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PII: S0014-2921(15)00160-9
DOI: http://dx.doi.org/10.1016/j.euroecorev.2015.07.021
Reference: EER2780

To appear in: *European Economic Review*

Received date: 24 May 2014
Revised date: 12 July 2015
Accepted date: 13 July 2015

Cite this article as: Shekhar Aiyar, Charles W. Calomiris and Tomasz Wieladek, How Does Credit Supply Respond to Monetary Policy and Bank Minimur Capital Requirements?, *European Economic Review* http://dx.doi.org/10.1016/j.euroecorev.2015.07.021

How Does Credit Supply Respond to Monetary Policy and Bank Minimum Capital Requirements?[1]

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Abstract

We use data on UK banks' minimum capital requirements to study the interaction of monetary policy and capital requirement regulation. UK banks were subject to both time-varying capital requirements and changes in interest rate policy. Tightening of either capital requirements or monetary policy reduces the supply of lending. Lending by large banks reacts substantially to capital requirement changes, but not to monetary policy changes. Lending by small banks reacts to both. There is little evidence of interaction between these two policy instruments. The differences in the responses of small and large banks identify important distributional consequences within the financial system of these two policy instruments. Finally, our findings do not corroborate theoretical models that raise concerns about complex interactions between monetary policy and macro-prudential variation in capital requirements.

Keywords: loan supply, capital requirements, monetary policy, macro-prudential regulation

[1] We are grateful to the editor and the referee for helpful comments, and to Mark Robson and the other staff of the Bank of England's Monetary and Financial Statistics Division for making the data on UK banks available to us and for helping us to access the data. This paper should not be construed as representing the opinions of the Bank of England, the IMF, or any other organization. All errors and omissions remain our own.
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I. Introduction

By the middle of the twentieth century, both academic economists and policy makers advocated the use of counter-cyclical monetary policy to stabilise the economy. Bank regulatory