Market Discipline under Financial Contagion

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Abstract:

We investigate the disciplining effect of debt on bank management under a situation where financial contagion occurs. Theory analyzing market discipline, which deals with a single bank, suggests that bankers become more "creditor friendly" by holding demand deposit or short-term deb (e.g. Calomiris and Kahn 1991; Diamond and Rajan 2012). However, when there is also a financial market other than a bank and when these are interconnected through a contagion of financial crises, an alternative effect arises: namely, a banker's incentive to make an effort is affected by the behavior of speculators in the financial market. We show that, when the speculators have much more precise information about fundamentals of the economy than that of creditors in the bank, demand deposit or short-term debt induces the bankers to "act against creditors' interest."

Keywords: Platform Market; Hotelling Model; Multi-purchase

JEL Codes: JEL: D21 (Firm Behavior: Theory); L13 (Oligopoly and Other Imperfect Markets)