

Economics

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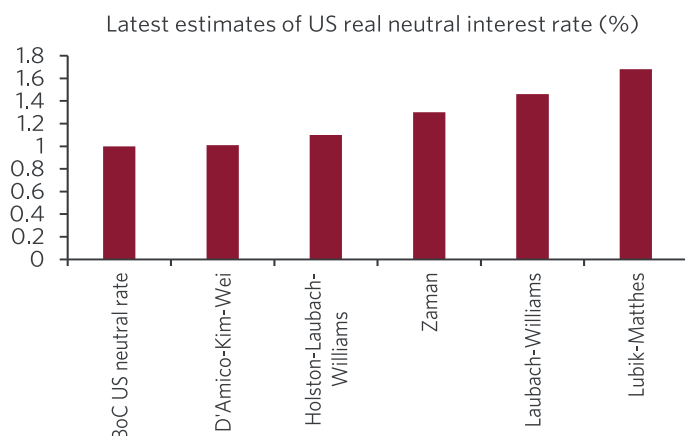
Neutrality across the border: A narrowing in the Canada-US neutral rate gap ahead

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The neutral rate of interest — the level that is neither an economic tailwind or headwind, allowing the country to stay on its potential (non-inflationary) growth path — is central to monetary policy. But, to our frustration, it's very difficult to measure. Despite the imprecision of the tools economists have on hand for that task, it's apparent that neutral rates in the US and Canada have drifted apart in recent years, with the American economy able to tolerate much higher real and nominal yields than Canada's.

Several factors have combined to make that so. Understanding the forces at play, and where they are headed, provides clues to how neutral rates are likely to drift ahead on each side of the border. Collectively, they make a case that US neutral rates could be somewhat lower than where they currently sit by 2028, while Canada's neutral rate could edge higher. That underlies our forecast that policy interest rates could also be closer to each other as we enter 2028 if events unfold in line with our forecasts, a development that could support a firmer Canadian dollar by that point.

Chart 1: Wide range of US neutral estimates



Source: St Louis Fed, NY Fed (for HLW and LW), Bank of Canada

Evidence for a lower neutral rate in Canada

The relative economic performance of the US and Canadian economies, particularly in interest-sensitive sectors, makes a prima facie case for the neutral rate being lower on the northern side of the border. That's despite the fact that, as noted above, competing models come up with different estimates for where the neutral rate sits in real time (Chart 1).

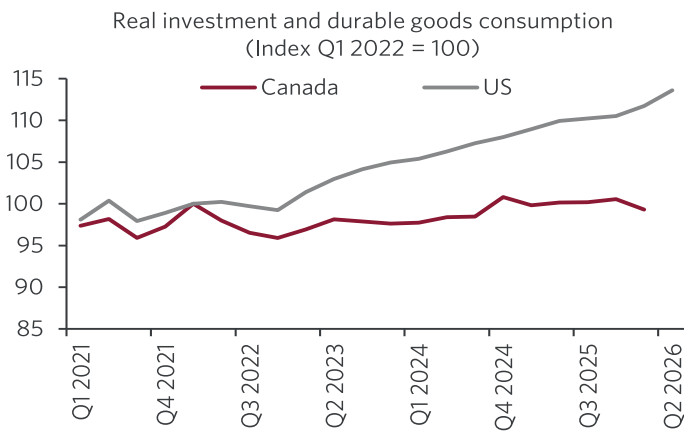
As a case in point, the Fed's Laubach and Williams (LW) model puts the US real neutral rate in early 2026 at 1.7%, while its Holstein, Laubach and Williams (HLW) version has it at just below 1.1%. Assuming a long-run trend inflation rate of 2%, would imply that the nominal neutral rate could be 3.1% (roughly in line with the "long run" neutral rate from the FOMC median), in which case current rates are restrictive, while LW's 3.7% nominal neutral measure would imply that current rates are already at neutral.

The HLW model, when applied to Canada, shows an implausibly higher real neutral rate for Canada, at 1.7%. With 2% trend inflation, that implies a nominal neutral rate of 3.7%. If that were true, Canada's current policy rate of 2.25% would be providing ample stimulus. Even if we strip out the drag on exports from the past year's tariffs, that flies in the face of the evidence that shows persistent weakness in interest-sensitive components of demand.

Wisely, the Bank of Canada recognizes some of the challenges in purely structural models like HLW, and takes an eclectic approach in which the results of several models are combined. The midpoint of its current estimate for the nominal neutral rate sits at 2.75%, a full percentage point lower than HLW, and marginally below the 3.0% midpoint for the BoC's assessment of the nominal US neutral rate.

In more recent years, changes in the BoC methodology have allowed for the Canadian neutral rate to be a bit more divergent from its US neutral estimate. We applaud that trend, as it lines up better with what we see on the ground. Canada's economy responded with a more decisive slowing as rates rose to similar

Chart 2: US sees stronger interest sensitive demand



Source: US BEA, Statistics Canada

levels in both countries during the post-pandemic inflation spike, necessitating an earlier end to the tightening cycle north of the border.

More recently, the US economy has been much more vigorous, particularly in interest sensitive demand for investment (including housing) and consumer durables than Canada's, despite a more aggressive central bank easing (Chart 2). As a result, we judge that Canada's neutral rate could be a half point or so below the BoC estimate, and closer to its current 2.25% level, while US neutral may be higher than 3%, implying an even wider gap than the BoC is assuming.

Why the gap?

While we can't measure the impact of each factor that influences where neutral rates lie, economic theory provides a useful way of identifying the various forces at play in Canada's lower neutral rate.

For those a bit rusty on their Eco100 course material, remember that in equilibrium, an open economy will satisfy the following condition: national savings plus net capital inflows from abroad (or minus the net trade surplus) equals national investment. Essentially, the savings of the household sector and the government (i.e. an operating budget surplus) and capital inflows (which will be the inverse of the trade surplus) have to be recycled into capital spending to keep the economy in equilibrium.

So the neutral interest rate can be thought of as the yield at which there is enough capital spending (business, government and housing) to absorb the pool of savings available when the economy is operating at its full non-inflationary potential. Factors that are boosting investment spending at a given rate of interest will raise the neutral rate, as will factors that lower the pool of savings offered up at a given rate of interest.

The fall in neutral rates across most countries after 2010 was attributed to a glut of global savings (particularly from emerging

China) that flooded other markets, and the weakness in capital spending after a deep recession that left a lot of excess capacity and sluggish housing demand. Slower trend economic growth, tied to weaker population growth, also meant that there was less need for capital spending at any given rate of interest to keep up with demand for goods and infrastructure that grows with population (housing, utilities, schools etc.). The result was that major industrialized economies experienced parallel declines in their neutral rates.

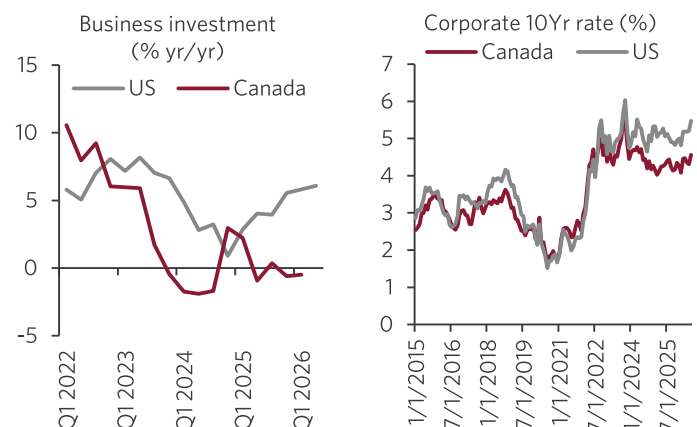
Whence the divergence in recent years? On the investment side, a few factors are obvious candidates for explaining much of the gap in neutral rates across the Canada-US border. US capital spending has been significantly boosted by AI related projects, which are proportionately less significant in Canada (Chart 3). The mad rush to stay ahead of the race for AI leadership in the US has seen the firms involved willing to tap into large scale debt issues over the past year, even as long rates escalated.

Canadian capital spending has been weakened by tariffs hitting some sectors, and fears of more to come are holding back expansion plans in other trade-oriented industries. Regulatory barriers, and a drop in oil prices after 2014, saw new oil sands projects come to a halt. Prior to that year, the energy boom was responsible for a third of all business capital spending.

A faster accumulation of equity wealth has also made the US economy less sensitive to higher interest rates. More substantial wealth gains have financed consumer spending at a faster pace stateside, and higher PE multiples lowered the cost of capital for businesses tapping into the stock market. Foreign savings also flooded into the US market in search of those same returns.

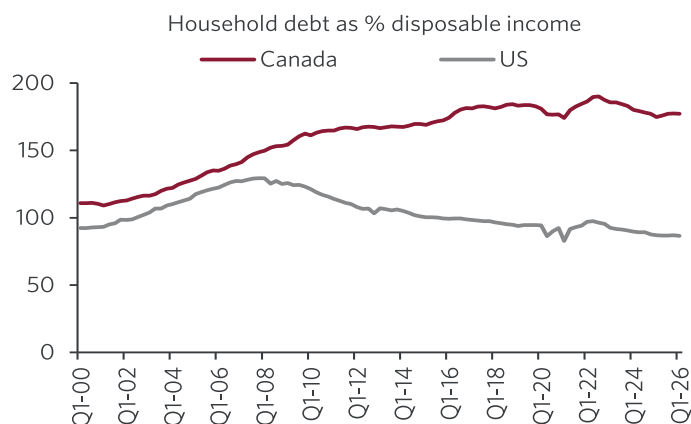
The economic literature has also tied higher debt levels to a lower neutral rate, since interest payments tend to entail transfers from those who borrow and spend to those who save more of their income and hold assets. While the US and Canada both have seen climbing aggregate debt levels, in Canada, that debt is more concentrated in the household sector, where

Chart 3: Business capital spending rising faster in US (left) despite higher corporate borrowing costs (right)



Source: US BEA, Statistics Canada, Bloomberg

Chart 4: Canadians carrying higher household debt burdens



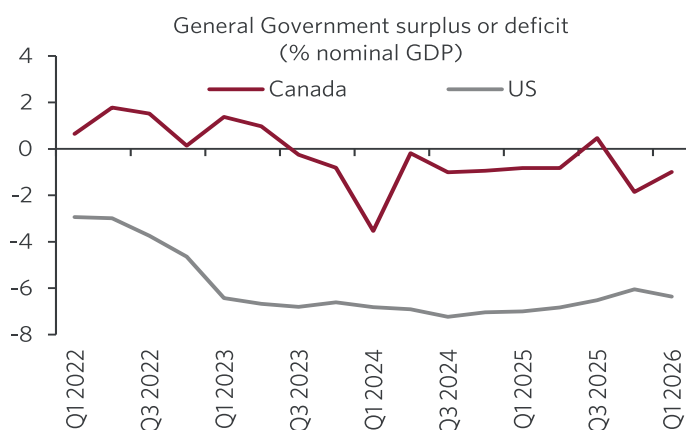
Source: Statistics Canada, Haver

borrowing limits are more binding, and more likely to squeeze spending when rates rise (Chart 4).

The resulting increase in debt sensitive to higher interest rates was well in evidence in Canada in 2022-26. As maturing low rate mortgages had to be refinanced at higher yields, household spending power was constrained, thereby slowing growth. South of the border, not only were household debt to income burdens much lower, but mortgages were largely locked in for decades at very low interest rates.

Government operating deficits are also lower in Canada than in the US as a share of GDP (Chart 5). That reduces national savings that has to be cycled back into investment spending, enabling the economy to grow at its non-inflationary potential with a slower pace for capital spending, again allowing it to tolerate a higher neutral rate. Or, more simply, the stimulus from government deficits reduces the economy's reliance on investment and housing spurred by low interest rates.

Chart 5: National Accounts General Government operating deficits



Source: Statistics Canada, US BEA

Two factors have kept neutral rates lower in both countries. Capital spending on housing has fallen off sharply in Canada, and higher long rates have also dented activity stateside. A steep drop in population growth has been a negative for trend growth in both countries, reducing the need for investment in capacity additions to keep up with demand.

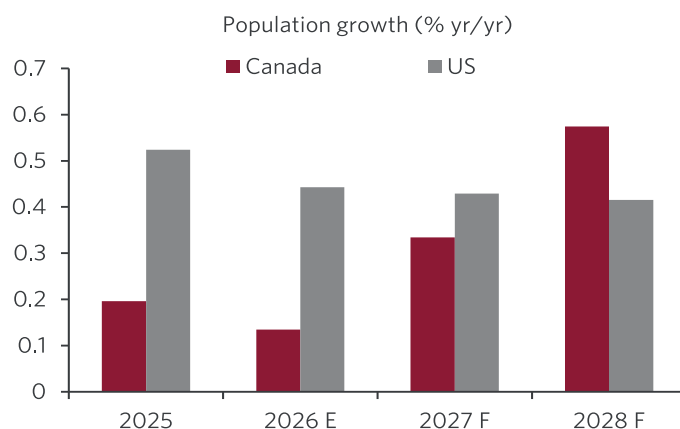
A narrower neutral gap ahead

Our laundry list of factors that have impacted neutral rates across the border provides clues on what lies ahead, and suggests that the Canadian and US neutral rates will at least partially converge by 2028. The clearest case for that lies in the outlook for investment spending, where we expect the growth in US AI projects to decelerate by 2028, even if in level terms it remains robust.

In contrast, supported by government initiatives to help finance and reduce regulatory burdens to large capital projects, Canadian investment spending is expected to rebound from its currently depressed pace. Given the lags getting such projects off the ground, 2028 could see more of that activity than 2027. Getting more investment spending at any given interest rate should increase Canada's neutral rate, while a less frenzied AI spending boom should have the opposite impact south of the border.

Canada is also much more likely to see a return to its longer-term population growth trend by 2028, ramping up related capital spending on housing and other infrastructure, as well as for capacity additions needed to meet the demands from more consumers. Next year could continue to see the exit of those previously admitted as students or temporary workers, as our analysis suggests that such exits are proceeding more slowly than assumed by Statistics Canada. By 2028, a much lighter negative from these non-permanent residents will no longer be weighing against the continued inflow of permanent residents (Chart 6). In the US, while deportations might ease off by 2028,

Chart 6: Canadian population growth outpaces US in 2028



Source: Statistics Canada, US Census, CIBC

Note: Cdn figures are CIBC estimates.

the existing policy is much tighter in terms of legal immigration levels, and it's not clear that public opinion or politics will prompt a change on that front.

After 2027, Canadian homeowners will have completed the refinancing of 5-year mortgages taken out during a period of ultra-low rates in 2020-21. That should also make the economy less dependent on keeping interest rates down to allow indebted households room to spend.

What it means for short term rates

Since we can't quantify these impacts, lacking an accurate fully specified model for neutral rates, we can't be sure whether all of the current gap in neutral rates will have closed. But a narrower gap in neutral rates is a clue to the direction of policy rates ahead.

In the US, a descending neutral rate by 2028 implies that, absent an easing by the Fed, the economy will be less able to hit the central bank's target for full employment. In the near term, the risks are that the Fed has to tighten to offset spillover inflation from energy costs and pressures on core prices from strong AI-related growth. But if the neutral eases off in the next two years, to maintain full employment, any rate hikes delivered in the next few quarters will have to be unwound, and the policy rate could still be lower than current levels when we enter 2028.

In contrast, a rising neutral rate for Canada by 2028 could have a forward-looking central bank delivering a modest dose of rate hikes prior to that year, consistent with the 50 bps of tightening we have in our outlook for later in 2027. The futures market has the right general idea on that, but is likely a bit premature in pricing that tightening in over the next few quarters. If the Canadian neutral rate is below 2.75% today, the Bank of Canada needn't move the policy rate higher until two things happen: a run of growth that closes the output gap, and the climb in the neutral rate discussed herein. If the latter doesn't really kick in until 2028, the Bank will have room to delay any tightening until the middle of next year.

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