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May 26-28, 2018
Clarion Hotel Sign, Stockholm

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THE SWEDISH FOUNDATION FOR HUMANITIES AND SOCIAL SCIENCES

Lesson from the Global Financial Crisis and Crises Past: Comment on Bernanke and Eichengreen

Nobel Symposium on Money and Banking,
May 26-27, 2018

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Alternative Narratives and Channels of Crises

- Great Depression: Who/what to blame?
  - The Bankers
    - Misconduct, Misrepresentation, Fraud
    - Congressional hearings by Pecora in 1933
  - The Fed's Monetary Policy
    - The Great Contraction
  - The Gold Standard
    - Golden Fetters
    - The French

Narratives and Policy Responses

- Great Depression: Responses
  - The Bankers
    - Structural separations in US Glass-Steagall (1933), not elsewhere; eventually relaxed in late 1980s
    - Deposit insurance (1933) but didn't relax branching restrictions
    - Expansions of specialized housing finance
      - Federal Home Loan Act (1932) expanded Savings & Loans, 1980s crisis
      - Federal Housing Authority (1934)
      - GSEs: Fannie Mae (1938) and Freddie Mac (1968)
  - The Fed
    - 1930s Amendments to Emergency Powers, Section 13(3)
  - The Gold Standard
    - Bretton Woods and its collapse in 1972
    - Central bankers "unfettered" from gold, then inflation targets

Long History of Housing Politics

Alternative Narratives and Channels of Crises

- Global Financial Crisis: Who/what to blame?
  - The Bankers
    - Misconduct, Misrepresentation, Fraud, *Moral Hazard*
    - →Seeds set by post-Depression safety net?
  - The Fed's Monetary Policy
    - Too low for too long in early 2000s, excessive credit growth
    - Inflation targeting, underemphasizing financial stability
  - The Regulators
    - Excess leverage and insufficient liquidity
    - Narrow micro focus rather than macro-prudential focus on interconnections and the "shadows"
  - Housing Policy/Political Economy
    - Community Reinvestment Act, GSEs,… especially interacting with global savings glut

Narratives and Policy Responses

- Global Financial Crisis: Responses
  - The Bankers
    - Volcker Rule, Clawbacks
    - Orderly Liquidation Authority
  - The Fed's Monetary Policy
    - Curtail emergency 13(3) powers to intervene
    - Implicit broader financial stability mandate
  - The Regulators
    - Dodd Frank, 250+ rulemakings; stress tests for large banks
    - Basel III enhanced capital and liquidity requirements
    - Legislation last week raises cut-off for stress tests
  - Housing Policy/Political Economy
    - GSEs have a *larger* share of housing market after government take over!

Alternative Channels of Crises

- What are key channels that allow a shock to ramify into a crisis?
  - Traditional bank runs, collapse of money multiplier and money supply, deflation,…
  - "Modern" bank runs related to short-term *external* finance, layers and costs of intermediation
    - "Panic" or "sudden stop" in wholesale funding and securitized credit
    - Insufficient capital and excess maturity "mismatch"
  - Credit channel/Financial accelerator
    - Loss of information/relationships
    - Debt-deflation/deleveraging, especially in housing
  - Insufficient debt restructuring

Alternative Narratives and Channels of Crises

- The Euro Crisis: Who/what to blame?
  - Fixed exchange rates
    - Contrast to international gold standard
  - Unwillingness to restructure debt
  - The Germans

Directions for research

- Eichengreen emphasizes the importance of looking globally for lessons from the Great Depression
- Bernanke emphasizes the usefulness of the recent US financial crisis as a “natural experiment” for drawing lessons
- Each suggestion can apply to the other
  - Look for “natural experiments” in 1920s/30s
  - Look globally, including emerging markets, in the recent period

Gold Clause and Debt Overhang/Deflation

- "Natural experiment" in 1930s to test the cost of debt overhang/deflation (Kroszner 2005)
- Virtually all long-term debt contained a "gold clause" effectively indexing debt repayments to gold value of the dollar
- The US breaks its "golden fetters" in 1933-34 and devalues the dollar by 69 percent relative to gold
- Enforcement of the gold clauses would have raised real debt burden by roughly the size of GDP
- Congress nullifies the enforcement of gold clauses resulting a massive debt forgiveness

Everyone sues!

- Supreme Court consolidates cases in January 1935
- *New York Times* front page headline Feb 18, 1935:
  - "Capital Tense, Expects Decision on Gold Today....Leaders are Confident But There Is No Indication of What the Supreme Court Will Decide."
- Landmark 5 to 4 decision upholds abrogation
- Market reaction:
  - Equities surge but debt prices *also* rise
  - Securities of firms with lower ratings and debt ratios benefit the most
  - → Consistent with high distress costs and debt-deflation
  - → Implications for debt restructuring/forgiveness?

Cross sectional real impacts of crises

- What is the impact of crises across firms with different levels of dependence on external funding (Kroszner et al 2007)?
  - Consider 38 financial crises in developed and emerging markets the quarter century *before* GFC
  - Financially dependent firms are hit much harder in a banking crisis than firms that rely less on external funding in countries with deep financial systems relative to countries with less developed financial systems
  - ➔ Consistent with importance of credit channel in a crisis; value of looking at many countries

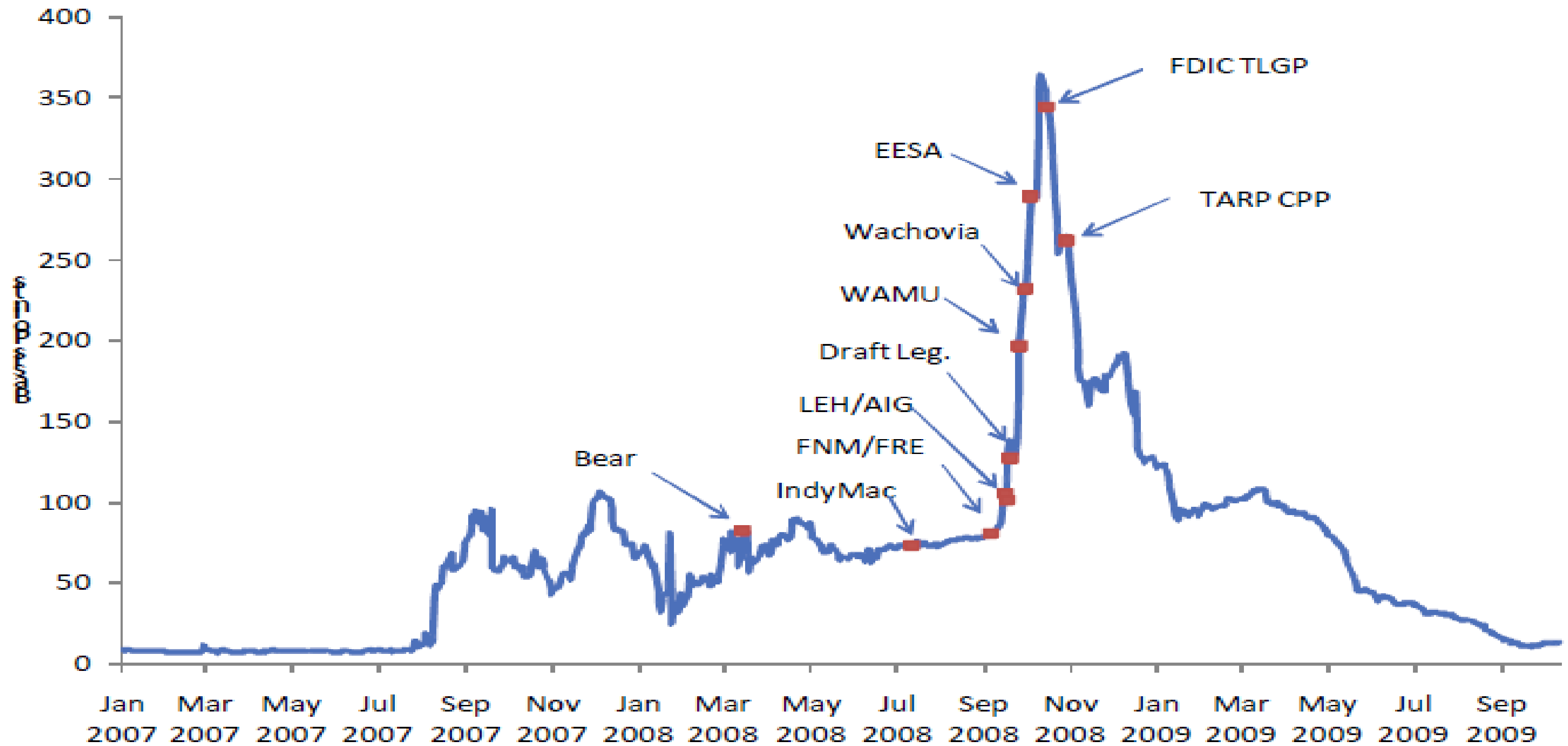
Lessons

- Alternative narratives of crisis still being debated a decade afterwards
- When does government/central bank action help/hurt?
- Have private incentives change? "Too big to fail"?
- More power for the Fed or less?
- Volcker and structural reforms?
- Housing reforms?
- In what circumstances, would debt restructuring be effective?

Figure 11

Three-Month LIBOR OIS Spread

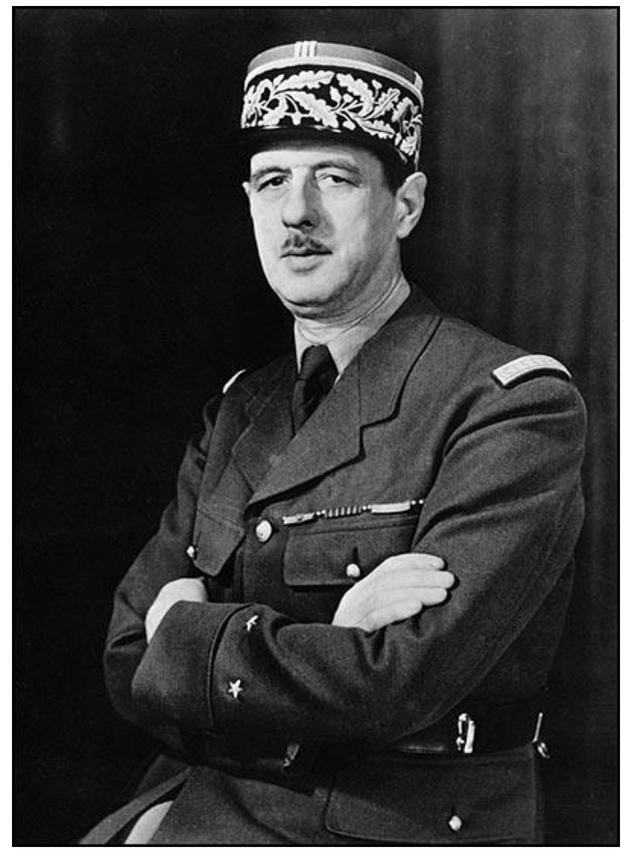
Source: Bloomberg Tickers US0003M and USSOC



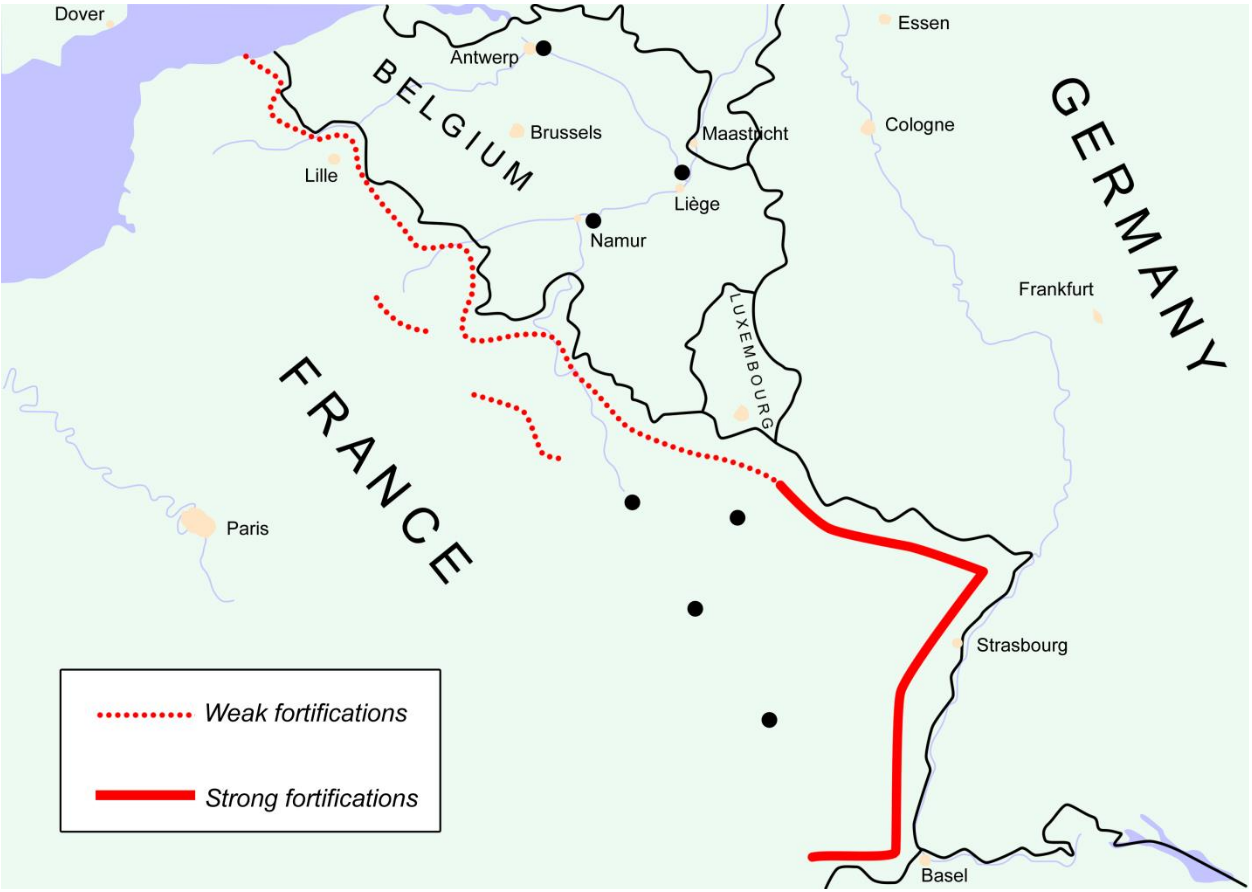
Here is a timeline of the crisis based upon one measure of the perceived creditworthiness of banks. The spread between the three-month London-Inter-Bank Offer Rate vs the Overnight Indexed Swap rate is such an indicator because LIBOR involves exchange principal whereas swaps do not so it because a rough guide to whether the bank is expected to be able to repay the principal. Note that Brunnermeier uses the TED spread between LIBOR and Treasuries, which provides a similar picture of a certain return (T-bill) and the uncertain return (bank repaying the LIBOR loan), but it represents the same idea. (Don't worry about the specifics of how this is

Appendix: Fighting the Last War?

Andre Maginot (1877-1932) vs Charles De Gaulle (1890-1970)



Maginot Line



Vulnerability: Ardennes Forest, May 1940, Blitzkrieg and Panzer

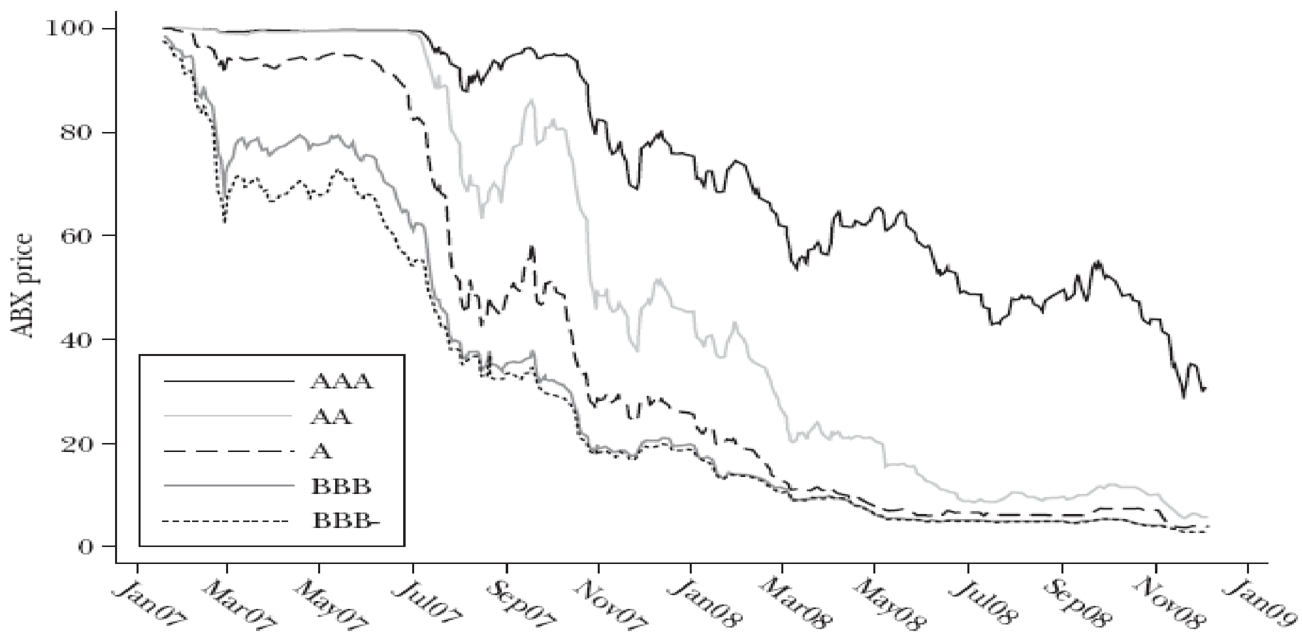
(see Kroszner 2011)

Appendix: First bank run in the UK in more than a century, Northern Rock, Sept 14, 2007

(AP)

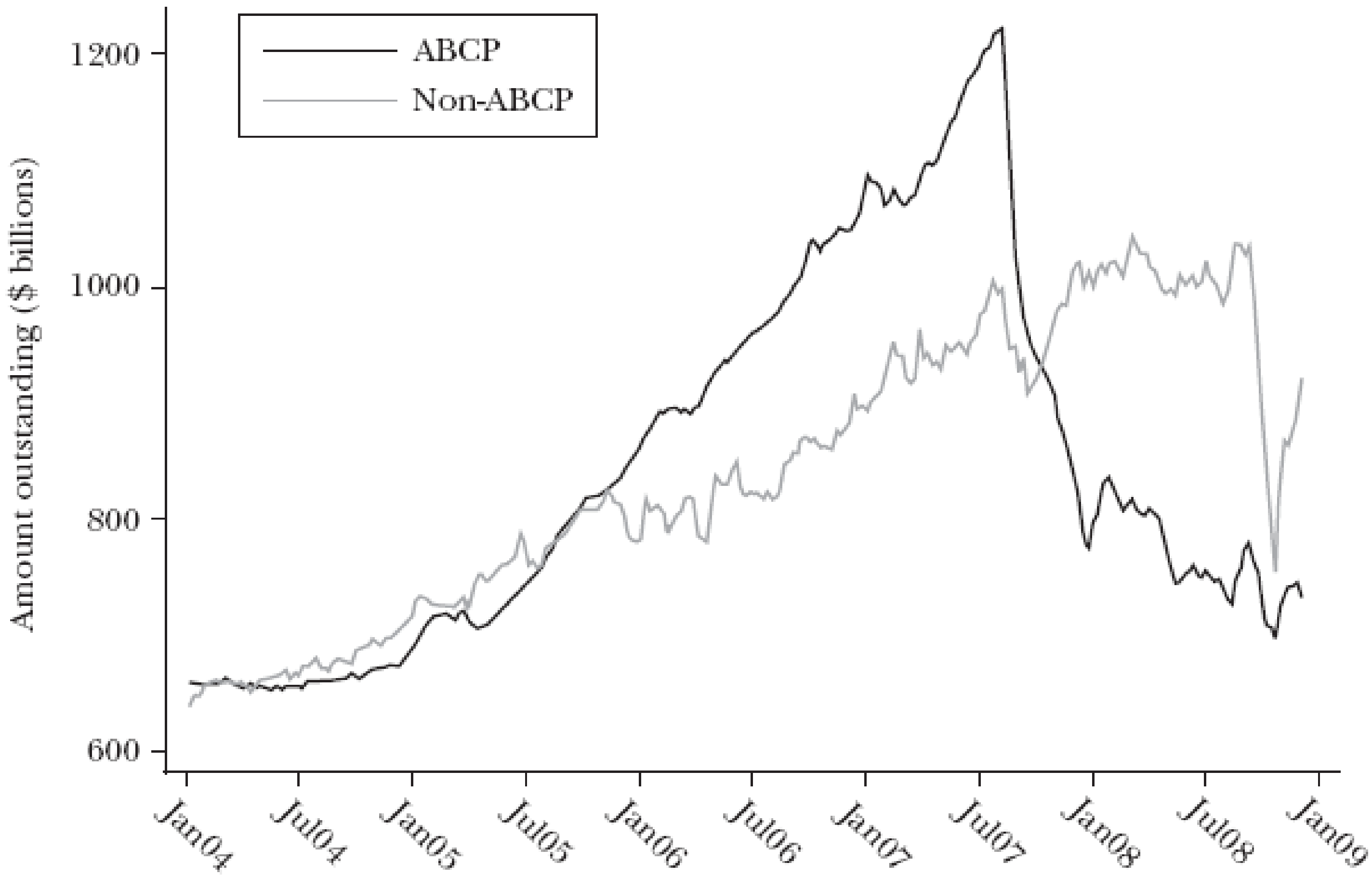
Northern Rock had no exposure to US housing market and no subprime

Figure 1
Decline in Mortgage Credit Default Swap ABX Indices
(the ABX 7-1 series initiated in January 1, 2007)



Source: LehmanLive.
Note: Each ABX index is based on a basket of 20 credit default swaps referencing asset-backed securities containing subprime mortgages of different ratings. An investor seeking to insure against the default of the underlying securities pays a periodic fee (spread) which—at initiation of the series—is set to guarantee an index price of 100. This is the reason why the ABX 7-1 series, initiated in January 2007, starts at a price of 100. In addition, when purchasing the default insurance after initiation, the protection buyer has to pay an upfront fee of (100 – ABX price). As the price of the ABX drops, the upfront fee rises and previous sellers of credit default swaps suffer losses.

Figure 2
Outstanding Asset-Backed Commercial Paper (ABCP) and Unsecured Commercial Paper



Source: Federal Reserve Board.

Bank of England Gov Mervyn King:
“We will support Northern Rock.”

But this what people heard/saw: "Run!"