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Asset Price Volatility and Banks

By YU ZHANG*

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This paper examines the operation of Diamond-Dybvig banks when depositors have access to the asset market. Previous studies have shown that banks are redundant in this environment since it is impossible to prevent the strategic withdrawals. This paper shows that the strategic withdrawals can be prevented if the market risk, due to asset price volatility, is considered. Banks provide deterministic returns to the depositors since the aggregate withdrawals are predictable, and therefore, banks can choose the portfolio such that no asset liquidation is involved. However, an individual consumer with stochastic liquidity need is vulnerable to the price volatility if he holds the asset directly. Therefore, banks improve the consumers' welfare by providing the insurance against not only the liquidity shock but also the market risk. Banks are not redundant.

JEL: D53; G10; G21

Keywords: banks; asset markets; liquidity; asset price volatility

Consumers are subject to liquidity shocks, and therefore, they need to get access to their assets and obtain liquidity on short notice. Both banks and asset markets provide such liquidity. Asset markets provide the investors with the opportunities to sell their long-term assets before maturity (e.g., Allen and Gale (1994)). Banks provide the depositors with liquidity by issuing the demand deposits (e.g., Bryant (1980), and Diamond

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