



BANK OF CANADA
BANQUE DU CANADA



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

Target for the Overnight Rate

The Target for the Overnight Rate is the main tool used by the Bank of Canada to conduct **monetary policy**—for this reason, it is also known as the policy interest rate. It tells major financial institutions the average interest rate that the Bank wants to see in the market where they lend each other money “overnight.” When the Bank changes the Target for the Overnight Rate, this change affects other interest rates in the economy.

Canada’s major financial institutions routinely borrow and lend money overnight among themselves, in order to cover their transactions at the end of the day. Through the **Large Value Transfer System (LVTS)**, these institutions conduct large transactions with each other electronically. At the end of the day, they need to settle with each other. One bank may have funds left over, while another bank may need money. The trading in funds that allows all institutions to cover their transactions at the end of the day takes place in the overnight market. The interest rate charged on those loans is called the overnight rate.

The Bank of Canada operates a system to make sure that trading in the overnight market stays within an “**operating band**.” This band is one-half of a percentage point wide and has the Target for the Overnight Rate at its centre. For example, if the operating band is 2.25 to 2.75 per cent, the Target for the Overnight Rate would be 2.50 per cent. The top of that band (2.75 per cent) is the Bank Rate—the

interest rate that the Bank charges on one-day loans to LVTS participants. The bottom of the band (2.25 per cent) is the deposit rate—the interest rate that the Bank pays on any surplus funds that participating institutions leave on deposit at the Bank overnight.

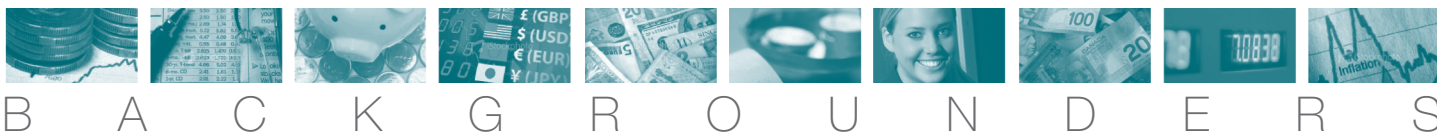
Since LVTS participants know that the Bank of Canada will always lend them money at the rate at the top of the band, and pay interest on deposits at the bottom of the band, there is no reason for them to trade funds at rates outside the band. The Bank can also intervene in the overnight market at the target rate, if the market rate is moving away from the target.

The Target for the Overnight Rate is the best rate to use for international comparisons. It is directly comparable with the U.S. Federal Reserve’s target for the federal funds rate, the Bank of England’s two-week “repo rate,” and the minimum bid rate for refinancing operations (the repo rate) of the European Central Bank.

Changes in the Target for the Overnight Rate influence market interest rates

When the Bank changes the Target for the Overnight Rate (the policy interest rate), this sends a clear signal about the direction in which it wants short-term interest rates to go. Changes in the target rate usually lead to moves in the prime rate of commercial banks,





and also influence other lending rates, including mortgage rates, as well as the interest rate paid on deposits, GICs, and other savings.

When interest rates go down, people and businesses are encouraged to borrow and spend more, boosting the economy. But if the economy grows too fast, it can lead to rising inflation. The Bank will then raise interest rates to slow down borrowing and spending, thus putting a brake on inflation.

The Bank of Canada sets the Target for the Overnight Rate at a level that will keep inflation low, stable, and predictable over the medium term. Low and stable inflation provides a favourable climate for sustainable growth in output, employment, and incomes.

January 2016

