FINANCIAL DICTIONARY PART 3

After covering the very basics of an investment portfolio in our last two issues, we are taking a break to look at some of the more current and topical definitions. With the federal election recently occurring, we will take a look at the yield curve, monetary policy, and fiscal policy.

The Yield Curve: The yield curve is the representation of the relationship between bond yields, and their term to maturity. While one could apply a yield curve to any entity that has multiple bonds outstanding, generally when the yield curve is discussed people are talking about a benchmark in relation to the Government of Canada bonds.

Usually, we would expect the yield of a bond to be higher based on longer term. Earlier in the year there was talk of the yield curve being inverted. Which meant that bonds maturing soon had interest rates higher than those maturing further into the future. This is usually due to changes in the interest rate set by the Bank of Canada.

Monetary Policy: Is the use of short-term interest rates to influence economic activity. Monetary policy is generally used to target or control the level of inflation in an economy. For example, when economic activity is declining (a recession), reducing interest rates can lower the cost of borrowing and encourage lending to facilitate economic activity. In Canada, The Bank of Canada sets the Overnight Lending Rate, which forms the basis of other interest rates within the Canadian economy.

The overnight lending rate is the rate at which banks can borrow money from the Bank of Canada. This rate trickles down through the economy, and reaches consumers in the forms of lines of credit, mortgages, and GICs. Banks or other similar entities increase the rate in order to make a profit, or entice you to invest in their products like bonds and investment certificates.

Fiscal Policy: Is the use of government revenue (taxes) by spending on projects and programs in Canada. Where the Bank of Canada operates monetary policy, the Government of Canada operates fiscal policy. In general, governments that are left of center tend to tax more and spend more on projects/programs, the opposite is true of those governments that are right leaning.

Government spending is used to stimulate the economy. In times of economic slowdown, the government will pay more contractors, employees, and businesses to complete projects or operate programs. In doing so, they put tax dollars back into the hands of Canadians to spend and continue perpetuating the economy. When the economy is booming, the government can spend less and cut back to just the essential services. In doing so, they reduce the amount of cash returned to the economy and slow down how fast it can accelerate.