Economics

Getting Back to Normal

BCREA Economist
Brendon Ogmundson

The severity of the 2008 financial crisis necessitated that global central banks, including the Bank of Canada, bring interest rates down to previously unthinkable levels. As the crisis dissipated and Canadian output and employment began to slowly recover out of recession, the Bank of Canada began raising its overnight lending rate in 2010, from 0.25 per cent to one per cent, with rate increases expected to resume later in 2011. This is often referenced as interest rate normalization, referring to the highly abnormal level of interest rates that prevailed during the recession. But what is normal and how long will it take to get there?

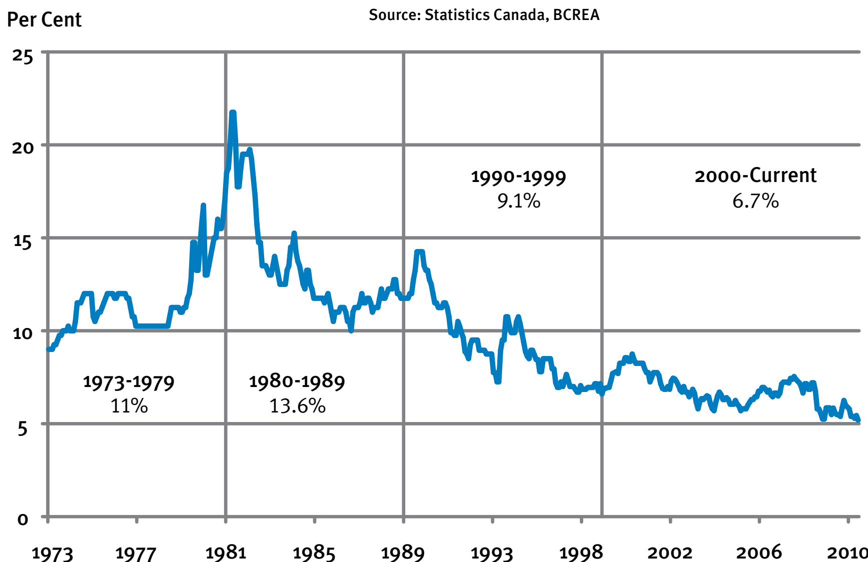
One definition of normal is the average interest rate prevailing over a period of time long enough to capture changes in business cycles, but not so long as to ignore key changes in the structure of the economy. For Canada, a suitable period might be the intervening years since the Bank of Canada began targeting a two per cent inflation rate in 1995. Using this definition, we would define a normal 5-year fixed mortgage rate at around 7.2 per cent, a 200 basis point increase from today's historically low level of 5.19 per cent.

However, the drawback of relying on the long-term average is that it does not account for key factors that influence mortgage rates such as the Bank of Canada's monetary policy objectives or market expectations of future growth and inflation. A long-term average also does not tell us anything about the possible timing of interest rate increases. A more useful definition of normal is the interest rate level consistent with a normally functioning economy. A good approximation of which is the interest rate level that the Bank of Canada judges as necessary to bring the economy back to its full potential and inflation back to its two per cent target.

The Bank's most recent forecast is that the Canadian economy will return to full capacity, and inflation will reach two per cent by the end of 2012. Under our definition, this implies a return to normal interest rates by the end of next year.

Running the Bank's forecast through our model of the Canadian economy suggests that to hit its two per cent target by the end of 2012, the Bank will have to raise the overnight rate by 200 basis points over the next two years. All else equal, a normalized overnight rate will push medium and long-term interest rates higher, which will in-turn influence consumer borrowing rates including variable and fixed rate mortgages. Our calculations show that interest rate normalization implies a 5-year fixed mortgage rate of 6.5 per cent at the end of 2012.

Just like returning to work from an extended vacation, getting back to normal interest rates will take some adjustment. Fortunately, the pace of these rate increases should be gradual, providing BC homeowners with time to lock-in still historically low borrowing rates or improve household balance sheets.



The average mortgage rate has fallen steadily over the past 35 years.

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Send questions and comments about *The Bulletin* to:

Editor: Damian Stathonikos
Assistant: Lindsay Cook

1420 - 701 Georgia Street West
PO Box 10123, Pacific Centre
Vancouver, BC V7Y 1C6

Phone: 604.683.7702
Fax: 604.683.8601
Email: bcrea@bcrea.bc.ca

www.bcrea.bc.ca

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