

Abstract

The recent financial crisis has challenged the effectiveness of conventional monetary policy measures. As risk perceptions changed adversely and banks' assets values deteriorated, the regulators faced difficulties in providing credit to the real economy. Recent research focuses on new role of capital as a monetary policy tool in addition to its objective to increase the resilience to the financial sector. The paper analyzes the costs and benefits of capital and studies its impact on monetary policy effectiveness through the bank lending channel. The interaction between monetary policy and bank capitalization is considered in the context of the bank capital channel that models explicitly equity as a determinant of banks' willingness and capacity to lend. Risk and other bank and sector specific characteristics that can influence the relationship between capital and monetary policy are also discussed. Finally, the implications on regulation and crisis prevention and response are considered. In a dynamic financial sector of increasing globalization, complexity and size, the capital's functions need to be further analyzed so that the challenges are faced and the opportunities are explored both by financial intermediaries and regulators.

Key concepts: bank capitalization, capital requirements, monetary policy effectiveness, bank lending channel, risk, regulation.