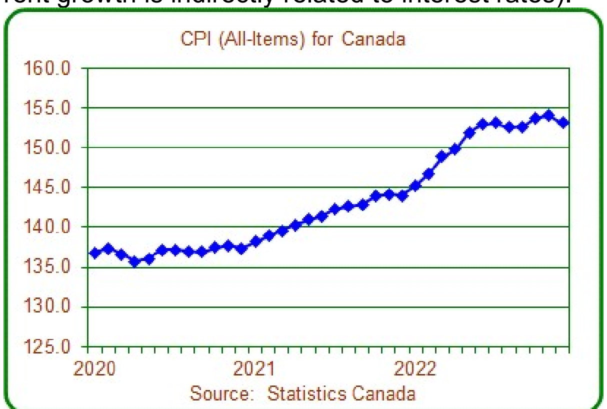
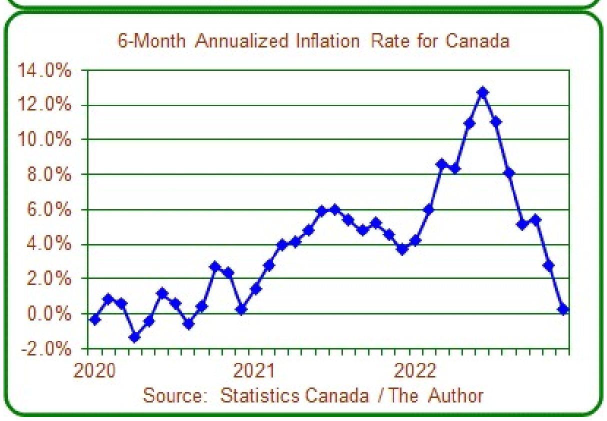
Housing Market Digest

Greater Toronto Area, January 2023

Inflation and the Bank of Canada

Inflation is moderating in Canada. As of December, the year-over-year inflation rate is still elevated, at 6.3%. But, there has been little growth in prices during the past half-year: as of December, the 6-month rate of inflation (expressed at an annualized rate) was 0.3%. Moreover, increasingly some of the current inflation is actually the result of interest rates (notably, the mortgage interest component of the CPI is up by 18% year-over-year). Plus, the recent rent growth is indirectly related to interest rates).





The Bank of Canada has been arguing that the Canadian economy (especially the employment situation) has been over-heated and that it is necessary to use above-neutral interest rates to cool the economy (in particular, it implies that there is a need to reduce the rate of wage growth).

Current economic conditions reflect the interest rates that existed during the first half of last year (when rates were very low, and far below "neutral" levels). The interest rate increases that occurred during the second half of last year have not yet begun to materially affect the economy (looking across the available indicators, the only one that has been substantively affected is the income generated by real estate sales).

The slowdown in inflation in context of stable demand demonstrates that the Bank of Canada has based its policy on a faulty diagnosis. In fact, even within its own analysis (in the October Monetary Policy Report), it is clear that this inflation has been due to world-wide supply-side issues, not excessive demand (notably, the "output gap" is not having a material impact). Using interest rates to crush the Canadian economy cannot fix world-wide supply-driven inflation.

Now that the global supply-side pressures are abating, the Bank of Canada should seize the opportunity to declare victory, and lower its policy rate (the "overnight rate"), to the "neutral" level of 2.5% (versus the 4.25% interest rate that currently exists). The rates that exist today will gradually impair the Canadian economy as 2023 unfolds, and by the second half of the year, conditions could be dire.

This would be a tragic policy error.

It might happen that the current (or future) waves of Covid will create more supply-driven inflationary pressures: if so, that will not mean we need higher interest rates.

The Stress Tests

The Office of the Superintendent of Financial Institutions ("OSFI") has started a consultation process, in which it proposes 3 measures that will further tighten mortgage regulations. I expressed some thoughts here: https://twitter.com/LooseCannonEcon/status/1613593068858376204

My bottom line is that from inception, there have been two major flaws in the policy design (the failure to consider the income growth and principal repayment that will occur by the time of renewal, and requiring stress testing for mortgages that are moved between lenders). The result is unduly harsh policy that has harmed Canadians and added to risks for the broader economy. Those harms and risks include:

- Forcing people to stay in rentals when they could afford a home ownership option that will meet their reasonable needs.
- Causing increased use alternative lenders at high interest rates.
- Adding to pressures for rent growth.

- Suppressing new housing construction (because it's more difficult than necessary to get financing for new homes), which has become a factor in housing supply shortages in Canada.
- Suppressing housing transactions and housing construction will cause employment in Canada to be lower than it could be.
- Causing some mortgage renewers to be trapped at their current lenders, resulting in higher interest rates than they could negotiate elsewhere.

Resale Market

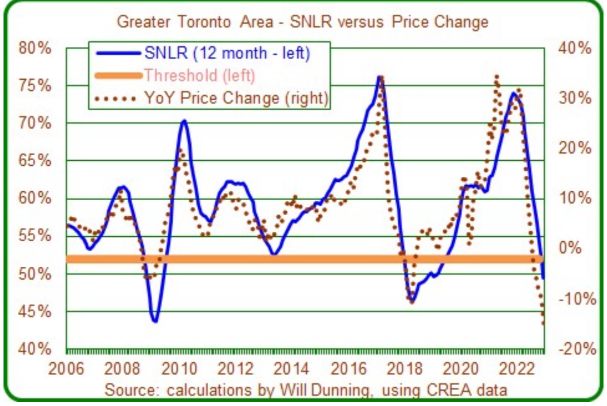
The story hasn't changed materially in the GTA resale market. The sales rate for December remained quite low at an annualized rate of 59,200. On a population-adjusted basis, this is still 45% below the long-term average. For all of Canada, December sales were 25% below average.

Source: CREA/StatsCan/Will Dunning Inc.

The market remains gridlocked, as flows of listings into the market are also below average (chiefly because few people want to move-up in this environment).

Source: CREA/StatsCan/Will Dunning Inc.

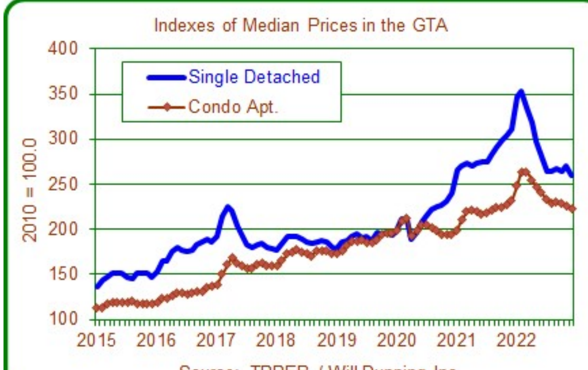
The sales-to-new-listings ratio (40.9% in December) remains well below the balanced market threshold (which I estimate as 52%). During the past 12-months, the SNLR has averaged 49.6%. During that same period, the average price has fallen by 14.9%.



Source: calculations by Will Dunning, using CREA data

There is risk that future job losses could force increased numbers of people to sell involuntarily, and that could cause downward pressure on pricing.

For the moment, pricing appears to have stabilized in the low-rise sector, but there might be some erosion for apartments. Based on median prices, values for single-detached homes have fallen by 26% since last February, but by 16% for condo apartments.



Source: TRREB / Will Dunning Inc.

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