

Transmission Mechanisms of Monetary Policy

FIN 204 Lecture 12.1.

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- 1 How Does Monetary Policy Affect the Economy?
 - The Traditional View on Transmission Mechanisms
 - The New View on Transmission Mechanisms

The Traditional View on Transmission Mechanisms

Money supply and interest rates

How does money supply affect the economy?

$$M_s \uparrow \Rightarrow i_r \downarrow \Rightarrow I \uparrow \Rightarrow Y \uparrow \quad (1)$$

where:

$$i_r = i - \pi^e.$$

Thus, the complete transmission mechanism is:

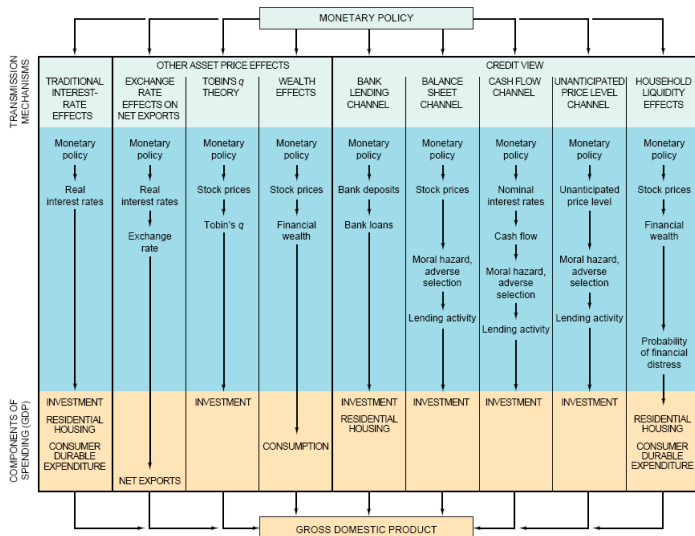
$$M_s \uparrow \Rightarrow P^e \uparrow \Rightarrow \pi^e \uparrow \Rightarrow i_r \downarrow \Rightarrow I \uparrow \Rightarrow Y \uparrow \quad (2)$$

Different opinions:

- Taylor (Stanford): there is evidence that this mechanism works
- Bernake (FED, ex-Princeton): evidence is not so strong. New mechanisms are needed to understand the transmission from M_s to Y .

The New View on Transmission Mechanisms

A summary



The New View on Transmission Mechanisms

The other asset prices channels

- 1 The exchange rate channel:

$$M_s \uparrow \Rightarrow i_r! \downarrow \Rightarrow E \downarrow \Rightarrow NX \uparrow \Rightarrow Y \uparrow \quad (3)$$

- 2 The Tobin's q theory:

$$q = \frac{\text{Firm Market Value}}{\text{Replacement Cost of Capital}} \quad (4)$$

More precisely: $M_s \uparrow \Rightarrow P_s \uparrow \Rightarrow q \uparrow \Rightarrow I \uparrow \Rightarrow Y \uparrow$

- 3 Modigliani's life cycle theory: lifetime income determines housing and durables expenditures

The New View on Transmission Mechanisms

The Credit View

- ① The bank lending channel:

$$M_s \uparrow \Rightarrow \text{Bank loans} \uparrow \Rightarrow I \uparrow \Rightarrow Y \uparrow \quad (5)$$

- ② The balance sheet channel:

$$M_s \uparrow \Rightarrow P_s \uparrow \Rightarrow \text{Firm Net Worth} \uparrow \Rightarrow I \uparrow \Rightarrow Y \uparrow \quad (6)$$

- ③ The cash flow channel:

$$M_s \uparrow \Rightarrow i_n! \downarrow \Rightarrow \text{Consumer/Firm Cash Flow} \uparrow \Rightarrow \text{Bank loans} \uparrow \Rightarrow I \uparrow \quad (7)$$

- ④ The household liquidity channel: similar to Modigliani's theory

$$M_s \uparrow \Rightarrow P_s \uparrow \Rightarrow \text{Consumers' Assets} \uparrow \Rightarrow \text{Durables Expenditures} \uparrow \Rightarrow I \uparrow \quad (8)$$