Monetary Policy

Backgrounder

Monetary policy is about ensuring that *money* can play its vital role in helping our economy run smoothly. To do this, the Bank of Canada focuses monetary policy on protecting the value of Canadian money by keeping *inflation* low and stable.

The ultimate objective

Keeping inflation low and stable is essential to keeping the economy on the smoothest possible track for long-lasting growth and job creation. The Bank's focus on inflation means that the *output gap* between the potential and actual performance of the economy is kept as narrow as possible. Monetary policy aims at avoiding inflationary "boom-and-bust" cycles that lead to painful recessions and rising unemployment.

Keeping inflation low and stable allows people to make spending and investment plans with a greater sense of confidence about the future. This helps to encourage the long-term investment that contributes to long-lasting growth and job creation, and leads to *productivity* growth that brings real improvements in our standard of living.

Low inflation creates many other direct benefits in its own right — such as protecting the purchasing power of pensioners and other Canadians on fixed incomes.

The elements of monetary policy

At the heart of monetary policy is the *inflation-control target* that the Bank of Canada and the federal government have established for Canada. The target range for inflation is from 1 to 3 per cent, as measured by the *consumer price index*.

The Bank of Canada carries out monetary policy mainly through changes in its *Bank Rate*. These changes influence other interest rates and may lead to movement in the exchange rate of the Canadian dollar. The level of *interest rates* and the *exchange rate* determine the *monetary conditions* in which the Canadian economy operates.

The *transmission of monetary policy* occurs as changes in monetary conditions affect the demand for goods and services. Lower interest rates, for example, tend to increase spending and reduce savings, and a lower dollar can boost exports and hold back imports. Conversely, higher interest rates tend to curb domestic spending and a higher dollar tends to curb exports and encourage imports.

Strong demand for Canadian goods and services puts upward pressure on prices if it exceeds the economy's capacity.

There are lags of from 18 months to 24 months between monetary policy changes and their effects on inflation and the economy. A chain of events is set in motion that affects consumer spending, sales, production, employment, and other economic indicators. This means that monetary policy must always be forward-looking. It must anticipate the monetary conditions needed today to help keep the economy on track for growth and job creation in the future.