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The Effect of Monetary Policy on Systemic Bank Funding Stability

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About the paper (1)

- **Two relevant research questions**
  - Does monetary policy influence banks' funding structure, shifting the ratio of core (retail deposits) to non-core (wholesale/market-based) funding?
  - Do these funding shifts, in turn, raise the risk of banking panics, crises and real downturns?
- **Uses a unique data set**
  - Worldwide (180 + countries, 1950s to 2022), monthly frequency, macro-financial dataset (IFS/IMF) which implied digitalization efforts.
  - Detailed bank balance sheet positions to construct
    - non-core funding = foreign liabilities + liabilities to other Fis + securities + loans + derivatives;
    - core = retail deposits (demand + part of time deposits).
  - Bank level dataset for the USA (1867-1904 & 1976-2020)

About the paper (2)

- Monetary policy shocks
  - **Trilema (Obstfeld and Taylor, 2004; Obstfeld et al., 2005)**: Countries with open capital accounts and fixed exchange rate systems, cannot simultaneously conduct independent monetary policy.
  - Those countries must adjust their policy rates following rate changes in the base country.
  - Base country does not consider "followers" macroeconomic conditions to set its policy rates.
  - Pegging country rate variations are, unpredictable, and exogenously induced (by changes in base country)
- Instrument (Romer & Romer, 2004)
  - Exchange rate regime (1 if pegged over the previous 23 months)
  - Residualized (OLS predicted) variations in base countries' rates changes.
- Uses the instrument to model the effect of monetary policy on Banks' funding structure

About the paper (3)

- Key finding

  "… bank's retail deposit franchise value acts as a hedge against interest rate risk, protecting it against mark-to-market losses on long-term assets.

  However, the combination of contractionary monetary policy shocks and high and rising exposure to market-based funding erodes this protection and undermines bank fundamentals, opening the door for run-induced bank failure and financial disruptions".

- A 10 bps contractionary policy shock induces over 12 months:
    - Non-core / demand-deposit ratio ↑ ≈ 1.5%
    - Real non-core funding ↑ ≈ 0.8%
    - Real demand deposits ↓ ≈ 0.9%

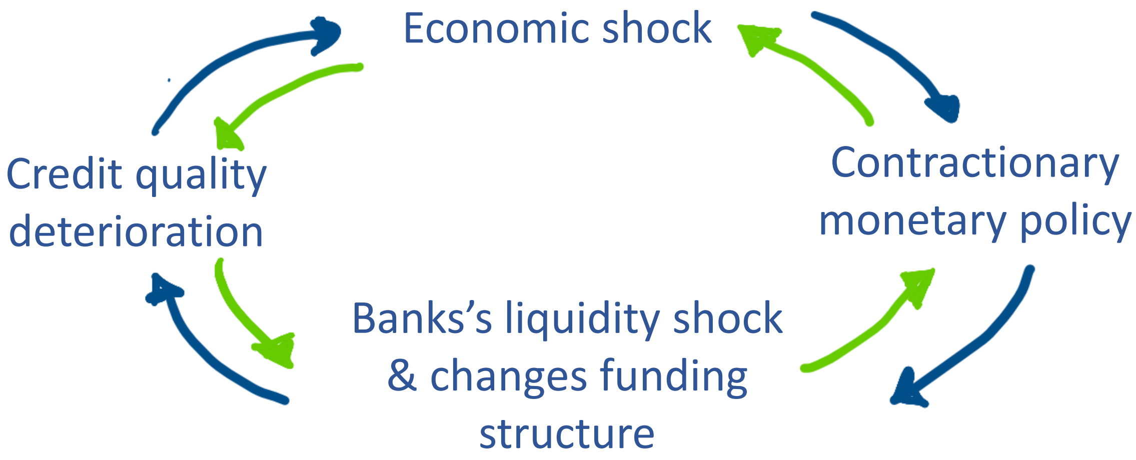
  – Effects are persistent: non-core ratio still ~3% higher after 3 years.

  – In the 3 years before a banking panic, the **non-core ratio grows by ~38%**, with falling demand deposits and rising non-core funding.

- Underlines the importance of well designed macroprudential policies limiting excessive non-core funding for banks.

Comments (1)

- About the story
  - Something is missing: Is the paper about liquidity shocks?
  - **Why we care about the ratio of core/non-core funding?** No doubt it is relevant, but relevance relies on refinancing-risks when assets are growing, or **assets (credit) quality is deteriorating**.
  - The abstract mentions something, but latter in the paper that story does not arise.
- The paper reveals an interesting transmission channel from monetary policy to financial instability.
  - However, it could be a chicken/egg problem:



Comments (2)

- Asset quality (deteriorating balance sheet)
  - Seems the paper is silent about it
  - Many financial crisis were detonated/exacerbated by high ratios of non-performing loans.
  - It is a critical factor –try to find a proxy (banks' asset composition, abnormal growth in consumer loans)
- Control for economic activity
  - Where does monetary shocks come from? Is this important for your story?
  - If you cannot control by it, provide a better reason than "do not have data".
  - What about country's capital outflow/inflow; import/exports;
  - Think about available proxies, if possible (change in unemployment rates, …)

Comments (3)

- There is too much heterogeneity across countries
- Monetary policy transmission mechanism
  - No all countries use **interest rate channel**
  - It will be interesting to analyze subsamples, or to remove countries not using the interest rate channel.
  - For example, from 1995 to ~2008, Mexico used an instrument named “the corto”, limiting available overnight funds for banks, to let the market set interest rates
- What about other mechanisms? asset prices, open market operations, exchange rate or bank lending channels.
  - Does other mechanisms also influence bank’s funding structure?

Comments (4)

- The probability of financial disruption increases with
  - Tightening monetary policy
  - Increase non-core funding ratio
- Relations could not be linear
  - Which level of non-core funding is safe?
  - Small rate changes have no effect?
  - Maybe implement quantile regressions
  - Many countries with no rate changes
- The role of capital ratios
  - Compare pre- and post-Basel-II/ Basel III subsamples to test if the monetary-policy → non-core → crisis link has weakened.
  - Interact monetary shocks with proxies for capital and liquidity (capital-to-asset ratios, liquid-asset ratios) to see if well-capitalized / liquid systems are less vulnerable.

Comments (5)

- **Some …other robustness checks**
  - Although the monthly peg-based IV is strong, some concerns remain: measurement error in exchange-rate regimes, de-facto floats, or policy coordination among anchor and peggers.
  - Robustness:
    - Re-estimate using only *hard pegs* (currency boards, dollarization).
    - Drop periods with capital controls (low Chinn–Ito index) to tighten the trilemma logic.
    - Use alternative base-country sets (e.g., U.S. only vs broader anchors) to show stability.

Comments (6)

- About the model (extends Drechsler et al. 2017)
  - Deposits channel for monetary policy.
  - Some questions worth to clarify:
    - What determines the elasticity ρ (substitution between deposits and cash)
    - Deposits decrease, but where does core deposits go? More spending, repaying credits because interest rates increased? Or depositors prefer higher rate investments as banks does not match policy rate increases?
    - The cycle of non-core funding is not very clear: non-core funding increases if policy rates increases, but what triggers sudden withdrawal? It is a subsequent unexpected monetary shock?
- You have test everything! But potential extensions
  - *Information-based runs* where adverse information about asset quality triggers wholesale withdrawals.
  - Is there a threshold in non-core share above which equilibria switch (this could be tested in the data).

Minor comments

- A country is a pegger if $q_{i,t} \geq 1$?
  - You cumulate monthly observations across the previous 23 months, so the result will be > 1.

- How do you define bank panics? What is the measure?
- FX vs domestic-currency liabilities –can you consider this additional test?
- For publication try to shorten the paper and to select core tests.

Thank you

Nicely accomplished research

Great paper!