OUR INTEREST FANTASY

Brennan Sorge

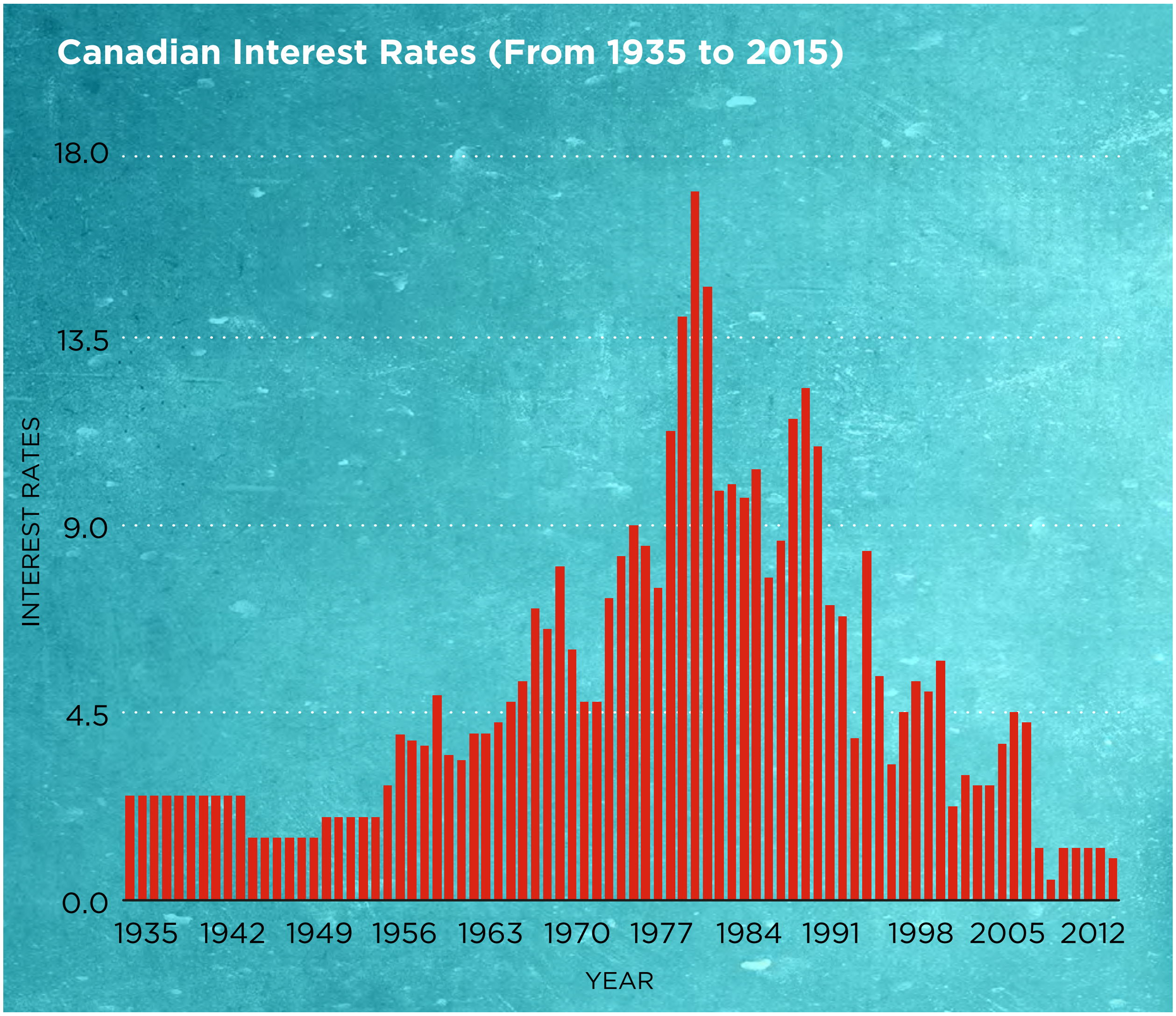
Today's interest rates are of historical significance. Until very recently, the idea of 0% interest rates, or as some nations have now experienced, negative interest rates, seemed, at best, a theoretical idea. Many interest rates in the developed world, especially in Europe, are now consistently below 1%.[1] Such an experiment has never been tried previously, and we are, as of yet, uncertain what the results of this experiment will be. Even though the results remain uncertain, we can gain some insight into how this might play out based on more general economic concepts.

For Canada, it will be very important to have some indication of which direction interest rates are likely to move.

There is a well understood relationship between cost and how much a good and service is demanded by consumers. All else being equal, if something is inexpensive, there will be a higher quantity demanded than if it were more expensive. If this rather simple idea is applied to our current interest environment, there are a few things that we would expect. Interest is the cost of borrowing money, so if our rule holds, it would be expected that in a low interest environment people would borrow in larger amounts than they might in a high interest environment. This expectation has so far been correct for households, and for governments at both the provincial and federal levels.[2,3]

Debt is unlike most other goods or services, even though it seems to follow the cost-demand relationship. After the initial purchase, debt is paid over a long period of time. The cost of that debt is dependent on interest rates, and unless interest rates are locked, a change in the interest rate can affect the cost of previously accumulated debts. For Canada, it will be very important to have some indication of which direction are interest rates likely to move. Information from past periods of low interest could potentially be used as this indicator.

There have only been a few other instances during which interest



rates remained at extreme lows for multi-year periods, the most recent of these having been the Second World War. By looking at changes in interest rates following the war, it may be possible to draw conclusions about our future rates. At wars end in 1945, interest rates remained suppressed at 1.5% for 5 years. In 1950, rates grew slightly, up to 2%. In October of 1955, interest rates began a steady increase, which, except for a few brief periods, kept interest rates above 3.5% until November of 1996. During this time, rates rose to highs above 10% for multi-year periods, reaching a peak of 21% in August 1981.[4] If current trends are even somewhat similar to those following World War 2, higher rates should be expected, with the real possibility of large increases in the long term.

This leads to another important question: what will the results be if interest rates increase? On a household level, many Canadians hold large amounts of debt, which will quickly become increasingly expensive given the realization of this trend.[5] In terms of home ownership it will become more difficult to borrow

for a new house. For existing home owners, many will face increased difficulty paying back their existing mortgages (if these mortgages haven't locked in low rates), some of whom will find this an impossible task, and will default.

Worst of all, we will be tasked with paying back the debt we are currently expanding, and shouldering the immense costs that entails.

However, public debt will also be a great concern. In order to pay for the rising cost of debt servicing, we will soon require new tax increases, and/or significant cutbacks to government services. Our economy will grow very slowly, if at all, with larger amounts of revenue being diverted to interest payments. This will hurt all of us, we will be faced with a heavy tax burden, few job opportunities, and severely diminished government assistance. Worst of all, we will be tasked with paying back the debt we are currently expanding, and shouldering the immense costs that entails. If Canadians wish to avoid this future, then it is time that we start paying our debts.

Brennan Sorge is graduating this summer from Sun Peaks Secondary Academy and is starting at Thompson Rivers University in the fall. Having taken an interest in politics and economic policy, he hopes to earn a degree in economics as well as law, and then continue into the political arena.

Endnotes

1 Trading Economics, retrieved April 20 2016 from http://www.tradingeconomics.com/country-list/interest-rate, Interest rates by country.

2 Stats Can, retrieved April 13 2016 from http://www.statcan.gc.ca/pub/75-001-x/2011002/article/11429-eng.htm#a1, Trends in household debt.

3 RBC, retrieved April 13 2016 from http://www.rbc.com/economics/economic-reports/pdf/provincial-forecasts/prov_fiscal.pdf, Canadian Federal and Provincial Fiscal Tables.

4 Bank of Canada, retrieved from April 20 2016. http://www.bankofcanada.ca/wp-content/uploads/2010/09/selected_historical_v122530.pdf, Bank rates. Chart data reflects the interest rate for each years January value.

5 Stats Can, retrieved April 13 2016 from http://www.statcan.gc.ca/pub/75-001-x/2011002/article/11429-eng.htm#a1, Trends in household debt.