

Liquidity Hoarding, Network Externalities, and Interbank Market Collapse

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Abstract

The interbank market collapse has been a central feature of the global financial crisis. In response to concerns about the viability of some off-balance sheet vehicles, banks stopped lending to each other at all but the shortest maturities resulting in a funding drought across the entire global financial system during 2007 and 2008. Taking a network approach, our paper argues that such systemic breakdowns of the interbank market are rare events that can be explained by precautionary hoarding amongst some banks due to concerns about their own future liquidity needs, and endogenous responses by banks to the liquidity hoarding of others. The failure of banks to internalise the potential consequences of their actions for the system as a whole points to a role for prudential policy. Our findings highlight the potential contribution that tougher liquidity requirements for systemically important institutions can make in averting contagion through funding markets.

Keywords: Interbank markets; Network models; Contagion; Systemic risk; Financial crises; Liquidity risk

JEL classification: D85; G01; G21

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