Comments on Bank Heterogeneity and monetary policy transmission by Brissimis and Delis

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Monetary Policy Transmission Mechanism
in the Euro Area: the first 10 years
European Central Bank, September 2009

Heterogeneity in the transmission of monetary policy

From countries to banks

- Usually papers analyze the cross country heterogeneity of the monetary policy transmission. This paper proposes to move to bank level data but not just classified by size in discrete terms
- The paper reviews theories on the relationship between aggregate lending, risk taking and profitability with monetary policy.
- The authors find the perfect argument. For instance when they analyze the relationship between monetary policy and credit risk: "Some results say positive; some others say negative. Both are correct. This is exactly what we find: for some bank the relationship is positive and for others is negative"
- ... and if there is no effect on average, "positives and negatives cancel out"

Going back to countries

- Since many characteristics of banks are probably country specific I wonder if it is possible to go from individual banks to aggregate banks by country.
- Can we say something about the aggregate effect by size of the bank?
- Separate descriptive statistics by US and Euro area but the reader would like to see the correlations among the variables that reflect liquidity, capitalization and market power (and probably also bank size in absolute terms) to understand better the results.
- More flexible is not always equivalent to better. When we impose constrains that are true the estimation becomes more efficient. It is true that potentially the misspecification of market boundaries can lead to bias but we know that many banks (and saving and loans) only compete in restricted geographical areas.

Proxying theoretical concepts

- Monetary policy: Federal Funds rate and ECB policy rate. There should be a comparison with other measures of the stance of monetary policy (for instance Bernanke and Mihov 1998).
- Liquidity: liquid assets to total assets. Need more explanation of what you mean by liquid assets: are FED funds sold included among the liquid assets?
- Market power is firm specific not market specific. I have problems understanding this.

On the time dimension

- On the frequency of the observations: lending equations are robust to the use of annual data (Gambacorta 2005) but, how about bank risk and bank profitability equations? When there are lots of changes in the intervention rate in one year it will not be the same to use the end of the year rate, the average of the initial rate.
- Data run from 1994 up to 2007: regime change and structural break.

On the econometric specification

- Why local GMM? There are other methods that allow for the estimation of heterogeneity. Why not a Bayesian approach? Priors versus bandwidth
- Where are the orthogonality conditions coming from? And the conditionality? Couldn't Z be a vector of variables?

$$\begin{aligned} E(g(\theta, W)|Z &= z) = 0 \\ E(g(q_0(X), W)|Z &= z) = 0 \\ E(g(q_0(Z), W)|Z &= z) = 0 \end{aligned}$$

- Why running the equations in differences? In particular for the ratio bad loans over total loans

$$\Delta r_{it} = \beta_1(z_{it})\Delta r_{it-1} + \beta_2(z_{it})\Delta M_{it} + u_{it}$$

More on the econometric specification

- "Bank profits persist but they will eventually return to their normal (average) **level**".
- The variables that play the role of Z in the LGMM should be exogenous. How likely is that liquidity is exogenous to the errors in the loan, bank risk and bank profitability equations? How about market power?
- Wouldn't it be advisable to have geographic controls?

Interpretation of the findings

- Using the average of the estimated coefficient on the interest rate variables the authors conclude that "the bank lending channel is less operative in the US than in the Euro area". But this is a statement on aggregate variables based on unweighted averages across banks.
- It would be interesting not only to discuss the distribution of the parameters but also the size of them (or at least the average size) to determine its economic significance. "An increase in 100 basis points in the Federal Fund rate will, on average, decrease loans a 6% in the steady state." Quantitative implications for banks with different degrees of liquidity, capitalization and market power (and associated parameter of the lag dependent variable).

More on the interpretation of the findings

- Imagine, hypothetically, that you were in a Central Bank, what would be your advise to policy makers to have the largest impact of monetary policy in the economy? How about the special liquidity facility mechanisms? Should they target types of assets or types of banks?