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Interbank Market Failure and Macro-prudential Policies

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Abstract

This paper analyses the effects of several macro-prudential policy measures on the banking sector and its linkages to the macroeconomy. We employ a dynamic general equilibrium model with sticky prices, in which banks trade excess funds in the interbank lending market. We find that an increase in the liquidity requirement effectively reduces the impact of an interbank shock on the real and financial sector, while an increased capital requirement propagates only through nominal variables as inflation and interest rates. We conclude that stricter liquidity measures which limit inside money creation, dampen the severity of a breakdown in interbank lending. Targeting interbank financing directly through liquidity measures along with a moderate capital requirement generates lower welfare losses. We thereby provide a comprehensive rationale in favor of the regulatory measures in Basel III.

JEL Classification: E40, E51, E58, G28

Keywords: Macro-prudential Policies, Interbank Market, Liquidity Ratio, Capital Ratio

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