



Cato Looks at Fragile Banking System

September 19, 2014

Robert Feinberg

The Cato Institute hosted a book presentation Sept. 8 for *Fragile by Design: The Political Origin of Banking Crises and Scarce Credit*, by Charles Calomiris, the Henry Kaufman Professor of Financial Institutions at Columbia Business School, and Stephen Haber, the A.A. and Jeanne Welch Milligan Professor in the School of Humanities and Sciences at Stanford University and a senior fellow at the Hoover Institution.

The event was moderated by Mark Calabria, director of financial regulation studies at Cato, and comments were provided by former Senate staffer Andrew Olmem, now a partner at Venable LLP.

Earlier this year the [American Enterprise Institute \(AEI\) held a similar program](#), but this writer, like the panelists, a long-time admirer of Calomiris, finds merit in taking another look because the book makes many provocative points and raises issues for further study.

At the threshold, this is one of the few books to examine the fundamental reasons why the banking industry is a constant source of financial mischief. This writer is much more concerned about the crisis part of the title than about scarcity of credit, because there are many sources of credit outside the banking system, and competing sources would probably be even more active if it were not for the vast array of direct and implicit subsidies of banks by the federal government.

In his introduction, Calabria observed that the causes of the 2008 episode of the ongoing financial crisis and even of the Great Depression are still hotly debated, and he noted the major finding of the book is that the United States has been subject to repeated banking crises whereas Canada has achieved the status of a prosperous industrial economy without ever experiencing such a crisis, even during the Great Depression. He called the book "an instant classic." The differences result from differences in the organization of government, regulation and interest groups.

Calomiris began by confronting the audience with the fact that the United States is living through "the worst pandemic of financial crises that the world has ever experienced," with a hundred banking crises worldwide over the last 40 years, corresponding to a negative net worth of failed banks equivalent to 16 percent of GDP, whereas from 1874 to 1913, also a period when banks played an important role in the economy, there were only 11 crisis episodes, an average severity of only 3 percent. Even in the Great Depression it was only 2 percent. Calomiris defined a banking crisis as either or both of 1) a sudden withdrawal of short-term debt, such as deposits

and 2) a very large number of bank failures.

The authors divide American history into three periods: 1) the Federalist period before 1830; 2) flourishing of unitary, agrarian banks (1830 to 1930); and 3) the rise of urban populist banks, which he attributes to a "new policy game" that brought together "too big to fail" banks and community groups seeking to grow through mergers that required Federal Reserve approval.

Through a combination of the 1992 government-sponsored enterprise legislation, which led to the subsequent wave of "no-doc" mortgage lending, and the earlier enactment of the Community Reinvestment Act (CRA), which empowered community groups to tax banks seeking to expand their branch networks, the book finds that the coalition partners were able to divide rents of as much as \$2.5 trillion. Because of the different structure of governmental and financial institutions in Canada, such a rent-seeking coalition never developed there.

Calomiris offered three policy takeaways: 1) Banking requires active participation of the government; 2) It is necessary to inquire as to which factions are in charge of the policy-making process; and 3) The ability to reform financial regulation is limited by the nature and organization of political institutions.

The ensuing discussion yielded ideas for further research, and readers can look forward to refinements and enhancements of this stimulating work.