Liquidity Provision and Equity Funding of Banks

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Abstract

The paper uses a general-equilibrium model to study the relation between liquidity provision and equity funding of banks. From one perspective, the two are substitutes because liquidity provision is tied to bank deposits, a form of debt. From another perspective, they are complements because additional equity makes the bank safer and enhance the liquidity of its debt. The view that liquidity provision is crowded out by equity is confirmed for the case of certainty about the banks' returns. The view that liquidity provision is improved by more equity is confirmed for the case of uncertainty. With perfect commitments of banks to their borrowing levels, equilibrium outcomes can be efficient. Without such commitments, equilibrium outcomes involve inefficiently low levels of equity and can be improved upon by equity regulation.