Bank Lending Channel. The bank lending channel is based on the analysis in Chapter 8, which demonstrated that banks play a special role in the financial system because they are especially well suited to solve asymmetric information problems in credit markets. Because of banks' special role, certain borrowers will not have access to the credit markets unless they borrow from banks. As long as there is no perfect substitutability of retail bank deposits with other sources of funds, the bank lending channel of monetary transmission operates as follows. Expansionary monetary policy, which increases bank reserves and bank deposits, increases the quantity of bank loans available. Because many borrowers are dependent on bank loans to finance their activities, this increase in loans will cause investment (and possibly consumer) spending to rise. Schematically, the monetary policy effect is

$$\begin{aligned}&\text{Expansionary monetary policy} \Rightarrow \text{bank deposits}\uparrow\\&\quad\Rightarrow \text{bank loans}\uparrow \Rightarrow I\uparrow \Rightarrow Y\uparrow\end{aligned} \tag{6}$$

An important implication of the credit view is that monetary policy will have a greater effect on expenditure by smaller firms, which are more dependent on bank loans, than

[16] See Franco Modigliani, "Monetary Policy and Consumption," in *Consumer Spending and Money Policy: The Linkages* (Boston: Federal Reserve Bank, 1971), pp. 9–84.

[17] Surveys of the credit view can be found in Ben Bernanke, "Credit in the Macroeconomy," Federal Reserve Bank of New York *Quarterly Review* (Spring 1993): 50–70; Ben Bernanke and Mark Gertler, "Inside the Black Box: The Credit Channel of Monetary Policy Transmission," *Journal of Economic Perspectives* 9 (Fall 1995): 27–48; Stephen G. Cecchetti, "Distinguishing Theories of the Monetary Transmission Mechanism," Federal Reserve Bank of St. Louis *Review* 77 (May–June 1995): 83–97; and R. Glenn Hubbard, "Is There a 'Credit Channel' for Monetary Policy?" Federal Reserve Bank of St. Louis *Review* 77 (May–June 1995): 63–74.