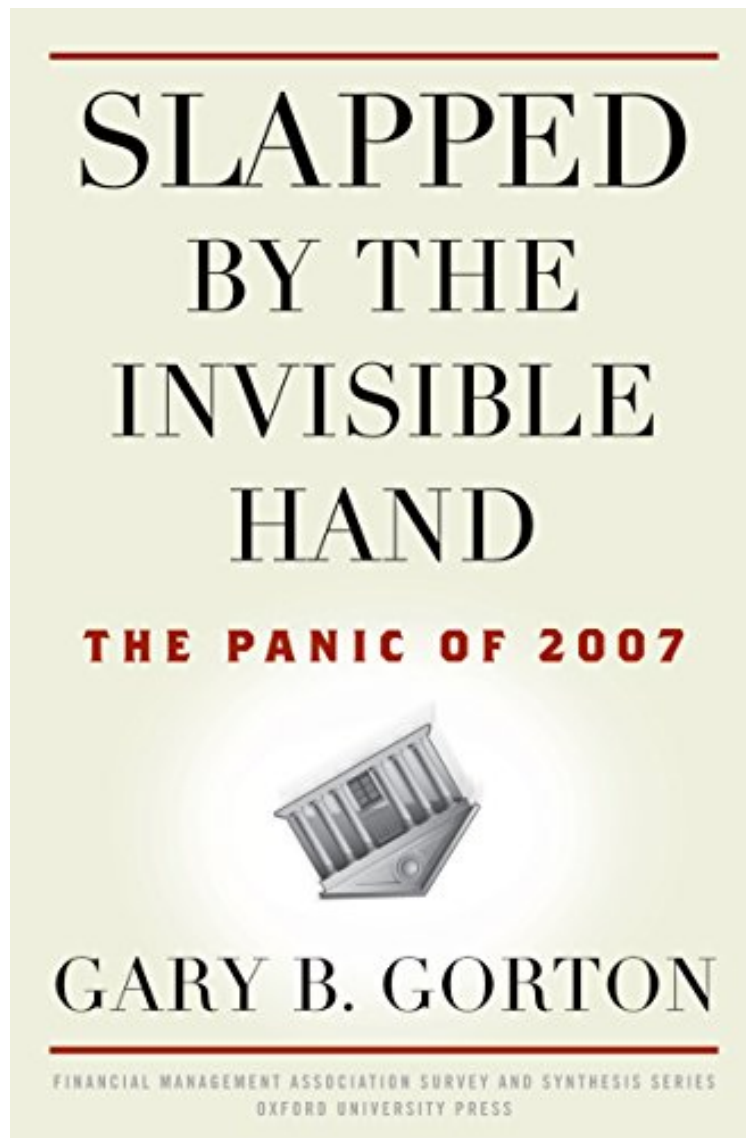


(Mobile library) Slapped by the Invisible Hand: The Panic of 2007 (Financial Management Association Survey and Synthesis)

Slapped by the Invisible Hand: The Panic of 2007 (Financial Management Association Survey and Synthesis)

Gary B. Gorton

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Gary B. Gorton : Slapped by the Invisible Hand: The Panic of 2007 (Financial Management Association Survey and Synthesis) before purchasing it in order to gage whether or not it would be worth my time, and all praised Slapped by the Invisible Hand: The Panic of 2007 (Financial Management Association Survey and Synthesis):

8 of 8 people found the following review helpful. Educational, Accurate, Insightful, and DifficultBy Rick SpellI am an

investment banker/mortgage trader and have been poring through the many books on the recession. MOST, concern subprime mortgages or reaction to the financial meltdown. This book is the printing of three research papers with wrapped analysis around those papers so calling it a book is somewhat of a stretch. Pretty short book to write since you are just using your previously written material. But what makes this book GREAT is its clinically written analysis of the cause of our banking panic. Instead of describing what happened as so many other books have, this clinical paper puts the recession/disruption in the terms of comparison to other bank runs. Now this wouldn't seem normal as I doubt the majority of working people would define this disruption as a bank run. Yes, Wamu and IndieMac may have had quick drops in deposits. But our real liquidity problems happened outside government guaranteed depository institutions. Rather the exotic security market became severely disrupted and the highly leveraged investment banks, whose debt was basically short commercial paper, could not roll over their paper. This is why the government had to step in, to protect the commercial paper market and our banking industry which supplies the leverage that runs our country. This book raises the theme of the substantial change in banking, the shadow banking system, and shows that its importance and fragile nature, which had for so long been ignored, was the major cause of the recession and the "new" bank run. It's a well documented book and worthy of reading. But not without flaws. For example, as mentioned earlier, it's really three research papers. No problem, but one of them veers far from the tenet of the book and is actually an analysis of private label securitization structure. While subprime securitization was the catalyst of the crash, do we suddenly three years later need to revisit the basic structure of securitization? In closing, if you want a serious discussion with flaws about why we had the crash, this is the book for you and I'm strongly recommend this for the serious students of financial history.

0 of 0 people found the following review helpful. Must-read on the financial crisis

By Justin Hoca

Gorton is a Yale Professor of Management and Finance and an expert in the history of banking and financial markets. Perhaps no one has done as much work on the makeup of the "shadow banking" system as he has. This book is a compilation of a few of his papers, one of which was famously presented at the Fed's Jackson Hole conference in 2008. Gorton's work is at the top of Ben Bernanke's financial crisis reading list.

What is a bank--can you define it? If banks are regulated, but certain non-banks engage in similar activities as a bank, what types of issues arise? I step away from all the books I've read on the issue and come away with two definitions of a bank:

1. An entity that creates a riskless, information insensitive, liquid asset for a customer and funding that asset by creating a relatively risky, information sensitive, illiquid liability for itself.
2. An entity that borrows short and lends long.

Gordon gives some insight into earlier U.S. banking panics that I was unaware of. In 1907, bank consortiums facing a run basically united behind the castle walls of a clearinghouse. Deposits at any individual bank could not be redeemed and customers were instead given a makeshift loan from the clearinghouse. In a panic no one knows which bank is safe, therefore even the healthiest ones are at risk of failure, so the clearinghouse protected all the banks until the panic subsided. Creation of the Federal Reserve eliminated this local clearinghouse concept as the Fed became the clearinghouse, and later allowed banks to fail en masse. Today, the repo market acts as the banking system for large firms. This activity is performed largely by non-banks and allows firms to earn interest on their large amounts of cash in exchange for collateral-- usually Treasury or other AAA assets. This collateral is generally information insensitive, liquid, and riskless. "Repo trading has been likened to speed chess; that is, there is no time to do due diligence on the collateral offered and indeed almost none is done." As the repo market grows, so does demand for AAA collateral. As subprime lending increased, the collateral more and more became claims on CDOs backed by mortgages. Once doubts began to arise about the worth of that collateral, the repo market began to seize up. There became a general panic about which assets were safe, everyone started to demand larger haircuts and Treasuries. As lending seized up, firms like Lehman Brothers went under and the dominoes fell.

If you have to read one book explaining the Panic of 2007, this is the one. Gorton isn't providing much narrative here, he is an academic looking at the data. As such, much of it is fairly technical. He delves into the prospectuses of various ABS and details how CDOs operate. He looks at econometric analyses to try and develop a theory about why banks and non-bank entities make the decisions they do under regulatory regimes.

If you piece together a narrative, it looks like this:

1. Deregulation of the financial sector led to increased competition and lower profits for banks who were now competing with non-banks.
2. "(I)n attempts to maintain profitability, banks enter new activities which are not necessarily a source of public policy concern per se, but become entwined with traditional banking activities and, hence, a source of concern." Capital requirements were navigated by doing off-balance-sheet activities and increasing securitization.
3. As this continued, the activities of banks and non-banks were increasingly "off the radar" of bank regulators. The repo market was one example of this, the Fed stopped trying to measure the activity altogether.
4. Eventually, ABS and CDOs were created from loans that required housing prices to keep going up in order to be profitable. A sub-prime loan was made with an initial 2-3 year fixed rate that then adjusted upward, with the expectation that in 2-3 years the borrower would refinance the loan having earned equity as the value of his house increased; this could be repeated indefinitely. The loan was sold and securitized as part of a bundle, which was then sliced and diced again into CDOs, CDO-squareds, etc.
5. In 2006, the ABX was introduced, for the first time introducing a price index for subprime securities. People could then bet/trade on what they thought they were worth, and the ABX started to decline as the market started to short subprime.
5. When housing prices stopped going up and the ABX started going down, the CDOs started to take

major losses.⁶ This triggered even more losses on CDS issued on the CDOs.⁷ Adherence to mark-to-market accounting rules forced major write-downs of firm assets, instantly causing many firms to become insolvent.⁷ Panic ensues. Gorton empirically examines two common hypotheses of the crisis and finds them wanting: 1. Lender's increasingly lower lending standards created the problem. This isn't backed up by the empirical evidence. 2. Originate-and-distribute (securitization) created misaligned incentives that created the problem. Gorton points out that all the originators suffered major losses, many going bankrupt. All originators kept a great deal of risk on their books. The problem was, basically, the creation of assets that were a one-way bet on housing prices. Once assets created from those started to rated well by rating agencies and considered riskless collateral, the system quickly spread soon-to-be-toxic risk all over the world. (I take issue with people who in hindsight say "everyone knew housing prices would fall," because if everyone knew that they wouldn't have made the loans and willfully taken billions in losses and gone bankrupt, would they?) Gorton takes issue with a few recommendations in regards to regulation. He sees higher capital requirements as only effective in shrinking the banking sector, which may not be what a society really wants or needs. He also notes that until "banking" is better defined, we're always going to have a hard time policing banking activity. Better to create a system that aligns incentives and eliminates information asymmetry problems. Mark-to-market accounting adherence during a crisis is ill-advised as well. There aren't any grand political statements in this book, or vilification of demons. Mostly facts and analysis and some stylized examples. I only give it 4 stars out of 5 because a lot of the information is jumpy and overlapping. Some of it, like his letter at the end to someone in 2107 was also a little...odd. I also read it on the Kindle and some of the equations and charts were hard to read in Kindle format. But I highly recommend the book. 4 of 4 people found the following review helpful. Unique and extremely important. By W. D. ONEIL. There have been a number of stories about the economic crisis of 2007-2008. Many have been more clearly and stylishly told, but this one is unique and extremely important because it is virtually alone in constructing a consistent operational picture of how precisely the sudden deflation of the U.S. housing bubble led, step by step, to a collapse of the world financial system. As some of the reviews here make clear, this is not a story to satisfy you if you come at this from an ideological perspective, whatever it may be. Gorton is writing not as a Keynesian or a neoclassicist or an Austrian, but as a technical financial economist. It is neither a morality tale nor a work of grand theory but an analysis of what Keynes referred to as "magneto trouble." It is somewhat disconnected and not altogether clear in some places. In part this is because this is a report from the front lines, written during or shortly after the battle. It will take a long time, as Gorton repeatedly emphasizes, to develop real clarity about what happened and why. Many of the details he goes into truly are mind-numbing, this is a feature rather than a bug, because in Gorton's view the details truly made a big difference, and if we don't understand that then we have much less chance of modifying the system so as to avoid repetition. By precisely identifying a mechanism for the crisis Gorton puts himself in a position to offer precise proposals for action. In the process, he casts a great deal of doubt on the efficacy of much of what has been put forward and in part adopted so far. He notes with regret that he has not been able to test his theses about the causes and mechanisms of the crash, but as he observes, it is scarcely possible to do so for a truly singular event such as this. We are left with no alternative but a case-study approach, and this is a very important start. Most of the book simply is a compilation of three previously-published papers, which may be read separately, if one prefers. I have been glad to have them in book form, however, and found that the introductory chapter added significantly to their value.

Originally written for a conference of the Federal Reserve, Gary Gorton's "The Panic of 2007" garnered enormous attention and is considered by many to be the most convincing take on the recent economic meltdown. Now, in *Slapped by the Invisible Hand*, Gorton builds upon this seminal work, explaining how the securitized-banking system, the nexus of financial markets and instruments unknown to most people, stands at the heart of the financial crisis. Gorton shows that the Panic of 2007 was not so different from the Panics of 1907 or of 1893, except that, in 2007, most people had never heard of the markets that were involved, didn't know how they worked, or what their purposes were. Terms like subprime mortgage, asset-backed commercial paper conduit, structured investment vehicle, credit derivative, securitization, or repo market were meaningless. In this superb volume, Gorton makes all of this crystal clear. He shows that the securitized banking system is, in fact, a real banking system, allowing institutional investors and firms to make enormous, short-term deposits. But as any banking system, it was vulnerable to a panic. Indeed the events starting in August 2007 can best be understood not as a retail panic involving individuals, but as a wholesale panic involving institutions, where large financial firms "ran" on other financial firms, making the system insolvent. An authority on banking panics, Gorton is the ideal person to explain the financial calamity of 2007. Indeed, as the crisis unfolded, he was working inside an institution that played a central role in the collapse. Thus, this book presents the unparalleled and invaluable perspective of a top scholar who was also a key insider.

"Think you know what caused the collapse of Wall Street? Gary Gorton, the Sherlock Holmes of the financial crisis, has news for you." --Robert Hahn, Founder of the AEI Center for Regulatory and Market Studies. *Slapped by the Invisible Hand* is essential to understanding the deep weakness in the banking sector that led to the financial crisis.

Like consumer banks before the Great Depression, the 'shadow banking market' is vulnerable to runs and panics and hysteria, and we are all, in turn, vulnerable to it. By looking beyond this financial crisis to the systemic flaws that make us vulnerable to all sorts of crises, Gary Gorton has created a necessary guidebook for what's happened, and what needs to be done."--Ezra Klein, Washington Post"Gorton has produced the clearest account yet of what has happened...Slapped By the Invisible Hand is not a conventional retrospective. Instead it is a real-time chronicle of what the authorities were told at key points in the drama by a practitioner who was steeped in the history of banking as well...it is a major contribution."--David Warsh, Economic Principals "Provides a lucid framework for understanding the crisis truly substantive Slapped deserves an audience of more than just crisis connoisseurs."--Barron's"It's must-reading for anyone who wants to understand the recent economic unpleasantness."--Matthew Yglesias, Think Progress"Fascinating for anyone interested in the crisis, or in banking and finance more generally, this is absolutely essential reading."--Tyler Cowen, Marginal Revolution, Professor of Economics at George Mason University"Slapped by the Invisible Hand tells us that there were bank panics--systemic crises--in 1873, 1884, 1890, 1893, 1896, 1907, and 1914. On the other hand, there were no systemic crises from 1934 to 2007. The problem, as Gorton makes clear, is that the Quiet Period reflected a combination of deposit insurance and strong regulation--undermined by the rise of shadow banking. So we have a choice: restore effective regulation or go back to the bad old days."--Paul Krugman, New York Times "Conscience of a Liberal""Gary Gorton has written an important book, one that clearly identifies the issues surrounding the recent financial crisis and separates them from the ongoing macroeconomic policy turmoil....quite an accomplishment, given that many of us are still trying to figure out happened in earlier panics and crises.... By narrowly focusing on the events and institutions of the Panic of 2007, how the economy got to where it is today becomes much clearer."--EH.net"Offers the most coherent and convincing account of the recent financial crisis that I have seen, stressing its essential similarity to historical banking panics. Gorton's analysis leads to operational proposals for a regulatory environment that would be consistent with a safe, closely regulated banking system and with continued innovation in other financial services."--Robert Lucas, University of Chicago, Nobel laureate in economics"To understand the actual moment and mechanism of crisis, the definitive take is Yale economist Gary Gorton's, in the delightfully titled Slapped by the Invisible Hand. Gorton's is a challenging book for a non-finance type, but there is no better technical explanation of the panic." --Slate.com "Essential reading for anyone who wants to know what really happened in the world financial meltdown of 2007-08. Gorton writes with a wide grasp of financial history and a detailed understanding of complex areas such as the repo market. This book deserves to be read widely."--Bill Bradley, Former United States Senator"Think about it. If porcine greed, by itself, is enough to crash the financial sector, why doesn't Wall Street crash every year? For that matter, why should the crash of the subprime market result in a recession so much worse than the one that followed, say, the dotcom bubble? To answer these questions, you should read [this] book. --National Post"An indispensable and insightful guide to the origins and the mechanics of the financial crisis. If you want to be among those who understand what happened and what should be done you must read Slapped by the Invisible Hand." --Peter R. Fisher, BlackRock and former Under Secretary of the U.S. Treasury for Domestic Finance"Gary Gorton's Slapped by the Invisible Hand perceptively explains how the financial crisis of 2008 was actually a crisis of 2007 and provides an essential historical context. It needs to be read by all who seek to shape our future policies."--H. Rodgin Cohen, Chairman, Sullivan Cromwell LLP"This is the best book on the crisis what makes this book a winner is that [Gorton] lays bare the root cause of the crisis." --David Merkel, CFA - Finacorp Securities, Aleph Blog "Gorton comes to the table with long experience in the study of financial bubbles: he offers a challenging analysis of the late meltdown as a classic bank panic in modern dress." --John D. Ayer, UC Davis Professor of Law Emeritus"Scholars like Gorton do not get enough attention as we try to understand what caused the crisis and how to prevent a repeat he is one of the people that will play an important role in shaping reform." --TheStreet.com"Gorton, an authority on financial panics, argues convincingly that our most recent unpleasantness is not so different from earlier monetary disasters. The big change is that this one didn't involve runs on your neighborhood 'retail' banks, but was a 'wholesale' crisis that came close to destroying the huge, unregulated network of brokerage houses that trade esoteric securities largely with each other. He believes that we must understand what caused the crisis before we can take steps to prevent another, similar crash in the very near future. His book is a guide to learning those lessons." --Internet of Books"The definitive history of the 2007 meltdown." -The Electric About the AuthorGary B. Gorton is the Frederick Frank Class of 1954 Professor of Management and Finance at the Yale School of Management, and Research Associate at the National Bureau of Economic Research. He formerly taught at the Wharton School for twenty-four years and worked in the Federal Reserve System. He is also a former consultant to AIG Financial Products, where he worked on credit derivatives and commodity futures for over ten years.