

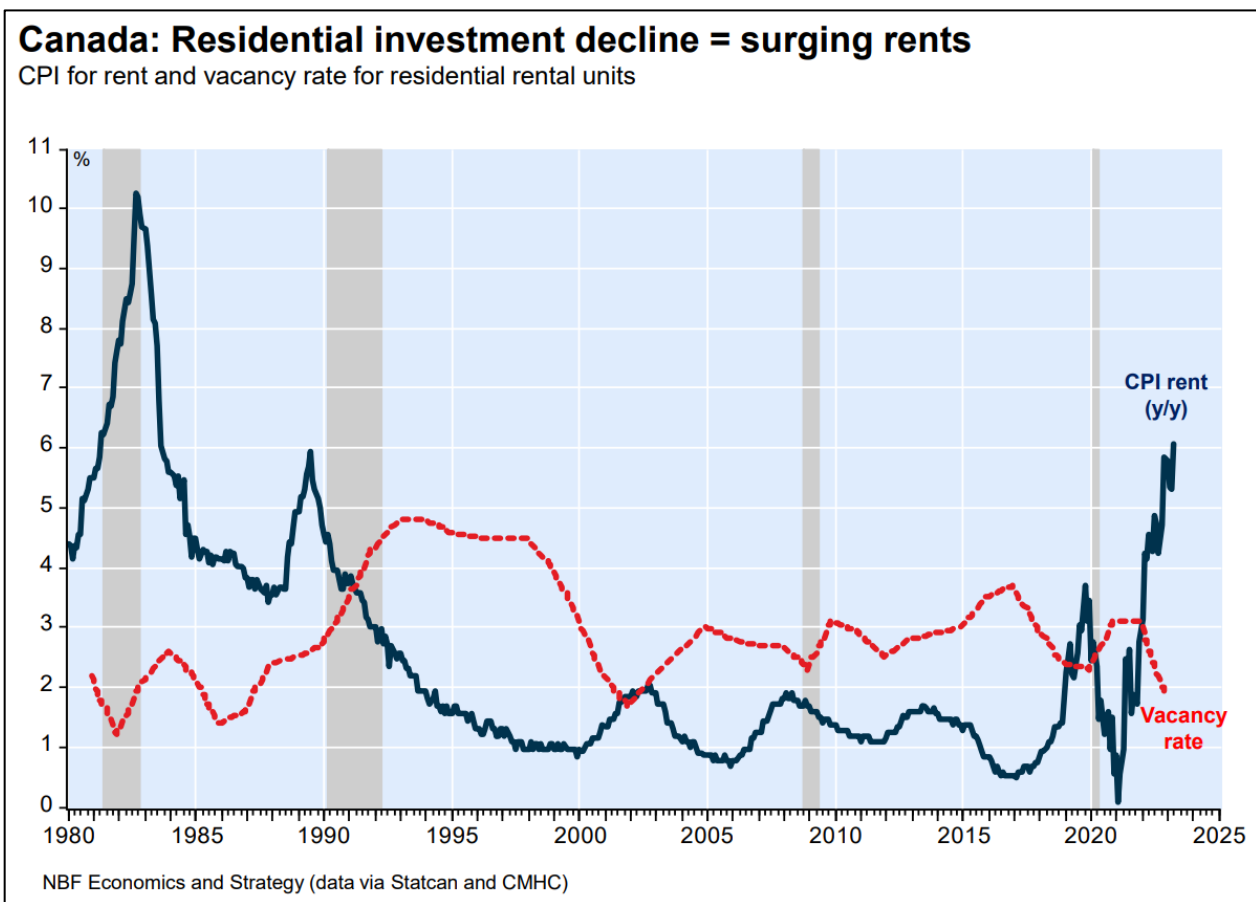
# Housing Market Driving Higher Inflation



June 10, 2023

The Canadian GDP report released on May 31<sup>st</sup>, revealed residential investment fell 14.6% in the first quarter of this year, the fourth consecutive double-digit decline and the worst streak of declining residential investment since 1995. As new construction slows to a crawl, the gap between the supply of housing and Canada's strong immigration policy continues to grow. Canada's working-age population has already increased by a record 270,000 (larger than the population of Regina) in only the first four months of 2023, six-and-one-half standard deviations above its historical average. In plain English, current Canadian immigration levels are at the highest levels ever observed.

High levels of immigration create substantial new demand for housing, both purchases and rentals. Furthermore, increased housing costs and higher mortgage rates are forcing more people to rent versus buy. As more people are forced into the rental market, rents have nowhere to go but up.



As shown in the chart above, Canada's rental vacancy rate is already at a generational low and will decline further if current immigration and residential investment trends continue.

Without a substantial change in immigration policy, Canadian demand for housing will continue to outpace supply until rents reach a level high enough to incentivize building new rental units. Clearly, we aren't there yet given the dramatic decrease in residential investment highlighted above.

From a monetary policy perspective, the Canadian housing dynamic is extremely important because housing represents the largest component of CPI (Consumer Price Index). The Bank of Canada has clearly stated their intent to reduce inflation (CPI) back to their 2% target (currently above 4%). Housing supply (residential investment) as well as housing demand (immigration) are not the purview of the Bank of Canada, thus, they have no control over the largest component of inflation. As the Bank of Canada debates whether they have increased interest rates enough to control inflation, housing inflation being driven by demand outpacing supply likely means interest rates must move even higher. This isn't good news for those hoping for lower rates because they need to renew their mortgage. The bottom line is rent inflation (at the highest level since the 1980's) is making it very difficult for the Bank of Canada to bring core inflation back to their 2% target. When rent inflation is being driven primarily by increased demand due to record immigration, there isn't much the Bank of Canada can do other than continue to slow the economy by increasing interest rates.

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