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UK Monetary Policy Change During the Financial Crisis: Paradigms, Spillovers, and Goal Co-ordination

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ABSTRACT

Policy responses to the tumult of the global financial crisis of 2007–9 prompt a consideration of the critical dimensions in specifying policy change. UK monetary policy between 2007 and 2009 is characterised by a remarkable degree of innovation yet counts as a 'normal' period of policy making under the Hall (1993) framework of policy change, the enduring workhorse of the comparative public policy field. This exposes its lack of conceptual refinement in describing significant but within paradigm policy change. This paper traces this failing to the notion of a policy paradigm, both its scale and the ideational mechanisms which bind policy change. The paper develops the UK monetary policy case to consider the potential of the recently-minted concept of a thermostatic policy institution for the development of Hall's framework; but finds analytical limitations in coping with significant policy spillovers. Suggestions are made to meet this important challenge for future research in policy studies on the specification of policy change.

Key words: *Frameworks of policy change, UK monetary policy, policy paradigms, thermostatic policy change, global financial crisis*

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In the light of the global financial crisis of 2007–9 and a putative period of intense and dramatic policy change, it is appropriate to reconsider critical dimensions of policy change, especially how the dependent variable for theories of policy change is constructed. The starting point is Peter Hall's (1993) specification of three orders of policy change: paradigms, instruments, and calibration. This scheme is built on a single case study of UK macroeconomic policy making from 1970 to 1989. The original 1993 paper has been cited well over 2,000 times as of March, 2011, according to Google Scholar. Its impact attests to its originality in moving the description of policy change beyond a single variable to stress cognitive and normative dimensions of policy alongside more formal, legalistic policy instruments. The application of the scheme has encouraged scholars to be sensitive to how ideas rather than calculations of material self-interest may drive policy-making; and in raising

questions about the relationship between ideational and material factors in policy processes by stressing that policymakers work within a framework of ideas that specifies goals and instruments, as well as the nature of the policy problems.

The first part of the paper uses Hall's framework to analyse UK monetary policy change between 2007 and 2009; this case should be favourable in assessing its enduring heuristic and descriptive value; it is an aspect of macroeconomic policy in the UK during an extraordinarily turbulent period in the global financial economy from which key UK actors have constructed an economic crisis with the potential consequence of 'de-institutionalising' important and settled aspects of policy ('t Hart and Tindall 2009; Pritchard 2009). The argument presented is that although UK monetary policy is marked by a remarkable degree of innovation both in the use of unconventional policy instruments and the settings of conventional ones, it is difficult to establish paradigm change. This is broadly consistent with the recent literature (Hodson and Mabbett 2009; Besley and Sheedy 2010) and voluminous pre-crisis literatures stressing the centrality of monetary policy to UK macroeconomic strategy. The Hall scheme describes this as a 'normal' period of UK monetary policy making, which this paper argues is an inadequate and potentially misleading categorisation of policy change over the period, confirming a weakness in the Hall framework in the specification of significant policy change within a stable, if evolving, policy paradigm (see, for example, Oliver and Pemberton 2004; Daugbjerg 1997).

The second part of the paper traces this limitation to the theoretical core of the Hall model: the logical type-value distinction that underpins the notion of policy paradigm change; and identifies its implicit hierarchy whereby large and significant policy change is only constituted by shifts in macro-level ideational variables. The third part of the paper considers the recent adaptation of the Hall taxonomy offered by Howlett and Cashore (2007) and Cashore and Howlett (2007) (hereafter H&C) which gives six dimensions of policy change. This uncovers original policy dynamics in the conceptual space between second and third order change not currently accounted for. In particular, we argue that the pattern of recent UK monetary policy is accurately characterised by their concept of thermostatic policy change.

However, the fourth section argues that the concept of a thermostatic policy institution as it is currently freighted obscures important dimensions of change: the relationships between different policy spaces, in particular cognate sectors and agendas. To preview the argument, the pattern of change in recent UK monetary policy is one where existing policy paradigm has not collapsed; indeed it has been actively preserved by extraordinary innovations. However, the operation of UK monetary policy as a thermostatic institution is not a closed loop system, in which policy change

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is limited exclusively to its own policy domain. Instead, monetary policy change has had important consequences for the relationship between cognate policy sectors; financial regulation, but also competition policy and fiscal policy in the medium term period of consolidation. Policy spillovers into cognate policy sectors and the subsequent reordering of relationships in policy space between different agendas and sectors – inter-policy system relationships – is an important dynamic; suggestions are offered for its relationship to the concept of thermostatic policy change. This is a contribution to a broader direction in public policy research: challenging the implicit hierarchy in Hall whereby big policy change is always characterised by the ascendancy of the ideational shifts which are prior to, and binding on, instrument and instrument setting change.

I. *UK monetary policy 2007–2009*

Monetary policy was central to the cause of and policy responses to the financial crisis of 2007–9. There are several book-length accounts and explanations of the crisis available[1] to complement the vast daily and weekly commentary from the period. Common to these accounts of the various complex conjunctions of factors which caused the crisis is a: (i) focus on the 'easy' monetary policy after the US recession of 2001 lasting into 2004; and (ii) stress on regulatory failure, in particular a lack of response to concerns about leverage ratios of 30 to 1 in some financial institutions trading in highly illiquid structured financial products. These factors are cited for the significant narrowing of risk spreads between high grade debt and high yielding bonds in the financial system. In other words, a trend toward substantial reduction in risk aversion, which when it rebounded, exacerbated by the collapse of Lehman and the return of counterparty risk as an important factor in interest rates, created an overshoot in the other direction. This was most acute in September and October 2008, when London Interbank Offered Rates (Libor) in sterling, dollar, and euro spiked upwards and volumes in the unsecured, inter-bank short term lending market collapsed. This malfunction in an essential cog in the contemporary financial system, rendered the stability of the entire edifice vulnerable.

In terms of monetary policy as a unit of analysis, the Lehman collapse of 15 September 2008 marked the beginning of the acute phase of the financial crisis. This triggered fears of deflation and inspired the widespread prophecies of a 1930s-style Great Depression. The prospect of a failure of this kind had been on UK policy-makers' horizons for just over a year. There had been an important change in monetary policy by the European Central Bank (ECB) in August 2007, when it initiated a policy of injecting substantial liquidity into the Eurozone banking system after a large spike in Euro Inter Bank Offered Rates (Euribor) on the news that BNP Paribas was

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facing severe liquidity problems (Financial Times 10 August 2007). This collapse in demand for a form of securitised debt augured the pattern of the financial crisis of the following year as well as its monetary policy implications. In the UK, the Bank of England (BoE) Governor Mervyn King had initially been resistant to any increased bank funding, but after the BoE has been forced to act as lender of last resort to the Northern Rock Bank – then accounting for a fifth of the UK mortgage market – sparking a public and old-fashioned bank run in October 2007 it moved toward the ECB position. In many ways, the ECB led international policy in this period, for example Governor Jean Claude Trichet won the FT 'Person of Year Award' among several other international prizes for his actions in 2007.

The collapse of Lehman in September 2008 turned a localised financial problem in one segment of the US mortgage market into a near-collapse of the global financial system. The systemic consequences of the bankruptcy of Lehman Brothers were huge, as measured by the enormous widening of risk spreads on interbank credit in months that followed. In addition, the initial rescue packages of AIG and Fannie Mae by the US government were regarded by the markets as being on punitive terms and the share prices of all banks in America collapsed. The UK government initially expressed enthusiastic approval for the US Treasury's actions (Financial Times 23 September 2008).

In response to the systemic effects of the Lehman collapse, a rival new formula for government financial support emerged to encourage private shareholders in banks and insurance companies. Alongside an acceptance of the need for government to protect all bank deposits, policy-makers perceived the requirement to create a new shareholder-friendly financial model for future bank bailouts. This relied less on excising toxic assets, the original Paulson plan in the US, and more on taking direct shareholding alongside forms of asset protection or insurance.

It was the threat of deflation, the concerns that financial instability would spill over into the real economy with dramatic adverse consequences that led to the extraordinary degree of monetary innovation in the UK and elsewhere. This included the UK government taking direct equity stakes in major banks, in common with the US and most Eurozone governments, and various forms of asset insurance like the Asset Protection Scheme (APS) in the UK. In addition to the bank bailouts, the cornerstone of UK monetary policy was the reduction of nominal interest rates to near-zero along with so-called quantitative easing; where an Asset Purchase Facility (APF) was established through which BoE has purchased around GBP200bn of government debt by creating new central bank reserves (Buiter 2009; Besley and Sheedy 2010).

Monetary policy underpinned the bank rescue: in particular, the prospect that a collapse of the financial system would be deeply deflationary

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with huge negative consequences for the real economy. The overarching goals of monetary policy remained unchanged through the financial crisis; but these required extraordinary interventions in terms of reducing short term rates to near zero and novel direct actions on the money supply through QE to inject liquidity into the system. The policy paradigm guiding UK monetary policy since 1979 has been, and remained, the achievement of price stability. After 1997, this was further institutionalised when the BoE was given operation independence to pursue an explicit inflation target. Whilst the crisis made decision-making undoubtedly difficult and brought forth unprecedented policy activity, the overall framework remains in place (Besley and Sheedy 2010). Hodson and Mabbett (2009) advance a broadly similar position but extend the insight to fiscal policy; arguing that despite unprecedented public deficits it remains essentially passive and not a key instrument of macroeconomic policy-making. Although consistent with the work of Hall (1993) and Hay (2007), this passive fiscal policy interpretation is disputed in the Clift and Tomlinson (2007a, b) analysis of New Labour in the UK.

Of concern here is that on Hall's scheme, there is no profound turning point in monetary policy-making: there is no obvious paradigm change. Hall's third order change – policy paradigm change – only occurs when dominant ideas about policy goals, nature of policy problems and best instruments to be used are altered. Of course, there were widespread claims in the immediate post-Lehman environment that 2008 marks an epochal shift from the market fundamentalism, which had characterised UK policy-making in the thirty year period after 1979. Yet the consistent thread amongst these claims is that policy-makers now recognise that a market economy requires active government; in UK monetary policy terms, this has always been the case. We have never observed a period of free banking in which market forces control the provision of banking services, where there is no central bank to protect commercial banks, or serve as a 'lender of last resort' and where money production is conducted through competition between monetary producers. Instead, in the UK, as elsewhere, the banking system is part of the state; it cannot be anything else because essentially the private banking system holds a public monopoly on creating money i.e. the state allows private banks to say that their deposits are equivalent to real money backed by the BoE. This has not changed nor has monetary policy's focus on price stability; rather in September and October 2008, guided by these two foundational premises, UK political leaders, civil servants, and central bankers quickly came to a consensus position that there was no alternative to guaranteeing all bank deposits and interbank transactions. Importantly, as will be discussed later, this consensus also included the view that limitless government guarantees would mean that banks – after the acute crisis phase was over – would face more intrusive

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scrutiny from regulators. It is financial regulation policy that would have to change profoundly; regulators would need to become bolder than in the past in challenging the political power of the financial services industry and its general preference for deregulation and/or 'light touch' regulation, in pursuing the objective of financial stability. Whilst the consensus on the need for change endures, a clear consensus on the content of that change remains elusive (see section IV below).

If the monetary policy paradigm has not changed, then on Hall's scheme the period between 2007 and 2009 is characterised as a 'normal' period of policy making. In other words, a period during which policy was adjusted without challenging the overall terms of a given policy paradigm; in the Kuhnian metaphor, 'normal science'. Furthermore in Hall's scheme, the conceptualisation of how policy paradigms change is a direct extension of the Kuhnian analogy: instances of policy experimentation and policy failure play the key role. Like scientific paradigms, a policy paradigm can be threatened by the appearance of anomalies, namely by developments that are not fully comprehensible, even as puzzles, within the terms of the paradigm. As these accumulate, *ad hoc* attempts are made to adjust the paradigm to account for them, but this gradually undermines the intellectual coherence and precision of the original paradigm. In policy terms, however, the 'normal' period label from the Kuhnian metaphor in Hall is potentially misleading. It evokes the tradition of incrementalism from Lindblom (1959, 1979), the view of policy-making via the branch method of successive, limited comparisons of options. Instead, policy paradigmatic anomalies may require experiments to reset the existing trajectory of policy, innovations that are well beyond considering limited means to settled policy goals and are better described as unsettling, non-routine and often dramatic policy changes. Of course, if the paradigm is genuinely incapable of dealing with anomalous developments, these experiments will result in policy failures that gradually undermine the authority of the existing paradigm. The point is that there exists the potential dynamic of significant policy change in pursuit of paradigm stability that seems to be precluded by the metaphor of a normal period of policy-making.

What is important in Hall's framework is that UK monetary policy in the period 2007 to 2009 appeared successful; policy-makers learned the right lessons from the 1930s Great Depression, and importantly the UK economy's 1930s recovery (Crafts and Fearon 2010), and introduced policy innovations such as (i) direct public ownership and asset insurance schemes in saving the banks from collapse, (ii) novel instruments to expand the money supply to compensate for the tightening financial consequences of recapitalisation in the financial sector. There was no spectacular policy failure driving policy paradigm change: UK policy-makers achieved their policy objectives. The monetary policy framework remained intact and

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indeed guided policy-making innovations such as unconventional instruments, step changes in the setting of existing instruments and the introduction of novel policy objectives such as avoiding deflation.

II. The Hall model

Type and value change in policy studies

The Hall scheme is addressed to the logical type-value duality that exists in any description of change. A thing's potential to change is limited by the range of possible states for its type. If the thing is monetary policy for example, only certain policy states are possible for that type i.e. only certain things can be that type of monetary policy. If the boundary of possibility is overstepped, the thing becomes another thing rather than a different value of the same thing. This logical divide underlies the Hall distinction between policy paradigm change (type) and policy instrument/settings change (value).

In terms of policy types, in Hall's model there is an ambiguity in the specification of the scale of paradigms. Although the term *policy* paradigm is used in the original 1993 article, as a concept it is actually used to analyse the crisis of Keynesianism in the 1970s at a broad political economy level. Confusingly, in much of the literature inspired by Hall the term is also applied at the meso-level of policy. Keynesianism is a good example of this scale ambiguity, it is employed as a societal level term to refer to a particular historical combination of a wide range of economic and social policies as well as a label for a specific set of macroeconomic policy ideas and instruments. Indeed, recent pre-crisis political economy debates on the trajectory of UK macroeconomic policy hinge on the definitional scope of Keynesianism; whether UK economic policy since 1997 can be admitted as Keynesian type relies on whether it is a category at the broad sweep of the political economy level or more tightly specified at the policy-level of analysis (Clift and Tomlinson 2007a, b; Hay 2007).

If we adopt the societal level interpretation of a policy paradigm, then in any account of policy change there is a potentially significant policy space between small change (at the instrument and programme level) and big, policy 'type' change (at the paradigmatic level). As shown in the UK monetary policy case, this reduces the sensitivity of Hall's framework to policy change; whilst it may provide analytical purchase on the policy-making consequences of rare, epochal shifts such as the putative end of Keynesianism after the 1979 election, it is much less able to account for episodes of substantial policy change that are significant beyond the 'normal' cycle of policy-making but nonetheless fall short of paradigm change as in the UK monetary policy case.

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There remains an empirical question as to whether Hall's description of the historical shift from Keynesianism to monetarism in the UK is accurate. Oliver and Pemberton (2004) present a longer sweep of UK macroeconomic policy than Hall and demonstrate distinct periods of the Keynesian policy paradigm form the 1940s onwards. They argue the Keynesian paradigm had evolved significantly in the UK in the decades before the 1979 election, beyond simple second order change but with sufficient continuity to rule out third order change. Clift and Tomlinson (2007a) argue that the victory of the monetarist policy paradigm in 1979 was not total, and that various strands of New Keynesianism survive in New Labour's political economy to the extent that one can characterise it as broadly Keynesian. The claim is that granting the Bank of England operational independence to target inflation as the core element of monetary policy (and its historic success in controlling inflation; see Besley and Sheedy 2010) allowed the New Labour government to achieve sufficient credibility in international capital markets to allow for 'constrained discretion' in fiscal policy; in particular, credibility begets the capacity to 'coarse tune' the economic in response to recessionary threats (see counter-arguments in Hay 2007; also Pemberton 2000; Greener 2001; Blyth 2002; Oliver and Pemberton 2004 on Hall's account of UK macroeconomic policy).

Problems of specifying paradigm change are perhaps not surprising given this was the subject of intense debate between Kuhn and his critics for several years after *The Structure of Scientific Revolutions* (1962). The leading pragmatist writer, Bernstein (1983: 57) argues against 'the slippery and controversial notion of a paradigm' saying that it is not clear what the term adds to debates about adjudicating between different theories in the scientific community. For Bernstein, our organising view of the world is not governed by necessary and sufficient rules of evidence but rather relies on exemplars and judgmental interpretation. Kuhn wished to avoid such a position – and the associated charge of relativism – by appealing to values or criteria that determine the choice of scientific theory. These though are potentially vague and the source of many of the debates in the philosophy of science about Kuhn's work. The problem in policy studies is that the comparison with Kuhn in terms of specifying paradigm change is much more metaphorical than analogical; therefore problems of vagueness apply *a fortiori* in the search for clear mechanisms for identifying and explaining paradigm change.

The constitutive logic of policy ideas

Kuhn leaves us another problem: although paradigms are open to different interpretations at different times, they are prior to and binding of 'normal' periods of scientific research. The relationship between policy paradigm change and second and first order policy change is not always

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explicit in Hall. This is part of the larger composition problem in all descriptions of policy change. As is well rehearsed in the literature (Parsons 1995; Colebatch 2002), and explicit in Hall (1993), the concept of policy is a construction which contains within it several different elements: the problem of composition is how these different elements compose the holistic dependent variable of 'policy'. What is the relationship between different policy levels? There is no impeccable formal logic to the relationship; neither is there an obvious natural science-type link related to the granularity of perspective adopted. In particular, as Campbell (2002) argues one of the main problems in the literature on ideas in policy-making is to understand how higher level, abstract policy paradigms constrain policy makers. For example, using a cross-national comparative study of Keynesianism, Lindvall (2009) argues that broad democratically authorised goals set significant limits on the influence of expert ideas in the policy process, whose effect tends to be seen at the first and second order levels of change; yet the mechanisms by which those goals limit other ideas in policy-making is not stated.

Hall's great contribution to policy studies is to assert a link between different levels and regard this link as at the crux of the study of public policy. Because policy is a social construction, any claim that there is a relationship between different policy levels involves *constitutive* rather than *causal* reasoning: scholars are looking at the structures and their levels that constitute policy rather than the set of conditions that cause policy. At the core of the Hall model of policy change is the claim that public policy is constituted *externally*; as a holistic entity by reference to external structures in which it is embedded. On this view, policy is constituted as a whole with reference to entities such as government departments, legislatures, think tanks and most importantly, an overarching paradigm. This external constitution is characteristic of the Hall-inspired literature on the policy paradigm change at the political economy level, where change is explained, for example, in terms of the differential effects of societal institutions, variations in national 'styles' of capitalism or the uneven effects of powerful economic ideas (Blyth 2002).

Surel (2000) argues that there is an important but often unacknowledged element of Hall's framework: the commitment to some form of structuralism; where the structure of the policy whole – the policy paradigm – in some way governs its constitutive elements – second and first order change. This is the case because without structures at the level of the whole, the properties of the whole (any regularities and so on) would not exist: they would be nothing but the constituent elements i.e. you would have reduced a policy paradigm to its constituent instruments and their settings. In such terms, policy might also be constituted internally in a form of reductionism; in an analogy with natural kinds or types, policy has a genetic structure.

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On a strict reductionist view, the policy whole is nothing but its internal constitutive elements.

However, whatever Hall's structuralist tendencies, his real insight is to reveal the implication of internal and external constitutive logic: analysis of policy change needs to be synthetic. In other words, it must be simultaneously holistic and reductionist. The study of policy change must leave open, but central, the thorny level of explaining relationships between levels. Unlike holism that stays at the top and reductionism that sticks to the bottom, synthetic analysis takes a round trip from the top to the bottom and back. It encompasses two or more perspectives, looking at the policy whole on its own level and looking at it on the levels of its constituents.

For research in policy studies it makes sense to say that 'monetary policy is changing because' or 'has tended in this direction because' and so on. However, for a full understanding of the systems including their composition, this macro-level analysis is necessary but not sufficient. As argued paradigm spotting is not sufficient, we also need micro-level analysis that connects the properties delineated in macro analysis to the properties of the constituents. Micro explanation depends on macro explanation, which first sets out what needs micro explanation. As a field, we need not only find the micro mechanisms underlying macroscopic properties, but also explain how the large ideational structures constrain the behaviours of individual constituents.

III. Recent refinements of the Hall scheme

The UK monetary policy case exemplifies the post-Hall research agenda of developing the capacity to look at the whole causal structure spanning the policy system and constituents from all angles – upward causation, downward causation – to get a comprehensive grasp of the complexity of composition. The appropriate approach to the composition problem is not to reduce the policy description framework but expand it to accommodate more perspectives, more postulates, and more theoretical tools to filter out irrelevant microscopic details and define novel emergent macroscopic properties. In important recent contributions, Howlett and Cashore (2007; henceforth, H&C) set out a new taxonomy of policy levels/orders that develops and builds on Hall (1993) in this direction, in order to improve the capacity of policy scholars to identify fine-grained processes of change. They argue that the orthodoxy in policy dynamics is the punctuated equilibrium pattern, where rare paradigm change punctuates long periods of incremental adjustments due to shocks induced by institutional change or new actors, ideas, beliefs which are exogenous to the policy system.

The identification of three levels remains the starting point: the theoretical abstract level of the composite whole; the instruments or programme

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level; and the settings on-the-ground level. In a novel step, policy ends are separated from policy means for each of those levels. This provides six dimensions on which policy might be measured and change identified (in order of decreasing abstraction):

Policy ends: (a) Goals, (b) Objectives, (c) Settings.

Policy means: (i) Instrument logic (general regulatory preferences/strategies), (ii) Mechanisms/instruments, (ii) Calibration of those instruments.

The strength of the H&C work is to move beyond the strict dualism that the UK monetary policy case reveals: that under Hall's three orders policy change is either incremental (orders one and two) or paradigmatic change (order three), with nothing in between. H&C offer a more sophisticated view of the different constituent elements of policy or combinations of the constituent elements and in doing so they reveal potential and actual patterns of policy change obscured in the Hall framework. Relevant to the specification of UK monetary policy change during the financial crisis is the possibility of a pattern of stable, higher level abstract goals alongside shifting objectives and instrument change.

H&C conceptualise this as thermostatic policy change,differentiated logically from the punctuated equilibrium pattern of policy change – which is homeostatic – where policy systems will tend to equilibrium in the absence of exogenous shocks outside the normal range of fluctuations in the policy environment but where large environmental changes – the 'big bangs' – shift the policy paradigm. In contrast, in thermostatic policy change, the paradigm functions as an institution in controlling policy instruments and their settings. In certain cases this policy institution may be 'tripped' by evidence about the broader policy environment that is exceptional or significantly outside the most recent historical range and which demands policy experimentation with respect to policy instruments and large scale change in policy settings in order to endure. For H&C, this is in the manner that a thermostat controlling the internal temperature is tripped by changes in the outside temperature. The notion of thermostatic institutions appeals generally in giving a pattern of important change that is not paradigmatic, and assists in the analysis of UK monetary policy, which exhibits this kind of conditional quality: if the level or extent of some factor (related to the prospect of future inflation or deflation) is tripped (up or down) then novel policy instruments will be introduced and settings adjusted (sometimes in a large way) in order to maintain and validate the higher level goal of price stability. This amounts to an institutionalised promise that a situation will be monitored and if that situation reaches a certain point, then large changes in settings will be tripped. Institutions always adapt to or respond to or absorb changes in the policy-making environment; in a sense, if they did not they would cease to function as institutions. The important dynamic that H&C uncover is that even when

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those environment changes are large and create shocks outside the 'normal' range of contextual variation, policies may be thermostatic. Institutionalised policies which are thermostatic are able to respond and adapt to external policy environments and can persist; but even in rare cases of large shock they can still survive without paradigm change. This gives us something between the duality of 'normal' persistence or 'rare' paradigm breakdown that is defined by the Hall framework.

IV. Specifying policy spillovers and goal coordination

Both Hall and H&C conceive of policy as a closed-loop or self-contained system, in that they only assess change within the particular policy system that is under the microscope. This is sound as a first analytical step in specifying policy change but it takes no account of the potential spillover effects of rapid and dramatic changes in objectives and the introduction of novel instruments on other policy sectors at the level of instruments and their settings. The consequences for the relationship between those sectors is an important dimension in policy change. At the micro-level, spillovers between policy subsystems can affect inter-policy sector relationships to the extent that individual policy subsystems may change from being isolated to being connected to other policy systems (Howlett and Ramesh 2002); and at a more abstract, higher level spillovers can affect the attention that governments give to certain areas, the prioritisation of particular political and policy problems as well as the extent to which policy is joined up across government. Returning to the UK monetary policy case, the section below discusses how spillovers at the instrument level may cause shifts in guiding policy ideas – at the policy objective level but within the extant policy paradigm. Besley and Sheedy (2010: 32) describe the major lesson for monetary policy from the crisis as: '…a need for a more joined-up approach recognising that the operation of financial markets in the creation of money and credit is essential for a proper understanding of monetary policy.'

Spillovers are related to the ambition for joined-up government, a theme of the UK's recent Labour government. Contemporary policy challenges have been seen as cross-cutting and demanding of an end to the forces of departmentalism and 'silo' approaches perceived as endemic in the UK government (e.g. sustainable development, which incorporates economic, social and environmental elements). This demands the integration of sectoral policy making through the application of centrally co-ordinated policy appraisal and the mainstreaming of the cross-cutting theme. Although the paradigm remains stable, it can expand to occupy a greater policy space and affect new agendas. In addition, an important policy dynamic is *unintended* spillovers between policy areas which may result in policy agendas coming into immutable interdependence which may lead

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to conflict and demand policy change in several policy sectors. Besley and Sheedy (2010: 29) seem to be referring to policy spillovers when reviewing recent UK monetary policy when they discuss the centrality of the: '…task of redefining what is monetary policy in a world where the lines between monetary policy, fiscal policy, and the wide range of policies designed to support banks and financial markets have become increasingly blurred.' Within a stable paradigm, policy change beyond normal adjustment is required to meet novel and significant policy problems.

Relationship between monetary policy and financial regulation

Unlike Hall's study, the 2007–2009 UK monetary policy case provides no 'big bang' election in which a rival governing policy paradigm enjoys support and is ready to be implemented with consequences for policy instruments and their settings. The UK general election of 2010 was novel in many ways but it was not 1979 in style, there was consensus among the main parties that the Bank of England should remain independent to pursue inflation targeting and that monetary policy was central to macroeconomic strategy. Despite some disputes about the timing of fiscal tightening, the main parties did not adhere to rival economic policy paradigms. Instead, any putative changes in UK monetary policy will be results of changing inter-sector relationships. This is the pattern where policy responses in different domains to a dramatically altered financial environment have possible spillover effects into other policy sectors outside their conventional purview. In monetary policy, the interaction of the price stability and financial stability agendas post-Lehman is having consequences in terms of shifting abstract policy ideas and mental maps at the levels of objectives (in H&C terms).

Monetary policy and financial regulatory policy are immutably interdependent; but in the UK over the last thirty years, this characteristic has remained almost unacknowledged in policy-making in both sectors. Further, over that period there has never been a consensus on policy goals and instrument logic for financial regulation equivalent to that which holds in the monetary policy sector. Financial regulation policy in the UK pre-GFC had been based on a general view, since 'Big Bang' in 1986, in favour of deregulation; and central to the politics of the crisis in the UK has been debate over the responsibility for and perverse consequences of incompetent regulation, e.g. in meeting capital requirements, in many cases banks were allowed to set up off balance sheet entities such conduit special investment vehicles and to put in them various risky assets and no capital was charged against it. Regulatory weakness and the financial industry's arbitrage strategies has been an important feature of the politics of attributing responsibility for the financial crisis and developing future policy.

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Whilst there is a firm consensus on the need for change, only a partial consensus has slowly emerged post-crisis on the changes needed in financial regulation: higher capital requirements, particularly trading; tighter liquidity regulation; stronger oversight regimes; banks as living wills; controls on bonuses. One prominent feature of the framing of the crisis in the financial regulation policy process in the UK has been the lack of macro-prudential regulation. Focusing on specific institutions meant there was no capacity to diagnose systemic risks that arise because of interactions between groups of institutions. This emerges from the politics of framing in the financial regulation reform process over the past 24 months, which has concentrated on the relationship between financial deregulation in the 1980s, subsequent financial market innovation and the financial crisis.

On 16 June 2010 the UK's Chancellor of the Exchequer, George Osborne, unveiled substantial reforms to the way financial institutions will be regulated in the UK which will be implemented by 2012 (Osborne 2010). At the core of the reform is the coupling of monetary and financial regulation policy. The Financial Services Authority (FSA), the current UK integrated regulator of firms and markets, will be dismantled and along with it the UK's tripartite system of regulation established in 1997 in which the FSA, BoE and UK Treasury shared responsibility for financial regulation. A new independent body, the Financial Policy Committee (FPC), will be established at the BoE as part of the Osborne reforms to 'look across the economy at the macro issues that may threaten economic and financial stability and take effective action in response' (Osborne 2010). The FPC will be chaired by the Governor of the Bank of England and will include the Deputy Governors for monetary policy and financial stability. This recognises institutionally the convergence of the two policy sectors and the potential for a composite policy paradigm to emerge, based on the essential characteristic of financial capitalism that the banking system enjoys a public monopoly in creating money, i.e. the state allows them to say that their deposits are equivalent to real money.

The analysis underpinning Osborne (2010) is that although inflation targeting had succeeded in anchoring low inflationary expectations, the tripartite policy framework was not able to respond to an explosion in balance sheets, asset prices and macro imbalances. The BoE mandate to focus on consumer price inflation had served to limit its views of other things; the Treasury had allowed its financial policy division to drift into a backwater; and the FSA had become by 2008 a narrowly focussed regulator on compliance issues at the individual institution level. There was no public organisation charged with responsibility for overall levels of debt, and when the credit crunch came no one knew who was in charge.

A central part of financial economics is that a financial system is inherently unstable partly because of asymmetric information but also

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because of its institutional form (Stiglitz 2010). Leverage of enormous proportions characterises all contemporary financial systems, and has been cited as underpinning the bank crises around the world over the last two decades in Indonesia, Argentina, Turkey, Japan, and Sweden. The lesson that has been drawn in the financial regulatory policy process in the UK is that if you have a system which is normally levered about 20 to 1 – debt to equity – it requires only relatively small losses and relatively small mistakes on the valuation of underlying assets and the financial system can become dangerously stressed. The 2007–2009 global financial crisis was unusual only in its geographical origin not in its relative scale or its timing. The OECD has produced reports of previous bank crises over the last thirty years (OECD 2009) that showed that in almost all cases financial institutions regarded themselves incorrectly as protected against potential shocks. The corollary of a highly leveraged system – both logically and in practice – is there is never enough capital in the system for financial institutions to protect themselves. Only the government has access to enough capital to protect the system; in other words, *in extremis* the banking system is part of the state in capitalism with the corollary that monetary policy and financial regulation policy will always be interdependent.

Neither the Hall framework nor the H&C refinement look explicitly at spillovers from one sector to another as an important dimension of policy change when this requires fresh co-ordination or reconciliation of objectives. It is necessary to be precise with the notion of spillover here, and to avoid any claim that reconciliation and explicit coordination of policy objectives is a necessary feature of policy change. However, in the search for dimensions and categories of policy change, one potential for change arises from the functional separation of policy space: change may come through the reordering of policy space, where no policy in individual sectors is changed but instead the interrelationship between different policy agenda and sectors is altered.

This is an important dimension for understanding UK monetary policy change. Alongside the dimension of paradigm stability and reinforcement set out in section I, there has been explicit recognition of the spillovers between financial regulation and monetary policy. Monetary policy and financial regulation policy are separate but necessarily connected at a deep institutional level. The spillovers between the sectors are two-way; cheap money as a stimulant to leveraging has financial stability implications; second, financial regulation independently of monetary policy for rest of the economy has consequences for credit availability.

Monetary policy remains occupied by the pursuit of the goal of price stability. However, as a result of the financial regulation policy process and the elevation of financial stability as a policy goal, monetary policy goals cannot be pursued in isolation. Importantly, the monetary policy for

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financial stability is different from price stability; thus at some point the two goals are interdependent. The policy process on financial regulation is clearly and heavily politicised, unlike monetary policy. This stimulates public anger against bankers and in response the political strength of the financial services industry is most clearly brought to bear. There remains no clear consensus on instruments and objectives, or the appropriate mix thereof. This is where coordination issues are at their greatest but where the potential spillovers to and from monetary policy are not explicitly part of either policy sector's agenda. For the purposes of the paper, it is here where there is a gap in the framework for specifying policy change. Policy interdependence and coordination is potentially a key dimension of specifying policy change that existing frameworks do not provide a means of assessing.

V. Conclusion

UK monetary policy-making between 2007 and 2009 remained highly technical and specialised, closed off in both its content and institutional structure from democratic and populist politics. Furthermore its guiding policy paradigm has survived the crisis intact. Despite the absence of paradigm change, the case is far from a 'normal' period of policy-making because of the extraordinary innovations in respect of the bank rescue, reduction of interest rates to near zero and the introduction of novel instruments to increase the money supply. The nature of the global financial crisis and the monetary policy changes in response have had spillover consequences in other policy sectors, introducing policy objectives such as financial stability and which though not strictly rivalrous with monetary policy are now deeply interconnected with price stability; as well as igniting public pressure against the still powerful political lobby of the financial industry. It is moot to what extent monetary policy can remain in its institutionally sealed, depoliticised arena has it has done in the pre-Lehman consensus.

The policy debate in financial regulation does seem to mark a new era in economic governance in the UK; governments will take responsibility for micro-economic decisions such as regulating speculation in mortgages that they previously avoided simply by asserting that prices reflected the market realities of supply and demand. Yet part of the policy framing contest underway in UK financial regulation concerns the claim that the Lehman bankruptcy and the failed Paulson plan reveals that governments make disastrous mistakes at least as often as financial markets. In UK terms particularly, the post-Lehman collapse in tax revenues has provided the lesson that governments need banks as much as banks need governments. The symbiotic relationship between imperfect markets and imperfect

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governments is perhaps the lesson of the crisis that will have the greatest effect on future policy paradigms: everyone understands that economic events are inherently unpredictable – and this implies that both markets and politicians are prone to error.

The UK monetary policy case presents a stable policy paradigm – which guided the goal of rescuing the banks in the final quarter of 2008 – alongside redundant policy frames, practices and routines – based on prior experiential learning – that had worked 'in normal times' to interpret and learn about a situation. Instead, UK policy-makers had a paradigm but were operating in uncharted territory. It is true of course, that UK policy-makers knew about the Japan, Sweden, and East Asian tiger's cases, but there was little practical know-how about or experience of the policy instruments to deal with banking crises and their deflationary effects. Rather, in co-ordination with international policy-makers, UK policy was spurred by the severity of situation to an extraordinary range of policy innovations in the field of monetary policy.

The case reveals limitations in Hall's policy change framework in capturing the nature of this rapid, experimental and extraordinary policy development in the UK. Furthermore, both Hall's framework and its adaptation provided by H&C struggle with specifying policy change associated with inter-sectoral spillovers. In particular, one of the consequences of the monetary policy actions in 2008–9 has been the rediscovery by policy-makers of the essential interdependence of the objectives of price stability and financial stability, which had been obscured for the twenty or so years of deregulation in the financial services industry. The process of re-establishing a relationship and ultimate priority between these sometimes competing objectives will be a key aspect of UK monetary policy change as a result of the global financial crisis.

The current field of policy studies provides limited means for characterising and specifying accurately this aspect of policy change. Whilst the Hall and H&C models cast light on the analytical importance of intra-policy relationships between different levels of description, the existence of spillovers between policy sectors serves to reveal the analysis of inter-policy relationships as central in describing change. This future research agenda requires interrogation of spillovers between policy sectors as a dimension of policy change. Spillovers may result from a shift in the external policy environment or from endogenous change within one domain. The Hall and H&C descriptive models are limited in characterising policy from the perspective of one domain, where the boundary condition for that domain is relatively fixed. In order to interrogate more sophisticated forms of policy dynamics – such as policy conversion, layering or boundary expansion – more sophisticated work on the assessment of policy change is required to capture spillovers.

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NOTE

1. See for example, Wolf 2009; Posner 2009; Tett 2009; Mason 2009; Kaletsky 2010.

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