with low technological and market liquidity and by issuing short-term debt claims, financial institutions expose themselves to a liquidity mismatch. This maturity transformation – better labeled liquidity transformation – is one of the functions of financial intermediation but results in fragility. Banks are subject to runs especially if they are also exposed to aggregate risk. A second function of financial institutions is to overcome financial frictions since they have a superior monitoring technology. They can ensure that the borrower of funds exerts enough effort such that projects are paying off with a high probability and loans can be repaid. A third function of financial intermediation is the creation of informationally insensitive – money like – securities. Informationally insensitive claims, like debt contracts, have the advantage that their payoff does not depend on information about some underlying cash flows. Nobody finds it worthwhile to collect information and hence asymmetric information problems, like the lemons problem, cannot emerge. Finally, financial institutions also play a central role in making certain future cash flows pledgable. Productive agents are often not able to pledge future cash flows because of renegotiation. Banks can avoid this problem – so the theory – by offering deposit contracts with a sequential-service constraint and thereby exposing themselves to bank runs. The threat of a bank run lowers the banker's ex-post bargaining power and hence allows them to pledge a larger amount ex-ante. This literature stresses the "virtue of fragility" as a ex-ante commitment device.

Importantly, financial intermediaries are key in understanding the interaction between *price stability* and financial stability; and monetary economics more generally. By issuing demand deposits, financial institutions create inside money. Outside money can take the form of specific commodities or of fiat money provided by the government. When banks are well capitalized they can overcome financial frictions and are able to channel funds from less productive agents to more productive agents. Financial institutions through their monitoring role enable productive agents to issue debt and equity claims to less productive agents. Without a financial sector, funds can be transfered only via outside money. Whenever an agent becomes productive he buys capital goods from less productive agents using his outside money, and vice versa. While the fund transfers are limited, money becomes very valuable in this case. In contrast, when the financial sector is well capitalized, outside money is not really needed and hence has low value. Now, a negative productivity shock lowers financial institutions' net worth, impairs their intermediation activity and importantly makes money more valuable absent any monetary intervention. The latter effect hits banks on the liability side of their balance sheet since the value of the inside money they issued increases. In short, a negative