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The Interest Rate Channel of Monetary Policy Transmission: The role of central bank characteristics

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ABSTRACT

The interest rate channel proposes that a monetary expansion or a decrease in the policy interest rate will affect, in the same direction, long-term interest rates, which increase investment, aggregate demand and employment. The study of Papadamou et al. (2015) reveals a better functioning interest rate channel under higher levels of transparency. Although, no research so far has investigated the link between central bank credibility and the channel's functionality and efficiency. The core model used can explain the monetary policy transmission through the interest rate channel as follows: $Z_{(i,t)} = \Gamma_0 + \Gamma_1 Z_{(i,t-1)} + f_i + p_t + e_{(i,t)}$, where $Z_{(i,t)}$ is a four-variable vector, including the channel's variables, namely Policy Rate, Lending Rate, Inflation and GDP. In this model, fixed effects (f_i) are introduced, in order to allow heterogeneity on each variable level (country-specific characteristic) (Arellano and Bover, 1995). Time-specific characteristics (shocks) are also measured using p_t . $e_{(i,t)}$ allows for both country and time-specific disturbances as it represents the error term. The sample of the research consists of annual data for 19 countries and the timeframe of the research is between 1999 and 2019. Optimal lag selection criteria, stability conditions, impulse-response functions and variance decomposition are also applied.

KEYWORDS Central Bank Credibility; Interest rate transmission mechanism; Panel VAR; Monetary Policy

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