Lecture 15: Gorton, Part I

ECON 43370: Financial Crises

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Misunderstanding Financial Crises

Gorton's central thesis is financial crises are a structural feature of modern economies

Banks create short-term debt that are used in transactions

These transactions media are not fully safe, because the backing collateral cannot be completely safe

"A financial crisis in its pure form is an exit from bank debt . . . it is not the asset side of banks which is the problem . . . but the liability side" (pg. 5)

Learning From History

Like Gorton and Tallman, this book emphasizes that we can learn from the past

What was the short-term debt?

- Pre-Civil War (Free Banking Era): private bank notes (for specie)
- National Banking Era (Civil War to Founding of Fed): deposits (for currency)
- Great Recession: repurchase agreements (repo) for (deposits)

Financial Innovation

The financial sector, like the economy, is always innovating

Regulators (and participants) are often slow to understand these changes

- In the 19th century, people were slow to realize the extent to which demand deposits (checks) had become important
- One-hundred years later, people didn't realize the importance of repo

Free Banking and the National Bank Acts

From 1837-1863, the currency of the US consisted of private banknotes issues by state-chartered (free) banks

These were required to be backed state bonds

But this did not result in these banknotes trading at par – poor, clunky transactions media (not really fully liquid)

The National Bank Acts (1863-1864): national banks could issue national banknotes, which were required to be backed by US Treasury bonds

This was successful in producing (for the first time!) a currency that traded at par

Livingston Doctrine

Livingston vs. The Bank of New York: 1857 New York Supreme Court Case

John Livingston held notes issued by the Bank of New York

He demanded specie (as he was entitled to)

Court did not side with him

- Temporary, systemic suspension is not automatic insolvency

Different rules for a crisis (G&T)

The Quiet Period

Gorton's Quiet Period: 1934-2007. No bank runs or systemic panics (in the US, not globally!)

Associates this with the Great Moderation

- I don't think this is fair. The Great Moderation is dated from early- to mid-1980s (e.g., 1984) to the Financial Crisis (some evidence that it continued post-crisis)

- Just about volatility of macro series being lower (relative to what it was from WWII to the 1980s)

Regulation and the Quiet Period

Gorton argues the Quiet Period wasn't random luck

It was a combination of deposit insurance (1934) with regulations

- Deposit insurance: depositors didn't have a reason to run
- Rate Ceilings: made basic banking profitable, helped create "charter value," and discouraged excessive risk taking by banks

Rough idea: deposit insurance creates moral hazard and reduces incentives for households to monitor, but charter value counters incentives to take on excessive risk

2007-08 Financial Crisis

Fundamental similarity with previous crises

"The financial crisis of 2007-08 was a run on repo, prime broker balances, and asset-backed commercial paper" (pg. 39)

- Repo: like demand deposits, very short-term, protected by collateral
- Commercial paper: generally unsecured short-term debt to meet short-term cash needs (but can also be asset-backed, meaning backed by a pool of assets such as loans or accounts receivable)
- Prime brokerage: banking for hedge funds and other large investments. Primer brokerage accounts are like demand deposits for hedge funds

Quotes from Actual Participants

"Repo lenders began shortening the duration of their loans and asking all borrowers to post higher quality collateral . . . during the week of March 10, 2008, Bear Stearns suffered from a run on the bank" – Paul Friedman, Bear Sterns

"The run on the bank then stared" – Richard Fuld, Lehman Brothers

"An extraordinary set of circumstances which lead to them being unable to repo those assets for a period of six or so" – Hector Sants, England's Financial Services Authority

Modern Crises with Central Banks

Mass runs don't necessarily occur and not as visible as they were in the past

Why? Because of expectations of government actions

"A financial crisis is an event where holders of short-term debt issued by financial intermediaries withdraw en masse or refuse to renew their loans – *or would have engaged in such a mass run had not explicit or implicit government intervention been in place or been expected.*" (pg. 43)

Liquidity

"Debt is the technology for conducting trade. It is short term and designed to be 'safe.' " (pg. 46)

"Minimizing the problem of secrets is the same as creating liquidity." (pg. 47)

"Markets are liquid when all parties to a transaction know that there are probably not any secrets to be known: no one knows anything about the collateral value and everyone knows that no one knows anything. In that situation, it is very easy to transact. The situation where there is nothing to know or nothing worth knowing – no secrets – is desirable and allows for efficient transactions." (pg. 48)

Equity banking / floating money market fund (MMF): Gorton argues inefficient

Banks and Money

Banks (and bank-like entities) produce short-term debt (money) that is used to transact

Money market instruments (repo and ABCP) are like checking accounts for large institutions (institutional investors, hedge funds, etc.)

Repo and ABCP often used collateral produced by the private sector, often from securitization

Long-term, securitized debt becomes the backing for the short-term debt

Securitized debt is good collateral, because it's opaque and had to figure out what it's worth

A run happens when people want to figure out if there are any secrets: the backing collateral goes from information-insensitive to information-sensitive

Lending and Secrets

Clearinghouse loan certificates were an attempt to increase liquidity by removing secrets

- Liabilities of the banking system, not a particular bank
- Presumably fewer secrets, but not completely secret-free (i.e., currency premia)

Term Securities Lending Facility (March 2008): exchange asset-backed securities for US Treasury Bonds

- Idea: replace information-sensitive debt (ABS) with information-insensitive debt (Treasuries)

Credit Booms

As we have discussed, financial crises often follow credit booms

This happens again and again through history. Often real estate and land. But also railroads and stocks

Asset price booms ("bubbles") are not necessarily bad

But – *to the extent they are financed via debt* – they make the financial system vulnerable to any bad news

William McChensey Martin: "take the punch bowl away just when the party is getting good"