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The dialectical role of information and disinformation in regulation-induced banking crises

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Abstract

The severity of banking crises increases with disinformation about the losses banks incur in making politically directed loans and about the budgetary costs to the government of standing ready to absorb these losses increases. When (as it eventually must) such disinformation begins to lose credibility, silent runs test the government's commitment to supporting its insolvent banks. An open banking crisis does not emerge until the size of unbooked obligations has become large enough to overwhelm the government's implicit and explicit support system. Multilateral assistance offered countries that experience banking crises should transmit incentives for prompt insolvency resolution, for reliable information disclosure, and for developing plans for dealing with future financial disasters.

JEL classification: F34; G18; G21

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1. Introduction

The title of this paper links four ideas: banking crises, misregulation, disinformation, and dialectical change. It is useful to explain these ideas at the outset.

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In medicine, the word *crisis* describes the point in the course of a serious disease at which a decisive change occurs. Prior to reaching a crisis, a patient will usually have been growing progressively sicker and sicker over time. Oftentimes, so-called ‘‘golden moments’’ exist when proper medical care could have cured the disease without further incident.

Similarly, prior to the emergence of an open banking crisis, a country’s banks have usually been getting sicker and sicker, too. An ailing bank is one whose economic solvency is in decline, by which we mean that the bank’s tangible and intangible assets have been losing their capacity to service the bank’s debts. As in case of medical neglect or malpractice, inappropriate regulatory treatment may intensify rather than cure a troubled bank’s slide into insolvency. This paper terms a regulator-driven slide into crisis as ‘‘regulation-induced’’.

Disinformation is false or half-true information that interested parties convince news media to publish as simple fact. Around the world, the efficacy of banking regulation is impaired by bank and regulatory disinformation about the value of bank loans and other kinds of banking risk exposures. Bank-initiated disinformation may be viewed as an interwoven series of cover stories designed to mask financial weakness and industry rent-seeking. Supporting strands of regulatory disinformation are rooted in officials’ sensitivity to industry criticism, in industry pressure for hidden subsidies, and in the lack of timely discipline on top regulators to truthfully characterize shortfalls in the quality of their supervisory performance. When and as financial stress grows, industry spokespersons and elected officials press regulators all the harder to cover up evidence of banking weakness and to communicate half-true disinformation about the opportunity costs of policy decisions.

Dialectical theories portray change — not rest — as an economy’s permanent state. *Dialectical change* is change that is actuated by a struggle between irreconcilable contradictory forces. In banking, the warring forces may be described as information and disinformation about banking-system income and net worth. The timing and depth of individual banking crises depend on the speed with which disinformation’s early victories are reversed by an expanding credibility gap.

Like earthquakes in geologically active regions, banking crises are an unpredictable but unavoidable part of economic life. They are triggered by the interaction of the decaying credibility of disinformation about the value of bank loans with the decaying credibility of explicit and implicit government guarantees of deposits at insolvent banks. During the final few months of an individual bank’s decline, more and more of the bank’s savviest depositors come to recognize the bank’s growing risk of failure. To protect themselves from loss, these clever early movers test the credibility of government backup by quietly starting to transfer deposits to safer (often foreign) depositories. When government support proves lukewarm, the creditors that take their place are often foreign institutions that make it a point to collateralize their positions in enforceable ways.