IMPACT OF MONETARY POLICY ON BANK LIQUIDITY CREATION: ECONOMIC POLICY UNCERTAINTY CHANNEL

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EXECUTIVE SUMMARY

This study examines how monetary policy affects bank liquidity creation in the U.S. from 2001 to 2022. Utilizing a dynamic panel Generalized Method of Moments (GMM) estimator on quarterly bank-level data, the findings indicate that monetary policy exerts a significant negative effect on bank liquidity creation. Crucially, the results demonstrate that economic policy uncertainty (EPU) acts as a key transmission channel through which monetary policy influences the banking sector's output. This adverse effect is particularly pronounced during periods of negative output gaps, suggesting that policy-induced uncertainty significantly dampens the supply of credit during specific economic cycles. These results remain robust across alternative measures of bank liquidity creation, including both category- and maturity-based indices. These findings offer important policy implications, highlighting the need for central banks to account for the mediating role of uncertainty when designing monetary interventions to mitigate shocks to the banking sector.

KEYWORDS

- Financial stability
- Bank liquidity creation
- Monetary policy transmission
- Economic policy uncertainty

RESEARCH RELEVANCE

- The findings indicate that monetary policy exerts a significant negative effect on bank liquidity creation within the U.S. banking system.
- Economic Policy Uncertainty (EPU) functions as a critical underlying transmission channel that mediates and reshapes the impact of monetary policy on the output of the banking sector.
- The adverse contractionary effects of monetary policy are significantly amplified during periods of negative output gaps, demonstrating the cyclical sensitivity of the EPU channel.
- Heightened policy uncertainty induces banks to engage in precautionary liquidity hoarding, which restricts credit supply to the real economy and dampens broader economic activity.

BIBLIOGRAPHIC INFORMATION

Lee, S., & Alam, M. (2026). Impact of monetary policy on bank liquidity creation: Economic policy uncertainty channel. Journal of Banking Regulation, 27(3), Article 39. Advance online publication. https://doi.org/10.1057/s41261-026-00340-2

"The empirical evidence presented in this study demonstrates that the banking industry's output responds negatively to contractionary monetary policy specifically when channeled through Economic Policy Uncertainty (EPU)"