Research Working Papers

International Financial Regulation: The Role of Banking Sector Sizes

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International regulatory standards can improve financial stability for all countries, but some countries have fewer incentives to adhere to them.

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This paper presents a simple two-region banking model of liquidity mismatch to study the strategic interactions between national regulators. Banks hold insufficient liquidity, which leads to a fire-sale externality in an international financial market, justifying coordinated prudential regulation. However, joint regulation is not necessarily a Pareto improvement, as jurisdictions with a smaller banking sector have an incentive to free-ride on foreign regulation. The framework eludes to several arrangements that could bring jurisdictions closer to the efficient outcome, if they cannot agree on common standards: partial global agreements, intermediate agreements among free-riders only, transfers, and capital controls imposed on free-riders. An empirical section demonstrates that key issues around the implementation of the Basel Agreements and the European Banking Union are consistent with the implications from the model.

JEL Classifications: D62, F36, F42 G15, G21

Article Citations

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Related Research

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