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Monetary Policy and Balance Sheets

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Abstract

This paper examines the transmission of monetary policy shocks through private sector balance sheets in the United States over the past three decades. Using a Factor-Augmented Vector Autoregression (FAVAR) model on an expanded dataset, including sectoral balance sheet variables, we show that the balance sheets of various economic agents act as important links in the monetary policy transmission mechanism and affect the impulse response of inflation, output, and unemployment. Balance sheets of financial intermediaries, such as commercial banks, asset-backed-security issuers and, to a lesser extent, security brokers and dealers, shrink in response to monetary tightening, while money market fund assets grow. However, their economic significance in the run-up to the recent financial crisis was small. Furthermore, judging from the magnitude of the interest rate elasticity of house price changes, it seems that large increases in interest rates would have been needed to avert a rapid rise of house prices and an unsustainable increase in leverage. This suggests that financial stability concerns may require some role for other policies such as macroprudential policy.

JEL Classification Numbers: E44, E52, G20

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