Comments on Role of Government in Crisis Mgt

BIS conference, Basel

June 25

, 2009

Bengt Holmstrom, MIT

Outline

- Comments on model
- Why does debt play a key role in liquidity provision?
- Transparency
- Tentative lessons

Main idea

- Put option in shallow pocket worth more than in deep pocket (reverse of taking bad assets off balance sheet)
- 2-period model: no trade
- 3-period model: wait for resolution of uncertainty about default
- Freeze at date 0; underinvestment in liquidity (by both types of intermediaries)

Some questions

- What does this freeze correspond to?
  - Not about initial freeze (in CDS, repo mkts)
  - But plausible explanation of subsequent credit freeze
- Why don’t depositors demand higher interest in response to bank risk?
- Why not sell to shallow pockets financed by LT debt? (SIVs)

Why is debt so prevalent in provision of liquidity?

Many models of liquidity provision, but not with debt (e.g. D-D, H-T)

Many models of debt, but not with liquidity provision (CSV, A-B)

Two exceptions:

- Diamond-Rajan
- Gorton-Pennacchi (Myers)

Non-transparency – a solution

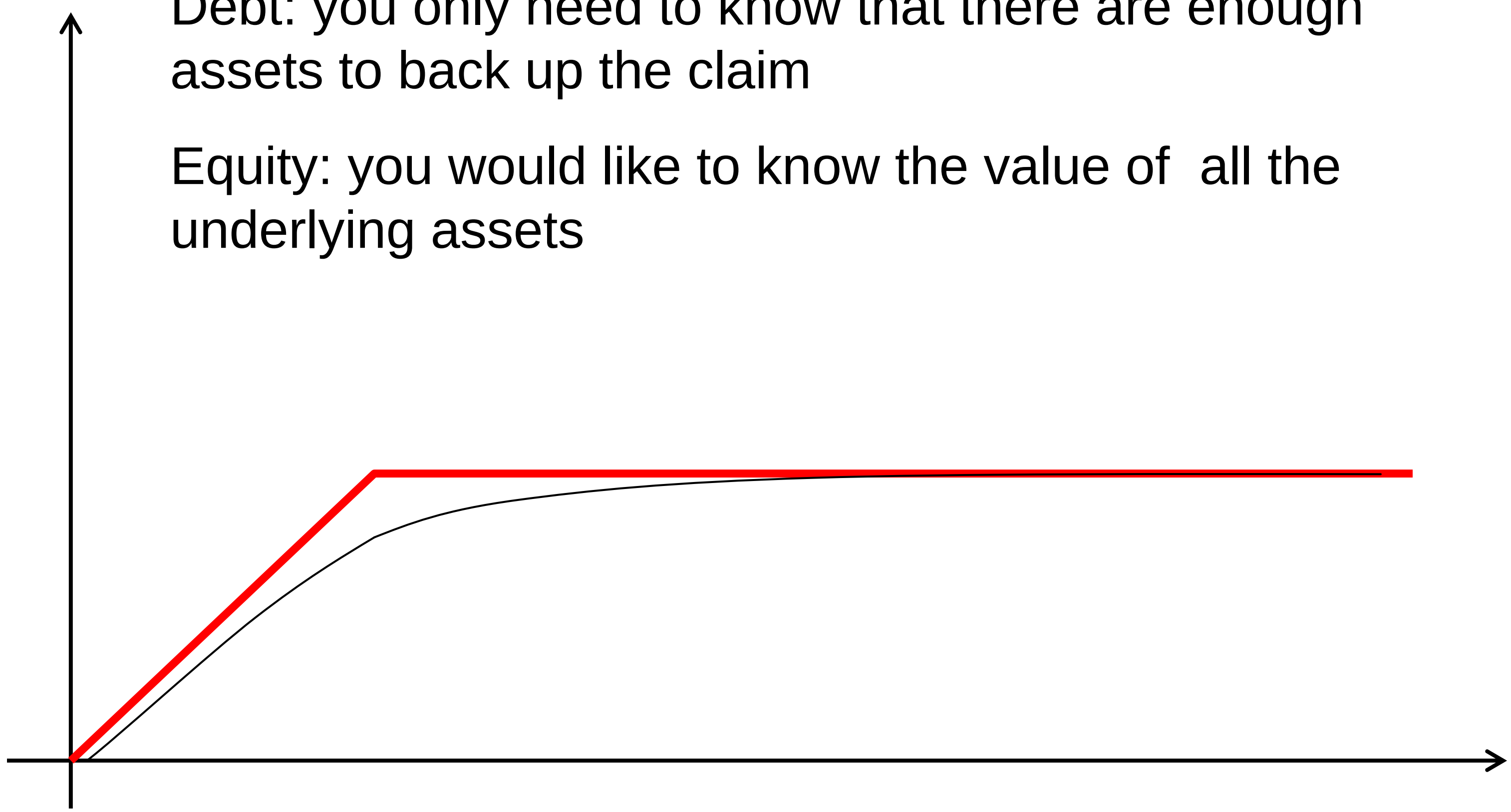
Liquidity = symmetric information about *payoffs*

Symmetry often easier to achieve by limiting transparency (e.g. deBeers)

Nature of liquidity provision

- High velocity markets
  - No time to evaluate creditworthiness
  - Commonality, trust (Morris-Shin)
- Demand for information insensitive instruments => debt (Gorton-Pennacchi)

Debt and information sensitivity



The fundamental problem

Relying on debt, securitization, coarse ratings, mechanical models, all makes sense – in good times

…but

- concentrate risk in tail
- hard to price systemic risk exactly because of info insensitivity
- externality gives excess systemic risk

What should be done?

- If private actors don’t have incentive to produce information – should governments do it? When?
  - Consider value of low transparency, not just current cost
- Liquidity providers should not carry tail risk, but who should?
  - Separate risk sharing and liquidity provision
  - Aggregate risk has to be carried by government – but only the tail risk
- Ex post measures critical – but also reduce liquidity