4 Transmission Channels of Financial Crises

As described above, the evolution of the interest rate plays a primary role in financial crises. It is, therefore, useful to focus on the monetary policy transmission channels to clarify how interest-rate variations influence economic activities. To do this, we illustrate two different views: the money view (section 4.1) and the credit view (section 4.2). We also provide details on the credit view, analysing the balance-sheet channel (section 4.2.1) and the bank-lending channel (section 4.2.2).

4.1 Money view

The money view, which places great emphasis on the monetary variables, considers the interest rate as the main transmission channel of monetary policy. Accordingly, an increase in the interest rate, achieved through a reduction in the supply of money by the central bank, slows down the economy and causes five relevant effects from a real economy standpoint: a) it reduces disposable income through the increase of the cost of debt; b) it generally depresses the financial wealth through a change of security prices; c) it reduces consumption due to an increased incentive to save as well as to an increase in the cost of borrowing; d) it reduces investment, as it raises the cost of funding; e) it impinges negatively on exports and positively on imports, as it amplifies capital inflows, which induce an appreciation of the exchange rate.

Vice versa, a reduction of the interest rate stimulates economic activity, producing effects that are opposite to those just described.

4.2 Credit view

Empirical studies have shown that interest-rate variations are not enough to explain the width of the economic fluctuations. For this
reason, the credit view (Bernanke and Gertler, 1995) has developed a framework featuring an additional transmission mechanism of monetary policy. As this channel acknowledges the existence of frictions in the credit market, like information asymmetries, it focuses more on financial variables assigning a special importance to the role of banks. Specifically, this additional mechanism is based on the external finance premium, which is the difference between the cost of external funding and the 'opportunity cost' of using internal funds. Most of the time, the cost of obtaining funds externally is higher because of the just described risks of adverse selection and moral hazard that banks (and the other investors) have to face. Therefore, as the external finance premium goes up and down following the policy rate set by the central bank, monetary policy not only influences the general level of interest rates, but also the width of this differential, amplifying its effects on the real economy.

In particular, the credit view identifies two distinct transmission sub-channels of monetary policy: the balance-sheet channel and the bank-lending channel.

4.2.1 The balance-sheet channel
The balance-sheet channel, which is induced by possible borrowing constraints, connects the width of the external finance to the borrower’s financial soundness. Specifically, the higher the latter’s net worth, the smaller the external finance premium. This is because, as described above, there is a low probability of conflicts of interest between the high net-worth borrowers and the lenders, due to the fact that a larger portion of the loan is backed by collateral. Monetary policy, via this channel, through a change in interest rates, not only modifies the cost of credit, but also the borrower’s financial soundness, thus creating an additional propagation effect. For example, an increase in interest rates negatively affects the financial soundness of firms and their ability to borrow money, both through direct mechanisms – such as higher cost of debt at variable rate or reduction of value of collateral securities – and through indirect mechanisms – such as the reduction of household consumption levels – which in turn reduce business profits.

4.2.2 The bank-lending channel
The bank-lending channel, instead, focuses on the possible deterioration in the capacity of intermediaries to provide credit. For example, an interest-rate increase may lead savers to shift their funds from deposits to other more remunerative investments. If banks are not able to