The Bank Rate

Backgrounder

The Bank Rate is the rate of interest that the Bank of Canada charges on short-term loans to financial institutions. It is the main "lever" that the Bank uses to conduct *monetary policy*. The Bank Rate is adjusted from time to time to help ensure a low-inflation environment favourable for long-lasting growth and job creation.

The Bank Rate as a trend-setter

The Bank Rate establishes a range—called the operating band—in which the overnight lending rate can move up or down. The overnight lending rate is the rate at which major financial institutions borrow from and lend one-day funds to each other.

The Bank Rate defines the upper limit of the operating band which is half a percentage point wide. For example, if the Bank Rate is set at 4.5 per cent, then the operating band will be from 4.0 to 4.5 per cent.

The upper and lower limits of the operating band are the rates at which the Bank of Canada will, respectively, loan one-day funds to financial institutions or pay interest on one-day funds deposited by financial institutions. This ensures that the overnight rate stays within the operating band.

For example, if a commercial bank needs funds to cover the transactions at its branches during the day, it can borrow from the Bank of Canada at the Bank Rate, or it can borrow from another financial institution that has excess funds.

By changing the Bank Rate and thus the operating band, the central bank sends a clear signal about the direction that it would like shorter-term interest rates to take.

Changes in the Bank Rate often lead to changes in the *prime rate*, which is the reference rate of interest for a large number of loan and savings rates that financial institutions offer their customers. These changes affect the rates charged to borrowers for mortgage, car, and business loans, as well as rates paid to savers on deposits and investment certificates.

Higher interest rates mean that people are likely to borrow less, spend less, and save more. This reduces the amount of money in circulation and acts as a brake on inflation. Lower interest rates encourage borrowing and spending and increase economic activity.

The chief influence that the Bank of Canada has over longer-term interest rates stems more from how the Bank influences inflation expectations than from actual changes in the Bank Rate. An increase in the Bank Rate and other shorter-term interest rates is sometimes followed by declines in longer-term interest rates, as well as in the 5-year mortgage rate. When this happens, it is usually a result of strengthened confidence that inflation will remain low.

When inflation is lower in Canada than elsewhere, this increases the attractiveness of Canadian-dollar investments and reduces the interest rate risk premium demanded by investors.