

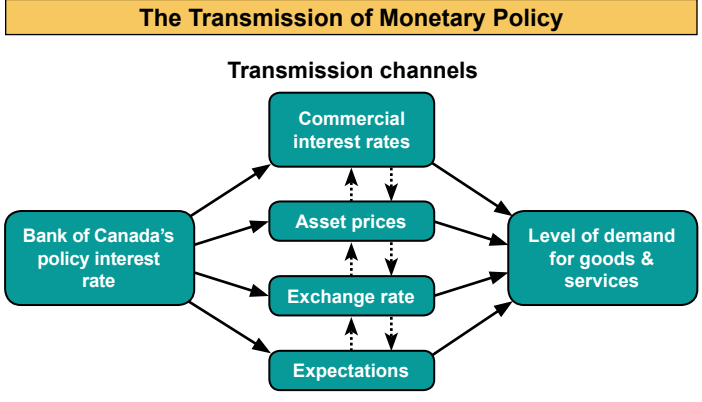


B A C K G R O U N D E R S

How Monetary Policy Works: The Transmission of Monetary Policy

The “transmission” of monetary policy is the process by which changes in the Bank of Canada’s policy interest rate work their way through the economy, ultimately to affect the rate of inflation. The process is complex, and there is some uncertainty about the timing and the relative importance of specific linkages.

The objective of monetary policy is to keep inflation close to the 2 per cent **inflation-control target**, thereby supporting sustainable economic growth. The Bank’s main inflation control tool is its policy interest rate, the **target for the overnight rate**. Changes in this interest rate affect various kinds of economic activity (and thereby, over time, inflation) through four main channels, as shown in the following illustration.



Changes in the policy interest rate affect commercial interest rates, asset prices, the exchange rate of the Canadian dollar, and people’s expectations of future interest rates, economic growth, and inflation, which in turn also affect asset prices and the exchange rate. While the relative importance of each channel may vary over time, the four transmission channels jointly influence the overall level of demand for goods and services.

The main transmission channel is the effect that changes in the Bank’s policy rate have on various commercial interest rates, e.g., for mortgages, for consumer loans, as well as for deposits at financial institutions. A decline in commercial interest rates reduces both the cost of borrowing and the money paid on interest-bearing deposits, which tends to encourage borrowing, spending and investing, and to discourage saving. As a result, over time, there is typically a boost to overall demand for goods and services. The opposite happens when commercial interest rates rise.

While the direction and pace of changes in market interest rates are almost always influenced by changes in the Bank’s policy rate, it is important to note that there’s usually not a one-to-one correspondence. Commercial lending rates are influenced by market forces, including the cost, for lenders, of





raising capital, competition among lenders in given markets, and the perceived credit worthiness of borrowers (see [lending rates](#)).

The second channel for the transmission of monetary policy is the effect that changes in interest rates have on the prices of various assets such as bonds, stocks, and houses. An increase in interest rates, for example, can put a damper on the prices of these assets, thus decreasing household wealth, which in turn may discourage borrowing and spending.

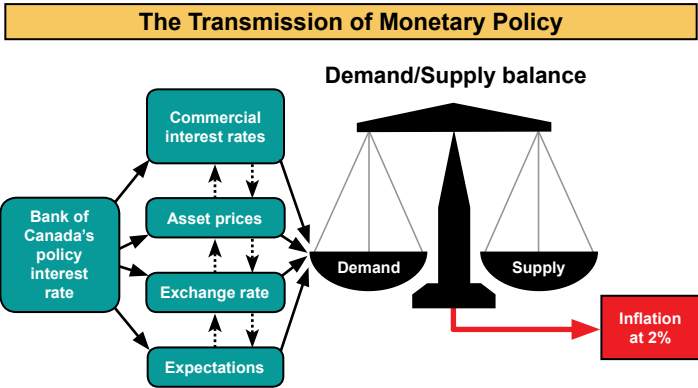
The third channel is the effect of changes in interest rates on the exchange rate. In general, a rise in Canadian interest rates relative to rates in other countries makes Canadian dollar-denominated assets more attractive to foreign (and domestic) investors, which can raise the demand for (and thus the value of) the Canadian dollar vis-à-vis other currencies.

In turn, a stronger Canadian dollar makes many imported goods (and often Canadian goods that compete with them) cheaper over time, and makes many Canadian products more costly in foreign markets, typically reducing demand for them. This puts a damper on inflation.

Finally, the fourth channel is the effect of changes in interest rates on people's expectations of future interest rates, growth, and inflation. These expectations often affect decisions of firms and households about current saving and investment choices, and they affect wages, the prices of goods and services, and asset prices. If, for example, inflation were expected to rise in the future, longer-term interest rates would typically rise to reflect this expectation. In Canada, inflation expectations have been well-anchored at 2 per cent since about 1997.

Changes in the policy interest rate work through all four channels to influence the overall level of demand, both domestic and foreign, for Canadian goods and services. An important determinant of inflation is the relationship between the overall level of demand for goods and services in the economy and the capacity of the economy to supply them (see [output gap](#)).

When overall demand exceeds the overall capacity to supply, prices are pushed upward. When this appears likely to happen, the Bank may raise the policy interest rate to dampen growth and keep inflation from going above target. When overall demand is less than the overall capacity to supply, the result is downward pressure on prices. Correspondingly, when this appears likely to occur, the Bank may decrease the policy rate to stimulate spending, absorb excess capacity, and keep inflation from falling below the target. When overall demand is in balance with overall supply, inflation is contained, as shown in the following illustration.



It is important to note that the transmission process takes time. While changes to the Bank's policy interest rate can affect commercial interest rates, asset prices, and the exchange rate quite quickly,





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there can be a significant lag before interest rate changes influence spending and saving decisions, and thus have an impact on overall demand and supply, and hence, inflation. The time lag is variable, but research suggests that it can take six to eight quarters for a change in the policy rate to have its full effect on inflation. This is why monetary policy decisions have to be made with a view to the future, mindful of the associated uncertainty.

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