

Lecture 15(ii)

Announcements

Question and Answer Sessions

Today!

- 4-5:30pm **Anderson 310**
- 6:30-8pm **Anderson 210**

Office Hours today (Wed): 1:30-4
Hanson 4-135

Final on Friday, 6:30-8:30pm

- Room locations for Final at
Final OneStop Page
(bottom of Canvas)
- **Bring ruler and pencils like
before!**

Lecture

1. Results of platform elections.
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2. Moral hazard in subprime lending
in the U.S.
3. Moral hazard in sovereign debt in
the Euro-zone
4. Fiscal Union?

Results of Class Vote on Immigration Policy

1: The Trump Plan

- Massive cut new immigration
- Deportations

2. An Updated Version of the 2013 Gang of Eight Plan

- Maintain immigration, but shift balance towards high skill workers
- Secure border to limit future unauthorized immigration
- Path to legality for existing unauthorized immigrants who haven't committed crimes (like DACA)

3: What Democrats seem to be aiming for at the moment

- DACA
- Border enforcement policy as exercised by President Obama.

Results:

11% Trump plan

62% Updated gang of 8

27% DACA+Obama border policy

Exactly the same as the vote from last year!

Moral Hazard in Banking and the Global Financial Crisis

Balance Sheet First Bank of EconLand

Assets	
Loans (mortgages)	200

Liabilities&Equity	
Liabilities (deposits, short-term credit...)	170
Equity	30
Total Liabilities &Equity	200

Last class discussed case where borrower puts down a 20% down-payment, has steady income, etc.

Now take case of a subprime loan.

- Give a loan to someone for 200k with no down payment. (That is, to buy a 200k house).
- And maybe even no income.

Why do something crazy like that? If next year the borrower can't pay, no problem. House will be worth 250k. Bank can sell it and make a profit.

That logic broke down when the housing bubble burst. Instead of going up, home prices started going down.

Suppose house price goes down to 170k. Homeowner is “[under water](#).” Better for homeowner to walk and let bank have the house.



Suppose for a moment that the bank can actually sell the house for 170k. How is that going to change the balance sheet of the bank?

Assets	
Loans (mortgages)	200
Liabilities&Equity	
Liabilities (deposits, short-term credit...)	170
Equity	30
Total Liabilities &Equity	200

What can we say now about the equity position of the bank?

Now, more realistically, take into account that the bank won't net \$170k from the repossessed home. Let say \$150k is all they can get. What can we say about the equity position of the bank now?

What happens next?

Balance Sheet First Bank of EconLand

Assets	
Loans (mortgages)	150 200
Liabilities&Equity	
Liabilities (deposits, short-term credit...)	150 170
Equity	0 30
Total Liabilities &Equity	170 200

Bank is Insolvent!

(Above accounting assumes limited liability, so equity gets marked to zero.)

What comes next....

(Movie clip)

When bank is insolvent and the creditors do not have insurance, there is an incentive for a "run" on the bank. If there are assets of 150 to go around and there are creditor claims worth 170, you don't want to be the last one trying to get your money back!

There is a famous scene of a bank run in the movie, "Its a Wonderful Life." This scene is from the banking crisis of 1932. A banking reform after that crisis was to set up the Federal Deposit Insurance Corporation (FDIC). With this system, a depositor (with less then 100k) in a checking or savings deposit need not run to the bank at the first sign of trouble. That's because the depositor's money is insured by the federal government.

As the crisis began, some bank creditors were insured (deposit < 100k) but others were not. To prevent a bank run by the uninsured creditors, at least for the big banks, the government stepped in and basically said it was going to back the banks up.

In the movie, Old Man Potter tells the depositors he will pay for their deposits at a rate of 50 cents on the dollar. In Wall Street terminology, Potter was offering them a "haircut." George Bailey injects his own capital in the bank (it comes from the money he was going to use for his honeymoon.) He convinces the depositors to take what they need out of his honeymoon money and wait out the problems.

Modern version, [clip from The Big Short](#)

Moral Hazard To Big to Fail (TBTF)

Bankruptcy process: GM, Chrysler bankruptcies not disruptive (in a relative sense).

Many argue banking is different
1) trust is what they do
2) greases the wheels of macroeconomy

So incentive for government to step in and not let huge banks go into bankruptcy.

Suppose a bank is insolvent...

Small Bank

Depositors (with less than 100k)
are insured by FDIC

Other creditors may not get all of
their money back.

Does not pose **systemic risk** or
bringing entire economy down

Large Bank

There is a concern that failure
poses a **systemic risk** (risk to
entire financial system)

**Incentive to government to bail
out even the uninsured creditors
of large banks**

So the moral hazard is..

1) Big banks have incentive to take
risks that are too big.

Heads I win....

..... Tails the government loses

2) Moral Hazard on the part of
creditors lending to the bank. Won't
be careful with the money.

The countries in the Euro-zone are in navy blue:



Common currency among sovereign nations. (Countries in the European Union not equivalent to states in the U.S. federal system.)

A number of the countries ran up unsustainable debt, denominated in Euros. Greece in particular.

If a country runs up debt denominated in its own currency, it doesn't have to default. It can just print boxes of money and say "Here."
(But U.S. can do this for its debt to China!)

Greece ran up a bigger dept than it can pay back. So what to do?

- Greece can't print Euro-notes because Germany won't let them
- As it is a sovereign nation, banks can't "foreclose" on Greece and take the keys to Athens
- What if Greece just defaults? Countries in the Euro-zone are worried about the contagious effect.

Upshot: Bailout. Germany stepping in and writing checks.

- Not just Greece getting bailed out.
- Banks lending to Greece getting bailed out.

Third Greek Bailout

August 2015

Demanded austerity

Can you see where the moral hazard is creeping in?

As these countries are too big to fail, there was moral hazard in bank lending. They were too eager to lend, overlooking problems, rationally anticipating that these countries (and the banks lending to them) would be bailed out in the end.

(And could perhaps argue that there is moral hazard at the country level. Greece went on a binge, rationally anticipating that its big brother Germany would pay the bill.)

The EU has been changing institutions to reduce the moral hazard. They are working on a fiscal pact that would impose budget rules on the members (limits to ability to go into debt). The treaty would take away some of each country's sovereignty to reduce moral hazard.

As an analogy, suppose 27 people go out to dinner and agree to split the bill 27 ways. There is a moral hazard problem here, and people will tend to order steak, expensive wine, fancy desserts... To limit moral hazard, the group may decide on a pact before dinner that no one can order dessert; no one can order steak, etc.