What Are Central Banks and How Do They Affect Interest Rates?

Wondering what central banks are and how they influence interest rates? Read on!

What is a central bank?

- A central bank is the authority that **sets the policy interest rate** for a country or group of countries.

Does that mean central banks are controlled by politicians?

- No. Canada and most other industrialized countries have an **independent central bank**.

What is Canada's central bank called?

- Our central bank is called the **Bank of Canada**. Other central banks include the **European Central Bank**, the **Bank of Japan** and the United States **Federal Reserve**.

Is the central bank's policy interest rate the interest rate consumers pay for loans?

- No.

What is the policy interest rate?

- The policy interest rate is the **interest rate that the central bank wants financial institutions to charge one another for short-term loans**.

Is the policy interest rate sometimes called something else?

- Yes. In Canada, the policy interest rate is also called the policy rate, the key rate and the **target for the overnight rate**.

How does the policy rate affect the interest rate that consumers pay?

- When a central bank changes its policy rate, financial institutions typically respond by adjusting their **prime rate**.

Do consumers pay the prime rate?

- Not necessarily. For a new **variable-rate loan**, consumers can typically expect to pay the prime rate plus or minus a certain percentage. Their actual interest rate will depend on a number of factors, including their credit score, the loan type and the loan amount.

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What influences fixed-rate loans?

- Changes to the Bank of Canada's policy rate **indirectly** affect **fixed interest rates** by influencing expectations for future changes in the policy rate.

How do all these interest rates work in practice?

- The central bank sets the policy rate. That policy rate influences financial institutions' prime rate. The prime rate in turn affects the interest rates consumers actually pay for a **variable-rate** loan. However, the prime rate does not influence **fixed-rate** loans.

Here's a closer look.

The Bank of Canada's **policy rate** influences how expensive it is for banks to borrow money.

When the policy rate goes up, it costs banks more to borrow money. They then pass on this cost to people and businesses in the form of higher interest on variable-rate mortgages and other loans.

So while the Bank of Canada's policy rate doesn't change the interest rate on your loan directly, it does influence it indirectly.

What happens when the Bank of Canada changes its policy rate?

- When the Bank of Canada raises its policy rate, you usually see variable-rate loans get more expensive. These loans include any mortgages, lines of credit, personal loans or credit cards with a variable interest rate. You might also see higher interest rates on savings accounts and guaranteed investment certificates (GICs).
- When the Bank lowers its policy rate, the opposite happens. Variable-rate loans get cheaper, and you may earn less interest on savings products.
- These rules apply only to variable-rate loans, however. If you have a **fixed-rate mortgage**, your interest rate won't change until you renew your loan.

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