# Opening the black box: Unpacking the Monetary Transmission Mechanism across 5 OECD Countries

Antonino Lofaro[1]

## Abstract

The recent sharp increase in interest rates by central banks in advanced economies, in response to surging inflation, has renewed focus on the monetary policy transmission mechanism. However, much of the economic debate remains focused on the effects of monetary policy on output and inflation, often treating aggregate demand as a “black box”. This paper seeks to open that box by examining how monetary tightening affects the main components of aggregate demand—household consumption, residential investment, and non-residential investment. The analysis covers five advanced economies (Canada, France, Japan, the United Kingdom, and the United States) using quarterly data spanning 1960 to 2019.

Using structural vector autoregressive (SVAR) models and counterfactual simulations, we disentangle both the direct and indirect effects of monetary policy arising from interactions among demand components. Our results reveal substantial heterogeneity in the transmission of monetary policy across spending categories. Residential investment emerges as the most interest-sensitive component, while non-residential investment responds more weakly and with greater delay. In line with the accelerator theory, we also identify indirect effects on business investment, driven by broader contractions in aggregate demand.

These findings highlight the importance of accounting for the sectoral composition of demand when designing and implementing monetary policy. In particular, the strong and rapid responsiveness of residential investment underscores the need for policymakers to monitor developments in the housing sector, given its central role in amplifying cyclical dynamics.

**Keywords**: Transmission mechanism of monetary policy; Aggregate demand composition; Structural vector autoregression; Counterfactual Analysis.

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[1] University of Bari, Department of Political Science. Email: antonino.lofaro@uniba.it