IWH
Halle Institute for Economic Research
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IWH Research Seminar in Economics

December 16, 2019, 14:15–15:45, conference room, ground floor

Netting

Giorgia Piacentino, Columbia University and CEPR

(together with Jason Roderick Donaldson, Washington University in St. Louis and CEPR)

We present a model to explain why banks maintain off-setting long-term debts without netting them out. We show that these non-contingent debts implement contingent transfers, since they embed the option to dilute with new debt to a third party. Even though a diluted bank is worse off ex post, a network of gross debts is stable ex ante, since each bank exercises its option to dilute when it is most valuable. However, the network harbors systemic risk: since one bank's liabilities are other banks' assets, a liquidity shock can transmit through the network in a default cascade.

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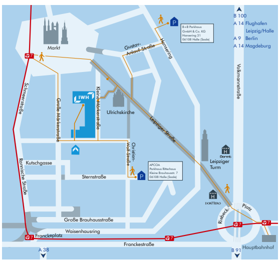

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