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Interest rate trajectory will depend heavily on housing market, Bank of Canada deputy governor says

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There are some signs that Canada's hottest housing markets have already begun to cool in response to rising interest rates.

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The Bank of Canada needs to keep raising interest rates to tackle runaway inflation, deputy governor Toni Gravelle said on Thursday – although how high rates go will depend on how the housing market responds to rising borrowing costs.

Mr. Gravelle said the central bank's policy rate, which has been at 1 per cent since April, is still "too stimulative." Bank officials have said they intend to get the benchmark rate into a "neutral" range – which neither stimulates the economy nor holds it back – of between 2 per cent and 3 per cent relatively quickly.

Whether the central bank pushes its policy rate above the neutral range will depend in large part on the real estate sector, Mr. Gravelle said in a speech hosted by the Association des économistes québécois in Montreal.

"Rising interest rates are designed to slow the economy by making borrowing more expensive. That tends to slow sectors like housing," Mr. Gravelle said, according to the English version of the speech.

"But this slowing might be amplified this time around because highly indebted households will face high debt-servicing costs and will likely reduce household spending more than they would have otherwise."

He noted that the Canadian household debt-to-income ratio hit a record 186 per cent by the end of 2021.

There are some signs that Canada's hottest housing markets have already begun to cool in response to rising interest rates. Home sales in Toronto dropped 27 per cent in April, and an index that measures home prices in the city showed the first monthly decline since October, 2020.

As interest rates rise, the economy may already be descending from its peak

Mortgage stress test rules may change as interest rates climb and housing market cools, says regulator

On the flipside, Mr. Gravelle said the housing market may prove to be more resilient than the bank expects, which could encourage it to move interest rates above 3 per cent.

"Specifically, we could also get stronger demographic demand from immigration. Or some of the increase in housing demand we saw during the pandemic – for bigger housing and in suburban locations – could persist much more than we have factored into our projection," he said.

Mr. Gravelle's speech offered the clearest explanation to date about what senior bank officials will be watching as they determine the pace and trajectory of interest-rate hikes. He said they will also be paying close attention to commodity prices and shifts in consumer spending.

Simon Harvey, head of foreign exchange analysis with Monex Canada, said the housing market is more likely to be a constraint than a tailwind to interest rates moving higher.

"When I'm looking at house price growth, price-to-income ratios, it just doesn't add up. At some point there will be a cooling effect from an increase in interest rates," he said in an interview.

The speech, titled "The Perfect Storm" focused largely on the differences between the current period of high inflation and the 1970s and 1980s, when central bankers lost control of inflation and had to rein it in at the cost of a painful recession.

Both periods involved supply-side shocks. In the 1970s, jumps in the price of oil sent global consumer prices soaring. Today, supply chain disruptions because of COVID-19 and a commodity price spike caused by the war in Ukraine are pushing consumer costs higher.

Despite some similarities, Mr. Gravelle isn't expecting a rerun of the kind of "stagflation" seen in the 1970s. Stagflation involves high inflation, high unemployment and low economic growth.

"Given where we are now, we don't see the stagnant part of stagflation – quite the opposite," he said.

Unemployment is at a historic low and the bank expects the Canadian economy to grow 4.2 per cent this year and 3.2 per cent next year. Moreover, the global commodity price shock that's squeezing consumers actually helps Canadian energy companies and farmers – although higher oil prices aren't expected to spur the same level of investment as in previous commodity cycles.

Mr. Gravelle noted several structural features that make today different from the 1970s. Employment contracts are less likely to be indexed to inflation today, reducing the chance a wage-price spiral will develop. The central bank also has built up credibility controlling

inflation over the past 30 years, which should help keep inflation expectations anchored, he said.

Mr. Harvey of Monex said that talk of stagflation is more appropriate for countries and regions that are more directly exposed to the economic fallout of Russia's invasion of Ukraine.

"We're talking about stagflationary environments in Europe, but not necessarily in North America, where there is strong growth momentum and a very constructive labour market outlook," Mr. Harvey said.

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