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 ε': positive shock so interbank trade w.pr. ρ
  - State ε'': no shock so no interbank trade w.pr. $1 - \rho$

Main result

- Central bank sets interest rates ℓ’ and ℓ’’ 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 ℓ’ and ℓ’’

- 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