Apr 23rd, 9:00 AM - 4:00 PM

The Effect of Disintermediation of the Banking System on the Money Multiplier

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The purpose of this research project is to determine how the shift from bank to non-bank lending affects the Federal Reserve Bank's ability to control the money supply. Traditional monetary policy holds that as the monetary base is increased through an expansion of bank reserves, the quantity of money in the economy should also increase. The transmission channel through which bank reserves becomes money is the money multiplier. This study involves a time series study of the effect of the disintermediation of banking on the money multiplier.

Based on the model developed by Garfinkel and Thornton of the St. Louis Federal Reserve Bank, this study tries to further explain changes in the currency demand deposit ratio based on the hypothesis that alternative sources of borrowing and lending have become substitutes for currency and demand deposits. The currency leakage from the money multiplier can be partially explained as a result of disintermediation. According to the theory that I have developed, as the amount of bank disintermediation increases there should be a corresponding decrease in the money multiplier as a result of increased leakages in the form of a larger currency to demand deposit ratio.