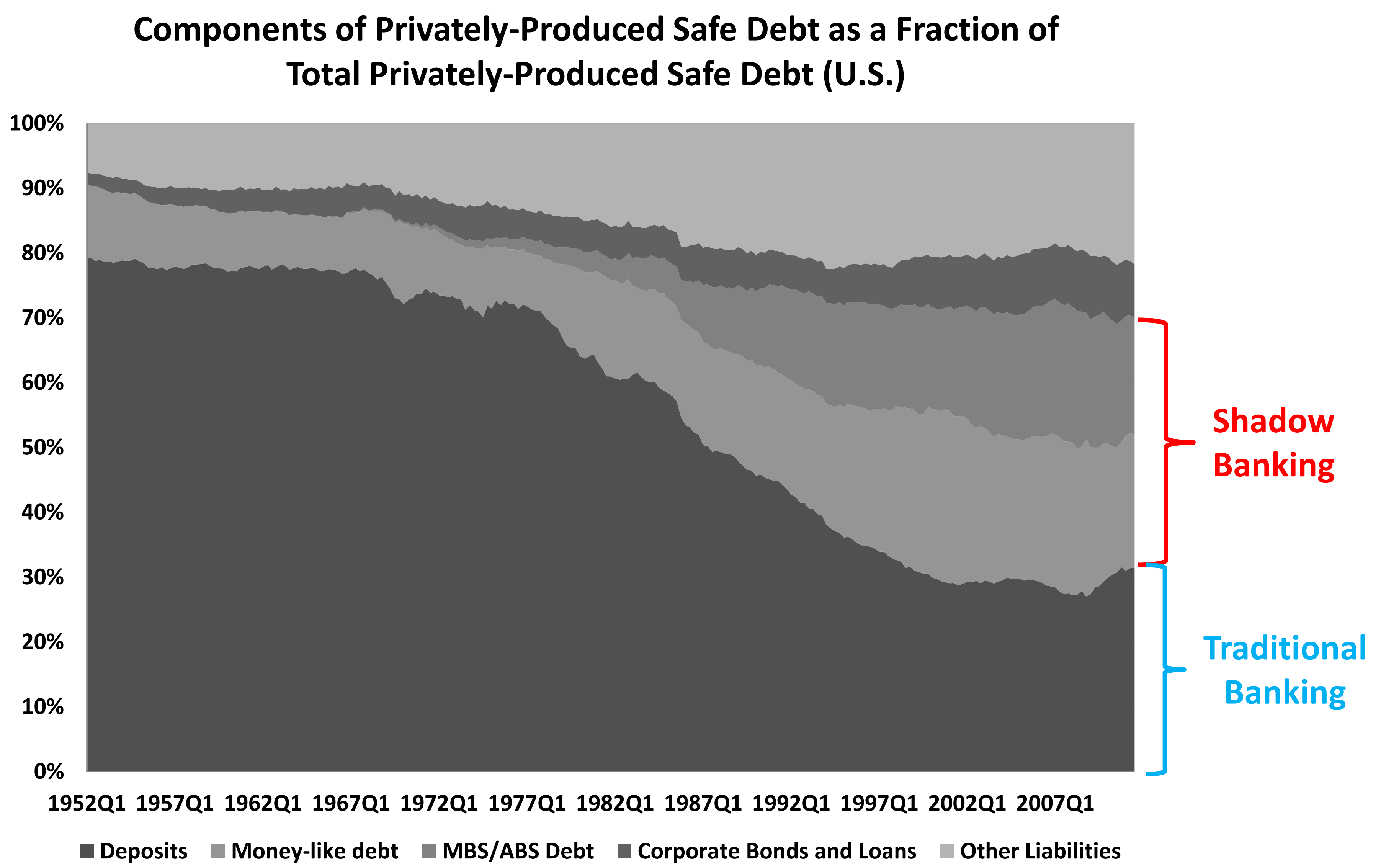
Mobile Collateral versus Immobile Collateral

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.)
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
1952Q1
1957Q1
1962Q1
1967Q1
1972Q1
1977Q1
1982Q1
1987Q1
1992Q1
1997Q1
2002Q1
2007Q1
Deposits
Money-like debt
MBS/ABS Debt
Corporate Bonds and Loans
Other Liabilities
Shadow Banking
Traditional Banking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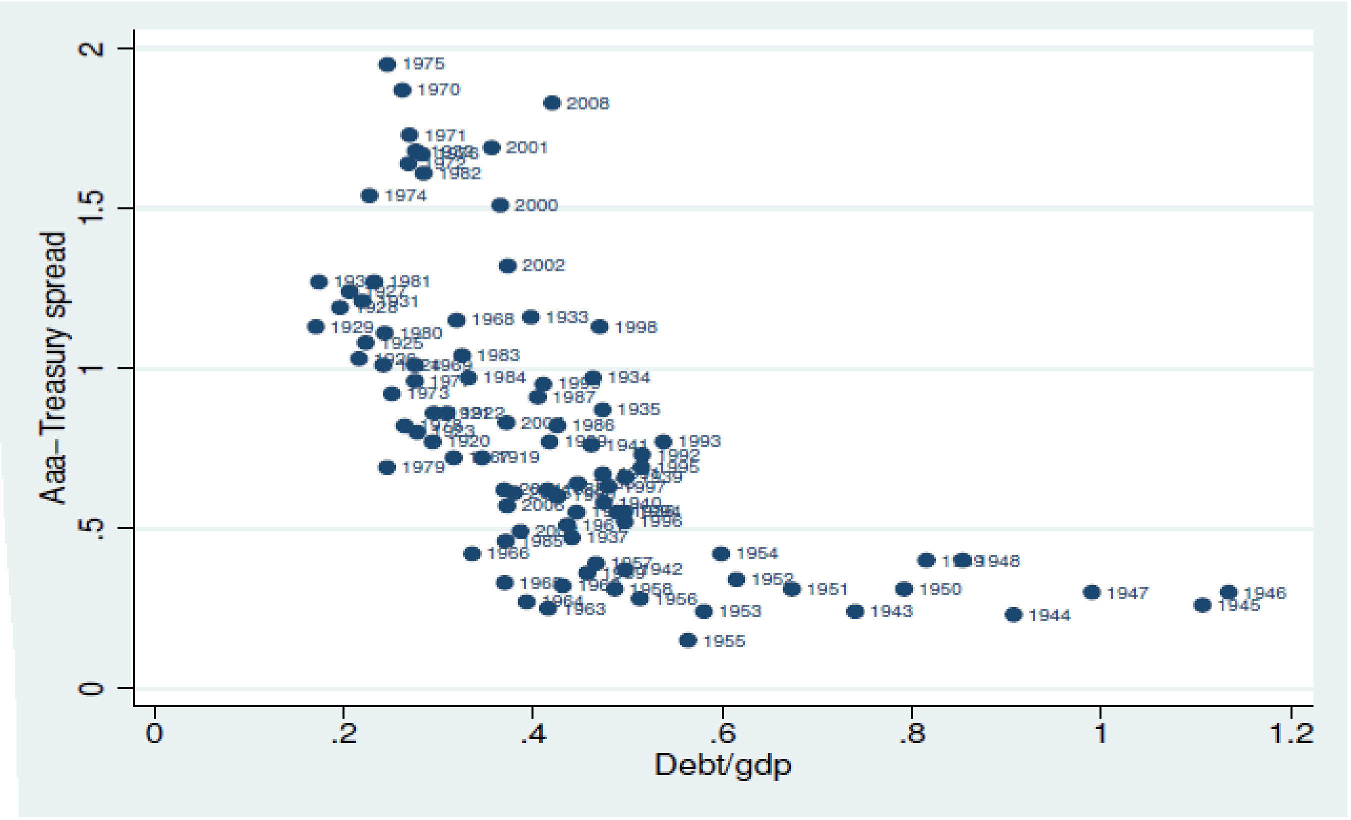
The Financial Crisis Regulatory Aftermath

- 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

Yield spread between Moody's Aaa bond yield and long term Treasury yield, versus Publicly held US Treasury Debt/US GDP. 1919-2008.



Yale SCHOOL OF MANAGEMENT

Source: Krishnamurthy and Vissing-Jorgensen JPE 2012

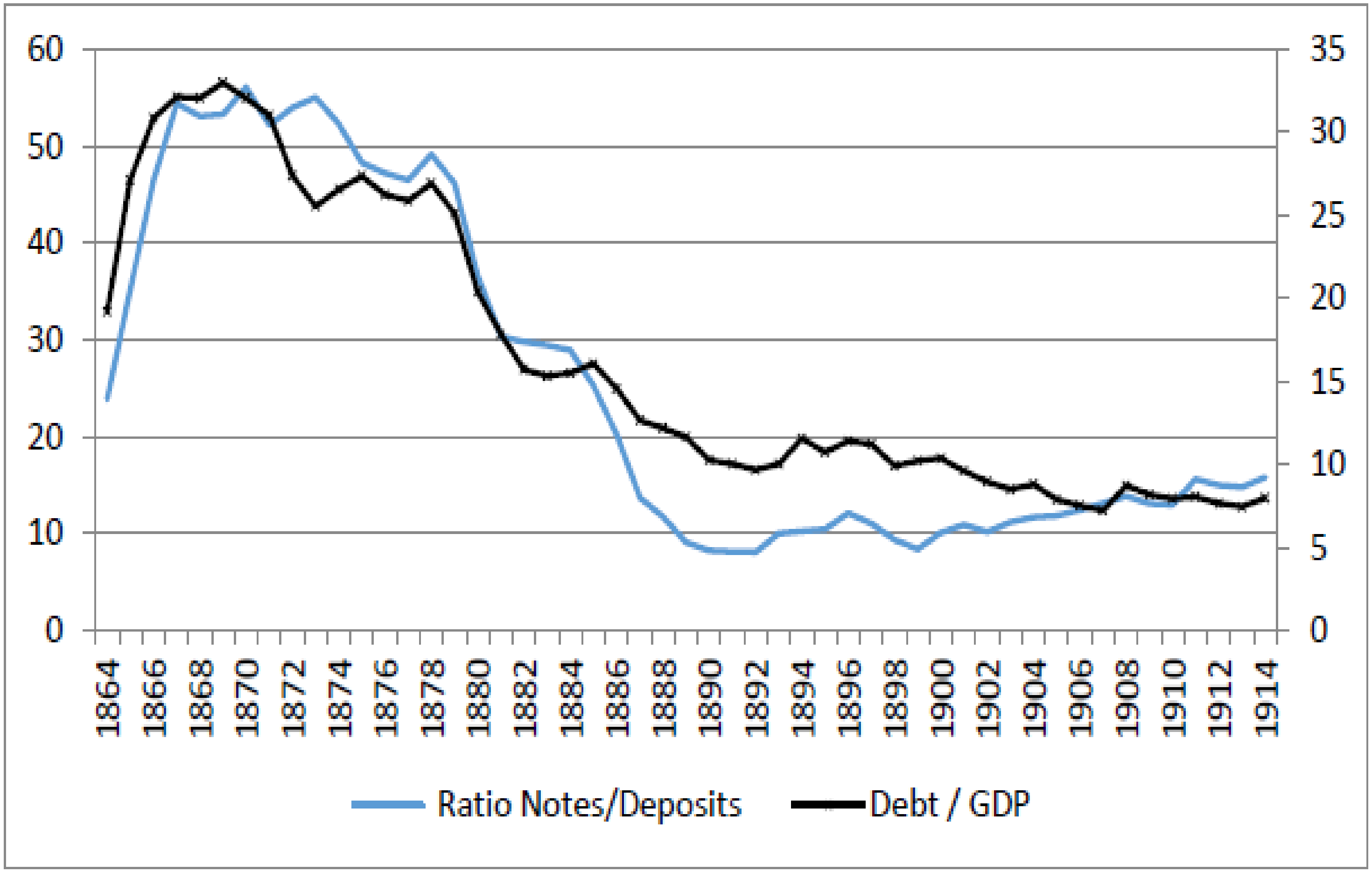
Lucas Critique

- How do we assess proposed new policies?

- Unintended consequences?

United States of America
12574
THE
FIRST
NATIONAL BANK
OF
FORT MYERS
FIVE DOLLARS
9035
9035
12574

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 <u>Banks and Politics in America</u>, 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.”

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