

Who should bear interest rate & liquidity risk?

■ Financial sector

- Holds long-term government bonds (no rollover risk for gov.)
- Issues short-term deposits
- If ~~“well capitalized”~~

In the real world

- In good times: Financial sector earns risk premium
- In bad times: Fiscal authorities or central banks have to bail out financial sector

■ Why is financial sector undercapitalized?

- Afraid that losses will be pushed onto it (financial repression)
- Moral hazard