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Monetary policy and financial stability in a banking economy

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CONCLUDING REMARKS

Several main findings are brought up in this study. In the first chapter we consider the model that identifies how, and what circumstances monetary policy tools can be used to achieve financial stability and vice versa. According to the transmission mechanism derived in that section, when the Central Bank interest rate reaches the zero bound, the monetary authority can affect the market rate (including bank lending rate) by adjusting the capital requirement ratio. In the second chapter, we find that credible commitment produces a negative association of the real interest rate with inflation expectations along the stable saddle path. We analytically establish in chapter three that dynamics exist which that emanate from the wedge between the actual financial capital ratio of a bank and its steady state position. In the last chapter, we use *VAR* estimation and find that a positive shock to the bank's capital ratio on impact causes a rise in the excess bond premium. A positive shock to the specific loan loss reserves does as well, and similarly a positive shock to the bank's coverage ratio that positively affects the required bond premium. We then conclude that the excess bond premium is not only a leading indicator for the real business cycles, but also a channel through which the banking sector affects these cycles.

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