Transmission Mechanisms of Monetary Policy
BFI Lecture 11.1.

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Outline

How does money supply affect the economy?

$$M_s \uparrow \Rightarrow i_{r!} \downarrow \Rightarrow I \uparrow \Rightarrow Y \uparrow \tag{1}$$

where:

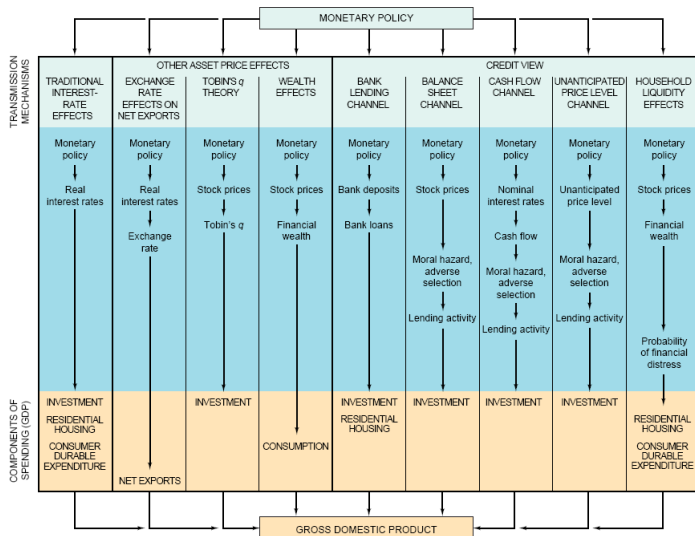$$i_r = i - \pi^e.$$

Thus, the complete transmission mechanism is:

$$M_s \uparrow \Rightarrow P^e \uparrow \Rightarrow \pi^e \uparrow \Rightarrow i_{r!} \downarrow \Rightarrow I \uparrow \Rightarrow Y \uparrow \tag{2}$$

Different opinions:

- Taylor (Stanford): there is evidece 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
The other asset prices channels

1. The exchange rate channel:

$$M_s \uparrow \Rightarrow i_{r!} \downarrow \Rightarrow E \downarrow \Rightarrow NX \uparrow \Rightarrow Y \uparrow \qquad (3)$$

2. The Tobin's q theory:

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

   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:

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

2. The ballance sheet channel:

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

3. The cash flow channel:

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

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

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