Master in Economics and Finance

Economics of Banking

David Martinez-Miera

The main objective of this course is to understand the key mechanisms underlying the behavior of banks and their consequences. The course present different setups that allow the participant to better understand:

1. The relevance of imperfect information in the credit market

2. The role of financial institutions in the economy

3. Banks' risk strategies and their impact on the overall allocation of capital in the economy

4. The role of banks and other agents in determining the inherent instability of the economy

5. The logic and possible unintended consequences underlying banking regulation

A useful reference for most of the course is the textbook of Xavier Freixas and Jean-Charles Rochet, Microeconomics of Banking, 2nd Edition, Cambridge, MA: MIT Press, 2008.

In brackets is the estimated length in weeks of the chapter. This might be subject to change

Chapters

1. Financial Intermediation and information frictions

   De Meza, D., & Webb, D. C. (1987). Too Much Investment: A Problem of Asymmetric Information. The Quarterly Journal of Economics, 102(2), 281–292.

   Stiglitz, J. E., and A. Weiss (1981), "Credit Rationing in Markets with Imperfect Information," American Economic Review, 71, 393-410.

2. Bank monitoring and the role of net wealth

   Diamond, D. (1984), "Financial Intermediation and Delegated Monitoring," Review of Economic Studies, 51, 393-414.

   Diamond, D. (1991), "Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt," Journal of Political Economy, 99, 689-721.

   Holmstrom, B., and J. Tirole (1997), "Financial Intermediation, Loanable Funds, and the Real Sector," Quarterly Journal of Economics, 112, 663-691.

   Krasa, S., and A. P. Villamil (1992), "Monitoring the Monitor: An Incentive Structure for a Financial Intermediary," Journal of Economic Theory, 57, 197-221.

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Rajan, R. (1992), “Insiders and Outsiders: the Choice between Informed and Arm's-Length Debt,” Journal of Finance, 47, 1367-1400.

Repullo, R., and J. Suarez (1998), “Monitoring, Liquidation, and Security Design,” Review of Financial Studies, 11, 163-187.

Repullo, R., and J. Suarez (2000), “Entrepreneurial Moral Hazard and Bank Monitoring: A Model of the Credit Channel,” European Economic Review, 44, 1931-1950.

3. The industrial organization of banks

Chiappori, P.-A., D. Perez Castrillo, and T. Verdier (1995), “Spatial Competitionin the Banking System: Localization, Cross-subsidies, and the Regulation of Deposit Rates,” European Economic Review, 39, 889-919.

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Tirole, J. (1988), The Theory of Industrial Organization, Cambridge, MA: MIT Press, Ch. 5 and 7. [LIB] Yanelle, M. O. (1997), “Banking Competition and Market Efficiency,” Review of Economic Studies, 64, 215-239.

4. Bank risk taking and competition

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Allen, F., and D. Gale (1998), “Optimal Financial Crises,” Journal of Finance, 53, 1245-1284.

Allen, F., and D. Gale (2000), Comparing Financial Systems, Cambridge, MA: MIT Press, Ch. 8.

Bhattacharya, S., A. Boot, and A. Thakor, A (1998), “The Economics of Bank Regulation,” Journal of Money, Credit and Banking, 30, 745-770.

Boyd, J., and G. De Nicolò (2005), “The Theory of Bank Risk-Taking and Competition Revisited,” Journal of Finance, 60, 1329-1343.

Farhi, E., and J. Tirole (2012), “Collective Moral Hazard, Maturity Mismatch and Systemic Bailouts,” American Economic Review, 102, 60-93.

Hellmann, T. F., K. C. Murdock, and J. Stiglitz (2000), “Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough?,” American Economic Review, 90, 147-165.

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5. Liquidity and runs

Allen, F., and D. Gale (2007), Understanding Financial Crises, Oxford University Press, Ch. 2 and 3.

Allen, F., and D. Gale (1998), “Optimal Financial Crises,” Journal of Finance, 53, 1245-1284.

Bhattacharya S., and D. Gale (1987), “Preference Shocks, Liquidity and Central Bank Policy,” in W. Barnett and K. Singleton (eds.), New Approaches to Monetary Economics, Cambridge: Cambridge University Press, 69-88.

Bryant, J. (1980), “A Model of Reserves, Bank Runs, and Deposit Insurance,” Journal of Banking and Finance, 4, 335-344.

Calomiris, C., and C. Kahn (1991), “The Role of Demandable Debt in Structuring Optimal Banking Arrangements,” American Economic Review, 81, 497-513.

Diamond, D., and P. Dybvig (1983), “Bank Runs, Deposit Insurance, and Liquidity,” Journal of Political Economy, 91, 401-419.

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Rochet, J.-C., and X. Vives (2004), “Coordination Failures and the Lender of Last Resort: Was Bagehot Right After All?,” Journal of the European Economic Association, 2, 1116-1147.

Shin, H. (2010), Liquidity and Risk, Oxford: Oxford University Press, Ch. 8. Vives, X. (2014), “Strategic Complementarity, Fragility, and Regulation,” Review of Financial Studies, 27, 3547-3592.

6. Banking Regulation: Capital Regulation

Admati, A., P. DeMarzo, M. Hellwig, and P. Pfleiderer (2011), “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive,” Stanford GSB Research Paper No. 2063.

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Blum , J. (1999) "Do capital adequacy requirements reduce risks in banking?" *Journal of Banking & Finance*, 23, 755-771

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Repullo, R., and J. Suarez (2013), "The Procyclical Effects of Bank Capital Regulation," Review of Financial Studies, 26, 452-490.

Vasicek, O. (2002), "Loan Portfolio Value," Risk, 15, December, 160-162.

7. Banks and Non-Banks

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Vives, X and Z. Ye (2022) "Information Technology and Lender Competition" Mimeo IESE.

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8. Banks in General Equilibrium

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Clerc, L., A. Derviz, C. Mendicino, S. Moyen, K. Nikolov, L. Stracca, J. Suarez, and A. Vardoulakis (2015), "Capital Regulation in a Macroeconomic Model with Three Layers of Default," International Journal of Central Banking 11, 9-63.

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Kiyotaki, N., and J. Moore (1997), "Credit Cycles," Journal of Political Economy 105, 211-248.

Lorenzoni, G. (2008), "Inefficient Credit Booms," Review of Economic Studies 75, 809-833.

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