

Asset Price Channel

Monetary policy affects households and economy through the effect of the interest rate policy on the valuation of equities. Higher interest rates bring equity prices down. Lower equity values lead to a drop in financial wealth, and less wealth means less spending. The drop in equity prices also impacts on Tobin's q effect. Low value of equities relative to the replacement cost of capital results in reduced investment spending.

The above monetary policy transmission channel can be illustrated as follows:

