
Imperfect Competition in the Interbank
Market for Liquidity as a Rationale for
Central Banking
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Casual empiricism

- Can the interbank market fail to reallocate liquidity efficiently?
 - Yes.
 - This market failure is not “chronic”, but occasional.
 - The failure seem to coincide with times of stress for the banking system.
 - A frozen interbank market may aggravate the stress, possibly leading to unnecessary bank failures and systemic problems
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Economic theory (up to now)

- Interbank market failures are due to asymmetries of information....
 - which become more relevant during times of stress
 - Banks become concerned about the solvency of their peers and refuse to lend
 - Some banks become illiquid, and various domino effects can lead to a systemic crisis
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Policy implications

- A LOLR that becomes the “market maker” during times of stress can address this market failure
 - Such LOLR can end up bearing some losses if it becomes exposed to insolvent banks
 - Having a well-informed LOLR reduces this risk
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Policy implications

- How to structure LOLR intervention?
 - Auctioning off liquidity should work under asymmetric information
 - This is indeed how many central banks inject liquidity
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This paper

- Because of moral hazard in monitoring, the amount of liquidity that a bank can get may be less than what is first-best optimal (limited pledgeability)
 - In addition, there is a double departure from perfect competition:
 - In the credit market: If bank A fails bank B can get some of its business and earns bigger profits. Thus, bank B *gains* from A's failure
 - In the interbank market for liquidity: Bank A can get liquidity *only* from bank B
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This paper

- In some parameter configurations, bank A does not get the liquidity it needs from bank B
 - It does not fail, but it has to sell some assets to B, which is socially inefficient because bank relationships are destroyed
 - This can occur even if there is no shortage of liquidity in the market
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This paper

- A LOLR can improve over the free market provided that it is either:
 - Willing to take losses
 - Or is better than private banks at monitoring
 - The latter suggests that the LOLR should also be the supervisor
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This paper—Implications

- The LOLR should intervene in specific banks at specific times, not just auction off liquidity or operate through open market operations
→ discount window
 - The interest rate on discount window loans should *not* be a penalty rate
 - The LOLR should also be the supervisor
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Comments

- Here the LOLR exists to safeguard the value of the lending relationship of individual banks, not the stability of the system
 - Are these relationships so valuable to justify this type of institutions?
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Comments

- If the bank assets are too specific, then competitor is unlikely to profit much from the demise of the bank. If they are not specific, there is no inefficiency
 - Inefficiencies of this sort likely exist in other industries
 - To raise cash a firm has to liquidate some of its assets, but assets are of value only to competitors....
 - Why LOLR only for banks?
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Comments

- Why are the inefficiencies described only present during periods of crises?
 - Banks borrow on the interbank market all the time. Are they always hostage to their competitors?
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Comments

- Is LOLR really the answer?
 - Maybe rules against “predatory behavior” during crises
 - There are already many rules on market conduct in financial markets...
 - There are also rules on anti-competitive behavior
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Comments

- During crises, other strategic considerations may make banks more willing to cooperate
 - For example, the threat of pushing the rival into insolvency may not be credible if:
 - There is a risk that one failure will lead to a panic (failures highly correlated...)
 - Banks have exposures to each other through a variety of channels, so that a default by one would lead to unraveling of transactions
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Comments

- ❑ While we do see instances of “predatory behavior” during crises, we also see “good samaritans” (LTCB rescue, for instance)
 - ❑ Can the authorities use moral suasion, pressures, or “ad hoc” sweeteners to force a deal when they suspect predatory behavior rather than LOLR intervention?
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