Accepted Manuscript

Interest Rates and Financial Fragility

Yang Li

PII: S0165-1889(17)30145-8
DOI: 10.1016/j.jedc.2017.06.009
Reference: DYNCON 3451

To appear in: *Journal of Economic Dynamics & Control*

Received date: 3 March 2017
Revised date: 21 June 2017
Accepted date: 28 June 2017

Please cite this article as: Yang Li, Interest Rates and Financial Fragility, *Journal of Economic Dynamics & Control* (2017), doi: 10.1016/j.jedc.2017.06.009

Interest Rates and Financial Fragility

Yang Li*

School of Finance, Nankai University

yang.li@nankai.edu.cn

June 20, 2017

Abstract

How do the interest rates banks earn on their assets affect the susceptibility of the banking system to a self-fulfilling run by depositors? I study this question in a version of the model of Diamond and Dybvig (1983) with limited commitment and a non-trivial portfolio choice. I show that the relationship between these interest rates and financial fragility is often non-monotone. For example, a small increase in the return on illiquid investment (or a small increase in the term premium) may raise banks' susceptibility to a run, while a larger increase would make the banking system more stable. The same is true for changes in short-term rates, holding the longer-term rates fixed. I provide a precise characterization of these comparative statics of financial fragility.

Keywords: Bank runs; Excess liquidity; Financial fragility; Portfolio choice; Term premium

JEL Classification: G21; E43; E44

*A previous version of the paper was circulated under the title, "Asset Returns and Financial Fragility". I thank two anonymous referees, Oriol Carbonell-Nicolau, John Landon-Lane, Hyeon Ok Lee, Yuliyan Mitkov, James Peck, Bruno Sultanum, Byoung Hark Yoo, and especially Todd Keister for their comments and suggestions. All errors remain my own.