Philippe Moutot*

Power of Inaction or Ability to Learn in Action within a Political Process? Comments on “The Power of Inaction” by Cornelia Woll

DOI 10.1515/ael-2015-0009

Abstract: How to best describe and assess the result of a bailout process? The author argues that the power of inaction of banks while relevant, as argued by Cornelia Woll in her book, is not sufficient to characterize the result of a bailout process. As such result should encompass financial stability and business cycle considerations, the power of inaction of banks needs to be viewed in combination with the ability of authorities to learn in action and the quality of the legal and political process that accompanies such learning.

Keywords: bail-outs, financial crisis, treasury-finance nexus

Table of contents

What the book does

Assumptions and findings

But is “the power of in action” sufficient to understand and summarize what happened?

Power of “in action” or power of “learning in action”?

Learning in action and quality of the legal and democratic process

Symposium on ‘The Power of Inaction. Bank Bailouts in Comparison’ by Cornelia Woll

- 1 Cornelia, Woll (2016) ‘A Symposium on Financial Power’, Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2016-0001.
- 2 Kelsey M. Barnes and Arthur E. Wilmarth (2016) ‘Explaining Variations in Bailout Policies: A Review of Cornelia Woll’s The Power of Inaction’, Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0012.
- 3 Matthias Thiemann (2016) ‘The Power of Inaction or Elite Failure? A Comment on Woll’ “The Power of Inaction”, Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0011.
- 4 Philippe Moutot (2016) ‘Power of Inaction or Ability to Learn in Action within a Political Process? Comments on “The Power of Inaction” by Cornelia Woll’, Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0009.

***Corresponding author: Philippe Moutot**, Department of Economics, European Central Bank, Frankfurt am Main, Hessen, Germany, E-mail: philippe.moutot@gmail.com

- 5 Raphael Reinke (2016) 'The Power of Banks and Governments', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2016-0003.
- 6 Jason O. Jensen (2016) 'Comment on *The Power of Inaction* by Cornelia Woll', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2015-0010.
- 7 Yuri Biondi (2016) 'Empowering Market-Based Finance: A Note on Bank Bailouts in the Aftermath of the North Atlantic Financial Crisis of 2007', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2016-0004.
- 8 Cornelia Woll (2016) 'A Rejoinder by the Author', Accounting, Economics and Law: A Convivium, DOI 10.1515/ael-2016-0005.

This book is a little treasure: it gathers all relevant information at national like at international level on an issue that is notoriously difficult to research: bank bail-out negotiations throughout an incredibly turbulent period, 2006–2013. Indeed, bank bail-outs unavoidably mix and confront public and private interests thereby raising questions of both democracy and confidentiality. Moreover, the analysis of bail-outs and their consequences is rapidly evolving institutionally and geographically as countries review, merge, create and even re-create their supervisory institutions.

Nonetheless, Woll succeeds in taking all those changes into account. Moreover, she takes the risk of presenting a definitive stance on a very controversial issue. Unfortunately however, this stance, although right, is insufficiently encompassing. Hence, some part of the little treasure remains hidden.

What the book does

The main achievements of “The Power of Inaction” (180 pages only) are as follows. First, the book succinctly presents debates which took place at multiple administrative levels – among central banks in reference to monetary policy and its interaction with Emergency Liquidity Assistance (ELA); among budgetary authorities concerning the relative merits of various recapitalisation tools and guarantees; among banks and their supervisors, and of course, among regulators and parliaments – as well as among academics and at the press level. Second, the book explains the outcome of this process and attempts to find a common rationale between a myriad of bail-out schemes, amid a multiplicity of laws and new frameworks, and among the ways in which they were devised.

For this purpose, the book chooses to present the evidence in a useful and synthetic manner: by pairing countries that would have been expected to react in a similar manner, it points out some of the less obvious but nonetheless, meaningful, asymmetries. Take first the US and UK who share a common view of markets and economic welfare. Then France and Germany who keep a preference for a financial

system based on universal banks, or Ireland and Denmark who share both small size and GDP, but also proportionally, a much larger banking industry.

It is easier with such comparisons to identify those factors leading to the differences of outcome. It helps outline and defend an overall thesis according to which the power of inaction of banks was the most important determinant of the shape taken by the crisis and therefore of the bail-outs. I do not find this claim fully convincing and I will discuss this later. But first, I will examine what it means.

Assumptions and findings

The book assumes, based on Barnett and Duvall's, Lukes's and Rose's approaches to the notion of power, on Foucault's "governmentality" and on Giddens' structuration theory, that the power of the financial sector, often described as the "state-finance nexus" or the "Wall Street-Treasury complex", might be exercised at 3 levels:

- the power of lobbying, i.e. the power of obtaining agreement as a counterpart to a monetary or real transfer—akin to corruption—is so direct a power, that it can be difficult to observe;
- the power of relations, defined as the set of habits created by financial integration, regulation and the state of technology. This is less direct than lobbying, but due to its structural and institutional nature, has difficulties justifying specific choices related to specific bail-outs;
- the power derived from systems of knowledge and discursive practices. Although structural, this power is one of interpretation and therefore more likely to take different shapes across time.

Although Woll does not ignore at all the role of the power of relations (see table 3.2), this third level is the level of power which Woll gives the highest weight to and chooses to use as context or backdrop in order to find a common explanation to the various features of the observed bail-outs.

Woll thus remarks that in countries like the US and the UK, where markets are supposed to be efficient, the banking sector has found itself in a better negotiating position by refusing collective action in bail-outs. They therefore obtained better conditions for themselves, contrasted to France, where collective action of bankers took place. This is also similar to what happened in Germany, where relations between state and banks are more at arm's length, and where collective action was refused due to opposing views between Deutsche Bank and the savings banks (Sparkassen).

These outcomes, described in table 3.1 of the Book, are interpreted as showing that the power derived from systems of knowledge and discursive practices in association with the structure of the banking sectors actually served inaction. Hence, the ability to refuse collective action, which the author calls “the power of inaction”, would end up giving an accurate description of the state-finance nexus. The dominance of a neo-classical or efficient markets approach would, in the right structural context, be associated to inaction (US, Germany) or imposed action (UK). This would be most costly to the state (UK, Germany, Ireland and according to original but not to recent calculations, US) while its absence or its weakness in discursive practices in a context where the structure of the banking sector allows for collective action would facilitate it (FR, DK) and minimize the cost to authorities (FR, DK).

But is “the power of in action” sufficient to understand and summarize what happened?

Although not wrong and in fact in line with many traditional approaches of financial crises focusing in priority on the measurement of their cost, such an assessment is not sufficient.

In my view, the power of inaction is only one part of the story explaining bail-outs. A fuller story should include at least two other factors: the ability to learn in action and the quality of the legal and political process necessary to best accommodate the diversity of challenges faced by an economy in a financial crisis. Of course, each of the latter factors condition and complement the other.

First from a purely theoretical viewpoint, inaction in the context of a given structural and institutional framework loosely combined to systems of knowledge and discursive practice cannot be the expression of a power given that it could also be the result of ignorance, which is a non-power. Indeed, stating that “not incompetence, but unwillingness to regulate the financial industry is the cause of the build-up to the crisis” is a credible statement. But can such statement be contradicted or disproved, as should be in accordance with K. Popper’s criterion of a scientific discourse? No. Indeed, unwillingness or inability – by contrast with the absence of specifically-defined incentives – is not a cause. Therefore considering the power of inaction as the overall determinant of the shape taken by the bail-out crisis is not fully scientific.

This can also be illustrated by taking a more applied view of the situation. Whether banks participated in a collective bail-out is relevant from the

viewpoint of authorities since all banks found some advantage in the bail-out of others and it ensures that the cost of the overall bail-out is not only at the charge of the budget.

However, such cost should not be and is not the only preoccupation of authorities. It is also relevant whether after the bail-out and as a result of it, the economy avails of enough credit to invest and grow and whether society achieves welfare and the central bank its inflation objective. Furthermore, the estimates of the overall cost to the budget fluctuate across time and should also include the costs of supplementary policies needed to achieve objectives other than financial stability whenever these objectives are affected by the bail-out outcomes. Woll, who does not ignore these arguments of course, does not analyse their consequences sufficiently.

For instance, the conclusions of table 3.1 would be quite different if such objectives were taken into account and a wider approach was followed. For instance, France would probably remain among the good performers if only direct costs of the bail-out were considered. But ranking of national performances would be strongly affected if the impact on growth and investment had been taken into account.

The US would rank first, since investment and growth rebounded there first and recent estimates of costs to the budget have turned positive. Germany would rank second, given that its economy has also rebounded and clearly remained the engine of growth in the Euro Area. This has allowed Germany to reduce its fiscal deficit despite bail-out costs. Moreover, its tradition of direct financing by banks to SMEs limited the pressure on those businesses. Hence, this has also limited distortions affecting investment.

France, however, waited the longest for a rebound of the economy and especially of investment. French financing of small firms remained weak although its overall credit was less affected, probably because its large businesses kept access to market finance, often with the active support of large French banks. Moreover, the overall French fiscal situation has remained weak and France has yet to succeed in inverting the movement of its debt ratio.

Even the case of the UK can be assessed differently. New information has shown that the situation of some of the UK banks, particularly RBS, had been much worse than anticipated. Hence, the cost to the UK, although high, was probably unavoidable, as recently recognised by the official decision to accept a loss on the re-sale of RBS. Moreover, in the UK the lack of investment and of sufficient financing for small firms from banks was perceived as invalidating earlier than in other countries and thus elicited specific responses. It led to official support for market financing of small firms when the targeted lending of the Bank of England proved insufficiently effective. In particular, capital support

was offered to start-ups able to help accelerate the digitalisation of loans refinancing by markets instead of banks (the “Fintech” initiative) and a change of strategy vis-à-vis RBS occurred. Overall, investment and growth rebounded earlier and stronger than in France even though the health of the UK banking sector may have been more affected by the crisis than that of the French one.

Overall, collective action alone does not present sufficient proof of policy optimality. What collective action proved, however, is that the views of the government and the views of the banking system were consistent enough, at a given point of time, for each side to be satisfied. Still, collective action of banks does not guarantee the best or more efficient outcome across time. Bail-outs have durable consequences which have to be considered across time, affect future economic growth and investment and, hence, cannot be equated to expectations, at the moment of the bail-out, of the corresponding direct fiscal costs.

Moreover, these direct costs constitute only one of the elements to be considered by authorities in a financial crisis. Other elements include: the dimension and exhaustiveness of the bail-out plan, which itself depends on the process followed by authorities and their strategy; the ability of authorities to avoid fire sales when they are dangerous; their ability to avoid the abuse of this argument when political consequences of delayed sales bear excessively on the ability to launch the necessary restructuring of the economy. Consequently, an optimal reaction by financial authorities and institutions to a crisis is a complex strategic process rather than the result of a simple power exercise by the State and its banking sector at the time of a bail-out. It involves almost continuous and rapid learning with repeated adjustment of positions. Its success can only be assessed once the business cycle has reverted to growth.

Power of “in action” or power of “learning in action”?

According to Woll, a successful bail-out reflects solely the power of “inaction” of banks which is conditioned by the structure of the banking sector and current discursive practices. However, a successful bail-out process does also embody the ability to “learn in action” of authorities and market participants.

Learning in action obviously refers to the general theme of “policy learning” which has attracted a considerable body of literature in economics and in political science. But I prefer to use the words “learning in action” for the following

reasons¹. First, I am not sure that there ever exists an optimal policy to be learned in a field as political as the one of bail-outs, even if believing in such existence is helpful for innovating and hence for learning. Moreover, referring to “learning in action” emphasizes the concrete, timely and informative nature of the corresponding accumulation and use of knowledge, thereby taking into account some of the personal dimensions of learning and acting in that field. Third, this also fits with the notion of quality of the legal and political process, which recognises that relatively close political or legal environments may yield rather different results and hence forces the identification of the interests at play.

For instance, dealing almost simultaneously with banking and non-banking sectors, as done in the US, helps avoid that one of the two channels of intermediation in the economy remains clogged and ends up overburdening the other channel. For an exaggerated reliance on one of these channels like in the Euro Area usually leads to an ad-hoc and therefore unfair selection of the beneficiaries of the remaining channel. In particular, the funding of small business projects may get discriminated. The ability to assess the existence of such issue in due time and to react to it is crucial.

Of course, this depends also on the usual structure of financing. When bank concentration is high and the use of market finance is very constrained, this reinforces the risk of low financing, especially to small firms, as in the UK and France or in the Euro Area peripheral countries. When bank concentration is lower and some banking networks have privileged relations with small and not so small firms, like the German Sparkassen usually have with the so-called German Mittelstand, such risks are mitigated or even absent.

However, such considerations are all the more relevant that solutions to these issues are not easy. The reliance of firms on financial markets instead of banks for financing cannot for instance be a full-proof solution: as many aspects of services to businesses are not yet digitalised, large firms are usually more stable in their functioning than small ones. This, in turn, makes stock prices more stable and thus, financing by markets easier and cheaper for large firms, and for the investors and the financial institutions that support them. This advantage to large firms, although diminishing across time, does not disappear when markets get deeper and remain substantial, as evidenced by the US performance.

Moreover, the arguments above should not be the basis for detracting from use of collective action whenever attainable. Dealing with the banking sector as a whole in a bail-out rather than bit by bit not only limits the costs of a

¹ But I can refer the interested reader to a very succinct report on that theme by René Kemp and Rifka Weehuizen available at <http://survey.nifu.no/step/publin/reports/d15policylearning.pdf> under the title: Policy learning, what does it mean and how can we study it?

bail-out to the budget but it allows playing the banks' respective interests against each other. This may permit, when legally possible, a more expeditious, cheaper, and hence more credible bail-out process, as in the case of Denmark. Indeed, Woll's support of collective action is particularly relevant when comparing Ireland and Denmark.

Furthermore, another occasion to learn and perform "in action" and one of the most difficult strategic choices for authorities is their role in the prevention of "fire sales" given the current degree of liquidity in the economy across the bail-out process. At the apex of the financial crisis, the constitution of "bad banks" prevented fire sales and avoided too many assets being liquidated below their equilibrium or fair value price. It makes sense that assets that are of sufficient quality and were bought at a reasonable price should be stored for some period of time.

However, once the central bank has made liquidity largely available to the economy and market-makers are ready to make the market again, it is also essential to recognise such ability and let them operate. Delaying sales excessively may delay the recognition that equilibrium prices are usually lower than hoped for by banks' managers. It may also end up encouraging the refusal of necessary losses and of the necessary restructuring of the economy. Somehow, keeping markets for some bank assets closed may by itself prevent the manifestation and in any case the recognition of equilibrium prices. The Spanish case was a prominent example of the failure to adjust to unpalatable equilibrium prices up to 2012 following a crash that started in 2006. This crash however, started speedily correcting itself as soon as the decision was made to take into account shadow prices and draw conclusions on the shape of the banking sector as part of a dedicated IMF programme. Hence, decisions have to be made in time and at the right prices. This is particularly challenging.

Learning in action and quality of the legal and democratic process

Lastly, the political and legal environment plays a more important role in the process of "learning in action" than usually surmised. This political environment may complement and sometimes help correct or adjust the outcomes of the bail-out, thereby allowing a wider expression of public interests and hence a better result². Somehow, it cannot be separated from the learning process itself.

² See for instance Calomiris and Haber (2015): *Banks: Fragile by design?* Yale University Press.

While her book gathers all the relevant information, this point is not given adequate weight by Woll.

This may work “ex post” but also “ex ante”. The debate – current and past – between the Fed and the Treasury on the one hand, and the US Congress on the other hand, was a major factor in allowing, explaining but also focusing and limiting the ambition of measures decided by the two former institutions. It thus cannot be excluded that – and Woll might have wanted to consider whether – the relative inaction of banks has been rightly complemented by the extensiveness of the Fed action. Combined to the severity of the overall control imposed by Congress, this may have played a role in the relatively quick rebound of the US economy. Therefore, the debate over “Treasury-Finance nexus”, made public and possible by such process, may have –unwittingly- played a positive role.

For instance, in 2009 in the US, the discussion on the Glass-Steagall act repeal was still recent enough (1998) to provide Congressmen an easy comparison of its original objectives with its actual consequences. The memory of those discussions certainly helped support the voting of the Volcker Rule and its separation of proprietary trading from banking activities. This does not however reveal ignorance or contempt of the power exerted by the banking sector. Rather, taking into account the strong interests of large investment banks in maintaining their trading activities and the concentration of the banking sector, such a separation certainly appeared more palatable than a simple return to the Glass-Steagall act and its geographical separation. In turn, this allowed the US to organise strong bank stress tests much earlier than in the Euro Area and was instrumental to the recovery.

Also, it is true that the first presentation of the Bernanke-Paulson package first led to a Congress outcry. However, the Congress elicits regular statements from the Fed Chairpersons, auditions him/her and the Fed Governors on the basis of their economic qualifications. Hence, it could hardly ignore for long the best advice of Ben Bernanke, Fed Chairman and former academic turned into the most reputed world expert on large financial crises at the time of the Great Recession. It is not astonishing then that the first “no” of the Congress to the plan proposed by Messrs Bernanke and Paulson was followed by a “Yes if” accepting its main characteristics, in particular its size and systematic aspect but adding much transparency to it. Moreover, the credible Congress monitoring encouraged the relative cheapness of the package in terms of price per security, strengthening and justifying ex post the notion of stigma felt by some bankers at the time but explaining with hindsight the finally limited cost of the US package to the US taxpayer.

In the UK, the public debate was also extensive but took different shapes. The survey of the Bank of England action undertaken by the House of Lords also played a role in the gradual re-assessment of the importance to be given to sufficient credit to small businesses and of the role of institutions associated to the monitoring of financial stability. However, the UK historical tradition which has since the nineteenth century stressed the dependence of good credit to small businesses on the combined action of the Bank of England and of the British Treasury, may have played a bigger role than elsewhere and conditioned more directly the actions of the Government.

In France, by contrast, the debate remained fairly limited and technical, was originally concentrated on commitments by banks to maintain credits to small firms that floundered when the constraints from Basel ratios became prominent. Only very lately, have some initiatives of support to start-ups been undertaken.

Finally, the Euro Area has collectively shown the importance of this symbiotic political and legal process in several ways: its absence transformed a crisis which seemed to originate from the US into a crisis with some of its roots in the Euro Area in 2011–12. This led to the creation of various new institutions (ESM, ESFS), to the definition and legalisation of specific operations like the ECB's OMT programme and the devolution to the ECB of supervisory responsibilities. These steps allowed the Euro Area to face another episode of the Greek crisis in 2015, but also epitomised the roles played by national politicians and Parliaments together with the European Parliament, in order to arrive to a consensus.

To conclude, the power of inaction is only one (important) part of the story explaining bail-outs. A fuller story should include at least two other factors: the ability to learn in action and the quality of the accompanying legal and political process. That said, "The Power of Inaction" is a worthy and hugely valuable insight into the recent financial crisis and the role, reasons and characteristics of the associated bail-outs.

Acknowledgments: The opinions presented in this article are mine and do not necessarily reflect the views of the ECB or even its discussions. I am therefore fully responsible for any mistake or error. I thank the Editor and reviewer of this Journal, C. Woll, as well as M. Sudrow for their comments.