Accepted Manuscript

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PII: S0378-4266(16)30144-3
DOI: 10.1016/j.jbankfin.2016.08.005
Reference: JBF 5002

To appear in: *Journal of Banking and Finance*

Received date: 8 March 2015
Revised date: 2 August 2016
Accepted date: 19 August 2016

Please cite this article as: Keyra Primus, Excess Reserves, Monetary Policy and Financial Volatility, *Journal of Banking and Finance* (2016), doi: 10.1016/j.jbankfin.2016.08.005

Excess Reserves, Monetary Policy and Financial Volatility

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September 15, 2016

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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*This article is a modified version of Chapter one of my Ph.D. dissertation. I am grateful to my Ph.D. supervisor, Professor Pierre-Richard Agnor (University of Manchester), for his valuable guidance and comments at different stages of this paper. I would also like to specially thank Roy Zilberman, as well as Issouf Samake, George Chouliarakis, Anne Villamil, Franka Primus, Emile Williams, DeLisle Worrell, Geert Bekaert (the Editor), two anonymous referees, participants at the Economics Ph.D. Conference (University of Manchester, United Kingdom, May 2013), the Central Bank of Barbados Annual Review Seminar (Barbados, July 2013), and the 9th Dynare Conference (China, October 2013) for helpful comments and discussions. The views expressed in this paper and any errors are my own.