Intermediaries, Markets, and Crises

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Course Description

This ten-hour course will study financial intermediation with an emphasis on the role played by intermediaries in engendering financial fragility and capital market imperfections. We shall focus on a number of specific themes based on papers ranging from the classics in the financial intermediation literature to very current research linking financial intermediation frictions to inefficiencies in financial markets and corporate governance.

To be more specific, we shall consider three main themes. First, we'll consider some theoretical arguments for the existence of financial intermediaries, emphasizing the core linkage between intermediation and financial fragility/crises. Second, building upon this, we'll introduce some recent – but now quite widely used – methodological advances (global games) to refine our study of the interaction between intermediation and crises, examining both applications and limitations. Finally, we'll consider some new territory that seeks to understand the broader role of financial intermediaries in impacting financial market equilibrium quantities (e.g. prices, volume, returns) and the nature of corporate governance.

The lectures will be based principally on research articles, usually simplified via my lecture slides. The starred articles listed are required reading. The bibliographies of the listed papers contain suggestions for further reading.

Course Outline

Topic 1: Intermediation and Financial Fragility

- *Financial intermediaries as liquidity insurance providers: The liquidity-fragility "trade-off"*

  Bryant, J. (1980), "A model of reserves, bank runs, and deposit insurance," Journal of Banking and Finance, 4, 335-344.

  (*) Diamond D. and P. Dybvig (1983), "Bank runs, deposit insurance, and liquidity," Journal of Political Economy, 91, 401-419.

- *Relationship lending and the disciplinary role of bank runs*

  Diamond, D. and R. Rajan (2001), "Liquidity risk, liquidity creation, and financial fragility: A theory of banking, Journal of Political Economy, 109, 287-327.

  Calomiris, C. and C. Kahn (1991), "The role of demandable debt in structuring optimal banking arrangements," American Economic Review, 81, 497-513.

- *The coexistence of intermediaries and markets and the role of intermediary capital*

  Jacklin, C. (1987) "Demand deposits, trading restrictions, and risk sharing," in Contractual Arrangements for Intertemporal Trade, edited by E. Prescott and N. Wallace, Minneapolis: University of Minnesota Press.

  (*) Holmstrom B. and J. Tirole (1997), "Financial intermediation, lonable funds, and the real sector, Quarterly Journal of Economics, 112, 663-692.

  He, Z. and A. Krishnamurthy 2011, "A Model of Capital and Crises," Review of Economic Studies, forthcoming.

Topic 2: Pinning down Financial Fragility: Some Recent Advances

- *Eliminating multiplicity: Global games*

  (*) Morris, S. and H. Shin (2000), "Rethinking multiple equilibria in macroeconomics," NBER Macroeconomics Annual 2000, 139-161. M.I.T. Press.

  Goldstein, I. and A. Pauzner (2005), "Demand Deposit Contracts and the Probability of Bank Runs," Journal of Finance, 60, 1293–1328.

- *Using global games: Is financial fragility all bad?*

  (*) Eisenbach, T. (2010), "Rollover Risk: Optimal but Inefficient", working paper, Princeton University.

- *Limitations and extensions of global games*

  (*) Angeletos, G-M. and I. Werning (2006), "Crises and Prices: Information Aggregation, Multiplicity and Volatility", American Economic Review, 96: 5.

  Angeletos, G-M., C. Hellwig, and A. Pavan (2006), "Signalling in Global Games: Coordination and Policy Traps," Journal of Political Economy, 114:3.

  Dasgupta, A. (2007), "Coordination and Learning in Global Games," Journal of Economic Theory, 134, 195-225.

Topic 3: Financial intermediaries and Financial Imperfections

- *Money managers as delegated traders: How intermediation affects markets*

  (*) Scharfstein, D. and J. Stein 1990 “Herd behavior and investment,” American Economic Review, 80, 465-479.

  Allen, F. and G. Gorton, 1993 “Churning Bubbles,” Review of Economic Studies, 60, 813-836.

  Chevalier, J. and G. Ellison, 1997 “Risk Taking by mutual funds as a response to incentives,” Journal of Political Economy, 105, 1167-1200.

  Chevalier, J. and G. Ellison, 1999 “Career concerns of mutual fund managers,” Quarterly Journal of Economics, 114, 389-432.

  (*) Allen, F., 2001 “Do Financial Institutions Matter?” Journal of Finance, 56, 1165-1175.

  Dasgupta, A. and A. Prat, 2006 “Financial equilibrium with career concerns,” Theoretical Economics, 1, 67-93.

  Dasgupta, A. and A. Prat 2008 “Information aggregation in financial markets with career concerns,” Journal of Economic Theory, 143, 83-113.

  (*) Dasgupta, A., A. Prat, and M. Verardo 2011 “The price impact of institutional herding,” The Review of Financial Studies, 24, 892-925.

  Dasgupta, A. A. Prat, and M. Verardo 2011 “Institutional trade persistence and long-term equity returns,” Journal of Finance, 66, 635-653.

- *Money managers as delegated stewards: How intermediation affects corporate governance*

  Dasgupta, A. and K. Zachariadis 2010, “Delegated Activism and Disclosure,”

  http://ssrn.com/abstract=1652148.

  Dasgupta, A. and G. Piacentino 2011, “The Wall Street Walk when Blockholders Compete for Flows,” http://ssrn.com/abstract=1848001.