That’s how we roll: an experiment on rollover risk

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Abstract

We design a continuous-time experiment to study how different short-term credit maturities interact with the state of the economy. We find that, when the economy is in a boom, long maturities stabilize the credit market. Yet, when in a downturn, such maturities increase the likelihood of credit freezes. This result has important regulatory implications, as it suggests that a policy aimed at reducing maturity mismatch in short-term credit markets might backfire during a recession.

Keywords: Experiment, Financial Crisis, Continuous-Time, Short-Term Credit.

JEL Codes: C92, C91, G01, GO2, G21

1. Introduction

While a relevant segment of the literature agrees on placing a run on short-term credit as one of the most destabilizing events of the recent financial crisis (e.g. Brunnermeier (2009), Krishnamurthy (2010), Bernanke (2008, 2009a,b) ), there is much less consensus on how to prevent another panic from happening. One policy that has been widely discussed consists in limiting the maturity mismatch of firms. Brunnermeier et al. (2009) suggests extending the maturity of short-term credits to help stabilize the market for credit, while Farhi and Tirole (2012) advocates for putting a cap on the total amount of short-term debt that firms can issue. Malherbe (2014), on the other hand, warns about the unintended consequences of limiting maturity mismatch.

This disparity of recommendations reflects the difficulty in studying markets for short-term credit, as maturities are endogenous, and field experiments not easily feasible. In this paper, we overcome these problems by bringing short-term credit markets into the lab. Our intention is to study the interplay between different maturity lengths and the state of the economy in a market for Asset Backed Commercial

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