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Discussion of

Money, Financial Stability and Efficiency

By

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Context

- Large literature on “Diamond and Dybvig” banking.
  - Banks are providing liquidity insurance
  - Where liquidity is a way to deal with consumption risk (shock between an early and a late consumption need).
- If banks rely on an (exogenously assumed) deposit contract, then you have inefficiency
  - In particular inefficient runs

This Paper

- It starts from this common framework but it assumes that
  - deposit contracts are nominal, not real
  - central banks can flood the market at no cost

$\Rightarrow$it shows that, unlike traditional Diamond and Dybvig, the competitive equilibrium is Pareto efficient

- Why?

Intuition

- From Allen and Gale previous work we know that suspension of convertibility (pro rata sharing) resolves Diamond and Dybvig's typical inefficiency .
- Why?
  – No benefit to run.
  – Each depositor gets pro quota the value of banks' assets
- The clever idea of this paper is that central bank can achieve same result by flooding the market with liquidity.

Intuition -2

- In a DD model pro-rata sharing (in real terms) eliminates incentive to run.
- Can you achieve the same with a first-come-fist served contract?
- Yes, if the contract is nominal.
- Liquidity provision by the central bank eliminates “pressure to withdraw”
- A subsequent rise in price level ensures that there is a pro-rata distribution of the time-1 resources.

Robustness

- Does this result survive if there is the possibility of investing at time 1?
- Does it survive in an open economy?

Comments

- Two sets of comments:
  - Theoretical: how does this model advance our understanding of banking ?
  - Practical: what does this model tell us about the world and the crisis?

Theoretical

- Usual limitations of DD model.
- Central bank has a role only because contracts are
  - first come first served
  - Nominal
  - Markets incomplete
- No progress on this front
- But better understanding about the role of contingent liquidity injections

Practical

- Access to the discount window is an essential element that allows banks to provide liquidity insurance effectively.
  - e.g. centralized clearing houses
- Access resolves the run problem.
- 2008 financial crisis was not a run problem, because eventually everybody had access to the discount windows.

Summary

- It is a neat idea
- I would like to see the robustness explored more
- It is very useful to rule out what was important and not important in causing the crisis.