The Reversal Interest Rate

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The “reversal interest rate” is the rate at which accommodative monetary policy reverses its intended effect and becomes contractionary for lending. It occurs when banks' asset revaluation from duration mismatch is more than offset by decreases in net interest income on new business, lowering banks' net worth and tightening their capital constraints. The determinants of the reversal interest rate are 1) banks' fixed-income holdings, 2) the strictness of capital constraints, 3) the degree of pass-through to deposit rates, and 4) the initial capitalization of banks. Furthermore, quantitative easing increases the reversal interest rate and should only be employed after interest rate cuts are exhausted. Over time the reversal interest rate creeps up since asset revaluation fades out as fixed-income holdings mature while net interest income stays low. We calibrate a New Keynesian model that embeds our banking frictions and show that the economics behind the reversal interest rate carry through general equilibrium.

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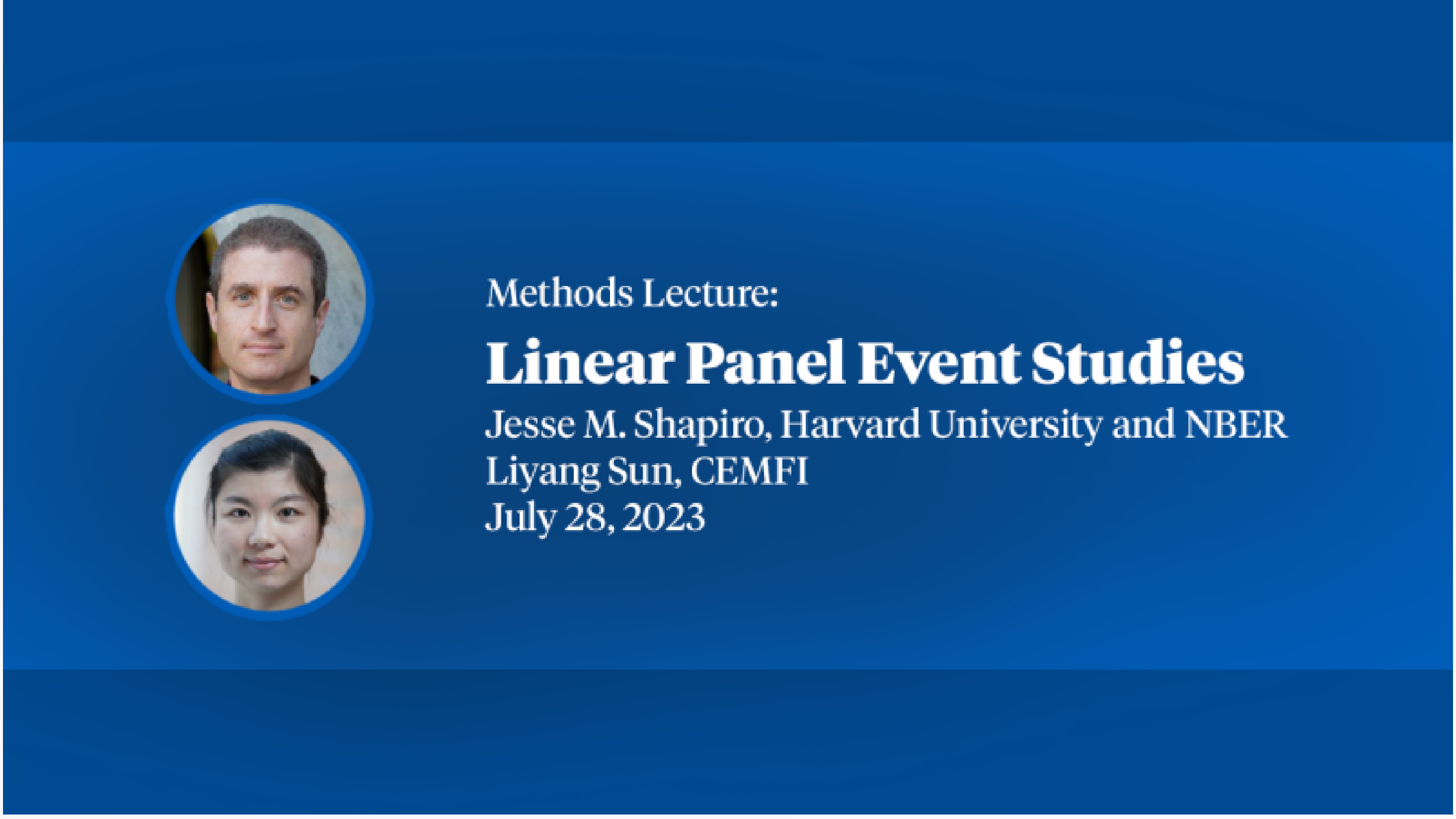

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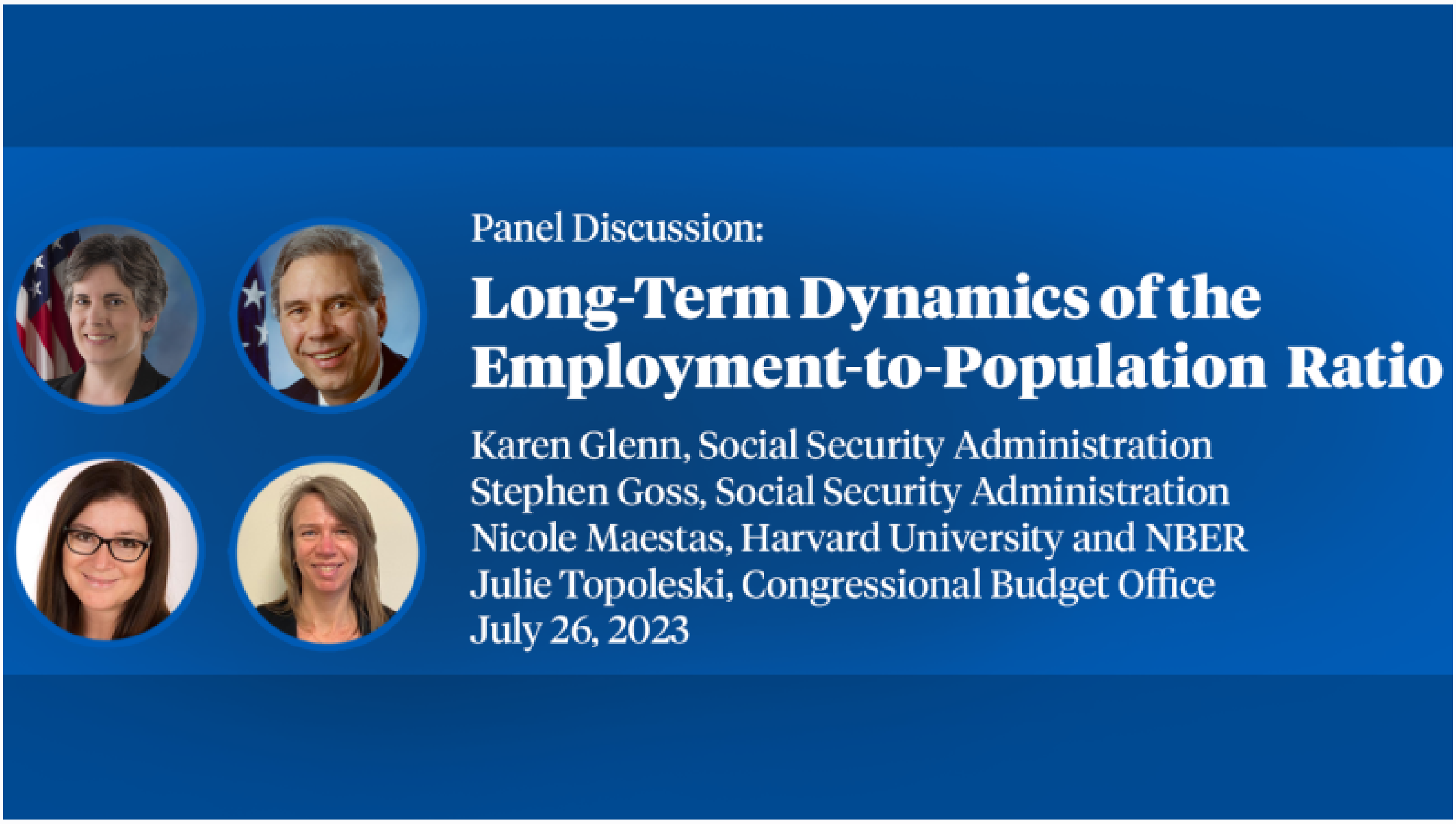

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