How do banks manage liquidity Evidence from the ECB’s tiering experiment

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AbstractWe study how banks manage their liquidity among the various assets at their disposal. We exploit the introduction of the ECB’s two-tier system which heterogeneously reduced the cost of additional reserves holdings. We find that the treated banks increase reserve holdings by borrowing on the interbank market, decreasing lending to affiliates of the same group, and selling marketable securities. We also find that banks have a preference for a stable portfolio composition of liquid assets over time. Our results imply that frictions in one market for liquidity can spill over to several markets.JEL CodeG21 : Financial Economics→Financial Institutions and Services→Banks, Depository Institutions, Micro Finance Institutions, MortgagesG11 : Financial Economics→General Financial Markets→Portfolio Choice, Investment DecisionsE52 : Macroeconomics and Monetary Economics→Monetary Policy, Central Banking, and the Supply of Money and Credit→Monetary Policy