A Word from the Economist
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Why Have Mortgage Interest Rates Reached Historically Low Levels?

This article is a summary of a more detailed report titled "Structural and Cyclical Factors That Explain Low Mortgage Interest Rates" recently published by the QFREB. To consult the report, click here.

Historically Low Interest Rates

Mortgage rates have been following a downward trend in the past few years and in March 2012, the average mortgage rate charged in Canada for a five-year term reached its lowest level since January 1951, at only 4.21 per cent. This level contrasts sharply with mortgage interest rates observed in the 1970s and 1980s, which had peaked at well over 10 per cent and even 20 per cent at certain times. In this article we will discuss the main structural and cyclical factors that explain the historically low mortgage interest rates that we see today.

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Changes in Bond Yields Dictate Changes in Mortgage Interest Rates

While movements in variable mortgage rates are mainly influenced by the Bank of Canada's key interest rate, changes in fixed mortgage rates are primarily influenced by the yield of Canadian government bonds of corresponding maturity. Bond yields represent a benchmark for the cost of funds that financial institutions use to finance the mortgage loans they provide and these funds come primarily from deposits made by savers. As they are guaranteed by the government, these deposits are considered a very safe type of investment and must provide then a competitive remuneration compared to Government of Canada bonds, which are similar financial products used as a reference. The other part of the funds is borrowed from the mortgage bond market (insured mortgage-backed securities). These mortgage bonds are a similar financial product to Government of Canada bonds, in terms of liquidity and default risk (both guaranteed by the Canadian government and rated AAA by major rating agencies). Changes to yields in the **mortgage bond market** depend on essentially the same forces that are at play on the **government bond market**, as evidenced by the almost perfect positive correlation between mortgage rates and government bond yields of similar maturity.

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Structural Factors Contributing to Low Mortgage Rates

Since the mid-1990s, structural factors affecting capital markets have contributed to the long-term decrease of interest rates in general, including mortgage rates.

a) Inflation-Control Target

The inflation premium, which aims to compensate investors for the loss of purchasing power due to an increase in prices, is an important determinant in financial asset yields, including government bond yields. In the 1970s and 1980s, increases in consumer prices were such that investors demanded a very high inflation premium. The inflationary environment in the 1970s and 1980s was therefore largely responsible for high interest rates.

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However, beginning in 1991, the Bank of Canada adopted a monetary policy for inflation-control targeting. This cornerstone of the monetary policy framework aims to maintain the inflation rate at around 2 per cent, the mid-point of a 1 to 3 per cent target range, guaranteeing therefore some stability in price changes and reducing uncertainty surrounding inflation. Ultimately, the Bank of Canada's adoption of this monetary policy framework contributed to the decrease in Government of Canada bond yields, thereby reducing Canadian mortgage rates.

b) Disciplined Management of Canadian Public Finances

The disciplined management of the Canadian debt that was implemented by the federal government in the mid-1990s has also had a lasting impact on Canadian bond yields and mortgages. By significantly and consistently reducing the debt burden in relation to the GDP between 1995 and 2007, the Government of Canada has sharply reduced its financing needs. This lower financing requirement by the federal government resulted in a decrease in the supply of government bonds, pushing their price up and their yield down. Moreover, by demonstrating since the mid-1990s that it was able to ensure a disciplined management of its public finances, Canada has earned a certain credibility among investors, who in times of economic uncertainty consider the Canadian government backed bond market as one of the safest investments. Thus, the Canadian bond market acts like a refuge for investors when they become risk averse. In the uncertain economic context of the past few years, investors' demand for Canadian bonds has surged, pushing their price up and lowering their yield.

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Cyclical Factors Have Also Contributed to Historically Low Mortgage Rates

Other factors that are more cyclical in nature also contribute, this time temporarily, to the decrease in interest rates.

a) Sluggish Economic Conditions

First, Canada's slowdown in economic growth and more pessimistic outlook regarding the economy led to lower inflation expectations. Because a part of bond yields is designed to compensate for the inflation risk, the decrease in inflation expectations has helped to exercise downward pressure on bond yields. Notably, inflation expectations fell sharply after the financial crisis broke out in the summer of 2008.

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Finally, the weak economic recovery in the U.S. resulted in a significant decrease in long-term yields in the United States. The increase in the spread between Canadian and American government bond yields led to a massive influx of capital on the Canadian bond market, which offered a higher return.

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b) Unstable Global Economy

Recently, some countries in the Euro zone have experienced major budget problems. The outbreak of this sovereign debt crisis raised fears of debt default by many European countries and forced investors to turn to countries with a more sound financial situation, such as Canada. In this context, the Canadian bond market has somehow played the role of refuge, reinforcing the substantial net influx of capital by international investors. This growing aversion to risk translated into a sharp increase in demand for bonds, pushing bond prices up and their yields down.

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Ultimately, all these movements on financial markets, called "portfolio effects", acted simultaneously and have contributed to an unprecedented increase in demand on the Canadian bond market, making mortgage financing increasingly accessible.

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Conclusion

The decrease in Canada's mortgage rates in recent years is mainly due to a decrease in the cost of funds used to finance mortgage loans. On the one hand, cyclical factors, such as weak economic growth in Canada, the United States and around the world, stock markets deemed too risky, or the outbreak of the sovereign debt crisis in Europe, have contributed to reducing the cost of funds used by Canadian financial institutions to offer financing on the mortgage market. On the other hand, structural factors, such as the inflation targeting adopted in the framework of the Bank of Canada's monetary policy, fiscal consolidation policies or a relatively prudent management of public funds by the Canadian government since the 1990s, have contributed to the long-term decrease in interest rates in Canada, including mortgage rates.

If you have any questions or comments about the content of this article, please contact us by email at: stats@fciq.ca.

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