



RESERVE BANK OF AUSTRALIA

Understanding the Transmission Mechanism of Monetary Policy

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Education

The Questions I Grapple With Every Day...

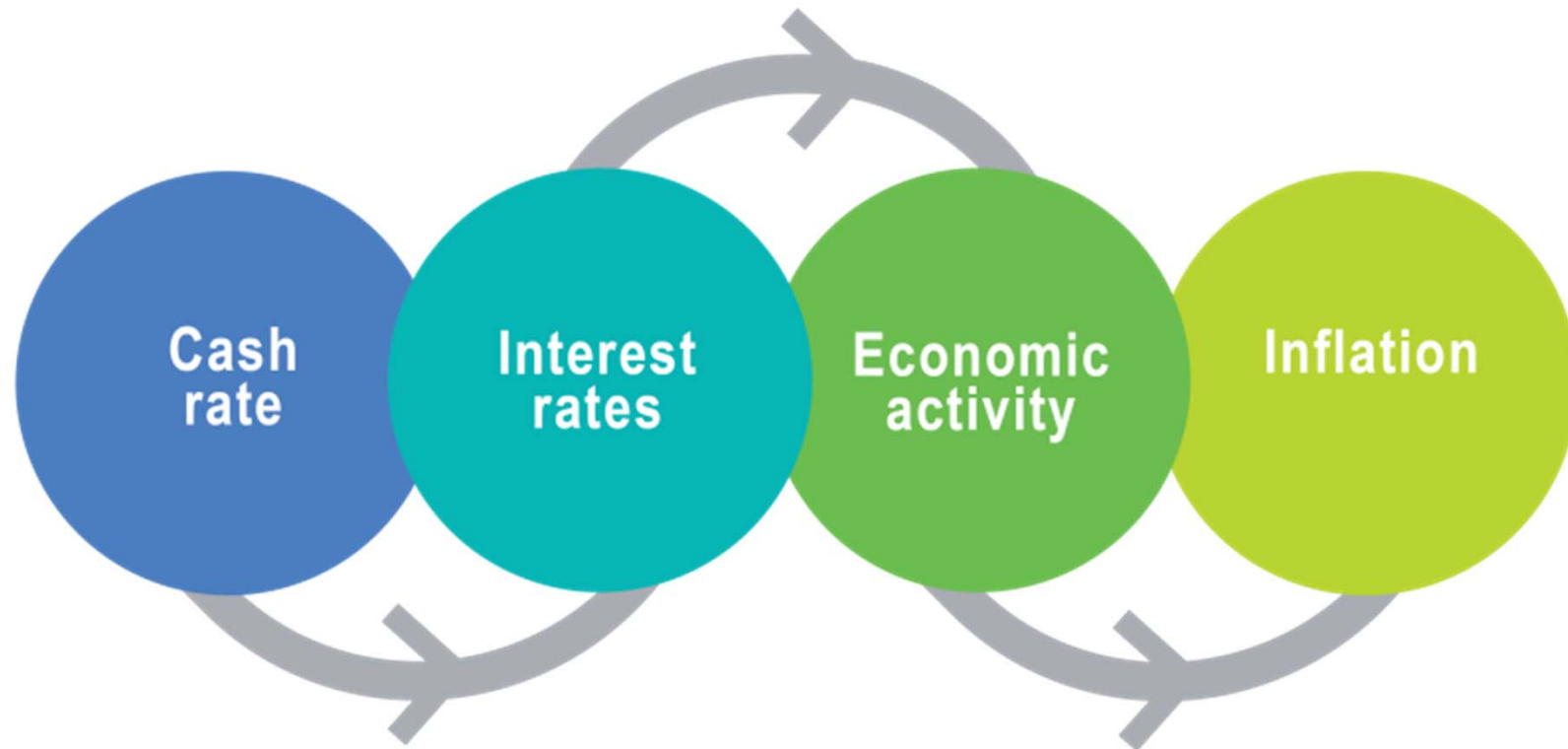
- How does monetary policy work? How do interest rates affect the economy? What are the channels?



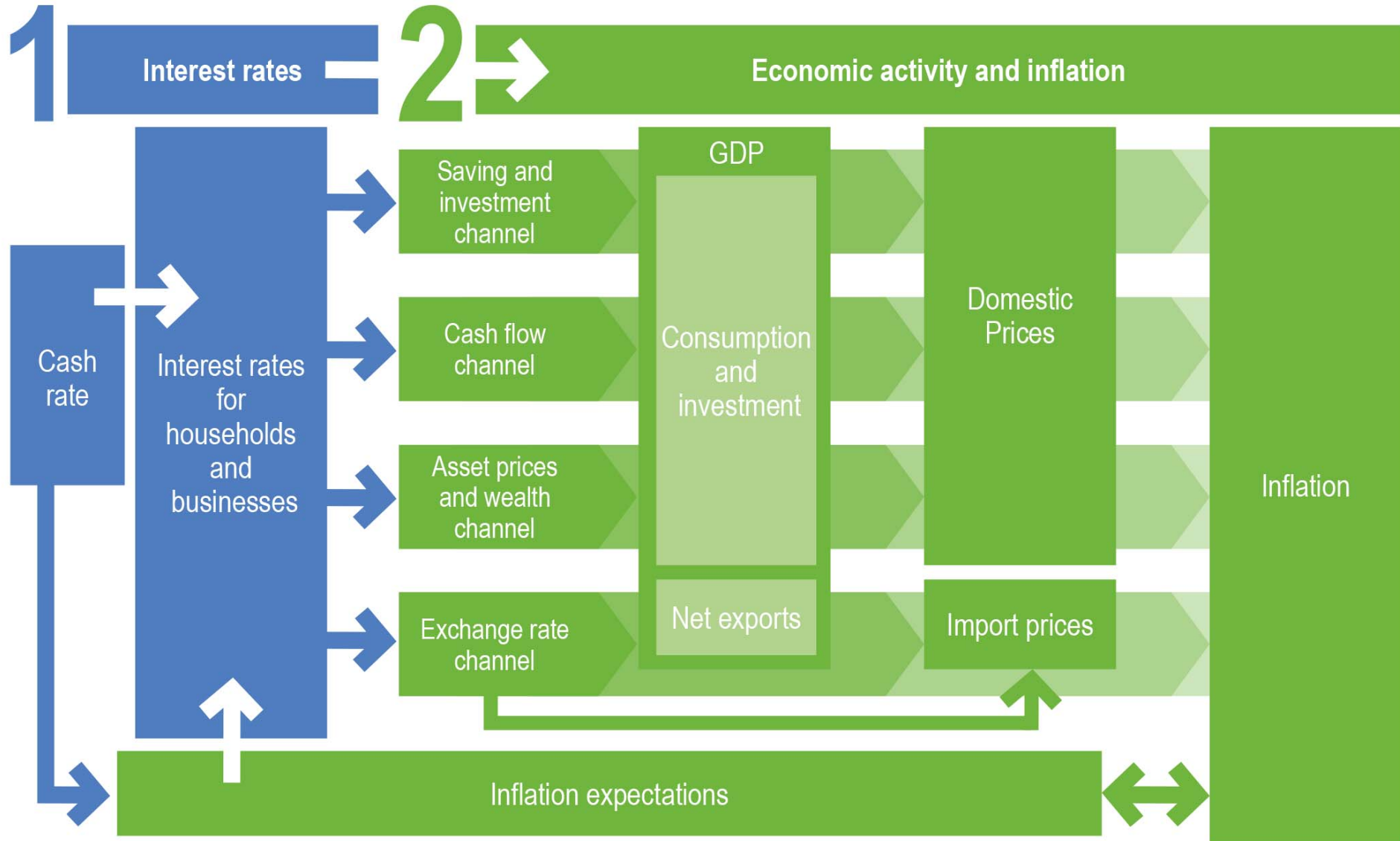
Overview

- What are the stages of the monetary transmission mechanism?
- What are the channels of transmission?
 - The investment/saving channel
 - The cash flow channel
 - The asset prices/wealth channel
 - The exchange rate channel
- Which channels are most important? Have they changed over time?
- What is the overall effect of interest rate changes on the economy?

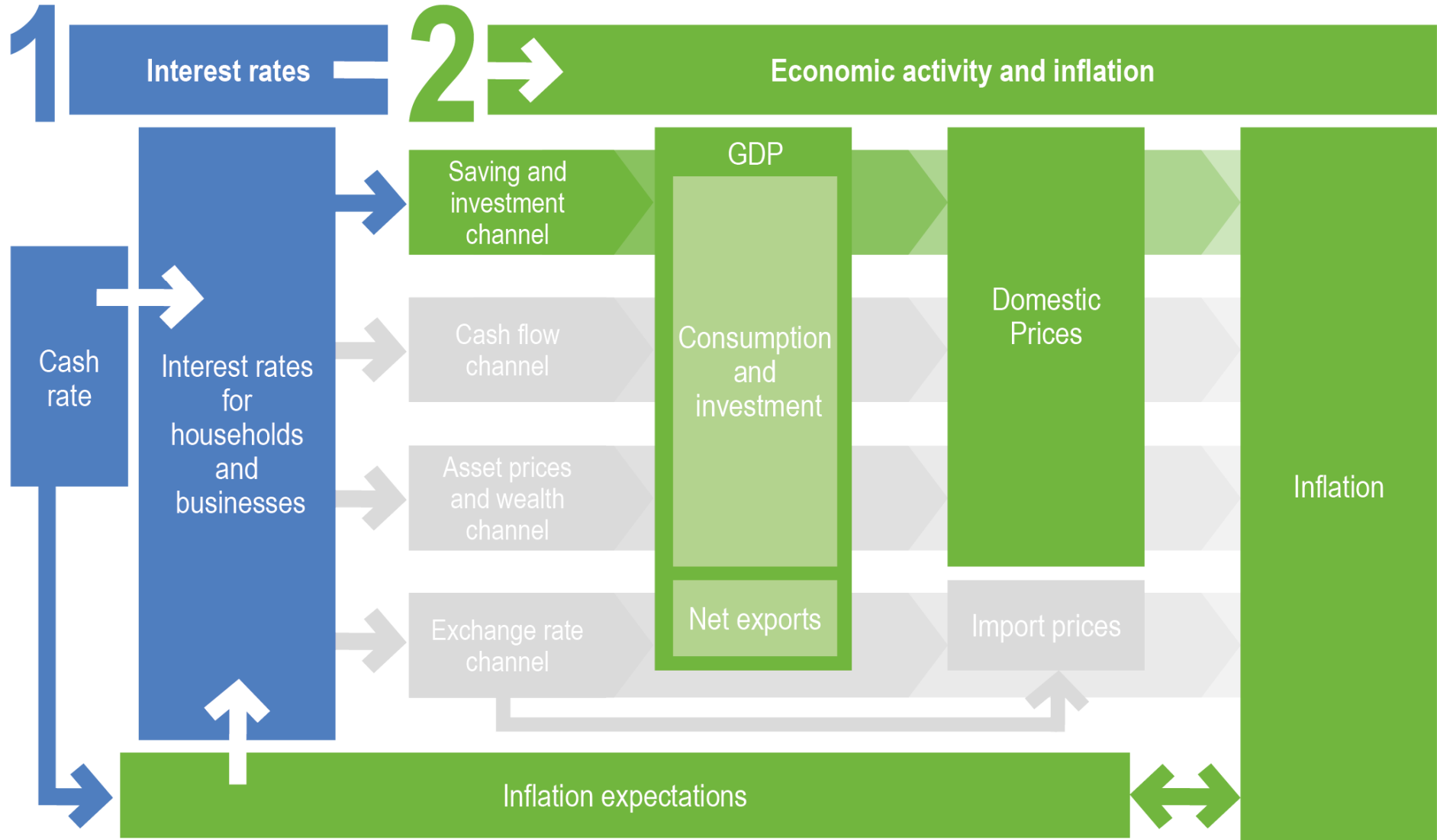
The Monetary Transmission Mechanism



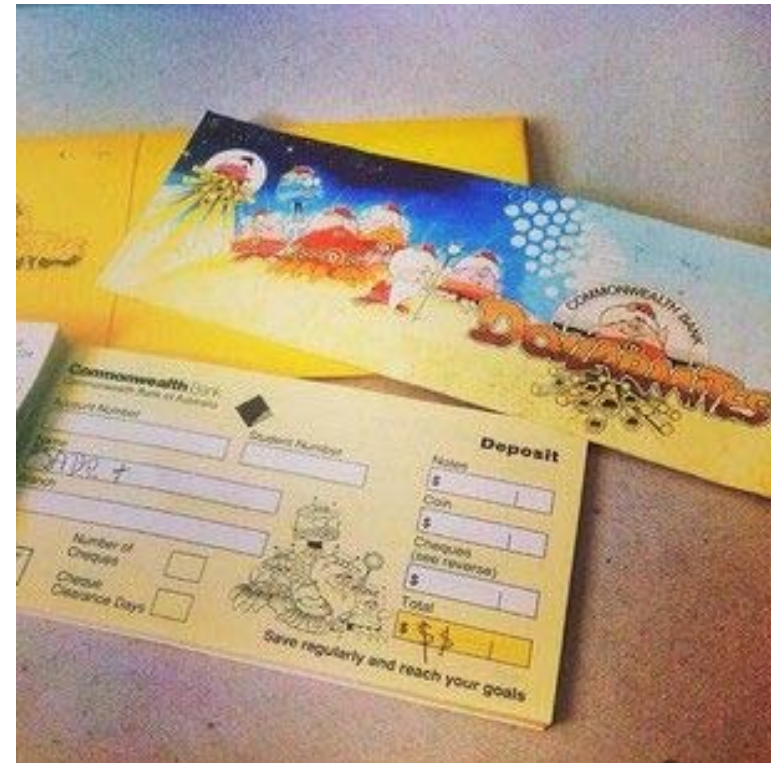
The Channels of Monetary Transmission



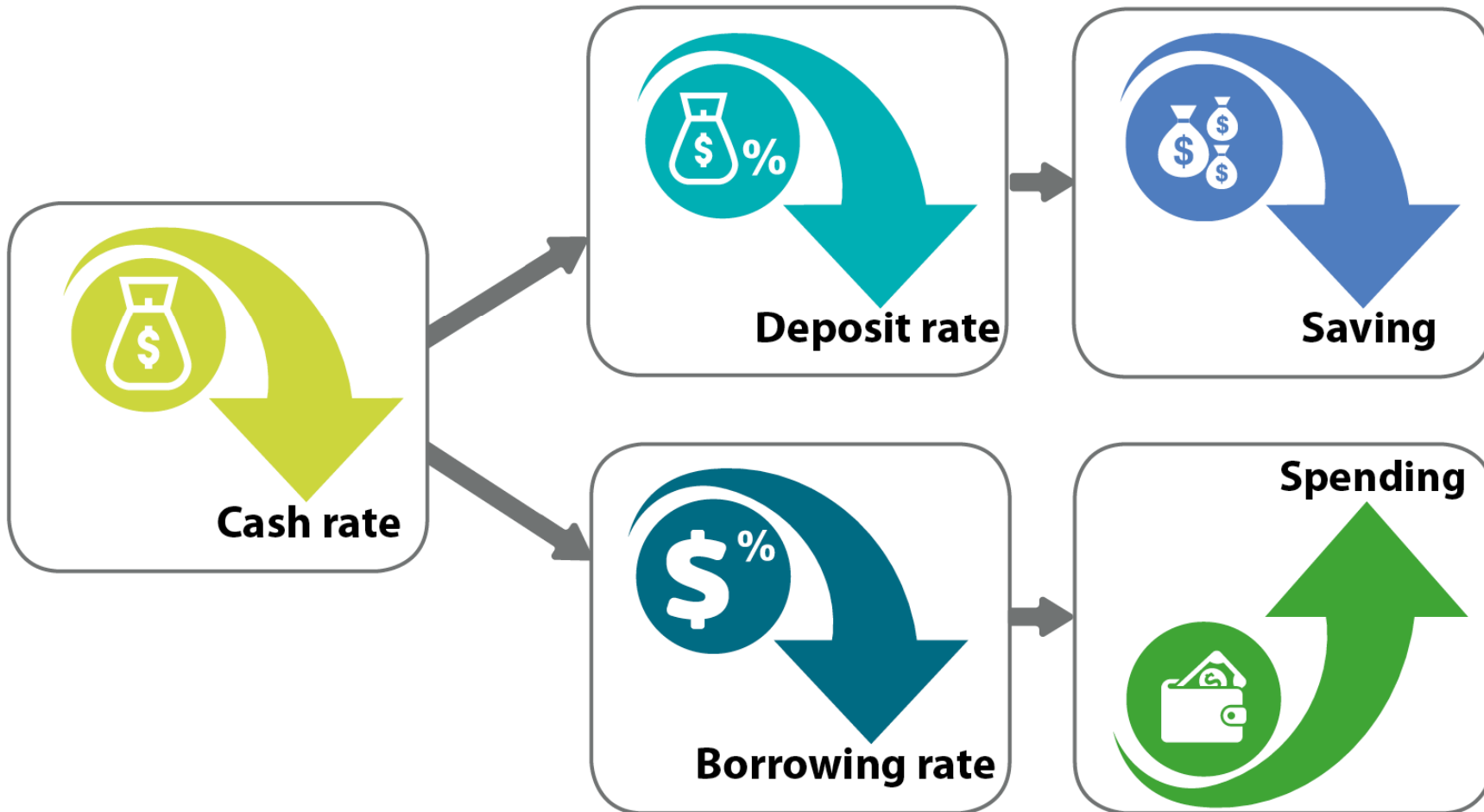
The Saving and Investment Channel



The Saving and Investment Channel



Investment/Saving Channel



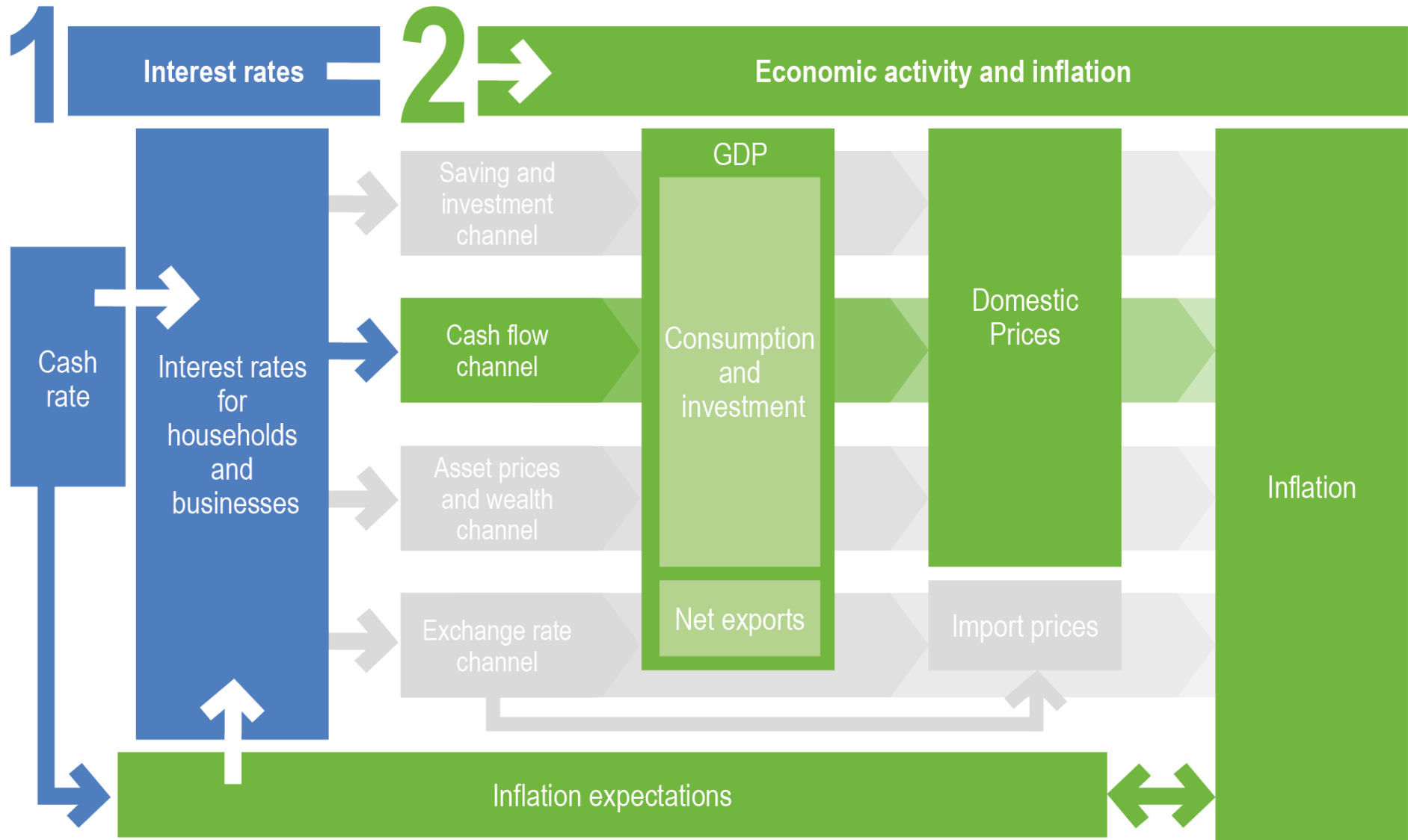
The Saving and Investment Channel

- Economists like to call it “the intertemporal substitution channel”
- In theory, works for households (e.g. dollarmite accounts) and for businesses (e.g. equipment investment)
- It is very important in macroeconomic models, but does it exist?
 - Ongoing debate on whether investment is sensitive to interest rates
 - Surprisingly hard to work out if households are sensitive to changes in interest rates via this channel

The Saving and Investment Channel



The Cash Flow Channel



Economy Real wages growth 'declining'
Low rates risk hot housing in slow economy



Mortgage holders winning battles



Uncertainty puts us in a fix

FINANCIAL SERVICES

Interest hikes hit indebted households



RBA bets on record rate to stimulate

Interest rate cut: Sydney is sacrificed to rescue the nation



Fixed Rate Home Loan	
4.89% _{p.a.}	5.98% _{p.a.}
years	Comparison Rate



Rates: home loan borrowers rejoice



Mortgage rate hikes pressure income



Retirees feel the interest pinch



Retirees lose out in RBA rate cut

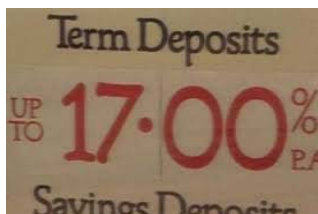


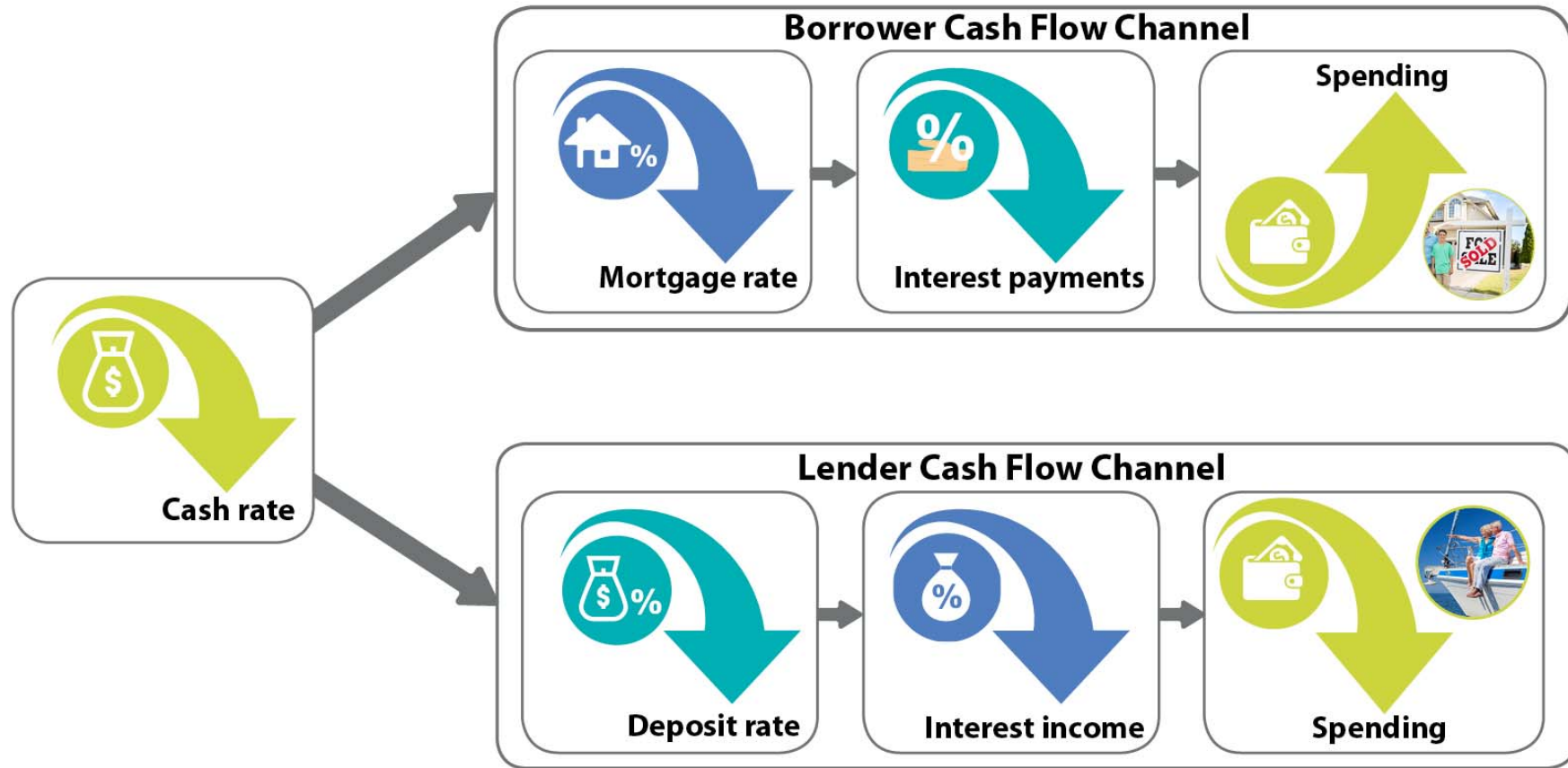
Rates future bleak for retirees

Reserve board minutes offer hope for retirees



RBA's pointless cut a cruel blow for retirees

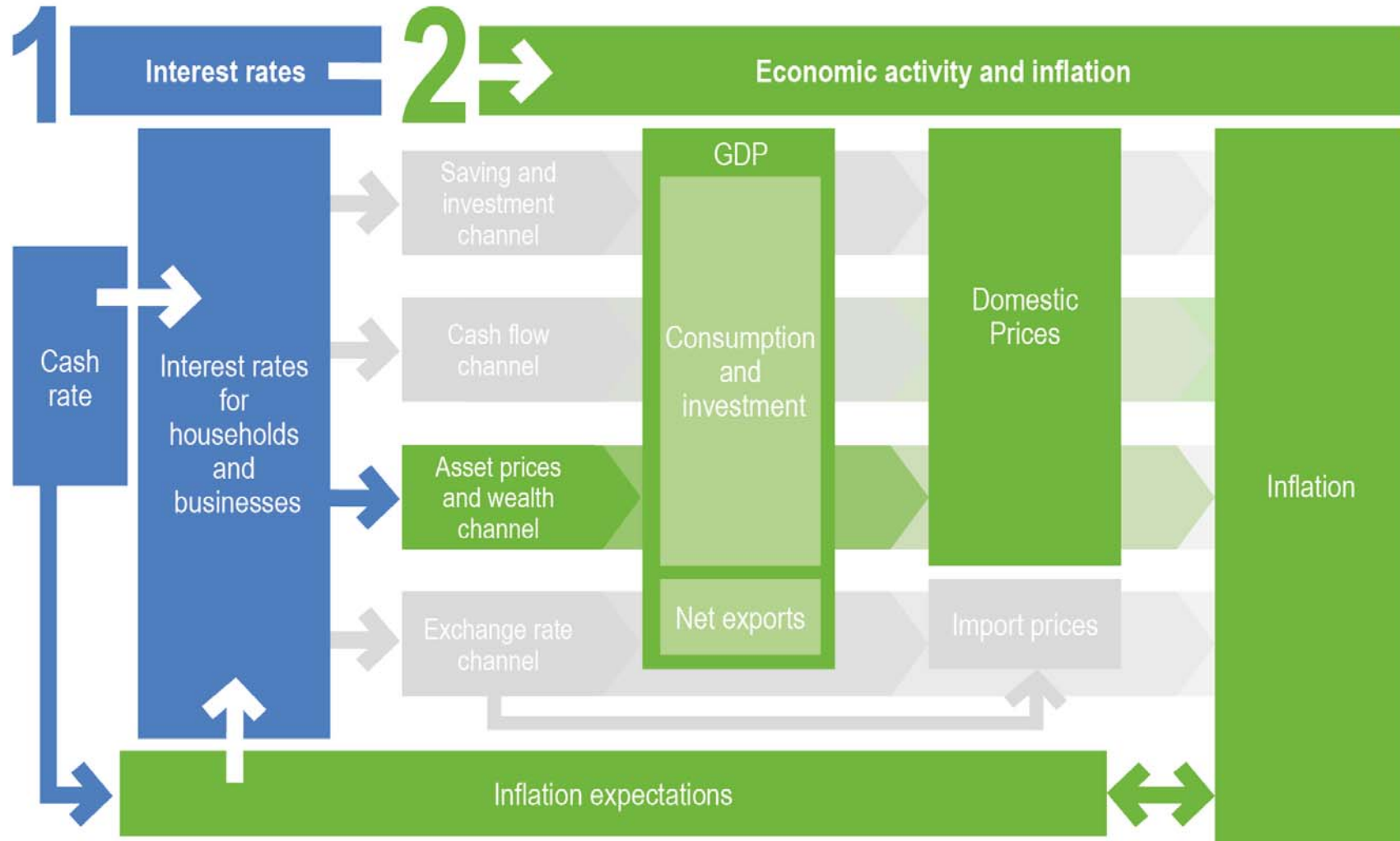




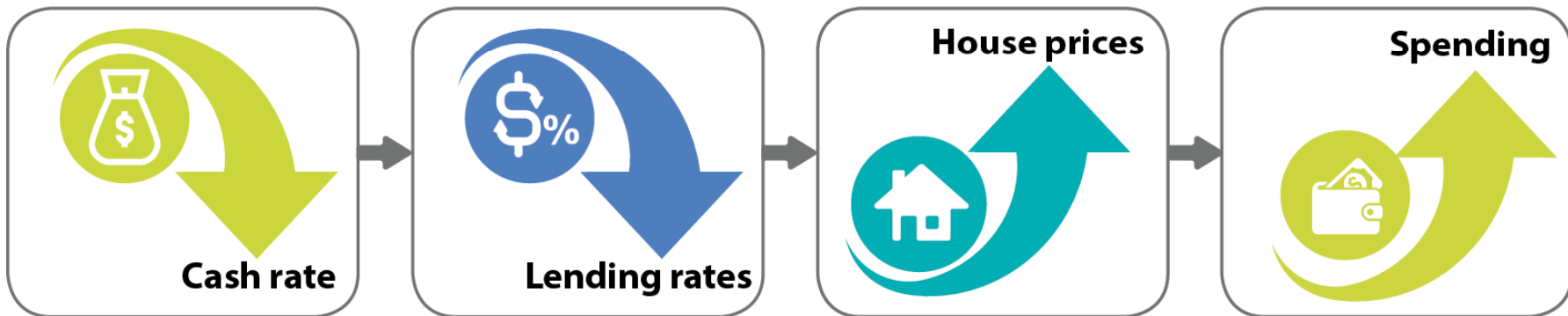
The Cash Flow Channel

- Consists of two channels
 - Borrower channel
 - Lender channel
- Seems to exist for households and for businesses
- Exciting area of growing research in Australia and overseas (e.g. La Cava, Hughson and Kaplan (2016))

The Asset Prices/Wealth Channel



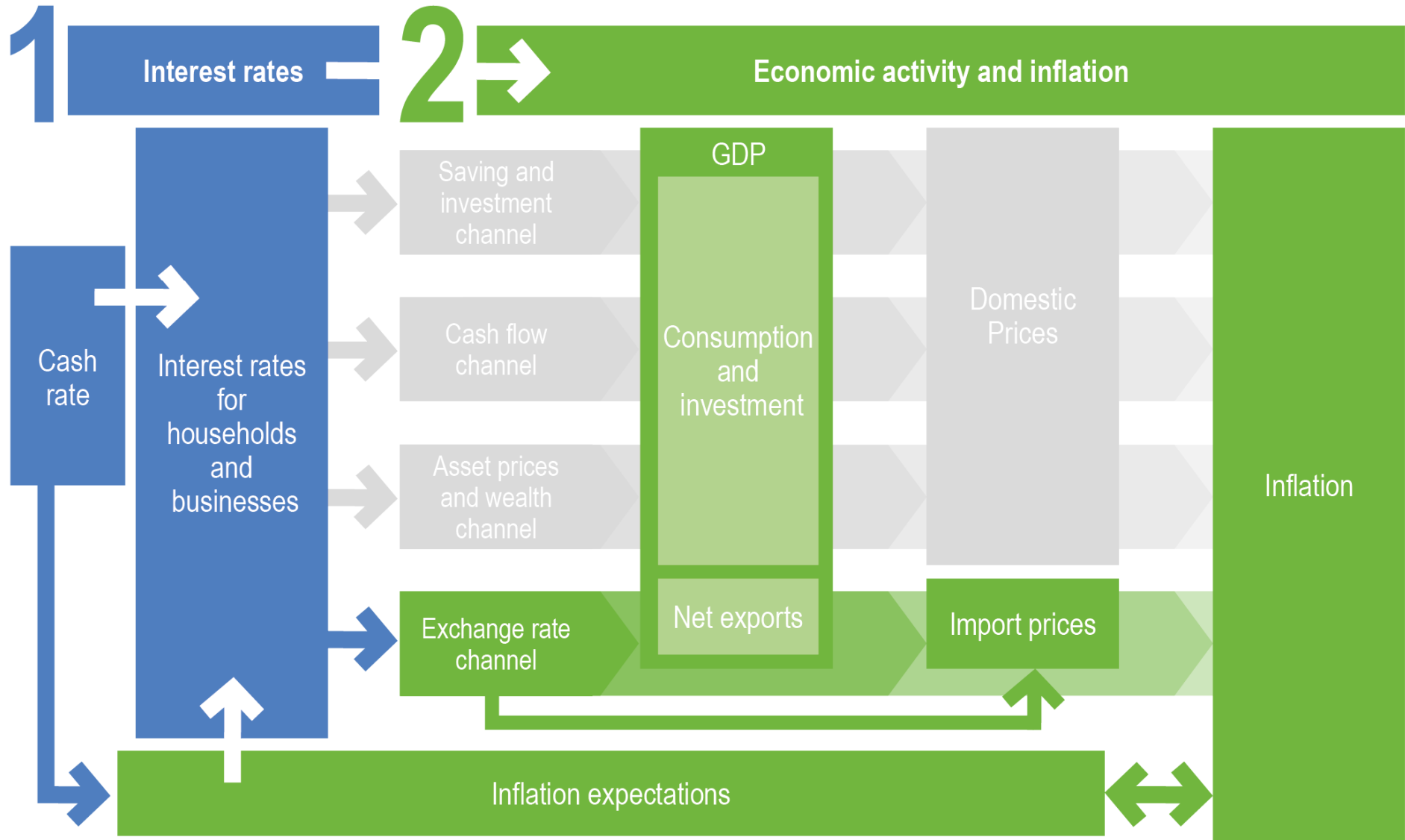
The Asset Prices/Wealth Channel



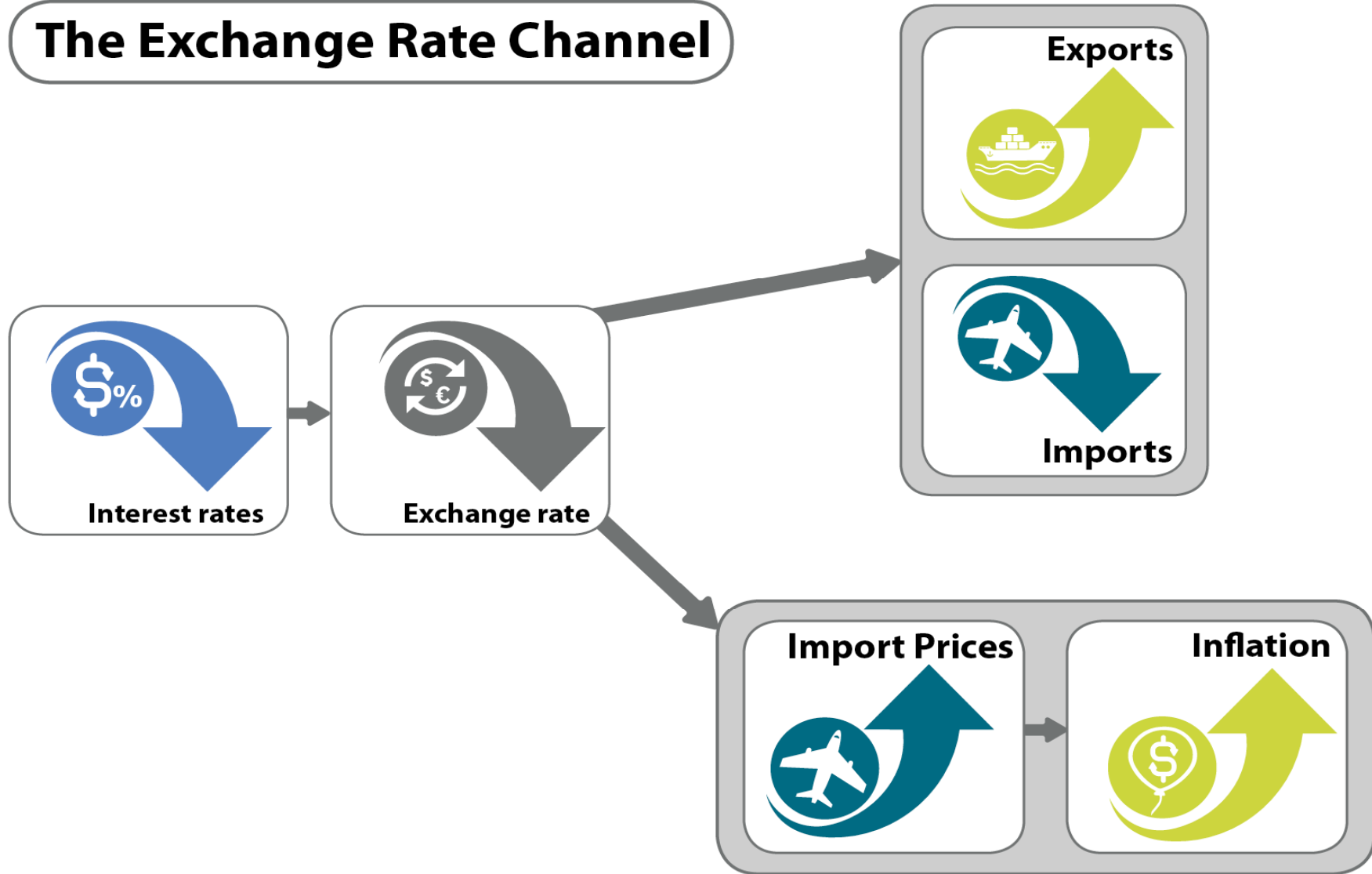
The Asset Price/Wealth Channel

- Interest rate changes can affect financial wealth (e.g. share prices) and, more clearly, housing prices
- Good evidence that housing prices affect spending, but not sure why!
 - Owners versus renters
 - Is housing wealth really wealth?
- Changes in housing prices can also affect investment in housing

The Exchange Rate Channel



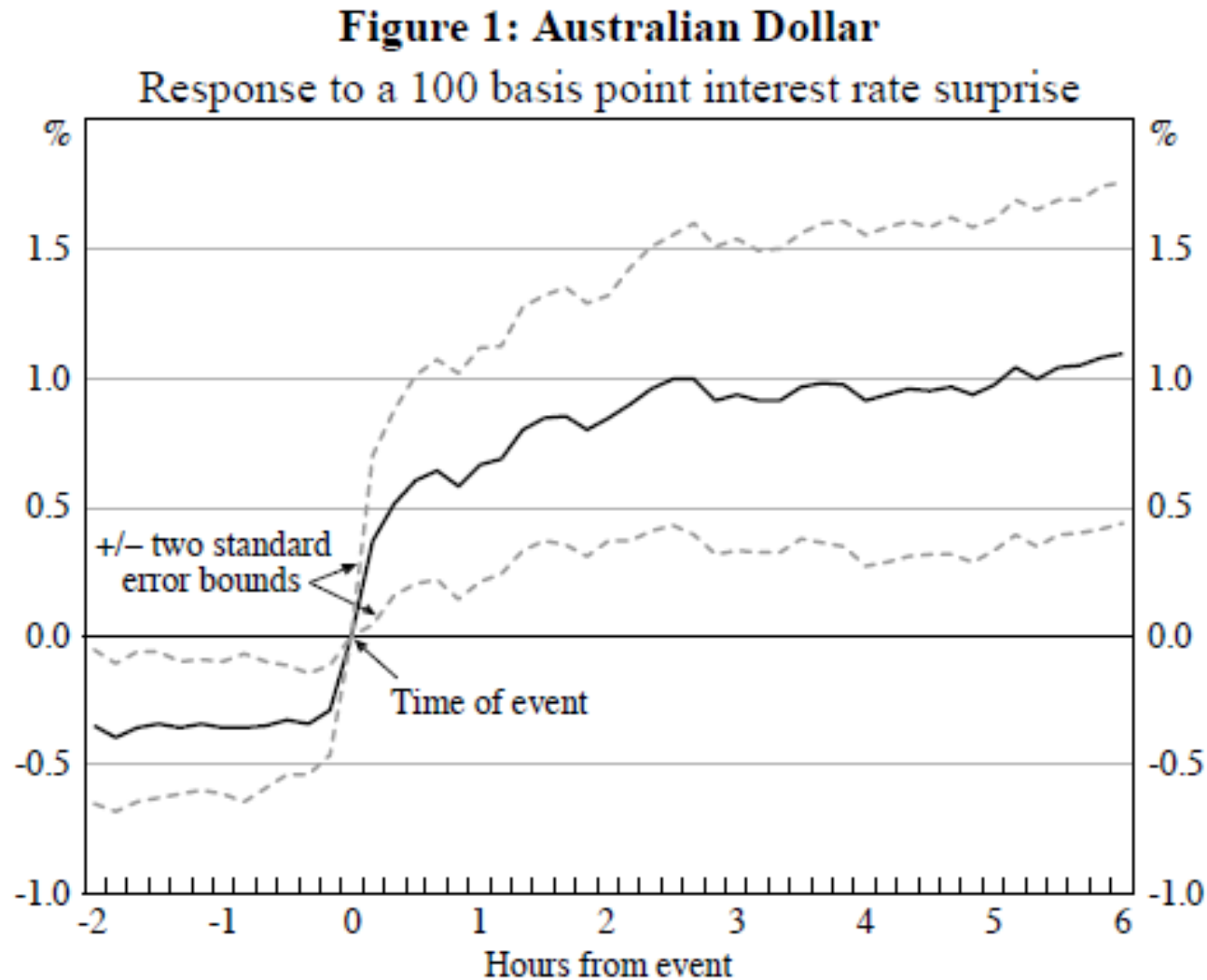
The Exchange Rate Channel



The Exchange Rate Channel

- Some evidence that interest rates affect trade
 - Interest rates can affect the exchange rate, at least in the short-run

The Cash Rate and the Exchange Rate

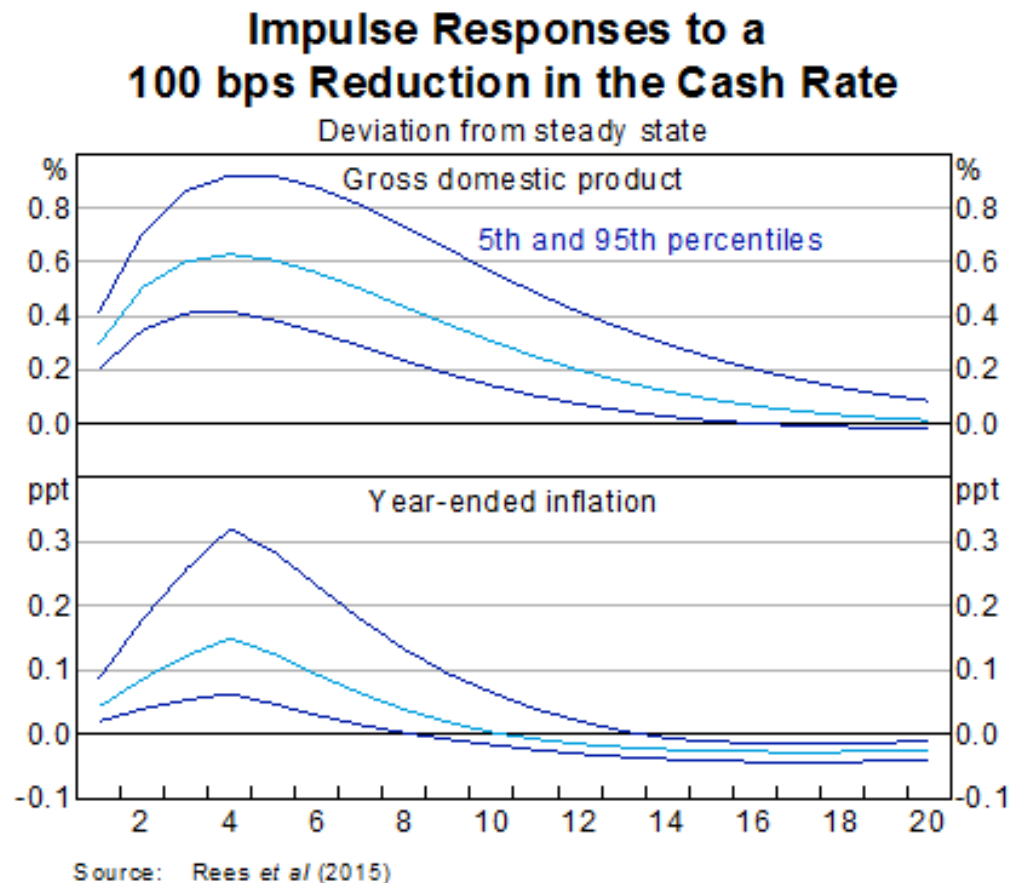


The Exchange Rate Channel

- Some evidence that interest rates affect trade
 - Interest rates can affect the exchange rate, at least in the short-run
 - Some evidence that exchange rate changes affect exports and imports
- But stronger evidence that exchange rate changes affect import prices and therefore inflation

So What Does This All Mean for The Economy?

- If the cash rate falls by 100 basis points...
 - GDP growth increases by about $\frac{1}{2}$ to $\frac{3}{4}$ ppts over 2 years
 - Inflation increases by a bit under $\frac{1}{4}$ ppts per annum over 2-3 years



Some Questions I'm Currently Grapping With...

- Which channels matter the most?
 - Very hard to say
 - Some are easier to identify than others
- Have the channels changed over time?
 - Very hard to say
 - But monetary policy still works
- Which is your favourite channel?
 - Not that hard to say
 - The cash flow channel (obviously...)

Former Governor's Exit Interview

Australian Financial Review: "How would you judge the transmission mechanism works here now...?"

Mr Stevens: "I would say that **cash-flow channels** still probably work...maybe not as strongly as they used to, because I think the evidence is that the borrower households – that's where the action comes from, and the way this is supposed to work is **the borrowers have more debt than the savers have deposits**. That's a fact. And when you change rates the borrowers are the ones who are...spending all their income, and if I give them a bit more income. They're likely to spend that. And the savers – the cut to their direct income is actually not as big, and they're less likely to respond."

Conclusion

- There are many channels through which monetary policy affects the economy
- It can be hard to separate them, but possible to find evidence for them (e.g. cash flow channel)
- See Atkin and La Cava (forthcoming) for more details!

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