Institutional Design and the New Systemic Risk in Banking Crises

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1. Introduction

Financial crises come in many shapes and forms. In a recent widely-acclaimed survey of eight centuries of financial crises around the globe, Reinhart and Rogoff helpfully categorize them as follows: sovereign defaults, which occur when a government fails to meet payments on its external or domestic debt obligations; banking crises, such as those the world has experienced since 2008, where a significant part of a country's banking sector has become insolvent after heavy investment losses; exchange rate crises, where the value of a country's currency falls precipitously; and, finally, crises marked by bouts of very high inflation that constitute the *de facto* equivalent of outright default on public or private sector debt.[1] Reinhart and Rogoff argue that over history there are many similarities within each category of financial crises in terms of their causes and consequences. Moreover, it might be argued that across these categories, a common characteristic tends to be a dramatic and unsustainable expansion of credit, often fueled by external financial inflows reflecting global monetary imbalances.[2]

In this paper, we focus on banking crises, with a special focus on lessons to be learned from the global financial crisis that began in 2008, typified by the dramatic growth in the scale and complexity of financial instruments in wide use throughout the financial sector, the expansion of a "shadow" banking sector implicating solvency and liquidity concerns for many financial institutions beyond the traditional focus on the solvency and liquidity of commercial banks; major contagion effects across national borders, reflecting the internationalization of financial institutions and financial transactions; and finally, the engagement of a broader range of regulatory institutions, both domestic and institutional, beyond the traditional regulatory focus on the solvency and liquidity of commercial banks.

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[1] See Carmen Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Century of Financial Folly* (Princeton University Press, 2009). See also "The slumps that shaped modern finance" *The Economist* (April 12, 2014) 49-54.
[2] *Ibid*. Preface; See Charles Kindleberger and Robert Aliber, *Manias, Panics and Crashes: A History of Financial Crises* (Palgrave McMillan, New York, 2011, 6th ed.), chapter 2.