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Liquidity, Monetary Policy, and Financial Cycles

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Abstract

A close look at how financial intermediaries manage their balance sheets suggests that these institutions raise their leverage during asset price booms and lower it during downturns - pro-cyclical actions that tend to exaggerate the fluctuations of the financial cycle. The authors of this study argue that the growth rate of aggregate balance sheets may be the most fitting measure of liquidity in a market-based financial system. Moreover, the authors show a strong correlation between balance sheet growth and the easing and tightening of monetary policy.

Keywords: monetary policy, financial intermediation, financial cycles

JEL Classification: E50, G00, G21

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