MACROECONOMICS

MONETARY POLICY

INTEREST RATES

Monetary Policy

The Money Supply

Interest rates affect decision making for consumers, business and government

Interest is the price paid for a loan and as a result the supply loanable funds is impacted by the laws of supply and demand

The demand for loans comes from 3 sources: consumers, business and government

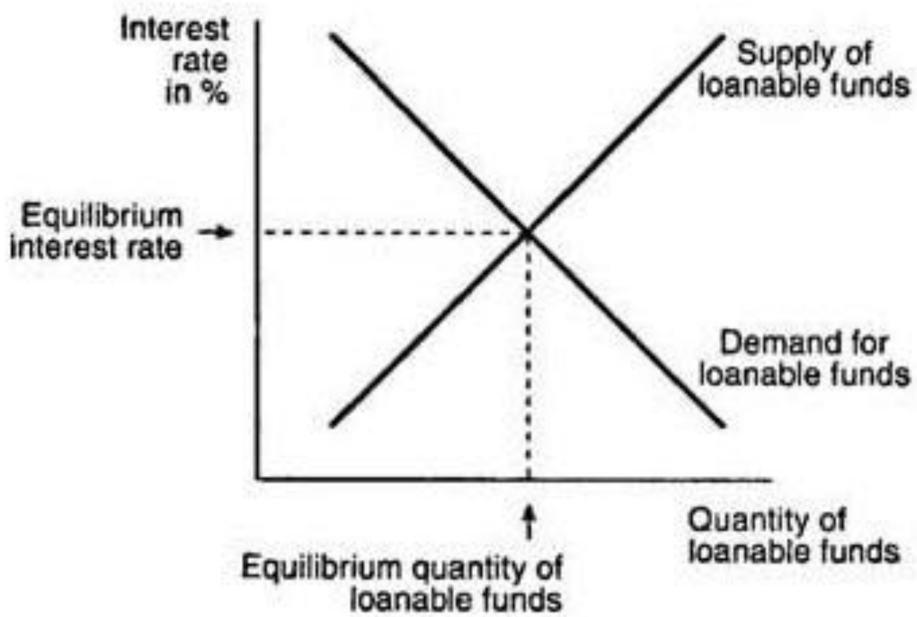
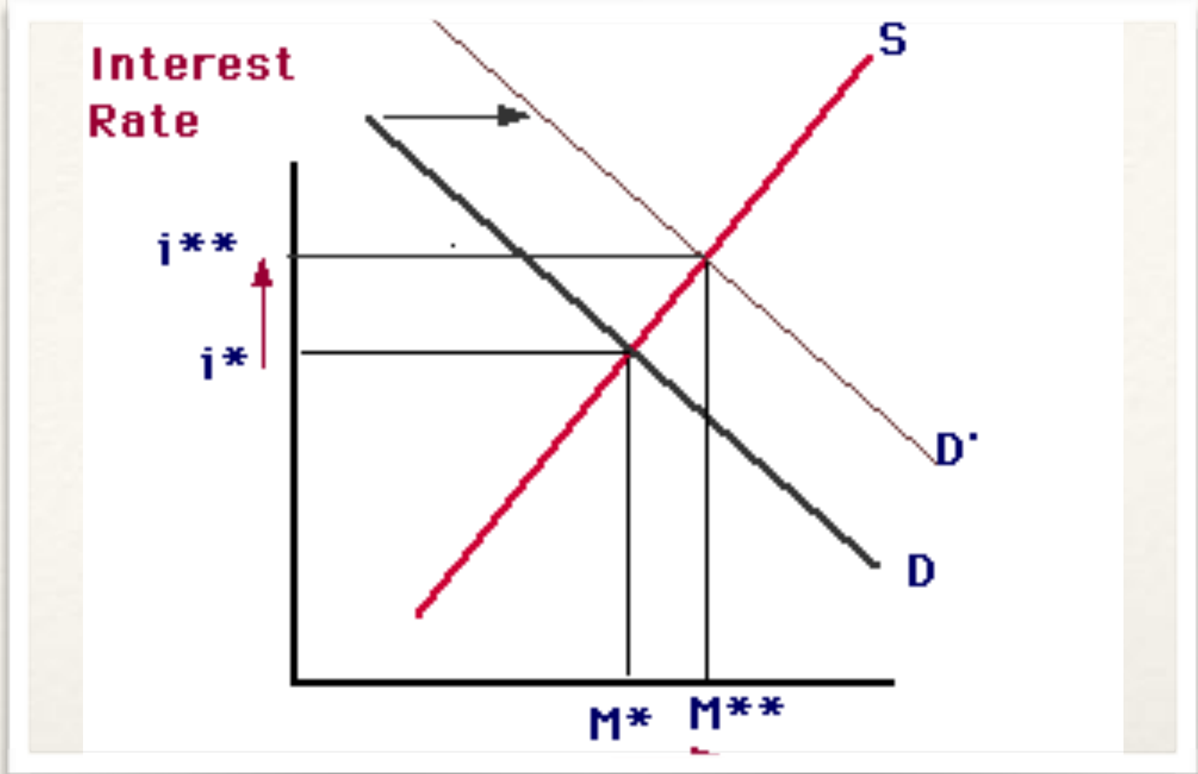
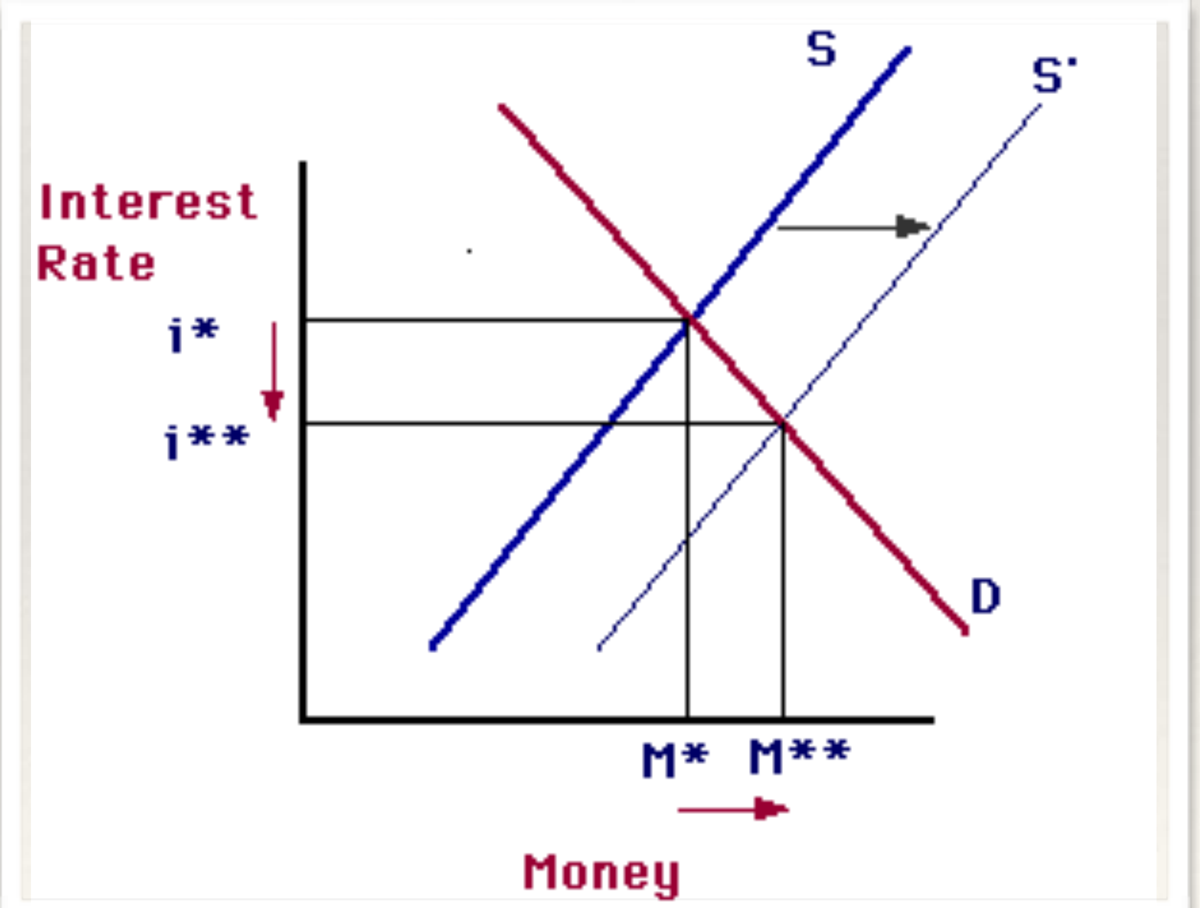


Figure 1
Determination of the equilibrium interest rate

The demand for loanable funds falls in recessionary times and rises in expansionary times



The supply of funds increases in expansionary times and decreases during recessionary times - why?



Types of Interest Rates

- **Prime Rate:** the lowest rate for the banks best customers and serves as a benchmark
- **Bank Rate:** The rate the Bank of Canada charges Chartered Banks
- **Nominal Rate:** inflation premium plus the allowance for risk
- **Real Rate:** Nominal rate less the expected rate of inflation

The Overnight Rate

- The main tool used by the Bank of Canada
- The **Operating Band**:The BoC pays 0.5% less than what it charges to borrow money
- The **Overnight Rate** target lies at the midpoint - the bank uses this overnight rate to signal which direction they want interest rates to move in.
- see figure 12.5/12.6 (274-275)

Bank of Canada: The Balance Sheet

- Assets: government bonds, ForEx, loans to Chartered Banks
- Liabilities: Money in circulation, Chartered Banks deposits, federal government deposits
- How is this used in monetary policy….

Stages of Monetary Policy in Canada

- Stage 1: the Bank shifts government deposits to the chartered banks which increases their reserves
- Stage 2: Lower interest rates to encourage borrowing for large purchases increasing output
- Stage 3: New borrowing results in money supply growth=consumption of increased output
- Stage 4: increased spending by business and consumers pushes up AD

How would the Bank of Canada create a tight money policy to tackle high inflation?

Open Market Operations

- The BofC buys and sells federal government bonds
- Its activities on the bond markets is a major tool of monetary policy

Open Market Operations

- When the BofC sells federal government bonds it effectively reduces money supply
- The sale of bonds reduces the cash reserves of deposit-takers, which in turn cuts back on lending and finally this decreases the money supply
- Why?

Open Market Operations

- When the BofC buys back federal government bonds it increases the money supply
- The purchase of bonds increases the cash reserves of deposit-takers, which in turn increases the cash reserves which increases the money supply
- Why?

Selling Bonds

Figure 14.3 A Bond Sale

Bank of Canada

Assets		Liabilities	
Bonds	–$1000	Cartier Bank's Deposit	–$1000

Cartier Bank

Assets		Liabilities	
Reserves at Bank of Canada	–$1000	Bondholder A's Deposit	–$1000

Bond Buy-Back

Figure 14.4 A Bond Purchase

Bank of Canada

Assets		Liabilities	
Bonds	+$1000	Cartier Bank's Deposit	+$1000

Cartier Bank

Assets		Liabilities	
Reserves at Bank of Canada	+$1000	Bondholder A's Deposit	+$1000

Alternate Views

Alternate Views