Accepted Manuscript

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PII: S1044-0283(18)30025-5
Reference: GLOFIN 409

To appear in: Global Finance Journal


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The Interplay between Liquidity Regulation, Monetary Policy Implementation and Financial Stability

Todd Keister*

Abstract

I outline a simple framework for thinking through how the Basel III liquidity regulations – in particular, the Liquidity Coverage Ratio (LCR) – will impact short-term interest rates and the process of monetary policy implementation. This framework suggests that a regulatory premium may arise in some market interest rates, creating a new wedge in the monetary transmission mechanism. I discuss ways in which a central bank could react to this new wedge, highlighting what may be a fundamental tension between implementing monetary policy effectively and using liquidity regulation to promote financial stability.

Keywords: Basel III, Liquidity coverage ratio (LCR), Interbank markets, Monetary policy transmission

JEL codes: E43; E52; E58; G28

* Department of Economics, Rutgers University, New Brunswick, NJ 08901, United States. I am grateful to conference participants at the Federal Reserve Bank of Atlanta and at the 19th Annual International Banking Conference, held at the Federal Reserve Bank of Chicago, for helpful comments on earlier versions of this paper. This article draws heavily from the paper presented at the Federal Reserve Bank of Chicago’s 2016 International Banking Conference and included in the conference proceedings; Keister (2017).
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