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Todd Keister

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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

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