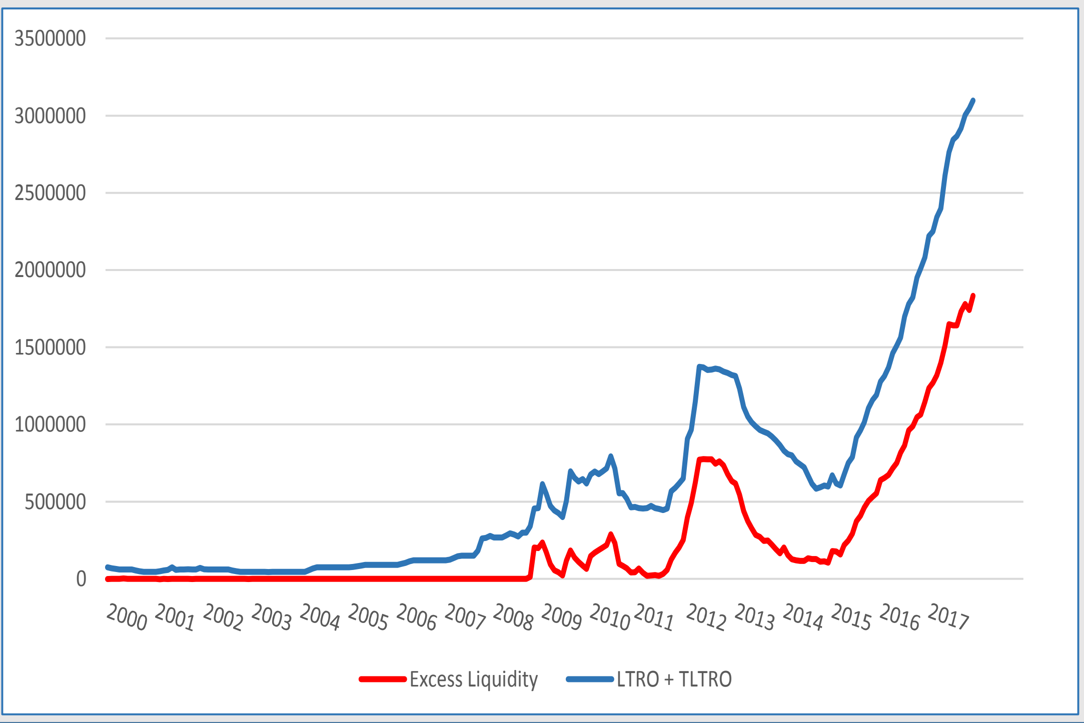
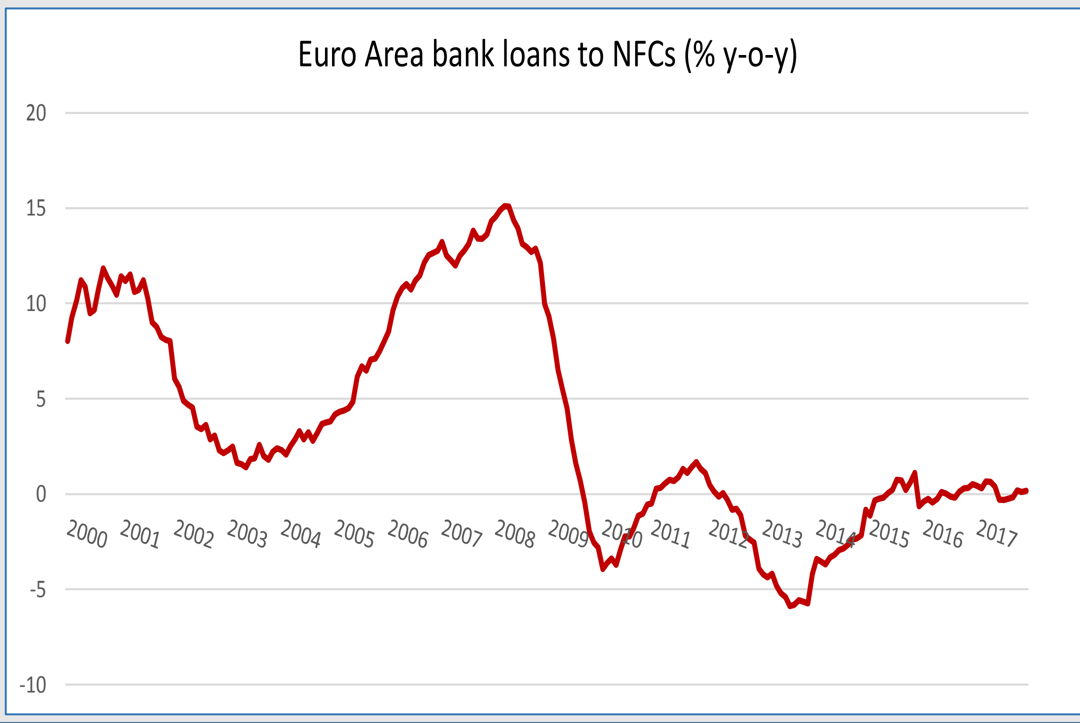
Financial Crisis Monetary Base Expansion and Risk

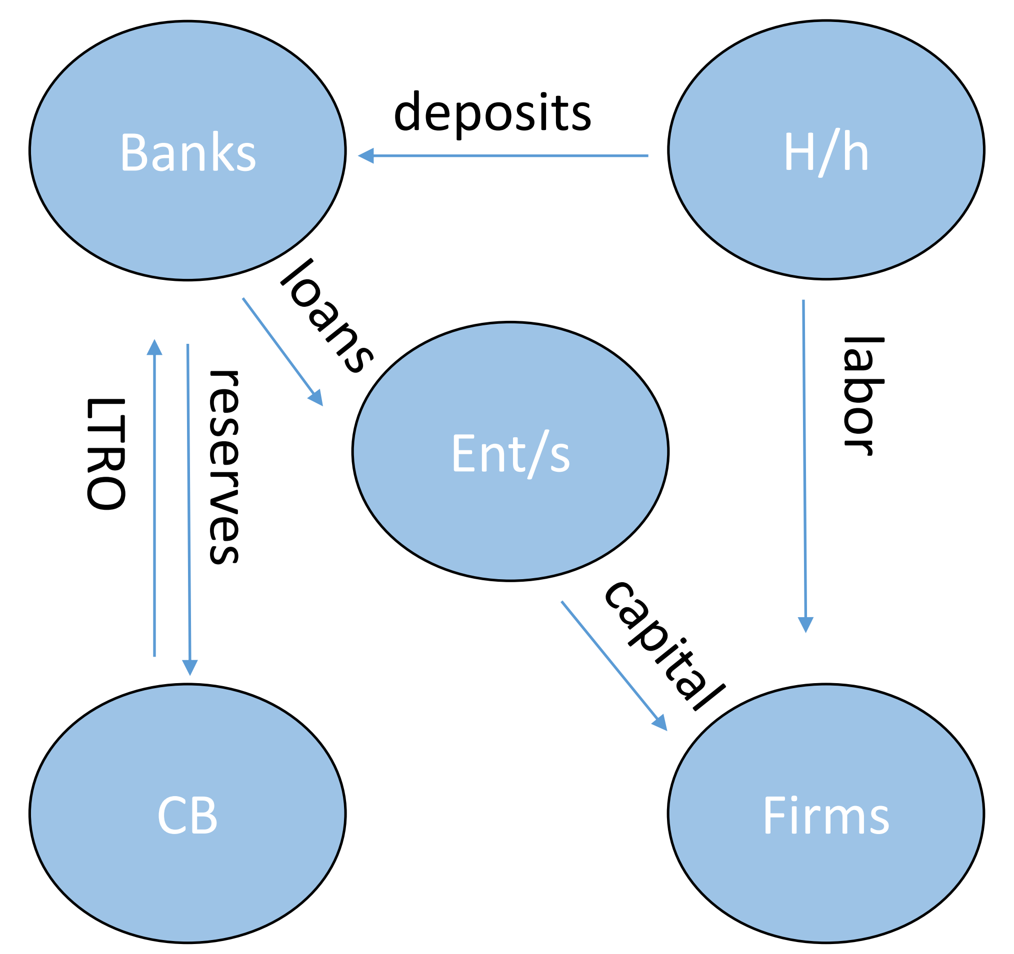
Stylianos Tsiaras (University of Surrey)
[s.tsiaras@surrey.ac.uk]

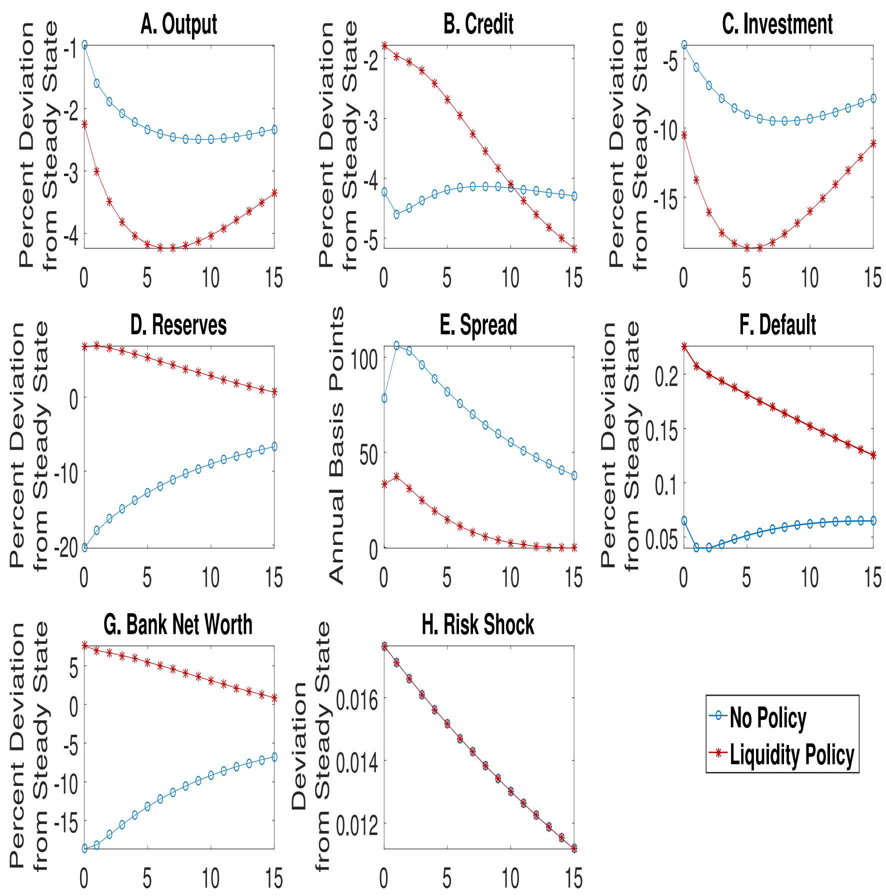
- **Do Central Banks stimulate lending by liquidity injections to the banks (LTRO, TLTRO)?**
- Yes, but risk-shifting channel is at work with negative consequences for the macroeconomy
- **Why banks accumulate reserves?**
- They do when it is risky to lend





DSGE model with financial frictions on the supply and the demand side of credit. Estimated for the Euro Area.





Key Results:

$$L_t = \phi_t N_t^B + \underbrace{\frac{1}{1-p(\bar{\psi}_t)}(\omega M_t)}_{\text{risk-shifting}}$$

$$\mathbb{E}_t\, R_{l,t+1} = \underbrace{\frac{\lambda_t}{(1+\lambda_t)}\frac{\theta}{\mathbb{E}_t\,\Lambda_{t,t+1}\Omega_{t+1}}}_{\text{liquidity component}} + \underbrace{\mathbb{E}_t\, R_{t+1}\frac{1}{1-p(\psi_t)}}_{\text{risk component}}$$

Risk Shifting Chanel

1. Firms' default likelihood ▲
2. Lending spread ▲
3. LTRO ▲
4. Lending spread ▼, Lending ▲
5. Firms net worth ▼
6. Default likelihood ▲
7. Investment , Output ▼

Policy Implications

- Liquidity injections increase risk-taking incentives by banks
- Focus on measures that improve the net worth of the production side