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Bank of Canada’s Tiff Macklem spells out limits of monetary policy, says interest rates won’t solve housing affordability

MARK RENDELL || FEBRUARY 6 2024

Bank of Canada Governor Tiff Macklem delivers a speech in Montreal on Feb. 6.CHRISTINNE MUSCHI/THE CANADIAN PRESS

Monetary policy cannot solve Canada’s housing affordability problem or boost the country’s longer-term economic growth prospects, the Governor of the Bank of Canada said Tuesday in a speech aimed at defining the limits of what central bankers can achieve by setting interest rates.

Speaking to the Montreal Council on Foreign Relations, Tiff Macklem said the bank's aggressive interest-rate hikes over the past two years have pushed up mortgage payments for many homeowners. But he argued that shelter inflation – now the biggest driver of Consumer Price Index growth – is primarily the result of long-standing imbalances in the housing market.

"Housing affordability is a significant problem in Canada – but not one that can be fixed by raising or lowering interest rates," Mr. Macklem said in his first speech since holding the bank's policy interest rate steady at 5 per cent in late January for the fourth consecutive time.

"Housing supply has fallen short of housing demand for many years. There are many reasons why: zoning restrictions, delays and uncertainties in the approval processes, and shortages of skilled workers. None of these are things monetary policy can address."

The rising cost of housing has become a key issue for the central bank in recent months, as well as a major topic of political debate. While overall inflation has fallen since mid-2022, the pace of shelter inflation – a combination of rents, mortgage interest costs, home prices and other housing-related costs – has increased since last summer.

Governments at different levels have ramped up efforts to deal with the imbalance in the housing market, which stems from a combination of rapid population growth, through immigration, and a perennial shortage of new home construction. This includes the federal government's decision to cap the number of international students at 35 per cent below last year's level, and moves by the federal and some provincial governments to cut taxes on purpose-built rental building construction.

Mr. Macklem's comments on the limits of monetary policy in addressing shelter costs raise the question: Will the bank look past the shelter component of the Consumer Price Index when determining when to cut interest rates?

On this point analysts were split. Tiago Figueiredo, a macro strategist with Desjardins, said Mr. Macklem's comments were "more dovish than previous communications."

"Housing affordability for Canadians won't be restored any time soon. For the central bank, that means that policy-makers should be more willing to look through shelter price inflation when determining the appropriate path for interest rates," Mr. Figueiredo wrote in a note to clients.

By contrast, Robert Both, a senior macro strategist with Toronto-Dominion Bank, said in a note to clients that the speech "struck a slightly hawkish tone." He highlighted Mr. Macklem's comment that the path back to the bank's 2-per-cent inflation target "is likely to be slow and risks remain."

Shelter inflation is a particularly tricky problem for the Bank of Canada. High interest rates are adding to housing costs by pushing up monthly payments when homeowners reset their mortgages. But interest-rate cuts could exacerbate inflation by sparking a rush of would-be buyers into the real estate market, driving up home prices and boosting housing-related economic activity.

There are already signs that this is happening in anticipation of potential rate cuts. Toronto home sales were up 9.6 per cent in January compared with December after removing seasonal influences, according to the Toronto Regional Real Estate Board. That's after a 19.5-per-cent rise in December from the previous month.

High interest rates may also be reducing the supply of housing by making it more expensive for developers to build and by reducing demand for presales, particularly for condos. Mr. Macklem acknowledged this problem in a news conference after the speech, although played down its significance.

"We certainly do hear from developers that increases in interest rates are impacting their ability for their construction projects to be profitable, and that's delaying certain projects. Having said that, it's very clear in the data that the effects of interest rates on demand are much bigger than those on supply," he said.

Benjamin Tal, deputy chief economist at Canadian Imperial Bank of Commerce, agreed with Mr. Macklem's argument that housing affordability is largely out of the central bank's hands. He said the recent cap on international students would help bring the rental market into better balance, but that much more needs to be done to spur the construction rental buildings.

"It is primarily about changing the economics of deciding to build a condo versus building a purpose-built [rental building]," Mr. Tal said in an interview. He added the tax change for rental construction is a step in the right direction but, "We need much more than that."

He also said Canadian policy makers need to get a better grasp on the actual pace of population growth in Canada.

In a note published Tuesday, Mr. Tal argued that Canada Mortgage and Housing Corp.'s estimate that the country needs to build 3½ million homes by 2030 to restore housing affordability was likely too conservative. When you take into account more up-to-date population growth figures and projections, the number is probably close to five million, he said.