

Lecture 12: Gorton and Tallman, Ch. 9-12

ECON 43370: Financial Crises

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Failures and Losses

Financial crises: fears about the insolvency of the banking system (as a whole) lead to liquidity pressures

In practice, how many banks fail?

- Very few
- G & T: three in 1884, one in 1890, and two in 1907

What about losses on loan certificates?

- \$169 million in loans, no losses

Summary

Crises are about doubts concerning value of short-term debt

- Free Banking Era: 1837 and 1857 were about banknotes
- Bank deposits: 1873, 1884, 1893
- Panic of 1907: deposits with trust companies

G & T Quote

At the time of a financial crises, it appears that the entire financial system might collapses, and without action it likely would collapse. But ultimately there is action and collapse is avoided, and in the aftermath of the crisis there are few bank failures no losses to emergency lending programs (pg. 129)

Key Lessons

Bagehot's rule is not enough

Must convince public of solvency of the banking system as a whole, hiding/protecting weak banks

Don't let a large, interconnect institution fail during a crisis
(Metropolitan National Bank, 1884)

Suspensions really helped:

- Stopped the bleeding
- Prevent fire sales (in 1907, trusts did not suspend)
- Led to currency premia and gold inflows

TARP

Troubled Asset Relief Program (TARP): October 2008

Purchased newly issued preferred stock. Gave banks cash and increased capital

No secrecy, but strong banks were “encouraged” to participate to hide the weak banks

Eventually, the preferred shares were mostly bought back (i.e., retired)

Modern Crises

Modern crises share fundamental similarities with crises of the National Banking Era

But there are baked in expectations of some kind of government intervention

Runs are therefore slower and silent

Lack of clarity on what a “bank” is and what kinds of debt are subject to runs

- Any levered institution that borrows short and lends long is a “bank”!
- All short-term debt is subject to runs!

Crises Since 1970

Laeven and Valencia (2012): 147 banking crises

- 85 percent: emergency lending facilities (Bagehot's rule)
- 50 percent: blanked guarantee of debt
 - This makes bank-specific information irrelevant. Managing the information environment
- Deposit freeze: rare, but similar to suspension of convertibility

Sudden Stops in Emerging Markets

A sudden reversal of capital inflows

This is like a wholesale run: refusal to rollover short-term debt, demanding repayment

Currency depreciation: borrowers still need to dollars to repay dollar-denominated debts

This makes it hard for borrowers to repay, banks have problems, liquidity problem becomes solvency crises

Intervention with the “original sin” (dollar-denominated debt) makes policy difficult: central bank cannot provide dollars

- Dollar swap lines have been used (more recently) for Fed to provide dollar liquidity globally

Indonesia, 1997-98

Private companies and banks borrowed short-term in foreign currencies

Companies had often borrowed directly abroad, not through domestic banks

Currency (rupiah) collapsed. Undermined confidence

Foreign wholesale run plus domestic retail run in large, uninsured deposits

Insuring small deposits and closing just 16 banks actually exacerbated things

Argentina, 2001-02

Dollar peg: one peso for one dollar, extensive borrowing in dollars

Macro conditions (recession + sudden stop): trigger fears of “pesification” (which ended up happening)

Depositors feared this would trigger insolvency for both banks and individuals/firms

Run started from converting pesos into dollars; spread to getting out of deposits altogether

Corralito: restriction on withdrawals. Actually undermined confidence

Modern analog of currency premium and alternative monies

Spain, 2008-14

Real estate boom then bust

Poorly managed *cajas*; became increasingly reliant on wholesale funding (largely foreign)

These were silent, slow runs

US, 2007-08

Securitization grew in part out of need for “safe” assets: not enough safe assets to serve as collateral in short-term financing arrangements (like repo)

Banking evolved out of the traditional, regulated banking system (“shadow banking”)

Who needed safe assets? Large institutional investors (pension funds, sovereign wealth funds, etc.)

- Like a household, they desire something like “deposits” that allows indirect access to high-return projects, but permits accessing funds on short notice (i.e., liquidity)
- No deposit insurance for the magnitude of short-term funds they desire
- “Safe assets” provide collateral for short-term loans (repo)

Housing and Collateral

There was a shortage of safe collateral coming out of the 1990s (low/negative US deficits)

This demand was met with securitized subprime mortgages

Subprime loans: bad credit score + low/no downpayment + teaser rate

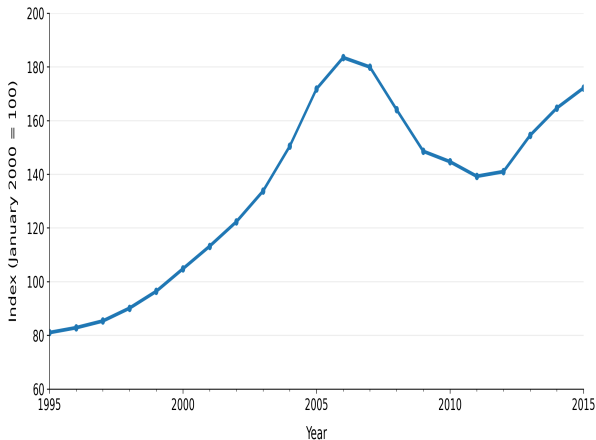
- As as house prices continue to rise, people can refinance into better loans they can afford

Thought was by securitizing many mortgages, you were diversifying away default risks, which were thought to be largely localized

US House Prices

U.S. National House Prices, 1995-2015

Case-Shiller index | Annual averages | Nominal prices



Source: S&P Dow Jones Indices via FRED (CSUSHPINSA).
Annual averages of monthly, not seasonally adjusted data.

Run From Short-Term Debt

The underlying collateral supporting short-term financing (e.g., repo) that was thought to be safe was no longer considered safe

It switched from being information-insensitive to information-sensitive

Slow, wholesale run

Tim Geithner: “A self-reinforcing downward spiral of higher haircuts forced sales, lower prices, higher volatility and still lower prices”

Money Market Funds

MMF: like a bank, but no equity and promised fixed share redemption (i.e., maintain the dollar)

Takes deposits that can be redeemed on short notice, invests in short-term, liquid securities (Treasuries, commercial paper, repo)

In this sense, really like a traditional mutual fund, but . . .

Share prices do not float: aim for a fixed, dollar-for-dollar share redemption

Pay out interest as dividends

Breaking the buck: concerns about value of assets, first out gets \$1, traditional bank run dynamic (Reserve Primary Fund, September 16, 2008)

Guiding Principles

1. Find the short-term debt
2. Manage the information environment
3. Open emergency lending facilities
4. Don't allow systemically important firms to fail during a crisis
5. Different set of rules in a crisis

Terms

Repo fail / repo reuse

Reverse repo

Convenience yield

Term Auction Facility (TAF)

Regulation Q

Term Securities Lending Facility

Primary Dealer Credit Facility

Dodd-Frank

Section 13(3)

Closing Quotes

“. . . financial crises are here to stay. Short-term debt backed by long-term debt is inherent in market economies. The form of the debt changes over time.” (pg. 187)

“Find the short-term debt and protect the banking system fast with whatever means necessary.” (pg. 188)