Fragile by Design: The Political Origins of Banking Crises*

János Szakács

Charles. W. Calomiris – Stephen H. Haber:
Fragile by Design: The Political Origins of Banking Crises
Princeton University Press, 2014, 584 pp.
ISBN: 978-0691155241

The stability of banking systems has received particular attention since the global economic crisis. Dysfunctional banking systems can cause substantial macroeconomic damage. Overly passive banking systems lead to suboptimal economic growth, while unstable banking systems result in more frequent bank crises, which in turn exacerbate the negative effects of economic crises and also directly increase taxpayers' burden, due to the costs of bank bailouts. *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* examines the underlying causes of the differences among nations in the occurrence of systemic banking crises. Starting from the case studies of five countries (United Kingdom, United States, Canada, Mexico and Brazil) the authors reached the conclusion that the occurrence of a systemic crisis is not random, but instead, it is a phenomenon entailed by the political establishment of each country.

There are significant differences by country in terms of the frequency of banking crises. According to the country list compiled based on the database of the World Bank and the IMF, of the 117 analysed countries, only 34 did not suffer any banking crisis, there was one crisis in 62 countries, two crises in 19 countries and three and four crises in 2 countries between 1970 and 2010. From these, the list of the countries that had two crises is of interest for us. In addition to Kenya, Nigeria, Brazil and Mexico, the list also features Spain, Sweden and the United States. By contrast, there was no crisis during that period of time in Canada, which is at the same level of development as these latter countries. So, the question is: how come developed economies are on the list of states that often suffer crises? How is it that certain countries suffer the burdens entailed by the instability of the banking system more than some others?

The authors claim that the answer can be deducted from the problem that is hiding in the book's title: banking systems are fragile by design. Governments everywhere have

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

János Szakács is Head of Department at the Magyar Nemzeti Bank. E-mail: szakacsj@mnb.hu

to face three main inherent conflicts of interest, and every government handles this differently, depending on its political institutions. On the one hand, governments are in charge of authorising and supervising banks while they also consider them as the key resource of their own funding. On the other hand, the government facilitates the enforcement of banks' claims vis-à-vis debtors, while it relies on the same debtors to support its political position. And thirdly, the government decides on how to allocate the losses among creditors and depositors in times of bankruptcies, while it strongly relies on the political support of the depositors. Consequently, it is an unavoidable conclusion that the factors fundamentally influencing the banks' operation are created not as the result of market processes, but to meet political interests, as part of some political game (the Game of Bank Bargains).

The political establishment and the development of the institutional system fundamentally define the outcome of the game. For example, an autocratic political leadership is unable to credibly bargain with the different interest groups, and in democratic countries the groups representing significant power through votes are also not able to interfere in governance by changing the political power. It is important to stress that a change in political structure only leads to the modification of bank bargains with considerable delay: the habits of the autocratic system only break down slowly in legal institutions. And finally, it is important to see that the organisation of the banking system is also essential in addition to the political structure: unstable systems can be created even in democracies, while even autocratic structures can lead to a stable banking system at least on a local level, through the functioning of the formation of different coalitions.

Table 1
Banking systems and state structures in different governmental establishments

Political establishment	Government	Relationship between government and banks	Banking system	State
Chaos	None	None	None	No state
Autocratic establishment	Absolute power	None	None	The "Poverty Trap"
	Centralized power	Profit distribution	Underfinancing, local stability	Strong state
	Weakly centralised	Distribution of inflation tax	Unsecured money market	State with moderate strength
	Local oligarchs	Few licensed banks	Small, fragmented	Weak state
Democracy	Liberalism	Competing, taxed banks	Broad financing, stable	Strong state
	Populism	There is no political pressure on the banks thanks to the welfare state	Limited role	Strong state
		Politically driven financing	Broad financing, stable	Strong state

Source: Figure 2.1 of the book

To come to the above conclusions, the authors use as case studies the historic development of the state establishments and the banking systems of some countries where the political establishment was formed through clearly distinct ways, which may also explain the different ways in which banking systems have evolved.

- **United Kingdom:** Over the past two centuries, the United Kingdom saw the alternation of constitutional monarchy, a narrow circle of citizens entitled to vote, a monopolised and unstable banking system resulting from the measures taken to establish a welfare state following the two world wars, and a competing and globally competitive banking system. The changing position of the banking system is well exemplified by the fact that in the 1960s the loans disbursed by banks represented only 20 percent of GDP, as opposed to the average value of 40 to 50 percent in Western countries and the 140 percent observed in the United Kingdom between 1990 and 2010. The city of London's role as a financial centre and the country's developed financial system are considered a novel phenomenon in a historical perspective, which changed in parallel with the political establishment.
- **United States:** The current form of the American banking system emerged only over the past 30 to 40 years. Until the 1970s the American banking system was composed of several tens of thousands of individual small banks. Due to state legislation, large banks were unable to open branches in other states, and in many states even the number of locally operated bank branches was limited. So the many individual banks led to a clearly risky, unstable, expensive banking system that, as a consequence, did not provide adequate financing, as economies of scale were left unexploited. Starting from the 1970s, urbanisation, more efficient ways to obtain information on credit worthiness thanks to technological developments, the spread of ATMs and the emergence of non-bank intermediaries as well as legislative reforms led to consolidation of the banking system. But the question inevitably arises: how did an efficiently functioning, highly competitive banking system lead to the recent financial crisis? The authors trace back both the formation of the so-called "too big to fail" banks and the spread of excessive risk appetite to the bargains between the banks and certain community groups and the ever-weaker lending conditions of refinancing mortgage loans of organisations enjoying governmental support, influenced by various political powers.
- **Canada:** Canada has similar historical and cultural origins to the USA, but there are major differences between the two countries in the historical evolution of their political establishments. One key difference which prevented the emergence of the small banks' system in Canada is that Canadian bank regulatory issues are decided on nation state level, and the political institutions established there were designed from the very start to counteract the influence benefitting certain interest groups. Consequently, only large banks with extended branch networks were created in Canada from the very start, the owners of which were

not motivated to create interest groupings with certain groups. According to the authors, these circumstances explain why not a single systemic bank crisis has emerged in Canada since the 1920s.

- **Mexico:** Mexico's example is used to compare democratic systems with autocratic establishments. In a country which practically operated without real electoral rights until the 1990s, Mexican governments usually strictly controlled access to the banking market, which ensured sufficiently high profits that could compensate the shareholders for the risk of expropriation. This arrangement led to suboptimal outcomes. Depending on the development of the specific political situation, either total chaos characterised the market (e.g. during civil wars) or only few banks were present that only financed those who belonged to the political elite. Although starting from 1997 most of the limitations were lifted as a result of which the proportion of the previously non-existing foreign owned banks spiked to 70 to 80 percent, and the banking system became stable, the access of households to financing has not improved at all compared to the early 1990s. The reason underlying this situation is that the legal instruments required for using and enforcing mortgage collateral needed in addition to the change in the shareholding structure have not yet been created.

- **Brazil:** Brazil is the model example of the alteration of the game of bank bargains, reflecting the changes that took place within the political institutions. During autocratic eras, the banking system was merely one of the instruments for collecting inflation tax. At the end of the 1980s inflation approached 2,500 per cent, while the banks and the government were able to split among them the inflation tax equivalent to 8 per cent of GDP. Banks were practically not lending, but instead, they pocketed the profit from the unpaid deposit interest earned during the time needed for financial transfers. But with the advent of free elections, this situation changed: by the mid-1990s inflation dropped to the level of the USA, and Brazilian banks started to lend. But even the current political structure has its downsides. The two largest banks are controlled by the government and according to the authors, they can influence the election results by granting sufficient financing to the business partners of certain candidates so that, in turn, they can increase employment at the companies within their spheres of influence.

Although the case studies are not fully representative, they can nonetheless provide a good basis for deducting certain trends. On the one part, in democracies, all other things being equal, more people have access to bank loans than in autocratic forms of state, but even democracies need some political institutions that render interest groupings among banks and certain groups more difficult. Considering the loan-to-GDP ratio as the indicator for measuring the volume of necessary lending and the number of banking system crises to be the measure of banking system stability, the authors conclude that the presence of democratic institutions increases lending activity, a core component of which is the strength of ownership. By contrast, excessively restrictive bank regulations usually characterising autocracies significantly reduce the loan offering and lead to underfinancing and systemic instability. Finally, excessive public safety nets may render the banking systems unstable, which are often created not out of economic necessity, but through some political arrangement.

These findings may shed new light on the current economic argumentation in connection with systemic banking crises. Although the well-known problems — such as excessive maturity mismatch at the systemic level, excessive concentration, the formation of networks, pro-cyclical decision-making, etc. — do indeed provide the foundation for the occurrence of systemic crises, the extent to which these problems exist depends on the decisions of the banks and the regulators, and these decisions, in turn, are shaped in line with the political establishment. If nothing prevents banks from assuming excessive risk by creating interest groupings with certain groups, or if banks are even encouraged to do so because of excessive public safety nets, these problems are much more likely to occur. And the different systemic shocks of political nature (wars, military takeovers, systemic changes, etc.) are also factors to be considered. Hence, in order to obtain a comprehensive picture, the existing theories must be supplemented with the components of political economy when making decisions.

The final lesson of the book is that despite the numerous negative effects of the game of bank bargains and the above described difficulties, historical examples also show that positive changes can also be achieved within the framework of the game. For this, however, it is necessary to understand the above described political processes and incentives, and to assess and understand the political institutions and historical context of the given country. Moreover, new options must constantly be contemplated, as it is far from certain that the previous political establishment tried to improve the situation of the banking system in every possible way.