What's Canada got that we ain't?

It is well known that the Canadian banking system largely escaped the ravages wrought by the financial crisis of 2008, a crisis that engulfed the banking systems of the United States and many Western European nations. Why was this so? What about Canada's system spared that country while others were so severely stricken? In "Why Didn't Canada Have a Banking Crisis in 2008 (or in 1930, or 1907, or…)?" (Working paper 17312, National Bureau of Economic Research, August 2011), Michael D. Bordo, Angela Redish, and Hugh Rockoff point to the different historical paths taken by the two North American countries as the reason they were differentially affected.

In the United States, right after the founding of the Nation, the Federal Government and the States sparred over the right to charter and regulate the banks. Alexander Hamilton and his supporters chartered the First and Second Banks of the United States in 1791 and 1816, respectively, but strong opposition kept the charters from being renewed when they each ran out 20 years later, thereby preventing the development of nationwide systems of branch banks. Instead, the States assumed the chartering and regulatory powers and prohibited the operation of branches of banks chartered in other States. The result was a fragmented, underfunded system that led to a heavy reliance on underregulated security markets to finance industry. Of course, certain benefits did accrue from this arrangement, namely, rapid economic growth; but the system was crisis prone, contributing to financial instability when stock markets crashed and investment banks failed.

Several attempts were made to reform the system, none of which were entirely successful. A national banking system established during the Civil War did not prevent the state banks from operating, and what emerged was a dual banking system, with the underregulated state banks operating alongside the new national banks. The Federal Reserve System, created in 1913, and the Federal Deposit Insurance Corporation, established by the Glass-Steagall Act of 1933, contributed to stability, but left intact the fundamental structural weakness inherent in an underregulated, fragmented banking system. Later, high inflation in the late 1960s and 1970s and the savings-and-loan crisis of the 1980s resulted in further reforms, but they did nothing to change the weak dual-structured banking system, out of which ultimately emerged the "shadow" banks—the investment banks, hedge funds, and money market funds and insurers—in the early 2000s. These nondepository institutions played a large role in the financial crisis of 2008 when, now with about the same share of financial resources as traditional depository banks, they stopped funding many entities in the U.S. financial system.

In Canada, banking history began with a strong power, vested in the then colonies (now provinces), to charter and regulate banks. Later, the Federal Government, through the British North America Act of 1867, which created the nation of Canada, took over from the provinces and assumed exclusive jurisdiction over banking, with nationwide branch banking as a consequence. Because Canadians were not as skeptical of the consolidation of power as Americans were, an oligopoly emerged, with five large banks dominating the system. Although this consolidation of power resulted in a financial system that was slower to innovate or to invest in new sectors of the economy, and offered services at near-monopoly prices, it nonetheless produced more regulation and greater stability.

Unlike traditional U.S. depository banks, Canadian chartered banks were able to absorb mortgage and investment institutions, to become genuine universal banks. Overseeing these banks was the Office of the Superintendent of Financial Institutions, which, by restricting securitization, hedge funds, and the like, constrained the development of a largely unregulated shadow banking system, thus reinforcing banking stability and providing a protective shield against panics and crises throughout Canadian history. The upshot is that the banking crises of 1907, 1930, 2008, and, undoubtedly, other financial crises largely bypassed the Canadian financial system while causing economic dislocation and hardship in Canada's neighbor to the south. ☐