Monetary Policy Transmission Mechanisms

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Hello everyone, I'm **Susanna Grigoryan**, an economist at the **Central Bank of Armenia** and a **Level One student at the Global Forecasting School**. In this extended video, we'll explore how monetary policy actually works — and why its effects often take longer to appear than people expect. This discussion brings together two important themes: the **monetary transmission mechanism**, and the idea of **long and variable lags** in policy effects.

Let's begin with the **monetary transmission mechanism** — the process through which central-bank decisions affect inflation and output. When the central bank changes its policy rate, that action ripples through financial markets, influencing borrowing costs, exchange rates, and expectations. In other words, monetary policy works through several channels that together shape spending, investment, and inflation expectations across the economy.

There are **four main channels** of transmission.

The first is the **interest-rate channel**. When the central bank raises or lowers its policy rate, it immediately changes short-term interest rates. Those shifts influence expectations about future rates, which affect long-term bond yields — for example, the ten-year government bond — and eventually the mortgage and business-loan rates that households and firms face. If we plot the ten-year bond yield and the thirty-year mortgage rate on a chart, they tend to move closely together. That relationship shows how expectations about the policy path and risk compensation determine borrowing costs throughout the economy.

The second is the **exchange-rate channel**. Expected interest-rate differentials across countries drive exchange-rate movements. Higher expected rates usually appreciate the domestic currency, making imports cheaper but exports less competitive. For small open economies, this is often one of the most powerful transmission routes.

The third is the **credit channel**. Banks' lending behavior determines how quickly policy changes reach borrowers. If the financial system is concentrated or risk-averse, or if banks hold excess liquidity, then the transmission of policy to credit conditions can be slow and uneven.

And finally, the **expectations channel** — arguably the most important. When the central bank communicates clearly and consistently, it anchors inflation expectations. That credibility influences real interest rates and public confidence, ensuring that monetary policy works through both psychology and financial conditions.

In open economies like Armenia's, these channels interact with global capital flows and exchange-rate dynamics. Expectations of appreciation or depreciation combine with risk-adjusted interest-rate differentials, amplifying policy effects. Here, global financial conditions, fiscal credibility, and clear communication all shape how effectively monetary policy transmits through the economy.

Another important concept in transmission is the **term and risk premium**. Long-term interest rates don't move one-for-one with expected short-term rates because investors demand compensation for uncertainty. That's the **term premium** — a reward for bearing interest-rate risk. In open economies, there can also be a **country-risk or exchange-rate premium**, reflecting investors' assessment of fiscal credibility or external vulnerability. Together, these premia explain why the ten-year government bond yield typically exceeds the policy rate by a margin that changes over time.

Now, let's turn to the second theme: **why the effects of monetary policy unfold with long and variable lags**. This idea goes back to **Milton Friedman's 1968 Presidential Address**, where he warned that monetary policy does not affect the economy instantly or in the same way every time. The transmission process is complex, influenced by wealth, expectations, and financial structure.

A good recent example comes from the **United States**. After the pandemic, the Federal Reserve began raising interest rates in 2022 — roughly a year later than ideal — and did so very aggressively, increasing the policy rate by more than 500 basis points. Historically, such a tightening would have signaled an impending recession, especially with the yield curve inverted. Yet, a recession never arrived.

Why?
Because other forces were at work. High equity prices, strong household balance sheets, and pandemic-era savings supported consumption and delayed the impact of higher rates. During COVID, real long-term interest rates had been deeply negative, which boosted asset prices and wealth. As **Michael Kiley's research** shows, these wealth and

liquidity conditions can lengthen the lags in transmission. The mechanism wasn't broken — it was simply slower, as other channels temporarily dominated.

Armenia's experience offers the opposite perspective. When the Central Bank eased policy, lending rates didn't fall quickly. Banks remained cautious, and the credit channel was slower to respond because of market structure and risk perception. This asymmetry is common — tightening tends to bite faster than easing — but the key point is that the transmission mechanism still works.

It's never truly broken. When one channel weakens, others can strengthen. Declaring the system broken risks undermining confidence in the nominal anchor. Instead, policymakers must identify which channels are currently active, monitor them continuously, and adjust policy instruments accordingly. That is precisely what the **FPAS Mark II** framework does — it provides a disciplined process for continuous monitoring, adaptation, and communication, ensuring that policy remains effective even when transmission lags change.

From this analysis, several lessons emerge for policymakers: First, expect lags to vary depending on wealth conditions, fiscal stance, and the global environment. Second, recognize asymmetry — policy tightening usually has faster effects than easing. Third, use all available channels and instruments to maintain credibility and manage expectations.

The essential message is that **monetary transmission always works, but never on a fixed schedule**. Patience and persistence are vital. Understanding these long and variable lags helps central banks stay disciplined, data-driven, and credible.

So, whenever someone asks whether monetary policy still works, the answer is simple: it does — it just takes time.

Thank you for watching, and I look forward to seeing you in the next episode of the **CBA Academy**.

See you there.

Literature & Further Reading

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