3rd International Conference on Advanced Research in Management, Economics and Accounting

16_18 September 2022
Barcelona, Spain

Market Illiquidity and the Bank Lending Channel

[1]Sergio Sanfilippo Azofra , [2]María Cantero Saiz, [3] Begoña Torre Olmo

[1,2,3] Universidad de Cantabria (Spain)

Abstract

This article analyses how stock and bond market illiquidity affect the bank lending channel. The traditional view of this channel considers that monetary restrictions lead to a reduction in banks' deposits, which gives rise to a decline in loan supply. This traditional view has been reformulated by other authors because the dependence of banks on financial market-based funds has increased rapidly in the last decades and banks no longer depend only on deposits for funding. According to this reformulation of the bank lending channel, monetary restrictions increase the cost of market funding for banks, which results in a decline in banks' loan supply. In this regard, illiquidity is a key element in the financial market that could also alter the financing conditions of the banking industry and thus impact on the bank lending channel. We directly analyse the effect that market illiquidity has on the effectiveness of the bank lending channel. This aspect, which has not been studied previously, represents a new application of the bank lending channel and thus provides a new contribution to the literature. We analyse how the marginal effect of monetary policy on loan supply varies with the level of both stock and bond market illiquidity including interactions between continuous variables. This approach exploits all the information included in the variables and provides a precise understanding of the relationship between illiquidity and monetary policy. Our empirical analysis comprises a sample of 862 listed banks from 21 OECD countries between 2002 and 2015. We find that the bank lending channel plays an important role in the transmission mechanism of the monetary policy when financial markets are very liquid. However, as market liquidity decreases, the bank lending channel becomes less relevant and ends up being ineffective.

Keywords: market illiquidity, monetary policy, bank lending channel.