Mobile Collateral versus Immobile Collateral

Gary Gorton, Yale and NBER

[Joint work with Tyler Muir, Yale]
The Transformation of the Financial System

• Over the last 30 years prior to the crisis, the architecture of the financial system changed.
• Thirty years ago the system was one of immobile collateral.
  – Bank loans stayed on bank balance sheets to back demand deposits.
• The world changed: other forms of money arose: repo, ABCP. Needed collateral.
• Not enough Treasuries so the private sector produced “safe debt”—RMBS, ABS.
Components of Privately-Produced Safe Debt as a Fraction of Total Privately-Produced Safe Debt (U.S.)

Deposits
Money-like debt
MBS/ABS Debt
Corporate Bonds and Loans
Other Liabilities

Shadow Banking
Traditional Banking
The Financial Crisis Regulatory Aftermath

• New money vulnerable to runs.
• Since the financial crisis, “reform” has aimed to return to the system of *immobile collateral*.
  – Must post collateral to CCPs, but CCPs do not post back.
  – On-balance sheet derivatives require collateral, and it cannot be rehypothecated.
  – The LCR requires essentially that all repo be backed dollar for dollar with Treasuries—a kind of narrow banking. One kind of money backs another kind of money.
Treasuries have a Convenience Yield


Source: Krishnamurthy and Vissing-Jorgensen JPE 2012
Lucas Critique

• How do we assess proposed new policies?

• Unintended consequences?
Ratio of Notes to Deposits and Treasury Debt to GDP
Correlation = 0.96
Demand Deposits not Understood

• Bray Hammond (1957), in his Pulitzer Prize-winning book Banks and Politics in America, wrote: “... the importance of deposits was not realized by most American economists ... till after 1900” (p. 80).

• Russell C. Leffingwell, the Assistant Secretary of the Treasury wrote as late as 1919: “All of these people who believe in the quantity theory of money ... choose to call bank deposits money, but bank deposits are not money.”
Conclusions

• Design of Nat’l Banking System led to the rise of demand deposits—”shadow banking.”

• Five major banking panics.

• Same problems now:
  – Unintended consequences
  – Conceptual issues
“Those who ignore history are entitled to repeat it.”