Financial Development and Monetary Policy Transmission

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Publication Date: Monday, 21 of November 2022 Abstract
This paper estimates the effect of financial development on the transmission of monetary policy. To do so, the paper employs a panel data set containing financial development indicators, policy rates, lending rates, and deposit rates for 43 countries for the period 2000-2019 and applies the empirical strategy of BrandaoMarques et al. (2020): firstly, monetary policy shocks are estimated using a Taylor-rule specification that relates changes in the policy rate to inflation, the output gap and other observables that are likely to influence monetary policy decisions; secondly, the residuals of this estimation (policy shocks) are used in a specification that relates lending or deposit rates to, among others, policy shocks and the interaction between policy shocks and measures of financial development. The coefficient on this interaction term captures the effect of financial development on the relationship between policy shocks and lending or deposit rates. The main findings of the paper are twofold: on the one hand, financial development does strengthen the monetary policy transmission channel to deposit rates; that is, changes in the policy rate in economies with more financial development induce larger changes (in the same direction) in deposit rates than is the case in economies with less financial development. This result is particularly driven by the effect of the development of financial institutions on policy transmission – the effect of financial markets development turns out to be smaller in magnitude. On the other hand, financial development does not strengthen the transmission of monetary policy to lending rates. This is consistent with a credit channel which weakens in the face of financial development in a context where banks cannot easily substitute short-term funding sources. These results highlight the relevance of financial development for the functioning of monetary policy across countries, and possibly imply the necessity of a more active role of monetary authorities in fostering financial development.

Fuente: https://www.banrep.gov.co/en/financial-development-and-monetary-policy-transmission