Is the economy threatened by rising interest rates?

The adoption of very accommodative monetary policies has resulted in extremely low interest rates. However, now that economic conditions are gradually improving, such low rates are becoming more difficult to justify. Since the spring, medium- and long-term interest rates have been rising significantly in many countries, and Canada is no exception (graph 1).

These trends are generating concern, as they could have negative effects on various sectors of the economy. However, higher interest rates could be beneficial in other ways. Lastly, one of the main issues will be the scope of rate increases. Moderate increases would obviously be less damaging, and that is what we are likely to see in the upcoming quarters. The central banks are also likely to be very careful about raising their key interest rates.

**HIGHER MORTGAGE PAYMENTS ON THE HORIZON FOR HOUSEHOLDS**

Buying a home obliges most households to take out a mortgage, whose terms of payment vary according to the amount of principal borrowed, the amortization period and the interest rate that is negotiated. The average interest rate applicable to mortgage debt in Canada is around 3.3% (graph 2). In the years to come, households that borrowed at a variable rate will see their mortgage payments rise in tandem with rising short-term interest rates dictated by monetary policy. Households that are locked into a fixed rate will see their payments rise when renewal time rolls around.

Over the next five years, the average monthly payment could increase by $67 per month per $100,000 of mortgage value. This calculation assumes an average mortgage rate increase of 1.5% and a remaining amortization period of 20 years at renewal time. According to this scenario, the average interest rate would return close to levels observed between 2004 and 2007, which would seem likely over a five-year horizon. Other results are presented in figure 1 on page 2, based on various rate increases and amortization periods.
The average value of a mortgage in Canada is in the neighbourhood of $200,000. Consequently, a homeowner's annual mortgage bill could climb by more than $1,500 if we assume a 1.5% interest rate hike and a remaining amortization period of 20 years. For all borrowers as a group, the total bill could amount to nearly $10 billion. While not insignificant, that amount is small if we compare it to the size of the economy; it would represent around 0.5% of Canada's GDP. Spread over five years, the shock would not be enough to shake the economy. Nevertheless, the cost would seem more considerable in borrowers' eyes, since they are the ones paying the bill. But we expect that rising disposable incomes will enable them to bear those costs. Between now and 2017, the disposable income per household will likely rise by around $10,000 (graph 3). Obviously, the portion of additional income that is allocated to higher mortgage payments will not be available to increase consumption.

Even if we take total household credit into account, the anticipated shock would still be small. Mortgage debt accounts for nearly 70% of total household debt; therefore, higher interest rates would have less impact on other debts. Moreover, the interest rates on certain types of loans, such as on credit card balances, fluctuate less over time. Credit cards represent approximately 5% of total household credit.2

**WILL REAL ESTATE PRICES FALL?**

For many years now, home prices have significantly been climbing. Low interest rates have contributed to this trend by limiting the increase in mortgage payments (graph 4). Were it not for lower interest rates, mortgage payments would have risen hand in hand with prices. Higher interest rates will make rising home prices clearly evident, which could have an impact on demand for homes. This raises concerns about the future trend in home prices. First-time homebuyers would probably not complain about lower prices, but on the other side of the coin, homeowners would see their wealth diminish. They might then be inclined to reduce their consumption, holding economic growth in check.

But demand for homes is also determined by other factors, such as household confidence, growth in disposable income and employment. In a situation of global economic recovery, these three factors will support demand for homes. In the end, slight growth in prices, or even stabilization, is the most likely scenario for the next five years.

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1 The outstanding mortgage credit is around $120 billion, which is divided by the number of households carrying a mortgage (approximately 6 million).

2 Estimate based on the consolidated credit operations of the chartered banks in Canada.
THE GOVERNMENT AND BUSINESSES WILL ALSO SEE THEIR FINANCING COSTS INCREASE

Governments and businesses will not be spared by higher interest rates. For the various levels of government, the consequences will mainly affect their borrowing costs, which will inflate their expenditures. In recent years, low interest rates have eased the burden of servicing the public debt even though the debt has been higher (graph 5). This exceptional situation is drawing to a close.

New spending cuts or tax increases could come about if governments have greater trouble balancing their budgets. But it is worth noting that higher interest rates have already been predicted. In its latest budget, the Canadian government estimated that the 10-year bond yield would reach an average of 2.1% in 2013, and 2.8% in 2014.3 Given the recent trends in the bond markets, we are likely to see values higher than those forecast, but not by much. For example, the 10-year yield could end up reaching an average of 2.3% in 2013 and approximately 3.0% in 2014.

For businesses, meanwhile, higher financing costs raise concerns about their ability to invest. But interest rates do not appear to be the main incentive for investment. Despite low interest rates, investment growth in Canada has generally been disappointing in recent quarters (graph 6). In fact, many companies are facing excess production capacity, and therefore have little reason to expand their investments. Growth in consumer demand is a more persuasive incentive. Expanding demand reduces businesses’ excess capacity and increases their revenues, making investment more profitable.

WILL THE DEMAND BE THERE?

One of the main factors supporting rising medium- and long-term interest rates is the improvement in economic conditions in many industrialized countries. So the demand is there. What is needed is for this growth to solidify over the next few quarters so that it may be described as sustainable, and to convince businesses to accelerate their investment. The risks that are hanging over the global economy will also have to dissipate further. Those risks include geopolitical tensions in the Middle East, slow growth in some emerging countries and sovereign debt problems in many industrialized countries.

Too large an increase in interest rates would also be likely to have a strong impact on demand. The effects on the real estate market, on consumption, government budgets and business confidence would be more significant. That said, the financial markets would probably adjust very quickly to any deterioration in economic conditions. In particular, we would see a decline in bond yields.

HIGHER INTEREST RATES CAN ALSO BE BENEFICIAL

Interest rates are one part of a set of mechanisms used to adjust economic growth. When the economy is in dire straits, interest rates go down to help it recover, but when the economy is doing well, rates increase to prevent it from overheating. This is a very important positive effect. In an overheating economy, the pressures on the job market and on production capacities can result in higher inflation and a loss of purchasing power for consumers. The situation can deteriorate to the point where people’s expectations for inflation become detached from the central banks’ targets, feeding an inflationary spiral that is more difficult to bring to a halt.

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If we look at the inflation numbers in the industrialized countries, we note very little inflationary pressure. Therefore, there is very little need for high interest rates to prevent the economy from overheating. This is one reason why future interest rate trends are likely to be more moderate than those we have observed since the spring. The absence of inflationary pressures also leads us to think that the central banks will bide their time for several more quarters before raising their key interest rates.

PREVENTING THE TRAP OF EXCESSIVE DEBT
Excessive indebtedness caused by keeping interest rates low for too long is a threat that could hamper economic growth in the long term. Mind you, it is difficult to objectively gauge the state of indebtedness. The danger thresholds are not clearly defined by economic and financial research. In any event, many people agree that Canadians’ debt levels have risen considerably, and that stabilization, or better yet, an orderly reduction of debt, is now desirable (graph 7). Higher interest rates will probably help with this.

MORE FAVOURABLE CONDITIONS FOR SAVERS
Low interest rates have been great for borrowers, but savers have had a hard time finding stable and attractive returns on their investments. Pension funds have also been struggling in recent years in tandem with the sharp drop in interest rates. Pensioners who count on their own savings have probably had to revise their budgets downwards. Clearly, higher investment returns should prove beneficial for a large segment of the population. A few more people might even be inclined to save their money, which would help reduce the overall rate of household indebtedness.

There is a shadow on the horizon, though, for savers who have sought refuge on the bond market. Higher interest rates mean that the selling price of bonds has fallen considerably. In the short term, losses could therefore be incurred.

THE INCREASE IN INTEREST RATES IS UNLIKELY TO BE TOO STEEP
In conclusion, higher interest rates could have a number of negative effects on the economy. On the other hand, the positive effects will make up for those in some measure; the main thing to remember is that the negative effects will be limited if the future interest rate hikes are small and gradual.

Some people might be tempted to think that interest rates will keep rising as quickly as they have been doing in the past few months. The economic data have been quite good since the spring in the United States and in other advanced countries. We are now anticipating the end of very accommodative monetary policies from the central banks. Having said that, the economy in general is still fragile, and interest rates will not be able to rise quickly without causing new deterioration to economic data. In other words, interest rates cannot be raised faster than the pace of the economy’s recovery.

Lastly, since increases to medium- and long-term interest rates are equivalent to a form of monetary tightening, the central banks will no doubt show even more caution. In the absence of inflationary pressures, they will wait several more quarters before starting to raise their key interest rates. If they succeed in conveying this message effectively to the financial markets, that will keep rises in medium- and long-term interest rates in check.

Hendrix Vachon
Senior Economist