Capital Adequacy Requirements and Financial Friction in a Neoclassical Growth Model

Miho Sunaga*

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Abstract

I introduce financial market friction into a neoclassical growth model. I consider a moral hazard problem between bankers and workers in the macroeconomic model. Using the model, this study analyzes how capital adequacy requirements for banks affect the economy. I show that there is a case in which policy institution should not change the minimum capital adequacy requirements in order to improve the steady-state level of consumption when the economy experiences a recession. This result implies that counter-cyclical capital requirements, that is, relaxing the rule when there is recession, is not always optimal for consumers. The condition for the above case depends on the combinations of parameters, such as the degree of financial friction, discount factor, and initial net worth of banks. Moreover, I show that when a negative shock on productivity occurs, deregulation has a good effect on the economy in only the country in which the financial market develops sufficiently.

Keywords: Capital adequacy requirements, Financial Intermediaries, Macro-prudential policies

JEL Classification Codes: E44, G21, G28

*Graduate School of Economics, Osaka University, 1-7 Machikaneyama, Toyonaka, Osaka 560-0043, Japan. E-mail: *pge014sm@student.econ.osaka-u.ac.jp*