

How Does Monetary Policy Affect Shadow Banking Activity? Evidence From Security Repurchase Agreements

Karl David Boulware *†
Jun Ma
Robert R. Reed

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Abstract

We investigate the relationship between instruments of monetary policy and gross financing activity by the primary government securities dealers of the Federal Reserve System. Specifically, we estimate the dynamic effect of money market conditions on repo activity using a recursively identified vector autoregression model at the weekly frequency. We measure shocks to the money market using the effective federal funds rate and open market operations. A positive shock to the federal funds rate significantly affects the level of credit activity. In particular, repo arrangements longer than a day display persistent declines. By comparison, overnight financing increases after a delay. This implies that contractionary monetary policy shocks lead to maturity substitution in the repo market. Our findings show that credit activity in the repo market is more sensitive to monetary policy than previously reported in the literature. Thus, our results indicate that monetary policy can contribute to systemic risk in the shadow banking system. Therefore, the policy actions of central banks should also focus on macroprudential implications in addition to the standard concerns about real activity and price stability.

Keywords: Monetary policy, shadow banking, repurchase agreements, primary dealers, federal reserve system open market account.

JEL classification: E44, E52, G23.

*Karl David Boulware, Corresponding Author, Department of Economics, Finance and Legal Studies, University of Alabama, email: kdboulware@gmail.com; Jun Ma, Associate Professor, Department of Economics, Finance and Legal Studies, University of Alabama, email: jma@cba.ua.edu; Robert R. Reed, Associate Professor, Department of Economics, Finance and Legal Studies, University of Alabama, email: rreed@cba.ua.edu.

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