Slapped by the Invisible Hand: The Panic of 2007

Gary B. Gorton. 2010. Oxford: Oxford University Press. ISBN: 978-0-19-973415-3, $34.95.

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The recent economic and financial crisis spawned numerous scholarly and popular books. Gary Gorton's book is one of the best contributions among the scholarly books. Unlike many other scholarly works and almost all of the popular works, Gorton does not seek to assign blame to individuals so much as to find what led to the crisis and what can be done to improve things in the future. He also does not address issues like the global savings glut cited by Federal Reserve System Chair Ben Bernanke or the low-interest-rate policy of the Fed for most of the previous decade. Instead, he argues that the financial crisis was a "run on banks," except not the type of run on banks people think of from the Great Depression. Gorton looks at the shadow banking system that developed in recent decades and compares what happened in the recent crisis to panics from earlier in the nation's history. He describes the recent crisis as the Panic of 2007.

In his introduction, Gorton claims that he was in a unique position to observe the events around the Panic of 2007. His research focused on banking and financial crises and banking panics, and included the completion of one of the few econometric study of panics. He also consulted for AIG Financial Products and worked on derivatives. Because of his background, he was invited to present a paper at the Jackson Hole Conference sponsored by the Kansas City Federal Reserve Bank in August 2008, and another paper at the Jekyll Island conference sponsored by the Federal Reserve Bank of Atlanta in May 2009. These papers make up a sizeable portion of the book.

After an introductory chapter in which he outlines his arguments, Gorton provides the two papers mentioned above, although in reverse order. Chapter 2 contains the paper presented at Jekyll Island in 2009, and the Jackson Hole paper is divided between chapters 3 and 4. Chapter 5 is a paper originally published in 1994 on the evolution of the shadow banking system. The final chapter is new material and addressed to those who might read his work a century from now, in 2107. In part, Gorton is trying to document and explain the history of the recent crisis in light of past panics for future generations.

Gorton says that he hopes to convince the reader that the Panic of 2007 is not very different from previous panics, such as the Panic of 1907. An important difference is that the Panic of 1907 was more visible, while the Panic of 2007 involved markets most people have never heard of. In both cases, there was a bank run, but again, the runs were different in important ways. Previous bank runs involved people trying to pull their money out of banks in bad times with the result that the banks could not cover all of the withdrawal requests. The recent run involved banks and corporations pulling funds out of other banks.

Gorton argues that the shadow banking system that developed over several decades "is, in fact, genuine banking and, it turns out, was vulnerable to the same kind of bank runs as in previous US history" (p. 6). Large firms and institutional investors have a demand for a place to put their funds when they do not want to make long-term investments. Traditional checking or savings accounts are inadequate because they are not insured. But they want something similar to a checking account: something that provides safety and easy access to the funds. The demand has been met in the repurchase market, or repo market.

Large firms and institutional investors "deposit" funds overnight with a bank and receive bonds of equal value as collateral. In the mid-2000s, these bonds were often created through securitization. The firm can keep the funds in the bank the next evening or withdraw the funds by not renewing the transaction. The bond received can be used as collateral in some other transactions as well. The repo market provides safety, easy access to funds, and reusing the collateral, called *rehypothecation*, is similar to writing a check.

Gorton distinguishes between collateral that is information insensitive from collateral that is information sensitive. He argues that a major function of banks is to create information-insensitive debt, such as demand deposits, which are short term, used for transactions, and insured by the government. No party to a transaction needs to be concerned about the value of a check. For the shadow banking system to carry on this role of a bank there must be information-insensitive collateral created. Securitization provided this mechanism.

An important contribution of Gorton's book is to explain securitization well and in a way that shows it is not inherently devious or subject to adverse selection. Securitization involves a pool of cash flows that provide the value of the new securities. The cash flows can come from leases, credit card receivables, and insurance receivables, as well as mortgages and auto loans. Gorton writes, "senior tranches of securitizations are information insensitive, though not riskless, like demand deposits. The most senior tranches of securitization transactions have never experienced defaults" (p. 22). Another helpful correction provided by Gorton involves subprime mortgages. They are often described as fraudulent or deceptive with low teaser rates to induce unsuspecting people to take a mortgage they cannot afford. Gorton shows the logic behind the low initial rates with a balloon payment after three years as a mechanism that reduced the risk to banks of granting a mortgage to someone who does not qualify by normal standards. The asset of value was the house itself, and given appreciation of house values at the time, the mortgagee would be able to refinance at better terms when the balloon payment came due. If the mortgagee turned out to be a bad risk, then the banks could not renew the mortgage. Gorton notes that between 1998 and 2006 the subprime mortgages worked as designed.

So what went wrong? Housing prices began to fall and there were defaults. But this does not explain why asset classes unrelated to the subprime market should have declined in value. Initially, the impact was only in the assets manufactured from subprime mortgages. The shock was combined with asymmetric information about the locations and sizes of exposure to subprime mortgages. Like depositors in previous generations who did not know whether their banks were sound, and went to withdraw their money in bank runs, the firms and banks using the repo market did not know which assets used as collateral were affected. Gorton writes that amid increasing uncertainty "about the solvency of counterparties, repo depositors became concerned that the collateral bonds might not be liquid; if all firms wanted to hold cash—a flight to quality—then collateral would have to decline in price to find buyers. This is the crucial link between the subprime shock and other asset categories" (p. 47).

Gorton argues that policy responses to the crisis need to be related to the problems that caused the crisis. He claims that the subprime mortgage crisis was caused by information problems and by the fact that subprime mortgages were dependent on house price appreciation. He continues, "because subprime mortgages are financed through a chain of securities and structures, investors could not easily determine the location and extent of the risk. Information was lost." This led to the downward valuation of many securities, a run on the banks in the repo market, and almost a complete shutting down of a crucial source of credit.

Gorton draws several conclusions from his analysis of the crisis. I will discuss a couple of them. He notes that the crisis illustrates the extent to which the savings-investment process no longer relies so heavily on traditional banks. He cites Merton Miller, who pointed out that financial innovation tends to be driven by regulation and taxes. When banking is regulated, nonbank financial institutions arise to take on profitable activities affected by the regulation. There has been entry into banking by competitors—foreign banks and nonbanks. The former do not pose special problems while the latter do. The activities of corporate lending and deposit can be and have been unbundled. This makes defining a bank much more difficult. Profitable activities flow from the institutions defined as banks to those that are not defined as banks. Gorton claims that prior to the rise of the shadow banking system, banks refrained from riskier activities because they had charters that were valuable because the government restricted entry into banking. With increased competition from nonbanks, the charters became less valuable and the banks were willing to take on more risk. Gorton argues that returning to a system where banks had valuable charters that could be lost may be preferable to one in which regulators try to monitor and control the activities more directly. His fundamental conclusion is that "the best approach is to define a set of activities which constitute 'banking,' and then limit these activities to firms which receive charters" (p. 171).

I find much of Gorton's analysis compelling. It links Main Street with Wall Street and shows how problems in the real economy, particularly in the housing market, led to the panic in the repo markets. Information problems and misaligned incentives play roles in the narrative. I believe this is more enlightening than seeking out whom to blame. Gorton's book is not the complete story, however, since the huge increase in housing prices that took place in the years leading up to 2007 is not explained by this narrative. Other works shed light on the events, for example Rajan (2010) and Reinhart and Rogoff (2009).

Since this book is a collection of articles, the narrative is not as coherent as it could have been. However, Gorton does a nice job of introducing the material in the first chapter. This is not a book for the general public, as it is fairly technical at places. The details on the workings of the shadow banking system, the creation of asset-backed securities, and his comparison of runs on traditional banks with runs in the shadow banking system are tedious at times. But the details are important. This is the work of a careful scholar.

I think the book is valuable also for Christian economists even though there is not a specifically Christian worldview underlying the analysis. In fact, I think it is important especially for that reason. It is easy for Christians to look at the crisis and have the same knee-jerk reaction that many popular press writers have, namely, claiming that the crisis was caused by greedy Wall Street bankers. It is easy to demonize the people we think brought this on. But Gorton's work shows that it was due less to personalities or bad people than it was to mistakes in how subprime mortgage-backed securities were created, the dependence of these securities on appreciating house values, information problems, and misaligned incentives. Furthermore, once a system of vulnerabilities is identified, the best solutions are more nuanced and flexible changes rather than wholesale re-regulation.

References

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