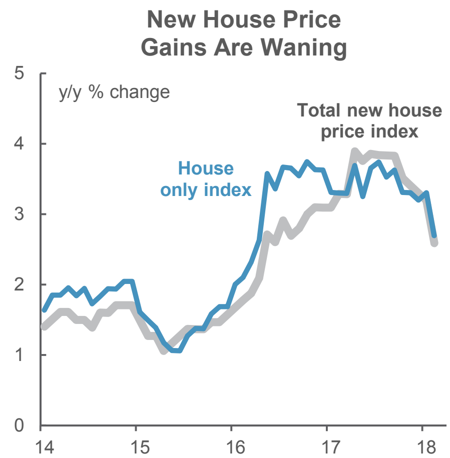
Housing's Small Emerging Influence On Canadian CPI Inflation

- Housing is still a very small direct effect on Canadian inflation. That's the takeaway from this morning's house price updates on the path to the next CPI update for March on April 20th. It should remain a modest influence going forward while other considerations are forecast to dominate the inflation outlook.
- Recall that Canadian CPI captures housing differently than in the US where the latter uses owners' equivalent rent. Canadian CPI uses homeowners' replacement costs with about a 5% weight in the CPI basket. Estimating replacement costs is significantly reliant upon the house-only component of this morning's new house price index (NHPI) from StatsCan. See the first two accompanying charts; the first one shows the headline and house-only price changes and the second chart shows the connection to the CPI component.
- The one percentage point slowdown in the pace of new house-only price gains now versus the peak rate of change in June and July of last year translates into less than a tenth of a percentage point change to the year-ago headline CPI inflation now and in the relatively near-term. That makes the direct effects of housing on CPI a rounding error thus far.
- If one were to apply today's weights to the peak annual house-only pace of new house price declines in the early 1990s, then the direct effect would be to lower CPI by about ½%. Obviously this is just for purposes of illustration by putting some parameters around hypothetical effects, whereas I don't expect such declines going forward—in contrast to the early 1990s when an awful lot was going wrong in the economy. I would think the most likely scenario going forward is that the direct weighted effect of house price changes on CPI is likely to be between -0.1% and +0.1%. Also of note is that new house prices have cumulatively risen by a lot less in this housing cycle than repeat sales prices as chart 3 below demonstrates which may imply less vulnerability than would otherwise be the case. This stands in contrast to the cycle of the 1980s; back then, new house prices were climbing at a double digit year-ago pace through a considerable portion of the 1986–1989 period whereas this cycle's gains have been much more tempered.
- Of course there are added knock-on effects from housing on broader shelter costs that comprise 27% of the CPI basket through the weights that are shown in the accompanying table. The direct effect relies upon new house prices. Changes in the prices of resale homes (and new homes) can also affect CPI through categories like property taxes and insurance premiums. Some of these effects (e.g. insurance) can lag.
- Other effects, like property taxes, depend upon the jurisdiction and upon whether prices are rising or falling. For instance, Ontario takes an asymmetrical approach: property assessments and taxes respond to house price increases with a four year phased-in lag; but property taxes respond more quickly to a decline in prices although they do so once a year when MPAC reassesses on January 1st. Because both resale (+2.2% y/y) and new house price indices were higher in January of this year than January of last year—although modestly so in both cases—there should still be very slightly positive average property tax influences upon CPI this year. Most of last

CONTACTS

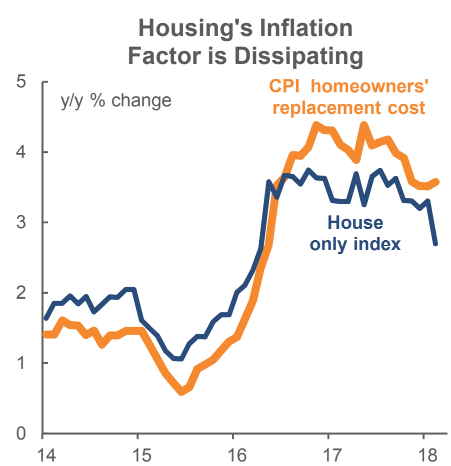
Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

year's run-up in house prices occurred after assessments and into the Spring market. The 3.6% weight on property taxes in CPI is likely to translate into a very small swing factor for CPI over time.

- Indeed, among the lower-weighted shelter cost categories, electricity prices are likely to be more influential on CPI going forward—and to the upside. Last year's three rounds of price cuts in Ontario dragged down average nationwide electricity prices with a 2 ½% weight in CPI, but as the effects shake out they will rise at about the rate of inflation. As chart 4 below demonstrates, this swing factor in electricity prices compared to the recent past applied to the CPI weights could add 0.2–0.3% to headline inflation compared to last year's peak drag effects before becoming an inconsequential influence as 2019 unfolds into 2020—until some future point when electricity prices are likely to rise more materially. Also of note in terms of the more lower-weighted shelter cost categories is the influence of mortgage interest cost; with about a 3 ½% weight, the swing from no change a year ago to mortgage interest costs as captured in CPI that are up by 2.3% y/y now amounts to an impact on CPI of less than +0.1% y/y. As rate hikes to date and in future flow through, mortgage interest costs are likely to remain a mild source of upward pressure on headline CPI.

- Beyond shelter costs, there is obviously the potential for house price changes and housing sentiment to impact other forms of spending that are either complementary (e.g. furniture, electronics, etc.) or partially reliant upon wealth effects (e.g. autos, vacations, the same complementary items, etc.). Our forecasts for fairly strong growth in nominal disposable income of almost 5% this year and 4% next year should position cash flow as the dominant driver of consumer spending while the saving rate remains around a cyclically respectable 4% in keeping with the roughly two-decade average. We also expect a soft landing for housing as last Spring's hot markets in some parts of the country drop out and then give way to a more muted pace of gains. Broader price pressures are forecast to be more directly determined by considerations such as tightening capacity and wage gains as discussed at length in forecasts that were released today.

- In conclusion, at least so far, housing is having little effect on headline CPI and offers little reason to alter the BoC's inflation outlook. It clearly remains something to continue monitoring over time, alongside myriad other influences upon inflation. Furthermore, the biggest swing influences from some categories of price changes would be largely cast aside upon considering the implications for the three central tendency inflation measures (trimmed mean, common component and weighted median).

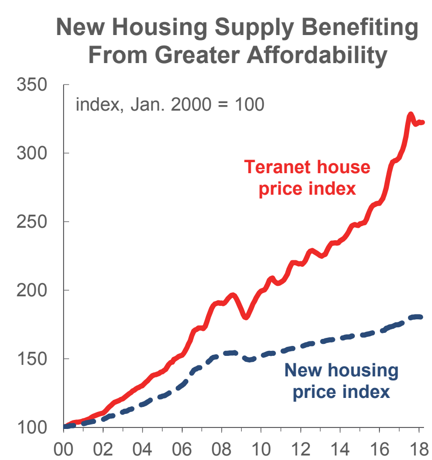
Shelter's all-in weight equals 27.1% of CPI and is comprised of the following:

Rent (6.35%) via:
- rent (6.17%)
- tenants' insurance premiums (0.1%)
- and tenants' maintenance, repairs and other expenses (0.1%)

Owned accommodation (16.5%) via:
- Mortgage interest cost (3.4%)
- Replacement cost (5%)
- Property taxes (3.55%)
- Home and mortgage insurance (1.4%)
- Maintenance and repairs (1.5%)
- Other owned accommodation expenses (1.7%)

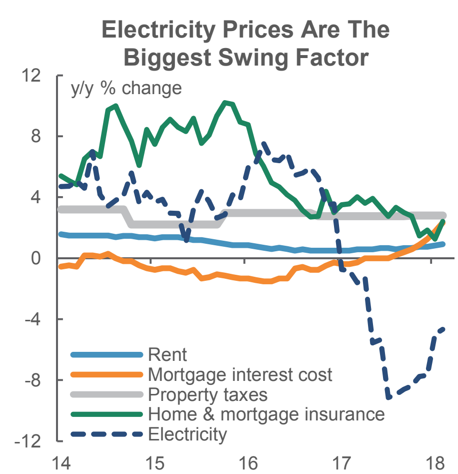
Water, fuel and electricity (4.3%) via:
- Electricity (2.5%)
- Water (0.7%)
- Natural gas (0.9%)
- Fuel oil and other fuels (0.3%)

Chart 3



Sources: Scotiabank Economics, Statistics Canada, Teranet & National Bank.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.