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The Political Economy of Financial Crises

Charles W. Calomiris and Matthew Jaremski *

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Abstract

Financial crises remain a recurrent feature of modern economies despite evidence that many are predictable and preventable. This chapter discusses how financial instability often reflects a political equilibrium rather than purely technocratic shortcomings. Contrasting economic and political perspectives on regulation, the chapter emphasizes how policymakers shape financial rules in ways that favor politically-influential groups but result in financial vulnerability. Key mechanisms include restricted bank chartering, safety nets, credit subsidies, and sovereign borrowing. Political forces also shape crisis management. Delayed interventions, selective support, and constrained policy responses can deepen and prolong crises. Together, these dynamics help explain the persistent and foreseeable nature of financial instability across time, legal origins, political structures, and institutional contexts. Instead of seeing financial crises as arising from an unavoidable vulnerability to external shocks they are better seen as a mirror of the societies in which they occur, reflecting their political structures, vying constituencies, cultural preferences, and blind spots.

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1. Introduction

Financial crises remain a recurrent feature of modern economies despite an extensive literature showing that many could have been prevented by responding to visible risks. There have been over 150 banking crises over the last century alone (Laeven and Valencia 2020; Baron and Dieckelmann 2022). Systemic banking distress is associated, on average, with real GDP declines of roughly 5.5 percent, while the median fiscal cost of resolving banking crises is approximately 16 percent of GDP (e.g., Laeven and Valencia 2012; Baron et al. 2021). The predictability of crises is difficult to reconcile with their high frequency and the magnitudes of their costs. Modern states seem to possess the regulatory tools necessary to prevent crises, and yet they do not. A growing literature argues that the solution to this puzzle is that crises are part of a political equilibrium. The architecture of financial systems is compromised by political decision-making that trades stability for other goals (McCarty et al. 2013; Calomiris and Haber 2014). This chapter examines how and why vulnerability to financial crises has been tolerated by various political regimes across countries and historical periods.

Two broad perspectives frame the debate over financial regulation. The economic approach to regulation treats it as a mechanism designed to enhance efficiency and reduce systemic risk. In that formulation, policy-makers choose regulations that do the best that one can possibly do to foster market stability (recognizing some potential trade-offs between prudence and economic growth). When a large-scale crisis occurs, it must then be due to exogeneous shocks (e.g., Covid, WWII, etc.) or novel factors (e.g., new financial technology) that either take time to fully learn about or contribute so much to growth that they are worth the risks they entail. By contrast, the political approach emphasizes government needs and the influence of organized interests in making ex-ante inefficient regulatory choices. In that formulation, policy-makers may craft regulation to achieve inefficient outcomes because those regulations favor themselves or members of society who have political influence. Financial crises thus are not necessarily *failures* of regulation design but rather the predictable consequences of the fragile financial structure chosen by a country's leaders.

Historical evidence provides ample support for the political perspective. Although publicly-available information can predict bank failures several quarters in advance (Correia, Luck, and Verner 2026), supervisory systems for identifying and resolving troubled banks often appear unwilling to act. For example, they may fail to identify and discipline visibly insolvent or

risky banks, as during the U.S. Savings and Loan Crisis, or the failure of several large U.S. banks in 2023. Few jurisdictions credibly compel regulators to close banks that display those observable risks. Governments even may enact regulations intended to signal vigilance to the uninformed without substantively constraining risk-taking by banks. Indeed, Barth, Caprio, and Levine (2006) and Beck, Demirgüç-Kunt, and Levine (2006) show that more extensive prudential requirements do not lower systemic risk (in contrast with market discipline, which predictably punishes risk-taking). They also find that ineffective regulatory requirements are most pronounced in corrupt political environments.

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) highlight the role that the legal origins of a country play in forming effective laws protecting shareholders and creditors, which shape financial market outcomes. However, within the same legal tradition, and even over time in the same country, politics shapes outcomes in ways that legal traditions do not capture (Rajan and Zingales 2003). This chapter conceptualizes "politics" in several related senses. First, politics drives actions that favor the survival of the underlying political regime. Calomiris and Haber (2014) find that financial systems are structured to satisfy the specific needs of the political regime that creates them. For instance, limiting bank charters to restrict competition has been used to both reward members of a ruling coalition or to expand government access to borrowing.

Second, political competition within a regime may give rise to targeted interventions by policymakers seeking to advantage particular sectors or interest groups. This can be accomplished through off-budget subsidies that are accomplished by access to government safety nets, government-owned banks' lending, or other credit subsidies. Such approaches weaken the normal pricing of risk and concentrate lending risk in subsidized intermediaries in ways that make crises more likely.

Third, office-seeking politicians may favor subsidies that seek to expand credit access to all groups in advance of an election. There is substantial evidence that voters respond to macroeconomic conditions (e.g., Lewis-Beck and Stegmaier 2000) and credit availability (Antoniades and Calomiris 2020). Policymakers know this and choose to stimulate credit expansion before elections to maintain their support, regardless of the potential future crisis risk.

Political regimes and historical circumstances shape how bargaining takes place. Political regimes (such as populist democracies, liberal democracies, centralized autocracies, and

decentralized autocracies) set the structural rules that determine the allocation of power, which govern political bargains. The historical context determines which particular pressures are most relevant at any given moment: the timing of railroad expansion, the rise of large-scale industry, or the salience of homeownership. The regimes themselves are also not static, and change in response to broader historical forces such as competition among nations, technological change, and shifting social coalitions. Yet, while each time and place displays unique aspects, they all have political bargains that allocate risks and rewards for specific groups, often producing and recurrent and foreseeable financial crisis risk (Calomiris and Haber 2014; Calomiris and Jaremski 2024, 2025).

Once crises occur, the management of financial distress and the allocation of losses are also shaped by political considerations. Electoral incentives and legislative bargaining can delay necessary interventions, thereby encouraging resurrection risk-taking and increasing potential losses. Political influence may also affect which institutions or borrowers receive assistance, often directing support toward those with greater political connections or lobbying capacity. In addition, the set of policy tools deployed to stabilize financial markets and the timing and scope of regulatory information disclosure may reflect existing political pressures. Collectively, these dynamics can prolong financial distress and increase the overall depth, duration, and fiscal costs of financial crises.

Just as important, the predictable politically-driven subsidization of risks to favored groups gives rise to further crises. For example, the same nineteenth- and early twentieth-century US agricultural borrowers that were favored by ex-ante risk subsidies related to unit (single-office) banking laws and deposit insurance, also were favored by ex post statewide debt moratoria when farmers were unable to pay their debts. Those unit banking policies, deposit insurance schemes and debt moratoria were all policies that had precedents going back to the early 19th century (Calomiris and Haber 2014, Chapter 6). In this way, political favoritism not only influences the probability of a crisis through regulation, but also reinforces the incentives for favored borrowers to continue taking risk leading to the next crisis.

2. Bank Charters as Political Acts

For more than four centuries, the rules governing the chartering of banks typically have not been designed to maximize financial stability; rather, they were created to serve the

government's fiscal and geopolitical objectives, or to reward groups that were members of the ruling political coalition.

In particular, the emergence of modern European nation-states in the seventeenth century generated unprecedented demands for revenue to fund imperial expansion and the resulting wars. Mercantilist statecraft relied on innovations such as the granting of monopoly trading rights, the chartering of privileged corporations, and the issuance of sovereign debt. Both autocratic regimes and emerging democratic systems experimented with financial innovation, but late developers such as England, France, and the United States adopted aggressive strategies to compete with incumbent empires, and the chartering of corporations – including banks – was a means of leveraging power by building coalitions with merchants and financiers.

In England, after the Glorious Revolution of 1688, King William III struggled to finance his war against France. To raise funds and refinance his debt, William and his Whig allies chartered the Bank of England in 1694. In return for sovereign debt management services, the Bank was given the exclusive right to issue bank notes. The King proceeded to charter several other competing institutions in order to increase his borrowing capacity and reduce his debt burden. Most notably, he allowed the Tories to charter the South Sea Company (SSC) in 1711 to respond to pressures of the War of the Spanish Succession and the Great Northern War. The SSC received monopoly rights to trade with Spanish America in exchange for converting outstanding government debt into company shares. When hostilities with Spain resumed and cut off trade profits, the SSC outbid the Bank of England for additional debt-refinancing operations. To meet its ambitious goals, the SSC inflated its share price through aggressive promotion, insider dealing, and the strategic use of political connections (Carlos and Neal 2006). Doubts about the sustainability of dividends rose with each new stock issue, eventually leading to a market crash.

At the time of the South Sea Bubble, England suffered from a highly concentrated banking structure and a scarcity of private credit. Only the Bank of England had a charter to operate within England and Wales, and the operations of other banks were constrained by a maximum limit on the number of any bank's partners. Many merchants and industrialists called for additional bank charters, including borrowers frustrated by the lack of available credit and the fragility of the nation's small-partnership banks. The inefficient English and Welch banking system contrasted with the more innovative Scottish model, where banks pioneered branch

banking, small-denomination notes, clearinghouses, commercial credit lines, and interest-bearing deposits (Checkland 1975).

Chartering reform in England was delayed for political reasons. The Bank of England's privileged position generated monopoly rents that were shared with the government, especially during the many eighteenth and early nineteenth century wars. The Bank's charter was renewed 9 times between 1694 and 1844 with each renewal typically accompanied by a low or no interest loan to the government (Broz and Grossman 2004). Only after Britain's military position stabilized following the end of the Napoleonic Wars in 1815 did the political rationale for preserving monopoly privileges weaken, and a liberalization of chartering rules began to be implemented.

France's early experience similarly illustrates the political logic of bank chartering under a mercantilist regime. After the death of Louis XIV in 1715, the regency government was nearly insolvent. This environment allowed the Scottish financier John Law to promote a sweeping program of monetary, fiscal, and mercantile consolidation. Law integrated France's banking, public debt management, and monopoly trade under a central authority. The new coincidence of interests incentivized perverse policies. When the Mississippi Company expanded stock sales to facilitate sovereign debt conversions, Law had the Banque Royale (previously the Banque Generale before Louis XV nationalized it at Law's behest) dramatically expand note issuance to support its stock price. The rapid growth of paper currency undermined confidence in the livre (Bruner and Miller 2020). As the new paper currency depreciated relative to specie, noteholders increasingly redeemed it for gold. The company's stock price collapsed by nearly 80 percent, Law fled the country, and France's financial credibility was damaged for decades (Garber 1990).

The early United States provides a parallel case. Following the Revolutionary War, the young republic was burdened by depreciated state and national debts. Treasury Secretary Alexander Hamilton proposed federal assumption of these obligations and the creation of a national bank (chartered as the Bank of the United States in 1791). To enhance demand for public debt, up to 80 percent of the Bank's share price could be paid in government securities. The arrangement boosted the prices of both the Bank's shares and federal bond prices as well as led to a general market boom. Between October 1791 and April 1792, seventeen new companies were chartered which was more than in the previous seven years combined (Jones 1992). Many households were involved in making security purchases using "time bargains" rather than

purchasing stock outright (Wright and Cowen 2006; Sylla et al. 2009). Expanded notes and lending enabled by the Bank of the United States' opening fueled further price increases and speculation (Cowen 2000). A credit tightening, however, caused a sudden and dramatic crash in 1792 (Taylor 2000).

Political entanglement between banks and governing elites is also evident in late nineteenth-century Mexico. Chaos and conflict had reigned for many decades before General Porfirio Diaz was able to create mutually beneficial arrangements among regional leaders and maintain a centralized autocratic regime, which enjoyed stability from 1877 to1911. A banking system comprised of a small number of chartered banks, capable of extending substantial funds to the government and its industrialist allies, was a key element of this approach. At the top, Diaz chartered the Banco Nacional de Mexico (Banamex) to provide credit to the government and act as the sole financial agent of the Treasury (Maurer 2002). Similar to the Bank of England, Banamex was given a monopoly on public finance in exchange. To satisfy local leaders, the General Banking Act of 1897 allowed the government to divide up markets into bank monopolies controlled by local elites. Bank charters formed part of long-term rent-sharing arrangements: privileged access to credit and note issuance was exchanged for political loyalty and fiscal cooperation. The system, however, was inefficient and focused on benefiting only ruling coalition members. For instance, Banamex and Banco de Londres y Mexico controlled nearly half of all assets and used their market power to ration credit and drive up rates of return (Maurer 2002). The restriction of credit and profits to political insiders undermined the legitimacy of the government and ultimately led to the Mexican Revolution in the 1910s.

A counter-example of this approach is Canada. Canada's path was closely tied to deliberate state-building choices that emphasized integration across a vast, sparsely-populated territory in which western development projects were only possible with the cooperation of already established colonies in the East. Quebec had been an obstacle to western development, and had even attempted a revolution of sorts in the 1830s. To avoid competition between English and French speaking areas, the creation of the Dominion constitution in 1867 and the subsequent implementation of the National Policy under John A. Macdonald, reflected a strategy of centralized coordination of economic policy. This centralized policy included protective tariffs to foster domestic industry, transcontinental railways to bind regions together, and federal authority

over key economic institutions like banks. These policies were designed not only to promote growth but also to ensure political cohesion in a country facing strong regional pressures.

Crucially, Canada's nationalizing impulse extended to financial infrastructure. Rather than allowing provinces or localities to dominate local financial development, policymakers favored institutions that could operate across provincial boundaries and reinforce the broader goal of economic integration. With the Bank Act of 1871 and its periodic revisions, Canada adopted a highly centralized regulatory framework that encouraged the growth of large, nationwide branch banks (Bordo et al. 1994, 2015). This structure facilitated geographic diversification of assets and liabilities, allowing banks to reallocate liquidity across regions and dampen local shocks. Canada experienced attempts by populist Western interests in the late 19th century to replace its banking system with one based on unit banking principles, like those in the US, but this was rejected by the Canadian Senate (Calomiris and Haber 2014, Chapter 9). By the early twentieth century, Canada's approach to bank chartering had produced a concentrated but resilient banking sector that was better equipped to withstand regional downturns and avoided many of the recurrent financial crises seen elsewhere. For example, while many branches closed in Canada during the Great Depression, no bank failed.

More recently, trading charters for government funding was also a feature of Russia's autocracy during the 1990s. Outside of the state savings giant Sberbank, the banking sector was dominated by a few Moscow-based institutions. The politically-connected banks invested heavily in high-yield government securities. After the breakup of the Soviet Union, tax revenues were quite low due to non-cash settlements and the "nonpayments system", and Pinto et al. (2000) estimate that implicit government subsidies to manufacturing were 7-10 percent of GDP in 1997 in addition to the explicit budget subsidy of 8 percent. Facing a severe deficit and a crucial upcoming election, the pro-market-based government of Boris Yeltsin enacted a "shares-for-loans" scheme in 1995-1996 that leased some of the state's largest industrial assets in exchange for loans by the banks (Liberman and Veimetra 1996). The auctions were rigged in favor of political insiders and banks, creating a symbiotic link between the oligarchs and the Kremlin; neither the loans nor the leases were repaid. When capital flows reversed following the Asian financial crisis in 1998, Russia's security and currency markets collapsed. Many of the major private banks defaulted following the large losses on their sovereign debt holdings and leveraged lending positions, reinforcing Sberbank's dominance.

Across these cases, bank charters and structural rules were not neutral technocratic solutions to bank instability. Instead, they were crucial coalition building blocks and sources of funding of the regimes that created them. These charters preserved political regimes and granted needed government funding, but they also generated vulnerabilities that manifested as crises. Specific chartering approaches reflect the political system from which they emerge. Calomiris and Haber (2014) develop a taxonomy of political systems (autocracies and democracies of various types) and link their political structure and the strength of the state to those chartering policies, which we reproduce in Figure 1. They show how each of these approaches to banking produced differences in banking system risk.

As Figure 1 indicates, in a centralized autocracy, property rights for the citizenry are weak and the ruling coalition often governs with an elaborate network of relationships, which control entry into important industries and into banking (historical Mexico is a prime example). Bank and industrial entry are inherently limited to bolster the network's power, and the subsidization of banks and industries occurs as a means of preserving the coalition network. In a decentralized autocracy, the central government is weak and often relies on the banking system as a source of revenue via the reserve tax and high rates of inflation (historical Brazil is a prime example). In a populist democracy, citizen borrowers are an important part of the winning political coalition, and they often use electoral power to win regulatory concessions, but entry is much less restricted (the US is a prime example). In a liberal democracy, Constitutional checks can establish "veto gates" that block the concentration of power in particular borrower vested interests (Canada is a prime example).

3. Sovereign Debt and Clustered Crises

Politicians often face strong pressures to stimulate economic growth either as a way to justify their regime's control or to protect the country from rivals. A common channel in developing economies through which this growth promotion dynamic unfolds is through substantial international sovereign borrowing. While the bank chartering policies described above can raise some government funds, developing countries' domestic financial markets are often too small to absorb large quantities of government debt. That insufficiency reflects a combination of circumstances: scarce endowments of capital that can be mobilized to form banks and fiscal weakness of governments that leads them to tax banks through reserve taxes. This

domestic capacity constraint threatens to limit large-scale transportation projects or other productive state investments. Political leaders thus frequently seek to enlarge their funding capacity by accessing international capital markets. While issuing sovereign debt on foreign markets is not necessarily a bad thing, the weak financial position that developing countries face when trying to float substantial levels of debt internationally often has caused them to accept conditions and institute policies that expose them to greater risk.

First, developing countries are often forced by foreign investors to issue bonds that are denominated in developed countries' currencies. This so-called "original sin" is especially pronounced for the many countries whose currencies are illiquid and subject to large exchange rate risk (Flandreau and Sussman 2010). To repay significant amounts of sovereign bonds denominated in foreign currency, a borrowing country must be able to access foreign currency. Yet developing countries often suffer from exchange rate volatility and inflation, and any currency depreciation leaves it with an increased real debt burden. Despite being predictable, this is the cause of many of the developing world's financial crises.

Second, in order to expand access to international capital markets, developing countries often make multiple structural changes in their economies at the same time. For instance, they often quickly reduce tariff and other barriers to free trade that had been protecting domestic producers in order to gain better access to needed foreign currency through exports. Countries also often liberalize and deregulate their banking sector to allow foreign capital to flow in. More generally, these "emerging markets" (named for their decision to emerge from state led economic management) seek to weaken state control and encourage competition. These sudden, ambitious reforms, however, require a learning process in which they are refined and adjusted to. The crises are often a way the need for learning is expressed (Kaminsky and Schmukler 2008).

Opening to international capital markets ultimately means opening to the global policy environment. The influence of the global environment on the prospects for developing countries' repayment of sovereign debt helps to explain why financial crises often cluster together. For starters, the creation of new global market opportunities for borrowing often contributes to the clustering of policy choices by developing countries to issue debt. If international funds were not widely available at reasonable rates, then countries would not have an incentive to pursue massive sovereign debt issues. Even more importantly, the shared exposure to international

capital markets means that a shift in the monetary or fiscal policies of major economies can generate financial stress throughout the globe. Several episodes illustrate this pattern.

In the wake of the French Revolution (1789-1799), many countries sought political independence. This clustering of Revolutionary movements reflected both the ideological influence of the Revolution – in Latin America, Simón Bolívar and José de San Martín drew inspiration from the French experience – and the geopolitical shocks that it created – Napoleon invaded Spain and Portugal and deposed both of their monarchs. Some of the Latin American revolutions (e.g., Venezuela, Argentina, Columbia, etc.) began as juntas formed by loyalists to Spain's King Ferdinand VII, which became increasingly autonomous. In Brazil, the arrival of Pedro I from Portugal ended up facilitating the transition to its independence from Portugal. Enlightenment ideas related to the French Revolution and Napoleon's invasion of Egypt weakened Ottoman control contributed to the Greek Revolution in 1821. Because the new nations were eager to develop infrastructure and exploit their mineral resources, the clustering of Revolutions created critical mass in the budding global sovereign debt market and the first truly global financial crisis of 1825 (Dawson 1990).

The demands of the new nations were met by a pent-up supply of British capital seeking higher yields after the Napoleonic Wars. After forcing the Bank of England to use contractionary monetary policy to resume specie payments at their pre-1797 parity, the country quickly shifted to expansionary policies (Neal 1997; Turner 2014). The Treasury retired high-interest long-term bonds held by the public, the Bank of England used their substantial gold reserves to buy war bonds from the public, and country banks outside of London began to grow their note issues back to their pre-war levels (Bordo 1998). The end of the war also calmed securities markets and lowered domestic returns. When Baring Brothers and Co successfully floated the first two issues of French *rentes* sold to pay the reparations and support Wellington's occupation forces (White 2001), it created an enthusiasm for other foreign bond investment.

There were many risks with the sovereign bonds. The countries had relatively no borrowing history or taxation powers and the long-distance trip meant information was slow to update. Moreover, the underwriting was not always rigorous. Neal (1997), for instance, relates the story of a Scottish adventurer who floated bonds for the imaginary government of Poyais on London's market. Nevertheless, financial intermediaries in advanced economies stepped in to market their bonds. The prestige and market power of these intermediaries overcame information

asymmetries between investors and unfamiliar sovereign issuers (Flandreau and Flores 2009). Due to the Latin and South American bonds' high returns and the UK's expansionary monetary policy, these intermediaries helped float many countries' bonds payable in sterling or gold on the London market. The new sovereign bonds were the largest single category of new investment in the London capital market in the period (Gayer et al. 1975). Between 1820 and 1825, Buenos Aires, Chile, Columbia, Greece, Guatemala, Mexico, Peru, Portugal, Spain, Austria, Brazil, Denmark, Napes, Prussia, and Russia all listed bonds. Flandreau and Flores (2009), however, show that at least one intermediary (i.e., the House of Rothchild) had higher returns and much lower default rates in the eventual crash, suggesting that risks were observable.

The London stock and bond market crashed in April 1825. Nervous depositors began to withdraw funds from banks. On December 12, 1825, a full banking panic ignited when the London bank Pole, Thornton, and Co stopped payments. Runs were particularly targeted on those banks with either high exposure to debt directly through bond holding or indirectly through their London correspondents (Olmstead-Rumsey and Ravalli 2026). By the end of the crisis, more than 10% of England's country banks went bankrupt. Countries also defaulted on their bonds during the crisis, but not all securities suffered to the same extent as some countries like Prussia, Austria, Russia, and Naples fared relatively well (Flandreau and Flores 2009).

As they had prior to 1825, many former colonies sought to accelerate development through sovereign debt in the mid-to-late nineteenth century. Again, credible financial intermediaries stepped in to lend their reputation to the debt issues and allowed a sizable number to be listed on the London market. Argentina was the first crisis to surface. Foreign investment financed major public infrastructure projects, including railway construction and public utilities. Meanwhile, the Free Banking Law of 1887 permitted banks to issue notes, provided that they purchased gold-backed government bonds, which expanded both public debt and the money supply (Della Paolera and Taylor 2007). These developments produced a boom that proved unsustainable. By 1890, bank runs had begun, and Argentina defaulted on nearly £48 million in debt (approximately 60 percent of the world's defaulted sovereign debt in the 1890s). The Argentinian crisis reverberated internationally because the prominent London merchant bank, Baring Brothers, had underwritten large portions of Argentine debt. Although the Bank of England organized a secret life-boat rescue plan (with the participation of other commercial banks) which successfully prevented systemic collapse, the crisis sharply curtailed the global

appetite for foreign sovereign debt and triggered financial distress in many other countries (Mitchener and Weidenmier 2008). For example, Brazil and Australia (which we will describe in more detail in later sections) experienced financial crises due to the same rise and fall in international capital during the early 1890s.

In the 1970s, 1980s, and 1990s, the so-called Washington Consensus promoted a set of open market-oriented reforms aimed at accelerating economic development (Williamson 1990). Those reforms were embraced as an alternative strategy to the decades of state-led economic management, reliance on government planning, and state taxation and control of banks (a policy regime known as "financial repression"). Emergence was associated with rapid export-led growth (Dollar and Kraay 2004) and productivity enhancing financial deepening (King and Levine 1993). However, the reliance on dollar-denominated borrowing and the disruptive learning process to adjust to an entirely new economic and political architecture was frequently associated with major financial crises that typically involved sharp contractions in GDP and severe banking system collapses that required costly bailouts (Frankel and Romer 1999; Kaminsky and Schmukler 2008; Laeven and Valencia 2012). Indeed, many emerging countries experienced "twin-crises" of their banking system and exchange rate peg because of increased dependency on dollar-denominated funding (Reinhart and Rogoff 2009).

In addition to the East Asian and Latin American Financial Crises of the 1990s (discussed below), the Latin American Debt crises of the 1980s were tied to this emergence. During the 1970s, many developing countries experienced rapid economic growth, but rising oil prices generated large current account deficits for oil-importing nations in Latin America. To finance these deficits, governments borrowed heavily on international markets which were flush with funds from the oil producing companies. This "petrodollar recycling" enabled near-zero real interest rates and strong global growth. Total external debt of Latin America rose from $29 billion in 1970 to $327 billion by 1982 (FDIC 1997). However, when the Volcker Fed and other industrialized countries' central banks tightened monetary policy to combat rampant inflation after 1979, sixteen Latin American nations and eleven other developing countries found their dollar-denominated debt burdens unsustainable and had to reschedule their debts (Devlin and Ffrench-Davis 1995; FDIC 1997).

The Eurozone sovereign debt crisis of 2010–2011 demonstrates that similar dynamics can emerge even within advanced economies. The establishment of a common currency in the

eurozone reflected political aspirations for unity, but not the necessary economic conditions for it. As Mundell's (1961) theory of optimal currency areas showed, commonality in productive potential is a key ingredient for countries to succeed in maintaining a common currency area. That precondition was not met for the eurozone, as some countries (such as Germany and Netherlands) enjoyed much higher productivity growth in the 1990s than other prospective eurozone members. Nevertheless, all the countries of the eurozone enjoyed widespread macroeconomic stability and unusually accommodative monetary policy in the years preceding the crisis (Taylor 2018). The adoption of the euro lowered borrowing costs for peripheral European economies by allowing them to access capital at interest rates closer to those of core Eurozone countries like Germany and France.

This inexpensive funding set off a wave of investment across the region that exacerbated the differences between core and periphery countries. That investment was funded by a combination of high fiscal deficits (in countries like Greece and Portugal) and high loan growth (in countries like Ireland and Spain). The growth of credit in many eurozone countries was not an indication of highly productive investments, but rather of the opposite. Countries with relatively low productivity growth in their tradables sectors saw credit growth as a means of boosting activity in nontradable sectors (such as real estate and government services) to counteract their lower productivity in tradables and the consequent recessionary pressure in tradable goods that resulted from adopting a common currency (which is an implication of the Balassa Samuelson Theorem).

Greece's euro adoption allowed the government to grow public spending, including public sector employment, pensions, and social transfers. Greek banks also expanded lending by relying heavily on cheap wholesale funding from European interbank markets (Gourinchas, Philippon, and Vayanos 2017). Tax revenues failed to keep pace with spending due to widespread tax evasion, and Greece's budget deficit increased from under 5 percent of GDP in 1999 to more than 15 percent by 2008–2009. Government debt-to-GDP reached unsustainable levels (in excess of 130%) in Greece in 2010, and its privately held sovereign debts were renegotiated with more than a 70% reduction of their face value.

Spain's euro adoption coincided with massive capital inflows that fueled a housing boom. Between 2000 and 2007, mortgage lending to Spanish households increased by more than 250 percent, while credit to the real estate sector grew by over 500 percent (Baudino et al. 2023). A

key driver of this expansion was the country's savings banks, or *cajas de ahorros*, whose governance structures included strong representation from regional and municipal governments. Political influence over lending decisions encouraged credit expansion to politically-favored borrowers and projects (Santos 2017). The estimate cost of the resulting crisis was around €80 billion (Baudino et al. 2023).

Similar behaviors to those of Greece and Spain occurred in the other countries of the euro crisis, notably Ireland and Portugal (Fernández-Villaverde et al. 2013).While the crisis countries of the eurozone took different paths, rising borrowing costs post-2010 were a common signal of economic fragility, which led to long, painful, and expensive crises. Greece, for example, lost roughly 10% of its population in the decade after its crisis.

4. Safety Nets and the Failures of Prudential Regulation as an Equilibrium

The political choice to install or expand bank safety nets also can have important adverse consequences for macroeconomic stability. Bank safety nets that limit depositor losses not only can reduce the downside risks faced by depositors, but they also reduce the risk of credit-supply contractions in the wake of bank losses, which favor creditors. Indeed, bank safety nets often serve as a political tool to enable banks to lend to politically-favored investments or constituencies. Nowhere is this dynamic more evident than in the adoption and design of deposit insurance systems. Deposit insurance eliminates depositors' incentives to withdraw funds from banks experiencing rising default risk, thereby reducing the likelihood of destabilizing runs and mitigating the amplification of recessionary shocks. However, by insulating depositors from losses, insurance weakens market discipline (Acharya and Thakor 2016). Depositors no longer need to differentiate among banks based on risk, which allows poorly-managed or risky institutions to survive. Moreover, once protected by insurance, bankers may face incentives to increase risk following losses as a means of maximizing the value of the implicit put option embedded in government guarantees (Merton 1977). The very mechanism designed to contain crises can thus encourage greater financial fragility.

In principle, prudential regulation such as minimum capital requirements, liquidity mandates, portfolio restrictions, and supervisory oversight can offset the moral-hazard incentives associated with greater safety net protection of banks. In practice, however, formal prudential regulation and supervision have proved to be poor substitutes for market discipline (Barth,

Caprio, and Levine 2006; Beck, Demirgüç-Kunt, and Levine 2006). Indeed, a large literature consistently finds that deposit insurance increases bank risk-taking rather than reducing it.

Deposit insurance was an American invention. Six states experimented with deposit insurance in the antebellum period, but all six of those systems had disappeared by the Civil War, either because the systems had collapsed in the wake of costly failures (which was the case in New York, Vermont, and Michigan) or because their member banks had been forced to close down by the imposition of a high federal tax on state-chartered bank notes (Calomiris 1989, 1990; Calomiris and Schweikart 1991; Jaremski 2013). Following the Panic of 1907, Oklahoma, Texas, Kansas, Nebraska, South Dakota, Mississippi, North Dakota, and Washington adopted deposit insurance systems, based on models that were similar to those of the three systems that had failed during the antebellum period. Insured banks expanded lending, reduced cash reserves, and maintained capital ratios near their regulatory minimums (Calomiris and Jaremski 2019). The lending policies of many of the insured banks effectively bet on the persistence of high agricultural prices during World War I. Depositors apparently trusted the credibility of these systems to fund losses despite the absence of credible state government guarantees. When commodity prices reversed in the early 1920s, the insured systems collapsed and generated losses that far exceeded those of neighboring uninsured systems (Calomiris 1990, 1992; Jaremski and Wheelock 2020). These failure experiences informed Candidate and President Franklin D. Roosevelt's opposition to Federal deposit insurance in 1932 and 1933. But despite his opposition, and the opposition of the Federal Reserve System, the Treasury, and the larger US banks, advocates of deposit insurance succeeded in enacting Federal deposit insurance as part of the reforms of the 1930s, and the Federal Deposit Insurance Corporation (FDIC) began operation in 1934.

Insurance eventually spread from the US to other countries, and its spread has amplified systemic vulnerability across the globe. The establishment of deposit insurance in Canada in 1967 was followed by a marked increase in bank failure rates (Carr, Mathewson, and Quigley 1994). When certain German savings banks lost insurance coverage in 2001, they curtailed lending to riskier borrowers and shifted toward more risk-sensitive liability structures (Gropp, Gruendl, and Guettler 2014). Insured Bolivian banks originated loans to lower-quality borrowers with higher ex post default rates (Ioannidou and Penas 2010). Cross-country studies show that deposit insurance leads to lower capital buffers (Nier and Baumann 2006) and raises the

likelihood of banking crises, particularly in countries with extensive coverage and weak institutional environments (Demirgüç-Kunt and Detragiache 2002). More generous systems are also associated with increases in loan-to-asset and debt-to-equity ratios (Calomiris and Chen 2022) and greater systemic fragility leading up to crises (Anginer, Demirgüç-Kunt, and Zhu 2014).

Both in the US case and in the diffusion of deposit insurance to other countries, political considerations were key factors in passing deposit insurance. In the United States, because branching threatened the market power of small rural banks, unit banking interests promoted insurance as an alternative mechanism for stabilizing local institutions. For instance, the geographic concentration of the eight states that installed deposit insurance in the early 1900s reflected the political strength of small banks and farming constituencies in undiversified economies (White 1981). Despite the failures of those state insurance schemes, federal deposit insurance gained momentum amid widespread bank collapses in the 1930s. Senator Carter Glass and President Franklin Roosevelt favored structural separation of commercial and investment banking, but could only secure sufficient congressional support by accommodating unit banking advocates who demanded federal deposit insurance, notably Representative Henry Steagall from Alabama. Legislators were aware of the moral-hazard risks, but responded to intense lobbying from small banks seeking protection (Calomiris and White 1994; Kane and Wilson 2000).

Demirgüç-Kunt, Kane, and Laeven (2008a,b) find that countries with more contestable political systems and larger, undercapitalized banks are more likely to adopt insurance systems. Those with more democratic political systems and more exogenously risky banks are also more likely to install more generous coverage. They also find that the recent global expansion of deposit insurance reflects, in part, its acceptance as an appropriate regulatory policy by influential political actors (e.g., the International Monetary Fund (IMF), the World Bank, and the European Union) in the 1990s. Often countries were required to adopt deposit insurance as one of the preconditions of receiving aid or joining the EU. Calomiris and Chen (2022) find that these same international influences explain the increasing generosity of deposit insurance systems after the 1990s.

The sudden policy advocacy of deposit insurance by the IMF, the World Bank and the EU, despite the evidence of its negative consequences was likely influenced by the multilateral institutions' own resource constraints. During the 1990s, each was grappling with the fallouts of

financial crises in multiple countries, and needed a way to stave off further payouts. Deposit insurance thus represented a political trade-off: a reduction in the immediate likelihood of crisis at the expense of greater long-run fragility.

In sum, the literature shows that safety nets may be a way to enact particular lending outcomes rather than to provide for a safer system. Deposit insurance forms part of a broader equilibrium political bargain that varies across regimes and historical contexts (Calomiris and Haber 2014). When safety nets are introduced to satisfy influential constituencies, complementary regulations may be deliberately weakened or insufficiently enforced. After all, it would be strange for a powerful political coalition to choose to subsidize a desired financial risk only to then undo that subsidy with prudential regulation. Consistent with that view, Fraccaroli et al. (2025) find that greater regulatory and supervisory independence is associated with improved financial stability.

5. Risk Subsidies and Special Access to Funds

In addition to employing safety nets as a means of subsidizing borrowers, governments intervene in other ways to channel subsidized credit toward politically important sectors. Those groups may include emerging industries viewed as engines of growth, politically-important sectors such as agriculture or housing, or firms closely aligned with governing coalitions. Granting access to inexpensive credit through the banking system is one of politicians' preferred methods for subsidizing favored groups because more direct fiscal transfers can be constrained by political opposition or institutional barriers (Rajan 2011; Calomiris and Haber 2014) or because the costs of credit subsidies are diffuse and difficult for taxpayers to observe (Coate and Morris 1995). Unlike direct transfers, credit subsidies can be embedded within financial regulation or policies, making them less transparent and easier to sustain.

Although these types of subsidies are justified as promoting development or expanding economic opportunity, they weaken the normal pricing of risk by allocating credit to sectors regardless of their underlying productivity or riskiness and lead to concentrated exposures within the banking system. When lenders and borrowers expect continued political support, they have incentives to take on greater leverage and engage in speculative investment. The resulting financial systems are often particularly vulnerable to adverse shocks.

Governments have relied on three principal mechanisms to provide credit subsidies. First, governments can grant explicit transfers. A prominent example occurred in the United States during the 1830s. Created in 1816, the (Second) Bank of the United States played a stabilizing role in the financial system by imposing discipline on banks and helping to maintain stable domestic exchange rates (Knodell 2017). However, President Andrew Jackson vetoed legislation to renew the Bank's charter and redistributed federal deposits to a group of politically-connected "pet" banks. This decision eliminated the stabilizing influence of the Bank and contributed to a rapid expansion of credit and money supply, led by the so-called "pet banks" allied with Jackson, and benefiting Jackson's agrarian supporters (Hilt and Liang 2020). The resulting Panics of 1837 and 1839 fueled a prolonged economic contraction lasting until 1843, during which more than 300 banks failed and nine states defaulted on or delayed payment on their debt (Temin 1969; Rousseau 2002; Wallis 2001; Lepler 2013).

Second, governments can channel subsidized credit toward preferred borrowers through government-owned or controlled banks (Kornai 1979; Shleifer and Vishny 1994; La Porta, Rafael, and Shleifer 2002). Sapienza (2004) finds that Italian government-owned banks provide preferential lending to large firms and to those in economically-depressed regions. Khwaja and Mian (2005) show that Pakistani government-owned banks extend cheaper credit to politically-connected firms. In both Italy and Pakistan, the magnitude of the credit subsidies scales with the political influence of the recipients. Claessens, Feijen, and Laeven (2008) document that those Brazilian firms contributing to successful political candidates experience abnormal stock returns following elections, reflecting preferential access to credit from state-controlled banks.

Third, governments can indirectly subsidize particular groups by altering regulations or policies that expand credit availability through the private banking system. As we have already pointed out, deposit insurance protection can be an example of such indirect credit subsidies. While the specific institutional arrangements of the regulations that entail credit risk subsidies differ across countries and time, the common feature of these policies is that they lower the effective cost of credit or increase its supply to politically-favored groups.

In some cases, more than one type of subsidy is utilized to achieve a political goal. For decades, Chinese state-controlled banks have directed large volumes of subsidized credit toward state-owned enterprises, infrastructure projects, and politically favored development initiatives. Cull and Xu (2003) find that direct government transfers to Chinese state-owned enterprises

were not associated with profitability between 1980 and 1994. Bai, Hsieh, and Song (2016) argue that the Chinese fiscal stimulus program channeled financial resources towards low-productivity but local-government-favored private firms. Li, Meng, Wang, and Zhou (2008) find that the Party membership of Chinese entrepreneurs positively affects their firm's performance due to enhanced credit access.

Given the wide range of subsides over time, the following subsections illustrate how they have been implemented across different sectors and historical periods.

5.1 Blanket Sectoral Subsidies

Politically important sectors or industries can receive financial subsidies through bank and non-bank channels. Agriculture and railroads were early sectors to receive financial subsidies of various kinds, but industrial subsidization has broadened and deepened over time. These subsidies reflected a combination of the political power of certain constituencies, as well as the geopolitical importance of certain sectors. With respect to the latter, broader industrial policies in Japan (e.g., Patrick 1967; Ramsayer and Rosenbluth 1998) and Germany (e.g., Calomiris 2000; Fohlin 2009) that were tied to their international military ambitions had important financial components (intermediaries that directed credit to industrial development).

With respect to powerful domestic constituencies, during the late nineteenth and early twentieth centuries, many European countries created specialized agricultural credit institutions (e.g., Germany's Raiffeisen and Schulze-Delitzsch cooperative banking systems or France's Crédit Agricole) to provide farmers and small businesses with subsidized access to loans (e.g., Guinnane 1997, 2012; Gueslin 1978, 1992). These institutions often operated with explicit or implicit government guarantees and benefited from favorable regulatory treatment. Although they often improved access to credit in rural areas, political favoritism sometimes encouraged excessive lending and weaker financial discipline. In fact, some government assistance was seemingly based on the political leanings of the cooperatives (Guinnane 1997, 2012).

Throughout much of U.S. history, policymakers imposed restrictions on bank branching. These regulations were not primarily designed to promote financial stability. In fact, unit banking systems—where banks are prohibited from operating multiple branches—tended to be more fragile because they prevented banks from geographically diversifying their loan portfolios or pooling resources to respond to regional shocks. Political factors explain the persistence of

unit banking despite its destabilizing consequences. Specifically, agricultural borrowers and small banks formed political coalitions that supported strict branching limits in order to increase the supply of credit to rural areas (Abrams and Settle 1993; Economides, Hubbard, and Palia 1996; Giedeman 2005; Calomiris and Ramirez 2008; Rajan and Ramcharan 2011, 2016; Calomiris and Haber 2014, Chapter 6).

Once established, small local banks had strong incentives to protect their markets from competition by larger city banks that typically had lower overhead costs and more diversified lending (Jaremski and Fishback 2018). This incentive was not unique to the US, as bankers in other countries also wanted less competition (see Rajan and Zingales 2003). The key differentiating features in the US were that state governments held sway over bank chartering and local agricultural borrowers were also strong advocates of unit banking within their states. This is visible both in the structure of political platforms (limits on branch banking was a key element of the agrarian-dominated Populist Party in the 1896 election), as well as when the issue was put directly to individual agrarian voters. In Illinois, for example, a 1924 referendum on branching restrictions passed by a margin of more than two to one (White 1985). Why would agricultural borrowers support laws that made banks less stable? Although unit banking had major downsides for these borrowers (greater risk of local bank failure and higher loan interest rates), unit banks functioned as a form of informal credit insurance because their close community ties increased the likelihood that they would continue lending during difficult economic periods (Calomiris and Ramirez 2008). Agrarian areas were particularly undiversified (dependent on a small number of crops with highly varying prices), so this sort of credit insurance was especially valued by farmers and explains their political support for unit banking laws.

Under different political circumstances for borrowers, unit banking did not enjoy their support. For example, branching was popular in the antebellum South because large farmers owned slaves that made them less dependent on local circumstances. After the Civil War abolished slavery and shifted agricultural production toward smaller farms, support for unit banking increased significantly in the South. Major crises that produced the disappearance of many unit banks also predictably shifted borrowers' political support for unit banking. For example, during the depths of the Great Depression, several states relaxed branching restrictions

after widespread bank failures left many rural communities without any financial institutions (Quincy and Xu 2026).

Brazil's Encilhamento Crisis also seems to have reflected politically motivated credit subsidies. The end of slavery in 1888 increased labor costs and weakened support for the monarchy among powerful agricultural elites, particularly coffee producers. In an attempt to maintain their political support, Brazil's finance ministers adopted policies that dramatically expanded credit availability (Tannuri 1981). These policies continued even after a military coup established a republic in 1889. The number of banks in Brazil increased more than fivefold. Unfortunately, many of these new institutions were poorly capitalized and closely linked to speculative ventures in railroads and manufacturing (Neuhaus 1974). The initial explosion of bank charters increased the nominal money supply by over 400% between 1888 and 1891, and fueled a dramatic speculative boom on the Rio de Janeiro Stock Exchange. However, external shocks (including the Baring Crisis discussed in Section 3) combined with Marshal Deodoro da Fonseca's failed self-coup of November 1891 to trigger a prolonged financial crisis that wiped out most of the newly-established banks and imposed severe macroeconomic costs (Gerber and Passananti 2015).

An important example of politically motivated credit subsidies that set the stage for financial crises occurred during the expansion of the American railroad system in the nineteenth century. Federal and state governments provided extensive support for railroad construction through land grants, government-backed bonds, and favorable regulatory treatment. The combination created incentives for rapid expansion. Railroad companies often built lines ahead of demand, while investors used inflated railroad securities as collateral for further borrowing. They also heavily lobbied politicians in order to receive less oversight and more subsidies. The most notorious scandal of the time was the Crédit Mobilier affair, in which Union Pacific Railroad executives created a separate construction company that extracted large profits from the government-backed project while distributing shares to members of Congress (Fogel 1960; Klein 2006; White 2011). The collapse of railroad financing triggered the Panic of 1873, and initiated a prolonged economic downturn (Wicker 2000, 2013; Ladley and Rousseau 2023). As we will describe in Section 7, the subsidies did not stop there as federal bankruptcy law evolved during the late 19th century to manage their distress and government funding was even targeted to railroads in Great Depression.

In the case of Australia, government programs were important in driving subsidies for local development in the late 19th century, which set the stage for Australia's most severe financial crisis in 1893. Unlike Canada, which opted to unify the country's economy, Australia's six colonies were separate and largely independent colonies until the creation of a federal government in 1901. The competition between the colonies led to inefficient within-colony investments (Butlin 2013). Local governments issued bonds in London to build massive railroad networks to take advantage of natural resources (particularly mining discoveries) and promote local development. The initial railroads were large trunk lines between major cities, but colonies eschewed lines that would benefit their neighbors and eventually started building smaller unprofitable lines at the behest of political pressure. Between 1865 and 1914, the country received about one-sixth of the overseas portfolio finance that passed through the British capital market (on par with Argentina) and received over half of all UK finance between 1883 and 1890 (Davis and Gallman 2001). By 1891, there were some 10,206 miles of track; and almost three-fifths of that total had been built during the previous decade (Davis and Gallman 2001).

With the colonies leading the way, a deluge of British savings also flowed into Australian commercial banks, land finance companies, and pastoral companies. British investors seemingly expected the British government to insure colonial repayment (Neal 2009). Given the extra low cost funds and expanding railroad access, these financial institutions lent out these new funds, creating a boom in real estate and stock prices (Cork 1894). Agriculture expanded into more arid lands and much of the funding went into an urbanization wave. Without a central bank to recognize the rules of the game and offset the risks associated with inflows by increasing interest rates, the macro prudential risk went unchecked. The land boom slowed towards the end of 1888 and land finance companies were only able to limp along with liquidity assistance from continuing British investments and Australian commercial banks. However, when British investment reversed after the Barings Crisis, land mortgage companies closed in large numbers (Cork 1894). Commercial banks quickly followed as they held substantial portions of British deposits, lent heavily to land companies and stock markets, and had decreased their average equity and cash ratios (Hickson and Turner 2002). By the peak of the crisis in April and May 1893, suspended banks accounted for 56 percent of deposits and 61 percent of the note circulation across the six colonies (Butlin 1961; Davis and Gallman 2001).

5.2 Subsidization of Specific Borrower Groups

Industrial development has also frequently been supported through credit subsidies that favor particular firms or conglomerates. We already described one early example of this in Mexico under the reign of Porfirio Diaz. A limited number of bank charters were granted to the privileged elite, and they specialized in lending to key insiders that were part of the centralized autocratic network that governed the country (Calomiris and Haber 2014, Chapter 10). There are several other examples of such groups.

Following the military coup led by General Augusto Pinochet in Chile in 1973, the new government privatized nearly all of the country's banks, selling them through auctions in which buyers could finance up to 90 percent of the purchase price. In practice, a small number of large conglomerates (known as *grupos económicos*) acquired most of the banks as well as industrial and service firms being privatized (Arellano 1983; Barandiarán and Hernández 1999). Financial regulations were simultaneously liberalized to dramatically increase credit availability. Much of this credit flowed from banks to firms within the same grupos, particularly those firms controlled by bank insiders. Rather than investing primarily in productivity improvements, many grupos used the credit to acquire additional firms and expand market share. Rising asset prices reinforced this strategy, as appreciating stocks were used as collateral for additional borrowing. When the global recession of 1981 weakened Chile's corporate sector, the banking system became insolvent. By May 1983, non-performing assets had reached an estimated 113 percent of bank capital and reserves. The government ultimately intervened and guaranteed bank deposits, with total resolution costs exceeding 40 percent of GDP (Barandiarán and Hernández 1999).

During the Latin American debt crisis of the 1980s, Mexico nationalized its banking system to expand the government's fiscal resources. In the early 1990s, however, the government reversed course. The privatization process prioritized maximizing sale prices rather than ensuring financial stability. Foreign bank entry remained restricted, and banks were allowed to avoid recognizing existing loan losses that would have required recapitalization. In addition, buyers were permitted to finance most of the purchase price over time, and the government guaranteed the liabilities of the privatized banks (Mackey 1999; Haber 2005). These policies led to high purchase prices but fragile banks. Many newly privatized banks engaged in risky lending to

insiders (La Porta and Lopez-de-Silanes 2003). When the Mexican economy slowed in 1993, the banking system collapsed and the resulting bank bailout exceeded 20 percent of GDP.

South Korea's development strategy centered on large industrial conglomerates known as *chaebol*, which enjoyed close relationships with political leaders and financial institutions. As the rapid growth in the 1970s and 1980s gave way to profitability declines in the 1990s, *chaebols* accumulated increasingly high levels of debt (Pomerleano 1998; Joh 2004). Yet banks and bond markets continued to extend financing on the basis of political influence rather than economic performance (Harvey and Roper 1999). When capital inflows to East Asia suddenly reversed during 1997-1998, the vulnerabilities of the Korean financial system became fully evident. Many banks and firms failed, and the cost of resolving the crisis has been estimated at roughly 30 percent of GDP (Bustelo 2004).

5.3 Housing Subsidization

In recent decades, political pressures have increasingly favored the expansion of housing finance. Real estate lending accounted for roughly 40 percent of total bank lending between 1970 and 1992, but this share rose sharply to approximately 55 percent from 1993 to 2007 (Jordà et al. 2015a, 2015b; Cournède and Denk 2015). Mortgage subsides have taken many forms, but most operate by reducing the effective cost of mortgage borrowing or by expanding the quantity of mortgage credit available to households relative to an unsubsidized market. These subsidies may be offset, in part, if they also increase the demand for housing and lead to higher house prices.

Mortgage lending is particularly vulnerable to systemic shocks because housing markets tend to move together over the business cycle, and real estate collateral can become difficult to value or liquidate quickly during downturns. Jordà et al. (2015a, 2015b) find that credit-driven asset price booms are closely associated with the onset of banking crises, but emphasize that housing bubbles financed by credit are especially dangerous. Additionally, Mian, Sufi, and Verner (2017) find that low mortgage spreads were associated with the increase in the household debt to GDP ratio leading up to 2007, and that a global household debt cycle partly predicts the severity of the global slowdown after 2007.

Government policies promoting homeownership have been a growing feature of American political economy for nearly a century. Examples include mortgage guarantees provided by the Federal Housing Administration and the Veterans Administration, mandates and

guarantees associated with government-sponsored enterprises such as Fannie Mae and Freddie Mac, and regulatory pressures on lenders to extend credit to targeted communities through the Community Reinvestment Act (Calomiris and Haber 2014, Chapter 7). Additional subsidies have arisen from low and risk-insensitive capital requirements for mortgage lending and regulatory forbearance that allowed insolvent mortgage lenders to continue operating during periods of distress. Lobbying by U.S. mortgage lenders influenced this legislative behavior during the 2000s housing boom. Igan et al. (2012) document that the riskiest mortgage lenders were among the most active lobbyists in Congress. Mian, Sufi, and Trebbi (2013) show that mortgage industry firms sharply increased their campaign contributions as the political stakes surrounding housing finance intensified. These contributions had a growing influence on congressional voting behavior regarding housing-related legislation. Together, these policies encouraged a substantial deterioration in mortgage underwriting standards leading up to the subprime mortgage crisis. Mortgage lenders increasingly relied on minimal documentation, high loan-to-value ratios, and complex securitization structures that obscured underlying risks.

Japan's financial crash in 1989 was also driven by credit expansion to housing and securities. The 1958 Bank of Japan Law strengthened the Ministry of Finance's influence over the Bank of Japan, embedding fiscal and industrial policy objectives within monetary governance. Coordinated credit allocation, tax incentives, and export promotion supported rapid growth in the 1960s and 1970s (Cowling and Tomlinson 2000). However, when growth slowed in the 1980s, the Bank reduced discount rates and set loan growth quotas to carry out the prevailing policy agenda (Okina et al. 2001). Banks extended credit with diminishing regard for borrower risk, concentrating new loans in property-related businesses such as construction, real estate, and non-bank financial services (Fujii and Kawai 2012). In particular, Jusen (non-bank companies designed to provide housing loans to individuals) shifted to invest heavily in real estate speculators and developers using the excess funds from banks and agricultural cooperatives (Milhaupt and Miller 1997). The Nikkei index and urban land prices nearly tripled from 1985 through 1989. The sudden crash in early 1990 severely weakened financial balance sheets and ushered in prolonged asset deflation and stagnation.

6. Electoral Politics and Financial Stability

Across different countries and time periods, voters reward incumbents during periods of economic expansion and punish them during downturns (e.g., Key 1966; Kramer 1971; Fair 1978, 1996, 2002; Hibbs 1987a, 1987b; Lewis-Beck 1988; Alesina et al. 1993; Campbell and Garand 2000; Lewis-Beck and Stegmaier 2000; Persson and Tabellini 2002; Brunet et al. 2026). Politicians face strong incentives to adopt policies that produce visible short-term economic gains before elections (e.g., Nordhaus 1975). Expanding household credit can generate precisely such gains: it raises homeownership rates, stimulates construction and consumption, and supports rising asset prices. However, while credit-fueled expansions often produce unusually strong short-run growth, they also deepen recessions once distress emerges (Jordà et al. 2013, 2016). Because voters typically evaluate incumbents based on recent economic performance, the short-term stimulus generated by credit expansion can translate into electoral advantages for politicians who promote such policies, even if it heightens financial vulnerability over the longer term.

The connection between expanded lending and voter support is not always clearly visible. In some contexts, intermediary organizations such as labor unions, agricultural cooperatives, or grassroots political networks facilitate this exchange between politicians and citizens by helping to mobilize beneficiaries (Calomiris and Haber 2014). However, many large-scale credit subsidies lack such intermediaries, and in countries with secret ballots, politicians cannot directly verify whether beneficiaries of these policies reward them electorally. Nevertheless, politicians behave as if such electoral rewards exist.

Cole (2009) finds that agricultural lending by government-owned banks in India increases by approximately 5–10 percentage points in election years, particularly in districts with close elections. These surges in lending are followed by significantly higher post-election default rates. Carvalho (2014) shows Brazilian government-controlled banks use credit to pressure firms in politically-important regions to increase employment prior to elections. Bircan and Saka (2021) find that government-owned bank lending increases in Turkish provinces when the incumbent mayor aligned with the ruling party faces election competition, and decreases in closely contested provinces when the incumbent mayor is from an opposition party. Englmaier and Stowasser (2017) find that German savings banks, which are controlled by county-level politicians, systematically adjust lending policies in response to local electoral cycles. In cross-

country studies, Dinc (2005) shows that government-owned banks substantially increase lending in election years relative to private banks and Iannotta et al. (2013) find that government-owned banks experience higher operating risk and governmental protection in election years.

Housing policy in the US provides a particularly clear example of how credit subsidies can become embedded in electoral politics. Expanded access to mortgage credit broadened homeownership and created large constituencies with a stake in continued credit availability. Mian et al. (2010) show that the geographic distribution of subprime borrowers influenced how members of Congress voted on housing-related legislation during the mid-2000s. Representatives from districts with larger numbers of subprime borrowers were more likely to support policies that expanded mortgage credit, even after controlling for campaign contributions from the financial sector. Antoniades and Calomiris (2020) show that voters responded to the post-2008 credit crunch by shifting their support away from the Republican Presidential candidate in 2008. Over a longer period of Presidential elections, however, voters only punished politicians for credit-supply contractions; they did not reward politicians for credit-supply expansions. One psychological interpretation of that finding is that borrowers attribute successful mortgage applications to themselves, but attribute a failure of their application to others.

The political importance of housing credit constituencies is not unique to the United States. In the United Kingdom, the housing policies associated with Margaret Thatcher—particularly the privatization of council housing under the "Right to Buy" program—significantly expanded homeownership and contributed to her popularity. The program allowed tenants in publicly-owned council housing to buy their rented accommodation at a heavily subsidized price, causing the share of home ownership in the UK to rise from 55% in 1979 to over 70% in the early 2000s (Disney and Luo 2017). More recently, the government of David Cameron maintained mortgage risk subsidies through the "Help to Buy" program even while implementing broader fiscal austerity measures (Carozzi et al. 2024). Mortgage market liberalization in Denmark, Sweden and the Netherlands reflected political coalitions of homeowners, lenders, and construction interests that supported continued credit availability (Anderson and Kurzer 2020). Similar dynamics are also visible in emerging and periphery economies. In Brazil, the large-scale housing subsidy initiative Minha Casa Minha Vida became a central element of social policy during the presidency of Dilma Rousseff. Observers widely credit the program with helping Rousseff secure a narrow electoral victory in the 2014

presidential election by expanding access to housing for lower-income households. Similar to Spain, Ireland's housing boom after Euro adoption created powerful electoral constituencies that benefited from continued credit expansion (Fernández-Villaverde et al. 2013; Santos 2017).

The broader implication of this evidence is that credit expansion directed toward households can serve as a political tool for incumbents seeking electoral support. However, these policies can also contribute to financial fragility by encouraging excessive leverage and weakening lending standards. Moreover, as we discuss in next section, these same political incentives can shape policymakers' responses when financial crises emerge. Politicians who have encouraged credit growth often face strong incentives to delay recognition of losses, support borrower relief programs, and resist policies that would sharply contract credit supply.

7. The Politics of Managing Financial Crises

Politics not only shapes the regulatory environments that give rise to financial crises, but it also plays a role in managing crises once they occur. Policymakers frequently enter crises without a fully developed framework for responding to shocks of unknown magnitude. Governments confronted with financial instability thus must decide when and how to intervene. These decisions are rarely purely technocratic, often combining elements of predictable policy design with improvisation by those in charge. Political forces influence crisis management along three primary dimensions: the choice of stabilization tools, the timing of intervention, and regulatory capture. The rest of this section discusses each of these dimensions in turn.

7.1 The Choice of Stabilization Tools

Effective crisis management requires a diverse set of policy tools capable of addressing shocks of different types and magnitudes. Yet the history of central bank institutions underscores the extent to which crisis-management frameworks are shaped by politics. Despite the long-standing recognition of systemic banking risk, central banks developed at different times and with markedly different statutory authorities. Even today, central bank powers vary widely across countries. Some central banks operate under narrowly defined mandates, while others possess broad discretionary authority to intervene in financial markets. Calomiris, Flandreau, and Laeven (2016) show that these differences are linked to the political regimes and contexts in which each central bank was created.

Comparative historical cases illustrate this point for lender-of-last resort behavior. At the turn of the twentieth century, both Russia and Mexico were governed by authoritarian regimes and faced severe liquidity shocks arising from global financial disturbances. Neither country had an independent central bank. In Russia's 1900 crisis, Finance Minister Sergei Witte personally evaluated the financial condition of major banks and selectively extended assistance to those he deemed viable, while allowing others to fail. In Mexico's 1907 crisis, Finance Minister José Yves Limantour had Mexican banks pool performing loans into a new institution, the Caja de Préstamos, which effectively created a structured financial vehicle resembling modern securitization. Because the government shared in potential losses of the vehicle, the arrangement was credible with international investors and generated profits for participating banks.

In the US, the founding of the Federal Reserve System in 1913 reflected deep political resistance to centralized financial authority that was rooted in earlier conflicts over institutions such as the First Bank of the United States and Second Bank of the United States discussed above. Progressive Era reformers sought to create a lender of last resort after recurrent banking panics, but agrarian and populist constituencies—particularly in the South and West—feared domination by Wall Street and concentrated financial power in New York (Lowenstein 2015; Broz 1997). As a result, the Federal Reserve Act deliberately fragmented authority across twelve regional Reserve Banks overseen by a politically-appointed but relatively weak Federal Reserve Board (Eichengreen 2015; Meltzer 2003). In this sense, the Fed's original structure was a political solution to longstanding distrust of centralized banking power, with institutional fragmentation serving as a mechanism to secure broad political support at the cost of reduced centralization (Calomiris and Haber 2014; Jaremski and Wheelock 2025). When crises arose, however, the decentralized system led to differential policies that prevented a strong nation-wide response and allowed fundamentals to continue to deteriorate (Friedman and Schwartz 1963). It was not until the Banking Act of 1935 that monetary policy control was centralized by shifting power from the regional Reserve Banks to the newly-renamed Board of Governors of the Federal Reserve System.

A related concern involves the legitimacy of emergency interventions. Without clearly established rules governing when and how assistance should be provided, crisis responses risk appearing arbitrary or politically motivated (Calomiris et al. 2017). Such legitimacy concerns can influence policymakers' behavior in subsequent crises. For example, Federal Reserve

interventions during the 1920s may have undermined the institution's credibility and contributed to excessive caution during the early years of the Great Depression (Carlson 2025). Similarly, the Federal Reserve's expansive role in the 2008–2009 bailouts generated political backlash that resulted in tighter restrictions on its emergency lending authority.

These experiences suggest that effective crisis-management frameworks require clear governance structures and pre-established rules. Ideally, responsibilities would be divided between monetary authorities and fiscal authorities in ways that preserve both flexibility and accountability. The Canadian approach (Daniel et al. 2005) provides a useful model, distinguishing among three categories of emergency support: assistance that central banks can provide independently (such as collateralized lending), assistance that requires Treasury approval (such as certain forms of unsecured lending), and assistance that can only be provided through fiscal authorities. Establishing such frameworks in advance reduces delays and uncertainty during future crises. Yet it is seemingly difficult to adopt such forward-looking arrangements. Politicians are likely hesitant to suggest that their country's financial system is unstable and that they could not prevent losses during a crisis without help. Instead bank regulation tends to follow financial crises and thus often is responding to the specifics of the previous crises rather than looking towards the next one (Barth et al. 2012; Tarullo 2019; Almasi et al. 2025).

7.2 The Timing of Crisis Intervention

Politics also shape the timing of regulatory interventions. Credit expansion directed toward households can serve as a political tool for incumbents seeking electoral support, but these same political incentives can shape policymakers' responses when financial crises emerge. Politicians who have encouraged credit growth often face strong incentives to delay recognition of losses, support borrower relief programs, and resist policies that would sharply contract credit in order to maintain their popularity. Regardless of the reason, such delays often encourage resurrection risk-taking, in which insolvent institutions take increasingly risky positions in hopes of recovering their financial health. When intervention finally occurs, losses are typically far larger than they would have been under earlier resolution.

Because bank closures often reduce credit availability and harm local economies, politicians frequently delay the recognition of bank losses or the closure of insolvent institutions during election periods. Studying emerging markets in the 1990s, Brown and Dinc (2005) find

that regulators are significantly less likely to intervene in failing banks during election years. Liu and Ngo (2014) show that U.S. bank failures are roughly 45 percent less likely in states where governors face reelection in the following year. The effect is even stronger when the governor's party controls both legislative chambers. Similarly for an earlier period, Del Angel and Richardson (2024) find gubernatorial oversight of bank regulators delayed bank failures during election campaigns.

Even when elections are not in play, politicians often delay the resolution of risky or even insolvent firms during crises. Indeed, much of the literature criticizing existing bank regulation and supervision has noted with some puzzlement its continuing reliance on poor measures of bank risk and ineffectual interventions by supervisors even when banks' weak conditions are evident (Correia, Luck, and Verner 2026). Calomiris and Herring (2013) show that the large US and European banks that failed during the 2008-2009 crisis were observably weak for months prior to the crisis, based on market indicators, but these were ignored by bank supervisors. Calomiris and Haber (2014, Chapter 8) argue that the regulatory treatment of subprime mortgage risk prior to the 2008-2009 crisis intentionally under-regulated risks relating to mortgage lending by banks and GSEs as part of the political bargain to support homeownership. Even the poor fundamentals of the large US banks that failed in 2023 were publically available many months out, but they continued to receive government assistance regardless. Böni and Zimmerman (2026) show that Credit Suisse also suffered from deterioration in its market value and increases in its credit spreads over a two-year period prior to its collapse in 2023.

There is a broad consensus within the academic community that incorporating more meaningful market-based information in regulation and supervision would make them much more effective (Financial Economists Roundtable 2024, Correia, Luck and Verner 2026). An obvious explanation for the continuing failure to do so is that ineffectual tools that can be controlled by politicians and regulators are preferred to effective ones precisely because using the ineffective tools avoids making a commitment to requiring discipline of banks. The political choice in response to crises to continue to use ineffectual prudential standards and prevent failures can be seen in several examples.

During the S&L crisis, many thrift institutions had been insolvent for years before the government acted decisively (Kane 1985, 1989). Insolvent thrifts continued to take greater gambles in order to try to stay afloat, increasing the eventual resolution costs. The delay was, in

part, because policymakers were reluctant to impose the political costs of closure. Romer and Weingast (1991) describe how congressional resistance was associated with the geographic concentration of failing institutions. Failing thrifts also heavily lobbied their congressmen (Jackson 1988). Ultimately, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 provided the legislative framework to resolve the crisis and restructure the thrift industry, but was only passed after the 1988 presidential election.

The policy response to the 2008–2009 subprime crisis provides another example of the complex interaction between politics and crisis management. Initially, U.S. Treasury Secretary Henry Paulson envisioned the Troubled Asset Relief Program (TARP) as a mechanism to remove illiquid or distressed assets from bank balance sheets, thereby restoring confidence in bank solvency and normalizing credit markets. Under his plan, the government would either buy troubled assets through structured auctions or guarantee their value at prices above depressed market levels. However, as the crisis intensified, policymakers abandoned the auction approach and shifted toward direct capital injections into banks, primarily through the purchase of preferred stock. This mechanism, incorporated into the legislation through congressional negotiations led in part by Representative Barney Frank, became the core of TARP's bank stabilization program.

The TARP legislative process was slow and politically contentious, delaying implementation during a period of rapidly deteriorating financial conditions. Moreover, the magnitude of losses faced by some large institutions (e.g., Citigroup and Bank of America) meant that preferred stock assistance alone proved insufficient (Calomiris et al. 2017). There is evidence that TARP was effective in reducing systemic risk and repairing the functioning of the banking system, with attendant improvements in the economy (Berger and Roman 2020), but in retrospect, it may have been less effective than earlier crisis-resolution mechanisms. During the Great Depression, the Reconstruction Finance Corporation (RFC) injected capital into banks using preferred stock more rapidly and on a larger scale (Butkiewicz 1995; Mason 2001, 2003; Calomiris et al. 2013; Calomiris and Khan 2015; Vossmeyer 2016).

Delayed resolution occurred in many of the crises addressed in this chapter. During Australia's 1893 crisis, most colonies chose "reconstruction" rather than liquidation for suspended banks. Specifically, they would quickly reopen a closed bank as a new bank after negotiating with depositors to accept longer-dated securities or preferred shares of the bank. The

approach allowed banks to continue to operate without fire sales (Ellis 1893), but encouraged runs at other banks in anticipation of further reconstruction. After Japan's 1990 crash, the government spent much of the decade allowing weak banks to continue operation in order to protect local employment, sustain credit supply, and avoid electoral backlash (Hoshi and Kashyap 2004; Peek and Rosengren 2005; Caballero et al. 2008). During Spain's recent housing bust, the government downplayed the crisis before the major elections of 2008 and propped up the *cajas* for some time because housing credit expansion was politically popular (Fernández-Villaverde et al. 2013). Many governments in our examples also installed or dramatically expanded deposit insurance in order to keep their banking systems afloat in the hopes that the delay would provide a way out of the crisis.

7.3 Regulatory Capture

Political interference during financial crises can also operate through regulatory capture and information suppression. If politicians are seeking to benefit certain groups with risk subsidies, they are not likely to suddenly abandon them in a crisis. Politicians thus have an incentive to protect that industry not only from losses, but also information releases that might harm their business.

The Florida real estate boom of the 1920s illustrates this point. Real estate companies frequently acquired controlling interests in banks, installed sympathetic directors, and used these institutions to finance speculative development projects (Vickers 1994). Although bank risk management practices appeared sound on the surface, the political connections in a chain of banks concealed significant vulnerabilities (Calomiris and Jaremski 2023). The connections prevented balance sheet information from being published at the height of the boom, shielded examination and liquidation records from becoming public, and drew out initial liquidations in order to allow the boom to continue. During 1926, house prices dropped by nearly half but nearly all banks that closed were part of the chain.

There are also cases of politicians closing firms to protect their favored institutions during crises. For instance, during the South Sea Bubble, the English government restricted corporate chartering to prop up the politically-connected SSC. Coinciding with the initial boom in the SSC stock prices was a sudden rise in new initial public offerings. SSC leadership claimed the existence of these "bubble" companies eliminated any premium that might have been

attached to SSC stock. As many politicians were owners of SSC stock, the SSC persuaded Parliament to enact the so-called Bubble Act in 1720, restricting firms from operating without a royal charter. Court rulings required bubble firms to justify their existence forcing many to close and causing a decline in stock prices and investment.

In the U.S. subprime crisis, mortgage lenders and voters also played an active role in shaping aid decisions. Politically-connected banks were significantly more likely to receive TARP funding (Duchin and Sosyura 2012; Berger and Roman 2015) as well as obtain more funding more quickly (Blau et al. 2013). Similarly, politically-connected banks were also 16–20 percent more likely to participate in the Fed's emergency loan programs than others (Blau 2017). Mian, Sufi, and Trebbi (2010) find that congressional support for the Foreclosure Prevention Act of 2008 was strongly predicted by local mortgage distress. Representatives whose districts experienced larger increases in mortgage defaults were significantly more likely to support foreclosure relief measures, particularly when those districts were electorally competitive or shared the representative's partisan affiliation.

7.4 A Feedback Loop

History plays a role in the evolving equilibrium that connects risk subsidies and financial crises. Predictable political subsidies and financial crises often reinforce each other through time. We have covered two aspects of this dynamic so far: (1) political subsidization of certain groups increases the risk of a financial crisis and (2) financial crises often cause politicians to step in and protect those same groups. However, there is a third step: (3) protection during financial crises encourages more bad behavior as industries become even more confident that they will be covered in the next crisis. To put it another way, once special ex post treatment occurs, it changes ex ante perceptions of protection in the future; ex post and ex ante protection are thus often intertwined in history. Some examples illustrate this behavior.

Previously we discussed how broad subsidies encouraged US railroad companies to quickly expand ahead of demand and led to the Panic of 1873. However, regulators continued to protect railroads even in bankruptcy. Under the argument that railroads could not be liquidated piecemeal without destroying economic value and disrupting commerce, equity receivership (initially a judicial workaround starting in the 1840s) was used more and more during the 1880s and 1890s as a de facto reorganization tool (Skeel 2001). In theory, courts were supposed to

appoint an indifferent party as receiver to liquidate. In practice, judges routinely appointed the president or other officers of the insolvent railway. Usually a committee of the bondholders using their bonds as payment then purchased the railroad thus reorganizing the firm. These practices, in turn, pressured Congress to enact permanent federal bankruptcy legislation (the 1898 Nelson Act). Politicians also protected railroads in subsequent crises. During the Great Depression, specialized provisions like Section 77 of the Bankruptcy Act (1933, with 1935 amendments) were provided for railroad reorganizations. And the RFC provided substantial targeted government funding for struggling railroads (Olson 1988; Butkiewicz 1995). The 1970 collapse of Penn Central almost led to its being bailed out by the government, and Penn Central became the largest bankruptcy in US history up to that time. Although Penn Central and other railroads were allowed to fail during that period, those failures prompted legislation through the Regional Rail Reorganization Act of 1973 to reorganize the insolvent carriers and ensure continuing service.

The predictably favorable treatment of railroads, not surprisingly, was associated with continuing performance problems by railroads. In a sample of large railroads that operated at the turn of the nineteenth century, Lubben (2003) finds approximately half went through a receivership between 1890 and World War I. Moreover, railroads that underwent a receivership before World War I were more than two-and-a-half times more likely to undergo another receivership or bankruptcy by 1937.

Another example of this self-perpetuating cycle comes from U.S. agricultural history. As previously described nineteenth- and early twentieth-century US agricultural borrowers were favored by ex-ante risk subsidies related to unit (single-office) banking laws and deposit insurance in order to expand credit availability. When adverse shocks reduced farm incomes and repayment capacity, these same political constituencies secured ex post relief through statewide debt moratoria and foreclosure restrictions, particularly during episodes such as the farm crises of the 1920s and the Great Depression (Alston 1984; Rucker and Alston 1987; Wheelock 2008). Policies that might have caused small farmers to take less risk were therefore not instituted and bankruptcy risk continued unabated through time. Taken together, this combination of ex ante credit subsidies and ex post borrower protections created a durable political equilibrium in which agricultural interests repeatedly obtained preferential access to finance, thereby reinforcing both the demand for such interventions over time.

8. Conclusion

This chapter has shown that financial crises are not simply the result of unpredictable shocks or technical regulatory failures. Instead, they are often the predictable outcome of regimes that use financial systems as instruments for achieving political objectives rather than stability. A quick summary of this chapter's major case-studies in Table 1 shows that politics has chosen weaker financial structure and enabled crises across time, legal origins, political structures, and institutional contexts.

Despite different specific details, three general mechanisms recur throughout the cases examined here. First, the structure of financial systems themselves often reflects political bargains embedded in bank charters, regulatory frameworks, and institutional mandates, all of which play crucial roles in ensuring the very survival of the political regime. Second, governments frequently deploy credit subsidies to politically-important sectors or constituencies. Third, electoral incentives can encourage policymakers to expand credit during elections. These mechanisms interact to produce financial systems that are simultaneously capable of supporting economic development and prone to systemic crises. These political choices are not sufficient conditions for an immediate financial crisis, but rather, they often open the door to other destabilizing market forces (Calomiris and Jaremski 2024, 2025).

Real-world crisis responses to financial crises are also frequently constrained by political considerations. Electoral incentives and legislative bargaining often limit the tools available to fight crises and delay necessary interventions. Politics can even influence which institutions receive assistance and how regulatory information is disclosed. These factors ultimately increase the length, depth, and costs of crises when they emerge.

While economic models of financial crises emphasize information asymmetries, leverage dynamics, or asset price bubbles, the historical evidence reviewed in this chapter demonstrates a central role for political considerations in explaining choices. Financial crises are not necessarily technical failures of markets or regulations, but recurring outcomes of political regimes. Recognizing this political dimension has important implications for financial regulation and crisis management. Efforts to strengthen prudential oversight or redesign financial safety nets must account for the incentives faced by political actors who influence these institutions.

Without addressing the political pressures, reforms aimed at improving technical regulatory design may prove insufficient or incapable of being passed.

Crises can discredit constructive policies. The Argentine crisis of 2001-2002 led to a backlash against Washington Consensus thinking that took the country down a path of resurgent state control, low growth and high inflation that took two decades to reverse. But crises are also a time when helpful financial regulation may be able to circumvent existing political roadblocks, with some positive consequences. Although much of the regulation passed in the wake of crises is typically backwards looking (Barth et al. 2012; Tarullo 2019; Almasi et al. 2025) and can create unintended costs (e.g., due to the expansion of the safety net), sometimes the upheaval is enough to allow the passage of effective policies. During the Great Depression, for example, the United States introduced several major reforms aimed at stabilizing the banking system that had been previously off-limits. Many of those reforms were economically counter-productive changes that gained support because of the upheaval of the moment (Calomiris 2010). But there were also positives. Despite its negative long-term consequences for systemic risk, federal deposit insurance helped restore depositor confidence about the opening of failed banks. The RFC's preferred stock program was an important innovation to the toolkit of bank assistance, and provided a centralized mechanism for rescuing distressed financial institutions through government capital injections. Many states lowered branching restrictions within their borders to encourage loan diversification. Similarly, the S&L crisis of the 1980s led to the gradual expansion of interstate branching despite some political influence (Kroszner and Strahan 1999). The Chilean banking crisis of 1983 ushered in meaningful regulatory changes that have stood the test of time for four decades (Brock 1992). In the international sphere, much of the aid (e.g., Brady bonds, IMF loans, etc.) provided to countries going through financial crises was conditional on particular financial reforms. Fraccaroli et al. (2025) also finds that regulators and supervisors have been granted increased independence from political bodies since the 2008 financial crisis. These reforms were not new inventions, as they had been used in previous crises across the globe and even discussed in the academic literature. Instead, politics kept them from being passed until a crisis forced a change in behavior.

The overarching theme of a political understanding of financial crises is that the common narrative that crises teach us that we are inherently vulnerable to external shocks is wrong. Instability is not a fact of nature. Effective reforms can make countries' financial systems as

stable as Canada's for the past two centuries, or Chile's since 1984. Financial crises are better seen as a mirror of who we are as a society, reflecting our political structures, vying constituencies, cultural preferences, and blind spots. A proper understanding of financial crises thus forces us to face the awkward truth that the costs that attend financial crises are often self-inflicted.

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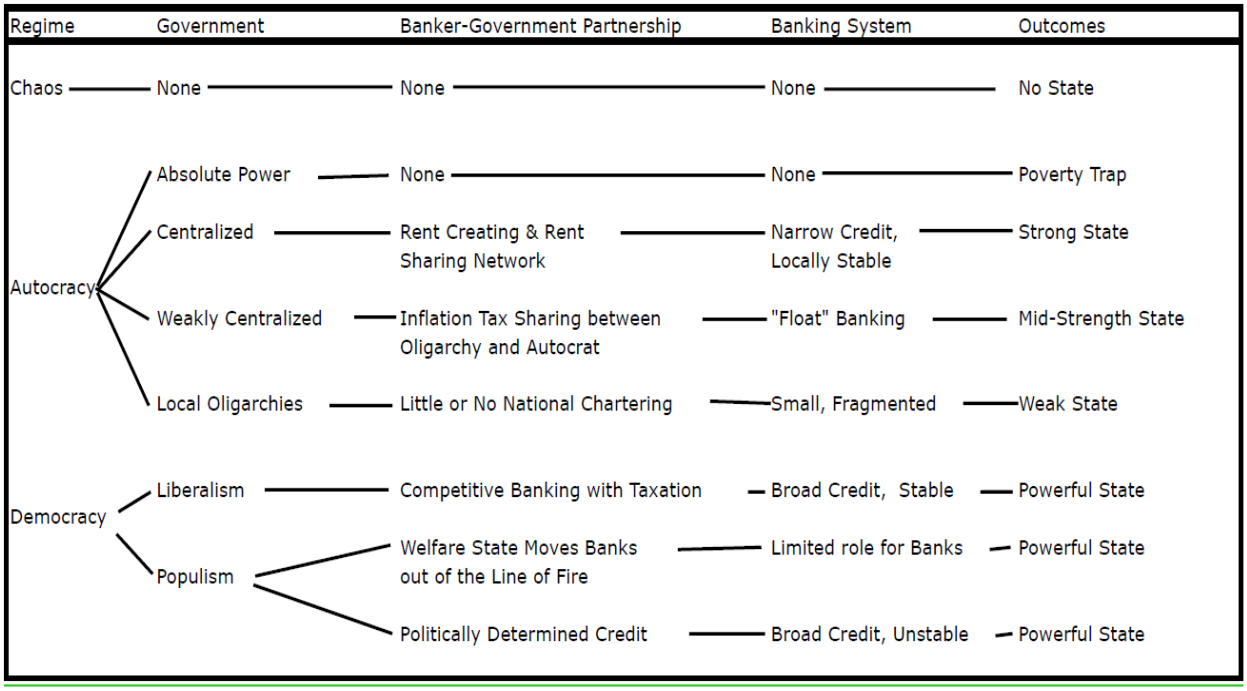
Figure 1: A Taxonomy of Political Regimes and Their Banking Systems



Notes: Figure comes from Calomiris and Haber (2014).

Table 1: Summary of Political Drivers of Financial Crises

Country	Period	Political Connection to Financial Crisis	Outcome
Argentina	1887–1890	Foreign borrowing and the Free Banking Law encouraged debt expansion and monetary growth	Argentina defaulted on sovereign debt and led to UK Barings Crisis
Australia	1880s–1893	Colonial competition encouraged overbuilding of railways financed by London borrowing; banks lent into the land and infrastructure boom	Panic of 1893
Brazil	1888–1891	To preserve elite support after emancipation and regime change, policymakers expanded credit and bank charters	Encilhamento crisis imposed severe macroeconomic costs
Chile	1973–1983	Privatization and deregulation let a small set of conglomerates acquire banks and channel insider credit	Banking system insolvency with resolution costs above 40 percent of GDP
England	1694–1825	Crown used bank charters to raise funds; the SSC used connections to inflate its stock price, while Bank of England privileges delayed chartering reform	Series of financial crises
France	1715–1720	Under an almost insolvent regency, John Law fused banking, public debt management, and trade	Stock and currency crash that damaged French financial credibility
Greece	1999–2010	Euro adoption lowered borrowing costs and enabled fiscal expansion to continue	Country suffered a long, painful crisis
Japan	1958–1990s	Ministry of Finance influence, coordinated credit allocation, and easy credit favored property and securities lending	Nikkei crash in 1990 followed by stagnant growth
Mexico	1877–1911	Monopoly privileges and credit access were exchanged for political loyalty and fiscal cooperation from local elites	Contributed to the Mexican Revolution
Mexico	1990–1995	Privatization of banks in poor financial condition prioritized sale revenue and insider-friendly structure over stability	System collapsed and the bailout exceeded 20 percent of GDP
Russia	1995–1998	Yeltsin's "shares-for-loans" arrangement tied banks to state finance ahead of electoral and fiscal pressures	Securities and currency markets collapsed, major private banks defaulted
South Korea	1970s–1998	Political ties between chaebol, banks, and the state sustained heavy borrowing despite weakening profitability	Banks and firms failed with resolution costs of 30 percent of GDP
Spain	2000–2012	Euro adoption allowed politically influenced cajas to fund housing and real-estate credit expansion	Housing bust generated crisis costs of roughly €80 billion

United States	1791–1792	Hamilton’s tied public-debt support to (First) Bank of the United States creation	Stock market crash of 1792
United States	1830s–1843	Jackson destroyed the stabilizing role of the (Second) Bank of the United states and shifted federal deposits to politically connected “pet banks”	Panics of 1837 and 1839
United States	1921-1926	Florida real-estate interests controlled bank and used political influence to suppress disclosure and delay liquidation	House prices collapsed in 1926
United States	1990s–2009	Housing policy, mortgage lender lobbying, GSE guarantees, and risk-insensitive regulation expanded mortgage credit and weakened underwriting	Subprime Mortgage Crisis