



RESERVE BANK OF AUSTRALIA

# The Transmission Mechanism of Monetary Policy

From the Bank: Gianni La Cava  
*(Economic Research)*

Education

# The Reason Why I'm Here Today





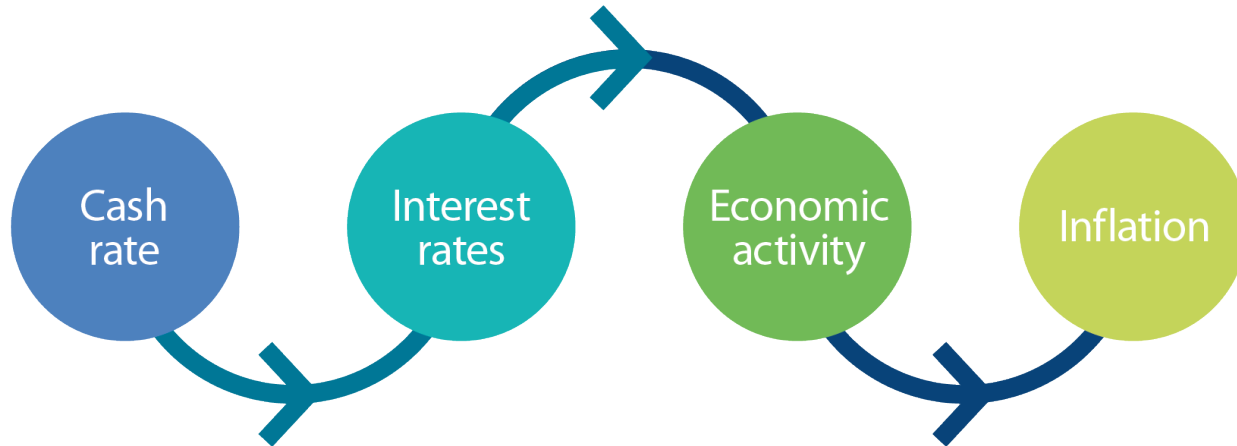
# The Questions I Grapple With Every Day...

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





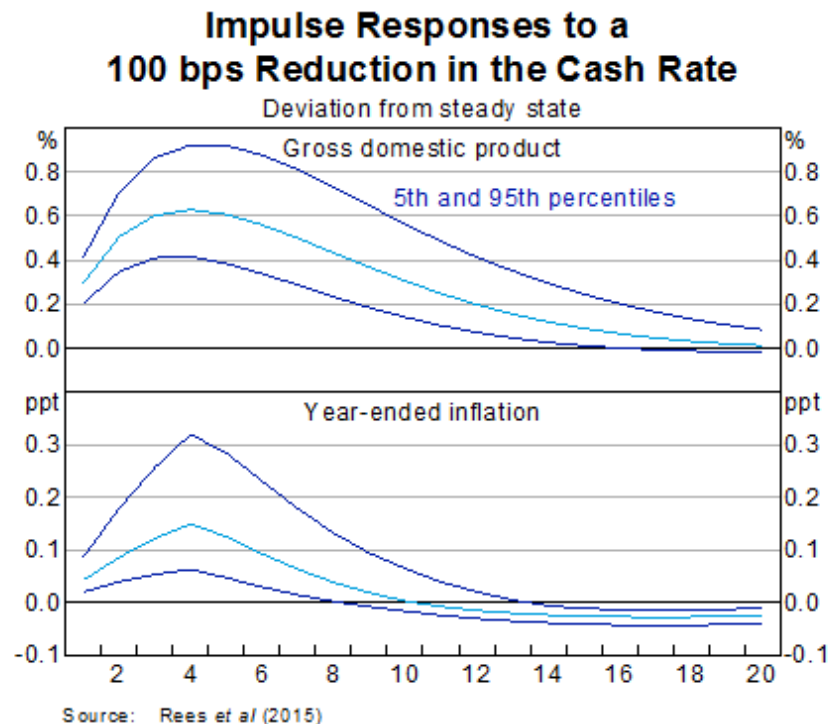
# The Monetary Transmission Mechanism



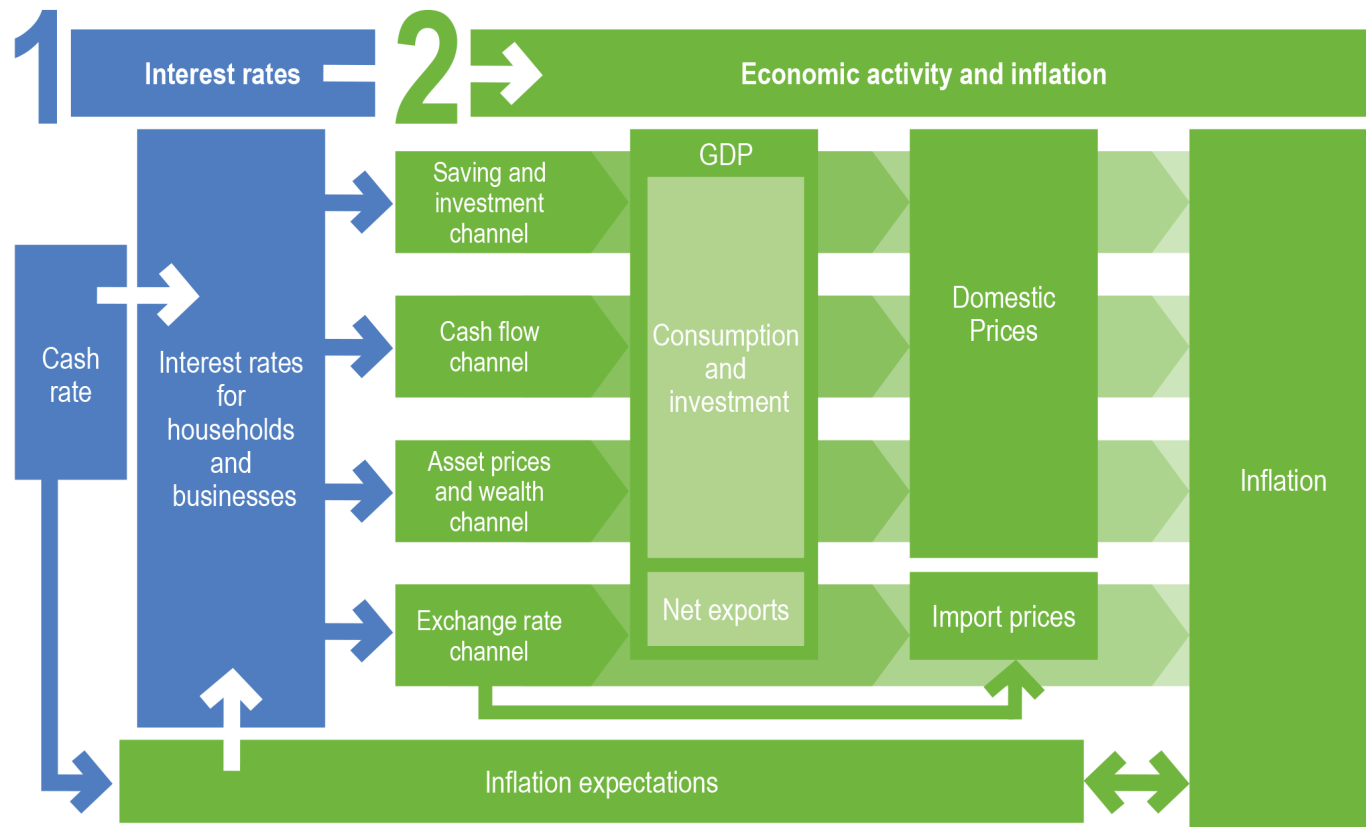


# How Does the Cash Rate Affect the Economy?

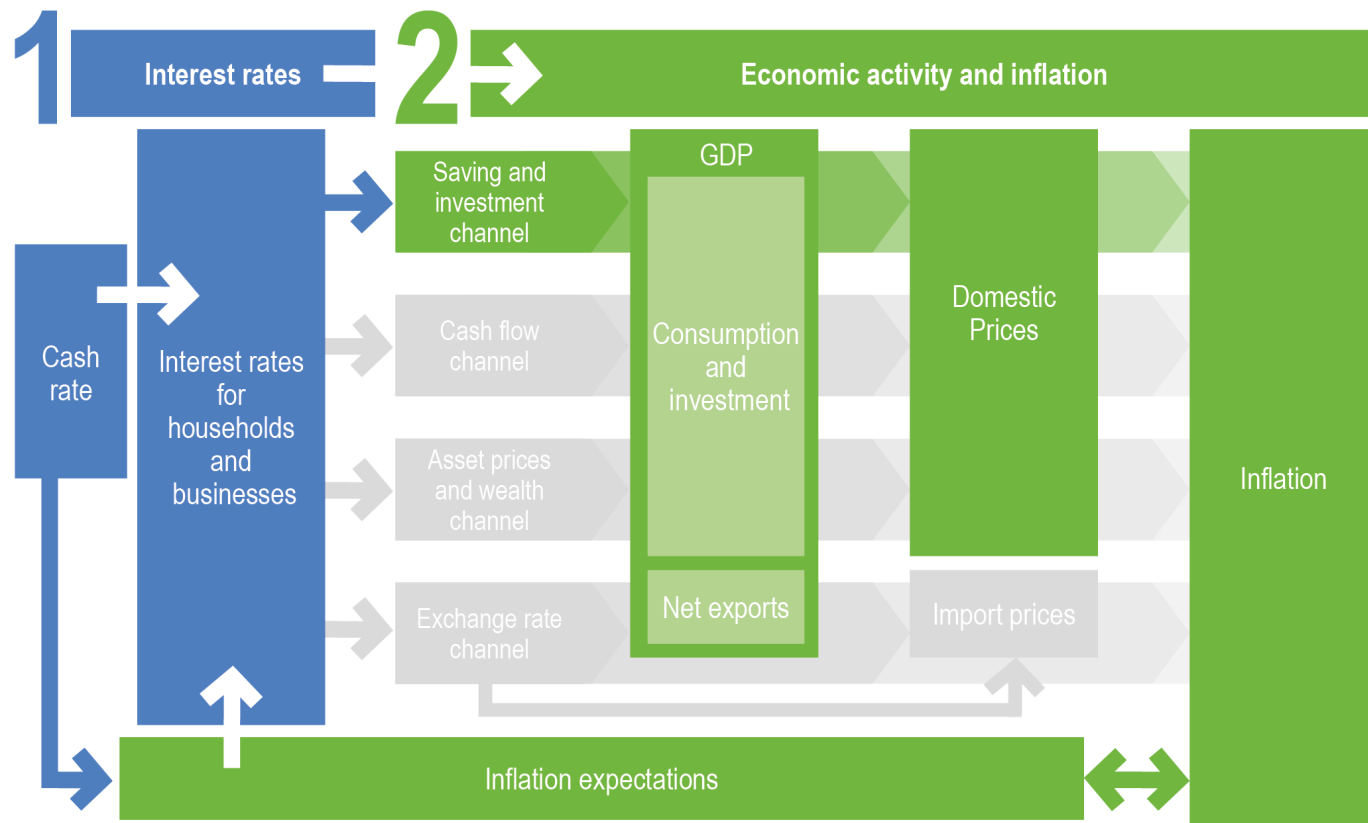
- If the cash rate is lowered by 100 basis points...
  - **GDP growth** increases by about  $\frac{1}{2}$  to  $\frac{3}{4}$  pts over 2 years
  - **Inflation** increases by a bit under  $\frac{1}{4}$  pts per annum over 2-3 years



# The Channels of Monetary Transmission



# The Saving and Investment Channel



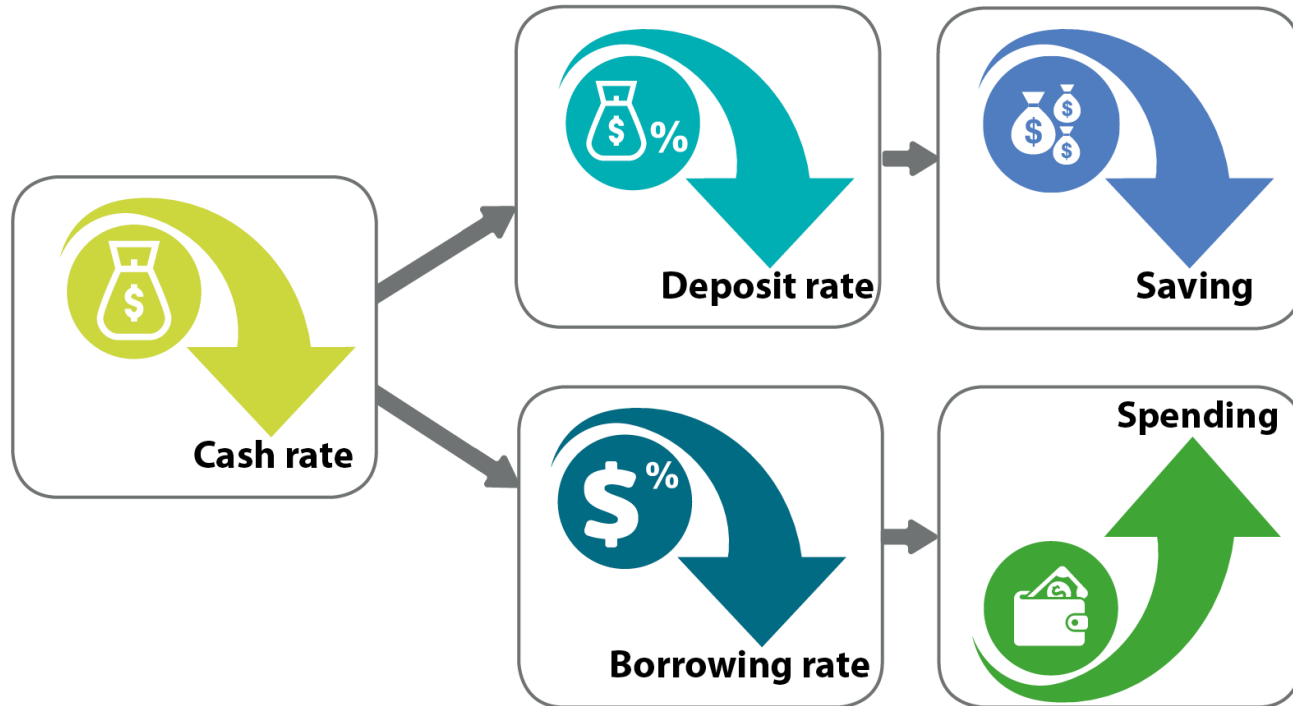
# The Saving and Investment Channel







## Investment/Saving Channel





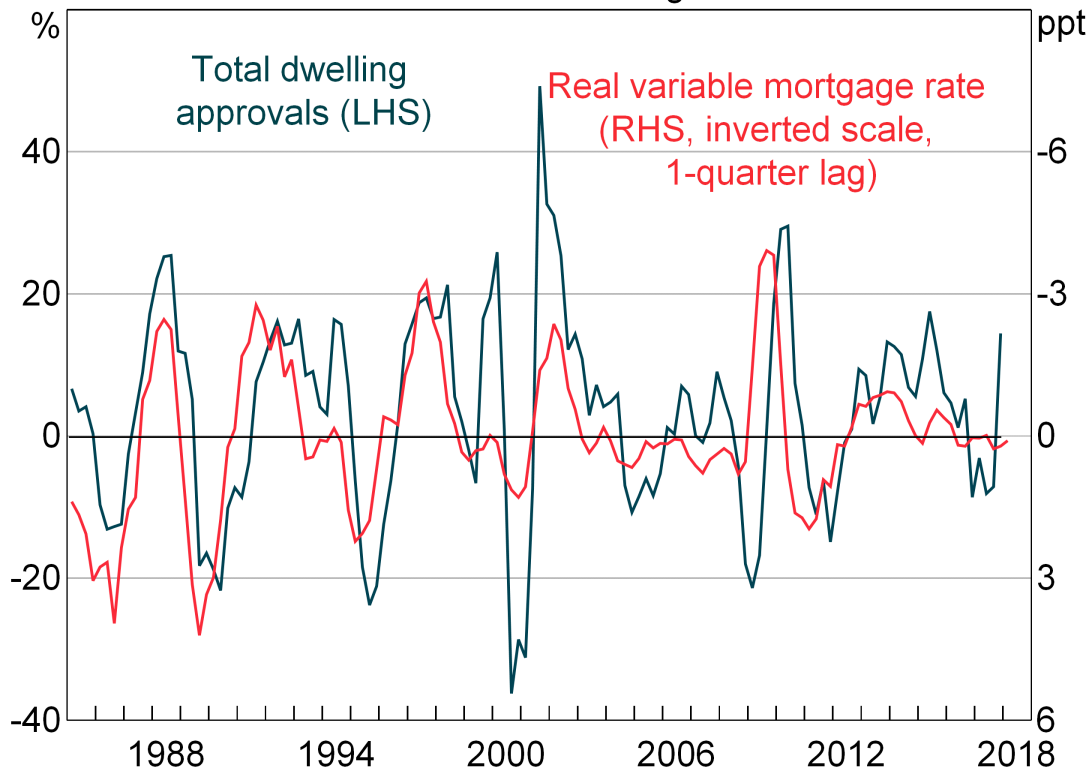
# The Saving and Investment Channel

- Otherwise known as the ‘intertemporal substitution channel’
- Works for households (e.g. dollarmite accounts) and for businesses (e.g. equipment investment)
- It is very important in theory, but does it exist in reality?
  - Ongoing debate on whether businesses are sensitive to interest rates
  - Surprisingly hard to work out if households are sensitive to changes in interest rates



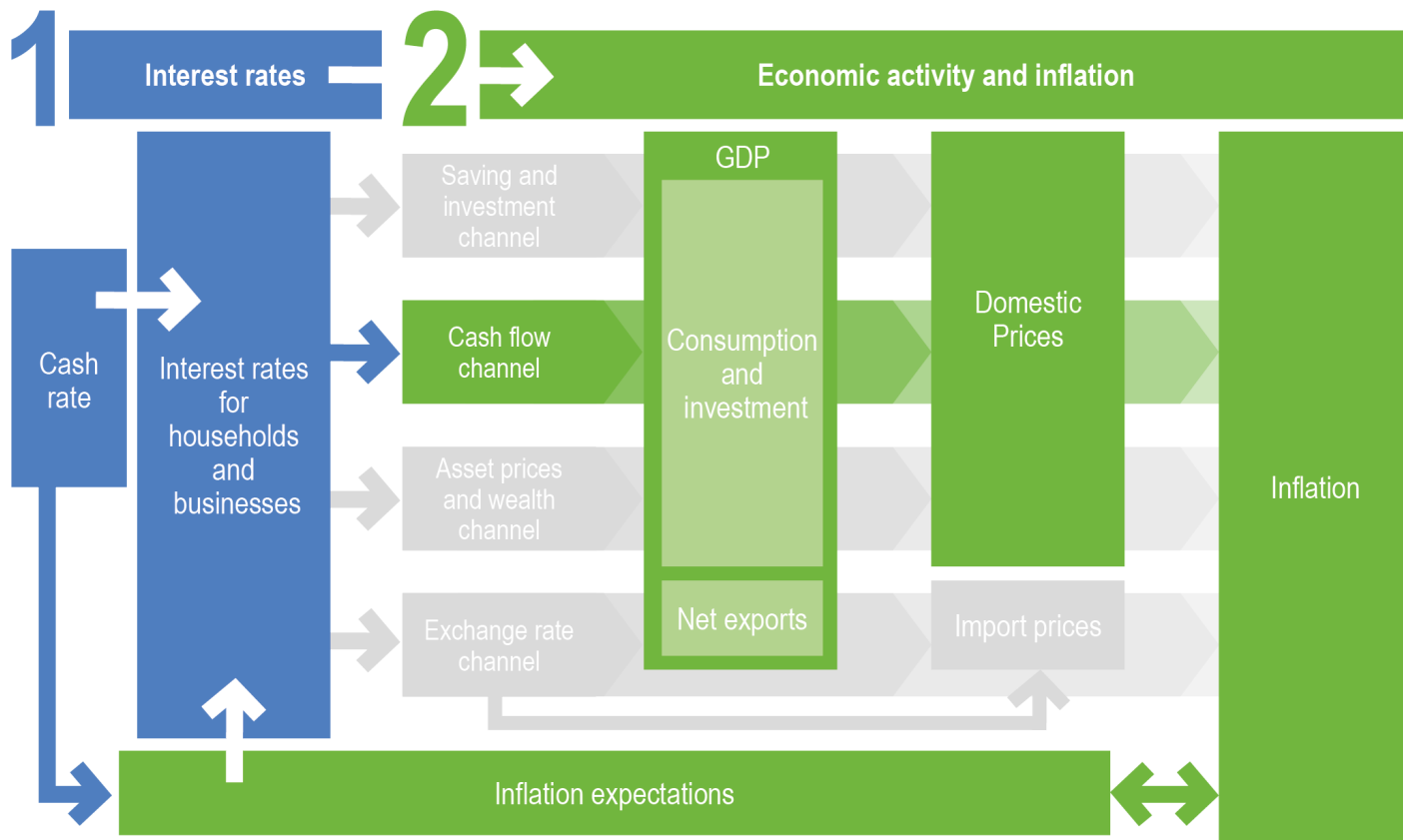
# Dwelling Approvals and Real Interest Rates

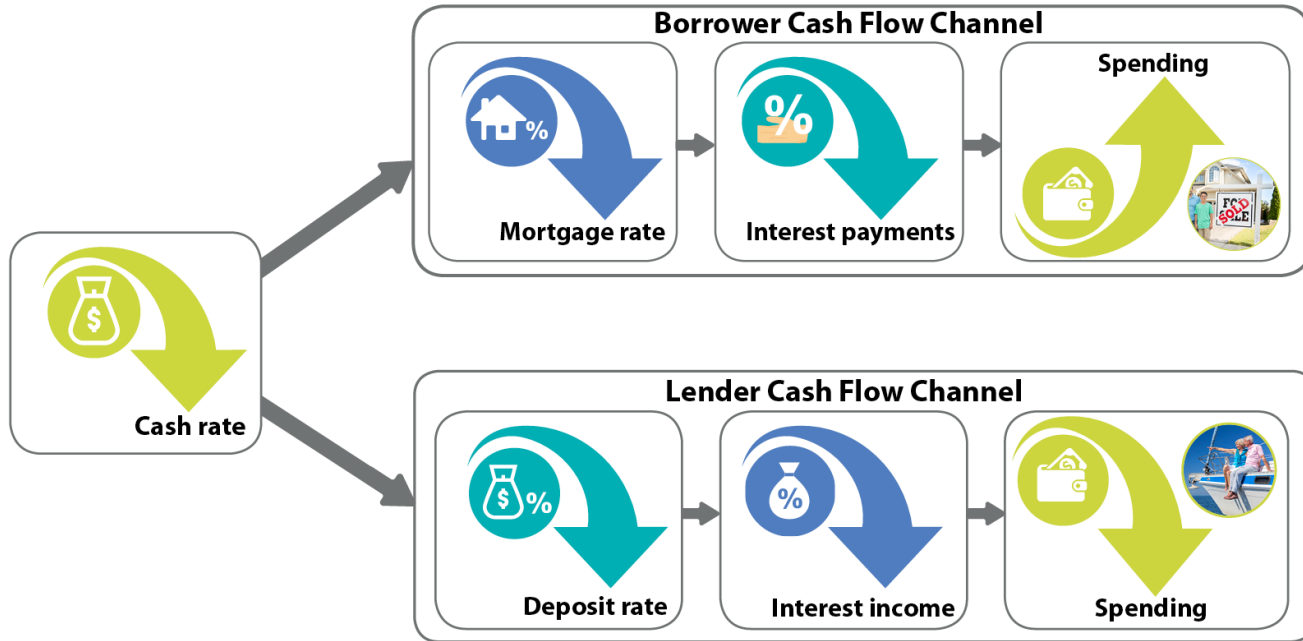
Year-ended change



Sources: ABS; RBA

# The Cash Flow Channel



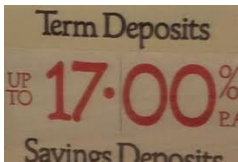




# Retirees feel the interest pinch



# Reserve board minutes offer hope for retirees



# Retirees lose out in RBA rate cut



# Rates future bleak for retirees



# RBA's pointless cut a cruel blow for retirees





**Economy** Real wages growth 'declining'

# Low rates risk hot housing in slow economy



Mortgage holders winning battles



# Uncertainty puts us in a fix

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Interest hikes hit indebted households



# RBA bets on record rate to stimulate

Interest rate cut: Sydney is sacrificed to rescue the nation



Rates: home loan borrowers rejoice



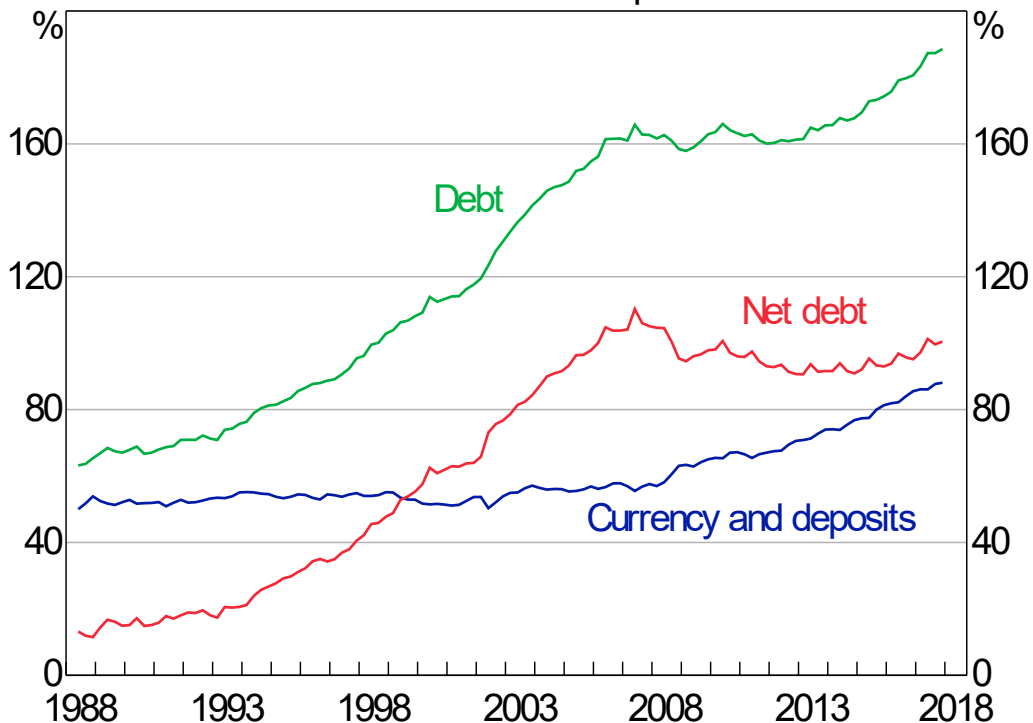
# Mortgage rate hikes pressure income





# Household Debt and Deposits

Per cent of annual household disposable income\*



\* Household sector includes unincorporated enterprises; disposable income is before the deduction of interest payments

Sources: ABS; RBA

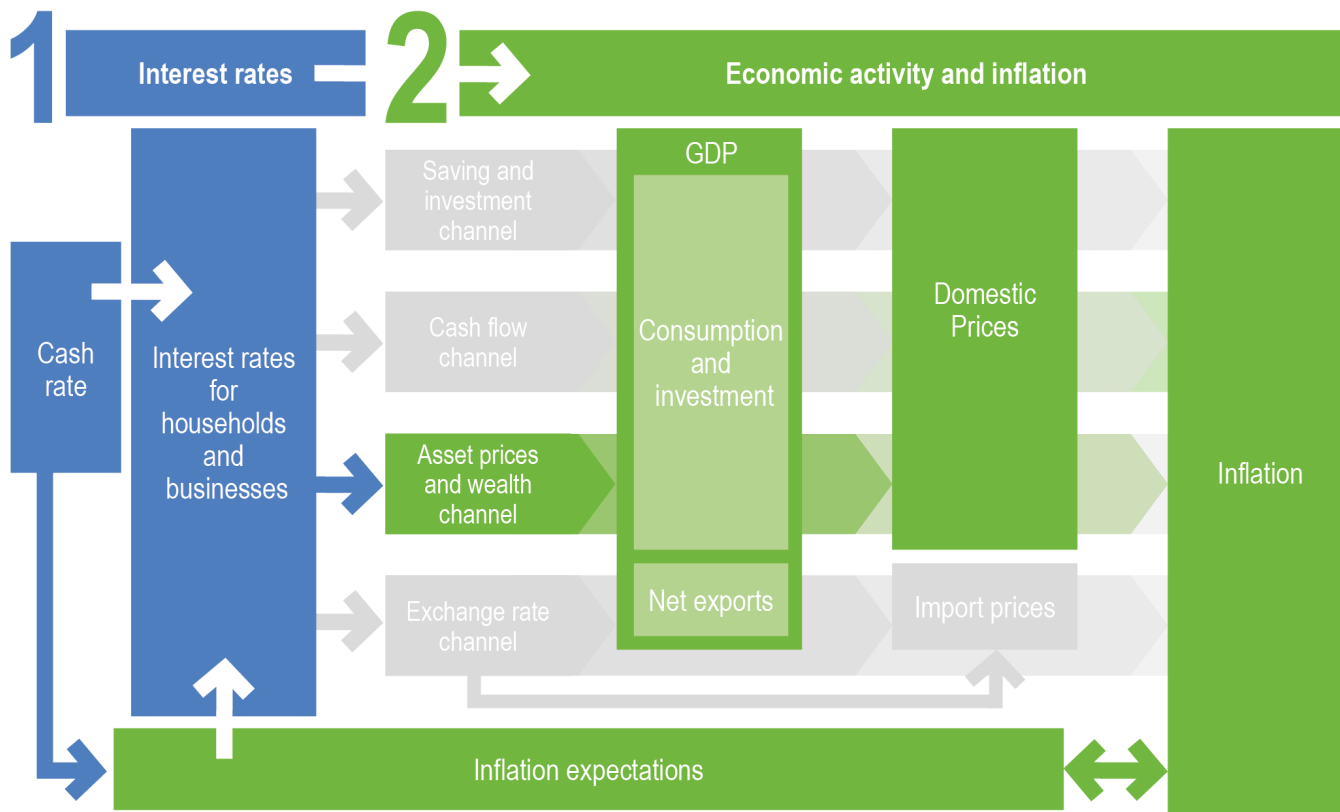




# The Cash Flow Channel

- Suggests that monetary policy partly works through the distribution of income and wealth in the economy
- Exciting area of growing research in Australia and overseas (e.g. La Cava, Hughson and Kaplan (2016))
- Seems to exist for businesses too (La Cava 2005)

# The Asset Prices and Wealth Channel





## The Asset Prices/Wealth Channel





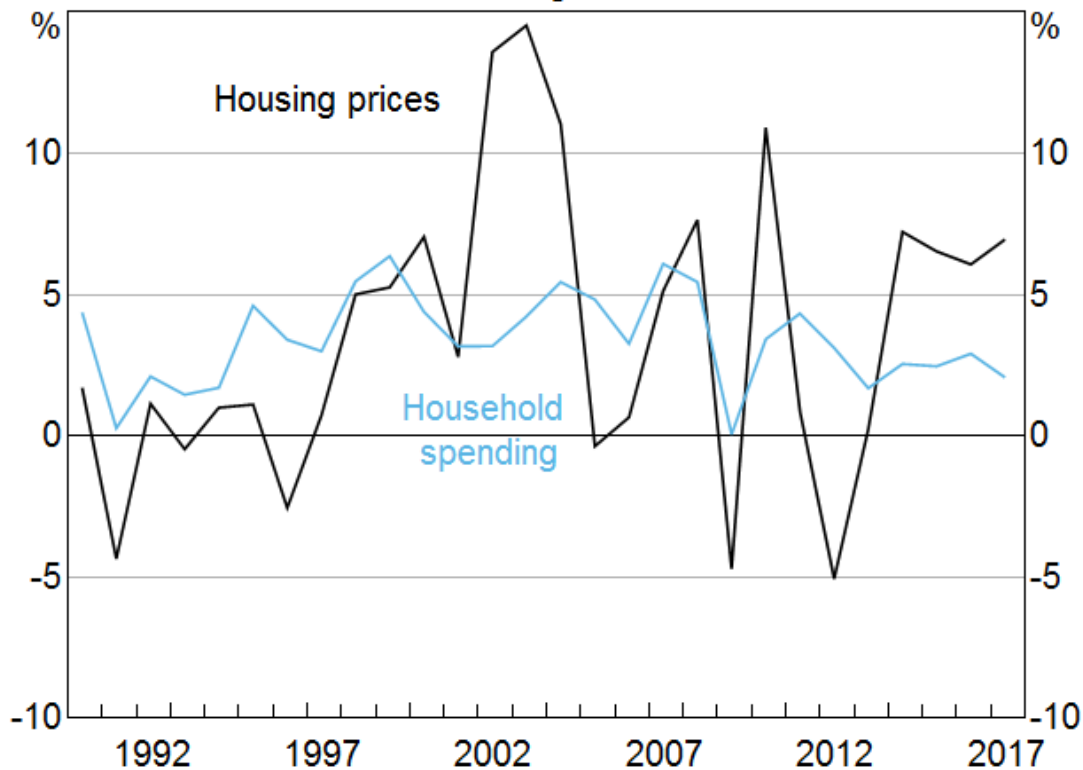
# The Asset Prices and Wealth Channel

- 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!



# Housing Prices and Household Spending

Annual growth



Sources: ABS; RBA



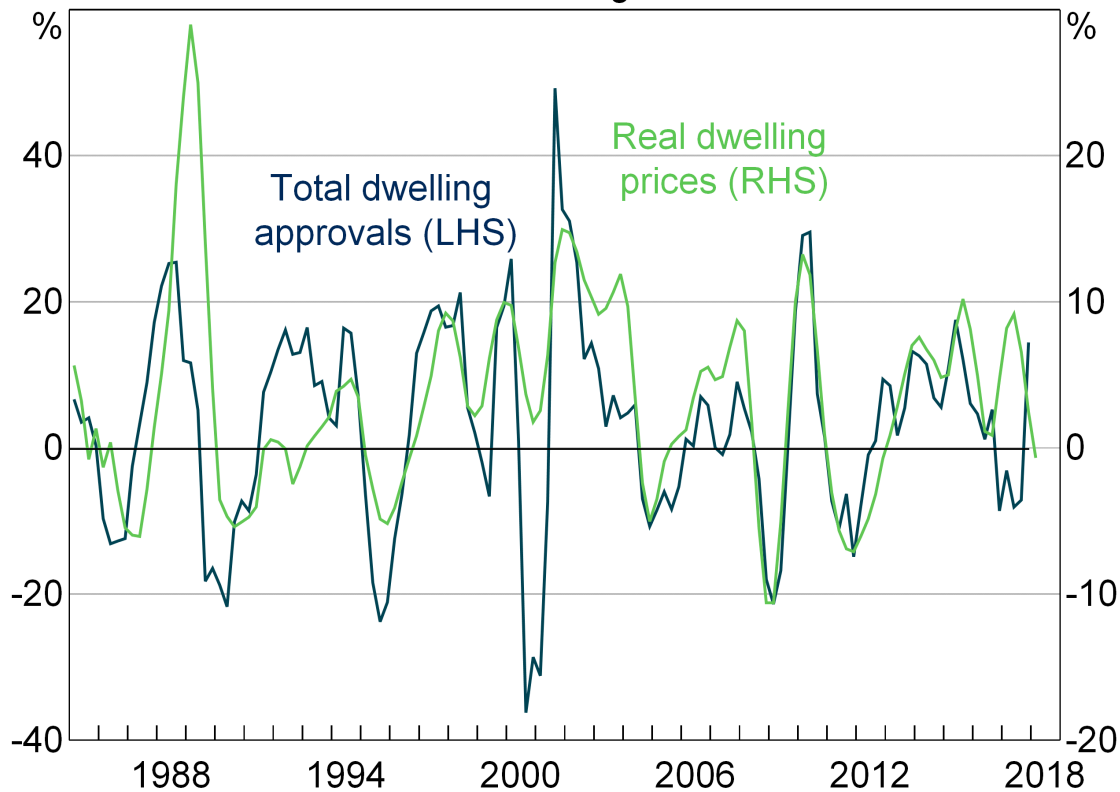
# The Asset Prices and Wealth Channel

- 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!
  - Is housing wealth really wealth?
  - Owners versus renters
- Changes in housing prices can also affect investment in housing



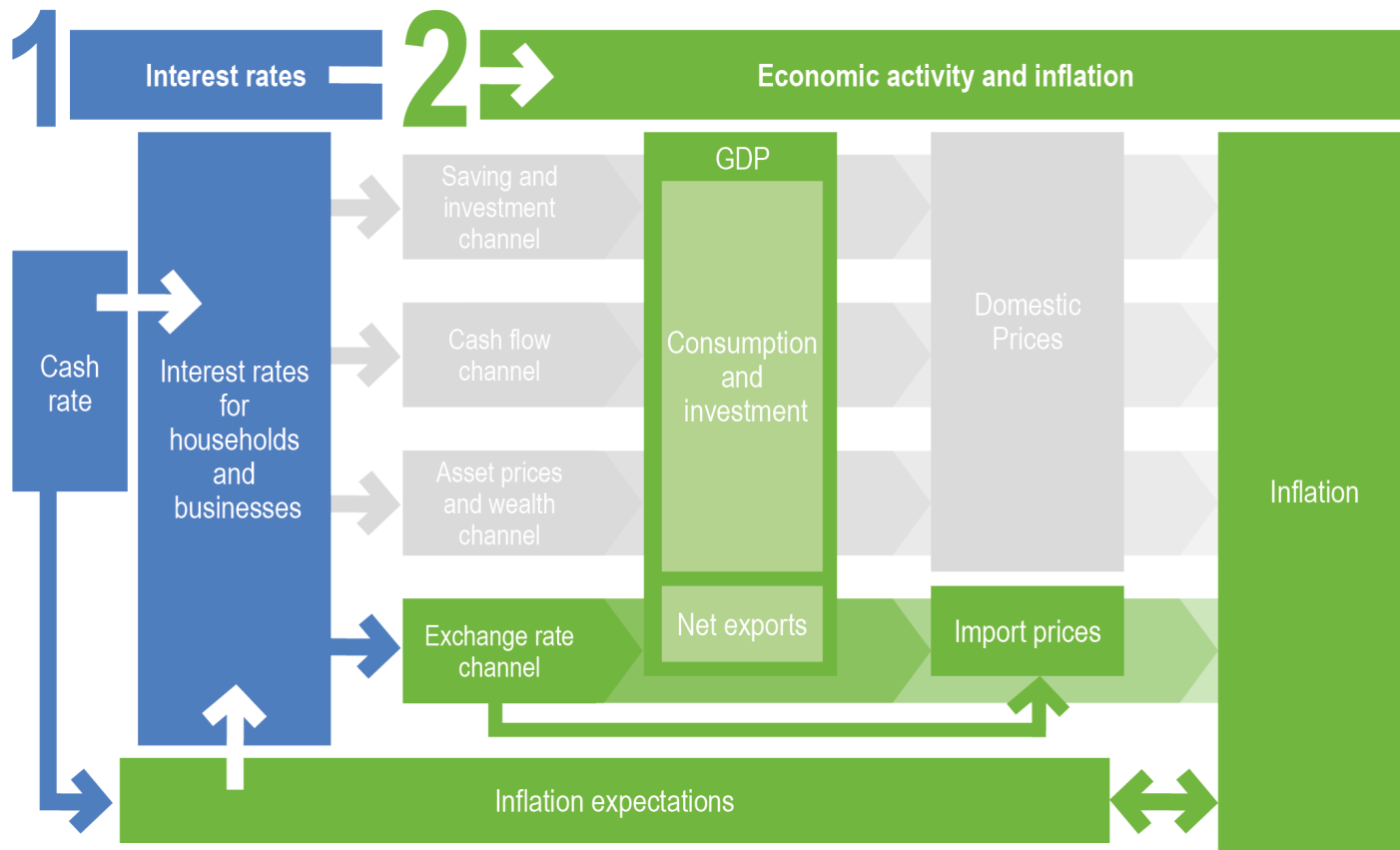
# Dwelling Approvals and Real Dwelling Prices

Year-ended growth



Sources: ABS; APM; Corelogic; RBA

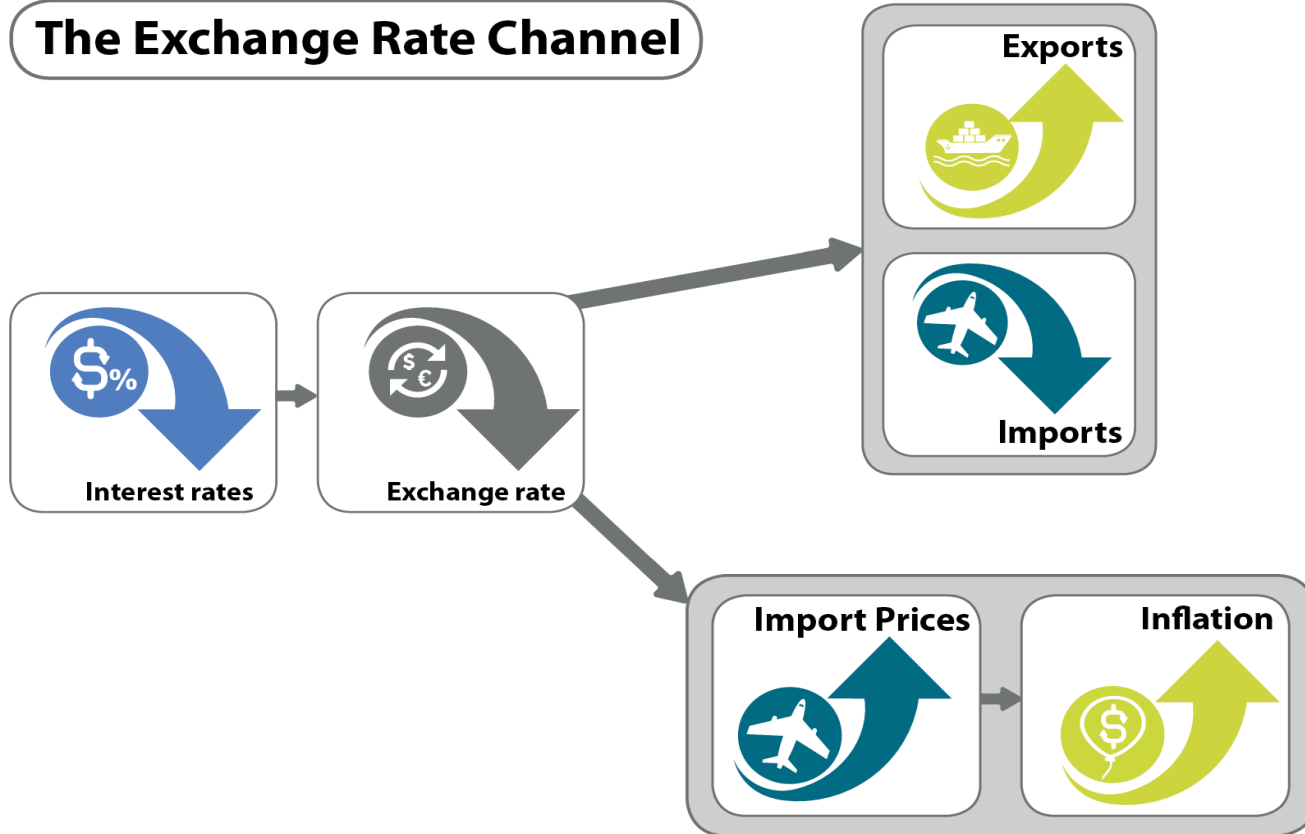
# The Exchange Rate Channel







## The Exchange Rate Channel





# The Exchange Rate Channel

- Strong evidence that exchange rate changes affect import prices and therefore inflation
- 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



# Former Governor's Exit Interview

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

**Mr Stevens:** “**I would say that the 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
- See Atkin and La Cava (2017) for more details!