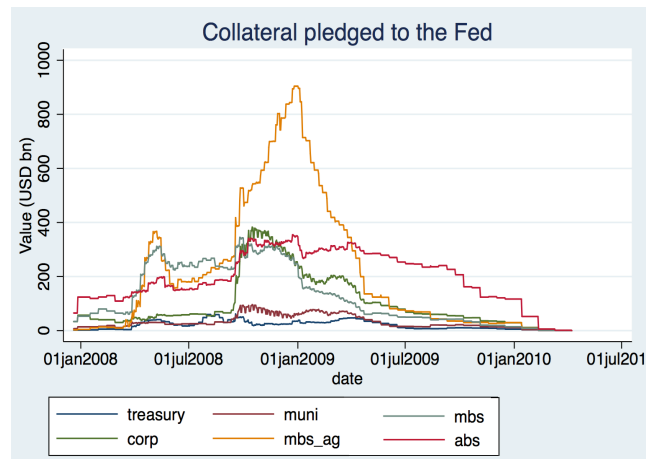
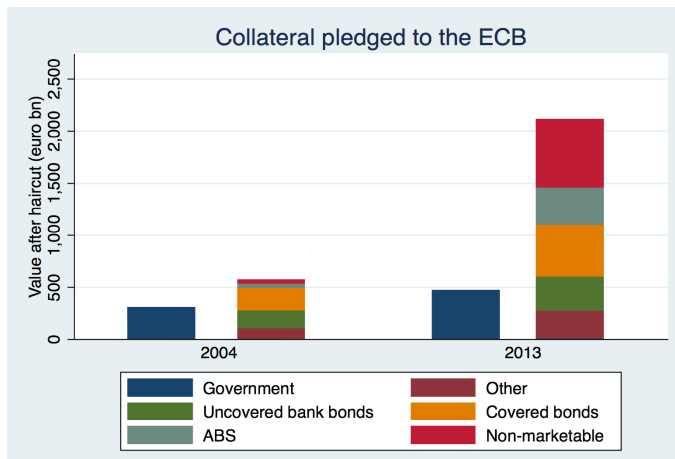


# Central Bank Liquidity Provision and Collateral Quality

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## Facts



- Bagehot : Central banks should lend against high quality collateral
- During 2007-2013 crisis, major central banks lent against illiquid collateral
- Our paper explicitly characterizes efficient central bank collateral policy and rationalizes the stylized facts

## Model

### Bank

- Cashless but owns an investment opportunity and a collateral
- Imperfect collateral quality  $v$  (valuation wedge)
- Borrows from interbank market or central bank
- Faces moral hazard

### Interbank Market

- Perfectly competitive
- Higher haircut boosts incentives but transfer assets to low valuation parties

### Central Bank

- Maximizes output while minimizing own expected losses

## Results

- Shift to collateralized funding when investment prospects deteriorate
- 3 regimes with collateral
- Lack of collateral can increase economy rates for a given policy rate
- Distorts the transmission of monetary policy
- A looser central bank collateral policy can reduce the spread and alleviate the credit crunch
- Risk of moral hazard in medium-term → Need regulation to ensure sufficient collateral holdings (e.g. Basel III Liquidity Coverage Ratio)

