THE STOCK MARKET AND MONETARY POLICY

There are two conceivable mechanisms for the stock market's transmission of monetary policy to the real economy. One involves a *change in the valuation of existing capital* (as reflected in share prices) relative to the cost of new capital. This ratio is known as Tobin's q. Rising share prices that bring the value of existing capital above its replacement value (Tobin's q>1) make investment in new capital profitable. The other mechanism involves share price movements that *alter household wealth and may thereby influence consumption.*

Share prices may thus affect economic activity, which leaves the question of how they in turn can be affected by monetary policy. The price of a share represents the discounted value of all its future dividends. In principle, the discount rate consists of a risk-free component and a risk premium. The dividends are dependent on the firm's profit levels. A monetary tightening gives a higher discount rate. At the same time, higher interest rates tend to subdue economic demand, which should entail lower profits and dividends. Thus, a restrictive adjustment of the monetary stance should lead to falling share prices, just as an expansionary turn should cause share prices to rise.

Empirical evidence of the first channel—from monetary policy via Tobin's q to investment—has proved difficult to find. Wealth effects on private consumption are less elusive but the relationship has mostly been studied with wealth represented by house prices, less frequently by share prices.

The path of private consumption is highly contingent on the lifetime resources of households, that is, on both current and expected income. Expected income is manifested in the pricing of the various assets which constitute household wealth. The main components of assets are owner-occupied housing and equity capital. In the wealth portfolio of Swedish households, own homes come first at about 40 per cent, followed by equity at almost 20 per cent (end 1996). The equity component has been growing since the early 1980s.

In the long run it seems reasonable for households to regard rising share prices as a reliable increment to wealth that augments their life income and scope for consumption. In the short run, however, the relationship may be weaker for a number of reasons. The impact of share price movements on private consumption is likely to be limited in that households strive to smooth consumption over time. Moreover, a large proportion of shareholdings is owned by households in the upper income and wealth groups, whose marginal consumption propensity tends to be low. Share investment by these groups is no doubt strongly influenced by long-term considerations, making the groups less reactive to short-term price fluctuations. Furthermore, the major component that consists of pension saving cannot be liquidised in the medium term.

House prices and private consumption are both steered by households' expectations. Rising house prices may therefore generate and/or indicate rising consumption. Share prices, on the other hand, are influenced not just by households' expectations but also and perhaps even more by the expectations of other agents. Share prices may therefore not be as strongly related to private consumption as house prices are.

This suggests that the channel from monetary policy to private consumption via the stock market is relatively weak. In practice, moreover, the growth of consumption displays a co-variation with equity capital gains that is lagged and appreciably weaker than the co-variation with capital gains from private property. The significance of the stock market for monetary policy therefore seems to be relatively limited. In that case, it is unlikely that a moderate share price fall would have more than marginal direct effects on the ongoing upswing in consumption.