Bank Runs and Asset Price Collapses

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Abstract

In this paper, I study the relationship between bank runs and asset prices. To this end, I consider a banking model that incorporates a secondary market for long-term assets. This secondary market might be illiquid due to adverse selection. The model generates multiple equilibria. When banks invest all the resources in long-term assets and don't hold liquid assets, even banks with good assets have to sell some of their long-term assets in the secondary market in order to meet the demands of the early withdrawers. Then, the market price can be high. In this case, bank runs cannot occur. On the other hand, if banks hold enough liquid assets, banks with good assets do not participate in the market and assets can only trade at the lemons price. This depressed asset prices cause bank runs.

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