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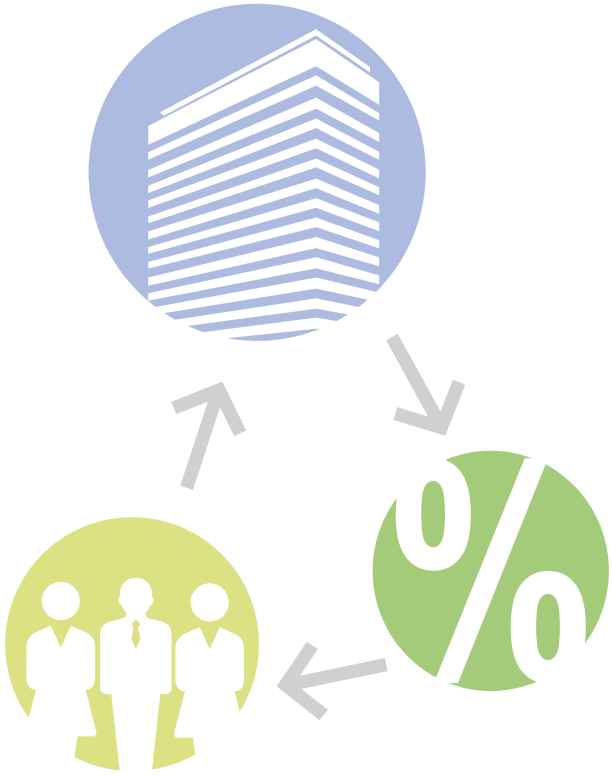
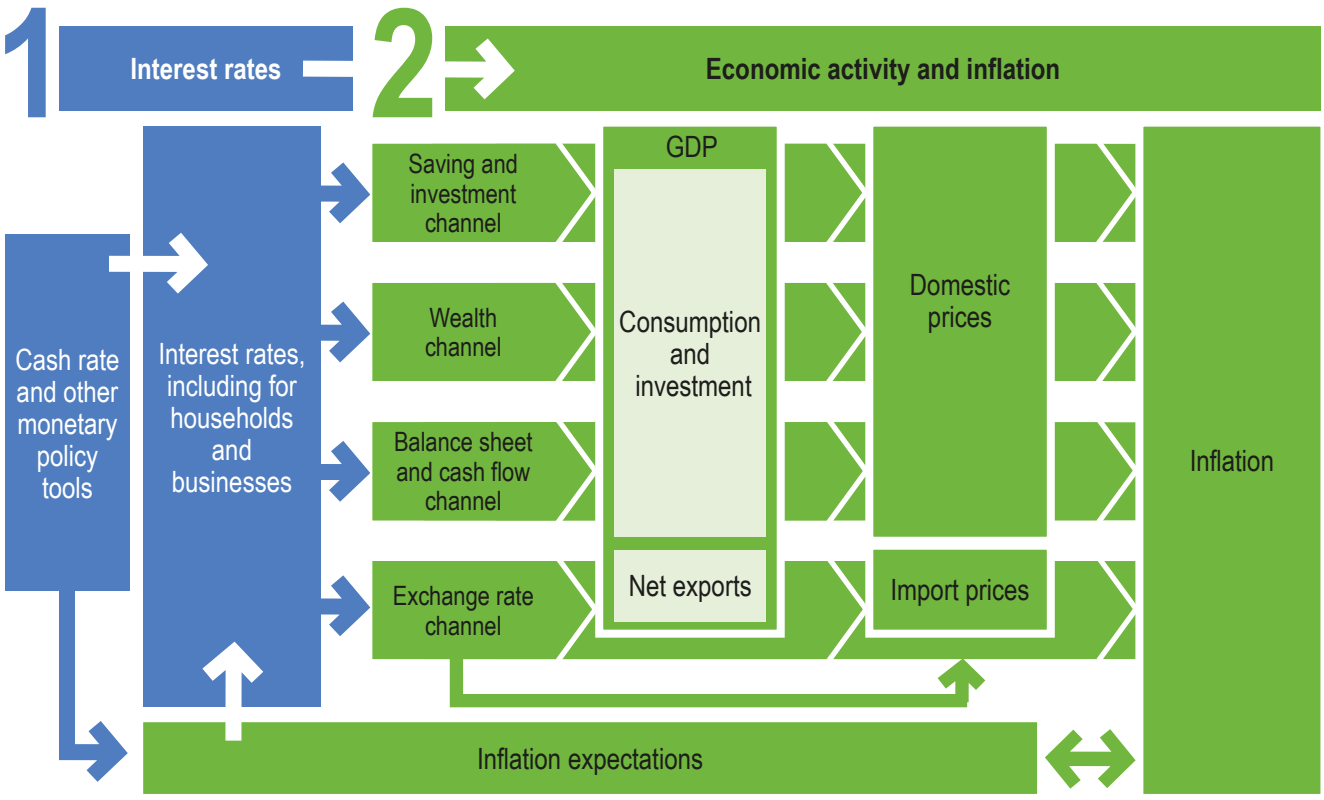
The Transmission of Monetary Policy

The transmission of monetary policy describes how changes made by the Reserve Bank to its monetary policy settings flow through to economic activity and inflation. This process is complex and there is a large degree of uncertainty about the timing and size of the impact on the economy. In simple terms, the transmission can be summarised in two stages.

1. Changes to monetary policy affect interest rates in the economy.
2. Changes to interest rates affect economic activity and inflation.

This explainer outlines these two stages and highlights some of the main channels through which monetary policy affects the Australian economy.





1 First Stage

Monetary policy in Australia is determined by the Reserve Bank's Monetary Policy Board. The primary and conventional tool for monetary policy is the target for the cash rate, but other tools have included forward guidance, price and quantity targets for the purchase of government bonds, and the provision of low-cost fixed term funding to financial institutions.

The first stage of transmission is about how changes to settings for these tools influence interest rates in the economy. The cash rate is the market interest rate for overnight loans between financial institutions, and it has a strong influence over other interest rates, such as deposit and lending rates for households and businesses. The Reserve Bank's other monetary policy tools work primarily by affecting longer-term interest rates in the economy.

While monetary policy acts as a benchmark for interest rates in the economy, it is not the only determinant. Other factors, such as conditions in financial markets, changes in competition, and the risk associated with different types of loans, can also impact interest rates. As a result, the spread (or difference) between the cash rate and other interest rates varies over time.

2 Second Stage

The second stage of transmission is about how changes to monetary policy influence economic activity and inflation. To highlight this, we can use a simple example of how lower interest rates for households and businesses affect aggregate demand and inflation. (Higher interest rates have the opposite effect on demand and inflation).

Aggregate Demand

Lower interest rates increases aggregate demand by stimulating spending. But it can take a while for the supply of goods and services to respond because more workers, equipment and infrastructure may be required to produce them. Because of this, aggregate demand is initially greater than aggregate supply, putting upward pressure on prices. As businesses increase their prices more rapidly in response to higher demand, this leads to higher inflation.

There is a lag between changes to monetary policy and its effect on economic activity and inflation because households and businesses take time to adjust their behaviour. Some estimates suggest that it takes between one and two years for monetary policy to have its maximum effect. However, there is a large degree of uncertainty about these estimates because the structure of the economy changes over time, and economic conditions vary. Because of this, the overall effects of monetary policy and the length of time it takes to affect the economy can vary.

Inflation Expectations

Inflation expectations also matter for the transmission of monetary policy. For example, if workers expect inflation to increase, they might ask for larger wage increases to keep up with the changes in inflation. Higher wage growth would then contribute to higher inflation.

By having an inflation target, the central bank can anchor inflation expectations. This should increase the confidence of households and businesses in making decisions about saving and investment because uncertainty about the economy is reduced.

Channels of Monetary Policy Transmission

Saving and Investment Channel

Monetary policy influences economic activity by changing the incentives for saving and investment. This channel typically affects consumption, housing investment and business investment.

- Lower interest rates on bank deposits reduce the incentives households have to save their money. Instead, there is an increased incentive for households to spend their money on goods and services.
- Lower interest rates for loans can encourage households to borrow more as they face lower repayments. Because of this, lower lending rates support higher demand for assets, such as housing.
- Lower lending rates can increase investment spending by businesses (on capital goods like new equipment or buildings). This is because the cost of borrowing is lower, and because of increased demand for the goods and services they supply. This means that returns on these projects are now more likely to be higher than the cost of borrowing, helping to justify going ahead with the projects. This will have a more direct effect on businesses that borrow to fund their projects with debt rather than those that use the business owners' funds.

Cash-flow Channel

Monetary policy influences interest rates, which affects the decisions of households and businesses by changing the amount of cash they have available to spend on goods and services. This is an important channel for those that are liquidity constrained (for example, those who have already borrowed up to the maximum that banks will provide).

- A reduction in lending rates reduces interest repayments on debt, increasing the amount of cash available for households and businesses to spend on goods and services. For example, a reduction in interest rates lowers repayments for households with variable-rate mortgages, leaving them with more disposable income.
- At the same time, a reduction in interest rates reduces the amount of income that households and businesses get from deposits, and some may choose to restrict their spending.
- These two effects work in opposite directions, but a reduction in interest rates can be expected to increase spending in the Australian economy through this channel (with the first effect larger than the second).

Asset Prices and Wealth Channel

Asset prices and people's wealth influence how much they can borrow and how much they spend in the economy. The asset prices and wealth channel typically affects consumption and investment.

- Lower interest rates support asset prices (such as housing and equities) by encouraging demand for assets. One reason for this is because the present discounted value of future income is higher when interest rates are lower.
- Higher asset prices also increases the equity (collateral) of an asset that is available for banks to lend against. This can make it easier for households and businesses to borrow.
- An increase in asset prices increases people's wealth. This can lead to higher consumption and housing investment as households generally spend some share of any increase in their wealth.

Exchange Rate Channel

The exchange rate can have an important influence on economic activity and inflation in a small open economy such as Australia. It is typically more important for sectors that are export oriented or exposed to competition from imported goods and services.

- If the Reserve Bank lowers the cash rate target it means that interest rates in Australia have fallen compared with interest rates in the rest of the world (all else being equal).
- Lower interest rates reduce the returns investors earn from assets in Australia (relative to other countries). Lower returns reduce demand for assets in Australia (as well as for Australian dollars) with investors shifting their funds to foreign assets (and currencies) instead.
- A reduction in interest rates (compared with the rest of the world) typically results in a lower exchange rate, making foreign goods and services more expensive compared with those produced in Australia. This leads to an increase in exports and domestic activity. A lower exchange rate also adds to inflation because imports become more expensive in Australian dollars. (To learn more about how exchange rate movements can affect prices and influence inflation outcomes, see Explainer: Causes of Inflation.)