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Financial market crisis, financial market reform: Why hasn't reform followed crisis

(Keynote address)

Financial Market Crisis, Financial Market Reform
Why Hasn't Reform Followed Crisis?

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"One year after the collapse of Lehman Brothers, the surprise is not how much has changed in the financial industry, but how little." New York Times, September 12, 2009

1. Introduction

Much conventional wisdom argues that crisis triggers or induces reform, though what this means has different interpretations. One view (Bruno, 1993) is that a crisis is necessary for major reform, that is, major reform rarely takes place without an economic crisis. Another view, closer to a statement about sufficiency rather than necessity, is that a severe enough crisis will lead to major reform, as in Olson (1982) or Drazen and Grilli (1993). The "crisis hypothesis", as it is sometimes termed, is part of political wisdom. For example, Rahm Emanuel, President Obama's chief of staff, has been quoted as saying in connection with the 2008 financial crisis, "You never want a serious crisis to go to waste … it's an opportunity to do things you could not do before."

Most would agree, however, that a year after the financial crisis, there has not yet been legislation for significant structural reform in the financial sector. Should we be surprised? Has the possible causal relation between crisis and reform been overstated? Have existing models of crisis and reform missed something (or perhaps missed the boat entirely)?

I think that existing work on relation between crises and reform is useful in some of its general lessons, but is not very informative in understanding specific reform episodes. My goal here is threefold. First, I will quickly summarize and existing theory and some of the empirical results. Second, on the basis of the existing literature, I will consider the specific question with which I began, namely the relation between the financial crisis and (lack of) financial reform. My main point here is that the strength of the financial sector lobby in the U.S. is key to the absence of reform so far. While some might say this is obvious, I will argue that the effect of special interest groups (SIGs) on the reform process is more complex than simple statements would suggest. Third, I will ask why generally why crisis might not trigger reform, at least quickly and perhaps not at all. These observations will be applied to efforts by powerful SIGs to block reform, especially but not only financial sector reforms. I will also ask what lessons can be learned about adopting reform when SIG strength is a key factor.

I will not address the question of what financial market reforms should be made, as this is not my expertise. I will concentrate on the experience of the United States, though I think many of the points apply to the EU as well.

2. Crisis and Reform – Basic Approaches

There are four basic approaches on why crisis triggers reform, which we denote the "crisis hypothesis". This summary is quite short – more to jog the reader's memory than to provide a self-contained summary. A more detailed discussion may be found in chapter 10 of Drazen (2000).[1]

The first type of argument is that a crisis changes our perception of how the world works and therefore makes us aware of a need for change not previously perceived (Harberger, 1993). Only when things reach "crisis proportions" do we realize that very different types of policies must be tried.

A second argument is that crisis makes groups willing to forgo private gain or makes weaker groups more ready to stop blocking programs favored by stronger groups (War of Attrition models: Alesina and Drazen, 1991; Drazen and Grilli, 1993). Larger distortions induce an earlier expected reform. Hence, if reform is delayed by the inability to gain consensus on how the burden of reform is to be divided among interest groups, a crisis can hasten agreement by increasing the distortion associated with the status quo, thus raising the cost of not agreeing to reform. In short, a crisis makes each interest group more amenable to reform.

Third, deterioration of the status quo makes groups more willing to accept the uncertainties associated with large structural changes (Fernandez and Rodrik, 1991; Laban and Sturzenegger 1994). If socially beneficial policy change is not enacted due to high uncertainty about who will be the winners and who the losers from the change, a large deterioration of the status quo will lead groups to accept the uncertainty associated with a reform.

[1] Empirical evidence on whether crisis leads to reform finds mixed results. See for example, Lora (1998), Drazen and Easterly (2001), Abiad and Mody (2005), and Alesina, Ardagna, and Trebbi (2006).

Finally, there is the view that crisis weakens powerful interest groups that block reform (Olson, 1982; Nelson, 1990). For example, Olson argues that economic success creates powerful groups with vested interests who may naturally be against policy changes that hurt them. If reform requires a significant weakening of the power of some interest groups, only a severe economic deterioration may be sufficient to weaken their power and bring about reform. However, as will be argued below, though a crisis may be necessary to weaken interest groups, crisis alone may not be sufficient to bring about reform. Nor, as will be argued, does a crisis necessarily weaken interest groups; it may in fact strengthen them.

3. **Why No Significant Structural Financial Reform?**

I now turn to the focus of the paper – why hasn't the financial crisis of 2008 led (at least so far) to more structural reform of the financial sector? Subject to an important caveat, the most relevant empirical paper for this question is probably Abiad and Mody (2005). Over a sample period 1973-9 they find that "when a country is in a banking crisis, the likelihood of a large financial reform falls from 5.5 percent to 2.6 percent and the possibility of reversals [of financial reform] increases from 2.3 percent to 9.5 percent." The caveat is simple but crucial: "financial sector reform" in their study means decreased regulation of financial firms and markets – the standard definition of "financial reform" prior to the recent crisis. After the 2008 crisis, similar to after other financial crises, "reform" generally means tighter rather than looser regulation. Hence, Abiad and Mody's finding is that a financial crisis slows or reverses deregulation, that is, leads to *more* reform in the sense we are considering it.

Numerous explanations have been given for why the crisis has not so far led to tighter regulation the absence of reform in the wake of the 2008 crisis.[2] First, there is the argument of *complexity*, that is, the problem of what to do is quite complicated, so much so that being unsure of what to do explains nothing having been done. This argument certainly

[2] Some arguments – such as reform being electorally unpopular – are not relevant. The evidence does *not* support view that tough policy loses elections in general (see, for example, Buti, Turrini, Van den Noord, and Biroli (2009) and the references therein); more specifically, greater regulation of Wall Street does seem electorally unpopular.

has some truth to it in general and seems particularly at in the case of structural financial reform in the wake of the 2008 crisis. However, it cannot be the whole story and leaves too much unexplained.

Second, there is the argument that once the immediate crisis passed, financial market reform became "yesterday's problem" in the competition for attention in an always overcrowded legislative policy agenda. That is, the sense of crisis has passed, where the "crisis hypothesis" requires perception of a crisis for there to be reform. This view, as stated, is also unsatisfactory. If the crisis hypothesis is true, why were there no significant policy changes when it was perceived there was a crisis? And why, if the sense of crisis has passed, is financial reform legislation still being discussed, however glacial the pace of action? I will argue below that the crisis hypothesis must be refined to recognize **adopting structural reform takes time.** Support for major changes takes time to form[3], both in the public and in the policy making apparatus – it must "percolate".[4]

A third argument is that special interests, both inside and outside government, are often responsible for the lack of significant reform in response to crisis. Inside government, bureaucrats fight to protect to "protect their turf". More importantly, powerful special interest groups (SIGs) block changes that hurt them. I believe this is central to the specific case of financial market reform after September 2008 in the U.S. – the role of the financial sector lobby in pushing against tighter regulation in the wake of the crisis is unquestionable.[5] The argument is far more general.[6] A second refinement of the crisis hypothesis is that **special interest group influence** needs to be reexamined in considering the effect of crises on reform. Does a crisis really weaken SIG power? If so, how?

[3]Brender and Drazen (2009) find that in normal circumstances, a new leader only affects expenditure composition after several years in office.

[4] There is a broader argument here, namely that changes in attitudes induce legal changes rather than the other way around. See for example Murrell (2009) on how the changes in the English political system often associated with the Glorious Revolution of 1688 are better seen as the result of ongoing evolution rather than the result of specific legislative changes.

[5] For example, consider a story head in the New York Times on 6/01/09, "In Crisis, Banks Dig In for Fight Against Rules", or a lead the following month (New York Times, 7/01/09), "Banks and mortgage lenders are placing top priority on killing President Obama's proposal to create a new consumer protection agency."

[6] An example is "regulatory capture", where agencies represent interests of the industries they regulate.

More generally, the basic argument that crisis triggers reform ignores the role of specific **political actors** who are likely to be important not only in blocking reform, but also in marshalling support for reform. Furthermore, the basic crisis hypothesis in my view pays insufficient attention to the **interactions** between factors. In the next section I expand on these three elements – time, political actors, and interactions – that may help explain the relation between crisis and reform both generally and in the case of financial market reform in wake of the 2008 crisis.

4. Expanding the Basic Argument

A first issue of time is that it is not only the severity of crisis, but also its duration which may prompt action. Only the war of attrition approach of Alesina and Drazen (1991) explicitly considers duration of a crisis, where it is central to inducing reform. Passage of time in a crisis reveals information about the relative political strength of different interest groups and is crucial to inducing weaker groups to concede once the ability of stronger groups to hold out becomes clear to them.

The duration of a crisis can be central to the adoption of reform for other reasons as well. Following Harberger's (1973) argument given above, the duration of a crisis may be important in convincing political actors (including voters) of the need for significant change. It may also be crucial in mobilizing citizens to oppose vested interests blocking reform by showing the "bankruptcy" of existing system and the groups that benefit. Finally, even when the need for significant change is accepted, the political process itself often requires time for new policy to be crafted and adopted.

Furthermore, for a crisis to trigger reform quickly, the reform must be seen as directly addressing the crisis. Structural reform to be enacted and cause of crisis should be closely tied. This is was true for the Glass-Steagall Act of 1933, discussed below, and for changes in the U.S. Auto industry in 2009. Generally, however, in the case of structural reform, crisis may logically delay rather than hasten reform. When the house is burning, one doesn't discuss fireproof building techniques. In the financial crisis, the priority was avoiding a financial meltdown or economic collapse.

There is an interaction here with the "identities" of political actors. Powerful SIGs often have special expertise, and hence they are used as the firefighters when the house is burning. This was certainly true in the reaction to the financial crisis. Moreover, the complexity of financial products that stands in way of effective regulation made financial actors especially important during the crisis itself, so that the crisis increased their power rather than weakening it.

The importance of considering political actors explicitly may also be seen in assessing the effect of a crisis on legislators. Put simply, does the crisis increase constituent pressure for tighter regulation more or less than pressure from SIGs, whom many legislators see as crucial in providing campaign finance, against tighter regulation? As Alan Blinder put it in considering what financial reform legislation is likely to pass, "People clearly want greater consumer protection and restrictions on executive pay. By no coincidence, those are the two pieces of financial reform that seem most likely to survive the Congressional sausage grinder." (*New York Times* 9/05/09)

Equally if not more important are leaders. Krueger (1993) has argued, "Most reforms seem to take place in one of two circumstances: Either a new government comes to power or a perceived economic crisis prompts action." But, crisis does not magically bring forth proposals and someone to push them. Effective leaders take advantage of crisis, weak leaders do not. I return to this below.

5. A Case Study – FDR, Pecora Hearings, and the 1933 Glass-Steagall Act

The above points may be illustrated in a short case study of financial reform after the financial crash of 1929, based on Leuchtenberg (1963). In the fall of 1929 the U.S. stock market crashed, and (without arguing causality) the Great Depression began. President Hoover's policies were largely ineffective in arresting the sharp decline, so much so that "[i]n Hoover's last days in office, the old order teetered on the brink of disaster." (Leuchtenberg, 1963). In January 1933, the Senate began hearings on the causes of the financial collapse headed by Ferdinand Pecora, a tough former prosecutor, who saw his job as uncovering the "secret financial history of the 1920s".

Franklin Roosevelt took office on March 4, 1933 and immediately called the newly elected (left-leaning) Congress into special session. On March 29, he sent Congress recommendations for financial regulation. Leuchtenberg (1963) wrote that a “short while before, such legislation would have been inconceivable, but the debate on the securities bill took place as the Pecora committee was carrying the popular outcry against Wall Street to a heightened pitch” (Leuchtenberg, 1963). In June 1933, the Senate passed with no dissent the Glass-Steagall Act imposing broad new regulations on banks with no dissent. The vote came two days after Pecora inquiry reveals that the 20 J.P. Morgan partners paid no taxes in 1931 and 1932, a revelation seen as strongly influencing the vote.

6. Is Reform Possible When SIGs are Powerful?

In the U.S., the financial sector has and continues to fight extremely hard against any legislation it views as harmful. But reform is possible.[7] As indicated above the duration of crisis, combined with perceived misbehavior of SIGs, weakens them. But as Boeri, et al. (2006) point out, there can be no real structural reform without costs, perhaps substantial. A leader, even one who received the Nobel Prize, must be willing not only to step on toes, but to step hard. Vito Tanzi, as quoted in Boeri, et al. (2006) puts it well: “If a minister starts his mandate with the promise that he will not take one dime out of the pockets of the citizens, or that a major tax reform will be done without any taxpayer experiencing an increase in taxes, it is likely that reforms will not take place.” Leaders who take advantage of crisis are those who are willing to make enemies. As Roosevelt put it in 1936, “They [‘organized money’] are unanimous in their hate for me, and I welcome their hatred.”

When vested interests are too powerful to buy out, they must be split with the cost of reform concentrated on targeted groups. That is, **“divide and conquer”**. Hence, policies must be crafted carefully – one can’t enact structural reform with policies that unite rather than divide the opposition. Consider two types of reform, one that keeps the SIG politically united (“*homogeneity-preserving*” reform), the other that induces political divisions in the SIG (“*heterogeneity-inducing*” reform). Financial sector views reforms ex-ante as the first type,

[7] See Boeri, Castanheira, Faini, and Galasso (2006), especially chapter 11, “Divide and Conquer”.

which unites them in opposition. In contrast, 1933 Banking Act politically separated large and small banks, creating a stronger constituency for reform.

Caselli and Gennaioli (2008) argue that policy makers can use the market to drive these political wedges that split powerful SIGs. Consider a situation in which current regulations protect insiders, who vary in their competence levels. A reform may hurt all, but differentially. In absence of a market for corporate control, all insiders are against the reform. With such a market, some insiders can "cash out" and hence may support a reform. The political constraints can be lessened by making a homogeneity-preserving reform into a heterogeneity-inducing reform.

Another lesson is the need for judicious sequencing of reforms. Dynamics allows divide and conquer over time, including playing groups off against their future selves.

7. Conclusions

So, what do we do? The above suggestions are easier said than done. But, I hope this lecture has provided insight into a question that has bothered many – why has there been no significant financial reform after the crisis, at least so far. In so doing I put a focus on special interest groups lacking in previous literature on political economy of reform. A key aim was to show that existing models of crisis and reform must be modified to better explain the real world.

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