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## Time-varying volatility, financial intermediation and monetary policy

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# Non-technical summary

## Research question

Following the 2007-08 financial crisis the Federal Reserve slashed interest rates to near zero, launched large-scale asset purchase programs and used forward guidance to influence economic activity. In spite of this massive monetary intervention, the recovery of the US economy has been sluggish. Against this backdrop, there has been renewed interest in the question of whether monetary policy is less effective in times of high volatility.

## Contribution

In this paper we argue that the effectiveness of monetary policy depends on the liability structure of the financial system. Financial intermediaries actively manage their balance sheets in such a way that leverage is high in periods of low volatility and favorable funding conditions, and it is low in times of high volatility. The procyclicality of leverage is a key feature of the US financial system, and in this paper we show that it has important implications for the monetary transmission mechanism. Low volatility periods induce financial intermediaries to lever up, which makes their balance sheets more sensitive to aggregate shocks and the financial accelerator more effective. On the contrary, in high volatility periods, banks decrease leverage, which renders the financial accelerator less effective. This in turn decreases the ability of monetary policy to improve funding conditions and credit supply, and thereby to stimulate the economy.

## Results

We study the differential effects of monetary policy in low and high volatility regimes, using a regime-switching threshold vector autoregression. Exogenous policy changes are identified by adapting an external instruments approach to this non-linear model. Our results suggest that expansionary monetary policy shocks lead to a significant reduction in credit costs and to a boom in output and investment. However, the effects of this monetary stimulus are significantly weaker in the regime characterized by high volatility. We provide a new explanation for the non-linearity observed in the data, which links the effectiveness of monetary policy to the procyclicality of leverage. Our empirical results can be reconciled with a standard New Keynesian general equilibrium model with financial frictions. In this framework banks adjust their leverage endogenously depending on the volatility of aggregate shocks, and their liability structure is central to the transmission of monetary policy. In low volatility periods leverage is high due to the perception of low risk. High bank leverage makes bank balance sheets sensitive to changes in asset values, which amplifies the effects of monetary policy shocks. Highly leveraged banks experience a strong increase in their net worth after a monetary stimulus, which enables them to borrow more and channel more funds to the real economy. In high volatility periods leverage is low. Therefore, this financial accelerator mechanism is dampened.

# Nichttechnische Zusammenfassung

## Fragestellung

Nach der Finanzkrise von 2008 senkte die US-Notenbank die Leitzinsen auf nahezu null, legte umfangreiche Programme zum Ankauf von Vermögenswerten auf und nutzte Forward Guidance, um Einfluss auf die Konjunktur zu nehmen. Trotz dieser geldpolitischen Intervention verläuft die Erholung der US Wirtschaft nur schleppend. Vor diesem Hintergrund ist die Frage wieder stärker in den Fokus gerückt, ob die Geldpolitik in Zeiten hoher Volatilität weniger wirksam ist.

## Beitrag

Wir argumentieren, dass die Wirksamkeit der Geldpolitik von der Passivstruktur des Finanzsystems abhängt. Banken steuern ihre Bilanzen so, dass in Zeiten niedriger Volatilität ein hoher Verschuldungsgrad und in Zeiten hoher Volatilität ein niedriger Verschuldungsgrad erreicht wird. Wir zeigen, dass die Prozyklizität der Fremdfinanzierung Implikationen für den geldpolitischen Transmissionsmechanismus hat. In Zeiten niedriger Volatilität tendieren Banken dazu, ihren Verschuldungsgrad anzuheben, was die Empfindlichkeit ihrer Bilanzen gegenüber makroökonomischen Schocks erhöht und die Wirksamkeit des *financial accelerator* steigert. In Zeiten hoher Volatilität reduzieren Banken ihre Verschuldung, sodass die Wirksamkeit des *financial accelerator* abnimmt. Dies beeinträchtigt die Fähigkeit der Geldpolitik, die Finanzierungsbedingungen und die Kreditvergabe zu verbessern und somit die Konjunktur zu beleben.

## Ergebnisse

Wir untersuchen die Effekte der Geldpolitik bei niedriger und hoher Volatilität unter Verwendung eines schwellenwertbasierten *regime-switching* Vektorautoregressionsmodells. Unsere Ergebnisse zeigen, dass expansive geldpolitische Schocks zu einer Verringerung der Kreditkosten und zu einem Produktions- und Investitionsboom führen. Die Wirkung geldpolitischer Schocks ist jedoch in Zeiten hoher Volatilität bedeutend geringer. Für die beobachtete Nichtlinearität bieten wir eine neue Erklärung, die eine Verbindung zwischen der Wirksamkeit der Geldpolitik und der Prozyklizität des Verschuldungsgrads des Bankensektors herstellt. Unsere empirischen Ergebnisse können mit einem DSGE Model mit Finanzmarktfriktionen erklärt werden. In dem Model steuern Banken ihren Verschuldungsgrad endogen in Abhängigkeit von der Volatilität makroökonomischer Schocks. In Zeiten niedriger Volatilität ist der Verschuldungsgrad hoch, da das makroökonomische Risiko als gering eingeschätzt wird. Ein hoher Verschuldungsgrad der Banken lässt die Bankbilanz empfindlich auf Veränderungen der Vermögenspreise reagieren, was die Wirkung geldpolitischer Schocks verstärkt. Banken mit hohem Verschuldungsgrad verzeichnen einen starken Anstieg ihres Reinvermögens nach einem geldpolitischen Schock, und können deshalb mehr Fremdkapital aufnehmen und der Realwirtschaft mehr Mittel zuführen. In Zeiten hoher Volatilität ist der Verschuldungsgrad niedrig, sodass der Effekt dieses *financial accelerator* gedämpft wird.

# Time-varying volatility, financial intermediation and monetary policy\*

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## Abstract

We document that expansionary monetary policy shocks are less effective at stimulating output and investment in periods of high volatility compared to periods of low volatility, using a regime-switching vector autoregression. The lower effectiveness of monetary policy can be linked to weaker responses of credit costs, suggesting a financial accelerator mechanism that is weaker in high volatility periods. To rationalize our robust empirical results, we use a macroeconomic model in which banks endogenously choose their capital structure. In the model, the leverage choice of banks depends on the volatility of aggregate shocks. In low volatility periods, banks lever up, which makes their balance sheets more sensitive to aggregate shocks and the financial accelerator more effective. On the contrary, in high volatility periods banks decrease leverage, which renders the financial accelerator less effective; this in turn decreases the ability of monetary policy to improve funding conditions and credit supply, and thereby to stimulate the economy.

**JEL classification:** C32, E44, E52

**Keywords:** Monetary policy, credit spread, non-linearity, intermediary leverage, financial accelerator

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# 1 Introduction

Following the 2007-08 financial crisis the Federal Reserve slashed interest rates to near zero, launched large-scale asset purchase programs and used forward guidance to influence economic activity. In spite of this massive monetary intervention, the recovery of the US economy has been sluggish. Against this backdrop, there has been renewed interest in the question of whether monetary policy is less effective in times of high volatility. In this paper we argue that the effectiveness of monetary policy depends on the liability structure of the financial system. Low volatility periods induce financial intermediaries to lever up, which makes their balance sheets more sensitive to aggregate shocks and the financial accelerator more effective. On the contrary, in high volatility periods, banks decrease leverage, which renders the financial accelerator less effective. This in turn decreases the ability of monetary policy to improve funding conditions and credit supply, and thereby to stimulate the economy.

We begin by estimating a structural threshold vector autoregression (TVAR) for the US economy over the period from 1969 to 2007. The TVAR distinguishes between two recurring regimes of “low” and “high” financial market volatility, which enables us to trace the regime-specific effects of expansionary monetary policy shocks. We identify exogenous policy changes by adapting the external instruments approach proposed by [Stock and Watson \(2012\)](#) and [Mertens and Ravn \(2013\)](#) to our non-linear model. As an external instrument for the underlying structural disturbances we use the monetary policy shock series constructed by [Romer and Romer \(2004\)](#) and [Gertler and Karadi \(2015\)](#).

We find that monetary policy is more effective in stimulating economic activity in periods of low volatility compared to high volatility periods. In the low volatility regime, an expansionary monetary policy shock generates an immediate reduction in the cost of credit for non-financial firms, reflected by a decline in corporate bond spreads. This reduction is accompanied by an increase in investment on impact and by a boom in output after some delay. In contrast, a same-sized expansionary monetary policy shock produces a much less dramatic reduction in the cost of credit in the high volatility regime, which accounts for an increase in investment and output that is substantially weaker, and that builds up only gradually over time.

To delve deeper into the channels underlying the higher effectiveness of monetary policy in low volatility periods, we investigate the regime-specific impact of monetary policy shocks on indicators of credit frictions. We show that banks’ willingness to lend increases more strongly, and the excess bond premium constructed by [Gilchrist and Zakrajsek \(2012\)](#) as well as the leverage ratio of security broker-dealers drop more strongly in the low volatility regime following a surprise monetary expansion. Monetary policy is thus more effective because of its stronger ability to reduce credit frictions and to improve funding conditions in periods of low financial market volatility.

In the second part of the paper, we show that our empirical results can be reconciled with a New Keynesian extension of the structural model proposed by [Gertler et al. \(2012\)](#). A key feature of this framework is that financial intermediaries issue both equity and short-term debt. Hence, they choose leverage endogenously, depending on whether the economy resides in a low volatility or a high volatility state, which in turn depends on the underlying fundamental shocks. A central implication of the model is a negative relation between financial intermediary leverage and volatility: leverage is relatively higher in periods of low volatility and lax funding constraints (see also [Adrian et al. 2015](#)). This relationship constitutes a salient feature of the US economy present in our data, as also documented by [Adrian and Shin \(2014\)](#).

The procyclicality of financial intermediary leverage has important implications for the regime-specific propagation of monetary policy shocks. Consistent with the results from the TVAR, the DSGE model predicts that monetary policy is more effective in low volatility regimes: expansionary monetary policy shocks generate a larger reduction in the cost of credit and a stronger output and investment boom in periods of low volatility compared to high volatility periods.

The model puts the liability structure of banks at the center-stage of the transmission mechanism. Banks increase their leverage in times of low volatility due to the perception of low risk. High leverage makes their balance sheets sensitive to monetary policy induced changes in asset prices. After an expansionary monetary policy shock, highly levered banks experience a strong increase in their net worth, and leverage drops. The improved balance sheet strength allows banks to borrow more and channel more funds into the economy. The credit spread drops leading to an investment and output boom. In contrast, banks hold more equity in times of high volatility because equity shields their net worth from asset price changes. Hence, expansionary monetary policy shocks have relatively less impact on banks' net worth, and the financial accelerator mechanism embedded in the model is weaker during periods of high volatility. Thus, the portfolio choice of banks, which generates procyclical leverage, can account for the state-dependent effects of monetary policy.

Our paper is related to the literature emphasizing the importance of financial intermediaries in the propagation of monetary policy shocks (e.g. [Bernanke 1983](#), [Bernanke and Blinder 1988](#), [Kashyap and Stein 1994](#)). Most importantly, using detailed bank-level data, [Kashyap and Stein \(2000\)](#) and [Kishan and Opiela \(2000\)](#) document the relevance of banks' balance sheet strength in the transmission of monetary policy to bank credit supply. They show that banks with weaker balance sheets, e.g., less liquid and more levered banks, react more strongly to monetary policy shocks. We offer a novel perspective on this issue along the time-series dimension, by showing that monetary policy effectiveness varies over time with the pro-cyclicality of bank leverage.

Our paper is also related to a growing literature studying the potentially state-dependent effects of monetary policy. According to the “wait-and-see” hypothesis pro-

posed by [Bloom \(2009\)](#) and [Bloom et al. \(2012\)](#), heightened volatility induces firms to delay investment and hiring decisions until the uncertainty associated with high volatility is resolved. The “wait-and-see” behavior results in a more modest response of economic activity to a monetary policy expansion in times of high volatility. [Vavra \(2014\)](#) shows that US consumer prices are more flexible in times of high volatility, and builds an SS pricing model to rationalize this finding. One implication of this result is that higher price flexibility reduces the effectiveness of monetary policy in influencing economic activity in periods of high volatility.<sup>1</sup> In a recent paper, [Berger and Vavra \(2015\)](#) use micro data to show that, while adjustment in durable holdings is always infrequent, households are particularly unlikely to adjust their durable holdings during recessions. Using a heterogeneous agent model with infrequent adjustment in durable consumption, they illustrate a strong state-dependence in impulse-responses of durable spending to aggregate shocks due to lumpiness in durable adjustment.

There has also been a proliferation in empirical work documenting asymmetries in the monetary policy transmission mechanism. [Aastveit et al. \(2013\)](#), [Pellegrino \(2014\)](#), and [Caggiano et al. \(2014b\)](#) estimate small-scale non-linear VARs and find that monetary policy shocks affect economic activity less in times of heightened volatility. However, they remain silent on the underlying economic mechanism driving the state-dependence in monetary policy transmission. [Tenreyro and Thwaites \(forthcoming\)](#) estimate state-dependent local projection regressions and find that in high volatility periods monetary policy tends to be less effective at influencing economic activity. They also provide evidence that the state-dependence is mostly apparent in durable consumption and business and household investment.

Relative to the existing literature, our approach offers two distinct contributions. First, our empirical results show that the effect of monetary policy shocks on the cost of credit is highly state dependent. Furthermore, we show that indicators of funding conditions and credit constraints react less to monetary stimuli during periods of high volatility. Our evidence thus suggests that in times of high volatility financial accelerator effects are smaller, providing a new channel that gives rise to state-dependent monetary policy effectiveness. Second, we show that an off-the-shelf model in which banks endogenously choose their capital structure can account for our results: in high volatility periods, banks endogenously choose to hold more capital, which weakens monetary policy transmission through banks’ balance sheets.

The remainder of the paper is organized as follows. In Section 2 we present the data and discuss the econometric methodology. Section 3 provides the key results and the robustness analysis. In Section 4 we describe the model and discuss the simulation results. We conclude in Section 5.

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<sup>1</sup>[Bachmann et al. \(2014\)](#) confirm the presence of higher price flexibility in high volatility periods using German micro data. However, using a New Keynesian DSGE model, they argue that the effect is quantitatively small.



## 2 Econometric methodology

### 2.1 The threshold vector autoregressive model

The empirical model is estimated in two steps. In the first step, we determine the threshold specifying the regimes based on a univariate self exciting threshold autoregressive (SETAR) model of order one fitted to the logarithm of stock market volatility  $sv_t$  (see [Tong and Lim, 1980](#)). The SETAR model can be written as:

$$sv_t = c + \alpha^1 sv_{t-1} + \nu_t^1 + (\alpha^2 sv_{t-1} + \nu_t^2) I_{\{sv_{t-1} \geq \gamma\}} \quad (1)$$

where  $\gamma$  represents the threshold value,  $\alpha^1$  represents the autoregressive parameter in regime 1 when  $sv_{t-1} < \gamma$ , the autoregressive parameter in regime 2 when  $sv_{t-1} \geq \gamma$  is given by  $(\alpha^1 + \alpha^2)$ , and  $\nu_t^j \sim N(0, \sigma^j)$  is a Gaussian white noise forecast error with  $\sigma^j = E(\nu_t \nu_t')$  for  $j \in \{1, 2\}$ . The model represented in equation (1) is estimated by OLS for all possible values of  $\gamma$  on an equally spaced grid of  $sv_{t-1}$ . The maximum likelihood estimate for  $\hat{\gamma}$  is then obtained by solving the following maximization problem:

$$\hat{\gamma} = \min_{\gamma_L \leq \gamma \leq \gamma_U} \left( \frac{T^1}{2} \log(\sigma^1) + \frac{T^2}{2} \log(\sigma^2) \right). \quad (2)$$

where  $\gamma_L$  is the 15<sup>th</sup> percentile and  $\gamma_U$  is the 85<sup>th</sup> percentile of the empirical distribution of  $sv_{t-d}$ . Hence, following [Balke \(2000\)](#), we restrict the search region such that at least 15% of the observations (plus the number of parameters) are in each regime.

In the second step we condition on the estimated threshold value  $\hat{\gamma}$  and estimate the full TVAR model. Let  $Y_t$  be an  $n \times 1$  vector of endogenous variables that contains quarterly US data on log real GDP, the log personal consumption expenditure (PCE) deflator, the effective federal funds rate, log stock market volatility, the log level of nonborrowed reserves, log total private investment (defined as the sum of residential investment, non-residential investment and durable consumption following [Berger and Vavra, 2015](#)) and the spread between Moody's seasoned Baa and Aaa corporate bond yields. We assume that the dynamics of  $Y_t$  is described by a TVAR model given in reduced form by (see [Balke, 2000](#)):

$$Y_t = \sum_{l=1}^p A_l^1 Y_{t-l} I_{\{sv_{t-1} \geq \gamma\}} + \sum_{l=1}^p A_l^2 Y_{t-l} I_{\{sv_{t-1} < \gamma\}} + u_t, \quad (3)$$

where stock market volatility  $sv_t$  is a transition variable. If stock market volatility crosses a threshold value  $\gamma$ , the economy switches from a “low” volatility regime ( $sv_{t-1} < \gamma$ ) to a “high” volatility regime ( $sv_{t-1} \geq \gamma$ ).  $I_{\{\cdot\}}$  is an indicator function which takes the value of one in the assigned regime and it equals to zero otherwise.  $A_l^j$  is a  $n \times n$  coefficient matrix for  $l = 1 \dots p$ , where  $p$  is the lag length and  $j \in \{1, 2\}$  denote the high and low volatility regimes, respectively. For ease of exposition we neglect any deterministic

terms in equation 3, however, we include a constant which can differ across regimes. The  $n \times 1$  vector  $u_t$  represents the reduced-form innovations. We stack all elements of  $u_t$  corresponding to regime  $j$  into a vector  $u_t^j$  for  $j \in \{1, 2\}$ . The regime-specific errors  $u_t^j$  are Gaussian with mean zero and regime-dependent positive definite covariance matrices  $\Sigma_u^j = E(u_t^j u_t^{j'})$ .

Our empirical framework can be considered as a limiting case of the smooth transition model which has recently gained popularity in studying regime-dependence in macroeconomics (see, e.g., [Auerbach and Gorodnichenko, 2012b](#); [Caggiano et al., 2014a](#)). In the smooth transition model transition across regimes is governed by a logistic function which assigns a certain probability to being in each regime. The parameter that determines the shape of the transition function is usually calibrated outside of the model, such that the regimes match some narrative evidence.<sup>2</sup> This approach ensures that the autoregressive coefficient estimates are not sensitive to changes in the parameters governing the regimes, as argued by [Auerbach and Gorodnichenko \(2012b\)](#). In the same vein, [Granger and Terasvirta \(1993\)](#) suggest fixing the regime switching parameter exogenously, which amounts to fixing the threshold value in our setup.

Following this line of argument, we prefer not to estimate the threshold level jointly with  $\{A_t^1, A_t^2\}$  but instead proceed with the two step approach just outlined. Our approach of identifying the regimes outside the TVAR model mimics the procedure used in [Auerbach and Gorodnichenko \(2012b\)](#). In particular, we estimate the threshold  $\gamma$  *a priori*, based on the SETAR model fitted to  $sv_t$ . We show below that the regimes identified by the threshold autoregressive model match well narrative evidence on the occurrence of financial stress periods. Once the volatility regimes have been identified, we estimate the full TVAR. Conditional on the threshold  $\gamma$ , the TVAR model reduces to a piecewise linear VAR which can be estimated equation-wise by OLS.

## 2.2 Shock identification

Our objective is to investigate the effects of monetary policy shocks in the low and high volatility regimes (see [Rigobon and Sack, 2003, 2004](#)). The structural shocks of interest  $\epsilon_t^j$  are related to the reduced-form residuals according to  $u_t^j = A_0^j \epsilon_t^j$ , with  $E(\epsilon_t^j \epsilon_t^{j'}) = I_n$ . The impact effects are captured in the orthogonal invertible Gaussian  $n \times n$  matrix  $A_0^j$  that satisfies  $\Sigma_u^j = A_0^j A_0^{j'}$ . One way to identify the structural shocks  $\epsilon_t^j$  is by imposing timing restrictions on the matrix  $A_0^j$ . However, the latter are problematic in monetary

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<sup>2</sup>In principle, the parameter governing the smooth transition from one state to another can also be estimated. However, this requires the number of variables in the model to be relatively small. In practice, the parameter is typically set exogenously to allow for smooth transmission from one state to another. However, [Auerbach and Gorodnichenko \(2012b\)](#) state that when estimating the parameter governing the shape of the logistic distribution, the approach seems to favor a model that switches regimes sharply at a certain threshold. In the same vein, [Artis et al. \(2007\)](#) show that the threshold VAR is preferred over a smooth transition specification using model selection criteria. Therefore, we believe that the threshold VAR – although perhaps less general than the smooth transition model – does not constitute a very restrictive data representation in practice.

VARs that include financial variables, as monetary policy and financial markets are likely to affect each other simultaneously. Thus, we identify structural monetary policy shocks using the external instruments approach proposed by [Stock and Watson \(2012\)](#) and [Mertens and Ravn \(2013\)](#). Crucially, our shock identification does not rely on recursive timing restrictions, which is a key advantage over other existing techniques.

Let  $Z_t^j$  denote an observable variable that constitutes the monetary policy shock instrument in regime  $j$ . We regress the reduced-form residuals associated with the monetary policy equation in the VAR,  $u_t^{j,p}$ , on the monetary policy instrument  $Z_t^j$ :

$$u_t^{j,p} = \alpha^j Z_t^j + v_t^j. \quad (4)$$

The fitted value of this regression  $\widehat{u}_t^{j,p} = \widehat{\alpha^j} Z_t^j$  contains only variation that is due to structural monetary policy innovations. In the second step, we use the fitted values to obtain the structural impact effects of all other variables in the VAR. This is done by regressing the remaining VAR residuals  $u_t^{j,r}$  on the fitted values  $\widehat{u}_t^{j,p}$

$$u_t^{j,r} = \beta^j \widehat{u}_t^{j,p} + \xi_t^j. \quad (5)$$

The coefficient vector  $\beta^j$  contains the regime-dependent impact effect of all variables in the system to a unit monetary policy shock. That is  $\beta^j = \frac{a^{j,r}}{a^{j,p}}$ . Using the condition  $\Sigma_u^j = A_0^j A_0^{j'}$  together with equation 5 allows recovering the impact effect of the monetary policy shock on the federal funds rate  $a^{j,p}$  and thereby the elements  $a^{j,r}$ . Specifically, consider partitioning the vector of reduced form residuals as  $u_t^j = [u_t^{j,p} u_t^{j,r}]$ , and the matrix of structural coefficients and the reduced-form variance-covariance matrix as:

$$A^j = \begin{bmatrix} a^{j,p} & a_{12}^j \\ a^{j,r} & a_{22}^j \end{bmatrix} \quad \text{and} \quad \Sigma^j = \begin{bmatrix} \Sigma^{j,p} & \Sigma_{12}^j \\ \Sigma^{j,r} & \Sigma_{22}^j \end{bmatrix}. \quad (6)$$

Then  $a^{j,p}$  is identified up to a sign and can be obtained by the following closed form solution

$$(a^{j,p})^2 = \Sigma^{j,p} - a_{12}^j a_{12}^{j'} \quad (7)$$

where

$$a_{12}^j a_{12}^{j'} = (\Sigma^{j,r} - \frac{a^{j,r}}{a^{j,p}} \Sigma^{j,p})' Q^{j-1} (\Sigma^{j,r} - \frac{a^{j,r}}{a^{j,p}} \Sigma^{j,p}) \quad (8)$$

with

$$Q^j = \frac{a^{j,r}}{a^{j,p}} \Sigma^{j,p} \frac{a^{j,r'}}{a^{j,p}} - (\Sigma^{j,r} \frac{a^{j,r'}}{a^{j,p}} + \frac{a^{j,r}}{a^{j,p}} \Sigma^{j,r'}) + \Sigma_{22}^j \quad (9)$$

This procedure delivers all elements of the vector associated with the monetary policy shock in the structural impact matrix  $A_0^j$ .

We use the monetary policy shock series constructed by [Gertler and Karadi \(2015\)](#) as an external instrument for exogenous policy changes in the TVAR model. [Gertler and Karadi \(2015\)](#) identify monetary policy shocks as surprises in fed funds futures that occur on the days of FOMC policy announcements, along the lines of [Guerkaynak et al. \(2005\)](#). To isolate the impact of news about monetary policy, the surprises in futures rates are usually within a tight window (e.g. thirty minutes) of the FOMC decision. The key identifying assumption is that news about the economy on the FOMC day do not affect the policy choice. Only information available on the previous day is relevant. Given this assumption, surprises in fed funds futures on FOMC dates are orthogonal to movements in macroeconomic and financial variables within a period (e.g., a month or a quarter). The Gertler-Karadi series is not available for the period before 1990Q1. Thus, we append to it the exogenous monetary policy shock measure free of systematic responses to information about future economic developments constructed by [Romer and Romer \(2004\)](#). The Romer-Romer measure is the residual from a regression of intended fed funds rate changes around FOMC meetings on the Fed's internal inflation and real activity forecasts.<sup>3</sup>

We conduct inference on the structural impulse response functions using a wild bootstrap. That is, we generate bootstrap residuals as  $u_t^b = u_t \omega_t$ , where  $\omega_t$  is a scalar drawn from the Rademacher two-point distribution:  $P(\omega_t = 1) = P(\omega_t = -1) = 1/2$ . Also, let  $Z_t^b = Z_t \omega_t$ . Based on the point estimates of the VAR parameters and  $u_t^b$  we derive the endogenous variables and re-estimate the VAR model. We then identify the monetary policy shocks making use of  $Z_t^b$ . The confidence bands are then constructed as the percentile intervals of the resulting bootstrap distribution of the impulse response functions. Throughout the paper we show median impulse responses along with 68% confidence bands.

## 3 Empirical results

### 3.1 Identified volatility regimes

We identify volatility regimes based on the realized variance of the S&P 500 index. We compute realized volatility as the quarterly sum of squared daily returns. This variable has a rather high quarter-to-quarter variability that would imply implausibly frequent regime changes. Therefore, following [Balke \(2000\)](#), we use as threshold variable the one-sided two-quarter moving average of the realized variance series.

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<sup>3</sup>A robustness exercise shows that using the pure Romer-Romer shock series on the baseline sample ending in 2007Q4 yields identical results. We thank Patrick Huertgen for providing us with a Romer-Romer shock series updated until 2008Q4; see also [Cloyne and Huertgen \(forthcoming\)](#).

Figure 1 shows (smoothed) realized stock market volatility (solid line) together with the estimated threshold (dashed line). The grey shaded areas denote high volatility periods. The regimes match well narrative accounts of financial stress episodes, such as those documented by [Lopez-Salido and Nelson \(2010\)](#). In particular, stock market volatility exceeds the threshold during the 1971 "Nixon-Shock" that effectively abolished the Bretton-Woods system, the first (1973) and second (1979) oil crises, the 1982 Latin American debt crisis, the 1987 stock market crash, the First Gulf War and capital crunch in the early-1990s and the period between 1998 and 2003 which includes the 1998 LTCM crisis, the Asian and Russian crises, the dot-com crash in the early 2000s, the 09/11, 2001 terrorist attacks, the stock market scandals (WorldCom, Enron etc.) of early-2002, and the beginning of the Second Gulf War in 2002-03.

Overall, the identified high volatility regimes overlap with financial crises, periods of political stress and recessions. In a robustness exercise we show that our main conclusions are not sensitive to varying the regime periods.

### 3.2 Baseline results

Figure 2 shows the key results from the baseline threshold VAR model. The left panel shows the impulse response functions to an expansionary monetary policy shock in the low volatility regime. The middle panel presents impulse responses in the high volatility regime. The right panel shows differences between impulse responses in the high and low volatility regimes. In both regimes we normalize the impulse responses such that the monetary policy shock is defined as an unexpected 100 basis point reduction in the federal funds rate on impact.

The results in the left panel of Figure 2 reveal that an unexpected monetary policy expansion has a relatively strong stimulative effect in the low volatility regime. The expansionary monetary policy shock induces a hump-shaped behavior of output. GDP increases for two years before peaking at around 2%, it then returns to its baseline value after around four years. The shock also leads to a strong investment boom. Investment increases significantly on impact by about 2%, peaks at 6% after one year and returns to baseline within nearly four years. The monetary policy expansion is followed by a very persistent increase in the price level, peaking at around 3% within 14 quarters after the shock. Nonborrowed reserves rise by about 0.5% in response to the monetary policy shock, remaining significantly positive for about a year. The surprise monetary expansion generates an immediate reduction in the cost of credit, reflected by a significant decline in the credit spread by almost 20 basis points on impact. The response of the cost of credit is very persistent, with the credit spread staying below baseline for nearly two years after the monetary policy shock.

In the high volatility regime the impulse responses draw a different picture. Output peaks at roughly 0.5% after around one and a half years and returns relatively quickly

to baseline after three years. The response of investment displays a similar pattern to output, with a maximum increase of roughly 2% after one year, returning to baseline already two years after the shock. Hence, compared to the high volatility regime, the expansion in economic activity induced by the monetary policy shock is more than three times larger in the low volatility regime. Prices decline temporarily after the shock and then turn insignificant. Most strikingly, the credit spread hovers around its regime-specific baseline value for about one year after the shock, without a tendency to fall. Five quarters after impact the credit spread displays a moderate, albeit significant, decline of 8 basis points. It then returns to its baseline value after only two years. The right column of Figure 2 shows that the impulse response functions in the two regimes for the main variables of interest are significantly different from each other, suggesting that the non-linear model specification is supported by the data.

Mertens and Ravn (2013) show that under certain distributional assumptions about the measurement error it is possible to compute the correlation coefficient between the monetary policy shock instrument and the unobserved “true” monetary policy shock (see also Kliem and Kriwoluzky 2013). In our setting, this correlation equals 0.41 in the low volatility regime and 0.69 in the high volatility regime, which indicates that the shock instrument contains substantial information for identification. Nevertheless, the correlation coefficients are well below unity, which suggests that the shock instrument is not free of measurement error, an issue that we address in a robustness exercise.

### 3.3 Credit frictions and funding conditions

The baseline results show that both economic activity and credit spreads respond relatively less strongly to monetary policy shocks in high volatility periods. In this section we investigate whether these baseline results can be reconciled with a credit channel of monetary policy transmission, or whether other factors are needed to explain credit spread dynamics after monetary policy shocks. To that end, we add to the baseline model specification one by one various indicators that capture credit frictions in financial markets. We note upfront that none of our key results (i.e., the responses of output, prices, credit spreads and investment) change with the inclusion of the additional variables. Hence, we only present the impulse response functions of the variables that we add to the baseline model specification.

We augment the baseline model specification with the excess bond premium (EBP) developed by Gilchrist and Zakrajsek (2012), the leverage of security brokers and dealers and a survey-based measure for banks’ willingness to lend. The EBP is a risk premium that reflects systematic deviations in the pricing of US corporate bonds relative to the issuers’ expected default risk. It thus arguably constitutes a good proxy for the

effective risk-bearing capacity of the financial sector.<sup>4</sup> We use broker-dealer leverage as an indicator of funding conditions following [Adrian and Shin \(2009\)](#), who argue that “...broker dealers may be seen as a barometer of overall funding conditions in a market-based financial system” (p. 600), and they show that fluctuations in broker-dealers assets have an impact on macroeconomic variables.<sup>5</sup> In addition, broker-dealer leverage helps to explain excess returns on a variety of assets, as shown by [Adrian et al. \(2014\)](#). A further reason to include the leverage of broker-dealers is that their business model closely resembles the concept of financial intermediation in DSGE models with banks in that their liabilities are short term and their balance sheets are typically marked to market. Finally, we use information from the Senior Loan Officer Opinion Survey on Bank Lending Practices on the net percentage of banks reporting an increased willingness to make consumer loans.<sup>6</sup>

Figure 3 shows the results for the different credit friction indicators. In the low volatility regime, the EBP responds with a significant decline to an expansionary monetary policy shock. The EBP displays substantial inertia comparable to that of the Baa-Aaa credit spread, staying below baseline for nearly three years. The response of the EBP suggests that most of the movement in the credit spread is related to changes in banks willingness to take credit risk rather than fluctuation in expected default. In addition, broker-dealer leverage drops significantly on impact and the response is very persistent, and the monetary policy shock triggers an immediate and very front-loaded increase in banks’ willingness to lend.

In periods of high volatility the effect of monetary policy on credit frictions is substantially weaker. The response of the EBP in the high volatility regime is again similar to the response of the credit spread itself. The EBP is not statistically different from zero for around one year after the shock before turning negative. Bank leverage hardly moves, and banks’ willingness to lend increases only marginally on impact; thereafter, however, the response is not different from zero.

On balance, the results presented thus far highlight that monetary policy is less effective at improving credit conditions in high volatility periods relative to low volatility periods. This might explain the stronger reduction of the credit spread in the low volatility regime, which might in turn explain the stronger boom in economic activity. To the best of our knowledge, we are the first to empirically document this aspect of the monetary policy transmission mechanism. The next section outlines a DSGE model that

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<sup>4</sup>The EBP is available from 1973Q1 onwards, and we estimate the model over a shorter sample starting in 1973Q1, replacing the credit spread with the EBP.

<sup>5</sup>Following [Adrian et al. \(2013\)](#), we detrend broker-dealer leverage with the one-sided Hodrick-Prescott filter. This allows us to abstract from secular trends in leverage due to changes in the structure of the financial system and financial regulation. [Adrian et al. \(2013\)](#) use different detrending techniques (among them the Hodrick-Prescott filter), and find that their results do not depend on the technique used.

<sup>6</sup>We use banks’ willingness to lend to consumers because other willingness-to-lend variables, e.g., the willingness to lend to firms, are not available back to 1968.

is able to match our main empirical findings. However, before turning to the theoretical rationalization of our results, we first present a series of robustness checks.

### 3.4 Additional results and robustness analysis

#### Unconditional model

We plot in Figure 4 the median impulse responses of the key variables obtained from a linear model (black, solid line). For better comparison with the results from the non-linear model we also add the median impulse responses of the variables for the high volatility regime (red, dash-dotted line) and low volatility regime (blue, dashed line). The impulse responses obtained from the linear model lie between the respective responses in the high and low volatility regimes, but are clearly tilted towards the responses in the high volatility regime. This finding indicates that the modest effects of monetary policy shocks on economic activity documented in the literature based on linear VARs (e.g. [Christiano et al. \(1999\)](#)) can be attributed to the muted effects of monetary policy shocks in the high volatility periods.

#### Omitted variables

We check the robustness of our results against omitted variables by including additional endogenous variables into the VAR. Specifically, we include the log level of real house prices and the log level of the real S&P 500 index to account for the asset price channel of policy transmission. Furthermore, to capture forward-looking aspects, we include one quarter ahead expected real GDP growth. Finally, we add the log of total factor productivity because periods of high volatility might reflect future movements in productivity (see [Caggiano et al., 2014a](#); [Bachmann and Bayer, 2013](#)).

Figure 5 shows the median impulse responses of the baseline variables obtained from the expanded TVARs and, for better comparability, the confidence band from the baseline model. In all cases the median impulse responses from the expanded model specification lie well within the confidence bands of the baseline model specification. Most importantly, our key result that the credit spread responds more weakly in the high volatility regime is not plagued by omitted variable bias.

#### Alternative credit spreads

We replace the baseline Baa-Aaa spread with two alternative widely used credit spreads. These are the Baa yield minus the 10-year constant maturity Treasury bond yield, and the credit spread recently proposed by [Gilchrist and Zakrajsek \(2012\)](#) (henceforth GZ



spread).<sup>7</sup> Figure 6 shows that these alternative credit spreads display similar responses to monetary policy shocks to those obtained with the Baa-Aaa spread.

### Alternative external instruments

We also experiment with different external monetary policy shock instruments. First, we use the original Romer-Romer shock series instead of the spliced Romer-Romer/Gertler-Karadi shock series. Figure 7 shows the key impulse response functions based on instrumenting the federal funds rate with the pure Romer-Romer shock instrument series. Our key results are unaffected. Our outcomes also do not change when we use other external instruments also explored by [Gertler and Karadi \(2015\)](#), which are computed based on the 3-months ahead fed funds futures, the 3-months ahead, 6-months ahead and 9-months ahead Eurodollar futures. We make the results available on request.

### Definition of regimes

We have shown above that our procedure detects regimes which accord well with narrative evidence. Nevertheless, we assess the robustness of our results with respect to the specific timing of the volatility regimes. We consider two alternative volatility regime definitions by excluding - one by one - potentially controversial periods from the baseline regime specification. The top panel of Figure 8 shows the baseline regime specification, the second panel shows the regime specification that excludes the period surrounding the stock market crash in 1987,<sup>8</sup> while the third panel shows the regime specification that excludes the non-recession period between 1998 and 2003. For comparison, the bottom panel in Figure 8 shows NBER recessions.

Figure 9 shows the impulse responses from the baseline model specification obtained with different volatility regime definitions. Our main conclusions are robust to a more conservative definition of high volatility periods. Specifically, the impulse responses depicted in Figure 9 are within the confidence bands of the baseline model. The only notable, albeit quantitatively small, difference is in the response of the credit spread which responds slightly less on impact to a monetary policy shock than in the baseline case. Nevertheless, in the low volatility the credit spreads significantly on impact while it is not different from zero in the high volatility regime. Hence, the key result that

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<sup>7</sup> [Gilchrist and Zakrajsek \(2012\)](#) use prices of senior unsecured bonds outstanding issued by individual nonfinancial firms to calculate a credit spread over a hypothetical risk free security with the same cashflow structure. The GZ spread corresponds to the average of these individual security credit spreads over all bonds of all firms. [Gilchrist and Zakrajsek \(2012\)](#) show that the GZ spread has high predictive ability for economic activity. We do not use the GZ spread in our baseline model because it is only available since 1973Q1. Hence, for the purpose of this robustness exercise, we extend the GZ series backwards using the Baa-Aaa spread. Estimating the model starting in 1973Q1 and using the pure GZ spread delivers qualitatively the same results.

<sup>8</sup> [Lopez-Salido and Nelson \(2010\)](#) did not include the 1987 and 2001 stock market crises in their definition of financial crises. See also [Prieto et al. \(2016\)](#).

the credit spread falls more in the low volatility regime compared to the high volatility regime continues to hold.

### **The zero lower bound period**

Our baseline sample ends in 2007Q4, and we conduct several robustness checks to account for the Great Recession and zero lower bound period. First, we estimate the baseline model over the period from 1969Q1 to 2012Q2. We allocate the entire period after 2007Q4 to the high volatility regime, while keeping the pre-crisis regimes unchanged. We show the results in Figure 10. The impulse responses obtained for the extended sample closely resemble those for the pre-2008 period. The key variables continue to display substantially weaker responses in the high volatility regime.

Second, we modify our baseline model specification in order to better capture the scope of monetary policy during the Great Recession and zero lower bound period. Following [Gertler and Karadi \(2015\)](#) we replace the federal funds rate with the 1-year government bond rate as the monetary policy indicator. The 1-year rate does still have some room to manoeuvre when short-run nominal interest rates are stuck near zero. Moreover, the 1-year rate incorporates information on forward policy guidance. This aspect seems particularly important during and after the Great Recession since the Federal Reserve made extensive use of forward guidance as an additional monetary policy tool. To maximize the informational content with respect to the effect of forward guidance we also change the monetary policy instrument. We replace (within-quarter averages of) changes in the current month federal funds futures rate with (within-quarter averages of) changes in the three months ahead federal funds futures rate.

In Figure 11 we show the results of the model estimated until 2012Q2 with the 1-year rate as policy indicator instrumented with the three month ahead federal funds futures rate. To ensure comparability of the shock sizes from the different model specifications we also include the federal funds rate into the model with the 1-year rate, and we normalize the shock such that the federal funds rate increases by 100 basis points. We compare the results of the model using the 1-year rate with those of the baseline model estimated on the sample running until 2012Q2. Our main conclusions remain unchanged also when accounting for the Great Recession period.

### **Different identification strategies**

***Identification using sign restrictions*** We identify monetary policy shocks by imposing the following sign restrictions on impulse responses: after an expansionary monetary policy shock the response of the federal funds rate is non-positive, while the responses of output, prices and nonborrowed reserves are non-negative. These restrictions are standard in the literature and disentangle monetary policy from aggregate demand and supply shocks (see [Faust, 1998](#); [Canova and de Nicolo, 2003](#); [Uhlig, 2005](#)). The restric-

tions also disentangle monetary policy from financial and uncertainty shocks insofar as the latter may trigger either aggregate demand or supply effects which a central bank that focuses on inflation and output stabilization will attempt to counteract. The restrictions are imposed on impact and over the subsequent two quarters after the shock. We implement the sign restrictions following the procedure suggested by [Rubio-Ramirez et al. \(2010\)](#).<sup>9</sup>

Figure 12 depicts the results from the sign identified model. For better comparability the shaded areas represent the confidence bands from the baseline model. Overall, the results from the baseline and the sign identified model are very similar, and confidence bands overlap over most horizons. Prices now rise also in the high volatility regime, as implied by the sign restrictions. However, their reaction is still much weaker than in the low volatility regime, and it does not seem to affect the remaining impulse response functions.

**Impulse responses by local projection** We compute impulse responses using threshold local projection regressions along the lines of [Jorda \(2005\)](#). The local projection approach is free from the dynamic restrictions implied by VARs, which makes it in general less prone to model misspecification. Furthermore, the local-projection approach allows for endogenous regime switching over the impulse-response horizon, something we so far ruled out. In the local projection approach, the monetary policy shock series is treated as observable, rather than an external instrument of the “true” monetary policy innovation. We use a model that closely resembles the smooth transition local projection models employed by [Auerbach and Gorodnichenko \(2012a\)](#).<sup>10</sup>

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<sup>9</sup>Let  $\Sigma_\epsilon^j = P_\epsilon^j P_\epsilon^{j'}$  be the Cholesky decomposition of the regime  $j$  reduced form variance-covariance matrix of the VAR. Further, let  $\Omega^j$  be a  $n \times n$  random matrix drawn from an independent standard normal distribution. The  $QR$  decomposition of  $\Omega^j$  delivers  $\Omega^j = Q^j R^j$ . The regime-specific impact matrix of the structural shocks is then computed as  $\tilde{A}_0^j = P_\epsilon^j Q^{j'}$ . If the impulse responses generated by the impact matrix  $\tilde{A}_0^j$  satisfy the sign restrictions, we keep the matrix, otherwise we discard it. We keep drawing from  $\Omega^j$  until we obtain 500 impact matrices which satisfy all sign restrictions simultaneously. Sign restrictions do not achieve unique identification of shocks. To summarize the evidence of the sign-identified VAR we adopt a “mean target” approach along the lines of [Fry and Pagan \(2011\)](#) and [Kilian and Inoue \(2013\)](#). That is, out of all admissible models we pick the one which yields impulse responses of the variables to the shock closest to the mean impulse responses. Hence, the selected model is a representation of the central tendency of the set of all impulse response functions. Given that we focus on mean target responses, confidence bands reflect parameter uncertainty rather than model uncertainty. This procedure is carried out for both regimes  $j \in \{1, 2\}$ . Finally, all other six shocks are required not to have the same characteristics as monetary policy shocks, i.e., they must not satisfy the sign restrictions we impose to identify monetary policy shocks.

<sup>10</sup>Our threshold local projections involve estimating univariate regressions of the following form (omitting regime-specific constants):

$$y_{t+h} = (\alpha_h^1 X_t + \beta_h^1 Z_t) I_{\{\forall t: sv_{t-1} \geq \gamma\}} + (\alpha_h^2 X_t + \beta_h^2 Z_t) I_{\{\forall t: sv_{t-1} < \gamma\}} + \zeta_t,$$

where  $h \in \{0, H\}$ ,  $\alpha_h^j$  are coefficients corresponding to the control variables  $X_t = [Y_{t-1}', \dots, Y_{t-p}']'$ , and  $\beta_h^j$  are coefficients corresponding to the monetary policy shock series  $Z_t$ , i.e. the measure we have used as an instrument in our baseline. The coefficient  $\beta_h^j$  on the shock series is the impulse response of variable  $y$  at horizon  $h$  in regime  $j$  to a one standard deviation monetary policy shock. The model is estimated for each  $h$  and the lag length  $p$  is set to two. Standard errors and confidence bands for the local projection

In Figure 13 we show the impulse responses from the local projection regressions. We normalized the impulse responses to lower the federal funds rate on impact by 100 basis points in the both regimes. The right panels show  $t$ -statistics of the test of equality of the point estimates in both regimes. Whenever the  $t$ -statistic falls outside the bands, the null hypothesis that the impulse responses are equal at that particular horizon is rejected at the 90% level against the alternative that they are different. All in all, the impulse responses from the local projection method tell the same story as the baseline model: GDP, investment and the credit spread react less in the high volatility regime compared to the low volatility regime. The test statistic concerning the significance of the difference between impulse responses in the high and low volatility regime confirm that the differences between the two regimes are statistically significant.

## 4 A macroeconomic model with financial intermediation

In this section we provide a structural interpretation of our empirical results using a macroeconomic model with a financial intermediation sector. The model we use closely follows [de Groot \(2014\)](#), and it constitutes a New Keynesian extension of the model proposed by [Gertler et al. \(2012\)](#). A key feature of this framework is that banks issue both (non-state-contingent risk-free) short-term debt and (state-contingent) equity, which makes leverage an endogenous choice that depends on banks' risk perceptions. The model implies a negative relationship between banks' liability structure and volatility: banks opt for greater leverage when the shock volatility, and therefore the perceived riskiness of the economic environment, is low. This relationship constitutes a salient feature of the US economy present in our data, as also documented by [Adrian and Shin \(2014\)](#).

The procyclicality of leverage has important implications for the state-dependent effects of monetary policy shocks. The high leverage in low volatility periods makes the balance sheet of banks relatively more sensitive to monetary policy induced changes in asset prices. Hence, highly levered banks experience a strong increase in their net worth after an expansionary monetary policy shock, and leverage drops. The improved balance-sheet strength allows banks to borrow more and channel more funds into the economy. The spread between the expected return on capital and the risk-free interest rate drops, leading to an investment and output boom. In contrast, when volatility is high, banks hold more equity because it has greater hedging value by shielding banks' net worth from adverse shocks. Thus, expansionary monetary policy shocks have relatively less impact on banks' net worth, and the financial accelerator mechanism embedded in the model is weaker in high volatility periods.

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regressions are computed using White's heteroscedasticity and autocorrelation consistent covariance estimator ([White 1980](#)).

## 4.1 The model

Households' preferences are given as

$$\max \mathbb{E}_t \sum_{i=0}^{\infty} \beta^i \frac{1}{1-\zeta} \left( C_{t+i} - hC_{t+i-1} - \frac{\varrho}{1+\nu} L_{t+i}^{1+\nu} \right)^{1-\zeta}. \quad (10)$$

$\mathbb{E}_t$  is the expectations operator conditional on time  $t$ . We formulate the preference function to allow for internal habit formation and to abstract from wealth effects on labor supply.

Households have access to non-contingent, risk-free bank deposits,  $D_t$ , paying the risk-free rate  $R_t$ , and state-contingent bank equity,  $E_t$ , that is priced at  $Q_{E,t-1}$ , and pays  $R_{E,t}$ . The households' budget constraint is given as:

$$C_t = W_t L_t + R_t D_t + Q_{E,t-1} R_{E,t} E_t - D_{t+1} - Q_{E,t} E_{t+1}. \quad (11)$$

Perfectly competitive entrepreneurs produce intermediate goods with a constant return to scale production function. Intermediate goods are sold to retailers. At the end of period  $t$  the entrepreneur purchases capital,  $K_{t+1}$ , at the price  $Q_t$ , using funds obtained from banks. The entrepreneur uses capital and labor,  $L_t$  to produce output  $Y_t$ . The production process is subject to capital quality shocks,  $\epsilon_{K,t}$ .

$$Y_t = (\exp(\epsilon_{K,t}) K_t)^\alpha L_t^{1-\alpha}. \quad (12)$$

At the end of each period, capital producers buy depreciated capital from entrepreneurs, repair depreciation, and build new capital. The repaired and new capital is then sold back to entrepreneurs. Production of capital involves convex investment adjustment costs. The objective function of capital producers is given by:

$$\max \mathbb{E}_t \sum_{i=0}^{\infty} \Lambda_{t,t+i} \left( Q_{K,t+i} I_{t+i} - \left( 1 + \frac{\rho I}{2} \left( \frac{I_{t+i}}{I_{t+i-1}} - 1 \right)^2 \right) I_{t+i} \right). \quad (13)$$

The economy's capital stock evolves as:

$$K_{t+1} = (1 - \delta) \exp(\epsilon_{K,t}) K_t + I_t. \quad (14)$$

Monopolistically competitive retailers buy intermediate goods from entrepreneurs, and costlessly differentiate them to produce their output  $Y_{t,r}$ . Final output,  $Y_t$ , is a CES aggregator of unit mass of output from differentiated retailers,  $Y_{r,t}$ :

$$Y_t = \left( \int_0^1 Y_{r,t}^{\frac{\varepsilon-1}{\varepsilon}} dr \right)^{\frac{\varepsilon}{\varepsilon-1}}. \quad (15)$$

From the cost minimization of users of final output we can derive the demand schedule for the output of retailers and the aggregate price level:

$$Y_{r,t} = \left(\frac{P_{r,t}}{P_t}\right)^{-\varepsilon} Y_t \quad \text{and} \quad P_t = \left(\int_0^1 P_{r,t}^{1-\varepsilon} dr\right)^{\frac{1}{\varepsilon-1}}. \quad (16)$$

Retailers face price adjustment costs as in Rotemberg (1982) when setting prices. Their objective is to maximize profits:

$$\max \mathbb{E}_t \sum_{i=0}^{\infty} \Lambda_{t,t+i} \left( \frac{P_{t+i}}{P_{t+i-1}} Y_{t+i} - X_{t+i} Y_{r,t+i} - \frac{\rho\pi}{2} \left( \frac{P_{t+i}}{P_{t+i-1}\pi} - 1 \right)^2 Y_{t+i} \right). \quad (17)$$

Costs associated with price and investment adjustment are paid in real terms. The economy's budget constraint is therefore given as:

$$\left(1 - \frac{\rho\pi}{2} \left(\frac{\pi_t}{\pi} - 1\right)^2\right) Y_t = C_t + \left(1 - \frac{\rho I}{2} \left(\frac{I_t}{I_{t-1}} - 1\right)^2\right) I_t. \quad (18)$$

Monetary policy is characterized by a Taylor rule with monetary policy shocks,  $\epsilon_M$ :

$$\frac{R_{n,t}}{R_n} = \left( \left( \left( \frac{\pi_t}{\pi} \right)^{\mu_\pi} \left( \frac{X_t}{X} \right)^{\mu_X} \right) \right)^{1-\mu_{R_n}} \left( \frac{R_{n,t-1}}{R_n} \right)^{\mu_{R_n}} \exp(\epsilon_M), \quad (19)$$

and nominal interest rates  $R_{n,t}$  relate to real interest rates  $R_t$  according to the Fisher relation:

$$R_{n,t} = R_t \mathbb{E}_t \pi_{t+1}. \quad (20)$$

Banks issue deposits and outside equity to finance the funds they provide to entrepreneurs. Banks also have inside equity – their own net worth  $N_t$  accumulated through past earnings. In each period the banks finance the entire capital stock  $K_t$  valued at the price  $Q_t$ . The banks earn the entire return on capital  $R_{kt}$ .

For the banks the flow-of-funds constraint states that the value of loans given out,  $Q_t K_t$ , is equal to the sum of banks net worth, deposits issued to households, and the value of outside equity issued to households:

$$Q_t K_t = N_t + Q_t^E E_t + D_t. \quad (21)$$

Net worth  $N_t$  at time  $t$  is the payoff from assets financed one period ago in  $t-1$  less the return paid to depositors and outside equity holders:

$$N_t = R_{kt-1} Q_t K_{t-1} - R_{et} Q_{t-1}^E E_{t-1} + R_t D_{t-1}. \quad (22)$$

The key feature of outside equity is that it allows the bank to hedge against fluctuations in the return on assets: Movements in the return on assets will be absorbed by concurrent

movements in the return on equity. It is this hedging value which makes outside equity valuable for banks, especially so in times of heightened volatility.

The objective of the bank at the end of period  $t$  is to maximize its franchise value:

$$V_t = \mathbb{E}_t \left( \sum_{i=t+1}^{\infty} (1 - \sigma) \sigma^{i-t-1} \Lambda_{t,i} N_i \right). \quad (23)$$

Because banks are financially constrained, it is optimal for banks to retain earnings until the financial constraint no longer binds. To limit the bankers' ability to become unconstrained we assume that in each period, with probability  $(1 - \sigma)$ , a banker exits the financial sector, transfers the accumulated earnings to the household and becomes a member of the household.

An agency problem limits the ability of the bank to obtain funds: After a bank obtains funds, the banker may transfer a fraction of assets to her family. Households recognize this and endogenously limit the amount of deposits and outside equity they provide to banks. Also, the fraction of assets a bank can divert depends on the liability structure of the bank. As in [Calomiris and Kahn \(1991\)](#), deposits serve as a disciplining device for the banker: Short-term deposits require to meet a non-state dependent payment, while the return on outside equity depends on the bank's performance, which is difficult for the equity holder to monitor. Therefore, we assume that at the margin it is easier to divert assets funded by outside equity than by deposits.

This argument suggests that the fraction of assets the bank can divert,  $\Theta$ , is a function of the share of assets funded by outside equity  $x_t = Q_{t-1}^E E_{t-1} / Q_{kt} K_t$ . The function  $\Theta(x)$  is convex in  $x$ :

$$\Theta(x) = \theta \left( 1 - \epsilon_1 x_t + \frac{\epsilon_2}{2} x_t^2 \right). \quad (24)$$

Because households are aware of the banks' incentive to divert funds, they will restrict the amount they lend to banks, generating an external financing constraint. Let  $V_t(K_t, N_t, x_t)$  be the maximized franchise value for a given asset-liability configuration at the end of period  $t$ . The incentive constraint ensuring that the bank does not divert funds is given by:

$$V_t \geq \Theta(x) Q_{kt} K_t. \quad (25)$$

Equation (25) states that for the household to be willing to supply funds to the bank, the bank's franchise value must be at least as large as the gain from diverting funds and closing down the bank.

Inserting Equation (21) into Equation (22) yields the evolution of bank net worth as a function of  $K_{t-1}$ ,  $x_{t-1}$ , and  $N_{t-1}$ :

$$N_t = (R_{kt} - x_{t-1} R_{et} - (1 - x_{t-1}) R_t) K_{t-1} Q_{kt} + R_t N_{t-1}. \quad (26)$$

Banks' franchise value at the end of period  $t - 1$  satisfies the Bellman equation:

$$V_{t-1}(K_{t-1}, N_{t-1}, x_{t-1}) = \mathbb{E}_{t-1} \Lambda_{t-1,t} \left( (1 - \sigma)n_t + \sigma \max_{K_t, x_t} [V_t(K_t, N_t, x_t)] \right) \quad (27)$$

In each period  $t$  the bank chooses  $K_t$ , and the liability structure  $x_t$  to maximize  $V_t(K_t, N_t, x_t)$  subject to the law of motion of net worth (26), and the incentive constraint (25).

## 4.2 Calibration and solution method

Table 1 summarizes the values assigned to the structural parameters. To keep the exercise transparent we use the parametrization of [Gertler et al. \(2012\)](#). Because of nominal rigidities and the Taylor rule we need to assign values for five additional parameters which are not present in the model version presented in [Gertler et al. \(2012\)](#). For these parameters we choose standard values taken from the literature. Specifically, the price elasticity of demand  $\epsilon$  is set at 4.17 (as e.g. in [Gertler and Karadi 2011](#) and [de Groot 2014](#)). The Rotemberg price adjustment parameter  $\rho_I$ , is 48.8, which is equivalent to  $(1 - 0.779)$  % of the firms re-optimizing prices each quarter in a Calvo-style setup, as in [Keen and Wang \(2007\)](#) (see also [Gertler and Karadi 2011](#) and [de Groot 2014](#)). The monetary policy parameters are set at 1.5, 0.125 and 0.8 for the parameters governing the inflation response, the markup response and the interest rate smoothing ([Gertler and Karadi 2011](#), [de Groot 2014](#)).<sup>11</sup>

The key feature of the model is that the bank chooses the capital structure endogenously. As is well known, in the non-stochastic steady state the portfolio decision of banks is not determined. That is, a meaningful portfolio choice between debt and equity requires incorporating the stochastic (or risky) nature of the economic environment in the solution of the model. We do so by working with second order approximations of the model where perceptions about future volatility matter: we employ the concept of the stochastic or risk-adjusted steady state ([Collard and Juillard 2001](#), [Schmitt-Grohe and Uribe 2004](#), [Coerdacier et al. 2011](#), [Juillard 2011](#), [Kliem and Uhlig 2016](#)). The stochastic state state differs from the non-stochastic steady state by second order terms, i.e. variance and covariances of the endogenous variable in the model. It is the point of the state space where, in absence of shocks in that period, agents would choose to remain although they take future volatility into account. Mathematically, let the model be described by

$$\mathbb{E}_t [f(X_{t+1})] = 0 \quad (28)$$

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<sup>11</sup>We conducted robustness tests with respect to the exact parametrization of the model and found that the key results and the mechanisms of the model are not dramatically sensitive to the exact choice of the parameters of the model.



with  $X_{t+1}$  including all variables (predetermined and non-predetermined) and all exogenous innovations to the model. Following [Coerdacier et al. \(2011\)](#), the risk adjusted steady state is defined by taking a second order expansion of the function  $f$  around  $\mathbb{E}_t(X_{t+1})$ :

$$\Phi[\mathbb{E}_t(X_{t+1})] = f[\mathbb{E}_t(X_{t+1})] + \mathbb{E}_t\left[f'' \times (X_{t+1} - \mathbb{E}_t(X_{t+1}))^2\right], \quad (29)$$

with the second order derivatives  $f''$  evaluated at  $\mathbb{E}_t(X_{t+1})$ . The risk-adjusted steady state is then obtained by finding an  $\bar{X}^r$  such that  $\Phi[\bar{X}^r] = 0$ . Our computation of the risk-adjusted steady state follows the procedure outlined in [Gertler et al. \(2012\)](#) and is substantially more demanding compared to the deterministic steady state. This is because the computation requires the risky steady state and the log-linear dynamics around it to be jointly determined. Specifically, we are searching for a steady state that is consistent with the conditional second moments generated by the dynamics around this steady state. Given a set of conditional second moments, the risky steady state is a function of the conditional second moments:  $\bar{X}^r = g_X(M)$ . At the same time, the conditional second moments are a function of the risky steady state:  $M = g_M(\bar{X}^r)$ . Computing the risky steady state is therefore a fixed point problem of finding an  $M^*$  such that  $M^* = g_m(g_X(M^*))$ . We solve the fixed point problem iteratively: starting from an initial estimate of the conditional second moments of the endogenous variables  $M$ , we solve for the risk adjusted steady state  $\bar{X}^r$ . We then compute the log-linear dynamics around this risky steady state using a first order approximation and obtain a new set of conditional second moments. We iterate over this procedure until we achieve convergence which usually takes only a few iterations.

### 4.3 Simulation results

We conduct simulations which illustrate how the model helps explaining the key empirical regularities uncovered above. We consider two different regimes characterized by high volatility and low volatility, and study the implication of the model concerning the dynamics of the economy after a monetary policy shock. We use the capital quality shock to trigger time variation in volatility, e.g., the high and low volatility regimes. We assume that the high volatility regime is generated by large exogenous shocks to the quality of capital, while the low volatility regime features small exogenous capital quality shocks. The capital quality shock can be thought of as a form of economic obsolescence. Periods of high capital quality shocks thus represent the model analog to high volatility periods in the empirical analysis.

In Table 2 we show the steady state values for some selected variables in the high and low volatility states. We note upfront that the steady state results are qualitatively identical to those presented in [Gertler et al. \(2012\)](#). The key result we want to stress is that the inside leverage ratio of banks drops when moving from the low volatility regime

to the high volatility regime. This is consistent with the data used in the empirical section. Figure 14 documents the negative relation between volatility and broker-dealer leverage born out in the data. The model provides an explanation for this pattern: in the high volatility regime banks aim at increasing the share of outside capital on the liability side. This is because in high volatility times outside equity has greater hedging value. The more extensive use of outside equity however intensifies the agency problem between banks and the providers of funds (see Equation (25)). For households to be willing to provide additional outside equity the bank needs to build up additional inside equity. Net worth of banks is therefore higher in the high volatility state relative to the low volatility state, and banks are less levered in the high volatility state.

This procyclicality in the leverage ratio across regimes has implications for the propagation of monetary policy shocks. In both volatility states we feed in monetary policy shocks of same size. In Figure 15 we show the response of some selected variables to a monetary policy shock. The expansionary monetary policy shock generates a substantially stronger boom in output and investment in the low volatility regime, which is in line with the findings from the TVAR analysis. Also in line with our empirical findings, the reduction in the credit spread and the drop in inside leverage is larger in the low than in the high volatility state.

The mechanism behind these results is intuitive. In the low volatility regime banks lever up because they perceive the economic environment as less risky. The highly levered balance sheet however makes banks inside equity very sensitive to changes in asset prices and returns induced by the monetary policy shock. The expansionary monetary policy shock increases net worth, and inside leverage drops strongly. This loosens banks' incentive constraint. Consequently, banks increase borrowing, allowing them to channel more funds into the economy. The credit spread drops strongly generating the investment and output boom. This financial accelerator mechanism is weaker in the high volatility regime because banks are better capitalized.

Our approach has a limitation that is important to mention. The prevailing assumption in our setup is that whenever the economy enters a particular volatility regime, agents believe that the regime will last forever. A possible extension would be to allow agents to form a probability distribution over possible future regime changes when forming expectations, as is done in the Markov-switching DSGE literature. However, except for cases with very extreme switching probabilities, it is unlikely that taking into account expectations of future regime changes will strongly affect the qualitative working mechanism of the model and the intuition we want to highlight.

We have shown that our empirical results can be rationalized within a standard general equilibrium model with financial frictions. In contrast to the existing literature on asymmetric dynamics of the economy to policy shocks, our theory stresses the role of banks' endogenous leverage decision in the effectiveness of monetary policy to stimulate the economy and is able to match the key empirical regularities uncovered in this paper.

## 5 Conclusions

Financial intermediaries actively manage their balance sheets in such a way that leverage is high in periods of low financial market volatility and favorable funding conditions, and it is low in times of high volatility. The procyclicality of leverage is a key feature of the US financial system, and in this paper we show that it has important implications for the monetary transmission mechanism.

We study the differential effects of monetary policy in low and high volatility regimes, using a regime-switching threshold vector autoregression. Exogenous policy changes are identified by adapting an external instruments approach to this non-linear model. Our results suggest that expansionary monetary policy shocks lead to a significant reduction in credit costs and to a boom in output and investment. However, the effects of this monetary stimulus are significantly weaker in the regime characterized by high volatility.

We provide a new explanation for the non-linearity observed in the data, which links the effectiveness of monetary policy to the procyclicality of leverage. Our empirical results can be reconciled with a standard New Keynesian general equilibrium model with financial frictions. In this framework banks adjust their leverage endogenously depending on the volatility of aggregate shocks, and their liability structure is central to the transmission of monetary policy. In low volatility periods leverage is high due to the perception of low risk. High bank leverage makes bank balance sheets sensitive to changes in asset values, which amplifies the effects of monetary policy shocks. Highly leveraged banks experience a strong increase in their net worth after a monetary stimulus, which enables them to borrow more and channel more funds to the real economy. In high volatility periods leverage is low. Therefore, this financial accelerator mechanism is dampened.

We want to emphasize that our results do not imply that monetary policy is *ineffective* in stimulating the economy during periods of high volatility. Rather, monetary policy makers should be aware that in times of heightened volatility they will get "less-bang-for-the-buck". At the same time, recent empirical evidence for the US provided by [Auerbach and Gorodnichenko \(2012b\)](#) suggests that the aggregate fiscal multiplier is larger in high volatility periods. Furthermore, [Canzoneri et al. \(2016\)](#) show that a general equilibrium model with financial frictions implies fiscal multipliers that are larger in periods of high volatility. Accordingly, fiscal policy might be a more effective tool in stimulating the economy in these periods.

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## 6 Tables

Table 1: Parameter values

Standard parameters		
$\alpha$	Capital share	0.33
$\beta$	Discount factor	0.99
$\zeta$	Risk aversion	2
$\varrho$	Labor weight in utility	0.25
$\nu$	Frisch elasticity (inverse)	1/3
$\delta$	Depreciation rate	0.025
h	Habit parameter	0.75
$\rho_I$	Investment adjustment parameter	1
$\rho_\pi$	Price adjustment parameter	48.8
$\varepsilon$	Price elasticity of demand	4.17
$\mu_\pi$	Taylor rule inflation response	1.5
$\mu_X$	Taylor rule mark-up response	0.125
$\mu_{R_n}$	Taylor rule interest rate smoothing	0.8
Banking sector		
$\sigma$	Survival rate of bankers	0.9685
$\xi$	Transfer to new bankers	0.0289
$\theta$		0.264
$\epsilon_1$		-1.24
$\epsilon_2$		13.41

Table 2: Steady state results

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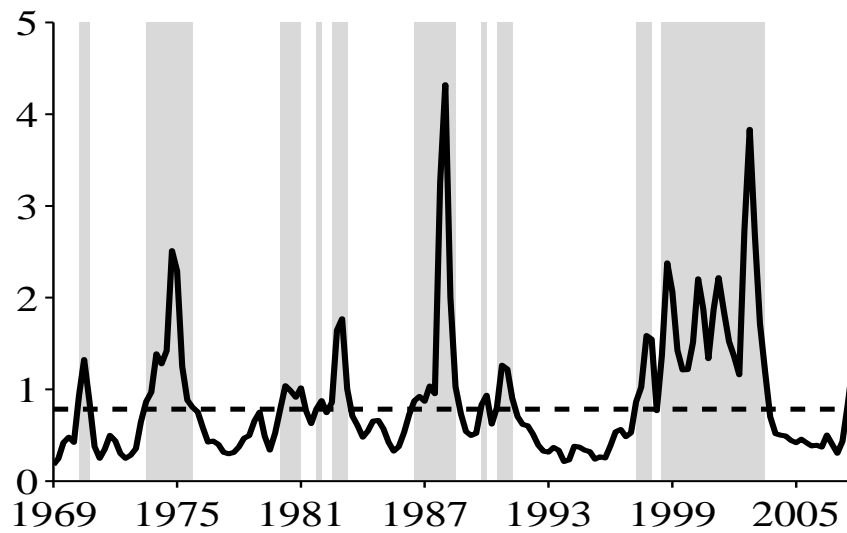
	Low volatility	High volatility
Output	6.24	5.93
Consumption	5.18	4.95
Labor	2.43	2.34
Capital	42.16	39.13
Net worth	5.47	5.81
Risk free rate	4.10	4.09
(Outside) Equity ratio	0.10	0.14
(Inside) Leverage ratio	7.72	6.74
SD capital quality shock	0.69	2.07

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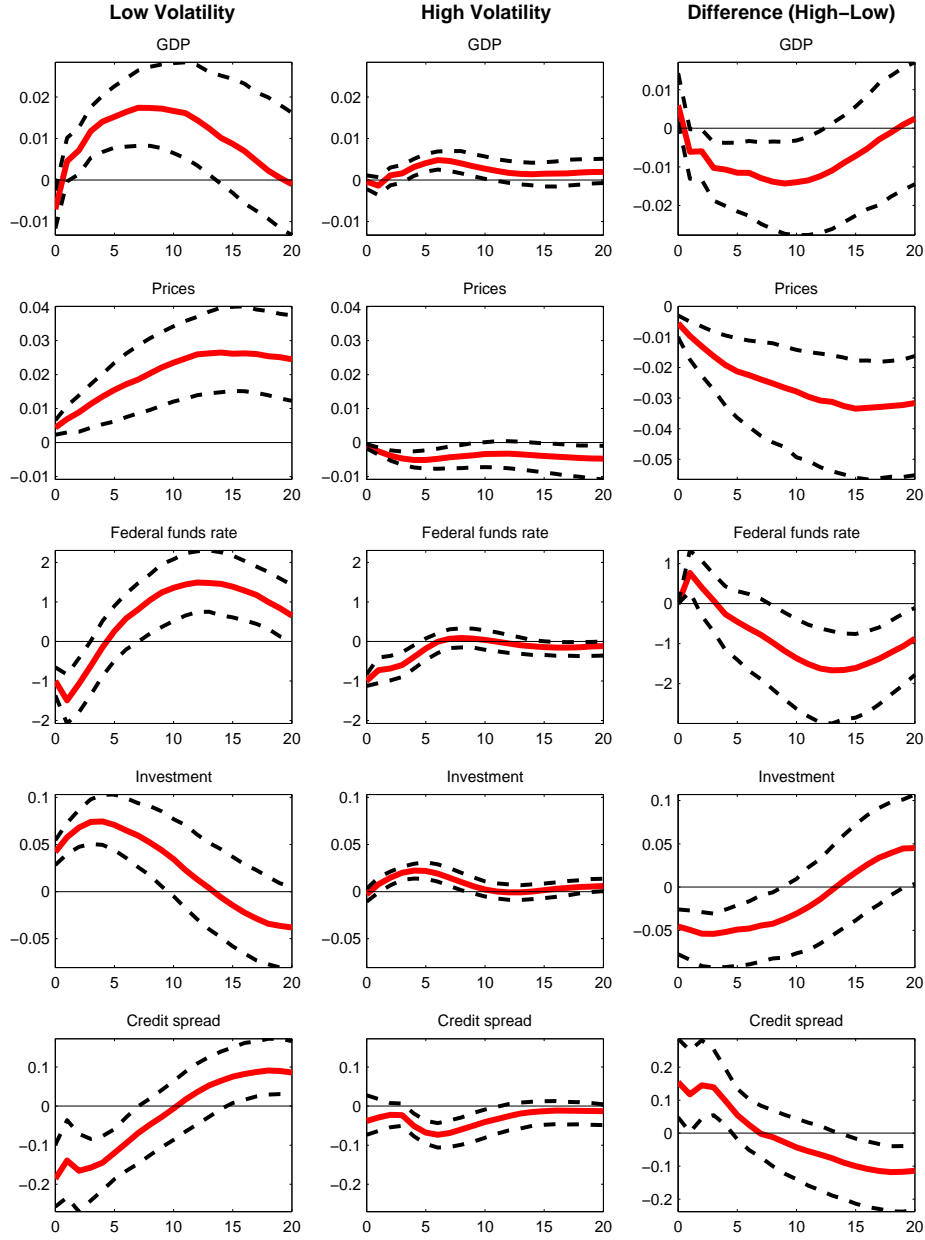
## 7 Figures

Figure 1: Stock market volatility and high and low volatility regimes



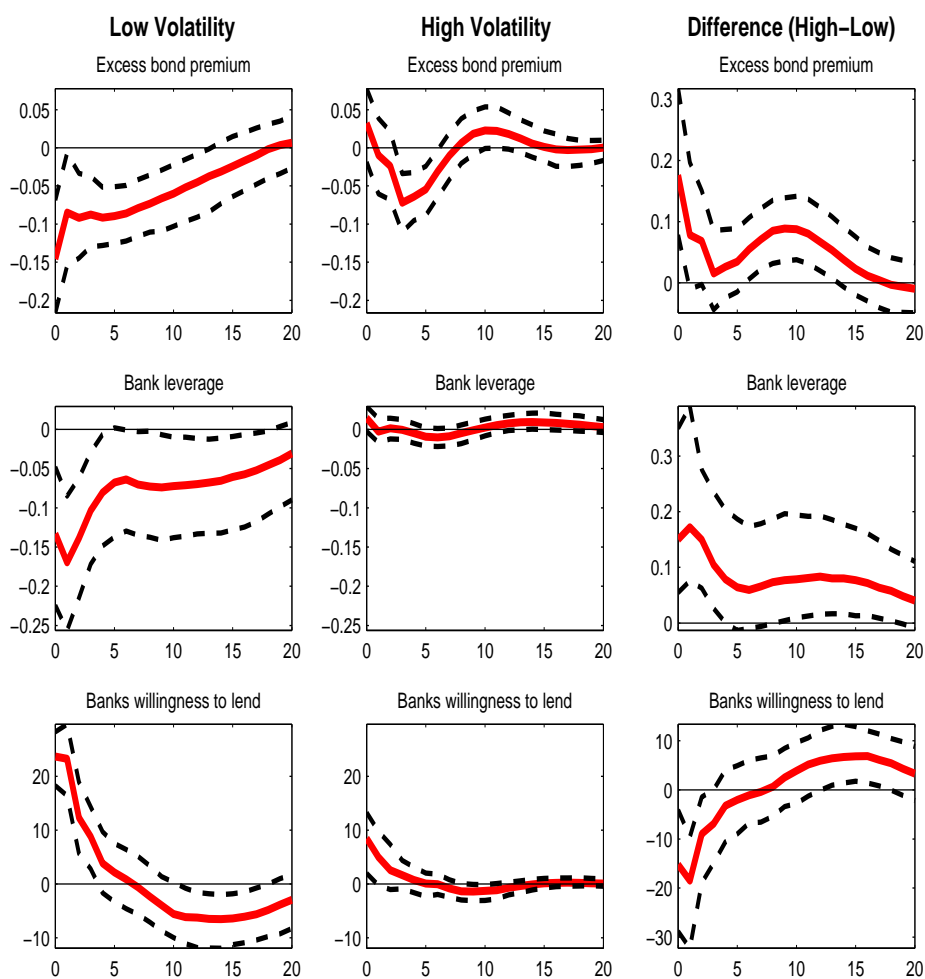
This figure shows the smoothed, realized stock market volatility (black line) together with the identified high volatility regimes (grey shaded areas). For details of the computation of the regimes and the volatility series see Sections 2 and 3, respectively.

Figure 2: **Effects of monetary policy shocks - baseline model**



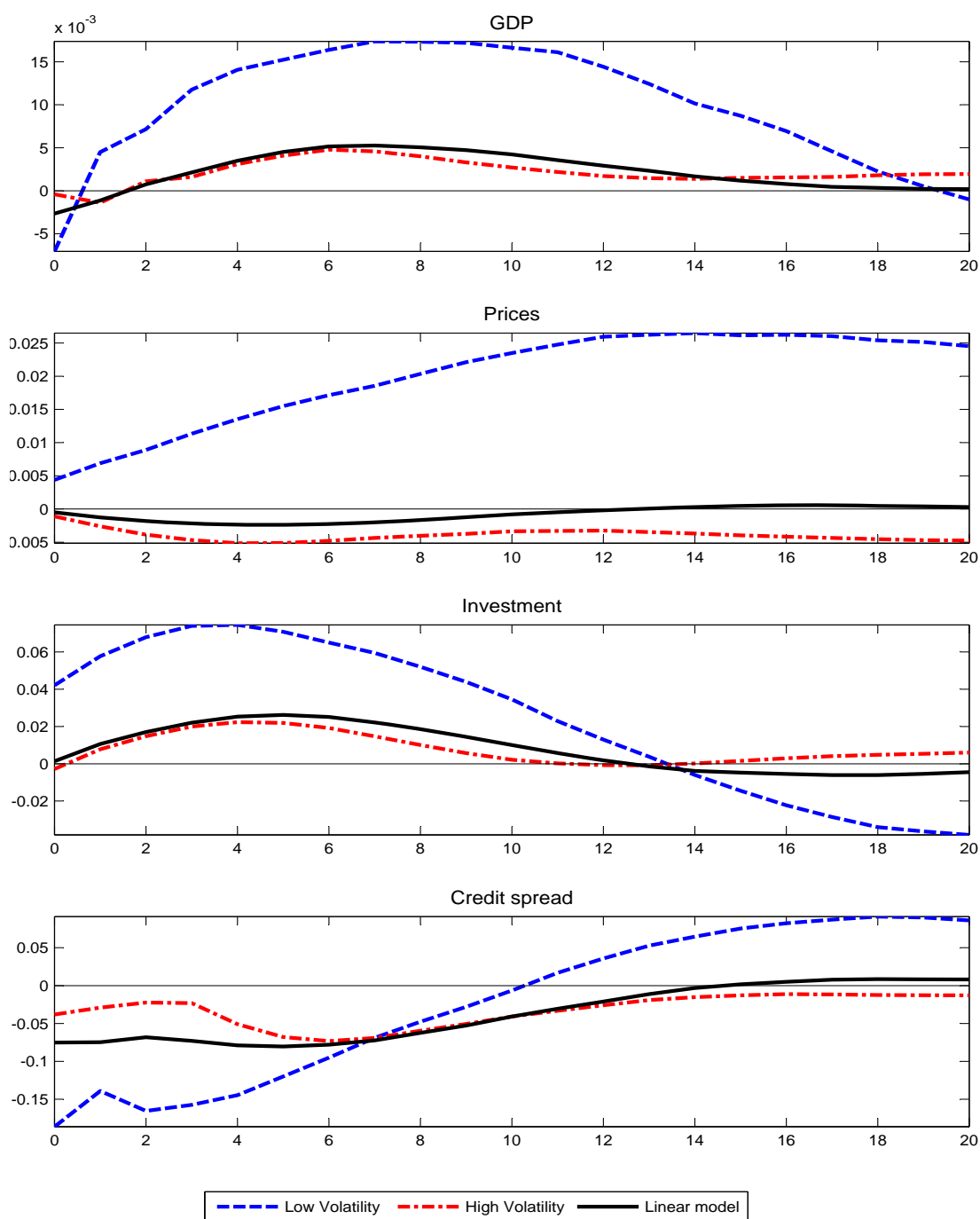
This figure shows state-dependent impulse responses to monetary policy shocks in the low volatility regime (left panel), in the high volatility regime (middle panel), and differences between these impulse responses (right panel). We show the median (red) and the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution. In both regimes, the monetary policy shock is normalized to reduce the federal funds rate by 100 basis points.

Figure 3: Effects of monetary policy shocks - credit supply effects



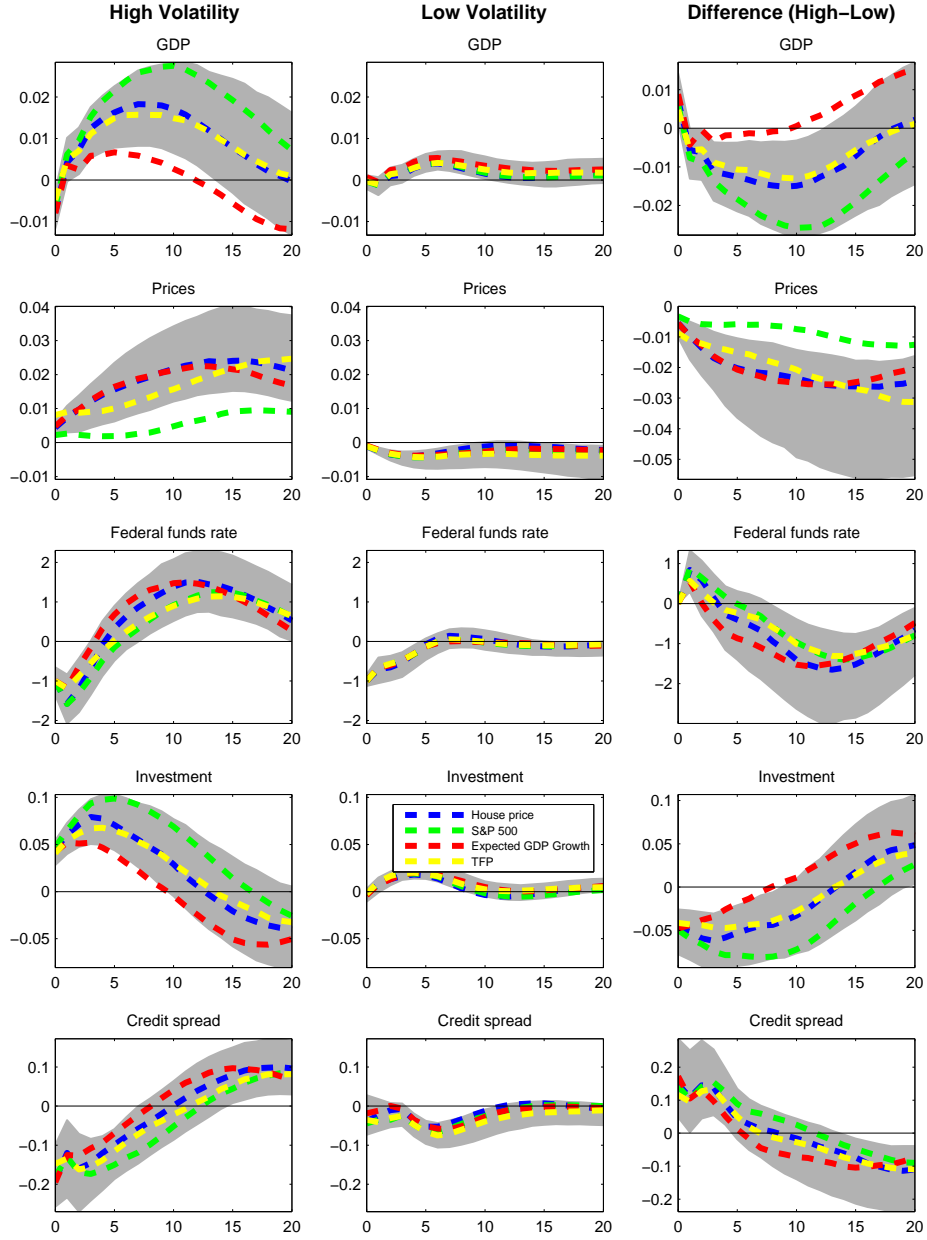
The impulse responses are derived from models which, besides the baseline variables, include the variable one by one, except for the model with the excess bond premium which replaces the baseline credit spread. Otherwise see notes to Figure 2.

Figure 4: Effects of monetary policy shocks - linear vs. state-dependent VARs



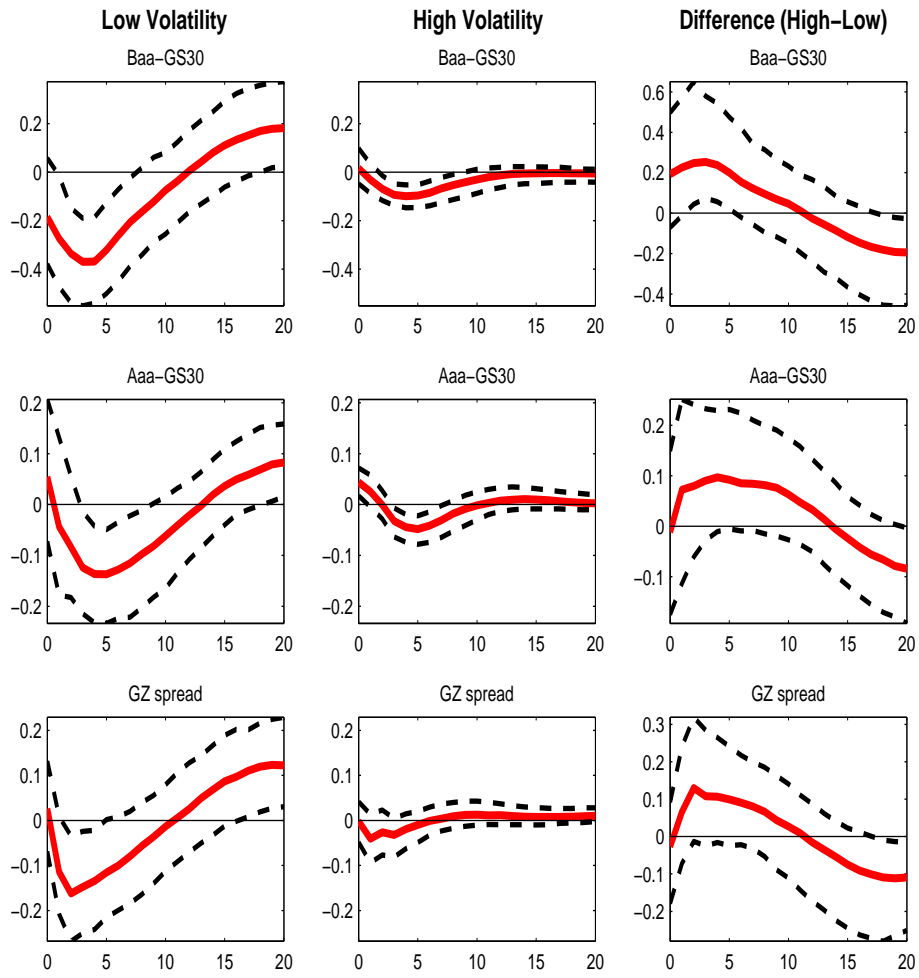
This figure shows state-dependent impulse responses to monetary policy shocks in the low volatility regime (blue line), in the high volatility regime (red line), and the impulse response obtained from a non-state dependent model (black line). We show the median estimate. In both models, the monetary policy shock is normalized to reduce the federal funds rate by 100 basis points.

Figure 5: Effects of monetary policy shocks - omitted variables



The grey shaded areas correspond to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model. The dashed lines correspond to the median impulse response of extended models which include, except of the baseline variables, the additional variables one by one. Otherwise see notes to Figure 2.

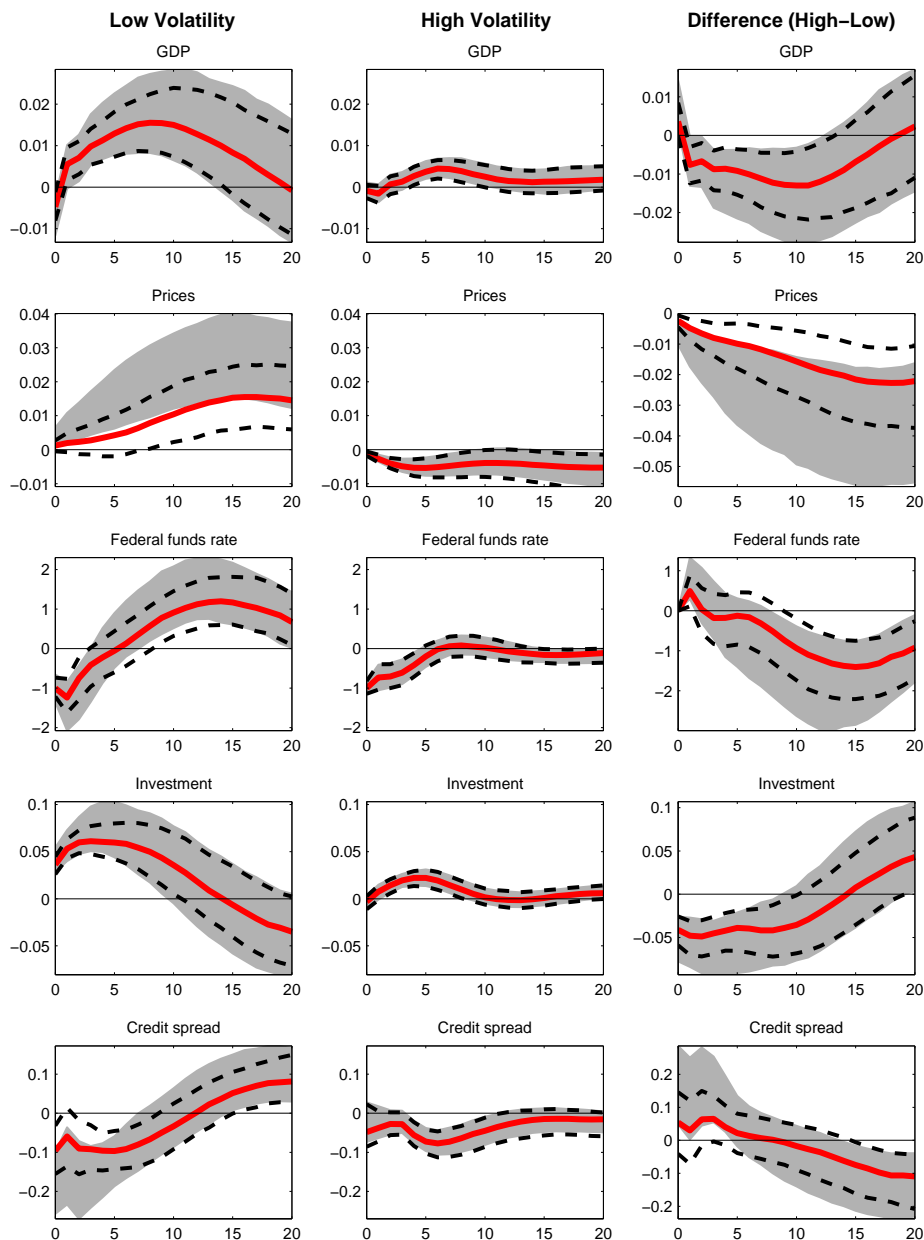
Figure 6: Effects of monetary policy shocks - alternative credit spreads



The impulse responses are derived from models in which we replace the baseline credit spread with alternative credit spread measures. Otherwise see notes to Figure 2.



Figure 7: **Effects of monetary policy shocks - pure Romer-Romer shock measure**



The grey shaded areas correspond to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model. The red line corresponds to the median impulse response and the black-dashed line to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the model using the the Romer-Romer shocks as as monetary policy shock instrument. Otherwise see notes to Figure 2.

Figure 8: Different regime definitions

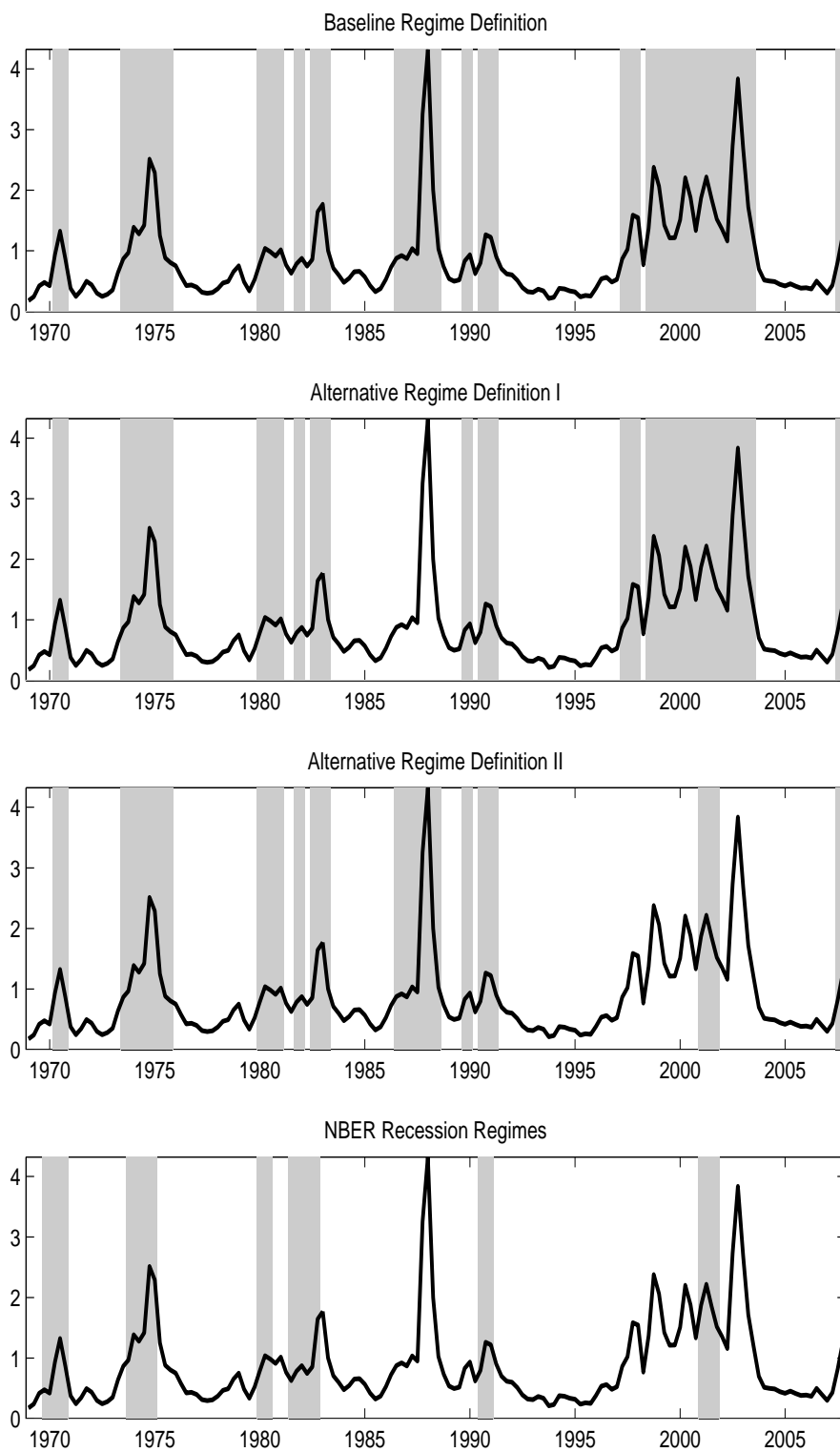
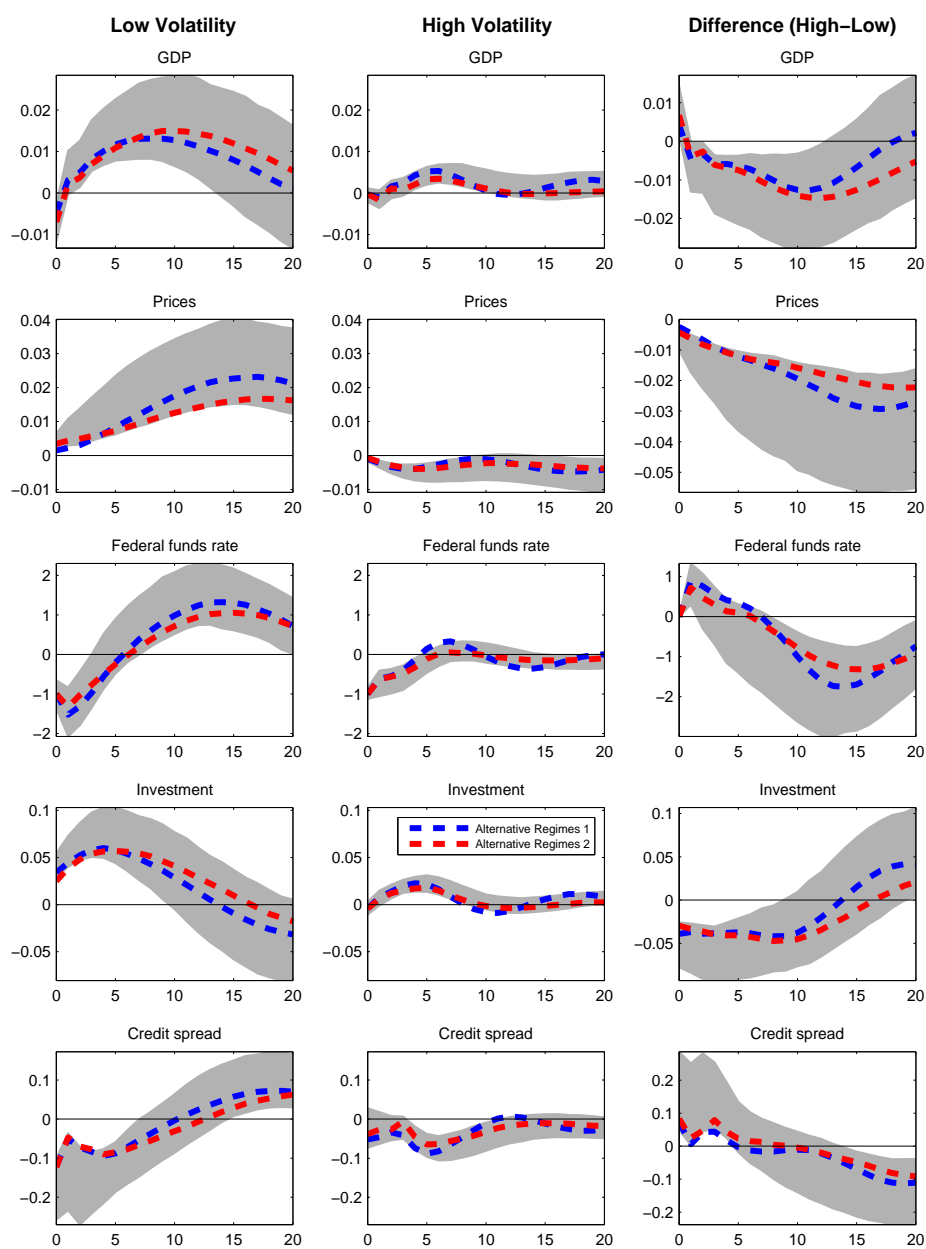
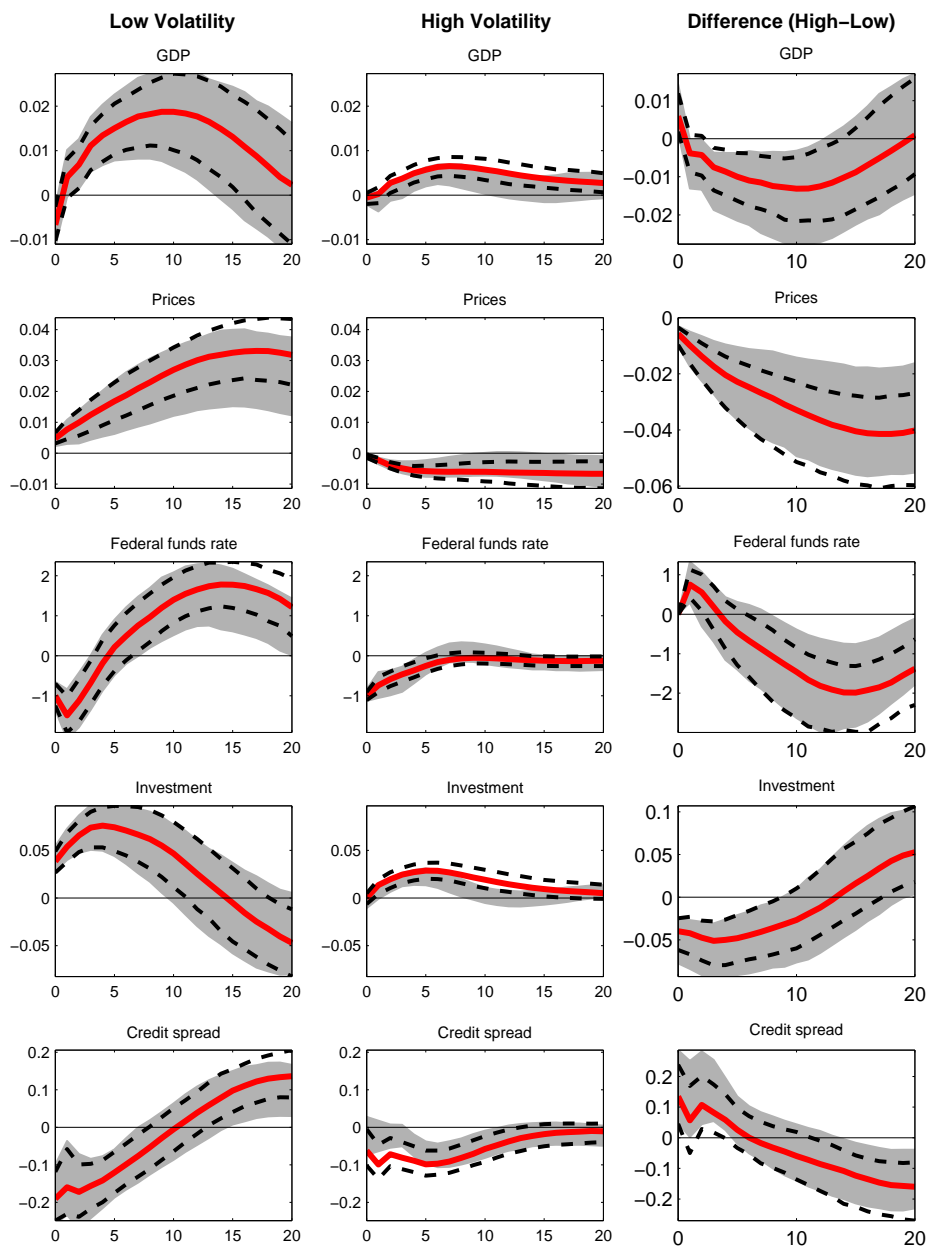


Figure 9: Effects of monetary policy shocks - Different regime definitions



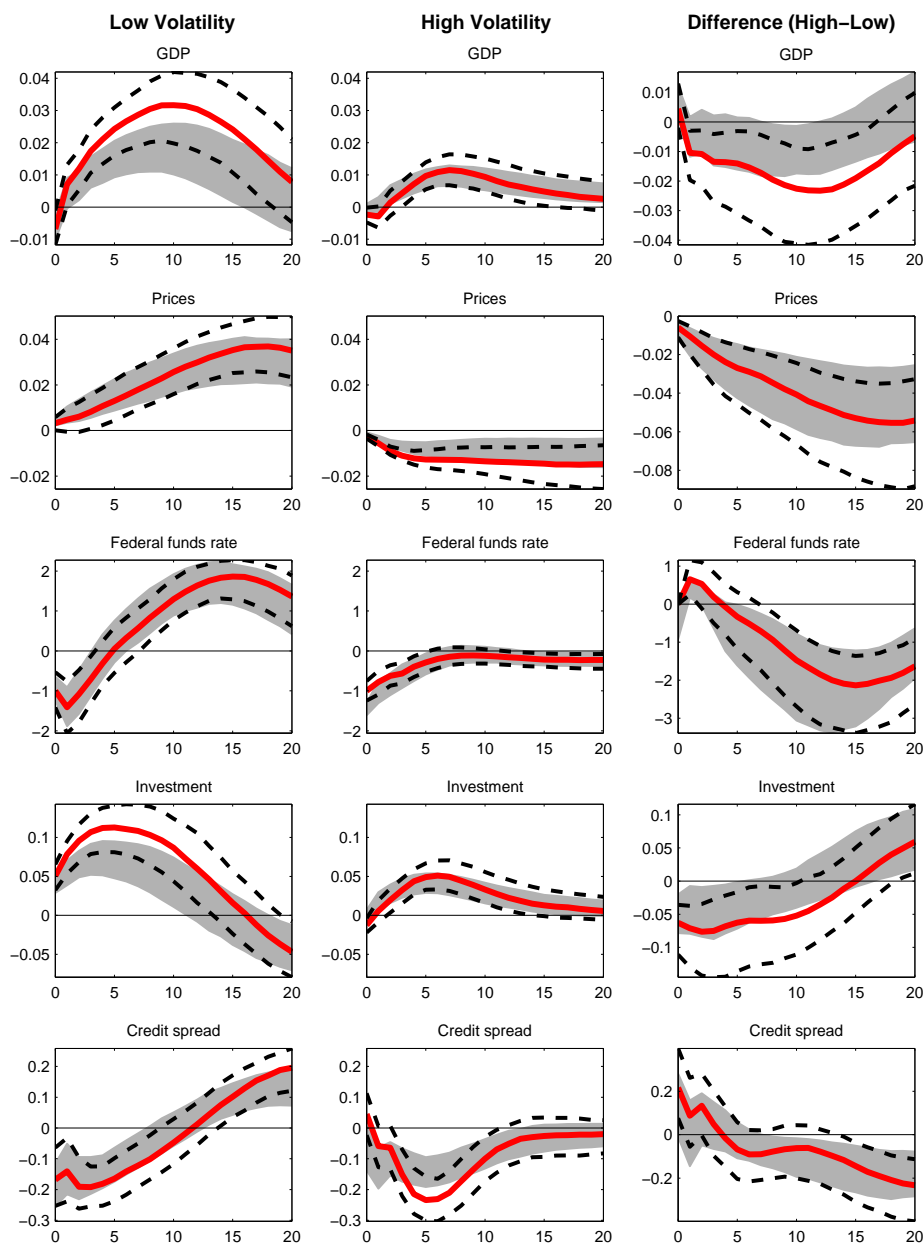
The grey shaded areas correspond to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model. The dashed lines correspond to the median impulse response of the models based on the regime definitions as defined in Figure 8. Otherwise see notes to Figure 2.

Figure 10: Effects of monetary policy shocks - 1969-2012



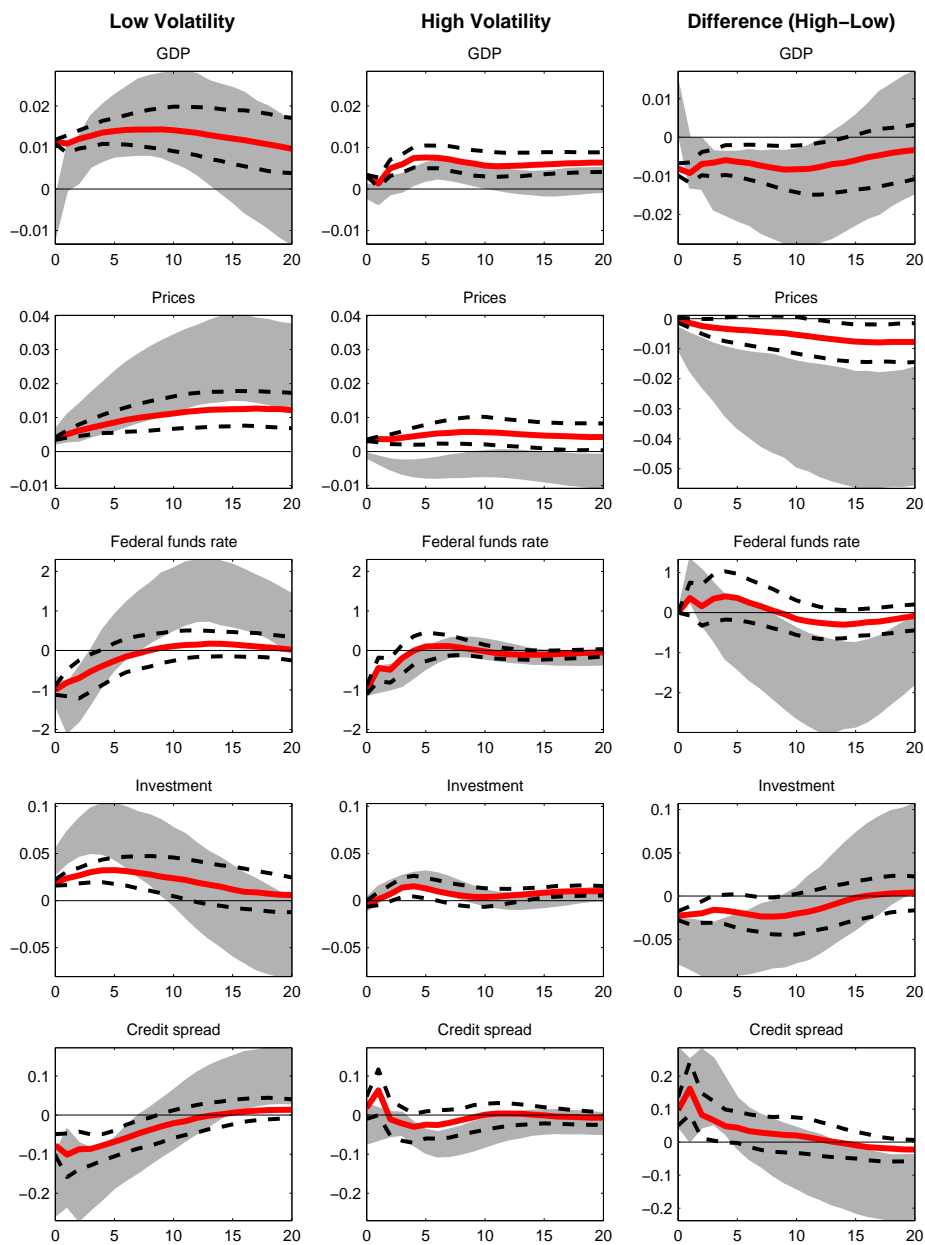
The grey shaded areas correspond to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model. The red line corresponds to the median impulse response and the black-dashed line to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model estimated over the period 1969-2012. Otherwise see notes to Figure 2.

Figure 11: Effects of monetary policy shocks - 1969-2012 accounting for forward guidance



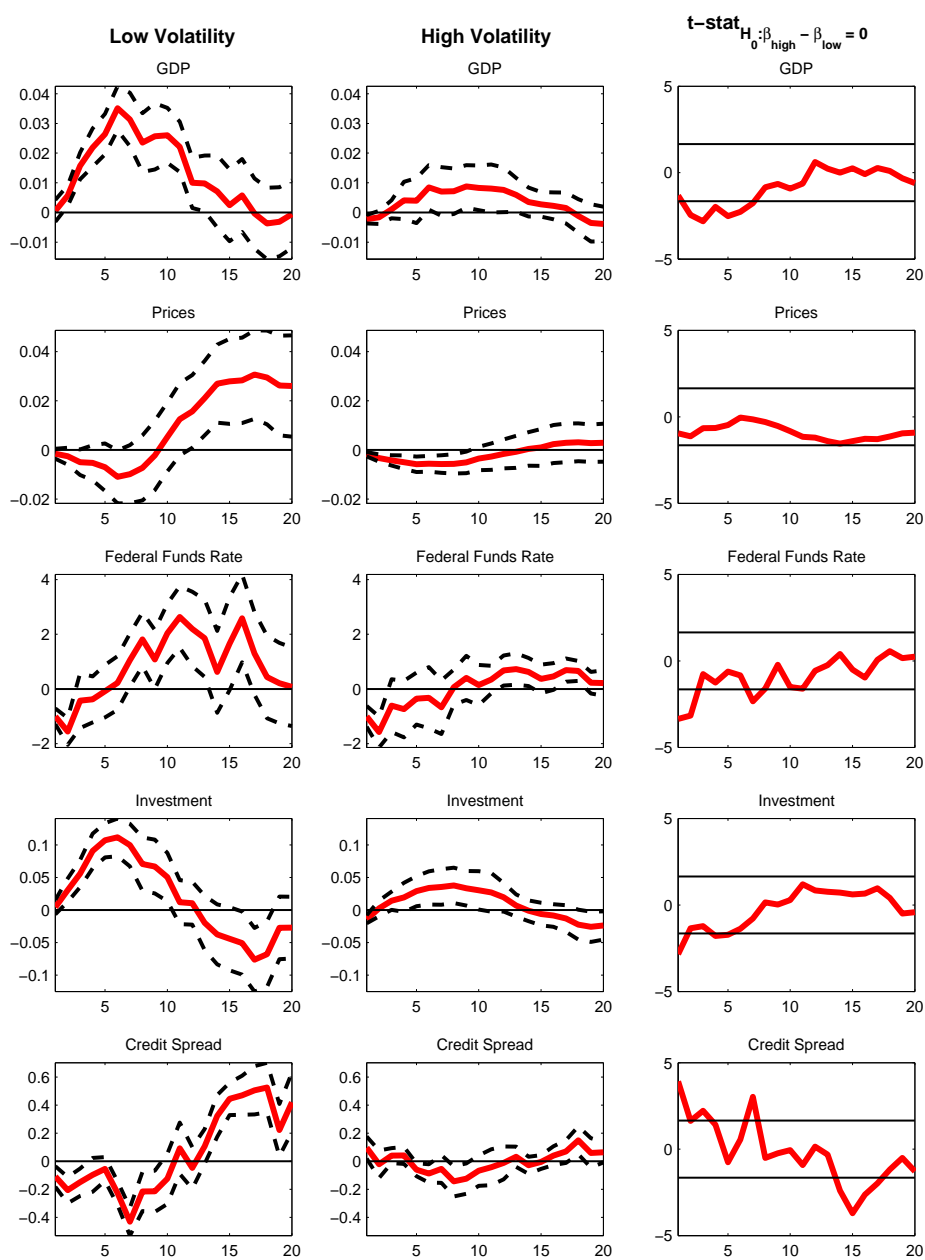
The grey shaded areas correspond to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model estimated over the period 1969-2012. The red line corresponds to the median impulse response and the black-dashed line to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the model estimated over the period 1969-2012 using the one-year T-bill rate as monetary policy indicator and changes in the one-quarter ahead fed funds future as monetary policy shock instrument. Otherwise see notes to Figure 2.

Figure 12: **Effects of monetary policy shocks - sign-identified VAR**



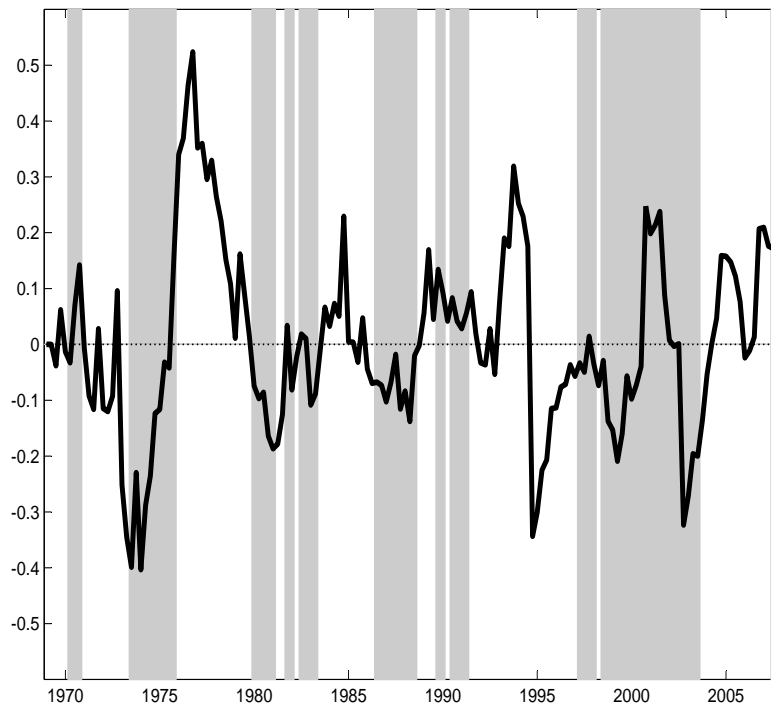
The grey shaded areas correspond to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the baseline model. The red line corresponds to the median impulse response and the black-dashed line to the 16<sup>th</sup> and 84<sup>th</sup> percentiles of the bootstrap distribution of the model with sign-identified monetary policy shocks. Otherwise see notes to Figure 2.

Figure 13: Effects of monetary policy shocks - local projection approach



This figure shows state-dependent impulse responses to monetary policy shocks in the low volatility regime (left panel), in the high volatility regime (middle panel), and differences between these impulse responses (right panel), based on local-projection regressions. We show the point estimate (red) and the 90% confidence intervals. In both regimes, the monetary policy shock is normalized to reduce the federal funds rate by 100 basis points.

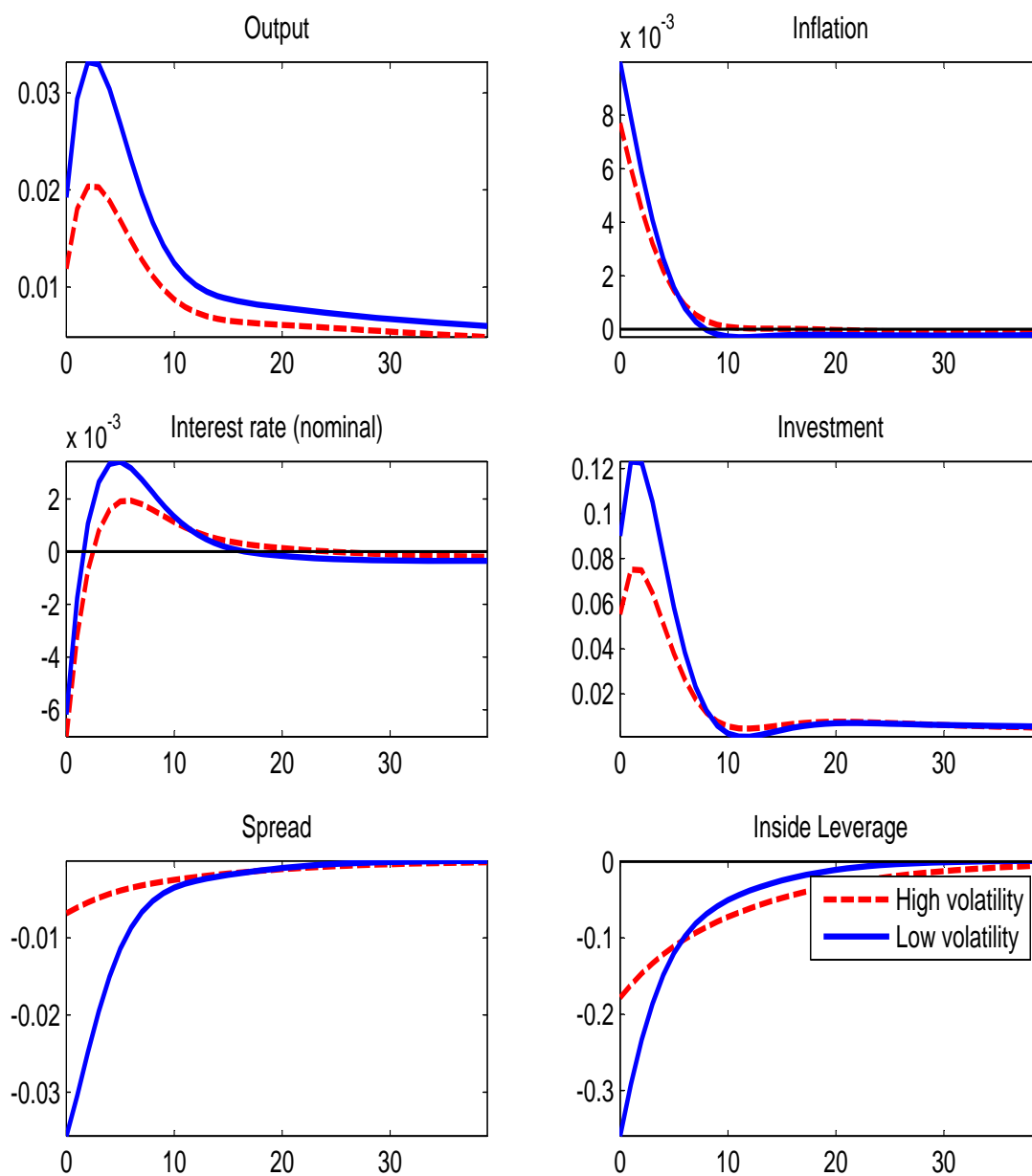
Figure 14: Volatility and leverage



This figure shows the (one-sided HP filtered) leverage of security brokers and dealers together with the identified high volatility regimes (grey shaded areas).



Figure 15: **Effects of monetary policy shocks - theoretical model implications**



This figure shows state-dependent impulse responses to a monetary policy shock obtained from the DSGE model presented in Section 4. All variables are in log deviations from the steady state.