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A Blessing in Disguise? Banking Crises and Institutional Change

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Summary. — We test if banking crises cause institutional reforms. Many banking crises are indirectly caused by a weak and volatile macroeconomic environment. This weakness is in turn often caused by the countries' economic and political institutions. A possible outcome of a banking crisis is therefore institutional reforms that improve the macroeconomic outcome and consequently reduce the risk of future problems in the banking sector. Specifically, we test three hypotheses: that only major banking crisis that affects economic growth leads to institutional reforms, that reforms implemented lead to more market-oriented economic institutions and more accountable and stable political institutions, and that democratic countries are more likely to reform than non-democratic countries. Our hypotheses are tested using a data set including 56 countries from 1985 to 2009. Institutional quality is measured using four indices: the ICRG index of political institutions, the Fraser index of economic freedom, the KOF index of trade and capital restrictions and the KOF index of political globalization. Our results support the first two hypotheses: only major banking crises cause institutional reforms and those reforms make economic institutions more market oriented and political institutions more stable and accountable. Our results do not support the third hypothesis, all countries irrespective of political regime reform institutions following a major banking crisis.

Key words — banking crisis, institutions, economic growth, reforms

1. INTRODUCTION

Banking crises are common among both developed and developing countries (Reinhart & Rogoff, 2011). These crises often spread to other sectors of the economy, causing lower growth and higher unemployment (Andersson & Karpestam, 2014; Dell'Ariccia, Detragiache, & Rajan, 2008). Although banking crises' short-term consequences for the economy are mostly negative, a crisis may also cause institutional reforms that have positive long-run economic effects. Such reforms may include changes to monetary policy (see, e.g., Mishkin, 2011; Orphanides, 2011) or changes in financial regulation (see, e.g., Eichengreen, 2011; Goodhart, 2011; Hanson, Kashyap, & Stein, 2011). However, reforms are not necessarily limited to monetary policy and financial regulation but may also include a wider set of reforms to a country's political and economic institutions (Claessens, Klingebiel, & Laeven, 2002). One contributing factor to many banking crises is weak economic and political institutions (Acemoglu, Johnson, Robinson, & Thaicharoen, 2003) that in turn cause a volatile and weak macro-economy (Demirgüc-Kunt & Detragiache, 1998). Consequently, over the long run, one possible policy response to the banking crisis is institutional reforms that improve the macroeconomic outcome and indirectly reduce the risks for a new banking crisis.

Empirical support for this hypothesis is so far limited. Evidence from Africa (Edwards, 1995), Latin America (van de Walle, 2001), and Europe (Jonung, Kiander, & Vartia, 2009; Korkman & Suvanto, 2015) suggests that banking crises may lead to some reforms. By contrast, Bologna and Young (2014) find no effect of banking or debt crises on institutions at all, and van de Walle (2001) argues that many reforms are only temporary and reverse after a few years. Similarly, Campos, Hsiao, and Nugent (2010) reject the idea that economic crises in general and not just banking crises have any effect on institutional reforms. The direction of the institutional reforms is also disputed; de Haan, Sturm, and Zandberg (2009) show that banking crises lead to more market-oriented economic institutions over the long term, but the effect is the opposite over the short term. Baier, Clance, and Dwyer (2012), by contrast, argue that the long-term effect is the opposite.

Each banking crisis has its own characteristics in terms of its causes, duration, and real economic effect, which may explain the differences in results. For example, there is little reason to expect any banking crisis automatically leads to institutional reforms to improve the macroeconomic outcome unless there is a clear link between the banking crisis and the macroeconomy. Such a link can either come through the banking crisis being caused by a weak and volatile macro-economic environment or by the banking crisis itself affecting economic growth.

Countries' reform capacity also differs; policymakers must also be both willing and able to implement reforms. It is therefore likely that the political regime affects whether countries pursue a reform agenda or not (Haggard & Webb, 1993). Democratic regimes, with more inclusive institutions, may be more willing to reform institutions to ensure a sustainable macro-economy that benefits the many rather than the few (Acemoglu, Restrepo, Naidu, & Robinson, 2014; Acemoglu & Robinson, 2012). Non-democratic regimes, conversely, can more easily overrule resistance to major reforms and impose tough reforms (Haggard & Webb, 1993).

This paper tests if there is a general long-term relationship between banking crises reforms of political and economic institutions. In the analysis, we control for various banking crisis characteristics and real economic effects. We also control for different political regimes. The study includes 56 countries (22 developed and 34 developing countries) covering the period from 1985 to 2009. The countries are split into three groups based on the Polity IV ranking of their political regimes (fully democratic, democratic, non-democratic). The data on banking crises are collected from Reinhart and Rogoff (2011) and Laeven and Valencia (2013). Institutional change is measured using four different indices of institutional

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quality from three independent sources: the International Country Risk Guide's political risk index (PR), the Fraser Institute's index of economic freedom (FEF), the KOF index of trade and capital restrictions (KOFTCR) and the KOF index of political globalization (KOFPG).

The results show clear evidence of banking crises causing institutional change over the long term in those cases where GDP growth is below potential growth during the crisis. Banking crises that do not affect GDP growth have no long-term effect on institutions. The results also show that political institutions become more democratic and more accountable following a banking crisis and that economic institutions become more market oriented. These results hold for all political regimes.

The remainder of the paper is organized as follows. In Section 2, we discuss our hypothesis. Section 3 contains the empirical analysis, and Section 4 concludes the paper.

2. BANKING CRISES AND INSTITUTIONAL REFORMS

Weak political and economic institutions can both cause a banking crisis and prolong its duration (see, e.g., Kaminsky & Reinhart, 1999; Kane & Rice, 2001; Ranciere, Tornell, & Westermann, 2008; Tommasi, 2004). A reversed relationship where a crisis causes institutional change is also possible. Claessens, Klingebiel and Laeven (2002), for example, argue that the policy response to a banking crisis follows three phases. During the initial phase, containment, policy makers try to prevent the banking crisis from spreading throughout the economy by trying to stabilize the financial system. Once financial markets have been stabilized, the second phase, restructuring of financial markets, begins. During this phase, financial markets and their institutions are reformed to enhance their sustainability and stability. Thereafter follows the third phase, structural reforms, which unlike the previous two phases, are not directed at financial markets but are rather aimed at strengthening the macro-economy. Many banking crises are caused by weak political and economic institutions (Acemoglu *et al.*, 2003), in turn causing a weak macro-economy (Demirgüc-Kunt & Detragiache, 1998). During the third policy phase, reforms are thus undertaken to improve the macroeconomic environment and indirectly prevent future banking crises (Claessens, Klingebiel & Laeven, 2002).

A crisis is of course not the only factor that can induce institutional reforms, nor is a crisis enough for reforms to take place (Cavallo & Cavallo, 2010; Drazen & Easterly, 2001; Williamson and Haggard, 1994). However, a crisis may create the right environment that enables policy makers to implement major institutional reforms if (i) policy makers conclude following the crisis that institutions must be reformed to prevent future crises, (ii) there is a political majority supporting reforms, (iii) the political system is capable of implementing a reform agenda, and (iv) there is a credible alternative to the existing institutions (Campos et al., 2010, Tommasi, 2004). Based on this discussion, it is possible to define three testable hypotheses on the relationship between banking crises and institutional reforms. First,

H1. Only banking crises that affect the real economy cause long-term institutional change aimed at improving the macroeconomic outcome.

That a banking crisis may cause changes to financial institutions is obvious. That a crisis may also cause wider institutional reforms to economic and political institutions in general is less obvious. According to our first hypothesis, a link between the crisis and institutional reforms is established if the banking crisis negatively affects the real economy. This link is established for two main reasons: First, lower growth during the crisis becomes a signal that future reforms are needed to boost growth to overcome the crisis and prevent future crises (Claessens, Klingebiel & Laeven, 2002). Second, a major real economic crisis can break down resistance to reforms and allow a reform agenda to be implemented either by an existing government changing its policy or by a change of government. Banking crises that do not affect the real economy is therefore not expected to cause institutional reforms.

Our second hypothesis is

H2. A banking crisis during the period 1985–2009 causes political institutions to become more stable, accountable, and globalized and causes economic institutions to become more market oriented and globalized.

A consensus on which institutions promote a sustainable macro-economic development has emerged since the 1970s (Blyth, 2002).These institutions include market-oriented economic institutions and greater professionalism and accountability of political institutions (Blyth, 2002; Pitlik, 2002). According to our second hypothesis, reforms after a banking crisis follows the same general trend of institutional reforms already pursued around the world to improve the macroeconomic outcome. A banking crisis thus either enables reforms to be implemented or highlights the needs for certain reforms to be implemented. But, a banking crisis does not cause reforms that otherwise would not have been implemented by a government interested to boost long-term economic growth. After a banking crisis we therefore expect to see more market-oriented economic institutions through liberalization of capital markets, goods markets, factor markets, and international markets. We expect similar reforms in both developed and developing countries. Many developing countries experiencing major economic crises have received support from the World Bank and the IMF, where the support has been conditioned on adapting similar institutions as among developed countries (Williamson, 2000).

We also expect political institutions to change after a banking crisis. The qualities of economic and political institutions are often correlated (Acemoglu & Robinson, 2012) and reforming economic institutions to improve economic growth is not sufficient when, for example, courts or the bureaucracy is politicized and its actions unpredictable (Hay, Shleifer, & Vishny, 1996). For a country with poor institutions political reforms are equally important. If a banking crisis leads to sustained reforms we can therefore expect both changes in economic and political institutions.

Political reforms are generally more difficult to implement as governments, bureaucracy or the legal system may resist reforms that affect their political influence (Glaeser, La Pota, Lopez-de-Silanes, & Shleifer, 2004). Either a change of government that introduces new policies or pressure from the outside (e.g. foreign lenders) may be necessary for political reforms to take place. The necessary but difficult coupling of economic and political institutional reforms leads us to our third hypothesis