10.5: Monetary policy indicators

Policy rules describe how a central bank, like the Bank of Canada, would use interest rates to stabilize output, prices, and inflation in the economy. To see how the Bank's actions affect economic activity and inflation, we need some indicators of the expansionary or restrictive stance of monetary policy. These monetary policy indicators will allow us to go beyond the central bank's descriptions of its policy and observe the effects of its policy actions on monetary conditions in the economy.

**Monetary policy indicators**: variables that provide information about the stimulus or restraint coming from the central bank's policy.

Our earlier discussion of the monetary transmission mechanism suggests two monetary policy indicators, namely, *interest rates* and *exchange rates*. The central bank sets nominal interest rates, which have important effects on asset prices, cash flows, and expenditures. Interest rates are also important to expenditure decisions. Changes in nominal interest rates over time will show how monetary policy has been implemented.

The foreign exchange rate as it affects net exports also provides an indicator of policy stance. Because exchange rates change in part as a result of interest rate differences between countries, changes in the exchange rate provide an indicator of the thrust of domestic monetary policy relative to foreign monetary policy. Although in Canada it is important to recognize that commodity prices also have strong exchange rate effects as illustrated by the recent depreciation of the Canadian dollar.

The monetary transmission mechanism works through both interest rates and exchange rates. In setting its interest rates, a central bank in a small open economy needs to consider recent changes in the exchange rate. If economic conditions, or policies in other countries, have caused changes in the foreign exchange rate, those changes will affect expenditures and output in Canada.
The depreciation of the Canadian dollar in 2015 is an important example. The corresponding appreciation of the US dollar raised import prices and increased the profitability of exports. Even without monetary policy, action expenditure and output in Canada would rise. The Bank of Canada had to make a decision. Was the setting of its operating range for the overnight rate still consistent with its inflation target once the exchange rate had risen? Should the Bank count on the stimulus from the exchange rate to offset the effects of lower energy and commodity prices or cut its interest rate to provide some further stimulus? If it were to respond, by how much should it lower interest rates? The Bank of Canada lowered interest rates. In this case the combined effect of interest rates and exchange rates was increased stimulus. However, the Bank could have decided that the exchange rate alone would suffice or even that the exchange rate depreciation gave too much stimulus. Clearly both are very important for designing and judging and monetary policy.

While interest rates and exchange rates provide important indicators of monetary policy, many economists and the Bank also regard the money supply or the rate of growth of the money supply as a policy indicator. Some suggest a monetary policy rule for money supply, which uses money supply as the central bank’s policy instrument. The demand for nominal money balances depends on nominal income. Taking this into account, the difference between the rate of growth of the money supply measure, M1B, and the rate of growth of nominal GDP provides an indicator of the stance of monetary policy. M1B growth that exceeds growth in nominal GDP provides easier financial market conditions and suggests an expansionary policy stance.

The growth rates in the money aggregates M1B+ and real M2+, adjusted for inflation, provide alternative indicators of the effect of monetary policy. In the current policy context, the Bank of Canada sets the interest rates and the growth rates of money supply reflect the demand for money balances at those interest rates. Empirical research at the Bank and by other monetary economists has found that the growth in real M1B+ is a useful indicator of future growth in real GDP. Growth in real M2+ also provides a leading indicator of inflation. From these findings, an observed increase in the growth rates of these money aggregates indicates that the Bank’s current policy is adding to aggregate demand.

Thus we have a basic set of monetary policy indicators: interest rates, exchange rates, and the growth rate in nominal and real measure of money supply. They come from our understanding of the way changes in monetary variables may affect expenditures, incomes, and prices and from our discussion of how monetary policy is designed and implemented. The Bank of Canada provides a more extensive list of key monetary policy variables at:

http://www.bankofcanada.ca/rates[indicators/key-variables/]

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This chapter completes the development and explanation of the basic expenditure and monetary structure of the economy under the assumption that the general price level is constant. Chapter 11 introduces a basic modern AD/AS model that explains short-run fluctuations, output, and inflation. That model is built on modern monetary policy that sets interest rates to achieve inflation control. It is used to illustrate and evaluate recent Canadian fiscal and monetary policies.