Liquidity and Ambiguity: Banks or Asset Markets?
Jürgen Eichberger  Willy Spanjers
Alfred Weber Institute  Department of Economics
University of Heidelberg  Kingston University

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Abstract
We study the impact of ambiguity on financial intermediation in an economy where ambiguity-averse agents have random liquidity needs. We compare an optimal liquidity allocation with the allocation achieved by trade in an asset market, by a mutual fund, and by a competitive banking sector.
Ambiguity of the agents is modeled by the degree of confidence in their additive beliefs. For intermediate levels of confidence the preferred intermediary institution is the asset market. The bank is optimal for high levels confidence, while, for low levels of confidence, disintermediation dominates all forms of financial intermediation.
The evaluation of a mutual fund depends on the feasibility of short sales. If short sales are impossible, then a mutual fund can implement the optimal outcome for any degree of confidence. With short selling of fund shares the asset market outcome results.

Address for correspondence:
Willy Spanjers, Department of Economics, Kingston University, Kingston upon Thames, Surrey KT1 2EE, United Kingdom.