Panel: Is Maturity Transformation the Devil's Work?

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Atlanta Fed Conference
April 10, 2012

A Quote from 1986

> Proposals to move toward 100% reserve banking would prevent banks from fulfilling their primary function of creating liquidity. Since banks are an important part of the infrastructure in the economy, this is at best a risky move and at worst could reduce stability because new firms that move in to fill the vacuum left by banks may inherit the problem of runs.

Diamond, Douglas W., and Philip H. Dybvig, 1986, Banking Theory, Deposit Insurance, and Bank Regulation, *Journal of Business* **59**

This is a follow-on policy piece, not the bank runs paper some people know. I think it holds up pretty well, but the statement that Money Market Funds are like 100% reserve banks should be qualified "in normal times."

How to Eliminate Bank Failures Completely

There seems to be a lot of talk about safety of banks, which is the benefit of regulation, but not very much on what are the potential costs of regulation. If we want to avoid the problem of banks blowing up, it is simple: just make banking illegal. Of course, this destroys whatever benefits we get from banks. Although there may be a populist sentiment that banks are evil and we are better off without them, of course everyone knows better and we do seem to need banking services for our economy to function.

What Banks Do

- Asset Side Services (e.g. originating and servicing loans)
- Liability Side Services (e.g. accepting deposits and providing cash)
- Transformation Services (creation of liquidity)

Maturity transformation in the title of this panel could mean interest rate exposure, but I will focus on liquidity creation. I think the critical question is how important is liquidity creation by banks. Diamond and Dybvig [1983] shows how liquidity creation by banks might be useful, but it is an empirical question how important it really is.

Questions

1. Is creation of liquidity by banks surplus liquidity in the economy or does it serve a useful economic purpose?

2. How about creation of liquidity by the shadow banking sector? Was it surplus? Did it represent liquidity banks could have provided?

3. From the events in the crash, it would seem that the liquidity provide by banks and shadow banks was important because their collapse is associated with the start of prolonged problems in the economy. Now, it is an empirical question whether these problems were actually caused by the banking collapse, and it is an interesting empirical question to test this against various alternatives (for example, maybe the problem is rising oil prices or unemployment due to increased automation). Personally, I suspect (but cannot prove) that loss of liquidity was a big problem.

Questions (cont.)

4. If, as I suspect, the loss of liquidity was a big problem, was that only a problem given that agents came to expect more liquidity than they needed and organized their affairs in a way that required too much liquidity? Or, is it a more fundamental problem and the liquidity is important for an efficient economy?

5. If there was too much liquidity in the economy, why? Some people have argued that it was because of too much stimulus and the government kept interest rates too low (and perhaps the Chinese government had a role as well as the US government). I don't want to take a side on these claims, but it is an important empirical question whether the explosion of the huge shadow banking sector was a distortion that was an unintended side effect of policy or whether it is an essential feature of a healthy economy.