

Illiquidity and All Its Friends  
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# Main points of the paper

- Current crisis
  - (i) Massive illiquidity; (ii) Market freezes; (iii) Fire sales
  - (iv) Contagion; (v) Insolvencies and bailouts
- Market breakdowns
  - (i) Adverse selection; (ii) Shortage of financial muscle
- Macroeconomic perspective
  - (i) Aggregate liquidity shortages; (ii) Mark to market
  - (iii) Monetary versus fiscal bailouts
  - (iv) Need for macroprudential regulation

# Frameworks

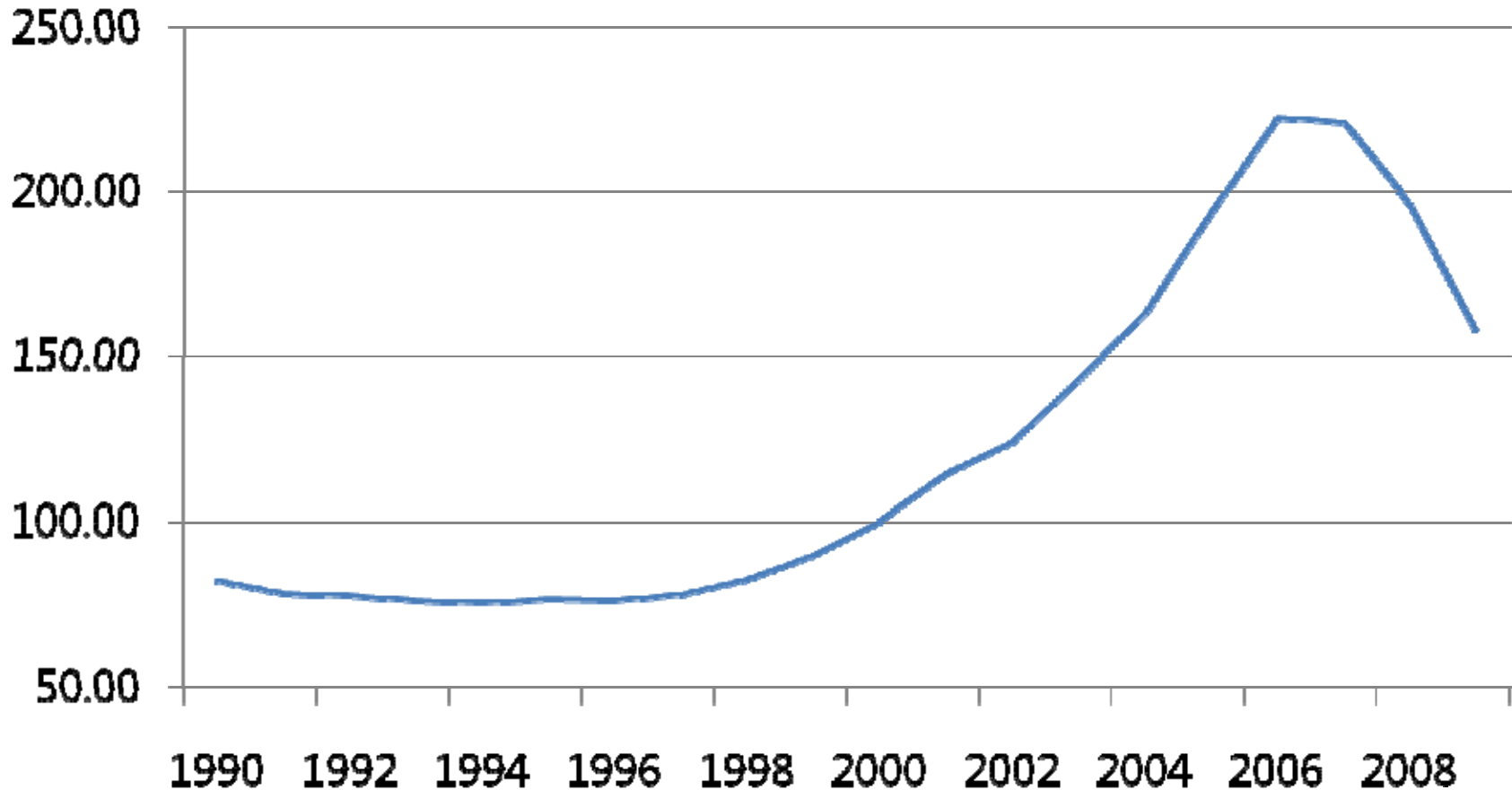
- Holmstrom and Tirole (1998)
  - “Finance as you go” may be prevented by market failures due to asymmetric information and other imperfections
  - The alternative is “liquidity hoarding” where firms hold assets to enable them to survive and keep investing
- Farhi and Tirole (2009)
  - Strategic complementarities in the choice of leverage because of the reaction of monetary policy
  - Monetary and fiscal bailouts
  - Need for macroprudential regulation

# What caused the crisis?

## Background :

- Reinhart and Rogoff (2009)
  - Systemic banking crises are typically preceded by credit booms and asset price bubbles particularly in real estate
  - The crises result, on average, in a 35% real drop in housing prices spread over a period of 6 years
- Consistent with previous literature
  - Kaminsky and Reinhart (1999)
  - Borio and Lowe (2002)
  - Herring and Wachter (2003)

# Current Crisis: Case-Shiller 10 Cities Composite



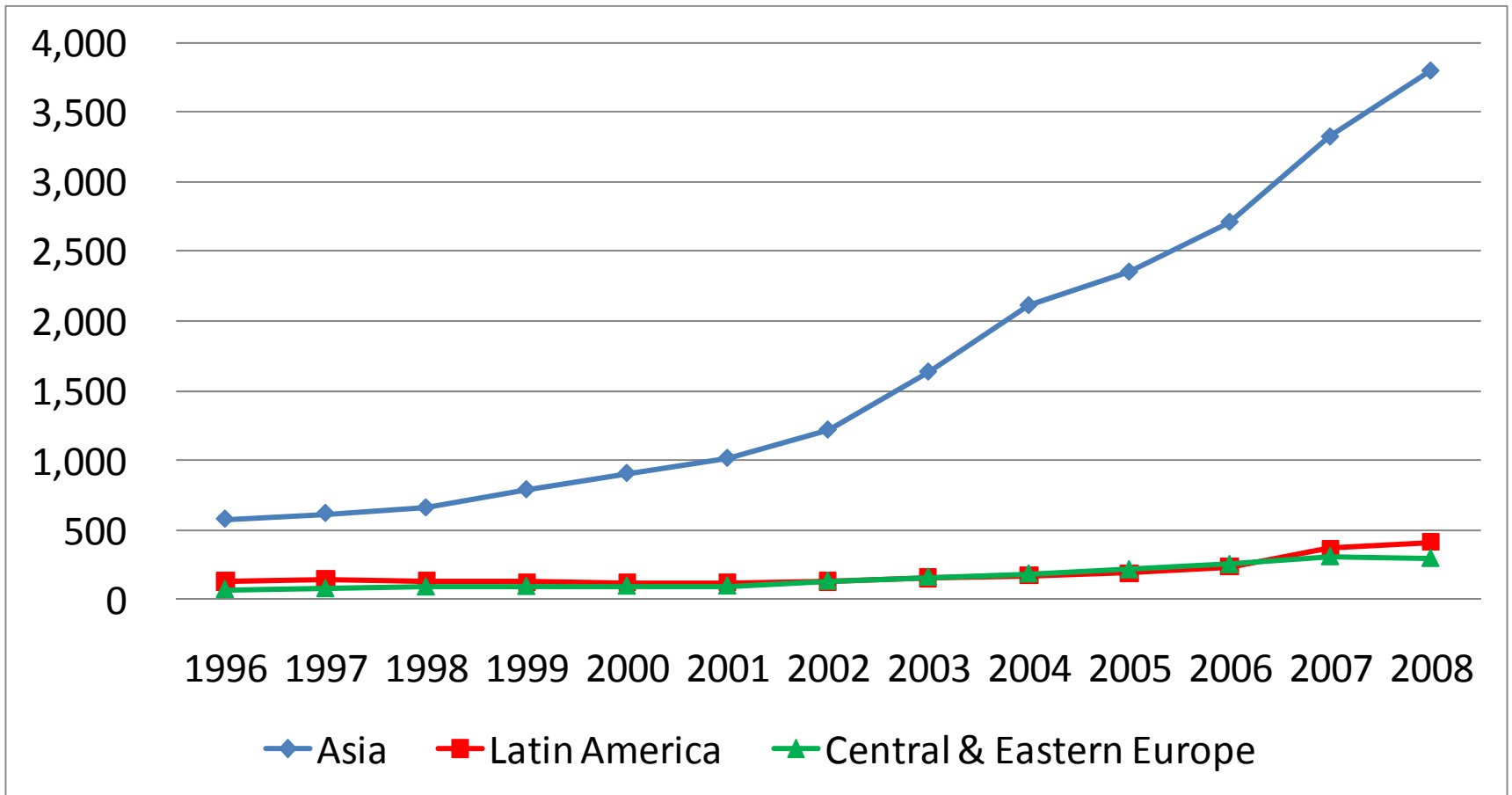
# What caused the illiquidity?

- Real estate peaked in July 2006
- Severe financial market problems started about 1 year later after it had become clearer this was a bubble
- Pricing of mortgage-backed securities
  - Adverse selection?
  - Illiquidity and limits to arbitrage?
  - Slow adjustment of real estate prices and resulting illiquidity of mortgage-backed securities makes them difficult to value?
- Why did so many people in the U.S. miss the bubble?

# What caused the bubble?

- The monetary policies of central banks particularly the US Federal Reserve were too loose – they focused too much on consumer price inflation and ignored asset price inflation
- Global imbalances – the Asian crisis of 1997 and the policies of the IMF led to a desire among Asian governments to save funds

# Reserves: Comparison





# Excessive risk taking

- Was it in the private sector or the public sector?
- Is central bank independence good for financial stability?
- Shouldn't there be more checks and balances?
- Chancellor Merkel's June 2, 2009 speech in Berlin to have Fed back off quantitative easing is probably not an optimal governance mechanism

# Solving the global imbalance problem

- Self-insurance by Asian and other countries through the accumulation of reserves is optimal for them, e.g. South Korea
- However, it is a very inefficient mechanism from a global perspective
- Reform of the IMF?
- China's global currency proposal
- Shift of power to China – Rmb as a reserve currency

# Other key reforms

- “Too big to fail” is not “Too big to liquidate”
- Resolution of large complex cross-border financial institutions
- Capital adequacy should be based on market capital as well as accounting capital
- Role for public sector banks in a mixed system?