



Implications of banking marketization for the lending channel of monetary policy transmission: Evidence from China



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ARTICLE INFO

Article history:

Received 11 December 2012

Accepted 15 July 2013

Available online 27 July 2013

JEL classification:

E52

G21

P34

Keywords:

Banking marketization

Lending channel

Monetary policy

China

ABSTRACT

This paper examines how banking marketization affects the transmission of monetary policy through the bank lending channel, and tests whether the relationship between banking marketization and the transmission of monetary policy changes across heterogeneous banks. Our results suggest that as the degree of banking marketization increases, China's monetary policy transmission through the bank lending channel weakens, and this works particularly for large, high profitability, and high capitalization banks. To improve the effectiveness of the monetary policy, authorities need to consider reducing dependency on the lending channel of monetary policy transmission and diversifying the monetary policy instruments.

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1. Introduction

China's economy has achieved remarkable developments in the last two decades. With the transformation and opening up of China's economy, the People's Bank of China (PBC), as the central bank, began to implement monetary policy to stabilize economic fluctuation. Although the interest rate channel for the transmission of monetary policy remains intact, the importance of the credit channel in magnifying the impact of monetary policy has obtained credibility (Mishkin, 2007; Walsh, 2010; Peek and Rosengren, 2010). As argued in Bernanke and Blinder (1988), the bank lending channel predicts a decline in the aggregate level of credit extended by banks in response to a monetary policy tightening.

Some factors may explain the key role played by bank lending in the transmission mechanism of China's monetary policy (Allen et al., 2005). The most important external financing source for firms is bank loans because stock and bond markets in China have not been well developed; furthermore, bank loans provide nearly 90% of funds to Chinese firms. This aspect is the principal reason that the PBC regards the lending channel with cardinal significance. In addition, although the recent experience of global financial crisis has highlighted that banking problems can directly cause systemic macroeconomic problems, banks are a crucial component of mitigating crises because many financial and non-financial firms are dependent on banks to provide liquidity and credit.

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The reform and opening up of China's financial system have gained significant achievements since the country's entry into the World Trade Organization (WTO). The degree of banking marketization¹ has improved gradually; the proportion of deposits taken by non-state-owned commercial banks in the total deposits and that of loans issued to non-state-owned firms in the total loans of China's banking sector have increased in the recent decade (Allen et al., 2012). The improvement in the degree of banking marketization inevitably leads to changes in the running objectives and norms of behavior of Chinese commercial banks, which are expected to affect the results of monetary policy by the lending channel. Nevertheless, this perspective is not considered in the existing empirical studies on China's monetary policy transmission mechanism.

It is worth to mention that banking marketization is different from banking privatization. Banking marketization focuses on the lesser intervention of the government in the allocation of credit funds of the banking sector in China, instead of focusing on the change in bank ownership. Since the banking sector in China is heavily controlled by the government, the degree of marketization of the credit fund allocation cannot be measured only by the nominal ownership changes of commercial banks. On one hand, although the number of partially private and private banks is rising, the market share of non-state-owned banks remains unchanged. Hence, state-owned commercial banks still monopolize the allocation of credit funds. On the other hand, banks of different ownerships could behave homogeneously. For example, state-owned, partially private, and private banks would prefer to lend to state-owned enterprises, and thus, non-state-owned enterprises might have difficulty in obtaining loans. Therefore, compared to banking privatization, banking marketization is a more generalized and accurate concept to measure the degree to which credit funds are raised and distributed by market mechanism, and not according to the wishes and interventions of the government.

Many existing studies have found some determinants of the bank lending channel (Bernanke and Gertler, 1995; Van den Heuvel, 2002; Gambacorta, 2005; Adams and Amel, 2005; Ashcraft, 2006; Olivero et al., 2009; Sichei and Njenga, 2012). Kashyap and Stein (1995) show that the size of a bank's assets is significantly associated with its sensitivity to monetary policy shocks. Kashyap and Stein (2000) illustrate that monetary policy has a limited impact on banks that can turn to liquid assets to cover the reduction in deposits. Peek and Rosengren (1995) find that an important determinant of a bank's reaction to monetary policy initiatives is its capital-to-asset ratio. Gunji and Yuan (2010) show that the impact of monetary policy on lending is weaker for banks with lower liquidity and larger banks; profitable banks are less sensitive to monetary policy. In light of the evidence provided by Bhaumik and Piesse (2008), bank behavior can be affected by whether or not it is subjected to market scrutiny. Olivero et al. (2011) argue that an increasing competition in the banking industry weakens the transmission mechanism of monetary policy by the lending channel. Bhaumik et al. (2011) examine the impact of ownership on the reaction of banks to monetary policy, and find that considerable differences exist in the reactions of different ownership types of banks to monetary policy initiatives.

In comparison, empirical evidence on the lending channel of China's monetary policy transmission remains scarce. Xie (2004) tests whether the money supply Granger-causes selected macroeconomic variables using aggregate data between 1998 and 2002, and finds that money is neutral with regard to long-run economic growth. Hsing and Hsieh (2005) estimate the impulse response functions between 1980 and 2000; they conclude that monetary policy has a strong effect on output in the long term. Liu et al. (2009) also consider the impact of monetary policy in China, and investigate the long-term relationship between inflation and deposit rates.

Most current studies on the bank lending channel of China's monetary policy transmission often use aggregate data and VAR models; however, this method is incapable of identifying the demand and supply for bank loans. Disaggregated data of banks may capture the distributional effects of monetary policy effectively (Bernanke and Blinder, 1992). Therefore, banking industry data are employed to analyze China's monetary policy transmission mechanism in recent research. Gunji and Yuan (2010) use bank-level data to examine whether the effect of monetary policy on banking lending depends on the characteristics of Chinese banks; they find that the impact of monetary policy on lending is weaker for banks with lower liquidity and larger banks, and that profitable banks tend to be less sensitive to monetary policy.

In this paper, to address the lacuna in recent literature by focusing on the relationship between banking marketization and lending channel, we investigate the impact of banking marketization on the results of China's monetary policy using banking industry data, controlling for pertinent macroeconomic variables that denote loan demand. We also investigate whether the relationship between banking marketization and the transmission of monetary policy changes across heterogeneous banks. Our analysis has an important role in obtaining new findings concerning the determinants of the lending channel.

Our main empirical results suggest that higher marketization in the banking sector weakens the transmission of monetary policy tightening through the bank lending channel. Therefore, as one of the monetary policy instruments, the required reserve ratio is no longer as effective as in the past along with the improvement in the degree of banking marketization; moreover, this works particularly for larger, high profitability, and high capitalization banks. Our analysis provides empirical evidence for the relative effectiveness of the lending channel of monetary policy transmission when the degree of banking marketization continuously improves in the emerging economy context, which also has rich implications for China's monetary policy practice.

¹ In this paper, the degree of banking marketization refers to the degree to which the credit funds of Chinese commercial banks are raised and distributed by the market mechanism, and not according to the wishes and interventions of the government. We constructed two variables to represent the degree of banking marketization. The first variable is the ratio of the deposits of non-state-owned banks to the total deposits of all sample banks. The second variable is the proportion of loans to non-state-owned enterprises in the total loans of sample banks.

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