Global Scientific JOURNALS

GSJ: Volume 9, Issue 8, August 2021, Online: ISSN 2320-9186
www.globalscientificjournal.com

EFFECTS OF MONETARY POLICIES ON LENDING BEHAVIOUR OF COMMERCIAL BANKS IN A DEVELOPING ECONOMY

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Abstract

The purpose of this paper was to investigate the effect of monetary policies on the lending behaviour of commercial banks in an emerging economy. Commercial banks are in the business of mobilizing and lending financial resources to borrowers .The bank lending channel suggests that banks play a special role in the transmission of monetary policies. Commercial banks are profit motivated institutions and their response to monetary policies largely influence their profit margins. The study analysed the response of commercial banks to monetary policies in context of interest rates (cost of lending) and reserves available for lending. The study employed a descriptive research design. The study target population was drawn from the five most profitable commercial banks in Nigeria. Purposive sampling was used to select respondents from credit department - lending department of each commercial bank while descriptive statistics and standard deviation were used to help in data analysis. Tables and other graphical presentations as appropriate were used to present the data collected for ease of understanding and analysis. The study established that Central Bank Rate CBR, cash reserve ratio, open market operation and uncertainty caused by possible outcomes caused by monetary policy changes influences lending behaviour by commercial banks .

Introduction

Monetary policy is one of the principal economic management tools that governments use to shape economic performance. Measured against fiscal policy, monetary policy is said to be quicker at resolving economic shocks. Monetary policy objectives are concerned with the management of multiple monetary targets among them price stability, promotion of growth, achieving full employment, smoothing the business cycle, preventing financial crises, stabilizing long-term interest rates and the real exchange rate. Experience shows that emphasis is usually placed on maintaining price stability or ensuring low inflation rates. The effectiveness of monetary policy on the real economy is still an issue under intense debate particularly related to the efficacy of the transmission. Research carried out on the choice of optimal monetary policy instrument for Kenya; Kehoe (2007) suggest further research to accommodate more realistic features in the economy like the exchange rate and foreign trade, the government sector and consumption behavior. Bank loans are one of the most important long-term financing sources in many countries (Freixas and Rochet, 2008). In some developed countries like Japan, long term bank loans represent more than 70% of its total long-term debt. The recent cross-country evidence shows that banks in the emerging and developing countries'economies are reluctant to extend credit to private businesses. Some factors influencing this reluctance are the unstable local government economic policies, the idiosyncratic country legal risk, monetary policies and the riskiness and opacity of business borrowers in these countries. Although there is a broad body of literature that addresses these issues, it either focuses on the demand side of debt (firms access to credit) or on the cross-country variation of bank lending behavior.

In the view of Nwankwo (2000), credit constitutes the largest single income-earning asset in the portfolio of most banks. This explains why banks spend enormous resources to estimate, monitor and manage credit quality. This is understandably, a practice that impact greatly on the lending behaviour of banks as large resources are involved. According to Adedoyin and Sobodun (1991), ―lending is undoubtedly the heart of banking business. Therefore, its administration requires considerable skill and dexterity on the part of the bank management‖. While a bank is irrevocably committed to pay interest on deposits it mobilized from different sources, the ability to articulate loanable avenues where deposit funds could be placed to generate reasonable income; maintain liquidity and ensure safety requires a high degree of pragmatic policy formulation and application (Chodechai 2004). However, lending behavior of banks is greatly influenced by a myriad of factors among them monetary policies. Monetary policy has developed considerably in recent years due to the governments urge to control inflation and to promote economic growth. In the fifties and sixties, monetary policy relied mainly on direct controls. The government often set limits on the amount that financial institutions could lend, and mortgages were effectively rationed. In those days the Bank could exert some control on financial institutions by what was known as 'moral suasion'. Banks and individuals had strict limits on the amounts they could change into other currencies.

Recently Financial sector reform (FSR) has become a major component of the structural adjustment programme in Kenya with the deregulation of interest rates. However, in terms of

attention, research efforts in this regard have been minimal, when compared to the efforts into the other components of the programme such as trade liberalization and exchange rate reforms. Even where research is available, emphasis has tended to be placed on the institutional aspects of the programme and here too the focus has been on the banking sub-sector (Ikhide and Alawode 1994). The reasons for this are not far-fetched. Stabilization issues tend to have more far reaching implications, given the structures of most Sub-Saharan African countries and given the nature of imbalances that necessitated the implementation of economic reforms in these countries in the seventies and early eighties. Efforts were geared towards the investigation of current account and government deficits as well as their implications for saving/investment imbalances. The financial sector in some of these countries is coterminous with the banking system and an examination of the role of the banks in the mobilization of savings for the purpose of bridging the savings/investment gap come naturally with the aforementioned concerns. The central bank has a great role in regulating the financial sector to achieve accelerated economic growth. The 3 principle objective of the Central Bank of Nigeria (CBN) is to formulate and implement monetary policy directed to achieving and maintaining stability in the general level of prices in the economy. To achieve these objectives monetary policy must directly affects bank lending.

Concept of Monetary Policy

Monetary policy refers to the combination of measures designed to regulate the value, supply and cost of money in an economy. It can be described as the art of controlling the direction and movement of credit facilities in pursuance of stable price and economy growth in an economy (Chowdhury, Hoffman and Schabert, 2003). Monetary policy refers to the actions of the Central Bank to regulate the money supply which could be through discretional monetary policy instruments such as the open market operation(OMO), discount rate, reserve requirement, moral suasion, direct control of banking system credit, and direct regulation of interest rate (Loayza, and Schmidt-hebbel, 2002).

Monetary policy comprises the formulation and execution of policies by the central bank to achieve the desired objective or set of objectives; the policies and decisions are aimed at guiding bank lending rates to levels where credit demand and money growth are at a level consistent with aggregate supply elasticity (Loayza and Schmidt, 2002). The objectives and goals that the central bank seeks to achieve generally are low inflation (usually targeted), protection of value of currency, full employment and sustainable economic output (economic growth). Monetary policy covers the monetary aspect of the general economic policy which requires a high level of co-ordination between monetary policy and other instruments of economic policy of the country. The effectiveness of monetary policy and its relative importance as a tool of economic stabilization varies from one economy to another, due to differences among economic structures, divergence in degrees of development in money and capital markets resulting in differing degree of economic progress, and differences in prevailing economic conditions (Faure, 2007). To achieve the desired stabilization in an economy, central banks use various monetary policy instruments which may differ from one country to another according to differences in political systems, economic structures, statutory and institutional procedures, development of money and

capital markets and other considerations. Some of the commonly used monetary policies include: changes in the legal reserve ratio, changes in the discount rate or the official key bank rate (Central bank Rate), exchange rates and open market operations. Monetary transmission mechanism is the mechanism through which changes in money supply affects the decisions of firms, households, financial intermediaries, investors and ultimately alters the level of economic activities and prices it can be thought of as encompassing the various ways in which monetary policy shocks propagate through the economy (Kuttner and Mosser 2002).

Theoretical Review

Loan Pricing Theory

Banks cannot always set high interest rates, e.g. trying to earn maximum interest income. Banks should consider the problems of adverse selection and moral hazard since it is very difficult to forecast the borrower type at the start of the banking relationship (Stiglitz and Weiss, 1981). If banks set interest rates too high, they may induce adverse selection problems because high-risk borrowers are willing to accept these high rates. Once these borrowers receive the loans, they may develop moral hazard behaviour or so called borrower moral hazard since they are likely to take on highly risky projects or investments (Chodecai, 2004). From the reasoning of Stiglitz and Weiss, it is usual that in some cases we may not find that the interest rate set by banks is commensurate with the risk of the borrowers.

Credit Market Theory

A model of the neoclassical credit market postulates that the terms of credits clear the market. If collateral and other restrictions (covenants) remain constant, the interest rate is the only price mechanism. With an increasing demand for credit and a given customer supply, the interest rate rises, and vice versa. It is thus believed that the higher the failure risks of the borrower, the higher the interest premium (Ewert et al, 2000). The increase in demand for credit brought about by low interest rates eventually may lead to depreciation of currency. Central bank therefore must adjust the interest rate to increase the cost of borrowing. Commercial banks in their turn must increase their rates and therefore lending is lowered as credit becomes expensive.

Loanable Funds Theory

Under the loanable Funds theory of interest, the rate of interest is calculated on the basis of demand and supply of loanable funds present in the capital market. The loanable funds theory of interest advocates that both savings and investments are responsible for the determination of the rates of interest in the long run while short-term interest rates are calculated on the basis of the financial conditions prevailing in an economy. The determination of the interest rates in case of the loanable funds theory of the rate of interest depends on the availability of loan amounts. The availability of such loan amounts is based on factors like the net increase in currency deposits, the amount of savings made, willingness to enhance cash balances and opportunities for the formation of fresh capitals (Bibow, 2000).

Central Bank Rate (CBR)

There is general agreement among economists and policymakers that monetary policy works mainly through interest rates. When the central bank policy is tightened through a decrease in reserve provision, for instance, interest rates rise. Interest rate rise means that the banks have to adjust their lending rates upwards. The rise in interest rates leads to a reduction in spending by interest sensitive sectors of the economy, such as housing and consumer purchases of durable goods. Therefore, the cost of credit becomes high and in most cases becomes unaffordable reducing demand for credit.

Some economists and policymakers have argued that an additional policy channel works through bank credit (Keeton, 2001; Stiglitz and Weiss, 2001). In this view, monetary policy directly constrains the ability of banks to make new loans, making credit less available to borrowers who depend on bank financing. Thus, in the credit channel, restrictive monetary policy works not only by raising interest rates, but also by directly restricting bank credit. However, Gambarcorta and Mistrulli (2004) study in Italian banks during the period 1992 to 2001 using short-term interest rates and found that well-capitalised banks can shield their lending from monetary policy shocks as they have easier access to non-deposit fund raising. Interest rate denotes the time value of money as it is the rate at which an amount of money accrues over time. In economic theory, interest is the price paid for inducing those with money to save it rather than spend it, and to invest in long-term assets rather than hold cash. Rates reflect the interaction between the supply of savings and the demand for capital; or between the demand for and the supply of money (O'Hara, 2005).

Cash Reserve Ratio

The reserve requirement (or cash reserve ratio) is a central bank regulation that sets the minimum fraction of customer deposits and notes that each commercial bank must hold (rather than lend out) as reserves. These required reserves are normally in the form of cash stored physically in a bank vault (vault cash) or deposits made with a central bank. The required reserve ratio is sometimes used as a tool in monetary policy, influencing the country's borrowing and interest rates by changing the amount of funds available for banks to make loans with. Western central banks rarely alter the reserve requirements because it would cause immediate liquidity problems for banks with low excess reserves; they generally prefer to use open market operations (buying and selling government-issued bonds) to implement their monetary policy (Chodechai, 2004). In banking, excess reserves are bank reserves in excess of the reserve requirement set by a central bank. They are reserves of cash more than the required amounts. Holding excess reserves has an opportunity cost if higher risk-adjusted interest can be earned by putting the funds elsewhere; the advantage of holding some funds in excess reserves is that doing so may provide enhanced liquidity and therefore more smooth operation of payment system. The reserve requirement can be used as an instrument of monetary policy, because the higher the reserve requirement is set, the less funds banks will have to loan out, leading to lower money creation and perhaps

ultimately to higher purchasing power of the money previously in use. The effect is multiplied, because money obtained as loan proceeds can be re-deposited; a portion of those deposits may again be loaned out, and so on.

Usman (2005), commenting on the factors that affect commercial banks‘ lending behaviour said that, ―the sound and viable functioning of commercial banks in Nigeria is adversely affected by the choice of certain policy instruments for the regulation of banking operations. Such instruments include a rigidly administered interest rate structure, directed credit, unremunerated reserve requirements and stabilizing liquidity control measures like the stabilization securities of the past‖. Ituwe (1983) also asserted that, ―a bank‘s ability to grant further advances is checked by the available cash in its vault. Customers‘ drawings are paid in two ways, either in cash or through bank accounts. Since cheques have to be met in cash in many cases, commercial banks, therefore, have to stock reasonable quantity of cash to meet customers‘ demands‖. Where a bank grants advances in excess of its cashing ability, the bank soon runs into difficulty in meeting its customers‘ cash drawings.

Open market operations

An open market operation (also known as OMO) is an activity by a central bank to buy or sell government bonds and bills on the open market. A central bank uses them as the primary means of implementing monetary policy. The usual aim of open market operations is to control the short term interest rate and the supply of base money in an economy, and thus indirectly control the total money supply. This involves meeting the demand of base money at the target interest rate by buying and selling government securities, or other financial instruments. Monetary targets, such as inflation, interest rates, or exchange rates, are used to guide this implementation. Federal Reserve has used OMOs to adjust the supply of reserve balances so as to keep the federal funds rate around the target federal funds rate established Open market operations are the principal instrument in affecting the full range of credit and monetary conditions. As the ultimate source of liquidity to the economy, the System cannot control total bank reserves precisely in the very short run because the monetary system of a modern economy must be able to respond flexibly to wide week-to-week changes in the demand for currency, bank deposits and credit that are imperfectly predictable as to timing and amount. But the System can and does exert a strong influence over the growth path of total bank reserves, deposits and credit by varying over time the division between reserves provided without strings through open market operations and those provided with strings through the discount window. Through open market operations, a central bank influences the money supply in an economy directly. Each time it buys securities, exchanging money for the security, it raises the money supply. Conversely, selling of securities lowers the money supply. Buying of securities thus amounts to printing new money while lowering supply of the specific security. The main open market operations are: Temporary lending of money for collateral securities ("Reverse Operations" or "repurchase operations", otherwise known as the "repo" market). These operations are carried out on a regular basis, where fixed maturity loans (of one week and one month for the ECB) are auctioned off; Buying or selling securities ("direct operations") on ad-hoc basis and foreign exchange operations such as forex swaps.

Treasury bills are the least risky and the most marketable of all money market instruments used by the government to raise money by selling bills to the public. T-bills have a maturity period of 91- and 182-day. Principally, sales are conducted via auction, at which investors can submit competitive or non-competitive bids. A competitive bid is an order for a given quantity of bills at a specific offered price. If the bid is high enough to be accepted, the bidder gets the order at the bid price (Madura, 2003). Individuals can purchase T-bills directly at auction or on the secondary market from a government securities dealer. T-bills are sold at a discount from face value (cash payment at maturity) and pay no explicit interest payments. At the bill‘s maturity, the holder receives from the government a payment equal to the face value of the bill (Bodie et al., 2002). T-bills are highly liquid, which means that they can easily be converted to cash and sold at low transaction cost with low price risk. It is therefore a preferred option by the banks to invest in. Before 2006 the 91 day Treasury bill was the benchmark rate applied to bank that were look to borrow overnight for the central bank. The rate was pegged at the 91 day Treasury bill rate plus a margin normally 3%. As a result it developed as the benchmark rates on which all rates were directly on indirectly pegged to. Prior to 2006 I would expect to find a very strong correlation between the 91 day Treasury bill rate and deposit rates Treasury bill also influencing the market by creating demand for money from the _loanable‘ funds Market. Repurchase agreements on the other hand, play a crucial role in the efficient allocation of capital in financial markets. ―With a repurchase agreement (REPO), one party sells securities to another for cash with an agreement to repurchase the securities at a specified date and price. In essence, the repo transaction represents a loan backed by the securities (Madura, 2003). The lender has claim to the securities, in the case that the borrower defaults on the loan. Most REPOs are overnight transactions, with the sale taking place one day and being reversed the next day. Long-term repos can extend for a month or even up to one year by being rolled over. A reverse repo refers to the purchase of securities by one party from another with an agreement to sell them. The term is used to describe the opposite side of a REPO transaction. Thus, a repo and a reverse repo can refer to the same transaction but from different perspectives (Wechsler, 1998).

In addition to the commercial paper market, banks use the repo market, the federal funds market, and the interbank market to finance themselves. Repurchase agreements, or ―REPOs,‖ allow market participants to obtain collateralized funding by selling their own or their clients‘ securities and agreeing to repurchase them when the loan matures (Markus, 2009). The Kenyan money market rate is the overnight interest rate at which banks lend reserves to each other to meet the central bank‘s reserve requirements. In the interbank market, banks make unsecured, short-term (typically overnight to three-month) loans to each other. The interest rate is individually agreed upon. While a repo is legally the sale and subsequent repurchase of a security, its economic effect is that of a secured loan. Economically, the party purchasing the security makes funds available to the seller and holds the security as collateral. If the security pays a dividend, coupon or partial redemptions during the repo, this is returned to the original owner. The difference between the sale and repurchase prices paid for the security represents interest on the loan. Indeed, repos are quoted as interest rates (Hull, 1997, p. 50). The dealer thus takes out a one-day loan from the investor and the securities serve as collateral. Repos are considered very safe in terms of credit risk because, in general, the loans are backed by government securities (CBK, 2012). Since they is low risk involved, banks prefer it to loans.

Research Methodology

The study employed a descriptive research design as descriptive research design helps describe the state of affairs as it is at present, as the intention of this study was to establish the effects of monetary policies on lending behaviour of commercial banks in Nigeria taking a case of the five (5) most profitable banks in Nigeria. Through the questionnaire the researcher was able to estimate the extent to which each of the monetary tool affect the lending behaviour. The main reason for using descriptive research design in this study was to ensure the in depth description of the state of affairs as it exists at the present.

To study the relationship between monetary policies and the lending behaviors of commercial banks, the study used the following regression model: $Y = \beta 0 + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + \varepsilon$ **Where:** Y = Bank Lending; β0 = Constant Term; β1, β2, β3 and β4 = Beta coefficients; X1= CBR; X2= Cash Reserve Ratio; X3= Open Market operations; X4= Uncertainty; ε = Error term

Purposive sampling was used to select respondents from credit department - lending department of each commercial bank, the study had 53 respondents who were used in data collection. The target sample in credit department was selected since they are the main drivers of lending policies and practices in commercial banks. This study collected both primary and secondary data. Primary data was collected using questionnaires. On the other hand secondary data was collected from newspapers, published books, journals, magazines and company handbook.

Data Analysis and Presentation

The researcher edited completed questionnaires completeness and consistency. Data clean-up followed; this process involves editing, coding, and tabulation in order to detect any anomalies in the responses and assign specific numerical values to the responses for further analysis. The data was then analyzed using descriptive statistics and content analysis. The descriptive statistical tools (SPSS version 20 and Excel) helped the researcher to describe the data. The Likert scale was used to analyze the mean score and standard deviation. The findings were presented using tables and graphs for further analysis and to facilitate comparison. This generated quantitative reports through tabulations, percentages, and measure of central tendency. The content analysis was used to analyze the respondents‘ views about to establish effects of monetary policies on the performance the five most profitable commercial banks in Nigeria. On testing the relationship between central bank rates and lending behaviors, the study looked at loan portfolio performance in the last three years quarterly.

The researcher further employed a Pearson‘s product moment correlation analysis multivariate and regression model to study the relationship between monetary policies and the lending behaviors of commercial banks. The research deemed regression method to be useful for its ability to test the nature of influence of independent variables on a dependent variable. Regression is able to estimate the coefficients of the linear equation, involving one or more independent variables, which best predicted the value of the dependent variable. Further, correlation analysis was done to illustrate the direction of relationship between the independent variables and the dependent variable.

The study sought to establish the extent Central Banks'Monetary Policy affect lending behaviour of commercial banks in Nigeria. The results are as indicated;

Very great extent	12%
Great extent	58%
Moderate extent	20%
Low extent	08%
Not at all	02%

The above indicates that, according to majority of the respondents, 58%, Monetary policy affect lending behaviour of commercial banks to a great extent, 20% said that it influences to a moderate extent, 12% indicated that it influences to a very great extent while 8% and 2% said that monetary policy affect lending behaviour of commercial banks to a little extent and to no extent respectively. This depicts that monetary policy influences lending behaviour of commercial banks to a great extent.

Below presents data on the level of agreement from the respondents with statements related to monetary policy and lending behaviour of commercial:

Statement	Mean	Standard Deviation
In the credit channel, restrictive monetary policy works not only by raising interest rates, but also by directly restricting bank credit	4.1429	1.36753
When the central bank policy is tightened through a decrease in reserve provision, interest rates rises	4. 3986	1.41238
Using short-term interest rates, well-capitalized banks can shield their lending from monetary policy shocks as they have easier access to non-deposit fund raising	4.1571	1.35417
Monetary policies induce changes in interest rates, and the amount of money and credit in the economy to minimize excessive price fluctuations, and promote economic growth	4.4821	1.33473

Majority of the respondent strongly agreed that monetary policies induce changes in interest rates, and the amount of money and credit in the economy to minimize excessive price fluctuations, and promote economic growth as indicated by a mean score of 4.4821. They also strongly agreed that when the central bank policy is tightened through a decrease in reserve provision, interest rates rise as indicated by a mean score of 4.3986. They were further in agreement with statements that using short-term interest rates, well-capitalized banks can shield their lending from monetary policy shocks as they have easier access to non-deposit fund raising as indicated by a mean score of 4.1571 and that in the credit channel, restrictive monetary policy works not only by raising interest rates, but also by directly re as indicated by a mean score of 4.1429.

Further, to establish the effect of central bank rate on lending behaviour of commercial banks, the study sought to the central bank rate trend . The data findings are as indicated:

	Frequency	Percentage (%)
Reducing	01	2
Fluctuating	31	62
Steady	03	6
Rising	15	30
Total	50	100

According to majority of the respondents (62%), CBR have been fluctuating in the 5 year prior to the study. 30% of the respondents indicated that the rates had been increasing, while 6% and 2% said that central bank rate in Kenya had been steady and reducing respectively in the 5 year period prior to the study.

To established that the trend of CBR influenced banks‘lending behaviour, the study sought to establish further the rate of this effect. The data effect is as presented:

	Frequency	Percentage
Negligible	03	6
Low	09	18
Moderate	11	22
High	22	44
Very High	05	10
Total	50	100

From the above, most of the respondents, 44%, indicated that the CBR trend effect on bank lending behaviour was high, 22% said that the effect was moderate and 18% indicated that CBR rates trend had low influence on banks‘ lending behaviour. Also, 10% of the respondents indicated that CBR trend effect on bank lending behaviour was very high while 6% indicated that it was negligible. According to the respondents, the effect of CBR trends was indicated to have led to herding behaviour by commercial banks where the banks mimic the behaviour of the leading banks. It has also caused conservative banks to withhold credit for fear of losing when rates changes due to default in payment by the customers. Further, this change in banks

willingness to lend affects borrowers who depend on bank lending as their investment and spending decisions are altered.

Conclusions and Recommendations

Based on the results from data analysis and findings of the research, one can safely conclude the following, based on the objectives of the study; bank lending behaviour is influenced by CBR. It also concludes low interest rate lowers the cost of borrowing and therefore banks attract new loans demands. On cash reserve ratio, the study concludes that it has effect on bank lending behaviour. The study also concluded that reserve requirements cause immediate liquidity problems for banks with low excess reserves thereby influencing lending and payment systems in the commercial banks concerned. It was also concluded that holding some funds in excess reserves provides enhanced liquidity and therefore more smooth operation of payment system and that the higher the reserve requirement is set, the less funds banks will have to loan out. The study further concluded that banks participate in market operations to a great extent and that OMO influences bank lending behavior Kimani (2013). The study also concluded that open market operations provides the bank with low risk investments with certainty in pay off and therefore banks may prefer OMO and that OMO also controls the short term market interest rate of base money in an economy.

Finally, the study concludes that uncertainty caused by expected changes in monetary policies influences banks'lending behaviour. It also concluded that decision to extend loans to new or existing customers by banks will be affected by both the current and near–term expected state of the macro-economy as dictated by variation in monetary policies, uncertainty may lead to herding behaviour by commercial banks and that when it is not certain on the changes in the monetary policies, banks might be forced to withhold credit in fear that it might result to non-performing loans. The study recommends that the government streamline the economic environment in which banks operates to help curb the fluctuation in CBR and therefore ensure stable rates of borrowing. The government through the central bank should put in measures to curb inflation. This will ensure that Kenyan currency does not lose much on world major currency and therefore this will help to stabilize the central bank rates. Further, the study recommends that central bank should hold cash reserve ratio constant so as cushion borrowers from fluctuating lending rates by commercial banks. However, since excessive borrowing will have inflationary effect in the economy, the study recommends that central bank commit commercial banks to open market operations to control short term interest rate and the supply of base money in an economy. With CBK effective monetary policies that cushions borrowers, this will curb speculative borrowing that affect lending behaviour by commercial banks.

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