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The Low Monetary Rates Paradox, Banking Stability and Credit: Evidence from the Euro Area

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The Low Monetary Rates Paradox, Banking Stability and Credit: Evidence from the Euro Area

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Paper motivation and objectives

- Low interest rates due to loose monetary policy have been blamed for the relaxation of lending standards that led to the sub-prime crisis.
  - Common argument is that as interest rates drop, banks increase risks in search for yields.
- Paper seeks to examine the impact of monetary policy on bank lending standards before and during the 2008 crisis.
  - Is there a paradox in that low interest foster crisis but are at the same time needed to mitigate the credit crunch during crisis, sowing the seeds for future crises?
- Paper also aims to study whether more stringent banking supervision and regulation affect the impact of monetary policy on lending standards.
  - i.e., Does regulation and supervision limit the extent of bank risk taking that results from low interest rates?

Summary of the analysis

- Uses the Bank Lending Survey (BLS) data conducted by Euro area national central banks to analyze impact of monetary policy (overnight interest rates & Taylor rule residuals) on lending standards.
  - Banks are requested to provide quarterly information on lending standards (whether they have tightened, loosened or not changed).
  - BLS contains information on factors affecting lending standards, in particular: quality of loan applicants (credit risk) and bank balance sheet capacity and competition (bank risk-taking).
- Summarizes evidence of impact of monetary policy on lending standards from related research using very detailed loan-level data from Spain (<u>This really does not belong here</u>).
- Assesses the impact of monetary policy and tightening of lending standards on GDP (This needs to be expanded or dropped).

Main findings/conclusions

- In the period prior to the crisis:
  - Low short-term interest rates softened lending standards.
  - The impact of low short-term rates is more significant than the effect of long-term interest rates or current account deficits.
  - The impact of loose monetary policy on lending standards is reduced by more stringent regulation and supervision.
- After 2008:
  - Loose monetary policy softened lending conditions, especially for banks with greater liquidity problems.
- Conclusion: monetary policy and macro-prudential regulation should be related since monetary policy impacts bank risk-taking.

Overall comments

- Topic is relevant and timely.
- Analysis presented so far is very interesting.
- But paper is work in progress.
  - Contribution of the paper needs to be spelled out more clearly.
    - What is the value added relative to previous work by the authors and others?
  - Writing needs to be polished and expanded.
    - E.g., more detailed description of data and survey questions would be valuable.
  - Tables need to be cleaned and presented with explanations.
  - Empirical analysis needs improvement.
  - Interpretation and economic significance of results needs to be expanded.
    - E.g., Table 8 and analysis in Figures 1 and 2 of contribution of monetary policy and lending standards to GDP.
  - Parts of the paper are missing.
    - The authors promise an analysis of monetary policy on loan conditions

Specific comments

- Why use net percentage of banks that have tightened credit standards as dependent variable instead of share that has loosen standards?
  - By taking %tightened - % loosened, aren't you just looking at the % that observed no change?
- Not clear what type of estimations are used to obtain results. Given dynamic panel nature of data, GMM estimates seem the best option.
  - FE estimates with dynamic term would be biased and inconsistent.
- Endogeneity cannot be ruled out in many estimations.
  - Since data is country level, it is possible that overall lending standards are driving monetary policy stance. Need to find a way to instrument for short-term rates in EU (maybe use foreign rates?)
- Separate demand from supply shocks.
  - Why not control for share of banks that say that demand has increased or decreased?
- To verify reliability of survey responses indicating changes in lending standards due to lender balance sheet conditions, why not correlate average bank characteristics to survey responses?

Specific comments

- Impact of regulation and supervision might be overstated. Some results are puzzling:
  - Table 4 – Panel A considering the interaction between monetary policy and capital stringency shows a negative impact of monetary policy and of capital stringency on overall lending standards.
  - Table 4 – Panel B – looking at lending standards due to balance sheet constraints shows impact of monetary policy and capital stringency only on business loans lending standards.
  - Table 4 – Panel C – using LTV as measure of regulation and supervision shows no impact of monetary policy and of LTV independently.

Conclusions

- Paper is very interesting and has potential… but more work is needed.
- Looking forward to the next version!