THE BLIGHT OF BANK BAILOUTS

TAXPAYER GUARANTEES ARE LIKE ICEBERGS – INVISIBLE UNTIL THEY SINK THE FISCAL SHIP

BY CHARLES W. CALOMIRIS & STEPHEN H. HABER

IS THERE HOPE FOR REFORM?

Perhaps not, at least until we recognize a major source of the world's government debt. When economists and politicians talk about the problem of unsustainable government debt, they often focus on the need to rein in government budgets and entitlement policies. But over the past four decades, for many countries, the most important source of government debt unsustainability has been something else: hidden guarantees for banks that behave a bit like icebergs — one can barely see them, and then all of a sudden, they sink the fiscal ship of state.

The United States saw a substantial bailout cost in 2008 with respect not only to the Troubled Asset Relief Program support for banks, but also the massive spending in support of Fannie Mae and Freddie Mac, which were rescued from insolvency by huge injections of taxpayer funds. However, this is not just a U.S. problem. According to Luc Laeven and Fabian Valencia of the International Monetary Fund, of the 117 nations with populations in excess of 250,000 — specifically, those not current or former communist countries and with banking systems large enough to consistently report data on private credit in the World Bank's Financial Structure Database — only 34 (29 percent) avoided a major banking crisis from 1970 to 2010. Sixty-two countries had one banking crisis. Nineteen countries experienced two. One country underwent three, and another weathered no less than four.

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Banking crises suddenly overwhelm countries' fiscal accounts, adding hugely to their debts. Between 1970 and 2011, the median direct fiscal cost of bank bailouts during these crises was 6.8 percent of GDP, and the median increase in country indebtedness during a crisis was 12.1 percent of GDP (also reflecting recession-induced deficit increases).

Ballooning government debt is not the only social cost of banking crises. They also cause enormous losses in GDP due to collapses in bank credit supply, losses in international creditors' confidence, capital flight by international investors, and exchange rate collapses that produce spikes in the cost of imports. Severe recessions result. From 1970 through 2009, the median lost output during a banking crisis amounted to 23 percent of GDP.

This pandemic of banking crises is unprecedented. What is causing it? Two kinds of influences are particularly important: political risk and excessive taxpayer protection of banks. Comparing the list of crisis-free countries with those that have had the most crises, the importance of political risk is readily apparent. Argentina — a nation so badly governed for so long that its political history is practically a synonym for mismanagement — had four banking crises since 1970. The close runner-up (with three crises since 1970) was the Democratic Republic of the Congo, a nation whose brutal colonial experience served as the inspiration for Joseph Conrad's *Heart of Darkness*. After independence, the Congo was governed by Mobutu Sese Seko, one of the world's longest-lived and most avaricious despots, whose subsequent history is itself a template for tragedy. Argentina and the Congo stand in stark contrast to crisis-free countries such as Australia, Canada, Hong Kong, Malta, New Zealand and Singapore.

Regarding the influence of taxpayer protection on the propensity for crises, a plethora of research over the past two decades has shown that such protection has grown dramatically in recent decades. In fact, the more banks are protected (for example, by generous deposit insurance guarantees), the more they realize that they stand to win by undertaking risks at taxpayer expense. This problem could have been forecast. Indeed, the U.S. president who enacted FDIC deposit insurance in 1933, Franklin D. Roosevelt, warned of these dangers in a 1932 letter to the New York Sun, in which he predicted that deposit insurance would "lead to laxity in bank management and carelessness on the part of both banker and depositor."

Why, then, did Roosevelt agree to enact deposit insurance? And why do taxpayers in so many countries tolerate the disastrous consequences of the increased risk that it has brought? For Roosevelt, it was a matter of political compromise — giving in on deposit insurance to get other things that he wanted. For taxpayers, part of the answer is the difficulty of putting the pieces together — in other words, seeing the connections between government protection of banks and the catastrophic losses of banking crises. Furthermore, bankers obtain protection through powerful political alliances, forged through deals with many unlikely partners — a process referred to as the Game of Bank Bargains.

Is there hope for reform? Certainly, taxpayers' resentment over bank bailouts is growing. The unresolved question is whether such resentment will lead to meaningful changes in public policy — most crucially, a regulatory regime that credibly constrains bank risk-taking at public expense. Reformers, of course, always claim to have solved the problem — the Dodd-Frank Act in the United States is one example — but thousands of pages of new rules do not necessarily produce credible reform. After all, powerful interests with substantial amounts of money are at stake, and the details of financial regulation are not generally the subject of family dinner conversation. It is all too easy to pretend to enact meaningful reforms while really enacting window dressing. It will take a great deal of public pressure and an increase in the public's attention span to change the rules of the Game of Bank Bargains. ◆

CHARLES W. CALOMIRIS is Henry Kaufman Professor of Financial Institutions at Columbia University and a visiting fellow at the research department of the International Monetary Fund. **STEPHEN H. HABER** is the A.A. and Jeanne Welch Milligan Professor in Humanities and Sciences and the Peter and Helen Bing Senior Fellow of the Hoover Institution at Stanford University. They are the authors of Fragile By Design: *The Political Origins of Banking Crises and Scarce Credit* (Princeton University Press, 2014).