Monetary Policy and Credit Conditions: Evidence From the Composition of External Finance

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In this paper we use the relative movements in bank loans and commercial paper to provide evidence on the existence of a loan supply channel of monetary policy transmission. A first necessary condition for monetary policy to work through a lending channel is that banks must view loans and securities as imperfect substitutes, so that monetary tightening does affect the availability of bank loans. We find that tighter monetary policy leads to a shift in firms' mix of external financing -- commercial paper issuance rises while bank loans fall, suggesting that loan supply has indeed been reduced. Furthermore, these shifts in the financing mix seem to affect investment (even controlling for interest rates). This implies that bank and non-bank sources of finance are also not perfect substitutes for businesses. We also argue that this view of the transmission mechanism can help explain why interest rate spreads involving commercial paper rates have had considerable predictive power for many measures of economic activity.

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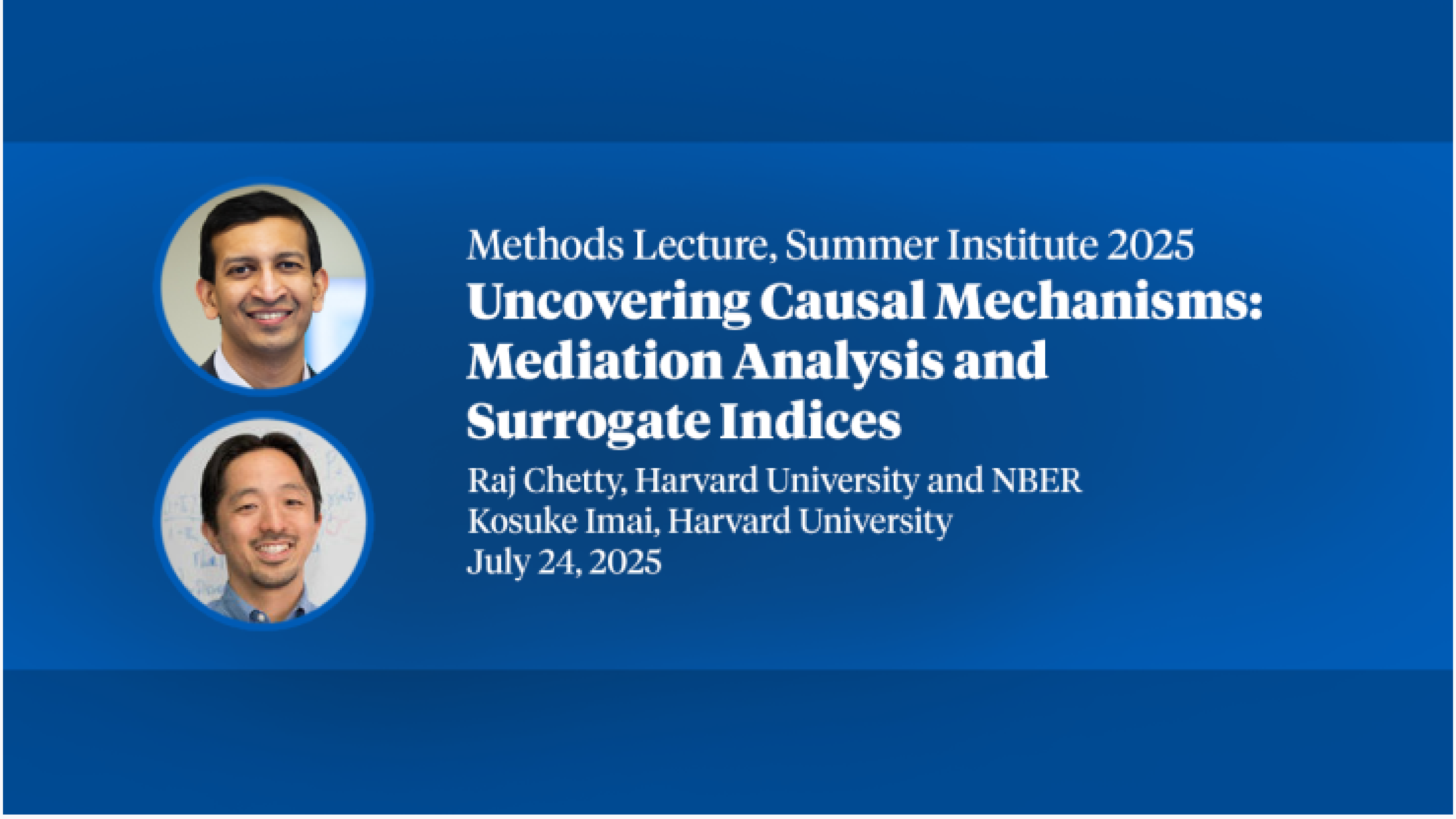

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