UK Economic Policy and the Global Financial Crisis: Paradigm Lost?*

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Abstract
The global financial crisis of 2007–08 produced a sudden change in the economic policy of the United Kingdom (UK). Prior to the crisis, the government preached the gospel of price stability, fiscal prudence and light-touch financial regulation. In the wake of the crisis, the government countenanced unconventional monetary policies, a surge in public-sector borrowing and the need for a rethink of financial supervision. This article seeks to understand the significance of these changes using Peter Hall’s theory of policy paradigms. Its central argument is that, contrary to appearances, the UK has not yet experienced a fundamental reordering of the instruments, institutions and aims of economic policy. Third-order change cannot be ruled out as the crisis unfolds but the economic ideas underpinning UK economic policy have, for better or worse, demonstrated remarkable resilience thus far.

Introduction
The UK has been among the European economies hardest hit by the global financial crisis. The worldwide financial turmoil that began in 2007 triggered the first run on a British bank since 1866 and a near meltdown in the banking system 12 months later. The credit crunch, the effects of which have been amplified by the bursting of the UK’s decade-old house price bubble, has taken a severe toll on the economy. According to the latest data, which are

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sketchy at best, UK GDP is expected to contract by at least 4 per cent in 2009, the country’s first recession in 17 years, and by some measures its worst one in 60 years (NIESR, 2009). The retail price index is expected to fall by 1.7 per cent in 2009, raising concerns over deflation and the number of unemployed is likely to reach 3 million people (an increase of nearly 60 per cent) before the economy recovers (NIESR, 2009).

The financial crisis has spurred ad hoc policy co-operation on the international stage (see Pauly, 2009) and energized efforts to strengthen financial supervision in the European Union (see Begg, 2009). It has also led to a dramatic change of direction in national economic policies, nowhere more so than in the UK. New Labour came to power in May 1997 promising fiscal prudence, price stability and a commitment to light-touch financial regulation. To this end, the government implemented a series of high-profile institutional reforms, adopting a set of fiscal rules, granting operational control of monetary policy to the Bank of England and creating a single financial regulator, the Financial Services Authority (FSA). The fate of these reforms has been thrown into doubt by the government’s response to the financial crisis, which has countenanced unconventional monetary policies, a surge in government borrowing and the introduction of new instruments of financial regulation.

This article seeks to understand the significance of these changes for the UK’s distinctive approach to economic policy using Peter Hall’s theory of policy paradigms (Hall, 1993). Hall’s theory, which was inspired by the shift from Keynesianism to monetarism in the UK in the 1970s, offers a three-fold insight into recent developments. Firstly, it provides us with a vocabulary for describing the configuration between the goals, instruments and institutions of economic policy prior to the financial crisis. Secondly, it sheds light on the political opportunities and constraints implied by New Labour’s economic policy. Thirdly, it offers a useful taxonomy for understanding the orders of policy change as the financial crisis has unfolded.

The central argument of this article is that New Labour’s response to the financial crisis remains rooted in the policy paradigm that it put in place after 1997. This paradigm is based on the dominant New Keynesian consensus in macroeconomic theory. We document the evolution of this paradigm before the crisis and examine how the challenge of the crisis has affected its operation. We find that there have been numerous ad hoc adjustments to instruments and institutions, but not a profound shift in the orientation and goals of policy.

The remainder of this article is divided into three main sections. Section I introduces Hall’s concept of policy paradigms and explores the economic theory underpinning New Labour’s approach to macroeconomic policy.
Section II uses Hall’s three orders of change to understand the initial impact of the financial crisis on UK economic policy. Section III considers whether the economic and political elements are present that could produce an ideational shift in UK economic policy over the longer term.

I. New Labour’s Macroeconomic Policy Paradigm

A policy paradigm, for Hall (1993, p. 279) is ‘a framework of ideas and standards that specifies not only the goals of policy and the kind of instruments that can be used to attain them, but also the very nature of the problems they are meant to be addressing’. He argues that the paradigm shift from Keynesianism to monetarism can readily be discerned from the Conservative government’s explicit prioritization of inflation control after 1979. That government was more circumspect in declaring itself ‘monetarist’ than Hall’s account might suggest, but the influence of monetarist economists on Margaret Thatcher seems clear (Frazer, 1982). New Labour has been even more reluctant to align itself with a particular economic theory, making it difficult to pin down the ideas behind its policies, despite some heroic efforts (for example, Dolowitz, 2004). This is partly because New Labour did not aim to achieve a clear break with the past, as, by 1997, the economy was faring well. It is also because of convergence in academic macroeconomics (Woodford, 2009), which, combined with the increasing complexity of the subject, makes it harder to identify distinct schools nowadays than it was in 1979. Nonetheless, we argue in this section that it is possible to find a discernible New Keynesianism in the current economic policy paradigm.

In a critique of Dolowitz’s (2004) attempt to relate New Labour’s welfare-to-work measures to endogenous growth theory, Watson (2004) argues that theory serves merely as an ex post rationalization for policies driven by ‘day-to-day changes in party political fortunes’ or ‘the governing party’s attempts to forge a sustainable long-term electoral bloc’ (Watson, 2004, p. 544). In our view, Watson overstates his case and risks losing sight of the inevitable if imperfect role played by theory in informing policy-makers about how their political purposes can be achieved. The problem is that the theoretical persuasions of policy-makers are often repackaged as ‘common sense’ (see Thatcher, 1980). But common sense is theory too, albeit often not very good theory, as Keynes (1936, p. 383) noted: ‘Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist’.

For Buiter (2009), the formality and abstraction that has overtaken academic economics in the last 20–30 years has resulted in ‘the unfortunate
uselessness of most “state of the art” academic monetary economics’. Mankiw (2006, p. 44) has argued that macroeconomics has lost its problem-solving, ‘engineering’ orientation, with the result that both New Classical and New Keynesian theory have ‘little impact on practical macroeconomists who are charged with the messy task of conducting actual monetary and fiscal policy’. These verdicts would seem to endorse Watson’s (2004, p. 545) argument that ‘economic policy and economic theory are simply not sufficiently commensurable such that the policy can be read off from the theory.’

If modern macroeconomics does not communicate with policy, one possibility is that policy is based on the last recognized episode of communication, which was monetarism. Oliver and Pemberton (2004, p. 433) document how monetarism, in the strict sense, was abandoned during the Conservative era and replaced by a ‘more generalized neoliberal paradigm’, which would seem to take in most possibilities. But it is possible to be more precise. We suggest that, while movement away from monetarism began in the Conservative era, the movement towards New Keynesianism continued under New Labour. By contrast with Hall’s case study of UK economic policy in the 1970s and early 1980s, but consistent with Oliver and Pemberton’s more comprehensive review of post-war economic policy (2004, p. 435), we find that there was a ‘punctuated evolution’ rather than a sudden replacement revolving around the 1997 election.

The most striking element of continuity in economic policy since 1979 has been the emphasis on controlling inflation. In his Mais Lecture in 1981, Geoffrey Howe, Thatcher’s first Chancellor, identified the fight against inflation as a ‘crucial condition’ for higher growth and prosperity (Howe, 1981). Tony Blair’s Chancellor and eventual successor as Prime Minister, Gordon Brown, said more or less the same thing in his Mais Lecture 18 years later, arguing that price stability was an ‘essential precondition’ for the achievement of higher and stable growth, and accepting that, on this particular issue, Milton Friedman was right (Brown, 1999).

Furthermore, New Labour continued the Conservative approach of announcing an inflation target and publicizing the advice of the Bank of England on the appropriate settings for monetary policy to achieve the target. Policy transparency was intended to influence inflation expectations and it was successful in achieving falling inflation despite falling unemployment both before and after the 1997 election. New Labour changed the institutional framework in one important way: it granted operational control over monetary policy to the newly created Monetary Policy Committee (MPC) of the Bank of England. No longer could the Chancellor go against the Bank’s advice in setting interest rates, as Conservative Chancellors had occasionally done (King, 1997).
As Burnham (2001, p. 128) has argued, this institutional change addressed the central problem of ‘Old Labour’ which had been trapped on two sides, ‘unable to meet the high expectations of its traditional supporters and trade union militants or convince financial capital of the probity of its economic policies’. In the financial markets, the government would only lose if it sought to deviate from the Bank’s advice; conversely, the decision to transfer operational control of interest rates to the Bank secured an immediate vote of confidence from the markets. One might expect that the Labour left would not be quite so satisfied; this was indeed an issue, as we explain below.

Assigning an inflation target to a central bank might appear to be very much in the monetarist tradition. Certainly the Conservative Chancellor, Nigel Lawson, saw the choice between monetary policy targets as a ‘second-order’ decision (quoted in Oliver and Pemberton, 2004, p. 434), an assessment echoed by Hall (1993, p. 282–3). However, there remained in academic economics two distinct theoretical approaches to inflation, and the New Keynesian approach gained ascendancy before the turn of the century. Whereas monetarists had favoured a ‘reduced-form’ account of inflation as determined by money supply growth, New Keynesians adopted ‘structural’ models in which a monetary stimulus would pass through the real economy to affect firms’ price-setting decisions. Specifically, inflation is modelled as the result of wage–price dynamics captured by expectations-augmented Phillips Curves. This implied that hitting the inflation target called for stability in output and employment around their ‘natural’ or ‘non-accelerating inflation’ levels. If an economic downturn loomed, this meant that inflation would decline and interest rates should be cut to stimulate the economy; conversely if the economy appeared to be overheating, interest rates should go up. Thus interest-rate policy and inflation targeting became the central means for regulating the economic cycle.

One problem with this approach concerned the evolution of asset prices. If ‘price stability’ meant asset-price as well as consumer-price stability, then the central bank should address apparent disequilibria, such as house price bubbles. Soon after Labour came to power, the then Governor implied that job losses in the north were an acceptable price to pay for curbing house price inflation in the south (Wighton and Tighe, 1998). Several Labour MPs called for the Governor’s resignation and trade unions also joined in criticizing the majority on the MPC for keeping interest rates too high.

In the midst of the row, the Governor issued a statement making it clear ‘that monetary policy can only target the economy as a whole, not particular regions or sectors, however uncomfortable that reality might be’ (Bank of England, 1998). It was vital that the Bank’s decisions did not produce salient distributional cleavages, so that it could sustain the claim that it was ‘targeting
the economy as a whole’. It became apparent that this was easier to achieve if the Bank met its inflation target by stabilizing the real economy, and set aside asset-price indicators.

When the price index used to define the inflation target was changed at the end of 2003, it became possible to hold that concern about house prices was outside the Bank’s statutory remit. The House of Lords Economic Affairs Committee ‘accept[ed] that households may be irrational and be over-optimistic about their ability to service and repay loans. And this may lead to overshooting in the sense of establishing an unsustainable position’ but so long as there was no direct measured impact on the inflation target, the Bank should not take house prices into account (House of Lords Select Committee on Economic Affairs, 2004, para 34). Furthermore, research by MPC members concluded that interest-rate rises to dampen the housing market would have severe real effects (see, for example, Nickell, 2005, p. 1). This might, in a different institutional setting, have been taken to indicate that other policy instruments were needed to reconcile growth, low inflation and financial stability, but members of the MPC refrained from advocating fiscal measures to dampen the housing market (see Barker, 2005).

New Keynesianism provided an intellectual rationale for focusing on the real economy rather than on asset prices, and after 1997 the Bank of England became discernibly more New Keynesian. The appointment of academic economists to the MPC tilted its intellectual orientation away from money and banking. Indeed the House of Lords complained in 2004 that recent appointments were not ‘acknowledged experts in monetary economics’ (House of Lords Select Committee on Economic Affairs, 2004, para 61). It did not name names, but the labour economist Stephen Nickell and dyed-in-the-wool Keynesian Chris Allsopp met its description. Mervyn King, appointed Governor in 2003, had an academic rather than a banking background, contributing to a shift in the Bank’s orientation. These shifts in personnel were part of a wider international trend in central banking as inflation targeting became more widespread. Most major central banks use macroeconomic models that are New Keynesian (Woodford, 2009; on the Bank of England’s model see Haldane, 2004). The change in the Bank of England was deepened by the decision in 1999–2000 to remove from it many of its financial regulatory functions and assign them to a new, unified regulatory body, the Financial Services Authority (FSA). The result was that, by the time the financial crisis hit, it could be claimed with only some exaggeration that the Governor had shaped the Bank into an ‘economic research department’ without a strong orientation towards money and banking (Congdon, 2009, p. 143).
Politically, the Bank’s shifting orientation permitted a harmonious relationship with the government, once the shock of losing many of its regulatory powers had passed. It should be noted that the Bank was never given ‘goal independence’: the government sets the inflation target for the MPC. Furthermore, the UK target is symmetrical (the actual inflation rate should not be more than 1 per cent above or below the target rate), so it does not allow the MPC systematically to achieve a lower inflation rate than the government chooses. The institutional design of the European Central Bank, by contrast, is built on the assumption that central bankers prefer lower inflation than governments. The UK government insisted on accountability: the Governor of the Bank of England is required to send an ‘open letter’ in the event that the inflation target is missed. This arrangement mirrors those found in other executive agencies in the UK.

The Bank’s acceptance of the role of executive agency for cyclical stabilization enabled the government to entrench a set of fiscal policy rules. The government adopted a Fiscal Code of Conduct in 1998 which committed it to two rules, the so-called Golden Rule and the sustainable investment rule. The Golden Rule states that only investment and not consumption should be financed by borrowing over the course of the economic cycle (Carlin and Soskice, 2006, p. 198). Under the sustainable investment rule, public-sector net debt should be stable as a percentage of GDP; the government set this at 40 per cent. By defining these rules across the cycle, the government envisaged that the automatic stabilizers would operate: there would be deficits in downturns due to lower tax revenues and higher social security expenditure, but the converse would occur in upturns, so fiscal sustainability could be achieved without resorting to pro-cyclical cuts in current expenditure.

It was important for New Labour to adopt a rule-based approach to fiscal policy in order to insulate the Chancellor against claims by other Cabinet members and interest groups associated with the Labour Party, notably the trade unions, for higher social expenditure. However, this restraint was achieved on the basis of a promise that fiscal policy would not be subject to cyclical economic vicissitudes. With the Bank of England maintaining macroeconomic stability, steady economic growth could provide the basis for gradual improvements in the scope and quality of public services. This would not do away with the perennial competition between spending ministries and legitimate political argument would take place about spending priorities. However, these arguments could be conducted without politicizing economic policy, thereby avoiding the problems that had plagued Labour in the past, which had left it open to the claim that the party’s welfare state ambitions were destroying the vitality of the UK economy.
New Keynesianism also provided a rationale for restricting the activist use of fiscal policy. The old Keynesian argument with monetarists rested on the elasticity of economic responses to monetary and fiscal stimuli; New Keynesianism put this aside by accepting that, at least in normal times, interest-rate adjustment was an effective instrument for cyclical demand management. However, by contrast with New Classical economic theory, which sees fiscal policy as unable to influence aggregate demand, New Keynesians argue that the fiscal stance does have real effects. The New Keynesian endorsement of monetary demand management rests on an analysis of the processes of economic policy-making. Discretionary fiscal policy is seen as slow to adjust because of lags in the budget process, while monetary policy can be adjusted quickly. To put it simply, fiscal policy is decided annually, while monetary policy is made monthly, or sometimes more frequently, so monetary policy can always ‘trump’ fiscal policy (Carlin and Soskice, 2006, p. 650). However, this argument does not rule out the possibility that fiscal intervention could combat recession or dampen a boom, if the timing was right. Furthermore, it is important not to get the timing wrong: fiscal tightening could significantly worsen a recession.

These details are important when judging whether the government’s fiscal response to the financial crisis constitutes a paradigm shift. For Arestis and Sawyer (2001, p. 256), the concept of ‘fiscal passivity’ was central to New Labour’s economic doctrine. This view, they argue, is founded on the belief that ‘fiscal policy has a passive role to play in that the budget deficit position varies over the business cycle in the well known manner, but an active fiscal policy is not required to either “fine tune” or even “coarse tune” the economy’. Hay (2004) echoes this, arguing that New Labour’s fiscal rules have effectively ruled out the use of discretionary fiscal policy even in a recession. Clift and Tomlinson (2006) dissent, arguing that the Code left open the door for fiscal activism in a recession. Indeed they argue that the pursuit of a credible medium-term budgetary strategy is precisely designed to put the government in a position to use this option. But contrary to their standpoint (and Hay’s 2006 rebuttal), this interpretation is consistent with New Keynesian theory: fiscal policy is effective, but ideally it does not have to be used for cyclical stabilization.

The discussion so far has sought to establish that New Labour’s macroeconomic policy framework was consistent with New Keynesian intellectual foundations. This policy paradigm defined ‘the very nature of the problems’ that macroeconomic policy should address as consumer-price inflation and unemployment. It did not define rising house prices or other asset prices as indicators of macroeconomic problems, although the possibility that there was in fact a house price ‘bubble’ was clearly in the backs of the minds of
monetary policy-makers. One New Keynesian member of the MPC, Stephen Nickell, put forward his own technical analysis to lay the ‘bubble’ issue to rest (Nickell, 2005). He argued that rising household indebtedness was matched by rising household assets; in other words, household portfolios were expanding in a potentially sustainable fashion.

The expanding balance sheets of households were not a problem; on the contrary, they were a solution to the problem that arises in traditional Keynesian analysis that households are not able to smooth their consumption through participation in financial markets: they are credit-constrained. This means that, if their income falls, their consumption must fall as well. A shock to income is ‘multiplied’ through this consumption response. In New Keynesian theory, the multiplier may operate, but it will be dampened ‘to the extent that the proportion of households able to lend and borrow is large enough’ (Carlin and Soskice, 2006, p. 571). This consumption-smoothing model relied on rational household behaviour; specifically, households should ‘rationally anticipate the response of the central bank to aggregate demand shocks’.

Thus it was consistent with prevailing ideas in macroeconomics that financial regulation was not part of New Labour’s macroeconomic policy paradigm. Furthermore, a benign attitude to financial markets was politically attractive to New Labour for several reasons. It endorsed the political reality that the City’s disapproval of Old Labour had to be countered, as it was in the ‘prawn cocktail offensive’ of the mid-1990s. New Labour was enthusiastic about the dynamism of the City, and willing to accept a degree of regulatory competition with New York and continental centres that would allow it to thrive. Furthermore, it suggested that, rather than going against the Conservatives’ popular policy of promoting home ownership, Labour should instead seek to widen the policy. Similarly, the Conservative policy of extending private-pension provision would not be reversed, but instead implemented more fairly, for example, through the introduction of ‘stakeholder’ pensions targeted to lower earners who did not have access to other suitable schemes.

Thus the government pursued microeconomic policy goals in its approach to financial regulation. One goal was to maintain and enhance the international competitiveness of the City of London, which could mean allowing a certain amount of ‘regulatory arbitrage’, adopting lenient policies to give firms in London a competitive advantage over their American and continental competitors (Vogel, 1997). Another goal was to ensure that financial scandals did not derail the promotion of ‘asset-based welfare’ for households (Schmidt and Westrup, 2008). In particular, high-profile problems with private pensions risked undermining the government’s welfare-state reform strategy. In the Financial Services and Markets Act (2000), the government charged the FSA with responsibility for maintaining market confidence, promoting public
understanding of the financial system, securing the appropriate degree of protection for consumers and fighting financial crime. The primary ‘selling point’ of the FSA was unification of a fragmented regulatory system, an idea that was well-received internationally and emulated in several countries. Advocates of unification noted with apparent approval that ‘[t]he securitization of traditional forms of credit’, the ‘increasingly elaborate ways of unbundling, repackaging and trading risks’ and so on, ‘blurred the boundaries’ between different types of financial institution (Briault, 1999, pp. 13–14). Unification reflected a view that the regulatory regime should adapt to financial innovation, rather than restraining it.

One decision about the creation of the FSA did create controversy. This arose from Labour’s decision to transfer responsibility for banking supervision from the Bank of England to the FSA. Peston (2006, pp. 135–7) presents the two standard arguments at the time about why banking supervision should be transferred, one based on technical effectiveness and the other on bureaucratic politics. The technical argument is that the Bank’s monetary policy function might come into conflict with financial stability, if, for example, a rise in interest rates needed for price stability would place banks or other institutions in financial difficulty. However, this argument can be turned on its head: without knowledge of the state of the financial markets, the Bank cannot estimate the effect of an interest-rate change (Goodhart and Schoenmaker, 1995).

The bureaucratic argument was that the new unified agency could not be located in the Bank as it would then be too large and too powerful. Davies and Green (2008, p. 179) suggest that the Bank lost responsibility for financial regulation because it had gained new authority over monetary policy, as otherwise it might become an ‘over-mighty citizen’. As section III shows, the assignment of functions between the FSA and the Bank has now become the focus of political contestation, but this assignment was never of central importance to the macroeconomic policy paradigm.

II. The Paradigm under Pressure

Hall (1993, pp. 278–9) distinguishes between three orders of policy change. First-order change involves modifications to the settings of policy instruments; second-order change entails the introduction of new instruments or shifts in the institutionalization of control over instruments. The idea of a ‘paradigm shift’ is reserved for describing third-order change, involving comprehensive changes in the goals of policy and the instruments assigned to achieve those goals. In this section, we document the changes in instruments
and instrument settings that have occurred since the financial crisis began. We consider financial sector stability, monetary policy and fiscal policy in turn, although developments in all three areas were closely linked.

While few people paid it much attention in 2000, the creation of the FSA was accompanied by the formulation of a Memorandum of Understanding between the Treasury, the Bank and the FSA which set out the operating rules for the ‘exceptional circumstances’ of a substantial financial failure. This established a Standing Committee on Financial Stability in which the three parties regularly met at official level. Whereas the institutional structure for normal times envisaged that the Treasury, the Bank and the FSA had distinct and separable goals, targeted by instruments specifically at their disposal, the Memorandum emphasized their interdependence. It specified how, in a crisis, the tripartite relationship would be structured. The Governor of the Bank and the Chair of the FSA would make recommendations to the Chancellor, who would have final responsibility for decisions to support financial institutions.

As the Memorandum envisaged, the Chancellor took a leading role as the financial crisis unfolded. On 13 September 2007 the BBC reported that the Bank of England was providing emergency financial support to Northern Rock, one of the country’s leading mortgage providers. On Friday 14 September and Monday 17 September, long queues formed outside the Rock’s branches. The run was halted when the government announced at the end of the day on Monday that it would guarantee all the Rock’s deposits. Subsequently, the government provided capital to Northern Rock and in February 2008 it was formally taken into public ownership.

The government’s announcement of a guarantee for Northern Rock depositors exposed serious deficiencies in the existing institutional framework, whereby the Financial Services Compensation Scheme provided a 100 per cent guarantee on only the first £2,000 of bank deposits. On 1 October 2007 the FSA raised this limit to £35,000 and subsequently to £50,000. Soon after, it became clear that the government would guarantee all retail-bank deposits in the UK. We see this as, at most, an ad hoc second-order change, although critics have argued that bank rescues represent a paradigm shift towards industrial policy by monetary means (‘mondustrial’ policy as Taylor, 2009, calls it).

It is in relation to monetary policy that we can see most clearly the challenge to New Labour’s paradigm. The crisis has brought unprecedented first-order changes in instrument settings. The Bank has implemented astonishing cuts in its base rate, from 5.75 per cent in November 2007 to 0.5 per cent a year and a half later. But the base rate instrument did not work on bank lending in the usual way; inter-bank lending rates remained high and volumes low. Furthermore, the Bank’s ability to manipulate the real interest rate was hampered by a sharp fall in inflation. Inflation allows the Bank to achieve
negative real interest rates, although its nominal rate instrument is bounded at zero.

As it became clear that interest-rate cuts were insufficient for reviving the economy, the Bank and the Treasury agreed on the need for other instruments. ‘Quantitative easing’ extended the Bank’s existing method of increasing liquidity, which was to lend cash against securities at its discount window. In January 2009 a new ‘Asset Purchase Facility’ was created, under which the Bank can buy securities rather than just lending against them. The operational framework for the Asset Purchase Facility was established by an exchange of letters between the Chancellor and the Governor, in which the Treasury committed to covering the Bank on capital losses it may incur through defaults on its purchases of private securities. Subsequently the Chancellor authorized the Bank to undertake up to £150 billion of purchases, of which up to £50 billion should be used to purchase private sector assets. The balance can be used to purchase government securities, thereby effectively ‘printing money’ to finance the fiscal deficit.

We see ‘quantitative easing’ through the Asset Purchase Facility as a second-order change. This is because the underlying commitment to low inflation is not jeopardized, although the institutionalization of that commitment in the operational independence of the Bank of England has not been sustained during the crisis. Operational independence has been suspended because interest rate policy is insufficient to prevent deflation; however, it appears that the Bank retains the independence to counter any future signs of inflation. This is the position taken by the government, which was at pains to emphasize that ‘the objectives of the monetary policy framework remained unchanged’ by the introduction of the Asset Purchase Facility (HM Treasury, 2009, Box 2.2), and it has been endorsed by the IMF (2009), which noted that the MPC can unwind asset purchases under the Facility without requiring authorization from the Treasury.

Turning to fiscal policy, one of the most striking symptoms of the financial crisis has been a massive increase in borrowing, with the government’s net cash requirement soaring from 2.3 per cent of GDP in 2007–08 to 11.3 per cent in 2008–09. This change is not the result of the workings of the automatic stabilizers, something that would have been compatible with the government’s fiscal framework under ‘normal’ policy-making. A rough estimate of the magnitude of the effect of the stabilizers can be derived by comparing the actual budget deficit with its cyclically adjusted value. This measure suggests that the automatic stabilizers caused a deterioration of about 0.3 per cent of GDP in the fiscal position in 2007–08 and 0.5 per cent in 2008–09 (HM Treasury, 2009, Table C2, 222). In 2009–10 and 2010–11 the effects are forecast to be stronger but still small: 2.6 per cent and 3 per cent, respectively.
The fact that this surge in borrowing went well beyond the workings of the automatic stabilizers forced the government to suspend its fiscal rules. In November 2008, Alistair Darling argued that an effort ‘to apply the rules in a rigid manner would be perverse and damaging’ (Darling, 2008). To this end, the Chancellor announced a ‘temporal operating rule’, which requires the government to reduce the cyclically adjusted budget deficit year by year once the economy emerges from the downturn.

For some commentators, the sharp increase in government borrowing and the suspension of the fiscal rules constitute an ideational shift at the heart of New Labour. Lee (2009), for example, sees a drift within the UK government towards a more radical Keynesian agenda. ‘[B]oth Brown and his chancellor, Alistair Darling, have rediscovered the political economy of […] Keynes’ (Lee, 2009, p. 30). The Conservative Party has advanced similar arguments, criticizing the government for ‘abandoning any pretence of fiscal responsibility […] [and] returning to 1970s Keynesian demand management’ (Osborne, 2008).

There is little evidence, however, to suggest that the government has reverted towards a more Keynesian paradigm based on raising expenditure on goods and services or increasing transfer payments. More than half of the deterioration in the fiscal balance has occurred because of expenditures that occurred as a result of the financial crisis. These ‘below the line’ expenditures do not directly raise household income or boost the demand for goods and services. The stimulus they potentially give to the economy has to work through monetary channels: the bail-outs were intended to revive the supply of credit. They represent the fiscalization of monetary policy, rather than conventional fiscal policy.

Discretionary decisions to reduce taxes or increase spending do not account for much of the ballooning fiscal deficit in the UK. According to the OECD (2009), the discretionary measures taken in the UK in 2008 will amount to around 1.4 per cent of GDP, which is considerably less than the expected stimulus in Germany (3 per cent) and the USA (5.6 per cent). The entirety of the UK’s fiscal stimulus came, moreover, from the revenue side of the budget (particularly, the temporary cut in VAT), which goes against the standard Keynesian view that government spending measures are likely to have a more potent impact on aggregate demand than tax cuts.

III. Prospects for the Policy Paradigm

The previous section showed that there has been considerable ad hoc adaptation and widespread first- and second-order policy change as a result of the
financial crisis. This section examines whether it is possible to identify the outlines of a new policy paradigm. First, it briefly discusses developments in economic theory that might provide the foundations for a different approach. Second, it considers the political obstacles that might stand in the way of these new (or newly fashionable) economic ideas. Third, and most extensively, it compares Labour’s proposals for reforming economic policy with those of the Conservatives in the light of this discussion.

The crisis has revealed a number of cracks in New Keynesian economic theory; not least its focus on the labour market as the key source of macroeconomic instability, to the neglect of financial markets. The analysis which suggested that households’ participation in financial markets would be stabilizing rather than bubble-creating has taken a tremendous blow. Writing in 2009, the outlines of an alternative theoretical approach in macroeconomics are becoming discernible. The alternative approach finds the drivers of economic instability in the cyclicity of subjective risk assessments rather than in oscillations around a long-run vertical Phillips Curve. Since the single instrument of the interest rate cannot manage asset-price bubbles without adverse real effects, new macroeconomic policy instruments are needed. These could potentially include fiscal-policy instruments, although recent attention has focused more on ‘macroprudential’ regulation (Brunnermeier et al., 2009).

To understand how these ideas about financial stability might be taken up by policy-makers, we have to ask how they will be received politically. Hall (1993, p. 280) argued that the shift from one paradigm to another is ‘more sociological than scientific’. Political attractiveness rather than theoretical soundness was the key factor behind the shift to monetarism, which fitted with Conservative views on public spending, the role of the state and the harmful influence of trade unions. Thus electoral politics played a significant role in the policy paradigm shift from Keynesianism to monetarism.

One obstacle to creating a constituency for asset-price stabilization is summed up by Brunnermeier et al. (2009, p. 37) as follows: ‘When regulation is needed, no-one wants it, because asset prices are rising, there is a boom, everyone is optimistic and regulation just gets in the way’. If there was a significant constituency that did not own assets, this argument might be contested, but both political parties continue to endorse owner-occupation along with other aspects of ‘asset-based welfare’ such as funded provision of old-age pensions. The solution advocated by Brunnermeier et al. involves depoliticization: the regulatory mechanism should be made automatic rather than discretionary, so that it can survive the shifts in the political as well as economic mood that characterize the business cycle.
However, this proposal encounters another obstacle: the political power of the City of London. Both the government and the Conservative opposition have made it clear that financial sector reform must not jeopardize the international competitiveness of the City. Proposals that would impose extra costs on UK-based banks, such as a substantial increase in bank levies to finance an enhanced deposit insurance scheme, have stalled because of this constraint. Martin Wolf (2009) has argued that as long as policy investigations are conducted around the question of how to ‘keep UK financial services competitive’, they will produce the wrong answers. There is no appetite to grapple with the UK’s ‘strategic nightmare [of having] a strong comparative advantage in the world’s most irresponsible industry’.

The government has so far (as of July 2009) taken only small steps towards establishing a system of macroprudential regulation. The 2009 Banking Act extends the Bank of England’s mandate to include financial stability as well as price stability. The Act created a new instrument of crisis management, a ‘special resolution regime’ for banks in trouble, but powers to set banks’ capital requirements and regulate their normal activities remain with the FSA, to the irritation of the Bank. The Governor has expressed ‘regret’ that the Bank’s new responsibility for financial stability ‘has not been accompanied by any new powers to deal with banks before they fail’ (Bank of England, 2009, p. 5).

Initially, the Conservatives proposed fairly modest changes to give the Bank of England a greater role in macro-prudential supervision without fundamentally altering the tripartite system (Conservative Party, 2008). By July 2009, the opposition had become a little bolder. The public dispute between the government and the Bank of England over financial regulation provided too good a political opportunity to miss, and the Conservatives stepped in with a white Paper on the side of the Bank, advocating returning to it holding most responsibilities for financial regulation (Conservative Party, 2009).

The Conservatives’ proposals exemplify the political art of appearing to advance radical new policies while actually proposing to change very little. The White Paper attacks the existing tripartite system but proposes a tripartite system of its own in which the FSA would become a consumer protection agency (which was, as noted above, the main function of the FSA before the crisis). Responsibilities for prudential regulation of the banking system would return to the Bank of England. The White Paper proposes the creation of a Financial Stability Committee, comprising Bank officials and outside experts, as with the MPC. Yet while the report noted that ‘the Bank of England needs a second instrument – macroprudential regulation – to target financial stability over the economic cycle’ (Conservative Party, 2009, p. 23), the ‘toolkit’ did not include provision for cyclically varying capital requirements.
The explanation for the lack of new instruments advanced by the White Paper is that the key measures require international agreement. The need for international agreement is intertwined with the argument that no regulatory measures should be taken that might undermine the City’s international competitiveness. Furthermore, the White Paper comments approvingly on international initiatives centred on Basel, while initiatives at the EU level are specifically attacked, notably the Alternative Investment Fund Managers Directive. Thus ‘international’ regulation is consistent with market openness and competitiveness, while ‘European’ regulation is portrayed as suspect over-regulation that will damage, not just UK interests, but those of French and German banks which compete in international markets via London. Rather opportunistically, the White Paper emphasizes strongly how a Conservative government will go into bat for the City in Brussels.\(^1\)

The implication is that the political appetite for a paradigm shift in financial regulation is rather small; the next election will not usher in a radically new approach. However, as Oliver and Pemberton (2004) argue, significant policy change may nonetheless occur. In their account, battles to institutionalize new ideas are important. Giving more power to the Bank of England may turn out to be significant, not because the Conservatives propose and intend that the Bank should wield new instruments, but because the Bank might use its enhanced institutional position to implement some of the ideas proposed by its economists. One of the ironies of the position taken in the White Paper is that the conservative press had previously decided that the present Governor, Mervyn King, ‘is out to get’ the banks, favouring a bank-financed deposit protection scheme and criticizing executive bonuses (Conway et al., 2008). Just as the work of the MPC evolved after 1997, so it is possible that the Financial Stability Committee could become an important conduit for policy change. But against this possibility must be set the question of whether any regulatory reform will bring a sustained reduction in the influence of the City over government policy, and reduce the degree to which the regulator can be captured by a climate of entrancement with the financial ‘masters of the universe’. Notwithstanding the personality of the current Governor, there is no historical evidence that the Bank is less susceptible to capture than the FSA, so shifting responsibilities between the two organizations might make little difference.

The fact remains that political support for the old paradigm has been damaged by the financial crisis. One major political problem concerns the future path of fiscal policy. The fiscal rules have been temporarily abandoned,\(^1\)

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\(^1\) See Quaglia (2009) on the UK’s influence on the EU stage during the initial stages of the financial crisis. Begg (2009) discusses the UK’s reticence towards stronger financial supervision at the EU level.
but cuts in welfare service provision are just around the corner, negating the promise that social policy objectives could be pursued within a stable framework for economic management. The government faces the unappetizing prospect of explaining why expenditure on health and education must be restrained when apparently unlimited funds have been poured into the banking system.

However, this problem for Labour is matched by an equal and opposite problem for the Conservatives. The party leadership faces calls for unfunded tax cuts from the right wing of the Conservative Party. This helps to explain why the party proposes to amend rather than abandon New Labour’s rule-based approach to fiscal policy. It proposes that the rules would be revised to achieve a falling debt/GDP ratio by pursuing a balanced budget over the economic cycle. Responsibility for monitoring these rules would be delegated to a new independent Office for Budget Responsibility, which would be empowered to offer non-binding recommendations to the government on the appropriate stance of fiscal policy on the basis of independently prepared forecasts. This new institution, it is stressed, would have no policy-making powers and its mandate would be set by the Chancellor of the Exchequer, who will continue to have final say over the formulation and implementation of fiscal policy. Tough talk about fiscal austerity may have appeased the right wing of the party (Davis, 2009) but the Conservatives have kept their fiscal policy options open. They supported the government’s decision to bail out the banks, a policy which, as noted above, accounts for more than half of the deterioration in the government’s cash balance incurred as a result of the financial crisis and they have been careful not to be drawn into guarantees of expenditure cuts on any part of government except ‘waste’.

**Conclusion**

This article has argued that the UK government’s response to the global economic crisis does not constitute a paradigm shift. In terms of Hall’s theory of policy change, we see first-order change to the setting of policy instruments and second-order change in the introduction of new instruments, but we do not see third-order change in the form of a simultaneous shift in policy instruments and goals driven by a fundamentally new understanding of how the economy works. In the case of monetary policy, the instrument of quantitative easing reflects the limitations of conventional monetary policies under present economic circumstances but it has not, as yet, changed the relationship between the government and the Bank. In the case of fiscal policy,
reports of the Labour Party’s re-conversion to Keynesian demand management have been greatly exaggerated. UK government borrowing has risen sharply in response to the global financial crisis but this change has more to do with the costs of bank bail-outs than the Chancellor’s rather modest fiscal stimulus package. In the financial sphere, the Northern Rock crisis has prompted the government to introduce a new policy instrument with the creation of a special resolution regime, but it has not introduced macro-prudential regulatory instruments that might reduce the ability of the City to profit from the next boom.

The financial crisis has exposed a number of blind spots in New Labour’s paradigm, including a lack of attention to financial stability and concerns over the ability of existing instruments to deliver asset price stability. The political bargain at the heart of New Labour’s economic policy, which exchanged fiscal discipline for the promise of balanced economic growth and steadily rising investment in public services, has also been profoundly shaken as a result of the crisis. However, in contrast to the late 1970s, electoral politics is unlikely to pave the way for a radically new approach to economic policy in the near future. Although the Conservative Party is promising a bold new approach to economic management, its economic policies are cut from the same ideational cloth as those of the Labour Party.

In the early 1970s, it was possible to identify the beginning of the end of the Keynesian paradigm in acknowledgements from Labour as well as Conservative politicians that more inflation could not achieve sustained reductions in unemployment. We do not see a corresponding shift in agreed wisdom today. We can see from developments in macroeconomic theory that a paradigm shift will entail a less optimistic view of the potential for asset-based welfare and more restraint on irrational exuberance in financial markets, but the incorporation of these ideas into policy is singularly uninviting for both the main political parties. Neither has much inclination to challenge the country’s attachment to homeownership or to rein in the City, if that would undermine its ability to compete internationally.

It is arguable, however, that Hall’s account of paradigm shifts asks too much of policy change. Oliver and Pemberton (2004) suggest that Hall’s account is based on an atypical episode in UK economic history. They suggest that significant shifts in UK economic policy have generally occurred as a result of first- and second-order changes, entailing the refinement of policy instruments and settings rather than a radical reordering of economic aims. This perspective suggests that changes in the roles of the FSA and the Bank of England could prove to be significant, but the battles will be fought inside the tripartite institutions and not in the electoral arena.

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