The Politics of Financial Stability

The role of the nation state in promoting a stable financial system cannot be emphasized enough. It is the duty of the political systems to establish laws and enforcement mechanisms to mitigate a variety of financial systems problems, including creditor-lender and owner-manager conflicts. These laws and mechanisms have implications for their financial stability. In this article, Girish V S examines whether the political systems of some countries produce financial systems that are fragile by design.

THE history of economic development has thrown up some interesting facets - some countries consistently create more wealth for their citizens than others. It is no surprise that banking systems differ across countries. Normally the performance of the Banking system is indicated by two criteria: availability and access to credit and the propensity for crises. These measures display dramatic and consistent differences across countries. Some countries create stable banking systems - that is, banking systems in which systemic crises are absent (can we consider ourselves among the favored few?), while others do not. Some countries create banking systems capable of providing abundant arms-length credit, while others do not. A few countries manage to achieve both stable and abundant credit, while many others achieve neither. However, the models of financial systems in general and banking in particular do not have a parameter called "country" that could be used to explain the differences in the financial systems.

In the run up to the recent financial crisis, governments failed to address the expanding macroeconomic imbalances that were festering within the system. The crisis owed its origin, in part, to both imprudence on the institution's part and regulatory failures. The governments responded with a crisis management program, rather than fixing the central, long term macro fundamentals within the system. Ad hoc policy coordination ensued as liquidity was injected into turbulent markets and troubled financial intermediaries were recapitalized or reorganized. The ham handed response from the political class reflected the poor fiscal foundations.

There are three common theories on the origins of financial crisis - bank structure, interbank linkages and human nature. Bank structure refers to the maturity and liquidity mismatch between banks' illiquid and long-term credit portfolio and their liquid and short-term liabilities portfolio. The "Banking Structure theory" regards financial crises as the result of the inherent exposure of banks to "liquidity risk" arising from this mismatch. Interbank connections can multiply the effects of this through risk externalities. Individual banks choose their portfolio of liquid assets and their leverage (debt relative to equity capital) based on their individual interests, and will ignore the social costs that arise from the spillover effects (also known as externalities) created by interbank connections. According to this thought, the primary role of regulation is to force banks to hold more liquid assets and to maintain lower leverage ratios than they would voluntarily choose. In other words, banks are expected to convert the externalities to internalities. The absence of sufficient regulation to internalize externalities, therefore, is the cause of banking crises. Other theories see banking crises as symptoms of the manager's narrow and selfish goals, which drives destructive cycles of greed and fear.

None of these theories are bad per se. They do identify the core causes of financial crisis and are therefore important. The recent crisis is testimony of the fact – the greed of a few pushed them to take on higher leverage. When things started going bad, the effects were compounded by the inter linkages between the banks and other financial entities. However, one lesson regulators and financial sector managers need to learn is that the economic understanding of systemic risk is insufficient when and where banking crisis will occur. Prudent banking can avoid bank structure related problems. Having strong institutional