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ECONOMIC VIEW

The Age of the Shadow Bank Run

By TYLER COWEN
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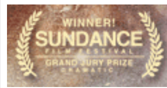

I RECENTLY asked a group of colleagues — and myself — to identify the single most important development to emerge from America's financial crisis. Most of us had a common answer: The age of the bank run has returned.

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Mark Shaver

Since the end of World War II, economists have generally thought that runs on banks were dead, at least as a phenomenon in advanced nations. In the United States, for example, bank deposits are insured by the Federal Deposit Insurance Corporation, and, as a last resort, the Federal Reserve can back deposits by printing money.

The new complication is that bank deposits are no longer the dominant form of modern short-term finance. The modern bank run means a rush to withdraw from money market funds, the disappearance of reliable collateral for overnight loans between banks or the sudden pulling of short-term credit to a troubled financial institution. But these new versions are in some ways still similar to the old: both reflect the desire to pull money out of an endeavor — and to be the first out the door. And both can set off a crash.

These newer forms occur in the so-called shadow banking system, involving short-term financial credit not guaranteed by the deposit insurance umbrella. According to the Federal Reserve Bank of New York, shadow banking accounts for about $15 trillion in assets — more than the traditional banking system. But as recently as 1990, the shadow-banking total was much lower, at less than $4 trillion. The core problem is that the growth of short-term credit has been outracing our ability to protect it, and since 2008 most investors have realized that these shadow-banking transactions are not risk-free.

On top of this problem is the market for derivatives. The quantity of open derivatives amounts to trillions, and these positions are another source of

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short-term credit risk. So a need for sudden payouts could also prompt a run on a financial institution.

It now seems that the 21st century will resemble the 19th and early 20th centuries, with periodic panics and runs on financial institutions, perhaps followed by deflationary collapses. In the euro zone, these problems have plagued banks and entire countries, like Greece and Portugal. The “country as bank” is a new and not entirely reassuring catch phrase, and it shows that the problem goes beyond the private sector.

If a central bank is deft enough, it can avoid deflation by using loans and monetary policy to guarantee the liabilities of run-prone institutions. That worked reasonably well in 2008, but in the long term such a policy sets up the system for even more danger, by subsidizing bank risk-taking and precarious financial structures.

Another problem is that ending those central bank guarantees isn’t always easy. The European Central Bank has stemmed a financial collapse for now, but only by lending large amounts to banks at 1 percent for a three-year window. And yet the euro zone has entered a recession, so it’s unclear when troubled European banks can return to private capital markets. The central bank may end up taking over much of the allocation of capital.

The arrangement also assumes that economic growth will pick up fairly quickly in the euro zone — hardly a certainty. And there is little market discipline to force European banks to clean up their balance sheets or to exercise caution for the future. So the system remains extremely vulnerable.

Another feature of this new order is that more and more financial transactions will be collateralized with the safest securities possible: United States Treasuries. Demand for them will remain high, and low borrowing costs will ease our fiscal problems. Still, the resulting low rates of return serve as a tax on safe savings, encourage a risky quest for yield and redistribute resources to government borrowing and spending. It isn’t healthy for the private sector when investors are so obsessed with holding wealth in the form of safe governmental guarantees.

THIS entire package of problems seems to be part of “the new normal” — it’s not going away anytime soon.

Some economists, like Ricardo J. Caballero of the Massachusetts Institute of Technology , have called for extending governmental guarantees well beyond traditional bank deposits. That would check the problem, but at what cost? In a larger financial crisis based on insolvency, our government would face intolerable financial burdens, as happened in Ireland when its government guaranteed bank debts.

A broader government guarantee would also spread the moral-hazard problem to an even larger class of financial transactions, raising the odds that the guarantee will someday have to be paid out. In any case, bailouts for creditors are already politically unpopular, and are unlikely to be expanded.

In short, no promising financial path is before us. It’s good that the American economy seems to be recovering, and this may shove some problems into the

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A version of this article appeared in print on March 25, 2012, on page BU4 of the New York edition with the headline: Call It The Age Of the Shadow Bank Run.

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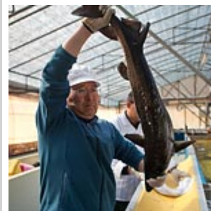

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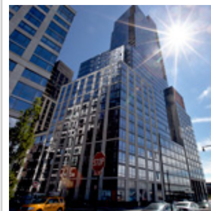

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