# Housing Market Digest

Canada, August 2022

### *Interest Rates and the Assault on Inflation*

For a long time, I've been saying that the greatest risk to the Canadian economy is a policy error (notably, mortgage regulations) that causes housing prices to fall by a substantial amount, causing a downward spiral in the economy. Now, I'm saying that the potential policy error is that interest rates are too high, which will cause very large housing price drops.

Interest rates reduce inflation by suppressing demand: consumers and businesses buy fewer goods and services. Suppliers have to compete more aggressively. Therefore, there is less upward pressure on prices. There is a cost: a weaker economy, with lost jobs and a lot of real hardship for people. One has to hope that the benefits that result from lower inflation will exceed the costs that result from lost jobs.

The current vogue for higher interest rates in much of the world is based on an assumption that current inflation is due to excess demand, and therefore the economy must be weakened. But, that assumption is wrong this time. Demand is not excessive (as I'm going to argue below).

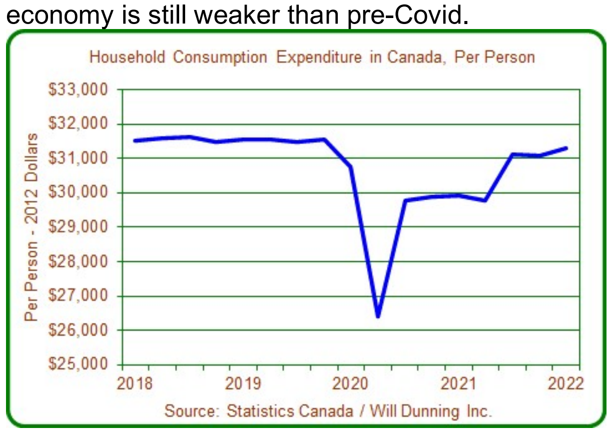
The cause of this inflation is the horrible stuff that's happening in the world, which is impairing supplies. Higher interest rates will not fix the horrible things, or the supply problems, and they will not materially alter inflation: what happens to inflation will be determined by what happens to those horrible things. It's possible that inflation will slow, or it might not. Again, what happens won't be the result of high interest rates.

But, what higher interest rates will achieve is to add another layer of horribleness in the world: by next spring, there might be 500,000 fewer jobs in Canada – a terrible cost for too many people.

Moreover, the higher interest rates will make it harder for new supplies to be generated, and in the medium-term and long-term this will add to inflationary pressures. We're already seeing evidence of this in the housing market, where pre-construction sales of new homes and apartments are falling (the chart below has data for the Toronto area, as of June – unfortunately we don't have national data on new home sales). Plus, rental projects are being put on hold. Housing starts will eventually fall by a substantial amount as the consequence of those higher interest rates: our housing supply problems will get worse.


People who study other sectors of the economy might be observing similar kinds of interest rate driven damage to future supplies.

In July, the Bank of Canada said inflation is "largely due to increases in the prices for energy and food. Global supply chain challenges have also persisted". It also said "the Canadian economy is now clearly in excess demand". https://www.bankofcanada.ca/2022/07/mpr-2022-07-13/ Supply issues have been well-documented, but I don't think the BoC has made an adequate case that there is excess demand. In this chart, I have taken StatsCan data on inflation-adjusted consumer spending, with an adjustment for population growth. For the most recent period (2022-Q1) consumer demand is still below the pre-Covid level. For the entire Covid period to date, spending per person is 5% lower than pre-Covid. Looking across major indicators, adjusted for population growth, the data is consistent that the economy is still weaker than pre-Covid.




The Bank of Canada is chiefly mandated to control inflation. But, interest rates aren't going to solve this supply-driven inflation. The BoC does not have the right kind of tools for this moment. It has decided to use the wrong tool. Two years ago, the Bank of Canada was telling us that we were experiencing extraordinary events and that extraordinary actions were required, so it set aside its inflation goals. Has the BoC not noticed that we are still in extraordinary times? It does have one very powerful tool that it used wisely for about two years – patience. It gave up on that tool too soon.

### Employment

Data on employment and unemployment, etc, comes from StatsCan's Labour Force Survey. It is based on a large sample survey. Each month, one-sixth of the sample is dropped and replaced. It is possible that this sample rotation can result in errors, if the people entering the sample have different labour force characteristics than the people who leave. A sign that this might have happened is when there are unusual and unexpected changes for both the estimated labour force and employment, that are in the same direction and have similar magnitudes. Usually, I notice one or two of these events each year. But, this has happened for two consecutive months. For July, StatsCan reported that employment fell by 30,600 and the labour force fell by 27,000. A similar event occurred in the data for June. In consequence, I caution that these estimates are quite possibly erroneous, and we should have no confidence that we know what's happening with employment in Canada.

StatsCan could add some clarity by providing additional analysis and commentary each month - supplementary "chain" analysis that looks at month-to-month changes for people who stayed in the sample. This is not a radical idea. For example, CMHC uses a chain analysis to calculate rent increases.

It is possible that the changes seen in June and July did actually happen, for example due to large numbers of people deciding to retire. That kind of possibility could be tested using chain analysis.

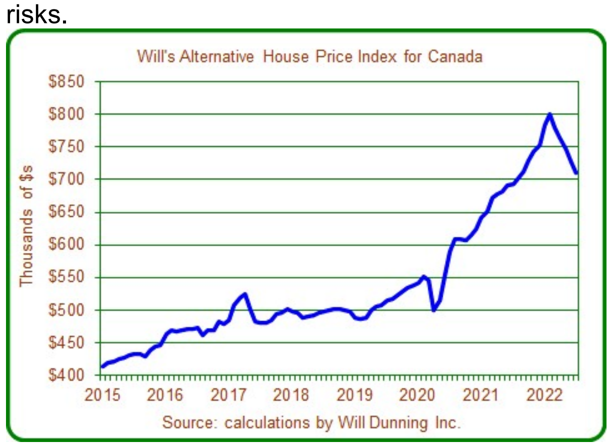
US and Canada employment data diverged sharply in both of June and July (very large rises in the US, drops in Canada - they usually track much more closely). This provides a further suggestion that the Canadian data is erroneous.

StatsCan's commentary for July includes some data that implies to me that illness and disability due to Covid caused employment to be lower than it would be, by just over 100,000. I think it would be useful for them to discuss this more explicitly. The LFS would be a good vehicle to measure and track some of the evolving economic consequences of Covid and Long Covid.

### Resale Market

Since February, sales have fallen for five consecutive months. For July, the annualized sales rate (451,600) was 18% below the population-adjusted long-term average. Sales in July mostly reflect locked-in interest rates from April and May. Further sales drops are coming.


Prices have now substantially reversed the surge that started a year ago. That's reasonable, but given the downward momentum and developing imbalance in supply versus demand, further price drops are quite likely, and this will raise economic risks.

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