The “Credit-Cost Channel“ of Monetary Policy. A Theoretical Assessment

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Overview

The paper develops a theoretical model, which links the credit and cost channels of monetary policy. The model assumes that when firms rely on bank loans aggregate supply is sensitive to bank interest rates, which in turn depend on the official interest rate controlled by the central bank. The author shows that the theoretical model developed in the paper is able to reproduce major empirical regularities, in particular the negative correlation between the policy rate and real wages. Besides providing a new framework, which does not rely on additional nominal goods and labour market imperfections to confirm empirical observations, several insights and policy implications are obtained. These include an emphasis on the banking sector as a link between monetary policy and the supply side as well as the importance of incorporating credit-market indicators into the signals to which central banks react.

By jointly considering the credit and cost channels of monetary policy, the paper provides a useful extension of the existing literature and some interesting policy recommendations are obtained. However, the paper would benefit from a more careful presentation of the model and its results. In the following, I first outline some of my major concerns followed by some minor remarks.

Main Comments

- The Literature Review: The review of the literature on DSGE models is incomplete and in particular does not take into account the fact that several papers have incorporated financial frictions into DSGE models. These include Bernanke, Gertler and Gilchrist (1999), Cespedes et al (2004) and Choi and Cook (2004) who have used the financial accelerator to incorporate financial frictions into a DSGE framework. Their approach was subsequently extended to interactions between housing prices, consumption and monetary policy by Iacovello (2005). I also do not agree with the statement in the introduction that DSGE models generally fail to reproduce the negative effects of policy shocks on real wages (see for example, Ratto et al, forthcoming Economic Modelling).

- The Model: The exposition of the model should be a lot clearer. Figure 1 regarding the timing of transactions does not really yield additional insights. It is also not clear to me which assumptions are standard in the literature and which are introduced by the author to derive the main results of the paper. A discussion of how important some of the assumptions are in obtaining the main conclusions would be useful. In particular, the assumptions that the net revenue from defaulting is zero and that the expected sale price in the next period equals the actual price index might be crucial in driving the results of the paper.
- The Results: The author states that the paper aims to reproduce 'the whole set of phenomena that are currently regarded as the stylized facts of monetary policy'. However, whilst the paper does address the negative relationship between policy rates and real wages, the paper does not theoretically assess the effects of policy rate changes on profits (this might be due to the fact that the model implicitly assumes that firms make zero profits in expected terms as firms are assumed to be homogenous an the idiosyncratic shocks sum to zero).

Minor Comments

- Rewrite introduction and put main contribution of paper before the literature review (having to read three pages of a literature review without learning what this paper is all about can be somewhat tiring)
- List of stylized facts in Introduction and Section 3 differs.
- Presentation of equations: line spacing between text and equations would be useful
- There are numerous typos and spelling mistakes in the paper (e.g. page 8, line 2, page 14, line 4…)