Confidence Cycles and Liquidity Hoarding[1]

V. Audzei

Discussion: Paweł Kopiec, Narodowy Bank Polski

[1]The views presented in this paper are those of the author, and should not be attributed to Narodowy Bank Polski.

Brief summary

- Very interesting and original paper
- Elegant structure: simple model solved by paper & pencil $\Rightarrow$ full-blown macro model
- It analyzes the macroeconomic effects of shifts in interbank market confidence and unconventional monetary policies

- Mechanism:

Decrease in expectations about market returns

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Projects get more risky, higher counterparty risk across banks

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Liquidity hoarding and lower volumes of interbank loans

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Lower supply of loans to the real sector

- Framework: an extended version of Gertler and Karadi (2011)
  - bounded rationality
  - heterogeneous banks

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Contributions of the paper

- Macroeconomic models with a banking sector
  - **Moral hazard:** Gertler and Karadi (2011), Gertler et al. (2012), Gertler and Kiyotaki (2015), Bocola (2016), Gourinchas et al. (2017)
  - Costly intermediation: Curdia and Woodford (2011)
  - Illiquidity shocks and search and matching: Bianchi and Bigio (2014), Kopiec (2018)

- Origins of interbank market turmoils
  - **Counterparty risk:** Flannery (1996), Afonso et al. (2011), Heider et al. (2015)
  - Precautionary liquidity hoarding: Acharya and Skeie (2011)

- Depressed lending after the Great Recession
  - **Supply-side view:** Bernanke (2010), Gorton (2010), Stein (2010)
  - Demand-side view: Mian and Sufi (2015), Bianchi and Bigio (2014)

Issue: interbank market rate during crises

- There is a serious discrepancy between the theoretical and the full-blown macro model:
  - theoretical model: low market beliefs $\Rightarrow$ low interbank rate
  - full model: low market beliefs $\Rightarrow$ high interbank rate
- Prediction of the theoretical model is at odds with empirical evidence
- Interbank market risk is present in the theoretical model so the upward pressure on interbank rates is there...
- What is behind the downward pressure?

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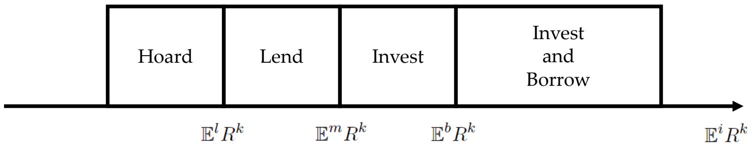
Theoretical model - normal times



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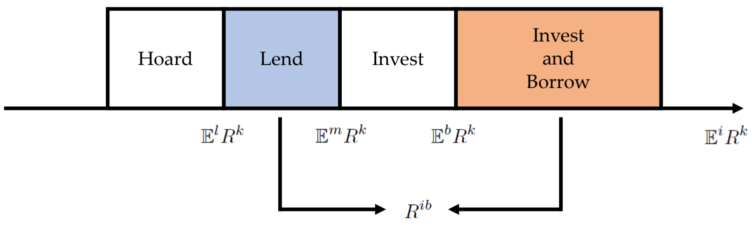
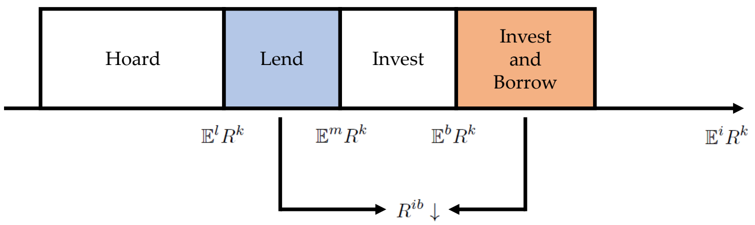


Theoretical model - confidence crisis



Fixing the problem

- Why interbank rates drop during the confidence crisis in the theoretical model?
  - Banks are free to choose their market position AFTER the materialization of a confidence shock
  - As a result, the pool of banks that borrow in the market shrinks (demand for interbank loans decreases)
- Is that a realistic scenario?
  - Not really...
  - Brunnermeier (2009): "On August 9, 2007, the French bank BNP Paribas froze redemptions for three investment funds, citing its inability to value structured products. Following this event, a variety of market signals showed that money market participants had become reluctant to lend to each other"
- My suggestion - modify the sequence of events, for example:
  - First: exogenous division of banks - borrowers and lenders
  - Second: confidence shock arrives
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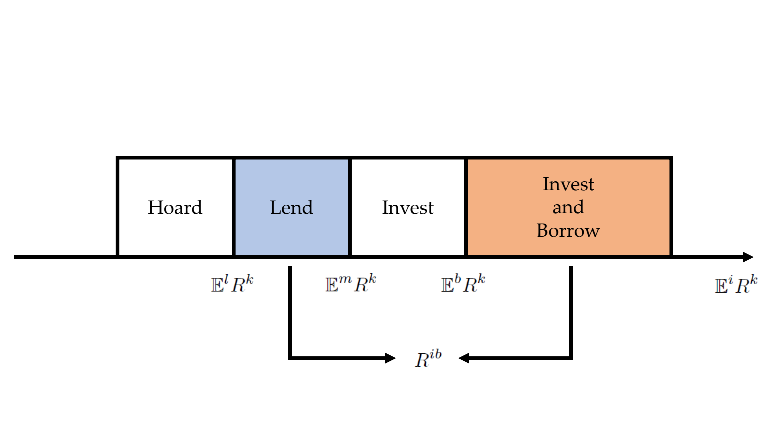
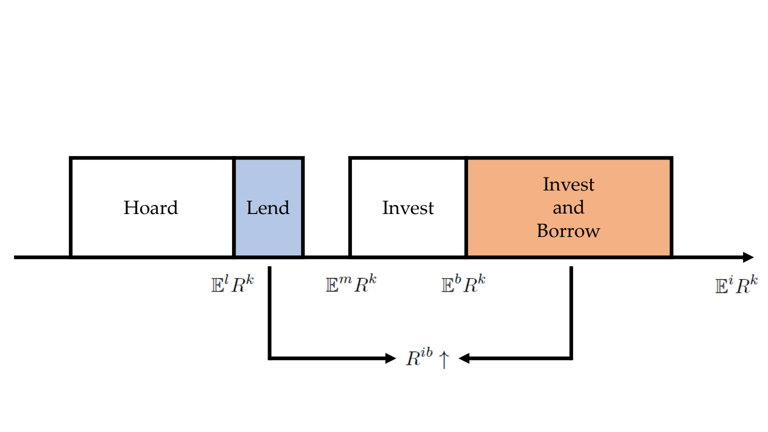


Modified model - confidence crisis



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The End

Thanks for your attention!