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Liquidity Needs in Economies with Interconnected Financial Obligations

by Julio J. Rotemberg

Abstract

A model is developed where firms in a financial system have to settle their debts to each other by using a liquid asset. The question that is studied is how many firms must obtain how much of this asset from outside the financial system to make sure that all debts within the system are settled. The main result is that these liquidity needs are larger when these firms are more interconnected through their debts, i.e., when they borrow from and lend to more firms. Two pecuniary externalities are discussed. One involves the choice of paying one creditor first rather than another. The second involves the extent to which firms borrow and acquire claims on other firms with the proceeds. When a group of firms raises their involvement in this activity, firms outside the group may face more difficulties in settling their debts.

Keywords: Economy; Borrowing and Debt; Financial Liquidity; Networks;

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