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

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ABSTRACT

This paper provides review for Calomiris and Haber (2014) which demonstrates the links between politics and banking. In addition to the perspective in Calomiris and Haber (2014), several recent studies relating to financial crisis are also introduced here. Issues about illiquidity, insolvency, credit boom, accuracy of credit rating, and neglected risk are discussed. Banking system is the bridge connecting households and sectors in the economy, where the design of the banking system has significant influence on the developments of countries.

KEYWORDS

Banking System, Financial Crisis, Illiquidity, Insolvency, Neglected Risk

INTRODUCTION

An information cascade occurs when a person, having observed the actions of those ahead of them, follows the behavior of preceding individual despite of their own private information. The conformity of the behaviors can be fragile when a small amount of public information is released (Bikhchandani et al., 1992). Financial contagion1, a similar term extending from “information cascade”, represents the spread of market disturbances across sectors. However, does either information cascade or financial contagion explain the cause of financial crisis? According to Calomiris and Haber (2014), the answer may be no.

In Calomiris and Haber (2014), the coalition resulted from the incentives of politicians, bankers, bank shareholders, depositors, debtors, and taxpayers plays an important role in the design and stability of country’s banking system. They look over the frequency of banking crisis in the 117 nations of the world that have populations exceeding 250,000, are not current or former communist countries, and with data reported for at least 14 years in the World Bank’s Financial Structure Database between 1990 and 2010. The fact shows the nonrandom distribution of banking crises that only three of the twenty-one crisis-prone countries are from high-income nations, where the United States is on the list of crisis-prone countries. If being crisis-prone is viewed as an unfavorable characteristic and outcome of the countries, why can we still observe high-income and well-governed countries on the list of crisis-prone countries?

REVIEW OF BOOK

The book, Calomiris and Haber (2014), is for the readers who have interests in the history of banking system evolutions in the modern era and would like to know more about how politics can shape banking-system outcomes. The Game of Bank Bargains is the key concept connecting each chapter

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in the book. From their point of view, the government-banker partnership is no avoiding, and the conflicts of interest inherent in this partnership can make the banking system fragile by design. When bankers raise deposits and equity capital to finance their operations, they need government to grant their privileges (the bank charters). By granting the charters, government requires a set of obligations for banks, including taxes on bank profits or capital, maintaining sufficient holdings of government fiat currency and bonds, and submitting to government supervision. The bank charter enables bank to create money that serves as a legal tender for its payment, hold government deposits, and declare limited liability for its shareholders.

However, the conflicts of interest among government, bankers, bank shareholders, depositors, debtors, and taxpayers are interdependent and unavoidable. Bank shareholders and depositors have to create mechanisms either for preventing the bankers from expropriating their capital or compensating bank shareholders and depositors for the risk of expropriation. Similarly, banks and government, also banks themselves, have to create mechanisms either for preventing government and debtors from expropriating banks or compensating banks for the risk of expropriation. The government is not a disinterested and unitary player. For example, in order to gaining political support from the electorate, the group in control of government may allow banks giving the senior creditors a haircut for keeping the banks running and also the deposit base undamaged. Moral hazard then occurs while banks are given incentives to take wild risks. In the even worse case of bank failures, government may decide rescues and bailouts of banks under the bills of taxpayers (Calomiris and Haber, 2014).

The authors (Calomiris and Haber, 2014) illustrate the Game of Bank Bargains with several countries’ outcomes of banking systems in different time periods, such as England’s financial repression from the late 1700s to the early 1900s, U.S. banking from Colonial times to 1990s, and Banking and State Finance in Imperial Brazil. Credit scarcity and banking instability can be viewed as equilibrium outcomes resulting from specific political institutions within which banking systems are constructed. Generally speaking, autocracies tend to produce unstable banking systems with limited entry and scarce credit, while democracies tend to induce stable banking systems with relatively open entry and more abundant credit. In short, the Game of Bank Bargains is the struggle among political coalitions, which determines the rules for all the participants in the banking system.

PERSPECTIVES FROM ECONOMISTS

Now, let us go back to Economics world. A bank faces illiquidity when its short-term debts be withdrawn before its assets mature (Diamond and Rajan, 2011), while insolvency occurs when its total asset value is lower than the debts the bank has. Banks finance by uninsured demand deposits are vulnerable to runs (Diamond and Dybvig, 1983), which we can trace back to the situation of the U.S. commercial banking system prior to the creation of Federal Deposit Insurance Corporation (Hanson et al., 2014). For measuring the liquidity risk, Brunnermeier et al. (2012) propose the Liquidity Mismatch Index (LMI), in which the LMI would indicate the difference between the market liquidity on the asset side and the funding liquidity on the liability side. Besides the illiquidity problem, insolvency of a bank is also an important concern.

Economists have debated either illiquidity or insolvency causing the collapses of banking system since the early 1930s (Richardson, 2007). However, illiquidity and insolvency interact and can cause each other. While aggregate liquidity conditions can affect bank solvency, bank solvency can also affect aggregate liquidity. The anticipated insolvency of a bank causes the withdrawal of its debts, which forces the fire sales of its assets to fulfill the liquidity demand. Moreover, a bank run exacerbate the aggregate liquidity shortages, which causes more banks insolvent. Liquidity infusion helps when
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