

MONETARY POLICY

Econ 345 – Ashar Kazi

The Basics:

- Monetary Policy is concerned with how much money circulates in the economy, and ultimately what that money is worth.
- Bank of Canada Act 1934:
“regulate credit and currency in the best interest of the nation”

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- Monetary Policy is concerned with how much money circulates in the economy, and ultimately what that money is worth.
- Bank of Canada Act 1934:
 - “regulate credit and currency in the best interest of the nation”
 - “mitigate by [our] influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada”

What are the best practices?



- For national well-being, they must **keep inflation low, stable and predictable.**
- **Managing expectations** is also very important.

Why inflation targeting?

Because:

- High inflation is costly for individuals and the economy.

because:

- Fallacy of the Phillips Curve considering the long run.

... and
because

- The Central Bank can credibly commit to a low inflation rate.

Key Ingredients:

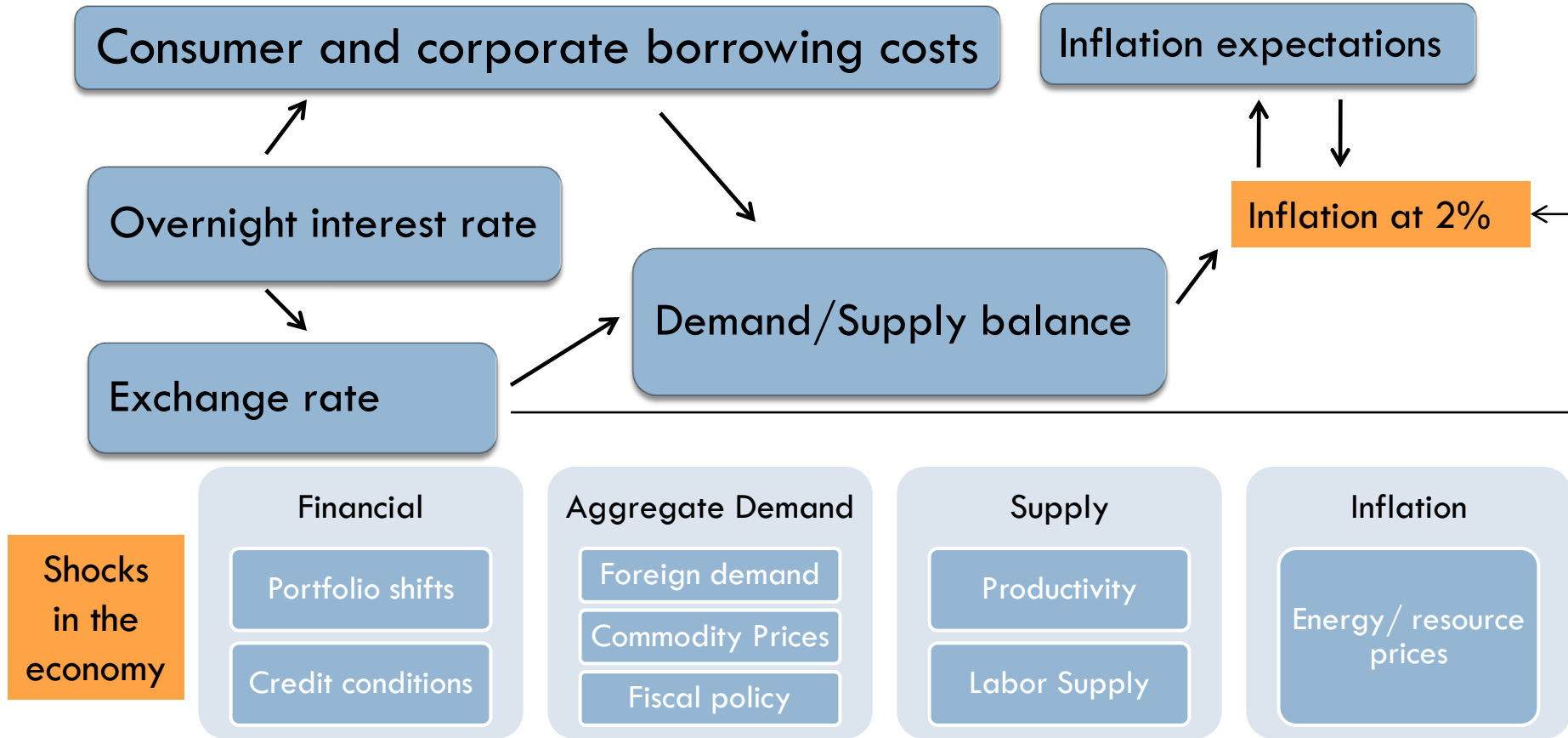
- The key ingredients of inflation targeting are:
 - 1) A low publically announced inflation target
 - 2) A commitment to achieve that target within a particular time frame.

In Practice:

- 1991: The Canadian Government and the Bank of Canada jointly announce inflation reduction targets.
- 4 subsequent agreements, 5 years in length.
- Target 12 month rate of change of the **Consumer Price Index (CPI)**.
- 2% middle point with +/- 1% deviation.
- Commitment to return to inflation target between 6 – 8 quarters.

A demonstration:

How does monetary policy affect inflation?



Managing expectations

- How are expectations managed?

Clear and open about the objective

Communicate the strategy for meeting the objectives

Monetary Policy Implementation:



- Large Value Transfer System (LVTS)
- Overnight rate
- Mechanism used to implement monetary theory.

LVTS – a revisit...

- Large Value Transfer System
- Electronic system for the transfer of payments between financial institutions
- System maintained by the Bank of Canada as the ultimate bank of banks
- Everyday financial intermediaries send money back and forth to each other

Overnight rate



- Rate at which financial intermediaries lend one-day funds to each other
- Monetary instrument used by Bank of Canada

On the target:

- When the bank announces the interest rate it wants to see for overnight loans (target overnight rate) **typically the overnight rate trades close to the specified target rate.**

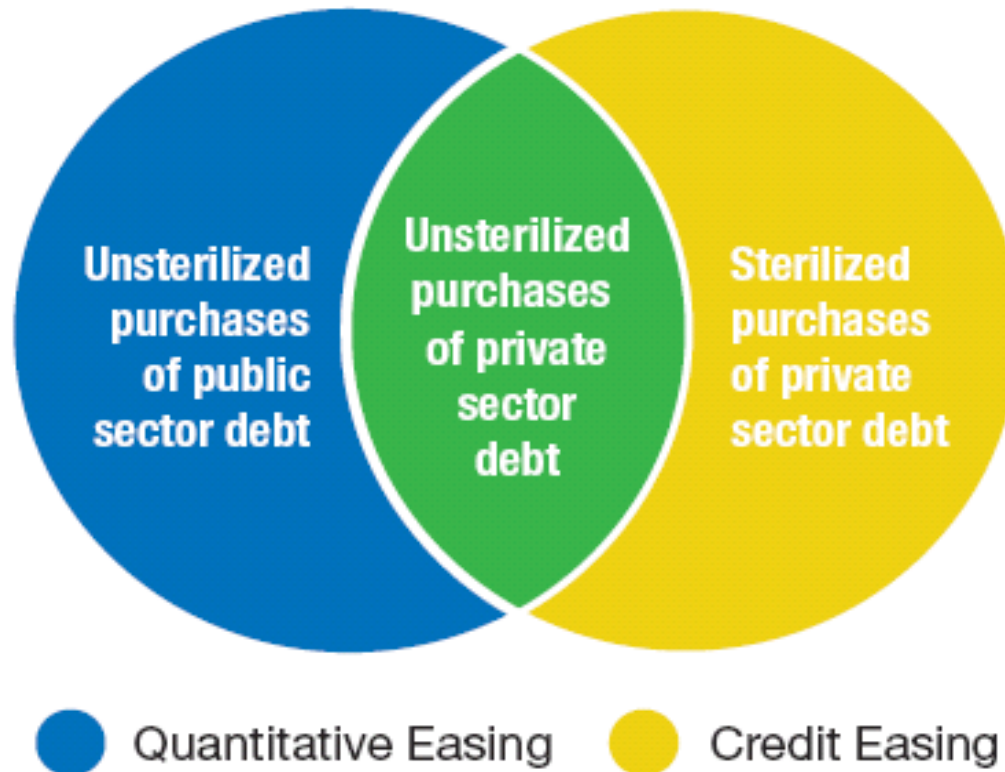
- IF NOT THE BANK INTERVENES...

How to control the target



Unconventional Monetary Policy

Financing and Types of Asset Purchases



Current Challenges:

- Interest rates currently on the lower bound
 - Generalized weakness of the US\$ exerts an upward pressure on the CDN\$.
- Exit strategy
 - Move interest rates to more normal levels.

Questions to ponder

- Q: What is Monetary Policy?

Monetary Policy is about how much money there is in the economy and how much that money is worth

- Q: Why inflation targeting?

High inflation is costly; you cannot buy lower unemployment by accepting higher inflation; low inflation policy to work the Central Bank must be credible

More questions

- Q: How does Monetary policy affect inflation?

This operates primarily through the management of aggregate demand and inflation expectations

- Q: How does the Bank implement monetary policy?

Through the Bank's ability to set the overnight interest rate

- Q: What is “unconventional” Monetary Policy?

Future path for target rate

Quantitative easing

Credit Easing

That's all folks!!!

