Research Working Papers

International Financial Regulation: The Role of Banking Sector Sizes

by: Johannes Matschke

November 17, 2021

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

RWP 21-13, November 2021; updated August 2023

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

- Matschke, Johannes. 2022. "International Financial Regulation: The Role of Banking Sector Sizes." Federal Reserve Bank of Kansas City, Research Working Paper no. 21-13, September. Available at https://doi.org/10.18651/RWP2021-13

Related Research

- Diamond, Douglas, and Philip H. Dybvig. 1983. "Bank Runs, Deposit Insurance, and Liquidity." *Journal of Political Economy*, vol. 91, no. 3, pp. 401-419. Available at https://doi.org/10.1086/261155
- Gazi, Kara. 2016. "Systemic Risk, International Regulation, and the Limits of Coordination." *Journal of International Economics*, vol. 99, pp. 192-222. Available at https://doi.org/10.1016/j.jinteco.2015.11.007

- Korinek, Anton. 2016. "Currency Wars of Efficient Spillovers? A General Theory of International Policy Cooperation." National Bureau of Economic Research, working paper no. 23004, December. Available at https://doi.org/10.3386/w23004

Author

Johannes Matschke

Economist

Johannes Matschke is an economist in the Macroeconomics and Monetary Policy Division at the Federal Reserve Bank of Kansas City. He joined the Bank in 2021 after obtaining his Ph.D. in Economics from the University of California, Davis. His research has focused on the international transmission of financial shocks, financial regulatory policies, and, more generally, macro finance.