FINANCIAL STABILITY REGULATION UNDER BORROWING AND LIQUIDITY EXTERNALITIES

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Abstract
We study financial stability regulation in an environment with pecuniary externalities and where banks face both a liability choice (between private money creation and long-term borrowing) and an asset choice (between liquid and illiquid investments). Return risk on illiquid assets gives rise to liquidity risk, because banks that learn to have low future returns find themselves unable to roll over 'money-like' debt. Privately optimal borrowing and investment decisions by banks lead, in general, to socially inefficient outcomes. The nature of inefficiency depends critically on the degree to which liquidity risk is systemic: When risk is highly systemic, banks hold the socially optimal amount of liquid assets, but create an excessive amount of money and overinvest in risky assets; when risk is *not* highly systemic, banks hold too little liquidity, create insufficient private money and underinvest in risky assets. Quantity- and price-based regulations to address the identified inefficiencies are discussed. (JEL: E44, E58, G21, G28)

Keywords: liquidity risk, macroprudential policy, pecuniary externalities, underborrowing, underinvestment.

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