Liquidity and Ambiguity: Banks or Asset Markets?

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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, disintermedistion 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.

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