

The Bank of Canada’s Target for the Overnight Interest Rate Policy Implementation Framework

Within the framework for implementing monetary policy, the Bank of Canada (the Bank) sets a target for the overnight interest rate. This target is the first stage in the transmission mechanism through which the monetary policy actions taken by the Bank affect the level of economic activity, and ultimately, inflation. The key features of this monetary policy implementation framework are the target for the overnight rate, the operating band, the ability to conduct buy-sellback and sell-buyback transactions at the target rate, and the management of settlement balances.¹ Given the nature of this framework and the Canadian overnight market, the Bank is best able to influence short-term rates by targeting a level for the collateralized overnight rate.

Target for the Overnight Rate

The Bank of Canada’s target for the overnight rate is the rate on collateralized, market-based overnight transactions.² This is defined as the rate at which major participants in the money market borrow and lend funds fully secured by acceptable collateral for a term of one business day. The Bank will use the rate on overnight general collateral (overnight loans that are secured by non-specific government securities, referred to as the GC overnight rate) as its guide to conditions in the overnight market, although this information may, at times, need to be supplemented by information on conditions in other sectors of the overnight market.³ Implicit in this arrangement is the possibility that, if collateralized funds trade at the Bank’s target for the overnight rate, uncollateralized funds may well trade at rates above the target.

Operating Band

The Bank’s target for the overnight rate is the midpoint of a 50-basis-point band. The interest rate charged for collateralized overdraft loans (advances) that are made available through the Bank’s standing facilities to members of the Large Value Transfer System (LVTS) at final settlement is the upper limit of the operating band, referred to as the Bank Rate. The interest rate paid by the Bank on any positive balances held by LVTS participants after final settlement is set at the lower limit of the operating band.

These arrangements encourage transactions for overnight funds in the marketplace at rates inside of this band, since participants are aware that they will earn at least the Bank Rate less 50 basis points on positive balances, and need not pay more than the Bank Rate

¹ For further details, see “A Primer on the Implementation of Monetary Policy in the LVTS Environment,” and “The Framework for the Implementation of Monetary Policy in the Large Value Transfer System Environment.” Both are available on the Bank of Canada’s website at www.bankofcanada.ca/en/monetary/lvts/index.html.

² Previously, the target for the overnight rate had been broadly defined as a target for the rate at which major participants in the money market borrow and lend one-day funds to each other.

³ Such as times when there are relatively few GC trades observed.

to cover negative balances. In addition, given that the opportunity costs of borrowing from and lending to the Bank at the end of the day are the same at the midpoint of the band, trades should generally take place near that point.

Open Market Purchase/Repurchase Agreements

To reinforce the target for the overnight rate, the Bank can intervene in the overnight market by conducting buyback operations at the target rate, if required. If the collateralized overnight rate is generally trading above the target rate, the Bank will intervene with Special Purchase and Resale Agreements (SPRAs), whereby the Bank purchases government securities from primary dealers⁴ with an agreement to resell those securities the next business day, with the difference in price equal to the value of interest for one business day paid at the target for the overnight rate. Conversely, if the collateralized overnight rate is generally trading below target, the Bank will intervene with Sale and Repurchase Agreements (SRAs), selling government securities with an agreement to repurchase them on the next business day, with the price difference equal to one business day's worth of interest calculated at the target for the overnight rate.

These operations are typically conducted at 11:45, encouraging market participants to trade with each other during the morning, when a large proportion of daily funding activity occurs. The Bank is prepared, however, to enter into multiple rounds of open market operations, if necessary, and to conduct those operations outside of the regular time, including earlier in the morning, if warranted by conditions in the overnight market.

Typically, the Bank neutralizes the cash impact on the system of any SPRA or SRA operations. However, as an additional tool to offset pressure on the overnight rate, the Bank has the option of not fully neutralizing the impact of open market operations. If some or all SPRA or SRA operations are not neutralized, the system could be left in a larger surplus or deficit position at the end of the day, requiring at least one LVTS participant to leave funds on deposit at the Bank of Canada at the Bank Rate less 50 basis points or to take advances at Bank Rate.

Settlement Balances

Since the introduction of the LVTS, the level of settlement balances in the system has typically been targeted at zero or greater. Any participant in the LVTS with a deficit position is therefore aware that, typically, there is at least one participant in the system with an offsetting surplus position who is a potential counterparty for transactions at market rates.

Several adjustments have been made to the target level of settlement balances since the inception of the LVTS. Currently, the Bank will typically target a small positive amount of settlement balances (\$25 million), thus alleviating transactions costs and other frictions from the end-of-day process and reducing the need for participants to take frequent small

⁴ Primary dealers are a subgroup of government securities distributors that have reached a threshold level of activity in the Government of Canada debt markets.

advances from the Bank. The Bank retains the right, however, to adjust the targeted level of settlement balances higher or lower if warranted by conditions in the overnight market.