Reflections on crisis inspired by “Central Banks and the Financial System” by F. Giavazzi and A. Giovannini

Bank of Finland, June 11, 2010

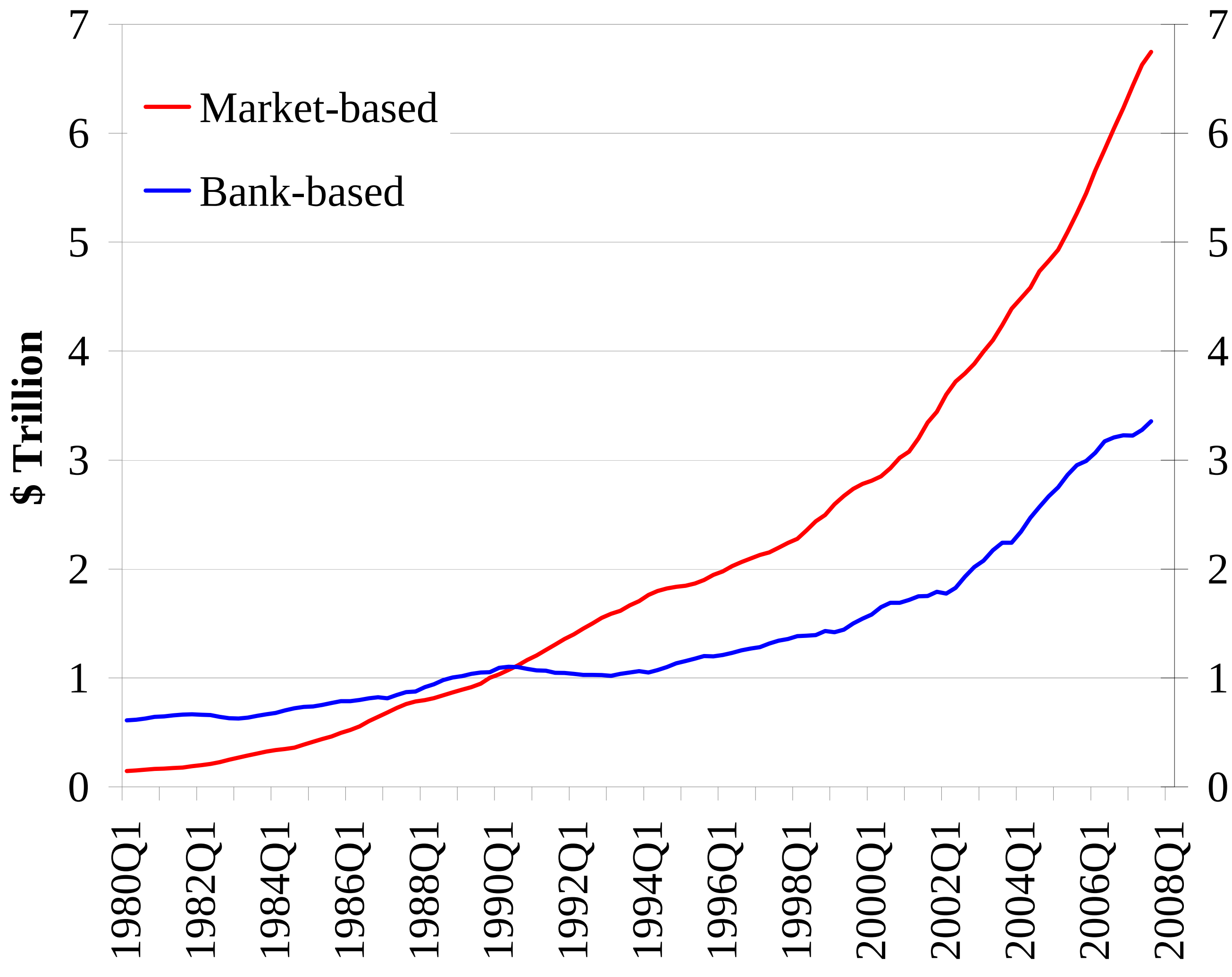
Conference in Memory of Pentti Kouri

Bengt Holmstrom, MIT

70 yrs without a banking panic – why? And why no longer?

Source: Banking and Monetary Statistics and FDIC. From Gorton-Metrick (2009)

Rise of shadow banking: global savings meets securitization



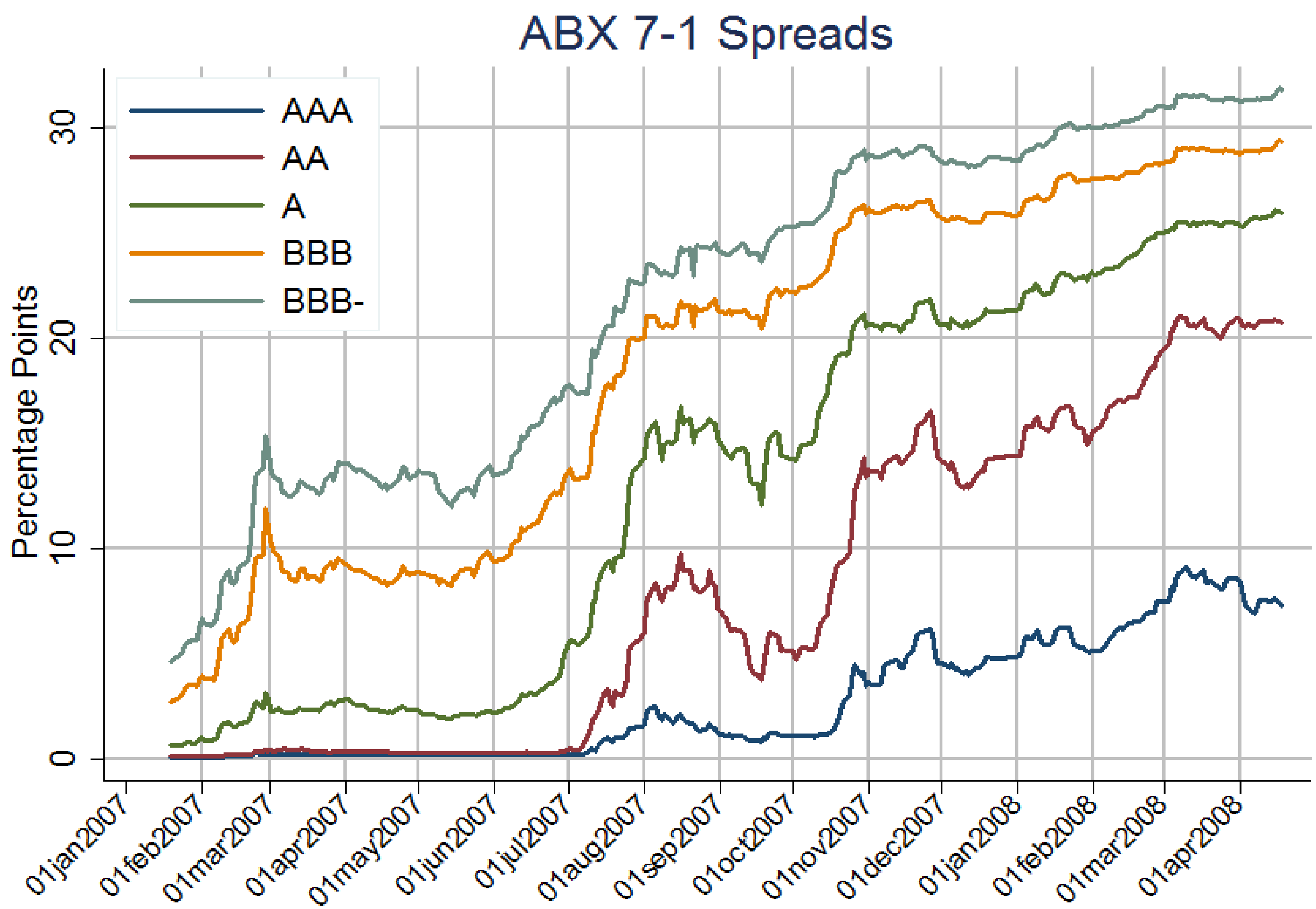
Repo markets: Emulating deposit insurance

- Repo transaction
  - Party A sells security to Party B
  - Simultaneously, Party A agrees to repurchase security, say, overnight.
  - Haircut is 5% if Party A gets 95 dollars for 100 dollar security (to protect lending party)

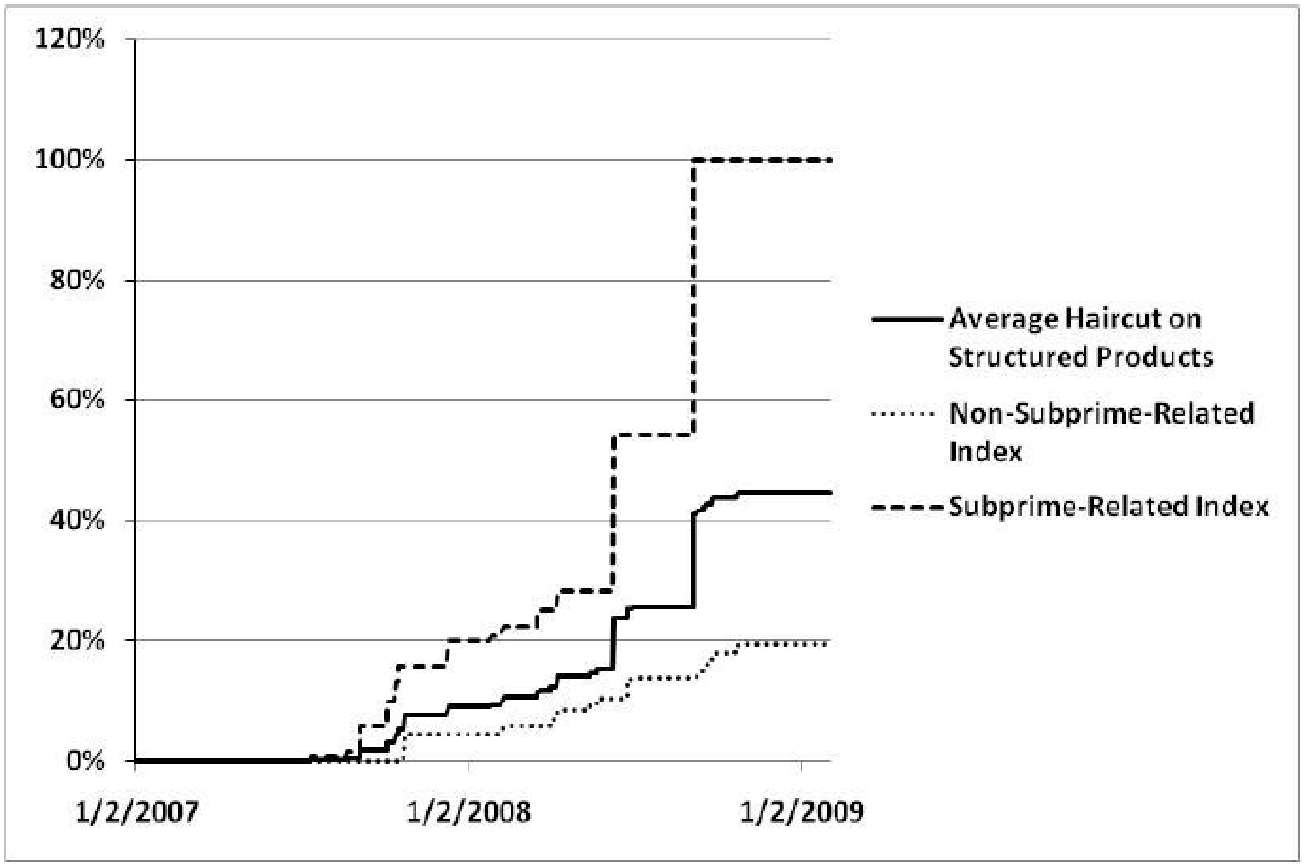
- What's the point?
  - Giant wholesale deposit market secured by collateral ("deposit insurance")
  - Huge demand for AAA-securities satisfied by securitization; fast growth.

- The hole in "deposit insurance":
  - Party A can't buy back security (pay back deposit)
  - Market becomes illiquid

Subprime spreads

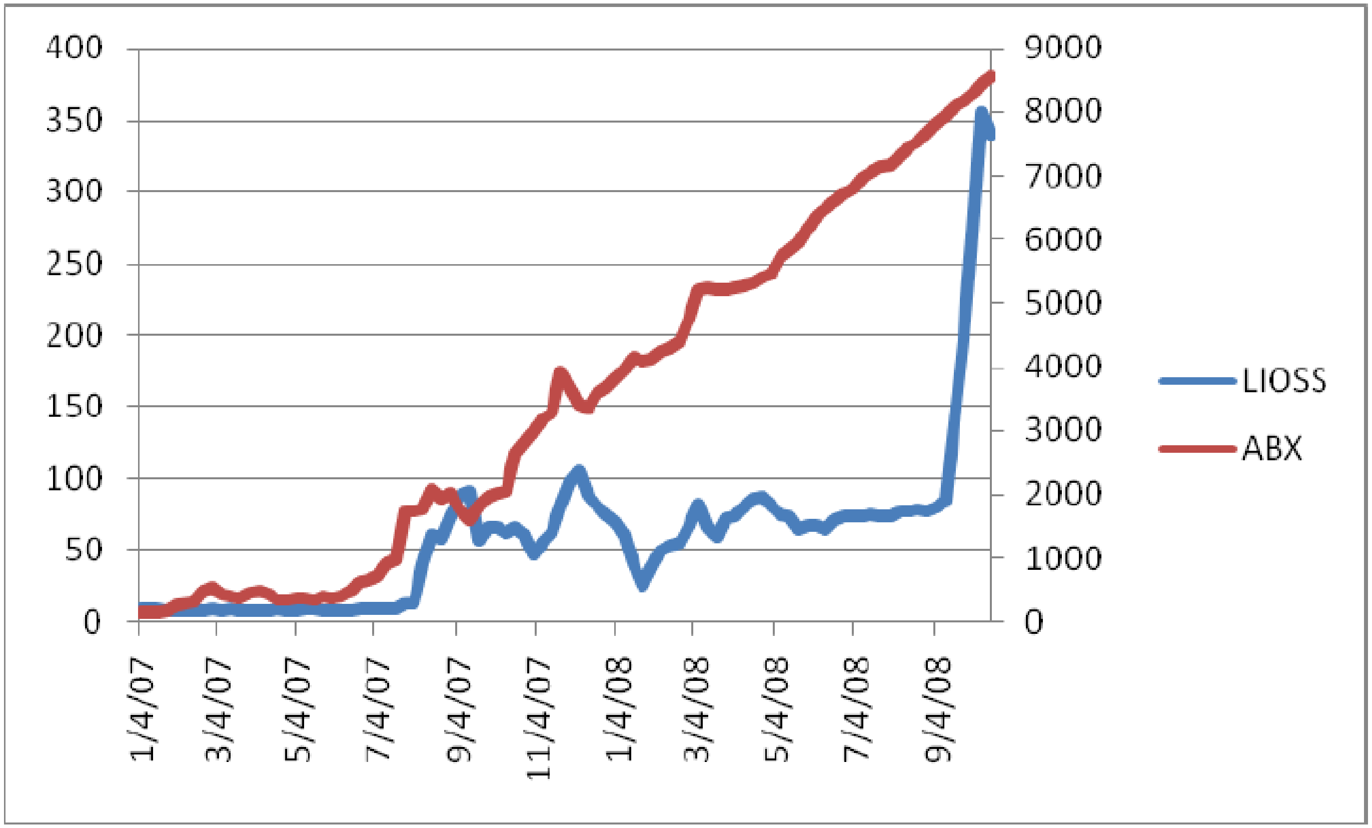


Run on repos



Gorton-Metrick (2009)

A scary picture:
ABX vs Libor-OIS spreads



Notes: ABX is for the 2006-1 BBB tranche. LIOSS on left-hand Y-axis, ABX spreads on right-hand y-axis.

Source: Gorton (2009)

National Banking Era revisited

- Current state of Europe (and beyond): one big Interbank market
- Market based funding = return to “private money” (National Banking Era)
- Vulnerable to run; few players, short-term loans, big amounts (tri-party repo market); lack of “deposit insurance”
- Lender of last resort: too small for rescue

Fixing the system

- “Never again” – the worst possible message
- Basic paradox: safer system brings about riskier behavior
- Ex ante regulation – all measures highly imperfect and create regulatory arbitrage
- Ex post regulation – resolution mechanisms essential; private and public insurance
- Consider decentralized (central) banking with potential for smaller crises that can be contained

Bank leverage 1840-1990

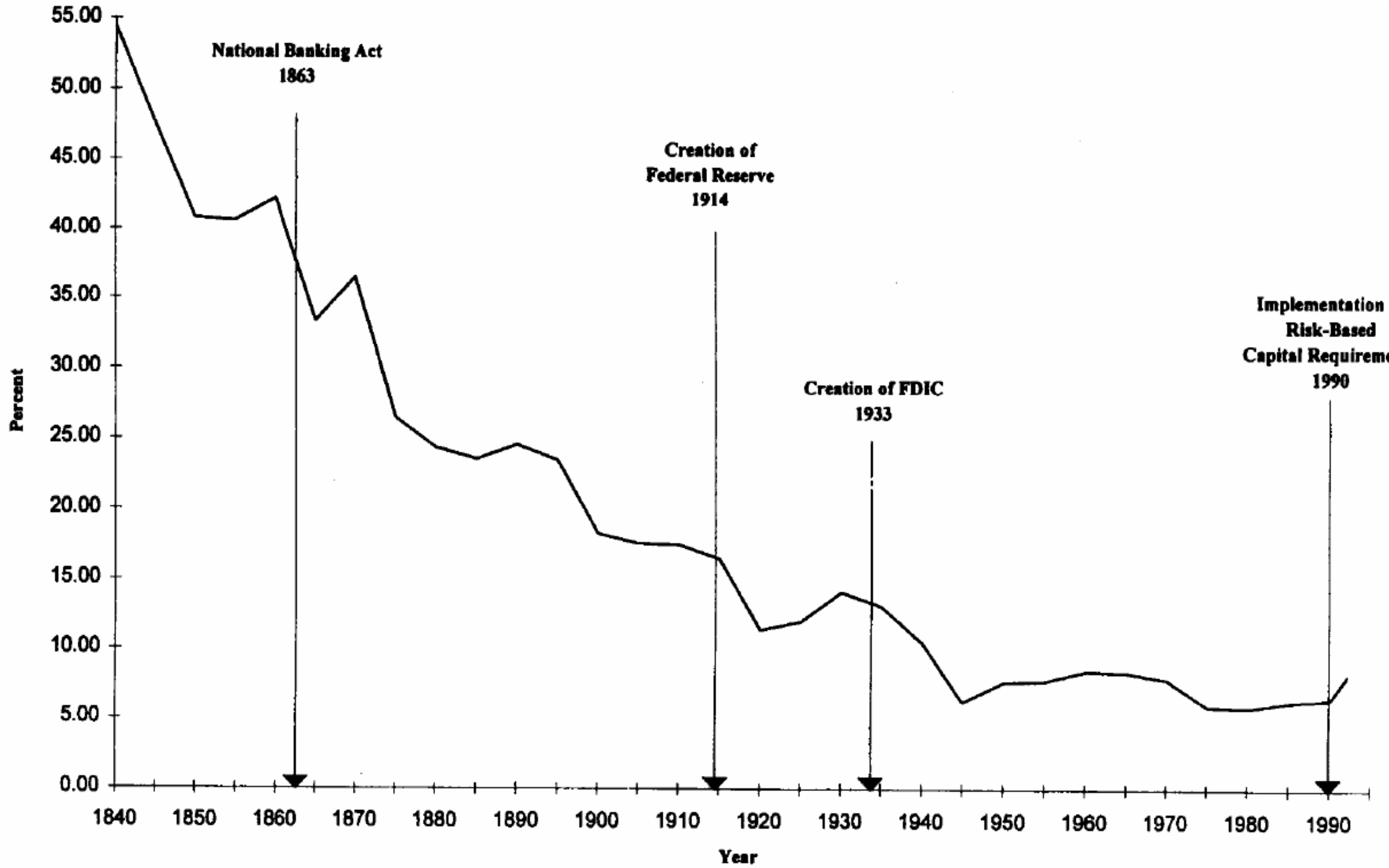


Fig. 1. Equity as a percent of assets, 1840–1993 for U.S. commercial banks. (Ratio of aggregate dollar value of bank book equity to aggregate dollar value of bank book assets.)

Source: Statistical Abstracts through 1970, Report of Condition and Income thereafter.