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MONETARY POLICY, CREDIT RATIONING AND UNCERTAINTY

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ABSTRACT

The objectives of this thesis are to assess contemporary Keynesian descriptions of the monetary policy transmission mechanism, with particular reference to credit rationing, to Australia's experience with deregulated financial markets and the allocation of credit; and to discuss the implications thereof for financial stability and the conduct of monetary policy and prudential control in Australia.

The views of neo-Keynesian, New Keynesian and post Keynesian economists with respect to the monetary policy transmission mechanism are compared and contrasted. Granger causality tests are undertaken to determine whether there is any basis, in fact, for preferring one description of the monetary policy transmission mechanism over the others in Australian financial markets. All of the Keynesian descriptions of the transmission mechanism are shown to be inadequate to their task, at least when applied to financial markets in Australia.

Because it was believed that, once financial markets were deregulated in Australia, interest rates would adjust to clear the market for loans and no credit directives would be issued, credit as a component of the transmission mechanism has largely been ignored. I explore whether credit rationing is a component of the monetary policy transmission mechanism in Australia using maximum likelihood estimates of loan supply and loan demand in the business and personal loan markets. I also show that banks have improved their ability since deregulation to set the interest rate which maximises profits when taking into account the effect of a change in interest rates on

borrowers' probabilities of default. This is the interest rate at which the loan supply schedule becomes backward bending so that non-price credit rationing may set in. Thus, the empirical work with respect to the bank-optimal interest rate provides additional support for the non-price credit rationing hypothesis when applied to Australian financial markets.

The conditions under which non-price credit rationing occurs may be important. Post Keynesians, in general, argue that economic agents do not act upon the basis of rational expectations because conditions are fundamentally uncertain. In contrast, neo- and New Keynesians argue that economic agents profit maximise and utility maximise upon the basis of well defined probability distributions. I argue that both views are flawed. Greater understanding of the behaviour of agents in financial markets including that to do with credit rationing and the allocation of credit can be achieved if we allow for the spectrum of behaviours which occur when conditions are merely risky to those which occur when conditions are fundamentally uncertain. As conditions in financial markets become increasingly uncertain, economic agents resort to 'rule-governed' behaviour so that non-price credit rationing arises. My analysis provides a tighter behavioural foundation than currently exists for some of the post Keynesian analysis with respect to credit markets, and for how decision-making is viewed more generally in post Keynesian analysis.

The previous analysis is then followed by a consideration of the interrelations between financial instability, decision-making under uncertainty and non-price credit rationing; and the implications thereof for monetary policy and prudential control in Australia.