Discussion of “Flight to Liquidity and Systemic Bank Runs”, by Roberto Robatto.

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"September and October of 2008 was the worst financial crisis in global history, including the Great Depression."

Ben Bernanke, Confidential Testimony made to the Financial Crisis Inquiry Commission, November 2009 (publicly released in 2011).

However: milder effects:

- Financially: no massive bank runs,

- No protracted deflation / massive slump in activity as in the Great Depression.
  (Unemployment peak: 10% against 25%).

⇒ Better policies: QEs, LTROs, FG ...

This paper formalizes this idea → monetary injections prevented a new depression.
Model

**Main elements:**
- Banks that invest in capital, issue deposits, manage reserves and subject to runs.
- Households face liquidity/consumption shocks (Diamond-Dybvig), use deposits/currency to insure but can withdraw.
- Illiquid capital.

**Main mechanism:** Mutual feedback between:
- Anticipation of runs,
- Asset prices

More precisely:
Anticipation of runs $\Rightarrow$ Money more desirable than deposits $\Rightarrow$ Lower value of capital $\Rightarrow$ weaker banks’ balance sheets $\Rightarrow$ Runs more likely.

*Note: Different from Diamond-Dybvig’s strategic complementarity in runs.*
Main results

- Multiple equilibria: good and bad (deflation, low velocity, low asset prices),
- Monetary injections:
  - **Ambiguous if small:** lower interest rates reduce the demand for deposits → may amplify flight to quality.
  - **If large:** avoid any bad equilibria.
  - Asset purchases are better than loans.
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A Dream for central bankers?

*Create a lot of money to avoid self-fulfilling liquidity crises?*

Limits to dreams? Costs of (large) monetary injections?
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This discussion: 1) moral hazard, 2) financial regulation and monetary policy, 3) additional words on communication and asymmetric information.
The moral hazard view

Financial crises: result from bad behaviors by banks, possibly sustained by bad incentives based on policy expectations.

- Small rather large bailouts,
- If possible, better to commit not to intervene - otherwise excessive risk-taking,
- Loans > Outright asset purchase: can be lemons.

In this paper:
- Exogenous banks’ initial positions.
  → No scope for banks’ moral hazard.
- No heterogeneity in banks’ capital assets.
  → No risk for the central bank when purchasing assets.
Evidence of moral hazard?

Numerous for the 2008 financial crisis: among (many) others:

- Over-lending (Mian and Sufi, 2010),
- Reallocation of assets in anticipation of bailouts/monetary injections (He and Krishnamurthy, 2010).

What about the Great Depression?

- Friedman and Schwarz (1963): long paragraphs to rule out any role for lending practices in the 20s.

⇒ This paper = consistent view.

Why do we care about moral hazard?

- Problem in this paper: potentially insolvent banks.

- Moral hazard view: ensure solvency $\rightarrow$ capital requirements.

- The better banks are capitalized initially:
  the more the price of capital has to drop $\leftrightarrow$ more low-type banks are needed.

$\Rightarrow$ This paper: financial regulation and monetary policy are substitutes.

$\Rightarrow$ Said differently: Monetary policy should act insofar financial regulation failed!
More tools are available:

1. Force banks to disclose information on capital (Asset Quality Review, ...)
2. Insure deposits and seize defaulting banks’ assets = targeted monetary injection at date-1.
3. Lending of last resort.

Alternatively, good banks can signal themselves?

⇒ Why using a blunt tool as monetary policy to ensure financial stability?

⇒ Related to another Friedman-Schwarz’ insight: excess reserves by banks associated with uncertainty on lending of last resort practices.

(In particular: not a sign that monetary policy stance can be tightened).

⇒ Again: more the sign of a failure of financial stability policies.
Do we really need to intervene on markets? Why not just coordinating on the good equilibrium by communication.

- The first best $\in$ set of equilibria.
  - $\Rightarrow$ Just a coordination game.

- The central banker just needs to announce that it will act if needed = ”do whatever it takes”.

If this is not feasible $\Rightarrow$ other frictions that prevent the CB to make credible announcements (risk of moral hazard?).
Non-observability of banks’ state: meaningful assumption.

- Yet: in the paper: non-observability of banks’ capital.

- Lots of signals: directly observable measures or indirectly through financial markets (stock market ...).

What seems less observable = the quality of banks’ balance sheets (which is equivalent, but this may deserve some further discussion).
What triggered the equilibrium shift in equilibrium in the Great Depression/Great Recession?

Connexion with Romer (1990) on ”The Great Crash and the Onset of the Great Depression”.

Global games? Results seem to depend whether each agent anticipates whether other agents flight to liquidity.

Bernanke (1983): also non-monetary effects of bank runs.

Minor points:

The introductory statement that a bad equilibrium can have very small deflation is not mentioned anywhere else in the paper (Figure 7?)
Conclusion

Very nice paper! Very polished and clear!

Diamond-Dybvig model
- introducing a new form of equilibrium multiplicity,
- formalizes within one setting Friedman-Schwarz (1963),
- tractable,
- able to perform numerical exercises to link macro to finance.

More policy analysis would be relevant!