‘Contagion and risk-sharing on the inter-bank market’

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ABSTRACT:
Increasing inter-bank lending has an ambiguous impact on financial stability. Using a computational model with endogenous bank behavior and interest rates we identify the conditions under which inter-bank lending promotes stability through risk sharing or provides a channel through which failures may spread. In response to large economy-wide shocks, more inter-bank lending relationships worsen systemic events. For smaller shocks the opposite effect is observed. As such no inter-bank market structure maximizes stability under all conditions. In contrast, deposit insurance costs are always reduced under greater numbers of inter-bank lending relationships. A range of regulations are considered to increase system stability.