Comment on Financial Intermediation and Monetary Policy in a General Equilibrium Banking Model

Stephen D. Williamson


Stable URL:
http://links.jstor.org/sici?sici=0022-2879%28199511%2927%3A4%3C1319%3ACOFIAM%3E2.0.CO%3B2-%23

*Journal of Money, Credit and Banking* is currently published by Ohio State University Press.

Your use of the JSTOR archive indicates your acceptance of JSTOR’s Terms and Conditions of Use, available at http://www.jstor.org/about/terms.html. JSTOR’s Terms and Conditions of Use provides, in part, that unless you have obtained prior permission, you may not download an entire issue of a journal or multiple copies of articles, and you may use content in the JSTOR archive only for your personal, non-commercial use.

Please contact the publisher regarding any further use of this work. Publisher contact information can be obtained at http://www.jstor.org/journals/ohio.press.html.

Each copy of any part of a JSTOR transmission must contain the same copyright notice that appears on the screen or printed page of such transmission.

JSTOR is an independent not-for-profit organization dedicated to creating and preserving a digital archive of scholarly journals. For more information regarding JSTOR, please contact jstor-info@umich.edu.
LITERATURE CITED


*Comment on Financial Intermediation and Monetary Policy in a General Equilibrium Banking Model,*

*by Stephen D. Williamson*

The objective of this paper is to analyze the effects of monetary policy in a model with an explicit financial intermediation sector. The model consists of a costly state verification intermediary structure embedded in an overlapping generations model with borrowing and lending. Households hold bank deposits and equity shares in banks, while banks in turn make loans to producers, and hold nominal government bonds and required reserves. Thus, money is held here only to satisfy banks’ reserve requirements, and the binding reserve requirement will imply rate-of-return dominance of money by nominal government bonds. There are aggregate technology shocks here which, given the nature of loan and deposit insurance, assures that depositors receive a noncontingent return on deposits, and the government finances the deposit insurance system by issuing money and bonds.

The paper focuses on a result whereby some class of monetary policy experiments is neutral. However, if verification costs decrease as the price level increases (interpreted as imperfect indexation), then a money injection will cause an increase in bank lending, since the real costs of intermediation fall.

I like the general idea of this paper. In particular, it seems to me potentially productive to explore the implications for monetary policy of different regulatory environments. It is hard to imagine how one would approach this problem in a serious way except, as is done here, by constructing an economic environment where explicit account can be taken of the roles played by financial intermediaries and money. Also, the approach permits a careful treatment of such features as deposit insurance and reserve requirements. In spite of this and Pam’s much-evident techni-

*Stephen D. Williamson is professor of economics at the University of Iowa.*

*Journal of Money, Credit, and Banking*, Vol. 27, No. 4 (November 1995, Part 2)

Copyright 1995 by The Federal Reserve Bank of Cleveland
cal abilities, I think the paper has two fundamental weaknesses. The first is that the model is far too complicated for the job it appears to have been intended to do. The second is that most of the paper is addressed to model construction, and there are few results.

Several modeling features are superfluous here, and the root of the problem is in the form that intermediary contracts take. In this environment, it is optimal for loan payments and returns on deposits to be contingent on aggregate shocks. Pam asserts that loan and deposit contracts are state contingent, but her results are inconsistent with that assertion. With intermediary contracts written contingent on aggregate shocks, perfectly diversified intermediaries would never fail. Matters would then be much simpler (though in some sense less interesting), as there would be no need to model bank equity and no role for deposit insurance.

In terms of the response of this type of model to some standard monetary policy experiments, much is known, in particular from the work of Neil Wallace and his coauthors and students. The model will behave qualitatively like a standard overlapping generations model with borrowing and lending and a reserve requirement. In a model like this, most types of changes in monetary policy rules yield nonneutrality. In particular, given what is permitted in this environment, changes in the time path of government bonds (implying changes in the path of the money stock, from the government budget constraint) will have real effects. Typically, policies that raise the ratio of money to bonds in the long run (interpreted as an open market purchase) tend to increase the quantity of lending, as government bonds tend to crowd out lending, and a higher real quantity of money will support more lending due to the binding reserve requirement. The class of policy changes that yields neutrality, as in this paper, is very restricted. The modification that is made to the model to obtain non-neutrality, that is allowing verification costs to vary with the price level, appears quite odd. There is no sound reason for the information technology here to be directly affected by the price level.

This model is equipped to examine some interesting questions. For example, since there is an explicit treatment of the intermediary structure and contractual arrangements, it is straightforward to explore how an intervention such as a loan guarantee affects the transmission of monetary policy. Loan guarantees, and other interventions that affect the form of contracts, alter the efficiency of the intermediary sector and, as such, they will alter (at least quantitatively) the mechanism by which changes in policy are transmitted. One could also modify the environment so that deposit insurance played some useful role (perhaps in the context of other regulations), and study how that type of intervention matters for the response to monetary injections. While Pam has done much in the way of useful modeling here, there are many important and interesting issues left to explore in this context.