Comments on:

Liquidity Contagion and Financial Crisis

By: Alexander Guembel and Oren Sussman

Comments by:

Ethan Cohen-Cole
Robert H Smith School of Business
University of Maryland – College Park

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General Thoughts

- Outstanding paper
  - (I'm not just saying that)
  - Simple framework, well implemented, easy to interpret
  - Captures many features of this and other liquidity crisis
  - Opens door for insight into regulation and remediation policies
- Short time, focus on a couple large questions

Primary questions

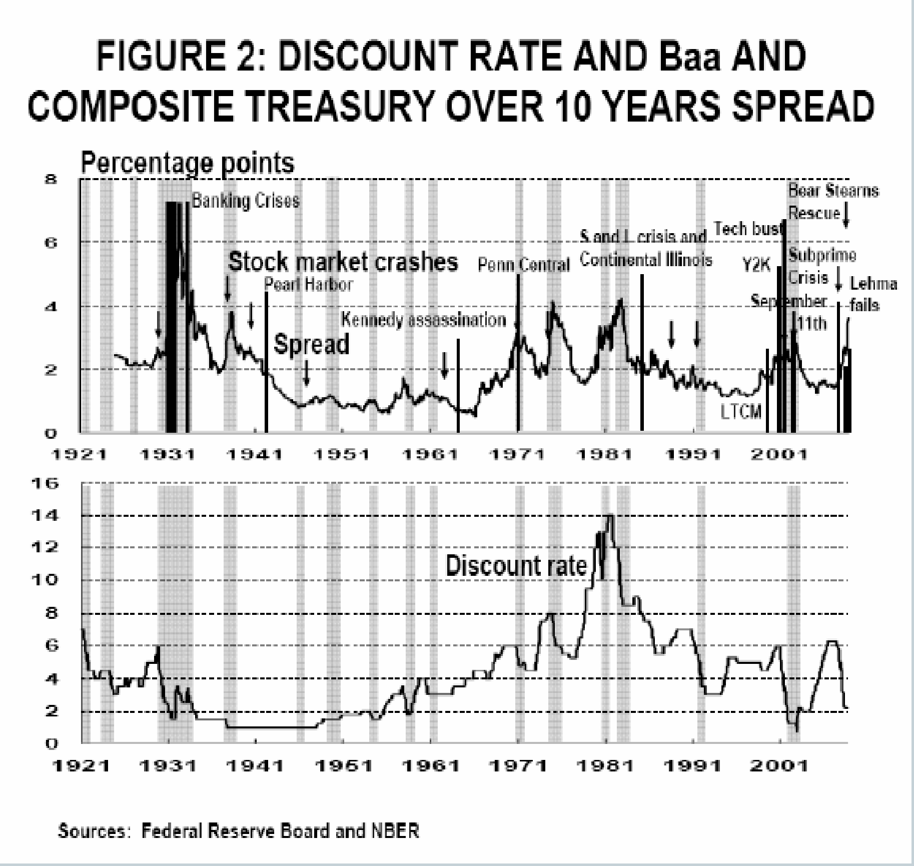
- How do we think about crises and the credit cycle?
- Does the insolvency / illiquidity tradeoff matter?
- Comment on liquidity insurance.

The classic crisis story

- Business cycle upswing driven by Fisher “displacement” (an exogenous event that provides new profitable opportunities for investment) leading to an investment boom **(APPROACH 3)**
- financed by
  - Bank money
  - Accommodating monetary policy
  - Innovation
- Leads to ‘euphoria’ where investors have difficulty distinguishing **(APPROACH 1),** and rampant fraud
- Then overindebtedness
- Crisis can lead to
  - fire sales of assets, declining net worth, bankruptcies, bank failures and an ensuing recession.
- Story from Bordo (2009); See: Wesley Mitchell (1913), Irving Fisher (1933), Hyman Minsky (1977), Charles Kindleberger

This story is at root one generated by the business cycle

- Spread peaks are at business cycle troughs
- Significant crisis overlap
- Policy rate tight prior, with significant drops into recession



(Figure from Bordo 2009)

Credit Cycle

- Encourage authors to think about:
  - Firm value (why invest? When?)
  - Credit cycles
  - Policy actions (other than corrective)

Insolvency and Liquidity

- Lessons from the great depression
  - Recovery started with:
    - FDR’s banking holiday (March 1933)
    - Floating the dollar (April 1933)
    - Massive gold purchases to increase money supply
  - NY Fed liquidity measures in 1929 didn’t help
- What else worked?
  - Reconstruction Finance Corporation (1930s), Resolution Trust (1980s), Sweden (1992), Japan? (1990)
- Wide variety of economists have argued that we need an equity solution to this crisis

- How can we integrate these with the current paper?

Insolvency (economic distress), cont

- Authors focus on financial distress and still generate crises (commendable)
- Would be useful to see economic distress in this model as well; one would expect:
  - More crises
  - Complementarity between types of distress
  - *Ambiguity* over the policy response:
    - With only financial distress:
      - Liquidity<Indiscriminate equity <targeted equity
    - With real distress:
      - I surmise (without evidence) that that policy recommendations would be quite different

Liquidity Insurance

- Lack of liquidity insurance plays a key role in model (acknowledged)
  - Banks cannot insure against short-term liquidity needs prior to contracting.
  - Thus fully exposed to fire-sale type price impacts ex-post

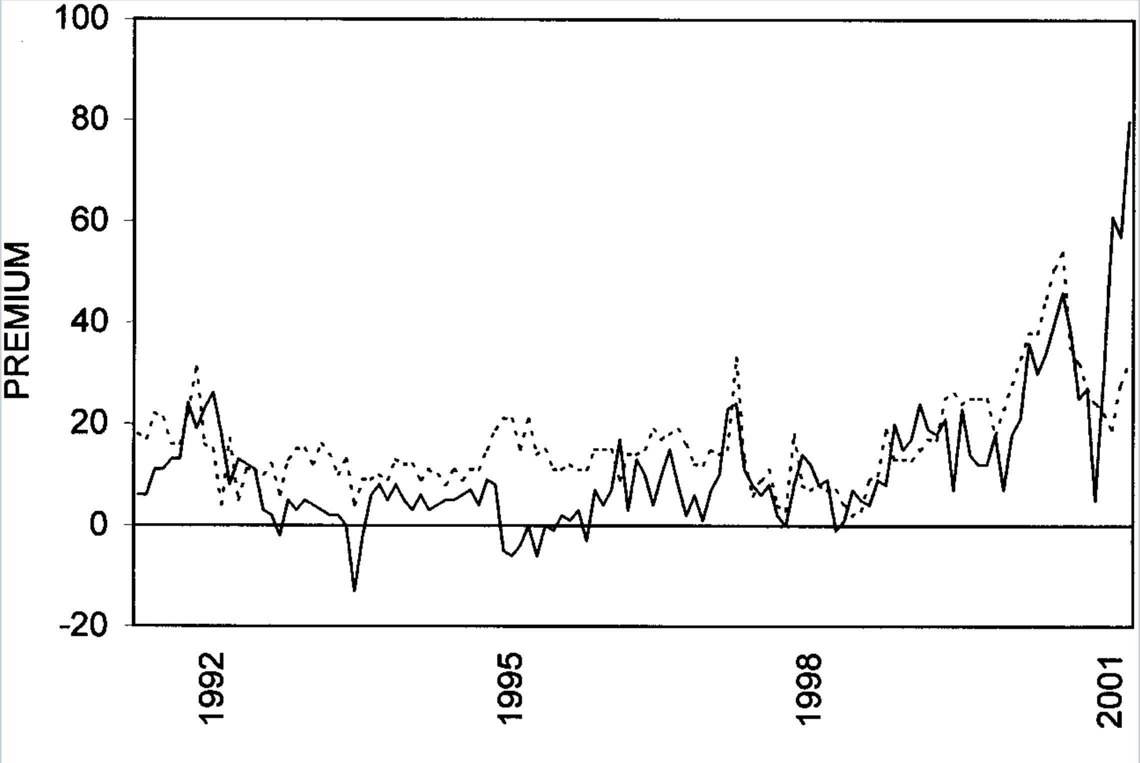
- But liquidity insurance exists (it is common)
  - Lines of credit (0.5-1% annual cost)
    - See Huang (2009) on use during financial crisis
  - Liquidity swaps
    - Sell illiquid bond
    - Buy liquid of same maturity

Liquidity Insurance, cont.

- What does this mean for the model?
- Once we shut down liquidity insurance, where is the price implication for liquidity in normal times?
  - Liquidity should have a premium.
  - Hoarding should be very profitable!
  - 40% drop in price of liquidated capital * 7.7% chance of crisis:
    - ~3% *real* annual liquidity premium!

- Data suggests a premium that is smaller.

Flight to Liquidity Premium



Longstaff (2002). Figure shows 1 year and 30-year liquidity premiums (bp) Calculated as the price premium of US treasuries over US-treasury guaranteed REFCORP bonds

Final Thoughts

- Credit cycle is important
- Isolation of liquidity effects is instructive
  - but why then match to data?
  - What does this imply about the role of other effects?
- Interventions:
- Can the cost of failure and cost of mistakes be included?
  - Not clear that government intervention makes much sense given the distribution of potential outcomes.
  - Need linear preferences – not clear that governments don't have min-max ones.

Good luck!