financial markets.

A distinct set of descriptive constructs begun to be used by the two central banks towards the end of 2007, when the market disturbances and readjustment proved to be more severe and persistent than had been expected. By then, the diagnosis of the events began to point to significant difficulties in the functioning, or even collapse, of some of the institutional foundations of financial markets. In addition to mentioning a severe liquidity shock and loss of confidence in the financial system by market players as major problems, the Fed and the ECB began to note the breakdown of the most fundamental market mechanism: the price discovery mechanism. Differing significantly from the previous diagnosis of healthy repricing, now the troubles in financial markets were seen as the result of the fact that buyers and sellers were unable to discover prices for a broad range of financial products due to a disruption of information.[6] Obviously, a market in which prices cannot be set is a fundamentally dysfunctional market in critical condition. Furthermore, it was noted that market players lost the confidence in their ability, under the current conditions, to quantify

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[6] For instance, "Financial instability and monetary policy", Frederic Mishkin, Member of the Board of Governors of the US Federal Reserve System, at the Risk USA Conference, New York, 5 November 2007; "Remarks on the recent turbulences in global financial markets", Jean-Claude Trichet, President of the European Central Bank, at the Policy Discussion "Global Economic Policy Forum 2008", New York University, New York, 14 April 2008.

and price risks.[7] This is a characterization of the situation that suggests the emergence of a crisis of "pragmatic legitimacy" (Morgan 2010), when market players stop trusting that established rules and practices can deliver the expected normal results. Hence, this diagnosis signals the commencement of the interpretation of the events in the financial markets as a crisis that might jeopardize the taken-for-granted status of accepted truths and institutional arrangements.

As conditions deteriorated, from early 2008 onwards, the diagnosis of the situation as an increasingly threatening and urgent systemic crisis became explicit. The potential severe and protracted damage of the current dynamic to the financial system and to the economy as a whole was vehemently emphasized.[8] The deleveraging process in financial markets was not defined as a healthy correction anymore, but as "very violent and dangerous".[9] Likewise, the two central banks stressed that the liquidity stress – a seemingly technical issue – turned into a solvency crisis of major financial institutions with risky systemic consequences.[10] Furthermore, the striking decline in market participants' confidence in the financial architecture itself,[11] and even a "complete breakdown in trust across financial markets",[12] were pointed out as causing a critical disruption in the functioning of the financial system; a

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7 "The end of history?", Kevin Warsh, Member of the Board of Governors of the US Federal Reserve System, to the New York Association for Business Economics, New York, 7 November 2007.

8 For instance, "Actions by the New York Fed in response to liquidity pressures in financial markets", Timothy Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the US Senate Committee on Banking, Housing and Urban Affairs, Washington DC, 3 April 2008; "Liquidity, financial markets and the economy – the role of central banks", José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Fundación Caixa Galicia, Santiago de Compostela, 16 October 2008.

9 "The Federal Reserve's liquidity facilities", William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Vanderbilt University Conference on Financial Markets and Financial Policy, Nashville, Tennessee, 18 April 2009.

10 For instance, "Modernizing bank supervision and regulation", Daniel Tarullo, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington DC, 19 March 2009; "Undervalued risk and uncertainty – some thoughts on the market turmoil", Jean-Claude Trichet, President of the European Central Bank, at the Fifth ECB Central Banking Conference "The Euro at Ten: Lessons and Challenges", Frankfurt am Main, 13 November 2008.

11 "Financial market turmoil and the Federal Reserve – the plot thickens", Kevin Warsh, Member of the Board of Governors of the US Federal Reserve System, at the New York University School of Law Global Economic Policy Forum, New York, 14 April 2008.

12 "Financial market turmoil – the Federal Reserve and the challenges ahead', William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Council on Foreign Relations Corporate Conference 2009, New York, 6 March 2009.

malfunctioning of such dimensions that the financial architecture was declared to be broken.[13] So much so that the current "great crisis" was seen as raising "questions on the functioning of financial markets and institutions, in particular their capacity to price, allocate and manage risk efficiently".[14] As noted previously, the broadly accepted notion that markets have the natural capacity to price, allocate and manage risks efficiently has been foundational to the process of innovation and enormous expansion experienced by the financial sphere since the 1990s; a notion that now was seen as being undermined.

An important component in the diagnosis of the crisis as threatening and acute was the emphasis put on its global character, that made it even more daunting. The events, particularly following the collapse of Lehman Brothers in September 2008, were defined as affecting the heart of the global financial system and posing extraordinary systemic risks to global financial and economic stability.[15] The gravity of the state of things was underlined by stressing that this is a situation that cannot be solved by the market on its own, making necessary intensive state intervention to preserve systemic stability and to make markets function again.[16] This severe diagnosis certainly served to justify the extensive interventionist measures taken by governments and central banks in order to rescue financial institutions and to contain the meltdown. Furthermore, the magnitude of the crisis was highlighted also by referring to historical analogies. Mentioning the Great Depression of the 1930s as an historical point of reference and analogy served as an extensively used rhetorical device to communicate the severity and urgency of the situation, not only in the media (Brassett and Clarke 2012;

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13 "The promise and peril of the new financial architecture", Kevin Warsh, Member of the Board of Governors of the US Federal Reserve System, at New York University, New York, 6 November 2008.

14 "Monetary policy and the 'Great Crisis' – lessons and challenges", Lucas Papademos, Vice President of the European Central Bank, at the 37th Economics Conference "Beyond the Crisis: Economic Policy in a New Macroeconomic Environment", the Austrian National Bank, Vienna, 14 May 2009.

15 "Troubled Asset Relief Program and the Federal Reserve's liquidity facilities", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 18 November 2008; "A paradigm change for the global financial system", Jean-Claude Trichet, President of the European Central Bank, at the International Colloquium "Nouveau Monde, Nouveau Capitalisme", Paris, 9 January 2009.

16 "Actions by the New York Fed in response to liquidity pressures in financial markets", Timothy Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the US Senate Committee on Banking, Housing and Urban Affairs, Washington DC, 3 April 2008; "Restoring confidence", Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the International Forum Economia e Società Aperta, Bocconi University, 25 November 2008.

Brassett, Rethel and Watson 2010; Hart and Tindall 2009b), but also in the ECB and the Fed diagnoses, that from mid-2008 onwards frequently defined the situation as the worst financial crisis since the 1930s.[17] This was defined as a panic situation, in which the practices and understandings that govern behavior and establish expectations in market economies were called into question; a situation in which "key articles of faith are cast in doubt".[18]

Diagnosing the current conditions as such a momentous crisis could potentially open up the political space to processes of delegitimation of the current policy paradigm and its ideational underpinnings. Yet, such a process is likely to be affected also by the particular form taken by the analytically next phase in the process of sense-making: the formulation of causal accounts of the crisis.

Causal Accounts: Misbehavior, Institutional Failures and Systemic Dysfunctions

As noted above, causal accounts of a situation diagnosed as a crisis can take varied forms, ranging from focusing on circumstantial, even accidental, factors to stressing systemic factors seen as inherent to the inner logic and functioning of the system. In the causal accounts of the crisis formulated and voiced by the Fed and the ECB we can notice a combination of three, generally interrelated, types of factors: market actors' misbehaviors and misjudgments, specific deficiencies in institutional arrangements in finance, and broader systemic processes in the global economy. The relative weight attributed to each of these factors varied over time, moving from more focused to more comprehensive causal accounts.

Before examining the three types of causal accounts, it is important to note that from quite early stages, both central banks clearly stated that the real roots of the financial stress should not be seen as confined to the troubles in the US sub-prime mortgage market, but rather as

[17] For instance, "Global financial turmoil and the world economy", Frederic Mishkin, Member of the Board of Governors of the US Federal Reserve System, at the Caesarea Forum of the Israel Democracy Institute, Eilat, Israel, 2 July 2008; "Financial reform to address systemic risk", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Council on Foreign Relations, Washington DC, 10 March 2009; "How to deal with the global financial crisis and promote the economy's recovery and sustained growth", Lucas Papademos, Vice President of the European Central Bank, at the 7th European Business Summit, Brussels, 26 March 2009.

[18] "The Panic of 2008", Kevin Warsh, Member of the Board of Governors of the US Federal Reserve System, at the Council of Institutional Investors 2009 Spring Meeting, Washington DC, 6 April 2009.

related to more general problems in the financial sphere at large.[19] Hence, whether focusing on particular players, on institutional rules or on broader systemic processes, the causal accounts articulated and provided by the Fed and the ECB tended to address the financial system as a whole.

The first type of account focused on the specific actions of actors in the financial markets, highlighting their misbehaviors and misjudgments as a key source of the crisis. During the initial months of the events, the too lax standards of credit underwriting, particularly but not only in the mortgage market, were mentioned as a central cause in the explanations given to the stress in financial markets.[20] Very soon, however, the causal accounts began to refer to more general trends in the attitudes and conduct of investors and financial intermediaries, especially overconfidence, complacency and even imprudence, which led to overall and massive underestimation of risk and overleverage across financial markets.[21] These trends were seen as expressing the increasing dominance of short-termism among financial actors and a wide-ranging erosion of market discipline.[22] Furthermore, it was stated that financial firms of various kinds, including large and important ones, employed inadequate models and procedures for liquidity and credit risk assessment and management, which caused

[19] For instance, “Financial market developments”, Kevin Warsh, Member of the Board of Governors of the US Federal Reserve System, at the State University of New York at Albany’s School of Business, Albany, New York, 21 September 2007; “Hearing before the Economic and Monetary Affairs Committee of the European Parliament”, Jean-Claude Trichet, President of the European Central Bank, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 11 September 2007.

[20] For instance, “Housing, housing finance, and monetary policy”, Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyoming, 31 August 2007; “The agenda for the competitiveness of Europe’s economy and financial system”, Jürgen Stark, Member of the Executive Board of the European Central Bank, at Ambrosetti Finance Workshop, Cernobbio, 5 April 2008.

[21] For instance, “Financial market turmoil and the Federal Reserve – the plot thickens”, Kevin Warsh, Member of the Board of Governors of the US Federal Reserve System, at the New York University School of Law Global Economic Policy Forum, New York, 14 April 2008; “Address upon receiving the 2007 “Risk Manager of the Year” Award of the Global Association of Risk Professionals”, Lucas Papademos, Vice President of the European Central Bank, at the 9th Annual Risk Management Convention & Exhibition, New York, 26 February 2008.

[22] For instance, “Addressing weaknesses in the global financial markets – the Report of the President's Working Group on Financial Markets”, Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the World Affairs Council of Greater Richmond's Virginia Global Ambassador Award Luncheon, Richmond, Virginia, 10 April 2008; “ECB Financial Stability Review December 2007”, Lucas Papademos, Vice President of the European Central Bank, at the press briefing on the occasion of the publication of the December 2007 ECB Financial Stability Review, Frankfurt am Main, 12 December 2007.

misjudgment of latent risks in their investments.[23] Due to the poor understanding of the complex financial instruments developed since the 1990s and the high costs of adequate assessment of the risks involved in them, investors and financial institutions refrained from making their own risk analysis, relying excessively on the evaluations of the credit rating agencies.[24]

As noted by Timothy Sinclair (2010), the blaming of the credit rating agencies developed as a major theme in the causal accounts of the crisis offered by many and varied actors, leading to a moral panic that marked them as one of the main villains of the story. The flawed actions of the credit rating agencies were indeed included in the causal accounts formulated by the Fed and the ECB, but not as a fundamental factor leading to the crisis. Though it was stated that as the result of the inadequate methodologies and data they used and also possibly due to conflict of interests,[25] credit rating agencies "failed to fulfill their raison d'être",[26] their actions were presented as a factor that exacerbated, but not caused, the general imprudence that spread among market actors.

The focus on the inadequate actions of actors as deviant behaviors which are conceptually exogenous to the normal functioning of the market could have precluded the emergence of causal accounts that address broader market processes and practices as root causes of the crisis (Deuchars 2010; Sinclair 2010). But in almost all cases, the Fed's and ECB's mention of mistakes and misconduct by market actors has been accompanied by detailed references to

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[23] For instance, "The importance of fundamentals in risk management", Randall Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the American Bankers Association Spring Summit Meeting, Washington DC, 11 March 2008; "Globalisation and central bank policies", Lucas Papademos, Vice President of the European Central Bank, at the Bridge Forum Dialogue, Luxembourg, 22 January 2008.

[24] For instance, "Liquidity-risk management in the business of banking", Randall Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Institute of International Bankers Annual Washington Conference, Washington DC, 3 March 2008; "Globalisation and central bank policies", Lucas Papademos, Vice President of the European Central Bank, at the Bridge Forum Dialogue, Luxembourg, 22 January 2008.

[25] "Addressing weaknesses in the global financial markets – the Report of the President's Working Group on Financial Markets", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the World Affairs Council of Greater Richmond's Virginia Global Ambassador Award Luncheon, Richmond, Virginia, 10 April 2008; "Address upon receiving the 2007 "Risk Manager of the Year" Award of the Global Association of Risk Professionals", Lucas Papademos, Vice President of the European Central Bank, at the 9th Annual Risk Management Convention & Exhibition, New York, 26 February 2008.

[26] "Global financial turmoil and the world economy", Frederic Mishkin, Member of the Board of Governors of the US Federal Reserve System, at the Caesarea Forum of the Israel Democracy Institute, Eilat, Israel, 2 July 2008.

specific failures in institutional arrangements that have encouraged, or at least allowed for, the actors' misbehavior. In this regard, a key locus of attention was the severe incentive and information problems caused by the originate-to-distribute model on which the process of securitization of credit was based. Framing the issue as a classic instance of the well-known principal-agent problem, both central banks frequently emphasized that the separation of originators from the ultimate holders of the loans resulted in a distorted incentive structure in which the originators have high incentives to constantly augment credit volume, which is the source of their profit-making, while simultaneously lacking incentives to maintain credit quality, leading to imprudent practices of excessive risk taking.[27]

Furthermore, the growing securitization of credit through the introduction of extremely complex structured financial instruments, such as asset-backed securities and credit derivatives, created fundamental information problems concerning the nature, distribution, and location of risks. The lack of transparency of the new innovative financial products with regard to the real nature and value of the assets backing them were repeatedly emphasized by both central banks as being at the root of the crisis,[28] as this made the accurate assessment of risks underlying the instruments "nearly impossible".[29] Tellingly, reflecting dominant understandings of the financial sphere, the securitization of credit and financial innovation in general were seen before the crisis as leading to broader spreading and trade of risks and hence to more efficient, liquid and frictionless financial markets that contributed to wide-spread prosperity. Even a couple of months after the financial stress had begun, Bernanke suggested that due to intensive securitization and innovation, financial markets have "became more like the frictionless financial market of the textbook, with fewer institutional or

[27] For instance, "Leveraged losses – lessons from the mortgage meltdown", Frederic Mishkin, Member of the Board of Governors of the US Federal Reserve System, at the US Monetary Policy Forum, New York, 29 February 2008; "Financial integration, financial innovation and development", Lucas Papademos, Vice President of the European Central Bank, at the Second Symposium of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe", Frankfurt am Main, 13 February 2008.

[28] For instance, "Liquidity-risk management in the business of banking", Randall Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Institute of International Bankers Annual Washington Conference, Washington DC, 3 March 2008; "Remarks on the recent turbulences in global financial markets", Jean-Claude Trichet, President of the European Central Bank, at the Policy Discussion "Global Economic Policy Forum 2008", New York University, New York, 14 April 2008.

[29] "Policies to bring us out of the financial crisis and recession", Donald Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Forum on Great Decisions in the Economic Crisis, College of Wooster, Ohio, 3 April 2009.

regulatory barriers to efficient operation".[30] When the crisis deepened, however, it was stressed that because of their opaqueness, the new financial instruments exacerbate information asymmetries that basically impair market functioning.[31]

Among the array of institutional arrangements that were singled out as responsible for the crisis, there were noted also several significant flaws and limitations in the supervisory and regulatory framework of the financial system, which permitted the explosion of credit and imprudent risk taking. Coverage gaps in supervision and regulation were mentioned as having allowed a whole range of financial intermediaries to become overleveraged, providing them with substantial opportunities for profit-making from regulatory arbitrage.[32] Furthermore, the regulative rules that were in force were depicted as too lax and outdated, and hence as incapable of ensuring the transparency and appropriate incentive structures of the new financial instruments and activities, so that they facilitated the emergence of the financial market excesses that led to the crisis.[33]

A more comprehensive causal account, which placed both actors' misbehaviors and specific institutional flaws within a broader framework that addressed developments occurring in the global economy and finance over the last decades, began to occupy a prominent place in both central banks' explanations of the crisis as financial and economic conditions deteriorated in the course of 2008. This shift occurred in tandem with the emergence of the diagnoses of the

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[30] Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyoming, 31 August 2007.

[31] For instance, "Addressing weaknesses in the global financial markets – the Report of the President's Working Group on Financial Markets", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the World Affairs Council of Greater Richmond's Virginia Global Ambassador Award Luncheon, Richmond, Virginia, 10 April 2008; "Financial turmoil, securitisation and liquidity", Jose Gonzalez-Paramo, Member of the Executive Board of the European Central Bank, at the Global ABS Conference 2008, Cannes, 1 June 2008.

[32] For instance, "The current financial challenges – policy and regulatory implications", Timothy Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Council on Foreign Relations Corporate Conference 2008, New York, 6 March 2008; "Main challenges for monetary policy in a globalised world", Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Conference "Monetary Policy in Sub Saharan Africa: Practice and Promise", Cape Town, 28 March 2008.

[33] "Financial market turmoil – the Federal Reserve and the challenges ahead", William Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Council on Foreign Relations Corporate Conference 2009, New York, 6 March 2009; "Growth and productivity of the financial sector – challenges for monetary policy", Jürgen Stark, Member of the Executive Board of the European Central Bank, delivered at the High-Level Central Bank of Luxembourg Policy Panel, Luxembourg, 12 November 2008.

situation as a threatening systemic crisis noted above. A central theme in this broader and more systemic account was the effects of global imbalances in current account positions and capital flows across major economies that emerged since the 1990s. This was clearly expressed in the telling title of a speech by Member of the Executive Board of the ECB, Lorenzo Bini Smaghi: "The financial crisis and global imbalances – two sides of the same coin".[34] According to this explanation, the shift of emerging economies from being net capital borrowers to net suppliers of funds to international capital markets created a large increase in available capital relative to real investment opportunities; a situation described by Ben Bernanke already in 2005 by the term "global saving glut".[35] These widening global imbalances in capital flows contributed to the creation of excessive international liquidity and a significant decrease in risk premiums, that caused in turn the imprudent hunt for yield and financial excesses that led to the crisis.[36] Furthermore, the funding of chronic shortage of savings in advanced economies by an excess of savings in emerging economies, fuelled the increasingly unsustainable credit expansion and debt financed over-consumption in the former.[37]

This systemic causal account also linked the global dynamic of saving glut and the intensive process of financial innovation, defining the interaction between the two as being at the root of the crisis. Financial innovation both promoted and was stimulated by the global imbalances in capital flows and a remarkable degree of global financial integration, creating an unsustainable credit boom and new sources of financial systemic instability that eventually

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34 "The financial crisis and global imbalances – two sides of the same coin", Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Asia Europe Economic Forum conference "The Global Financial Crisis: Policy choices in Asia and Europe", Beijing, 9 December 2008.

35 "The Global Saving Glut and the U.S. Current Account Deficit", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia, 10 March 2005.

36 For instance, "Reducing systemic risk in a dynamic financial system", Timothy Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at The Economic Club of New York, New York, 9 June 2008; "The financial crisis and global imbalances – two sides of the same coin", Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Asia Europe Economic Forum conference "The Global Financial Crisis: Policy choices in Asia and Europe", Beijing, 9 December 2008.

37 For instance, "Financial reform to address systemic risk", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Council on Foreign Relations, Washington DC, 10 March 2009; "What lessons can be learned from the economic and financial crisis?", Jean-Claude Trichet, President of the European Central Bank, at the "5e Rencontres de l'Entreprise Européenne", Paris, 17 March 2009.

resulted in the crisis.[38] Moreover, it is important to emphasize that financial innovation was addressed in these accounts as part and parcel of a general processes of financialization of the global economy, manifested in the rapid expansion of financial disintermediation and marketization of credit.[39] Within this framework, it was noted that the exponential rise of new complex, often esoteric, financial instruments had gone too far and became uncontrollable, so that "'creative destruction' turned into 'destructive creation'".[40] Rather than diffusing risk, as had been postulated and believed, the new structured financial products gave rise in fact to a dangerous spiral of risk amplification and concentration. Hence, the crisis was explained by referring not only to specific flaws and institutional failures in the design and implementation of particular financial instruments, but rather as linked to a far-reaching process of change in the configuration and functioning of the global economy: the increasing centrality of speculative financial activities and their growing disconnection from the real economy.

This comprehensive causal account connoted an extension of the time-span of the script explaining the crisis. The processes of liberalization and financialization that took place in the global economy over the last two decades -- the years of the "Great Moderation" that was hitherto celebrated as having brought about better integrated and more efficient financial markets, as well as stable growth with less volatility and risk -- were now reconsidered and some aspects of them were explicitly referred to as key causal factors of the crisis.[41] This reassessment and negative judgment of excessive financialization was forcefully expressed by Jean-Claude Trichet, who stated:

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[38] For instance, "Stabilizing the financial markets and the economy", Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Economic Club of New York, New York, 15 October 2008; "Reflections on the current financial market correction", Jean-Claude Trichet, President of the European Central Bank, at the International Capital Market Association's Annual Conference, Vienna, 15 May 2008.

[39] "Productivity and innovation in financial services", Donald Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Official Celebration of the 10th Anniversary of the Central Bank of Luxembourg, Luxembourg, 12 November 2008; "Main challenges for monetary policy in a globalised world", Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Conference "Monetary Policy in Sub Saharan Africa: Practice and Promise", Cape Town, 28 March 2008.

[40] "Issues paper for the conference 'The financial crisis and its consequences for the world economy'", Jürgen Stark, Member of the Executive Board of the European Central Bank, Tübingen, 10 December 2008.

[41] "Reducing systemic risk in a dynamic financial system", Timothy Geithner, President and Chief Executive Officer of the Federal Reserve Bank of New York, at The Economic Club of New York, New York, 9 June 2008.

> In the last ten years, we saw a dramatic shift in influence away from entrepreneurship in the real economy to speculation and gambling in the financial sector. The assumption and the hedging of genuine *economic risk* gradually ceased to be the main concern of international finance. This is the risk that companies face when introducing innovative new products and new processes. Over time, the creation and assumption of *financial risk* became the core activity of the financial industry. This is the risk inherent in arbitrage and deliberate exposure to asset price changes. At some point, the financial system seemed to be no longer there primarily to hedge existing economic risks, but more and more to create and propagate risks on its own [emphasis in original].[42]

It is important to emphasize that this does not mean that the ECB and the Fed adopted a wholehearted anti-financialization stand or that they abandoned their fundamental belief in financial liberalization and innovation. They kept stressing the benefits of extensive financial activity for the global economy, but simultaneously highlighting the dangers of its excesses. The understanding manifested in this causal account was that financialization has run wild, compromising the central banks' regulatory capacities, and contradicting therefore their institutional interests and logic as key agencies in charge of financial stability. This is highly significant, as it connotes a substantial reassessment of hitherto dominant formulas of sweeping financial liberalization that were promoted, among other actors, by central banks themselves. Hence, as the causal accounts of the crisis formulated by the Fed and the ECB evolved from focusing on financial actors' misbehavior to addressing systemic developments in the global economy, expanding therefore the breadth and time-span of the explicatory scheme, they offered understandings of the economic field and its dynamics that differed to a considerable extent from previously dominant reasoning.

Conclusions

During the global financial crisis of 2007-10, the possibility that it would open up the political space for basic institutional changes in the governance of the global economy and the emergence of a new policy paradigm was raised and discussed quite intensively, both in the

[42] "What lessons can be learned from the economic and financial crisis?", Jean-Claude Trichet, President of the European Central Bank, at the "5e Rencontres de l'Entreprise Européenne", Paris, 17 March 2009.

public sphere and in the academic field (Cerny 2009; Hall Forthcoming; Helleiner and Pagliari 2009; Morgan 2010; Mosley and Singer 2009; Seabrooke 2010). As the situation in financial markets and in the real economy deteriorated, the events came to be seen as a daunting challenge to the established policy paradigm for governing global financial capitalism, not only regarding concrete policies and institutional arrangements but also with respect to its conceptual underpinnings: the ways in which economic processes, the desirable relationship between the state and the market, and the specific roles of policy are conceptualized. Yet, the implications of the crisis for a fundamental shift in the global political economy still remain unclear.

In this article I have explored a key facet of the ideational dynamic underlying the politics of the global financial crisis, examining the interpretative and communicative practices through which the two most powerful central banks in the world – the Fed and the ECB –made sense of the events. Tracing the evolution of diagnoses and causal accounts formulated by influential actors with epistemic authority highlights the salience of explicit practices of sense-making in times of extreme uncertainty, when established taken-for-granted notions and understandings appear to have lost their relevance and credibility. As they feed into the actors' preference formation, these practices constitute essential political acts that can affect not only the actions taken to manage the crisis, but also the prospects for fundamental institutional change in its aftermath. The analysis presented in this article contributes therefore to the examination of the global crisis from a constructivist neoinstitutional perspective, by illuminating the ways though which powerful political actors have formulated and communicated to others varied descriptive and explanatory plots to make sense of the volatile state of things. By focusing on processes of sense-making, this study sheds light on a fundamental ideational dynamic that connects between crises and potential institutional change.

An important first point worth emphasizing concerns the remarkable similarity in the crisis diagnoses and causal accounts offered by the two central banks, and in the path along which they evolved over time. Despite the existence of some important differences in their positioning within the political economy and in their institutional legacies, and some variance in the ways in which they tended to define the main task of central banks, when it came to diagnosing and explaining the crisis, the Fed and the ECB voiced the same notions, themes and arguments. This certainly reflects the operation of a tight and highly institutionalized international network of central banks that serves as an institutional space for consultation, exchange of information and the formulation of common ideational frameworks to make sense of the economic world (Marcussen 2006b). This pattern of close relationships intensified enormously during the crisis, when the main central banks in the world not only maintained permanent consultations about the situation but also coordinated, both formally and informally, emergency policy measures directed at containing the financial meltdown. This intense contact facilitated the formulation of common diagnoses and causal accounts, which in turn strengthen the ability of central banks to provide authoritative and persuasive interpretations of the crisis.

The path followed by the diagnoses and the causal accounts articulated by the Fed and the ECB was one of increasing graveness and consideration of broad foundations and dynamics of the global economy. Furthermore, while in the first stages of the crisis they tended to ratify dominant notions and understandings of the financial field, they later evolved as involving a partial, but still significant, reassessment of established truths. As the economic conditions worsened and conventional policy tools failed to contain the crisis, the diagnoses of the state of things as a normal and healthy readjustment of self-regulating markets turned into a characterization of the situation as a fundamental threat to the functioning of the global financial system and the economy as a whole. Both central banks emphasized the breakdown of fundamental notions and assumptions that lie behind the actions and expectations of market actors in normal conditions. In other words, they diagnosed the situation as a crisis that challenges taken-for-granted understandings and calls for their reassessment. Similarly, the causal accounts also evolved as more comprehensive and systemic, as they increasingly linked actors' misbehaviors and specific and confined institutional flaws to fundamental dynamics that emerged and intensified in the global economy since the 1990s: growing global imbalances in capital flows and the excessive financialization of the economy.

These coherent and detailed diagnoses and causal accounts touched upon some of the most basic attributes of global financial capitalism as it developed in the last decades, carrying with them the potential for helping to open up the political space for a reevaluation of some of its ideational underpinnings, such as the notion of self-regulating financial markets and the unproblematic commensurability of financial risks. These sense-making frames did not represent an overall rupture from the premises of the neoliberal mode of governance; yet, by qualifying them and calling for their reconsideration, they undermined to some extent their hitherto hegemonic status among dominant actors in the global political economy. This is particularly significant given that these interpretative plots of the crisis were not offered by outsiders, but rather by established and powerful actors, such as the Fed and the ECB, with recognized expertise and high epistemic authority. Thus, the effects of these diagnoses and causal accounts on the ways in which the global economy and its dynamics are conceived constitute an important factor in the politics of potential institutional change which is still taking place in the aftermath of the crisis.

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