The Role of Interbank Relationships and Liquidity Needs*

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Abstract

In this paper, we study to what extent peer monitoring or more precisely relationship lending prevails in the German interbank market. In particular, we empirically investigate whether interbank relationships help banks to smooth liquidity shocks. We find that banks that have a higher number of bank relationships in the interbank market bid less aggressively in an ECB auction. However those banks with diversified borrowing structures are also more likely to participate in the auction. This suggests that while the decision of participating in an auction is driven by the degree of interbank relationships, bidding behavior is determined by the diversification of bank liquidity risk.

Keywords: Interbank markets, liquidity, relationship lending, networks

JEL Codes: G21, E58, D44, L14, D85

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