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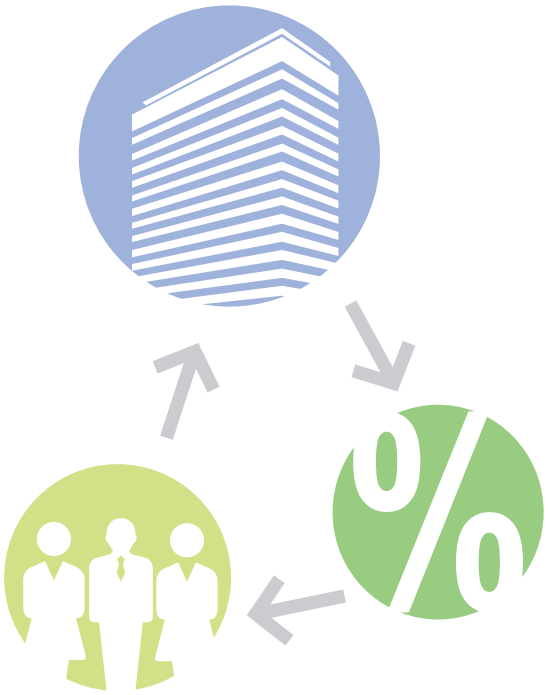
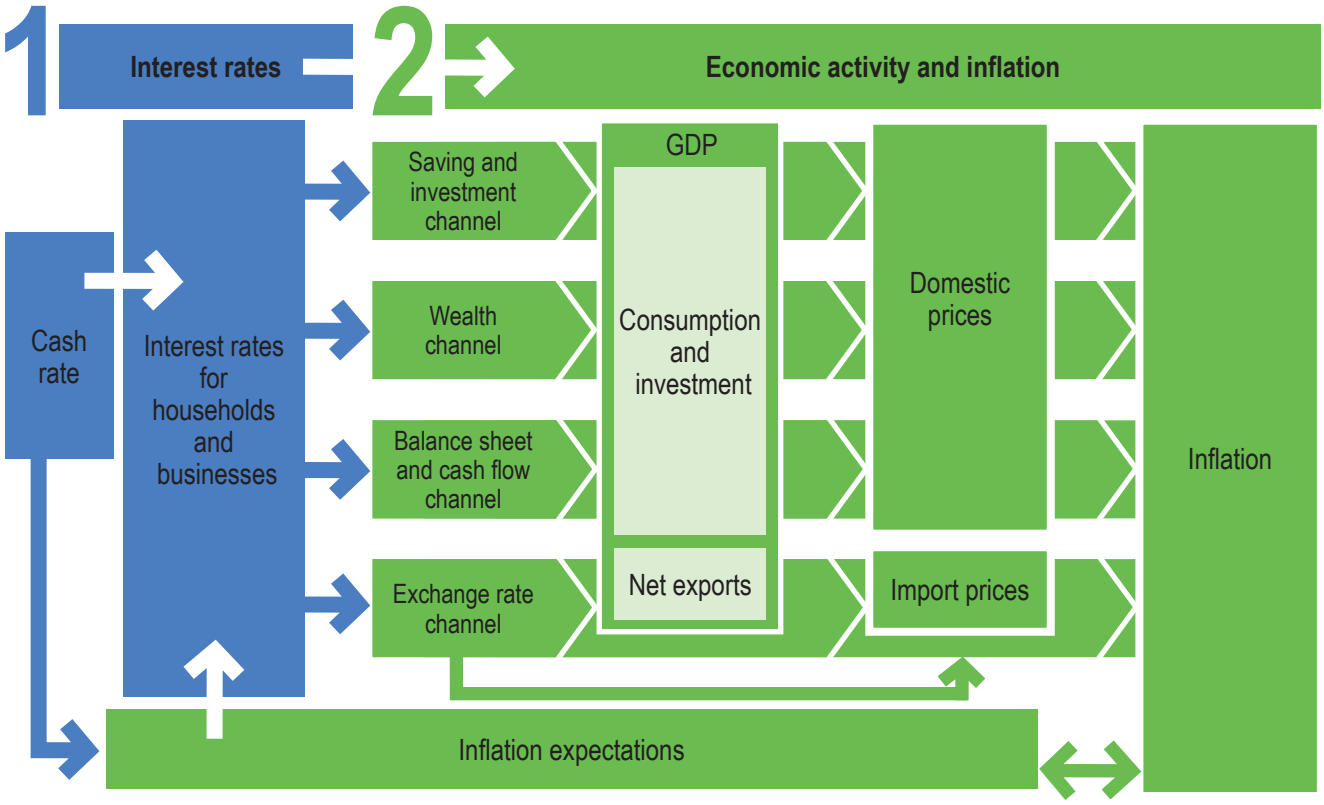
The Transmission of Monetary Policy

The transmission of monetary policy describes how changes made by the Reserve Bank to the cash rate – the 'instrument' of monetary policy – 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 the cash rate flow through to other interest rates in the economy.
2. Changes to these 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.



This resource does not reflect unconventional measures currently in place. For a description of unconventional monetary policy, please see Explainer: Unconventional Monetary Policy.

1 First Stage

Monetary policy in Australia is determined by the Reserve Bank Board and is set in terms of a target for the cash rate. The first stage of transmission is about how changes to the cash rate influence other 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.

While the cash rate 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. An example of this has been the increase in banks' lending rates relative to the cash rate since the financial crisis, which has occurred at the same time as their funding costs have risen.

2 Second Stage

The second stage of transmission is about how changes to interest rates influence economic activity and inflation. To highlight this, we can use a simple example of how a reduction in interest rates (an 'easing' of monetary policy) affects aggregate demand and inflation. (A tightening in monetary policy has the opposite effect on demand and inflation).

Aggregate Demand

Lower interest rates increase aggregate demand by stimulating spending. But it can take a while for supply to respond because more workers, equipment and infrastructure may be required. 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 effectiveness of monetary policy and the length of time it takes to affect the economy can also 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

Interest rates influence economic activity by changing the incentives for saving and investment. This channel typically affects consumption, housing investment and business investment.

- A reduction in deposit rates reduces the incentive for households to save their money. Instead, there is an increased incentive for households to spend their money on goods and services.
- Lower lending rates can encourage households to increase their borrowing as they face lower repayments and because banks will generally lend more to them. Because of this, lower lending rates support higher demand for housing assets.
- Lower lending rates can increase investment spending by businesses (on capital goods like new equipment or buildings). This is because the 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 fund their projects with debt rather than those that use shareholders' funds.

Cash-flow Channel

Interest rates influence 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 cannot spend as much as they want because of the size of interest repayments, or because they can't borrow the amount they want at the current interest rates).

- 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 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.