Book Reviews

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

By Charles W. Calomiris & Stephen H. Haber

*Reviewed by Andrew Olmem**

"In this age, in this country, public sentiment is everything. With it, nothing can fail; against it, nothing can succeed."

Abraham Lincoln

For most people, the Financial Crisis of 2008 was an unexpected, unforgettable, and harrowing event. For Charles Calomiris of Columbia University and Stephen Haber of Stanford University, however, the crisis was just the latest in a long series of banking crises throughout American history. By their count, the United States has endured 12 banking crises since 1840. In their view, the more surprising and consequential number is the number of banking crises experienced by Canada during the same time period: zero.

In *Fragile by Design*, Calomiris and Haber set out to explain why some countries, like the United States, appear prone to banking crises, while other countries, like Canada, have been crisis free. Their conclusion is that it all comes down to politics. While this may appear to be an easy answer, their account of how politics shapes banking systems is a must-read for anyone interested in understanding the complex, political foundations of banking.

Calomiris and Haber begin by noting the sharp differences among countries with respect to the performances of their banking systems. Of 117 countries reviewed, most experienced at least one banking crisis since 1970, but 34 countries had no crises, while 21 countries had experienced more than one. Moreover, their analysis also revealed a wide-spectrum on the availability of credit. Only 6 countries had banking systems that were stable (no crises since 1970) and produced abundant credit.

What accounts for these differences? Calomiris and Haber contend that a country's politics shapes its banking system due to the interdependence of governments and banks. Banks need governments to enforce property rights and provide charters, while governments need banks to function as modern states, especially to fulfill military and welfare state commitments. Thus, banks are inherently connected to and impacted by governments.

What really matters though is how a government makes its decisions. This is where a country's political institutions play a decisive role because the powers and structures of political institutions affect outcomes. Through a process the authors' label the "Great Game of Bank Bargains," political institutions interact with banks, regulators, interest groups, and voters to first establish and then oversee a country's bank regulatory regime. The authors contend that the resulting "bargain" closely tracks the nature of the political institutions involved. For example, autocratic governments have a difficult time establishing banking systems because bankers and consumers/depositors (unsurprisingly) are unwilling to engage in banking in countries where property rights depend on the whims of the rulers. On the other hand, democracies with histories of protecting property rights are accompanied by banking systems where credit is widely available.

This emphasis on the importance of institutions is not novel. It is reminiscent of David Hume's essay *That Politics May Be Reduced to a Science,* where he argued that whether a government was "good or bad" depends not upon "the character and conduct of the governors," but upon "forms of government." What is unique, however, is Calomiris and Haber's use of economic history to support their conclusion.

To make their case, Calomiris and Haber recount the histories of banking for five countries (Brazil, Canada, Mexico, the United Kingdom and the United States). These economic histories make up the bulk of the book's 500 pages, but are hardly a slog. Rather, they provide not only a fascinating and illuminating tour of modern banking, but also a provocative discussion of the art of statecraft.

The histories of banking in Mexico and Brazil vividly illustrate the incompatibility of political instability and autocracy with a healthy banking system. Brazil and Mexico also provide Calomiris and Haber with examples of how changes in a country's political system produce corresponding changes to its banking systems. The recent emergence of democratic governments in those countries has been accompanied by significant advances in their banking systems. Banking supervision has improved, competition has steadily grown, and bank balance sheets have strengthened. In addition, inflation rates have fallen dramatically. It turns out that voting provides the public with a reasonably effective tool for preventing the government from expropriating the assets they hold at banks.

Yet, the existence of democratic governments in Brazil and Mexico does not mean that banking crises will be a thing of the past. Calomiris and Haber believe those countries still have a long way to go before their banking systems can be deemed successful. While democracy may be a necessary condition for a stable, healthy banking system, Calomiris and Haber by no means view it as sufficient. As their histories of banking in Canada and the United States reveal, structural differences in the political institutions of democratic governments can lead to very different banking systems and vastly different outcomes.

In Canada, the national government was granted exclusive authority over bank regulation by the Canadian Constitution. As a result, Canada created a national banking system comprised of large banks with nationwide branching. As noted earlier, this system has proven remarkably resistant to banking crises. Calomiris and Haber single out Canada's

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allowance of nationwide branching as particularly important because it allowed Canadian banks to allocate assets in response to regional economic shocks. Consequentially, regional economic problems did not lead to bank failures. Branches also enabled banks to capture economies of scale, further enhancing their financial resiliency, while also allowing them to efficiently serve Canada's dispersed small farming communities, as well as its large coastal cities. In this way, nationwide branching has been good for Canadian banks and Canadian consumers alike.

Calomiris and Haber also argue that by placing the responsibility for banking law in Canada's national (and bicameral) legislature, the Canadian Constitution made Canada's banking system more durable. Although transient political movements might be able to capture a provisional government, they are far less likely to be able to build the broad coalition needed to secure passage of national legislation, especially if, as Calomiris and Haber contend, Canadian banks have satisfied the needs of businesses and consumers across the country. Hence, throughout Canadian history this structural aspect of its government has provided security for property rights and limited government interference with Canadian banks. Indeed, Canada did not even have deposit insurance until 1967.

While Canada was establishing its national banking system, the United States was proceeding in the opposite direction. In contrast with the Canadian Constitution, the federalism of the United States Constitution preserved the states' authority to charter banks. Although Alexander Hamilton was initially successful in establishing the First Bank of the United States, his efforts to create a national banking systems were quickly overwhelmed by a state-based coalition of agrarian farmers, local merchants, and unit banks opposed to national banks. With Andrew Jackson's veto of a bill to reauthorize the Second Bank of the United States (the charter for the First Bank of the United States was allowed to lapse, but soon thereafter the need to finance the War of the 1812 prompted Congress to charter the Second Bank of the United States), this coalition achieved complete victory and its "bank bargain" was adopted. For the next 150 years, the banking system of the United States was highly fractured as states prohibited interstate, as well as intrastate, branching to keep banking confined to local communities.

Calomiris and Haber view the adoption of unit banking as a grievous error that left the country highly vulnerable to banking crises. Unlike in Canada, regional economic crises in the United States produced wide-spread bank failures as banks were unable to diversify their portfolios or act collectively to stem crises. Yet, unit banking endured according to Calomiris and Haber due in large part to the strength of state governments and local interests under the U.S. Constitution. Had the United States Constitution vested authority for banking law exclusively with Congress, the history of American banking would likely have followed a another course.

If this book had been written twenty-five years ago, this history would strongly recommend that the United States foster diversified national banks. And starting in the 1980's and culminating with the Riegel-Neal Interstate Banking and Branching Efficiency Act of 1994, this is exactly what happened. As Calomiris and Haber recount, these reforms were finally possible because the once invincible unit bank coalition had broken down in the face of demographic (growth in urban populations), regulatory (rising inflation), technological (automated underwriting; ATMs), competitive (emergence of large foreign banks), and market (rising bank failures) factors. Calomiris and Haber should have added growing popular support for federal regulation to this list as well, but they make the point nevertheless. By the mid-2000s the United States, like Canada, had nationwide branching and banks could operate coast-to-coast. Unfortunately, however, these reforms were insufficient to prevent the Financial Crisis of 2008.

To their credit, Calomiris and Haber recognize this dilemma and dedicate two chapters to explaining their views on the crisis. Many readers will find these chapters the most interesting, but the more valuable and insightful aspect of this book lies in its last chapter. There, Calomiris and Haber temper their earlier position on the importance of institutions, reflecting that in a democracy "[w]hat is crucial is *persistent popular support* for good ideas." This is a simple, but far too often neglected, truth with important implications. In particular, it signifies the limits of institutions. Certainly, as Calomiris and Haber persuasively demonstrate, institutions play a critical role in formulating and implementing policy, but, ultimately, their policies, as well as their authority, depend on public support.

Therefore, despite their emphasis on the role of institutions, Calomiris and Haber sensibly conclude by emphasizing the need for persuasive leaders to build coalitions favoring prudent policies. To demonstrate their point, Calomiris and Haber look to the success of Margret Thatcher in convincing the British public to support her economic reforms, including modernization of the financial system. Although London's place as a global financial center is often assumed to be a legacy of its empire, Calomiris and Haber correctly note that prior to Thatcher, its banking system was a relatively minor aspect of the British economy, having been over-regulated for decades under Britain's post-war welfare state experiment. It was Thatcher's Big Bang that really put London on the modern global financial map. It is worth noting that Thatcher's financial reforms were not accompanied by any corresponding changes in British political institutions. What made reform possible and durable was Thatcher's ability to persuade the British public that reform was in their interests. The consensus she forged was so strong that, even in the wake of the 2008 Financial Crisis, it remains largely intact.

Some readers will be disappointed that Calomiris and Haber refrain from setting forth the reform agenda future Thatchers should rally around. This is an understandable criticism, but their omission should be excused. The focus of this book is on the process by which banking systems are created. And in focusing on the process, Calomiris and Haber have wisely shown that the first step in preventing banking crises in democracies is securing public opinion. The task cannot merely be delegated to experts and regulators. The public must understand the reasons behind and steadfastly back at the ballot box the necessary policies to have a stable and healthy banking system. Absent such public support for sound underwriting, market pricing, and prudent regulation, however implemented, political institutions simply will be unable to do their part. Calomiris and Haber clearly see the difficulties in building the necessary coalition, but, as their valuable work reveals, in a free society there is no alternative.