Intelligence MEMOS

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To: Interest Rate Watchers

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Re: **How Housing Complicates the Bank of Canada's Interest-Rate Decisions**

News that Canada's inflation rate fell in January prompted fresh talk about cuts in the Bank of Canada's policy interest rate, which has been at 5 percent since last July. Many observers still expect the Bank will stand pat at its March announcement, and in April as well, even though the year-over-year increase in the CPI was just 2.9 percent in January, inside the 1-to-3 percent band around its 2 percent target. Why the caution?

Partly because we've been here before: the CPI's year-over-year increase dropped below 3 percent last spring, then sprang back up. And also because, despite January's encouraging headline number, measures of core inflation are still well above 3 percent.

There is a straightforward reason for inflation's apparent stubbornness: How the CPI measures the cost of owning a house.

The correct way to do that isn't obvious. Is the main cost of a house what you pay for it? Or what you pay for your mortgage? Both matter. Statistics Canada's approach is to construct a "mortgage interest cost" (MIC) index that takes both house prices and mortgage interest rates into account.

On average, people refinance their mortgages more often than they buy a new home – indeed, people with variable-rate mortgages effectively refinance every time mortgage rates change. That means the interest rate component of the MIC responds faster to changes in interest rates than the house component does to changes in housing prices.

The timing matters because changes in interest rates affect the two components of the MIC differently. Lower interest rates obviously push the interest component of the MIC down. But lower rates also typically raise house prices, which pushes the house component of the MIC up. The effects do not exactly offset. Because the interest component moves faster than the house component, its decline affects the MIC more than the house component's rise, so the overall MIC falls. And when interest rates rise, the faster movement of the rising interest component dominates the slower movement of the falling house component, so the overall MIC rises. But either way, the movement in house prices mitigates the influence of the movement in interest rates.

When the Bank of Canada's policy rate plummeted during COVID, the effect was what we would have expected. Lower interest rates lowered the interest component of the MIC and raised the house price component. But the faster-moving interest component dominated, so the MIC fell.

When the Bank hiked the overnight rate to fight inflation coming out of COVID, the story was a bit different. The faster-moving interest component of the MIC jumped a lot. But higher immigration and an overstimulated economy kept house prices from falling much. So the influence of higher interest rates dominated completely. Since last spring the MIC has been running at about 30 percent year-over-year. January's reading was 27.4 percent.

The MIC's weight in the CPI is only 3.8 percent, but even something relatively small makes a difference when it's rising at 30 percent. The rest of the CPI was up 2.0 percent in January – it was the MIC that pushed the overall index up 2.9 percent.

None of this is to say we should ignore the MIC. It is a reasonable way of estimating the mortgage-related costs of owning a home. But how the index works does help explain why inflation seems stuck – and, in turn, why the Bank of Canada, with its credibility strained by its slow reaction to surging inflation coming out of COVID, might be reluctant to cut its policy rate just yet.

This tension will last as long, but only as long, as the MIC keeps exerting outsize upward pressure on the CPI. The influence of the interest component of the MIC is fading. Year-over-year increases in the total CPI may stay near 3 percent through the spring but should drop after mid-year. That would give Canadians confidence the Bank is once again controlling inflation – which, in turn, will make the Bank comfortable delivering the lower policy rate for which we are all waiting.

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