Capital Regulation and Credit Fluctuations

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Abstract

We provide a rationale for imposing counter-cyclical capital ratios on banks. In our simple model, bankers cannot pledge the entire future revenues to investors, which limits borrowing in good and bad times. Complete markets do not sufficiently stabilize credit fluctuations, as banks allocate too much borrowing capacity to good states and too little to bad states. As a consequence, bank credit, output, capital prices or wages are excessively volatile. Imposing a (stricter) capital ratio in good states corrects the misallocation of the borrowing capacity, increases expected output and can be beneficial to all agents in the economy. Although in our economy, all agents are risk-neutral, counter-cyclical capital ratios are an effective stabilization tool. To ensure this effectiveness, capital ratios have to be based on ex ante equity capital, as classical capital ratios can be bypassed.

Keywords: Credit Fluctuations, Complete Markets, Macroprudential Regulation, Misallocation of Borrowing Capacity.

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