CHAPTER 2

MONETARY POLICY AND THE RISE OF NONBANK FINANCE

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.