



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

# Monetary Policy

The Bank of Canada’s mandate is to conduct monetary policy in a way that promotes the economic and financial well-being of Canadians. The Bank does this by regulating money and credit in the economy so as to preserve the value (purchasing power) of the nation’s currency.

## Monetary policy is focused on keeping inflation low, stable and predictable

Experience has shown that the best way to foster confidence in the value of money and to contribute to solid economic performance and rising living standards is by keeping inflation low, stable and predictable. In this sense, low inflation is not an end in itself, but rather the means to an end—a stable, growing, well-functioning economy.

Low and stable inflation **benefits** Canadians in important ways. It creates an environment favourable to steady, healthy growth in output, employment and incomes over time. It gives Canadians greater confidence about the future, allowing them to make sound economic decisions. Specifically, it helps to encourage long-term investments that contribute to lasting economic growth, job creation and **productivity** gains that are critical to improvements in our standard of living. Low inflation preserves the purchasing power of Canadians, particularly those on fixed incomes, such as pensioners.

## Canada’s monetary policy framework

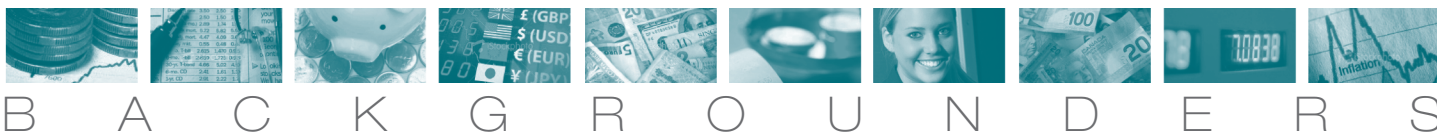
At the heart of Canada’s monetary policy framework is the **inflation-control target**, which the Bank and the Government of Canada jointly adopted in 1991 and which they have since renewed five times—the latest one in November 2011 for another five years to the end of 2016. The target for inflation is the 2 per cent midpoint of a control range of 1 to 3 per cent.

Inflation is measured as the year-over-year rate of increase in the total **consumer price index** (CPI), which is the most relevant estimate of the cost of living for most Canadians. The Bank also monitors a set of “core” inflation measures, including the CPI-X which strips out eight of the most volatile CPI components. These “core” measures allow the Bank to “look through” temporary changes in total CPI inflation by focusing on the underlying trend of inflation. In this sense, core inflation is monitored as an *operational guide* to help the Bank achieve the total CPI inflation target, not as a replacement for it.

The other important element of Canada’s monetary policy framework is a flexible **exchange rate**. A floating Canadian dollar allows the Bank to pursue an independent monetary policy that is best suited to Canada’s economic circumstances and is focused on achieving the inflation target. Movements in the exchange rate also provide a “buffer,” helping our economy to absorb and adjust to external and internal shocks.

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## How monetary policy works

The Bank carries out monetary policy through changes in its policy interest rate—the [Target for the Overnight Rate](#).<sup>1</sup> The process by which these changes feed through to the economy and to prices is known as the “[transmission mechanism of monetary policy](#).” Changes in the policy rate work through several channels to determine the level of total demand and spending in the economy.

First, a change in the policy rate influences the whole range of market [interest rates](#) set by financial institutions, and thus borrowing costs for consumers, homebuyers and businesses, as well as the interest rate earned by savers on bank deposits, GICs, etc. Lower interest rates encourage people to save less and to borrow and spend more. Higher interest rates do the opposite. Second, changes in the policy rate can also influence the [prices of assets](#), such as bonds, stocks and houses, thus increasing or reducing household wealth, which in turn may encourage or discourage spending. Third, a drop (or rise) in the policy rate in Canada relative to other countries may also make Canadian-dollar assets less (or more) attractive to investors, and this may lower (or raise) the [exchange rate](#) for the Canadian dollar. A lower value for the Canadian dollar boosts exports and restrains imports; a stronger dollar does the opposite.

When all is said and done, a reduction (increase) in the policy rate—i.e., an easing (tightening) of monetary policy—can be expected to boost (restrain) total demand for Canadian goods and services. But if total

demand is too strong (weak) and the economy is operating above (below) its production capacity, this will push inflation consistently above (below) target, prompting the Bank to raise (lower) the policy rate to curb (bolster) spending and return inflation to target.

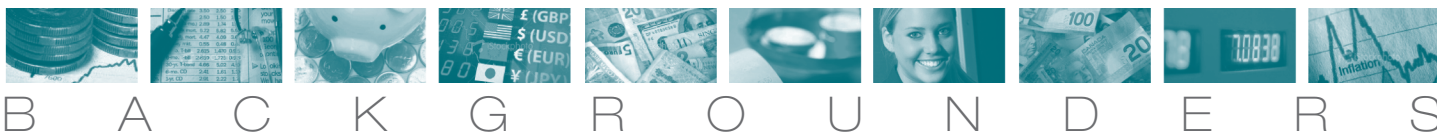
Monetary policy actions (changes in the policy rate) take time—usually between six and eight quarters—to work their way through the economy and to have their full effect on inflation. For this reason, monetary policy must always be *forward looking*. So, the policy rate is set based on the Bank’s judgment of where inflation is likely to be six to eight quarters down the road (if policy action is not taken), not what it is today. This explains why the Bank may start raising (lowering) interest rates while, to all appearances, economic growth is still moderate (healthy) unemployment relatively high (low), and inflation tame (fairly high).

The Bank re-evaluates the outlook for the economy and inflation before each of its eight interest rate decisions a year. This reassessment involves a careful examination of the economic evidence accumulated since the previous interest rate decision, particularly with regard to the balance of supply and demand in the economy and other factors affecting underlying inflationary pressures. The lens through which the Bank assesses this information is focused on the achievement of the inflation target.

Consistent with its commitment to clear, transparent communications, the Bank explains regularly the rationale and implications of its interest rate decisions. And four times a year, it publishes a revised economic outlook in its *Monetary Policy Report*, outlining its perspective on the forces at work in the economy and their implications for inflation. Parliamentary appearances and speeches and interviews by Governing Council members are also part of the Bank’s monetary policy communications.

<sup>1</sup> When the policy rate is at its lowest possible level (the zero lower bound), as during the recent global financial and economic crisis, additional monetary stimulus to achieve the inflation target can be provided through a *conditional* statement about the future path of the policy rate and through two other non-traditional tools—credit easing and quantitative easing. The Annex in the April 2009 [Monetary Policy Report](#) describes these tools and the principles guiding their use.





## Canada's inflation-targeting approach is symmetric and flexible

### Inflation targeting is *symmetric*

Canada's monetary policy functions *symmetrically* around the inflation target. In other words, the Bank is equally concerned about inflation rising above or falling below the target and will act to rein in or to boost demand in order to bring inflation down, or push it back up, to 2 per cent. Such an approach guards against both high inflation and persistent [deflation](#).

### The Bank's *flexible* approach to inflation targeting

The Bank does not pursue the objective of low, stable and predictable inflation single-mindedly; nor does it stick to mechanical rules regardless of circumstances or economic costs. In fact, the Bank's inflation-targeting approach has always been flexible.

At times, shocks to the economy push inflation above or below target in ways that cannot be offset in the short run (given the lags in monetary policy), without risking significant volatility in output and inflation.<sup>2</sup>

In assessing the monetary policy actions that are needed under these circumstances to achieve the inflation target, the Bank must also make a judgment about the most appropriate horizon for returning inflation to target, so as to minimize the economic and financial volatility that these actions may cause. Such volatility can be harmful to the economic well-being of Canadians, which goes against the ultimate objective of a low-inflation policy.

The *flexibility* inherent in the inflation-targeting system practiced in Canada (and elsewhere) allows the Bank to adjust somewhat the typical two-year horizon for returning inflation to target—lengthening or shortening it, as appropriate, depending on the nature and persistence of the shock(s) hitting the economy. While this may mean sacrificing some inflation performance over the usual two-year horizon, it can lead to greater financial, economic and price stability over a somewhat longer horizon.

Broadly speaking, there are three sets of circumstances under which it may be desirable to return inflation to target over a somewhat longer-than-usual horizon.<sup>3</sup>

First, the effects of a shock could be sufficiently large and persistent that a longer horizon may be needed to provide greater economic and financial stability. Such considerations could, for example, lead the Bank to accommodate over a longer period the inflationary effects of a sharp, persistent increase in oil prices, or the disinflationary effects of a serious global economic slowdown, including the possible constraints of the zero lower bound on interest rates (ZLB).

Second, through a longer horizon, monetary policy can also promote adjustments to financial imbalances. For example, there could be instances when, even though inflation is above target, continued monetary stimulus and a somewhat longer horizon would be desirable to facilitate the adjustment to extensive deleveraging (running down of debts). Likewise, a tighter monetary policy that keeps inflation below target longer than usual could help to prevent excessive borrowing and a broader buildup of financial imbalances.

<sup>2</sup> Carney, M. 2011. "Renewing Canada's Monetary Policy Framework." Remarks to the Board of Trade of Metropolitan Montreal, Montreal, Quebec, 23 November.

<sup>3</sup> Bank of Canada. 2011. *Renewal of the Inflation-Control Target: Background Information*. (November).

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Third, the horizon may vary depending on whether the overall risks to the Bank's most likely outlook for inflation are seen to be on the downside or the upside and how much "risk management" the Bank deems appropriate to undertake. Simply put, when there is a relatively high risk that a negative shock will materialize, the Bank has the flexibility, through a longer-than-usual horizon, to "buy some insurance" against that risk and in this way minimize the associated adverse consequences.

During its 20 years of experience with inflation targeting, the Bank has made use of the flexibility to adjust the target horizon on several occasions. Typically, it has sought to restore inflation to target within six to eight quarters. There has, however, been considerable variation in the horizon, from as short as two quarters to as long as 11 quarters, depending on the shock(s). To date, the horizon has been extended beyond eight quarters on nine occasions.

The Bank's scope for exercising certain flexibility with respect to the target horizon is founded upon its demonstrated success and credibility in achieving the inflation target over time (since 1991, inflation has in fact averaged close to 2 per cent). This credibility is in turn best safeguarded by the Bank's continued commitment to, and success in, achieving the inflation target.

December 2011

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