INVESTMENT FUNDAMENTALS

What is the Policy Interest Rate?

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Snapshot

- The policy interest rate is an interest rate set by the Bank of Canada for overnight lending between major banks.
- The Bank of Canada's strategy around setting the policy interest rate requires a delicate balancing act.
- Changes made to the policy interest rate have implications for the broader Canadian economy.

It's no mystery that Canadian markets are sensitive to the policy interest rate, an interest rate targeted by the Bank of Canada (BOC) for overnight lending between major banks. An adjustment to the rate only needs to be anticipated—not actually made—for the markets to react. And sometimes it's a lack of change that drives market volatility.

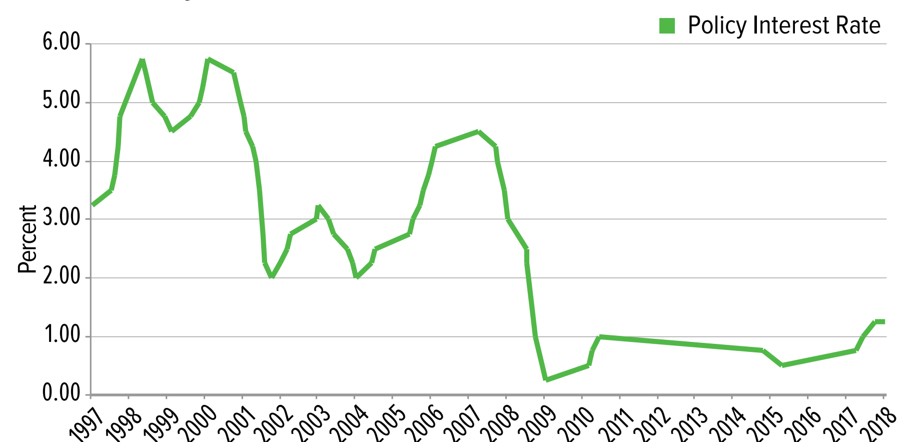
But what remains a mystery to many is what exactly the policy interest rate is, how it's set and why its movements (or lack thereof) can have such a profound effect on market activity.

Putting the "Policy" in Policy Interest Rate

The BOC is Canada's central bank where the country's money supply and interest rates are managed. Among other functions, the central bank is intended to provide monetary stability and facilitate credit market liquidity.

The policy interest rate (Exhibit 1) used for overnight lending is typically reviewed at eight scheduled meetings each year, during which the BOC typically assesses the country's economic and financial condition.

Exhibit 1: Policy Interest Rate



Source: Bank of Canada, SEI.
Data as of 4/28/18.

The BOC's strategy around setting the policy interest rate requires a delicate balancing act—typically based on the conditions of two factors: achieving maximum employment and price stability. If employment is weak, for example, the rate might be lowered to spur economic growth, as inexpensive borrowing costs would make job-creating activities more feasible for established companies and entrepreneurs. However, in weighing whether or not to lower the rate, the BOC must consider that doing so might fuel inflation (or rising prices), since the supply of borrowed money available for spending would expand.

On the other hand, if the primary concern of the BOC is inflation, it might increase the policy interest rate in order to slow prices (by reducing demand for borrowed money). But a consequence of this is that job creation may suffer.

BOC: Setting the Tone

The BOC's need to execute such a delicate balancing act shows that the policy interest rate affects more than overnight borrowing at the BOC—it also has implications for Canada's broader economy. In fact, the policy interest rate serves as a reference point for most other short-term financing activity in the country.

Changes in the policy interest rate set off a series of events that affect a range of economic variables, including consumer loans, mortgages and the Canadian dollar exchange rate. It also impacts the labour market and the prices of goods and services. Essentially, the policy interest rate has downstream consequences that influence Canada's entire economy.

What it Means for You

What should you do in the face of potential market volatility around interest-rate activity? First, know that volatility is an expected, if unpredictable, part of investing and is as dynamic as the market itself. Second, as always, stay focused on your long-term investment objectives. While stocks frequently feel pressure when the BOC raises interest rates, historically they have made up for this in the long term. Overreacting by selling investments could result in missing out on gains when the market bounces back.

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