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Unconventional monetary policy and aggregate bank lending: Does financial structure matter?

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Abstract

This paper addresses a previously unexamined intersection between the financial structure literature and the unconventional monetary policy literature. First it examines how differences in financial structure –the mix of financial instruments, markets, and intermediaries, have been responsible for differences in approach to unconventional monetary policy between the Bank of Japan and the Federal Reserve. Then, by conducting multivariate time-series analyses, this paper shows empirically to what extent differences in financial structure between Japan and the U.S. have affected the relationship between unconventional monetary policy and aggregate bank lending. The results indicate that financial structure should be thought of as an important factor determining the approach and effects of unconventional monetary policy.

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1. Introduction

The monetary policy of central banks is usually conducted through open market operations in order to guide interest rates. If we call it the “conventional” way of conducting monetary policy, then a different way from it could be called “unconventional”.

After 2008, in a simultaneous global recession triggered by a global financial crisis, the central banks of advanced economies successively adopted unconventional monetary policies, and this

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movement has attracted world-wide attention (Bowdler & Radia, 2012; Gambacorta, Hofmann, & Peersman, 2014). In the U.S., in order to tackle the subprime mortgage crisis, the Federal Reserve cut the federal funds rate at an unprecedented speed from the autumn of 2007, as well as creating a number of new lending facilities (Credit Easing, CE) to provide liquidity to financial markets. In December, 2008, the Fed cut the federal funds rate to a target range between zero and 0.25%, and thus, in fact shifted to a Zero Interest-Rate Policy (ZIRP) *de facto*. As additional easing measures after the federal funds rate fell to nearly zero, the Fed announced its first round of large-scale asset purchase (LSAP1) program on November 25, 2008.

However, in the history of monetary policy, it was the Bank of Japan that first adopted an unconventional monetary policy. After the ZIRP, which was conducted from February, 1999 to August, 2000, in order to cope with the prolonged deflationary depression, the BOJ shifted its operating target for money market operations from the interest rate (the uncollateralized overnight call rate) to the outstanding balance of the current accounts held by financial institutions at the Bank, and thus implemented the unconventional monetary policy known as Quantitative Easing Policy, from March, 2001 to March, 2006 mainly by purchasing long-term Japanese government bonds.

The unconventional monetary policies of Japan and the U.S. had something in common. They both aimed to achieve a further monetary easing effect in a situation in which the short-term interest rate was close to zero in the face of the non-negative constraint on the nominal interest rate, and both greatly expanded the size of the central bank's balance sheet.¹ However, the policy approaches used in conducting unconventional monetary policy in these two countries were different.

While the primary target of Quantitative Easing Policy in Japan was current account balances at the BOJ, which are on the liability side of the Bank's balance sheet, in the case of the U.S., the unconventional monetary policy was focused on the extension of credit and the purchase of securities, which are on the asset side of the Fed's balance sheet (Bernanke, 2009).

Why do the BOJ and the Fed take such different approaches in conducting unconventional monetary policy? Do their policies have different results? This paper tries to answer these questions from the viewpoint of financial structure. In Goldsmith's pioneering work on financial structure, he suggested that financial structure is determined by a combination of financial instruments and financial institutions (Goldsmith, 1969, p.26). In Allen and Gale (2000), another comprehensive study of financial structure, financial systems are divided into bank-based systems and market-based systems according to whether finance is conducted by banks or by financial markets. They classify Japan as one example of bank-based systems and the U.S. as one example of market-based systems. In the financial structure literature, the two countries have been used to compare bank-based financial systems and market-based financial systems, for example, Prowse (1990), Demirgüç-Kunt and Levine (1996), Demirgüç-Kunt and Levine (2004). This paper follows the classification used in the literature.

Why is it necessary to take financial structure into account when looking at monetary policy? As Levine (1997) points out, we haven't obtained sufficient understanding of the economic implications of different financial structures yet. Japan and the U.S. have contrasting financial structures, although they are at the same level of economic development, and the central banks of both countries adopted unconventional monetary policy to stimulate bank lending. This provides us with a good opportunity to identify the links between financial structure and monetary

¹ It has long been assumed that it would be impossible to set the nominal interest rates below the lower limit of zero. However, in June, 2014, the European Central Bank (ECB) became the first major central bank to introduce negative interest rates.

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