Fragile by Design: The Political Origins of Banking Crises and Scarce Credit

Charles W. Calomiris & Stephen H. Haber
(Princeton: Princeton University Press, 2014)
584 pp.
US$35

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By any yardstick, *Fragile by Design*[1] is a remarkable achievement and an important contribution to our understanding of the roots of banking crises. Charles Calomiris and Stephen Haber have sketched a daring thesis, attributing banking crises through modern history to the destabilizing demands of different political coalitions. Such a work might be shrugged off as yet another of the steady flow of books that propose to explain the roots of the 2008 financial crisis from which banking systems worldwide — and the global economy — are still healing.

But to group *Fragile by Design* with those other books would be a grave miscategorization. The authors do not attempt to bash their audience with salacious anecdotes about CEO abundance or regulatory incompetence; rather, they delve into the political-economy backdrop to banking regulation, wedding law, history, politics and economics into an answer to their central question: "Why can't countries construct banking systems capable of providing stable and abundant credit?"

The book consists of fifteen chapters grouped in four sections: the historical relationship between banks and nation states; banker-populist alliances in the United States and Canada; banking systems in Mexico and Brazil; and questions raised by historical narratives. Although not readily predictive, their assessment is necessarily deterministic: political conditions and institutions constrain what is possible. In their account, which is based implicitly on a path dependency argument, banking systems are inevitably at the mercy of (largely informal) political coalitions — their so-called "Game of Bank Bargains". These coalitions lobby for particular forms of banking regulation that subtly skim rent and apportion these to the coalition's members.

The collateral effects of this rent-seeking are banking structures that are inherently unstable — for instance, the inefficient fragmentation and local monopolization of the U.S. banking system, its propensity for ostensible irrational exuberance in surges of credit to homebuyers, depositors' hobbling distrust for Mexico's crony-ridden credit regime or Brazil's inflationary expropriation of its banking sys-

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1 Charles W. Calomiris & Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, NJ: Princeton University Press, 2014).

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tem to finance government spending. In contrast, Canada is the boring but dependable cousin, and the authors leverage Canada's colonial history and constitutional arrangements as a foil for the U.S. experience, explaining how political conditions facilitated a robust branch-banking system north of the 49th parallel.

The authors anchor their analysis in the well-recognized moral hazard resulting from a taxpayer-funded backstop for insolvent banks, as well as regulatory capture by rent-seeking interest groups (bank insiders foremost in the pack, but the disseminated masses of eager mortgagees also allegedly culpable) and the principal-agent problems that beset any corporation's governance. Calomiris and Haber present a three-way tension among: bank managers' incentive to "tunnel" bank resources to their cronies; a government's incentive to fund state expenditures through regulatory expropriation of the bank balance sheet; and borrowers' incentive to press for cheap short-term credit.

The broad economics of this story are not novel, but the authors uniquely unpack the institutional detail and assemble a thorough historical narrative. This an ambitious work of breathtaking scope and depth, drawing from various countries' histories from colonization to the present to explain the comparative roots of each country's political institutions around banking regulation. The book is identifiable with the "institutions and growth" renaissance in economics, largely spearheaded by Daron Acemoglu and James Robinson. Indeed, in various respects, *Fragile by Design* appears to be a banking spin-off of *Why Nations Fail*.[2] It is also a worthy complement to Ken Rogoff and Carmen Reinhart's *This Time is Different*,[3] picking up from those authors' international-macro analysis of debt generally with a financial history at the level of financial institutions themselves.

Yet, while offering useful cross-country case-studies, *Fragile by Design* also suffers from some critical gaps. First, the authors take as given that we care about bank failures and yet they present banks as largely engaged in a tweaked form classic production, just with deposits as the inputs and loans as outputs. It is not clear from the authors' stylized depiction of what banks do why we should care when banks fail and why rampant "creative destruction" that is generally desirable in other industrial sectors is a bad thing for banks.

Readers might think the answers obvious, particularly in light of recent financial history. However, there is more nuance to the micro-economics of banking than the authors let on. The authors' analysis would have benefited from an expanded treatment of the economic model for banking, the role of competition in banking systems, and the transmission between financial instability and the real economy (so-called "macro-financial linkages").

Specifically, the banking system itself is inherently rent-seeking: the lingo of "financial products" aside, banks do not make widgets; rather, they intermediate credit between pools of depositors and borrowers and juggle the demand for short-term liquidity with long-term collections on credit. Banks' profits come from being an institutional solution to the information asymmetries and liquidity mismatch fac-

2 Daron Acemoglu & James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (New York: Crown, 2012).

3 Carmen M. Reinhart & Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press, 2009).

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ing disaggregated individual lenders. This dynamic is the source of the economies of scope and scale witnessed in the banking industry: banks are able to price credit to borrower risk because of the information accumulated during long-lived relationships, and banks leverage a large pool of depositors in order to borrow short and lend long.

In short, the banking system serves three key roles that differentiates it from classic firm production: it intermediates borrowers and lenders, lowering transaction costs for assessing investment risks; it creates liquidity, solving the mismatch between long-term borrowers and short-term lenders, allowing access to deposits on demand and credit for timely payment; and it provides "insurance" for depositors since deposits have guaranteed returns and liquidity.

These micro-economic features of banking systems have implications for macro-financial linkages. In contrast with the desirability of "creative destruction" in other sectors, the consequent systemic disruptions are why ordinary citizens should care about banking crises. Unfortunately, discussion of this transmission mechanism and its macro-financial implications, is largely absent from express discussion in *Fragile by Design*. The authors appear to be concerned with central banks primarily as last-resort providers of liquidity for banks. While this is the traditional role of central banks, the book pays very little attention to central banks' developing role as *the* conduit for transmitting monetary policy to real economy.

This oversight is perhaps excusable given the egregiously simplistic and still-nascent theoretical literature on this mechanism. However, in the wake of the U.S. near-deflation experience following a contraction in credit and consequent ebb in monetary aggregates, many scholars have turned to scrutinize banks' role in creating money. Put another way, central banks don't just exist to shore-up banks against temporary liquidity downdrafts; they provide the channel by which central banks throttle an economy's aggregate demand and impact price stability. The further corollary is that conditions in the "real economy" impact bank balance sheets and lending behaviour. This is the source of the procyclicality witnessed during the financial crisis, and the vicious downward spiral of contracting credit and knock-on fall in aggregate demand is what central banks mean when speaking about "systemic risk". An elaboration of these features and particularly the nebulous concept of systemic risk, would have been a useful backdrop for explaining the economic consequences of comparative banking structures especially given current legal reforms in this area in Canada and abroad.

Interestingly, the authors specifically limit their analysis to banks, rather than financial markets generally. Indeed, the authors even more narrowly define their subject as "commercial banks", expressly omitting merchant banks and investment banks. They briefly explain this choice as based on the central role that banks play in providing liquidity for financial markets: i.e. banks, rather than financial markets, are the lynchpin to financial stability and availability of adequate credit. Impliedly, this point follows from the macro-financial role of banking. Likewise though, this point could have used elaboration, particularly given the modern trend to "super-market" banks (now long the norm in Canada) with both commercial banking and brokerage-side operations. In the context of explaining why financial markets weren't relevant to its analysis, *Fragile by Design* would have benefited from a discussion of the transmission mechanism between banks and asset prices in financial markets more broadly.

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Second, the authors should be commended for their assembly of an excellent and thorough chapter on Canadian banking history that fills a gaping hole that domestic scholars of economic history have largely failed to address. But while the portrayal of Canada's "boring but stable" banking regime as the ideal will delight many Canadians, Calomiris and Haber take license in discussing Canada's constitutional division of powers. They lead-off from the historic French-English tensions (well familiar to any Canadian), arguing that in the aftermath of the Plains of Abraham leading up to Confederation in 1867, British overlords designed Canadian political institutions to contain the influence of Quebec. They then contend that Canada's geography conspired with these political institutions in the roll-out of western settlement and frontier economic development. Their broad narrative for the Canadian banking system is rooted in their view of Canadian political institutions as highly centralized and designed to prevent local coalitions from overwhelming national objectives. The account overlooks the strong role that individual provinces, including Ontario and Quebec, played in the development of Canada's financial markets.

Unlike the U.S. banking system, in which certain coalitions fought the perceived behemoth of inter-state banking and which became riddled with local monopolies, Canadian branch banking explicitly was structured to intermediate prairie agricultural production, eastern industrial production of farm-goods, and trans-Atlantic trade of Canada's agricultural commodities. In the hinterland, the national network of banks financed hewing wood and drawing water; in the eastern cities, banks financed tractor plants and maritime trade credit. The authors sketch the interplay between Canada's geography and economic destiny, but the precise linkages will strike most Canadian historians as a bit loose let alone overplayed. Nonetheless, the broad account is a useful starting point and rich with institutional detail about the origins of Canadian banking structure.

Interestingly, the authors' hostility to government intervention in mortgage markets (ripe in their U.S. chapter for obvious reasons) also infiltrates their analysis of the Canadian post-war creation of the Canada Mortgage and Housing Corporation (CMHC) and move of Canadian banks into secured lending to households. The authors appear somewhat skeptical, viewing these developments as purely rent-seeking from the system by politically mobilized households. Of course, the recent U.S. experience provides an enticing explanation for the political imperative to allow (and incent) excesses in household borrowing; however, too little attention is paid to the role of mortgage market policy as a tool of long-term macroeconomic stabilization — a role that Canadian arrangements exemplify (notwithstanding near-term concerns about the run-up in CMHC liabilities).

Specifically, recognizing housing as most households' most valuable asset, housing market stability has a major impact on short-term business cycles and households' long-term "lifecycle" saving behaviour. Again, banks provide a key conduit for macroeconomic policy, with a legitimate role for certain, carefully-tailored mortgage market can arguably buffer against procyclical downturns that wallop real estate, with knock-on effects for consumption broadly.

The authors' analysis of Canada's federal-provincial division of powers also suffers some significant flaws. In pitching their "highly centralized" narrative of Canadian federalism, they emphasize the federal competencies for banking, currency, and "trade and commerce", but neglect the complex interplay with provin-

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cial constitutional jurisdiction over property and civil rights. Their view of federalism (and explicit decision to ignore financial markets) particularly overlooks the fragmented regulation of capital markets between and among provinces, as though somehow capital markets can be easily separated from financial markets more broadly. As Canada's own near-death experience with Asset-Backed Commercial Paper (ABCP) highlights, this fragmentation is a potential source of instability in the era when there is closer interconnection between banks and financial markets. Indeed, in Canada's context, the securities situation arguably provides a contrasting illustration, showing how local interests have thwarted national goals for safeguarding for building more robust financial architecture.

Nonetheless, banking is indisputably a sector where the world needs "more Canada." Legal and economic historians may quibble with the lines of historical causation drawn in *Fragile by Design*, but the work provides an important dive into the evolution of Canada's banking system. The final section of their Canada chapter also wades into the corollary debate about whether the trade-off for banking stability has been too little competition, effectively concluding that it has not. Their comparison is unfortunately only bilateral with the U.S., but it usefully surveys the evidence that Canadian branch banking in fact priced credit more competitively — particularly on the prairies — than did their stateside counterparts (where the fragmentation granted local monopolies and the inter-bank funding resulted in greater spreads).

In his 1975 chronicle, *The Canadian Establishment*,[4] Peter C. Newman referred to Canada's bankers as "Guardians of the Temple", remarking that "Money is no joke in this country, and banking is very much more than a business. It is a calling. . . . The bankers discharge their powers with the self-conscious virtue of representative elders at a Presbyterian synod meeting: never pushy, seldom impatient, always careful, gracious, proper, and, above all, serene in the security of their faith. They view banking as a beneficial discipline, foreordained to reward the worthy and the able." A latter-day viewer might question the accuracy of this reverential cultural characterization if strolling down Bay Street today. Nonetheless, amid the torrents of past financial crises, Canadian banking remains an uncannily stable island. Calomiris and Haber have given a valuable answer as to why.

4 Peter C. Newman, *The Canadian Establishment* (Toronto: McClelland and Stewart, 1975).

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