BOOK REVIEWS

Rethinking Bank Regulation: Till Angels Govern
James R. Barth, Gerard Caprio Jr., and Ross Levine
Cambridge: Cambridge University Press, 2006, 428 pp.

When experts recommend economic policies for developing countries, they often fail to take into account the inability of weak governments to implement those policies. An important exception is *Rethinking Bank Regulation: Till Angels Govern* by three academic economists with a long history of research on banking.

With support from the World Bank, the authors have assembled a database on bank regulation and supervision in over 150 countries. Based on statistical analysis of this data, the authors conclude that the development of banking systems—especially in countries with weak political institutions—will be helped the most by private monitoring of the financial health of banks rather than by conventional government regulation and supervision.

The database includes the official policies for bank regulation and supervision in each country. One weakness, however, is that no effort is made to determine whether the actual regulation follows these policies. With help from the World Bank or International Monetary Fund, it is easy for a developing country to adopt the most sophisticated policies. But implementing them successfully is far more difficult.

Using this database, the authors attempt to determine what type of regulation works best. They use various indicators of how well a country's banking system is performing. As a measure of the size and importance of the banking system, the indicator used is the amount of credit issued by banks to private-sector firms relative to gross domestic product. As a measure of the stability of the banking system, the indicator is whether or not the country has experienced a large-scale banking crisis over the period 1988–99. Other indicators include whether banks are efficiently managed as measured by net interest margin and overhead costs, and the degree of corruption in bank lending as measured by surveys of private-sector businessmen.

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I reached similar conclusions about banks in my book *Just Get Out of the Way: How Government Can Help Business in Poor Countries* (Cato Institute, 2004). Conventional government regulation of banks is likely to backfire because the regulators are frequently incompetent or corrupt. Instead of serving the public interest, regulators often end up serving the banking industry and its political supporters.

The most compelling evidence for this point of view is the many banking crises around the world in which large numbers of banks have failed, leaving governments with the cost of compensating depositors. By one count, there were 168 such crises from 1976 to 2002. The usual cause is that both governments and private owners have turned banks into pyramid or Ponzi schemes in spite of government regulation. The banks are insolvent (bankrupt) because a high proportion of their loans are bad and will never be repaid. Yet the banks can remain liquid and continue to operate for years because new deposits keep coming in. Such schemes are possible because of explicit or implicit government guarantees and insurance of bank deposits that reduce the incentive for the private sector to monitor the financial health of banks.

The statistical analysis in *Rethinking Bank Regulation* also supports this view. The book concludes that increasing the powers of official bank supervisors does not reduce the likelihood of banking crises nor does it compensate for the reduced private-sector monitoring caused by deposit insurance.

About two-thirds of low- and medium-income countries have had major banking crises over the last 30 years. They have cost their governments as much as 40 percent of GDP to compensate the depositors. Surprisingly, almost the same proportion of high-income countries have also had large-scale bank failures. We only have to look at the savings and loan fiasco in the United States in which roughly 3,000 banks failed, costing taxpayers $180 billion.

If rich countries with better political and government institutions have a hard time making conventional bank regulation work, is it plausible that countries such as Bangladesh, Tanzania, or Uzbekistan will be able to make it work? Yet the recommendation of most banking experts is that they should try.

The conclusion that private monitoring is likely to be more effective than conventional government regulation should not be surprising because private monitoring is the primary means of regulating the sale of financial securities other than bank deposits. In most countries, the only role of government is to require that a private firm selling securities such as stocks and bonds disclose information about the finances and operation of the firm (for example, an audited financial statement or a prospectus) so that investors can make informed decisions. The government does not purport to regulate the activities of the firm to ensure that it is prudently managed and its securities are low risk, and the government certainly does not guarantee the value of those securities.

Though the authors of *Rethinking Bank Regulation* should be congratulated for their impressive research on this issue, the book is weak in one important area—the authors are reluctant to give concrete or specific advice to governments about how they should change bank regulation. The most the authors seem willing to say is that their research "raise[s] a cautionary flag regarding reliance on direct official oversight of banks, government ownership of banks, generous deposit insurance, and regulations that restrict bank activities and impede the entry of new domestic and foreign banks" (p. 310). The authors conclude that countries should instead "focus on improving and empowering the private market's ability to monitor and discipline banks" (p. 316).

How are governments supposed to implement those vague recommendations? Should governments abandon entirely conventional bank regulation and deposit insurance and instead regulate bank deposits in the same way as other financial securities? New Zealand, for example, has done exactly this. Alternatively, is there some happy compromise between the two approaches that governments should use instead?

I believe that conventional bank regulation hinders private monitoring and should not be used—particularly in developing countries. Weak or corrupt government regulation (especially if coupled with deposit insurance) will give depositors and other creditors the illusion that their investments are safe, which only makes it easy for the bank owners and managers to implement pyramid schemes.

In this regard, the statistical analysis in *Rethinking Bank Regulation* supports the view that powerful bank regulators "further their own interests by inducing banks to lend to politically connected firms, so that strengthening official supervisors accommodates increased corruption in bank lending" (p. 241).

Any reform of conventional bank regulation will be difficult because of the large vested interests in preserving the existing system. For example, domestic banks in a developing country favor government deposit insurance because it helps them to compete against large international banks that would otherwise be viewed as the lower risk alternative. For similar reasons, the U.S. government introduced nationwide deposit insurance in 1933. The numerous and politically influential small "country" banks wanted deposit insurance so they could better compete for deposits with the large "big city" banks.

Consultants and experts on the conventional system of bank regulation in rich countries tend to advise poor countries to adopt the same system, and poor countries often consider it a point of national pride to adopt the same institutions as their richer, more developed cousins. Indeed, they would be insulted if told to adopt a different system because they are incapable of implementing conventional bank regulation. This way of thinking is reinforced by the recommendations of the international Basel Committee on Banking Supervision, which have become the accepted "best practices" to which all countries should aspire.

As a result of World Bank and IMF loans for banking-sector reform, policy advice, and the Financial Sector Assessment Program, which evaluates the stability of the financial sector, these institutions have a major influence over how governments regulate banks in developing countries. The real test of whether the book's recommendations have any impact is whether the World Bank and IMF begin to change their recommendations on bank regulation in developing countries.

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