FINANCIAL INTERMEDIATION THEORY

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Course Description

Financial intermediation plays a critical role in improving economic efficiency. However, as past and recent experience demonstrates, it is also prone to fragility, leading to large crises that hurt the economy. I will review traditional and advanced theories of financial intermediation, trying to understand why intermediaries emerge, how they bring economic value, and why fragility is an inherent feature of intermediation. Key roles played by financial intermediaries that will be highlighted are liquidity provision, risk sharing, diversification, and monitoring. The dynamics leading to coordination failures and bank runs will also be analyzed in depth. After presenting the theories, I will discuss implications for policy that is aimed at reducing fragility and evaluate the different tradeoffs involved. Finally, I will also discuss the link of the different theories to empirical evidence and identify challenges in distinguishing between the different mechanisms in the data.

Tentative Outline

1. Introduction
    a. The role of financial intermediaries
    b. Financial crises of different types
2. Banks, Liquidity and Runs; Diamond and Dybvig (1983)
    a. Banks as liquidity providers
    b. Bank runs
    c. Challenges for policy and bank regulation
3. Global-games approach
    a. Deriving unique equilibrium in models of strategic complementarities
    b. Currency attacks; Morris and Shin (1998)
    c. Bank runs; Goldstein and Pauzner (2005)
4. Global-game uses and policy analysis
    a. Use of global-games approach for equilibrium analysis, policy analysis, and empirical implications
    b. Government guarantees and financial stability; Allen, Carletti, Goldstein, and Leonello (2018)
5. Detecting strategic complementarities in the data
    a. Crises: fundamentals vs. panic; empirical evidence
    b. Strategic complementarities in mutual funds; Chen, Goldstein, and Jiang (2010), Goldstein, Jiang, and Ng (2017)
    a. Lenders' reaction to public information; Hertzberg, Liberti, and Paravisini (2011)
6. Banks as monitors and credit market frictions
    b. Banks as monitors; Diamond (1984)
    c. Net worth and credit constraints; Holmstrom and Tirole (1997)
    d. Link to banking crises and currency crises
7. Contagion
    a. Contagion in the interbank market; Allen and Gale (2000)
8. Summary and future directions
    a. Lessons from recent events
    a. Future directions for research

References

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