Federal Reserve Bank of Atlanta

Scott Frame

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Moderator: *Welcome to Research Insights, a podcast from the Federal Reserve Bank of Atlanta. Our topic today is credit channels of monetary policy. We're talking with Atlanta Fed Financial Economist and Associate Policy Adviser Scott Frame. The conversation follows the Atlanta Fed Conference on the Credit Channel of Monetary Policy in the 21st Century, which took place in June 2007. First question is: What is the credit channel of monetary policy?*

**Scott Frame:** So, Bill, what we're talking about here is about how monetary policy actions are transmitted to the real economy. So, when we're thinking about this, you know, one naturally thinks of the straightforward and inverse linkage between the level of short-term interest rates and investment demand. For example, as interest rates *rise,* investment demand falls, thereby slowing the economic growth.

But these simple interest rate effects may be further amplified by this notion of a credit channel, whereby monetary policy also influences something that economists refer to as the "external finance premium." A way to think about this external finance premium is that it's really the degree of mark-up faced by borrowers, relative to the risk-free rate of interest.

Now, within the context of the credit channel, academics have identified two possible linkages between monetary policy and this external finance premium. The first is a balance sheet channel, which arises from the notion that interest rates affect borrower asset values and cash flows. These developments in turn can affect borrower creditworthiness and hence the credit risk premium they are charged. So, for example, if the Fed raised interest rates by 25 basis points, the credit channel would predict that borrowers would actually see their interest rates increase by more than 25 basis points.

The second sort of component of the credit channel is a more narrow view that's often referred to as the "bank lending channel." And according to this conjecture, monetary policy also can have significant influences upon the supply of bank credit by altering banks' access to deposits.

Moderator: *Scott, have changes to the financial system, such as the increased importance of non-bank financial institutions and widespread introductions of asset-backed securitization, altered views about the credit channel of monetary policy?*

Frame: Well, clearly views about the credit channel of monetary policies have evolved over the past 25 years. Especially in terms of the bank lending channel. Now, as discussed by Chairman Bernanke at the conference, it's likely now the case that U.S. monetary policy has little aggregate effect on bank loan supply due to deregulation and financial innovation.

Now, in terms of the banking sector, at least three important developments have occurred in recent years. First, banks no longer face regulatory restrictions on the interest rates they can pay on deposits. Second, reserve requirements have been markedly reduced. And third, banks' ability to tap nondeposit sources of funding has greatly improved. These changes, coupled with asset securitization, which is another form of nondeposit funding, and the increased importance of nonbank lenders, suggest that the bank lending channel component is probably much less important today in the U.S. With this said, we do not believe that the balance sheet channel component has been especially altered by changes to the financial system.

Moderator: *Very good. I know that Chairman Bernanke came to the Atlanta Fed for this conference. Scott, can you tell us what some of the particular issues are that he discussed?*

Frame: Well, he gave a very nice overview of the issues. The chairman's views about the evolution of the credit channel really provided overall context for the research presented at the conference. The individual papers generally provided some very deep insight into very narrow but related questions, and I think what the chairman's talk did was provide an overall context for the event as a whole. Now, I personally appreciated Chairman Bernanke sharing his views about how deregulation and financial innovation may have affected monetary transmission.

Moderator: *Thank you, Scott. Again, we've been speaking with Atlanta Fed Financial Economist and Associate Policy Adviser Scott Frame. This concludes our Research Insights podcast on the Credit Channel of Monetary Policy in the 21st Century. Thanks for listening, and please return for more podcasts. If you have comments, please send us e-mail at podcast@frbatlanta.org.*

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