Macro-Modelling

with a focus on the role of financial markets

ECON 244, Spring 2013

Summary

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April 11, 2013
U.S. Crises a Century Ago

- **Crisis 1857**
  - Contagion occurs (and panic spread out) via information acquisition.
  - How news spread out and information is acquired?

- **Crisis 1907**
  - Clearinghouses were an example of market self-generated mechanisms to avoid panics. Panics evolved among institutions that did not belong to clearinghouses.
  - JP Morgan was key to stop it. Importance of signals.
  - What is the role of competition? It reduces monopolistic power, but doing so also reduces reputational incentives.
Great Depression

- The crisis reduced the efficiency of intermediaries to channel credit to real activity.
- Danger of deflation (particularly at a global level). Channel for international contagion.
- Banking runs were generated by liquidity or by solvency concerns?
  - Timing matters. Liquidity concerns can easily mutate into solvency problems via asset fire sales.
  - Still difficult to know which one leads. Are news about insolvency what generates a panic? Or is it a panic based on mistaken news what generates a self-fulfilling solvency problem?
Great Depression

- The literature has come out with heterogenous and ingenious ways to answer these questions
  - Exploits geographical differences in fundamental shocks to assets.
  - Exploits geographical differences in regulation and supervision.
  - Exploits daily micro data to analyze geographical contagion.
International Crises

- What matters is not only the volume of credit supply, but also whether it is channeled efficiently to real activity.
  - In Japan, allowing for zombie banks delayed the recovery.
  - The same was true in Mexico when compared to Chile.
- Lesson: When trying to raise total credit in the economy, be careful to maintain efficient creation and destruction of real activity.
Recent Crisis

- Bank run on shadow banking.
  - No traditional bank runs. Effectiveness of deposit guarantees.
  - Run on shadow deposits (such as repos, SPV, money market, etc).
  - Very liquid markets (overnight and information insensitive), backed by assets (collateral) and widely used as a medium of exchange (rehy-pothecation).
  - Liquidity requires ignorance.
- Too big to fail (AIG, Lehman, pension funds).
- Too many to fail (high correlation and exposure of risk)
Recent Crisis

- Large increase in shadow banking during the years preceding the crisis. Why?
  - Low interest rates (when compared to the Taylor rule) generated excessive leverage, poor loan quality and excessive risk taking.
- How was credit affected during the crisis?
  - Less new credit. More drawdowns.
  - Lines of credit are not conditional on aggregate conditions. This lead to fragility of financial institutions with outstanding lines.
Recent Crisis

- Other key elements
  - The rise and complexity of securities led to excessive risk taking.
  - Market discipline broke down due to more competition in the banking system. Less charter value of financial institutions.
  - Lesson: Increase regulation in the right time, not when trying to take the system out of a crisis.
Big Remaining Questions

- Egg or Chicken?
  - Liquidity or Solvency.
  - Low interest rates create or fix a crisis.
  - Financial development or economic development?
- Are the long-run benefits of financial markets larger than the short-run costs of financial crises?
- Optimal Regulation?
- What is the role of information in financial markets?