'Gertler-Kiyotaki: Banking, Liquidity and Bank Runs in an Infinite Horizon Economy', AER (2015)

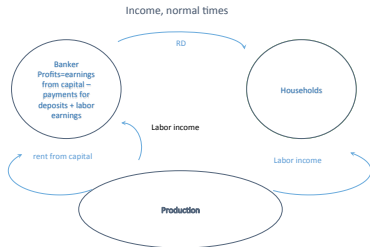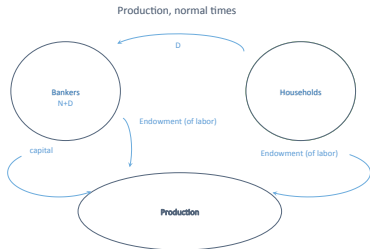Lawrence J. Christiano   Husnu Dalgic   Xueting Wen

Background

- In the period, 2007 - 2009(?), it appeared that there was a big 'bank run', in that financial institutions could not roll over the liabilities they had issued to finance long-term mortgage backed securities.
- This bank run was thought to have disrupted the financial system and dealt a blow to the real economy.
- Gertler-Kiyotaki (GK) designed a model that could in principle capture this vision.
- The model draws on the ideas of Diamond and Dybvig and Cole and Kehoe.

'Banks'

- The commercial banking system supervised by the Fed does not have runs.
    - Fed's lender of last resort function.
    - Federal Deposit Insurance.
- Banks in the Model: shadow banking system
- 'Households' in the Model: combination of actual households and commercial banking system.
- Gertler-Kiyotaki-Prestipino (forthcoming, Handbook of Macroeconomics):
    - construct a model that is explicit about the distinction between commercial banks, shadow banks and households.

Model In 'Normal' Times (no bank runs)

Production, normal times

Bankers
N+D

Households

D

Endowment (of labor)

capital

Endowment (of labor)

Production

Income, normal times

Banker
Profits=earnings
from capital –
payments for
deposits + labor
earnings

Households

RD

Labor income

rent from capital

Labor income

Production

Capital

- Abstract from capital accumulation
  - Total capital in the economy is fixed at $\bar{K}$ (=1).
  - No depreciation of capital.

- Ownership of Capital
  - Normally banks own most of the capital because they are efficient at operating it.
    - alternatively, the people they lend to are good at running it.
  - Households can also hold capital, but they are not efficient at it.
    - Stand in for idea that the banking system is specialized.
    - When institutions involved in management of capital are damaged and other institutions must take over, there is a loss (in practice, perhaps only a temporary loss).

Financial Frictions in Banks

- 'Normal' agency problem: banks can run away with fraction, θ, of assets. If they run away, we say they *default*.
  - If banks try to issue too many deposits, depositors worry that the bank will default and they refuse to give the bank any funds. Knowing this, banks limit how many funds they try to issue.

Source of Bank Run: Maturity Mismatch

- Banks hold long-term assets (capital) and finance it by one-period deposits.

  - In normal times, households simply *roll over* their deposits
  - the accrued principal and interest on deposits is simply converted into new deposits (rolled over), so the bank does not have to sell assets to pay the household.

- If households do not roll over their deposits, then banks must sell assets to pay the principle and interest on deposits.

  - It is possible to be in a situation where *all* households refuse to roll over: this is a *Bank run*.
  - In a bank run, banking system has to sell the capital to less productive users of capital, at a loss ('firesale price').
  - Bank equity is wiped out and without net worth the banking system cannot do its job, damaging the rest of the economy (the agency problem in banks plays a crucial role here).

What We Do

- Study an equilibrium in which the only source of uncertainty is the possibility of a bank run.

  - Explore the events before, during and after a bank run.

General Idea

- Let s denote the state of the economy at the start of a period.
  - s can take on a finite number of values, $s \in [1, ..., T+2]$.
  - $s = 1$ state in which a bank run occurs.
  - $s = j$, state in which the last bank run occured $j-1$ periods ago, $j = 2, 3, 4, ..., T+2$.

- Let s_t denote the realized value of the random variable, s, in period t.

'probability of a bank run in next period'
$$prob\left[s_{t+1} = 1 | s_t = j\right] = P(j)$$

'probability of no bank run in next period'
$$prob\left[s_{t+1} = j+1 | s_t = j\right] = 1 - P(j)$$

General Idea

- Let $X(s)$ denote the values of the equilibrium objects (e.g., rates of return, consumption, bank deposits, etc.), including $P(s)$, in state s.

  - $X(s)$ represents all the possible values of a multinomial random variable.

- Let X_t denote the realized value of the multinomial random variable in period t.
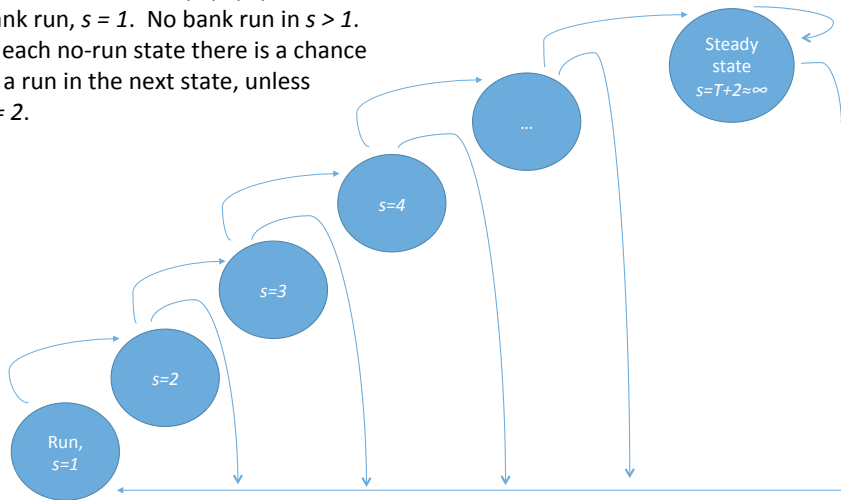
- 'Steady state':

  - suppose that

$$X_\infty = \lim_{t \to \infty} X_t, \ X_\infty \ \text{~ 'steady state'}$$

  - approximate $t = \infty$ with $t = T + 2$, T big.

- Idea: for t big, $X_t \approx X_{t+s} \ s > 0$.

Possible states: *s = 1, 2, 3,…, T+2*.
Bank run, *s = 1*. No bank run in *s > 1*.
In each no-run state there is a chance
of a run in the next state, unless
s = 2.

Run,
s=1

s=2

s=3

s=4

...

Steady
state
s=T+2≈∞

Outline of Analysis

- First part: compute $X(s)$ for all s.

  - In $t = 1$: bank run state.
  - In $t = 2, 3, ..., T + 1$: sequence of realizations of s_t in which no bank run occurs (although, in each t a bank run could occur in $t + 1$).

    - *State after run*: $t = 2$
    - *Middle states*: $t = 3, ..., T + 1$
    - *Steady state*, $t = T + 2$

- Full stochastic equilibrium as a first order Markov chain.

Eight Equations

- Bankers (where most of the action is)
  - participation constraint of banks.
  - law of motion of bank net worth.
  - probability of a bank run.
- Households
  - deposit decision.
  - capital decision.
- Other conditions:
  - resource constraint and two more equations.

Birth and Death of Bankers

- In each period the number of bankers corresponds to the number of points on the unit interval ('there is a unit measure of bankers').

- At the start of period t, $1 - \sigma$ bankers are randomly selected to exit the economy ('die'), and σ remain as bankers for period t.
  - Dying bankers consume their net worth in the period they exit.
    - That last meal is what they live for.
  - Bankers are risk neutral and their objective is to maximize the expected present discounted value of consumption.

- The population of bankers is constant, so $1 - \sigma$ new bankers are born in each period.
  - If the period of their birth is a bank panic, then bankers delay entry for one period (technically useful assumption).

- Bankers receive a one-time payment, w_t^b, in the period that they enter. Without this 'seed money' they can't issue deposits.

Bankers' Problem in a No Bank Run State

- Individual banker has net worth, n_t, and issues deposits, d_t.
- Buys capital, k_t^b :
$$Q_t k_t^b = n_t + d_t,$$
  where Q_t is price of capital in period when there is no bank run.
- The banker now has the option to default on its obligations to the household, or remain in business and possibly default later.
- First, consider no default. Then, default option.

Banker in a No Bank Run State Who Chooses Not to Default

- Period $t+1$ assets of banker that does not choose default in period t :

$k_t^b \left(Z_{t+1} + Q_{t+1}\right) - \bar{R}_t d_t$	if no bank run in $t+1$
$k_t^b \left(Z_{t+1} + Q_{t+1}^*\right) - \bar{R}_t x_{t+1} d_t$	if bank run in $t+1$

where $Q_{t+1}^* < Q_{t+1}$ and $Q_t k_t^b = n_t + d_t$.

- In the equilibria we consider, bank assets are wiped out in a bank run state.

  - So, in a period $t+1$ bank run the recovery rate, x_{t+1}, for depositors is:

$$x_{t+1} = \frac{k_t^b \left(Z_{t+1} + Q_{t+1}^*\right)}{\bar{R}_t d_t} < 1.$$

  That is, in a bank run state households recover less than $\bar{R}_t d_t$.

Banker in a No Bank Run State Who Chooses to Default

- Immediately after receiving deposits, the banker has the option to 'default'.
- Takes a fraction, θ, of the assets:

$$\theta Q_t k_t^b,$$

  and leaves $(1 - \theta) Q_t k_t^b$ for the depositors.

- Defaulting banker exits from banking, and so consumes $\theta Q_t k_t^b$ in a default. Thus,

$$\text{value to banker of default in period } t : \ \theta Q_t k_t^b.$$

- Banker chooses default if, and only if, the default option dominates V_t, where V_t is the value of not defaulting in period t :

$$\theta Q_t k_t^b > V_t.$$

Value to Banker of Not Defaulting

- V_t value of not defaulting in t and keeping open the option of defaulting in $t+1$.

$$V_t = \max_{d_t} E_t[\beta \overbrace{(1-\sigma)}^{\text{exogenous probability of exiting in } t+1} n_{t+1}$$

$$+\beta\sigma \overbrace{\max\left(V_{t+1}, \theta Q_{t+1} k_{t+1}^b\right)}^{\text{a banker has option to default in } t+1}]$$

Participation Constraint

- Banker never chooses a d_t that implies it would default, since in this case no household will place its deposits in that bank.
- Household has better alternatives than to deposit in a bank that defaults:
  - It could invest in capital directly, though at a low rate of return because the household is not efficient at this.
  - It could place a deposit in another bank if there is another bank that can be relied upon to not default.
- As a result, the banker chooses d_t subject to the restriction that it not violate:
$$\theta Q_t k_t^b \leq V_t.$$

Bankers' Problem and Participation Constraint

- Banker problem:

$$V_t \;=\; \max_{d_t} E_t \left[\beta \left(1 - \sigma \right) n_{t+1} + \beta \sigma V_{t+1} \right],$$

  subject to: $\qquad \theta Q_t k_t^b \leq V_t$, for each t.

- Bankers have different n_t because each has a different age. By scaling, can see that aggregation is simple in this model:

$$\psi_t \equiv \frac{V_t}{n_t}, \;\; \phi_t \equiv \frac{Q_t k_t^b}{n_t}.$$

- Note that d_t can be replaced by leverage, ϕ_t, in this scaled notation, so that

$$\psi_t \;=\; \max_{\phi_t} E_t \left\{ \left[\beta \left(1 - \sigma \right) + \beta \sigma \psi_{t+1} \right] \frac{n_{t+1}}{n_t} \right\}$$

  subject to: $\qquad \theta \phi_t \leq \psi_t$

Bankers' Problem and Participation Constraint

- Banker problem:

$$\psi_t = \max_{\phi_t} E_t \left\{ \left[\beta \left(1 - \sigma \right) + \beta \sigma \psi_{t+1} \right] \frac{n_{t+1}}{n_t} \right\}$$

subject to: $\quad \theta \phi_t \leq \psi_t$

- Law of motion of individual banker net worth:

$$n_{t+1} = \begin{cases} \overbrace{n_t \left[\phi_t \dfrac{Z_{t+1} + Q_{t+1}}{Q_t} - \left(\phi_t - 1 \right) \bar{R}_t \right]}^{=k_t^b (Z_{t+1}+Q_{t+1}) - d_t \bar{R}_t} & \text{no run in } t+1 \\ 0 & \text{if run} \end{cases}$$

where $\bar{R}_t$ denotes interest rate on deposits in the event of no run.

  - Recall, $\phi_t \equiv \frac{Q_t k_t^b}{n_t}$, so $\phi_t - 1 = d_t / n_t$.

Bankers' Problem and Participation Constraint

- Only uncertainty is whether or not there is a run in period $t + 1$
  - period t probability that there is a run in $t + 1$ is denoted P_t.
  - P_t exogenous to an individual banker.
- Then, the banker problem is

$$\psi_t = \max_{\phi_t} \{ (1 - P_t) \left[\beta (1 - \sigma) + \beta \sigma \psi_{t+1} \right] $$

$$\times \left[\phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\phi_t - 1) \bar{R}_t \right] \}$$

subject to: $\theta \phi_t \leq \psi_t$

- Absence of n_t here implies that all bankers choose the same ϕ_t regardless of n_t.
- Also,

$$V_t = \psi_t n_t,$$

where ψ_t is independent of n_t. So, $n_t = 0$ implies $V_t = 0$.

Bankers' Problem and Participation Constraint

- Assume that

$$\frac{Z_{t+1} + Q_{t+1}}{Q_t} - \bar{R}_t > 0,$$

  but not too big (see GK, p. 2020). Then the banker participation constraint is always binding and they go to maximum leverage:

$$\phi_t = \frac{\psi_t}{\theta}.$$

- The banker's choice of leverage is characterized by:

$$\phi_t = (1 - P_t) \frac{\beta}{\theta} \left[1 - \sigma + \sigma\theta\phi_{t+1} \right]$$
$$\times \left[\phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\phi_t - 1) \bar{R}_t \right].$$

- Must verify numerically the above inequality.

Bankers' Problem and Participation Constraint

- Individual bank participation constraint:

$$\phi_t = (1 - P_t) \frac{\beta}{\theta} \left[1 - \sigma + \sigma\theta\phi_{t+1} \right]$$
$$\times \left[\phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\phi_t - 1)\bar{R}_t \right].$$

- Since each banker's ϕ_t is the same, it is also equal to the aggregate economy-wide leverage ratio, Φ_t, so

Participation Constraint (1)

$$\Phi_t = (1 - P_t) \frac{\beta}{\theta} \left[1 - \sigma + \sigma\theta\Phi_{t+1} \right]$$
$$\times \left[\Phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\Phi_t - 1)\bar{R}_t \right]$$

No Bank Run in State t+1

- Let $\zeta_t(n)$ denote the measure of bankers with net worth, n, in period t. Then,

$$N_t \equiv \int_0^\infty n\zeta_t(n)\, dn.$$

- Assuming no bank run in period $t+1$, the net worth of bankers in business during period t :

$$\int_0^\infty n\left[\phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\phi_t - 1)\bar{R}_t\right]\zeta_t(n)\, dn$$

$$= N_t\left[\Phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\Phi_t - 1)\bar{R}_t\right]$$

$$= K_t^b(Z_{t+1} + Q_{t+1}) - D_t\bar{R}_t$$

- A randomly selected fraction, $1 - \sigma$, of bankers in business in t exit in period $t+1$ and consume their net worth:

$$C_{t+1}^b = (1 - \sigma)N_t\left[\Phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\Phi_t - 1)\bar{R}_t\right]$$

No Bank Run in State t+1

- A measure, $1 - \sigma$, of new bankers enter in period $t + 1$ to replace the $1 - \sigma$ that exit.
  - Entering bankers in period $t + 1$ have an endowment of labor with productivity w_{t+1}^b which they supply inelastically to labor market. They are paid w_{t+1}^b.

- In case there is no bank run in $t + 1$:

  law of motion of aggregate net worth (2)

  $$N_{t+1} = \sigma \left[K_t^b \left(Z_{t+1} + Q_{t+1} \right) - D_t \bar{R}_t \right] + \overbrace{W_{t+1}^b}^{(1-\sigma)w_{t+1}^b}$$

- Note:

  $$C_{t+1}^b = \frac{1 - \sigma}{\sigma} \left(N_{t+1} - W_{t+1}^b \right).$$

Bank Run in State t+1

- We assumed above that
$$\frac{Z_{t+1} + Q_{t+1}}{Q_t} - \bar{R}_t > 0.$$

- Multiply by $Q_t \left(1 - K_t^h\right)$ and use $Q_t \left(1 - K_t^h\right) = D_t + N_t$,

$$\underbrace{(Z_{t+1} + Q_{t+1}) \left(1 - K_t^h\right)}_{\text{assets at the start of } t+1} > \bar{R}_t (D_t + N_t) \geq \bar{R}_t D_t.$$

so, in the absence of a bank run, bankers are *solvent*.

- In a bank run, depositors want to be repaid in full by setting $D_{t+1} = 0$, requiring banks to sell assets.

- If all banks had to sell their assets, the price of assets, Q_{t+1}^*, could be so low that *depositors' recovery ratio in the event of a bank run*, x_{t+1}, would be less than unity:

$$x_{t+1} \equiv \frac{(Z_{t+1} + Q_{t+1}^*) \left(1 - K_t^h\right)}{\bar{R}_t D_t} < 1.$$

Bank Run in State t+1

- Is $D_{t+1} = 0$ consistent with individual rationality if $x_{t+1} < 1$?
- Assume that in case of $D_{t+1} = 0$ (i.e., a bank run):
  - The $1 - \sigma$ bankers that would have entered in $t+1$ do not enter
    - this implies $N_{t+1} = 0$.
  - Why new entrant banks stay away (GK, p. 2024):
    - "Suppose, for example, that during the run it is not possible for households to identify new banks that are financially independent of the banks being run on: new banks accordingly wait for the dust to settle and then begin issuing deposits in the subsequent period."
- It is individually rational for households to make no bank deposit in period $t+1$ because the banks (having $V_{t+1} = 0$ because $N_{t+1} = 0$) would default on the deposit.
  - households assumed to be able to earn more by investing in capital directly, or going to a non-defaulting bank if one exists (must be verified numerically).

Sunspot Selection of Bank Run or No Bank Run in t+1

- If $x_{t+1} < 1$, then it is an equilibrium to have a bank run and it is an equilibrium that there be no bank run in $t+1$.

  - bank run: $D_{t+1} = 0$, so that households refuse to roll over their period t liabilities.

- In t, determine whether a bank run occurs in $t+1$ according to a binomial variable with probability:

Probability of a Bank Run (3)
$$P_t = 1 - \min\{x_{t+1}, 1\},$$

where, recall:

$$x_{t+1} \equiv \frac{(Z_{t+1} + Q_{t+1}^*)(1 - K_t^h)}{(\Phi_t - 1) N_t \bar{R}_t}, \quad (\Phi_t - 1) N_t \bar{R}_t = D_t \bar{R}_t.$$

Eight Equations

- Bankers
  - participation constraint of banks. (X)
  - law of motion of bank net worth. (X)
  - probability of a bank run. (X)
- Households
  - deposit decision.
  - capital decision.
- Other conditions:
  - resource constraint and two more equations.

Households in No Bank Run State

- Representative household's budget constraint:

$$C_t^h + D_t + Q_t K_t^h + f\left(K_t^h\right) = W_t^h + R_t D_{t-1} + (Z_t + Q_t) K_{t-1}^h,$$

where

C_t^h ~ household consumption

D_t ~ deposits

Q_t ~ price of capital

K_t^h ~ household capital

$$f\left(K_t^h\right) = \frac{\alpha}{2}\left(K_t^h\right)^2 \text{ ~ goods required to manage } K_t^h$$

Z_t ~ productivity in period t of capital

W_t^h ~ productivity of household's labor endowment

R_t ~ return on household deposits

Households in No-Run State

- Household has log utility of consumption, so the intertemporal equation associated with the deposit decision is:

household deposit decision (4)

$$(1 - P_t)\,\bar{R}_t \beta \frac{C_t^h}{C_{t+1}^h} + P_t \beta \frac{C_t^h}{C_{h,t+1}^*}\bar{R}_t x_{t+1} \;=\; 1,$$

where (recall) x_{t+1} denotes the recovery rate on deposits in period $t+1$:

$$x_{t+1} \equiv \frac{\left(Z_{t+1} + Q_{t+1}^*\right)\left(1 - K_t^h\right)}{\left(\Phi_t - 1\right) N_t \bar{R}_t} < 1 \text{ if } P_t > 0.$$

Households in No-Run State

- The intertemporal equation associated with the household capital decision, K_t^h:

$$(1 - P_t)\,\beta\,\frac{C_t^h}{C_{t+1}^h}\frac{Z_{t+1} + Q_{t+1}}{Q_t + \alpha K_t^h} + P_t\beta\frac{C_t^h}{C_{h,t+1}^*}\frac{Z_{t+1} + Q_{t+1}^*}{Q_t + \alpha K_t^h} \leq 1,$$

where the weak inequality is an equality in case $K_t^h > 0$ and

$Q_t + \alpha K_t^h$ ~period t marginal outlay for capital acquired in t.

- Can express this in the form of a complementary slackness condition:

household capital decision (5)

$$0 = K_t^h[1 - (1 - P_t)\,\beta\,\frac{C_t^h}{C_{t+1}^h}\frac{Z_{t+1} + Q_{t+1}}{Q_t + \alpha K_t^h}$$

$$-P_t\beta\frac{C_t^h}{C_{h,t+1}^*}\frac{Z_{t+1} + Q_{t+1}^*}{Q_t + \alpha K_t^h}]$$

Other Conditions in No Bank Run State

Resource Constraint (6)

$$\overbrace{C_t^h + C_t^b + \frac{\alpha}{2}\left(K_t^h\right)^2}^{\text{uses of output}} \leq \text{gross output}$$

$$= \overbrace{Z_t}^{\text{Production using all capital}}$$

$$+ \overbrace{W_t^h}^{\text{household endowment}}$$

$$+ \overbrace{W_t^b}^{\text{output produced by 'labor' of new-born bankers}}$$

- Two other equations:

$$\textbf{(7)} \ \Phi_t = \frac{Q_t\left(1 - K_t^h\right)}{N_t}, \ \textbf{(8)} \ N_t + D_t = Q_t\left(1 - K_t^h\right).$$

Eight Equations

- Bankers
    - participation constraint of banks. **(1)**
    - law of motion of bank net worth. **(2)**
    - probability of a bank run. **(3)**
- Households
    - deposit decision. **(4)**
    - capital decision. **(5)**
- Other conditions:
    - resource constraint. **(6)**
    - leverage definition, **(7)**, and budget constraint of bankers, **(8)**

Variables and Equations

- Eight equations in eight no-bank-run variables:

$$X_t = \left[K_t^h, D_t, Q_t, \bar{R}_t, P_t, C_t^h, \Phi_t, N_t \right].$$

- Use **(2)**, **(7)**, **(3)**, **(6)** to determine N_t, Φ_t, P_t, C_t^h :

$$N_t = \sigma \left[K_{t-1}^b \left(Z_t + Q_t \right) - D_{t-1} \bar{R}_{t-1} \right] + W_t^b$$

$$\Phi_t = \frac{Q_t \left(1 - K_t^h \right)}{N_t}$$

$$P_t = 1 - \min\left\{ x_{t+1}, 1 \right\}, \quad x_{t+1} \equiv \frac{\left(Z_{t+1} + Q_{t+1}^* \right) \left(1 - K_t^h \right)}{\left(\Phi_t - 1 \right) N_t \bar{R}_t}$$

$$C_t^h = Z_t + W_t^h + W_t^b - \overbrace{C_t^b}^{= \frac{1-\sigma}{\sigma} \left(N_t - W_t^b \right)} - \frac{\alpha}{2} \left(K_t^h \right)^2,$$

for $t = 3, 4, \ldots$.

Middle Equations, States 3 to T+1

- Let the unknowns be:

$$z_t = \begin{pmatrix} Q_t \\ K_t^h \\ D_t \\ \bar{R}_t \end{pmatrix}.$$

- The equations, **(1)**, **(4)**, **(5)**, **(8)**, for $t = 3, 4, ..., T+1$ can be expressed:

$$v\left(z_{t-1}, z_t, z_{t+1}\right) = 0,$$

where $T+1$ denotes the state before the steady state value of z_t is assumed to be reached.

- The equations for state $t = 2$ are slightly different (see below).

Middle Equations, States 3 to T+1

- Equations that define $v\left(z_{t-1}, z_t, z_{t+1}\right) = 0$, $t = 3, 4, ..., T+1$:

$$\Phi_t = (1 - P_t) \frac{\beta}{\theta} \left[1 - \sigma + \sigma\theta\Phi_{t+1}\right]$$

$$\times \left[\Phi_t \frac{Z_{t+1} + Q_{t+1}}{Q_t} - (\Phi_t - 1)\bar{R}_t\right] \text{ (1)}$$

$$1 = (1 - P_t)\bar{R}_t\beta \frac{C_t^h}{C_{t+1}^h} + P_t\beta \frac{C_t^h}{C_{h,t+1}^*}\bar{R}_t x_{t+1} \text{ (4)}$$

$$0 = K_t^h[1 - (1 - P_t)\beta \frac{C_t^h}{C_{t+1}^h} \frac{Z_{t+1} + Q_{t+1}}{Q_t + \alpha K_t^h}$$

$$-P_t\beta \frac{C_t^h}{C_{h,t+1}^*} \frac{Z_{t+1} + Q_{t+1}^*}{Q_t + \alpha K_t^h}] \text{ (5)}$$

$$D_t + N_t = Q_t\left(1 - K_t^h\right) \text{ (8)}$$

Steady State

- Value of z such that:

$$v(z, z, z) = 0,$$

  can be found using MATLAB's fsolve.m.

  - Problem: don't know if the solution is unique.

- Alternative (computationally cumbersome!) strategy :

  - Online notes provide an algorithm that finds the steady state by solving a set of nested one-dimensional zero-finding problems, using fzero.m.
  - In this way it is easy to verify that there is only one solution, for the given parameter values.
  - In the numerical examples we studied, we found that the steady state is unique.

- Note: the equations, v, require $Q^*, C^{h,*}$!

  - for this, must study period 1, the bank run state.

Equilibrium Conditions in Run State

- Household fonc for deposits, **(4)**, bank participation constraint, **(1)**, definition of leverage, **(7),** and banker budget constraint, **(8)**, all irrelevant.

- Law of motion of net worth, equation **(2)**, becomes

$$N_2 = \overbrace{W_2^b}^{\text{labor income of bankers born in period 2}}$$
$$+ \overbrace{\sigma W_1^b}^{\text{labor income of bankers born in period 1 who survive to period 2}},$$

- $P_1 = 0$ (equation **(3)**):
  - Bank liabilities in $t = 2$ are zero ($D_1 = 0$), so the probability of a bank run in $t = 2$, P_1, is zero.

Equilibrium Conditions in Run State

- Household foc for capital, **(5)**,

$$\beta \frac{C_1^{*,h}}{C_2^h} \frac{Z_2 + Q_2}{Q_1^* + \alpha} = 1,$$

  using $K^h = 1$ and $P_1 = 0$.

- Resource constraint, **(6)**

resources used by households to manage capital

$$C_1^{*,h} + \overbrace{\frac{\alpha}{2}}$$

output produced from capital   output produced by household labor

$$= \overbrace{Z_1} + \overbrace{W_1^h}$$

Simplifying Assumption

- Bank run state, $t = 1$, is independent of which state preceded it, i.e., whether $t = 3, 4, \ldots$.

  – For this, we impose the following time-invariance assumption:

  $$Z_t = Z, \ W_t^h = W^h, \ W_t^b = W^b, \text{ for all } t.$$

- Equations **(5)** and **(6)** reduce to:

$$\beta \frac{C^{*,h}}{C_2^h} \frac{Z + Q_2}{Q^* + \alpha} = 1 \qquad (1)$$

$$C^{*,h} + \frac{\alpha}{2} = Z + W^h.$$

- Note that $C^{*,h}$ is in effect an exogenous variable. But, Q^* appears in an equation with other endogenous variables.

First State After Run

- Two equations affected from $t = 3, ..., T + 1$.
- Replace equation **(2)** by the value of N_2 implied by run state:

$$N_2 = (1 + \sigma) W^b.$$

- Period 2 resource constraint, (**6**), slightly adjusted to reflect banker endowments and $C_2^b = 0$:

$$C_2^h = \overbrace{Z + W^h + (1 + \sigma) W^b}^{\text{gross output}} - \frac{\alpha}{2} \left(K_2^h \right)^2$$

First State After Run

- Equations **(7)** and **(3)** not affected, and can be used to compute Φ_2 and P_2 :

$$\Phi_2 = \frac{Q_2 \left(1 - K_2^h\right)}{N_2} \text{ (7)}$$

$$P_2 = 1 - \min\{x_3, 1\}, \quad x_3 \equiv \frac{(Z + Q^*) \left(1 - K_2^h\right)}{(\Phi_2 - 1) N_2 \bar{R}_2} \text{ (3)}$$

First State After Run

- System of four equations in state $t = 2$: $\tilde{v}(z_2, z_3) = 0$, where

$$
\begin{aligned}
\Phi_2 &= (1 - P_2)\frac{\beta}{\theta}\left[1 - \sigma + \sigma\theta\Phi_3\right] \\
&\quad \times \left[\Phi_2\frac{Z + Q_3}{Q_2} - (\Phi_2 - 1)\bar{R}_2\right] \text{ (1)} \\
1 &= (1 - P_2)\bar{R}_2\beta\frac{C_2^h}{C_{2+1}^h} + P_2\beta\frac{C_2^h}{C_{h,2+1}^*}\bar{R}_2 x_{2+1} \text{ (4)} \\
0 &= K_2^h[1 - (1 - P_2)\beta\frac{C_2^h}{C_{2+1}^h}\frac{Z + Q_{2+1}}{Q_2 + \alpha K_2^h} \\
&\quad - P_2\beta\frac{C_2^h}{C_{h,2+1}^*}\frac{Z + Q_{2+1}^*}{Q_2 + \alpha K_2^h}] \text{ (5)} \\
D_2 + N_2 &= Q_2\left(1 - K_2^h\right) \text{ (8)}
\end{aligned}
$$

Solution Strategy

- One dimensional search in Q^* ($C^{*,h}$ is a function of parameters).

- Define the following mapping:

$$Q^{*\prime} = f(Q^*).$$

  - Given Q^*, find z that solves $v(z, z, z) = 0$.
  - Given Q^*, $C^{*,h}$ and z, find $z_2, z_3, ..., z_{T+1}$ that satisfy

  $$\tilde{v}(z_2, z_3) = 0, \ v(z_{t-1}, z_t, z_{t+1}) = 0, \ t = 3, ..., T+1$$

  (for this, $z_t = z$, $t = 2, ..., T+1$ can be used as initial conditions).

  - Using the computed value of z_2, solve for Q^* using (1). Denote this by $Q^{*\prime}$.

Solution Strategy

- Find fixed point of f :

$$Q^* = f(Q^*).$$

- The procedure suggested by GK works well. Select an initial guess for Q^*, $Q^*(1)$. Then, iterate to convergence on

$$Q^*(j+1) = f(Q^*(j)), \; j = 1, 2, \ldots .$$

Order of Events in One Period
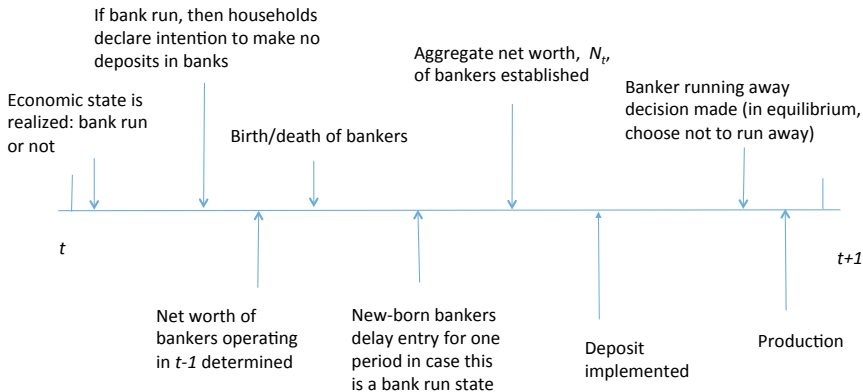
If bank run, then households declare intention to make no deposits in banks

Aggregate net worth, N_t, of bankers established

Banker running away decision made (in equilibrium, choose not to run away)

Economic state is realized: bank run or not

Birth/death of bankers

t

$t+1$

Net worth of bankers operating in $t-1$ determined

New-born bankers delay entry for one period in case this is a bank run state

Deposit implemented

Production

Possible states: *s = 1, 2, 3,…, T+2*.
Bank run, *s = 1*. No bank run in *s > 1*.
In each no-run state there is a chance
of a run in the next state, unless
s = 2.

Steady
state
s=T+2≈∞

...

s=4

s=3

s=2

Run,
s=1
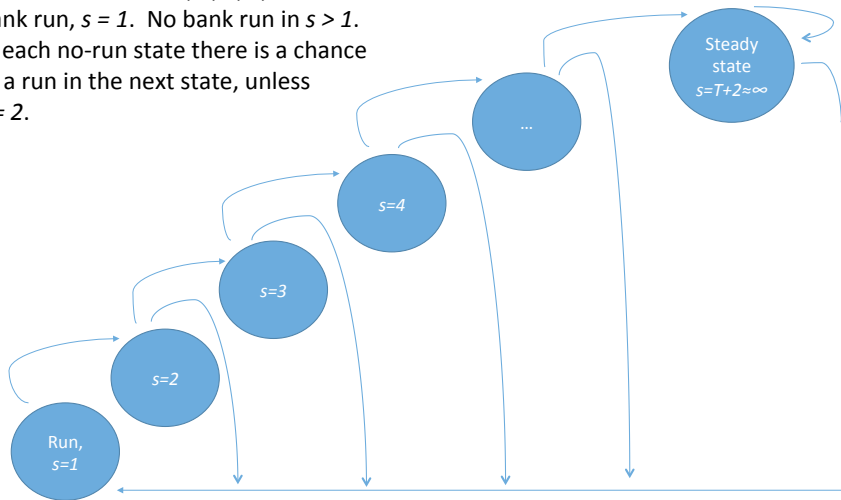
Numerical Example

- Model parameter values

$$\begin{aligned} \alpha &= 0.00797, \ \theta = 0.1934, \ \sigma = 0.95, \ \beta = 0.99, \\ W^h &= 0.045, \ W^b = 0.0011487/50. \end{aligned}$$

- Solution

$$\begin{aligned} Q^* &= 0.91, \ Q_\infty = 0.98, \ K^h_\infty = 0.28, \ D_\infty = 0.66 \\ R_\infty &= 1/\beta, \ \Phi_\infty = 14.93, \ p_\infty = 0.0075, \ N_\infty = 0.047, \\ C^h_\infty &= 0.055, \ C^b_\infty = 0.0025 \end{aligned}$$

Mapping from Q^* to $Q^{*\prime}$
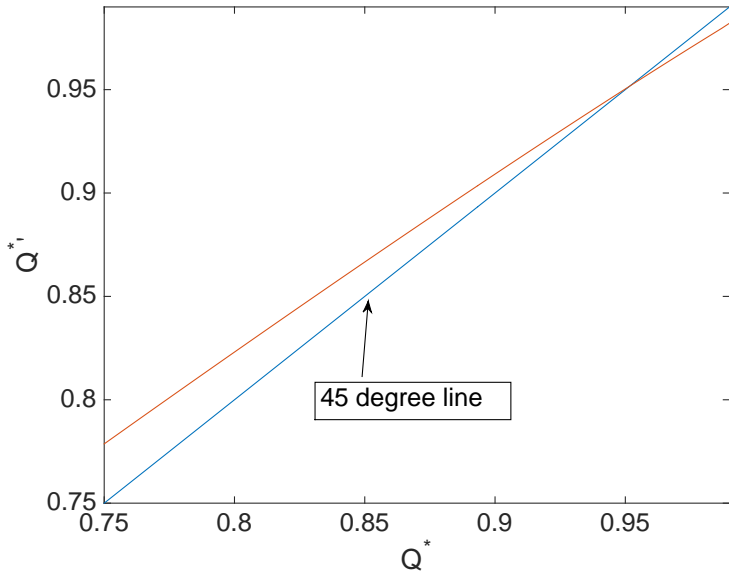
Bank Run and No Bank Run States

- Bank run in state 1, followed by no bank run until steady state.
- A bank run can occur after state 1 with the probability indicated in the 2,2 diagram.
  - In case of a bank run, the economy restarts in state 1.
  - In the immediate period after a bank run, no bank run is possible.
- As the banking system restarts, in state 3, the probability of another bank run is 'high', over 4 percent.
  - probability falls as the net worth of the banking system rises from zero.
- Striking feature of simulation: it takes (at least) about 10 years for the banking system and economy to fully repair themselves.
  - To recover its capacity to conduct intermediation, banking system needs to have a high amount of net worth.
  - To grow its net worth, banking system retains earnings, which requires issuing a lot of deposits. But, to be able to issue a lot of deposits, must have a lot of net worth!

Response of Economy to Bank Run, When no Additional Run Occurs
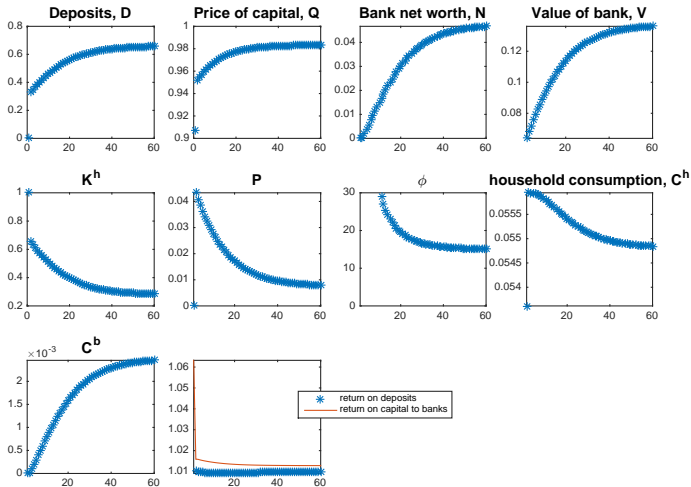
Domestic Product (consumption)

- In the period of the bank run, $C^h + C^b$ fall 7 percent.
  - Reflects loss of direct endowment of entering bankers and inefficient management of capital.
  - As capital flows bank into the hands of people that know how to manage it, GDP begins to rise again.
- One expects that in an economy with capital investment, the effects of a bank run might be more substantial.
- The bank run can magnify a recession triggered by a shock that would make the economy slow down anyway (see GK's AER article)

GDP = C^h + C^b
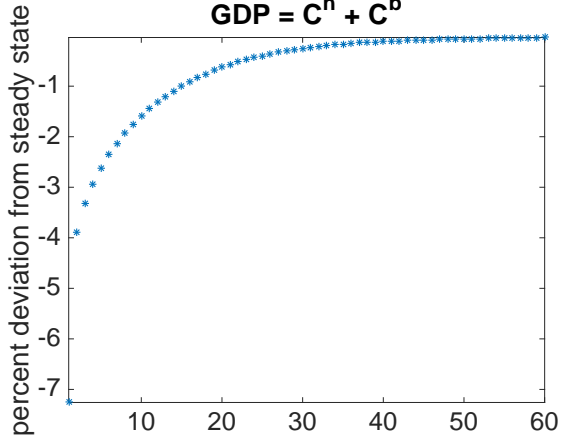
Stochastic Equilibrium as a First Order Markov Chain

- Equilibrum represented as a 122-state Markov chain with states

$$s \in \{1, 2, ..., 122\},$$

where

$s = 1$ state in which a bank run occurs

$s = i$ state in which $i - 1$ periods have passed since last bank r
       $2 \leq i \leq 122$

Computations described above provides the 8 equilibrium variables for each state:

$$X(s) = \left[K^h(s), \ D(s), \ Q(s), \ \bar{R}(s), \ P(s), \ C^h(s), \ \Phi(s), \ N(s) \right]$$

Stochastic Equilibrium as a First Order Markov Chain
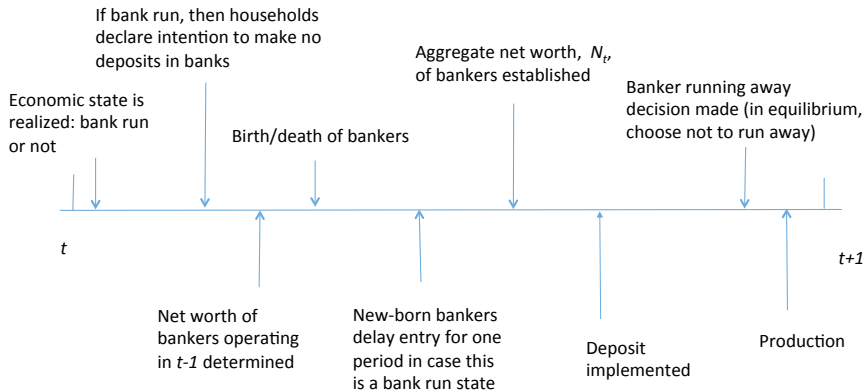
- Let the Markov transition matrix be

$$\pi_{ij} = prob\left[s_{t+1} = j | s_t = i\right],$$

  where s_t denotes a random realization of the state.
- All elements of π equal to zero except:

$$\pi_{1,2} = 1, \ \pi_{i,i+1} = P_i \text{ for } i = 2, 3, ..., 121.$$
$$\pi_{ii} = 1 - P_i, \ i = 2, ..., 122$$

Order of Events in One Period

If bank run, then households declare intention to make no deposits in banks

Aggregate net worth, N_t, of bankers established

Economic state is realized: bank run or not

Banker running away decision made (in equilibrium, choose not to run away)

Birth/death of bankers

t

$t+1$

Net worth of bankers operating in $t-1$ determined

New-born bankers delay entry for one period in case this is a bank run state

Deposit implemented

Production

Partial Realization of a Stochastic Equilibrium

- Following figure displays stochastic simulation of length 400 periods (i.e., 100 years).
- Note:
  - the periodic collapses in economic activity triggered by bank runs.
  - the probability of collapse is greater when the banking system has not yet fully restored its net worth.
- The first 150 periods (35 years) is a time of tranquility.
  - then, there is a bank run, soon followed by another. Economy has recovered after 10 years.
  - then, again a bank run followed by another.
  - finally, three bank runs in a row.
- Problem with bank run is that it leads to a period of mismanagement of capital, as less efficient institutions take over.

One Hundred Year Stochastic Simulation
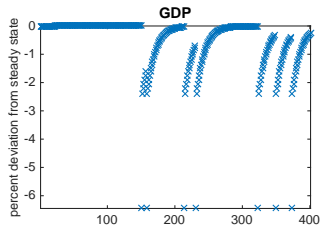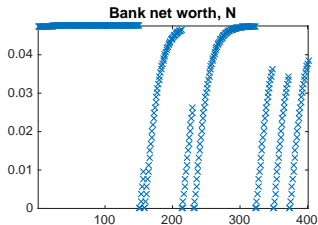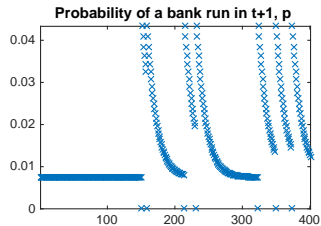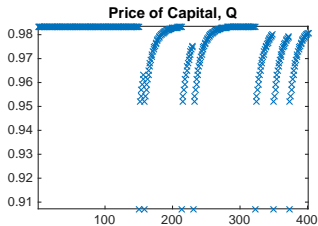
Policy Implications

- In a banking crisis, it makes sense for the government to underake 'unconventional actions'.

  - could provide tax-financed deposits into banks, which it commits to roll over.
  - government makes use of fact that banks can't run away from it to shore up intermediation system.
  - no doubt, there are inefficiencies associated with this type of action, but they may be smaller than the inefficiencies associated with a full-blown crisis.

- Question:

  - are restrictions on bank leverage, beyond what occurs in unregulated economy, desirable?
  - if yes, then what do these restrictions look like?