Monetary policy

The Bank of Canada conducts monetary policy for the government of Canada

. Was founded in 1935

It is the central bank of Canada

It supervises the financial institutions

It is the sole issuer of Canadian money

Monetary policy objectives

The Bank's job is to control the quantity of money and interest rates in order to avoid inflation and prevent excessive swings in real GDP growth and unemployment

Important interest rates

1. Bank rate

The interest rate at which the chartered banks can borrow from the Bank of Canada

A bank can borrow from the Bank of Canada at the bank rate

2. Settlement balances rate

The interest rate chartered banks earn on their reserves at the Bank of Canada

Chartered banks' reserves at the Bank of Canada are called **settlement balances**

The interest rate the Bank of Canada pays on these balances is the **settlement balances rate**

3. Overnight loans rate

The interest rate on overnight loans that chartered banks make to each other

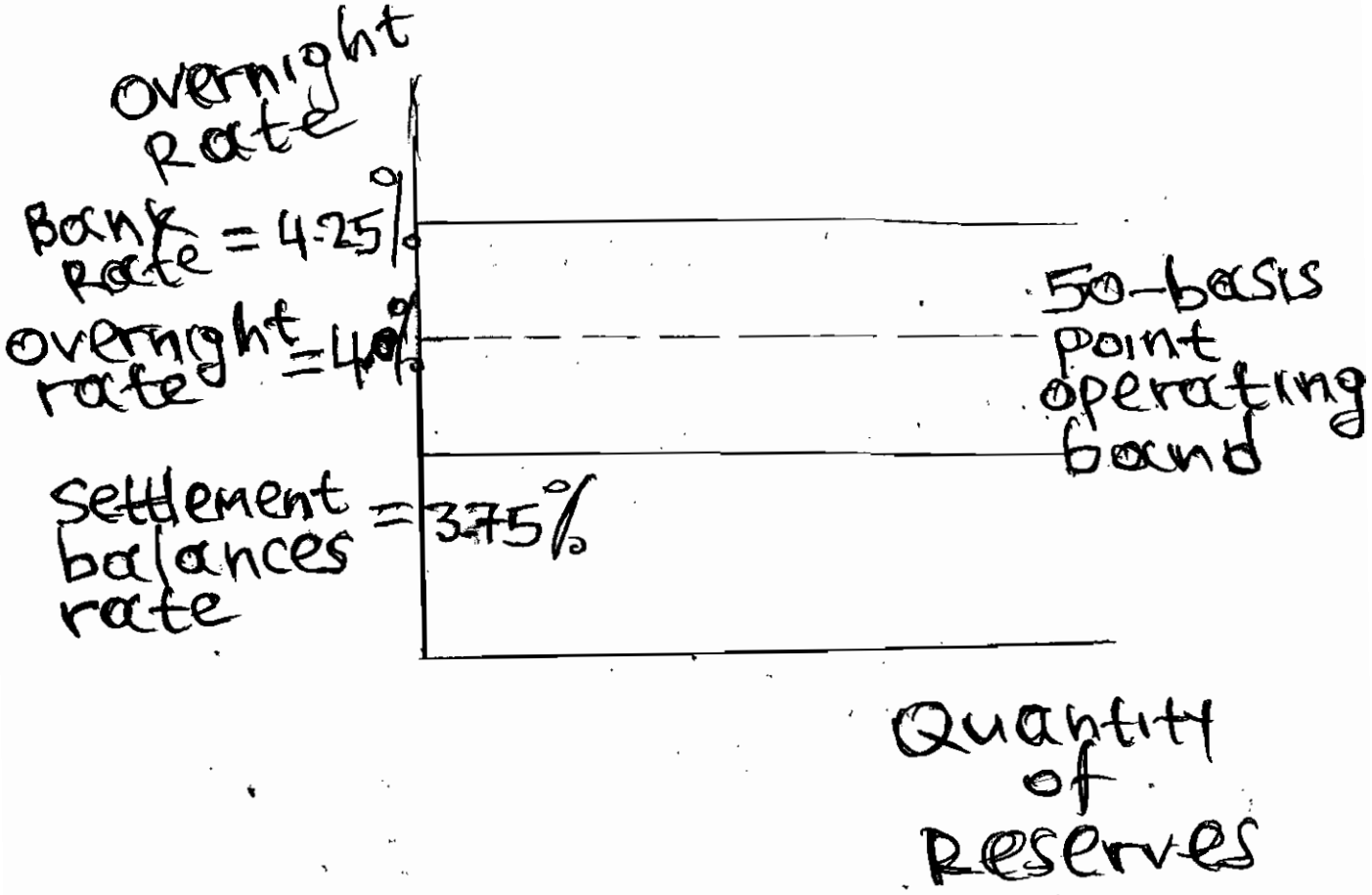
It is a short-term interest rate

Conduct of monetary policy

The Bank of Canada sets a target for the overnight interest rate

If the announced target for the overnight rate is 4 per cent, the Bank sets the bank rate at 4.25 percent and the settlement balances rate at 3.75 per cent.

operating Band For the Overnight interest rate



The operating band is 0.5 percentage points wide

The bank rate is set at the upper end of the range of the Bank's target for the overnight rate

The settlement balances rate is set at the target overnight rate minus 0.25 percentage point

Inflation rate targeting

The Bank of Canada wants to keep CPI inflation at a target of 2 percent a year

A target range is set between 1 and 3 percent

keep inflation at the 2 percent midpoint of the target range

To implement inflation targeting, the Bank of Canada uses the overnight interest rate as the policy instrument

when the Bank wants to slow inflation, it takes actions that raise the overnight loans rate.

- The value of money is protected by keeping inflation low and stable
- Inflation targeting provides an anchor for expectations about future inflation
- Firmly held expectations of low inflation make the short-run unemployment-inflation trade-off possible.

Open Market Operations

An open market operation is the purchase or sale of government of Canada securities such as Treasury bills and government bonds by the Bank of Canada

open market operations are the main tool for controlling the quantity of money and influencing interest rates they are used to move the overnight rate to its target.

1. If the overnight rate is above target, the Bank of Canada buys securities (treasury bills and govt bonds) to increase reserves, which increases the supply of overnight funds and lowers the overnight rate.

2. If the overnight rate is below target, the Bank of Canada sells securities (Treasury bills and gov't bonds) to decrease reserves, which decreases the supply of overnight funds and raises the overnight rate.

By using open market operations, the Bank of Canada determines the quantity of reserves in the banking system and therefore keep the overnight rate on target.

Monetary policy Transmission

Trace the events that follow a change in the overnight rate

when the Bank of Canada <u>lowers</u> the overnight rate, other interest rates also decrease
The exchange rate also decreases (depreciates).

The quantity of money and the supply of loanable funds increase.

The amount of credit and loans that people and businesses take increases

The long-term real interest rate falls.

The lower interest rate increases consumption expenditure and investment.

The lower exchange rate (depreciation) makes Canadian exports cheaper and imports more expensive so net exports increases

Aggregate demand increases, which increases real GDP and the price level.

Real GDP growth and inflation increases

1. Consider an expansionary monetary policy (loose monetary policy)

The Bank of Canada wants to lower unemployment

The economy is initially below full-employment equilibrium.

A decrease in the overnight loans rate increase the quantity of money and depreciates the exchange rate

AD Curve shifts to ~~AD~~ AD_1

Real GDP increases

Full employment is achieved

Price level increases

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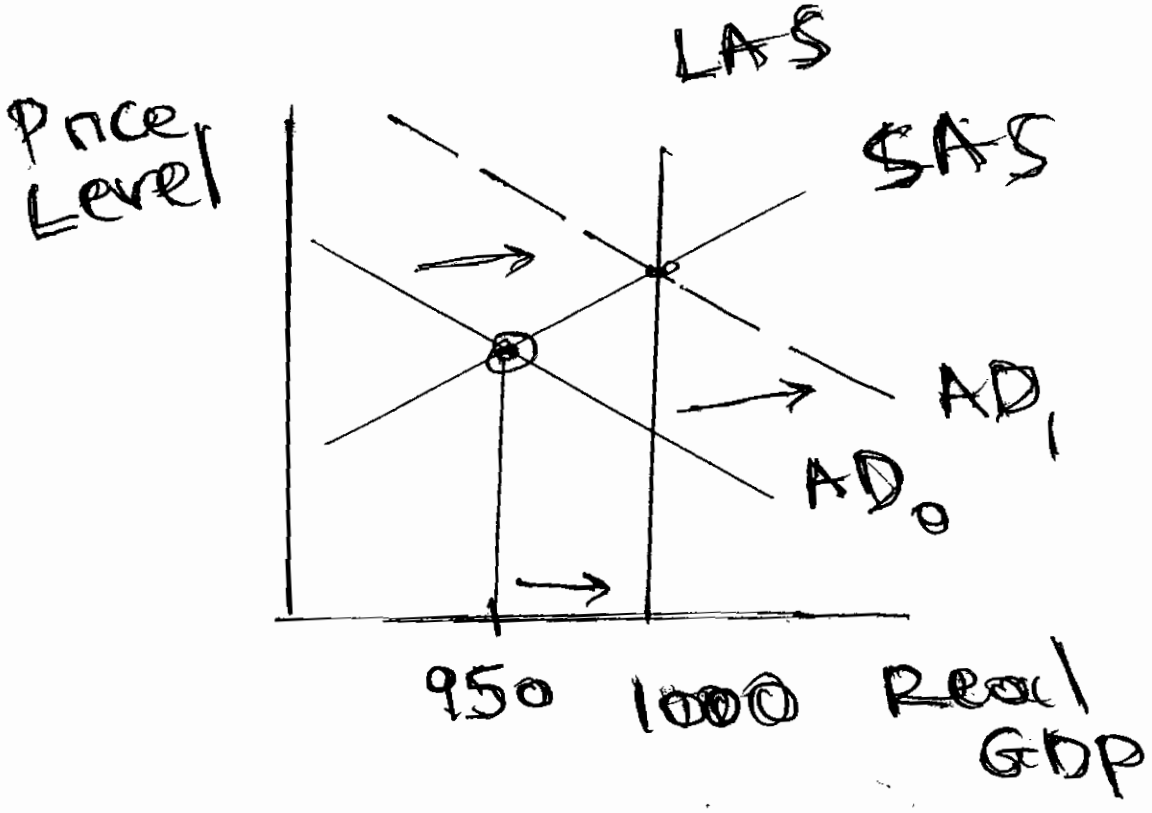
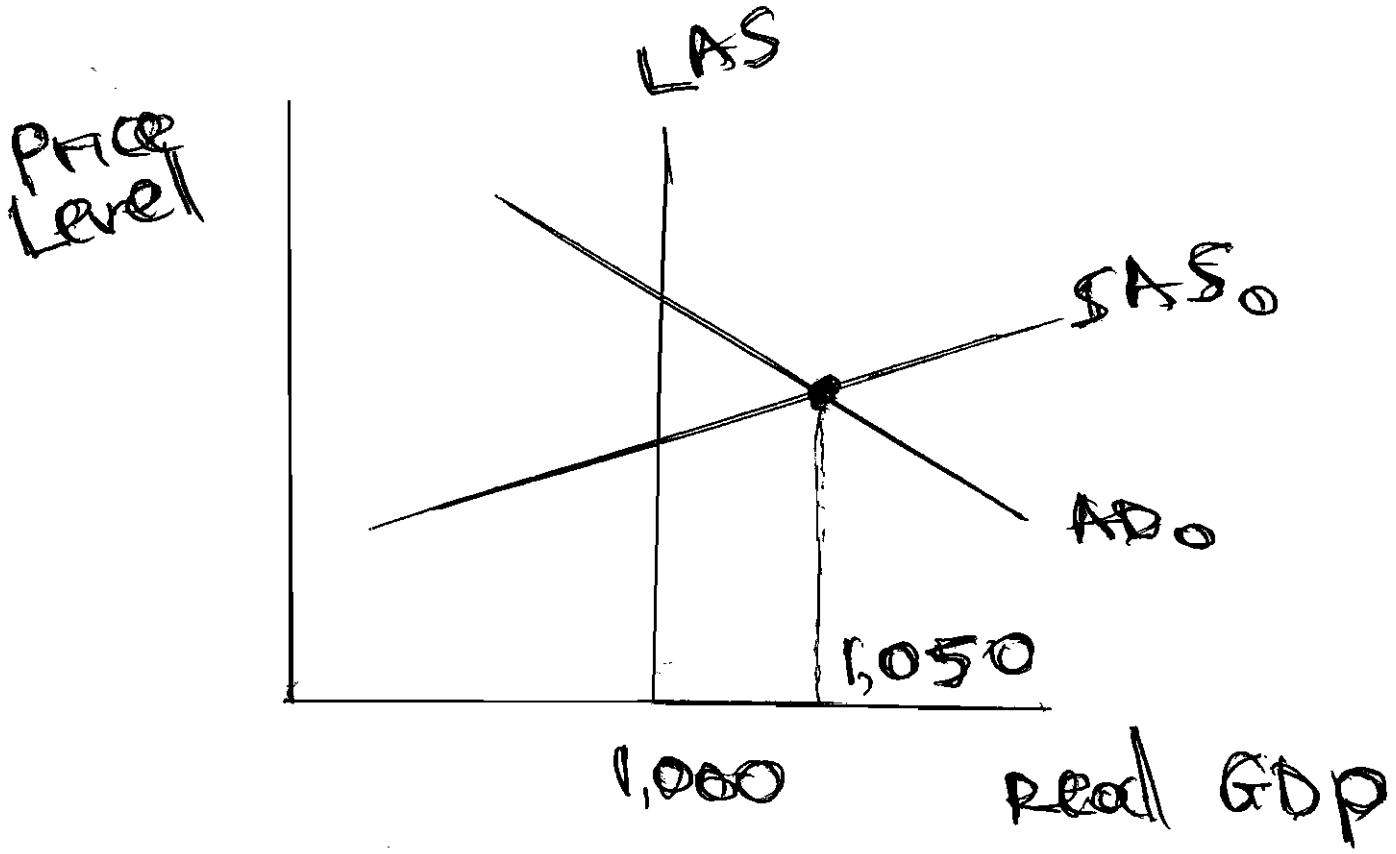


2. Consider an contractionary monetary policy (tight monetary policy)

The Bank of Canada increases the overnight loans rate to lower inflation

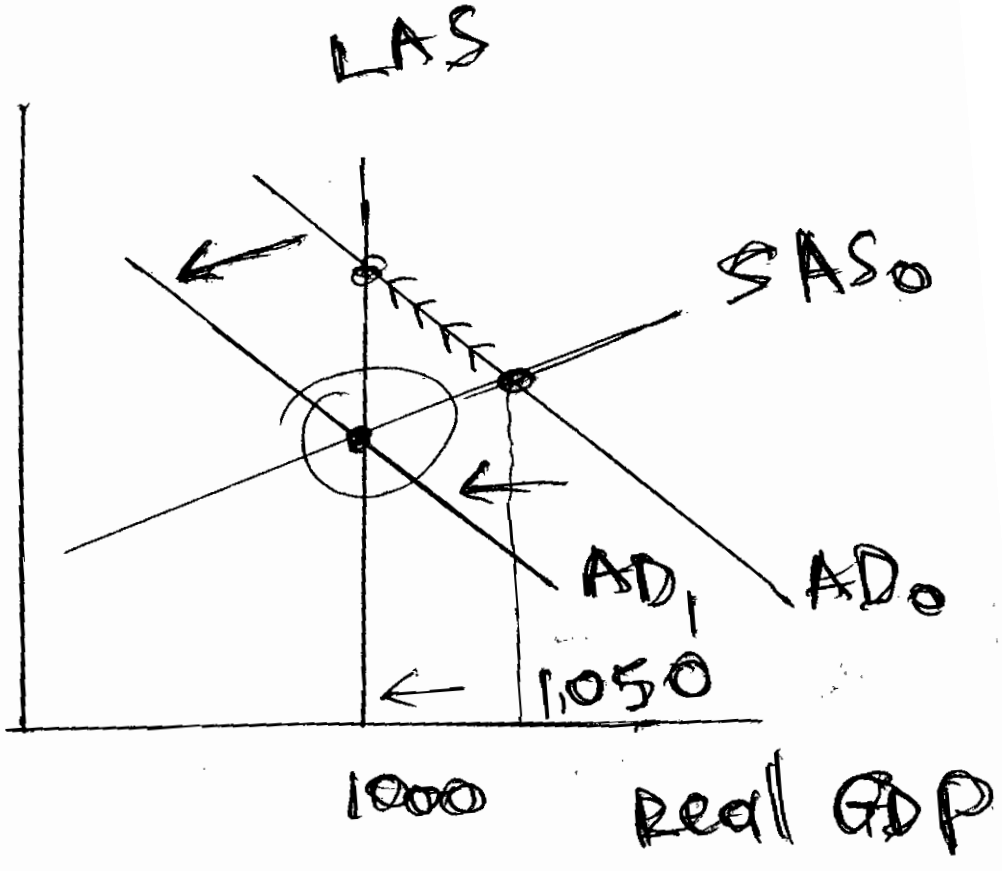


Initially, the economy is above full-employment equilibrium

There will be inflation pressures

For example, the money wage rate will rise and the SAS will shift up, causing higher price level and inflation

The Bank of Canada could prevent this by decreasing the quantity of money so that the aggregate demand curve shifts to AD1



The economy returns to full-employment

Time Lags

A change in the overnight rate changes real GDP about one year later and changes the inflation rate with an even longer time lag.

Conclusion

- The Bank of Canada's goal is to keep the inflation rate around 2 percent a year
- The Bank uses an interest rate strategy
- It targets the overnight loans rate
- Monetary policy is about managing inflation expectations

Interest-sensitive expenditure components are:

- Autonomous consumption
- Investment
- Net exports