

A Basic Understanding Interest Rates and Economics

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Why change interest rates?

Money can be considered to be like any other commodity where the price is determined by supply and demand. When the Bank of Canada revises its key lending rate, it's changing the supply of money (or "monetary stimulus" in bank-speak).

Making money more expensive to borrow reduces monetary stimulus because it reduces the demand for money. The Bank of Canada does this when it's worried about rising inflationary pressures in an overheated economy.

The central bank's main way of keeping inflation in check is by hiking the benchmark lending rate.

On the other hand, the best way to jump-start a stagnant economy is by making it cheaper to borrow money — a stimulative move.

Does the Bank of Canada set all interest rates?

No. The Bank of Canada sets the "target for the overnight rate." The overnight rate is the interest rate that banks charge each other to cover their short-term daily transactions. The target for the overnight rate is a half-percentage-point band. If, for instance, that band is 3.25 per cent to 3.75 per cent, it means that banks will charge 3.75 per cent interest on money they lend to other banks and pay 3.25 per cent interest on money deposited by other banks.

The chartered banks use the overnight rate as a guide in setting their prime lending rate — the rate at which the bank's best customers can borrow money. When the central bank changes its overnight rate, it's sending a signal to the chartered banks that it wants them to change their prime rates.

The banks usually follow suit. If the central bank raises its overnight rate and a bank leaves its prime rate unchanged, it will make less profit.

The Bank of Canada does not directly set mortgage rates or credit card rates. Variable mortgage rates and other floating-rate loans like lines of credit move up and down in lockstep with the prime lending rate. But the rates for fixed mortgages depend more on the bond market. Banks rely on the bond market to raise money for those kinds of mortgages.

Stan Stanchev
Real Estate Adviser
RE/MAX Crest

Direct: 604-202-1412 Office : 604-988-8000 Fax: 604-988-3882 Email: stanstanchev@shaw.ca

Interest rates on the bond market can move up or down more frequently than the prime rate because the bond market is far more sensitive to market fluctuations. Rates move when traders believe the central bank may be about to increase — or reduce — interest rates.

Credit card rates, on the other hand, hardly budge at all. Most cards carry an annual interest rate of around 19 per cent. Department store and gas station cards are often around 28 per cent.

The higher rates on credit cards, according to the Canadian Bankers Association, are attributable to risk.

A mortgage is a secured loan because the loan is backed up with a tangible asset: your home. Using a credit card is essentially taking out an unsecured loan because there is nothing physical used as security for the lender.

In addition, the CBA says, credit cards are much more susceptible to fraud — even with all those security enhancements, the credit card companies say they've implemented over the past few years — which necessitates an interest rate that remains consistently high.

What happens when rates go up?

While it costs more to borrow money when interest rates increase, this doesn't have much of an impact on most day-to-day buying decisions.

But if you're in the market for a home, you might think twice about buying as rates rise. For instance, if you needed a \$200,000 mortgage and your interest rate was five per cent, you would be paying \$1,163.21 every month in principal and interest for 25 years.

If that rate climbed just one percentage point higher, your mortgage payment would be \$1,279.62 per month.

Bump the rate to seven per cent and your payments are just over \$1,400 a month. Might be enough to make you think twice about buying.

And if you don't buy, those big-box hardware stores might not see as much of you since you won't be renovating that new home. Same goes for the furniture stores that wanted to sell you that entertainment unit for the new home theatre you were thinking of installing.

On the other hand, if you've paid off your mortgage and have a whack of cash lying around, higher rates mean the bank will likely pay you more to let your money sit with them in savings accounts or GICs.

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You might not notice the impact on a personal line of credit — at least not at first.

If you owe \$10,000 at 4.25 per cent, you'll be paying about \$35.42 a month in interest. If rates go up by one-quarter of one percentage point, your monthly interest obligation will rise to about \$37.50.

So for every \$10,000 you owe, your monthly interest payment goes up by \$2.08 with every quarter-point increase. After 10 of those increases — a total jump of 2.5 percentage points — your monthly interest payment rises to \$54.16, or almost \$20 a month.

The same principle works for various levels of government. If the national debt is \$568 billion — as the federal government estimated in its last budget — an increase of one-quarter of one percentage point increases monthly interest payments by more than \$118 million. Over the course of a year, that's more than the cost of security for a G8/G20 summit combo.

What happens when rates go down?

The simple answer is, of course, that the cost of borrowing goes down. But there's method behind the maneuvering.

Lower rates are an unmistakable signal from the central bank that it's worried that the economy is weakening and people aren't buying enough big-ticket items. Lowering rates helps to spur economic growth because it makes borrowing more attractive for businesses and consumers.

The central bank must be careful not to inject too much stimulus into the economy, to avoid igniting inflation. Correctly forecasting this balance of risks is the central bank's most difficult and most important task.

When are interest rates set in Canada?

The Bank of Canada sets its benchmark rate eight times a year — in late January, early March, mid-April, late May/early June, mid-July, early September, mid-October and early December.

The bank retains the option of taking action between fixed dates, but only under extraordinary circumstances.

The U.S. Federal Reserve also sets rates eight times a year. The Bank of England sets rates 12 times a year.

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Do U.S. and Canadian rates move in sync?

Usually. If Canadian and U.S. rates move in opposite directions, it would be unusual, but not unprecedented. After all, the Canadian economy does not necessarily follow the American economy in exactly the same expansion or contraction.

But there's no question that the movement of U.S. rates broadly influences what happens on this side of the border. According to the Bank of Canada:

"Interest rates in Canada are broadly determined by the level of interest rates in the United States, the relative inflation rates in both countries and the relative stances of their monetary policies. A risk factor is also factored in. The result is that Canadian interest rates can be either higher or lower than U.S. rates but are never fully independent."

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RE/MAX Crest

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