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## Is the Financial System Politically Independent? Perspectives on the Political Economy of Banking and Financial Regulation

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**IS THE FINANCIAL SYSTEM POLITICALLY INDEPENDENT?**

**PERSPECTIVES ON THE POLITICAL ECONOMY OF BANKING AND FINANCIAL REGULATION\***

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# IS THE FINANCIAL SYSTEM POLITICALLY INDEPENDENT?

## PERSPECTIVES ON THE POLITICAL ECONOMY OF BANKING AND FINANCIAL REGULATION

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### Abstract

This paper investigates the relationship between politics and the banking and financial system and explores the implications of this interdependence for understanding regulations and their reforms. Five complementary positive political economy theories are outlined and applied to understand the pattern of regulation and deregulation in banking and corporate finance. First, the public interest approach considers the maximization of social welfare as the prime motivation for regulation. Since many regulations cannot be rationalized on such grounds, the private interest theory provides a second approach. This theory emphasizes the strength and organization of interest groups that compete to lobby for protections and privileges. Changing ideology of legislators and voters offers a third alternative. Pro- and anti- business commitments may play a role, but understanding what drives ideological change is difficult. Fourth, the institutional structure of policy-making can affect both the incentives of interest groups to organize and their effectiveness in influencing policy outcomes. Finally, “Leviathan” budgetary considerations of politicians and bureaucrats can motivate regulations that generate funding for government operations. These approaches then help to identify technological, legal, and economic innovations that have been driving the global movement toward financial liberalization and regulatory reform. The paper concludes with lessons from positive political economy approaches for ways to facilitate the policy reform process.

*JEL* Classifications: D72, D78, G28, G38

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The structure and regulation of a country's financial markets and institutions are the focus of much policy attention for a number of economic and political reasons. Banks and other financial institutions encourage and collect savings that finance a country's economic growth. By allocating the savings to enterprises and monitoring the use of the funds, these institutions and markets play an integral part of the corporate governance system that ultimately affects the productivity of resources throughout the economy (see Rajan and Zingales 1999a and 1999b). Banks and other financial institutions also play a key role in transmitting the government's monetary and credit policies to the rest of the economy. Parts of the financial sector are effectively regulated as means to provide subsidized credit or services to targeted groups (including the government itself) and to protect particular groups (from, for example, competition, hostile takeovers, or expropriation).

While the economics of financial regulation have been studied extensively (see, e.g., Herring and Santomero 1999 and Kroszner 1998a), the politics have received less -- albeit increasing -- attention. Rather than take regulations as given, the political economy approach attempts to provide a positive analysis of how and why regulations evolve as they do and what forces can lead to their durability as well as their potential for change. The focus of this study will be to illustrate how the banking and financial system is not independent of politics and what implications this interdependence has for understanding regulations and reform. This perspective provides an alternative lens through which to analyze regulation and which is complementary to the traditional normative analysis undertaken by economists studying "optimal" regulation.

When the infamous American bank robber Willie Sutton was asked why he robbed banks, he replied "That's where the money is." The same might be said for why there is such

involvement of the government with the banking and financial system -- that's where the money is. This idea manifests itself in a number of ways, related to the positive political economy analysis. In the next section, I briefly outline a number of approaches to understanding the political economy of government involvement in the economy and then try to understand why the banking and financial system appears to be particularly vulnerable to politicization.

I then examine the technological, legal, and economic shocks that the political economy approach would suggest are the primary factors that disturb a regulatory equilibrium in banking and financial markets. A case analysis of the world-wide reforms in government securities markets then illustrates the motivations for and outcomes of financial regulatory change. The next section then examines the role of "crises" in regulatory change, emphasizing the redistributive aspects of crises that result in rapid shifts in the strength of different interest groups. The final section draws some tentative lessons from the political economy approaches concerning how to make more likely the "incentive compatibility" of "incentive compatible" regulation. This will also include a brief discussion of the role that academic advocates can play in the process of regulation and its reform.

### *Alternative Approaches to the Political Economy of Regulation*

Both policy-reformers trying to effect change as well as researchers trying to develop positive theories of government policy-making have struggled to understand how government intervention and regulation occurs and how and whether it can be subsequently sustained (Rodrik 1996). Five related approaches have been taken to analyzing these phenomena: Public Interest, Private Interest, Ideology, Institutions, and Leviathan. While these approaches are not mutually

exclusive, they emphasize different aspects of the interaction between economics and politics.

Each captures an important element in the process. I will briefly discuss each and apply them to understand aspects of banking and financial regulation.

*Public Interest.* The traditional approach that economists took to explaining the existence of regulation emphasized that regulations exist to correct market failures and protect poorly informed consumers from harm.<sup>1</sup> From this perspective, regulatory intervention occurs primarily to maximize social welfare, so this approach is often called the “public interest theory” of regulation. Public interest rationales are given for capital regulation and deposit insurance to provide a sound banking system because stability of the financial system can have spillover effects for general macroeconomic performance (e.g., Kaufman and Kroszner 1997). Statutory protections of shareholders and creditors from ex post appropriation and supervisory agencies in like a Securities and Exchange Commission are rationalized on the grounds of investor and consumer protection.

A key challenge to the public interest view is that many forms of regulation have little or no redeeming social value. Entry restrictions that protect banks or other financial institutions from competition, portfolio restrictions that hinder diversification, and geographic restrictions that have prevented expansion within a country or across national borders are generally difficult to rationalize on public interest grounds. Statutes or regulatory procedures that protect incumbent management from many forms of discipline by shareholders or outsiders provide additional examples. Regulation that does not appear to serve a public interest also is ubiquitous in other sectors (see Stigler 1988).

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<sup>1</sup> Joskow and Noll (1981) call this normative analysis as positive theory.

Virtually all regulation, regardless of whether it may have a public interest rationale, has significant distributional consequences. The parties affected by the regulation thus have an incentive to try to ensure that the government structures the regulation in such a way as to benefit them. A public interest argument often is used to mask the private interests that the intervention serves. Private interests may try to confuse the public debate by providing false or misleading information to make it difficult to discern what policy would improve social welfare (e.g., Kane 1996 and Dewatripont and Tirole 1999).

*Private Interest.* The “private interest theory” of regulation, also called the economic theory of regulation, characterizes the regulatory process as one of interest group competition in which compact, well-organized groups are able to use the coercive power of the state to capture rents for those groups at the expense of more dispersed groups (e.g., Olson 1965, Stigler 1971, Peltzman 1976 and 1989, and Becker 1983). Changes in the size, strength, and organization of interest groups thus provide the key to understanding policy changes. Regulated groups may be sufficiently powerful that they influence the politicians and the regulatory bureaucracy to serve primarily the interests of those subject to the regulation. In other words, the regulated group “captures” the regulators, hence this is sometimes called the “capture theory” of regulation.

The incentives for such regulatory behavior may be direct or indirect. Pressure may be exerted directly on politicians, through campaign contributions or votes. The politicians then pass a new statute or pressure the regulators to act sympathetically towards the interest group. Indirect incentives may come through regulators understanding that cooperative behavior may be rewarded with lucrative employment opportunities in the industry after leaving the government, a practice so common in the past with Japanese Ministry of Finance officials that it is

euphemistically called *amakudari* or the “descent from heaven.”

The effectiveness of the interest groups depends upon a number of factors. First, cohesive groups will find it easier to organize and overcome free-rider problems in lobbying for regulations that may benefit them. Producers of goods and services tend to be more compact and better organized than consumers, so there is a tendency for regulation on net to benefit producers more than consumers (Stigler 1971). The parallel in corporate finance is that incumbent managements tend to be better organized and more effective than dispersed shareholders, so there is a tendency for regulation to benefit incumbent management against small shareholders (see Hellwig 1998 and discussed further below). The ability of a group to organize is often inversely related to its size, but many labor unions and trade organizations have been able to develop effective lobbying bodies through carefully crafted incentives that provide a variety of information and support services in return for membership (see Olson 1965).

Second, groups tend to be more effective not only when the benefits are concentrated among group members but also when the costs of the regulation are relatively diffuse. A compact group of potential losers each of whom would experience high losses associated with the regulation will be likely to form a lobby that will try to counteract the original interest group’s pressure. Interest groups most directly affected by the regulation may build a coalition to lobby for or against the regulation.<sup>2</sup>

Third, in addition to the diffusion of the costs across different groups, the level of the

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<sup>2</sup> In addition, groups with completely unconnected interests may form “support trading” or “log rolling” coalitions. Two groups may agree to support each other even if the members of one group are not affected by the regulations that the other wants. Tariffs are a classic case of “log rolling” in which, say, lumber and glass producers support each other’s call for higher protection, thereby providing greater support for higher tariffs than otherwise would be (Irwin and Kroszner 1999).



costs relative to the benefits obtained by the interest group play an important role (Becker 1983). Deadweight loss is defined as precisely the difference between the winner's benefit minus the loser's cost from the change in output generated by the regulation. Factors affecting the "efficiency" of the regulatory or transfer mechanism thus may have an important impact on political outcomes. As the deadweight loss grows, for example, the losers are losing more for each krona of the winner's gain. When this gap widens, losers have a greater incentive to fight each krona of the winner's gain and the winners have less incentive to fight for each krona of the loser's loss. In other words, when deadweight losses are high, an interest group faces greater opposition to its protective regulation on the margin and hence is less likely to be successful.<sup>3</sup>

Similarly, politicians in electoral democracies are concerned about finding an optimal support coalition to promote their re-election chances, so they take into account the marginal costs and benefits to different groups. The rents generated by regulation in an electoral democracy thus are likely to be spread among different groups, even though one group may be the primary beneficiary (Peltzman 1976).<sup>4</sup> Regulation that protects financial institutions from competition and subsidized government deposit insurance to banks generates rents for this sector that are then partially shared through directed credit allocation.<sup>5</sup>

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<sup>3</sup> Becker (1983) argues that competition among lobbying groups thus will lead to the most efficient (lowest deadweight cost) regulations being chosen, so there is a tendency for regulation to be "efficient" in this sense. Wittman (1995) takes this argument further to conclude that both democratic institutions and outcomes are efficient.

<sup>4</sup> When the constraint of future elections is less binding on politicians, they may engage in less rent-sharing and provide windfalls to targeted groups. McGuire and Olson (1996), however, argue that less democratic regimes may be better able to insulate themselves from rent-seeking and might find it in their own interest to pursue economic policies in the public interest.

<sup>5</sup> Also, flat rate deposit insurance tends to subsidize the smaller and riskier banks at the expense of the larger, better diversified, and safer banks. Lobbying for flat rate deposit insurance historically has been

The private interest theory thus helps to explain why the banking and financial system is particularly susceptible to political influence. The banking system provides an effective but off-balance-sheet way for the government to redistribute resources (Kroszner forthcoming). Few if any other sectors provide the same degree of flexibility to redistribute resources, whether implicitly through Bank of Japan “window guidance” or explicitly through statutes such as the Community Reinvestment Act. Credit allocation through financial institutions can be an important implicit or explicit part of a government’s industrial policy.<sup>6</sup> Banks and financial institutions may be induced to act, at least in part, as implicit fiscal arms of the state, but must be compensated through protective regulation.

Since the government is so heavily involved in banking, it may be very difficult to have effective government regulation of the domestic banking and financial sector. In these circumstances, simply hiring more and better-trained supervisors and adopting good regulatory principles is not sufficient because the government may have little incentive to enforce rules of sound banking, either on state-owned banks or privately-owned banks. The co-dependence of the banks on the government and of the politicians on the banking industry allows problems to grow unchecked, as the depth of the banking troubles in the Asian currency crisis countries illustrates. This linkage also may help to explain why governments cannot seem to avoid bail-outs of the financial sector, even as officials acknowledge and decry the moral hazard problems of the bail-outs themselves. These perverse incentives are not unique to developing countries, as the long

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consistent with this pattern of relative benefits (e.g., Calomiris and White 1994 and Hubbard et al. 1996).

<sup>6</sup> Gershenkron (1962), for example, argued that the German government fostered the development of strong universal banks in Germany, at the expense of financial market development, to promote rapid economic development in the nineteenth century.

delays in responding to the Savings and Loan crisis in the U.S. and the banking problems in Japan also show.

In developing a political economy explanation of practices and regulations in corporate finance, Hellwig (1998) emphasizes the contrasting interests and organizational costs facing insiders versus outsiders. He explains, for example, the heavy reliance in firms on internally generated cash flows, rather than external sources of funds, to finance investment as arising not from failures in the capital markets but from the incentives of managers to avoid subjecting themselves to outside discipline. From this perspective, investment choices could be distorted by managers taking into account the potential loss of their private benefits associated with using outside sources of finance.

Insiders, such as firm management and controlling shareholders, have incentives to try to insulate themselves from external pressures and to attempt to disenfranchise other shareholders (Hellwig 1998). Incumbent management and controlling shareholders of large and well-established firms, for example, have been effective in most countries in obtaining statutory and regulatory barriers to raise the costs of hostile takeovers. Part of the strong backlash against Michael Milken and “junk” bonds, for example, may be because Milken and these instruments permitted small and unknown outsiders to subject even the largest firms to the pressures of the market for corporate control (see Fischel 1997). In addition, the ubiquity of laws that make it difficult for small shareholders to remove directors and exercise other forms of control over management’s decisions can be seen as arising from the greater cohesion and lower costs of organizing incumbent management relative to dispersed shareholders (see La Porta et al. 1999).

Ideology. While the private interest theory has had much success in explaining a wide

variety of regulatory interventions that are difficult to rationalize on public interest grounds, it has been less effective in explaining the widespread economic deregulation that has taken place in many countries during the last two decades (Peltzman 1989 and Noll 1989 but see Kroszner and Strahan 1999). Many political scientists and some economists emphasize the importance of beliefs and “ideology” of voters and politicians to explain regulation and deregulation (e.g., Kalt and Zupan 1984, Goldstein 1988, and Poole and Rosenthal 1997). Difference across countries or among citizens over time in their general beliefs about the appropriate role of the government in economic affairs might affect the extent of intervention. Roe (1994), for example, has argued that populist fears of excessive concentration of power in the hands of financial elites was an important driving force behind many banking and financial regulations in the early part of this century (but see Hellwig 1998 for an alternative interpretation).

Poole and Rosenthal (1997) have developed a useful measure of ideology based on roll-call voting that rates legislators on a simple left-right scale. This ideology measure has had much success in accounting for a wide variety of economic regulation and deregulation not well explained by private interest group variables or party politics. Berglof and Rosenthal (1999), for example, analyze bankruptcy law in the United States and find that this measure of ideology is a key element for understanding the voting patterns on bankruptcy legislation during the last two centuries. Poole and Rosenthal (1993) find an important role for ideology in the battles over the origins of economic legislation in the United States during the nineteenth century.

Identifying the driving forces behind changes in ideology over time, however, have been difficult. What constitutes “ideology” and whether it can be measured independent of economic interests is the subject of an extensive and ongoing controversy (see Peltzman 1984 and

overviews by Bender and Lott 1996 and Poole and Rosenthal 1996).

*Institutions.* The new institutional economics approach emphasizes transactions costs and institutional arrangements for decision-making as key factors influencing the outcome of the policy process (e.g., McCubbins, Noll, and Weingast 1988, North 1990, Williamson 1996, Alston, Eggerston, and North 1996, Dixit 1996, and Irwin and Kroszner 1999). This approach examines how alternative policy-making structures (e.g., delegation to an independent agency versus a parliamentary vote versus an executive order) influence the incentives of both special interests and governmental actors to shape policy. Opportunities for vote-trading and issue-linkages, for example, may differ under alternative structures and can confer advantages (e.g., agenda control) to particular players. These institutional and transactions costs features can in turn affect the incentives for interest groups to organize and the effectiveness of their lobbying efforts. Interest group size and strength, thus, is not given but may be endogenous and it is important to take such considerations into account if one wishes to make a durable policy change (e.g., Irwin and Kroszner 1999).

The regulation of bank powers illustrates the endogeneity of interests with respect to the regulatory framework (e.g., Kroszner 1996). In 1933, the U.S. adopted the Glass-Steagall Act which fragmented the U.S. financial system by strictly limiting the powers of commercial banks. In particular, commercial banks could not engage in securities underwriting, much in contrast to classic German universal banks and banks in many parts of Europe. While there does not appear to be an economic justification for such a separation (see Kroszner and Rajan 1994 and 1997), there may be a redeeming feature in terms of the political economy of financial regulation.

The silver lining in the cloud of Glass-Steagall is that in the U.S. a rich variety of

alternative financial services providers have developed and they compete in both the financial market and the market for financial regulation. In Germany, for example, the early implicit state fostering of strong, universal banks allowed them to capture the regulatory system and thwart the development of alternative institutions and markets. In the U.S., well-organized groups have helped to establish competing regulatory bodies that are likely to keep the market for financial regulation far from being a monopoly even if the Glass-Steagall Act is relaxed today. The financial services sector is the largest source of political action committee (PAC) campaign contributions in the U.S., giving roughly 20 percent of total PAC contributions, but most of these funds are spent on battles among the rival interests rather than on battling the consumer (Kroszner and Stratmann 1998). The initial regulation and the existence of the regulatory bodies helped to provide incentives for the alternative groups to organize and lobby.

*Leviathan.* Politicians and the bureaucracy may be considered a distinct interest group concerned about expanding their size and influence over the economy. Niskanen (1971) and Brennan and Buchanan (1977) suggest that an objective of the government may be to maximize or, on the margin, increase its size and expenditures and discuss institutional structures that can mitigate the tendency toward growth. This view has been characterized as the “Leviathan” approach.

The fiscal demands of the government help to explain some of the close relation between politics and the banking and financial sector and the origins of numerous regulations.

Geographic restrictions on banks in the U.S., for example, arose in the early nineteenth century as a way for state governments to maximize revenues from the sale of bank charters by providing a series of local monopolies (Kroszner 1997). The federal government began to grant bank charters

during the U.S. Civil War to create a new class of banks that would hold federal debt and, thereby, facilitate the financing of the war effort. The Bank of England was founded as a way to aid in the financing of the Crown in England. More recently, as governments have come to rely more heavily on deficit financing through the issue of sovereign debt, reforms of the government securities markets around the world can be understood from this perspective (as will be discussed below).<sup>7</sup> Debt moratoria, debt abrogation, and changes bankruptcy law also can be seen in this light (e.g., Berglof and Rosenthal 1999, Bolton and Rosenthal 1999, and Kroszner 1999).

***Political-Economy Factors Driving the Recent Trend toward International Financial Liberalization and Regulatory Reform***

The interest-group competition framework outlined above suggests a number of factors to explore when trying to understand how financial reform can become politically feasible. In this framework, technological, legal, and/or economic shocks must occur in order to change the relative strengths of interest groups that would then alter the previous political-economy equilibrium. Identifying and analyzing these factors can provide a basis for facilitating and perhaps shaping future reforms (see Kane 1984, 1987, and 1988, Kroszner 1997a, and Kroszner and Strahan 1999).

Technological change is often cited as a key force behind the innovations in financial markets and institutions during the last two decades. In the political-economy framework, technological improvement does more than simply shift the production possibility frontier for an

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<sup>7</sup> The government also raises revenues thorough seniorage, and the ability to tax through inflation is another reason for the government's long involvement with money and banking affairs.

industry. Technical change can have significant distributional consequences, completely independent of its effects on the costs and efficiency of production, that is, such change is rarely “distributionally neutral.” New products and markets bring forth new constituencies. Innovations affect the pre-existing markets and institutions and cause shifts in the interests and alliances. Changing the relative strength of competing interests can then lead to regulatory reform.

From the political-economy perspective, we must try to identify shocks to the old equilibrium that would lead to regulatory reform fostering globalization and liberalization (see Kroszner and Strahan 1999). A number of shocks, for example, have increased the elasticity of the supply of investors’ and depositors’ funds and thereby have eroded the value of regulation protecting geographic monopolies, whether local or national. First, the invention of the automatic teller machine (ATM) in the early 1970s was one factor that began to reduce the value to the local banks of geographic protections. In countries like the United States, legal challenges about whether an ATM constituted a branch slowed the spread of the ATMs until the courts determined that an ATM was not a branch, thereby permitted the growth of interstate ATM networks. ATM networks then rapidly spread worldwide.

Second, consumer-oriented money market mutual funds and accounts offered by investment banks arose in the last two decades. These types of new opportunities for individuals demonstrated that banking by mail and telephone, using toll free numbers, provided a feasible and convenient alternative to local banks. Third, technological innovation and deregulation have reduced transportation and communication costs, particularly since the 1970s, thereby lowering the cost for customers to use distant and foreign banks.

Since the increasing elasticity of deposits supplied to banks reduces the value of



geographical restrictions to their traditional beneficiaries, these beneficiaries had less incentive to fight strenuously to maintain them. Also, as elasticities increase, there are fewer rents to share among competing groups so regulation becomes less likely (Peltzman 1989). While any deregulation that eliminates inefficient regulation is broadly consistent with the public interest theory, the timing of the deregulation is difficult to explain by that approach. The opening of banking markets occurs precisely when the geographic restrictions are becoming less burdensome for the public, due to the elasticity-increasing innovations discussed above.

On the lending side, increasing sophistication of credit-scoring techniques, following innovations in information processing technology, financial theory, and the development of large credit data bases, has begun to change the relationship-character of bank lending towards less personal and more standardized evaluation. As a result of these innovations, for example, securitization of mortgages, loans, and consumer credits have become commonplace in the developed countries and are becoming increasingly so in emerging markets. In recent years even banks' lending to small businesses has become increasingly automated, relying less on the judgement of loan officers and more on standardized credit scoring programs.

Technological change thus has diminished the value of specialized local knowledge that long-established local bankers might have about the risks of borrowers in the community. Such changes have increased the feasibility and potential profitability for large and foreign banks to enter what had traditionally been the core of small, local bank activities. The large and foreign banks have therefore had an incentive to increase their lobbying pressure to attain the freedom to expand into these markets. In terms of the Becker (1983) model, the deadweight costs of preventing the large and foreign entry is increasing, so the small, local banks are less likely to be

able to maintain the restrictions. In addition, as the value of a local banking relationship declined, local firms that were the main borrowers from the local banks also would be more likely to favor the entry of large and foreign banks into local markets (Kroszner and Strahan 1999).

The method of opening up of the banking markets also is consistent with the private interest theory (see Kroszner 1997). Typically, new foreign entry is first permitted through investment in existing banks and mergers, rather than *de novo* entry (particularly of institutions that are in financial distress, as Citicorp's new entry into Mexico illustrates). By removing the geographic barriers in this way, the small, local banks have an opportunity to share in the benefits of deregulation by selling out at a premium rather than being competed out of existence. The smaller banks in the country thus would tend to lobby for foreign entry through mergers because they would prefer to have more potential bidders in the market, which tends to increase the premium paid for small banks (Brickley and James 1987).

An increase in foreign financial institution penetration can generate a virtuous circle in that foreign banks tend to be less politically connected and less likely to be able to "capture" the regulatory authorities. In addition, they are less likely to succumb to pressure for directed lending by the government. With capture less likely and fewer direct benefits to the politicians of bank regulation (e.g., through *quid pro quos* for directed lending), regulatory reform becomes more likely. New Zealand, for example, began its reform process when roughly 30 percent of the banking system was already foreign owned. By the end of the reform process, a very large fraction of the banks had become foreign owned. This helps to increase the likelihood that the reforms are sustainable and not simply temporary. In sum, technological change was a shock to the old political-economy equilibrium and had important distributional consequences that are

typically ignored in economists' emphasis on efficiency issues but are extremely important to a positive explanation of regulatory change.

***Public Finance Motives behind Financial Reform and Globalization: The Case of  
Government Securities Markets Reform***

Since the late 1970s, there has been dramatic growth in the use of publicly-traded debt as a financing tool for both emerging as well as developed countries (Kroszner 1997b). Before this time most countries, with the exception of the US, typically placed a large share of their debt with domestic banks, either directly or through a bank syndicate arrangement.<sup>8</sup> While the banks were to some extent captive financiers of the government, they typically received compensation through protective regulation, below market discount loans from the central bank, and implicit lender-of-last-resort or deposit insurance subsidies.<sup>9</sup> With government debt growing much more rapidly than bank assets, however, it was no longer feasible for governments to rely so heavily upon direct funding by the banks.

Motivated by a desire to keep financing costs on their rapidly mounting debt relatively low, politicians thus had incentives to broaden their sources of funding. Consistent with our deadweight cost analysis above, politicians would like to engage in their redistributive activities but must take into account the losses associated with the transfers. The worldwide reforms of the

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<sup>8</sup> This form of financing could be seen as a mild form of financial repression (Fry 1997).

<sup>9</sup> There is a long and rich history linking a government's financing desires and financial regulation. During the first fiscal revolution in the U.S. when state governments began to rely heavily on debt financing in the 1840s, for example, many states adopted "free banking" statutes. This legal change eased entry into banking but required the banks to hold state government securities as reserves, thereby boosting the demand for the state's bonds (see Kroszner 1997a and Kroszner and Strahan 1999).

structure and operation of government securities markets during the last two decades, particularly in emerging markets, can be explained in terms of this motive. Auctions replaced or significantly supplemented the traditional placement of securities with the banks. Simultaneously, the government created or formalized a primary dealer system in which it authorizes specially designated dealers to have the exclusive right to bid directly in the auctions and to have the responsibility of distributing the securities to investors.

An important feature of these reforms was that foreign-controlled financial firms were permitted to enter the market and become primary dealers, thereby encouraging the globalization of the investor base.<sup>10</sup> Previously, developing countries typically had shielded their domestic banking and financial markets from foreign competition. The politicians had a strong incentive to broaden their investor base to finance their growing deficits, and the percent of government debt owned by foreigners has grown rapidly during the last two decades (see Kroszner 1997b).

The internationalization of the government debt markets also has been associated with an increase in the liquidity of these markets. The primary dealers have an obligation to the government, as well as their own private incentive, to foster the growth of a liquid secondary market in government bonds. Liquid secondary markets help to reduce the government's financing costs, by fostering demand by investors (especially foreign investors) who are more willing to hold instruments which have easily observable market prices and can be easily traded. Liquidity also facilitates the dealers' distribution of the securities to investors. The depth of the government securities markets typically has been associated with an increase in the depth and

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<sup>10</sup> See Drazen (1997) for a detailed political-economy explanation of why governments may wish to sell their debt to foreigners.

development of other securities in these countries and increased foreign involvement.

As the economic theory of regulatory reform would suggest, the changes which began the opening of domestic financial markets to foreign competition and created liquid debt markets, providing another form of competition to the banking sector, did not occur without some quid pro quo for the banking industry. In particular, the choice of auction technique illustrates a role for private interests in the details of the institutional changes.

Governments consistently adopted sealed-bid, multiple-price auctions (also called "discriminatory" or "first-price" auctions) rather than uniform-price auctions (also called "non-discriminatory" or "second-price" auctions).<sup>11</sup> The popularity of the multiple-price auction technique in the recent reforms contrasts sharply with the sustained academic criticism that this format has received relative to the uniform-price technique as a way to issue securities (e.g., Friedman 1960 and Smith 1966, and more recently Reinhart 1992, U.S. Treasury et al. 1992, Umlauf 1993, Tenorio 1993, and Nyborg and Sundaresan 1996). Unlike the uniform-price auction, the multiple-price auction is subject to the winner's curse. The probability of winning is positively related to the price that one bids in both types of auctions. In the multiple-price auction, unlike in the uniform-price auction, the expected profit from winning is negatively related to the bid price, given that there is some uncertainty as to the exact value of the securities in the secondary market. As a result, bidders will tend to bid a bit less at the auction than what they

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<sup>11</sup> In multiple-price auctions, winning bidders pay the price that they bid, so different winners may pay different prices. Winners are determined by ordering bids by price and filling bids from highest to lowest price until the total quantity of securities auctioned has been sold. In a uniform-price auction, all of the successful bidders pay the same price. Who wins is determined the same way as in the multiple-price auction, but the price that the winners pay is highest unsuccessful bidder's price, not the price each winner bid (see U.S. Treasury et al. 1992).

estimate the secondary market value will be.

In addition, potential bidders without access to detailed information on which to base the estimates of the secondary market value would be less willing to participate directly in a multiple-price than a uniform-price auction. Consequently, the demand curve at auction using a multiple-price format will be below that in the uniform-price auction. The demand curve also is likely to be flatter, since the uncertainties generated by the "pay what you bid" format tend to make the bidders at the auction more price sensitive.

In principle, the revenue loss from the downward shift in demand at a multiple-price auction relative to a uniform-price auction could be offset by the ability to price-discriminate in the multiple-price auction. Actual and experimental evidence, however, generally indicates that the added revenue from price-discrimination is not sufficient to compensate for the lower and flatter demand curve (see, e.g., Smith 1966). In Mexico, for example, Umlauf (1993) showed that the government's auction revenue increased in their Treasury bill market when Mexico temporarily switched from multiple-price to uniform-price format. Tenorio (1993) found similar results for Zambia.

The sealed-bid, multiple-price technique also suffers from the potential for manipulation and may foster cartel-like behavior among dealers. The potential for precisely such manipulations was widely understood, having been described by Friedman (1960) decades earlier. When Mexico briefly switched from a multiple-price to a uniform-price auction, for example, bidders' overall profits fell sharply and auction revenue rose, suggesting that the multiple-price format permitted greater scope for manipulation (Umlauf 1993).

Given that the potential problems of the multiple-price auction were well-known, why

have the reforms almost universally adopted this format? One explanation is that other countries were simply copying the U.S. which had used this format for many years. This solution, however, is unsatisfactory. Although the reforms followed the general pattern of moving in the direction of a US-style market, there are enough country-specific variation that adopting a different auction technique certainly would have been feasible.

An alternative explanation is that the multiple-price technique enhances the value of the information to which the primary dealers have privileged access. The reforms initially gave primary dealers or syndicate members exclusive access to the inter-dealer brokers, consultations with the Ministry of Finance, regular dealings with the central bank through open market operations. Most trading in the government securities also is concentrated in their hands. In a uniform-price auction, information gathered from such sources and activities is less valuable since both the informed and the uninformed bidders will pay the same "consensus" price. The primary dealers, *ceteris paribus*, thus would prefer to have the government use the multiple-price technique, and governments appear to have obliged. Also, it is extremely difficult to measure the extent of this benefit for there is no line item in the government's budget to represent it. Obscure transfers are much more likely to avoid public scrutiny (as described in more detail at the end of the next section) and, hence, are a preferred means of compensation by the government. The reforms provided some benefits to the government, reducing their fiscal burden, and preserved some rents for the large financial institutions.<sup>12</sup> Part of the trend toward globalization and

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<sup>12</sup> Rapid technological innovation, however, has begun to erode the information advantages associated with being a primary dealer. Proliferation of inter-dealer broker screens and the growth of organized derivatives markets, for example, are narrowing the information gap between the primary dealers and others. As this trend continues, the value to the primary dealers of the multiple-price format may fall sufficiently that they would be indifferent between the two techniques. Eventually, governments then may switch over to uniform-price auctions and relax some of the distinctions between dealers and non-dealers

financial liberalization, thus, can be accounted for by public finance motives.

*What is the Role of Crises in the Political-Economy of Regulatory Reform?*

Reforms are often associated with banking and economic crises, and the “crisis” hypothesis provides an alternative to the political-economy approach. Developing as well as developed countries experiencing major bank insolvencies have subsequently undertaken some reform and restructuring of their banking regulatory and supervisory systems (Caprio and Klingebiel 1996), and Sweden is no exception. First on the list of sixteen hypotheses about reform drawn up by John Williamson (1994), distilled from the experiences of top policy-makers presented at a conference on “The Political Economy of Policy Reform,” is that “policy reforms emerge in response to crisis.”

Are crises an independent factor which can be said to “cause” reform to occur? Rodrik (1996) has been critical of the crisis hypothesis because it is almost nonfalsifiable -- if reform does not occur, proponents of this view will say that the crisis was not sufficiently severe -- and because reforms responding to similar crises take very different forms (e.g., Caprio and Klingebiel 1996). The U.S., for example, responded to the banking and economic crisis of the early 1930s by fragmenting the financial system (Kroszner 1996). The Glass-Steagall Act of 1933 narrowed the range of activities permissible for commercial banks, and a series of Acts starting with the Federal Home Loan Bank Act of 1932 created modern Savings & Loan institutions which narrowly focused on the financing of residential mortgages. In continental Europe, however, a number of countries responded in the opposite way by increasing the diversification of their

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that no longer provide important benefits to the primary dealers (see Kroszner 1997b).



financial institutions, by introducing or broadening powers.

From a political-economy perspective, crises are associated with reform because crises are likely to upset the old political-economy equilibrium. There are four reasons for this. First, crises rarely affect all parties similarly and tend to have important distributional consequences. Since the relative position of competing interests is one of the key elements to a political-economy equilibrium, it is thus not surprising that reforms often occur following crises. Powerful groups or coalitions may fragment as their interests diverge during economic trouble, and new constituencies may be created. Although smaller, less diversified banks tended to support federal deposit insurance, for example, they became politically powerful enough to enact it only in 1933 (Hubbard et al. 1996, but also see Calomiris and White 1994).

Second, economic upheaval can change the relative costs and benefits of particular regulations. An interest rate ceiling, which may act like a price-fixing arrangement among banks to enhance their profits during normal times, for example, could lead to large outflows of funds and liquidity problems during high-interest crisis periods (see Barth 1991 and Kroszner and Strahan 1996). Hyperinflation crises turn many of the regulations that had protected banks from competition into obstacles in the new circumstances. Innovations in financial technology may create new markets and institutions, and new constituencies with them.

Third, crisis can also affect bureaucratic incentives for regulatory change. Deposit insurance, for example, commits the government to bail-out banks that have liquidity and solvency problems. During times of crisis, deposit insurance funds typically are bankrupt so an explicit taxpayer-financed bail-out would be necessary. To postpone such actions, politicians and regulators may have incentives to reduce various regulatory barriers as a quid pro quo for a

financial institution using its private funds to bail out a troubled institution. Special dispensations to cross geographic or product lines have occurred in the U.S., particularly during the Savings & Loan crisis (Kroszner and Strahan 1996), Mexico, where Citicorp recently took a large stake in a troubled local Mexican bank, dramatically easing the expansion of its operations in Mexico, and in Japan, where “arranged” mergers have helped some banks expand into new activities.

Finally, the enormous costs of a financial crisis may serve an important educational role for the public (see Kane 1996). During normal times, individual voters may not know the full value of the implicit or explicit guarantees that the government, that is, the taxpayer, is making. After a crisis, however, the government is likely to have to raise taxes and sell bonds in order to pay for the bail-out. This more explicit accounting will reveal the costs of policies that the public may not have known were so costly. Bank failures thus may heighten the public’s awareness of the costs of regulation and may make it more difficult, that is, more costly in terms of votes, to maintain the old regulatory regime. The banks now would have to provide more support to politicians, for example, through greater campaign contributions, in order to offset the greater popular opposition. Since the banks are experiencing financial distress, they may not be in a strong position to provide the additional funds, so the likelihood of reform increases.

The reform and repeal of the Argentine deposit insurance system follows this pattern. During the 1980s, Argentina experienced two major banking crises. The first in 1980-1982 has been estimated to have required more than 50 percent of GDP to resolve and the second crisis in 1989-90 roughly 13 percent of GDP to resolve (Rojas-Suarez and Weisbrod 1996 and Lindgren, Garcia, and Saal 1996). With such large costs to the bail-outs, the public was now acutely aware of the costs of government guarantees of deposits. Due to the hyperinflation, there were

relatively few deposits left in the bank system to be insured by 1990, so there were fewer depositors demanding insurance. Also, the banks were in a rather weak position. In other words, the crisis involved a dramatic shift in the relative strength of the groups supporting and opposing deposit insurance. In these circumstances, it became politically feasible to eliminate deposit insurance and Argentina did so.

This reform, however, was not completely sustained. Five years later, during the Tequila crisis, the interests in favor of deposit insurance grew and a private deposit insurance scheme was instituted (Guidotti 1996). The deposit insurance premia are relatively high but the insurance agency is owned by the banks that contribute to it. Thus, if the system stays healthy, they earn the profits from the insurance agency but will bear the burdens when the banks require bail-outs.

The changes in geographic restrictions within the U.S. also can be understood within this framework. Kane (1996) argues that an important shock to the old equilibrium favoring branching restrictions was an increase in the public's understanding of the costliness of having government-insured but (geographically) undiversified financial institutions. During the 1980s, an increasing number of depository institution failures and the Savings and Loan crisis culminating in the taxpayer bail-out heightened the awareness by the public of the costs of restrictions that make depository institutions more fragile and more likely to require infusions of taxpayer funds. The result is the 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act which phases out geographic restrictions on bank expansion within the U.S. (see Kroszner and Strahan 1999).

### *Conclusions for Facilitating the Policy Reform Process*

The thrust of the arguments above focus on interest group competition and how the battle

among the interests will be a key determinant of the regulatory outcomes. Are careful scholarly analyses of regulations and their reforms then of little relevance for policy so academics should retreat to the Ivory Tower? An organized interest group, money, and/or votes may be necessary for a view to prevail in the political marketplace but it is not sufficient, due to the rivalry among interest groups. Theory and facts, not only money and power, are relevant to the debates.

Without an interest group to champion a position, however, an argument may have little effect.

(Television, radio, and the internet, however, have been reducing the costs for both information to be disseminated and for groups to organize.)

A logical and empirically supported argument affects the productivity of the lobbying efforts by an interest group, much like a technological shock that can increase the productivity of investments. Although rival interests will always have an incentive to provide disinformation and generate “hack” alternative studies, a well executed can be a great help to a particular group. In terms of Becker’s pressure group model, careful studies can inform the rival groups about the size of the dead weight losses involved with policy alternatives. Reducing uncertainty about the outcome can energize the losing side to increase lobbying effort. Thus, one implication of the political-economy analysis is that the education of the public and of policy-makers of the actual and potential costs of regulation can play a useful and important role in the policy reform process.<sup>13</sup>

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<sup>13</sup> Kane (1996) argues that bank regulators and beneficiaries of restrictions on geographic expansion of banks purposefully misinformed the public and legislators about the costs of the regulations. Only a combination of large failures and costly bail-outs with academic studies explaining why the bail-outs are so costly were able to change the perception of the social welfare effects of the regulation. Jensen (1991) argues that much popular support for corporate governance regulation protecting incumbent management arises primarily from ignorance rather than purposeful misinformation, so that more policy-relevant research is important to effect reform.

A second implication is that competition among rival interest groups can increase the likelihood of beneficial reform. Rival groups have an incentive to battle each other in addition to battling the consumer. If they dissipate their efforts against each other, they are less likely to be able to support narrow special interest regulation. In many emerging markets today, e.g., Russia, a major question concerns whether creating universal banks would allow one particular interest to have too much political power and thwart reform. In addition, the rival groups have an incentive to try to unmask any misinformation that the competing side is generating. This can help to inform both the policy-makers and the public.

Third, the structure of regulatory and government institutions also plays a role. A clear structure of legislative oversight of the regulatory process through, for example, specific committees in the Parliament with responsibility for banking and financial matters may provide a forum which fosters the information generation process (Gilligan and Krehbiel 1989, McCubbins, Noll, and Weingast 1989, Krehbiel 1991, Austin-Smith and Wright 1992 and 1994, Kroszner and Stratmann 1998). Similarly, the incentives for groups to overcome free-rider problems and organize is related to the expected benefit of them doing so. In other words, the organization of interests is endogenously related to the structure of the regulatory process (see Irwin and Kroszner 1999). Opening the regulatory process to include clear channels for new groups that would tend to oppose narrow special interest “capture” regulation increases the likelihood of regulatory reform by increasing the costs of maintain the regulation to the special interest.

Fourth, greater transparency in government involvement in the financial system is significant. Politicians often use the financial system, either through implicit guidance or explicit through state owned banks, to provide low-cost financing to targeted industries or groups.

Directed lending leads to implicit or explicit quid pro quos in order to have the banking sector follow this direction. Problems in Korean banks, for example, stem from encouragement by the government to continue lending to troubled enterprises in return for implicit assurances of a bail-out. Privatization of state owned enterprises, for example, can reduce the benefit to politicians' of directing credit and can generate new constituencies for an efficient banking and financial sector -- as long as the firm has been fully privatized and does not have special influence with the government (Kroszner 1996b). Requiring that any such transfers or subsidies be explicitly included in the government's fiscal accounts would clarify such transactions and help to break nexus of implicit agreements and quid pro quos through regulation that support them. Less secrecy and increased disclosure in government supervision of financial institutions also would permit increased monitoring of the government's role in the financial system.

Finally, foreign entry can generate a virtuous circle because foreign institutions tend to be less politically connected domestically and less likely to be able to capture the regulatory authorities. Foreign institutions also are less likely to succumb to pressure for directed lending by the government. With capture less likely and fewer direct benefits to the politicians of regulation (e.g., through quid pro quos for directed lending), regulatory reform becomes more likely. While there is no simple formula for successful and sustained banking and financial regulatory reform, a positive analysis of the political-economy of rent-seeking does suggest how process and institutions facilitate beneficial reform.

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