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Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007

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Gary B. Gorton (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=17513)

Yale School of Management; National Bureau of Economic Research (NBER); Yale University - Yale Program on Financial Stability

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Abstract

The 'shadow banking system' at the heart of the current credit crisis is, in fact, a real banking system – and is vulnerable to a banking panic. Indeed, the events starting in August 2007 are a banking panic. A banking panic is a systemic event because the banking system cannot honor its obligations and is insolvent. Unlike the historical banking panics of the 19th and early 20th centuries, the current banking panic is a wholesale panic, not a retail panic. In the earlier episodes, depositors ran to their banks and demanded cash in exchange for their checking accounts. Unable to meet those demands, the banking system became insolvent. The current panic involved financial firms 'running' on other financial firms by not renewing sale and repurchase agreements (repo) or increasing the repo margin ('haircut'), forcing massive deleveraging, and resulting in the banking system being insolvent. The earlier episodes have many features in common with the current crisis, and examination of history can help understand the current situation and guide thoughts about reform of bank regulation. New regulation can facilitate the functioning of the shadow banking system, making it less vulnerable to panic.

Keywords: financial crisis, banking panic, Panic of 2007, repo markets**JEL Classification:** G01, G1, G12, G18, G21[Suggested Citation](#) >[Show Contact Information](#) >

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