Capital regulation, risk-taking and monetary policy: A missing link in the transmission mechanism?∗

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A B S T R A C T

Few areas of monetary economics have been studied as extensively as the transmission mechanism. The literature on this topic has evolved substantially over the years, following the waxing and waning of conceptual frameworks and the changing characteristics of the financial system. In this paper, taking as a starting point a brief overview of the extant work on the interaction between capital regulation, the business cycle and the transmission mechanism, we offer some broader reflections on the characteristics of the transmission mechanism in light of the evolution of the financial system. We argue that insufficient attention has so far been paid to the link between monetary policy and the perception and pricing of risk by economic agents—what might be termed the “risk-taking channel” of monetary policy. We develop the concept, compare it with current views of the transmission mechanism, explore its mutually reinforcing link with “liquidity” and analyse its interaction with monetary policy reaction functions. We argue that changes in the financial system and prudential regulation may have increased the importance of the risk-taking channel and that prevailing macroeconomic paradigms and associated models are not well suited to capturing it, thereby also reducing their effectiveness as guides to monetary policy.

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1. Introduction

Few areas of monetary economics have been studied as extensively as the transmission mechanism. The literature on this topic has evolved substantially over the years, following the waxing and waning of conceptual frameworks and the changing characteristics of the financial system.

The evolution driven by conceptual frameworks is of older vintage; at the cost of some oversimplification, it can roughly be characterised as follows. In the now seemingly distant days of the battles between monetarists and Keynesians, there was a consensus that a key channel through which monetary impulses affected aggregate expenditure was through their impact on the relative yields of imperfectly substitutable assets. The main bone of contention at the time had to do with the degree of relative substitutability between money and other assets and, relatedly, with how large the set of those assets should be to adequately capture the effects. Monetarists highlighted a low elasticity and often envisaged a much broader set than Keynesians, including real assets and possibly human wealth. In fact, in the simplest IS-LM framework, in cases where the distinction is necessary, we thus exclude the factors that affect the split between prices and output.

See, for example, Friedman (1959), Brunner and Meltzer (1976), Meltzer (1995), and Tobin (1961). This, of course, is a simple characterisation. In fact, the monetarist...
which monetarists often found so constraining, the only relevant distinction was between "money", an asset whose nominal yield was exogenously fixed (normally at zero), and "bonds". This way of approaching the issue was a natural consequence of conceptual frameworks that emphasised stock equilibrium.

Subsequently, the main emphasis shifted to the distinction between internal and external funding. The bone of contention here has been whether informational imperfections (frictions) in financial markets are such as to drive a quantitatively significant wedge between the two sources of funding, or indeed between different forms of external funding. In other words, how significant are the "broad credit" (or "balance sheet") and "bank lending" channels compared with the interest rate channel, defined to include any inter-temporal substitution and wealth (permanent income) effects on expenditures?4 This literature has drawn strength from major advances in the formal theory of contracts in the presence of asymmetric information. In spirit, the approach is intellectually closer to the loanable funds theory of the interest rate, in so far as it focuses more on flows than stocks.

The changing characteristics of the financial system have recently encouraged a shift of focus in the analysis from the role of monetary controls to that of prudential controls in the transmission mechanism, especially to that of capital regulation. A few decades back, a variety of restrictions were in place in several countries on intermediaries' balance sheets as part of credit allocation and overall credit control policies. Over time, as these restrictions were lifted, the only constraint receiving attention became minimum reserve requirements. This was viewed as an integral part of the bank lending channel, with shifts in the non-bank public's portfolios between capital market instruments (bonds) and reservable deposits seen as impinging on the supply of bank lending. More recently, with the increasing influence of minimum capital requirements on bank behaviour, a growing literature has started to consider the corresponding implications for the transmission mechanism based on the differential cost of equity funding (the "bank capital" channel).

In this paper, taking as a starting point a brief overview of the work on the interaction between capital regulation, the business cycle and the transmission mechanism, we offer some broader reflections on the characteristics of the transmission mechanism in light of the evolution of the financial system. The analysis is very much of a speculative, exploratory nature. We do not develop any new specific model or present new econometric evidence, but simply highlight what appear to us as under-researched aspects of the issues.

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