Liquidity and Leverage

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The set up

- Project
- Entrepreneur
- Financier
- Other financier

Diagram:

- \( C \) from Project to Entrepreneur
- \( \beta C \) from Entrepreneur to Financier
- \( \frac{2\beta C}{3} \) from Financier to Other financier
Illiquidity from rents

Project → $C$ → Entrepreneur → $\beta C$ → Financier → $\frac{2\beta C}{3}$ → Other financier

Rent = $(1 - \beta)C$

Rent = $\beta C / 3$
Bank creates liquidity through demand deposits

Project → Entrepreneur
Rent = (1 − β)C

Entrepreneur → Banker
Rent = 0

Banker → Depositors
βC/n → Depositors
βC/n → Depositors
βC/n → Depositors
The aftermath of a run: An unhappy disintermediated banker

Project → Entrepreneur → Depositors → Unhappy disintermediated banker
The difference between bankers and entrepreneurs: the cost of failure

Unhappy banker: Dick Fuld of Lehman

Happy entrepreneur
Some related papers with Doug Diamond

Weakness of internal accounting control