

# Discussion of "Liquidity Shortages and Monetary Policy"

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- Why do banks exist?
- Are banks socially desirable?
- Are bank **runs** socially desirable?
- Is the **threat** of a bank-run socially desirable?

- In a nutshell
- Banks  $\equiv$  **financially fragile** institutions
- Is this good or bad? Good!
- Why? Because "**financial fragility generates liquidity**" (Diamond-Rajan 2001)

- "Lender" - borrower relationship has a structural **illiquidity** problem. Why?

→ Assets (loans) **cannot** be liquidated (or borrowed against) for the full value they would generate in their best use

→ Es: difficult to seize assets, inability to committ, etc..

- Hence lenders may **not** be willing to lend as much needed, or could even **refuse** to lend up-front
- Need to magically **generate liquidity** elsewhere

- The trick? A **fragile** demand deposit structure (first-come-first-serve)
- Deposits act as a **discipline device** because they are intrinsically **subject to runs**

- **Key implication:** although loans held by banks are illiquid, banks can borrow against the **full value** of the loan
- Hence banks can satisfy entrepreneurs' demand for funds **upfront** → No need to ask for a liquidity premium

- Financial fragility, i.e., banks, **generates** liquidity.
- To address illiquidity problem on the **asset** side need to generate liquidity on the **liability** side
- For this need the blessing of deposit structure with the curse of bank runs

- Bank runs **destroy** liquidity

The answers .

- Are banks socially desirable? **YES** (comparative advantage)
- Are bank **runs** socially desirable? **NO** (destroy liquidity)
- Is the **threat** of a bank-run socially desirable? **YES** (allow to alleviate illiquidity problem)

- Suppose now aggregate illiquidity shock / Es: fall in aggregate **house prices**
- Anticipated insolvency of banks → may trigger a bank run → self-fulfilling

BANK RUN



DESTROY LIQUIDITY



INTEREST RATE RISES



PDV of ASSETS FALLS



BANK RUN

- **This paper**

- Bank failures (runs) dry-out liquidity → bank runs socially inefficient

- Monetary policy intervention to **provide liquidity** may seem good idea

- Yet what about **moral hazard**? Anticipated CB intervention may encourage **excessive** risk-taking

- Anticipated CB intervention may actually **exacerbate illiquidity** problem!
- Paradox: if promise to provide liquidity in the case of crises → generate **less** liquidity

- Conclusion: normative implications not clear-cut
- Injecting liquidity can alleviate liquidity problem only if probability of **bad state** is low

- Need to commit "**not to provide liquidity**" to free riding banks
- Typical **time inconsistency** problem

- Can we design a **time consistent** policy? In principle: yes if we view it as a **repeated** game
- Macro-policy literature define it a **sustainable plan** (note for game theorists: a *subgame perfect Bayesian equilibrium*)

- Analogy: government levies distortionary **taxes** to finance govt. exp and issues debt
- If there is no commitment technology to future actions → optimal (Ramesy) policy is to **default on debt** to avoid levying distortionary taxes
- **Dynamic** game: government internalizes that if it defaults → not be able to raise funds **in the future**
- If cost of future borrowing difficulties exceeds benefit of current default → no default is equilibrium

- **Not defaulting** in every period is a sustainable plan
- Usually: need sufficiently high discount factor

- **Main idea:** CB needs to internalize the future consequences of its "liquidity interventions"

- Other issue: is it anticipated CB intervention or is it financial evolution per se?

- Still troubling: lack of **general equilibrium** → Tepid on welfare implications