Monetary Conditions

BACKGROUNDER

Monetary conditions is the combined effect of the level of short-term *interest rates* and the *exchange rate* of the Canadian dollar.

With an open economy like Canada's, and a flexible exchange rate, changes in the dollar's external value have a large influence on demand for goods and services. For example, a lower dollar can result in more goods being exported, more tourists visiting, and higher import prices, leading to fewer goods being imported. Higher import prices also affect consumer prices.

This means that the Bank must take into account both the exchange rate and interest rates when adjusting monetary conditions to help keep the economy on a smooth course.

It is sometimes mistakenly said that the Bank of Canada changes its *monetary policy* by moving the *Bank Rate* up or down.

What is really happening in these cases is that the Bank is moving the Bank Rate to adjust monetary conditions. It does this to ensure a sound, low-inflation climate for long-lasting growth and job creation—the ultimate objective of monetary policy.

Tracking monetary conditions

To carry out monetary policy, the Bank of Canada tracks monetary conditions with the monetary conditions index, a tool developed by the Bank and published in its *Weekly Financial Statistics.*

The index reflects interest rates and the exchange rate—a three-per-cent change in the exchange rate is equivalent to a one-percentage-point change in interest rates, a relative weighting of three for interest rates and one for the exchange rate.

The information provided by the index helps to guide the monetary policy decisions of the Bank—particularly decisions on when to adjust the Bank Rate in response to changing economic developments.

When the Bank needs to change monetary conditions directly, it moves the Bank Rate, which in turn can affect the exchange rate. Higher Canadian interest rates attract funds to this country, leading to a stronger Canadian dollar. Lower interest rates tend to bring a lower exchange rate.

However, the Bank does not respond to short-term movements in the exchange rate and in monetary conditions. It attempts instead to maintain monetary conditions in a range consistent with the long-term objectives of monetary policy.

The Bank must also take account of the lag in the *transmission of monetary policy* due to the sequence of events that must take place to transmit a change in monetary conditions, work through the economy, and affect the inflation rate.