Non-technical Summary

for the *Financial crises and reversals in financial development* project with number

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This paper linked a rich history of banking crises in 76 countries to the development of financial reforms in seven reform areas. Those are:

1) Credit controls: to what extent the government is intervening directly into the allocation of scarce financial resources;
2) Interest rate controls: to what extent the government is directing the price of the financial resources;
3) Entry barriers: how easy it is to start a bank in a given country;
4) Banking supervision: to what extent the government is ensuing that an independent monitoring of the financial system is in place;
5) State ownership in the banking sector: how involved the government is in the banking sector in terms of direct ownership;
6) Capital controls: how easy is to move money into and out of a given country; and
7) Securities markets policies: to what extent the government is encouraging the creation of alternative channels for spurring investment in the economy.

This work also analyzed how banking crises affect the overall pattern of financial reforms which is affected by reforms in all those areas simultaneously. Unlike previous literature, this work adopts a more realistic transmission mechanism of crises across countries and constructs a crisis exposure for each country and year. This more realistic transmission mechanism is at the heart of identifying the causal effect of banking crises on financial reforms.

On the one hand, systemic banking crises reverse the overall pattern of financial reforms. They also reverse most of the other particular financial reforms, although with a varying reaction lag. In addition, systemic banking crises improve banking supervision which is perhaps a natural policy reaction to a crisis occurring in the banking sector. Non-systemic banking crises, on the other hand, exert a much weaker influence on financial policies and regulations.

Whereas financial crises reverse reforms, economic downturns tend to make governments liberalize their financial systems. After recessions, governments reduce their direct favors to particular industries, and sell their ownership shares in the banking sector. A recession also makes banking supervision less independent from the incumbent government and might reduce the coverage of financial institutions.

Recessions also exert a more positive impact on financial liberalization of countries which are closer to the regional reform leaders. This is especially valid for credit controls and for securities markets policies and regulations. Exchange rate movements rarely play a significant role for shaping financial reforms, except for capital controls.

Finally, the results here suggest financial reforms tend to move to one of two states: a fully liberalized financial system or a fully repressed financial system, with neither of the two systems meaning zero or an infinite number of regulations in the financial industry.

A rich set of intuitive **policy implications** emerges from this work. First, governments should not jump to reversing the pattern of financial liberalization after crises as they seem to be doing. This is so, because it has long been established that financial reforms lead to financial development and financial development leads to growth. If growth is the rational target after crises, then reversing the reform pattern which this work shows is the case may not lead to a quicker recovery.

Second, governments impose more control on the credit activity after crises. Specifically, they allocate favors to particular industries which might reduce competition in those industries. Governments should reduce favors after crises in order to spur competition both within the private sector, and between the state-owned firms and the private sector, which is another channel for creating growth after crises.

Third, crises impose more entry barriers in the banking industry. However, more competition in the banking industry could reduce interest rates and spur private investment. To do so, governments should reduce those barriers.

Fourth, systemic crises induce more state ownership in the banking sector. This is perhaps natural given the importance of not letting systemically important financial institutions fail. However, in the more recent environment of aversion to fiscal expansion, other mechanisms of saving or dismantling those institutions might be more plausible and efficient than making future generations pay for the save. Further, once an active owner in the banking sector, the government should refrain from staying there too long. Instead, the government should privatize the healthy businesses as plenty of evidence suggests that increased government ownership in the banking sector hampers financial development.

Fifth, systemic crises lead to more capital inflow and outflow controls. This might be an efficient way to stem a looming crisis but the evidence in this work points to the fact that more often than not governments implement capital account restrictions as a *reaction* to a crisis, not as means to *prevent* it. To restore growth after a crisis, governments should refrain from the longer term usage of both inward and outward capital controls as they might prevent longer term investment in the country.

Sixth, crises slow down the creation and development of securities markets. If the banking system in a country has no alternative channel between savings and investment but it has just undergone a major crisis, then slowing down the securities market development is hardly the most efficient policy response to a crisis.

Seventh, if a recession occurs, the countries closer to the regional reform leaders create a growth-enhancing financial regulatory framework faster. If growth is on the policy agenda of the laggards in financial liberalization, they should also target adopting a competitive regulatory framework for spurring financial development.