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MONEY AND THE TRANSMISSION OF MONETARY POLICY

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Money and the Transmission of Monetary Policy[*]

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Abstract

The transmission mechanism of monetary policy has received extensive treatment in the macroeconomic literature. Most models currently used for macroeconomic analysis exclude money or else model money demand as entirely endogenous. Nevertheless, academic research and many textbooks continue to use the money multiplier concept in discussions of money. We explore the institutional structure of the transmission mechanism beginning with open market operations through to money and loans to document that the mechanism does not work through the standard multiplier model or the bank lending channel. Our analysis, however, does not reflect on the existence of a broader credit channel.

Introduction

The transmission mechanism of monetary policy has received extensive treatment in the macroeconomic literature. The level of reserve balances in the U.S. banking system has ballooned with the Federal Reserve's nontraditional monetary policy. As a result, there has been renewed interest in the transmission of monetary policy from reserves to the rest of the economy. Since the 1980s, two broad transmission mechanisms have been discussed: a "interest-rate" or "money channel," in which interest rates adjust to clear markets and influence borrowing and lending behavior; and a "credit channel," in which the quantity as much as the price of loanable funds transmit monetary policy to the economy. The credit channel is not monolithic. A narrow "bank lending channel" view of the world suggests that changes in open market operations and the quantity of reserves directly affect the amount of lending that banks can do, whereas the "financial accelerator" view of the transmission mechanism is a broader process by which changes in policy are amplified in financial markets, often motivated as a result of asymmetric or imperfect information.

In the past couple of decades, New Keynesian models that have been used for macroeconomic policy analysis exclude money. The exceptions in this class of models are those where a money demand equation is appended, and the quantity of money is entirely endogenously determined with no feedback to real variables. This extreme marginalization of money is not universal, however. Some researchers for example, Hafer, Haslag, and Jones (2007), Leeper and Roush (2003), Ireland (2004), Meltzer (2001) and most notably, the European Central Bank, put serious weight on the role of money in the macroeconomy and policy analysis. Indeed, at the other extreme, many economics textbooks and some academic

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research, for example, Freeman and Kydland (2000) or Diamond and Rajan (2006) continue to refer to the very narrow money multiplier and accord it a principle role in the transmission of monetary policy. We explore money from an institutional perspective to identify its role in the transmission mechanism, starting with open market operations (OMOs) and going through to loans over the period after 1990. We argue that the institutional structure in the U.S. argues against a lending channel in that period. We provide empirical evidence and document that the transmission mechanism does not work through the standard money multiplier model to bank loans. Our analysis, however does not reflect on the broader credit channel, but does question the role attributed to the most narrow bank lending channel in the United States. In the absence of a multiplier, open market operations, which simply change reserve balances, do not affect lending behavior at the aggregate level. Consequently, to the extent that banks have access to external funds, the Fed can not change broader monetary aggregates or bank lending directly via open market operations.[1] Put differently, if the quantity of reserves is relevant for the transmission of monetary policy, a different mechanism must be found.

Although the real side of the transmission mechanism is clearly important, the topic has received, and continues to receive, a great deal of attention, and so this paper will not address which sectors of the economy are affected by monetary policy. Nevertheless, to avoid misspecifying endogenous monetary policy in the empirical work, we include standard measures of economic activity. In a similar vein, we do not address the yield-curve implications of the transmission of monetary policy. While these concerns are clearly important, our focus is a bit

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[1] It is important *not* to interpret the above result as the 'liquidity puzzle'. The Fed can and does affect total balances by changing interest rates. However, the flow of events is different. When the FOMC changes its monetary policy stance (say by raising the funds rate target), demand for reserve balances declines, which in turn prompts the Fed to reduce total balances via open market operations. Two things to emphasize are first, the decline in supply of balances follows a demand adjustment (and does not precede it) and the Fed's control over broader aggregates is limited to total balances.

narrower. Instead, in examining the transmission mechanism from open market operations to money and then to bank lending, we base our investigation on the institutional facts. To demonstrate the mechanism, we appeal to Granger causality tests and vector autoregressions (VARs) to let the data summarize the relationships involved.

The argument that the monetary transmission mechanism may not work through the money multiplier, that the Federal Reserve may not have direct control over monetary aggregates, and thus direct control over bank lending is not new. For example, Bernanke and Blinder (1988) and Kashyap and Stein (1995) point out that following, say an open market sale, *if* the depository institutions can make up for the decline in reserves through external sources of funding, then, they do not necessarily need to cut their lending. What is new, however, is to show that this is indeed the case both at the aggregate and cross sectional bank level. We argue that bank reserves are not sufficient to fund bank loans in the recent era and illustrate empirically that banks from all sizes, liquidity, or capital ratios finance their loans through external funds.

Our paper makes two contributions to the literature on the monetary transmission mechanism. First, we highlight the institutional structure in the U.S. throughout the last interest rate targeting regime and note that the workings of the monetary transmission mechanism are simply inconsistent with the money multiplier and the bank lending channel. Second, we support this institutional intuition with empirical analysis both at the aggregate and cross sectional level. Our findings offer strong evidence against the bank lending channel where bank loans are primarily funded by nonreservable deposits. This result implies that the marginal cost of raising external funds is negligible.

In a framework where the marginal cost of raising external funds is zero, a reduction in the supply of reservable deposits does not affect bank lending at all, ruling out the bank lending

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channel. Furthermore, if bank lending is a function of nonreservable deposits, banks can actually increase their lending following a policy tightening if demand for bank loans increases (demand for bank loans may increase due to loan commitments. We discuss this issue in more detail later in the paper). Under these circumstances, a traditional multiplier mechanism, which predicts a decline in loans (or securities) following a contraction ceases to exist. A theoretical appendix—not intended for publication—illustrates these relationships in a simple model.

The Money Multiplier: Fact or Fiction?

The lack of a multiplier, which is implied by our empirical findings, can be illustrated in a straightforward manner by plotting the theoretical and the actual multipliers implied by the data. Figure 1 plots these multipliers from 1990 to 2008. Two types of multipliers are described in textbooks. The first one, called the simple multiplier links reservable deposits to bank reserves according to equation (1):

$$\Delta R = \frac{1}{r} \Delta D \tag{1}$$

where ΔR refers to changes in total reserves, ΔD refers to changes in reservable deposits, r is the required reserves ratio, and $\frac{1}{r}$ is the simple multiplier. According to the standard textbook story, open market operations change the quantity of reserves, say, increasing them. This increase in reserves, combined with the fractional reserve requirements in the US imply that banks can lend out extra funds. The extra lending increases both lending and the money supply because loans are created as demand deposits. As the money supply is increased, more lending can be done, and the multiplier relationship implies that for a given increase in reserves, money

increases by $1/r$ and lending increases by $(1-r)/r$. The story is symmetric, so contractionary policy works in precisely the opposite direction.

The upper panel in Figure 1 plots the theoretical simple multiplier (black bars) against the actual multiplier implied by the data (gray bars). The panel suggests that the theoretical multiplier often deviates from the actual multiplier. The constant required reserves ratio since 1992 leads to a constant theoretical multiplier after that year. Yet, the actual ratio of changes in total reserves to reservable deposits has been rather volatile in that period, which is generally greater than the value suggested by the theoretical simple multiplier.

Even more telling about the money multiplier and its distance from reality is the current financial crisis, which is represented as the last observation in the figure. Recently, reserve balances have exploded, going from around \$15 billion in July 2007 and topping out over \$788 billion in December 2008. However, this increase by a factor of 50 did not lead to a similar increase in any measure of money, as suggested by the multiplier. The monetary base, the narrowest definition of money, doubled while M2 grew by only 8½ percent over that period. Hence, while the actual multiplier was about twice the theoretical multiplier in 2003, it was about $1/50^{th}$ of the theoretical multiplier in 2008.

The simple multiplier abstracts from the real world by assuming that banks hold no excess reserves and the public holds no excess currency. A more general and more realistic multiplier is developed to address these issues. This multiplier, called the "money multiplier," relates broader monetary aggregates (such as M2) to the monetary base according to:

$$\Delta M = \frac{1+c}{c+e+r} \Delta MB \qquad (2)$$

where c is the ratio of currency in circulation to reservable deposits, e is the ratio of excess reserves to reservable deposits, and r is the required reserves ratio. In the special case where

$c=e=0$, the money multiplier, $\dfrac{1+c}{c+e+r}$, reduces down to the simple multiplier in (1). The lower

panel in Figure 1 plots the theoretical money multiplier (black bars) against the implied money

multiplier (gray bars). Here, the discrepancy is even greater. Indeed, while the mean absolute

deviation of the theoretical and the actual multipliers is 4.01 in the upper panel (excluding 2008),

the corresponding number jumps to 8.43 in the lower panel. Perhaps not so surprisingly, the

money multiplier gets closest to the actual multiplier in 2008 for coincidental reasons.[2] Indeed,

2008 turns out to be a year when the discrepancy between the theoretical and the implied money

multiplier is minimized but the discrepancy between the simple and the theoretical multiplier is

maximized. Because such fluctuations reflect extraordinary circumstances due to the current

economic turmoil, we omit the recent crisis from our analysis.

Our evidence against the existence of a money multiplier implies that monetary policy

does not have a direct effect on broader monetary aggregates. We argue that this finding is a

natural outcome of the underlying institutional structure in the U.S. First, the presumed direct

link between OMOs and money—as defined as M2—does not exist. Reserve requirements are

only assessed on about one-tenth of M2, and so the link from reserves to money is not especially

useful to consider. Moreover, OMOs affect Federal Reserve balances owned by the banking

sector, not required reserves, specifically. We use the term "reserve balances" to denote any

balances of depository institutions held at the Federal Reserve. These balances can be required

reserve balances, contractual clearing balances, or excess reserve balances. See Carpenter and

Demiralp 2006 for a more extensive discussion. The link between reserve balances and required

reserves is incomplete and the link between required reserves and M2 is incomplete, implying

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[2] M2 growth rate was relatively weaker in 2008 as a reflection of the economic slowdown which dragged down the implied multiplier below one. At the same time, excess reserves holdings reached record-high levels which drastically reduced the theoretical multiplier.

that the link between OMOs and M2 is questionable, at best. Second, the presumed direct link between money—defined as M2—and bank lending does not exist. As has been noted before, if banks have access to funding that is not reservable (and as a result, not included in M2), the channel breaks down. More importantly, large time deposits, a liability that banks seem to manage more directly to fund loans, are not included in M2 and getting back to the first issue, are not reservable. Additionally, money market mutual funds account for about one-fifth of M2, but are not on bank balance sheets and thus cannot be used to fund lending. The link between M2 and loans, then, is also tenuous.

Finally, the assumed link between the creation of loans, and the creation of demand deposits is dubious. For the multiplier to be operational, it must be the case that an increase in lending is associated with an increase in demand deposits. The data do not reflect any such link. This fact likely reflects the use of sweep agreements and the likely shift of funds to other types of deposits, more generally.

Already, then, the textbook story appears to be missing some important points. Given a federal funds rate targeting regime, the supply of reserve balances is endogenously determined by the demand for reserve balances. What then is the link between open market operations and the transmission of monetary policy?

Bank Balance Sheets

Given this understanding of the federal funds market, we look for ways to understand the transmission mechanism as traditionally explained. One vitally important, though frequently overlooked, aspect of this question is the definition of money. For better or worse, most economists think of M2 as the measure of money. M2 is defined as currency plus checking

deposits plus savings deposits plus retail money market mutual funds, plus small time deposits.

Money demand models typically express M2 as a function of a scale variable—such as GDP—

and by the opportunity cost of holding money—typically a short-term interest rate or a spread of

short-term interest rates such as the Treasury bill rate less the weighted-average rate paid on M2

assets. The money demand decision is a portfolio allocation problem where money provides

liquidity services but has an associated opportunity cost. In contrast, to think about the

transmission mechanism, particularly through the money multiplier, we have to ignore those

parts of M2 that are not reservable, about 90 percent of the aggregate. It is the link between

money and reserves that drives the money multiplier relationship. Since 1992, the only deposits

on depository institutions' balance sheets that had reserve requirements have been transaction

deposits, essentially checking deposits.[3]

For perspective, M2, averaged about $7 ¼ trillion in 2007. In contrast, reservable

deposits were about $600 million, or about 8 percent of M2. Moreover, bank loans for 2007

were about $6 ¼ trillion.[4] As a result, even this simple comparison suggests that reservable

deposits are in no way sufficient to fund bank lending. When we consider the fact that reserve

balances held at the Federal Reserve were about $15 billion and required reserves were about

$43 billion, the tight link drawn in the textbook transmission mechanism seems all the more

tenuous when confronted with reality. To understand a bit of the disconnect, consider Figure 2

which plots required reserves with M2 (both panels). There is no relationship between the two.

M2 trends upward as the economy grows, and money grows with it in nominal terms. Required

reserves, however, fell dramatically just after 1990 following the reduction in required reserve

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[3] To be precise, some other types of deposits are technically reservable, but their reserve requirement was set to zero.
[4] Indeed, this measure severely understates the discrepancy between reservable deposits and depository credit as it represents only on commercial bank credit. Savings banks and other thrifts account for a nontrivial fraction of lending in the United States.

ratios and trended down through 2000, largely as retail sweep programs allowed depository institutions to avoid their reserve requirements. The reason for the general disconnect between money, measured as M2, and required reserves is the now-familiar fact that only a very small portion of M2 is reservable. Bank loans are shown as the dashed line in the upper panel and have a similar trend to that of M2. Of course trending nominal variables will often exhibit spurious correlation, but note that there is no link between reserves and loans, either.[5]

Further complicating the story is the fact that open market operations are not aimed at changing the level of reserves. As discussed above, open market operations are aimed at adjusting the supply of reserve balances, not just required reserves. The lower panel in Figure 2 shows the level of reserve balances as the dotted line. It too bears little if any relationship to the pattern of M2. For purposes of the transmission mechanism, we want to ask if there is a link from Federal Reserve open market operations to other quantities that matter.

An Empirical Look at the Traditional Transmission Mechanism

Aggregate Analysis at the Monthly Frequency

i) Granger Causality Tests

As a first look at the transmission mechanism, we run some Granger-causality tests in first differences of deposits, bank loans, and balances of depository institutions at the Federal Reserve at a monthly frequency. The data appendix provides more detail about these variables. To refresh the readers' memories about the various variables in Granger causality tests, consider the following aggregated, simplified balance sheet of the banking system:

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[5] The fact that part of M2, retail money funds, is not on depository institutions' books is not relevant. Money funds account for only about ten percent of M2, and a graph of M2 excluding money funds would look quite similar.

Assets	Liabilities
Required Reserve Balances	Reservable Deposits
Contractual Clearing Balances	Managed Liabilities
Excess Reserve Balances	Other Liabilities and Capital
Applied Vault Cash	
Surplus Vault Cash	
Loans	
Securities	
Other Assets	

Managed liabilities refer to deposits that can be increased or decreased at will, such as large, or wholesale, time deposits, Eurodollar and other Eurocurrency borrowings, repos, and federal funds purchased to meet a bank's needs for funds to pay off maturing deposits and fund new loans.

We look at differences to avoid the clear nonstationarity problem evident in the charts of M2 and bank loans. Further, we want to consider the effect of an open market operation on bank loans, so the changes—not simply the level—of the variables are of interest. Open market operations are aimed at changing the level of balances, so we want to test how that level of balances is determined and what other variables those balances affect.

Table 1 presents results of Granger causality tests. Each row shows the p-values from pair wise Granger causality tests where the dependent variable is shown in the left hand column and the independent variable is the variable indicated in the column heading (1 through 6).[6] If the traditional money multiplier story were valid, we would expect to see changes in required reserves (which is equal to the sum of required reserves balances and applied vault cash) or total balances (which is the sum of the first three assets in the balance sheet above)—the quantity controlled by the Fed—result in changes in money and through money result in changes in bank loans.

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[6] We also run Granger Causality tests with lags of CPI (in difference form) included for comparability with the previous literature. The results are virtually identical (not shown).

First, we test the direction of Granger causality between reserves and balances on the one hand and reservable deposits on the other. Given that required reserves are close to a linear function of reservable deposits, it is unsurprising to see that reservable deposits Granger cause reserves (row 1, column 2). If a depository institution's customers deposit more funds in their checking accounts, that depository institution is required to hold a higher level of reserves. Reservable liabilities do not Granger cause reserve balances, a fact that is neither obvious nor especially surprising (row 4, column 2). Because a depository institution's reserve requirement rises, it has the option of satisfying that requirement with either vault cash or balances at the Fed. Moreover, balances can adjust independently if a depository institution changes its contractual clearing balance, so there is not a mechanical link between reservable deposits and reserve balances.

The traditional money multiplier story posits that the central bank changes the quantity of reserves through an open market operation. If the level of reserves is increased, the amount of funds that a bank can lend out increases, and concomitantly, the level of reservable deposits increases in line with the change in loans. So, if this channel were operative, we would expect to see a change in reserves cause a change in reservable deposits and a change in loans. Furthermore, we would see a change in loans cause a change in reservable deposits, because the multiplier theory assumes that the lender bank puts the loan proceeds into the borrower's checking account. The Granger causality results do not, however, bear out these types of relationships. We cannot reject the hypothesis that reserves do not Granger cause reservable liabilities (row 2, column 1) or loans (row 3, column 1). That is to say, the causality is unidirectional, from deposits to reserves. Similarly, we cannot reject the hypothesis that loans Granger cause reservable liabilities (row 2, column 3) either. Interestingly, reservable deposits

appear to Granger cause loans (row 3, column 2). Reservable liabilities could be a source of funds for banks and they can be used to support bank loans, however, the volume of reservable liabilities is simply not sufficient to meet the funding needs for bank loans at the aggregate level and banks meet the rest of their funding needs by issuing managed liabilities. In fact, when we compare the changes in reservable deposits to changes in loans (not shown) we observe that changes in the former are generally about an order of magnitude smaller relative to changes in loans. This observation holds when we lag the series relative to each other as well. Meanwhile, changes in managed liabilities are comparable to changes in loans. Hence, we claim that reservable liabilities cannot be driving loans.

At this point, we feel reasonably confident that there is little evidence that open market operations can change loans by changing deposits directly. It must be the case, however, that as assets on a bank's balance sheet change, liabilities must also change. A more plausible channel is that demand for loans is based on price and other economic variables. To fund these loans, banks have a set of liabilities that they can adjust in reaction to shifts in demand. If this characterization is accurate, these managed liabilities and loans should move together, but the ability to identify statistical causality and true causality is unclear (we address this issue in more detail in the next section). That said, as illustrated in rows 5 and 6, we can see that both changes in managed liabilities and its sub-category large time deposits Granger cause loans (row 3, columns 5 and 6). Meanwhile, changes in loans do not Granger cause managed liabilities and only marginally cause large time deposits (rows 5 and 6, column 3). Because loans and managed liabilities in a real sense represent two sides of a balance sheet, they ought to covary. Furthermore, we note that changes in reservable deposits Granger cause large time deposits (but not vice versa). This is consistent with the argument that when faced with a change in reservable

deposits, banks adjust the volume of their large time deposits to make sure that there is sufficient funding for their loans.

ii) Vector Autoregression Analysis

In this section we consider VAR analysis to investigate the role of deposits played in the monetary transmission mechanism at the aggregate level. We first consider a simple extension of the model considered in Bernanke and Blinder (1992). In order to explore the role of funds rate in the monetary transmission mechanism, Bernanke and Blinder estimate a monthly, six-variable VAR with the federal funds rate, consumer price index, bank loans, total deposits, bank securities, and the unemployment rate. All monetary aggregates are in log form and are normalized by the consumer price index. We decompose bank liabilities into reservable deposits and managed liabilities because the multiplier story hinges on the different nature of these two types of liabilities in the loan generation process. We consider six lags, as in Bernanke and Blinder. Our sample period covers January 1990 to June 2007, which corresponds to the most recent interest rate targeting regime.[7]

Figure 3 shows the results from the impulse response analysis to a funds rate shock. Total loans increase in the first year following a shock to funds rate, in contrast to Bernanke and Blinder's findings for an earlier sample period (1959-1978) where total loans declined significantly following a monetary tightening. The likely explanation is from the credit channel literature. Following a monetary tightening, it is harder for businesses to obtain non-bank sources of funding, and therefore demand for bank loans may increase. Indeed, the number of borrowers who tap their revolving credit lines seems to be rising. In the post-1990 sample, an

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[7] While the Federal Reserve started to announce changes in the funds rate explicitly after February 1994, the interest rate targeting regime started in late 1980s (see Meulendyke, 1988, Carpenter and Demiralp, 2008)

increasing share of bank loans are made under a previous commitment. That is, some time in the

past, the borrower and the bank make an agreement on terms of a loan and the borrower has the

option on when to take it out, see Morgan, 1998.   During a tightening cycle, as terms and

standards on all borrowing becomes more restrictive, borrowers may call in these previous

commitments and there may be a consequent increase in bank loans even though the rest of the

economy may be slowing.[8]

While it is difficult to know exactly how much the magnitude of loan commitments

changed over time, we can infer this information indirectly. The Survey of Terms of Business

Lending notes that the percentage of C&I loans made under commitment remained stable around

70 to 80 percent from 1982 through 2008.[9] Combining this information with the positive trend

in C&I loans over that sample period (not shown), one can conclude that total loans under

commitment increased significantly over the last decade, which was not prevalent in Bernanke

and Blinder's sample.

The gradual change in the behavior of bank loans and the rising role of loan

commitments can be observed more clearly when we restrict the analysis to the 1959-1978

sample period considered by Bernanke and Blinder (Figure 4). For this sample, we substitute

large time deposits (Deposits_Lg) for managed liabilities because the data for the latter is only

available after 1988. Here, we do not observe any increase in bank loans following a tightening,

and hence, there is no consequent increase in large time deposits to fund such loans.

Going back to Figure 3, the responses of reservable deposits and managed liabilities

following a shock to the funds rate are also consistent with the story told above. Reservable

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[8] In a recent paper, Ivashina and Scharfstein (2008) underlined this phenomenon by pointing to the rise in
commercial and industrial (C&I) loans around the bankruptcy of Lehman Brothers during the recent financial
turmoil. They noted that companies rushed for their revolving credit facilities when they think that credit conditions
will tighten in the near future.
[9] Federal Reserve statistical release E2.

deposits decline following the increase in the funds rate, likely due to the increase in the

opportunity cost of holding checking accounts, similar to the response of total deposits in

Bernanke and Blinder. However, managed liabilities rise following the increase in the funds rate

because banks need to fund the increase in loans by issuing more managed liabilities. At the end

of about two years, managed liabilities return to their original value, just around the same time

when bank loans return to their original value. The multiplier story would suggest a decline in

loans, following the decline in reservable deposits after a monetary tightening. Clearly, this is

not the case and banks simply raise more external funding to finance their loans.

Traditionally, studies that investigate the monetary transmission mechanism face the

difficulty of identifying whether the change in loans is due to demand (that is the interest-rate or

money channel) or supply (credit channel) following a monetary policy action. For our sample

period, it is relatively easier to identify the increase in bank loans as an increase in demand

because the decline in reservable deposits would not "cause" such an increase in loan supply.

The evidence clearly suggests that the narrow bank lending channel is not functional at the

aggregate level for the period after 1990.

Figure 5 investigates the determinants of bank loans in more detail. The upper panel

shows that managed liabilities rise immediately in response to an increase in bank loans whereas

the increase in reservable deposits is barely significant and short-lived, reinforcing the notion

that it is managed liabilities that fund a substantial portion of lending. Because these liabilities

are not subject to reserve requirements, the textbook story of the money multiplier cannot be the

operative channel of policy transmission. Bank loans rise slightly in response to an increase in

managed liabilities (lower right panel). These patterns may be simple correlation that is

imperfectly identified by the ordering in the VAR. Regardless, there is a clear link between

managed liabilities and loans. In contrast, bank loans move in the wrong direction following a

shock to reservable deposits (lower left panel). If we take these results completely literally, bank

loans increase rather than decrease in response to a decrease in reservable deposits. Recall that

the multiplier story presumed that bank loans increase significantly in response to any increase in

reservable deposits and our results clearly illustrate that this is not the case.

Impulse response functions are useful summaries of the reaction of variables to shocks to

other variables. Another potentially useful metric of the impact of reserves on money and bank

lending is to look at the variance decomposition from VARs. The first two columns of Table 2

show the percentage of the forecast error in bank loans explained by reservable deposits and

managed liabilities (the rest of the variables included in the VAR are not shown). The two

variables have comparable predictive power in explaining bank loans. The last two columns

show the variance decomposition analysis from an alternative VAR where managed liabilities

are replaced by large time deposits.[10] The difference between the explanatory powers of

reservable and non-reservable deposits is more noticeable when we use this sub-component of

managed liabilities. It is also important to note that these results are obtained despite the fact that

managed liabilities or large time deposits are ordered after reservable deposits. These findings

suggest that changes to the balance sheet from managed liabilities are more important than

changes in deposits that are linked to the money multiplier.

iii) Counterfactual Experiments

In Figure 3, we documented an increase in bank loans in response to a contractionary

monetary policy action. We argued that banks support this increase in bank loans by increasing

their managed liabilities, despite a decline in reservable liabilities, which is evidence against the

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[10] The impulse response analysis from this VAR specification is very similar to the original specification in Figure 3.

traditional bank lending channel. Another way of understanding the role of reservable deposits and managed liabilities in funding bank loans is to consider what happens to impulse response functions when their roles are suppressed by setting their coefficients at the current and all lagged values to zero. The difference between the actual impulse-response function and this counterfactual impulse response function should measure the work that each variable does in the VAR. If a variable has a significant role in funding bank loans, the impulse-response function with its action suppressed should be significantly different from the original one. This type of an exercise may also shed light into the true causal structure between bank loans and liabilities.

In the first counterfactual experiment, we suppress managed liabilities and reservable deposits one at a time and observe the behavior of bank loans to a funds rate shock. Figure 6 shows the results from this exercise. In this figure, the solid line replicates the original impulse response function in Figure 3, while the line with hollow circles and the line with stars plot the impulse response functions with managed liabilities and reservable deposits suppressed respectively. The three functions are not significantly different from each other, suggesting that the increase in bank loans following a funds rate shock is not due to a change in bank liabilities. This result is consistent with our argument that the increase in bank loans following a monetary tightening is driven by demand side pressures due to loan commitments.

Figure 6 suggests that the causal direction between bank loans and liabilities does not go from liabilities to loans. Does it go the other way round? Do banks raise their managed liabilities when faced with an increase in loan demand? In order to address this question, we need to investigate the role played by loans in generating managed liabilities. The upper panel in Figure 7 looks at the response of managed liabilities to a funds rate shock. Once again, the solid line replicates the response of managed liabilities in Figure 3. When bank loans are kept

constant, the increase in managed liabilities lies significantly below the original impulse response function in the second half of the year. In other words, the increase in managed liabilities that we have observed in Figure 3 seems to be related to the increase in loan demand. Faced with an increase in total loans, banks raise more managed liabilities to fund these loans. Hence, the causality seems to flow from loans to liabilities. What about reservable deposits? Banks do not have an active role in controlling reservable deposits because their customers tend to determine how much money to keep in these accounts. Therefore, the response of reservable deposits is not expected to be different when we suppress bank loans. Indeed, the lower panel in Figure 7 shows that that the impulse response function from the counterfactual experiment is not significantly different from the original impulse response function.

The message that we get from Figure 7 is that following a monetary tightening, managed liabilities do not increase as much when bank loans are suppressed. Nevertheless, there is still a significant rise in the first six months following a tightening. What other variable besides bank loans could explain this increase? The most likely candidate is deposit rates embedded in the funds rate shock. Interest rates offered on large time deposits are set competitively to adjust the volume of external funding. Hence, when faced with an increase in loans, it is plausible to expect banks to increase the rates offered on large time deposits to raise their volume. In that respect, the counterfactual experiment in the upper panel of Figure 7 fails to control for the entire influence of loan demand on managed liabilities because the funds rate shock itself may reflect the increase in deposit rates.

Our last exercise adds the interest rate offered on six-month CDs to the VAR.[11] The CD rate is ordered after the funds rate assuming that banks can adjust the rates offered on these CDs within the same month as the Fed's policy action. The impulse response analysis from this VAR

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[11] Considering CD rates with alternative maturities do not change the qualitative results (not shown).

look very similar to Figure 3 and the response of CD rate follows the same path as the funds rate

as we would expect (not shown). In the counterfactual experiment, we first suppress the CD rate

to evaluate the role played by the CD rate alone. The upper panel in Figure 8 shows the response

of managed liabilities. The increase in managed liabilities declines if the CD rate is kept

constant but the difference is mostly insignificant. The lower panel in Figure 8 suppresses the

CD rate together with bank loans. This time, we observe that managed liabilities hardly change

in response to a monetary policy action. This is strongly supportive of our underlying argument

that managed liabilities (and not reservable deposits) are used as the primary source of funds for

bank loans.

Aggregate Analysis at the Quarterly Frequency

In this section, we repeat the VAR exercise at the quarterly frequency. One virtue of

working at this frequency is that there is data on total domestic non-financial borrowing at this

frequency. In the previous section, we argued that the increase in bank loans following a

monetary tightening may be due to a decrease in non-bank sources of funding. If non-bank

funding does become more scarce, we would expect total borrowing to decrease (or remain

constant) following a tightening even though bank loans may increase. Because total borrowing

data is only available at a quarterly frequency, we consider a VAR at this frequency and also add

data on GDP and the GDP deflator to fully capture the policy maker's reaction function. The

structural VAR is identified with the following Choleski ordering: Unemployment rate, GDP,

GDP deflator, required reserves, loans, total nonfinancial borrowing, reservable deposits,

managed liabilities, securities, and funds rate. Nominal variables, which are in log form, are

normalized by the GDP deflator. Macroeconomic variables are ordered first and the funds rate is

ordered last because the funds rate is expected to respond to these variables contemporaneously at a quarterly frequency. The VAR is estimated with two lags consistent with six lags that were considered in the earlier analysis at a monthly frequency. Figure 9 shows the results from this exercise in response to a funds rate shock. Despite the increase in bank loans following a tightening (second row, first column), there is a decline in total nonfinancial borrowing (second row, second column), a result that is consistent with the asymmetric information problems discussed earlier.

If the multiplier story was accurate, we would expect a monetary tightening to be associated with a decline in bank reserves, which in turn, would reduce reservable deposits. Required reserves exhibit no such decline in Figure 9 and the point estimate is positive through most of the forecast horizon (first row, fourth column).

Disaggregated Quarterly Frequency

Our analysis so far documented evidence that the bank lending channel and the simple money multiplier are not functional at the aggregate level in the post-1990 period. In particular, we have shown that a contractionary monetary policy action is accompanied by an increase (not a decrease) in bank loans and an increase in managed liabilities to fund these loans. Despite the observed decline in securities to a funds rate shock, the combined effect of an increase in loans and a decrease in securities offsets any multiplier effect on broader monetary aggregates. Are these findings supported across the banking universe? In other words, is the aggregate data driven by a dominant group, or are the results valid across all bank types? If there is a dominant group that has easier access to external finance, is it bank size, bank liquidity (see Kashyap and Stein (2000)), bank capital (see Kishan and Opiela (2000)) or a combination of these factors that characterize this group? In order to answer these questions, we move to bank level data and

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maintain the same VAR methodology from the previous section. This way, we are able to

compare the micro level evidence with macro evidence and pinpoint the underlying differences.

Bank-Level Data

Our source for all bank level variables are the Consolidated Report of Condition and Income

(known as the Call Reports) that insured banks submit to the Federal Reserve each quarter. The

data are reported on a quarter-end basis. The main challenge of working with Call Report data is

that the data are designed primarily for regulatory purposes that make working with the data

difficult. We follow the filters adopted by the previous researchers (Kashyap and Stein (2000),

Den Haan, Sumner, and Yamashiro (2007)) to clean up the data from potential reporting errors

and form consistent time series. Because there is a break in total securities series in 1994, we

start our sample in 1994:Q1 and end it shortly before the beginning of the crisis in 2007:Q2.[12]

We use large time deposits as a proxy for managed liabilities and transaction deposits for

reservable deposits. The data is gathered at the individual bank level. The appendix describes

the construction of our key series in detail.[13]

Table 3 examines the balance sheets for banks of different sizes. There are two panels

corresponding to the starting and the ending points of our sample. The size categories are

formed following Kashyap and Stein (2000): banks below the 75th percentile by asset size,

banks between 75th and 90th percentiles, banks between the 90th and 95th percentiles, banks

between the 95th and 98th percentiles, and banks above the 99th percentile. What is interesting

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[12] Our results with the aggregate data remain mostly unchanged when we restrict the sample to the post-1994 period, although the increase in total loans is less pronounced.

[13] Kashyap and Stein (2000) use the consolidated total loan series in their analysis (RCFD 1400) whereas Den Haan et al. (2002) suggest the use of domestic total loan series (RC0N 1400) because the consolidated series displays discontinuity. While we report the results with domestic total loans series, our results remain virtually identical if we use the consolidated series.

for our purposes is that despite the larger share of transaction deposits relative to large time deposits across all size categories in the earlier sample (more than three times as much), the relative share of large time deposits increased substantially as the share of transaction deposits declined by the end of the sample. As of 2007:Q2, large time deposits exceed the share of transaction deposits in all size categories except for the smallest size category. This information alone suggests that banks' ability to raise large time deposits increased drastically over the last decade and that banks rely on these deposits rather than transaction deposits to fund their loans, ruling out the bank lending channel.

Table 4 displays alternative breakdowns with respect to the ratio of securities to assets (upper panel) and the ratio of equity to assets (lower panel) respectively. Note that these distributions are not as skewed as the distribution with respect to asset size, and the most liquid or the well capitalized banks are not necessarily the largest banks with respect to asset size. However, no matter how we divide the banks, the share of large time deposits exceed transaction deposits as of the second quarter of 2007.

In order to test whether our VAR evidence at the aggregate level is driven by large banks, we first group banks into three size categories as in Kashyap and Stein (2000): the smallest one contains all banks with total assets below the 95th percentile, the middle one includes banks from the 95th to 99th percentiles, and the largest one has those banks above the 99th percentile. We place each bank into one of these size groups in each quarter. If a bank experiences a substantial change in its asset size (either due to a merger or a persistent change in its growth rate), then it switches to a different size category and stays there indefinitely unless it experiences another major change in future quarters.[14]

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[14] In addition to these enduring changes across size categories, a bank may potentially oscillate between size groups if it is a borderline case with respect to the asset size. These temporary fluctuations are dropped from estimation.

We consider a panel VAR to exploit the bank level data and yet preserve our methodology from the previous section. Our quarterly VAR includes the federal funds rate, GDP deflator, securities, loans, transaction deposits, large time deposits, and the unemployment rate. Balance sheet variables are normalized by the GDP deflator and are in log form. Because the Call Report data are reported as quarter-end values, we maintain the ordering from our monthly analysis.[15] The two differences with respect to the monthly analysis are that the CPI is replaced by the percentage change in the GDP deflator and the aggregate unemployment rate is replaced by the state-level unemployment rate. In the panel analysis, we control for bank-specific fixed effects. Because fixed effects are correlated with the regressors due to lags of the dependent variables, the mean-differencing procedure that is generally used to eliminate fixed effects creates a bias in the coefficients. Therefore, we use forward-mean differencing following Arellano and Bover, (1995). The system is estimated by GMM, using lagged regressors as instruments following Love and Zicchino (2006).

Figure 10 shows the impulse response functions with respect to a one standard deviation shock to funds rate for the three size categories. It is plausible to expect contractionary monetary policy to be more binding for smaller banks because "these banks are least likely to be able to frictionlessly raise uninsured finance" (Kasyhap and Stein, 2000, p. 409). However, this expectation is not supported by the data. Looking at the response of bank loans to a funds rate shock (row one), we notice that the increase in bank loans is clearly not driven by large banks. In fact, bank loans decline initially following a contractionary shock and hover around zero for large and medium banks (columns one and two) whereas they increase substantially for small

Specifically, if a particular bank switches to a different size category for less than three quarters, then it will not have sufficient history to have two lags for the VAR estimation and will be automatically dropped from the sample.
[15] We use the last day of the quarter value for the federal funds rate and the last month of the quarter value for the GDP deflator.

banks (column three). If small banks indeed had difficulties in raising nonreservable deposits, and if bank loans were indeed a function of transaction deposits, then, small banks would not be able to meet the increase in loan demand as is observed in the data. Clearly, the empirical evidence is against the traditional belief about the workings of the bank lending channel. Instead, it seems to be the case that small banks sell securities and raise large time deposits to offset the decline in their transaction deposits and meet the increased demand for loans. The decline in bank loans in other bank sizes may suggest that the customers of smaller banks have a higher tendency to use their loan commitments relative to the customers of larger banks.

If the bank size alone does not determine a bank's ability to raise nonreservable deposits, what other factors could? Our next experiment is to consider the role of liquidity in generating nonreservable deposits. We measure liquidity by the ratio of securities to assets as in Kashyap and Stein (2000). We group banks based on whether their securities to assets ratio is less than 20 percent (least liquid), between 20 and 30 percent (liquid), and more than 30 percent (most liquid) in each quarter. This classification divides the sample into three comparable sized bins.[16] Kashyap and Stein (2000) note that the smallest, most illiquid banks are the most responsive to monetary policy. Our previous findings suggest that bank size does not appear to be a restriction in bank lending behavior, at least for the period after 1990. What about liquidity? Figure 11a shows the impulse response functions to a funds rate shock for three liquidity groups. Looking at the response of bank loans to a funds rate shock, we observe that the least liquid banks are hit by the contractionary shock the most. Indeed, the response of bank loans (row 1) is mostly negative for the least liquid banks (column one), declines after the third quarter for the liquid banks (column two) and it is entirely positive for the most liquid banks (column three). The

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[16] We have a total of 158,297 bank quarters in the least liquid bank group, 119,134 bank quarters in the liquid bank group, and 159,844 bank quarters in the most liquid bank group.

decline in bank loans for the less liquid banks may either suggest that the bank lending channel is functional for these banks, that is the decline in loans is driven by the decline in reservable deposits, or it is an outcome of the deterioration in the balance sheets of the loan applicants for these banks, that is the balance sheet channel), or the observed response is driven by demand side factors such that more liquid banks offer more loan commitments, or the customers of liquid banks tend to honor their loan commitments more. We need to investigate the response of other components to identify the underlying reason.

Looking across the liquidity categories, we note that all three groups experience a persistent decline in transaction deposits following a contractionary policy shock (row two), and all three groups try to offset this decline in liabilities by raising large time deposits (row three). However, the extent of the increase in large time deposits varies across categories, likely reflecting their relative needs for funding. For example, the least liquid banks are more aggressive in raising large time deposits. This could be because these banks cannot afford to sell their securities to offset the decline in transaction deposits. Indeed, the response of securities (row four) is consistent with this claim. Note that the banks with the least liquid balance sheets do not decrease their securities as much while the banks with the most liquid balance sheets sell off their securities more than the other banks to keep their loan portfolio intact.

The first two rows in Figure 11b confirm our findings at the aggregate level that bank loans are primarily driven by large time deposits. Similarly, the relationship between bank loans and transaction deposits is either negative or non-existent at the micro level (row four), in contrast to the predictions of the bank lending channel.   Clearly, if the decline in bank loans for the less liquid banks was due to a decline in reservable deposits, we would expect loans to respond positively to a shock in transaction deposits. A negative and significant relationship as

displayed in row four cannot be consistent with the bank lending channel and suggests that it is

demand and not supply side that drives the response of loans to monetary policy.

Row three indicates that banks try to offset the decline in reservable deposits by raising

nonreservable deposits. While banks in all three liquidity categories significantly raise more

large time deposits to shield against the loss in reservable deposits, the negative relationship is

most pronounced for the least liquid banks likely because these banks cannot sell many securities

to offset the decline in their liabilities and insulate their balance sheet from the contractionary

cycle. Because banks respond to a decline in transaction deposits by selling off their securities,

there is a positive relationship between these variables (row five), the extent of which

strengthens with the liquidity of the bank.

Our last experiment considers grouping banks based on their capital leverage ratios. It

may be argued that banks with higher capital ratios have less difficulty in raising nonreservable

funds and hence they should be able to insulate their balance sheets from monetary policy

actions, see for example Kashyap and Stein (2000) and Kishan and Opelia (2000). Following

Kishan and Opelia (2000), we focus on the equity capital to total asset ratios and form the groups

as: <8 percent (undercapitalized), ≥ 8 and <10 percent (adequately capitalized), and ≥ 10 percent

(well-capitalized) in each quarter. Once again, the relative sizes of the three groups are

comparable.[17] Figure 12 shows the impulse response functions to a funds rate shock for the three

groups. Similar to the breakdown with respect to liquidity, we note that the well capitalized

banks (column 3) can honor their loan commitments and supply more loans while adequately

capitalized (column 2) and undercapitalized banks (column 1) experience mostly a decline in

their loans following a contraction (row 1). Different from figure 11a, all three groups reduce

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[17] We have a total of 104,909 bank quarters in the undercapitalized group, 153,601 bank quarters in the adequately capitalized group, and 178,766 bank quarters in the well capitalized group.

their securities to offset the decline in liabilities because there are no systematic differences in securities holdings between the three groups (row four). As a result, the responses of large time deposits also resemble each other across the three groups, where banks in all groups raise their large time deposits. The impulse response functions for the rest of the variables are very similar to our findings in Figure 11b (not shown). In particular, the response of bank loans to transaction deposits is negative or non-existent for all categories. If banks with lower capital ratios indeed reduced bank loans because they had trouble raising non-reservable deposits, we would find a positive response of bank loans to transaction deposits. Once again, our findings argue against the existence of a narrow bank lending channel.

Evaluation of Panel VAR Analysis

　　Our analysis at the bank level supports our findings at the aggregate level that bank loans are simply not funded by reservable deposits and suggests that the bank lending channel is not functional, no matter how we group the banks. The observed differences in the response of bank loans to monetary policy seem to be driven by demand factors. In particular, less liquid and undercapitalized banks observe a decline in bank loans following a contractionary shock. The money multiplier can be operative only for these banks. For the more liquid and well-capitalized banks, the increase in bank loans counteracts the decline in securities and offsets any multiplier effect.

　　The results from the aggregate data seem to be driven by the most liquid or well-capitalized banks. A priori, it is hard to see why this is necessarily the case, given that these banks do not constitute a larger share in the universe of all banks, as indicated in Table 4. While the aggregate balance sheet data are based on the Call Reports, the bank credit data comes from

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voluntary bank credit reports submitted to the Federal Reserve (Board of Governors, H.8. Statistical Release). Our results suggest that perhaps a larger percentage of these volunteers have higher securities or equity relative to their assets.

Conclusions

The role of money in macroeconomics has a long history. Simple textbook treatments of the money multiplier give money a central role in the transmission mechanism of monetary policy. This role is a function of fractional reserve accounting, where money and reserves are directly and tightly linked, and the central bank intentionally changes the quantity of reserves through open market operations. We have demonstrated that this link is implausible in the United States for a number of reasons, especially in recent decades. First, when money is measured as M2, only a small portion of it is reservable and thus only a small portion linked to the level of reserve balances the Fed provides through open market operations. Second, traditionally, the Fed has aimed to control the federal funds rate, the interest rate in the market for reserve balances, not just required reserves. Reserve balances are supplied elastically at the target funds rate. Finally, reservable liabilities are a minor fraction of the amount of bank lending and thus cannot be the liability that is funding these loans. All of these points suggest that the textbook role of money is not operative and are a reflection of the institutional structure of the U.S. economy.

While the institutional facts are compelling, we demonstrate empirically that the relationships that are implied by the money multiplier do not exist in the data for the most liquid and well-capitalized banks. Changes in reserves are unrelated to changes in lending and open market operations do not exercise a direct impact on lending. We conclude that the textbook treatment of money in the transmission mechanism can be rejected. Specifically, our results

indicate that the bank loan supply is not adjusted through a bank lending channel no matter how we group the banks.

Our evidence against the bank lending channel at the aggregate level is consistent with other recent studies such as Black, Hancock, and Passmore (2007) who reach a similar conclusion about the limited scope of the bank lending channel in the U.S. or Cetorelli and Goldberg (2008) who point out the importance of globalization as a way to insulate the banks from domestic monetary policy shocks. Our findings are also consistent with the predictions of Bernanke and Gertler (1995) from over a decade ago that the importance of the traditional bank lending channel would likely diminish over time.

Our evidence against the bank lending channel at the micro level is consistent with Oliner and Rudebusch (1995), but it contrasts previous findings of a lending channel for small, illiquid, or undercapitalized banks (see Kashyap and Stein, 2000, Kishan and Opiela, 2000, Jayartne and Morgan, 2000). What is common in all these studies is that their sample periods cover the period prior to 1995, a period where reservable deposits constituted the largest source of funding. As we have shown in Table 3, this is no longer a feature that characterizes bank balance sheets in the post-1994 period. Furthermore, Kashyap and Stein (2000) and Kishan and Opiela (2000) interpret a change in the sensitivity of bank lending to monetary policy as evidence of a bank lending channel. We argue that changes in the sensitivity of bank loans may stem from the demand side and a better test for the lending channel is to check whether bank loans are financed by reservable deposits. Our findings suggest that this is not the case.

In general, our results echo Romer and Romer (1990)'s version of the Modigliani-Miller theorem for banking firms. They argue that banks are indifferent between reservable deposits and non-reservable deposits. Hence, shocks to reservable deposits do not affect their lending

decisions and all that changes to reserves do is to alter the mix of reservable and non-reservable deposits. Our findings in this paper support the argument that shocks to reservable deposits do not change banks' lending decisions.

In the current financial crisis, the Federal Reserve has supplied an enormous quantity of reserve balances relative to historical levels. The question arises whether or not this unprecedented rise in reserve balances ought to lead to an explosion of money and lending. The results in this paper suggest that the quantity of reserve balances themselves are not likely to be the trigger. To be sure, the low level of interest rates could stimulate demand for loans and lead to increased lending. That said, the narrow, textbook money multiplier seems unlikely to convert those reserve balances into loans.

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Data Appendix

Aggregate Data

Most of the series were obtained from the Federal Reserve Board. The specifics for each series are provided below.

Required Reserves: H.3 Release, Aggregate Reserves of Depository Institutions and the Monetary Base

Reservable Deposits: Demand Deposits (H.6 release, Components of M1) +Other Checkable Deposits (H.6. release, Components of M1)[18]

Bank Loans: Total Loans and Leases (H.8 release, Assets and Liabilities of Commercial Banks in the United States)

Total Balances: Reserve Balances with Federal Reserve Banks (H.4.1. Release, Factors Affecting Reserve Balances)

Managed Liabilities: Large time deposits (H.6 release, Components of Non-M2 M3) + Net due to related foreign offices (H.8 release, Assets and Liabilities of Commercial Banks in the United States)+ Borrowings from other nonbanks (H.8 release, Assets and Liabilities of Commercial Banks in the United States).

Large Time Deposits: H.6 release, Components of Non-M2 M3

Securities: H.8 release, Assets and Liabilities of Commercial Banks in the United States

Federal Funds Rate: Effective Federal Funds Rate (H.15 Release, Selected Interest Rates)

Six Month CD rate: Bank Rate Monitor

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[18] Our reservable deposits data consists of demand deposits and other checkable deposits, the former being held exclusively at commercial banks. Moreover, transactions deposits are these two types of deposits adjusted for various other technical factors, such as cash items in the process of collection, but the difference is not material for the purposes of this discussion.

Unemployment Rate: U.S. Department of Labor: Bureau of Labor Statistics. State level unemployment rate data is obtained by the Federal Reserve Bank of Cleveland's web-site.

CPI: Consumer Price Index for all urban consumers: All Items (U.S. Department of Labor: Bureau of Labor Statistics)

GDP Deflator: Federal Reserve Bank of St. Louis, FRED database

Bank Level Data

The following series are obtained from the Call Report series available on the Federal Reserve Bank of Chicago's website. Because there is a break in total securities series (RCFD 0391) from 1994 to 2002, we start our sample in 1994.Q1 and use the sum of total held to maturity series (RCFD 1754) and total available for sale securities (RCFD 1773).

Variable	*MDRM Code and Definition*
Total Assets*	RCFD2170: *TOTAL ASSETS*
Cash	RCFD0010: *CASH AND BALANCES DUE FROM DEPOSITORY INSTITUTIONS*
Securities*	RCFD1754 (*HELD-TO-MATURITY SECURITIES, TOTAL*) +RCFD1773 (*AVAILABLE-FOR-SALE SECURITIES, TOTAL*)
Total Loans*	RCFD1400 (*TOTAL LOANS AND LEASES, GROSS*)
	RCON1400 (*TOTAL LOANS AND LEASES, GROSS*)
Real estate loans	RCFD1410 (*LOANS SECURED BY REAL ESTATE*)
C&I loans	RCFD1600 (*COMMERCIAL AND INDUSTRIAL LOANS (TOTAL LOANS OUTSTANDING)*)

Loans to individuals	RCFD1975 (*LOANS TO INDIVIDUALS FOR HOUSEHOLD, FAMILY, AND OTHER PERSONAL EXPENDITURES*)
Total deposits	RCFD2200 (*TOTAL DEPOSITS*)
Transaction deposits*	RCON2215 (*TOTAL TRANSACTION ACCOUNTS*)
Large deposits*	RCON2604 (*TOTAL TIME DEPOSITS OF $100,000 OR MORE*)
Brokered deposits	RCON2365 (*TOTAL BROKERED DEPOSITS*)
Subordinated debt	RCFD3200 (*SUBORDINATED NOTES AND DEBENTURES*)
Other liabilities	RCFD2170 (*TOTAL ASSETS*) -RCFD2950 (*TOTAL LIABILITIES*)
Equity*	RCFD3210 (*TOTAL EQUITY CAPITAL*)
* Indicates the series that are used in VAR analysis.	

We adopt the following screens to form consistent time series.

1) Banks located within the fifty states and DC (0<RSSD 9210<57).

2) Insured banks (RSSD 9424=1, 2, 6, or 7) where 1 = FDIC/BIF (not valid after 2006.Q1), 2 = FDIC/SAIF(not valid after 2006.Q1), 6 = FDIC/BIF and FDIC/SAIF(not valid after 2006.Q1), and 7 = DIF (Deposit Insurance Fund), (not valid prior to 2006.Q1)

3) Institutions chartered as commercial banks (RSSD=200). In contrast to Kasyhap and Stein (2000) and following Den Haan et al. (2002), we exclude non-deposit trust companies and savings banks from the sample. The excluded banks report on a semi-annual basis. Den Haan et al. note that inclusion of these institutions lead to oscillating series.

4) If any of the series that enter the VAR directly (i.e. securities, loans, transaction deposits, large time deposits) or indirectly (i.e. assets) have a have a non-positive value, we eliminate that bank from that sample in that period, suspecting that this is a reporting

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error. The only exception is bank capital, which is one of the four entries in the Call Reports that is allowed to be negative.

5)   For the series that enter the VAR directly or indirectly, observation t of series i is dropped if the growth rate is more than five standard deviations away from the cross sectional mean growth rate of series i in period t.

6)   Observation t of series i is included only when four preceding observations are available.

Appendix

A Simple Theoretical Model

In this paper, we tested the existence of a bank lending channel by checking whether or not bank

loans are a function of reservable deposits. Our empirical evidence suggested that this is not the

case. We argued therefore that a contraction in reservable deposits has no negative impact on

bank loans. Instead, bank loans are primarily driven by demand factors. If there is an increase in

demand for loans, banks increase their supply of loans (despite a decline in reservable deposits)

and obtain the funding by issuing uninsured deposits.

In the context of a simple theoretical model, these claims can be illustrated by showing

that the change in bank loans in response to a shock to the supply of reservable deposits is zero

where the marginal cost of raising external funds is negligible. Furthermore, the partial

derivative of bank loans with respect to a shock to loan demand is positive. In this appendix, we

illustrate these claims with the help of a simple model.

The simple theoretical model developed by Jayaratne and Morgan (2000) serves well for

our purposes. They consider a case where banks only make loans, *L*. The marginal revenue

from lending is given by $r^L = l_0 - l_1 L$ where l_0 captures loan demand and l_1 is the marginal

revenue of lending which is decreasing: $l_1 > 0$. Banks fund their loans with reservable (or

insured) deposits, *RD* and with managed liabilities (or uninsured funds), *ML*. The marginal cost

of reservable deposits and managed liabilities are: $r^D = d_0 + d_1 RD$ and $r^{ML} = u_0 + u_1 ML$

respectively. d_0 captures shocks to the supply of reservable deposits. It is assumed that

$u_0 > d_0 > 0$ to capture the idea that federal deposit insurance is provided at subsidized rates.

Jayaratne and Morgan (2000) note that the key parameter in the model is u_1, which

determines whether the marginal cost of external funds is flat or increasing. They assume that

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$d_1 > u_1 \geq 0$ indicating that the marginal cost of reservable deposits is steeper than the marginal cost of nonreservable funds. This assumption ensures that banks fund their marginal loans with uninsured funds. The evidence in this paper further suggests that it is flat: $u_1 = 0$.

In order to maximize profits, banks choose the optimal amount of loans and the cost minimizing levels of reservable deposits and managed liabilities. At the optimum level, the marginal revenue of loans equals the marginal cost of reservable deposits and managed liabilities: $r^L = r^{RD} = r^{ML}$. The balance sheet condition requires that $L = RD + ML$. These two conditions and the above equations determine the equilibrium quantities of reservable deposits, managed liabilities, and loans: RD^*, ML^* and L^* respectively.

$$D^* = [u_1(l_0 - d_0) - l_1(d_0 - u_0)] / [u_1(d_1 + l_1) + l_1 d_1]$$

$$ML^* = [d_1(l_0 - u_0) - l_1(d_0 - u_0)] / [u_1(d_1 + l_1) + l_1 d_1]$$

$$L^* = (l_0 - d_0)/l_1 - d_1[u_1(l_0 - d_0) - l_1(d_0 - u_0)] / [u_1(d_1 + l_1) + l_1 d_1] l_1$$

The first result in Jayaratne and Morgan (2000) indicates that "a reduction in the supply of deposits (that is an increase in d_0) will reduce bank lending if and only if the marginal cost of uninsured funds is increasing"(p.81). Formally:

$$\frac{\partial L^*}{\partial d_0} = \frac{-u_1}{u_1(d_1 + l_1) + l_1 d_1}$$

The empirical evidence in this paper, which suggests that $u_1 = 0$ implies that $\frac{\partial L^*}{\partial d_0} = 0$, that is, a reduction in the supply of reservable deposits leaves bank lending unchanged.

Under these circumstances, an increase in loan demand (say because more customers honor their loan commitments following a tightening) results in an increase in equilibrium bank

loans. In other words, a positive shock to loan demand (that is an increase in l_0) increases the

equilibrium quantity of loans:

$$\frac{\partial L^*}{\partial l_0} = \frac{l_1(u_1 + d_1)}{[(u_1 + d_1) + l_1 d_1]l_1} = \frac{1}{1 + l_1} > 0 \text{ when } u_1 = 0.$$

Consequently, if contractionary monetary policy triggers an increase in loan demand, the

money multiplier mechanism, which predicts a decline in loans or securities, fails.

Table 1: Granger Causality Tests (1990-2007)*

 (Variables are in first differences)

Monthly Frequency

	1. Required Reserves	2. Reservable Deposits	3. Bank Loans	4. Total Balances	5. Managed Liabilities	6. Large Time Deposits
1. Required Reserves		0.0000	0.8042	0.0000	0.9277	0.0006
2. Reservable Deposits	0.6813		0.1725	0.0003	0.7637	0.4208
3. Bank Loans	0.3197	0.0198		0.2133	0.0006	0.0313
4. Total Balances	0.0124	0.2147	0.9867		0.7757	0.4337
5. Managed Liabilities	0.7086	0.1483	0.2753	0.7656		0.8400
6. Large Time Deposits	0.4243	0.0006	0.0731	0.0000	0.0935	

*The month that corresponds to September 11, 2001 is excluded from the sample.

For each forecasting variable, the entries across each row are the marginal significance levels for omitting six lags of the variable indicated in the column heading.

Analysis includes six lags of each variable.

Source: Authors' calculations.

Table 2: Variance Decomposition Analysis of Loans

Monthly Frequency

Period	VAR Specification: FFR, CPI, Loans, Reservable Deposits, Managed Liabilities, Securities, Unemployment		VAR Specification: FFR, CPI, Loans, Reservable Deposits, Large Time Deposits, Securities, Unemployment	
	Percentage of the Forecast Error in Bank Loans Explained by:		Percentage of the Forecast Error in Bank Loans Explained by:	
	Reservable Deposits	Managed Liabilities	Reservable Deposits	Large Time Deposits
1	0.00	0.00	0.00	0.00
2	0.08	0.10	0.67	0.96
3	0.37	0.27	1.35	2.60
4	1.97	2.06	2.45	3.21
5	4.20	3.35	3.94	3.66
6	5.14	5.25	4.43	5.02
7	5.54	5.79	4.70	7.04
8	5.66	6.20	4.94	9.47
9	5.50	6.42	4.82	11.93
10	5.35	6.43	4.57	14.63
11	5.45	6.25	4.28	17.58
12	5.55	6.06	3.96	20.45
13	5.56	5.86	3.61	23.07
14	5.53	5.66	3.27	25.45
15	5.42	5.44	2.98	27.51
16	5.27	5.20	2.73	29.26
17	5.09	4.99	2.53	30.71
18	4.88	4.79	2.38	31.92
19	4.66	4.61	2.27	32.91
20	4.45	4.43	2.20	33.71
21	4.24	4.28	2.16	34.38
22	4.05	4.13	2.13	34.92
23	3.87	3.99	2.13	35.34
24	3.70	3.86	2.14	35.67

Variables are ordered as they are listed in the VAR specifications in each column heading.

Source: Authors' calculations.

Table 3: Balance Sheets for Banks of Different Sizes

1994.Q1

	Below 75	75-90	90-95	95-98	98-99	over 99
Number of Banks	7787	1557	519	312	104	104
Mean Assets (1994 $ millions)	53.70	194.52	443.07	1232.90	4000.21	15137.65
Median Assets (1994 $ millions)	47.02	182.67	426.05	1079.11	3765.98	10299.89
Fraction of total assets	0.13	0.09	0.07	0.12	0.13	0.47
Fraction of total loans	0.12	0.09	0.07	0.12	0.13	0.47
Cash	0.05	0.05	0.05	0.06	0.07	0.09
Securities	0.35	0.33	0.30	0.27	0.26	0.19
Total loans	0.53	0.56	0.59	0.60	0.60	0.57
Total deposits	0.88	0.87	0.84	0.81	0.76	0.67
Transaction deposits	0.27	0.27	0.26	0.25	0.26	0.21
Large deposits	0.08	0.07	0.07	0.07	0.06	0.05
Brokered deposits	0.00	0.00	0.01	0.01	0.01	0.02
Subordinated debt	0.00	0.00	0.00	0.00	0.00	0.01
Other Liabilities	0.10	0.09	0.09	0.08	0.08	0.09
Equity	0.10	0.09	0.09	0.08	0.08	0.07

2007.Q2

	Below 75	75-90	90-95	95-98	98-99	over 99
Number of Banks	5046	1009	336	202	67	68
Mean Assets (2007 $ millions)	89.25	359.61	771.81	1786.65	4755.34	36908.83
Median Assets (2007 $ millions)	76.44	347.04	736.12	1648.24	4678.33	20541.57
Fraction of total assets	0.11	0.09	0.06	0.08	0.07	0.59
Fraction of total loans	0.11	0.09	0.07	0.09	0.07	0.56
Cash	0.04	0.03	0.03	0.03	0.04	0.05
Securities	0.21	0.18	0.18	0.17	0.21	0.17
Total loans	0.67	0.72	0.72	0.72	0.65	0.62
Total deposits	0.84	0.81	0.80	0.77	0.71	0.69
Transaction deposits	0.22	0.13	0.10	0.09	0.08	0.06
Large deposits	0.17	0.17	0.16	0.14	0.14	0.10
Brokered deposits	0.03	0.05	0.05	0.05	0.04	0.04
Subordinated debt	0.00	0.00	0.00	0.00	0.00	0.02
Other Liabilities	0.11	0.10	0.10	0.11	0.12	0.13
Equity	0.11	0.10	0.10	0.11	0.12	0.11

Source: Federal Reserve Bank of Chicago
(http://www.chicagofed.org/banking_information/financial_institute_reports_des_call_main.cfm).

Table 4: Balance Sheets for Banks for Alternative Classifications

A. Composition of Bank Balance Sheets based on $\dfrac{\text{Securities}}{\text{Assets}}$ as of 2007.Q2

	Below 20	20-40	40-60	60-80	over 80
Number of Banks	1345	1346	1345	1346	1346
Mean Assets (2007 $ millions)	696.68	1054.78	537.37	568.51	309.86
Median Assets (2007 $ millions)	129.34	135.90	122.64	94.85	68.53
Fraction of total assets	0.22	0.33	0.17	0.18	0.10
Fraction of total loans	0.26	0.36	0.18	0.15	0.05
Cash	0.03	0.03	0.03	0.07	0.05
Securities	0.06	0.13	0.18	0.25	0.49
Total loans	0.76	0.70	0.71	0.54	0.35
Total deposits	0.68	0.73	0.76	0.74	0.76
Transaction deposits	0.08	0.08	0.09	0.09	0.12
Large deposits	0.13	0.10	0.14	0.12	0.12
Brokered deposits	0.09	0.03	0.03	0.02	0.01
Subordinated debt	0.02	0.01	0.01	0.01	0.00
Other Liabilities	0.16	0.12	0.11	0.11	0.09
Equity	0.14	0.10	0.10	0.10	0.08

B. Composition of Bank Balance Sheets based on $\dfrac{\text{Capital}}{\text{Assets}}$ as of 2007.Q2

	Below 20	20-40	40-60	60-80	over 80
Number of Banks	1345	1346	1345	1346	1346
Mean Assets (2007 $ millions)	851.62	769.10	538.58	377.82	630.19
Median Assets (2007 $ millions)	142.63	145.68	113.58	88.72	67.09
Fraction of total assets	0.27	0.24	0.17	0.12	0.20
Fraction of total loans	0.22	0.26	0.19	0.13	0.20
Cash	0.07	0.03	0.03	0.03	0.03
Securities	0.25	0.17	0.15	0.16	0.13
Total loans	0.53	0.69	0.74	0.72	0.65
Total deposits	0.74	0.75	0.75	0.77	0.64
Transaction deposits	0.09	0.08	0.09	0.11	0.08
Large deposits	0.12	0.10	0.14	0.14	0.12
Brokered deposits	0.03	0.03	0.04	0.03	0.07
Subordinated debt	0.01	0.01	0.01	0.01	0.01
Other Liabilities	0.09	0.10	0.11	0.12	0.20
Equity	0.07	0.09	0.10	0.12	0.19

Source: Federal Reserve Bank of Chicago
(http://www.chicagofed.org/banking_information/financial_institute_reports_des_call_main.cfm).
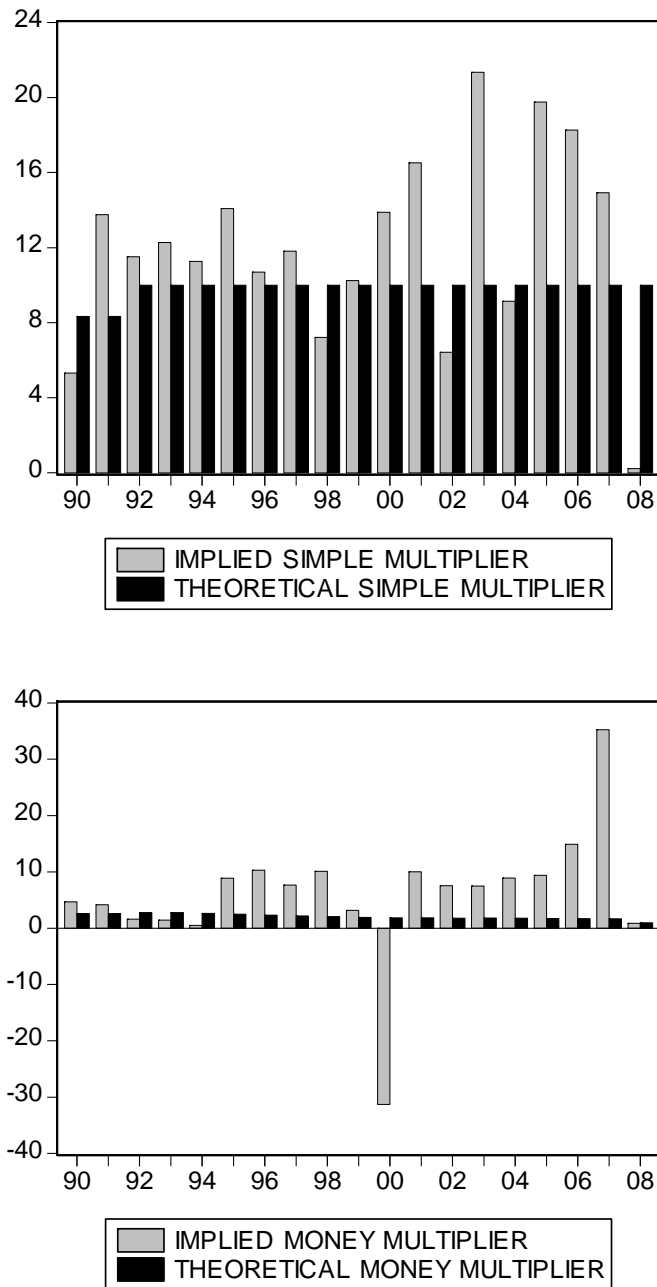
**Figure 1: The Discrepancy between the Theoretical and the Actual Multiplier**

Source: Simple multiplier: Federal Reserve Statistical Releases H.3 (Required reserves) and H.6 (reservable deposits); implied money multiplier: authors' calculations; theoretical money multiplier: Federal Reserve Statistical Releases H.3 (monetary base, excess reserves) and H.6 (reservable deposits, M2).
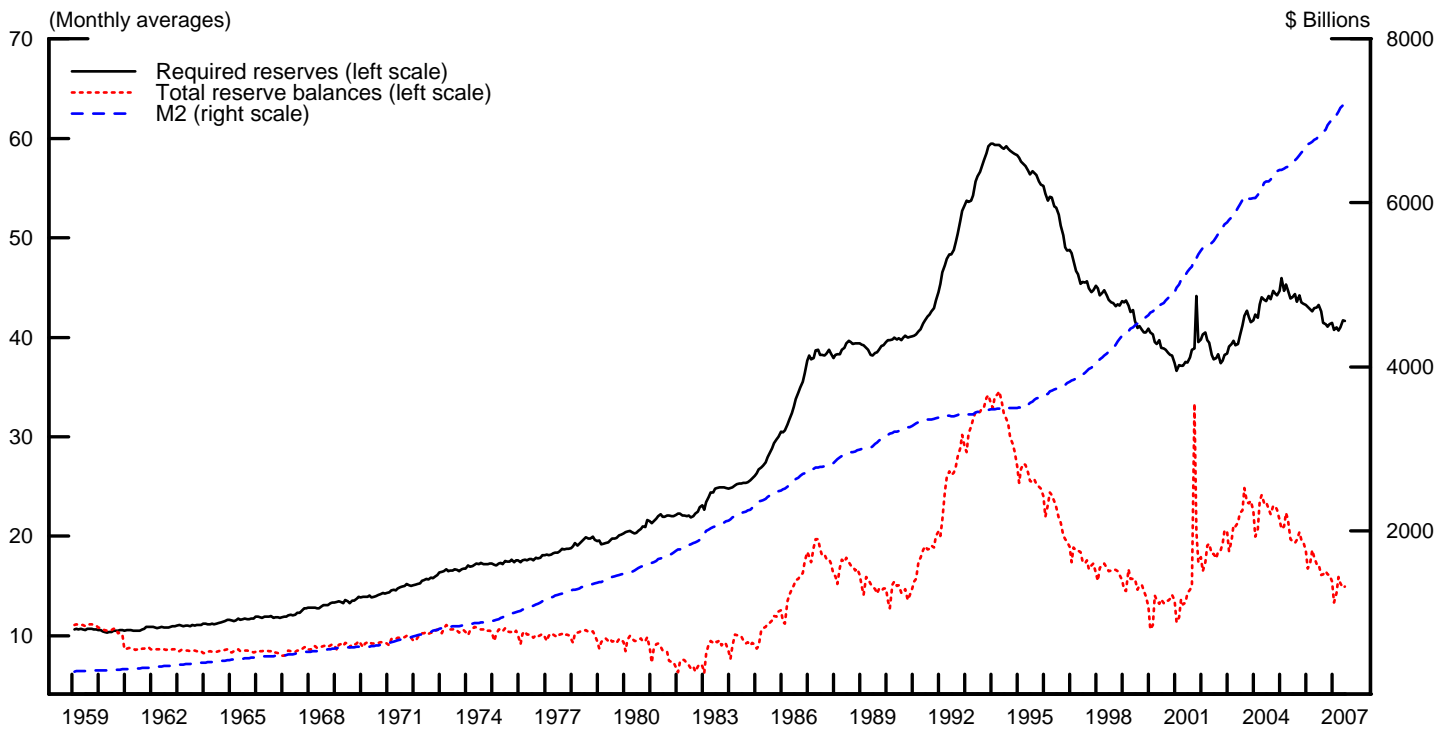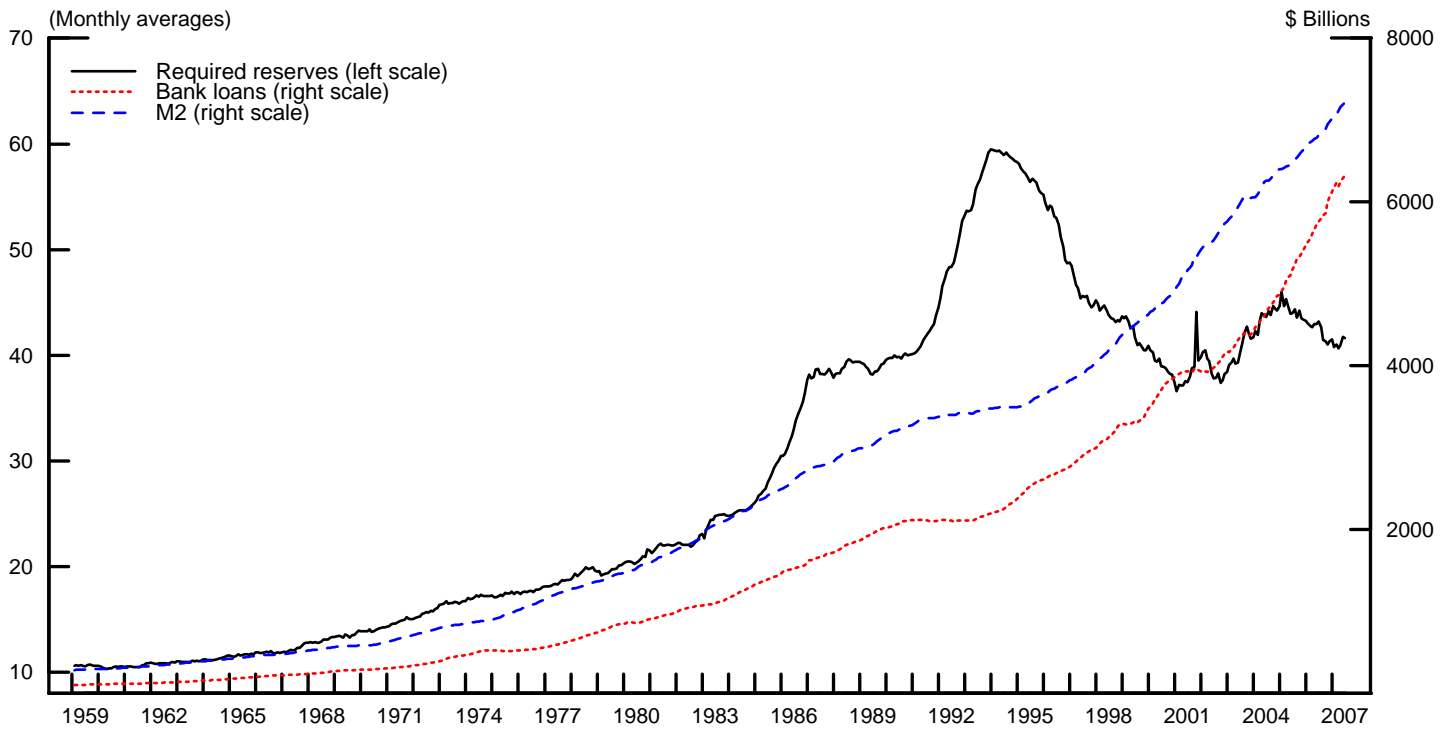
Figure 2: Monetary Aggregates and Bank Loans (1959-2007)

Response to Cholesky One S.D. Innovations ± 2 S.E.
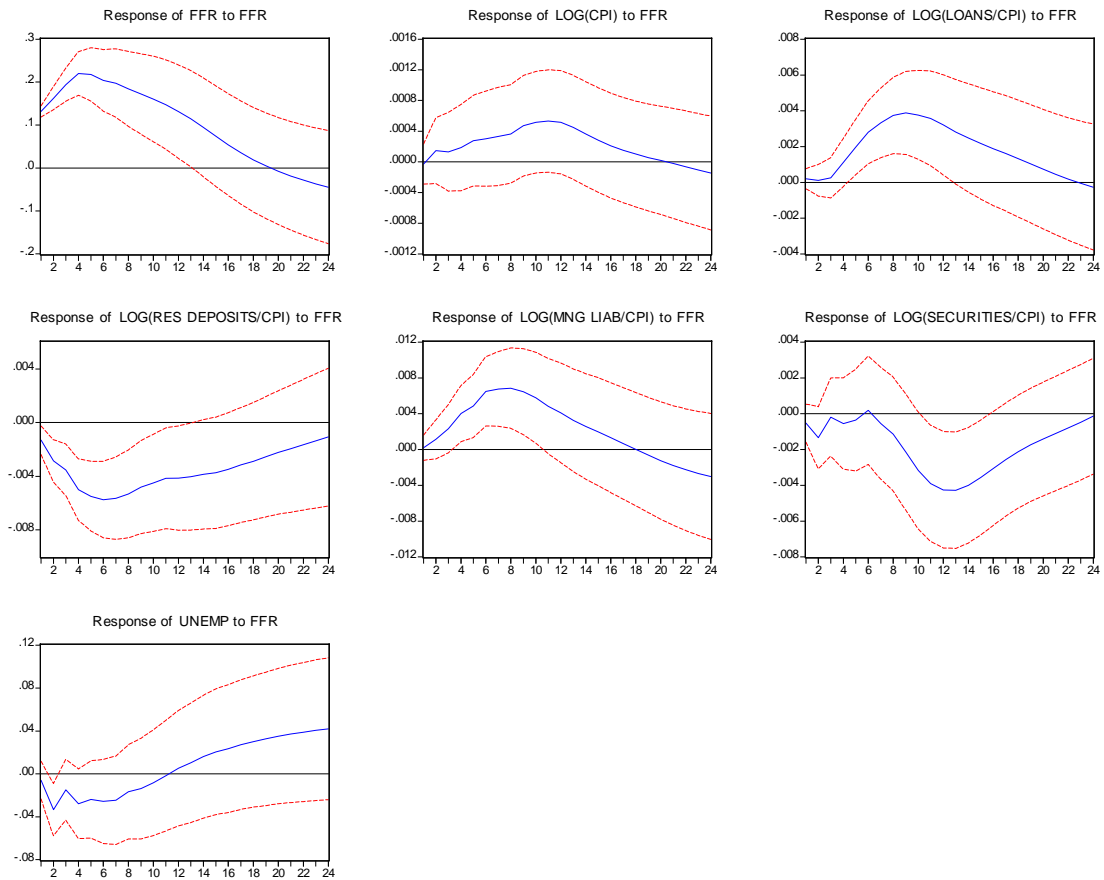
*excluding September 2001

where:

FFR:	Federal Funds Rate
CPI:	Consumer Price Index
Loans:	Total Bank Loans and Leases
Res Deposits:	Reservable Deposits
Mng Liab:	Managed Liabilities
Unemp:	Unemployment Rate

Figure 3: Bernanke and Blinder Updated (1990-2007)*

Source: Authors' calculations.

Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of FFR to FFR

Response of LOG(CPI) to FFR

Response of LOG(LOANS/CPI) to FFR

Response of LOG(RES DEPOSITS/CPI) to FFR

Response of LOG(DEPOSITS_LG/CPI) to FFR

Response of LOG(SECURITIES/CPI) to FFR

Response of UNEMP to FFR
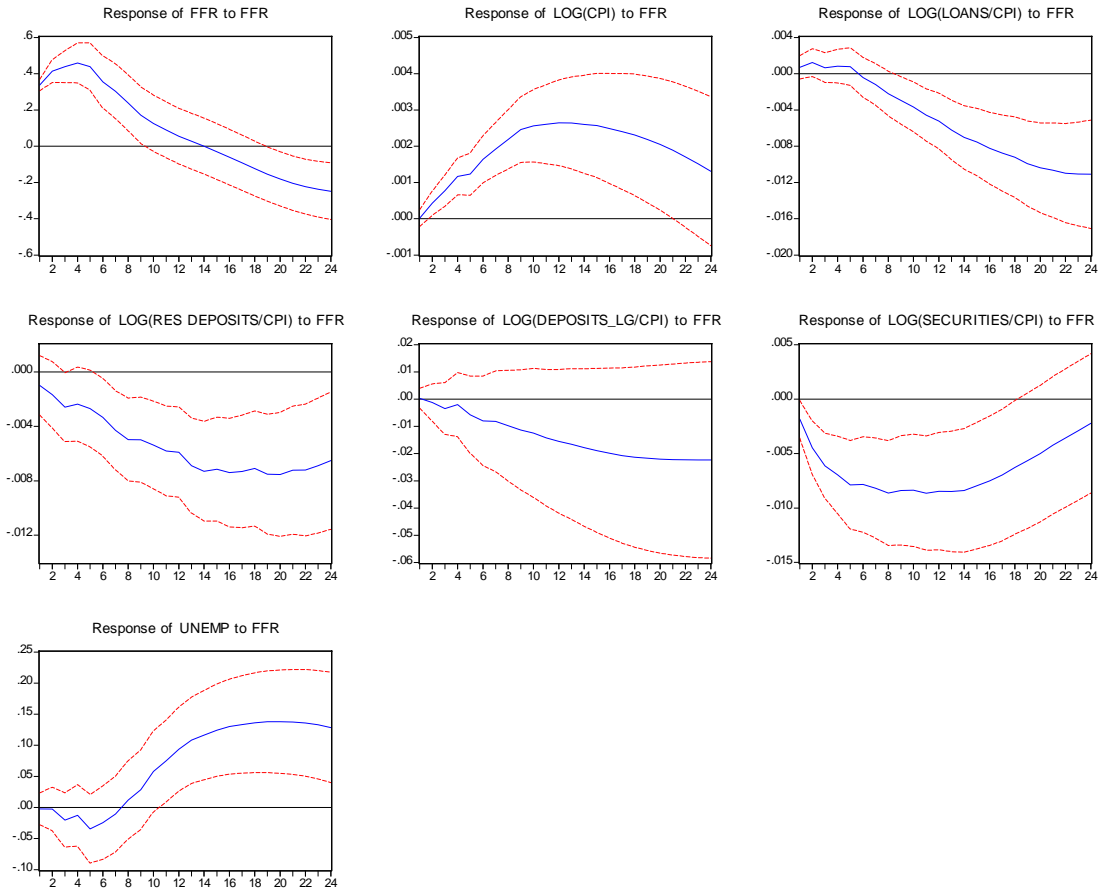
Figure 4: Bernanke and Blinder (1959-1978)

Source: Authors' calculations.

Response of Liabilities to Loans
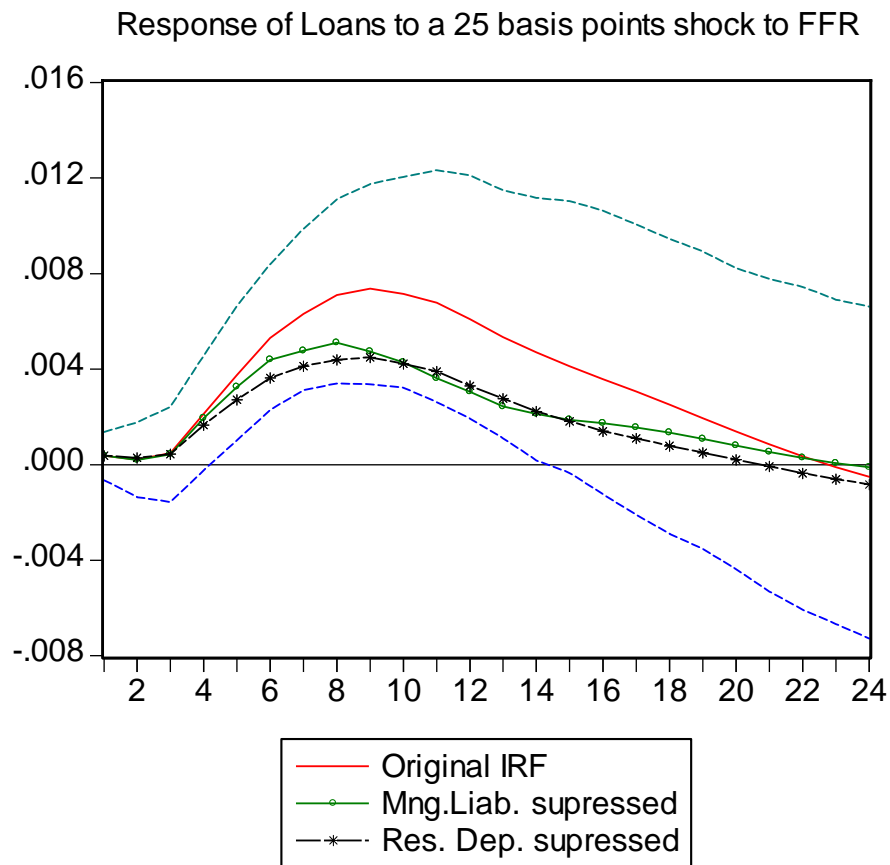
Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of DEPOSITS to LOANS

Response of MNG LIAB to LOANS
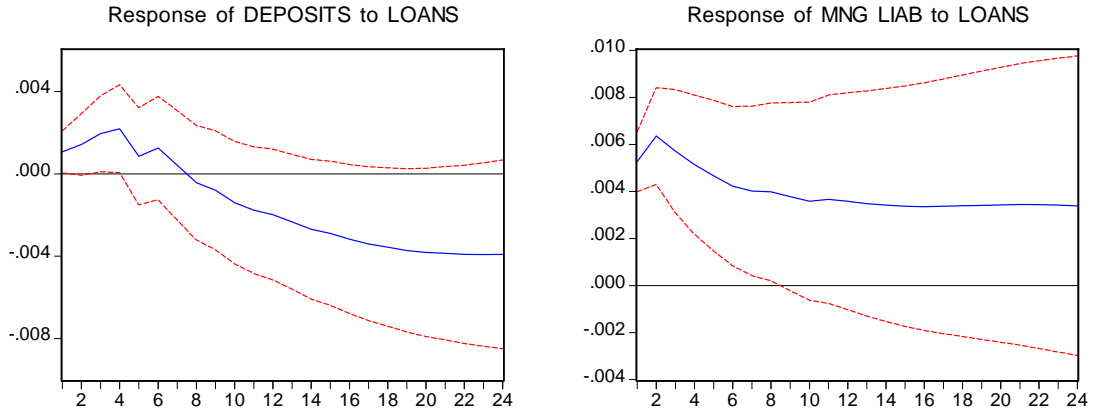
Response of Loans to Liabilities

Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of LOANS to DEPOSITS

Response of LOANS to MNG LIAB
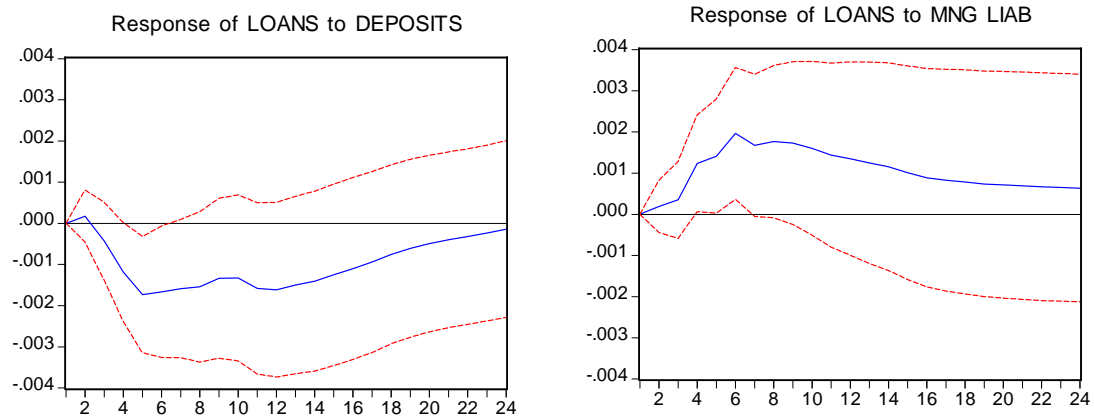
Figure 5: Bernanke and Blinder Updated (Cont'd)

Source: Authors' calculations.

Response of Loans to a 25 basis points shock to FFR

The dashed lines represent 95 percent confidence intervals computed by bootstrap method.
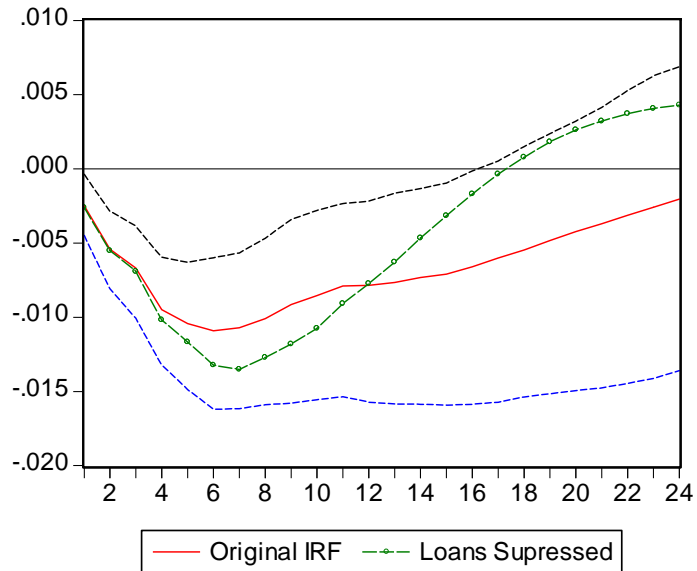
Figure 6: The Response of Bank Loans under Counterfactual Experiments

Source: Authors' calculations.

Response of Managed Liabilities to a 25 basis points shock to FFR
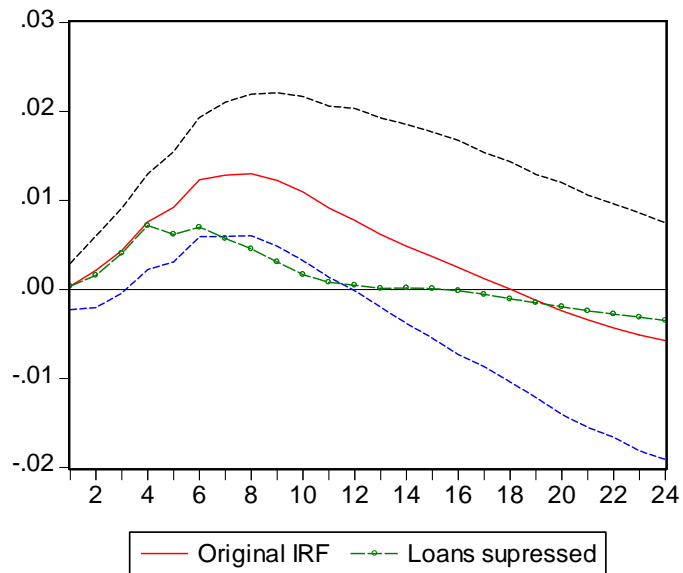
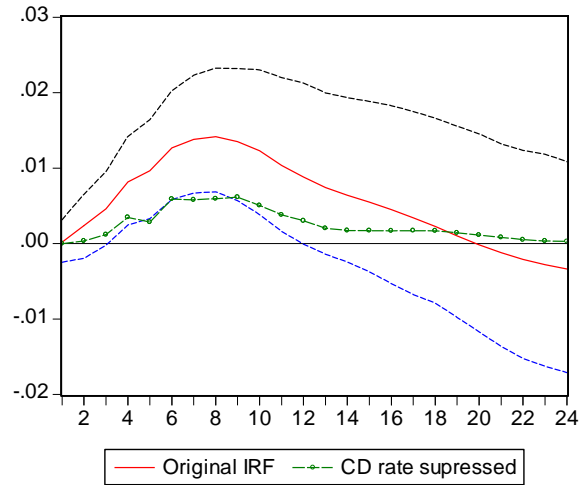Response of Reservable Deposits to a 25 basis points shock to FFR

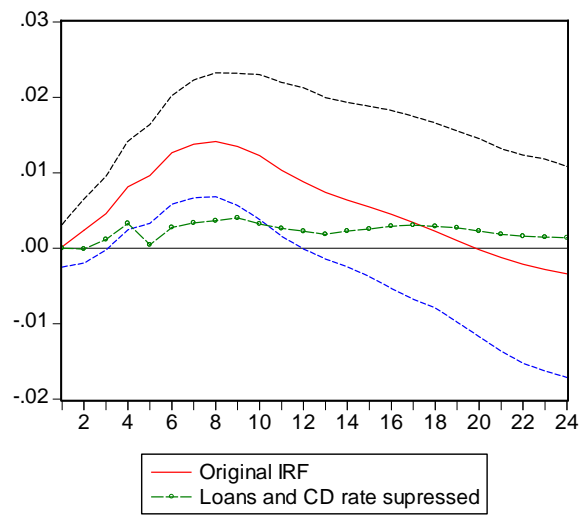The dashed lines represent 95 percent confidence intervals computed by bootstrap method.

Figure 7: The Responses of Different Bank Liabilities under Counterfactual Experiments

Source: Authors' calculations.

Response of Managed Liabilities to a 25 basis points shock to FFR

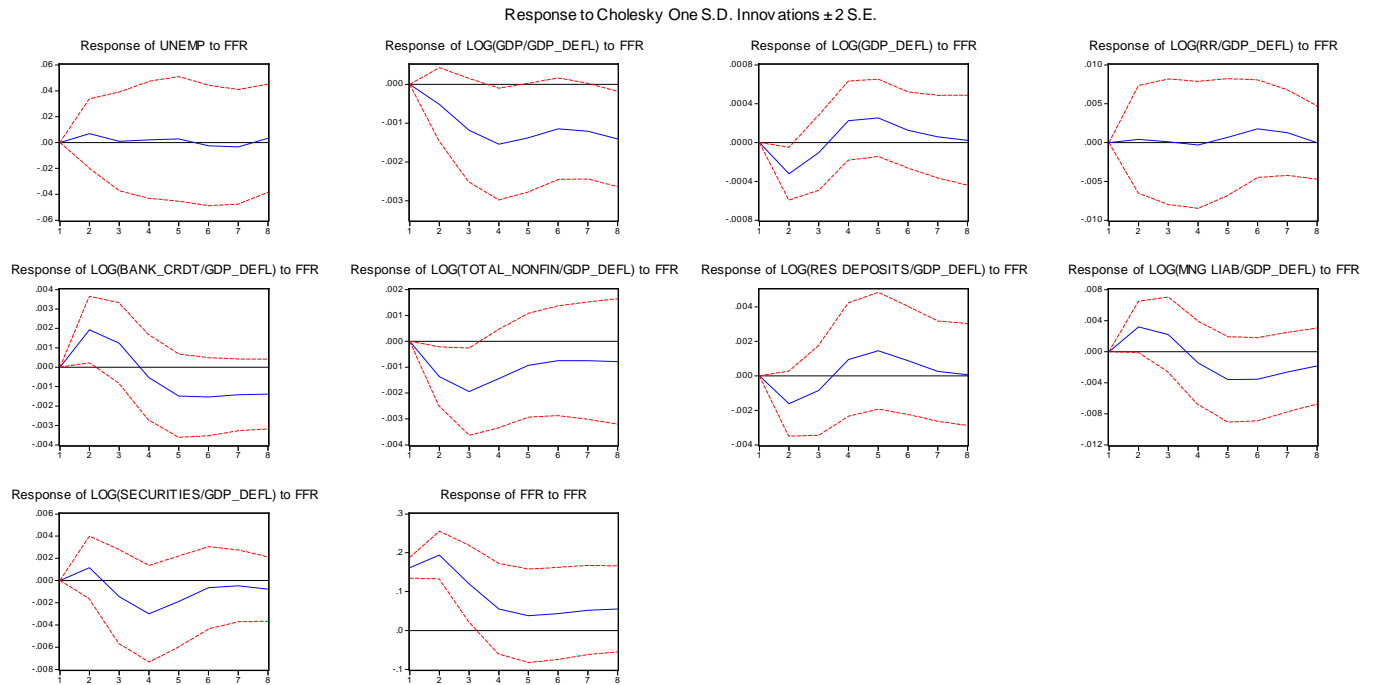Response of Managed Liabilities to a 25 basis points shock to FFR

The dashed lines represent 95 percent confidence intervals computed by bootstrap method.

Figure 8: The Responses of Different Bank Liabilities under Counterfactual Experiments
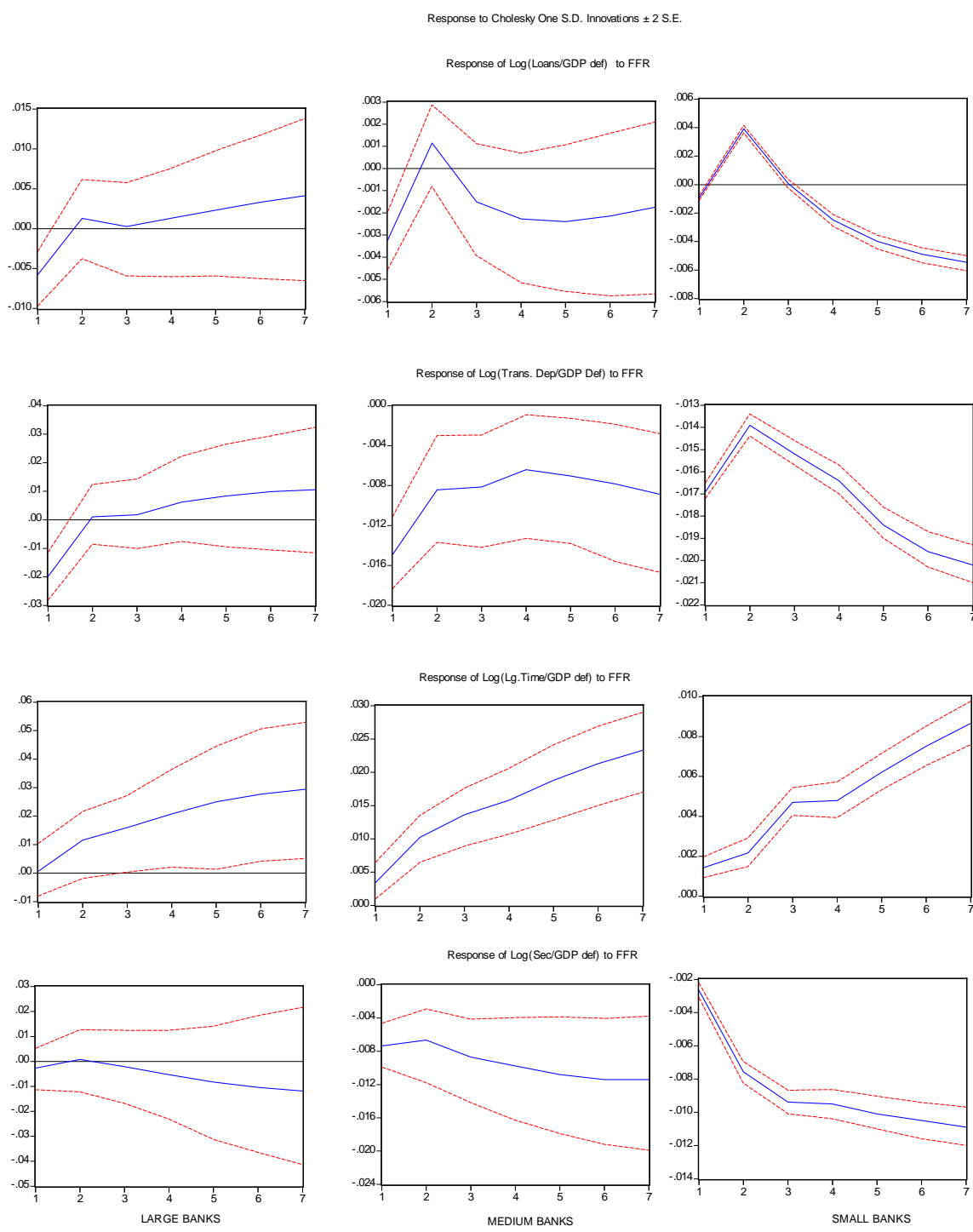
Source: Authors' calculations.

Response to Funds Rate

Response to Cholesky One S.D. Innovations ± 2 S.E.

where:

|	
FFR:	Federal Funds Rate
GDP_Defl:	GDP Deflator
Bank_Crdt:	Total Bank Loans
Total_nonfin:	Total Non-financial Borrowing
Re Deposits:	Reservable Deposits
Mng Liab:	Managed Liabilities
Unemp:	Unemployment Rate
RR:	Required Reserves

Figure 9: VAR Analysis at the Quarterly Frequency

Source: Authors' calculations.

Figure 10: Panel VAR Analysis (Breakdown with respect to Asset Size)
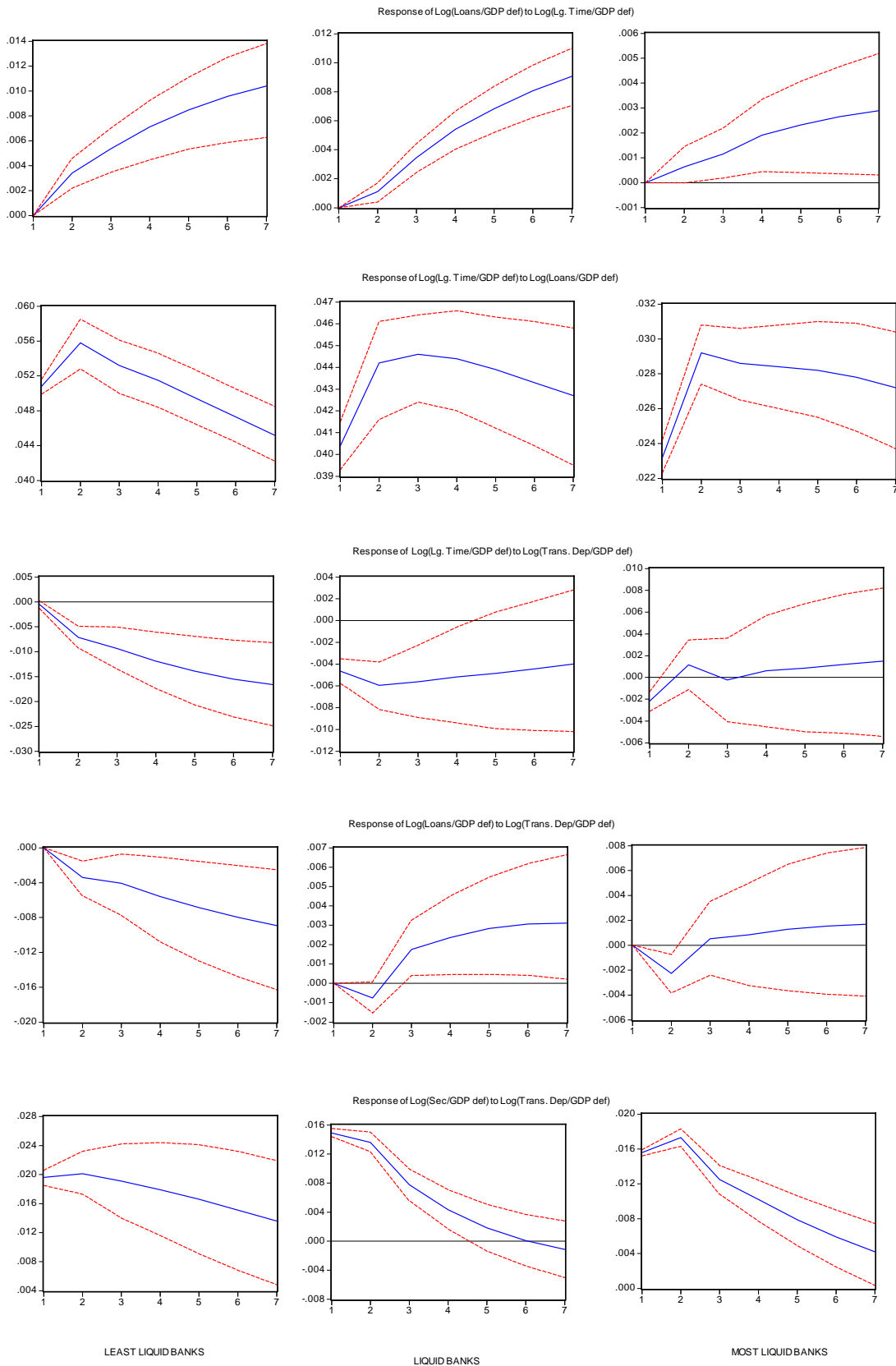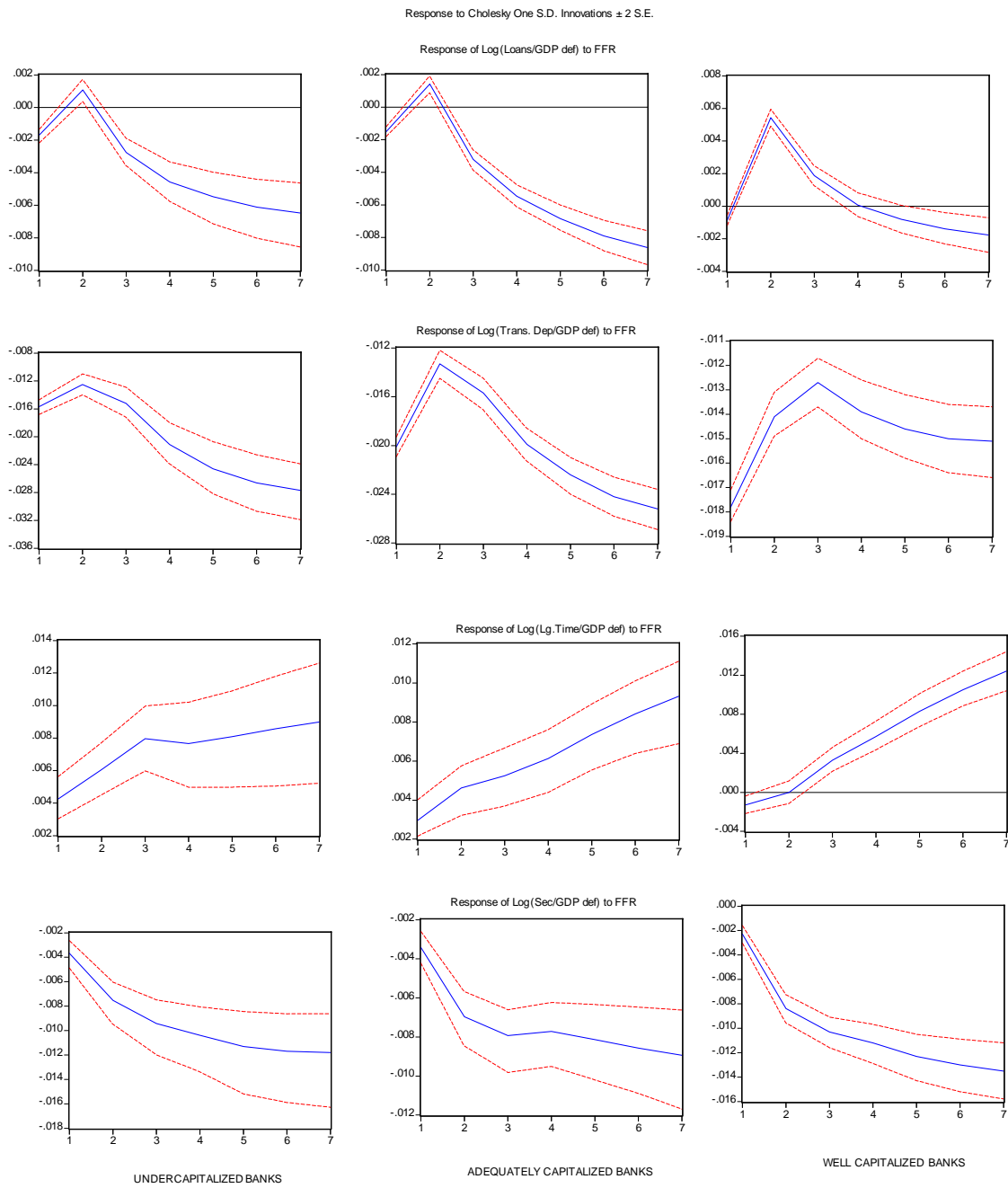
Source: Authors' calculations.

Response to Cholesky One S.D. Innovations ± 2 S.E.
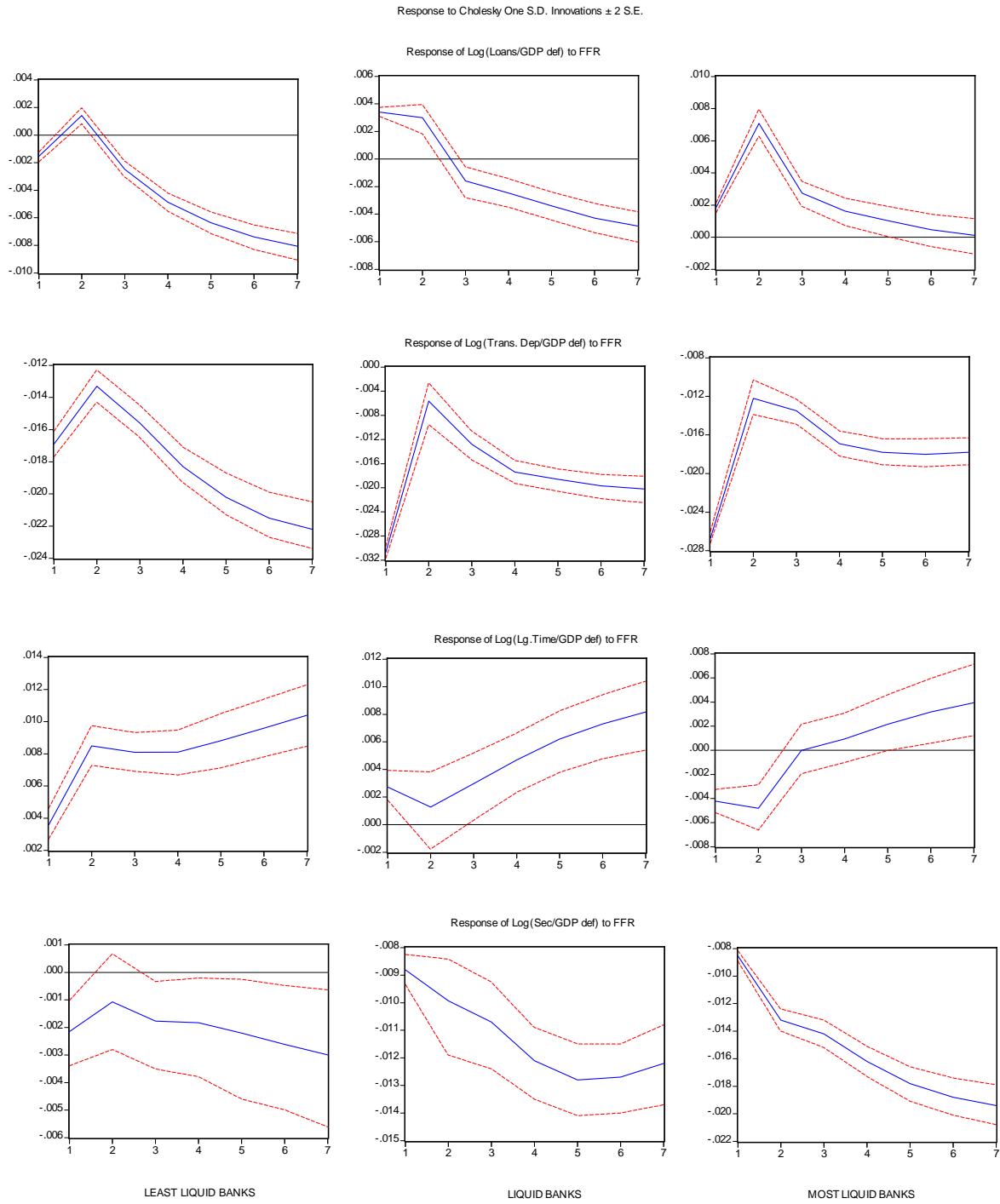
Figure 11a: Panel VAR Analysis (Breakdown with respect to $\dfrac{\text{Securities}}{\text{Assets}}$ Ratio)

Source: Authors' calculations.

Response of Log(Loans/GDP def) to Log(Lg. Time/GDP def)

Response of Log(Lg. Time/GDP def) to Log(Loans/GDP def)

Response of Log(Lg. Time/GDP def) to Log(Trans. Dep/GDP def)

Response of Log(Loans/GDP def) to Log(Trans. Dep/GDP def)

Response of Log(Sec/GDP def) to Log(Trans. Dep/GDP def)

LEAST LIQUID BANKS

LIQUID BANKS

MOST LIQUID BANKS

Figure 11b: Panel VAR Analysis (Breakdown with respect to $\dfrac{\text{Securities}}{\text{Assets}}$ Ratio)

Source: Authors' calculations.

Response to Cholesky One S.D. Innovations ± 2 S.E.

Response of Log(Loans/GDP def) to FFR

Response of Log(Trans. Dep/GDP def) to FFR

Response of Log(Lg.Time/GDP def) to FFR

Response of Log(Sec/GDP def) to FFR

UNDERCAPITALIZED BANKS

ADEQUATELY CAPITALIZED BANKS

WELL CAPITALIZED BANKS

Figure 12: Panel VAR Analysis (Breakdown with respect to $\dfrac{\text{Capital}}{\text{Assets}}$ Ratio)

Source: Authors' calculations.