Banking, Liquidity and Bank Runs in an Infinite Horizon Economy

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Recent financial crisis started in summer 2007

Despite of many attempts, DSGE models with financial friction forecasted no deep recession until fall 2008

After 2008Q4, models with financial friction predict deeper recession than the models without

To explain financial crisis, we need "bank run" or "sudden stop"

Liquidity mismatch opens up the possibility of run $\longrightarrow$

Inefficient liquidation of assets, loss of intermediation, and deep recession

We develop a simple macro model of banking crisis

- Financial accelerator / Credit cycles
- Banks runs

Macroeconomic conditions affect whether runs are feasible

- Bank leverage ratio
- Liquidation prices

An increase in the likelihood of run contracts the economy severely

Basic Model

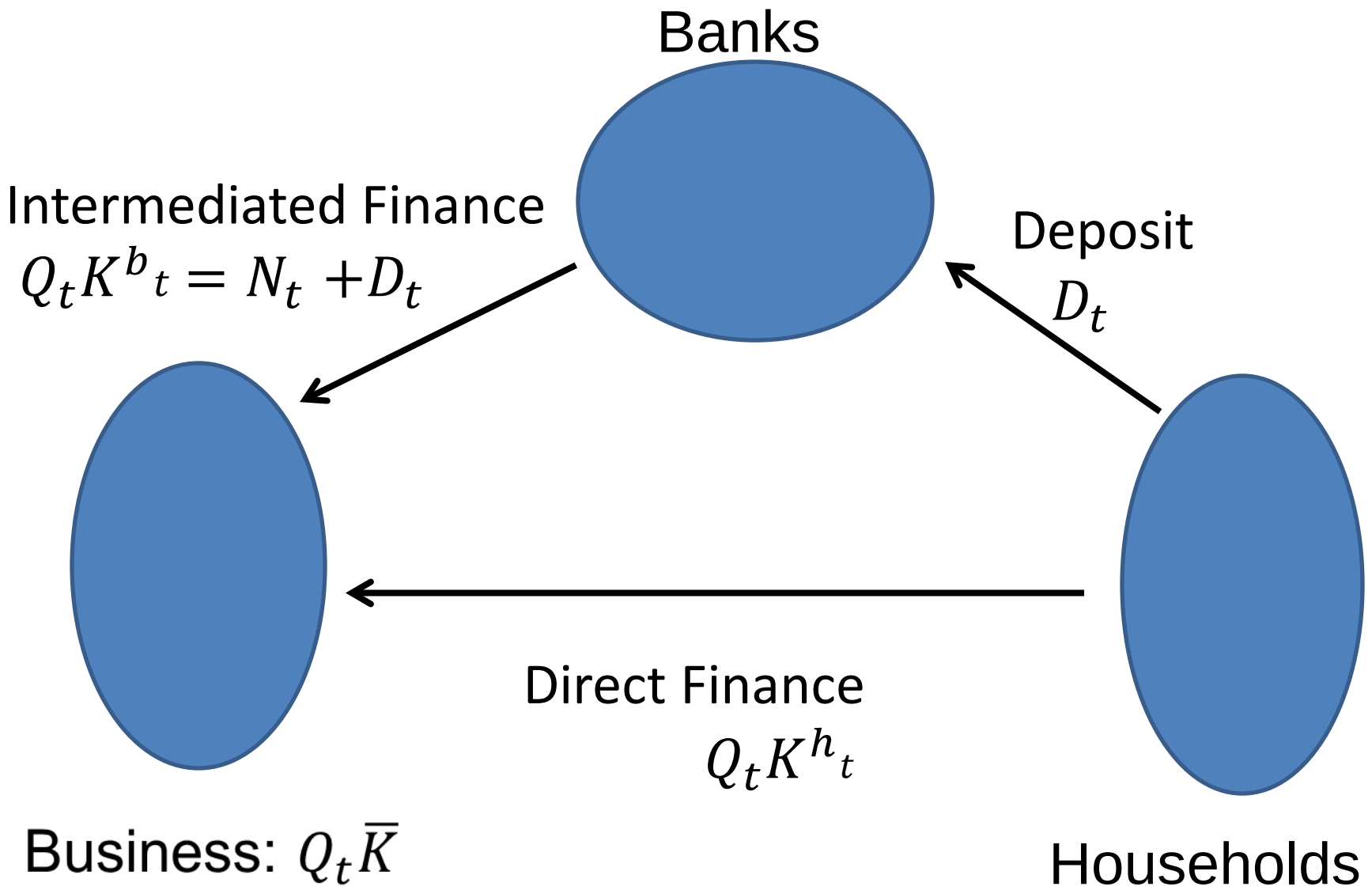
Capital is either intermediated by banks or directly held by households

$$K_t^b + K_t^h = \overline{K}$$

$$\begin{array}{c} \textit{date } t \\ K_t^b \text{ capital} \end{array} \Big\} \longrightarrow \begin{cases} \textit{date } t{+}1 \\ K_t^b \text{ capital} \\ Z_{t+1} K_t^b \text{ output} \end{cases}$$

$$\left.\begin{array}{c} \textit{date } t \\ K_t^h \text{ capital} \\ f(K_t^h) \text{ goods} \end{array}\right\} \longrightarrow \begin{cases} \textit{date } t{+}1 \\ K_t^h \text{ capital} \\ Z_{t+1} K_t^h \text{ output} \end{cases}$$

$f(K_t^h)$: management cost $f' > 0,\ f'' \geq 0$


Banks
Intermediated Finance
$Q_t K^b{}_t = N_t + D_t$
Deposit
D_t
Direct Finance
$Q_t K^h{}_t$
Business: $Q_t \bar{K}$
Households

Deposit contract

Short term

Non-contingent return R_{t+1} (absent a bank run)

Sequential service constraint (as in Diamond/Dybvig)

In the event of a run, payoff either R_{t+1} or 0, depends on place in line

In Basic Model, bank run is completely unanticipated

Households maximize

$$U_t = E_t \left(\sum_{i=0}^{\infty} \beta^i \ln C_{t+i}^h \right)$$

subject to:

$$C_t^h + D_t + Q_t K_t^h + f(K_t^h) = Z_t W^h + R_t D_{t-1} + (Z_t + Q_t) K_{t-1}^h$$

$\longrightarrow$

$$1 = E_t \left(\Lambda_{t,t+1} \right) R_{t+1}$$

$$1 = E_t \left(\Lambda_{t,t+1} \frac{Z_{t+1} + Q_{t+1}}{Q_t + f'(K_t^h)} \right)$$

$$\Lambda_{t,t+1} = \beta \frac{C_t}{C_{t+1}}$$

Many bankers

Each has an i.i.d. survival probability of σ

Banker consumes wealth upon exit: $c_t^b = n_t$

Preferences are linear in "terminal" consumption

$$V_t = E_t \left[\sum_{i=1}^{\infty} \beta^i \sigma^{i-1} (1-\sigma) c_{t+i}^b \right]$$

Each exiting banker replaced by a new banker with an endowment $w^b = n_t$

Bank balance sheet

$$Q_t k_t^b = d_t + n_t$$

Net worth n_t of surviving bankers

$$n_t = (Z_t + Q_t) k_{t-1}^b - R_t d_{t-1}$$

Agency Problem:

After the banker raises funds, it may divert a fraction of θ of loans at the end of period t

If the banker does not repay its debt in period $t + 1$, the creditors shut the bank down

Incentive constraint

$$\theta Q_t k_t^b \leq V_t$$

Bank chooses k_t^b and d_t to maximize

$$V_t = \beta E_t[(1-\sigma)n_{t+1} + \sigma V_{t+1}]$$

subject to $\theta Q_t k_t^b \leq V_t \rightarrow$

$$V_t = \nu_{kt} k_t^b - \nu_t d_t = \underbrace{\left(\frac{\nu_{kt}}{Q_t} - \nu_t\right)}_{\mu_t} Q_t k_t^b + \nu_t n_t \geq \theta Q_t k_t^b$$

$$\frac{Q_t k_t^b}{n_t} \leq \phi_t = \frac{\nu_t}{\theta - \mu_t}$$

$$\nu_t = \beta R_{t+1} E_t[\Omega_{t+1}]$$

$$\mu_t = \beta E_t[(R_{t+1}^b - R_{t+1})\Omega_{t+1}]$$

$$\Omega_{t+1} = 1 - \sigma + \sigma(\nu_{t+1} + \phi_{t+1}\mu_{t+1})$$

$$R_{t+1}^b = \frac{Z_{t+1} + Q_{t+1}}{Q_t}$$

Aggregate leverage constraint

$$Q_t K_t^b = \phi_t N_t$$

Aggregate net worth

$$N_t = \sigma \left[(Z_t + Q_t) K_{t-1}^b - R_t D_{t-1} \right] + (1 - \sigma) w^b$$

Goods market

$$\begin{aligned} & C_t^h + (1 - \sigma) \left[(Z_t + Q_t) K_{t-1}^b - R_t D_{t-1} \right] + f(K_t^h) \\ = \; & Z_t \overline{K} + Z_t W^h + (1 - \sigma) w^b \end{aligned}$$

Bank Runs

Ex ante, zero probability of a run

Consider the possibility of a run ex post

At the beginning of period t, depositors decide whether to roll over their deposits

If depositors "run", the bank sells its capital to households who are less efficient in managing capital

A bank run equilibrium exists if:

$$\left(Z_t + Q_t^*\right) K_{t-1}^b < R_t D_{t-1}$$

$Q_t^* \equiv$ the liquidation price of the bank's assets

Liquidation Price Q_t^*

After a bank run at t :

$$K_{t+i}^h = \overline{K},\ \forall i$$

Household condition for direct capital holding $\longrightarrow$

$$Q_t^* = E_t \left\{ \sum_{i=1}^{\infty} \Lambda_{t,t+i} [Z_{t+i} - f'(\overline{K})] \right\} - f'(\overline{K})$$

where $f'(\overline{K})$ is the marginal management cost which as at a maximum at $K_t^h = \overline{K}$

Table 1: Parameters

Baseline Model		
β	0.99	Discount rate
σ	0.95	Bankers survival probability
θ	0.35	Seizure rate
α	0.1	Household managerial cost
$\bar{K}^h$	0.096	Threshold capital for managerial cost
γ	0.72	Fraction of depositors that can run
ρ	0.95	Serial correlation of productivity shock
Z	0.0161	Steady state productivity
ω^b	0.0019	Bankers endowment
ω^h	0.045	Household endowment

Figure 1: A Recession in the Baseline Model: No Bank Run Case

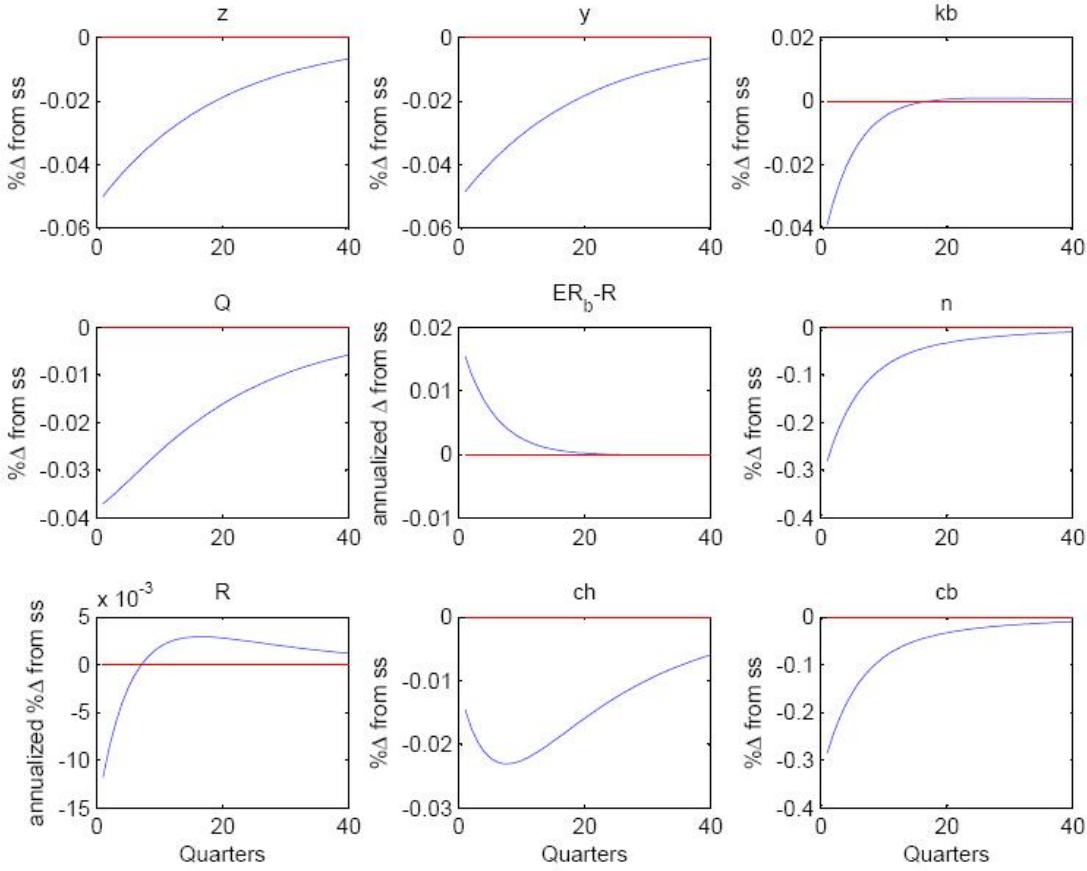
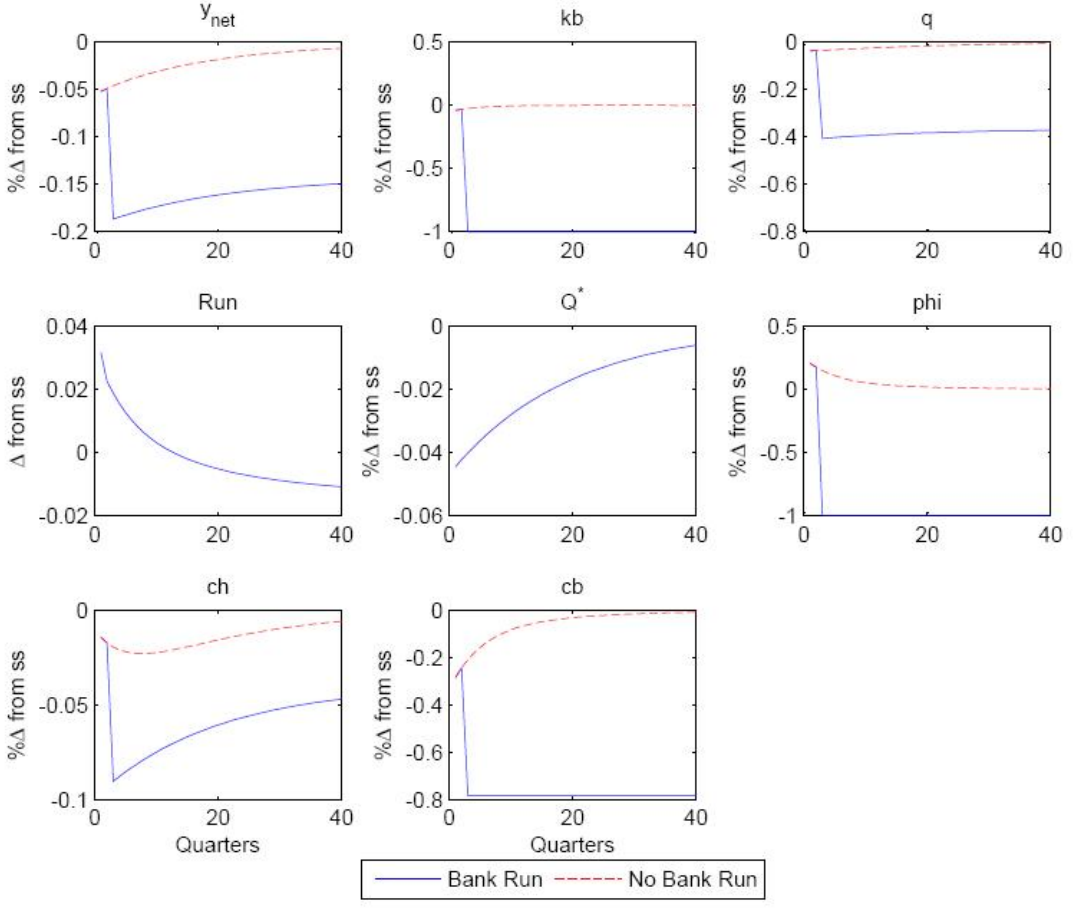


Figure 3: Ex Post Bank Run in the Baseline Model



Extension: Anticipated Bank Runs

Deposit returns

$$R_{t+1} = \begin{cases} \overline{R}_{t+1} \text{ if no bank run} \\ \overline{R}_{t+1} \text{ with prob } x_{t+1} \text{ if run} \\ 0 \text{ with prob } 1 - x_{t+1} \text{ if run} \end{cases}$$

$$x_{t+1} = \frac{\left(Q^*_{t+1} + Z_{t+1}\right) K^b_t}{\overline{R}_{t+1} D_t}$$

Incidence of bank run

$$\begin{aligned} \iota_{t+1} &= 0 \text{ always if } x_{t+1} \geq 1 \\ \iota_{t+1} &= 1 \text{ sometimes if } x_{t+1} < 1 \end{aligned}$$

Household FONC for deposits is

$$1 = \overline{R}_{t+1} E_t[(1 - \iota_{t+1})\Lambda_{t,t+1} + \iota_{t+1}\Lambda^*_{t,t+1} x_{t+1}]$$

Leverage rate of bank

$$\frac{Q_t K_t^b}{N_t} = \phi_t = \phi(\underset{-}{\theta}, \underset{+}{\mu_t})$$

$$\mu_t = \beta E_t \left[(1 - \iota_{t+1}) \Omega_{t+1} (R_{t+1}^b - \overline{R}_{t+1}) \right]$$

Evolution of net worth

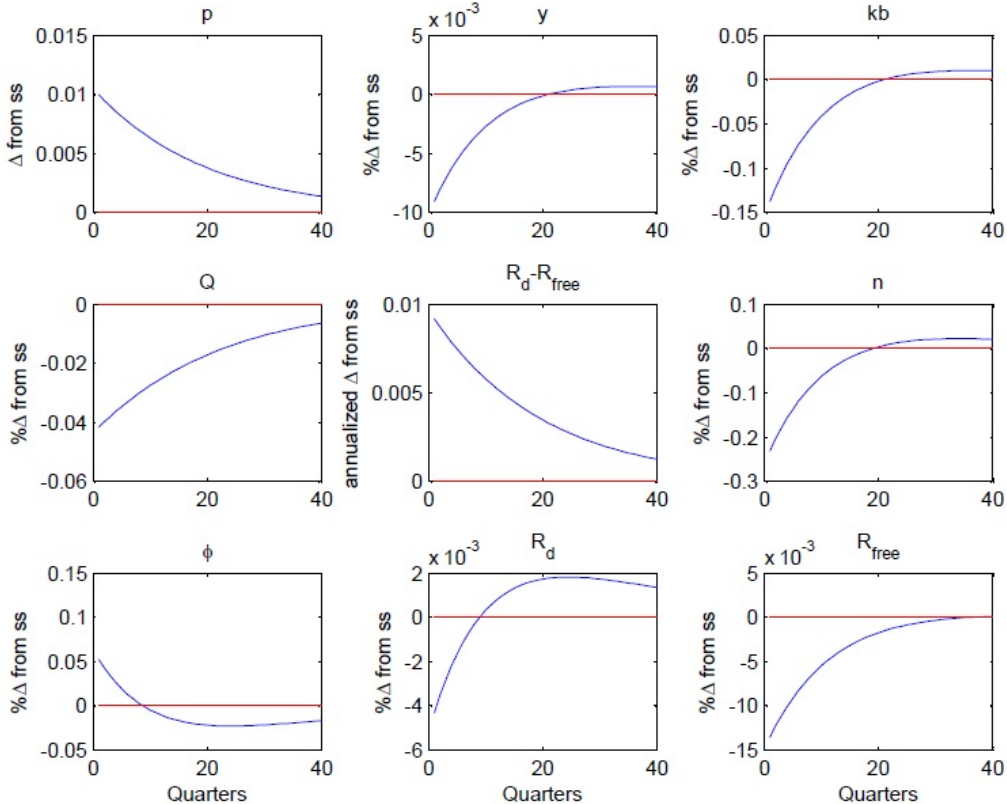
$$N_t = \sigma \left[(Z_t + Q_t) K_{t-1}^b - \overline{R}_t D_{t-1} \right] + (1 - \sigma) w^b$$

An anticipated increase in likelihood of run is contractionary in two ways

leverage ϕ_t declines since μ_t falls

N_{t+1} decreases even without run since $\overline{R}_{t+1}$ increases

Figure 5: Increase in the Probability of a Run



Some Remarks About Policy

Deposit insurance can eliminate bank run equilibrium

But may have moral hazard of risk-taking

Capital requirement reduces bank risk-taking and likelihood of bank run

Can increase intermediation cost if capital is costly to raise

Lender-of-last resort stabilizes liquidation price and reduces likelihood of bank run

Can purchase or lend against a good quality securities e.g. AMBS