

Fatalistically Flawed: A Review
Essay on *Fragile by Design*, by
Charles W. Calomiris and
Stephen H. Haber

By George Selgin
March 19, 2015

CATO WORKING PAPER
No. 28/CMFA No. 4



1000 Massachusetts Avenue NW, Washington DC 20001

*Cato Working Papers are intended to circulate research in progress for comment and discussion.
Available at www.cato.org/workingpapers.*

Fatalistically Flawed: A Review Essay on
Fragile by Design, by Charles W. Calomiris and Stephen H. Haber

George Selgin, Director
Center for Monetary and Financial Alternatives
The Cato Institute
Washington, DC 20001
gselgin@cato.org

Forthcoming in *International Finance*. I am grateful to Don Boudreaux, Hugh Rockoff, and Peter Selgin for their comments and suggestions.

Calomiris, Charles W., and Stephen H. Haber (2014), *Fragile by Design: The Political Origins of Banking Crises & Scarce Credit*. Princeton: Princeton University Press.

I. Introduction

Not long ago a colleague of mine, who works regularly with legislators, attended a conference at which the lunch speaker, a famous economist, began by telling everyone why governments regulate financial institutions. The reasons the economist gave consisted of various (supposed) financial-market failures. Said the colleague to me later: “I just wanted to stand up and shout, “That’s got nothing to do with it!”

I relate this because some readers may otherwise fail to appreciate the importance of a work whose chief revelation is that financial legislation—and consequently the general structure of financial systems—are shaped by politics. My colleague didn’t need to be told, but others, including many economists, evidently do.

In *Fragile by Design: The Political Origins of Banking Crises & Scarce Credit*, Charles Calomiris and Stephen Haber tell them. Banking arrangements, they argue, are “not a passive response to some efficiency criterion but rather the product of political deals that determine which laws are passed” (pp. 13 and 38).¹ What’s more, the laws such deals give rise to are, more often than not, detrimental to bank safety and soundness. In few words, banking instability has its roots, not in any fragility inherent to commercial banking, but in deals struck between governments and various interest groups.

Fragile by Design is at once an alternative interpretation of the history of banking and a contribution to the debate on the causes of the recent crisis. Though other reviewers have tended to focus their attention on the latter contribution, many of *Fragile by Design*’s most important insights, as well as many of its more serious flaws, are independent of its take on the subprime crisis. It is to those insights and flaws that I wish to draw attention.

¹ Where parentheses contain page numbers only, the reference is to Calomiris and Haber (2014).

II. Daring History

In a passage that ought to be emblazoned on every monetary economist's laptop, John Hicks (1967, p. 156) observed that "Monetary theory is less abstract than most economic theory; it cannot avoid a relation to reality, which in other economic theory is sometimes missing. It belongs *to* monetary history, in a way that economic theory does not always belong to economic history."

What goes for monetary theory goes for theories about banking, because there's no separating the two. Unlike most other works on banking instability, *Fragile by Design* takes Hicks' observation seriously. By doing so, it exposes the parochialism, if not the sheer ignorance of history, upon which most conventional wisdom about banking instability rests.

At the heart of this wisdom lies the claim that commercial banking systems are inherently unstable. As Nobel Laureate Robert Lucas put it in a series of lectures he gave during and after the 2008 crisis, "a fractional reserve banking system will always be fragile, a house of cards" (Lucas 2011). "Even a superficial acquaintance with the basic facts of banking history," Calomiris and Haber observe, reveals an obvious problem with this claim and theories of banking crises based on it. Were all modern banking systems really so many "houses of cards," one would expect to see crises happening everywhere, whereas in truth "some countries have had many [crises], whereas others have had few or none" (p. 480). Evidently the peculiar features of different banking systems also matter. And those differences themselves mainly reflect the different banking laws to which political conditions give rise. In short, unstable banking is an unintended consequence of the political horse trading that Calomiris and Haber call the "Game of Bank Bargains" (p. 27).

Fragile by Design is a brave book, not just because it challenges conventional wisdom, but because it challenges it using "narrative" history—the old-fashioned, verbal sort. To appreciate how daring this is, one must appreciate the culture that's taken hold of academic economists and (alas) even many political scientists. To those steeped in that culture, writing "narrative history" is but a poor man's alternative to gathering numbers and running regressions. To their colleagues who wonder why they "bothered with

hundreds of years of history” instead of crunching numbers (p. 25), Calomiris and Haber must explain that:

when people want to understand the factors that shape complex systems and shift those systems from one equilibrium to another, they undertake multidimensional analyses—and one of the dimensions on which they focus is time (p. 25)

and that:

Researchers who do not take history seriously wind up reducing the study of complex banking systems to an analysis of correlations among various influences... This approach often fails to find the connections because the influences being modeled are considered without taking context into account. And when such a modeling approach does find empirical correlations, the meaning can be misinterpreted because the correlations identified by the researcher reflect deeper, omitted influences on all the variables being measured (p. 486).

Readers free of the economics profession’s peculiar prejudices might rather be spared such ponderous apologies for doing history. Still, they have reason to be grateful to Calomiris and Haber for rejecting those prejudices.

III. Tales of Two Countries

Narrative history, no less than econometrics, can be done well or badly. Calomiris and Haber often do it very well, as in their review of the Bank of England’s origins, and of the bearing of some of its many legal privileges on British financial stability.

“The Bank of England,” they observe, introducing their account, “was a monopoly set up to finance a government that had spent more than it taxed and which was therefore willing to trade a set of lucrative privileges to a group of financiers in exchange for loans to the government” (p. 84). Over the course of the Bank’s first decades the government enhanced its privileges, enfeebling other English banks (especially by limiting them, until 1826, to six partners or less), in return for further fiscal assistance. In

other words, the government “quite consciously constrained in the growth of the banking system in order to favor itself” (p. 85).

King and Parliament depended on the Bank because, from the time of the Bank’s founding until Napoleon’s defeat more than a century later, it was almost constantly at war with France. Calomiris and Haber skillfully review that ongoing conflict, showing how the Bank financed England’s part in it; how, by its “six partner rule,” the government, in Lord Liverpool’s famous words, created a banking system “of the fullest liberty of what is rotten and bad, but of the most complete restriction as to all that is good” (Dowd 1989, p. 125). The stage was thus set for repeated crises that helped to give rise to the current myth that banking systems are inherently fragile. After surveying those crises the authors turn their attention to Scotland where Parliament chose not to concentrate privileges in a single bank. Thanks to that decision the Scottish banking system, instead of taking part in England’s recurring crises, became “the very model of competition, innovation, accessibility to credit...and stability” (p. 101).²

Fragile by Design’s survey of North American banking history is equally engaging. In the United States, the substantial powers enjoyed by state governments (bolstered, I might add, by the view that “banking” was distinct from “commerce,” and therefore unprotected by the Commerce Clause), resulted in “a fragmented system composed of thousands of geographically isolated unit banks” (p. 183), Thanks to a “unit banker-agrarian populist coalition,” this system endured until 1994, when the Riegle-Neal Act finally did away with surviving barriers to branch banking (p. 195).

By then, however, a new demon possessed U.S. banking: moral hazard. The roots of that problem also lay in unit banking, for as Calomiris and Haber observe,

Although the civics textbooks...portray deposit insurance as a necessary step to save the banking system, all the evidence indicates otherwise: it was a product of

² Although Calomiris and Haber’s assessment of the performance of the Scottish banking system is sound, their explanation for its relative freedom—that “the crown” [*sic*] simply found it “easier to adopt a policy of laissez-faire” there while relying upon the Bank of England for financial support (p. 103)—is not. The truth is rather that Parliament, suspecting the Bank of Scotland’s directors of Jacobite sympathies, ended its monopoly of Scottish banking, and thereby opened the way to competition, by chartering the Whig-controlled *Royal Bank of Scotland* in 1727.

lobbying by unit bankers who wanted to stifle the growth of branch banking (p. 190).

But it was the doctrine that some banks are “too big to fail,” traceable to the Fed’s bailout of Continental Illinois in 1984, that really made the problem explode, causing the banking-structure pendulum to swing, as barriers to branching tumbled, from the noxious pole of fragmentation to that of rampant and excessive consolidation (pp. 215-16).

Canada, by contrast, achieved a remarkable degree of banking-system stability—not since 1839 has it witnessed a serious financial crisis; remarkably, it did so “with little government intervention to protect or shore-up failing banks” (p. 284) and, until 1935, without a central bank that could serve as a lender of last resort. Canada’s successful arrangement rested on its own very different version of federalism, one that gave its central government “a monopoly over economic policy making” (p. 286), thereby denying local governments the ability to throw-up barriers to branching.

The experiences of Britain and North America are especially informative, as they offer what economists call “natural experiments”—instances in which otherwise similar or integrated economies differ chiefly in their politics and policies, making it relatively easy to link differing economic outcomes to different policies. The policies in turn can more easily be linked to deeper political differences.

But rather than rest their case on these experiences alone, Calomiris and Haber go on to review the experiences of Mexico and Brazil, from which they draw conclusions regarding the influence of autocratic regimes on banking structure. They also take briefer looks at several other countries—Germany, Japan, Chile and China—to decide whether their banking experiences contradict, as they superficially seem to, conclusions drawn from the countries they look at more closely.

Still I plan to devote most of my remaining remarks to *Fragile by Design’s* interpretations of British and North American experience, both because I regard these interpretations as especially informative, and because I think they reveal most clearly the work’s main shortcomings. Those shortcomings consist of (1) a misleading account of governments’ necessary and desirable role in banking; (2) a tendency to overlook the

adverse historical consequences of government interference with banks' ability to issue paper currency; (3) an unsuccessful (because overly deterministic) attempt to draw general conclusions concerning the bearing of different political arrangements on banking structure and (4) an almost complete neglect the of role of *ideas*, and of economists' ideas especially, in shaping banking systems, both for good and for evil. The last two shortcomings are especially unfortunate, because they suffuse *Fragile by Design* with a fatalism that weakens its own capacity to prompt needed change.

IV. States and Banks

Though they deplore many of the outcomes of the Game of Bank Bargains, Calomiris and Haber also believe that “There is no avoiding the government-banker partnership” that is the most dangerous bad outcome of them all:

Thinking that one can do so is tantamount to a utopian dream—reminiscent of John Lennon’s famous song “Imagine”—that human civilization can function without countries. Bankers who imagine that they can live in a world without countries will, despite Lennon’s assurances, find it hard to do so. They rely on the police power of the state. [As Bismarck might have said], for better or worse, successful bankers interested in solving their fundamental property-rights problems must ally themselves with governments that have iron and blood at their disposal (p. 27).

While bankers depend on states to define and enforce their basic property rights, states in turn depend on bankers for revenue, especially to pay for expensive wars. At least one bargain between bankers and government is therefore unavoidable: governments supply the necessary laws, but only in return for bankers’ fiscal support.

Banks, Calomiris and Haber say, must turn to states for legal support because only states can “enforce [bankers’] contracts with one another, with the merchants, and with foreign states” (p. 83). In particular, the development of bills of exchange and banknotes (a later offshoot) called for “the legal enforcement of a new concept of debt, which became known as the negotiable instrument,” and that enforcement in turn “required the

involvement of the state, which had to determine through its statutes and courts what sorts of contracts were enforceable under the law and on what terms” (p. 73).

But legal historians say otherwise. Many in fact view the law of bills as the paradigmatic instance of law developing where there are, in effect, “no countries,” namely, in the realm of international trade. Instead of being nurtured by governments, the law took root within the *lex mercatoria* or “Law Merchant”—a merchant-based system of adjudication that came to govern international commerce after the fall of Rome. As such the law was, according to the standard view, “voluntarily produced, voluntarily adjudicated and voluntarily enforced” (Benson 1989, p. 647, and sources cited therein). Nor could it have been otherwise. Official courts, unlike their merchant-governed counterparts, long refused to adjudicate disputes arising from contracts involving either foreigners or the least hint of usury. Nor could merchants count on state courts to correctly judge cases involving unfamiliar technicalities of exchange, let alone do so expeditiously enough to avoid disrupting their affairs (Benson p. 650). Finally, England’s common-law courts long resisted treating a bill as a contract binding upon its drawer (or, after acceptance, its drawee) to pay whoever held it in good faith, as opposed to a mere written instruction incidental to an underlying sale (Rogers 1995, pp. 94ff; Kohn 1999, p. 3). In short, much of the commercial law that Calomiris and Haber confidently insist can be created and enforced only by sovereign states was in fact created and enforced beyond, or only at the edges, of their jurisdiction.

Calomiris and Haber’s attendant belief that states need banks and, specifically, that they need “chartered” banks (meaning ones granted unique privileges), likewise rests on flimsy ground. This time the culprit is not bad history but the assumption that what was true historically remains so today. Past rulers, to be sure, “needed” chartered banks “to provide the funds necessary to fight the seemingly endless wars involved in building viable states” (p. 61). But that hardly proves that states “need” such banks for such support today. Today thick markets for their securities make it possible for at least some governments to borrow immense amounts without resorting to banks at all. And though even otherwise well-financed governments might borrow more cheaply from central

banks, such borrowing—unless it’s merely incidental to the pursuit of macroeconomic stability—threatens to undermine that stability. In light of such considerations it seems atavistic to insist that modern states “need” banks for their very survival, to say nothing of their needing them as “Tools of Conquest” (p. 60).

As if anticipating such criticism, Calomiris and Haber ask, “Why are [chartered] banks ... more ubiquitous than armies or taxes?” (p. 60) Good question. The answer, though, isn’t that such banks are ubiquitous because they are “essential to modern states” (ibid.). Most of today’s central banks (to refer to privileged banks of issue by their contemporary name) have been established since World War I, for reasons quite different from those that informed the establishment of most earlier ones. As I shall explain later, these reasons had nothing to do with states’ fiscal needs.

In short, the observed interdependence of states and banks isn’t as deep-seated and inescapable as Calomiris and Haber claim. Consequently, keeping bankers and governments from getting too cozy with one another isn’t quite so difficult as they suppose.

V. Banknotes in Britain

For the first two centuries of the history of commercial banking, banknotes were an indispensable means of bank funding, and the Game of Bank Bargains was mainly played over who could and could not issue them, and under what conditions. Calomiris and Haber recognize this. But instead of putting laws restricting banks’ freedom to issue paper currency under the same hot lamp they employ in examining other outcomes of the Game of Bank Bargains, they tend to let these restrictions off scot-free.

This leniency may stem, in part, from Calomiris and Haber’s exaggerated view of states’ role in making banking of any sort possible, which causes them to exaggerate as well states’ part in the development of paper substitutes for coin. “The creation of the chartered bank as a fundamental institution of the modern state,” they write, “soon gave rise to another fundamental innovation...fiat (paper) currency” (p. 74). They add that “for an IOU—in particular, a banknote or any other paper money—to function as a legally

accepted measure of value for settling debts, it had to be given legal-tender status under the law” (p. 75).

Even allowing “fiat currency” (a term generally used to refer to inconvertible paper money) to refer to convertible banknotes, these claims are incorrect. Although it’s true that receipts for coin deposited at the government-sponsored Bank of Amsterdam, established in 1609, were frequently traded and served to some extent as substitutes for coin itself (p. 75), these receipts traded, not at par, but at an agio of 4 or 5 percent, which is what the Bank deducted in cashing them, and so were distinct from genuine banknotes.³ Actual banknotes made their first appearance, in the West, around the middle of the 17th century, in the shape of London goldsmiths’ “running cash” notes, and so anticipated the first banknotes to be issued by a chartered bank—those of the Bank of Sweden, in 1661—by some years.

Nor is “legal tender status” needed for banknotes to be “legally accepted...in settling debts” (p. 75), though it may of course serve to *compel* their acceptance. Throughout the history of banknotes, as distinguished from irredeemable fiat monies, legal tender status has actually been the exception rather than the rule. Even the commercially-issued banknotes currently in use in Scotland and Ireland are not legal tender. Indeed, because Bank of England notes are themselves legal tender only in England and Wales, there is today no such thing as a legal tender in either Scotland or Ireland.

Whether such misconceptions are to blame or not, the fact remains that Calomiris and Haber often overlook the part regulation of banknotes has played in siring financial instability. They claim, for example, that during the decades following the 1825 Panic Parliament saw to the “unwinding” of the Bank of England’s monopoly (p. 111), thanks to which “advocates of greater competition in bank chartering ultimately won the day” (p. 114). But while reforms did allow rival joint stock banks to be established, first beyond a 65-mile zone centered in the City of London, and later within that zone as well, the same

³ The agio was necessary because for most of its existence the Bank of Amsterdam kept reserves almost equal to its outstanding receipts, and so could not have covered its operating expenses without it. In this respect the Bank was more a warehouse than a financial intermediary.

reforms, and Peel's Act especially, far from "unwinding" the Bank of England's monopoly of paper currency, solidified and eventually perfected it. The supposed victory of advocates of bank competition was therefore a half-victory at best.

The victory was, moreover, a pyrric one also, for England's banking crises, instead of "immediately ending," as Calomiris and Haber's own account of their causes might lead one to expect, "persisted for four decades" (p. 106), dooming many of England's newer joint-stock banks. Calomiris and Haber, instead of suggesting that the Bank's monopoly of currency contributed to this persistence, claim that consolidation of that monopoly was crucial to the Bank's conversion into a "stabilizing" last-resort lender (p. 112).

The truth is quite otherwise. Even when it was still limited to London the Bank of England's currency monopoly caused other English banks to treat its notes, rather than gold or silver coin, as their preferred cash reserve medium. Other banks therefore tended to exchange gold and silver that came their way for credits on London discount houses, which in turn exchanged the gold and silver for Bank of England IOUs. The 1797-1819 suspension, as well as the 1833 decision to grant Bank of England notes legal tender status, further reinforced this tendency. The result, Walter Bagehot (1873) later explained, was a "one reserve" system instead of the "many-reserve" system typical where numerous banks enjoy equal note-issuing privileges. Such a one-reserve system, Bagehot further explained, is highly unstable, because it invites overgenerous lending by the privileged bank, inspiring overgenerous lending by the system as a whole, accompanied by a lowering of interest rates and, in time, rising prices. Under England's then-functioning metallic standard, low interest rates and rising prices would eventually trigger foreign withdrawals of specie—an "external drain." Because specie was to be had only from the privileged bank, it would bear the brunt of the drain, and would therefore be tempted to stop credit, even if so doing meant the ruination of thousands.

Having identified the root cause of English financial instability, Bagehot went on to offer his now-famous advice that, when faced with an external drain, the Bank of England, instead of stopping credit, should lend freely, on good paper, and at high rates—that it should, in other words, become a lender of last resort. But far from wishing to

recommend a similar arrangement to other nations, Bagehot made it perfectly clear that he regarded his proposal as a second-best one only, and that he recommended only because he saw no prospect for undoing the Bank of England's privileges. "I know it will be said," he wrote (1873, p. 329),

that in this work I have pointed out a deep malady, and only suggested a superficial remedy. ...I can only reply that I propose to retain this system because I am quite sure that it is of no manner of use proposing to alter it. ... You might as well, or better, try to alter the English monarchy and substitute a republic, as to alter the present constitution of the English money market, founded on the Bank of England, and substitute for it a system in which each bank shall keep its own reserve (ibid, pp. 329-3).

VI. ...and in North America

Calomiris and Haber overlook as well the harm done by North American legislation that limited banks' freedom to issue paper notes. In discussing the infirmities of antebellum U.S. banking, for instance, they seem unaware of the adverse effects of the "bond-deposit" provisions included in misnamed state "free banking" laws. These provisions allowed banks to issue notes only after tendering eligible securities to state authorities for the ostensive purpose of securing the notes' holders from loss. Calomiris and Haber (p. 169) note that, by making their own bonds eligible for this purpose, states were able to force banks to lend to them "in exchange for their right to operate." Still they fail to point out that some states force-fed their banks, not "high-grade" bonds (ibid.) but junk ones, and that it was this practice, rather than unit banking, that was the main cause of bank failures during the so-called "free banking" era (Rolnick and Weber 1984; Dwyer 1996).⁴

Despite the shortcomings of state-bank currencies, the northern government's Civil War decision to tax state banknotes out of existence only heaped injury on injury, by contributing to later financial instability and by dooming the South to decades of

⁴ Even if America's "free" banks had been allowed to branch many would still have suffered heavy losses on their bond holdings.

postwar financial underdevelopment and consequent stagnation (Selgin 2000). Although they refer to this measure, Calomiris and Haber (pp. 180-81) fail to see it for what it was, namely, another ill-considered outcome of the Game of Bank Bargains, motivated by a government's quest for revenue: the step made room for the notes of recently-authorized national banks, whose notes had to be backed by (guess what?) Union securities. At one point Calomiris and Haber forget the tax altogether, incorrectly claiming that national bank notes "drove the notes of state-chartered banks out of existence" (p. 177).⁵

Unit banking was also not the only, and perhaps not even the principal, cause of post-Civil War financial instability. A more notorious cause was the "inelasticity" of the post-Civil War currency stock, meaning its inability to expand and contract in response to fluctuations in the public's demand for hand-to-hand money. The inelasticity was due mainly to the fact that the stock of national bank notes, having been linked for revenue purposes to the government's outstanding debt, tended to shrink as that debt was retired, instead of increasing with overall economic activity or expanding temporarily to meet harvest-time needs.⁶ Consequently the U.S. money market tightened every autumn, as rural banks drew upon their legal tender reserves, and also those of their city correspondents, to meet farmers' needs. Every decade or so, tight credit gave way to full-blown panic (Livingston 1986, pp. 71-75; Sprague 1910).

In Canada, in contrast, banks' almost unrestricted ability to issue notes contributed to the banking system's stability no less than banks' branch networks did. There the stock of circulating currency, consisting mainly of the notes of a dozen or more commercial banks, exhibited over the years an upward-slanting saw-tooth pattern perfectly consistent with underlying growth and fluctuations in demand. Seasonal credit crunches, not to mention currency panics, were therefore unknown. Although Calomiris and Haber say nothing about this source of the Canadian system's stability, its advantages

⁵ Although passed in 1865, the 10% tax did not ultimately come into effect until in August 1866.

⁶ Apart from limiting bank diversification and encouraging banks to keep and (with the law's sanction) count as reserves balances with city correspondents, unit banking also contributed to the inelasticity problem by preventing the speedy redemption of unwanted banknotes (Selgin and White 1994). Freedom of note issue also reduces substantially the cost to banks of maintaining extensive branch networks, by making it unnecessary for branches to keep expensive inventories of high-powered cash.

were well known to contemporary U.S. experts, who authored numerous proposals, some of which were embodied in bills, for establishing Canadian-style “asset currency” in the U.S. But these efforts, like those (often included in the same measures) aimed at introducing branch banking, were thwarted.

Calomiris and Haber will not be surprised to be told that in this instance as well, reformers’ hopes were dashed by populism, in the shape of no less a populist than William Jennings Bryan, who wanted nothing to do with commercial banknotes, favoring either silver or greenbacks instead. His opposition caused plans for asset currency to give way to ones for a “central reserve bank”—an option somewhat more palatable to populists, as it at least involved more government control. Still the passage of the Federal Reserve Act in December 1913 was a close-run thing, accomplished only thanks to Bryan’s last-minute decision not to oppose it (Dunne 1963). Consequently Bryan’s “tireless populist campaigning,” far from having left a permanent mark mainly by encouraging Henry Steagall and FDR to give their blessing to the FDIC some years after Bryan’s death, as Calomiris and Haber suggest (p. 491), shaped the modern U.S. monetary system in a far more fundamental, if not more deleterious, way.

VII. Theory and history

Fragile by Design promises, not just to document the part that politics have played in making banking systems fragile, but also to show how certain political arrangements “result *predictably* in stable and plentiful bank credit,” while others result, no less predictably, “in unstable and scarce bank credit” (p. 14, my emphasis). Ultimately, however, its authors discover only two supposedly reliable patterns, to wit: that while both democracies and autocracies “can generate coalitions that undermine the stability of the banking system and its ability to provide credit” (p. 40), autocracy tends to be worse, because an autocracy “cannot constrain itself from expropriating banks” (p. 477); and that “liberal” democracies tend to have sounder banking systems than “populist” ones.

Even these modest findings must be taken with a grain of salt. Concerning the first, of only six polities said by Calomiris and Haber to have possessed crisis-free banking systems since 1970, one, Hong Kong, though neither a democracy nor a centralized

autocracy, thrives under the shadow of an autocratic regime, while another, Singapore, though technically democratic, lacks effective opposition parties and a free press, and is often considered autocratic for these reasons. Calomiris and Haber's accounting may also exclude other sound yet "autocratic" banking systems, because it fails to distinguish banking crises connected to speculative attacks on pegged exchange-rate regimes from others, and so conflates dysfunctional exchange-rate regimes with dysfunctional banking systems.

As for the finding that, other things equal, more "populist" regimes inevitably produce worse banking systems, to sustain it Calomiris and Haber must, first of all, define populism quite broadly. Their list of populist U.S. presidents and presidential candidates, for instance, explicitly includes, besides William Jennings Bryan—the most obviously qualified—Thomas Jefferson, Andrew Jackson, Franklin Roosevelt, Richard Nixon, Newt Gingrich and Barack Obama. As for "liberal" presidents, there is some doubt as to whether anyone since John Adams can safely be so labeled. The trouble isn't so much that Calomiris and Haber employ these terms indiscriminately, but rather that they subscribe to William Riker's definition, in *Liberalism against Populism* (1982), of a "populist" as someone who subscribes to the view that democracy, and majority voting in particular, allow governments to act according to the will of their citizens—a view professed, if not sincerely held, by virtually every modern office seeker.

Tracing bad banking to populism becomes especially easy if one allows, as Calomiris and Haber do, that populist politicians might cater at any moment to the wants of any number of interest groups within their constituencies, including bank depositors, or bank debtors, or bank shareholders, or that they might "decide that the path of least political resistance is to favor all of these groups" (p. 36). In light of these many possibilities, explaining why some democratic polities have or have had relatively stable and efficient banking systems risks becoming a matter of not looking quite so hard for populist political maneuverings that one might otherwise discern. In short, Calomiris and Haber's references to populism, much as they may serve to enhance our understanding of

past experience, are not nearly as successful in establishing an *inevitable* connection between more populist regimes and worse banking laws as may appear to be the case.

Ironically, Riker himself, in the very work Calomiris and Haber draw upon for their understanding of populists and liberals, cautions against attempts to regard the legislative outcomes of democratic systems as anything other than unpredictable. As an astute reviewer of *Liberalism against Populism* puts it, Riker's purpose in that work is to argue that, under democracy, "accurate predictions about social outcomes are not possible" or, in Riker's own, incongruous language, "that the power that comes from scientific knowledge is well-nigh unobtainable for political abstractions" (Zagare 1983, p. 845).

VIII. The Role of Ideas

That it isn't really possible to predict what a banking system will be like simply by noting the political soil it grows in means that banking systems may differ because of something other than sheer politics—including, as Keynes famously put it, "the ideas of economists and political philosophers, both when they are right and when they are wrong" (Keynes 1936, p. 385). Keynes was no doubt guilty of exaggeration in claiming that "the world is ruled by little else." But Calomiris and Haber are no less so in insisting that "banking regulation is and has always been *all* about politics" (p. 17, my emphasis). By failing to search beyond the lamppost of politics for causes of banking system fragility, they understate both the extent to which bad ideas have contributed to that fragility, and the capacity of better ones to alleviate it.

Consider deposit insurance. It's one thing to trace its original adoption in the U.S. to the fragility of unit banking, and thence to the peculiar politics of U.S.-style federalism, but quite another to leave the impression that similar politics, unassisted by major changes in expert opinion, can account for its eventual worldwide adoption (pp. 461-2). Nor is it hard to see why opinions changed, given the tendency, in recent decades especially, for policymakers everywhere to turn to U.S.-trained economists for advice, and for those economists in turn to take the necessity of deposit insurance for granted. For proof one need only attend one of the FDIC's many overseas "training" exercises, or reflect upon how the appearance of Diamond and Dybvig's (1983) immensely popular

model of banking instability coincided with a marked acceleration in deposit insurance's worldwide spread. Although Calomiris and Haber make short work of exposing the shortcomings of that model, they don't assign it, or the "inherent fragility" myth it formalizes, sufficient responsibility for the spread of deposit insurance and, hence, for the increase in *actual* banking system fragility to which that spread has itself contributed.

Or take Pinochet's decision to privatize Chile's banks. According to Calomiris and Haber, with respect to banking legislation one of the few reliable differences between autocratic and democratic governments consists of the greater likelihood that the former will confiscate private bank assets. Yet Chile's banks were nationalized by Salvador Allende's democratically-elected government, and then reprivatized by Pinochet's authoritarian regime. Calomiris and Haber attempt to account for the anomaly by noting that "the Pinochet government managed to build a robust private banking system only after a disastrous bank privatization that had many of the hallmarks of similar fiascos in many other authoritarian regimes" (p. 463). But the explanation hardly suffices, for the theory it is meant to salvage asserts not that autocrats are unable to privatize banks without raising havoc, but that they aren't inclined to privatize them at all. Pinochet's decision ceases to be puzzling once one grants—as practically all other historians of the episode do—that ideas as well as sheer politics were behind it. That Chile's "Chicago Boys"—economists trained mainly at the University of Chicago but also at Harvard and Columbia—convinced Pinochet to pursue market-oriented reforms, including the privatization of Chile's banks, is notorious.⁷ So far as *Fragile by Design* is concerned, the story's significance, like that of the dog in Conan Doyle's "Adventure of Silver Blaze," rests in the fact that, for once, we don't hear it at all.

Academic scribblers and other idea-peddlars have also been responsible for the proliferation of privileged banks of issue, and hence for both the stabilizing *and* the destabilizing consequences of that proliferation. Throughout the 19th century there were lively debates, in England and elsewhere, between advocates of competitive note issue or "free banking" and those favoring state-sponsored currency monopolies (Smith 1990

⁷ See Edwards and Edwards (1991). Alas the details of the story, especially concerning Milton Friedman's part in it (which was actually minor) are all too frequently misrepresented.

[1936]). Consequently, although fiscal considerations inclined governments to favor currency monopolies during that time, up to the outbreak of the Great War only 18 nations had such monopolies.

During the interwar years, in contrast, a crusade led by Montague Norman, then Governor of the Bank of England, and Benjamin Strong, his counterpart at the New York Fed, and promulgated in resolutions passed at the Brussels and Genoa conferences of 1920 and 1922, led to a doubling of the number of central banks, as currency monopolies were then increasingly coming to be known. Behind the crusade was the view, natural enough to the world's most powerful central bankers but nevertheless mistaken (Gallarotti 1995), that the prewar gold standard's success had depended upon cooperation among then-existing central banks, and that similar cooperation, aided by the establishment of central banks in countries still lacking them, was crucial to the standard's postwar reconstruction (Borio and Toniolo 2006, pp. 5-10; Singleton 2011, pp. 50-90). In particular, Norman, Strong and other experts subscribed to the (in the event tragically mistaken) belief that, by taking part in an international gold "exchange" standard, with international settlement on the books of either the Bank of England or the Federal Reserve standing in for actual gold remittances, a league of central banks would make that reconstruction possible without heavy resort to either deflation or devaluation. The European effort in turn inspired Edwin Kemmerer, Princeton's "Money Doctor," to spread the same central-bank gospel around Latin America (Seidel 1972, p. 525).

With the collapse of the gold-exchange standard itself, and the Great Depression that followed, economists stopped thinking of central banks as devices for upholding the gold standard, and instead began recommending them, first as lenders of last resort, and somewhat later as devices for implementing countercyclical monetary policies. Here again, the ideas of economists, and of Bagehot and Keynes especially, played an important part, though as we've seen it wasn't Bagehot's actual advice but a severely distorted version of it that took hold. In any event, when the end of World War II set a wave of decolonization in motion, the leaders of the newly-independent nations, instead of having to wheel and deal to overcome resistance to their efforts to replace what were

often relatively sound monetary arrangements with ones that were to frequently take part in sometimes heartbreaking episodes of inflationary finance, were spared the necessity of doing so by the then well-established dogma that every sovereign nation needs, not only its own flag, but also its own central bank (Singleton 2011, pp. 161-83).

So ideas can indeed influence political decision, even in majoritarian democracies. What's more, modern public-choice theory offers no grounds for supposing otherwise. On the contrary: one of its more important findings is that ideas can shape policies to a very considerable degree, precisely because voters have no good reason to think that their votes "count" other than as means for expressing their beliefs, and therefore are inclined to cast them accordingly, and not simply to favor those politicians who might cater to their more selfish interests (Brennan and Lomasky 1997; Caplan 2007).

IX. Surrendering to Reality

The short-shrift that Calomiris and Haber give to ideas in shaping the development of banking systems goes hand in hand with their suggestion that economists who imagine they can influence banking legislation for the better may be deluding themselves:

The problem is that while economists like to develop ideas about optimal government policies, including banking regulation, politicians are not in the business of implementing those ideas. In reality, banking policies reflect deeply entrenched political partnerships, which fashion banking bargains to make them difficult to undo (p. 500).

Elsewhere, as if to settle any doubts, Calomiris and Haber observe that "One of our central messages is that societies do not choose their banking systems in any meaningful sense" (p. 501), and that the "answer to the central question posed in chapter 1—why can't all countries construct banking systems capable of providing stable and abundant credit?—is that political conditions constrain what is possible" (p. 477). "Possible," mind you: not merely "probable" or "easily accomplished." Unstable and inefficient banking

arrangements may, in short, “be the best that the societies that create them can do under the political circumstances” (p. 51).

Nor are democracies much better off than autocracies, for while in principle good ideas might make a difference in them, they can do so only when they receive “persistent popular support” (p. 504). To gain such support is, however,

easier said than accomplished. Self-interested groups with strong vested interests...will distract and misinform the public, making it very hard for good ideas to win the day. And even if they do prevail, self-interested coalitions will always be looking for an opportunity to reverse them (pp. 504-5).

Resistance to bad banking laws, *Fragile by Design*'s readers might be pardoned for concluding, is futile. Nor do Calomiris and Haber make their own efforts appear inconsistent with such a conclusion. “This is a book intended to describe the world as it is,” they observe, “not to imagine it as it might be” (p. 487). “Our goal,” they say elsewhere, “is to *explain*” the game of bank bargains (p. 7). “Explain”: not influence, let alone subvert. While it will supply many of its readers with a much-improved understanding of the causes of unstable banking, *Fragile by Design* may also convince them that, when it comes to trying to change things, their newfound understanding will be of little or no avail.

But if unstable banking is due as much to bad ideas as to politics, such pessimism isn't warranted: if bad ideas have made the world's banking systems fragile, better ones can make them less so. Of course getting better ideas accepted isn't easy. Still it's easier, I believe, than Calomiris and Haber suggest: as William Hutt (1971, p. 85) has reminded us, “Changes in public opinion of a kind which nearly all experienced observers would have regarded earlier as 'inconceivable' do occur in practice.” Who, when the Anti-Corn Law League was founded in Great Britain in 1838, would have predicted the Corn Laws' repeal less than a decade later? Who then can deny, scientifically, the possibility that, provided its deterministic bits were ignored, the revelations of *Fragile by Design* might alter the face of banking?

Nor are economists qualified to speculate concerning which reforms are, and which aren't, likely to gain support.

What is the 'probability' that a policy-influencing marginal change in attitudes will result from planting an idea...in the classroom or in an address or in social intercourse? With what degree of immediacy, both in point of time and in point of the number of intermediate impacts? [H]owever an idea may get into a mind, it is capable of dying there or of gathering immense force. Moreover, a number of minds can be seeded with one expression of the idea. Potentially, then, the force may grow at an exponential rate. All the determinants of whether it dies or gathers strength in a particular mind, we simply do not know (Philbrook 1953, pp. 856-57).

Milton Friedman once observed that "The role of the economist in discussions of public policy" ought to be "to prescribe what should be done in the light of what can be done, *politics aside*, and not to predict what is 'politically feasible' and then to recommend it" (Friedman 1953, p. 264; my emphasis). If Friedman was right, then it is surely not economists' place to argue that potentially beneficial reforms aren't politically feasible at all, and to thereby appear to recommend leaving bad arrangements as they are.

X. Utopian Libertarians

The taint of fatalism that weakens their otherwise powerful message may also account for Calomiris and Haber's surprising treatment of "The House of Libertarian Utopianism"—one of several "houses" upon which they jokingly wish "a plague" (p. 491). Although Calomiris and Haber don't refer to any occupants of this "house" by name, their complaint that "The notions that banking systems can arise spontaneously, or that they could function efficiently without active government involvement, are utopian fantasies" (p. 491), together with their observation that the utopians in question idealize the pre-1845 Scottish system, make it evident that they have in mind those economists, including

Kevin Dowd, Larry White and myself, who favor competition in currency and free banking.⁸

Calomiris and Haber's remarks are surprising because the views of free bankers (to assign the group a less tendentious name) are actually very close to their own. Like them, we view banking instability not as an inevitable feature of commercial banking systems, but as a product of harmful legislative interference. "Despite frequent claims to the contrary," I argued in a longish article some years ago, "fractional-reserve banking systems are not inherently fragile or unstable. The fragility and instability of real-world banking systems is not a free-market phenomena but a consequence of legal restrictions" (Selgin 1989, p. 456). I also singled-out for blame many of the same harmful regulations that Calomiris and Haber refer to, and made comparisons similar to their own of U.S. with Canadian experience and, following Larry White's (1984) example, of English with Scottish experience. Finally, I observed that many destructive regulations were "aimed at generating revenue for the government or at propping up special interests within the banking industry."⁹ Elsewhere I compiled evidence concerning the incidence of banking crises in different countries, concluding from it that the conventional theory of crises "appears to fail the most elementary kind of empirical test" (Selgin 1994, p. 595). Similar echoes of *Fragile by Design's* main claims occur throughout the free banking literature.

What is it about free bankers, then, that nettles Calomiris and Haber? It's "the libertarian conception of the ideal state":

Under that conception, libertarian theorists argue that there is no role for the state in chartering or regulating banks. But that view is founded on an incomplete conception of the state. The state needs banks as a financing tool. States without banks cannot and have never existed. Indeed, ironically, it is precisely the most

⁸ White's (1984) work on Scottish banking is the only one from this group to which Calomiris and Haber refer, though not in discussing "libertarian utopians." I resist naming F. A. Hayek, whose *Denationalisation of Money* (1978) revived interest in Scottish-style free banking, because Professor Calomiris has assured me that he and Haber did not have Hayek in mind in speaking of Libertarian Utopians. I did not think it proper to ask about myself or my close associates.

⁹ Elsewhere White and I (1999) argue that fiscal considerations alone account for much of the world's historical banking and monetary legislation.

basic function of the state recognized by libertarians themselves—defense—that makes banks so important (p. 492).

The objection as stated is hardly fair, for it is Calomiris and Haber themselves who, by referring to them as “Libertarian Utopians,” hold free bankers responsible, not only for their expressed opinions on banking, but for “libertarian” opinions to which not all of them (and, for that matter, not all self-styled libertarians) subscribe. The relevant question is not whether the libertarian conception of the state is or isn’t sound, but whether it is or isn’t possible, as a matter of positive economics, for at least some *modern* states to survive without “chartering or regulating banks” (p. 492). As I argued previously, it is in fact quite possible for them, or at least some of them, to do so.

Let’s admit nevertheless that all modern states are in fact determined to draw upon their banking systems for revenue, by maintaining chartered banks or otherwise, and to pass banking legislation aimed solely at allowing them to exploit bankers more effectively. That still doesn’t mean that states *must* interfere with their banking systems this way, or that those who would propose reforms to prevent them from doing so betray “an incomplete conception of the state” (p. 492). They may betray an overly sanguine view of the prospects for improvements, and certainly a more sanguine one than Calomiris and Haber hold. But such sanguineness hardly qualifies as intellectual error.

On the contrary: by confusing what states have done in the past, or what they may be intent on doing now, with what they *cannot be prevented* from doing, Calomiris and Haber themselves partake in a pseudoscience that pretends to be able to distinguish politically impossible reforms from politically possible ones, obscuring in the process their true convictions concerning both the positive economics of banking and the *desirability* of state interference. Do Calomiris and Haber in fact believe that a banking system would not be stable and efficient were governments to play no role in banking save that of enforcing bankers’ contracts? If so, they should say so, and explain why. If not, they should admit that free banking would be desirable, were it only achievable. By conflating what “is” with what “must be,” Calomiris and Haber steer adroitly around such questions, avoiding by so doing any risk of exposing themselves to their own charge

of utopianism. But, as John Morley (1898, p. 216) explained long ago, the tactic has a cost, for when persons whose opinions might encourage needed change elect instead to keep their counsel, “hurtful elements of worn-out beliefs and waste institutions remain to enfeeble the society” (Morley 1898, p. 216).

XI. An Unreasonable Conclusion

As if to yank themselves back from the precipice to which their own reasoning takes them, Calomiris and Haber conclude *Fragile by Design* with a paragraph aimed at dispelling the impression they convey throughout the rest of their book. Coming as it does at the last moment, the disclaimer is more jarring than reassuring:

Readers should not mistake our unvarnished appreciation for...the difficulties of bank regulatory reform, as cynicism or hopelessness. Despite its challenges, political entrepreneurship within a democracy can sometimes reshuffle the deck in the Game of Bank Bargains by getting participants in the game to revise their views of what best serves their interests....It does no good to assume, passively, that all alternative feasible political bargains must already have been considered and rejected. As George Bernard Shaw said, “The reasonable man adapts himself to the world; the unreasonable man persists in trying to adapt the world to himself. Therefore all progress depends on the unreasonable man.” Meaningful reform in a democracy depends on informed and stubborn unreasonableness (pp. 506).

Amen. But it seems to me that, if anyone is to get credit for practicing stubborn unreasonableness, it is not Calomiris and Haber, but some of the very writers on whom they hurl anathema.

References

- Bagehot, Walter (1873), *Lombard Street: A Description of the Money Market*. London: Henry S. King and Co.
- Benson, Bruce L. (1989), 'Spontaneous Evolution of Commercial Law', *Southern Economic Journal*, 55(3), 644–661.
- Borio, Claudio, and Gianni Toniolo (2006), 'One Hundred and Thirty Years of Central Bank Cooperation: A BIS Perspective', BIS Working Paper No. 197.
- Brennan, Geoffrey, and Loren Lomasky, eds. (1997), *Democracy & Decision: The Pure Theory of Electoral Preference*. Cambridge, U.K.: Cambridge University Press.
- Caplan, Bryan (2007), *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*. Princeton: Princeton University Press.
- Diamond, Douglas W., and Philip H. Dybvig (1983), 'Bank Runs, Deposit Insurance and Liquidity', *Journal of Political Economy*, 91(3), 401–19.
- Dowd, Kevin (1989), *The State and the Monetary System*. London: Philip Allen.
- Dunne, Gerald T. (1963), 'A Christmas Present for the President', *Business Horizons*, 6(4), 43–60.
- Dwyer, Gerald P., Jr. (1996), 'Wildcat Banking, Banking Panics and Free Banking in the United States', Federal Reserve Bank of Atlanta *Economic Review* (December), 1–20.
- Edwards, Sebastian, and Alejandro Cox Edwards (1991), *Monetarism and Liberalization: The Chilean Experiment*. Chicago: The University of Chicago Press.
- Friedman, Milton (1953), 'Comments on Monetary Policy', in idem., *Essays in Positive Economics*, pp. 263–73. Chicago: University of Chicago Press.
- Hayek, F. A. (1978), *Denationalisation of Money: The Argument Refined*. London: Institute of Economic Affairs.
- Hicks, John R. (1967), 'Monetary Theory and History: An Attempt at Perspective', in idem., *Critical Essays in Monetary Theory*, pp. 155–73. Oxford: Clarendon.
- Hutt, William (1971), *Politically Impossible*. London: Institute of Economic Affairs.

- Keynes, John Maynard (1936), *The General Theory of Employment, Interest and Money*. London: Palgrave Macmillan.
- Kohn, Meir (1999), 'Bills of Exchange and the Money Market to 1600', Dartmouth College Working Paper 99-04.
- Livingston, James (1986), *Origins of the Federal Reserve System: Money, Class and Corporate Capitalism, 1890-1913*. Ithaca, NY: Cornell University Press.
- Lucas, Robert E., Jr. (2011), 'The U.S. Recession of 2007-201?', Milliman Lecture, University of Washington, 19 May. Available at <http://econ.washington.edu/files/2013/05/millimansl.pdf>.
- Morley, John (1898), *On Compromise*. London: Macmillan and Co.
- Philbrook, Clarence (1953), "'Realism" in Policy Espousal', *American Economic Review*, 43(5), 846-59.
- Riker, William (1982), *Liberalism against Populism*. Prospect Heights, IL.: Waveland Press.
- Rogers, James Stevens (1995), *The Early History of the Law of Bills and Notes: A Study of the Origins of Anglo-American Commercial Law*. Cambridge, U.K.: Cambridge University Press.
- Rolnick, Arthur J., and Warren E. Weber (1984), 'The Causes of Free Bank Failures: A Detailed Examination', *Journal of Monetary Economics*, 14(3), 267-91.
- Seidel, Robert N. (1972), 'American Reformers Abroad: The Kemmerer Missions in South America, 1923-1931', *Journal of Economic History*, 32(2), 520-45.
- Selgin, George (1989), 'Legal Restrictions, Financial Weakening and the Lender of Last Resort', *Cato Journal*, 9(2), 429-69.
- (1994), 'Are Banking Crises Free-Market Phenomena?', *Critical Review: A Journal of Politics and Society*, 8(4), 591-608.
- (2000), 'The Suppression of State Banknotes: A Reconsideration', *Economic Inquiry*, 38(4), 600-15.
- Selgin, George, and Lawrence H. White (1994), 'Monetary Reform and the Redemption of National Banknotes', *Business History Review*, 68(2), 205-43.
- (1999), 'A Fiscal Theory of Government's Role in Money', *Economic Inquiry*, 37(1), 154-65.

- Singleton, John (2011), *Central Banking in the Twentieth Century*. Cambridge, U.K.: Cambridge University Press.
- Smith, Vera (1990 [1936]), *The Rationale of Central Banking and the Free Banking Alternative*. Indianapolis: Liberty Press.
- Sprague, O. M. W. (1910), *History of Crises under the National Banking System*. Washington: Government Printing Office.
- White, Lawrence H. (1984), *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845*. Cambridge, U.K.: Cambridge University Press.
- Zagare, Frank. C. (1983), review of William H. Riker's *Liberalism against Populism: A Confrontation Between the Theory of Democracy and the Theory of Social Choice*, *American Political Science Review*, 77(3), 844–5.