Macroprudential Regulation, Financial Stability, and Economic Growth

Kazunari Tanabe*

University of Tokyo

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Abstract

How does macroprudential regulation affect economic growth? What are its welfare implications? To address these questions, we develop an endogenous growth model in which a financial crisis is driven by Fisherian debt deflation. A price-dependent collateral constraint and technological spillovers introduce two externalities into the model: pecuniary externalities and physical capital externalities. Our main result is that macroprudential regulation which corrects only pecuniary externalities is welfare-reducing, because the growth-reducing effect surpasses the growth-enhancing effect, and the cost of hurting economic growth outweighs the benefit of securing financial stability. Moreover, we show that whether the decentralized economy exhibits over/under-borrowing or over/under-investment depends on the relative distortions in capital demand and supply induced by the two externalities.

Keywords: financial crises, endogenous growth, macroprudential regulation, overborrowing, pecuniary externalities, physical capital externalities

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