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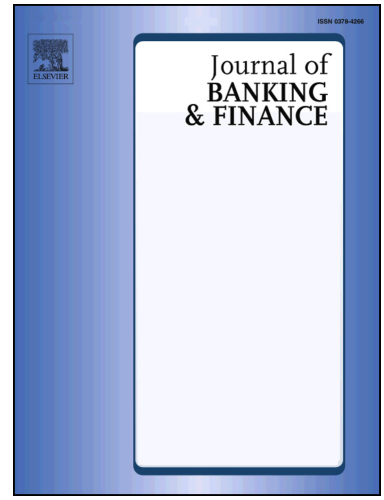

The Role of Interbank Relationships and Liquidity Needs∗

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The Role of Interbank Relationships and Liquidity Needs*

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Abstract

In this paper, we focus on the interconnectedness of banks and the price they pay for liquidity. We assess how the concentration of credit relationships and the position of a bank in the network topology of the system influence the bank's ability to meet liquidity demand. We use quarterly data of bilateral interbank credit exposure among all German banks from 2000 to 2008 to measure interbank relationships and network characteristics. We match these data with bids placed by individual banks in the European Central Bank's (ECB) weekly repo auctions. The bids measure each bank's willingness to pay for liquidity, since they had variable rate tenders with a "pay-your-bid" price. Controlling for bank characteristics and the daily fulfillment of reserve requirements, we find that banks with a more diversified borrowing structure in the interbank market bid significantly less aggressively and pay a lower price for liquidity in the ECB's main refinancing operations. These findings suggest that incentives to diversify banks' liquidity risk dominate the benefits of private information. When the network position of the bank is taken into account, we find that central lenders in the money market bid more aggressively in auctions.

Keywords: Interbank markets, liquidity, relationship lending, networks

JEL Codes: G21, E58, D44, L14, D85

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