

Fear of Fire Sales, Illiquidity Seeking, and Credit Freezes

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Abstract

Is there any need to clean up a banking system by closing some banks and forcing others to sell assets if the risk of a crisis becomes high? Impaired banks that may be forced to sell illiquid assets in the future have private incentives to hold, rather than sell, those assets. Anticipating a potential fire sale, liquid buyers expect high returns, reducing their incentive to lend. Privately optimal trading decisions therefore lead to a worse fire sale and a larger drop in lending than is necessary. We discuss alternative ways of cleaning up the system and the associated costs and benefits.

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