Leverhulme Centre for Research on Globalisation and Economic Policy

Nottingham School of Economics

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Are Financial Markets Efficient? Banking in Crisis

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The Credit Crunch of 2007-2008

References

Books

Liaquat Ahamed, 2009, Lords of finance: The bankers who broke the World

William Cohan, 2009, House of cards: How Wall Street's gamblers broke Capitalism

David Einhorn, 2008, Fooling some of the people all of the time

John Lanchester, 2010, Whoops: Why everyone owes everyone and no one can pay

Charles Morris, 2008, The Trillion dollar meltdown: Easy money, high rollers and the great credit crash

Frank Partnoy, 2009, F.I.A.S.C.O.: Blood in the water on Wall Street

Richard Posner, 2009, A failure of Capitalism

Gilliam Tett, 2009, Fool's gold: How the bold dream of a small tribe at J. P. Morgan was corrupted by Wall Street greed and unleashed a catastrophe

Articles

Paul Krugman, 2009, How did economists get it so wrong? The New York Times, September 6

John Lanchester, 2008, Cityphilia, London Review of Books, January 3

John Lanchester, 2008, Cityphobia, London Review of Books, October 23

John Lanchester, 2009, It's finished, London Review of Books, May 28

Paul Mizen, 2008, The credit crunch of 2007-2008: A discussion of the background, market reactions, and policy responses, Federal Reserve Bank of St Louis Review, September/October

Related Readings

George Akerlof and Robert Shiller, 2009, Animal spirits: How human psychology drives the economy, and why it matters for global Capitalism

Nassim Nicholas Taleb, 2004, Fooled by randomness: The hidden role of chance in life and the markets

Iceland, Northern Rock and 'Too Big to Fail'

Luca Pacioli, *Summa de arithmetica* and the Birth of Modern Accounting

A snapshot of a firm

- **Balance Sheet**
- **Income Statement**
- **Cash Flow Statement**
- **Retained Earnings Statement**

A typical balance sheet

Assets	Liabilities
Cash & Investments	Loans
Fixed Assets	Bonds
Inventories	Equity
Accounts Receivable	Accounts Payable

The Bank Balance Sheet

Assets	Liabilities
Reserves	Deposits
Loans	Equity

An example (2008)

Assets £m		Liabilities £m	
Cash	17,866	Deposits by Banks	312,663
Treasury Bills	18,229	Customer Accounts	682,365
Loans	1,048,710	Other	814,065
Derivatives	337,410	*Total*	1,809,093
Other	478,304	Equity	91,426
Total	1,900,519	*Total Liabilities and Equity*	1,900,519

- **Insolvency: Total Assets < Total Liabilities; Negative Equity**

Guess who?

- **Total Assets: £1,900,519,000,000; 1.9 trillion pounds**
- **U.K. GDP: 1.7 trillion pounds**
- **The biggest company in the world**
- **Royal Bank of Scotland**

What makes banks different?

	Apple Computers (2008)	RBS (2008)
Assets	$39.5 billion	£1,900 billion
Liabilities	$18.5 billion	£1,109 billion
Equity	$21 billion	£91 billion

A measure of risk

- **Leverage ratio: Liabilities/Equity**
  - **Apple Computers: <1**
  - **RBS: 18.8**
  - **Barclay's 61.3**
  - **US Banks: 35**
  - **UK Banks: 41**
- **What it takes to become insolvent?**
  - **On average, in the U.S. it takes 1/35 of a bank's assets go bad, for the bank to go bust.**
  - **On average, in the U.K. it takes 1/41 of a bank's assets go bad, for the bank to go bust.**

A Game

	All other depositors at your bank		
You		Stay	Go
	Stay	(1+r)X	0
	Go	X	pX

- **Bank run: Everyone chooses Go!**

Insolvency versus illiquidity

- **A solvent bank: Equity > 0**
- **An illiquid bank: Demand for withdrawals > Liquid assets (cash, Treasury Bills, deposits with other banks)**
- **Illiquidity leads to insolvency: selling illiquid assets at prices below book prices**

‘Too Big to Fail?’

A very concise history of financial (de)regulation

- **Glass-Steagall Act (1933)**
  - **Separation of Commercial Banking from Investment Banking**
  - **<u>Rationale</u>: Commercial banks allocate funds collected from depositors to households and firms in the form of loans. The viability of the intermediation process crucially depends on the beliefs of depositors about the soundness of the banking system. Investment Banking would expose commercial banks to great levels of risk. The separation allowed the government to offer *protection to depositors*.**
- **(1986) ‘Bing Bang’: Complete deregulation of the U.K. financial system.**
- **(1999) Abolition of the Glass-Steagall Act**

Incentives and bail-outs

- **Depositors vs Shareholders**
- **Upside risk vs Downside risk and moral hazard**
- **Management compensation (bonuses)**
- **Political risks – TBTF**

Bill please!

- **U.S. bail-out cost (Bloomberg News Service): $7.76 trillion**
  - **Marshall Plan**
  - **Louisiana Purchase**
  - **1980s Savings and Loan Crisis**
  - **Korean War**
  - **New Deal**
  - **Invasion of Iraq**
  - **Vietnam War**
  - **Total Cost of NASA**