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Excess Reserves, Monetary Policy and Financial Volatility

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Abstract

This paper examines the real and financial effects of reserves in a Dynamic Stochastic General Equilibrium (DSGE) model with monopoly banking and credit market imperfections. The framework explicitly accounts for the fact that commercial banks hold excess reserves and they incur costs in holding these assets. The model also accounts for imperfect substitutability between bank funding sources and it shows that this feature is an important channel through which reserve requirement shocks can affect real variables. Numerical experiments show that raising reserve requirements creates a countercyclical effect for real economic activity. The results also indicate that the combination of an augmented Taylor rule which responds to excess reserves and a countercyclical reserve requirement rule is optimal to mitigate macroeconomic and financial volatility associated with liquidity shocks.

JEL Classification Numbers: E43, E52, E58

Keywords: Excess Reserves, Countercyclical Reserve Requirements, Financial Volatility

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