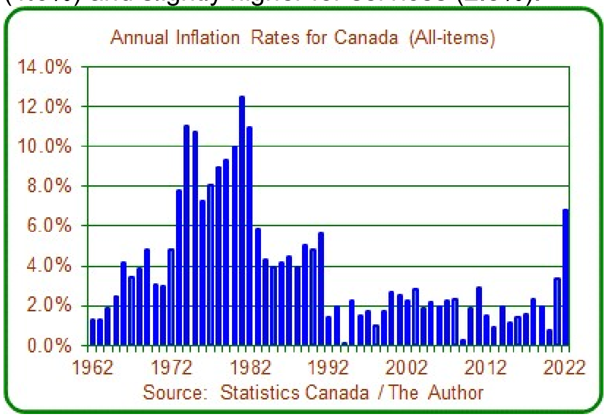
Housing Market Digest

Canada, March 2023

Inflation Targeting

During the past three decades, "off-shoring" of manufacturing (mostly to Asia) has been strongly deflationary: the much lower wage rates that can be paid at Asian factories have resulted in very slow inflation, and in many cases falling prices, for many of the finished products that we buy.

This has resulted in low inflation rates, which has made it easy for central banks to set low targets for inflation, and easy to achieve those targets. During the past three decades, the all-items inflation rate for Canada averaged 2.0% per year. The average rate was slightly less for goods (1.6%) and slightly higher for services (2.3%).



Prior to the massive off-shoring, the inflation rates had been higher.

Average Annual Inflation Rates by Decade			
Decade up to…	All-items	Goods	Services
1972	3.3%	2.6%	4.5%
1982	9.6%	9.9%	9.2%
1992	4.3%	3.9%	4.8%
2002	1.8%	1.5%	2.1%
2012	2.0%	1.3%	2.6%
2022	2.2%	2.0%	2.3%
Source: Statistics Canada table 18-10-0005-01, calculations by Will Dunning Inc.			

If and when there is an end to shifting production to Asia, the deflationary effects will be reduced, which will make it harder for the Bank of Canada (and other central banks) to achieve a target of a 2% inflation rate.

And, if there is a reverse process that moves production back to Canada, the US, and Europe – let's call it "reshoring" – that would reverse the deflationary pressures and cause re-inflation.

I can imagine some factors that could cause a large and long-lasting reshoring, such as:

- Geopolitics – decisions to be less dependent on countries that have autocratic governments.
- Concerns about stability of supply chains.
- Environmental considerations.

And so, I can imagine a future in which there is inherently more inflationary pressure. I'm not saying that I foresee this as a certainty, but it is a possibility.

I think we should see the 2% inflation rate over the past three decades as an accident of history, an accident that in some ways was very beneficial to us. (There has also been a downside, as off-shoring has contributed to worsening of income inequality.) 2% inflation might not be achievable for the future, at least not at an acceptable cost.

All of this to say, I see a possibility that during the coming years we will get into arguments about resetting the official target for inflation. During the second half of the 1960s and of the 1980s, a 4% inflation rate was typical, and it was acceptable economically and socially. That might be the future.

The sharp rise in inflation seen during 2021 and 2022 is partly related to the historical off-shoring, due to disruption of supply chains. In this situation, high interest rates aren't going to fix the inflationary pressures: they are going to cause a lot of pain, and will add to medium-term inflation pressures (by discouraging investment). In a longer process of reshoring, using interest rates to fight re-inflation would be an expensive mistake.

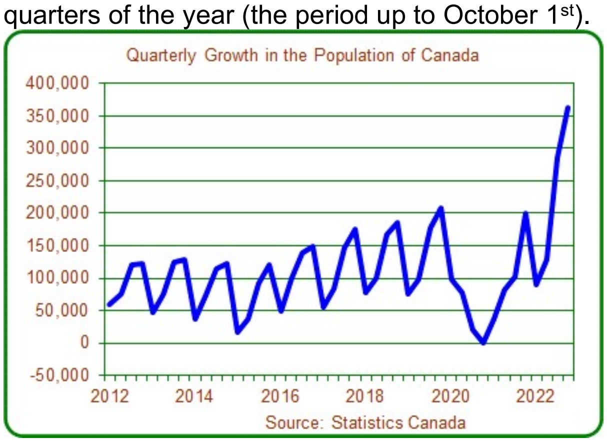
I expect to hear some rebuttals, like "we can't give up the hard-earned gains that we get from 2% inflation rates". But, we didn't do anything that "earned" 2% inflation. It was an accident of history, and it was easy. When that accident ends, 2% inflation will no longer be easy.

Interest Rates

As I commented last month, the path for interest rates (both variable and fixed rate) will depend on policy decisions made by the Bank of Canada. The BoC's policy rate didn't move above its neutral level until September. If rates were neutral, I would expect employment to rise at about the same rate as the population. The policy rate is now 2 points above neutral. Consequently, during this year and next, we might see job growth significantly slower than population growth: the employment-to-population ratio might fall by 1.5-2 points by late next year. The level of employment in Canada might be about a half million lower than it could be. Is that what the government wants?

Population Growth

Statistics Canada has reported very large increases in employment during the past three months. The percentage of adults who have jobs (the employment-to-population ratio) has not changed materially during the past year. So, the job growth is mainly related to extraordinary population growth during the second and third quarters of the year (the period up to October 1st).



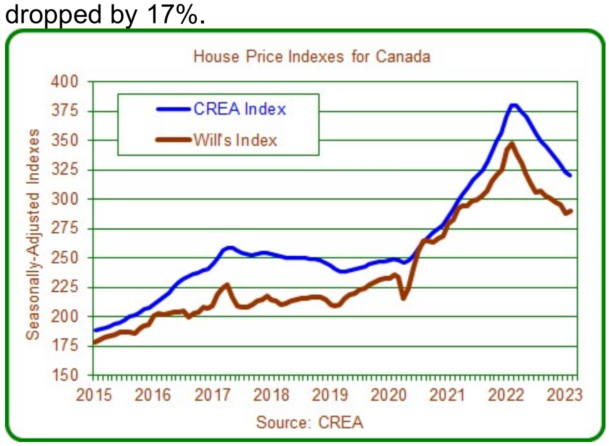
The population growth was due to in-flows of temporary residents, mostly people on work and educational permits, as well as refuges (including from Ukraine). Statistics Canada's next release on population (as of January 1st) should be available soon, and I might write a short essay on it (which would be published on the Recent Reports page).

Resale Market

Resale activity was slightly less-bad in February than in January, as the sales rate rose by 2.3% to an annualized rate of 403,500. This is still far below (by 27%) the population-adjusted long-term average. We are still seeing only first-round effects of high interest rates. It remains to be seen to what extent changes in employment will create a second round.

The flow of new listings into the market has slowed even more (due to increased hesitancy by potential sellers), causing the sales-to-new-listings ratio to jump to 58.4% for February, which is now above the 52% threshold for a balanced market.

CREA's price index is now down by 16% from the peak last February. My alternative index has dropped by 17%.



How to Reach Will Dunning Inc.

Email: wdunning@sympatico.ca
Web site: www.wdunning.com
Twitter: @LooseCannonEcon

Disclaimer of Liability

This report has been compiled using data and sources that are believed to be reliable. Will Dunning Inc. accepts no responsibility for any data or conclusions contained herein.