Financial and Economic Review, Vol. 15 Issue 4., December 2016, pp. 167–170.

Systemic financial crises*

Balázs Világi

Gary B. Gorton:
Misunderstanding Financial Crises – Why We Don't See Them Coming
Oxford University Press, 2012, 296 p.
ISBN-13: 978-0199922901

Many books have been published on the 2007-2008 financial crisis, analysing in detail the characteristics of the financial markets before the crisis, the subprime mortgage market and the process of securitisation. These volumes are full of expressions exotic for layman such as CDO, SPV, CDS, mezzanine tranches, NINJA loans, etc. However, these books make one common mistake: it is difficult to find out the essence from them. They discuss in detail the individual characteristics of the 2007-2008 crisis, but it does not actually turn out from these why all this is important.

The book of Gary B. Gorton titled *Misunderstanding Financial Crises – Why We Don't See Them Coming* is in sharp contrast to this approach. While he looks for an answer to the question of why the majority of the economist profession was surprised by the crisis in 2007, he also provides an answer to what the common root of the systemic financial crises is. The principal virtue of the book is that it places the current crisis in an economic history context and sheds light on the similarity between the classic banking panics of the 19th century and modern financial crises.

The proposition of Gorton is that this general cause is the inherent vulnerability of the liability-side of the financial intermediary system. Specifically, this means that on the liability-side of the banks and other mediators there are short-term debts or sight deposits, whereas on the asset side there are longer-term investments. In normal periods, maturity transformation does not represent a problem. However, in periods when bad news about the condition of the economy starts to proliferate, confidence in the banking system falters as well, and at this time, if there is a run on the banking system in the form of large-scale withdrawal of deposits or if the short-term loans of the banks are not renewed on a large scale, then a systemic financial crisis occurs.

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

Balázs Világi is a Head of Department at the Magyar Nemzeti Bank. E-mail: vilagib@mnb.hu.

Systemic financial crises are essentially liquidity crises. In the case of an individual bankruptcy, the assets of the bank are impaired due to its deficient investment policy or fraud or simply bad luck, and the bank cannot repay its debts. In the case of a systemic financial crisis, it is not that the asset side of the entire banking system is impaired, but instead the creditors of the banks withdraw their credits on a large scale and immediately due to a loss of confidence. This has taken various shapes in economic history: creditors intended to convert bank notes to gold or deposits to bank notes on a large scale, the current crisis took place on the money markets in a less evident manner, however, in terms of its essence, it was the same phenomenon.

The vulnerability of the financial intermediary system has structural reasons. On the one hand, behind the investments of the asset side of the banks, all things considered, there are real economy investments, which, stemming from their nature, are long-term investments. On the other hand, the short-term liabilities of the banks play an important role in the operation of the economy, since those are the transaction media of the economy, they play the role of money. And the economy is unable to operate adequately without transaction media.

The 2007-2008 global financial crisis started in the United States and, similarly to the crises in 1837, 1857, 1873, 1893, 1907 and 1933, it started with a liquidity run on the financial system. This was the largest financial crisis since the great crisis of the 1930s and its consequences have been felt up to now as well. It has clearly proven the untenability of the opinions that there will be no systemic financial crisis in modern, developed economies any more.

In the 2007-2008 crisis, the panic went on not in the market of depositors, but in the money markets, the market of repo and other short-term instruments. Similarly to historical bank crises, the panic was started by bad economic news, namely the problems in the subprime mortgage market. As a result of this, there was a run on repo, and creditors demanded their money immediately. However, it is important to emphasise that the collapse of the subprime market is insufficient to explain the extent of the crisis. Just like in the past, it was not the impaired assets but rather the run on debt that created the crisis.

The mortgage market crisis played a role in starting the panic, but liquidity was at the centre of the crisis this time as well, just as in the case of all the past systemic crises. When they were not willing to renew the short-term credits of certain banks on the money markets, banks had to obtain cash, thus, they had to fire sell their assets, below the fundamental price fire sale. As a consequence of decreasing asset prices, other banks ran into trouble as well, and hence they were also compelled to sell their assets causing prices to fall even more. Thus, a self-reinforcing spiral was started, which finally led to a systemic crisis.

All this, of course, has serious regulatory consequences. In the United States in the 1930s the introduction of deposit insurance – which is a liquidity-type regulatory instrument – created the "quiet period", there was no systemic financial crisis during the period until 2007. However, the outbreak of the latest crisis was exactly the result of the fact that a so-called shadow banking system was created, in addition to the traditional financial intermediary institutions, that was not regulated and its liability-side was subject to liquidity panics just like the traditional banking system had been before the introduction of deposit insurance. Thus, if we intend to avoid systemic crises in the future, all the elements of the financial intermediary system must be regulated.

After the review of all this, the author makes an attempt to answer the initial question of the book, i.e. why did the majority of economists misunderstand the operation of the financial intermediary system and why did they deny the possibility of systemic financial crises?

As a point of departure, Gorton calls the attention to the fact that the personal experience of an event is not substituted by reading or studying about it. If someone was a witness in some form of the 2007-2008 panic or experienced the negative consequences of that, then that person will think about financial crises in a different way than a person who met that only as a dry, historical data set. Similarly, the great crisis of the 1930s was a critical experience of an entire generation of economists: they fanatically attempted to understand it and to avoid similar cases in the subsequent period. By contrast, for the subsequent generations the great crisis was only an extreme, rarely occurring deviation in the data which does not necessarily have to be explained.

Many people share the opinion that the knowledge of economists is distorted because they use too many models. However, the problem is not with the models, in general, but with the way in which we validate those. Macroeconomic models are mostly tested with the data of the "quiet period". But if a theoretical model is created in such a way that it explains the data of a crisis-free period, that model will obviously fail in connection with the forecast and the interpretation of crises.

The main mistake of economics is not that it produces theories, since no science can exist without theories. The problem is that, when selecting from the theories, it did not depend on facts properly, it was not sufficiently empirical. However, it should be emphasised as well that this is often not a simple task at all, because of the lack of appropriate data.

The lack of data is an especially relevant question in terms of the subject of the book. Financial crises occurred relatively frequently in capitalist economies. But here the emphasis is now on the word "relatively". Financial crises are frequent events compared to what an ordinary person or even what an average economist thinks. But these are rare compared to how much data would be necessary for making statistically significant statements.

However, the problem of financial crises is too important to give up their analysis based on some kind of statistical purism. There are situations in other areas of life, but in science as well, when we have to make decisions or statements that are based on some anecdotal evidence and not on significant statistical relationships. If rigorous nature and relevance can be implemented only at the expense of each other, current economics votes for the former instead. It is a typical trend that researchers are more interested in preparing formally perfect, but completely uninteresting studies. By contrast, the really interesting and relevant studies are often rejected by the editors of scientific journals, because they find these as not sufficiently sophisticated in terms of methodology.

According to the author, economics has come to a fork in the road after the 2007-2008 crisis. It faces an important choice: in the future, either it will embrace reality, or, ignoring the lessons of the financial crisis and its own failure, it will languish in irrelevancy.