TOPIC III – THE CREDIT CHANNEL OF MONETARY TRANSMISSION
Overview

- The Traditional Monetary Transmission Mechanism: the effect of monetary policy is felt on the demand for credit and it operates in two ways:

1. **Flexible Prices:** anticipated inflation affects the opportunity cost of holding money, hence:
   - **MIU:** reduces the agent’s utility
   - **CIA:** raises the total cost of goods whose purchase requires cash

2. **Sticky prices:** changes in current and expected $M^s$ affect real vars.
Credit View: the effect of m.p. is felt on the supply of credit instead. Empirically, there is insufficient correspondence between interest rates and output fluctuations. Hence, we need a theory to explain this.

Important distinctions:

- bank versus non-bank sources of funds
- internal vs. external financing
- heterogeneity among borrowers
Mechanisms

Emphasis on the role of information asymmetries between borrowers and lenders:

1. Adverse selection
2. Moral Hazard
3. Monitoring Costs
4. Agency Costs
Bank Lending Channel

M.P affects the banking sector’s balance sheet through its asset holdings. A drop in reserves has to be compensated by either of:

- a reduction in securities or,
- an increase in liabilities or,
- a reduction in loans

*If* banks cut loans *and* there is no close substitute for bank credit, this results in a contraction of credit. This will affect small firms the most since they do not have access to credit markets due to information asymmetries.
Similar imperfections may characterize all credit markets. Informational asymmetries create a wedge between the cost of *internal* vs. *external* financing:

- **Agency costs**: associated with information asymmetries and the ability of lenders to monitor borrowers costlessly.
- **Financial accelerator effect**: a “negative shock” weakens sources of internal finance and the firm’s *net worth*, thus increasing its borrowing costs precisely at the time when it needs financing the most. Hence, negative shocks can be *amplified*. 