

Lecture 22

Transmission Mechanisms of Monetary Policy

Why do we study TM?

- ▶ Key question after crisis: What policies should be implemented to reduce fluctuation in output and inflation in the future.
- ▶ To answer the above question, one needs:
 1. accurate assessment of the timing and effect of monetary policy on the economies.
 2. Understand mechanism through which monetary policy affects economy.



Meaning of TM

- ▶ Transmission mechanism of monetary policy means the ways in which monetary policy affects aggregate demand and the economy (inflation and output).
- ▶ It emphasize the link between financial system, monetary policy, and the real economy.



Transmission channels

- ▶ 1. Traditional interest rate channel
- ▶ 2. Other asset price channel
- ▶ 3. Credit channel



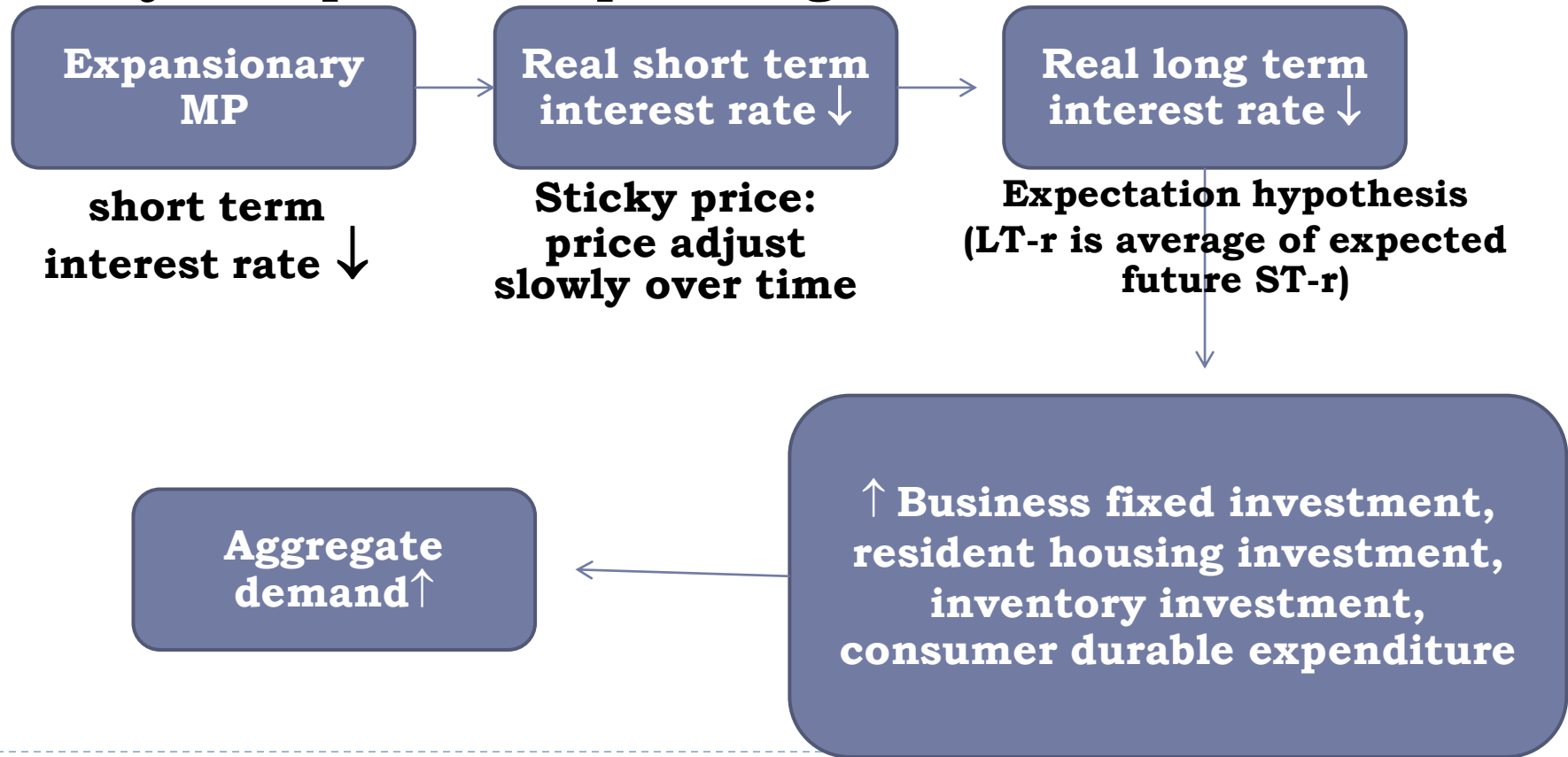
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Traditional interest rate channels

- ▶ Emphasize on real long term interest rate → affect consumer and business decision, having major impact on spending.



Application:

- ▶ TM during zero lower bound interest rate:

TM can still be effective.

A commitment to future expansionary MP can raise expected inflation

→ reduce real interest rate (no change in nominal interest rate, real interest rate decline with respect to increasing inflation expectation)

→ real long term interest rate decline

→ Investment and spending increase

→ Aggregate demand increase.

