BANKS ON THE BRINK:

GLOBAL CAPITAL, SECURITIES MARKETS, AND THE POLITICAL ROOTS OF FINANCIAL CRISES

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Brief Overview of the Book

Banks on the Brink explains why some countries are more prone to systemic bank failures than others. We focus on the political decisions that shape the structure of financial markets and the international economic forces that make some countries especially vulnerable to financial instability. We highlight the effects of two variables in combination: foreign capital inflows and financial market structure – specifically, the relative prominence of securities markets versus commercial banking in the domestic financial system. Foreign capital is the fuel for banks' potentially dangerous behavior, whereas banks are more likely to take on excessive risks when operating in a financial system with large securities markets.

The study of banking is inherently political, but not in the way that many observers might imagine. Granted, bankers themselves have political preferences and may express them publicly, and some banks lobby for favorable public policies and donate to political campaigns and political action committees. But at a deeper level, banks are embedded in financial markets, which themselves reflect an accumulation of government choices. Banks today operate in an environment shaped by these choices, some of which make banks more resilient, others of which make them more prone to crisis.

Our research design combines statistical analysis with comparative historical case studies. We assemble and analyze data from the 1970s through the early 21st century for most of the world's developed economies, and we compile detailed historical narratives of two countries – Canada and Germany – to explore how countries embarked, often inadvertently, on divergent financial development paths in the 19th and early 20th centuries. The long-term effects of their early political decisions are still manifest today in the structure of their respective financial systems. Our quantitative empirical analyses include macro-level investigations of the correlates of banking crises across developed countries as well as micro-level studies of banks' risk taking. Our case studies constitute one of the book's unique strengths. In contrast to most recent studies of financial crises, we look beyond the immediate events of the last decade and beyond the case of the United States to identify the key determinants of banking crises across space and time. Our historical analysis of Canada—which has never experienced a systemic banking crisis—demonstrates that the Canadian constitution and subsequent political decisions put the country on a path toward powerful and centralized banks and regionally fragmented and underdeveloped stock markets. Our case study of Germany illustrates how interest-group and party politics, rising nationalism and anti-Semitism in the late 19th century, and the Nazis' ascendance to power in the 1930s all maneuvered to restrict the development of stock markets prior to World War II, and how these restrictions persisted in the postwar era until the 1980s. In both cases, we show that banks were stable as long as competitive pressures from stock markets were weak; as stock markets grew in prominence, so did the potential for foreign capital to trigger a debilitating crisis. These case studies highlight how political battles and decisions in the late 19th and early 20th century have had long-run implications for financial stability.

The concluding chapter addresses policy responses to bank instability. Perhaps surprisingly, our findings suggest that Glass-Steagall regulations which separate commercial and investment banking would *not* address the underlying reasons for banks' excessive risk taking. We also argue against capital controls. Instead, we suggest that regulators should focus their efforts are tightening bank capital requirements, especially in financial systems with prominent or growing securities markets. We also discuss the pros and cons of combining bank regulatory agencies, securities regulators, and central banks.