

## Summary

The structure of financial markets has been changing considerably. Ongoing financial innovation, weakened bank balance sheets following the financial crisis, changes in business models, and strengthened bank regulation have all supported a strong shift from bank lending to bond issuance. This has allowed a larger role for nonbanks, such as insurance companies, pension funds, and asset managers. Nonbanks are very important for financial intermediation in the United States and have become significantly more important in Europe and some emerging market economies.

Has the rise of nonbank financing rendered monetary policy less powerful? Some have argued that the impact of monetary policy action on economic activity has lessened because one of the traditionally key transmission channels—bank lending—has become less important. In theory, nonbanks can either dampen or amplify the transmission of monetary policy. On the one hand, nonbanks may be able to step in to lend in lieu of banks if their funding cost is not as strongly affected as that of banks by changes in monetary policy, or if they are not subject to the same regulatory constraints, potentially dampening the transmission of monetary policy. On the other hand, nonbanks may amplify the transmission of monetary policy if their risk appetite is more sensitive to changes in monetary policy. This chapter explores this important but relatively uncharted territory, first laying out a conceptual framework, and then examining the empirical evidence with novel analyses.

The chapter finds that the increasing importance of nonbanks for financial intermediation has, if anything, strengthened monetary policy transmission over the past 15 years. The potency of monetary policy appears to have risen in various countries and seems to be, on average, stronger in countries with larger nonbank financial sectors. Like banks, nonbanks contract their balance sheets when monetary policy tightens, and, in general, nonbank financial intermediaries contract them more than banks. This behavior is in part explained by the effect of monetary policy on risk taking, particularly in the asset management sector. As a result, bond yields and risk premiums move, affecting the cost of borrowing and real activity. Thus, the composition of the nonbank financial sector matters for the transmission of monetary policy.

The growing role of nonbanks implies that the conduct of monetary policy will need to continue to adapt to changes in the transmission mechanism. The dosage and timing of monetary policy actions must be continuously recalibrated as their impact and the speed of their effect change. For example, as the relative importance of the risk-taking channel grows, the effects of monetary policy changes on the real economy may become more rapid and marked. Although not a focus of this chapter, changes in the regulatory framework are likely to affect the strength of monetary policy transmission because some of the differences in banks' and nonbanks' responses to monetary shocks reflect differences in their regulatory regimes.

The effects of monetary policy on financial stability are becoming more important. For instance, monetary policy actions are likely to have stronger consequences for the financial soundness of banks and nonbank financial institutions because the risk-taking channel seems to be an increasingly important mechanism in driving the responses of financial intermediaries. This suggests the need for greater vigilance by prudential and regulatory authorities.

Monetary policy needs to take into account the size and composition of balance sheets of key financial intermediaries to better gauge changes in financial institutions' risk appetite. Given the growth of the nonbank financial sector, the information contained in the balance sheets of nonbanks is potentially at least as useful as traditional measures of monetary aggregates. For instance, the leverage and changes in leverage of broker-dealers and total assets managed by bond funds can be informative for monetary policy. In this context, closing data gaps on nonbanks is essential.

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**E**merging market economies have become more financially integrated with the rest of the world, allowing greater access to capital but also exposing them to financial shocks. With this increased integration, have institutional and legal frameworks improved accordingly, helping these economies to be more resilient in the face of a more volatile external environment?

This chapter focuses on the interrelatedness of corporate governance, investor protection, and financial stability across emerging market economies. Corporate governance and investor protection encompass rules and practices at both the country and firm level and deal with ways in which suppliers of financing to corporations ensure that they get a return on their investment. Past financial crises across major emerging market economies underscored how corporate governance deficiencies can contribute to financial instability.

The chapter finds that corporate governance and investor protection have generally improved in emerging market economies over the past two decades. The progress is apparent in both firm- and country-level indicators. Even so, there are important differences across emerging market economies, and there is room for further improvement.

The analysis supports the notion that stronger corporate governance and investor protection frameworks enhance the resilience of emerging market economies to global financial shocks. The chapter develops new firm-level indices of governance in emerging market economies and employs novel empirical approaches. The results show that corporate governance improvements foster deeper and more liquid capital markets, allowing them to absorb shocks better. Corporate governance improvements also enhance stock market efficiency, thereby making equity prices less sensitive to external shocks and less prone to crashes. For example, moving from the lower to the upper end of the country- and firm-level governance indices reduces the impact of global shocks by up to 50 percent for emerging market firms, on average. Emerging market economies with better corporate governance and investor protections generally have stronger corporate balance sheets. In particular, better-governed firms typically display lower short-term debt ratios and default probabilities and are able to borrow at longer maturities. This reduces their vulnerability to dry-ups in funding, enhancing financial stability.

The financial stability benefits associated with improved corporate governance strengthen the case for further reform. Although there is no single model, good corporate governance frameworks have some common characteristics. Accordingly, this chapter makes the following policy recommendations:

- All emerging market economies should continue to reform their legal, regulatory, and institutional frameworks to foster the effectiveness and enforceability of corporate governance regimes.
- Most emerging market economies should continue to bolster the rights of outside investors, in particular minority shareholders.
- Bringing disclosure requirements fully in line with international best practice is needed in many emerging market economies. Promoting greater board independence is also likely to yield benefits.