Interest rates: What will the new normal look like?

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Bank of Canada interest rates: What will the new normal look like?

The next decade will see atypically low rates

In its last rate announcement with Mark Carney at the helm, the Bank of Canada unsurprisingly left short-term interest rates at 1%. Good news for borrowers; not so good for savers.

As has become its habit, the Bank also reminded us that rates won't stay low for ever; they'll stay where they are for "a period of time." Inevitably, interest rates will go up, and eventually return to more normal levels. The question is: What will the new normal level look like?

Historically, the normal – or "neutral" in economic jargon – rate has been about 4%, but it varies over time. Over the coming decade or so, our assessment is that the neutral rate for Canada is likely to be lower than the historical average, due to fundamental shifts in domestic and world determinants of saving and investment intentions.

Interest rates are determined in the market for investment and savings. In this market, the real – i.e. adjusted for inflation – interest rate adjusts to equilibrate savings with investment. Shifts in the demand or supply of savings from households, firms and governments can cause a shift in the rate that equilibrates savings with investment. For instance, an increase in households' desire to save is likely to lead to a lower equilibrium rate of interest.

When the economy is operating near full capacity, the Bank of Canada usually aims to set short-term rates that are consistent with the supply of funds being equal to the demand for funds at full employment. The Bank expects the Canadian economy to return to full capacity by the second half of 2015, after which time we should expect a return to normal interest rates.

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Long-term trends related to global savings and investment intentions suggest that the normal or "neutral" rate of interest will remain low in the next 10 years or so. Most notably, this is because desired saving, both domestically and internationally, is expected to remain high. Saving decisions for households are influenced by individuals' life cycle: People tend to spend more than they earn in earlier years, and to have high saving rates as they approach retirement. In Canada, as in other developed countries, a large cohort of the baby-boomer generation is edging towards retirement and, in the meantime, is increasing its saving level.

There's also the rise of China and the concomitant rise in its level of savings by households. Due largely to the lack of a western-style social safety net, Chinese households have a high level of precautionary savings. While a social welfare system has taken shape to some extent, the coverage remains limited and fragmented. This fact is unlikely to change in the near future, only perhaps in the longer term.

The "Great" Recession of 2008-2009 has also affected saving intentions. As with similar past events, the fallout from the Great Recession is characterized by households, businesses and governments trying to reduce their debt levels. Consumers are looking to save more to restore the health of their balance sheets. Similarly, governments in most developed countries are looking to increase their own saving levels given their difficult fiscal positions. And businesses have allowed their holdings of cash to rise, reflecting at least partly their learned need for precautionary holdings of cash or other liquid assets in the wake of recent recessions.

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Finally, there is the investment side of the equation: The level of investment on the part of businesses has been low in many developed countries for over a decade. For example, non-residential investment has been low in the U.S. since the end of the high-tech expansion of the 1990s. It picked up during the 2003-06 expansion, but the peak was below the 1980s and '90s. This may reflect a difficulty on the part of firms in finding new innovations that deserve investment of the size seen in the '80s and '90s, associated with the information technology revolution.

While new investment opportunities may be around the corner, they are not yet apparent. And the decline in investment demand, over the last three decades or so, is unlikely to be significantly reversed over the next several years, given that investment cycles are very long.

A high propensity to save, coupled with low investment intentions, are likely to ensure normal interest rates stay relatively low for years to come. Canadians should brace for higher interest rates, but the new normal almost surely will be lower than history suggests.

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