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Financial crisis begets financial reform? The origin of the crisis matters

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ABSTRACT

The empirical literature assessing whether crisis begets reform has paid little attention to the role of the origin of crises. This paper considers seven dimensions of financial reform, as well as an aggregate index of these dimensions, and focuses on crises defined as sudden stops in financial flows. Recent work on gross financial flows provides a suitable strategy to distinguish between domestic crises (sudden flight) and external crises (true sudden stops). While the origin of the crisis plays no role in explaining the likelihood of reform in the case of the aggregate index of financial reform, different origins of crises affect different individual dimensions of financial reform. Thus, the origin of the crisis matters when assessing the nexus between financial crisis and financial reform. The evidence is particularly compelling for the case of sudden flight and reform of capital account restrictions, and more tentative for the case of true sudden stops and reform of banking regulation and supervision. These findings underscore the need to pay greater attention to the origin of crises in empirical work focusing on the relationship between financial crisis and financial reform, and also in theoretical models of the political economy of financial reform.

1. Introduction

The crisis-begets-reform hypothesis postulates that economic policy reforms are more likely to be implemented at times of economic crisis. A crisis provides policymakers with an opportunity to carry out those reforms that could not be implemented prior to the crisis. More specifically, the occurrence of a crisis shifts the existing political equilibrium and thereby increases the likelihood of observing economic policy reforms. Importantly, the deterioration in the relevant economic conditions must be severe enough for reform to become more likely. Thus, there is a sense that the relevant economic conditions must cross some threshold for crisis to facilitate reform.

The purpose of this paper is to assess whether the origin of crises matters when assessing whether crisis begets reform. Existing empirical studies have typically identified crises as dummy variables taking a value of one when some macroeconomic variable crosses a given threshold, and zero otherwise. While this approach captures the idea that economic conditions must deteriorate significantly enough for crisis to facilitate reform, it fails to account for the origin of crises. In fact, a macroeconomic variable may cross a given threshold either because of a domestic crisis, that is a home-grown crisis due to the failure of domestic policies, or because of an external crisis, that is a crisis elsewhere that gets transmitted to the domestic economy through trade and financial spillovers. These two different origins of crises may play different roles in determining the likelihood of reform implementation. The possibility that different origins of crises have a different impact on the likelihood of reforms is the central

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question of this paper. To my knowledge, this question has not been addressed in the empirical literature on the crisis-begets-reform hypothesis.

In principle, an assessment of the role of the origin of crises would be based on an empirical strategy that provides for a clean way to distinguish the domestic and external origins of many kinds of crises. In such a way, the analysis would speak to the broad hypothesis that crisis begets reform. In practice, however, finding a well-grounded strategy to distinguish domestic and external crises remains very difficult. For this reason, this paper focuses on the specific case of financial crises in the form of sudden stops in financial flows. For this specific case, recent work on gross financial flows offers a suitable empirical strategy. The identification of sudden stops in financial flows has traditionally been based on the behavior of net financial flows (Calvo et al., 2004). However, Rothenberg and Warnock (2011) and Cowan et al. (2008) have shown that this identification strategy can mask very different financial flow dynamics. A sudden stop in net financial inflows may arise either from a sudden stop in gross financial inflows (a true sudden stop), or from a sudden rise in gross financial outflows (a sudden flight). How do these different financial flow dynamics help distinguish between domestic and external crises? Empirical studies show that sudden flight is relatively more closely related to domestic policy developments than true sudden stops, whereas true sudden stops are relatively more affected by external developments than sudden flight. Thus, the relative importance of domestic and external factors in driving gross financial flow dynamics underpins the distinction between domestic and external crises in this paper. Episodes of sudden flight proxy for crises resulting from domestic policy failures, while episodes of true sudden stops proxy for crises resulting from external developments, including policy failures elsewhere and global shocks.

The empirical approach to test whether domestic and external crises have a different impact of financial reform makes use of the seven individual dimensions of financial reform, as well as the aggregate index of financial reform, provided by Abiad et al. (2008). The seven dimensions and the aggregate index are regressed on both types of crises as well as a number of control variables. The sample consists of 72 advanced and emerging market and developing economies over the period 1980–2005. While estimation results for the aggregate index of financial reform do not indicate any difference in the effect of true sudden stops and sudden flight on financial reform, I find that different origins of crises affect different individual dimensions of financial reform. The evidence is particularly compelling for the case of sudden flight and reform of capital account restrictions, and more tentative for the case of true sudden stops and reform of banking regulation and supervision. Thus, the origin of the crisis matters when assessing the nexus between financial crisis and financial reform. More generally, the results underscore the need to look beyond the veil of aggregate indices of reform and to conduct a more focused assessment of the crisis-begets-reform hypothesis by looking at narrower measures of reform.

The remainder of this paper is organized as follows. Section 2 reviews some of the key aspects of the empirical literature on the crisis-begets-reform hypothesis. Section 3 outlines the empirical approach which borrows extensively from Abiad and Mody (2005) for reasons outlined therein. Section 4 presents the results. The final section provides concluding remarks.

2. Selective review of the literature

Testing the crisis-begets-reform hypothesis requires measuring both reform and crisis. This section provides a selective review of the empirical literature on this hypothesis.[1] This review does not aim to give an exhaustive survey of the literature. Rather, it serves as a motivation for some of the choices regarding the measurement of variables and the empirical specification used in this paper.

2.1. Measuring reform

Reform refers to a process of change. The literature on the political economy of economic reforms does not aim to explain how things are at a given point in time, but rather how things change (or do not change) over time. Reform can be measured indirectly by looking at the change in some macroeconomic variable (outcome), e.g. economic growth or the inflation rate, or more directly by looking at the change in some measure of the economic policy regime, e.g. capital account openness or the exchange rate regime.

The early empirical literature focused on macroeconomic outcomes as an indirect measure of reform given the lack of consistent datasets on economic reforms at the time (Bruno and Easterly, 1998; Drazen and Easterly, 2001). With the recent development of large datasets on reforms, including systematic information across countries and over time, more recent empirical testing of the crisis hypothesis has relied on more direct measures of economic policy regimes. A more direct measure is probably superior as the mapping between reforms and macroeconomic outcomes is bound to be an imperfect one.

Economic policy regimes are often expressed as indices in recent datasets. Such indices aggregate a large amount of information on a varying number of policy dimensions. For example, the Economic Freedom of the World index aggregates five policy dimensions, including size of government, legal system and property rights, sound money, freedom to trade, and regulation. In turn, each of these five dimensions comprises numerous components, leading up to a total of 42 distinct variables (Gwartney et al., 2013). This index has been used by several scholars to test the crisis hypothesis as it captures a broad range of policy

[1] Drazen (2000) reviews the theoretical arguments underpinning the crisis-begets-reform hypothesis (Chapter 10, 444–454).