Chapter 6

Knowledge and Governance: Can Systemic Risk in Financial Markets Be Managed? The Case of the Euro Crisis

Stephen Bell and Andrew Hindmoor

In *Masters of the Universe, Slaves of the Market*, Bell and Hindmoor (2015) portray a highly “structuralist” account of the 2008 Global Financial Crisis (GFC) that originated in the Wall Street and London markets. Such an account implies that structural influences, here defined as material forces in financial markets, are important not only as a result of action by relevant agents, but also as subsequent influences of agents’ options and behavior, especially in driving forced asset fire-sales and credit freezes. A structural account of this kind can be contrasted with an institutional account, in which an agent’s behavior is shaped by institutional factors—primarily rules, norms, or operating procedures in formal or informal organizational or institutional settings. Hence, structures and institutions are somewhat similar in that they both shape behavior, but the sources of incentives or constraints (emanating from either structures or institutions) are different in each case.

Prior to and during the 2008 crisis, bankers in the key New York and London markets faced institutional pressures from within their own organizations for high returns, linked also to remuneration packages and professional prestige. Bankers were also influenced by wider structural forces, such as growing competitive pressures for high short-term returns in financial markets. The favored strategy to achieve such returns was highly leveraged trading in mortgage-backed financial assets, all of which finally ended in calamity. Other structural dynamics were also at work. One was the growth of “systemic risk.” Here, agents (largely unknowingly)

S. Bell (✉)

School of Political Science and International Studies, University of Queensland,
Brisbane, QLD, Australia

e-mail: stephen.bell@uq.edu.au

A. Hindmoor

Department of Politics and International Relations, University of Sheffield, Sheffield, UK

e-mail: a.hindmoor@sheffield.ac.uk

had constructed a fragile system of highly complex independencies between financial institutions that enhanced the prospect of contagion effects in markets that would rapidly escalate into panic and the domino-like collapse of global credit markets and many major banks and financial institutions. This was essentially a structural characteristic of the system. Systemic risk of this kind gradually built up during the 2000s, eventually “crystallizing” into a full-blown crisis of panic-selling and a global credit crash in the wake of the Lehman Brothers’ collapse in late 2008. All this was driven, most proximately, by the behavior of bankers who were structurally ensnared in a context of their own making that left them little choice but to ultimately pursue collectively destructive behaviors: a malign form of structural power, mutually exerted.

In recent decades, social scientists participating in the long-running debates on agency and structure have tended to give a greater focus to agency. Yet the above account of the GFC is grimly structuralist, suggesting little room for agency or at least for agent choice (see also Bell & Hindmoor, 2018a, b). This raises the question of whether such situations of structural exigency can be prevented or managed. The question is important given the prevalence and costs of financial crises in recent decades.

A key question is then whether it might be possible to shape or manage banker behavior in order to try and avoid the panicked herding and fleeing behavior, asset fire sales, and withholding of credit that are typical during the crystallization of systemic risk amidst a full-blown financial crisis. Our response is tentatively affirmative, based on the experience of the Euro crisis, whose actors have thus far avoided both the crystallization of systemic risk and a banking crisis, despite the ongoing fragility of the large European banks (Bell & Hindmoor, 2018a, b). We argue that the key to such an outcome hinges on the relationship between agency, knowledge, and governance arrangements. In particular, we argue from this case that if agents are knowledgeable and aware of the potential for catastrophe, they may illicit institutional responses and governance arrangements that may serve to build resolution strategies. The aim here is to stabilize market sentiment, thus helping to avoid the (unwanted) crystallization of systemic risk via the mutual exertion of structural power by key agents in financial markets that proved so destructive during the GFC.

In this chapter, we therefore focus on the Euro crisis, which is, thus far, quite unlike the GFC. The latter saw bankers and key agents stumble blindly into disaster, with little knowledge or forewarning of the complex chain of events that awaited them (Bell, 2017). By contrast, key agents of the Euro crisis (bankers, regulators, and policy makers) have proven far more aware of the potential for the crystallization of systemic risk and a banking crisis. As we argue more fully below, this kind of knowledge has been central, and cognizant agents have proved capable of using institutions and governance strategies to (thus far) forestall a potential debt and banking collapse in Europe.

We use the resources of political science to explore these issues, unpacking the concepts of systemic risk and structural power in more detail. We then examine the relevant governance and historical institutionalist literature in political science to

find useful tools and concepts to help us probe the knowledge, relational, and contextual issues in question in order to better understand if or how systemic risk in financial markets might be managed.

Authors of governance literature have focused on the role of both the state and non-state actors in forging governance partnerships to develop solutions to complex collective action problems. As we shall lay out below, private actors and state-supported networks prevented the crystallization of systemic risk amidst the Euro crisis and thereby played an important role in managing systemic risk, essentially by arranging a form of collective action amongst financial interests, supported by states, that helped contain the crisis. As we shall argue, however, the governance literature contains only a limited account of agency and agential knowledge. It is here that the historical institutionalist literature is better able to analyze how agents use ideas in institutional settings to forge change or reform strategies; in this case with a focus on how relevant agents dealt with the unfolding Euro crisis. We will begin, however, by unpacking concepts such as systemic risk and structural power in financial markets.

Systemic Risk and Structural Power in the GFC

In the run-up to the GFC, bankers and financiers produced a very complex asset-and-debt structure that was fragile in the extreme and difficult to understand and ultimately control. Market actors thus produced systemic risk, leading to a structural context of fragility that was marked by complex and highly leveraged securities trading and myriad other intricate and often opaque interdependencies in the financial system (Bell & Hindmoor, 2015). How should scholars theorize this interaction between agents and structure? Archer (2000, p. 465) argues that “structures only exert an effect when mediated through the activities of people. Structures are only ever relational emergents and never reified entities existing without social interaction.” How, then, did agents actualize and mediate such structural effects?

In the context of the GFC, agents were unaware of the full complexity and fragility of the system they had created (Bell, 2017). Yet they became increasingly aware of at least some of the relevant dangers when the US mortgage market saw a downturn from mid-2007, threatening the value of mortgage-backed assets that formed the basis of what would later be known as the *toxic* securities trading at the center of the crisis. As the crisis mounted through 2008, bankers and financiers sought more funding whilst selling assets, which saw further falls in asset values and growing concerns about debt exposures and risk. The panic really set in when Lehman Brothers collapsed in September 2008, leading to a global freeze in credit markets and further bank runs and failures. In this structural context, panic and herding fuelled the liquidity crisis and greatly increased the scale of the overall financial crisis. Agents thus *actualized* the structural impacts of the context they had established. This was not a matter of structure *over* agency (cf. Kim & Sharman, 2014), but one of the mutual constitution of structures and agents.

The crystallization of systemic risk thus involved a structural power context in which bankers exerted mutually generated power over other bankers, forcing them into unwanted fire sales and the withholding of credit, which essentially defined the crisis. “Bankers and financiers were thus caught in a series of severe collective action problems stemming from an institutional and structural environment they had helped create and eventually could not control” (Bell & Hindmoor, 2015, p. 69). Concepts of power are central here because agents were forced by other agents to act against their will. Power is often thought of as a resource that is deployed or used by agents, usually in a strategic manner. But there is another category of power, in which agents mutually exert power over one another, through the way they interact in a structured context. In the case we are examining, bankers were subject to a form of power that they themselves had created and exerted collectively, though unwillingly. They did not wish to withhold credit or engage in asset fire sales, but were forced to do so by the structural pressures and incentives they confronted. This was not about power being exercised by those in a structurally privileged position (Lindblom, 1977). Nor was it about exerting power through controlling discourse (Foucault, 1979). Instead, this was about agents exerting power over each other in a structured context that brought on collective ruin. Agents thus produced large structural effects that they did not anticipate and could not ultimately control. Prior to the crisis, bankers and financiers thought the institutions and relationships they had created were built on sound risk management and rational contracting. But as Bell and Hindmoor (2015, pp. 70–71) argue:

Prevailing ideas and assumptions concealed the true nature of the structural dynamics confronting agents. In this sense, ideas and structures proved to be dangerously congruent. Only as the crisis was breaking did bankers come to realize what they had created. They ceased being ‘true believers’ in financial markets at precisely the moment that it became too late to escape.

Solutions?

Because the crystallization of systemic risk stemming from mutually exerted forms of structural power arises from the behavior of bankers and financiers in financial markets, any solution to these problems must ultimately involve modifying the behavior of these actors. To avoid the crystallization of systemic risk, they must attempt to collectively mold or shape their behavior to avoid such an outcome. The relevant behavior here is shaped by actors’ knowledge, ideas, and motives, as well as by the governance, institutional, and structural terrains in which they operate. We explore these factors below, starting with the contribution of authors of governance literature.

The Governance Literature

In recent decades, the authors of the burgeoning governance literature have highlighted the interactions of public and private actors in the governance of public affairs. Much of this literature has a *society-centred* perspective, in the sense that it emphasizes relatively horizontal forms of governance networks, which are said to have marginalized government (Bell & Hindmoor, 2009). As Sørensen and Torfing (2007, p. 3) put it: “[T]he sovereign state ... is losing its grip and is being replaced by new ideas about pluricentric government based on interdependence, negotiation, and trust.” Hence, this literature’s authors have allegedly shifted from “government to governance,” involving interactions between a wide range of actors in formal and informal “self-organising networks.” For Stoker (1998, p. 17), “the essence of governance is its focus on governing mechanisms which do not rest on recourse to the authority and sanctions of government.” Sørensen and Torfing (2007) similarly emphasise the centrality of “non-hierarchical forms of governance” (p. 3), the “absence of top-down authority” (p. 44), and the “role of horizontal networks of organised interests” (p. 3). Bevir and Rhodes (2003, pp. 55–56) argue that “networks are the defining characteristics of governance,” and offer a “coordinating mechanism notably different from markets and hierarchies.” In this account, key dynamics in politics, such as hierarchy, power, and conflict, tend to recede, to be replaced by more horizontal forms of negotiation, networking, mutual dependence, reciprocity, and trust relations.

Bell and Hindmoor (2009) argue that this approach, although useful in highlighting multiple actors in governance, downplays the role of the state and of hierarchy that are typically found in politics and in governance practices. Indeed, even when governments *choose* to govern in alternative ways, in using markets for example, governments and state agencies typically remain important players in establishing and operating the agendas and rules for such strategies, in sanctioning the role of key players, and in providing resources and support. Indeed, the relational aspects of governance can often be seen as a way of *strengthening* state capacity. As Andersen (2004, p. 7) argues:

Many researchers have claimed that the restructuring of governance is a general retreat of government and the state ... yet there is no reason to assume that the rise of governance necessarily leads to a decline of government ... the main reason for the rise in state capacity through restructuring is ... the fact that the state is now able to influence hitherto non-governmental spheres of social life through partnerships, in other words, an enlargement of state competencies.

In this view, posing a choice between society-centred and more state-centric approaches to governance is misleading because both sets of dynamics are often involved. Moreover, this approach sees governance as an extension of traditional forms of public policy, with the state as a key actor but utilizing a wider variety of governing strategies and actors, often involving non-governmental actors, including business, unions, associations, NGOs, or communities.

The governance literature’s strength, then, is its focus on the role of both the state and non-state actors in forging governance partnerships aimed at working out

solutions to complex collective action problems. As we shall see below, in preventing the crystallization of systemic risk amidst the Euro crisis, the role of private actors and networks working in tandem with the state has been of central importance.

Although useful, the governance literature in general and the society-centred governance literature in particular have several limitations. First, their authors fail to adequately deal with questions of knowledge and agency. At the extreme, there is a highly interpretivist account within the society-centred literature that focusses almost exclusively on agents and their ideas (e.g., Bevir & Rhodes, 2003). This, however, fails to adequately account for the dialectical interaction between agents and wider institutional or indeed structural contexts in which agents operate, largely because researchers view such contexts as the artefacts of an agent's interpretation. State-centric governance accounts harbor almost the opposite problem, as their authors focus on the dynamics of state-society relationships but spend little time dealing with detailed questions of agency. Admittedly, the authors of certain works in this approach have discussed how states use persuasion as a governance strategy, leveraging the ideas and cognition of relevant actors in reshaping behavior (Bell & Hindmoor, 2009; Bell, Hindmoor, & Mols, 2010). Yet even this approach's proponents does not delve deeply enough into how agents themselves actually operate in ideational terrains and appraise and respond to the knowledge and information they confront.

Second, scholars advocating the society-centred version of governance literature, in particular, with its emphasis on horizontal networks, largely ignore the role of hierarchy, not only in relation to the role of the state, but also within societal networks themselves. As we illustrate in the case below, the collective action responses that European bankers and financiers were able to achieve were orchestrated not by horizontal networks but by organized hierarchies within such networks, centred, in particular, around the associational role of the Institute of International Finance (IIF), the international bank lobbying organisation, which represented the major global banks and financial institutions and which worked in tandem with relevant state actors.

These gaps in relation to agency and hierarchical organisation within the governance literature are significant. The agency issue is especially important because a key issue that emerges from both the GFC and the Euro crisis is that key agents' knowledge, ideas, and perceptions crucially shape their role and actions in financial markets (Bell, 2017). Knowledge and ideational factors matter in relation to whether systemic risk is perceived and whether it eventually crystalizes, and they also matter in forging governance strategies and responses. Researchers must therefore know how agents think and respond in a cognitive and ideational sense to the situations they confront.

The Institutional Literature

Arguably, contemporary institutionalist scholars are better able to flesh out the interactions between the cognitive and ideational realm of agency and the institutional and structural terrains in which agents operate.

Agents do not operate in a vacuum, but shape and are shaped by their institutional and wider structural contexts. As Karl Marx once famously observed, “men make their own history, but they do not make it as they please; they do not make it under self-selected circumstances, but under circumstances existing, already given, and transmitted from the past” (quoted in Tucker, 1978, p. 575). Institutional contexts are important in this respect. As Scharpf (1997, pp. 41–42) argues, “once we know the institutional setting of interaction, we know a good deal about the actors involved, about their options, and about their perceptions and preferences.” Institutions are primarily about the rules and norms (formal or informal) that shape actor behavior. Institutions matter because they shape actor identities, interpretations, and preferences, the norm and rule-based scope of agents’ discretion, and the resources and opportunities available to agents within organizations or institutions. As Farrell (2018, p. 26) puts it: “Institutions are not historical constants; rather, they are themselves the product of human agency, and as humans enact institutions, they correspondingly transform them.”

In political science, one of the main versions of institutional theory is historical institutionalism (HI). There has been a problem, however, because proponents of various strands of institutional theory, including strands of HI, have tended to emphasize highly constraining notions of institutions. Prominent theorists such as North (1990, p. 3) define institutions as “the humanly devised *constraints* that shape human interaction” (our emphasis). This is a *sticky* form of institutional theory. It has a limited account of agency and is better at explaining institutional continuity than change. Blyth (1997, p. 230) is among many critics who argue that institutional theorists view institutions as largely “constraining rather than enabling political action.” Weyland (2008, p. 281) similarly argues that “institutionalism has emphasised inertia and persistence,” offering a *static* view of institutional life. Schmidt (2008, p. 314) also sees established theorists as “subordinating agency to structure,” whilst Crouch and Keune (2005, p. 83) argue that “institutional configurations are often presented as a straitjacket from which endogenous actors cannot escape.” We are sympathetic to such criticisms and wary of subscribing fully to overly *sticky* versions of HI theory (Bell, 2011). For example, the sweeping institutional changes that constituted the revolution in banking institutions and practices with the rise of highly leveraged trading during the 1990s and 2000s in the core financial markets of the US and UK suggest there is something wrong with such accounts (Bell & Hindmoor, 2015). Thelen (2004) similarly finds a pattern of agent-driven institutional change in the German vocational training system, whereby incremental changes led to more profound changes over time.

In recent years, scholars have made a number of revisions to HI. The authors of more flexible accounts within HI have shifted to a more agency-centred,

“post-determinist” (Crouch, 2007) analysis, recognizing that institutions are subject to endogenous, agency-driven change and that dialectical interactions between agents and institutions are central to institutional life and in driving institutional change (see Bell, 2011; Bell & Feng, 2014; Campbell, 2004; Steinmo & Thelen, 1992). A major step in this direction was Thelen’s work with various colleagues, pointing to sources of agency-based discretion as a basis for *incremental* institutional innovation and change (Mahoney & Thelen, 2010; Streeck & Thelen, 2005; Thelen, 2004). Proponents of this approach recognize that agents operate with varying degrees of initiative and discretion, in a context in which institutions are both constraining and enabling (Bell, 2011). Hence, agents both shape and are shaped by institutions:

Institutional and/or structural environments can exert potential, though always agency-actualised effects, by imposing costs or benefits on agents, by shaping actor interpretations and preferences, the scope of bounded discretion, and the resources and opportunities available to actors. (Bell, 2011, p. 892)

Glückler and Lenz (2016, p. 257) add that agency is manifest when “legitimate mutual expectations” about rules and behavior help reinforce stable patterns of interaction within institutions.

In recent work, constructivist institutionalists also argue that agents can actively interpret institutional rules and norms, again creating at least some room for agency (Blyth, 2002; Hay, 2007; Schmidt, 2010). Actors use ideas and typically rely on agreed understandings to interpret and navigate such institutional terrains. Importantly, however, institutions and structures are also “distinct strata of reality” that are not simply reducible to the actors that inhabit them. Bell (2011) has therefore cautioned that ideational accounts must ground agents squarely and dialectically within institutional and wider settings.

Knowledge and Ideas

As noted, institutions and structures only exert an effect when mediated through the activities of people (Archer, 2000). This suggests that people’s ideas, knowledge, and basic behavioral biases shape how they interact with institutions and wider structural forces. Hence, an “agency-based HI approach can easily integrate constructivist notions of interpretive agency and give full recognition to the fact that ideas, knowledge, language and inter-subjective discursive processes provide the crucial building blocks for establishing meaning and understanding and thus of purposeful action in politics and institutional life” (Bell, 2011, p. 893).

Amidst the GFC, for example, most of the participants in the financial system were not simply responding to skewed incentive structures such as highly competitive pressures for profits or bank remuneration schemes that rewarded risk taking. They were also on the whole “true believers.” The assumption made within many banks was that their trading activity and leverage were largely risk-free. Bank

traders, bank CEOs, regulators, investors, and even many politicians were “boundedly rational,” operating on incomplete information, myopia, group think, herding, and over-optimism (Bell, 2017). This led them to discount or neglect inconvenient or complex information as well as warning signals. Such ideas and motives mattered because in an uncertain environment the assumptions key actors made about how markets work, how other actors would behave, and how governments would respond, shaped their perceptions and actions (Bell, 2017; Hindmoor & McConnell, 2013).

A further important and related finding from behavioral studies comes from prospect theory (Kahneman & Tversky, 1979; Tversky & Kahneman, 1992). Its proponents argue that agents subjectively define value in terms of gains or losses from a given (often current) reference point rather than in terms of final gains or overall wealth positions. A finding of relevance to systemic risk issues is that individuals thus tend to be loss averse; they will worry about downside risks, and will take bigger risks (compared to securing a gain) to avoid losses, which helps explain market panics and asset fire sales.

Overall, the literatures above provide key elements with which to analyze agent behavior within institutional, structural, and governance settings in financial markets that feature the potential for systemic risk. From the above, it is clear that researchers must be attentive to the role of agency, as shaped by the knowledge and cognitive and ideational drivers of behavior and how agents use them to understand and react to the situations in which they find themselves. From the institutionalist literature, we also need to factor in the way in which agents are shaped and in turn shape the institutional and structural contexts in which they operate. Important here also is the notion that agents are not only pressured by institutional and structural contexts, but that they also have some scope to shape and manage these contexts. Finally, the authors of the governance literature emphasize the possibility that agents might band together in hierarchical networks capable of dealing with collective action and governance challenges and that, more often than not, the state is an important part of such arrangements. In the next section, we probe the basic elements of the Euro crisis and show how the explanatory elements outlined above can help reveal how relevant institutionally-situated agents used knowledge and ideas to ascertain the nature of the systemic risks they confronted and then forged collective action solutions that thus far have prevented the crystallization of systemic risk.

The Euro Crisis

One key institutional context pertinent to the unfolding Euro crisis was the establishment of the European Central Bank (ECB), a body charged with overseeing European monetary integration. The introduction of a common currency in 1999 was a further key institutional development. These institutional contexts shaped the behavior of major banks and debt markets and effectively meant that the markets treated all members of the Euro area in broadly similar ways. Crucially, this form of

monetary integration and the ideas held by lenders meant that the less productive economies on Europe's periphery—the likes of Portugal, Spain, Ireland, and especially Greece—were able to borrow freely at lower interest rates than might have been the case otherwise. These countries subsequently piled on debt to fund what would turn out to be real estate bubbles in Portugal, Spain, and Ireland, as well as a sovereign debt crisis in Greece. Lenders viewed these economies as part of the EU monetary system, assuming that Irish or Greek debt, and so forth, would be treated similarly to German debt. Lenders also assumed that member states and the EU would support the major banks if troubles developed.

If the peripheral economies had their own national currencies, financial market agents might have imposed a degree of discipline on borrowing. But because the countries in question were members of the Euro, external market pressures were not effective in bringing about change in economies that would normally have been judged to be “living beyond their means,” potentially facing a market-driven currency depreciation. For example, before Greece joined the European Monetary Union, its large and rising public debts would have probably initiated rising interest rates and/or falling exchange rates as markets reacted to the rise in perceived risk. This would have helped to stem debt increases. However, the EMU system largely eliminated such market constraints on debt, and the EU's own policy and administrative monitoring regarding debt and fiscal balances also clearly failed.

The periphery's various and growing private and sovereign debt problems were exacerbated by the GFC from 2008 onwards and would become a key structural problem for the Eurozone. In Ireland, for example, debt helped fuel the “growth miracle” that developed into a massive property bubble, which eventually collapsed, exposing Irish and European banks. Indeed, the huge burden of public and private debt at the center of the Euro crisis was largely held by German, French and UK banks. The German banks, for example, were “structurally hugely vulnerable to crisis,” according to Thompson (2015, p. 856), whilst the French banks' exposure was even larger. It is estimated that the French, German, and UK banks' combined exposure to peripheral European debt at the height of the crisis was as high as two trillion US dollars (Kalaitzake, 2017, p. 396; Thompson, 2015, p. 857). Any default on such would place enormous pressure on these banks, risking a bank-run and banking insolvency, in turn forcing national governments to try and bail the banks out. This posed a major systemic risk to the European banking system, not only because of the debt exposures and highly fragile nature of the large Euro banks in question (Bell & Hindmoor, 2018a, b), but also because of these banks' sheer scale relative to the national GDPs involved. This posed the question of whether bailouts would even be fiscally feasible for the relevant governments and authorities. The scale and uncertainties surrounding these potential problems thus constituted an acute context of systemic risk and raised wider institutional questions about the design of the Euro system and its capacities for crisis management and adjustment. For the debt-laden peripheral economies the problem was that they were locked into a relatively inflexible institutional system that was never designed for such crises and that, for example, foreclosed currency depreciation as an adjustment mechanism.

Preventing the Crystallization of Systemic Risk Amidst the Euro Crisis

As noted above, agents tend to be loss averse and will often take drastic action in the face of impending losses and instability. In this context, the challenge was to try and prop up European debt markets and prevent a run on the major European banks. In other words, the challenge was to prevent the crystallization of systemic risk whereby financial market actors could potentially bring on collective ruin by exerting a form of structural power, mutually exercised, thus presenting market actors with a severe and urgent collective action problem.

In the literature on structural power, researchers often treat the structural dimensions of such power separately from so-called instrumental dimensions of business power, with the latter based on overt business activism, organization, and lobbying. But these two forms of power should not for the most part be analytically separated and can in fact interact. Indeed, structural power need not be deterministic or automatic and can be mediated through agency, ideas, and collective organization (Bell, 2012).

Kalaitzake (2017) uses this framework to analyze the response to the Greek crisis and the way in which European and international bankers, and especially the leaders of the IIF, understood the challenges and risks they confronted and used ideas, knowledge, and experience regarding the dynamics of previous banking crises and debt resolution strategies in a range of developing countries to help chart a way forward in this new European situation. The IIF thus emerged as an important enabling institution that was knowledgeable, expert, and well-connected with European leaders and officials. Over the course of the crisis, the IIF was able to frame the key issues, articulate clear response strategies, and use associative means to help organize collective action responses. The IIF also worked closely with European state leaders and officials in the European Commission, the European Central Bank, and the IMF, and was valued by the authorities as a knowledgeable and organizationally capable partner. All of these actors had a key knowledge advantage compared to those involved in the GFC, who were essentially overwhelmed by a more complex and completely unexpected chain of events, starting with the collapse of mortgage-backed assets and ending with the meltdown in global wholesale funding markets (Bell, 2017). In contrast, European actors were confronted with a more conventional and more clearly understood debt and potential bank run type of crisis. As noted, the IIF leaders were well versed in such crises, and this was in contrast to the level of experience and knowledge held by many European leaders and officials who “had little grasp of the technical issues involved” (quoted in Kalaitzake, 2017, p. 399). Above all, it was well understood that it was essential to uphold market confidence and prevent panic and contagion and that the only way to do this was to organize responses that would stabilize the debt situation and above all convince relevant market actors that the situation was in hand. According to one private sector participant, the European authorities thus recognized the IIF “as a valuable platform to coordinate policy objectives with the majority of

bondholders as a unified block [and] foster stronger policy communication to financial markets more broadly, allowing officials to better manage policy expectations and market reactions” (Kalaitzake, 2017, p. 399).

In the case of the Greek sovereign debt crisis, tough medicine in the form of fiscal restraint and other austerity measures were imposed as the condition for liquidity assistance from the European authorities and the IMF. As the crisis worsened in May 2010, a 110bn Euro bailout was announced to facilitate Greek debt servicing. This was largely aimed at buying time and reassuring markets that the situation was in hand. Policymakers initially directed their efforts at avoiding a debt write down and a private sector debt haircut in order to avoid market panic and the potential for contagion in other stressed markets in the Euro periphery. As Kalaitzake (2017) notes, it was initially feared that “a creditor write-down in Greece would trigger a ‘Lehman-type event’ resulting in bank runs and rising borrowing costs.” The Euro leaders also developed an emergency bailout or lending fund—the European Financial Stability Facility. ECB President Mario Draghi’s famous promise in 2012 to do “whatever it takes” to resolve the crisis was also intended to both reassure skittish financial markets and to justify buying “unlimited” quantities of sovereign bonds. As the IMF (2013, p. 28) argued, the imposition of pain on Greece but not initially on creditors “provided a window for private creditors to reduce exposures and shift debt into official hands.” This process saw almost 100 billion Euros of Greek debt pass from the private to the state sector between the initial bailout and a further debt restructuring deal announced in 2012, the latter prompted by the continuing instability of the Greek debt situation. Having bought some breathing space with the first bailout, the IMF began to insist that any further official assistance would need to be supported by a private sector bail-in or haircut in which creditors would be exposed to losses. In this context, the IIF worked to organize a collective banking response and forged agreement with Euro leaders that by March 2012 was focused on a second Greek bailout, though this time with a substantial degree of private sector bail-in, amounting to an over 50% write down for bond holders. Yet policymakers sweetened the bail-in with generous offsets, including swaps for certain amounts of Greek debt for official bonds of various maturities. Overall, these arrangements benefited the banks and private sector creditors by avoiding a disorderly default, and reduced the risk of panic and contagion, the threat of more coercive government measures to restructure debt markets, and market exposure to the Greek crisis—all based on essentially voluntary, collective private sector responses and organization, backed and supported by the EU authorities. In contrast to Woll (2014), who argues that private financial sector disorganization forced governments into more generous banks bailouts in some countries after the GFC, this case illustrates the advantages of private financial sector knowledge and organization in cases of sovereign debt crises.

This episode shows that systemic risk in financial markets can be managed even in the face of a potential *Lehman-type event*, but only if market and state actors are able to perceive the looming threat and act in an organized manner with sufficient institutional back-up and resources to avoid the crystallisation of systemic risk. Ideas, financial expertise, experience, the willingness and capacity to act

collectively, all supported by appropriate institutions and public-private partnerships and effective governance strategies were all involved in this case. The key contrast here, compared to what happened in the case of the GFC, is that bankers and state leaders in the Euro situation were able to clearly understand and perceive the potential for the crystallisation of systemic risk and act to avert it.

Finally, it is true that the bailouts and actions taken to assuage market actors exposed the states and authorities in question to moral hazard—a form of reassurance and an outcome that is likely to reduce risk perceptions and embolden market actors going forward. This situation always puts states and the authorities in a bind, but the reality is that financial markets are now so large that systemic financial collapse cannot be countenanced. This essentially structural market shift now means that the potential crisis-induced collateral damage to wider economies and even to the fate of nations is now so great in most cases of large, complex, and interconnected financial markets that concerns about moral hazard now take second place to the need to avoid a financial meltdown.

Conclusion

Knowledge, collective capacity, and governance can clearly matter in understanding and managing complex human interactions amidst financial markets that are structurally prone to systemic risk and its crystallization. This occurred in a dramatic and damaging way during the 2008 GFC, but thus far at least the Euro crisis has not morphed into a Euro banking crisis, although many Euro banks remain fragile and vulnerable (Bell & Hindmoor, 2018a). As we have demonstrated, at the crisis's peak around 2010, the Euro authorities and states managed to avoid the crystallization of systemic risk through collective action, with the help of a knowledgeable and organized private sector.

We have argued that various strands of research and theory in political science offer useful tools for understanding such dynamics and outcomes. The authors of governance literature point to the importance of the state and the orchestration of public-private cooperation in meeting governance challenges. But we have argued that institutional analysis also offers a way of locating agents in relevant institutional and structural contexts, through tracing dialectical relations of mutually shaping interactions over time. This approach also offers a way of bringing in deeper insights about agents' cognitive and ideational processes in shaping the way agents use knowledge to help appraise and react to situations and in building institutional and collective responses to risk environments. Future researchers must bring together these elements in wider studies of how knowledge and governance strategies have been deployed, studying other cases of financial market dynamics or in broader settings.

References

- Andersen, H. (2004). Governance and regime politics in Copenhagen (pp. 1–17). Eurez Lecture: Vol. 16. University of Copenhagen, Department of Geography.
- Archer, M. S. (2000). For structure: Its reality, properties and powers: A reply to Antony King. *Sociological Review*, 48, 464–472. <https://doi.org/10.1111/1467-954X.00226>
- Bell, S. (2011). Do we really need a constructivist institutionalism to explain institutional change? *British Journal of Political Science*, 41, 883–906. <https://doi.org/10.1017/S0007123411000147>
- Bell, S. (2012). The power of ideas: The ideational shaping of the structural power of business. *International Studies Quarterly*, 56, 661–673. <https://doi.org/10.1111/j.1468-2478.2012.00743.x>
- Bell, S. (2017). Historical institutionalism and new dimensions of agency: Bankers, institutions and the 2008 crisis. *Political Studies*, 65, 724–739. <https://doi.org/10.1177/0032321716675884>
- Bell, S., & Feng, H. (2014). How proximate and ‘meta-institutional’ contexts shape institutional change: Explaining the rise of the People’s Bank of China. *Political Studies*, 62, 197–215. <https://doi.org/10.1111/1467-9248.12005>
- Bell, S., & Hindmoor, A. (2009). *Rethinking governance: The centrality of the state in modern societies*. New York, NY: Cambridge University Press. <https://doi.org/10.1017/CBO9780511814617>
- Bell, S., & Hindmoor, A. (2015). *Masters of the universe, slaves of the market*. Cambridge, MA: Harvard University Press.
- Bell, S., & Hindmoor, A. (2018a). Are the major global banks now safer? Structural continuities and change in banking and finance since the 2008 crisis. *Review of International Political Economy*, 25, 1–27. <https://doi.org/10.1080/09692290.2017.1414070>
- Bell, S., & Hindmoor, A. (2018b). *Structural forces can come with instruction sheets and blindside agents: Structure and agency in financial markets in Europe and the United States* (Unpublished paper). University of Queensland, St. Lucia.
- Bell, S., Hindmoor, A., & Mols, F. (2010). Persuasion as governance: A state centric-relational perspective. *Public Administration*, 88, 851–870. <https://doi.org/10.1111/j.1467-9299.2010.01838.x>
- Bevir, M., & Rhodes, R. A. W. (2003). *Interpreting British governance*. London: Routledge. <https://doi.org/10.4324/9780203135914>
- Blyth, M. (1997). Any more bright ideas: The ideational turn in comparative political economy. *Comparative Politics*, 29, 229–250. <https://doi.org/10.2307/422082>
- Blyth, M. (2002). *Great transformations: Economic ideas and institutional change in the twentieth century*. New York, NY: Cambridge University Press. <https://doi.org/10.1017/CBO9781139087230>
- Campbell, J. L. (2004). *Institutional change and globalization*. Princeton, NJ: Princeton University Press.
- Crouch, C. (2007). How to do post-determinist institutional analysis. *Socio-Economic Review*, 5, 527–567. <https://doi.org/10.1093/ser/mwm001>
- Crouch, C., & Keune, M. (2005). Changing dominant practice: Making use of institutional diversity in Hungary and the United Kingdom. In W. Streeck & K. Thelen (Eds.), *Beyond continuity: Institutional change in advanced political economies* (pp. 83–102). Oxford, UK: Oxford University Press.
- Farrell, H. (2018). The shared challenges of institutional theories: Rational choice, historical institutionalism, and sociological institutionalism. In J. Glückler, R. Suddaby, & R. Lenz (Eds.), *Knowledge and institutions* (pp. 23–44). Knowledge and Space: Vol. 13. Cham: Springer. https://doi.org/10.1007/978-3-319-75328-7_2
- Foucault, M. (1979). *Discipline and punish: The birth of the prison*. New York: Pantheon.
- Glückler, J., & Lenz, R. (2016). How institutions moderate the effectiveness of regional policy: A framework and research agenda. *Investigaciones Regionales*, 36, 255–277.

- Hay, C. (2007). Constructivist institutionalism. In R. A. W. Rhodes, S. A. Binder, & B. A. Rockman (Eds.), *The Oxford handbook of political institutions* (pp. 56–74). Oxford, UK: Oxford University Press. <https://doi.org/10.1093/oxfordhb/9780199548460.001.0001>
- Hindmoor, A., & McConnell, A. (2013). Why didn't they see it coming? Warning signs, acceptable risks and the global financial crisis. *Political Studies*, 61, 543–560. <https://doi.org/10.1111/j.1467-9248.2012.00986.x>
- IMF (International Monetary Fund). (2013). *Global financial stability report: October 2013*. Washington, DC: International Monetary Fund.
- Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica*, 47, 263–291. <https://doi.org/10.2307/1914185>
- Kalaitzake, M. (2017). The political power of finance: The Institute for International Finance and the Greek debt crisis. *Politics & Society*, 45, 389–413. <https://doi.org/10.1177/0032329217707969>
- Kim, H. J., & Sharman, J. C. (2014). Accounts and accountability: Corruption, human rights and individual accountability norms. *International Organization*, 68, 418–448. <https://doi.org/10.1017/S0020818313000428>
- Lindblom, C. E. (1977). *Politics and markets: The world's political-economic systems*. New York: Basic.
- Mahoney, J., & Thelen, K. (2010). A theory of gradual institutional change. In J. Mahoney & K. Thelen (Eds.), *Explaining institutional change: Ambiguity, agency and power* (pp. 1–37). New York, NY: Cambridge University Press. <https://doi.org/10.1017/CBO9780511806414>
- North, D. C. (1990). *Institutions, institutional change and economic performance*. New York, NY: Cambridge University Press.
- Scharpf, F. W. (1997). *Games real actors play: Actor-centred institutionalism in policy research*. Boulder: Westview. <https://doi.org/10.4324/9780429500275>
- Schmidt, V. A. (2010). Taking ideas and discourse seriously: Explaining change through discursive institutionalism as the fourth “new institutionalism”. *European Political Science Review*, 2, 1–25. <https://doi.org/10.1017/S17557739099021X>
- Schmidt, V. A. (2008). Discursive institutionalism: The explanatory power of ideas and discourse. *Annual Review of Political Science*, 11, 303–326. <https://doi.org/10.1146/annurev.polisci.11.060606.135342>
- Sørensen, E., & Torfing, J. (2007). Introduction: Governance network research: Towards a second generation. In E. Sørensen & J. Torfing (Eds.), *Theories of democratic network governance* (pp. 1–24). Basingstoke: Palgrave Macmillan. https://doi.org/10.1057/9780230625006_1
- Steinmo, S., & Thelen, K. (1992). Historical institutionalism in comparative perspective. In S. Steinmo, K. Thelen, & F. Longstreth (Eds.), *Structuring politics: Historical institutionalism in comparative analysis* (pp. 1–31). Cambridge, UK: Cambridge University Press.
- Stoker, G. (1998). Governance as theory: Five propositions. *International Social Science Journal*, 68, 15–24. <https://doi.org/10.1111/issj.12189>
- Streeck, W., & Thelen, K. (2005). *Beyond continuity: Institutional change in advanced political economies*. Oxford, UK: Oxford University Press.
- Thelen, K. (2004). *How institutions evolve: The political economy of skills in Germany, Britain, the United States and Japan*. Cambridge, UK: Cambridge University Press. <https://doi.org/10.1017/CBO9780511790997>
- Thompson, H. (2015). Germany and the Euro-Zone crisis: The European reformation of the European banking crisis and the future of the Euro. *New Political Economy*, 20, 851–870. <https://doi.org/10.1080/13563467.2015.1041476>
- Tucker, R. C. (1978). *The Marx-Engels reader*. New York: Norton.
- Tversky, A., & Kahneman, D. (1992). Advances in prospect theory: Cumulative representation of uncertainty. *Journal of Risk and Uncertainty*, 5, 297–323. <https://doi.org/10.1007/BF00122574>
- Weyland, K. (2008). Toward a new theory of institutional change. *World Politics*, 60, 281–314. <https://doi.org/10.1353/wp.0.0013>
- Woll, C. (2014). *The power of collective inaction: Bank bailouts in comparison*. Ithaca, NY: Cornell University Press. <https://doi.org/10.7591/cornell/9780801452352.003.0003>

Open Access This chapter is licensed under the terms of the Creative Commons Attribution 4.0 International License (<http://creativecommons.org/licenses/by/4.0/>), which permits use, sharing, adaptation, distribution and reproduction in any medium or format, as long as you give appropriate credit to the original author(s) and the source, provide a link to the Creative Commons license and indicate if changes were made.

The images or other third party material in this chapter are included in the chapter's Creative Commons license, unless indicated otherwise in a credit line to the material. If material is not included in the chapter's Creative Commons license and your intended use is not permitted by statutory regulation or exceeds the permitted use, you will need to obtain permission directly from the copyright holder.