

Unifying bank-run theories and the trap of financial integration

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Abstract

When a banking model is extended to feature multiple queues, with risk sharing restricted by a sequential-service constraint analogous to that proposed by Wallace (1988), we find that direct mechanisms defined by solutions of the larger planner's problem can also implement bank runs. The result survives the disclosure of positions considered by Green and Lin (2003) and thus complements previous analysis by Allen and Gale (xxxx), and Peck and Shell (2003). It however offers the novel implication, not considered by Diamond and Dybvig (1988) seminal paper, that access to a lender of last resort can increase the provision of liquidity to the point of creating stronger conditions for formation of bank panic.

Keywords: Diamond-Dybvig model, sequential service, implementation

JEL codes: E4, E6.

1 Introduction

This paper concerns an old question about bank stability: whether financial integration can produce stabilizing effects given the economic forces that produce an illiquid banking system. There are well known difficulties in integrating theories of bank failure with availability of markets or policies that could allow for some ex-post redistribution of resources. A classic case is the tension between the initial version of the seminal Diamond-Dybvig