Monetary policy and bank lending in the Euro area: Is there a stock market channel or an interest rate channel?

Robert E. Krainer*

Krainer University of Wisconsin–Madison, 975 University Avenue, Madison, WI 53706-1323, USA

Abstract

In this paper I compare a traditional demand oriented model of bank lending with its focus on short-term interest rates in the money market, to a non-traditional capital budgeting model of bank lending based on movements in share valuations for the Euro area. Using non-nested hypothesis tests, omitted variables tests, and Granger Causality tests, I reject the traditional demand oriented model of bank lending and fail to reject the capital budgeting model of bank lending for Monetary Financial Institutions (MFIs) in the Euro area. Even though Europe is a bank-based financial system, it appears the stock market plays a key role in the lending decisions and allocation of resources in Europe. One possible policy implication of this research is that the central bank should try and stabilize stock prices in order to achieve their goal of stabilizing bank lending and the economy.

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Tel.: +1 608 263 1253.
E-mail address: rkrainer@bus.wisc.edu.

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1. Introduction

Banks as financial intermediaries play an important role in the financial system and the real economy of countries. As the institution whose deposit liabilities represent an important component of the medium of exchange, they are well-positioned to reduce the information asymmetries that naturally arise in the transfer of resources from household savers to investing firms in a decentralized market economy. Accordingly there is a large amount of cross-sectional empirical research in banking that documents the importance of bank screening and monitoring of small and medium-sized firms where the real investments and investment returns of these firms are particularly opaque. Furthermore there is evidence that indicates the benefits of bank screening and monitoring go beyond small and medium-sized firms. Large firms having access to external capital markets also benefit from bank screening and monitoring. When a bank grants a new loan, or, extends (or fails to extend) an existing loan to a firm, that piece of information sends a strong signal to the capital market that is reflected in the market valuation of the firm’s outstanding securities.

In addition to allocating financial resources across firms in different sectors of the economy at a point in time, there are other important questions concerning the role of bank lending in the supply of finance over time. More particularly, does aggregate bank lending amplify or dampen the business cycle? How does monetary policy affect bank lending and the economy? As for the first question the preponderance of academic research in this area suggests that bank lending does amplify the business cycle by changing the budget constraints of firms and households. The run-up in bank lending prior to the world-wide Great Recession starting in 2007 is but the most recent case prompting Basle 3 to implement a countercyclical capital buffer. As for the second question the traditional view of monetary policy is that it works through an interest rate channel and balance sheet channel for both borrowers and lenders. According to this traditional view an expansionary monetary policy has the central bank purchasing financial assets in the money market that in turn reduces short-term interest rates and increases bank reserves both of which should in principle increase bank lending through supply and demand channels.

In this paper I revisit the nexus between financial markets and bank loan finance in the Euro area. Why the Euro area? I choose Europe because Europe is generally regarded as having a bank-based financial system built on the substructure of a civil law code (Levine, 1998). This presumably makes Europe’s bank oriented financial system different than the market oriented financial systems in the U.S. even though monetary policy in both have traditionally been carried out in the short-term money market. The main question raised in this paper is: What assets and markets should the central bank target when implementing a monetary policy designed to stabilize bank lending and ultimately real output and employment? Should they operate primarily in the short-term money market to influence short-term interest rates as they have traditionally done but without much success in the current Great Recession, or, should they operate directly in some other market? The market we will suggest below is not the long-term government bond market nor the market for mortgage backed securities liked the Federal Reserve has recently chosen in its “Operation Twist” and QE3, but instead the stock market. Why the stock market? Casual observation reveals that while short-term interest rates in the Euro area (and also the U.S.) have been historically low during the 2008–2012 period indicating that loan finance

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