What is the Bank Lending Channel of Monetary Policy Transmission?

The mechanism by which monetary policy is transmitted to the real economy remains a central topic in macroeconomics. The bank lending channel represents the credit view of this mechanism. According to this view, monetary policy works by affecting bank assets (loans) as well as banks' liabilities (deposits). The key point is that monetary policy besides shifting the supply of deposits also shifts the supply of bank loans. For instance, an expansionary monetary policy that increases bank reserves and bank deposits increase the quantity of bank loans available. Where many borrowers are dependent on bank loans to finance their activities, this increase in bank loans will cause a rise in investment (and also consumer) spending, leading ultimately to an increase in aggregate output, (Y). The schematic presentation of the resulting monetary policy effects is given by the following:

$$\mathbf{M} \uparrow \rightarrow \textbf{Bank deposits} \uparrow \rightarrow \textbf{Bank loans} \uparrow \rightarrow \boldsymbol{I} \uparrow \rightarrow \boldsymbol{Y} \uparrow$$

(Note: **M**= indicates an expansionary monetary policy leading to an increase in **bank deposits** and **bank loans**, thereby raising the level of aggregate investment spending, ***I***, and aggregate demand and output, ***Y**,).*

In this context, the crucial response of banks to monetary policy is their lending response and not their role as deposit creators. The two key conditions necessary for a lending channel to operate are: (a) banks cannot shield their loan portfolios from changes in monetary policy; and (b) borrowers cannot fully insulate their real spending from changes in the availability of bank credit.

The importance of the credit channel depends on the extent to which banks rely on deposit financing and adjust their loan supply schedules following changes in bank reserves; and also the relative importance of bank loans to borrowers. Consequently, monetary policy will have a greater effect on expenditure by smaller firms that are more dependent on bank loans, than on large firms that can access the credit market directly through stock and bond markets (and not necessarily through the banks).