

Discussion of “To Sell or To Borrow?” by Michał Kowalik

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European Central Bank



The Paper

“To Sell or To Borrow? A Theory of Bank Liquidity Management”



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- Deals with banks' liquidity management.



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- Banks can meet intermediate date withdrawals with cash, by **borrowing** on the interbank market or **selling** assets on the secondary market.

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- Deals with banks' liquidity management.
- Banks decide to allocate their endowment between cash and investments in illiquid assets.
- Banks can meet intermediate date withdrawals with cash, by **borrowing** on the interbank market or **selling** assets on the secondary market.
- Market functioning is impaired by **asymmetric information** on asset quality.

First Thoughts

Liked the paper a lot



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- Sound (and fun!) technical analysis
- Very insightful
- Combines interesting insights with very concrete and relevant policy recommendations.



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- Three time points: $t = 0, 1, 2$.
- At $t = 0$ Choose how to split endowment between cash and an (ex ante) profitable, illiquid asset.
- Faces liquidity and solvency shocks at $t = 1$



The Paper

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- At $t = 1$, the firm faces two independent shocks:
- A **quality** shock to the asset and a **liquidity shock** to the bank.
- Liquidity shock: illiquid banks need to pay at $t = 1$ to continue, liquid banks do not.
- Quality shock: good assets will surely return at $t = 2$, bad assets might fail and yield 0. Bad assets are less profitable than cash, ex post.

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- Thus at $t = 1$ firm can be in four possible situations: GI, GL, BI and BL.
- Firms can obtain liquidity by either selling assets on **secondary market** or borrowing on the **interbank market**.
- Secondary market: confusion of bad banks dumping assets and good illiquid banks raising cash.
- Interbank market: adverse selection on probability of repayment.

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- For some values of the banks' cash holdings, liquidity shortage at $t = 1$: leads to bank failures.



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- Still, ex ante, banks can choose these levels of cash holdings, do not fully internalize the failure risk.
- These failures are socially wasteful: policy intervention?



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Addresses three types of policy intervention:

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- **Asset purchases** at $t = 1$ are ineffective because of adverse selection.
- **Liquidity injections** on the interbank market at $t = 1$ are effective eliminating liquidity shortage.
- **Liquidity requirements** at $t = 0$ can be effective.



My Remarks

- Nature of liquidity shock



My Remarks

- Nature of liquidity shock
- Types of equilibria



My Remarks

- Nature of liquidity shock
- Types of equilibria
- Nature of interbank market and secondary market.



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- Types of equilibria
- Nature of interbank market and secondary market.
- Policy measures.



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Nature of Liquidity Shock

Liquidity shock is also a solvency shock.

- Liquidity shock is also a cost
- Not a bad assumption in terms of interpretation
- Nevertheless, it might be cleaner to consider **pure** liquidity shocks: really disentangle liquidity and solvency effects.



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In the $t = 1$ analysis, implicit assumption that banks play **symmetric pure strategies**.

- More than technical.
- Might specialization occur: liquid, safe banks versus risky, potentially profitable ones.
- Does this change anything?



The Two Markets

- Two differences: specialization and cash constraints



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- Justification of why these are the salient differences.



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The Two Markets

- Two differences: specialization and cash constraints
- Justification of why these are the salient differences.
- Why not other differences? Information asymmetry?
- Over-the-counter markets: other inefficiencies.



Policy Measures

- Liquidity injections: what happens ex ante?



Policy Measures

- Liquidity injections: what happens ex ante?
- Liquidity requirements: robustness.



Policy Measures

- Liquidity injections: what happens ex ante?
- Liquidity requirements: robustness.
- Rules vs. discretion?

