

Study Questions for Mehrling et al. (2013), “Bagehot was a shadow banker”:

1. The title of the piece is “Bagehot was a shadow banker.” What is the connection being drawn between banking in Bagehot’s day and modern-day shadow banking? How does traditional “Jimmy Stewart” banking differ?
2. What are the important conceptual *differences* between modern shadow banking and banking in Bagehot’s day? Relate this to the concepts of funding liquidity and market liquidity.
3. Describe what the authors mean by the “market-based credit system.” Who are the different parties involved? And in particular, what incentive do each of them have to participate?
4. The authors focus heavily on the role of dealers in the market-based credit system. Justify this focus. The authors discuss two types of dealers: money dealers and risk dealers. What do each of these entities do? Which one would be most familiar to Bagehot, and why? Why does the dealer system function well during “expansion mode” but poorly during “contraction mode”?
5. According to Bagehot, in what ways should the central bank intervene in the bill funding market? What would this look like in the modern money market? The authors extend this line of thinking into the modern-day *capital* market. Absent central bank intervention, what problems could this market face in times of crisis? What should the central bank do, and why would this help?
6. From page 8: “Just so, consider the situation of a shadow bank that holds both a risky asset and various swaps that reference that risky asset, and then finances the lot in the wholesale money market, as in Figure 1.” If the swaps are able to transform the risky asset into a quasi-Treasury bill, does the bank face any risk? If so, what kind of risk? Explain how a fluctuation in the price of the asset puts pressure on the bank, and how the bank’s actions could exacerbate a crisis.
7. What do we mean by “dealer of last resort” and “lender of last resort”? Explain the relationship between the two.