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Bank of Canada Changes Basis for Setting Bank Rate

OTTAWA — The Bank of Canada announced today that, effective Thursday, 22 February 1996, it will be using a new basis for setting the Bank Rate. Henceforth, the Bank Rate will be set at the upper limit of the Bank of Canada's operating band for the overnight financing (one-day) rate and will change only when there are changes in the operating band. Previously, the Bank Rate had been linked to the 3-month treasury bill rate and was announced each week.

The new approach will link the Bank Rate more closely to the interest rate on which the Bank focusses in implementing monetary policy. As a result, changes in the Bank Rate will provide a clearer signal to all Canadians of changes in the stance of monetary policy than does the current Bank Rate setting. The Bank will issue a press release to announce changes in the operating band and the Bank Rate.

This change in the method of setting the Bank Rate will not alter the way in which the Bank conducts monetary policy.

The Bank Rate as of 22 February will be adjusted from its present level of 5.41 per cent to 5.50 per cent. This adjustment simply reflects the difference between one-day and 3-month interest rate levels and does not imply any change in the stance of Bank of Canada policy.

BACKGROUND INFORMATION

Since March 1980 the Bank Rate has been set each week at a level equal to the average interest rate established at auctions of 3-month Government of Canada treasury bills, plus 1/4 of a percentage point.

Effective 22 February 1996, the Bank Rate will no longer be linked to the 3-month treasury bill rate. Instead it will be set at the upper limit of the Bank of Canada's operating band for the overnight financing rate – the rate at which major participants in the money market borrow and lend one-day funds.

The following questions and answers are provided as background information for the change.

1. What is the Bank Rate?

The Bank Rate is the rate used by the Bank of Canada for advances to financial institutions that are Canadian Payments Association members and for purchase and resale transactions with the key investment dealers in the money market. It is also, of course, a rate commonly used by the general public as an indicator of the stance of Bank of Canada policy.

2. What is the overnight financing rate that is the new basis for the Bank Rate?

It is the rate at which banks, investment dealers and other financial market participants borrow and lend funds for one day. It is, for example, the rate paid by investment dealers to finance their holdings of securities from one day to the next.

The overnight financing rate also is the interest rate over which the Bank of Canada has the most control. Through its daily operations, the Bank affects the liquid position of the major financial institutions and, in turn, this influences the rate paid for one-day funds.

3. What is the “band” for overnight rates to which the Bank Rate will be linked?

In mid-1994, the Bank decided to provide the market with a clearer guide as to its near-term objectives. It also was decided that this guide would be based on the overnight rate, because it is the rate that the Bank focusses on in its operations. Specifically, the Bank's operations would be aimed at keeping the overnight rate within a band of 1/2 of a percentage point. The band allows some movement of the rate but clearly establishes for the market the upper and lower bounds that the Bank has in mind.

4. Why is this a better basis for the Bank Rate than 3-month treasury bill rates?

The Bank Rate will be a better indicator of the current Bank policy stance. This is because the Bank's influence over the overnight rate is more direct than with 3-month rates. Since the Bank established its band for overnight rates 1 1/2 years ago, changes in this band have provided a more accurate reading of the stance of policy than Bank Rate changes. With the new basis for the Bank Rate, these two measures will be consistent, and the confusion that has existed over which is the key indicator will be eliminated.

Also, the overnight rate is a better basis for the Bank Rate because the Bank's transactions to which the Bank Rate applies – lending to financial institutions and some market transactions – are typically for one-day terms. Pricing of these transactions therefore is more appropriately based on overnight rates than, as previously was the case, on 3-month rates.

5. Why is the change being made now?

A new electronic payments system is under development that will provide same-day settlement for large value payments. Discussions have been held by the Bank with the financial community as to how monetary policy operations will be carried out in this new environment. Given that under the new framework the Bank Rate will be tied to the upper limit of the operating band, the decision was made to proceed now in order to gain the benefits of the new Bank Rate setting arrangements.

6. Will the “new” Bank Rate be higher or lower than the “old”?

This will vary because the relationship between overnight and 3-month treasury bill rates varies. When interest rates are falling, the bill rate often moves far enough below the overnight rate so that the new Bank rate would be higher (as at present). In contrast, when interest rates are rising, the bill rate is likely to be enough above the overnight rate that the new Bank Rate would be lower.

7. How often will the Bank Rate change?

That will depend on when the Bank decides to alter its operating policy stance and to change its band for overnight rates. There have been 21 changes in the band since mid-1994.