The World that Bagehot Knew

- When a corporation buys goods from another corporation, they give a "bill of exchange" (a promise to pay money for the goods in 90 days)
    - The corporation selling the goods will sell the bill of exchange to a bank at a discount (lower than face value) in return for cash
    - The corporation buying goods will settle the bill of exchange by paying the bank cash (which it got by selling the goods)
- Two ways for a bank to balance their cash flow
    - Change the discount rate
        - So fewer customers will come to them to discount loans (so the bank needs fewer notes)
    - Rediscount with another bank
        - Rediscount a loan that the bank has as an asset with another bank (by selling it to them at a discounted price)
        - This increases the bank's supply of notes
- Central banking is about manipulating the bank rate
- Bagehot rule: lend freely at a high rate during a crisis
    - Only people that really need the money will borrow from the central bank
    - They will pay back the loan quickly once the market rate is lower than the bank rate (by borrowing in the market to pay back the loan)

Dealers and Liquid Security Markets

- Two type of liquidity:
    - Funding liquidity - the ability to get money to fund an inventory
    - Market liquidity - the ability to buy and sell a security quickly and in large volumes without impacting the price
- Dealers provide liquidity by having inventories of cash and securities
    - They are always willing to buy and sell securities, but charge a bid-ask spread for the liquidity that they provide
    - Dealers need to protect themselves from:
        - Traders with inside information who will get the dealer to sell when the price is going up and buy when the price is going down
        - Price volatility of the security
    - Dealers protect themselves by:
        - Setting a limit on the maximum long position and the maximum short inventory
        - Increasing the price they will buy or sell at when they have a large short inventory
            - Large short inventory = a lot of people are buying this stock (so it is probably worth more than the old price suggests)

            - Decreasing the price they will buy or sell at when they have a large long inventory
                - Large long inventory = a lot of people are selling this stock (so it is probably worth less than the old price suggests)
- Another type of dealer is a leveraged dealer
    - When buying a security, they take a loan to provide capital
    - When selling a security, they short the security
    - But this leads the dealer to have exposure to the price movement of the security
- In reality, dealers don't do either of these things, instead using:
    - Repos to borrow funds by using securities as collateral
    - Reverses to get funds by lending money
    - This allows dealers to minimize net exposure (long positions minus short positions) while still maintaining a lot of gross exposure (the size of the balance sheet)