Illiquid Banks, Financial Stability, and Interest Rate Policy

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Abstract

Banks finance illiquid assets with demandable deposits, which discipline bankers but expose them to damaging runs. Authorities may not want to stand by and watch banks collapse. However, unconstrained direct bailouts undermine the disciplinary role of deposits. Moreover, competition forces banks to promise depositors more, increasing intervention and making the system worse off. By contrast, constrained central bank intervention to lower rates maintains private discipline, while offsetting contractual rigidity. It may still lead banks to make excessive liquidity promises. Anticipating this, central banks should raise rates in normal times to offset distortions from reducing rates in adverse times.