

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

By

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(Princeton University Press, forthcoming)

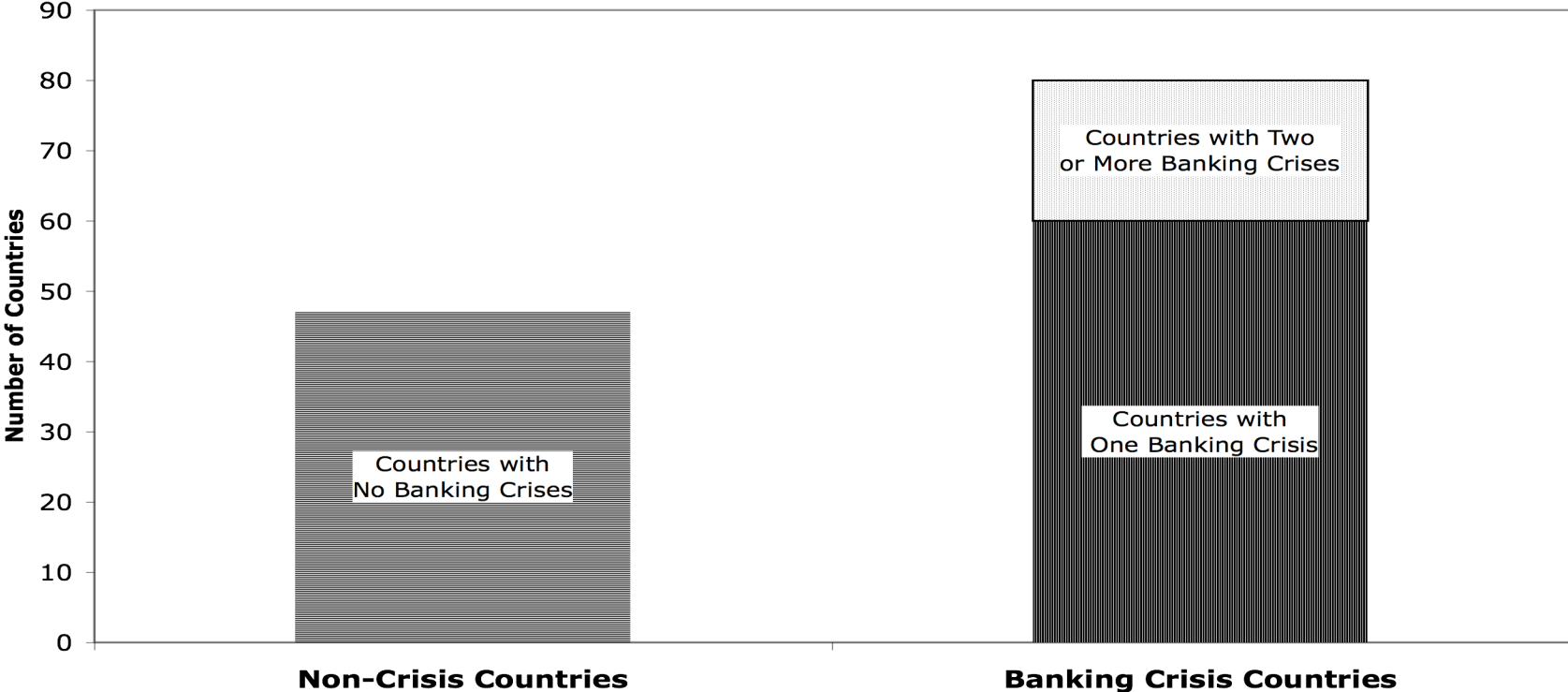
Who is *Fragile by Design* aimed at?

This is a book about the politics of banking crises directed at a **broad audience**.

But, in accomplishing that goal, we are simultaneously writing a book designed to change the way that academics and policy makers think about banking systems and bank regulation.

Fact 1: Systemic Banking Crises are Endemic

Figure 1.1
The Frequency of Banking Crises, 1970-2009



Source: Calculated from Data in Laeven and Valencia 2010;
and World Bank Financial Structure Database, 2010.

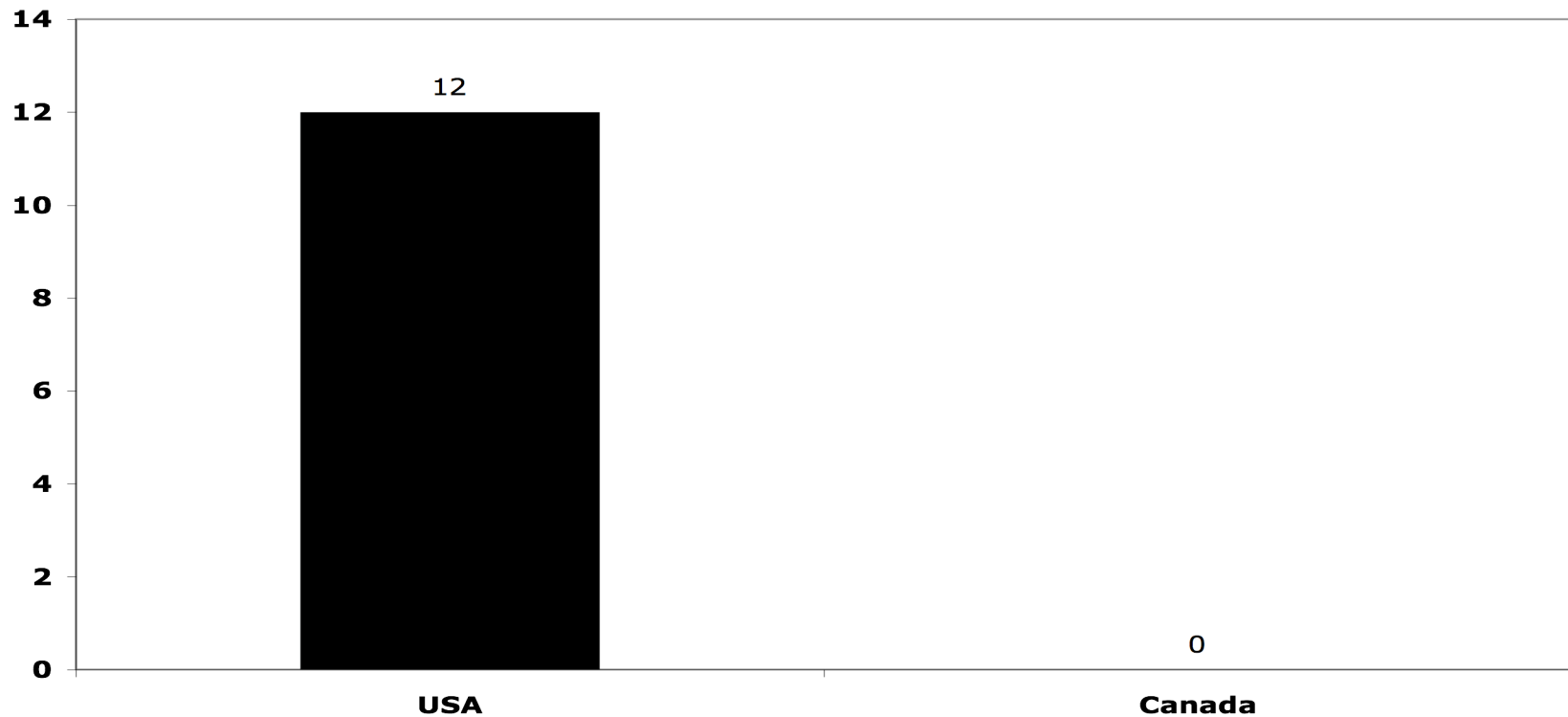
Fact 2:

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.

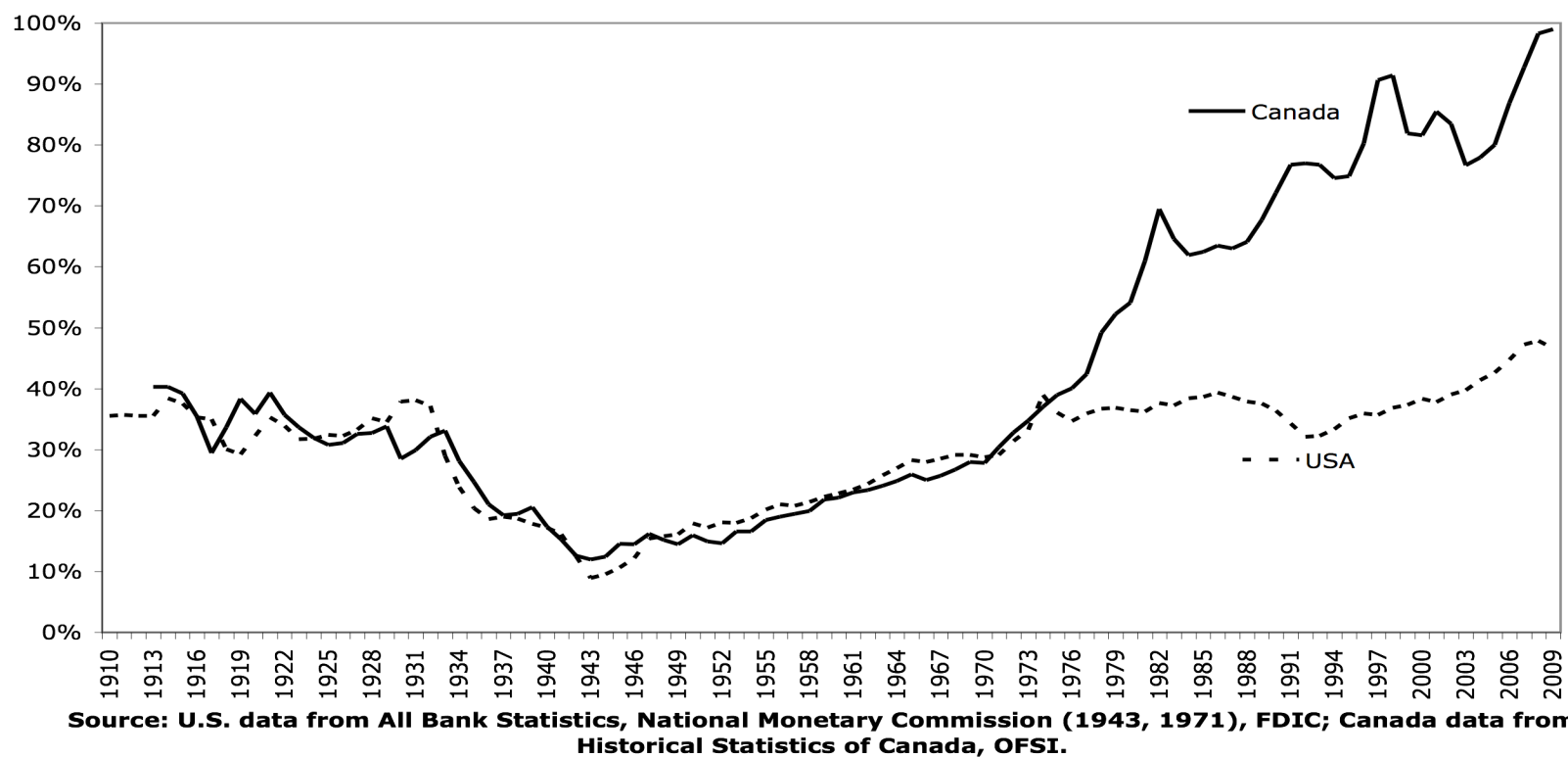
The USA is not in this list of crisis-prone countries by accident

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



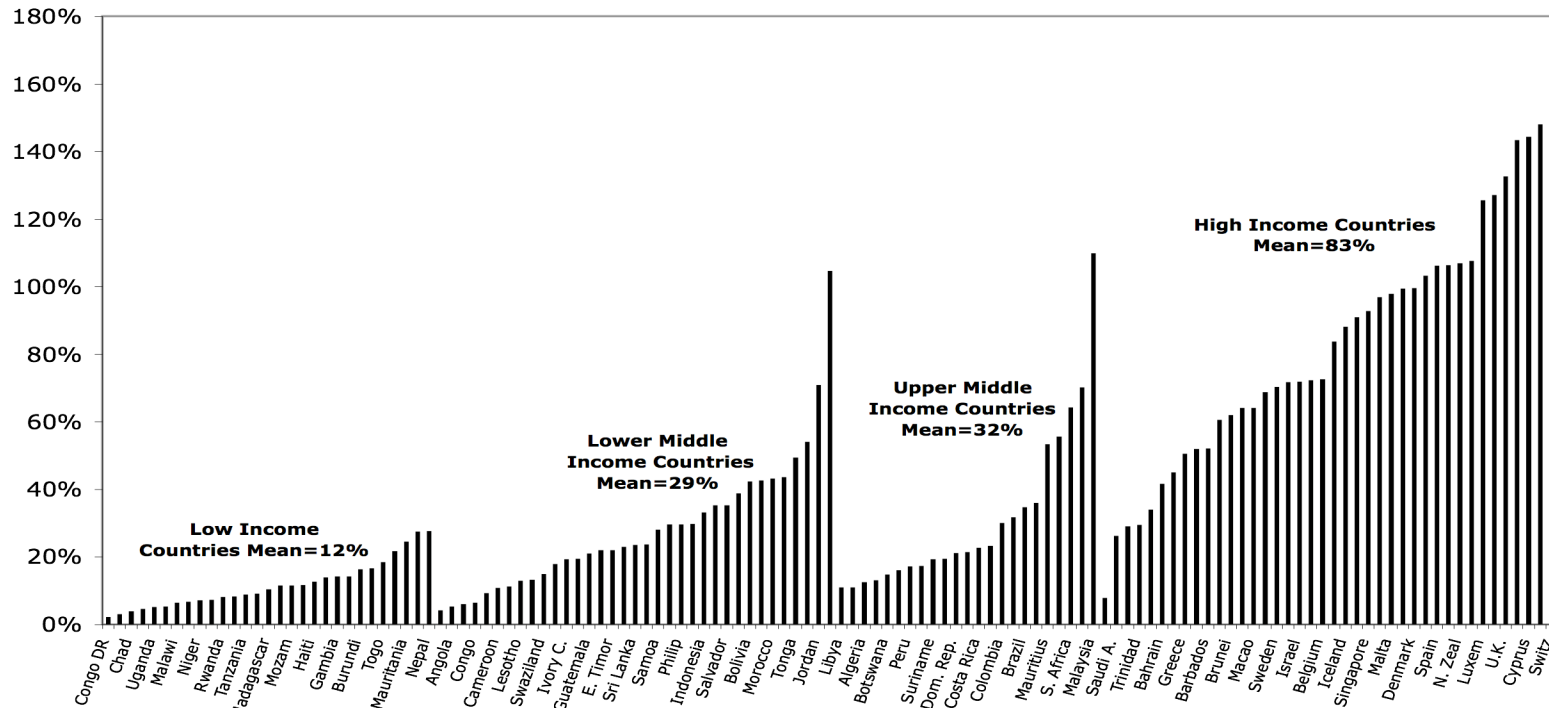
The difference in stability between the USA and Canada is not a function of lower levels of credit in Canada

Figure 8.1
Ratio of Private Credit from Commercial Banks to GDP,
USA and Canada, 1910-2009



Fact 3: Scarce credit is also not randomly distributed

Figure 1.2
Private Bank Credit as Percent of GDP,
Average 1990-2009, by Income Groups



Source: Calculated from World Bank Financial Structure Database (2010); Laeven and Valencia (2010).

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

Thirteen. They are:

Bahamas, Malta, Cyprus, Brunei, Singapore,
Hong Kong, Macao, South Africa, Italy,
Austria, New Zealand, Australia, and Canada.

Half of these are island city states.

The other half are democracies that tend to
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 core insight of *Fragile by Design*

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

1. Bank insiders, minority shareholders, and depositors must be protected from expropriation by the government.
2. Depositors and minority shareholders must be protected from expropriation by bank insiders.
3. Bank insiders, depositors and minority shareholders must be protected from expropriation by debtors.

These property rights problems are hard to solve because...

Almost all the institutions necessary require government--and 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. That game governs entry and competition, the pricing of credit and its terms, and the allocation of losses when banks fail.
4. Who is in the partnership varies across countries and within countries over time.
5. The political institutions of the country determine who has to be in the partnership.

In order to show how these partnerships work we...

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

Scotland

England

The United States

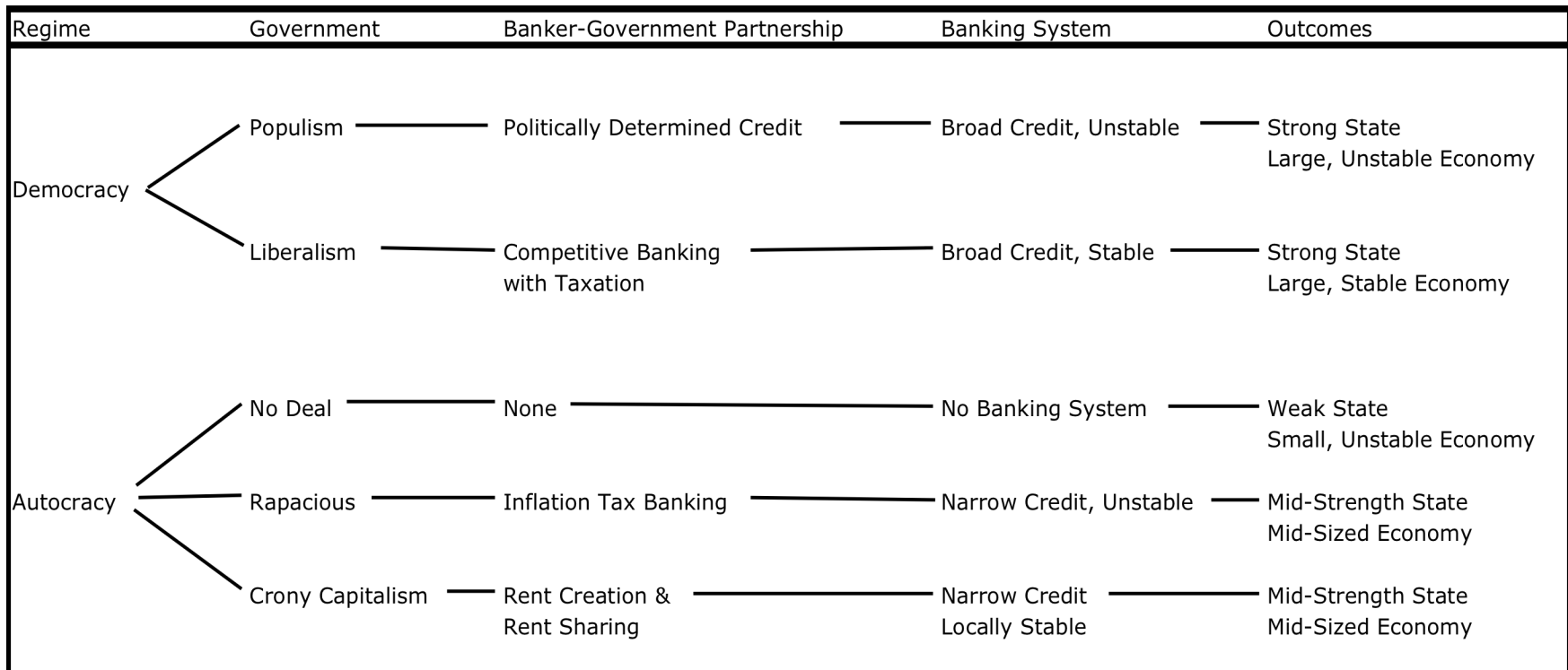
Canada

Mexico

Brazil

A theoretical framework emerges from six cases (consistent with other cases)

A Taxonomy of States, Economies, and Banks



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

Scotland: Competitive from the beginning.

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.

What explains the difference then?

US vs. Canada Comparison

1. Until the 1990s, banking in the United States was composed of segmented monopolies. There were thousands of unit banks.
2. The Canadian banking system has always been structured around a nationwide system of branching banks.
3. These differences reflect understandable and important differences in political history.

A glimpse into what we do

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

1. Original political conditions and fundamental political institutions of the USA.
2. The government--large banker partnership of the early republic.
3. The government--unit banker--agrarian populist partnership of 1830-1980.
4. The government--large banker--urban populist partnership of 1980 to the present

A brief history of Canadian banking

1. Original political conditions and the fundamental political institutions of Canada.
2. The government--large banker partnership, 1867-present.
3. The limits imposed on the Canadian partnership by suffrage.
4. The unusual nature of Canadian bank charters.

A brief history of Brazilian banking

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

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).
4. Part of positive change is for the public to understand the game of bank bargains while it is being played.