Discussion of:

**Stress, Crises, and Policy**

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Summary

- Paper sets up a simple model of intermediation with a global-games information structure

- Studies how equilibrium outcomes are affected by:
  - choices of agents (liquidity, leverage, etc.)
  - exogenous shocks (increased stress or vulnerability)
  - the information structure

- Derives some implications for regulation of financial intermediaries

- Interesting paper
  - a nice complement to the first paper this morning
Positives

(1) Framework clearly distinguishes two types of crisis events

- liquidity crisis (failure due to heavy withdrawals)
- solvency crisis (failure due to low asset values)

• In principle, these events are difficult to separate

  - low asset values tend to encourage “panic” withdrawals
  - much (confused) discussion over the course of the crisis

• Important to have a clear, unified framework for thinking about these issues
(2) Approach shows how the information *structure* affects outcomes

- Example: What are the effects of introducing a new index?
  - the information was available before, but ...

(i) people find it easier to use the information, and

(ii) know that *others* are now more likely to look at this information

- These effects are clearly important in reality
  - model here addresses the role of *public* information
Model shows how policy affects the probability of a crisis

- A general objective function for choosing a policy $x$

$$W(x) = (1 - q(x)) W_{NC}(x) + q(x) W_C$$

- The optimal policy satisfies

$$(1 - q(x)) W'_{NC} + q(x) W'_C - [W_N - W_C] q'(x) = 0$$

- My model assumed $q'(x) = 0$

- Approach here generates a function $q(x)$
  - $q$ responds to changes in policy in an intuitive ways
Negatives

(1) Measuring welfare is tricky in this framework

- model is intentionally simple, reduced form
- how does leverage affect the welfare of investors, for example?

- In other words, model is weaker on the $W'_{NC}$ and $W'_C$ terms

\[
(1 - q(x)) W'_{NC} + q(x) W'_C - [W_N - W_C] q'(x) = 0
\]

- Paper takes a different approach to policy prescriptions

  - If policy maker wants to cap the probability of a crisis at $\bar{q}$, ...

- Is this necessary, or can we do optimal policy here?
Model assumes particular contractual arrangements

- Banks issue short-term debt that must be rolled over
  - matches reality, but no clear rationale for it in the model
  - this approach is very common, but ...

- Presumably agents derive some benefit from the contracts we observe
  - perhaps it solves an insurance problem with private information

- Can we safely abstract from the benefits of short-term debt?
  - or might the frictions that create a role for short-term debt affect the policy prescriptions of the model?
Summary

• An interesting paper than addresses important, timely issues

• The question of how policy affects the probability of a crisis is particularly important
  – what can we do to prevent a another “great panic”?

• I learned a lot from reading the paper
  – shows how to deal with some elements missing in my approach
  – I find the two papers highly complementary

• The area in between may be fertile ground for future research