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Research Methods

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Term Project

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Monetary Policy Transmission Mechanism in Liberia. (Examining the Bank Lending Channel)

Literature Review

A crucial channel in the Monetary policy transmission mechanism's macroeconomic variables is the credit channel. Transmission of monetary policy is a useful tool for affecting the economy (Farajnezhad, M, 2022).
Following the global financial crisis of 2007, the reevaluation of the bank lending channel gained prominence due to the banking sector's soundness (Salachas, et al, 2017). By responding more strongly to inflation expectations, monetary policy has stabilized the economy more effectively in the post-1980 period (Boivin, J., & Giannoni, M. P., 2006,). A key mechanism linking financial shocks to the real economy is the bank lending channel which claims that financial shocks propagate to the real economy via banks' credit supply channel (Jiménez, G., et al, 2020). Transmission mechanisms for monetary policy are the means by which modifications to the tools of monetary policy produce the intended policy outcomes, such as price stability and economic growth (Sichei, M. M., 2005). A country must have a strong banking sector to achieve sustainable economic growth (Onuonga-Okeri, 2014) (Mishi, S., & Tsegaye, A., 2020,). Commercial banks should note that they need to do a lot in order to ensure good lending behavior even where a good measure of macro economic stability is achieved. It therefore follows that effort should be made by commercial banks to enforce the most easily realizable policies and good credit management in every situation (Olusanya, S. et al, 2012). According to (Bernanke, B. S., & Gertler, M., 1995,) banks play an important role in overcoming informational problems in credit markets, and that as a result many borrowers are substantially bank dependent, seems well established. (Gomez, M., et al, 2021) furthering the evidence if the bank lending channel opined that their main results are consistent with a standard bank lending channel, whereby external financing for banks is costly, and positive income shocks alleviate constraints on lending. Liberia's financial system includes eight commercial banks: Liberian Bank for Development & Investment, Ecobank Liberia Limited, International Bank Liberia Limited, Global Bank Liberia Limited, First International Bank Liberia, United Bank for Africa Liberia Limited, Access Bank Liberia, and Guaranty Trust Bank Liberia (Botoe, et al, 2012).

Monetary policies can be transmitted through channels such as the exchange rate channel, interest rate channel, bank lending channel, assets pricing channel, risk-taking channel, expectations channel, balance sheet channel, and so on

(Kamara, B. S., & Zuo, D. Y., 2020,). In principle, bank credit is very important in financing the economy and as a driving force for economic growth (Utari, et al, 2012) The study of the transmission mechanism of monetary policy in the scientific literature is considered a priority area in the development of modern monetarism (Mishchenko, et al, 2021). For monetary policy to operate through a credit channel, not only must there be bank dependent borrowers, but monetary policy must also directly affect banks' willingness to lend (Morris, C. S., & Sellon, G. H., 1995). Currently, the empirical literature includes a broad set of findings from many countries, demonstrating that outcomes range between central banks around the world. To mention a few, (Abradu-Otoo, et al, 2003) investigated the transmission mechanisms of monetary policy in Ghana using the structural vector error correction analysis and found interest rates to be an effective tool in positively affecting economic activity. Employing the vector error correction methodology, (Adeoye, et al, 2017) also resulted in the conclusion that empirically, the monetary policy transmission mechanism can stimulate economic growth through interest rate only if the exchange rate is carefully managed.

Furthermore, (Naumenkova et al, 2021) who conducted similar research in Ukraine have shown that the exchange rate channel has the most significant impact on macroeconomic indicators such as real GDP growth and inflation. Following that, the interest rate channel is considered the second most effective, followed by the monetary channel in third place, and the credit channel is ranked last. However, (Kamara, B. S., & Zuo, D. Y., 2020) in an investigation of the monetary transmission mechanism in Liberia, recommended that policymakers should focus on the combined impacts of money supply and the bank lending channels on real output. Even Though Liberia lacks monetary independence (Maynard, G., 1970) in a study concluded that lack of an independent monetary system does not provide a crucial constraint on the government's ability to manage the economy in the short run or to promote real economic development in the longer run. According to (Lavina, K. G, 2012,) Liberia's economy is highly dollarized, a reflection of the environment in which financial markets function. It is among the most so in the world. Because of the exchange rate, the cost of all products and services in Liberia is determined by the US dollar, which makes up over 90% of the country's total money supply. (Gbatu, A. S., 2022,)Historically, Liberia had never had credit rating agencies since its existence dating from 1822. By that, for lenders, there is virtually no creditworthiness information available due to the lack of a comprehensive database for borrowers' credit history . (Iddrisu, et al, 2020,) found that the interest rate and the bank lending channels are operative in South Africa. For the lending channel, a percentage monetary policy restriction reduces overall inflation by 0.004% in South Africa, implying that the lending channel is more prominent in the South African context. Positive shocks to financial circumstances induce economic activity and produce a long-term expansion when the credit-to-GDP gap or growth is minimal. (Bangura, M., et al, 2021) findings lend support to the hypotheses that, bank lending channel operates in Sierra

Leone, suggesting that bank loans as an important channel through which monetary policy shocks are transmitted to the economy. (Aikman, et al, 2002) however favorable shocks to financial conditions that initially stimulate economic activity eventually cause excessive borrowing and economic recession when the credit-to-GDP gap or growth is large.

In light of examining the credit channel of monetary policy transmission, it is important to consider the banking structure. According to (Sanfilippo-Azofra, at al, 2018) the banking market structure is demonstrated to be important to the operation and can affect the effectiveness of monetary policy by enhancing or hindering the bank lending channel.

Banks' capital adequacy requirements are an important aspect of their stability. In a contemporary study, (Abiodun, et al, 2020) investigated the effect of bank-specific and macroeconomic determinants of capital adequacy in Nigeria. Their study indicated that Nigerian banks' capital adequacy ratio was positively impacted by lagged capital adequacy ratio, profitability, and loan to total assets.

Under-capitalized banks could be more susceptible to contractionary monetary policy and that such banks have less benefit from expan-sionary monetary policy, as compared to well-capitalized peers (Nguyen, T. P., & Dinh, T. T. H., 2022). Capital adequacy ratio has a positive effect on bank performance. Capital ratio that indicates a bank's ability to provide funds for business development needs and accommodate the risk of loss of funds caused by bank operations (Margono, H., et al, 2020). From a policy point of view, (Gomez -Gonzalez, et al, 202) assertions imply that models of monetary policy transmission must consider financial variables to generate precise estimates of the required policy shock to achieve their goals.

Related to the bank lending channel but different is the shadow banking channel - money market funds, hedge funds, etc.. that facilitate credit and liquidity creation outside traditional banks. According to (Xiao, 2020) The shadow banking channel is important for two reasons. First, in recent years, more than 30% of deposits in the United States are created by shadow banks.

Second, the shadow banking channel suggests that monetary policy not only affects the total amount of bank deposits but also the relative shares between the shadow and commercial banking sectors. (Woodford, M.,2008) A first question about the role of monetary aggregates in a sound strategy for monetary policy is whether one can reasonably base policy decisions on models of the transmission mechanism for monetary policy that make no reference to monetary aggregates. Many of the quantitative models now used in central banks are of this kind, and this is surely one of the reasons for the minor role now played by monetary statistics in policy deliberations at many

central banks, as the quotation above from Meyer indicates. But is there perhaps something inherently problematic about relying upon models with this feature, especially in a central bank that takes the maintenance of price stability as its primary objective? (Thornton, D, L, 2014) The analysis suggests that the efficacy of monetary policy for countercyclical stabilization policy is much less effective than is commonly believed. Nevertheless, money is essential for controlling the price level. Consequently, if policymakers conduct an overly aggressive monetary policy, they run the risk of missing their inflation objective. *In the Greenwald-Stiglitz models, monetary policy is largely mediated through the banking system. The lowering of interest rates may (or may not) be reflected in a commensurate lowering of lending rates or a commensurate increase in credit availability. Indeed, there is a new version of a liquidity trap—not caused (as Keynes suggested) by a high elasticity of the demand for money, but by a low responsiveness of bank lending, even as the central bank provides the banking sector with more liquidity* (Stiglitz, J. E., 2013). Over time, the financial sectors of most developing countries — at least those known as emerging markets — have gradually become more liberalized and open. The globalization of their finances began in the late 1970s with the syndicated bank loans that recycled petrodollars to oil-importers. Successive waves of capital inflow followed after 1990 and again after 2003. The largest outpouring of economic research was provoked not so much by the capital booms as by the subsequent capital busts: the international debt crisis of 1982–1989, the emerging market crises of 1995–2001, and perhaps the global financial crisis of 2008–2009 (Frankel, J., 2010). The choice of exchange rate regime is no more clear-cut for emerging market countries than it is for advanced countries. On the one hand, small size, openness and less developed financial markets point relatively more to fixed exchange rates. On the other hand, terms of trade volatility and the experience with speculative attacks point toward more flexible exchange rates. Some began to float after the crises of the 1990s. In place of the exchange rate as a favored nominal target for monetary policy, the conventional wisdom has anointed inflation targeting, with the CPI as the choice for price index. This chapter has departed in one place from the mission of neutrally surveying the literature: It argues that events associated with the global crisis of 2007-09 have revealed limitations to this role for the CPI (Frankel, J. A, 2010). To date, most of the papers that try to explain policy as the outcome of an optimization problem assume that agents are perfectly informed about the state of the economy. Since there is no conflict between real-time and revised concepts under perfect information, the models featured in this literature are typically estimated with *ex post* revised data. However, this type of analysis appears as vulnerable to the Orphanides critique as those based on the Taylor rule, which treats central bank behavior as a primitive rather than the product of rational optimization. By endowing agents with full information and ignoring the intrinsic uncertainty of real-time data, the researcher is viewing history through a distorted lens. Attempts to validate such a model empirically may produce biased estimates of the economic structure and, in particular, the policy objective function (Gregory, E, G., Michael,

K, S, 2015). There is a need for reforms of the financial sector, legal and regulatory framework, regulation and supervision of banks and nonbank institutions, including microfinance, as well as for interbank payments and digital finance. Additionally, processes and institutions that facilitate a sound and competitive financial market must be improved for efficient allocation of credit and insurance, collection of loans, and secure and efficient payment services based on transaction accounts, as well as the protection of depositors and safety of the financial system. These reforms would contribute to improving the quality and affordability of financial services available to consumers and business of all sizes, particularly SMEs and to low-income households and thus spur growth in Liberia (PROWD, R. S., 2018).

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