

Capital Regulation and Credit Fluctuations

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1 Highlights

- 2 • We provide a rationale for imposing counter-cyclical capital requirements on banks.
- 3 • Banks lend too much in good times and too little in bad times.
- 4 • This occurs even when financial markets are complete.
- 5 • Capital requirements in good times correct capital misallocation across sectors.
- 6 • Counter-cyclical capital requirements can be an effective stabilization tool.

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