The Effect of Monetary Policy on Systemic Bank Funding Stability

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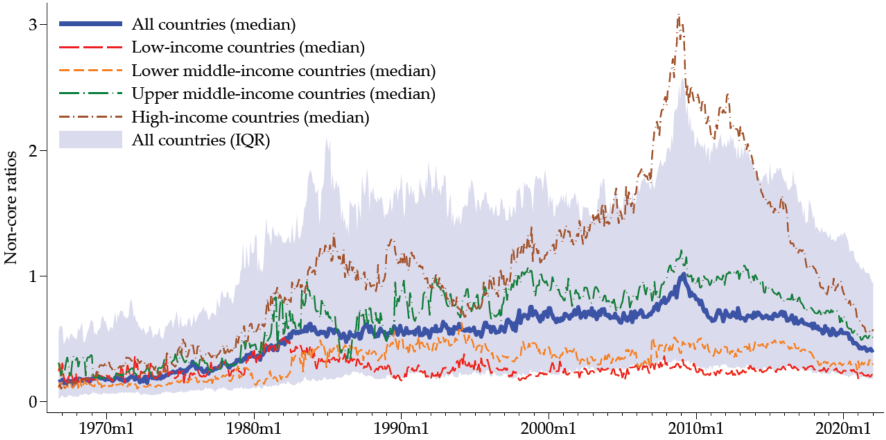
Main Finding

Contractionary monetary policy causes:

- outflow of retail stable deposits of the banking sector.
- an increase on the reliance of non-core funding.
- impressive data set of over 150 countries between 1950 and 2020

Figure 1: *Non-core ratios over time.*



Non-core funding ratio = (sum of foreign liabilities, liabilities to other financials, securities, loans, derivatives) / demand deposits

Higher Non-Core Funding Ratio Increases Financial Instability

Substitution of demand deposits to non-core funding (about one-for-one):

- can predict individual bank failures.
- increases the probability of a subsequent banking panic.

Contribution:

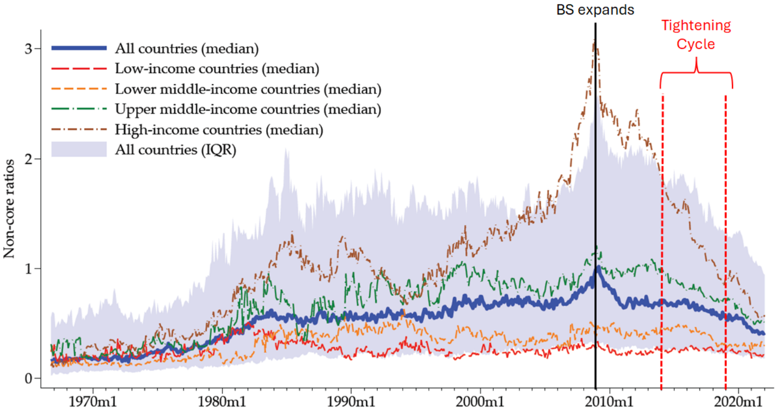
- data set
- meticulous econometric approach
- numerous robustness checks (appendix is the same length of the paper!)

Comment 1: How does the central bank's balance sheet play a role?

- Post-GFC, Quantitative Easing was used by central banks in many advanced economies as a monetary policy tool to flood their economy with reserves.
- How would a large central bank balance sheet affect the non-core funding ratio?

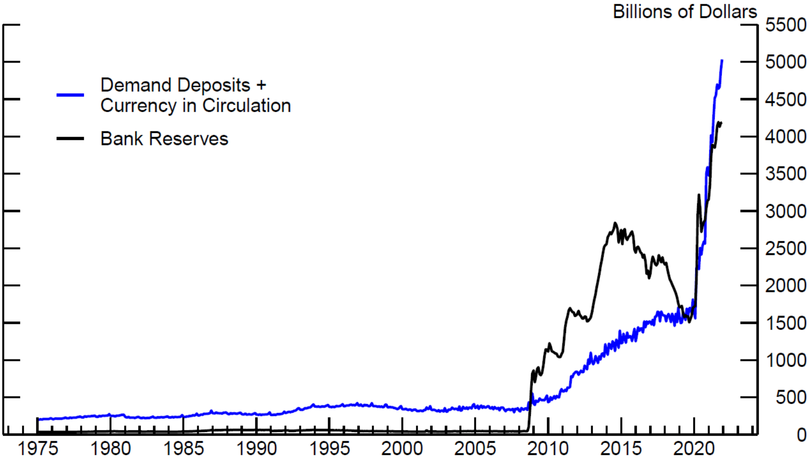
Monetary Policy Frameworks Changed Post-GFC

Figure 1: *Non-core ratios over time.*



- Despite a tightening cycle post-GFC, decline in non-core ratio.
- With advanced economies moving to *ample reserves frameworks*, there are a lot of demand deposits.

The Rise of Deposits Post-GFC



Note: Month−End Values.
Source: Federal Reserve Economic Data.

Comment 2: Does an Ample Reserves Framework lower the Financial Instability of the non-core funding?

Banks (Scarce Reserves)	
Loans	Bank deposits $\Downarrow$
Reserves	Non-core funding $\Uparrow$

Banks (Ample Reserves)	
Loans $\downarrow$	Bank deposits $\Downarrow$
Reserves	Non-core funding $\Uparrow$

- Banks hoard reserves because of LCR.
- For every \$1 reserve created, only 92 cents extended of loans (Diamond, Jiang, Ma, JFE 2024).

Conclusion

- Fascinating paper that shows that contractionary monetary policy (rising interest rates) causes banks to substitute from stable demand deposits to less stable funding.
- Robust econometrics. Impressive data effort.
- Curious how large central bank balance sheets play a role and whether ample reserve frameworks help with potential funding vulnerabilities.