Using Economic Theory to Think of Bank Regulation: Remarks at Weberfest

V. V. Chari
University of Minnesota and Federal Reserve Bank of Minneapolis
Basics

- Financial intermediaries often have deposits/short-term debt as liabilities and illiquid loans as assets
- System prone to runs/confidence issues
- Mechanism seems crazy
Stories for Mechanisms

- Insurance/maturity transformation
  - Diamond-Dybvig

- Efficient way of extracting information
  - Chari-Jagannathan

- Discipline managers
  - Calomiris-Kahn
  - Diamond-Rajan
Diamond-Dybvig requires illiquid assets. No hidden trading

- See Jacklin-Wallace

Suggests prohibiting banks from holding widely-traded assets!

Suggests suspension of convertibility

Discipline story says do not suspend for idiosyncratic shocks, do suspend for aggregate shocks

Debt convertible to equity?
Sprague studies National Banking era

Widespread banking crisis led to suspension

Could not take cash out of system

Could exchange deposits with other depositors in system

Average discount was?
Historical Evidence

- Sprague studies National Banking era
- Widespread banking crisis led to suspension
- Could not take cash out of system
- Could exchange deposits with other depositors in system
- Average discount was?  
  2%!
• We cannot return to glory years from 1935–1980

• System too competitive

• We cannot rely on regulators

• If majority of market participants think the world is fine, why should majority of regulators be different?
Moral

- When aggregate shock hits
- Make returns state-contingent
- Suspend convertibility
- Convert debt to equity
- What rules to use?
- What role for discretion?