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CRISES, GOOD OR BAD

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We are gathered here for a symposium on "Financial Crises as Global Challenges." I feel privileged to be invited to offer some opening remarks.

As we all know, financial crises are nothing new. From the very beginning of modern finance, with the emergence of family banks in Renaissance Italy, crises were endemic – often associated with defaults by sovereign borrowers. Charles Kindleberger, in his justly celebrated study of *Manias, Panics and Crashes* (1978), refers to financial crisis as a "hardy perennial" – no more avoidable than death or taxes. In every era there have been hopes that "this time is different," to use the ironic phrase of Carmen Reinhart and Kenneth Rogoff (2009) – but it never is. Booms and bubbles always end up the same way – in crisis. It is never a question of *whether* a crisis will occur. Count on it. Sooner or later, crisis will strike. The more interesting question is: What will the outcome be? Will we learn from our mistakes, or will we be condemned to repeat them?

The importance of the question is obvious. Consider, for example, the recent "Report Card on International Cooperation" issued by the Council of Councils, a network of some 24 foreign policy institutes in 23 countries around the world (Council of Councils 2015). In assessing the global response to the financial crisis of 2008, the Council of Councils felt it could award governments a grade no better than C+ – not much to boast about in an era known for grade inflation. Clearly outcomes may turn out to be far less favorable than we would like. At a policy level, it seems that we do not always learn from our mistakes.

Can we do better? And, if not, why? At issue are the forces that shape political responses to financial crisis. In these brief remarks, I hope to stimulate greater discussion of the causal relationships involved.

THE MEANING OF CRISIS

To begin, we must be clear about what w mean by crisis. Like so many critical concepts in the social sciences – for example, capital or power -- different scholars use the same term to mean very different things. Too often, thousands of hours of intellectual firepower have been wasted on acrimonious debates that, in the end, have turned out to revolve around nothing more than a misunderstood word.

A common misapprehension is to use the word crisis to stand for a persistent, even chronic policy challenge. In Europe people speak of the euro crisis that has now been going on for some five years. In my country commentaries speak of the Social Security crisis – how to finance the retirement benefits of an aging population – that has stretched out over an even longer period of time. And in the global South observers regularly refer to a development crisis that has endured for decades, if not centuries. Crisis is equated with problem. But that, I believe, is not the meaning that the organizers of this symposium had in mind when they put the program together.

More to the point is a definition of crisis that conveys a vivid sense of *urgency* – a condition of sudden change and immediate danger. For me, there is no better definition of crisis than one offered decades ago by political scientist Charles Hermann (1972), who equated the phenomenon with three critical dimensions: high threat, short decision time, and an element of surprise. Many agree that these three dimensions capture the essence of the concept (e.g., Kahler and Lake 2013: 10). Popular commentary has made use of the colorful metaphor of a *black swan* (Taleb 2007) to describe unexpected events of major impact. Black swans appear only

rarely in nature, but when they do show up they attract a lot of attention – just like a crisis. That is the meaning of the term that I will employ here.

In the world of finance, black swans come in diverse shapes and sizes. We have banking failures, speculative bubbles, currency shocks, balance-of-payments emergencies, and sovereign debt defaults. Each type is distinctive, with its own unique features and dynamics. Yet, when deconstructed, they all come down to the same basic elements: surprise and urgency. Given the overall theme of this conference – financial crises as *global* challenges – I will concentrate my remarks today on financial crises that have an *international* dimension. Many shocks, such as a bank run or real-estate collapse, never cross territorial frontiers. Confined to a single country, with few spillovers to affect economies elsewhere, they normally call for action by just the home government alone. These will not be considered here. My interest is in black swans that are international in scope and thus require a *collective* response by the governments involved.

By a collective response, I mean some meaningful degree of coordination of relevant policy choices – essentially the same thing that Robert Keohane (1984), a leading US theorist, meant by the word *cooperation*. Central to Keohane's now classic definition of inter-state cooperation is a degree of mutual policy accommodation achieved through formal or informal bargaining. By relevant, I mean reciprocal adjustments that are intended, directly or indirectly, to dampen the risk of repeated crisis in the future. By meaningful, I mean policies that can reasonably be expected to make a real difference.

DANGER OR OPPORTUNITY?

In the Chinese language, the word for "crisis" is composed of two characters that are commonly translated as "danger" and "opportunity." The implication is that crises can end badly – but not necessarily.

That crises may be *dangerous* is no surprise. We need only recall the Great Depression that followed the financial crisis of 1931, which began innocently enough not far from here with the collapse of a single bank, Vienna's Credit-Anstalt. Or even nearer in time, we can think of the troubles of today's euro zone that still persist years after the global crisis that started when the housing bubble burst in my own country in 2007. There is no doubt that crises can lead to dislocation, trauma, and years of hardship and suffering.

But that is not the only possible outcome. Crises can also be *opportune* if actors are prepared to seize the day. Remember the old saying "Never let a good crisis go to waste," variously attributed to, among others, Winston Churchill and Barack Obama's former chief of staff (and now Chicago mayor) Rahm Emanuel. Some even refer to it as Rahm's Rule. The idea of Rahm's Rule is that a severe shock may be just what the doctor ordered to encourage strategic experimentation and healthy adaptation. Sources speak optimistically of crisis as a "critical juncture," "tipping point," or "window of opportunity."

In the United States a favored metaphor for all this is the notion of *punctuated equilibrium*, a concept borrowed from evolutionary biology and now widely employed in various branches of the scholarly literature on international relations (IR) and international political economy (IPE). The punctuated equilibrium model assumes that public policy normally changes only incrementally. That is due to a variety of constraints, such as the "stickiness" of institutional cultures, vested interests, and the bounded rationality of individual decision makers. The policy process, accordingly, tends to be characterized by long periods of relative stability, punc-

tuated only on occasion by large, though less frequent, changes triggered by crisis. In this context, crisis is seen to be like an ice breaker creating a path through a frozen sea for major shifts in society or government.

Following the Asian financial crisis of 1997-98, for example, observers overwhelmingly agreed that the trauma was a "turning point" for the region (Chey 2009: 450); an "impetus for many financial cooperation initiatives" (Sussangkarn and Vichyanond 2007: 25); a shock that "opened the door to significant policy-led integration in East Asia" (Park 2007: 96). Many made use of the word "catalyst" (e.g., Amyx 2004: 98). Indeed, one major retrospective on the experience was entitled, simply, *Crisis as Catalyst* (MacIntyre et al. 2008).

Likewise, in the midst of the euro zone's current troubles, we find many sources taking the sanguine view that all will end well -- precisely because of the catalytic role of crisis. Europe, it is commonly argued, has always relied on shocks to overcome resistance to deeper and more comprehensive integration (Gross 2011; Schmitter 2012; Lefkofridi and Schmitter 2015). Though not everyone agrees (see Parsons and Matthijs 2015), most are inspired by Jean Monnet's early admonition that "Europe will be forged in crises, and will be the sum of the solutions adopted in those crises" (Monnet 1978: 417). As summarized by one recent source (McCormick 2012: 3): "The problem of the euro presents us with the ideal opportunity to engage Europeans more actively in the work of the EU, to take care of all its unfinished business, and to ensure that the EU emerges from this crisis both stronger and leaner."

In short, crises may not always be "bad." They may also turn out to be "good," depending on circumstances. A good crisis may be defined as one that leads reasonably quickly to meaningful cooperation in Keohane's (1984) sense of the term: reciprocal policy adjustments that, in the eyes of relevant stakeholders, significantly reduce the risk of recurrent shocks in the future. Just as old soldiers often reminisce about what a "good war" they or their friends may have had, we can speak of good crises -- turbulent times that, happily, end well. The key to a "good" crisis is a genuine commitment to effective collective action.

A "bad" crisis, by contrast, is one that conspicuously fails to improve on the *status quo ante*. At best, turbulence might produce some temporary "fixes" – shoddy political compromises that effectively kick the can down the road (to use a familiar American expression). At worst disaster might strike, as it did in the 1930s. The window of opportunity may close before salutary action can be taken. The ice may prove too thick to be broken.

In brief, in a good crisis collective action significantly reduces the risk of future instability (or at least appears to do so); in a bad crisis, collective action fails to deliver lasting amelioration. The distinction is admittedly crude, requiring a fair amount of subjective judgment. But the challenge is hardly unfamiliar. How do we judge beauty, for instance, whether in the arts or in human beings? In assessing beauty, we do not seem to need a very precise definition in order to know it when we see it. The same is true for crises. We know, for example, that by most standards we can consider the Asian trauma of 1997-98 a good crisis. Inter alia it resulted in the Chiang Mai Initiative, a multilateral liquidity mechanism, that has given the nations of the region an extra layer of insurance against possible future financial disruptions (Cohen 2012). Conversely, we know that for the most part the euro zone's current troubles seem to be proving to be a very bad crisis. Half a decade after the first rescue of Greece, the monetary union still seems unable to save itself from the threat of fiscal imbalances among its members (Cohen 2015).

The question I propose to address here is: Which crises will turn out to be good in the general sense provided, and which will be bad?

PRIOR EFFORTS

The distinction between good and bad crises is by no means unfamiliar in the academic literature. Remarkably, however, very few sources have attempted to systematically identify the factors that might actually determine which outcome is more likely. Why does policy adjust effectively in some cases and not in others? As a matter of theory, the issue is surprisingly under-researched.

There is, of course, a voluminous literature on the political economy of crises, going back to Peter Gourevitch's justly celebrated *Politics in Hard Times* (1986). The theme is a staple of the field of comparative political economy. But much of the crisis literature is concerned with the causal role that politics plays in determining either the *origins* of shocks or else the severity of their *outcomes*. Typical of the former are Shimpalee and Breuer (2006), who focus on domestic social and political institutions as the sources of currency crisis; Satyanath (2006), who highlights the fatal effects of miscommunication within borrower governments; or Broz (2013), who locates the origins of financial crises in partisan politics. Typical of the latter are analysts like MacIntyre (2001) or Angkinand and Willett (2008), who look to the role that institutions play in explaining why investment recovers more quickly in some countries than in others in the aftermath of a crash. Relatively little effort has been put into explaining the policy choices that are made in direct response to a crisis.

Further, even when direct policy responses are made the focus of inquiry, in almost all cases analysis tends to concentrate on the actions of individual countries, each considered more or less on its own rather than in combination. One or another causal variable is invoked to explain why governments separately react as they do. For some observers, the key is to be found in the interests and power of diverse domestic actors. These include Gourevitch (1986) himself, who explored at length the role that changing political coalitions and cleavages play in shaping public responses to financial or economic shocks. More recent contributions, emphasizing the distributional conflicts surrounding the politics of adjustment in financially open economies, have come from Pontusson and Raess (2012) and Walter (2013). For others, by contrast, it is the nature of the domestic political regime that is paramount (Oatley 2003; Keefer 2007; Rosas 2009). Factors such as ideological divisions among lawmakers, relations between the legislative and executive branches of government, electoral considerations, and budgetary positions are highlighted as possible explanations (Bermeo and Pontusson 2012). Rarely, however, is much attention paid to opportunities for collaboration *among* national governments. Across the crisis literature, systematic studies of the determinants of *collective* responses (or lack thereof) to the appearance of black swans are extraordinarily difficult to find.

A lacunae exists, therefore, that cries out for attention. At issue is the international dimension of financial shocks. Some crises result in effective collective action; others do not. The question is: Why? What factors determine whether a crisis will prove to be constructive or destructive? In brief, why are some crises good and others bad?

LEVELS OF ANALYSIS

In the limited time available to me, I could hardly hope to provide a definitive answer. For that, I apologize in advance. I make no claim to present a formal research paper. Rather, in

the spirit of a keynote lecture, my aim is simply to encourage more systematic consideration of an important and under-theorized issue. My strategy will be to provide some food for thought in the form of a few selective *vorspeisen.* I can only hope that you will find my speculations appetizing.

Following a long-standing tradition in mainstream IR and IPE in the United States, I will make use of the so-called "levels of analysis" derived from the early work of the well-known theorist Kenneth Waltz (1959, 1979). In principle, three broad levels are distinguished, each a general theoretical orientation highlighting certain key factors as explanatory variables for policy preferences and behavior. These are generally known as the *systemic* (or structural), *domestic,* and *cognitive* levels of analysis.

The distinctions among the three levels are familiar. At the systemic level, analysis focuses on the sovereign state itself, promoting or defending its national interests in an insecure world. Inquiry concentrates on constraints and incentives for policy deriving from the broader structure of inter-state relations. Behavior, as Waltz put it, may be studied from the "outside-in" (Waltz 1979: 63). At the domestic level, by contrast, behavior is studied from the "inside-out," concentrating on the internal characteristics of states rather than their external environment. Attention is directed to the strategic interactions among all domestic actors, inside or outside government, with actual or potential influence on a state's foreign actions as well as to the institutional settings through which diverse interests are mediated and converted into policy – in short, the political and institutional basis at home for policy preferences abroad. Finally, at the cognitive level, analysis focuses on the base of ideas and consensual knowledge that lend legitimacy to governmental policymaking – an approach that contrasts sharply with the materialist rational-actor models characteristic of both the systemic and domestic levels of analysis. Here we find the contributions of constructivists, with their emphasis on social learning and the independent effects of norms on state behavior.

Each of the three levels of analysis highlights key factors that might influence the outcome of a crisis: considerations that would appear to either inhibit or promote effective collective action. The candidates are many. In the time available, I will concentrate on just a core handful that I regard as potentially most salient.

SYSTEMIC LEVEL

At the systemic level, where possible influences are "outside-in," two candidates stand out: either other states or market forces. In the midst of a crisis, state behavior may be shaped either by what other governments do or by pressures from global markets. In either instance, the impact may be either positive (making for a good crisis) or negative (a bad crisis).

In "outside-in" analysis, we enter the realm of what is known as *diffusion theory* – a relatively new body of literature that focuses on the way policy initiatives may spread from one country, a first mover, to others (Simmons et al. 2008; Solingen and Börzel 2014). Four models of diffusion are typically distinguished – coercion, competition, learning, and emulation. *Coercion* involves the deliberate manipulation of incentives by powerful states to encourage or discourage specified forms of policy behavior. *Competition,* less overtly, operates through rivalry for key economic desiderata, such as investment capital or market share. *Learning* refers to changes in behavior that result from observation and interpretation of what is happening else-

where. And *emulation* embodies an imitative "follow-the-leader" type of strategy where one or more countries serve as exemplars for what others might consider most respectable.

Though seemingly distinct in principle, the latter two models – learning and emulation – are exceptionally difficult to distinguish in practice. How can we really know whether a first mover's policy is adopted because it seems to "work" or simply because the first mover has a good reputation? For empirical purposes, therefore, the two models are often combined as one, a single learning-emulation model, and that is a practice that I will follow here. Further consideration of the learning-emulation model can be postponed, for reasons that will become clear, until consideration of the cognitive level of analysis. Here I will focus on the first two models of diffusion – coercion and competition.

The underlying premise of the coercion model is the existence of *hierarchy* in inter-state relations – hardly an unrealistic assumption. In reality, in every aspect of the global political economy, including international finance, sovereign power is distributed asymmetrically (Lake 2009). Some governments are clearly in a position to exercise leverage over others, should they choose to do so, through the traditional instruments of statecraft: coercion, bribery, or persuasion. But will they choose to do so? And if they do choose to do so, will their leadership prove to be constructive or destructive? Will they be like the Biblical Moses, guiding their people to the promised land? Or will they be like the Pied Piper of Hamelin, leading followers to oblivion?

Likewise, the underlying premise of the competition model is the existence of *markets* on which states are dependent in one way or another – again, in a capitalist order, not an unrealistic assumption. In the world of international finance, where most activity is carried on by non-state actors, states are particularly vulnerable to the vagaries of investor sentiment, which as we know can ebb and flow like the tides. Many states compete for capital, whether to underwrite investments, diversify risk, finance budget deficits, or meet foreign obligations. Initiatives by one state that could cultivate favorable market reactions may well trigger parallel responses by others not wishing to be left behind. But again, the question is: Will the outcome prove to be constructive or destructive?

Both models suggests conjectures for future study. Key to the coercion model, I would submit, is the degree of *asymmetry* in power relations. In his justly celebrated book, *A World in Depression* (1973), Kindleberger suggested that a monetary leader would be expected to play three distinct roles: (1) maintain a relatively open market for distress goods; (2) providing contracyclical, or at least stable, long-term lending; and (3) acting as a lender of last resort at times of crisis. In later work (Kindleberger 1981: ch. 21) he added two additional functions: (4) policing a relatively stable system of exchange rates and (5) ensuring some degree of coordination of macroeconomic policies. Arguably, a state's willingness to take on any or all of these responsibilities will depend, other things being equal, on how great its power is seen to be relative to others. The more assured its dominance, the greater will be its incentive to preserve its top position in moments of crisis – hence the greater the likelihood that it will strive to ensure a "good" outcome. Conversely, the less secure is the state's power position, the less it will feel it can afford to accept the potentially costly burdens of leadership – hence the greater is the likelihood of a "bad" outcome. Many will recognize this is a variation of the well known theory of hegemonic stability: the notion, first attributed to Kindleberger himself, that systemic stability requires the presence of a benevolent hegemon. In this context the proposition could be stated as follows:

Conjecture 1. Ceteris paribus, the probability of a good crisis rises with the degree of asymmetry in inter-state power relations.

Key to the competition model, in turn, would seem to be the degree of *intensity* in the rivalry among states for capital. Stephan Haggard and Sylvia Maxfield (1996), writing about the 1980s and 1990s, have cited the key part played by balance-of-payments shocks in encouraging financial liberalization in developing countries. Though it might seem counterintuitive, they found that governments faced with the threat of a run on their currency often found it expedient to increase rather than decrease financial openness, in order to cultivate credibility with the markets. Liberalization in the face of crisis, they contend, "signals foreign investors that they will be able to liquidate their investments, indicates government intentions to maintain fiscal and monetary discipline, and thus ultimately increases capital inflows" (Haggard and Maxwell 1996: 211). Arguably, the incentive to act in that way will depend greatly on how much governments feel they must worry about losing the favor of investors. The greater the degree of rivalry for available funds, the more likely it is that states will be moved to undertake reforms designed to assure market actors that the mistakes of the past will not be repeated. This too may be stated formally:

Conjecture 2. Ceteris paribus, the probability of a good crisis rises with the degree of competition among states for capital.

DOMESTIC LEVEL

At the domestic level, where possible influences are "inside-out," two other candidates stand out: either competing interest groups or governing social institutions. State behavior may be shaped either by the interests of key societal actors or by the character of the political regime. Here too the impact may be either positive (making for a good crisis) or negative (a bad crisis).

In "inside-out" analysis, we enter the realm of what is known as *open economy politics* (OEP) – the formal analytical paradigm that has come to dominate what I have elsewhere called the American school of IPE (Cohen 2008). As first articulated by David Lake (2011), OEP builds outward in linear fashion from the interests of individuals and other social units to the policy preferences of states and, finally, to strategic interactions at the international level. Methodologically, three steps are distinguished. First comes the derivation of particularist interests, derived from established economic theories highlighting the distributional implications of different government policies. Second comes analysis of how interests are aggregated and mediated through domestic political institutions, drawing on familiar models from political science. And then, once policy preferences are determined, comes a third stage of international bargaining as states seek to influence one another's behavior, either explicitly or implicitly. OEP's third stage, obviously, takes us back to the systemic level of analysis that I have already discussed. The first and second stages, by contrast, encompass precisely what we mean by the domestic level of analysis.

The underlying premise of the first stage of OEP is that certain key constituencies may play an outsized role in the policy process – again, not an unrealistic assumption. We all know that political power tends to be distributed unequally among societal actors. Some groups are too large in number to mobilize effectively to defend or promote their collective interests; others may have more resources at their disposal to support lobbying activity. We also know that moti-

vations to make use of political power will vary depending on the distributional implications of given policy choices. For some groups, the impacts of a particular policy may seem too inconsequential to worry about, whereas for others the same choice could be central to their material welfare. Depending on circumstances, the mix of constituencies with the power and motivation to move policy may vary considerably.

The underlying premise of the second stage is that the practical influence of any domestic constituency can be greatly impacted, positively or negatively, by key features of the political regime. Is the government autocratic or democratic? If an autocracy, is the government run by civilians or the military? If a democracy, is the voting system majoritarian or proportional? For some societal actors, practical leverage will be amplified by specific institutional characteristics; for other, influence will be blunted or diluted.

Here too, both stages suggest conjectures for future study. Key to the first stage, I submit, is the *breadth* of a crisis – how widely the impact of the crisis is felt among relevant stakeholders in the countries involved. Will many societal actors be motivated to demand effective collective action? If only a small number of groups in a few places are directly affected, pressures in favor of significant reform are unlikely to be substantial. Few constituencies will feel moved to compromise their particularist preferences in the common interest. But the incentive to find common ground is apt to be greater if the impact of a crisis is more widespread, threatening a broader range of domestic and transnational actors. Then the chances are greater that new political coalitions will begin to coalesce in support of constructive policy adaptation, tilting the balance of political influence. What matters is how much a crisis is felt as a *shared* experience. Does everyone feel they are in the same boat? Formally:

> Conjecture 3. Ceteris paribus, the probability of a good crisis rises with the number of constituencies in the states involved that feel their interests to be similarly threatened.

Key to the second stage, in turn, would seem to be the *depth* of a crisis – how severe the collective threat is felt to be. For all the distinctions in the literature concerning different types of political institutions or regimes, most analysis comes down to the number of veto players in a given system – actors with the capacity to block or postpone action (Tsebelis 2002). If a shock is relatively moderate, few veto players will feel moved to reduce their resistance to new policy initiatives. However strong the demand for reform may be, supply will be restricted. But resistance is apt to be eroded if the crisis is deeper, raising the cost of sticking to the *status quo*. Then the chances are greater that veto players will reassess their objections, opening new "policy space." Interest groups, as we know, can be very stubborn in defense of their privileges. But as Mancur Olson (1982: 40) long ago reminded us, minds can change if "there is a social upheaval or some other form of violence or instability." What matters is how much a crisis affects calculations of benefits and risks. Formally:

> Conjecture 4. Ceteris paribus, the probability of a good crisis rises with the overall severity of the threat involved.

COGNITIVE LEVEL

Finally, there is the cognitive level, where possible influences are more subjective and work through the force of values and norms. At both the systemic and domestic levels of analysis, behavior is assumed to be driven primarily by a logic of consequence. The emphasis is on material gains and losses. At the cognitive level, by contrast, behavior is assumed to respond more to a logic of appropriateness, with emphasis on the social construction of intersubjective beliefs. It is here where we return to the learning-emulation model of diffusion, focusing on how much room there is for the spread of new policy ideas among the countries impacted by a crisis.

As Jeffrey Chwieroth (2010a, 2010b) rightfully emphasizes, much depends on the presence or absence of a cadre of "norm entrepreneurs" – advocates prepared to challenge entrenched notions of what policies may be regarded as acceptable or illegitimate. Norm entrepreneurs may be found inside government as well as in wider society. What unites them is a willingness, even eagerness, to promote strategic experimentation in moments of peril. In Chwieroth's words: "Norm entrepreneurs employ their ideas to implicate the status quo as flawed ... and as necessitating change [stressing] what has gone wrong and how it can be remedied" (2010b: 497). What makes norm entrepreneurs effective greatly depends on the credibility of their diagnosis and prescriptions, which in turn is a function of both the reputation of the advocates and the perceived quality of their arguments. The more that credible norm entrepreneurs can converge on one set of recommendations, the more likely it is that effective collective action can be achieved. Formally:

> Conjecture 5. Ceteris paribus, the probability of a good crisis rises with the degree of consensus among credible norm entrepreneurs.

CONCLUSION

In summary, I have proposed five conjectures that might be worth some further thought. These are that, ceteris paribus, the probability of a good crisis rises with:

1. The degree of asymmetry in inter-state power relations.
2. The degree of competition among states for capital.
3. The number of constituencies in the states involved that feel their interests to be similarly threatened.
4. The overall severity of the threat involved.
5. The degree of consensus among credible norm entrepreneurs.

Obviously, these are not the whole story. Not everyone will agree with all parts of my logic; each of my conjectures could surely be refined in various ways; and there are no doubt other factors at work as well. But that is precisely my point – to encourage more systematic consideration of a critically important question. I have argued that financial crises are endemic. If so, we have every reason to hope that they will turn out to be "good" rather than "bad." In English, we have a saying: If you can't beat them, join them. My message today is similar. If you can't avoid them, learn from them. That, I expect, is what we all will do at this symposium over the next couple of days. The agenda is rich and the experts are many. We will surely learn.

Thank you.

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