Bank Liquidity, Interbank Markets and Monetary Policy

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Introduction

• Model is in the tradition of
  – Diamond and Dybvig (1983)
  – Bhattacharya and Gale (1987)

• Basic issue: How should the central bank set interest rates?

• Very different from the standard macro approach to central bank intervention and monetary policy
The model

• Standard 3 date structure \( t = 0,1,2 \) and a short and long asset

• Focus is on idiosyncratic bank shocks (no aggregate shocks)

• Innovation is that there are two states with different idiosyncratic bank shocks
  – State \( \varepsilon' \): positive shock so interbank trade w.pr. \( \rho \)
  – State \( \varepsilon'' \): no shock so no interbank trade w.pr. \( 1 - \rho \)
Main result

• Central bank sets interest rates \( \ell' \) and \( \ell'' \) between \( t = 1 \) and 2 in the two states subject to the constraint that banks must be willing to hold both the long and short asset between \( t = 0 \) and 1

• Show that there is a multiplicity of equilibria depending on the choice of \( \ell' \) and \( \ell'' \)

• One of these equilibria is the first best allocation
Why are these models important?

- Very different from standard ways of thinking about monetary policy

- Does the microstructure of interbank markets really matter?

- Yes, because they are a building block for understanding financial stability and the market failures associated with financial instability
The market failures

• In the current crisis the market provision of liquidity has appeared to be inefficient and has led to multiple types of intervention by central banks
  – These models have the potential to provide insight into how best to intervene

• The contagion that acts through the interbank market is another significant market failure
  – Bear Sterns and Lehman Brothers
Policy implications

• To understand optimal policy interventions we need a good idea of how interbank markets work

• Academic research moves at a slow pace and we currently don’t have a good understanding of this

• Given the trajectory the economy is on and the ineffectiveness of current policies we need to **temporarily nationalize** the worst performing banks