Discussion of "Deposit Insurance and Money market Freezes" by Bruche, Suarez

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Motivation

1. In financial crisis, especially the current one, money market (MM) stop working
2. How does this happen?
3. Why this matters for the real economy (Vs the financial sector)?
4. What policy can prevent or ameliorate this outcome?

The Economy

- Build a general equilibrium model with standard ingredients:
  - Individuals save and provide capital and deposit to the banks
  - Firms borrow from (competitive) banks
  - The government provides **Deposit Insurance**
  - Individuals receive firms profit and interest payments by banks
- but in addition ...
  - credit is relationship-based and thus intermediated by banks
  - economies is divided in two regions, each served by a different (representative) bank
  - So there is role for interbank Money Market (MM). Why?
- When a bank needs funds in excess to capital and deposit available in his region
  - because there are decreasing marginal returns in firms investment
- Access MM to borrow from the other bank/region

MM Freezes

- What can go wrong?
  - if the real economy experiences a sudden increase in systemic risk
    - i.e. higher risk that firms/creditors go bankrupt
  - then banks in the borrowing region may fail
  - Government steps in to refund depositors
  - but lending banks in the other region suffer an (uninsured) loss
  - so banks in the lending region, anticipating systemic risk, stop inter-bank lending
  - **MM Freeze**: even though it is beneficial not to stop it

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- Deposit Insurance is a double edged sword:
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  - it "scares away" inter-bank lending

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2. Do nothing: take away Deposit Insurance (in Appendix)
   - No reason NOT to do it in the model. Actually it's welfare superior because NO TAX

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- Since depositors concentrate their savings/deposits where they live
- Natural argument for large banks: avoid regional segmentation and undesired effect DI

Final Remarks

- Spill-over implication of the analysis (not present in the paper): theoretical support of bank bailouts. Why?
- Saving banks is a way of preserving MM lending
- in fact it stopped exactly when some banks were feared to fail

- If you can't move the money, move the people!
- maybe optimal not to spread economic opportunities far away from location of savings (banks)
- regional disparities in credit market may be optimal reaction to Deposit Insurance (DI)

- **Main Comment**: role is missing for asymmetric information regarding the current crisis and interbank lending in particular
- Benefit, over regional segmentation, is that is more intuitive and easier to defend
- Regional segmentation of bank activity seems so fragile as equilibrium phenomenon