Marriage of government and banks: For better or for worse!

Alex J. Pollock of the American Enterprise Institute waxes lyrically about Charles Calomiris and Stephen Haber's latest study.

***Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, by Charles Calomiris and Stephen Haber, combining their scholarship of banking and political institutions, is a book full of fertile ideas, instructive histories of the evolution of a number of banking systems, and provocative interpretations of the co-dependency between banks and governments.**

Three main tenents inform the bulk of Calomiris's and Haber's joint study of the banking sector, namely that each banking system needs to be understood as a mutually profitable deal between the politicians who control the government and the bankers who receive government charters for their banks. These deals vary among countries in historically contingent or "path dependent" ways, resulting in quite different banking systems – in some countries, robust; in others, systems prone to collapse. The governments of modern states absolutely need banks, not least to lend money to the government itself. In exchange, they grant banks various charter privileges, including restricted competition and government support. Likewise, the banks need the government for their chartered existence. Working out the specifics of these deals the authors call "the game of bank bargains."

Thinking of banking systems in this fashion, as deals between governments and banks, is without question a deep and powerful perspective.

As a perfect current example of such a deal, consider that European banks are now full of credit to European "sovereign borrowers," i.e. governments. In two particular cases, as economist Brendan Brown recently observed, "Spanish and Italian banks have been loading up on their domestic government bonds, as part of their deal in the overall rescuing of those respective sovereigns from insolvency."

Meanwhile, paradoxically, the credit of the banks themselves is dependent on the support of these governments.

As Brown continues, "Yes, the banks get regulatory forbearance on their holding of government bonds" – of course! since the regulators work for the government – "and can treat the carry trade profit on these as

full earnings with no loss reserves. And yes, there are barriers to entry of new banks who would not own legacy bad assets and who might refuse to take part in government financing. Yet would-be equity shareholders are deeply anxious about this façade."

The "Grand Bargain"

In one sense it is indeed a façade. But in another, it is a classic government-bank bargain – more appropriately termed a "Grand Bargain." The European situation has been referred to as "the perverse nexus of governments and banks." Calomiris and Haber's argument is that a nexus between these two is always there, though it may or may not be perverse.

In this perspective, "banks" include the central banks, which are an essential part of the banking system and an essential part of the government-bank deal. This is exemplified by the European Central Bank's "whatever it takes" support of government debts, and even more explicitly in the Federal Reserve's monetisation of US Treasury debt and government mortgage securities – to the combined tune of US$4 trillion.

Old Lady of Threedneedle St.

This pattern is nothing new. Central banks are always available to lend money to the government when needed, and get in exchange monopoly powers. This is seen in archetypical form in the history of the Bank of England – often referred to as the "Old Lady of Threadneedle Street."

As the book discusses, the foundation of the Bank of England in 1694 was a bank-government deal in pure form: The Bank committed to lend the government money to finance King William's wars against France, and in return got a monopoly in limited liability banking and in currency issuance in London.

The long-term history of banking cannot be considered apart from the history of wars, which have generated the biggest government needs for borrowing and for inflationary depreciation of debts.

A notable example of a bank bargain (Grand Bargain) in the context of war, as instructively explored in the book, is the US National Banking Act, originally called the National Currency Act, of 1863-64, developed under the auspices of the Abraham Lincoln Administration.

Demands of war

This key banking deal was to help finance the vast American Civil War, by creating national banks which could issue paper currency for a profit, but which in order to do so, had to buy an equivalent amount of US government bonds – a clever idea. It was also intended to create a uniform national currency, and drive the currency previously issued by hundreds of state-chartered banks out of circulation.

It was thus a nationalist idea, and yet, as Calomiris and Haber convincingly argue, it left intact an older bank deal, that guaranteed a state-centered banking system of mostly small, undiversified, local unit banks. This was, they further argue, the result of a robust political coalition between rural populists and unit bankers to fend off any concentration of financial power in the form of nationwide banks. The success of this coalition for 150 years meant that US banks were limited to single states, and often to single

offices – as they were when I myself was a young banking officer.

Catalogue of crisis

The result of this government-bank deal, the authors conclude, was to give the United States a fragmented, risky banking system prone to periodic panics and collapses. The country (USA) witnessed banking crises, by the authors' count, in 1837, 1839, 1857, 1861, 1873, 1884, 1890, 1893, 1896, 1907, the 1920s, 1930-33, 1980-92, and 2007-09. We should add the crisis of 1974-76 to this long list of episodic banking events.

In time, Calomiris and Haber relate that the rural populist-small bank coalition was replaced by a new one: urban populists and big banks. This reflected the shift from a predominantly rural to an urban population, but also in the political dynamics of the rapid banking consolidation which has marked the past three decades.

US Federal legislation of the 1970s put urban populist "community groups" in a position to object to, delay and possibly stop mergers which the big banks wanted to do, as the long-delayed natural consolidation of American banking got rolling.

New "populist" alliances

It was cheaper and more efficient for the big banks to promise money and lower credit quality loans to the constituencies of the urban populist organisations, than to have their mergers held up, thus launching a new political alliance.

This shift of US bank bargains –"Grand Bargain" – over time is strikingly symbolised by the names of the Congressional committees with jurisdiction over banks. Traditionally, in both the Senate and the House of Representatives, the name was "The Committee on Banking and Currency." A sensible title.

But in the 1970s, the Senate committee changed its name to "The Committee on Banking, Housing and Urban Affairs," while the House changed to "The Committee on Banking, Finance and Urban Affairs." The new names represent very different ideas from the old one! As a former Senate Committee staffer told me, "It seemed like the committee was more about housing than banking."

Canada: A paragon of virtue?

After the Republican Party took control of the House in the 1990s, they changed the Committee's name again, to "The Committee on Financial Services." The different names in the two houses now nicely summarise two very different approaches: whether the government should be the guarantor of housing finance and the promoter of low quality mortgage loans and higher leverage or not!

A banking system with a different bank bargain, and the banking system most admired by Calomiris and Haber, is that of Canada. Indeed the Canadian system has much to say for itself, especially its long-term stability as contrasted with the US propensity for cyclical collapses. Since 1839, the authors write, "some Canadian banks have failed, but the country has experienced no systemic banking crises. The Canadian system has been extraordinarily stable…there has been little need for government intervention in support of the banks since Canada became an independent country in 1867."

How this historically came about is described in interesting detail, with Canada's notable banking stability provides a convincing refutation of the theory of the proponents of the Glass-Steagall Act, or more recently of the "Volcker Rule," since Canada's principal banks are all universal banks, which combine commercial, investment, and retail banking, as well as other financial services.

Stability and competition?

Canada is similar to the US in many ways, though economically on a smaller scale. Its population is about 11 per cent of the United States, and its GDP is likewise about 11 per cent. But its banking assets are proportionately much bigger, about 23 per cent of the US. And in contrast to the 7,000 US banks, only five nationwide banks entirely dominate the Canadian banking sector.

An oligopoly of five nationwide banks has evidently provided stability. But is Canadian banking competitive, with the advantages for customers only competition can bring? Calomiris and Haber consider the evidence and conclude that it is quite competitive. So what's not to like?

Canadian housing bubble

Maybe real estate lending? Interestingly enough, US national banks and Canadian chartered banks were both originally prohibited from making real estate loans, since these were considered too risky for banks.

In both countries that prohibition is long gone. In the US, even the central bank is now a US$1.7 trillion investor in real estate loans, and the five big Canadian banks own most of the real estate mortgages in their nation.

Furthermore, Canada did not share in the extremes of the 2007-09 banking crisis, but five years later, does now seem to have its own housing bubble. At least housing prices there are at historic highs, having increased far more than US house prices did at the peak of its bubble. What happens to the Canadian banking system then, if or when their housing bubble deflates? Will it retain its historical record of banking stability? This may be a good stress test for the Canadian bank bargain.

Omissions

Speaking of the future, I wish the authors had more to say in the way of explicit prescriptions, especially for the US government-bank deal, to add to their admirable history. Would we in the US, for example, want five nationwide, universal banks with 90 per cent of the market among them, in exchange for the stability of the Canadian system? If five is too few oligopolistic, nationwide banks for a country as big as the US, how many such banks would we like?

Should we try to move to a non-populist bank bargain like Canada's? Even though the book's theory suggests that given our historical path, we can't get there, should we try? How many banks should the US have in total? If 7,000 is too fragmented and unstable, what is the perfect number?

How can we undo the housing part of the US bank bargain and defeat the coalition which promotes hyper-leveraged real estate risk, as symbolised in the name of the Senate committee? Is some other coalition possible? Perhaps the sequel to *Fragile by Design* will address these and other pressing questions. •