

THE FINANCIAL AND TAX EFFECTS OF MONETARY POLICY ON INTEREST RATES

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SUMMARY

Standard analysis of monetary policy effects on interest rates in terms of liquidity, income, and expectations effects is incomplete. After a change in monetary policy, substitution among securities will increase as time elapses and so reduce or eliminate financial effects caused by short-run financial market segmentation. Also, the standard expectations effect omits the transfer of income tax liability on that part of the interest payment representing a return of real capital. So a 1 percentage point increase in the expected inflation rate should increase the nominal interest rate by $1/(1 - \tau)$ percentage points, τ being the marginal tax rate.

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