Bankers Gone Wild

Source: End This Depression Now, Krugman, cap. 4.

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How banks work

Banks receive deposits and lend loans. Reducing the trade off between preference for **liquidity** and **revenues**.

Moreover, banks **create money** they give loans creating deposits.

How banks work

When a bank is created:

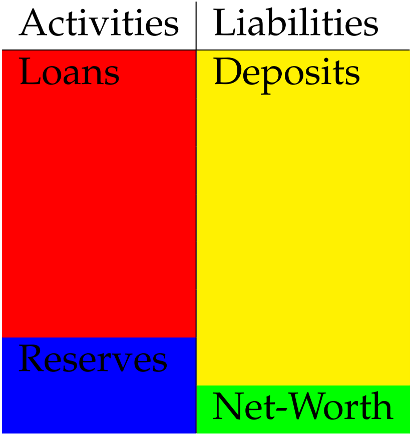
Activities	Liabilities
Reserves	Net-Worth

The bank collects deposits:

Activities	Liabilities
Reserves	Deposits
	Net-Worth

How banks work

The bank lends loans:



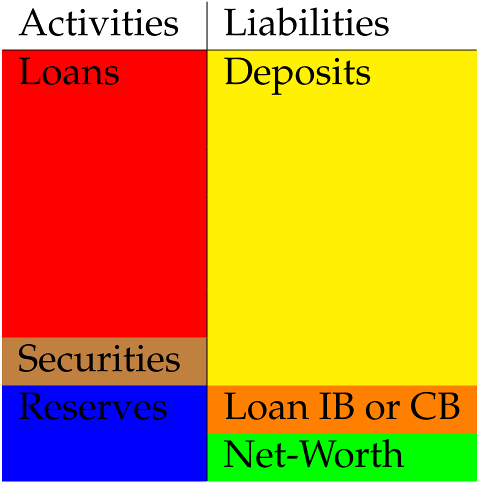
How banks work

The bank can buy some shares on financial markets:

Activities	Liabilities
Loans	Deposits
Shares	
Reserves	Net-Worth

How banks work

The bank can borrow from other banks or from the central bank to increase their reserves:



How banks work

The quantity of loans they supply is limited by **capital requirement**, thus the quantity of their own capital with respect to loans (net-worth), in fact their own capital can be used to cover losses.

Credit supply is limited by profitability and so also by the **cost of reserves**.

How banks works

Deposit are larger than reserves this may lead to a bank run, this is a case of **illiquidity**

Moreover, a bank can fail if part of its loans are not payed back and liabilities become larger than assets, this is a case of **insolvency**.

Finally a bank can fail if the value of its shares decline and the loss is so big that liabilities become larger than assets, this is a case of **insolvency**.

Maturity mismatch

Banks tend to **lend long** and **borrow short**. Loans take a long tame to be payed back, while deposits can be withdrawn at any moment.

If there is panic among depositors they want to withdraw their money but into the bank there are not enough reserves to cover deposits **bank run**.

So in order to avoid bank run:

- Having a lot of deposits.
- High capital requirements.
- Lender of last resort.

Glass Steagall Act

The Glass Steagall act established the Federal Deposit Insurance Corporation that **guarantees deposits**.

At the same time limits the amount of risk bank can take, in order to avoid **moral hazard**.

So separating **commercial bank** from **investment bank**: commercial bank collect deposits but cannot invest in stocks they just make safe loans.

Deregulation and No new regulation

Since the ′80 the banking sector started to be **deregulated** and in the ′90s the Glass Steagal act was abolished.

Moreover new institutions, the so called **shadow banks** enter the market: corporations that act like banks, borrowing short and lending long, but that are not subjected to any regulation, they make large profit but they are exposed to huge risk.

Deregulation and no regulation of shadow banking **increased debt**.

How no bank financial corporations work

An investment bank or shadow bank, borrow short from money market fund and lend long or buy assets.

Activities	Liabilities
Loans	Short term loan
Securities	
	Net-Worth

Saving and loans banks

The saving and loans deregulation in the ’80s, was an example of risk of **deregulation** associated to **moral hazard**.

These bank give long run credit at fixed low interest rates and with the inflation in the ’70s they have reduced profits.

With deregulation they started to provide risky credit and loans to dubious creditors, because nobody loss (moral hazard).

In the 1989 they failed.

The Big Lie

According to some analyst the growth of debt in particular in the hosing sector was due to the government with act that favored credit for **poorest classes**.

But the increase of credit was associated to **many forms of loans** and not only to credit to poor people

Moreover, the great part of mortgage credit was provided by **private** lenders and not by public agencies.

Deregulation and Moral Hazard

At the end deregulation created a big **moral hazard problem**: **depositors** don’t mind how their deposits are used because they are covered by the assurance and by lending of last resort, so **bankers** can take great risk.