ECONOMICS

THE WEEK AHEAD

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Who needs a bigger dose?

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Switzerland made the first move, but the stage is being set for others to follow. Markets were surprised by the Swiss National Bank's choice to cut rates this week rather than wait until June, but really should have expected that, since inflation has been subdued for a full year. In other countries where central banks have hiked rates, the inflation trend has been choppier, but overall, still headed in the right direction. So, the focus is now not on whether we'll see interest rate relief in the next couple of years in much of the developed world, but when, and importantly, in what dosage.

Once inflation looks sufficiently tamed, the dosage will come down to just how much of an economic squeeze the existing level of rates has applied. That will reflect differences in how high rates actually climbed, but also on the degree to which domestic demand is interest sensitive. In turn, one of the most salient drivers of that sensitivity has been the divergent response to higher rates in consumer spending. Canada has seen falling per capita consumption while American consumers, until perhaps the last two months, stayed on an all-out shopping spree, helping the US economy avoid the economic slowdown seen in Canada, the UK and much of the Eurozone.

The sharp divide across the 49th parallel owes in part to how mortgage markets function in the US and Canada. Unlike Canadians, Americans are largely in long-term fixed rate mortgages that don't reset for as long as 30 years when rates are rising, but which can be refinanced when rates fall. That difference has been widely cited over the past few years, but where do other countries stand?

Like Canadians, home buyers in the UK and Australia are exposed to higher rates when their mortgages reset, which happens in five years or less. Germans often lock in for a decade or more. But nowhere other than the US is a 30-year fixed rate the norm.

There are also differences in home ownership rates, and importantly, in typical mortgage sizes relative to incomes. That's where Canada has been particularly hard hit by rising rates relative to other countries that also don't lock in rates for decades. OECD data show that the ratio of house prices to incomes in Canada has climbed 40% since 2015, far eclipsing what's been seen in other countries where mortgage borrowers are also exposed to rising rates. Countries in Europe and Japan with older populations also tend to have more home owners who have paid off their mortgages.

Put it all together, and Canada's household sector was set up to be among the most vulnerable to rising mortgage rates. Driven by the fastest run-up in house prices since 2015, a harmonized measure of debt service burdens, shows Canadians are second only to Australians among seven major economies in the share of their incomes spent on interest and principal (Chart).

The result is that when it does come time to ease, Canada's central bank could require a larger dose of interest rate relief to get the economy moving again. That is reinforced by the fact that only about half of all mortgages issued have faced a reset since rates rose materially, and those coming due in 2025 will include maturing five-year mortgages issued when rates were at rock bottom levels in 2020. Whether Canada will be next after the Swiss, or wait a bit longer, there's a good reason to expect that rate cuts will have to be deeper here than in countries with lower household debt burdens, cheaper houses, or locked in mortgages.