lunchtalk@bruegel

Illiquid Banks, Financial Stability, and Interest Rate Policy

12 May 2011, Bruegel

Bruegel hosted a lunchtalk with Raghuram G. Rajan (Prof. at the University of Chicago) and David Miles (discussant, Bank of England). Bruegel's Director, Jean Pisani-Ferry chairing this event.

Prof. Rajan started his presentation (based on a coauthored research paper) by showing the main features of a relatively stylized model of demandable deposits which connects financial markets' functioning and monetary policy acting in crises' times. By stressing that the model was not directly aimed at explaining the last crisis, he illustrated a set up in which an ex post expansionary monetary policy can be preferred to direct intervention from governments. In such a context, agents and banks could anticipate the persistence of low short-term interest rates and in so doing cause short-term leverage and incentivize to hold illiquid assets (compared to the social optima). Given that ex ante regulation of banks could be circumvented by non-bank operators which are able to replicate bank structures, monetary policy intervention can be more efficient, Prof. Rajan added. In particular, central banks could curtail promises of liquidity by increasing interest rates in normal times more than what market conditions would warrant. This way of acting would strengthen the disciplinary role of deposits and thus reduce moral hazard. Intervention comes always at a cost but this cost is lower if one intervenes through monetary policy instead of bailouts, Mr. Rajan concluded.

Mr. Miles welcomed the paper especially because of its attempt to link financial markets to monetary policy. However, he stressed that the disciplinary role of the deposits in the model rises somehow artificially from the assumption that managers cannot take advantages of their monopoly power over the means to recover the proceeds of bank lending. Moreover, he lamented the absence of equity as source of financing in the model. In addition, capital regulations like capital requirements are dismissed as inefficient and the role of recapitalization is undervalued in the framework presented, he added. Furthermore, he asked to clarify whether the mechanism of intervention proposed in the paper was really one of monetary policy (as claimed by the authors) or a fiscal policy one.

Prof. Rajan took on board some of the criticisms rose but claimed, at the same time, that a model can never fully capture the reality, although the model could be easily extended to include more realistic assumptions about markets' functioning. However, this would not distort the main message of the paper, he stated. The authors chose to model the behavior of banks but other financial institutions could straightforwardly fit the structure of the model. In answering the questions posed by the discussant, he pointed out that whenever an authority decides to intervene to resolve a crisis, there exists always a fiscal side of it since money cannot be created out of nothing. Besides, there is a role for recapitalization but, he stated, more is needed in bad times. The audience asked whether the behavior of central banks in the model could be interpreted as an anti-cyclical monetary policy. Prof. Rajan admitted there might be affinities, but he stressed that it's not really the point they are trying to sell in their paper. Some participants asked whether the model could be extended to include bonds in banks' portfolios. Mr. Rajan affirmed that it would not be trivial to do it given the structure of the paper. Finally, the presenter and the discussant were asked by Jean Pisani-Ferry to give their idea on the role of macro prudential regulation to prevent or alleviate the consequences of a financial crisis. Mr. Miles declared to be more in favor of a bigger role for macro prudential regulation; Prof. Rajan said instead that giving more room to monetary policy would be more efficient; they both agreed, in the end, that a combination of macro regulation and monetary policy is needed.