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Discussion of
Money, Financial Stability and Efficiency

By

Allen Carletti and Gale
Context

• Large literature on “Diamond and Dybvig” banking.
  – Banks are providing liquidity insurance
  – Where liquidity is a way to deal with consumption risk (shock between an early and a late consumption need).

• If banks rely on an (exogenously assumed) deposit contract, then you have inefficiency
  – In particular inefficient runs
This Paper

• It starts from this common framework but it assumes that
  – deposit contracts are nominal, not real
  – central banks can flood the market at no cost
⇒ it shows that, unlike traditional Diamond and Dybvig, the competitive equilibrium is Pareto efficient

• Why?
Intuition

- From Allen and Gale previous work we know that suspension of convertibility (pro rata sharing) resolves Diamond and Dybvig’s typical inefficiency.

- Why?
  - No benefit to run.
  - Each depositor gets pro quota the value of banks’ assets

- The clever idea of this paper is that central bank can achieve same result by flooding the market with liquidity.
Intuition -2

- In a DD model pro-rata sharing (in real terms) eliminates incentive to run.
- Can you achieve the same with a first-come-first-served contract?
- Yes, if the contract is nominal.
- Liquidity provision by the central bank eliminates “pressure to withdraw”
- A subsequent rise in price level ensures that there is a pro-rata distribution of the time-1 resources.
Robustness

• Does this result survive if there is the possibility of investing at time 1?
• Does it survive in an open economy?
Comments

• Two sets of comments:
  – **Theoretical**: how does this model advance our understanding of banking?
  – **Practical**: what does this model tell us about the world and the crisis?
Theoretical

• Usual limitations of DD model.
• Central bank has a role only because contracts are
  – first come first served
  – Nominal
  – Markets incomplete
• No progress on this front
• But better understanding about the role of contingent liquidity injections
Practical

• Access to the discount window is an essential element that allows banks to provide liquidity insurance effectively.
  – e.g. centralized clearing houses

• Access resolves the run problem.

• 2008 financial crisis was not a run problem, because eventually everybody had access to the discount windows.
Summary

• It is a neat idea
• I would like to see the robustness explored more
• It is very useful to rule out what was important and not important in causing the crisis.