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How Interest Rates Work

If there is ever a time to start understanding how interest rates work, now might be it! The Bank of Canada has been slashing interest rates since the beginning of the COVID-19 pandemic. Below is a simple explainer of what it means to cut rates and how it could affect you and your money.

What Is the Federal Fund Rate? And Why Does it Change?

The federal fund rate, also known as the overnight rate, target rate or nominal rate is one of the most important tools the federal government has. A central banks ability to change the target rate is used to sway the economy in two major ways:

1. The first is inflation. The government can raise interest rates when inflation is becoming too high as a way to stabilize it. The idea is that the raised rates lessen the flow of credit into the financial system by increasing the cost of borrowing. These raised rates tend to discourage people from borrowing and spending, which in turn can stop the rise of inflation.
2. The second is to stimulate the economy. This is when growth is too low and unemployment is too high. By lowering the rates and offering a lower cost of borrowing, the central banks hope to encourage borrowing and start a flow of money into the economy.

How Will Changes Affect You and Your Money?

Rate changes will affect anyone who has any debt. That means mortgages, lines of credit, credit cards…essentially anything you pay interest on! This is important for mortgages; especially when rates go down. If you have a fixed rate mortgage, rates going down may be a good reason to refinance and take advantage of lower interest rate.

What Do Interest Rates Have to Do with Investing?

Lowered rates are meant to encourage people to start investing in risky assets such as stocks and bonds. This of course is part of the plan to stimulate the economy. By lowering interest rates, securities become more attractive than keeping your money in cash. The fact that the government takes steps such as this in an economic downturn is one of the reasons that securities typically will outperform cash in the long term.

The central banks have been using interest rate cuts to try to hedge against the economic impact of the COVID-19 pandemic. Lowered interest rates are designed to provide opportunity to businesses and investors. Be sure to talk to your advisor to find out how you could benefit.