FINANCE theory GROUP

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Short Term Debt and Incentives in Banks

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Abstract

Banks hold extremely large amounts of short term debt on their balance sheets. The literature has proposed two leading explanations as to why this is the case, and what different kinds of distorted incentives may explain it. According to one explanation, banks' short –term debt is a result of their liquidity provision role, which is fueled by government guarantees that might encourage banks to hold excessive short-term debt. The second explanation suggests that short-term debt provides market discipline against bank managers' risk shifting motives. In this lecture, I will briefly review the classic theories behind banks' short-term debt. I will then focus on two recent theoretical papers, representing the two key approaches, which provide new results on the interaction between banks' short-term debt, financial fragility, and welfare. I will discuss the policy implications and the insights for interpreting existing empirical evidence.

References (I will focus on the two papers marked with *):

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Douglas Diamond and Philip Dybvig, (1983) "Bank Runs, Deposit Insurance, and Liquidity," ***Journal of Political Economy***, vol. 91 (3), pp. 401-419

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