Journal of Financial Intermediation **11**, 232–268 (2002)
doi:10.1006/jfin.2002.0336

# Monetary Policy and Government Credit Programs

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Received November 28, 2000

Credit rationing is a common feature of most developing economies. In response to it, the governments of these countries often operate a number of programs intended to expand the supply of credit to the private sector. Expansionary monetary policy is often seen as a way of reducing the extent of credit rationing. We examine the consequences of a common policy tool in these economies: the use of expansionary monetary policy combined with direct central bank lending to inject credit. In the context of a small open economy we show that such a policy increases long-run production if and only if the economy is in a development trap. Moreover government credit programs often lead to endogenously arising aggregate volatility. Thus the case for government intervention in credit markets relies largely on the notion that output is artificially low because the economy is in a development trap. However, it is the case that the kind of policy we consider can be used to eliminate certain indeterminacies of equilibrium created by endogenous credit market frictions. *Journal of Economic Literature* Classification Numbers: E44, O16, O42. © 2002 Elsevier Science (USA)

*Key Words:* credit rationing; monetary policy; credit programs; financial intermediaries.

## 1. INTRODUCTION

It is often asserted that the presence of credit rationing gives monetary policy considerable scope to affect real economic activity.[1] In particular, the claim is that

[1] See, for instance, Blinder and Stiglitz (1983) or Stiglitz and Weiss (1992). More generally, this is the point of view implicit in the literature on the "credit channel" view of monetary policy.



1042-9573/02 $35.00

when credit is rationed, an "easier" monetary policy can expand the availability of credit. As a result, there can be a corresponding expansion of lending, investment, and production.

It is also the case that the rationing of credit seems to be especially prevalent in developing countries. Moreover, in developing country contexts, central banks are often actively involved in the allocation of credit. Indeed, the central bank often lends directly to banks engaged in making loans to "strategic" sectors of the economy or rediscounts a variety of private sector loans. Here, then, the connection between monetary expansion and the supply of credit is particularly tight: money growth is used to finance direct or indirect lending by the central bank.[2] If the claim about the link between monetary policy and credit availability in the presence of credit rationing is correct, this link should be particularly strong in developing countries.

However, expansionary monetary policy has other consequences in addition to its impact on the availability of credit. Most specifically, increases in the rate of money creation also increase the rate of inflation. And, it is empirically well-established that increases in the rate of inflation can have strong adverse consequences for credit market conditions[3] and consequently output growth.

These observations suggest an obvious question: which of these effects is likely to dominate? Or, alternatively, when (if at all) should a central bank use expansionary monetary policy as a means of injecting credit into an economy? Clearly, expansionary monetary policies can lead to an expansion of credit only if the consequences of credit injection are strong enough to offset the contractionary effects of higher rates of inflation on bank lending.

All of the issues mentioned thus far can be posed with reference to long-run equilibria. In addition, there is the question of how the use of monetary policy to inject credit affects equilibrium dynamics in a small open economy—a category which presumably includes most developing countries. In this regard, two facts are well established but not theoretically explained: (a) high average rates of inflation are strongly associated with high inflation variability, and (b) when the rate of inflation exceeds some critical level, further increases in inflation can lead to so-called *inflation crises* with dramatic consequences for output.[4] One of our goals is to provide theoretical explanations for these observations. We would also like to understand whether the use of monetary policy to fund credit extension can affect the determinacy of equilibrium.

In order to investigate these issues, we construct a conventional monetary growth model (Diamond, 1965), which has been reformulated so that capital investment requires access to external finance. In our model, credit rationing arises endogenously

[2] For example, in Turkey central bank rediscounting was the dominant instrument of monetary policy into the late 1980s ("The Turkish Economy and the Financial Sector," 1995, p. 12). Central bank rediscounting in Mexico is discussed, for example, by Chavez (1983).

[3] On this point see Boyd *et al.* (2000), Gonzalez-Vega (1984), Johnson (1983), or Khan *et al.* (2001).

[4] "Inflation crises" are discussed by Bruno and Easterly (1998).