



HIGHLIGHTS

- Canadian housing sales have surged, with a rush of homebuyers lured by attractive mortgage rates, leading to a rebound in resale home prices.
- Recent Bank of Canada statements indicate that it is closely watching the housing market, expecting its recent strength to be “temporary”.
- TD Economics believes that the most likely scenario is that real estate will moderate and inflation will remain in check, with the Bank beginning to gradually raise rates in Q4 2010.
- If real estate activity does not cool, it might prompt the Bank of Canada to tighten earlier or more aggressively than anticipated.

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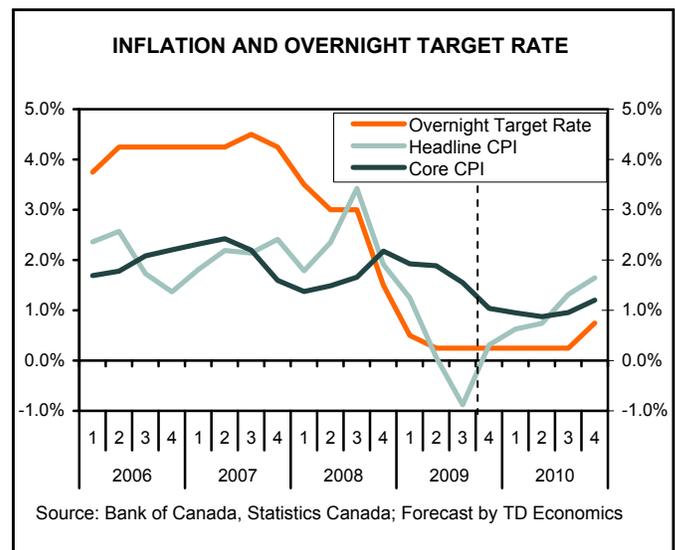
REAL ESTATE TRENDS COULD IMPACT FUTURE PATH OF CANADIAN MONETARY POLICY

With the recession drawing to a close, the focus has shifted to the shape of the recovery and the implications for the eventual rebalancing of monetary policy. TD Economics believes that the most likely scenario is a gradual economic expansion in 2010, which will do little to absorb the significant slack that has developed in the form of unemployed workers and unused plants and equipment. The implication is that inflation is not a major risk next year. In fact, core inflation is expected to dip below 1% in the first half of 2010 (see TD Observation “Canadian Inflation to Remain Under Wraps” July 23, 2009). While the recovery will gain momentum in 2011, price pressures are expected to remain in check. This backdrop suggests that the Bank of Canada can deliver on its conditional commitment not to raise rates until June 2010, and it might be able to wait until late next year to begin gradually tightening policy.

However, there are always risks to a forecast. If the economy stumbles or the Canadian dollar soars, the future rate hikes would likely be delayed even further.

Similarly, should the current stance of monetary policy prove too stimulative, the Bank may feel the need to go sooner and/or more aggressively. On this possibility, we will argue that the key risk is not an unanticipated acceleration in consumer prices, but rather excessive strength in real estate from the prevailing low interest rate environment. While the Bank emphasizes that its “sole monetary policy objective is to achieve its 2% inflation target”¹, recent statements also hint that the Bank will seek to “lean” against signs of emerging asset bubbles and are correspondingly attentive to developments in home prices. The Bank’s view at the moment is that the recent resurgence in real estate is temporary, but if it does not moderate in the coming year – or worse still if price growth accelerates – it could lead to an earlier and more substantial tightening in policy than currently anticipated.

It should be stressed that the Bank of Canada targets the rate of consumer price growth and does not target asset values. However, given the risks from an asset bubble to both financial system stability and sustainable economic growth, central banks are watching closely for evidence that the current low interest rates might be too stimulative. The Reserve Bank of Australia surprised markets today by

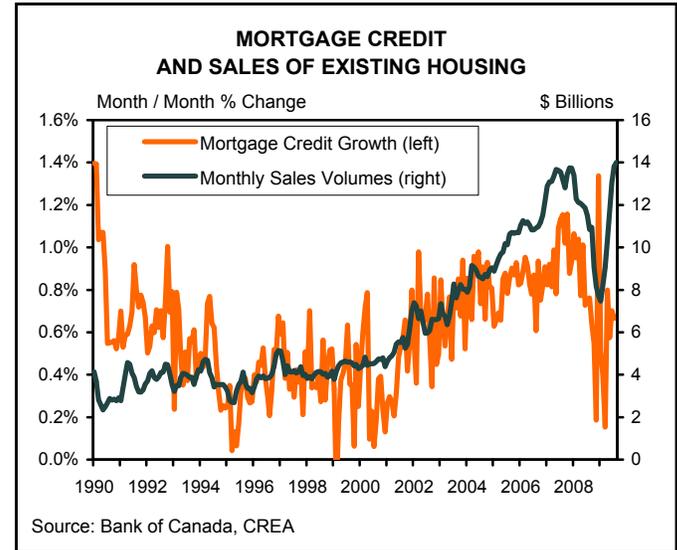


hiking rates and cited significant growth in housing credit and dwelling prices as part of the justification.² The Bank of Canada could very well follow suit if Canadian real estate continues to heat up.

Real estate comes roaring back

The performance of Canada's real estate markets during the economic downturn has been remarkable. In the second half of 2008, there was a dramatic pullback in sales that led to a retreat in prices. However, the weakness proved surprisingly short lived. By the Spring of 2009, there were already signs that activity was coming back to life. This is particularly impressive, as it coincided with a deep economic contraction – accompanied by significant job losses, rising unemployment and weaker personal income growth. The 'counter-cyclical' reflected the fact that improving financial conditions for real estate trumped weakening economic fundamentals. The Bank of Canada's unprecedented easing of monetary policy in response to the financial crisis set the stage for record low mortgage rates, which when combined with falling home prices, fuelled a sharp improvement in home affordability. Once people realized that the economic downturn was going to be 'just' a severe recession, and not a repeat of the 1930s, individuals who felt that their job was secure jumped back into the real estate market to take advantage of mortgage rates that were perceived as 'too good to last'. At the same time, the Canadian banking system weathered the financial turmoil quite well, with the result that mortgages were accessible to the pool of buyers entering the market. The surge in sales far outpaced listings, supporting a rebound in prices. The Canadian Real Estate Association (CREA) estimate of national homes sales was up 18.5% year-over-year in August and national average home prices had increased 11.3% year-over-year.

The key issue is whether the low interest rate environment is creating an economic imbalance that requires a rebalancing of monetary policy. There is some evidence that real estate price growth might not be as strong as it appears at face value. The CREA statistics are based on sales through the multiple listing service (MLS) and the average of prices can be distorted by the type and location of homes sold (See TD Report "A Different Look at Canadian Home Prices" November 20, 2008). These issues are tackled by the Teranet-NB House Price Index, which is calculated by using the sale prices of homes that have been sold at least once before (and using only periodically adjusted weights for the six urban centres in the composite index). The Teranet-NB measure of home prices increased for a third consecutive month in July, but prices were still



down 5.1% year-over-year. However, given the strong home price gains experienced during Canada's "housing boom" (see TD Report "Overpriced and Overbuilt" April 7, 2009), this decline in values may not have been sufficient to clear past excesses in some real estate markets. Moreover, the Teranet-NB measure has its own drawbacks, the foremost being that it is lagged two months and, anecdotally, late summer sales were very strong. So, both the CREA and Teranet-NB price measure show that real estate has turned a corner, but the latter doesn't suggest as strongly that there was a problem brewing – at least as of July.

TD Economics believes that home sales will show some cooling in the coming months and MLS price growth is expected to return to a mid-single digit pace. First, a large number of recent sales were fuelled by pent-up demand created during the second half of 2008. At least half of that pent-up demand is likely absorbed. Second, the rebound in home prices and tighter mortgage pricing by some lenders is dampening affordability. Third, the economic fundamentals will remain weak, as unemployment will be slow to decline and personal income growth is likely to remain soft. Fourth, increasing confidence in the economic recovery and the rise in home prices is likely to induce a supply response, bringing an increase in listings that should moderate the growth in home sales and prices. This forecast will be explained at length in a TD Economics housing report to be released later this week.

Overall, the most likely scenario is that home sales growth will moderate and home price growth will not become excessive. Recent comments from the Bank of Canada suggest that they also believe the recent strength in MLS readings is temporary.

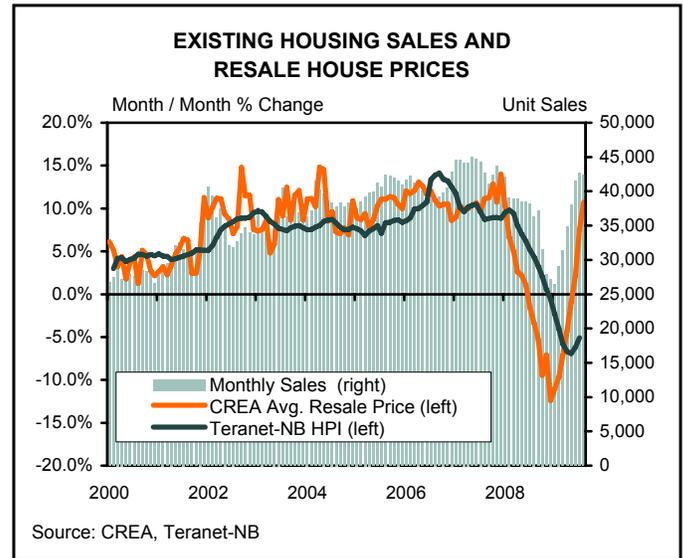
Bank of Canada may worry if real estate doesn't cool

There is a material risk, however, that real estate may not cool. The persistence of extremely low mortgage rates might induce more buyers into the market and speculation could take on a greater influence. If so, the question is whether this could provoke a tightening in monetary policy, even in an environment where inflation as measured by the Consumer Price Index is at, or below, the Bank of Canada's 2% target?

In the past, the general view has been that changes in the benchmark policy rate are a poor vehicle for addressing sectoral imbalances, largely due to the fact that the impact of interest rates cannot be targeted and instead impact the overall economy. As Fed Chairman Greenspan expressed during his final term, asset bubbles are notoriously difficult to recognize and monetary policy was better at "cleaning" up the mess after an asset bubble had burst by providing monetary stimulus. However, in the wake of the recent financial turmoil and deep economic downturn arising from the bursting of the U.S. real estate bubble, the view of 'cleaning' has been questioned and many central bankers now believe that monetary policy needs to 'lean' against the development of asset price excesses by running a tighter monetary policy.

Governor Mark Carney's speech at this year's annual Jackson Hole symposium³ seemed to show the belief that price stability is not enough and that financial vulnerabilities should be a consideration in monetary policy: "The combination of the central bank's silence over the existence of a possible bubble, the certainty that it would not respond to emerging financial pressures unless they affect price dynamics over the monetary policy horizon, and the expectation that it would mop up if the bubble bursts all conspire to sow the seeds of the next crisis." In other words, the Bank's credible commitment to price stability has a potential "dark side" in encouraging households and firms to make "mistakes" in bidding up asset values beyond their fundamentals.

While there are pros and cons to the 'lean' or 'clean' debate, the Bank of Canada appears to be weighing in on the 'lean' side of deflating bubbles before they grow too large. Of course, the overnight interest rate is still a blunt tool for this purpose, and is somewhat like using a meat cleaver when a scalpel is required. Ideally, interventions would target (either by regulatory discretion or design) particular markets where assets were becoming inflated. As Carney's Jackson Hole speech observed, 'counter-cyclical' financial regulation is a preferable means of dampening the 'pro-cyclical' tendencies of the monetary transmission mechanism, taking



the "weight off monetary policy to act for financial stability purposes". And, it is not evident how forceful the Bank will be in adopting any leaning, since Carney's speech contained the specific proviso that "it should not be seen as having any bearing on the current conduct of monetary policy or the prospective management of financial stability in Canada." Moreover, "If the central bank were to lean for financial stability and miss its inflation target as a consequence, its accountability could be diminished."

A risk to watch

The main conclusion is that the Bank of Canada will likely be watching developments in Canadian real estate quite closely. Governor Carney has expressed the view that the strength in existing home sales is "temporary", reflecting "pent-up demand" and improved affordability.⁴ However, if surging existing home sales do not cool, the Bank may be inclined to respond. Governor Carney's comments suggest that government regulatory actions are preferable to monetary policy action to address sectoral imbalances, but given that the overnight rate is at a mere 0.25%, there is a significant risk that the Bank might lift the overnight rate to help temper real estate activity. And, the response could come while inflation is still below target. While housing replacement and mortgage interest costs are included in the CPI, their impact is very lagged (see TD Observation "Mortgage Interest Costs and Canadian CPI" March 25, 2009) and their weight in the CPI is modest. Again, the base case economic forecast does not anticipate that hot real estate markets will force the Bank of Canada's hand, but it is a risk worth closely monitoring.

**END NOTES**

- ¹ Mark Carney “The Three Rs: Review, Reflect, and Reaffirm.” Remarks to the Greater Victoria Chamber of Commerce, 28 September, 2009. <http://www.bankofcanada.ca/en/speeches/2009/sp280909.html>
- ² Statement by Glenn Stevens, Governor, Monetary Policy, Reserve Bank of Australia. 6 October, 2009. <http://www.rba.gov.au/MediaReleases/2009/mr-09-23.html>
- ³ Mark Carney “Some considerations on Using Monetary Policy to Stabilize Economic Activity.” Remarks to a Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009. <http://www.bankofcanada.ca/en/speeches/2009/sp220809.html>
- ⁴ Carney (2009) “The Three Rs”

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