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Master‘s thesis
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The transmission of monetary policy and the bank lending channel in Switzerland

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Executive Summary

The transmission of monetary policy is of significant interest to economists and monetary policy authorities. To be able to conduct monetary policy effectively and accurately, it is necessary to analyze the process of monetary policy transmission and the effect it has on real economic variables.

The bank lending channel represents one way through which monetary policy can influence real economy. It is based on the credit view, which focus on credit market imperfections to explain the effect of monetary policy on the economy. The mode of operation of the bank lending channel can be explained by describing the impact of a monetary policy shock. For example, a monetary contraction leads to reduced reserves of banks. This deterioration of the balance sheet has a consequence for banks, as they are obliged to hold a certain amount of deposits as reserves. In order to match the reserve requirement, banks have to adjust their balance sheet. They have the possibility to compensate for the drop in reserves by financing themselves through other non-deposit sources of funds or to shrink the asset side by selling liquid assets or cutting the loan portfolio. In the latter case, a reduced lending volume is followed by a drop in investment spending in the economy and consequently leads to less aggregate output. This effect on the real economy explains the function of the bank lending channel as a transmission mechanism of monetary policy.

This thesis attempts to find evidence concerning the existence of the bank lending channel in Switzerland for the period from 2001 to 2014. This is primarily achieved by testing if the lending activity is a function of the liquidity level of banks and if this dependence correlates with Switzerland's monetary policy stance.

The size of the banks is addressed as well by observing the banks' different size categories to examine whether smaller banks are more strongly affected by monetary policy as they find it more difficult to turn to other sources of funds to compensate the drop in bank reserves after the monetary shock. As a result, their reaction to the monetary policy shock is expected to be stronger and they consequently should adjust the loan portfolio to a greater extent as larger banks. Therefore, the bank lending channel is expected to be strengthened by smaller banks.

The results in this thesis demonstrate that there is evidence of the existence of the bank lending channel in Switzerland during periods from 2001 to 2014. The results imply that the banks' lending activity is affected by their liquidity level and that this dependence varies with the monetary policy stance in Switzerland. This thesis has not detected evidence to support the supposition that smaller banks strengthen the bank lending channel in Switzerland.