The strengths and shortcomings of a banking system are the predictable consequences of political bargains, and those bargains are structured by the fundamental political institutions of societies.

This is the central thesis of a sweeping study of the links between banks and political institutions by Calomiris and Haber, professors at Columbia and Stanford universities respectively.

The subprime crisis was simply the latest in a very long string of American banking crises. What must be explained is why the United States has a banking system that is so persistently crisis prone. What is it about American political institutions that generates incentives for bankers and populists to search one another out and forge such powerful coalitions?

The Scarcity of Stable and Efficient Financial Institutions

While most people recognize that politics is everywhere, they still believe that banking crises are an exception, the result of unforeseen circumstances. This book suggests instead that the politics operating everywhere else also determines whether societies as diverse as Argentina and the United States suffer repeated banking crises while a society like Canada never experiences one.

The fundamental political institutions of a society shape the incentives of politicians, bankers, shareholders, depositors, debtors, and taxpayers to form coalitions with one another to shape laws, policies, and regulations in their favor—often at the expense of everyone else. A country does not choose its banking system; rather it gets the banking system that is consistent with the institutions that govern its distribution of political power.

Banking systems are susceptible to collapse only when two conditions are met: there must be sufficient risk in the loans and other investments the banks are making, and there must be inadequate capital to absorb the losses that result from those risky loans and investments.
However, this deadly combination does not take place randomly across all banking systems. If such catastrophes were random events, all countries would suffer them with equal frequency. In fact is, though, some countries have had lots of them, while others have few or none.

The United States is highly crisis prone. It had major banking crises in 1837, 1839, 1857, 1861, 1873, 1884, 1890, 1893, 1896, 1907, the 1920s, 1930-1933, the 1980s, and 2007-2009 – 14 banking crises over 180 years. Neighboring Canada, which shares a common culture and language, had only two brief and mild bank illiquidity crises during that same period—both in the late 1830s and neither involving significant bank failures.

In the period 1970-2013, only 18% of the 117 countries surveyed by the authors had two or more banking crises, while 53% had one, and 29% had none. The 21 countries that had two or more banking crises do not seem random until you get to the three high-income, well-governed countries on this list. This suggests that being crisis-prone is connected to other relatively undesirable traits and outcomes; many on this list are low-income countries which have suffered from poor political governance and under-banking. The phenomenon of under-banking—systems that provide too little credit relative to the size of the economy—is not random. It is often associated with low-income countries because insufficient credit means individuals have a more trouble financing purchases of homes, automobiles, and consumer goods, and it is more difficult for businesses to obtain working capital. The contrast is evident in the two NAFTA partners of the United States. In the two decades 1990 to 2010, private bank lending to firms and households in Canada averaged 95% of GDP, but only 19% in Mexico.

So why is the United States on this list?

Looking at those economies where bank credit is abundant (those with a ratio of bank credit to GDP above 83%) and those that have stable banking systems (no systemic crisis since 1970), there are only seven countries meeting both criteria: Singapore, Malta, Hong Kong, China, Cyprus (before the crisis in 2013), Australia, Canada, and New Zealand. Half of these are small island or city states, and most of the others are democracies that have anti-populist constitutions.

Banking crises are costly both to individuals and to the economy as a whole. When the costs were borne by shareholders and depositors, they imposed discipline on the bankers. In the middle of the 20th century, however, there was a shift and taxpayers began to bear the costs. The incentives of stockholders and depositors to discipline bankers are now much weaker, and bankers are willing to take bigger risks, increasing the probability of failure. As a result, after 1945 banks in the world’s most developed economies became more highly leveraged. How can it be that a sector of the economy that is highly regulated and closely supervised works so badly in so many countries?

The answer is that fundamental differences in political institutions determine how robust or fragile the banking system can be and how abundant or scarce bank credit will be. All governments face inherent conflicts of interest in a banking system, but some governments—particularly democracies which have political institutions that can limit the influence of populist coalitions—can mitigate those conflicts of interest better than others.

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1 Argentina, the Democratic Republic of the Congo, Chad, the Central African Republic, Cameroon, Kenya, Nigeria, the Philippines, Thailand, Turkey, Bolivia, Ecuador, Brazil, Mexico, Colombia, Costa Rica, Chile, Uruguay, Spain, Sweden, and the United States.
The Game of Bank Bargains

It is difficult to mitigate simultaneously all of the conflicts of interest inherent in the partnership between banks and governments. Those political systems that succeed in blunting populist currents manage this balancing act, but those systems are rare. This means that as a rule the conflicts of interest in partnerships between banks and governments make most banking systems fragile by design.

Solving these problems requires government, but governments must surmount these conflicts of interest regarding banks: Governments simultaneously borrow from banks and regulate them; they enforce debt contracts but need the political support of debtors; they distribute losses in the event of bank failure, but they need the political support of depositors.

In order for there to be a banking system, three property rights problems have to be mitigated: Shareholders and depositors must be protected from expropriation by the government; depositors and minority shareholders must be protected from expropriation by majority shareholders; majority shareholders, depositors and minority shareholders must be protected from expropriation by debtors.

The property rights system that structures banking is not a passive response to some efficiency criterion, but rather it is the product of political deals that determine which laws are passed, which groups of people have licenses to contract with whom, for what, and on what terms. These deals are guided by the logic of politics, not the logic of the market.

The fact that the property rights system underpinning banking systems is an outcome of political deal-making means that there are no fully “private” banking systems. Rather, all modern banking is best thought of as a partnership between the government and a group of bankers, and that partnership is shaped by the institutions that govern the distribution of power in the political system. Government regulatory policies toward banks reflect the deals that gave rise to those partnerships, as well as the power of the interest groups needed to sustain those deals.

That partnership is the product of a strategic interaction called the “Game of Bank Bargains.” This game operates according to the logic of politics, not the logic of efficiency. The game governs entry and competition, the pricing of credit and its terms, and the allocation of losses when banks fail. 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.

Tools of Conquest and Rule: Why States Need Banks

Governments need banks. That is why the institution of the government-chartered bank emerged in the 17th century as Europe was reconfigured from a hodgepodge of duchies, principalities, and kingdoms into a set of modern nation-states. Rulers had strong incentives to become aggressive proponents of the financial innovations that underpin all modern banking systems, such as chartered corporations, negotiable instruments, and sovereign debt instruments. The rulers that encouraged innovation were able to create durable nation states and global trading networks. The rulers that failed to do so disappeared, and their territories became absorbed into some other nation state.
These government-banker partnerships evolved as political systems became more complex in the 19th and 20th centuries, giving rise to a broad array of quasi-government, quasi-private entities, including central banks and special purpose intermediaries (such as the mortgage repurchase giants Fannie Mae and Freddie Mac).

**War, Empire and the Monopoly Structure of English Banking**

*England* is the first of five studies of actual countries over very long periods of time, illustrating how the Game of Bank Bargains has been played in different political environments. The studies look at the variation in political institutions across countries, and, perhaps even more importantly, on variation in political institutions within countries over time.

England was initially a crony system based on rent-sharing and later became a system based on competitive banking with taxation. It started when the English government granted a monopoly charter to the Bank of England after the Glorious Revolution of 1688, which gave Parliament primacy over the king. England no longer had an absolute monarch who could expropriate at will, but it also had an extremely limited electoral franchise. This meant that wealthy financiers were able to form a durable coalition with the parties in control of Parliament, giving the Bank of England unique privileges in exchange for loans to the government. The result was a monopoly banking system that allocated credit narrowly and was inherently unstable.

Pax Britannica permitted both an expansion of the franchise and a relaxation of the government’s need to finance expensive wars, giving rise to political coalitions that favored a greater openness in bank chartering. The stable, efficient, and competitive banking system that England had forged by the turn of the 20th century was then repressed by the government, once again, in the three decades of World War I, rearmament, and World War II. Once the war ended, political coalitions that favored the creation of a welfare state and nationalized industries made the banking system mostly irrelevant. In short, the banking system that one sees today in London—which is not just the center of the British banking system but is a central hub of global finance—is actually a very recent phenomenon.

**The Cost of Banker-Populist Alliances: The United States Versus Canada**

In the United States, the banking system initially was based on crony rent sharing, but came to be dominated by populist banking in the 1820s. U.S. banking history powerfully illustrates the thesis that banking regulation is all about politics and always has been.

U.S. banking today is dominated by institutions like the Bank of America, which seems to have a branch or ATM on every corner. But until relatively recently U.S. banks were blocked from having branches in more than one state. Until the 1970s, most U.S. states even had laws that prevented banks from opening branches within the state. The U.S. banking system was composed of tens of thousands of “unit banks” (individual banks, with no branches) that divided the U.S. market up into thousands of quasi-segmented local markets. No other country had a banking system like this, and for good reason: a system composed of tens of thousands of unit banks is inherently unstable because banks can neither spread risks across regions nor move funds easily from one location to another to manage liquidity problems. Such a system is also operationally inefficient, because banks
cannot take advantage of scale economies. As a result, Americans paid higher interest rates for loans (and received lower interest rates on their deposits) than they would have in a system of branching banks.

This was not the system that the first U.S. Treasury secretary, Alexander Hamilton, had in mind when he created America's first banking institutions in the 1780s and 1790s. Hamilton's vision was undermined within a few decades by a very strange and very determined coalition of agrarian populists (who were opposed to corporations of any kind, as well as the elites who controlled them) and small bankers (who knew that they did not have a prayer of competing against big banks that could open branches as they pleased). This unlikely coalition was so successful because it was able to exploit a fundamental feature of the American political system, federalism.

Banking legislation was largely up to states, not the central government. This meant that the populist-banker coalition could fight and win in state houses, rather than in a national political debate. Those successful state-level coalitions could then be used to influence the selection of congressmen to carry their cause to Washington. Every time that a crisis wrecked their inherently fragile system, this coalition managed to turn efforts at reform to their advantage—even outmaneuvering Franklin Roosevelt in the writing of the Glass-Steagall Act. That they were so successful, for so long, is a testament to the durability of their coalition, which enjoyed a century and a half of dominance until it was undone by a combination of demographic, economic and technological changes that undermined unit banks as a business model.

The evolution in U.S. banking shows that there is no escaping the Game of Bank Bargains. Politics will always intrude into bank regulation, so that even when U.S. banks were freed from restrictions on branching and competition, which should have made the system more stable, they instead were positioned for the spectacular banking crisis of 2007-09.

The political coalition between unit bankers and small farmers was replaced by a new coalition between the rapidly growing megabanks and urban activist groups. Bankers wanted to merge, and were quite ambitious in their plans for doing so. Their plans were, however, subject to a political constraint: they needed to be judged as good citizens of the communities they served in order for the Federal Reserve Board to approve the mergers. Activist groups wanted to be able to direct credit to their memberships and constituencies, and the “good citizenship” merger criterion gave them a powerful lever with which to negotiate with merging banks.

The two groups—the bankers and the activists—forged a coalition that consolidated the American banking industry into a set of megabanks that were too big to fail even as they committed trillions of dollars to obtain good citizenship ratings. A crucial step in making these arrangements work was that two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, which repurchased and securitized mortgages, lowered their underwriting standards and took these loans into their own portfolios, paving the way for weaker underwriting standards for everyone.

As noted above, bank insolvency crises require a combination of imprudent lending and inadequate bank capital backing high-risk loans. This is what happened when prudential regulatory measures were lacking and U.S. banks were allowed to back their portfolios of low down payment, no documentation, adjustable rate mortgages with capital buffers that clearly were inadequate. Neither “Wall Street fat-cats” nor activist groups are to blame for America’s 2007-09 banking crisis, however. The subprime crisis was simply the latest in a very long string of American banking crises.
Placing blame is unproductive because it distracts people from the important question: what steps could we take to change political institutions to reduce the incentives to form socially unproductive coalitions?

**Politics and Banking in Canada**

**Canada** is a country that has had competitive banking with taxation for its entire history. Canada presents something of a counterfactual experiment: it had a similar colonial and cultural heritage to the United States, but it did not have the particular set of political institutions and circumstances that drove the bizarre, “unit banking” in the United States. Specifically, Canada’s political institutions were purposely constructed such that almost all economic policies and regulations, including those pertaining to banking, had to be decided by a national, bicameral legislature, one of whose houses was appointed, not elected.

Canadian populists and would-be Canadian unit bankers could not succeed in controlling the banking system because they had to win their political struggles at the national level with a parliamentary structure designed to block control by populist factions. The structure of the Canadian banking system was therefore strikingly different. From its beginnings, the Canadian system was characterized by a small number of very large banks with large national branch networks. The owners of those large branching banks were never drawn into coalitions with Canadian populists to create and share rents at the expense of everyone else. The result has been not just lower costs of credit in Canada, but a much more stable banking system.

**Banking and Politics in Mexico**

**Mexico** had no banking at all until the 1880s, then crony banking until the 1990s, turning increasingly competitive and stable since democratization.

Mexico shows the differences between banking systems in authoritarian and democratic political systems. Unlike Britain, the United States, and Canada, Mexicans were denied the right to effective suffrage until the late 1990s. During most of its history, Mexico was governed by one type of authoritarian system or another. Moreover, those authoritarian governments engaged in either partial or total expropriations of the banking system on several occasions.

Mexico demonstrates how authoritarian political leaders form coalitions with bank insiders and minority shareholders to create a banking system. It also reveals the conditions under which autocrats break those coalitions by seizing the wealth of those insiders and minority shareholders. This raises a question: How did the government manage to coax bankers into new coalitions to create banking systems despite this history of periodic expropriation? The key is that the government tightly regulated bank entry in order to drive rates of return up high enough to compensate bank insiders and shareholders for the risk that, at some point, they would be expropriated.

In Mexico, as elsewhere, banking was indeed all about politics. Mexican political outcomes oscillated between moments of chaos (like civil wars, during which banking systems collapsed) and moments
of relative calm, during which crony banking systems comprised of a small number of banks allocated scarce credit among politically influential insiders.

**Banking and State Finance in Brazil**

*Brazil* illustrates the proposition that when fundamental political institutions change, the Game of Bank Bargains changes.

For most of its history as an independent country, Brazil was governed by one form of autocracy or another. Indeed, it was not until 1989 that Brazil staged its first direct election for the presidency under rules of universal adult suffrage. Since that time, Brazil has been a stable democracy, but one in which strong populist currents dominate.

Indeed, Brazil’s political institutions combine features that heavily tilt politics in favor of populist constituencies: a strong president (and a weak legislature), centralized tax collection, but decentralized government spending; centralized political parties; universal adult suffrage, and a constitution that specifies a long list of “positive rights.”

The basic choice facing all Brazilian governments since 1808 has been to tax the rich, tax the poor through inflation, or have a poor, weak state. The usual answer was inflation taxation, but this is not consistent with democracy. At its peak in the late 1980s, inflation ran at nearly 3,000% per year, and the banks and the government split nearly 8% of GDP between them in inflation tax revenues. Brazil’s democratically elected governments quickly brought an end to inflation taxation. By the mid-1990s inflation had fallen nearly to U.S. levels, which forced banks to get into the business of actually lending money, rather than just earning income off of the “float” on checking accounts.

It was the inflationary surge that ultimately undermined the legitimacy of the military dictatorship and led to a transition to a democracy with a strong populist current. The government could then focus on redistributing income by shifting the burden of taxation toward the middle classes and the rich, by providing direct aid to families and increased spending on anti-poverty programs, and by having government-controlled banks like Banco do Brasil make loans to firms that could generate jobs in politically crucial areas. As a result, banks in Brazil, arguably for the first time, have made lending to the private sector one of their main focuses. All this has taken place in the context of deep reforms to government and fiscal institutions, providing some room for optimism about the future of the Brazilian banking system.

**Traveling to Other Places: Is Our Sample Representative?**

The type of narrative in these five case studies serves as a useful alternative and complement to econometrics, which takes *a priori* views from economic and political theories about the likely channels of causation to help sort cause from effect in the analysis of correlations.
These country narratives can be useful for identifying causal patterns, so long as they are more than a string of facts. In general, including the role of narratives in causal inference can help restore balance to the social sciences.

The five case studies then have a broad explanatory power for banking systems in other countries. They demonstrate that, all other things being the same, democracies are more conducive to a broad distribution of bank credit than autocracies. Second, they show that democracies with liberal institutions that make it difficult for bankers and populists to form coalitions are more conducive to both a broad distribution of bank credit and the absence of banking crises. Lastly, the cases illustrate how government safety nets, including deposit insurance, tend to destabilize banking systems, and that such safety nets are created not for reasons of economic efficiency but because they are outcomes of political bargains.

Conclusions

An obvious problem with the dominant theories of banking crises is that they see the crises arising from aspects of banking that are common to all times and places. As this book shows, however, banking crises are not common across time and space. Therefore, they cannot be a consequence of any general economic characteristics about banks, but result from these characteristics combined with specific aspects of the political environments in which banks operate.

General theories of banking crises posit three aspects of banking to explain the origins of crises: bank structure, interbank connections, and human nature. The decisive influences for these three factors to result in banking crises, however, are political. If the government decides to establish generous safety nets protecting banks, and does not accompany those safety nets with a credible commitment to prudential regulation, then banks will become less cautious in their management of risk. The extent of safety nets and prudential regulation are choices made by politicians, and in making those choices they generally are motivated by maximizing what is good for their own short-run political futures, not just what is socially desirable in the long run.

Political outcomes of the game of bank bargains shape the rules under which banks operate, and define the shocks to which they will be subject. The dramatic political differences across times and places where banking crises are absent or frequent show that a political economy approach to thinking about banking crises is essential to understanding the most basic facts about crises – that is, when and where they are likely to occur.

In the case of the United States, how likely to persist is the current political alliance between mega-banks and activist groups in the United States? The outcome is not clear. What seems certain, however, is that if that partnership persists into the future, some re-contracting will be required. The merger wave in U.S. banking during the 1980s and 1990s created strong partnering opportunities between big banks and urban community groups, resulting in increased lending to low-income groups. But the merger wave is over, and the banking crisis has deeply damaged popular support for both large-scale banking and risky mortgage lending. In the current U.S. environment, it is far from clear what the emerging alliance will be that will govern the Game of Bank Bargains going forward.

Societies do not choose their banking systems in any meaningful sense of the word. Instead, they get the banking system that their political institutions and dominant coalitions will permit. The
prospects for meaningful bank regulatory reform are more favorable in a democracy like that of the United States, but reform is not easy. A U.S. reform agenda that would end the subsidization of mortgage risk, end “too-big-to-fail” bailouts, create regulatory rules that would force banks to manage risk effectively and maintain adequate capital, and promote greater competition among large banks clearly would benefit the majority of citizens. It would reduce distortions in the allocation of credit, and it could bring an end to the crisis-prone history of the U.S. banking system.

But the reforms that have been introduced in the wake of that crisis have done little to end the subsidization of housing risk, to prevent banks from continuing to abuse the same system of capital regulation to hide risks in the future, or to prevent too-big-to-fail bailouts.

This unvarnished appreciation for the realities and ironies of the political world, and the difficulties of bank regulatory reform, should not be mistaken for cynicism or hopelessness. Despite its challenges, political entrepreneurship within a democracy can reshuffle the deck in the Game of Bank Bargains by getting participants in the game to revise their views of what best served their interests. This sort of political entrepreneurship may not always work, but then again, it might. Those who wish to improve the world – including its banking system – must begin from a clear sense of how political power is allocated, and identify gains for those that have the power to make beneficial changes happen.