

Lecture 3: The US and Canada – Contrasting Banking Systems

Key Themes

- Comparison of banking system stability in the US vs. Canada.
 - Structural choices: unit banking (US) vs. nationwide branching (Canada).
 - The role of political institutions in shaping financial stability.
 - The puzzle of similar economies with drastically different banking crisis histories.
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Main Concepts

1. Banking Fragility

- Banks face **maturity/liquidity mismatch**:
- **Assets**: illiquid loans with fixed maturities.
- **Liabilities**: demand deposits withdrawable anytime.
- Inherent fragility: depositors can “run” to withdraw funds first (first-come, first-served).
- BUT: fragility doesn’t always lead to crises. Banks can manage risk with:
- **Higher equity capital** (lower leverage).
- **More cash reserves**.

2. US vs. Canadian Banking Histories

- **US**:
- Prone to crises: 17 major crises since 1790.
- Adopted **unit banking**: most banks restricted to a single branch.
- Result: lack of diversification, highly localized risks, and poor coordination.
- **Canada**:
- **Zero crises in 200 years**.
- Banks allowed to branch nationwide, creating diversification across sectors and geography.
- Small number of large banks could coordinate during shocks.

3. Diversification & Coordination

- **Ex ante diversification:**
- US banks small and local → exposed to regional shocks (e.g., crop prices).
- Canadian banks large and national → risks spread across regions and industries.
- **Ex post coordination:**
- US: 20,000 small banks → no coordination possible.
- Canada: a dozen or fewer large banks → could meet, cooperate, or rescue troubled banks.

4. Political Determinants

- US: **agrarian populism** favored unit banking.
- Farmers preferred local banks tied to their communities → credit “insurance.”
- Opposition to branch banking viewed as opposition to Wall Street domination.
- Canada: same populist impulses, but constitutional structure centralized banking regulation, preventing local populists from shaping national banking rules.

5. Crises and Political Choices

- **Scotland vs. England parallel:**
 - England: monopoly Bank of England, weak regional banks, unstable.
 - Scotland: free entry and innovation, stable.
 - **US vs. Canada parallel:**
 - US: populist-driven restrictions → unstable.
 - Canada: centralized structure → stable, innovative, diversified.
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Important Data & Facts

- US had **17 major crises**; Canada had **0** (1790–present).
- US banks held more cash & capital (0.45 cash/asset, 0.20 equity/asset) vs. Canada (0.27 cash/asset, 0.19 equity/asset), showing US banks knew they were riskier.
- GDP paths of both countries are almost identical → instability difference not due to economic fundamentals.
- **National Monetary Commission (1910)** studied Canadian banking, recognized

advantages, but ignored unit banking in recommendations (politically untouchable).

Examples

- **Panic of 1907:** led to the National Monetary Commission. Despite knowing unit banking was the problem, Congress avoided addressing it due to political backlash.
 - **Canadian coordination:** Bank of Montreal and peers cooperated to stabilize troubled banks, sometimes absorbing failing institutions preemptively.
 - **Real estate risk:** US historically subsidized mortgage risk → higher volatility. Canada avoided subsidies → fewer mortgage defaults, even in 2008.
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Summary

- Banking crises are not mechanically inevitable; they are shaped by **political and regulatory choices**.
 - US: unit banking + agrarian populism = high fragility and frequent crises.
 - Canada: nationwide branching + constitutional design = stability and zero crises.
 - The persistence of bad banking policy in the US illustrates how **politics often outweighs economics** in shaping financial systems.
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Questions for Review

1. What structural differences explain why the US had frequent crises and Canada had none?
2. How does unit banking increase fragility in the US system?

3. Why did agrarian populists oppose branch banking despite its stability benefits?
4. How does the Scotland–England comparison mirror the US–Canada comparison?
5. What does the National Monetary Commission’s failure to address unit banking reveal about the role of politics in financial reform?