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Reserve Requirements for Price and Financial Stability - When are They Effective?

Banque de France Working Paper No. 363

57 Pages

Posted: 21 Feb 2012

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Date Written: February 1, 2012

Abstract

Reserve requirements are a prominent policy instrument in many emerging countries. The present study investigates the circumstances under which reserve requirements are an appropriate policy tool for price or financial stability. We consider a small open economy model with sticky prices, financial frictions and a banking sector that is subject to legal reserve requirements and compute optimal interest rate and reserve requirement rules. Overall, our results indicate that reserve requirements can support the price stability objective only if financial frictions are important and lead to substantial improvements if there is a financial stability objective. Contrary to a conventional interest rate policy, reserve requirements become more effective when there is foreign currency debt.

Keywords: reserve requirements, monetary policy, financial stability, capital flows, business cycle**JEL Classification:** E58, E52, F41, G18[Suggested Citation](#) >[Show Contact Information](#) >[Download This Paper \(Delivery.cfm/SSRN_ID2008665_code1462840.pdf?abstractid=2008665&mirid=1\)](https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2008665_code1462840.pdf?abstractid=2008665&mirid=1)[Open PDF in Browser \(Delivery.cfm/SSRN_ID2008665_code1462840.pdf?abstractid=2008665&mirid=1&type=2\)](https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2008665_code1462840.pdf?abstractid=2008665&mirid=1&type=2)

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