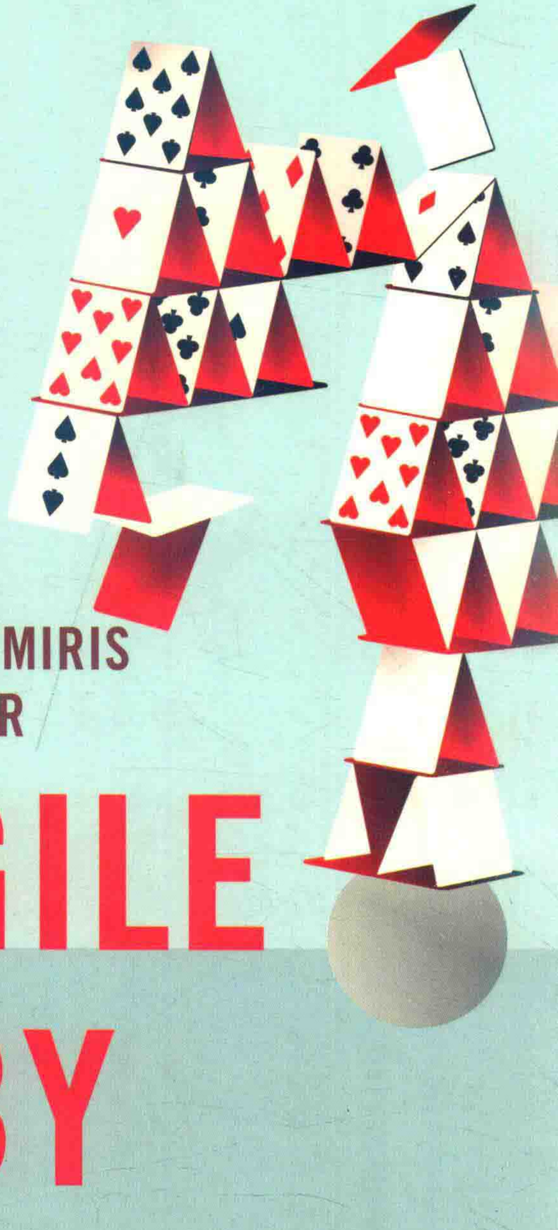
CHARLES W. CALOMIRIS
STEPHEN H. HABER



FRAGILE BY DESIGN

THE POLITICAL ORIGINS OF BANKING CRISES & SCARCE CREDIT

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The Political Origins of
Banking Crises and Scarce Credit

CHARLES W. CALOMIRIS *and* STEPHEN H. HABER

PRINCETON UNIVERSITY PRESS
Princeton and Oxford

Published by Princeton University Press, 41 William Street, Princeton, New Jersey 08540
In the United Kingdom: Princeton University Press, 6 Oxford Street, Woodstock, Oxfordshire OX20 1TW

press.princeton.edu

Library of Congress Cataloging-in-Publication Data

Calomiris, Charles W.
Fragile by design : the political origins of banking crises and scarce credit / Charles W. Calomiris and Stephen H. Haber.
pages cm.—(The Princeton economic history of the Western world)
Includes bibliographical references and index.
ISBN 978-0-691-15524-1 (hardcover : alk. paper)
1. Banks and banking—History. 2. Bank failures—History.
3. Credit—History. I. Haber, Stephen H., 1957– II. Title.
HG1561.C35 2014
332.109—dc23
2013033110

British Library Cataloging-in-Publication Data is available

This book has been composed in Sabon with Whitney display by Princeton Editorial Associates Inc., Scottsdale Arizona.

Printed on acid-free paper. ∞

Printed in the United States of America

1 3 5 7 9 10 8 6 4 2

FRAGILE BY DESIGN

The Princeton Economic History of the Western World

Joel Mokyr, Series Editor

A list of titles in this series appears at the back of the book.

TO OUR DAUGHTERS

Eleni Sophia Calomiris

Zoi Nicoletta Calomiris

Natalie Camila Haber

to do so, we integrate evidence and analytic tools from three distinct disciplines: history, political science, and economics.

We argue that banks' strengths and shortcomings are the predictable consequences of political bargains and that those bargains are structured by a society's fundamental political institutions. Citizens may be satisfied to blame the deficiencies of their country's banking system on the moral failings of bankers or regulators, or on "market failures" related to greed and fear, but when they do so, they miss the opportunity to see banks for what they really are, for better or worse: an institutional embodiment—a mirror of sorts—of the political system that is a product of a society's deep history.

This project grew out of our participation in the John and Jean De Nault Task Force on Property Rights at Stanford University's Hoover Institution. We had known one another for over two decades, and our paths had crossed at numerous conferences and workshops. It was within the De Nault task force, however, that the two of us first sat down together to explore three fundamental questions about banking that defined the starting point of this book: Why are some societies able to construct banking systems that avoid banking crises, while others are not? What makes some societies limit the right to charter a bank to a favored few, even though doing so limits the availability of credit to broad swaths of the population? Why do societies sometimes fail to protect the property rights of lenders, depositors, and bank stockholders in ways that undermine the ability of banks to raise funds or lend them?

Four years and many conversations and cross-country visits later, we completed this manuscript. Along the way, we accumulated more intellectual debts than we can ever repay. We are indebted to many colleagues at institutions around the world who offered comments on chapter drafts, or on the entire manuscript, including Daron Acemoglu, Terry Anderson, Michael Bordo, Michael Boskin, Florian Buck, Forrest Capie, Gerard Caprio, Matthew Carnes, Latika Chaudhary, Isaias Chávez, Gustavo del Angel-Mobarak, Darrell Duffie, Roy Elis, Richard Epstein, Nick Eubank, Adriane Fresh, Alex Galetovic, Richard Grossman, James Huffman, Scott Kieff, Dorothy Kronick, Sandra Kuntz Ficker, Ross Levine, Gary Libecap, Jonathan Macey, Noel Maurer, Allan Meltzer, Victor Menaldo, Joel Mokyr, Ian Morris, Aldo Musacchio, Larry Neal, Raquel Oliveira, Agustina Paglayan, Edward Pinto, Alex Pollock, Lucas Puente, Russ Roberts,

James Robinson, Jared Rubin, Thomas Sargent, Henry Smith, Paul Sniderman, William Summerhill, John Taylor, Larry Wall, Peter Wallison, and three anonymous referees. We also thank our students in classes at Columbia University and Stanford University, where we taught parts of the book in various courses; their reactions taught us a great deal about how to frame and organize the material. Our research assistants, Ishan Bhadkamkar, Ianni Drivas, and Patrick Kennedy, helped us find data and track references as well as providing cogent comments about chapters as they took shape.

We were fortunate to be able to present drafts of chapters at workshops and conferences and to receive valuable feedback. We thank the institutions that organized those workshops and conferences, including the Banco de México, the Center for Economic Studies of the Ludwig-Maximilians-Universität München, the Centro de Investigación y Docencia Económicas, Chapman University, the All-Chicago Friends of Economic History Dinner, the Federal Reserve Bank of Atlanta, Harvard Business School, the Hoover Institution's Working Group on Economic Policy, the International Monetary Fund, the London School of Economics, and the World Bank.

Research support does not grow on trees; we are therefore grateful to John Raisian and Richard Sousa, director and senior associate director of the Hoover Institution, respectively. Seth Ditchik, Beth Clevenger, and Terri O'Prey at Princeton University Press and Peter Strupp at Princeton Editorial Associates ably shepherded the manuscript through the production process. We owe special thanks to our series editor, Joel Mokyr, whose enthusiasm, humor, and constructive criticisms did much to improve the book and to facilitate its timely completion. Finally, we are deeply grateful to our wives, Nancy Calomiris and Marsy A. Haber, for their constant patience, support, and encouragement throughout the four years of our bicoastal collaboration.

We dedicate this book to our daughters. We hope that young people who read this book, including the three of them, will not misinterpret our discussions about political bargains as a call to cynicism about democratic politics. Our intent is rather to illustrate the value of learning history, thinking critically, and facing the hypocrisy of politicians with a sense of humor. They will need all three in a search for solutions to the deep problems that face democracies during the current global pandemic of banking crises.

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No Banks without States, and No States without Banks

1

If Stable and Efficient Banks Are Such a Good Idea, Why Are They So Rare?

> The majority of economists . . . tend to assume that financial institutions will grow more or less spontaneously as the need for their services arises—a case of demand creating its own supply. . . . Such an attitude disposes of a complex matter far too summarily.
>
> Rondo Cameron and Hugh Patrick, *Banking in the Early Stages of Industrialization* (1967)

Everyone knows that life isn't fair, that "politics matters." We say it when our favorite movie loses out at the Academy Awards. We say it when the dolt in the cubicle down the hall, who plays golf with the boss, gets the promotion we deserved. We say it when bridges to nowhere are built because a powerful senator brings federal infrastructure dollars to his home state. And we say it when well-connected entrepreneurs obtain billions in government subsidies to build factories that never stand a chance of becoming competitive enterprises.

We recognize that politics is everywhere, but somehow we believe that banking crises are apolitical, the result of unforeseen and extraordinary circumstances, like earthquakes and hailstorms. We believe this because it is the version of events told time and again by central bankers and treasury officials, which is then repeated by business journalists and television talking heads. In that story, well-intentioned and highly skilled people do the best they can to create effective financial institutions, allocate credit efficiently, and manage problems as they arise—but they are not omnipotent. Unable to foresee every possible contingency, they are sometimes subjected to strings of bad luck. "Economic shocks," which presumably could not possibly have been anticipated, destabilize an otherwise smoothly running system. Banking crises, according to this version of events, are much like Tolstoy's unhappy families: they are all unhappy in their own ways.

This book takes exception with that view and suggests instead that the politics that we see operating everywhere else around us also determines whether societies suffer repeated banking crises (as in Argentina and the United States), or never suffer banking crises (as in Canada). By politics we do not mean temporary, idiosyncratic alliances among individuals of the type that get the dumbest guy in the company promoted to vice president for corporate strategy. We mean, instead, the way that the fundamental political institutions of a society structure the incentives of politicians, bankers, bank shareholders, depositors, debtors, and taxpayers to form coalitions in order to shape laws, policies, and regulations in their favor—often at the expense of everyone else. In this view, a country does not "choose" its banking system: rather it gets a banking system that is consistent with the institutions that govern its distribution of political power.

The Nonrandom Distribution of Banking Crises

Systemic bank insolvency crises like the U.S. subprime debacle of 2007–09—a series of bank failures so catastrophic that the continued existence of the banking system itself is in doubt—do not happen without warning, like earthquakes or mountain lion attacks. Rather, they occur when banking systems are made vulnerable by construction, as the result of political choices. Banking systems are susceptible to collapse only when banks both expose themselves to high risk in making loans and other investments and have inadequate capital on their balance sheets to absorb the losses associated with those risky loans and investments. If a bank makes only solid loans to solid borrowers, there is little chance that its loan portfolio will suddenly become nonperforming. If a bank makes riskier loans to less solid borrowers but sets aside capital to cover the possibility that those loans will not be repaid, its shareholders will suffer a loss, but it will not become insolvent. These basic facts about banking crises are known to bankers or government regulators; they are as old as black thread.

By contrast, consider what occurs when bank capital is insufficient relative to bank risk. Bank losses can become so large that the negative net worth of banks totals a significant fraction of a country's gross domestic product (GDP). In this scenario, credit contracts, GDP falls, and the country sustains a recession driven by a banking crisis. Governments can prevent this outcome by propping up the banking system. They can make loans to the banks, purchase their nonperforming assets, buy their shares in order to provide them with adequate capital, or take them over entirely.

If such catastrophes were random events, all countries would suffer them with equal frequency. The fact is, however, that some countries have had many, whereas others have few or none. The United States, for example, is highly crisis prone. It had major banking crises in 1837, 1839, 1857, 1861, 1873, 1884, 1890, 1893, 1896, 1907, the 1920s, 1930–33, the 1980s, and 2007–09.[1] That is to say, the United States has had 14 banking crises over the past 180 years! Canada, which shares not only a 2,000-mile border with the United States but also a common culture and language, had only two brief and mild bank illiquidity crises during the same period, in 1837 and 1839, neither of which involved significant bank failures. Since that time, some Canadian banks have failed, but the country has experienced no systemic banking crises. The Canadian banking system has been extraordinarily stable—so stable, in fact, that there has been little need for government intervention in support of the banks since Canada became an independent country in 1867.

The nonrandom pattern of banking crises is also apparent in their distribution around the world since 1970. Some countries appear immune to the disease, while others are unusually susceptible. Consider the pattern that emerges when we look at data on the frequency of banking crises in

[1]Throughout this book we regard banking crises as either systemic insolvency crises or systemic illiquidity crises. Some crises, like the subprime lending crisis in the United States, and the other U.S. crises in 1837, 1839, 1857, 1861, the 1920s, 1930–33, and the 1980s, have involved extensive bank insolvency, not just moments of illiquidity when banks experience severe withdrawal pressures. Thresholds of insolvency sufficient to constitute a crisis are defined differently by different scholars, but roughly speaking, bank insolvency crises are usefully defined as events during which the negative net worth of banks, or the costs of government interventions to prevent those insolvencies, exceed some critical percentage of GDP. This approach underlies the databases on banking crises for the recent era derived by researchers at the World Bank and International Monetary Fund (e.g., Caprio and Klingebiel [2003]; Laeven and Valencia [2012]). A second class of banking crises is those that entail systemic illiquidity disruptions (e.g., widespread bank runs) but do not involve significant bank insolvencies or costly government interventions to prevent those insolvencies. Calomiris and Gorton (1991), for example, categorize the U.S. banking panics of 1873, 1884, 1890, 1893, 1896, and 1907 as systemic and important liquidity shocks even though they did not produce a high degree of bank insolvency. Both of these definitions of crises are more restrictive than those that are sometimes employed in the "financial crisis" literature (e.g., Reinhart and Rogoff [2009]), where negative events, such as the failure of a single large bank, are considered to be evidence of a crisis. By those less restrictive standards, the world's banking systems would appear to be even more crisis prone.

the 117 nations of the world that have populations in excess of 250,000, are not current or former communist countries, and have banking systems large enough to report data on private credit from commercial banks for at least 14 years between 1990 and 2010 in the World Bank's Financial Structure Database.[2] Only 34 of those 117 countries (29 percent) were crisis free from 1970 to 2010. Sixty-two countries had one crisis. Nineteen countries experienced two crises. One country underwent three crises, and another weathered no less than four. That is to say, countries that underwent banking crises outnumbered countries with stable banking systems by more than two to one, and 18 percent of the countries in the world appear to have been preternaturally crisis prone.

The country that experienced the most crises was Argentina, a nation so badly governed for so long that its political history is practically a synonym for mismanagement. The close runner-up (with three crises since 1970) was the Democratic Republic of the Congo, the nation whose brutal colonial experience served as the inspiration for Joseph Conrad's *Heart of Darkness*, which was governed after independence by one of the third world's longest-lived and most avaricious despots (Mobutu Sese Seko, who ruled from 1965 to 1997), and whose subsequent history is a template for tragedy.

The 19 countries that had two banking crises are also far from a random draw. The list includes Chad, the Central African Republic, Cameroon, Kenya, Nigeria, the Philippines, Thailand, Turkey, Bolivia, Ecuador, Brazil, Mexico, Colombia, Costa Rica, Chile, Uruguay, Spain, Sweden,

[2] We exclude former and current communist countries from this analysis because their state-run banking systems do not allocate credit but rather act as an accounting system for the state-controlled allocation of investment. The concept of a banking crisis has no real analytic meaning in such a system. Former communist countries have tended to be crisis prone. If we had included them in our data set, an even greater percentage of the countries of the world would be counted as crisis prone. We exclude countries that do not report at least 14 observations for the ratio of private credit by deposit money banks to GDP during the period 1990–2010. That is, in order to mitigate measurement error, we require observations for at least two-thirds of all possible observations for any country. We draw the credit data from the period 1990–2010 because the coverage of the World Bank Financial Structure Database tends to be less complete, especially for poorer countries, prior to 1990. We draw the data on banking crises from Laeven and Valencia (2012) and include both their "systemic" crises and their "borderline" crises in our definition of crises. We update their work by adding the case of Cyprus in 2013.

and . . . the United States. One of the striking features of this list is the paucity of high-income, well-governed countries on it. Of the 117 countries in our data set, roughly one-third are categorized by the World Bank as high-income nations. But only three of the 21 crisis-prone countries, 14 percent, are in this group. This suggests that, for the most part, being crisis prone is connected to other undesirable traits and outcomes. But that raises another troubling question. Why is the United States on this list?

The Nonrandom Distribution of Under-Banked Economies

There is, of course, more to having a good banking system than simply avoiding crises. Equally problematic are banking systems that provide too little credit relative to the size of the economy—a phenomenon known as under-banking. This outcome, too, appears not to be randomly distributed. Consider the striking contrast between Canada and Mexico, the United States' partners in the North American Free Trade Agreement (NAFTA). From 1990 to 2010, private bank lending to firms and households averaged 95 percent of GDP in Canada, but in Mexico the ratio was only 19 percent. The dramatic difference in those ratios means that Mexican families have a much more difficult time financing the purchase of homes, automobiles, and consumer goods, and Mexican business enterprises have much more difficulty in obtaining working capital, than their Canadian counterparts. The result is slower economic growth. Little wonder, then, that over 500,000 Mexicans—roughly half of all new entrants to the Mexican labor market—illegally cross the border to the United States each year.

As figure 1.1 shows, the stark difference between Canada and Mexico is part of a recurring pattern. In the world's poorest countries (those on the far left-hand side of the figure), including for example, the Democratic Republic of the Congo, the ratio of bank credit to GDP averages only 11 percent. In the richest countries (shown on the far right-hand side of the figure), the ratio of bank credit to GDP averages 87 percent.

Crucially, there is also substantial variance across countries within each of the four income groups, which suggests that the amount of credit extended within countries is not solely a function of demand for credit but also reflects constraints on the supply of credit. In other words, the fact that some countries in each income group extend much more credit than