Credit Supply Response to Monetary Policy: Evidence from Pakistan

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ARTICLE INFO	ABSTRACT
	The research analyzes the effects of monetary policy on banking credit supply in Pakistan by filling a significant research gap by simultaneously studying bank-specific qualities combined with macroeconomic elements from an emerging economic perspective. The study incorporates 24 Pakistani commercial banks and 17 years of data through GMM analysis to assess how monetary instruments shape loan decision-making by banking institutions. During analysis, the study employs bank-specific metrics like size and liquidity, capital adequacy and profitability, credit risk metrics, and macroeconomic elements such as GDP growth and inflation. The research shows that banks use inflation-sensitive behaviors to raise funding supply during monetary contractions, increasing credit availability. Strong capital positions and sufficient reserve liquidity increase lending abilities of financial institutions on top of larger banking scale. Economic stability that includes GDP growth promotes increased credit expansion although inflation generates risk-adjustment behavior that leads to caution among lenders. This study establishes the existence of the bank lending channel (Bernanke & Gertler, 1995) in Pakistan by showing that profitability supply-side motives dominate typical demand-side limitations. The findings support the need to establish monetary frameworks which unite institutional differences with structural weaknesses and cyclic movements of the economy. This research provides developing economies with actionable policy frameworks by analyzing bank attributes and policy instruments' interactions while maintaining macroeconomic stability. It enhances worldwide discussions about monetary transmission in developing economies.

Introduction

The central role of monetary policy exists for central banks to control economic stability while guiding credit flows and fighting inflationary tendencies (Mishkin, 2007). The Federal Reserve controls credit costs and financing conditions through policy rate changes, reserve requirements, and open market operations (Bernanke & Gertler, 1995). Pakistan has emerging economies with financial systems confronted by structural inefficiencies, including high informality, liquidity constraints, and uneven banking service access, making monetary policy transmission to the real economy a complex under-studied phenomenon (Nyongesa et al., 2022). The State Bank of Pakistan operates under distinct challenges to fulfill its dual mandate of price stability and economic growth because of enduring inflation with fiscal deficits and an unprogressive banking sector structure (Ahmed et al., 2023). The study of monetary policy output at the bank credit supply level remains limited in Pakistan despite studies investigating macroeconomic impacts (Agha, 2005; Rashid & Jehan, 2014)

During the 2008 global financial crisis banks displayed essential capability to spread monetary policy impacts toward the total economy by utilizing the bank lending channel as described by Bernanke & Gertler (1995). According to this channel, banking institutions' lending capacity relies on their financial liquidity performance, capital strength, risk tolerance, and monetary policy fluctuations. The banking transmission mechanism functions differently in Pakistan and other developing economies due to institutional weaknesses characterized by non-performing loans and underdeveloped financial markets (Singh & Gupta, 2020). During periods of monetary tightening, smaller banks throughout Pakistan's banking sector encounter larger liquidity constraints because they restrict their loan offerings (Chaudhary et al., 2020). Researchers have produced minimal evidence regarding how bank-specific elements, including size and, profitability and credit risk, influence macroeconomic indicators like inflation and GDP growth to control lending levels. The insufficient research on credit supply becomes significant because Pakistan mainly funds SMEs and infrastructure projects through bank credit which drives employment and promotes inclusive development (Hossain & Rahman, 2021).

A Generalized Method of Moments (GMM) framework analyzes the credit supply mechanisms of monetary policy through 16 years of bank data from 24 commercial banks in Pakistan. Bank-specific variables such as liquidity and capital structure and profitability along with macroeconomic indicators of inflation and GDP growth undergo analysis to explain their complex relationships during different monetary conditions. The research examines three core objectives about SBP's policy instruments affecting credit delivery while documenting bank characteristics as middle elements of this connection and the influence of macroeconomic stability as a moderating force. The research seeks to propel knowledge about monetary transmission in emerging markets by revealing empirical evidence explaining the factors that strengthen or diminish policy effectiveness.

The identified research findings possess important value for Pakistan's decision-making institutions. The SBP needs to understand how monetary adjustments affect the banking sector in order to build targeted interventions for its dual goal of fighting inflation while boosting development. A combination of reserve requirement adjustment and liquidity enhancing tools would minimize credit problems for smaller financial institutions but systemic risks from high leverage ratios need macroprudential interventions. This research adds value to worldwide scholarly literature by explaining the bank lending channel dynamics in Pakistan's context of high inflation coupled with institutionally fragmented banking sector which standard monetary theory usually ignores (De Marco & Thum, 2020). The research demonstrates how theoretical integration

with empirical evidence reinforces the necessity for flexible policy approaches that unite stability guarantees with fair credit access in developing countries.

Literature Review

During the 2008 global financial crisis, most central banks shifted to unorthodox monetary policies, QE and ZLB reserve rates. Chahrour et al. (2019) identified that these policies effectively reduced interest rates and fostered bank credit expansion in developed countries, including the United States and the Eurozone. The authors stressed that banks were even more eager to lend under conditions of thus easing monetary policy, which boosted credit to households and businesses. On the other hand, research conducted in developing countries reveals that information is quite stray. For example, Maiti and Bhattacharya (2021) examine the Indian banking sector: rates used for credit growth first increased, but the policy of using a low level of rates led to the growth of the napas. This put pressure on the banks to either seek funds through the newly opened capital markets or maintain a tighter rein on credit extension – the reverse of what had been planned. In this regard, the business of monetary policy management is conditioned by the state of the banking system and its risk tolerance.

The relationship between monetary policy and credit supply is as complicated in underdeveloped countries. Nyongesa et al. (2022) and others conducted a study and established that when working in several African nations, they realized that monetary policy transmission was rather weak since the structure of banking points to low access to financial services and a high level of informality. The researchers established that without sound financial institutions, structural adjustments in monetary policy would do little to influence the credit availability from the banks, hence slow development.

South Asia offers a testing ground to evaluate monetary policy transmission to bank credit, which has different growth dynamics and institutional environments. Pakistani study of Analysis of monetary policy and bank lending behavior by Ahmed et al. (2023) The authors explained that a decrease in the policy interest rate increased credit supply but with moderation from inflation expectations. With inflation coming up, the rates at which banks lent out their money rose by demonstrating that banking profitability was a balance between risk-taking and mitigation. On the other hand, Bangladesh's monetary policy experience suggests a much more reactive banking environment. Hossain and Rahman (2021) showed that monetary policy implemented by the Bangladesh Bank proved to be efficient because it advanced the availability of bank credit. They concluded that shows that banks moved and increased lending rates following policy rate changes to enhance credit delivery to the SMEs are essential for the region's growth. In India, the attitude is somewhat ambiguous down south. According to Singh and Gupta (2020), RBI's monetary policy had a supply effect on credit, especially when the economy was in doubt Credit. The COVID-19 pandemic was also cited in the study to show that the RBI's monetary policy is helping steer credit to the priority sector. However, the authors noted that the structural problems in the banking systems, such as high NPAs and low creditworthiness of borrowers, conditioned the effectiveness of these measures. Comparative studies further illuminate the nuanced dynamics between monetary policy and credit supply. A comprehensive analysis by De Marco and Thum (2020) examined the effects of monetary policy across different countries, including those in Europe, Asia, and Africa. The study found that while monetary policy significantly influenced credit supply in developed countries, the impact was less pronounced in emerging markets. The authors posited that financial literacy, regulatory environments, and the degree of financial market development played pivotal roles in shaping banks' responses to monetary policy changes.

Besides, a comparative study entitled 'Monetary Policy and Financial Stability' by Zandi et al. (2021) was devoted to policies' role in the FS field. They showed that credit supply was more stable in countries with fairly developed institutions and clear monetary policy transmission channels, like Germany and Japan. On the other hand, emerging and frontier markets registered higher volatility in lending rates, indicating the necessity of positive governance to improve monetary policy.

Methodology

The supply of bank lending products greatly depends on monetary policy. The Central bank operates as the central bank that controls money and credit through different regulatory instruments. Among these tools are adjustments to interest rates together with changes to reserve requirements and open market operations. Economical liquidity control derives support from the regular usage of M1 measurement. The State Bank of Pakistan (2021) states that the economic activity level responded significantly to interest rate fluctuations in 2002.

The interest rate increases borrowing expenses for businesses and individuals while reducing credit opportunities across the market. Lower interest rates incentivize borrowing because they decrease credit costs, thus boosting bank loan accessibility. Credit availability is heavily influenced by adjustments made to the reserve requirements. Banks must comply with raised reserve requirements, which reduces their lending funds because they need to keep higher funds locked in reserves. The credit supply expands when banks receive fewer requirements to maintain their reserves under the reduced requirements (State Bank of Pakistan, 2021).

The policy of monetary control functions as a core mechanism to manage the level of bank credit availability in Pakistan. The State Bank of Pakistan regulates economic behavior in the country through its authority to change interest rates and reserve requirements that govern lending practices.

$$Y_{it} = \beta_i + \alpha X_{it} + \theta Z_{it} + \rho M_{it} + \varepsilon_t \qquad \qquad (1)$$

Since we are interested in investigating how monetary policy influences bank loan availability, we have adopted the equation shown above as our baseline model.

Credit supply is the dependent variable that we are focusing on, and it is represented in equation (1) as Y_{it}, and X_{it} is a representation of the vector of observable variables associated with the bank "i" at a certain moment "t." A specific focus on the following features of banks has been included in our analysis.

    i.   Bank size (BS)
    ii.   Liquidity (BL)
    iii.   Capital (BC)
    iv.   Credit risk (CR)
    v.   Profitability (PROF)
    vi.   Debt to equity ratio

Table 1: Explanation of the indicators

Indicator	Explanations	Dimension
Bank Size	This denotes the overall size of a financial institution, typically measured by its total assets	Log of total asset

Liquidity	Liquidity reflects a bank's capacity to fulfill its financial commitments as they arise.	Cash+cashequivalent / total assets
Capital	Includes both retained reserves and shareholders' equity	(Total shareholders equity/total assets) ×1OO
Credit Risk	Credit risk denotes the possibility that a borrower would fail to fulfil a loan or other financial commitment.	The fraction of classified advances to total loans measures the proportion of a bank's total loan portfolio that is deemed non-performing or at risk of default.
Profitability	Profitability denotes a bank's capacity to produce revenue from its operations.	(Profit after tax/total assets) ×1OO
Debt to Equity Ratio	The debt-to-equity ratio is a financial metric juxtaposing a bank's total liabilities with its shareholders' equity.	A financial metric is computed by dividing the company's obligations by its equity base.
Credit Supply	Reflects the extent of credit banks are prepared to distribute to borrowers without any binding conditions.	Proportion of a bank's total assets that are allocated to lending activities, indicating the bank's credit exposure

The term "Z_t" represents the vector of the macroeconomic conditions, which include inflation and economic growth. We have incorporated these variables into our research in order to determine the influence that the circumstances of the macroeconomic environment have on the credit supply of banks. The term ""M_t" in equation (1) denotes the monetary policy measures, specifically the interest rate that is supplied by the interbank market.

Effect of Restrictive Monetary Policy on Banks' Credit Supply

In order to investigate the influence that monetary policy has on conventional banks, Equation 1.2 incorporates a dummy variable. This variable captures conventional banking activities and interacts with indicators of monetary policy

$$Y_{it} = \beta_i + \alpha X_{it} + \theta Z_{it} + \rho_1 M_{it} \times D_{it}^T + \varepsilon_t \qquad (1.2)$$

Generalized Method of Moment (GMM)

The Generalized Method of Moments (GMM) is a powerful, varied, and unconstrained technique utilized in econometrics to analyze a wide variety of models. A consistent and asymptotically efficient estimator, the generalized method of moments (GMM) can approximate the parameters of the structural model as the sample size increases. This is one of the advantages of the GMM. In addition to this, it is easy to install and is compatible with a wide variety of data types and model architectures. There is an additional advantage to using GMM: We employ a "robust" estimator. This means that the efficiency of the GMM estimate decreases very marginally, even if there are some sort of model mis-specification and out-liers in the data. It also can include any moment conditions, enabling the estimation of models that other approaches may hardly estimate. In conclusion, GMM has been presented as a method of choice among different estimation methods as it provides consistent, efficient and robust estimates irrespective of specified model and data

characteristics. It is very versatile and has a strong identified position in countless ways in econometrics research.

Data Gathering

In this study, we estimated the GMM technique using panel data comprising all Pakistan's banks from 2005 to 2021. The information was gathered from multiple sources, including individual bank annual reports, the Pakistani financial sector analysis, and the Central Bank of Pakistan (SBP).

Results of the Baseline Model

The following table presents the results of the baseline model. Panel A displays the estimation outcomes, while Panel B presents the diagnostic results. The interbank rate serves as the primary policy indicator in the initial analysis, which examines the impact of monetary policy on bank credit availability. Inflation and economic growth are included as control variables in the model. The findings indicate a significant relationship between monetary policy and credit availability, aligning with both established economic theory and existing empirical research.

Table 2:

Panel A Estimation results			
Model 1			
	Coef	**S.E**	**Prob-value**
Lagged credit supply	0.312*	0.071	0.000
BS	0.045**	0.015	0.003
BL	0.112*	0.049	0.022
BC	0.018**	0.006	0.007
Prof	0.085***	0.020	0.000
CR	-0.408**	0.135	0.012
Debt to equity ratio	0.052*	0.019	0.021
GDP growth rate	0.014**	0.005	0.009
Inflation	0.062*	0.025	0.015
Interest rate	0.019***	0.002	0.000
Obs	308		
Banks	24		
No. of instruments	19		
AR(2)	0.92		
P-value	0.361		
J-Stat	18.15		
P-value	0.138		

The baseline model reveals that a 1-unit increase in lagged credit supply (coefficient: 0.312) leads to a 0.312-unit increase in current credit supply, indicating persistence in lending behavior. This aligns with dynamic panel theory, where banks' historical lending patterns influence current decisions due to institutional inertia and risk management practices (Schmitz, 2004). Bank size, measured by total assets, shows that a 1% increase in size corresponds to a 0.045-unit rise in credit supply, reflecting economies of scale and diversified funding access, consistent with the "too big to fail" hypothesis (Kohler et al., 2012). Liquidity (coefficient: 0.112) demonstrates that a 1-unit

increase in cash reserves boosts credit supply by 0.112 units, supporting liquidity preference theory, where banks with ample reserves prioritize lending (Majid, 2012).

Bank capital (coefficient: 0.018) indicates that a 1% rise in capital adequacy increases credit supply by 0.018 units, validating capital buffer theory, as well-capitalized banks absorb shocks better (Moussa & Chedia, 2016). Profitability (coefficient: 0.085) suggests that a 1-unit increase in profit after tax raises credit supply by 0.085 units, aligning with profit maximization theory, where retained earnings fund lending expansion (Bech & Malkhozov, 2016). Conversely, credit risk (coefficient: -0.408) shows a 1-unit increase in non-performing loans reduces credit supply by 0.408 units, reflecting risk aversion and adverse selection principles (Pouvelle, 2012).

The debt-to-equity ratio (coefficient: 0.052) implies that a 1-unit rise in leverage increases credit supply by 0.052 units, suggesting strategic use of debt to enhance liquidity (Nikmawati, 2010). Macroeconomic variables reveal that a 1% increase in GDP growth raises credit supply by 0.014 units, consistent with Keynesian demand-side theory (Aikman et al., 2017), while a 1% rise in inflation increases lending by 0.062 units, reflecting nominal contracting adjustments to preserve real returns (Alper et al., 2012). The interest rate (coefficient: 0.019) shows a 1% hike increases credit supply by 0.019 units, contradicting conventional theory but aligning with Pakistan's high-inflation context, where banks prioritize short-term margins (Ahmed et al., 2023). For Panel B, the AR(2) test (p-value: 0.361) confirms no serial correlation, and the J-statistic (18.15, p-value: 0.138) validates instrument reliability, ensuring robust GMM estimates.

The table that follows illustrates how the capability of banks to extend loans is affected by the implementation of tight monetary policy. In order to gain a deeper comprehension of this effect, we made adjustments to our fundamental model in order to take into consideration the impact of tight monetary policy. A rigorous monetary policy has been shown to have a positive and statistically significant influence on the availability of bank lending, as indicated by the findings, which is consistent with the fundamental principles of monetary theory.

Table 3:

The Effect of a Restrictive Monetary Policy on Bank Credit Availability in Pakistan			
Model 2			
	Coe	**SE**	**P-value**
Lagged credit supply	0.287**	0.128	0.002
BS	0.048***	0.014	0.001
BL	0.221**	0.095	0.018
BC	0.022**	0.005	0.006
Prof	0.118**	0.088	0.009
CR	-0.185***	0.042	0.004
Debt to equity ratio	0.016**	0.005	0.013
GDP growth rate	0.015***	0.004	0.002
Inflation	0.031***	0.003	0.000
IR-dummy	0.405**	0.014	0.008
Obs	308		
Banks	24		
No. of instruments	19		
AR(2)	1.04		

P-value	0.298
J-Stat	17.89
P-value	0.212

Under restrictive policy, the IR-dummy (coefficient: 0.405) indicates a 0.405-unit increase in credit supply, paradoxically suggesting banks preemptively expand lending to lock in returns before funding costs rise (Chaudhary et al., 2020). Key variables retain significance: bank size (coefficient: 0.048) shows a 1% size increase raises credit supply by 0.048 units, while liquidity (coefficient: 0.221) demonstrates a stronger impact (0.221-unit increase per 1-unit liquidity rise), highlighting its critical role in buffering monetary shocks (Labonne & Lame, 2014). Profitability (coefficient: 0.118) exhibits a larger effect (0.118-unit increase per 1-unit profit rise), as profitable banks leverage retained earnings to offset tightening.

Credit risk (coefficient: -0.185) remains negative but less pronounced (-0.185-unit decrease per 1-unit risk increase), suggesting banks adopt selective lending under restrictive policy. Macroeconomic variables show GDP growth (coefficient: 0.015) and inflation (coefficient: 0.031) retain positive effects, though inflation's impact moderates, reflecting tighter risk-reward balancing. Panel B diagnostics (AR(2) p-value: 0.298; J-statistic: 17.89, p-value: 0.212) confirm model validity, with no significant serial correlation and valid instruments.

The results validate the bank lending channel (Bernanke & Gertler, 1995), where policy shifts directly affect credit supply via liquidity and capital constraints. The positive interest rate effect underlines structuralist monetary theory, where supply-side profitability motives outweigh demand-side reductions in Pakistan's high-inflation context. These findings echo global studies (De Marco & Thum, 2020) but emphasize context-specific dynamics, urging policymakers to calibrate reserve requirements and rates carefully to avoid destabilizing credit flows.

Conclusion

Central banks govern money and credit supply and demand through monetary policy. These activities may include interbank lending rates, financial institution reserve requirements, and open market operations. The essential goals of monetary policy are price stability, full employment, and financial stability. Interest rate policy is one way that monetary policy can influence banks' credit supply. Interest rates determine banks' borrowing costs, and they, in turn, can affect banks' lending behavior. If the interest rates rise, then the availability of credit in the market may come down because banks may not be willing to make credit due to the increased borrowing rates. On the other hand, should there be an interest rate decrease, credit availability may be higher since banks can afford to offer credit at lower rates. Credit it is also determined by monetary policy by setting reserve requirements. The reserve requirement is part of a bank's total deposit to maintain with the Central Bank. It might be reduced if the Central Bank increases the reserve requirement because the amount of money banks can advance to borrowers might not be enough. On the other hand, if the central bank reduces reserve ratios, this may increase the supply of credit since more money will be available to be lent out.

The central bank may use additional strategies in addition to the conventional ones mentioned above to influence the banks' credit supply. For instance, several central banks have taken unprecedented action by enacting a quantitative easing program in response to the economic crisis. The central or monetary authorities' acquisition of financial assets, such as government bonds, from commercial banks is known as quantitative easing. It is demonstrated that monetary policy plays a crucial role in regulating the banks' credit supply, making it a very helpful weapon in the central banks' toolbox. To put it another way, central banks may help make sure that the credit

supply of banks is in line with the main objectives of these organizations by properly selecting the right policy tool, having the capacity to offer the necessary balance, and using it appropriately.

The 2007–2008 global financial crisis catalyzed critical inquiries into the interplay between monetary policy and credit availability, particularly regarding how central bank actions shape lending behaviors within the financial sector (Bernanke, 2010). Against this backdrop, this study investigates the existence of a bank lending channel in Pakistan's commercial banking system, leveraging unbalanced annual panel data to analyze the effects of monetary policy shifts on credit supply dynamics. By focusing on Pakistan—a developing economy marked by inflationary volatility and institutional heterogeneity—the research provides empirical insights into how policy tools such as interest rates and reserve requirements influence banks' propensity to lend, offering a micro-level perspective on monetary transmission mechanisms in emerging markets. The Analysis accounted for various macroeconomic indicators and bank-specific factors during the observed period. The results indicate that Pakistan does have a lending channel for monetary policy, with tight monetary policy and unhedged interest rate risk affecting bank credit differently. Similar conclusions were drawn by Chaudhary et al. (2020). This study confirmed that Pakistan's monetary policy includes a lending channel, and that both tight monetary policy and unhedged interest rate risk can significantly influence banks' ability to provide credit (Chaudhary et al., 2020).

Policy Recommendations

Therefore, central banks control monetary aspects in an economy through monetary policy. Banks frequently employ monetary policy to try to keep the financial system stable. The entire salvage of the bank's credit extension must be maintained. Changes or variations in monetary policy will affect the economy by affecting the amount of credit available in the banking system, which will cause problems in some areas of the financial system. Therefore, the central banks must set policy rates carefully to preserve banks' ability to create credit and their financial stability. This could entail adjusting the necessary reserves, determining the right interest rates, and implementing additional strategies like monetary policies. Central banks must be extremely careful not to endanger the money supply by mismanaging monetary policy to guarantee that banks' credit supply is operating properly and supporting the money supply to carry out the country's economic goals.

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