

**Fragile by Design:
Banking Crises, Scarce Credit,
and Political Bargains**

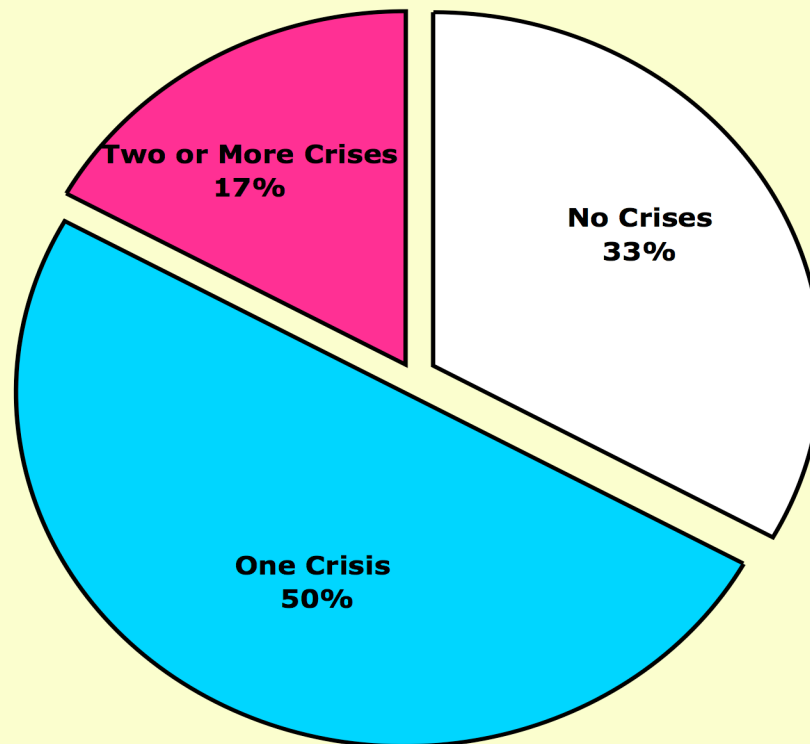
By

Charles W. Calomiris and Stephen Haber

(Princeton University Press, forthcoming)

Fact 1: Systemic Banking Crises are Endemic

Figure 1
The Frequency of Systemic Banking Crises, 1970-2010



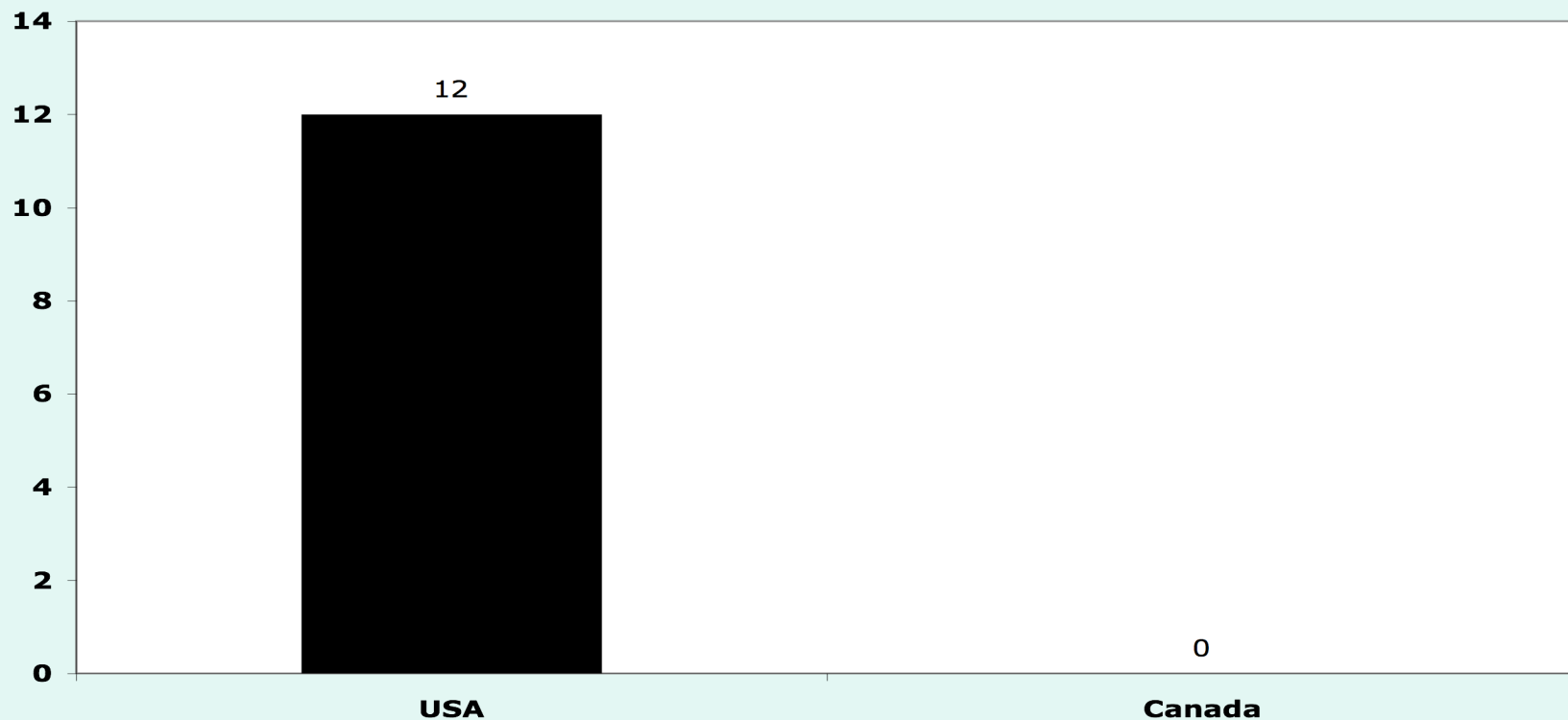
Fact 2:

The countries that are especially crisis prone are not a random draw

They are: Argentina, the Democratic Republic of the Congo, Chad, the Central African Republic, Cameroon, Guinea, Kenya, the Philippines, Nicaragua, Brazil, Bolivia, Costa Rica, Thailand, Mexico, Ecuador, Colombia, Uruguay, Chile, Turkey, Spain, Sweden,and the United States.

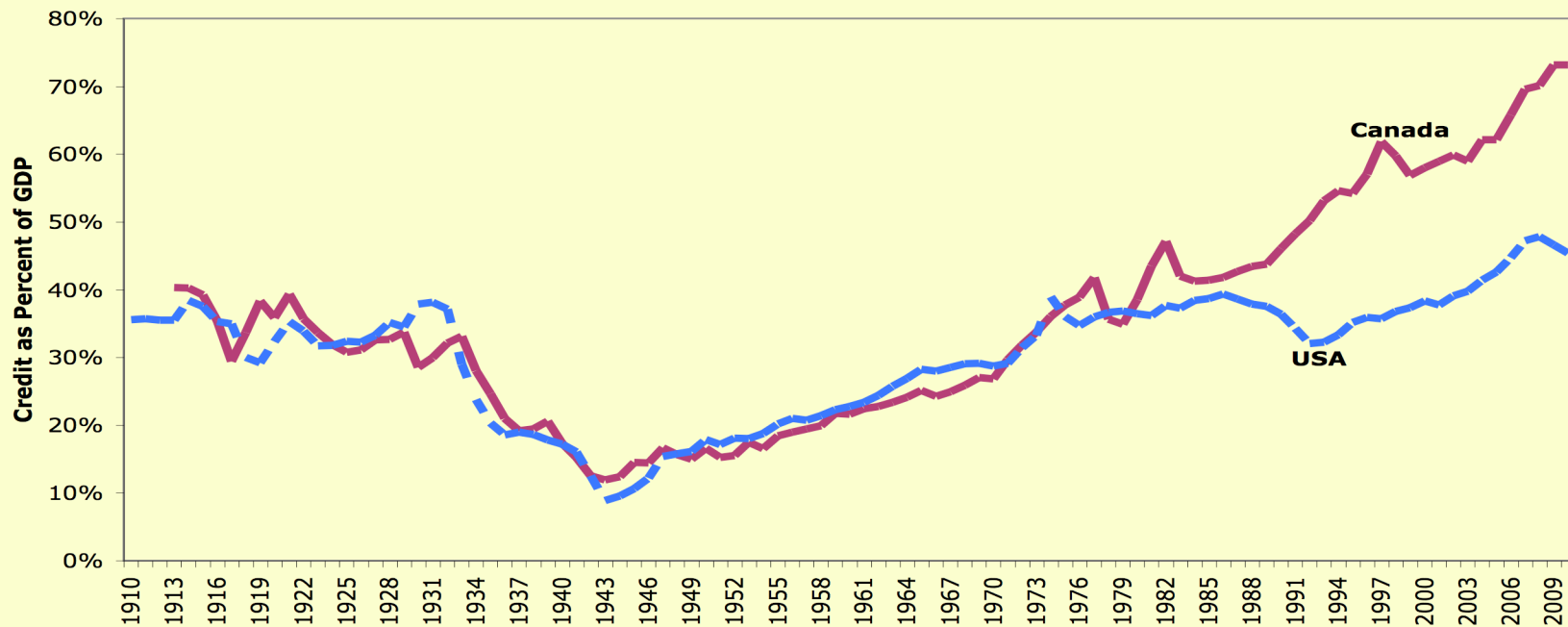
The USA is not in this list of crisis-prone countries by accident

**Number of Systemic Banking Crises Since 1840,
Canada and the USA**



The difference in stability between the USA and Canada is not a function of lower levels of credit in Canada

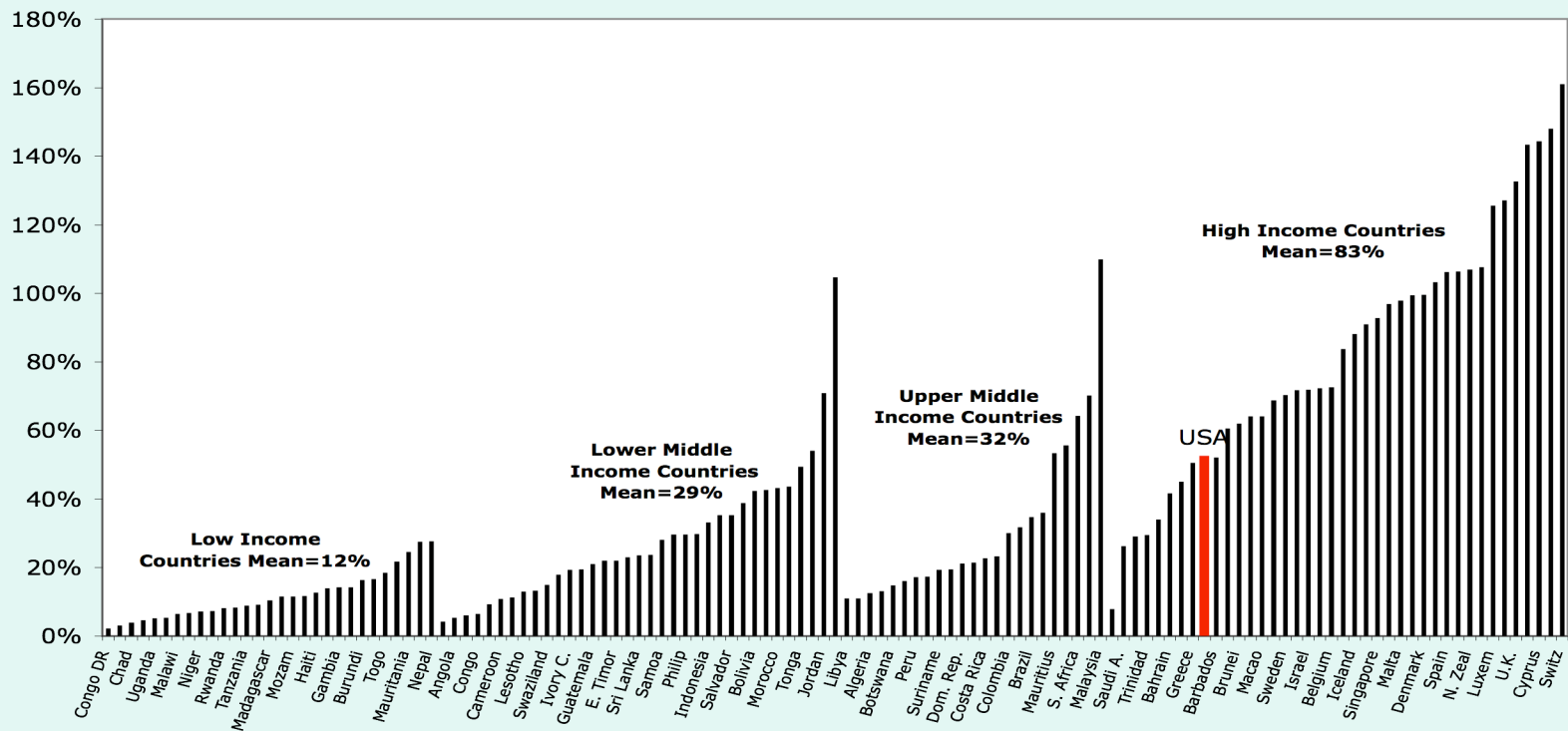
Figure 8.1
Ratio of Commercial Bank Private Credit to GDP,
Canada and the United States, 1910-2010



Source: Historical Statistics of Canada, Bank of Canada Statistical Review, Bank of Canada Review; Federal Reserve, All Bank Statistics, Bureau of Economic Analysis, Banking and Monetary Statistics, FDIC website. Canada series excludes foreign lending.

Fact 3: Scarce credit is also not randomly distributed

Figure 2
Private Bank Credit as Percent of GDP,
Average 1990-2009, by Income Groups



Source: Calculated from World Bank Financial Structure Database (2010).

Exactly how many crisis-free,
abundant credit countries are there?

Only 7!

- Singapore
- Malta
- Hong Kong, China
- Cyprus
- Australia
- Canada
- New Zealand

Half of these are small island or city states.

The other half are democracies that have anti-populist
constitutions.

The puzzle of *Fragile by Design*

If finance is so good for growth, why are stable and efficient banking systems so rare?

The Answer of *Fragile by Design*

Politics are “baked into” the property rights systems that underpin banks.

Thus, countries do not “choose” their banking systems in any coherent meaning of the word.

Rather, countries get the banking system that their political institutions will permit.

In order for there to be a banking system, three property rights problems have to be mitigated

1. Majority shareholders, minority shareholders, and depositors must be protected from expropriation by the government.
2. Depositors and minority shareholders must be protected from expropriation by majority shareholders.
3. Majority shareholders, depositors and minority shareholders must be protected from expropriation by debtors.

Solving these problems requires government, but governments have inherent conflicts of interest when it comes to banks

1. They simultaneously borrow from banks and regulate them.
2. They enforce debt contracts but need the political support of debtors
3. They distribute losses in the event of bank failure, but they need the political support of depositors

The implications:

1. Banking systems are implicit partnerships between governments and private actors.
2. That partnership is the product of a strategic interaction we call the “Game of Bank Bargains.”
3. The Game of Bank Bargains operates according to the logic of politics, not the logic of efficiency.
4. The game governs entry and competition, the pricing of credit and its terms, and the allocation of losses when banks fail.
5. Who is in the partnership varies across countries and within countries over time--because who is in the partnership depends on who is politically crucial.

A basic taxonomy of regimes and banking systems

Figure 1.1
A Taxonomy of Regimes and Banking Systems

Regime	Government	Banker-Government Partnership	Banking System	Outcomes
Chaos	None	None	None	No State
Autocracy	Absolute Power	None	None	Poverty Trap
	Centralized	Rent Creating & Rent Sharing Network	Narrow Credit, Locally Stable	Strong State
	Weakly Centralized	Inflation Tax Sharing between Oligarchy and Autocrat	"Float" Banking	Mid-Strength State
	Local Oligarchies	Little or No National Chartering	Small, Fragmented	Weak State
Democracy	Liberalism	Competitive Banking with Taxation	Broad Credit, Stable	Powerful State
	Populism	Welfare State Moves Banks out of the Line of Fire	Limited role for Banks	Mid-Strength State
		Politically Determined Credit	Broad Credit, Unstable	Powerful State

In order to show how political institutions and banking systems co-evolve we...

Look at what actually happened in five countries from the late 17th century to the present

England

The United States

Canada

Mexico

Brazil

Our five cases allow us to show each of the possible states of the world

England: Initially a crony system based on rent-sharing; later a system based on competitive banking with taxation.

The USA: Initially based on crony rent sharing; but dominated by populist banking since the 1820s.

Canada: Competitive banking with taxation.

Mexico: No banking at all until 1880s, then crony banking until 1990s; increasingly competitive and stable since democratization.

Brazil: Inflation tax banking from 1808 to 1994; increasingly competitive and stable since democratization.

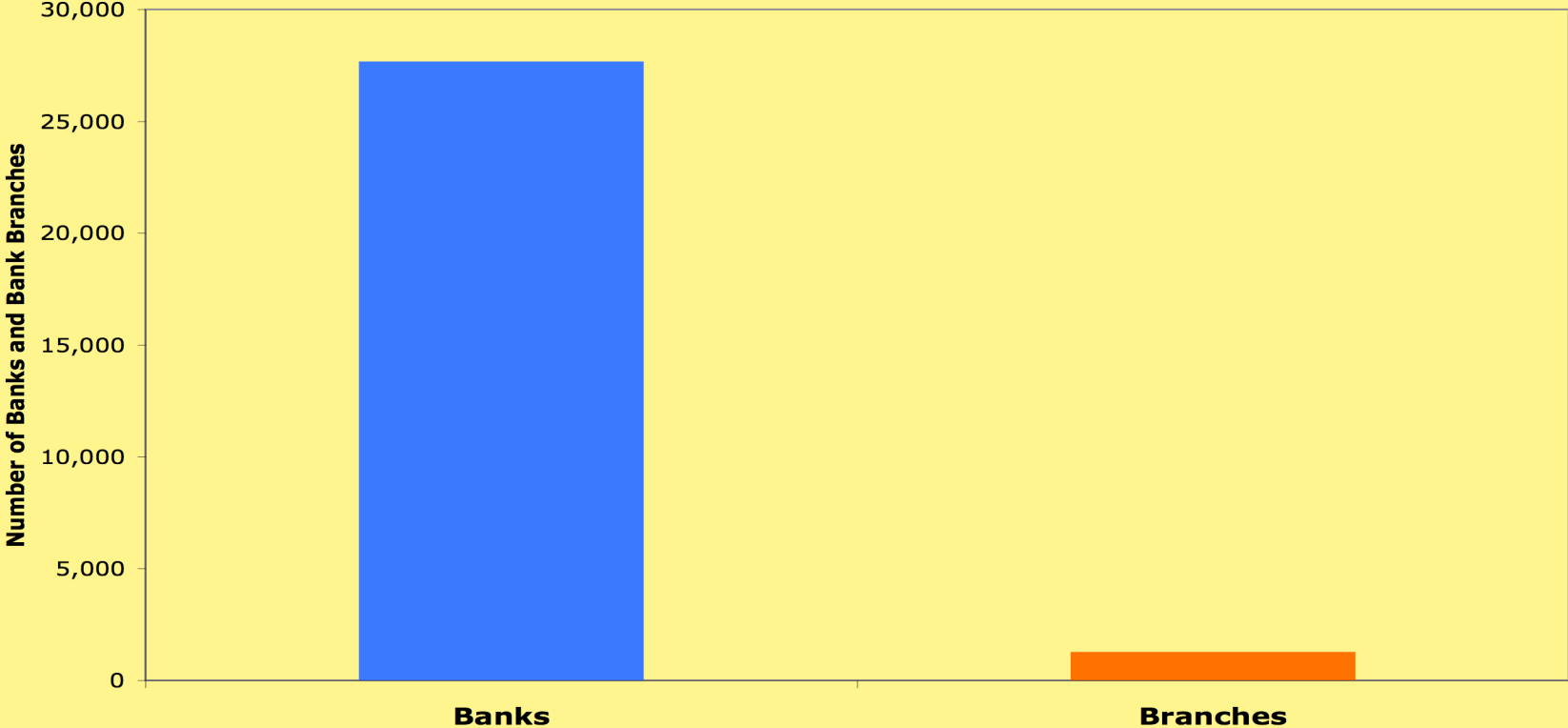
A glimpse into what we do

A brief history of the U.S. Banking System.

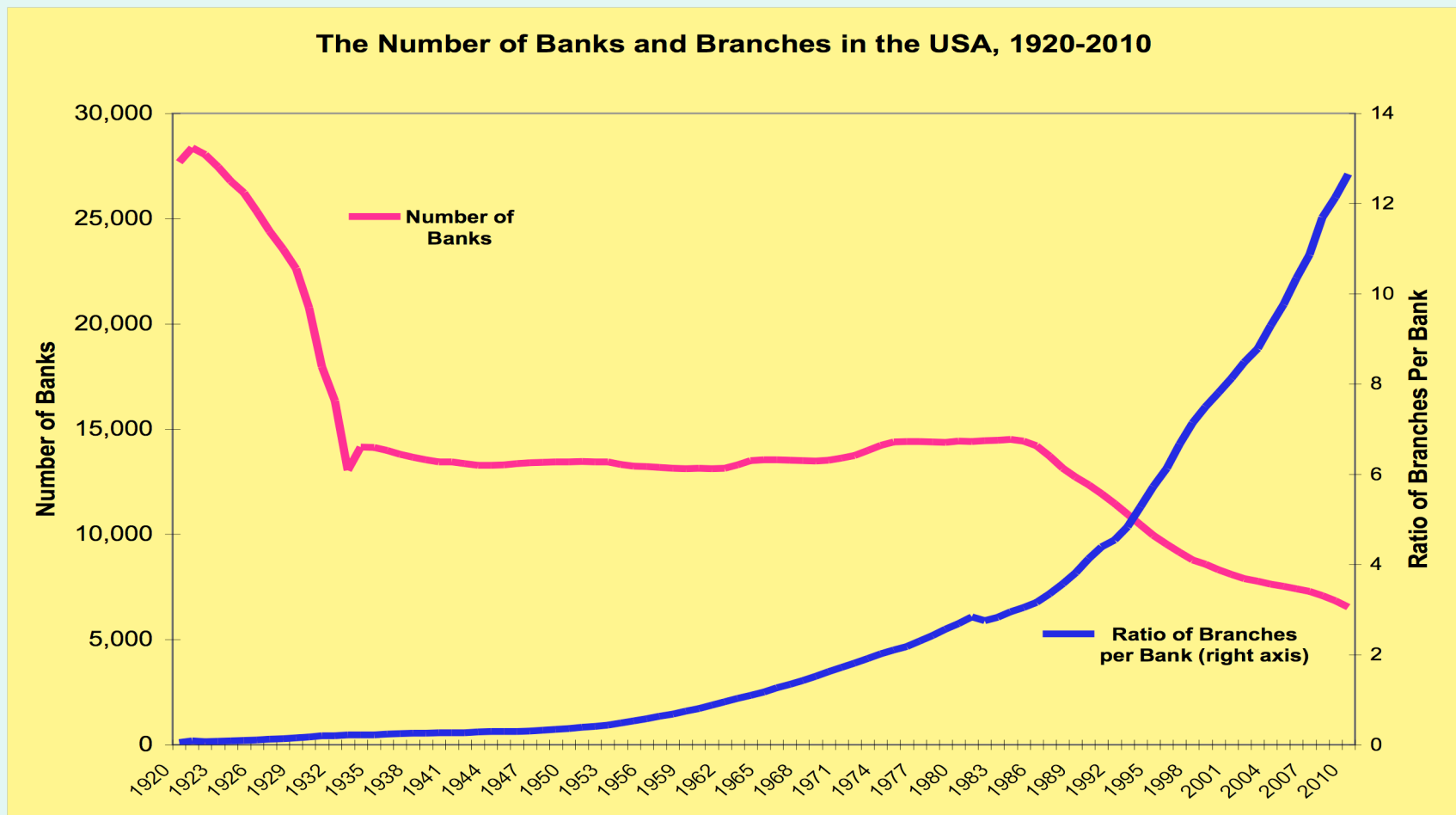
1. Populism versus liberalism at the outset.
2. The government--large banker partnership of the early republic.
3. Hamilton's undoing. The unit banker-
agrarian populist partnership of 1830-1980.
4. The government--large banker--urban
populist partnership of 1980 to the present

The Populist outcome in the United States: 27,000 banks, but almost no branches

**The Peculiar Structure of the U.S. Banking System, 1920
(A System of Tens of Thousands of Banks, but almost no Branches)**



The death of the unit banker-agrarian populist coalition, and the rise of the large banker-urban populist coalition



Why are Canadian political institutions so different from those of the U.S.?

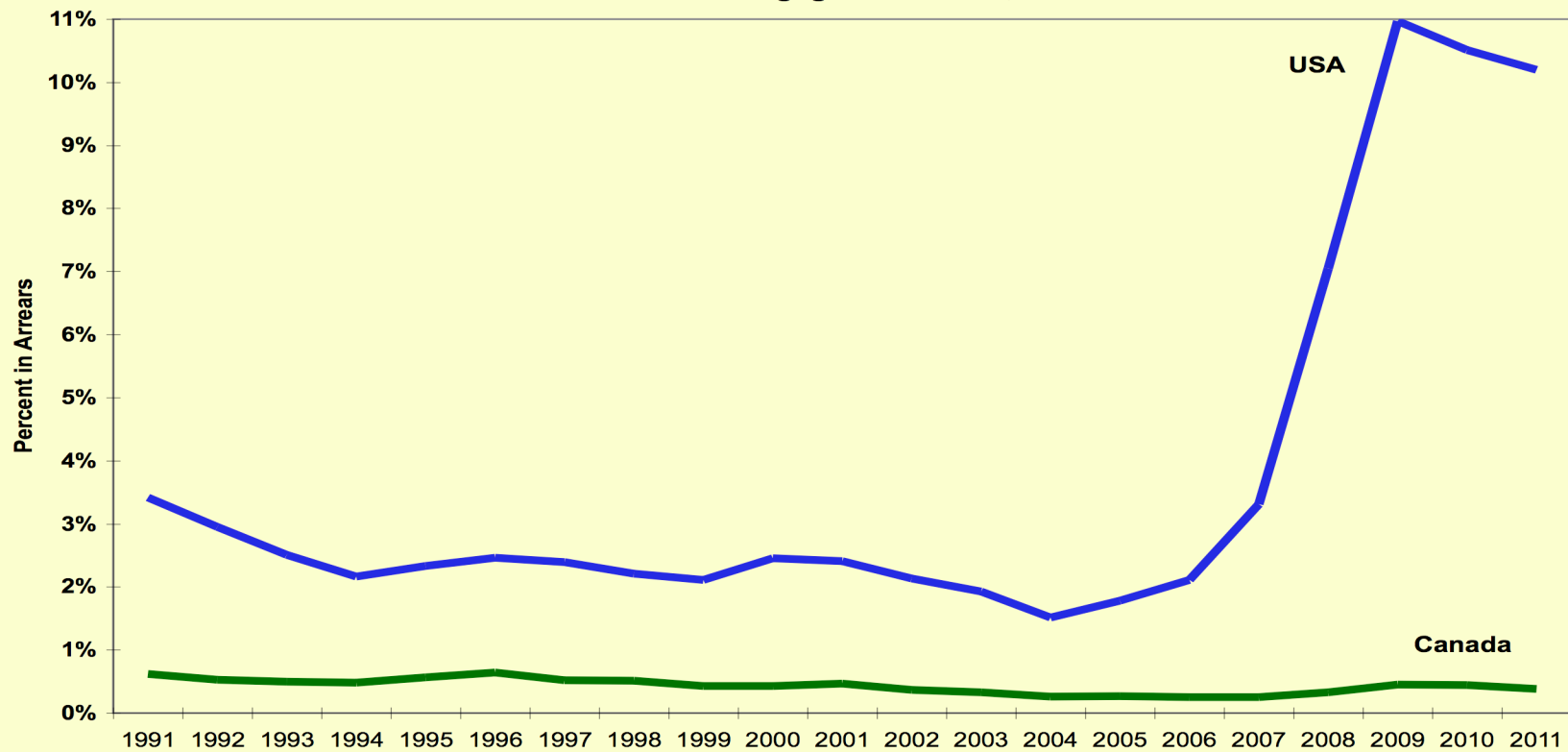


Implications for Canada's government-banker partnership

1. Banking policy in Canada was centralized in the national government; while banking policy in the US was historically left to the states.
2. It was therefore possible to build local rent seeking coalitions in the US, but not in Canada.
3. Not so in Canada, where populist banking proposals are always beaten back: Canada has had a system of a few large banks since 1817.
4. The limits imposed on the Canadian partnership by the franchise (the unusual nature of Canadian bank charters).

Liberalism versus populism in the subprime crisis

Figure 8.2
US and Canadian Mortgages in Arrears, 1991-2011



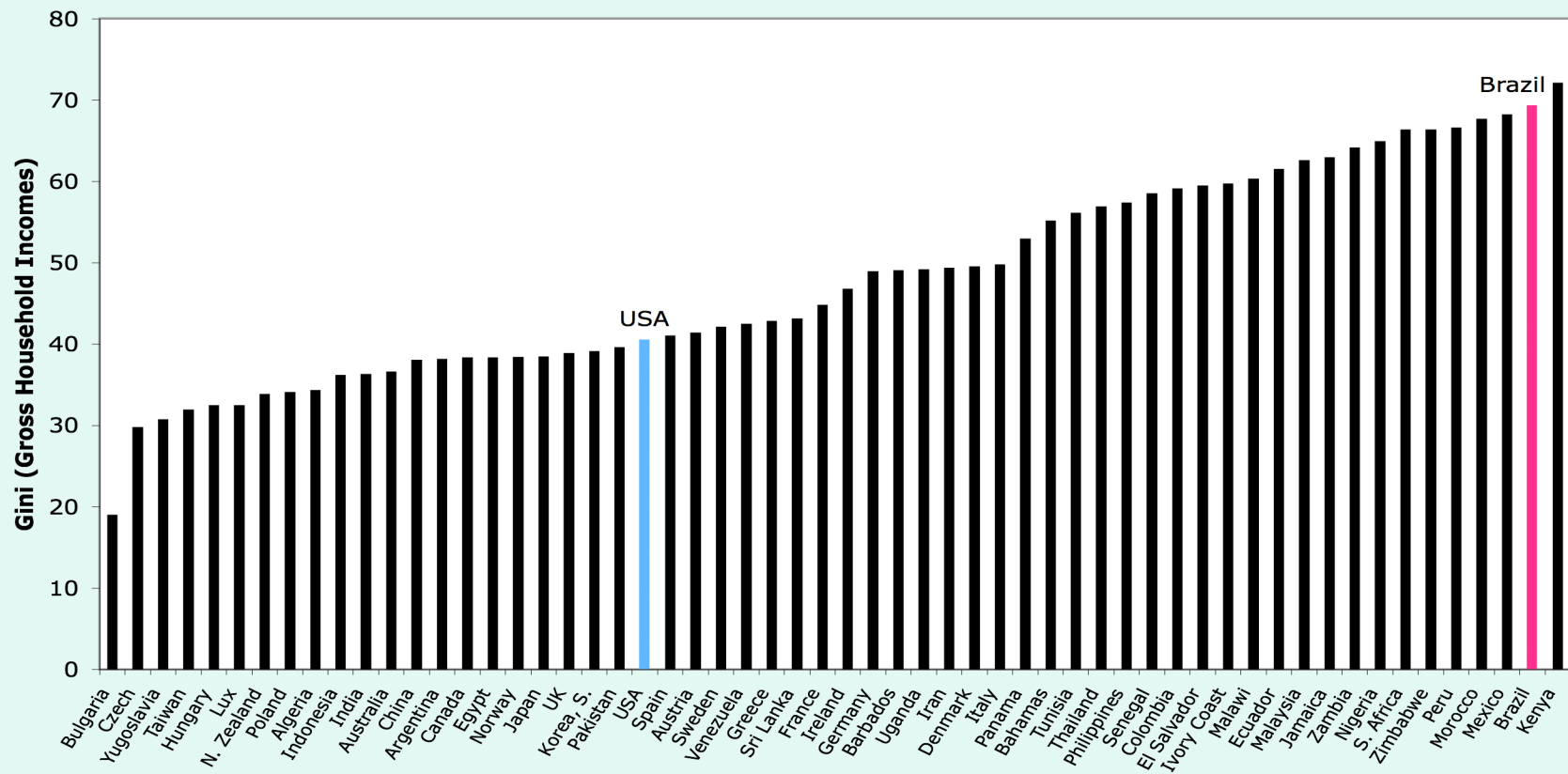
Source: U.S. Federal Reserve; Canadian Bankers Association. In the U.S., mortgages are in arrears after 30 days, in Canada after 90 days. Thus, the most meaningful comparison is the ratio of the two over time.

A brief history of Brazilian banking

1. Initial conditions and the fundamental political institutions of Brazil.
2. The inability to tax.
3. The answer: Inflation tax banking since 1808
4. Populist democracy, the end of inflation tax banking, and government banks as employment-creation machines.

The Defining Characteristic of Brazil: Inequality

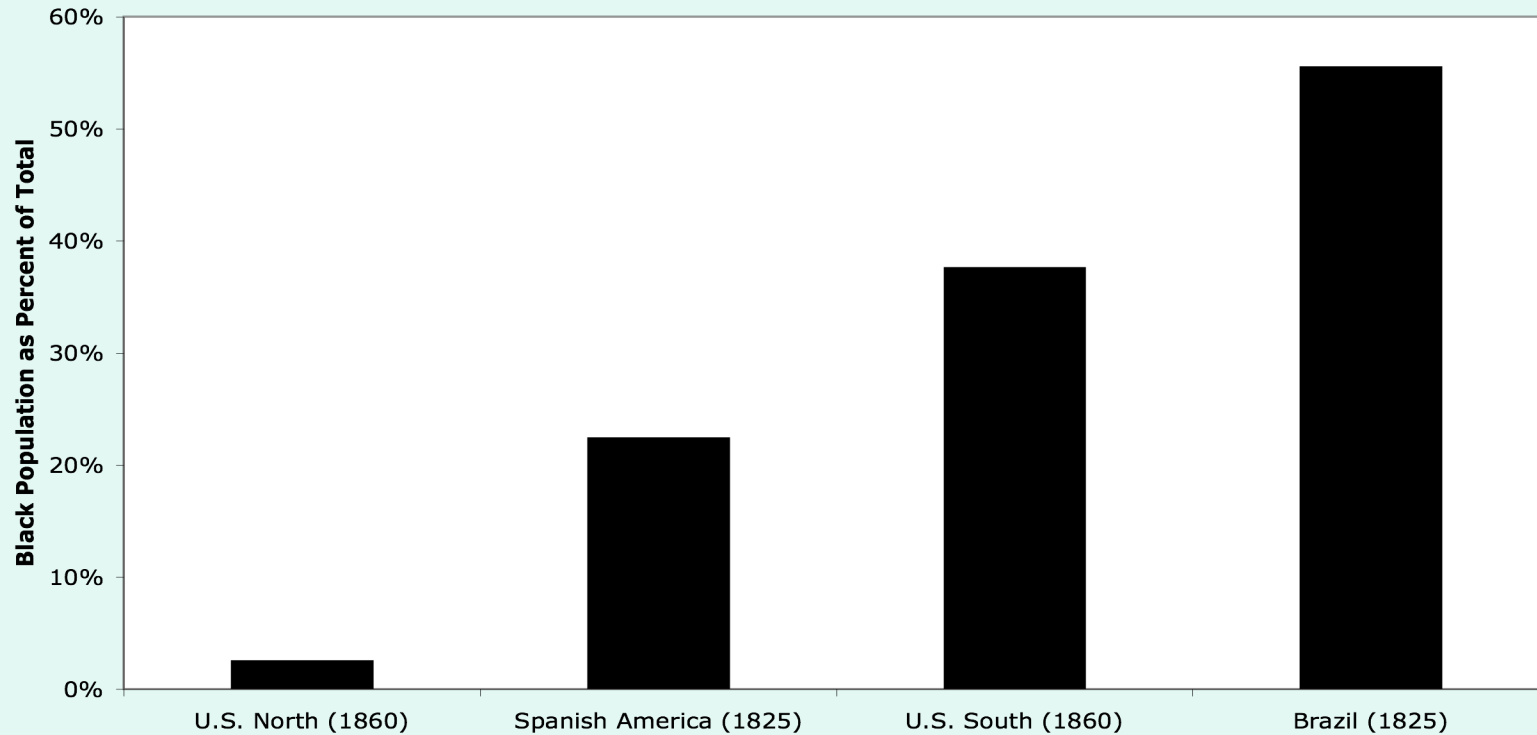
Figure 10.2
The Distribution of Income, by Country, 1970



Source: Solt 2009.

The roots of Brazilian inequality are found in plantation slavery

Figure 10.3
Black Population as Percent of Total Population,
New World Societies circa 1825-60



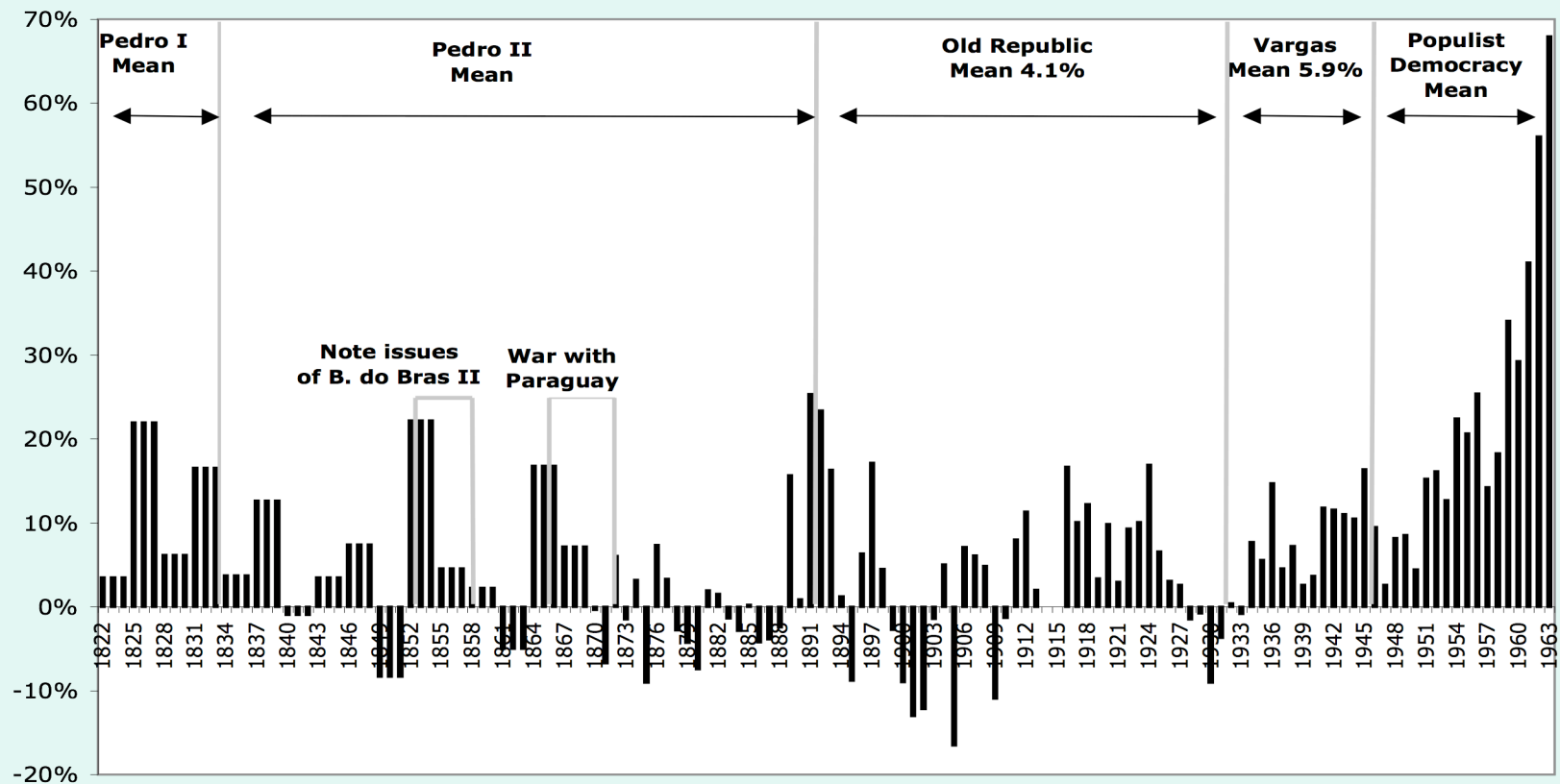
Source: Engerman and Sokoloff (1997).

The basic choice facing all Brazilian governments since 1808

1. Tax the rich.
2. Tax the poor through inflation
3. Have a poor, weak state.

The usual answer: inflation taxation

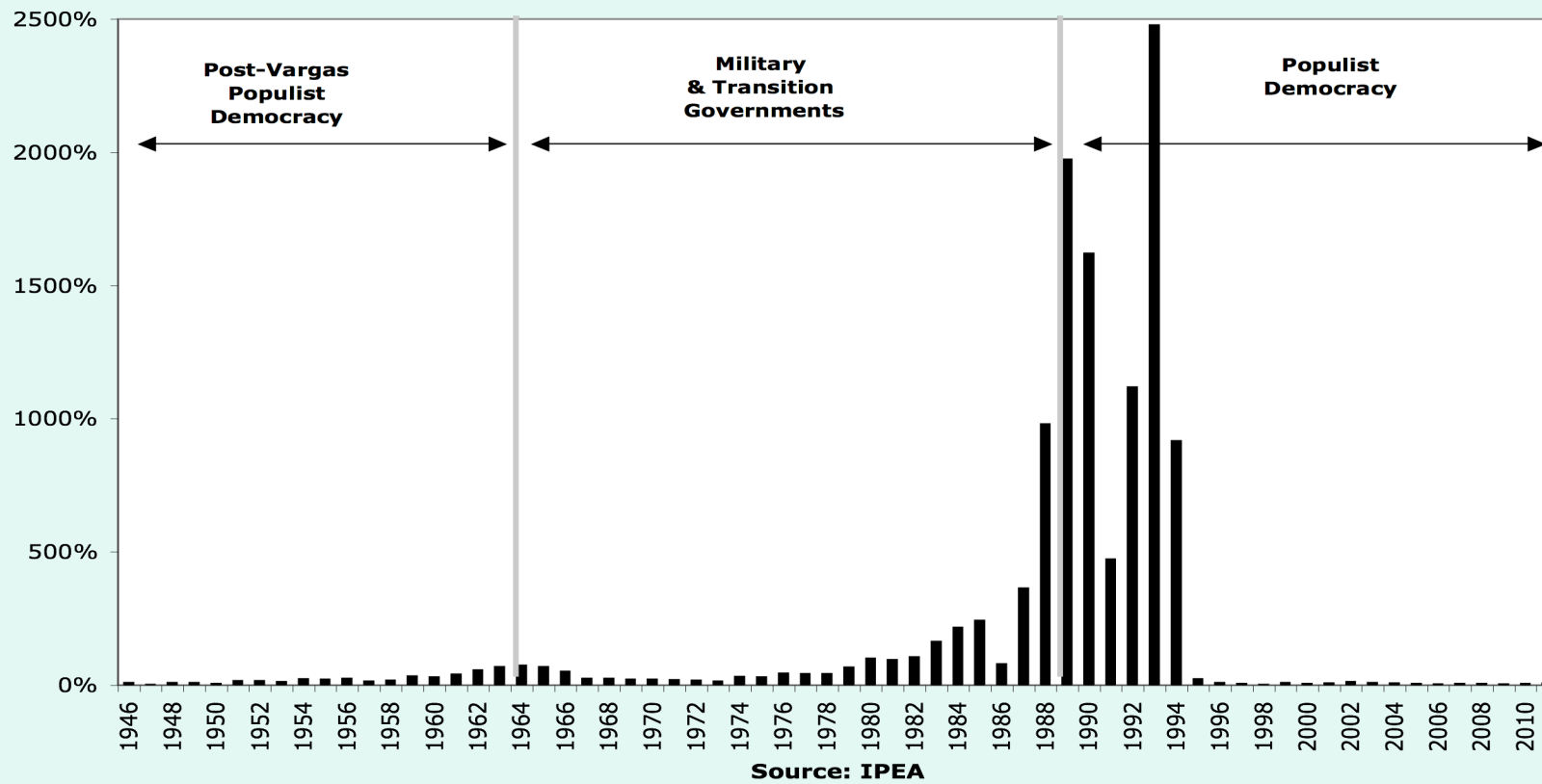
Figure 10.1
Inflation in Brazil, 1822-1963



Source: 1822 to 1870 data are 3 year averages; see footnote xxx.

Inflation taxation is not consistent with democracy

Figure 10.2
Inflation in Brazil, 1964-2011



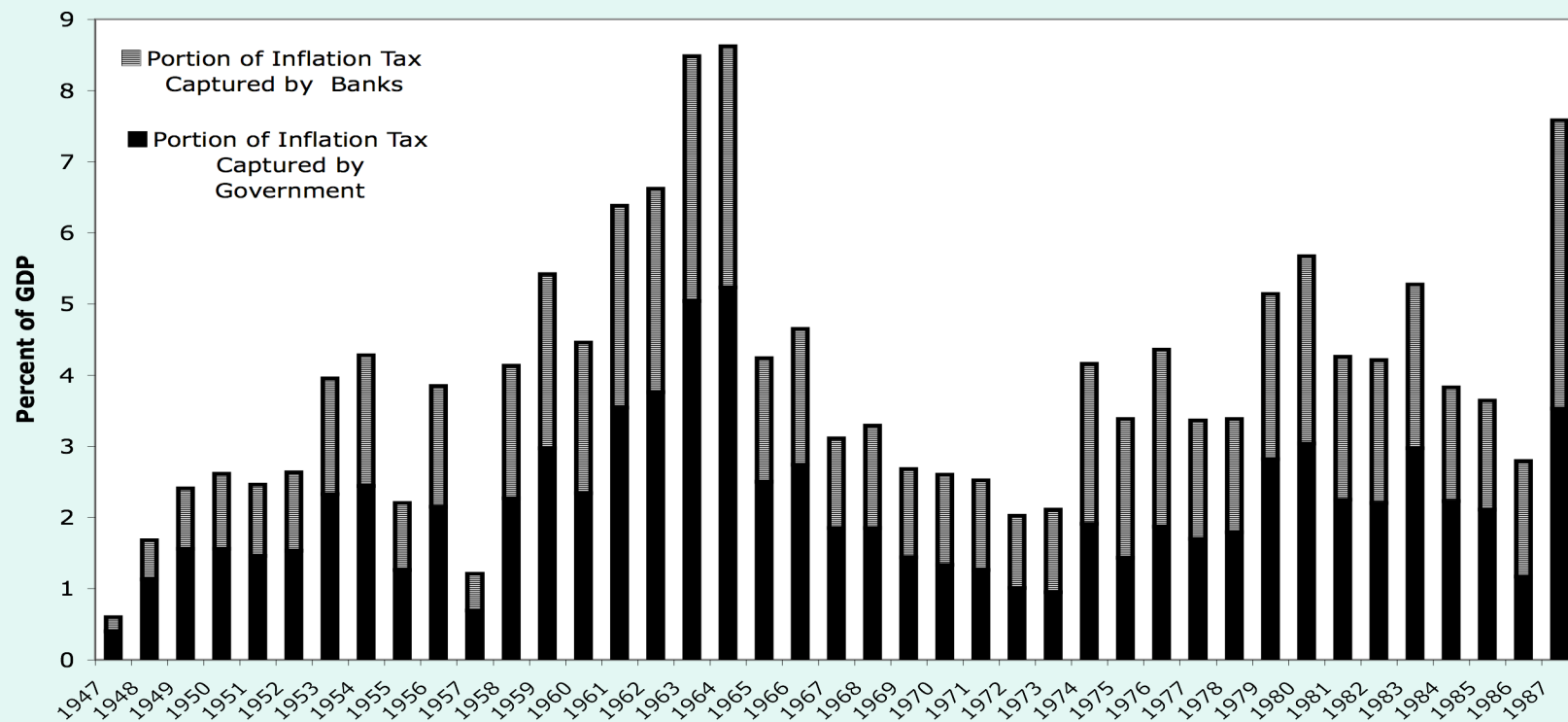
How can credit intermediaries operate under hyper-inflation?

Answer: If inflation runs at 100%, and the government decrees that checking accounts pay 0%, and that banks have to maintain large deposit reserves, banks get out of the intermediation business.

They go into the “float” business.

The Division of the Brazilian Inflation Tax, 1947-1987

Figure 11.X
The Inflation Tax in Brazil, as Percent of GDP, 1947-1987



Source: Lees, Botts, and Penha Cysne (1990), pp. 38-39.

So, did democracy bring credit intermediation in Brazil?

Not much, because:

1. Populist democracies make it easy for debtors to expropriate banks.
2. Populist democracies use banks to maintain full employment, not connect entrepreneurs with savers.

The largest banks in Brazil are still government-owned--and they're in the full employment business

Bank	Type	% of Assets
Banco do Brasil	Govt	18%
Itau	Private	16%
Bradesco	Private	13%
BNDES	Govt	12%
Caixa Economia Fedl	Govt	11%
Top 5 as % of all Banks		71%

Takeaways

1. There is no getting politics out of bank regulation. Politics is baked in, and that explains why few countries achieve abundant and stable bank credit.
2. Debates about “more versus less” regulation are a distraction.
3. Positive change is possible, but only within the constraints imposed by a society’s political institutions. (e.g., The USA cannot chose to have the Canadian banking system).