

Financial Frictions and Crises

- WEEK SEVEN -

Fatih Kansoy

 <https://macroeconomics.info>

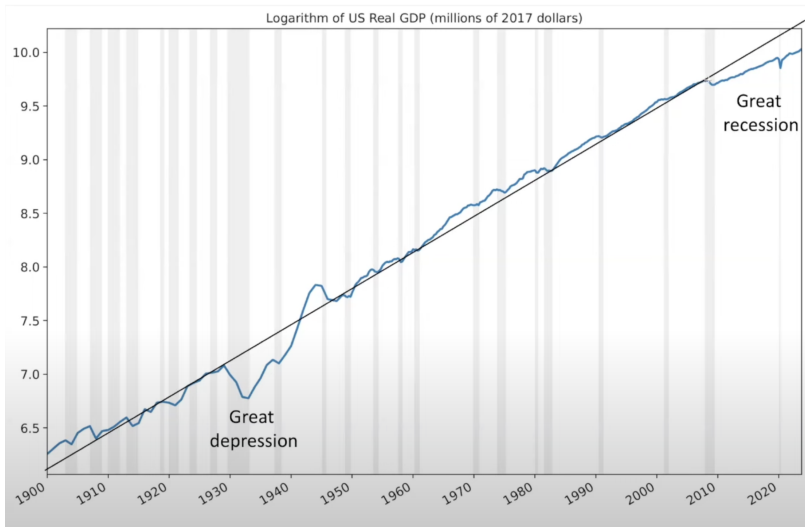
Hilary Term 2025

- OXFORD SAÏD BUSINESS SCHOOL -

Today: Outline

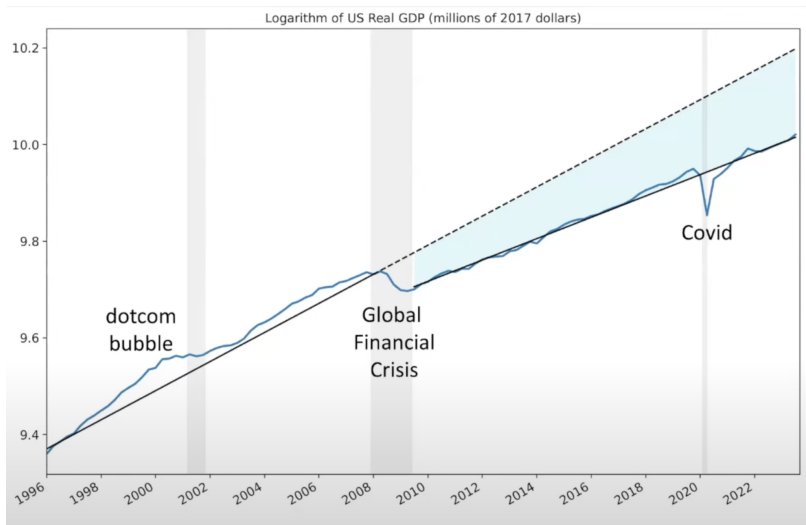
1. Questions and Introduction
2. Agency Problems and Financial Accelerator
3. Diamond-Dybvig Model
4. Contagion
5. Government Guarantees and Moral Hazard

What happened?



Source: Markus Brunnermeier

What happened?



Source: Markus Brunnermeier

Queen's Question

- *If these things were so large, how come everyone missed them? Why did nobody notice the "awful" financial crisis earlier?*[LSE - 2008]

[Financial Times - 2008]



Queen's Question

- ▶ *If these things were so large, how come everyone missed them? Why did nobody notice the "awful" financial crisis earlier?*[LSE - 2008]
- ▶ *Queen finally finds out why no one saw the financial crisis coming. Her Majesty gets the answer to her question – four years after she asked it – on a tour of the Bank of England* [Bank of England - 2012]

[Guardian - 2012]



Queen's Question

- ▶ *If these things were so large, how come everyone missed them? Why did nobody notice the "awful" financial crisis earlier?*[LSE - 2008]
- ▶ *Queen finally finds out why no one saw the financial crisis coming. Her Majesty gets the answer to her question – four years after she asked it – on a tour of the Bank of England* [Bank of England - 2012]

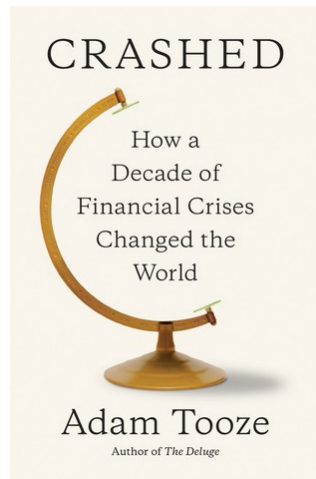
[[Financial Times - 2008](#)]

* Sorry Ma'am — we just didn't see it coming



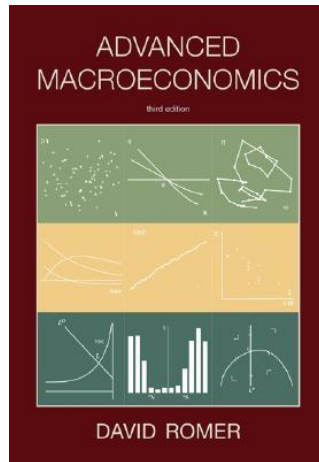
Why did we miss it? - Some books

- The economic crisis (the great recession) has changed the world and the way we understand economics.



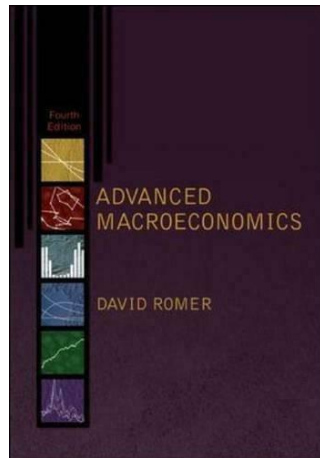
Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*



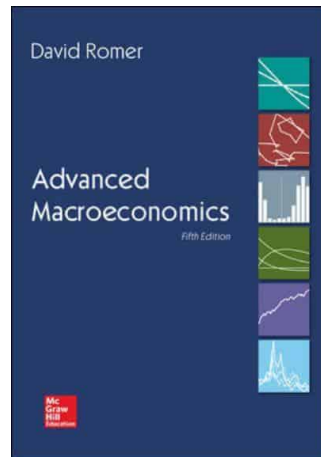
Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).



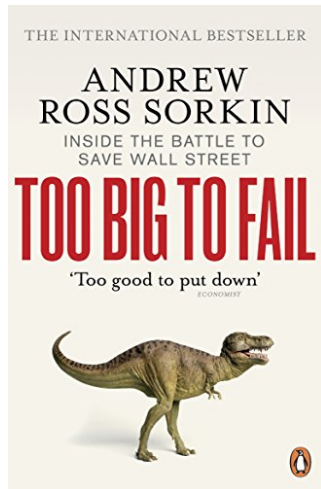
Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).
- ▶ Admitting that we got it wrong



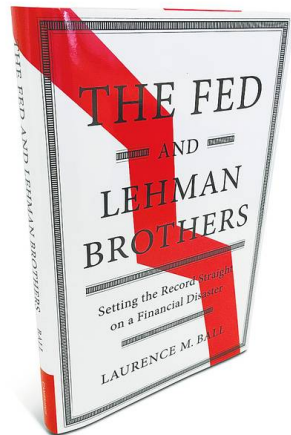
Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).
- ▶ Admitting that we got it wrong
- ▶ Action and reaction



Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).
- ▶ Admitting that we got it wrong
- ▶ Action and reaction
- ▶ The Fed did not rescue Lehman but rescued Bear Stearns and AIG. Why?

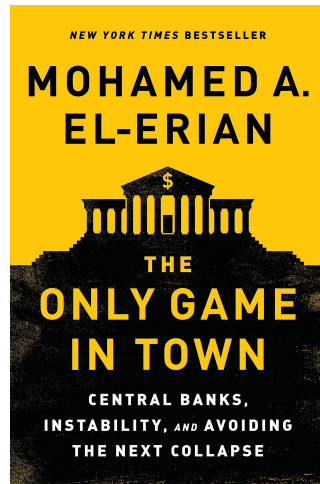


Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).
- ▶ Admitting that we got it wrong
- ▶ Action and reaction
- ▶ The Fed did not rescue Lehman but rescued Bear Stearns and AIG. Why?

Some extra reading:

- * Central banks & bankers became the central figures.



Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).
- ▶ Admitting that we got it wrong
- ▶ Action and reaction
- ▶ The Fed did not rescue Lehman but rescued Bear Stearns and AIG. Why?

Some extra reading:

- * Central banks & bankers became the central figures.
- * The new & most powerful main decision maker.

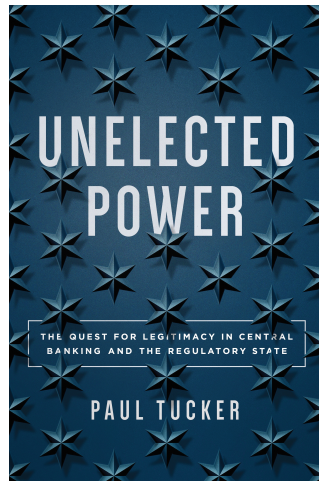


Why did we miss it? - Some books

- ▶ The economic crisis (the great recession) has changed the world and the way we understand economics.
- ▶ Not only an economic crisis but *crisis in economics*
- ▶ There was no chapter on financial crises in the textbook (and many other textbooks).
- ▶ Admitting that we got it wrong
- ▶ Action and reaction
- ▶ The Fed did not rescue Lehman but rescued Bear Stearns and AIG. Why?

Some extra reading:

- * Central banks & bankers became the central figures.
- * The new & most powerful main decision maker.
- * Unelected Power.



Introduction

Introduction

- ▶ In the models that we've seen so far the financial markets are perfect:
 - * Households save or borrow to satisfy their Euler equations.
 - * Firms borrow until the marginal product of capital = interest rate.
 - * There are no defaults or borrowing constraints.
- ▶ The Crisis of 2007-8 demonstrated that even in the advanced modern economies this description could not be further away from the truth.
- ▶ There has been a tremendous increase in macro-finance research.
- ▶ Major issues this research is interested in:
 - * Do financial markets amplify and propagate macroeconomic shocks?
 - * Are financial markets an independent source of shocks to the economy?
 - * Why do financial crises happen, and what should policymakers do? etc.

Plan of action

- ▶ There are potentially many different imperfections in the financial sector with important macroeconomic consequences.
- ▶ The literature is huge, and warrants a separate course.
- ▶ Today we will focus on three classic models that illustrate *some* of the most important issues in macro-finance:
 1. 'Real' financial frictions and financial accelerator
 2. Liquidity provision by banks and bank runs.
 3. Moral hazard created by government guarantees (time-permitting).
- ▶ We will discuss how these models fit in the modern macro-finance literature and help us shed light on complex events and policy choices.

Agency Problems and Financial Accelerator

What is an Agency Problem?

- ▶ An **agency problem** arises when two parties—**principals** and **agents**—have conflicting interests, and the agent has incentives to act in their own interests rather than those of the principal.
- ▶ Typically occurs when there is **asymmetric information**:
 - * Principals (e.g., investors, depositors) cannot easily observe or verify actions or decisions made by agents (e.g., managers, bankers).
 - * Agents thus have the opportunity and incentive to pursue their own objectives, potentially harming the principals.
- ▶ **Example from the 2008 Financial Crisis:**
 - * Bank executives (agents) took excessive risks (e.g., subprime mortgage lending) to maximize short-term profits and bonuses.
 - * Resulting losses primarily affected shareholders, depositors, and taxpayers (principals), highlighting severe agency problems.
- ▶ Addressing agency problems is crucial for financial stability and efficient economic outcomes.

Asymmetric information and agency problems in finance

- ▶ There are a lot of information asymmetries in the financial markets:
 - * Firms are much better informed about their prospects than investors.
 - * It may be difficult to tell good and bad entrepreneurs apart.
 - * Managers that have limited liability may invest in too risky projects.
 - * Firms' performance may be difficult to verify by external investors.
 - * Fund managers may not exert effort to make the best investments etc.
- ▶ We therefore have institutions like banks, mutual funds, and credit rating agencies that specialise in acquiring & transmitting information.
- ▶ But as became obvious during the 2008 Crisis, such institutions themselves may not be immune to agency problems.
- ▶ Asymmetric information and agency costs can distort investment choices, as well as magnify effects of shocks to the economy.

A simple model of moral hazard in financial intermediaries

- ▶ Several ways agency problems are modelled in the literature:
 - ⇒ **Costly state verification, adverse selection, moral hazard** etc.
- ▶ They all, however, have broadly similar implications:
 - * It is important that agents (e.g. banks or entrepreneurs) have enough **'skin in the game'**, i.e. their own resources they contribute to projects
 - * The wealth, or **'net worth'** of key players in the economy can thus have important macroeconomic consequences.
- ▶ Today we will focus on a particularly simple way to model moral hazard introduced by Gertler-Karadi (2011) & Gertler-Kiyotaki (2015) (simple 2-period model)
 - ⇒ **Banks can default and do a runner with their depositors' funds.**
- ▶ The model predicts that the net worth of the banking sector becomes crucial to the efficiency of financial intermediation.

Setup

- ▶ There are two periods $\{1, 2\}$.
- ▶ There are households, banks, and firms in the economy.
- ▶ Each household has a unit mass of members, including a banker.
- ▶ A banker runs a bank that provides services to other households.
 - * Generated profits shared with his own household.
- ▶ In period 1, a representative household has endowment y .
- ▶ Household deposits d with a bank in period 1.
- ▶ Deposits pay return R in period 2.
- ▶ Household receives profit π from the own banker in period 2.
- ▶ All members within a household consume the same amounts: c_1 in period 1, and c_2 in period 2.

Household problem

- ▶ A representative household maximizes utility:

$$\max_{c_1, c_2, d} U(c_1, c_2) = \sqrt{c_1} + \beta \sqrt{c_2} \quad (1)$$

- ▶ Subject to period 1 and 2 budget constraints:

$$c_1 + d = y \quad (2)$$

$$c_2 = Rd + \pi. \quad (3)$$

- ▶ Note that R and (lump-sum) π are treated as *given* by the household, but will be endogenously determined in the financial markets.
- ▶ Substitute constraints in and take the FOC to get the Euler equation:

$$\frac{1}{\sqrt{c_1}} = \beta \frac{1}{\sqrt{c_2}} R \quad \Longleftrightarrow \quad c_2 = c_1 (\beta R)^2 \quad (4)$$

For detailed explanation go to <https://macroeconomics.info/>.

Solution to household optimisation problem

- ▶ Three equations (2 BCs [(2) and (3)] + Euler [(4)]) and three unknowns: c_1 , c_2 , d .
- ▶ The solution is:

$$c_1 = \frac{y + \frac{\pi}{R}}{1 + \beta^2 R} \quad (5)$$

$$d = y - c_1 \quad (6)$$

$$c_2 = Rd + \pi \quad (7)$$

- ▶ Substitution effect dominates: c_1 is a decreasing function of R .
- ▶ Therefore, the supply of funds d by households increases in R .

Firms

- ▶ Produce goods for consumption in period 2.
- ▶ Constant return to scale technology: each unit of good invested in period 1 generates R^k goods in period 2 (R^k exogenously fixed).
- ▶ A representative firm borrows s from banks in period 1, and so generates sR^k in period 2.
- ▶ Firms are perfectly competitive, so entire return sR^k goes to banks.
- ▶ Note: Firms are unable to borrow directly from households.
 - ⇒ Think about banks as relationship lenders that are able to screen and monitor firms they lend to, while households are not.

Bankers

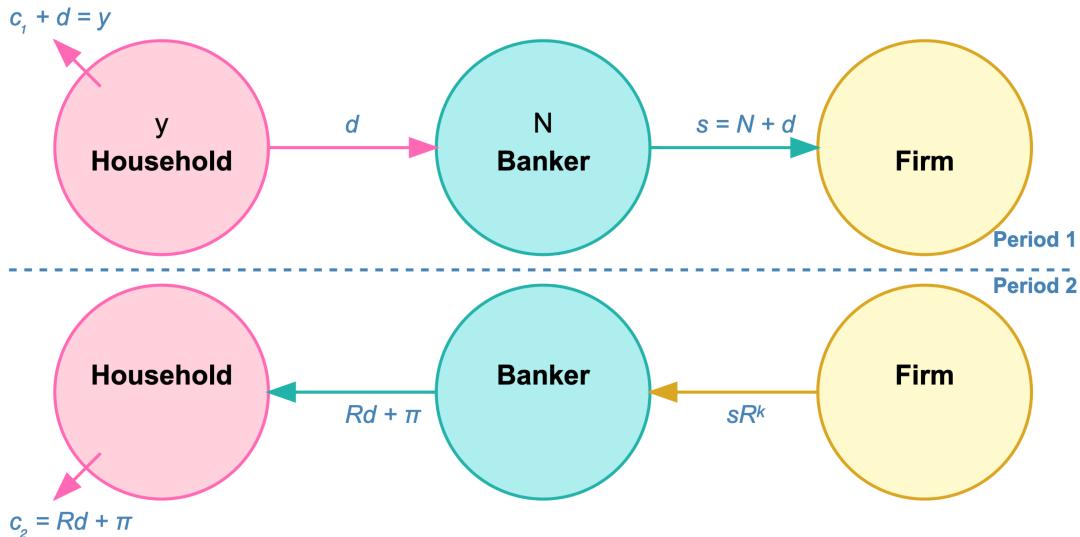
- ▶ A representative banker is endowed with N goods in period 1.
 - * This is in addition to their household's endowment y .
 - * We will refer to N as the banker's **net worth**.
- ▶ The bank accepts deposits d from households and lends s to firms.
- ▶ Takes market rates of returns on deposits R and loans R^k as given.
- ▶ Chooses d and s to solve

$$\max_{d,s} \pi = sR^k - Rd.$$

- ▶ Always maxes out on s , as loans pay positive return with certainty:

$$s = N + d.$$

Overview



Benchmark equilibrium: conditions

► Equilibrium requires three conditions:

1. **Household maximisation:** given R, π , solves

$$\max_{c_1, c_2, d} \sqrt{c_1} + \beta \sqrt{c_2} \quad (8)$$

$$\text{subject to: } c_1 + d = y, \quad c_2 = Rd + \pi. \quad (9)$$

2. **Banker maximisation:** given R, R^k , solves

$$\max_d \pi = (N + d)R^k - dR. \quad (10)$$

3. **Market clearing:**

$$\text{Deposits market: } d^{\text{household}} = d^{\text{banker}}, \quad (11)$$

$$\text{Securities market: } s = N + d. \quad (12)$$

Benchmark equilibrium: interest rate determination

- ▶ With no financial frictions, equilibrium requires:

$$R = R^k. \quad (13)$$

- ▶ Otherwise, contradictions arise:

- * If $R > R^k$, banks would set $d = 0$: no financial intermediation.
- * If $R < R^k$, banks' demand for deposits becomes infinite ($d \rightarrow \infty$).

Benchmark equilibrium: implications

- ▶ With $R = R^k$, bank profits are:

$$\pi = NR^k. \quad (14)$$

- ▶ Banks earn market returns on their own net worth N , but earn zero additional profits from deposits intermediation.
- ▶ Equilibrium outcomes c_1, c_2, d are computed explicitly:

$$c_1 = \frac{y + \frac{\pi}{R}}{1 + \beta^2 R}, \quad d = y - c_1, \quad c_2 = Rd + \pi. \quad (15)$$

- ▶ The resulting equilibrium is **first-best** (efficient allocation).

Introducing moral hazard

► Moral hazard à la Gertler-Karadi (2011):

- * Banks can default after receiving sR^k from firms in period 2.
- * If default occurs, banker absconds with a fraction θ of resources:

$\Rightarrow \theta R^k(N + d)$ goes to the banker, $(1 - \theta)R^k(N + d)$ goes to depositors.

► Banker does not default if:

$$\underbrace{(N + d)R^k - Rd}_{\text{Profit when no default}} \geq \underbrace{\theta R^k(N + d)}_{\text{Profit when default}} \quad (16)$$

► $N \uparrow$ increases LHS more than RHS, so makes default less likely.

► Real-world example (2008 Financial Crisis):

- * During the crisis, banks with low net worth (N) faced incentives to take excessive risks.

Case Study: Lehman Brothers.

For detailed explanation go to <https://macroeconomics.info/>.

Equilibrium with no defaults

- ▶ Without loss of generality (WLOG), we can **restrict attention to equilibria in which banks never default**:

- * If there is an equilibrium in which banks default, the effective return on deposits that households get (after default) is:

$$R^{\text{effective}} = \frac{(1 - \theta)R^k(N + d)}{d}. \quad (17)$$

- * Households anticipate the default, so use $R^{\text{effective}}$ rather than the promised return R when making their saving choices d .
- * But then there is also an equivalent equilibrium in which $R = R^{\text{effective}}$:
 - + households supply the **same amount of savings** d .
 - + banks do not default, since (16) holds with equality (easy to verify).

- ▶ Thus, we look for a symmetric equilibrium with no default:

1. Household maximises utility given R, π .
2. Banker maximises profit given R, R^k , and **no default condition** (16).
3. Markets clear.

The Banker's Problem

- ▶ The representative banker explicitly solves:

$$\max_d \pi = (N + d)R^k - Rd \quad (18)$$

$$\text{s.t.} \quad (N + d)R^k - Rd \geq \theta R^k (N + d) \quad (19)$$

- ▶ The no-default constraint ensures:

- * Banker profits without default (LHS) **at least equal** profits from defaulting and capturing fraction θ of assets (RHS).

- ▶ Two possible equilibrium scenarios clearly arise:

1. **Slack constraint:** $(N + d)R^k - Rd > \theta R^k (N + d)$
2. **Binding constraint:** $(N + d)R^k - Rd = \theta R^k (N + d)$

Slack Constraint (Inequality holds strictly):

$$(N + d)R^k - Rd > \theta R^k(N + d)$$

- ▶ **Intuition:** The banker is comfortably above the default threshold.
- ▶ In other words, there's extra "room"—the banker is not close to defaulting.
- ▶ Under these circumstances, the constraint does not actively limit the banker's decisions. The banker makes choices exactly as if no moral hazard existed.
- ▶ Therefore, equilibrium mirrors the frictionless benchmark:
 - * Interest rate R exactly equals return on capital R^k .
 - * We explicitly get the "first-best" efficient allocation.

Binding Constraint (Inequality holds exactly):

$$(N + d)R^k - Rd = \theta R^k (N + d)$$

- ▶ **Intuition:** The banker is exactly at the boundary of defaulting.
- ▶ There's no "extra room." If the banker accepts even slightly more deposits, the banker would default.
- ▶ Hence, the constraint actively shapes the banker's choices:
 - * The banker cannot accept unlimited deposits.
 - * To prevent default, the banker must limit deposit-taking and possibly pay a lower rate R .
 - * Financial friction emerges clearly—banks restrict lending, deposits, and investment fall below the optimal (first-best) levels.
- ▶ Therefore, equilibrium becomes "second-best," clearly characterized by:
 - * Interest rate spread emerges: the deposit rate R is strictly below the return on capital R^k .
 - * This spread explicitly captures inefficiency due to moral hazard and default risk.

Why banks cannot raise unlimited deposits?

- ▶ Rewrite and simplify clearly:

$$(N + d)R^k(1 - \theta) \geq Rd$$

- ▶ As banks increase deposits d :

- * LHS grows at rate $R^k(1 - \theta)$ (honest returns).
- * RHS grows at rate R (promised returns to depositors).

- ▶ If $R < R^k(1 - \theta)$:

- * The LHS grows faster than RHS as d increases. In this scenario, the bank can keep raising deposits comfortably without defaulting.

- ▶ If $R > R^k(1 - \theta)$:

- * Bank liabilities grow faster than safe returns.
- * Eventually, the no-default constraint binds:

$$(N + d^*)R^k(1 - \theta) = Rd^*$$

- * For $d > d^*$, default incentives trigger.

- ▶ Thus, banks face an explicit upper limit on safe deposits due to default incentives.

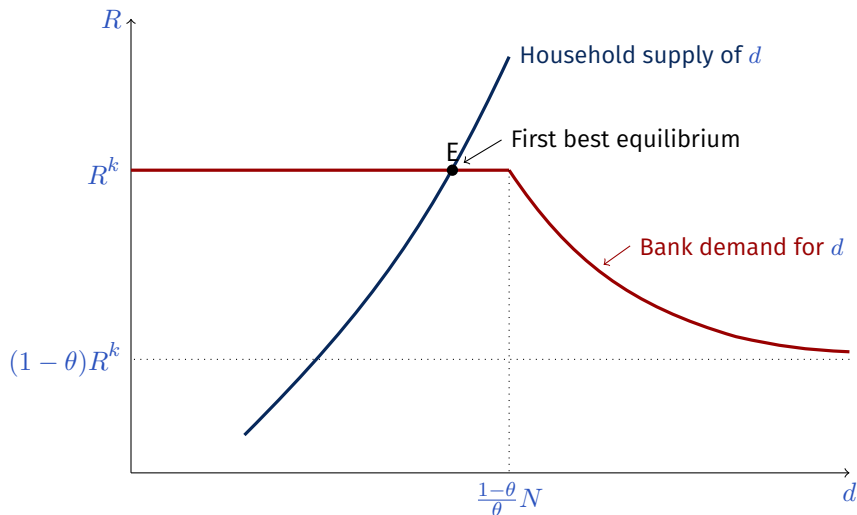
Case 1: The financial constraint is slack

- ▶ If the no-default constraint (19) is slack, then it is irrelevant, and analysis in the benchmark case applies.
- ▶ Thus $R = R^k$ and we again have the **first-best allocation**.
- ▶ This is indeed the equilibrium iff (19) is satisfied at $R = R^k$.
- ▶ Substituting for R and rearranging, yields:

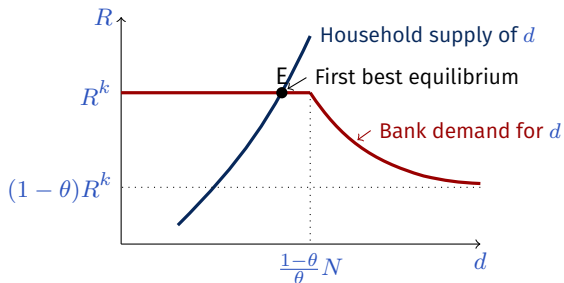
$$d \leq \frac{1-\theta}{\theta} N \quad \text{or} \quad N \geq \frac{\theta}{1-\theta} d \quad (20)$$

- ▶ That is, the net worth of the banking sector has to be sufficiently high relative to the supply of funds by households.
- ▶ **Intuition:** high N implies bankers have enough ‘skin in the game’.

First-best equilibrium when N is high



First-best equilibrium when N is high



► Equilibrium (E):

- * Intersection of supply and demand at $R = R^k$.
- * Efficient (first-best) outcome with no default risk.

► Critical Threshold ($\frac{1-\theta}{\theta}N$) explicitly identifies the maximum level of deposits banks can safely accept without default incentives:

- * For $d \leq \frac{1-\theta}{\theta}N$, the **constraint remains slack**, banks pay $R = R^k$.

► Intuition (high N): Banks have sufficient net worth ("skin in the game"), preventing moral hazard and default incentives.

Case 2: the financial constraint binds

- ▶ The financial constraint (19) binds in equilibrium when N is low, i.e.

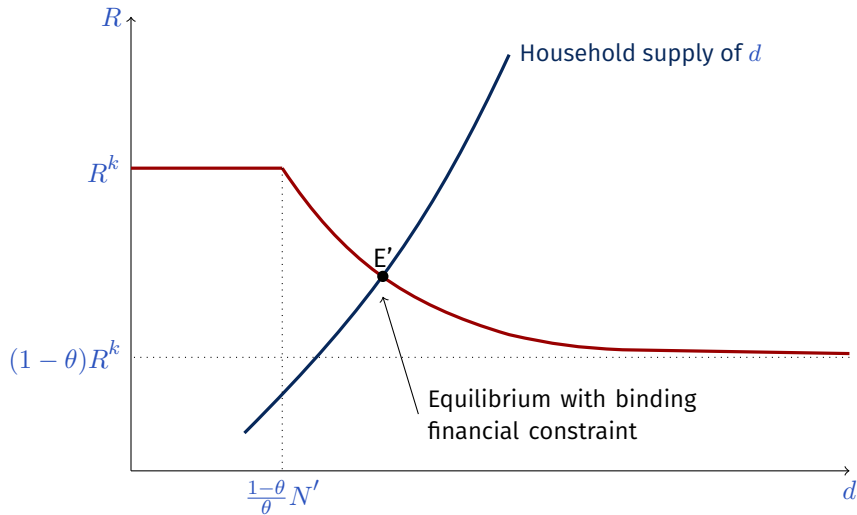
$$N < \frac{\theta}{1-\theta}d. \quad (21)$$

- ▶ Banks' demand for deposits is now a decreasing function of R .
- ▶ Indeed, binding (19) yields a downward-sloping curve in (d, R) space:

$$R = (1-\theta)R^k \left(\frac{N}{d} + 1 \right). \quad (22)$$

- ▶ **Intuition:** as d increases relative to N , banks have a stronger incentive to default, so R must fall to reduce their liabilities Rd .
- ▶ Equilibrium obtains where the household supply of d intersects (22).

Equilibrium when banks' net worth is low



Role of banker net worth

- ▶ Note that $R < R^k$ when the financial constraint binds in equilibrium.
- ▶ Thus there is a **positive spread** between the exogenous return R^k on technology and the deposit rate R .
 - $\Rightarrow R$ and d are less than socially optimal.
- ▶ Can verify by rearranging the binding constraint (19) and using (21):

$$\frac{R^k - R}{R^k} = \theta - (1 - \theta) \frac{N}{d} > 0. \quad (23)$$

- ▶ $N \uparrow$ raises R nearer to R^k .
- ▶ $N \uparrow$ thus brings financial intermediation closer to the first best.
- ▶ Explains the desire to repair bank balance sheets after 2008-9 crisis.

The Incentive Constraint and Net Worth

- ▶ The core friction in the Gertler-Kiyotaki model is the incentive compatibility constraint:

$$(1 - \theta)(N + d)R^k \geq dR$$

- * Left side: Banker's return from operating honestly
- * Right side: Banker's return from defaulting on deposits
- ▶ Rearranging for maximum sustainable debt:

$$d \leq \frac{(1 - \theta)NR^k}{R - (1 - \theta)R^k}$$

- ▶ **Critical Insight:** Sustainable debt is proportional to net worth N
 - * When $N \downarrow \Rightarrow$ sustainable debt $d \downarrow$
 - * This leverage effect creates the foundation for the financial accelerator
- ▶ The constraint becomes more binding as:
 - * θ increases (moral hazard worsens)
 - * R^k decreases (return on assets falls)
 - * R increases (funding costs rise)

The Amplification Mechanism

- **Financial Accelerator:** Mathematical representation of amplification

- 1. Initial shock reduces bank net worth: $\Delta N < 0$
- 2. Change in maximum sustainable debt:

$$\Delta d = \frac{\partial d}{\partial N} \Delta N = \frac{(1 - \theta)R^k}{R - (1 - \theta)R^k} \Delta N$$

- 3. Leverage multiplier (amplification factor):

$$\mu = \frac{\Delta d}{\Delta N} = \frac{(1 - \theta)R^k}{R - (1 - \theta)R^k}$$

- 4. Total balance sheet contraction:

$$\Delta(N + d) = \Delta N \cdot (1 + \mu) = \Delta N \cdot \left(1 + \frac{(1 - \theta)R^k}{R - (1 - \theta)R^k} \right)$$

- **Example:** With $\theta = 0.3$, $R^k = 0.08$, $R = 0.05$:

- * Leverage multiplier: $\mu = \frac{0.7 \times 0.08}{0.05 - 0.7 \times 0.08} \approx 5.6$
- * A \$1 fall in N forces a \$5.6 reduction in debt capacity
- * Total balance sheet contraction: \$6.6 per \$1 of net worth loss

Dynamic Propagation of Shocks

- ▶ The multi-period model shows how shocks propagate dynamically:
- ▶ **Initial Impact** (Period t):

$$\Delta N_t < 0 \Rightarrow \Delta d_t = \mu \cdot \Delta N_t \Rightarrow \Delta s_t = \Delta N_t + \Delta d_t = (1 + \mu)\Delta N_t$$

- ▶ **Real Economy Effects** (Period $t + 1$):

$$\Delta k_{t+1} = \Delta s_t < 0 \quad (\text{Reduced investment in capital})$$

$$\Delta y_{t+1} = MPK \cdot \Delta k_{t+1} < 0 \quad (\text{Output falls})$$

$$\Delta \pi_{t+1} = \Delta(R^k s_t - R d_t) < 0 \quad (\text{Bank profits decline})$$

Dynamic Propagation of Shocks

- **Feedback to Financial Sector** (End of Period $t + 1$):

$$\Delta N_{t+1} = \Delta \pi_{t+1} < 0$$

- **The Recursive Cycle** continues in subsequent periods:

$$\Delta N_t \rightarrow \Delta s_t \rightarrow \Delta y_{t+1} \rightarrow \Delta \pi_{t+1} \rightarrow \Delta N_{t+1} \rightarrow \Delta s_{t+1} \rightarrow \dots$$

- This creates persistent effects from temporary shocks
- The cycle's strength depends on:
 - * Leverage multiplier μ (higher leverage = stronger propagation)
 - * Marginal productivity of capital (higher MPK = stronger output effects)
 - * Bank profit sensitivity to output conditions

Asset Prices and Collateral Amplification

- ▶ Adding asset price dynamics creates an even more powerful accelerator:

- ▶ **Asset Market Clearing:**

$$p_t \cdot a_t = N_t + d_t$$

where p_t is asset price and a_t is quantity of assets

- ▶ **Price-Net Worth Feedback Loop:**

$$\Delta N_t < 0 \quad (\text{Initial shock})$$

$$\Rightarrow \Delta d_t = \mu \cdot \Delta N_t < 0 \quad (\text{Debt capacity falls})$$

$$\Rightarrow \Delta(N_t + d_t) = (1 + \mu)\Delta N_t < 0 \quad (\text{Purchasing power falls})$$

$$\Rightarrow \Delta p_t < 0 \quad (\text{Asset prices decline})$$

$$\Rightarrow \Delta(p_t \cdot a_t) < 0 \quad (\text{Asset values fall})$$

$$\Rightarrow \Delta N_{t+1} < 0 \quad (\text{Net worth further deteriorates})$$

- ▶ **Policy Implications:**

- * Small initial shocks can generate large fluctuations
- * Capital injections ($\Delta N > 0$) can break the negative cycle
- * Countercyclical capital requirements reduce amplification
- * Asset purchase programs can stabilize prices and halt the cycle
- * The system becomes highly nonlinear when R approaches $(1 - \theta)R^k$

What have we achieved?

- ▶ We have seen a simple model in which a fall in net worth of banks can lead to a fall in lending, and distort investment.
 - * Theory not limited to banks, and applies also to firms, households, etc.
 - * Alternative formulations of agency problems lead to similar conclusions.
- ▶ Because the model does not feature money or any role for liquidity, these mechanisms are known as **real financial frictions**.
- ▶ Financial frictions are present and cause welfare losses all the time:
 - * Significant empirical evidence that there're financially constrained firms,
 - * implying that average investment may be inefficiently low, while
 - * business cycles are amplified and propagated by financial accelerator.
- ▶ But agency problems can become particularly bad during crises:
 - * Baron et al (2020) document that large declines in bank equity are associated with substantial credit contractions and output losses.
 - * Financial accelerator can make the situation a lot worse.
- ▶ We now turn to the issues of liquidity.

Diamond-Dybvig Model

What Just Happened March 2023 ?



- ▶ **2021 The most profitable year ever** — 40-year-old bank.
- ▶ **16th Largest Bank**
- ▶ **Hub of Tech Start-up**

- ▶ **Friday, March 10** — Silicon Valley Bank (SVB) collapsed. Biggest banking collapse in the US since 2008.
- ▶ **Sunday, March 12** — FDIC shut down Signature Bank after a run on deposits.
- ▶ **Wednesday, March 15** — Swiss authorities announced a backstop for Credit Suisse after shares collapsed.
- ▶ **Thursday, March 16** — First Republic Bank teetered. US Treasury and JP Morgan provided support, but it **collapsed May 1, 2023**.
- ▶ **Sunday, March 19** — UBS agreed to buy Credit Suisse in an emergency rescue deal.

Power of Bad News

YouTube Video (Click to Open)

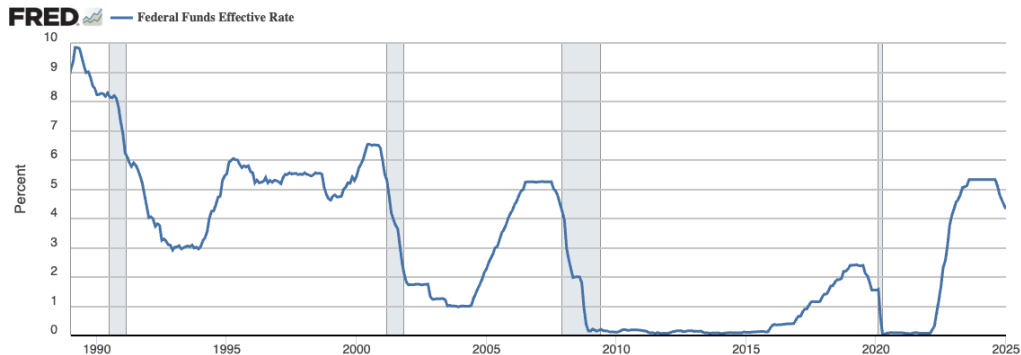
Power of Bad News



The Metro Bank hoax shows the immense power of fake news on WhatsApp



The U.S. Federal Funds Rate since 1990



Source: Board of Governors of the Federal Reserve System (US) via FRED®
Shaded areas indicate U.S. recessions.

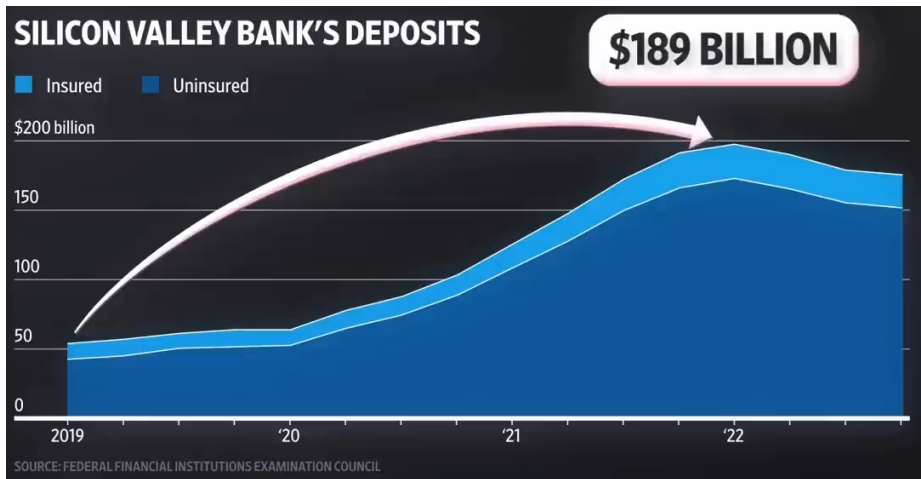
fred.stlouisfed.org

Interactive Chart (Click to Open)

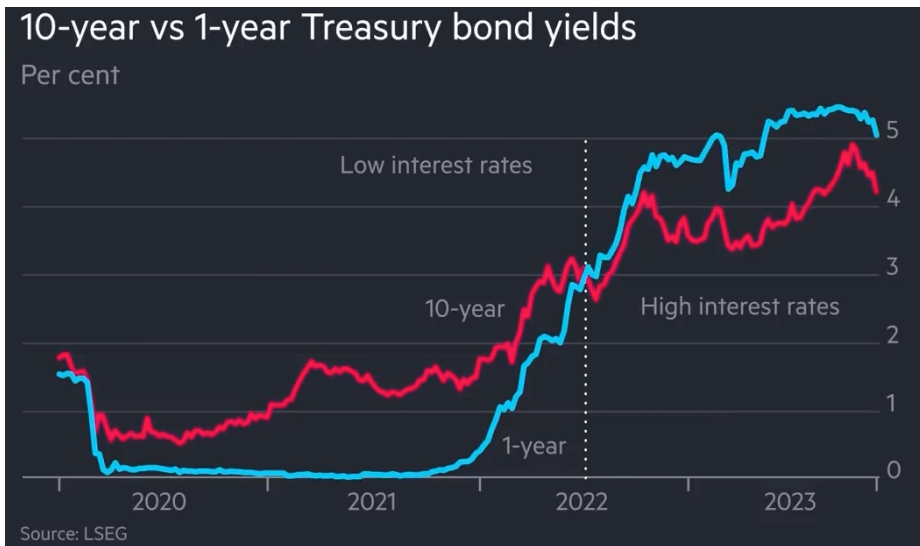
Hub of Tech Companies



The Good Old Days



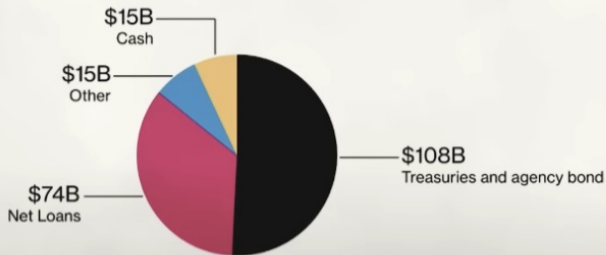
The Good Old Days



The Good Old Days

SVB Had More Than Half Its Assets in Treasuries and Agencies

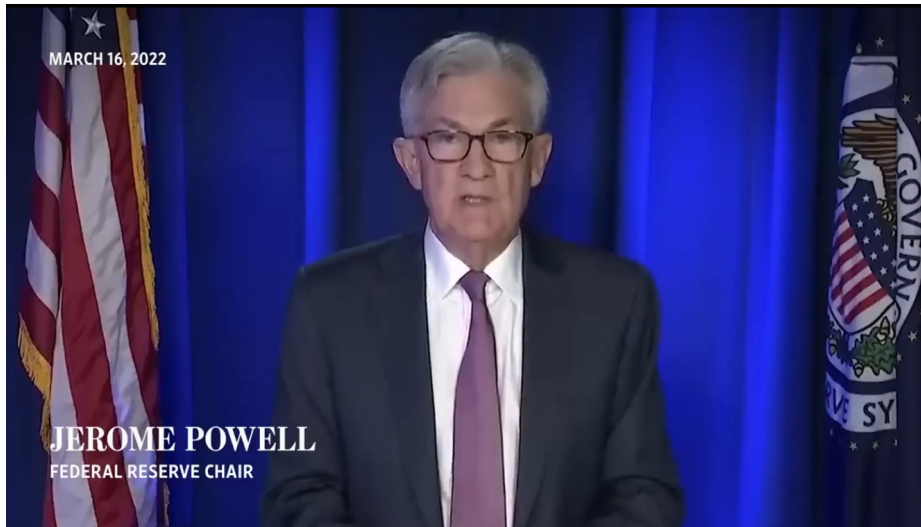
SVB Financial's assets by category



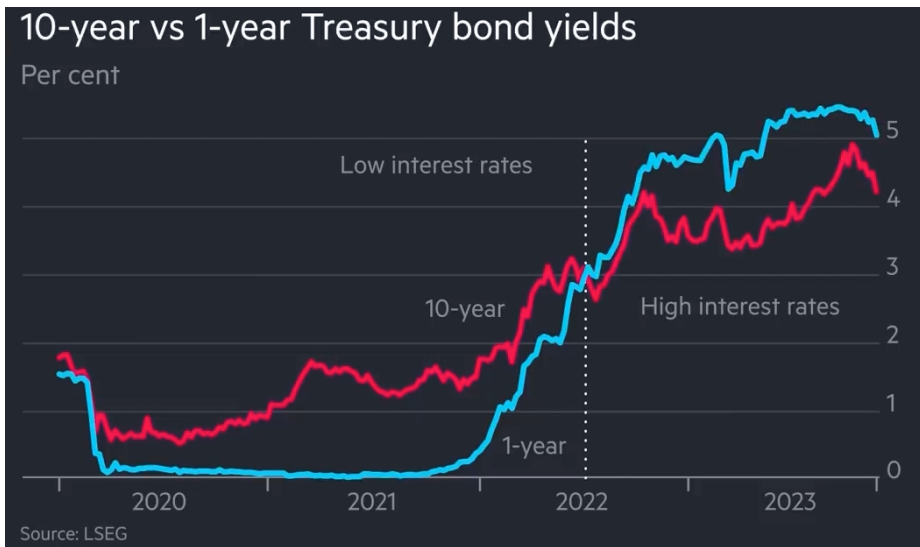
Source: Company presentation

Note: Figures as of end of December

Fed Sent shockwaves



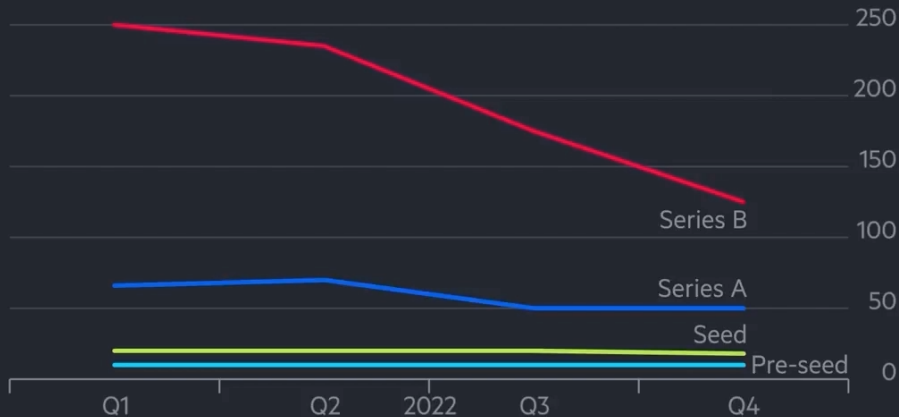
The Good Old Days



The Good Old Days

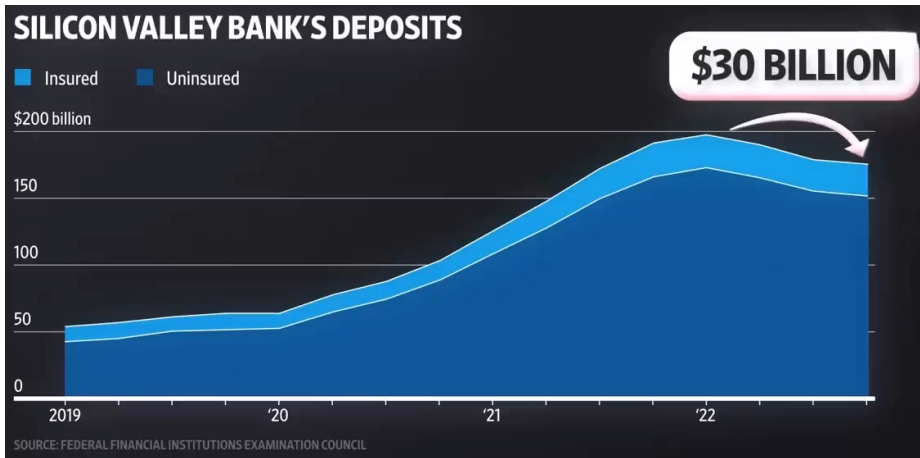
Median valuations for US early-stage start-ups

Quarter-on-quarter, 2022 (\$mn)

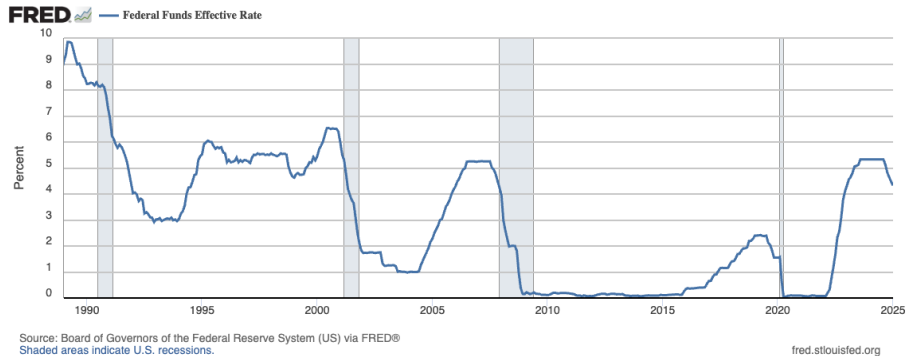


Source: AngelList

A little more withdraw

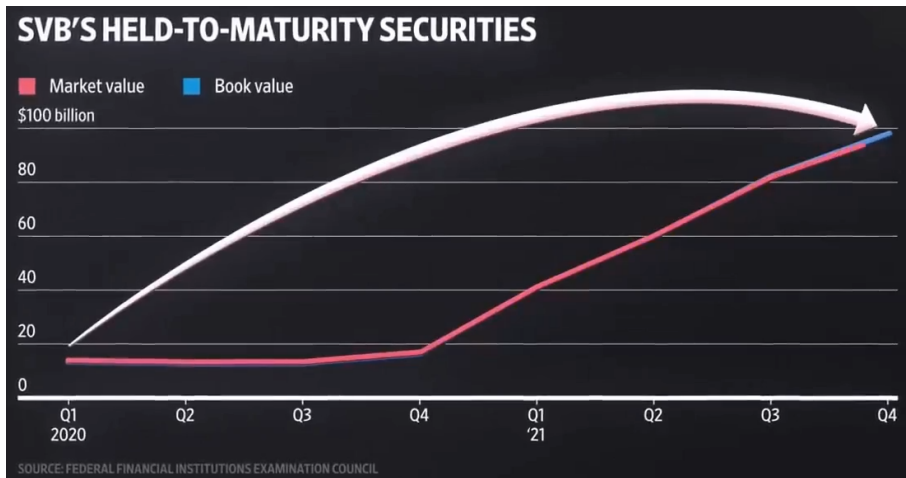


A long-term change

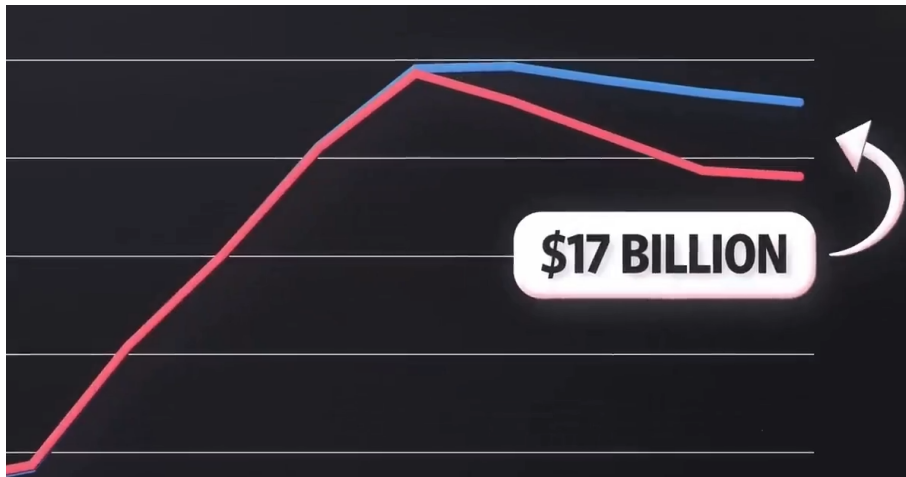


Interactive Chart (Click to Open)

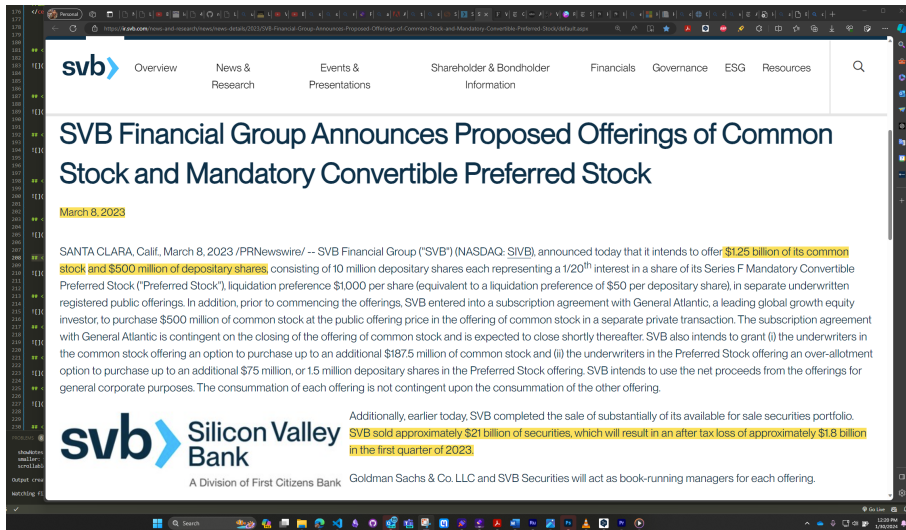
A long-term change



A long-term change



Spark that will set the whole place on fire



The screenshot shows the SVB Financial Group website. The header includes the SVB logo and navigation links: Overview, News & Research, Events & Presentations, Shareholder & Bondholder Information, Financials, Governance, ESG, and Resources. The main headline reads: "SVB Financial Group Announces Proposed Offerings of Common Stock and Mandatory Convertible Preferred Stock". Below the headline is the date "March 8, 2023". The body of the press release states: "SANTA CLARA, Calif., March 8, 2023 /PRNewswire/ -- SVB Financial Group ("SVB") (NASDAQ: SIVB), announced today that it intends to offer \$1.25 billion of its common stock and \$500 million of depositary shares, consisting of 10 million depositary shares each representing a 1/20th interest in a share of its Series F Mandatory Convertible Preferred Stock ("Preferred Stock"), liquidation preference \$1,000 per share (equivalent to a liquidation preference of \$50 per depositary share), in separate underwritten registered public offerings. In addition, prior to commencing the offerings, SVB entered into a subscription agreement with General Atlantic, a leading global growth equity investor, to purchase \$500 million of common stock at the public offering price in the offering of common stock in a separate private transaction. The subscription agreement with General Atlantic is contingent on the closing of the offering of common stock and is expected to close shortly thereafter. SVB also intends to grant (i) the underwriters in the common stock offering an option to purchase up to an additional \$187.5 million of common stock and (ii) the underwriters in the Preferred Stock offering an over-allotment option to purchase up to an additional \$75 million, or 1.5 million depositary shares in the Preferred Stock offering. SVB intends to use the net proceeds from the offerings for general corporate purposes. The consummation of each offering is not contingent upon the consummation of the other offering." Below the main text is the SVB logo and the text "Silicon Valley Bank" and "A Division of First Citizens Bank". To the right of the logo, it says "Additionally, earlier today, SVB completed the sale of substantially of its available for sale securities portfolio. SVB sold approximately \$21 billion of securities, which will result in an after tax loss of approximately \$1.8 billion in the first quarter of 2023." At the bottom, it says "Goldman Sachs & Co. LLC and SVB Securities will act as book-running managers for each offering."

svb> Overview News & Research Events & Presentations Shareholder & Bondholder Information Financials Governance ESG Resources

SVB Financial Group Announces Proposed Offerings of Common Stock and Mandatory Convertible Preferred Stock

March 8, 2023

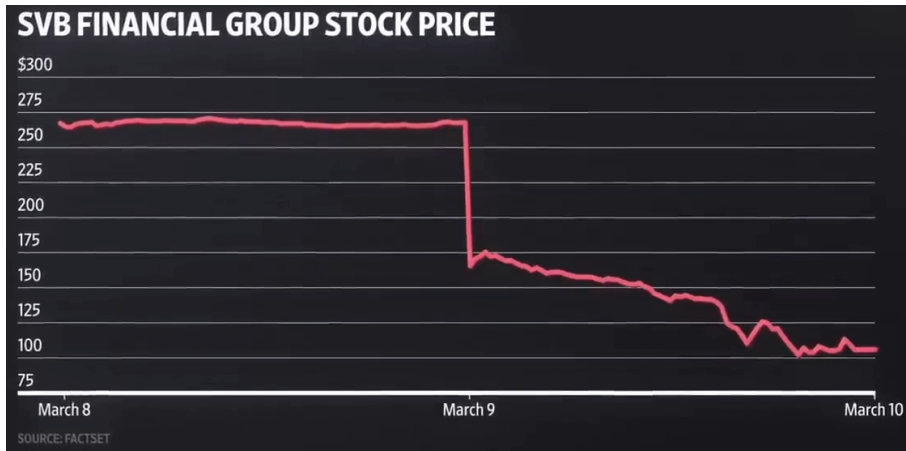
SANTA CLARA, Calif., March 8, 2023 /PRNewswire/ -- SVB Financial Group ("SVB") (NASDAQ: SIVB), announced today that it intends to offer \$1.25 billion of its common stock and \$500 million of depositary shares, consisting of 10 million depositary shares each representing a 1/20th interest in a share of its Series F Mandatory Convertible Preferred Stock ("Preferred Stock"), liquidation preference \$1,000 per share (equivalent to a liquidation preference of \$50 per depositary share), in separate underwritten registered public offerings. In addition, prior to commencing the offerings, SVB entered into a subscription agreement with General Atlantic, a leading global growth equity investor, to purchase \$500 million of common stock at the public offering price in the offering of common stock in a separate private transaction. The subscription agreement with General Atlantic is contingent on the closing of the offering of common stock and is expected to close shortly thereafter. SVB also intends to grant (i) the underwriters in the common stock offering an option to purchase up to an additional \$187.5 million of common stock and (ii) the underwriters in the Preferred Stock offering an over-allotment option to purchase up to an additional \$75 million, or 1.5 million depositary shares in the Preferred Stock offering. SVB intends to use the net proceeds from the offerings for general corporate purposes. The consummation of each offering is not contingent upon the consummation of the other offering.

svb> Silicon Valley Bank
A Division of First Citizens Bank

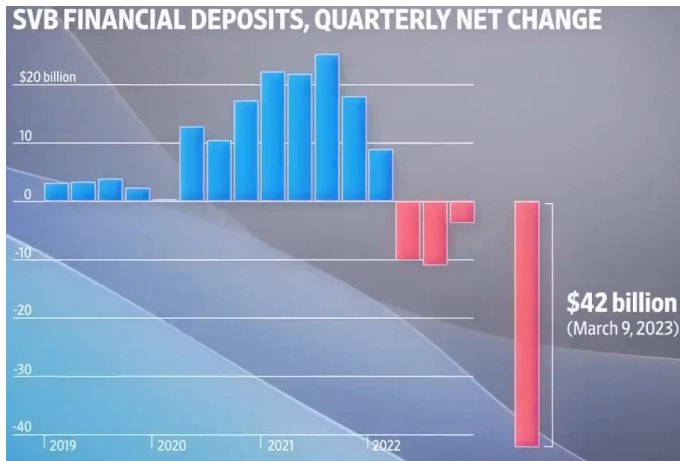
Additionally, earlier today, SVB completed the sale of substantially of its available for sale securities portfolio. SVB sold approximately \$21 billion of securities, which will result in an after tax loss of approximately \$1.8 billion in the first quarter of 2023.

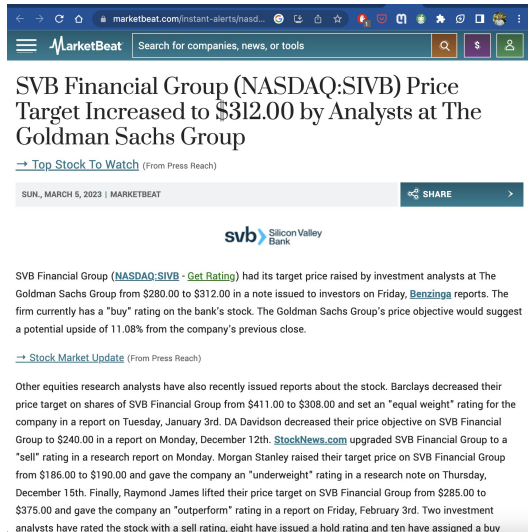
Goldman Sachs & Co. LLC and SVB Securities will act as book-running managers for each offering.

Beginning of the end



The End





The screenshot shows a web browser displaying a MarketBeat article. The browser's address bar shows the URL 'marketbeat.com/instant-alerts/nasd...'. The MarketBeat logo is in the top left, and a search bar is in the top center. The article title is 'SVB Financial Group (NASDAQ:SIVB) Price Target Increased to \$312.00 by Analysts at The Goldman Sachs Group'. Below the title is a link to 'Top Stock To Watch' with the text '(From Press Reach)'. A date bar indicates 'SUN., MARCH 5, 2023 | MARKETBEAT' and a 'SHARE' button. The SVB Silicon Valley Bank logo is centered. The article text states that SVB Financial Group's target price was raised from \$280.00 to \$312.00 by investment analysts at The Goldman Sachs Group on Friday, according to Benzinga reports. The firm currently has a 'buy' rating on the bank's stock. The Goldman Sachs Group's price objective would suggest a potential upside of 11.08% from the company's previous close. Below this, a 'Stock Market Update' link is shown. The text continues by mentioning other research analysts: Barclays decreased their price target from \$411.00 to \$308.00 and set an 'equal weight' rating; DA Davidson decreased their price objective to \$240.00; StockNews.com upgraded SVB Financial Group to a 'sell' rating; Morgan Stanley raised their target price to \$190.00 and gave an 'underweight' rating; and Raymond James lifted their price target from \$285.00 to \$375.00 and gave an 'outperform' rating. Finally, it notes that two investment analysts have rated the stock with a sell rating, eight have issued a hold rating, and ten have assigned a buy rating.

marketbeat.com/instant-alerts/nasd...

MarketBeat Search for companies, news, or tools

SVB Financial Group (NASDAQ:SIVB) Price Target Increased to \$312.00 by Analysts at The Goldman Sachs Group

[→ Top Stock To Watch](#) (From Press Reach)

SUN., MARCH 5, 2023 | MARKETBEAT [SHARE](#)

svb Silicon Valley Bank

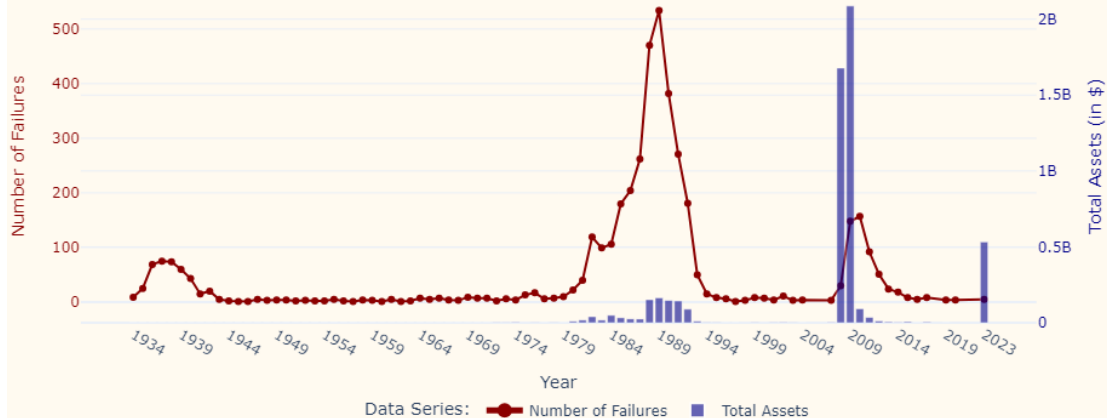
SVB Financial Group ([NASDAQ:SIVB](#) - [Get Rating](#)) had its target price raised by investment analysts at The Goldman Sachs Group from \$280.00 to \$312.00 in a note issued to investors on Friday, [Benzinga](#) reports. The firm currently has a "buy" rating on the bank's stock. The Goldman Sachs Group's price objective would suggest a potential upside of 11.08% from the company's previous close.

[→ Stock Market Update](#) (From Press Reach)

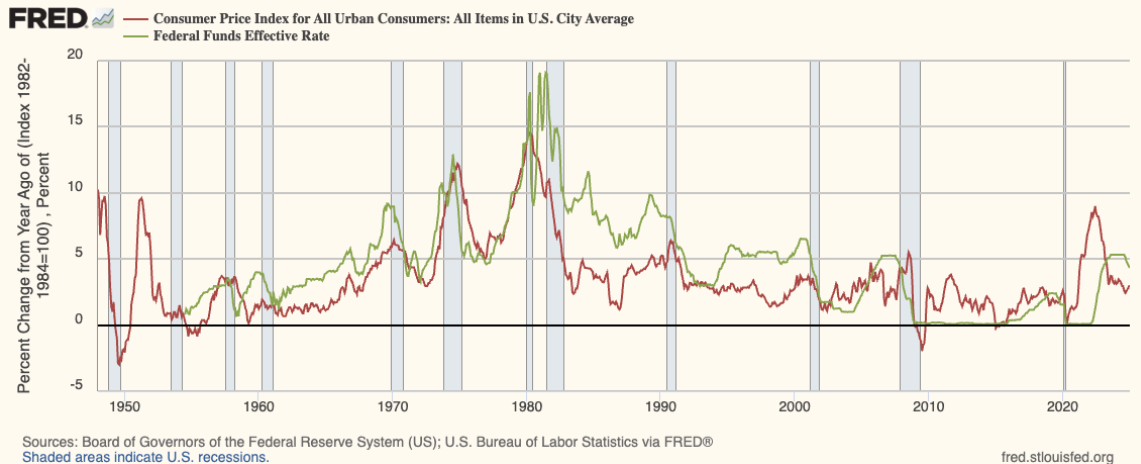
Other equities research analysts have also recently issued reports about the stock. Barclays decreased their price target on shares of SVB Financial Group from \$411.00 to \$308.00 and set an "equal weight" rating for the company in a report on Tuesday, January 3rd. DA Davidson decreased their price objective on SVB Financial Group to \$240.00 in a report on Monday, December 12th. [StockNews.com](#) upgraded SVB Financial Group to a "sell" rating in a research report on Monday. Morgan Stanley raised their target price on SVB Financial Group from \$186.00 to \$190.00 and gave the company an "underweight" rating in a research note on Thursday, December 15th. Finally, Raymond James lifted their price target on SVB Financial Group from \$285.00 to \$375.00 and gave the company an "outperform" rating in a report on Friday, February 3rd. Two investment analysts have rated the stock with a sell rating, eight have issued a hold rating and ten have assigned a buy

Lessons from [Financial] History?

Bank Failures and Total Assets in the US Over Time



Lesson from Financial History?

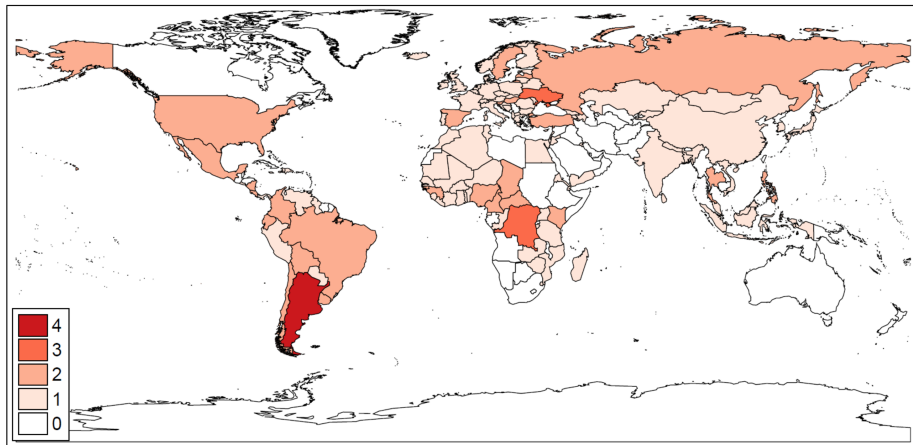


Interactive Chart (Click to Open)

Regulation $\neq$ Bureaucracy

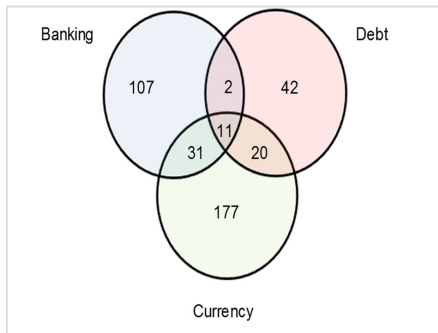
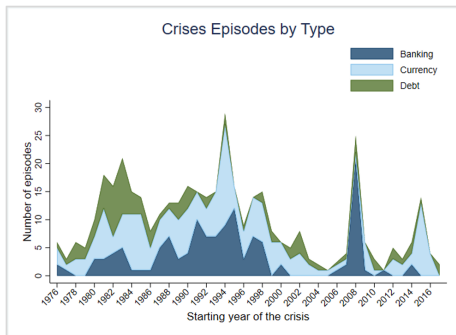
YouTube Video (Click to Open)

Not Just US and Not Just in 2023



Laeven, M.L. and Valencia, M.F., 2018. Systemic banking crises revisited. IMF.

Not Just the US and Not Just in 2023



Laeven, M.L. and Valencia, M.F., 2018. Systemic banking crises revisited. IMF.

Models that explain banking

FINANCIAL TIMES

Search icon

Silicon Valley Bank Added

Top Fed official blasts SVB collapse as 'textbook case of mismanagement'

Michael Barr said US central bank's board had been briefed on troubles at California lender in mid-February



In testimony released ahead of an expected grilling on SVB's failure by US lawmakers on Tuesday, Michael Barr, the Fed's vice-chair for supervision, criticised the bank's 'concentrated business model' © Bloomberg

James Politi and Lauren Fedor in Washington MARCH 27 2023

127

- ▶ Diamond & Dybvig (JPE, 1983): Banking Crises & Expectation [We will look at this model mainly.]
- ▶ Milgrom & Roberts (Economics, Organization and Management, 1992): Banking Crises & Moral Hazard
- ▶ Gertler & Karadi (JME, 2011): Agency Costs and Bank Capital
- ▶ Gertler & Kiyotaki (AER, 2015): Combining Financial Accelerator Effects and Bank Runs

Diamond-Dybvig (1983) model: an overview

- ▶ Financial markets are subject to sudden, convulsive changes.
 - * A bank that appears to function normally can suddenly be in trouble.
 - * Financial crises typically unfold very rapidly.
- ▶ In the seminal paper, Diamond and Dybvig (1983) model **bank runs** as a spontaneous switch between **multiple equilibria**.
- ▶ Both earned a Nobel prize in 2022 for this work!
- ▶ The model makes two fundamental predictions:
 1. Banks improve social welfare because they **provide liquidity**;
 2. But bank runs are possible exactly because banks' liabilities are liquid.
- ▶ Key: **maturity mismatch** of banks' liquid liabilities & illiquid assets.

Setup

- ▶ There are three periods, denoted $\{0, 1, 2\}$.
- ▶ There is a continuum of agents of mass 1.
- ▶ Each agent is endowed with 1 unit of consumption good in period 0.
- ▶ **Investment technology:** each unit invested in period 0 yields
 - * $R > 1$ if held to maturity in period 2;
 - * only 1 if the project is liquidated in period 1.
- ▶ Agents can also freely store the good between periods.
- ▶ Because the investment technology dominates storage (since it pays out at least 1), all endowments are invested in period 0.
- ▶ Agents decide whether to liquidate projects in period 1, and how much to consume in periods 1 and 2, c_1 and c_2 , respectively.

Types of agents and liquidity shocks

- ▶ 2 types of agents in the economy:

- * **'type-a'**, or **'impatient'** individuals only value consumption in period 1:

$$U^a = \ln c_1^a. \quad (24)$$

- * **'type-b'**, or **'patient'** agents are willing to consume in period 1 or 2:

$$U^b = \rho \ln(c_1^b + c_2^b), \quad \rho \in (0, 1), \quad \rho R > 1. \quad (25)$$

- ▶ $\rho < 1$ implies that impatient agents value consumption more.

- ▶ All agents are identical ex ante: type is unknown in period 0.
- ▶ In period 1, a fraction $\theta \in (0, 1)$ of agents learn that they are **type-a**, and a fraction $1 - \theta$ learn that they are **type-b**.
 - * Each agent thus faces a probability θ of being impatient ex ante.
 - * Once realised, an individual's type is not observable by others.
- ▶ 'Impatience' here is a metaphor for **liquidity needs** more generally.
 - * e.g. an entrepreneur may need liquidity to pursue unexpected investment opportunities.

Benchmark 1: competitive equilibrium

- ▶ Agents hold investments directly and every period there is a **competitive market for claims** on future consumption goods.
- ▶ Because agents' types are not observable, such claims cannot be contingent on buyers' or sellers' types.
- ▶ Period-1 price of a claim on a unit of period-2 consumption is $1/R$.
 - * If it was above, type-a agents would keep their investments and sell such claims to finance their consumption, but there would be no buyers.
 - * If it was below, type-b agents would liquidate their investments and buy such claims, but there would be no sellers.
- ▶ Similarly, equilibrium in period 0 requires that
 - * price of period-1 consumption is simply 1;
 - * price of period-2 consumption is simply $1/R$.
 - * Otherwise everybody would want to buy 'underpriced' claims or sell 'overpriced' ones, which cannot be an equilibrium.

Benchmark 1: competitive equilibrium (cont.)

- ▶ Agents are identical in period 0, so there is **no trade** at these prices.
- ▶ Each individual invests their own unit of endowment.
 - * In period 1, impatient agents liquidate their projects and consume 1.
 - * Patient agents wait until period 2 and thus consume R .
- ▶ Allocation is therefore the same as under **autarky**, since markets serve no useful purpose here.
- ▶ Expected utility is

$$\mathbb{E}[U^{\text{autarky}}] = \theta \ln 1 + (1 - \theta)\rho \ln R = (1 - \theta)\rho \ln R. \quad (26)$$

- ▶ Is this competitive equilibrium efficient?

Benchmark 2: first-best social optimum

- ▶ Suppose there is a social planner that observes individual types.
- ▶ Social planner chooses consumption levels of each type (c_1^a and c_2^b) to maximize the expected utility of a representative agent:

$$\mathbb{E}[U] = \theta \ln c_1^a + (1 - \theta) \rho \ln c_2^b. \quad (27)$$

- ▶ Note that the planner always sets $c_2^a = c_1^b = 0$,
 - ⇒ type-a's do not value consumption in period 2, while consumption and utility of type-b's can be increased by waiting until period 2.
- ▶ Social planner must respect the resource constraint:

$$(1 - \theta) c_2^b = (1 - \theta c_1^a) R, \quad (28)$$

where θc_1^a is the fraction of investments liquidated in period 1.

Benchmark 2: first-best social optimum (cont.)

- ▶ Substituting for c_2^b in the objective function from the constraint, taking the first-order condition w.r.t. c_1^a , and solving for c_1^a yields:

$$c_1^{a*} = \frac{1}{\theta + (1 - \theta)\rho} > 1. \quad (29)$$

⇒ Impatient agents' c_1^{a*} is higher than in the competitive/autarky case.

- ▶ The constraint (28) then implies:

$$c_2^{b*} = \frac{\rho R}{\theta + (1 - \theta)\rho} < R. \quad (30)$$

⇒ Patient agents' c_2^{b*} is lower than in the competitive/autarky case.

- * Although still higher than c_1^{a*} , since $\rho R > 1$.

- ▶ The **competitive outcome is thus not socially efficient!** Why?

- * Social optimality requires greater liquidation of projects in period 1,
- * i.e. patient agents insuring individuals with liquidity shocks.
- * But because types are unobservable, such insurance **market is missing**.

Introducing a bank

- ▶ **Key insight:** we do not need a social planner or observability of agents' types to achieve the first best, all we need is to set up a bank!
- ▶ The bank offers **deposit contracts** on the following terms:
 - * agents deposit their unit endowments to the bank in period 0.
 - * anyone, regardless of their type, can withdraw c_1^{a*} units in period 1.
 - * Whatever funds the bank has in period 2 are divided equally between the remaining depositors who did not withdraw in period 1.
- ▶ The bank invests all deposits in the projects, and liquidates investments as required to meet the demand for early withdrawals.

Supporting the social optimum

- ▶ Suppose **only** impatient agents withdraw in period 1 and get c_1^{a*} .
- ▶ The amount that patient depositors receive in period 2 is then c_2^{b*} :

$$c_2 = \frac{(1 - \theta c_1^{a*})R}{1 - \theta} = c_2^{b*}. \quad (31)$$

- ▶ This is exactly the socially optimal allocation we saw before!
- ▶ It is also a **Nash equilibrium**, since no-one has incentives to deviate:
 - * Impatient agents always prefer to withdraw in period 1, not 2.
 - * Because $c_2^{b*} > c_1^{a*}$, patient agents indeed prefer to wait and withdraw in period 2, not 1.
 - * All agents indeed have incentives to deposit their endowments in period 0, since their expected utility is greater than under autarky.
- ▶ Banks are socially useful: they **provide liquidity**.

Bank runs

- ▶ What happens, however, if **all agents try to withdraw** in period 1?
 - * The bank cannot pay $c_1^{a*} > 1$ to everyone.
- ▶ The **sequential-service constraint** (aka first-come, first-served):
 - * Pays c_1^{a*} to as many agents as possible, until runs out of resources.
 - * Since types are not observable, those who are paid are chosen randomly.
 - * E.g. who happens to reach the queue first.
 - * The remaining depositors get nothing.
- ▶ Unfortunately, such a **bank run** is also a Nash equilibrium:
 - * If all agents withdraw early, there is nothing left in period 2.
 - * Thus, if all patient agents believe that other patient agents will try to withdraw in period 1, they prefer trying to withdraw in period 1 too.
 - * Better a probability of something than certainty of nothing!
- ▶ Why would anyone deposit in the bank in period 0 then?
 - * Can construct cases when it's still optimal if a run probability is small.
- ▶ Possibility of a bank run is thus another **key result** of the model.

Taking stock

- ▶ We saw that banks support two types of equilibria:
 1. Socially optimal equilibrium $\succ$ competitive equilibrium/autarky
 2. Bank run equilibrium $\prec$ competitive equilibrium/autarky.
- ▶ The second equilibrium exists because of **maturity mismatch**: bank has illiquid assets, but liquid liabilities.
- ▶ In the model, a run is a **pure liquidity crisis** for the bank:
 - * Bank is **solvent** in the sense that it would have enough funds to make promised payments in period 2 (which is not always the case!).
 - * The problem is that all depositors panic and demand funds immediately.
- ▶ Diamond & Dybvig consider several policies to prevent liquidity runs.

Policy #1: Suspension of convertibility

- ▶ Modify the deposit contract: pay out c_1^{a*} to *at most* fraction θ of depositors, and then suspend payments until period 2.
- ▶ Success: type-b agents no longer have incentives to run.
- ▶ This is what XIX and early XX century banks actually did.
- ▶ However, if aggregate liquidity needs are uncertain (e.g. fraction θ of impatient agents is random), this does not maximize social welfare.
- ▶ Moreover, in practice there is a risk that insolvent banks may suspend payments, even though liquidation is preferable.

Policy #2: A lender of last resort

- ▶ Government (central bank) can also act as a **lender of last resort**.
- ▶ I.e. stand ready to lend to the bank at a gross interest rate c_2^{b*}/c_1^{a*} .
- ▶ Suppose fraction $\phi > \theta$ of agents withdraw.
 - * Bank pays θ of them by liquidating projects, and $\phi - \theta$ by borrowing.
 - * Bank thus has $(1 - \theta c_2^{a*})R = (1 - \theta)c_2^{b*}$ resources in period 2.
 - * Uses $(\phi - \theta)c_2^{b*}$ to repay the central bank and $(1 - \phi)c_2^{b*}$ to pay remaining depositors, who thus get c_2^{b*} each.
 - * But now all type-b depositors prefer to withdraw in period 2.
- ▶ How does the central bank finance its lending to the affected banks?
 1. Backed by fiscal authority: tax early withdrawers.
 2. CB can **supply new money** (if we introduce it into the model):
 - + Assume that deposits are denominated in nominal terms.
 - + CB lending to the bank increases money supply and nominal prices of goods in period 1 $\Rightarrow$ real consumption of early withdrawers falls.
- ▶ Government **power to tax and create inflation is crucial**.

Lender of last resort: Diamond-Dybvig vs. Bagehot dictum

- ▶ Note that because $c_2^{b*}/c_1^{a*} = \rho R < R$, the CB **lends at the discount** compared to the market rate R .
- ▶ This can generate a **moral hazard**:
 - * Bank has incentives to borrow rather than liquidate assets in period 1.
 - * This leaves the bank with a profit at the expense of the central bank and taxpayers, since its projects generate more than it has to repay.
 - * The solution is a **reserve requirement**: the bank must meet first θ withdrawers by liquidating own assets before it can borrow from CB.
- ▶ W. Bagehot (1873) argued that the lender of last resort should:
 1. lend freely against a good collateral
 2. but at a penalty interest rate to discourage unnecessary draws.
- ▶ The Diamond-Dybvig model supports #1, but not #2.

Policy #3: Deposit insurance

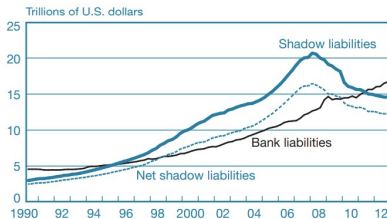
- ▶ Government guarantees that all who wait until period 2 get c_2^{b*} .
- ▶ Government finances these payments by **levying a tax** on those who withdraw in period 1, if more than fraction θ withdraw.
- ▶ Again, type-b agents no longer have incentives to run.
- ▶ Run equilibrium is eliminated by the mere presence of deposit insurance, the government never needs to make actual payments.
- ▶ Policy widely introduced around the world after the banking crises that accompanied the Great Depression in 1930s.
 - ⇒ Arguably, traditional runs on commercial banks are left in the past.
- ▶ But, as we will see now, it does not mean that there can be no panics in the modern financial system.

Panics during the 2008 Financial Crisis?

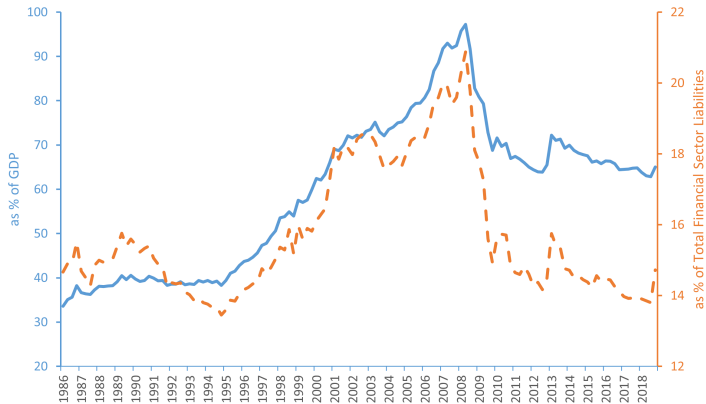
- ▶ Modern 'bank runs' can take various forms.
- ▶ Gorton and Metrick (2012) argue that the panic of 2007-2008 was effectively a **run on the repo** (sale and repurchase) market:
 - * repos = very short-term, collateralized transactions widely used as a primary source of financing by institutions like investment banks.
 - * Not commercial banks → not subject to deposit insurance.
 - * Repo run = many investors simultaneously **refusing to roll over** their loans, or demanding much tougher terms.
 - * The bank is thus forced to liquidate investments early, and may fail.
 - * Therefore, a repo run can be a **self-fulfilling equilibrium**: once many investors refuse to roll over loans, everybody refuses.
 - * just as in the Diamond-Dybvig model!
- ▶ Similarly, Covitz et al. (2013) document runs on asset-backed commercial paper (ABCP) in 2007.

The rise of shadow banking

- ▶ Repos and ABCP are prominent examples of shadow banks' liabilities.
- ▶ **Shadow banks** are non-bank financial institutions that perform many banks' functions: credit, maturity and liquidity transformation.
- ▶ E.g. investment banks, money market funds, mortgage companies etc.
- ▶ Mostly outside normal banking regulations $\Rightarrow$ subject to runs.
- ▶ Shadow banking grew dramatically since 1990s (Pozsar et al. 2013):



Runnable liabilities in the US before and after the Crisis



Notes. The data on aggregate runnable liabilities comes from Bao et al. (2015). It includes uninsured deposits, repurchase agreements, securities lending, commercial paper, money market mutual funds shares, variable-rate demand obligations, federal funds borrowed, and funding agreement backed securities. The data on total financial sector liabilities is from the Board of Governors of the Federal Reserve System.

Contagion

Macroeconomic contagion

- ▶ Financial crises are characterised by simultaneous difficulties faced by many financial institutions, firms, and individuals.
- ▶ But if e.g. we introduce many banks in the Diamond-Dybvig model, there is no reason why a run on one bank would spread to others.
- ▶ We will now briefly discuss the issue of **contagion**: how do financial troubles faced by individual agents spread at macro level?
- ▶ There are several major sources of contagion:
 1. Counterparty contagion
 2. Confidence contagion
 3. Fire-sale contagion
 4. Macroeconomic contagion.

Sources of contagion

1. Counterparty contagion

- * In practice, financial institutions often hold claims on one another.
- * When one fin. institution faces a run and a risk of failure, institutions that are exposed to it may see the value of their claims fall,
- * and ultimately suffer similar fate.

2. Confidence contagion

- * Recall that the Diamond-Dybvig model is that of a pure liquidity run.
- * But a run could also happen when investors suspect that there is a risk that the bank may be insolvent.
- * In fact, bank runs tend to happen when fundamentals are weak.
- * If a large bank faces a run, it could provide a negative signal about its solvency and the value of its assets.
- * But this could lead investors of other banks that hold similar assets to question their solvency and run as well.

Sources of contagion (cont.)

3. Fire-sale contagion

- * An institution facing a run or a large increase in borrowing costs is likely to have to sell assets.
- * But if many institutions do it simultaneously in an imperfect financial market, this leads to a fall in asset prices.
- * Decrease in the value of collateral leads to a further round of insolvencies, runs, and fire sales.

4. Macroeconomic contagion

- * Difficulties faced by borrowers are likely to reduce economic activity
- * Which in turn reduces asset prices and agents' net worth
- * Leading to further increases in borrowing costs etc.

This is the financial accelerator again.

Government Guarantees and Moral Hazard

Government guarantees and moral hazard: an overview

- ▶ In the wake of the 2008 Financial crisis, governments responded with interventions of unprecedented scale:
 - * Involved both recapitalizations and lowering borrowing costs for banks.
 - * In line with the models we have covered so far.
- ▶ But if banks anticipate such policy response, it creates moral hazard:
 - * Banks have incentives to increase leverage and invest in riskier projects.
 - * This increases their returns in the upside, while possible losses in the downside are borne by the government and taxpayers.
- ▶ Indeed, prior to the Crisis, large-scale maturity mismatch and exposure to systematic risks appeared to be widespread among fin. institutions
 - ⇒ likely increased both ex-ante likelihood and ex-post costs of the Crisis.
- ▶ Such seminal papers as Kareken and Wallace (1978), Farhi and Tirole (2012) and others formalise this argument.
- ▶ We will now consider a very simple model that captures its essence.

Setup

- ▶ There are two periods $\{0, 1\}$
- ▶ Households have a wealth endowment of 1 in period 0.
- ▶ Households only consume in period 1, and their utility is given by:

$$U = -(c - \bar{c})^2, \quad (32)$$

where $\bar{c} > c$ is the 'satiation' consumption level.

- ▶ In period 0, a representative bank invests the endowment on behalf of a representative household, and acts to max. their expected utility.
- ▶ The bank has access to two assets:
 1. **Safe asset** that pays a certain return $R > 1$ in period 1.
 2. **Risky asset** that pays either $\theta - \varepsilon$ or $\theta + \varepsilon$, each with probability $1/2$.
- ▶ The risky asset offers a higher average return than the safe asset, i.e. $\theta > R$, but performs worse in the downside, i.e. $\theta - \varepsilon < R$.

Benchmark: no government guarantees

- ▶ The Bank allocates $\mu \in [0, 1]$ to the risky asset, and $1 - \mu$ to the safe asset to maximize the consumer's expected utility:

$$\begin{aligned} \max_{\mu} \mathbb{E}[U] = & -\frac{1}{2}[(1 - \mu)R + \mu(\theta - \varepsilon) - \bar{c}]^2 \\ & -\frac{1}{2}[(1 - \mu)R + \mu(\theta + \varepsilon) - \bar{c}]^2 \end{aligned} \quad (33)$$

- ▶ Taking FOC and solving for μ yields

$$\mu^* = \frac{(\bar{c} - R)(\theta - R)}{\varepsilon^2 + (\theta - R)^2}. \quad (34)$$

- ▶ $\mu^* < 1$, assuming $\bar{c} - R$ is sufficiently small.
- ▶ Bank invests in a balanced portfolio that maximizes welfare.

The effect of a government guarantee

- ▶ Suppose now that the government guarantees that bank investors receive a return of at least R whatever the state of the world.
 - * This could be either an explicit deposit insurance in place to prevent panics, or an implicit guarantee that the gvt. will not let banks fail.
 - * It is only invoked when the return on the risky asset is low.
- ▶ Anticipating this government policy, the bank now maximizes:

$$\max_{\mu} \mathbb{E}[U] = -\frac{1}{2}[R - T - \bar{c}]^2 - \frac{1}{2}[(1 - \mu)R + \mu(\theta + \varepsilon) - \bar{c}]^2. \quad (35)$$

- ▶ To finance assistance in the low state, the gvt. imposes lump-sum tax:

$$T = \mu(R - \theta + \varepsilon). \quad (36)$$

- ▶ But a bank takes T as *given* and unaffected by its private choice of μ .
- ▶ Since $\theta + \varepsilon > R$, (35) increases in μ , so bank sets $\mu = 1 > \mu^*$.
- ▶ **Risk shifting:** bank shifts more of the downside risk on the gvt.

Welfare and policy consequences

- ▶ Exposure to risk is now inefficiently high:
 - * Substituting T from (36) into (35), the welfare of a representative agent is still given by (33), but now with higher μ .
 - * Government guarantees are unambiguously bad in this simple model.
- ▶ Does it mean that the government should not assist banks in crises?
 - * No! We have seen that there are good reasons for intervention.
 - * Crisis is also not a time to worry about moral hazard.
 - * Caballero (2010) compares crisis to a heart attack: we would save people with heart attacks even if we knew that the presence of defibrillators incentivizes them to lead unhealthy lives in the long run.
 - * The government may simply not be able to commit not to intervene.
- ▶ So what can we do to prevent crises then?
 - * Need to regulate fin. sector: risk-adjusted capital requirements, liquidity requirements, stress tests and other **prudential policies**.
 - * But all these can also increase costs of intermediation in normal times.
 - * Getting the balance right is a very important and active research area.

Conclusion

- ▶ Financial markets are complex: we have seen various mechanisms that can generate financial frictions and trigger financial crises.
- ▶ These issues are all inter-related:
 - * For example, in practice it is often difficult, if not impossible, to distinguish between illiquid and insolvent banks.
 - * A bank may be solvent under normal macro conditions and asset prices.
 - * But insolvent once there are widespread runs on its counterparties and a collapse in asset prices.
- ▶ Modern macroeconomic models often combine different mechanisms.
- ▶ Gertler and Kiyotaki (2015) is a great example:
 - * Their model features the conventional financial accelerator.
 - * But systemic bank runs are also possible.
 - * Run equilibria exist only in recessions when the macroeconomic fundamentals are sufficiently bad, which is realistic.