The Transmission of Monetary Policy

BACKGROUNDER

The Bank of Canada carries out *monetary policy* with the aim of protecting the value of Canadian *money* by keeping *inflation* low and stable.

Monetary policy is implemented mainly through changes in the *Bank Rate* which influence other *interest rates* and affect the level of spending and economic activity in the country.

However, changes to the Bank Rate do not have an immediate impact on the economy in a manner that is readily predictable. The transmission mechanism of monetary policy has long and variable lags because the economy takes time to adjust to changes in *monetary conditions*.

Time lag is 18 to 24 months

Interest rate changes can take from 18 to 24 months to work their way through the economy to have a significant effect on inflation. A dynamic process of adjustment takes place in the economy in the following stages:
—changes in interest rates lead to changes in spending and sales;
—changes in spending and sales lead to changes in production (and employment); and
—changes in production lead to changes in inflation.
Each of these stages lags behind the previous stage and the length of the lags can vary.

Because the effect of *monetary policy* actions on prices can have a long lag, the Bank of Canada must recognize as early as possible any signals that indicate the emergence of upward or downward pressure on prices down the road and take corrective measures well in advance of the time their impact will be felt.

Bank adjusts monetary conditions

If the Bank estimates that the economy will be exceeding its capacity down the road, the Bank may need to adjust monetary conditions early to prevent inflation pressures from building. Conversely, if the economy was expected to slow down, the Bank would take action to ease monetary conditions, by lowering interest rates, so that inflation will not fall below the target range.

To make a judgement about what inflation is likely to be 18 to 24 months down the road, various economic indicators are used, including the intensity of credit demands, the pace of monetary expansion, and developments in prices and costs.

Timely, measured steps are necessary to ensure that the economy can grow on a sustainable basis—that is, without generating inflation pressures.

Because of the lag, monetary policy must focus on the future, rather than the present. By always acting in a forward-looking manner, the Bank of Canada aims to pre-empt future inflation, keeping it within its *inflation-control target range*.