Financial Post – February 21, 2024

Posthaste: There's one big factor keeping the Bank of Canada from cutting rates

High shelter inflation keeping central bank from meeting 2% inflation target, TD says

Victoria Wells || February 21, 2024

The Bank of Canada building in Ottawa. Shelter costs are keeping the overall inflation reading running hot, TD says. PHOTO BY DAVID KAWAI/BLOOMBERG

The Bank of Canada's inflation flight is getting drawn out longer than necessary because of the soaring cost of housing, Toronto-Dominion Bank says.

Rising shelter prices are keeping inflation from reaching the central bank's two per cent target, and in turn, keeping interest rates higher for longer, according to James Orlando, a senior economist at TD.

That's because shelter inflation accounts for 30 per cent of the consumer price index basket, giving it an outsized impact on the headline inflation reading and policymakers' interest rate decisions.

"The Bank of Canada's inflation problem is mostly a housing issue," Orlando said in a report released Feb. 20. "With shelter inflation accounting for roughly half of overall inflation, this has become the biggest hurdle preventing the Bank of Canada from cutting rates."

Skyrocketing rents and a record rise in mortgage interest costs are keeping housing inflation running hot. Shelter inflation grew 6.2 per cent in January, up from six per cent in December, according to Statistics Canada. Rents rose 7.8 per cent, compared to 7.5 per cent in December. Mortgage interest costs were up 27.4 per cent in January.

Housing inflation isn't expected to cool down any time soon. TD expects shelter inflation to run at an average of six per cent over this year, which means getting headline inflation to the Bank of Canada's two per cent target will be all but impossible.

"The rest of the inflation basket must have close to zero price growth for the Bank of Canada to get inflation down to two per cent," Orlando wrote. "That is highly unlikely outside a significant recession."

The Bank of Canada has indicated it won't cut interest rates too quickly for fear of fuelling shelter inflation even more. But according to TD's analysis, even early and quick rate cuts are unlikely to have much impact on inflation in the housing sector. Rate cuts would likely bring mortgage interest costs and rents down quicker, but housing prices would also likely increase faster.

At the same time, unless the bank cuts interest rates to two per cent or lower this year, a wave of people renewing their mortgages "are in for a big payment shock," TD said, which will add to mortgage interest costs. Rent inflation will also remain higher for longer amid strong population growth and a lack of housing supply. Altogether, that will keep shelter inflation high over the next two years, TD said.

With housing causing so many problems, the Bank of Canada might want to consider removing it from its preferred measure, TD said. That wouldn't be unheard of, because before 2016, the bank excluded mortgage interest costs, among other volatile items such as produce and gas prices, from its CPIX preferred inflation reading. In fact, if the central bank went back to the CPIX, core inflation would have come in at 2.6 per cent in December.

The Bank of Canada now uses three core measures of inflation to guide it on monetary policy. But TD said those measures no longer move with the economy, mostly due to housing. That's clouding policymakers' view when making interest rate decisions, keeping rates elevated and extending financial pain for Canadians.

"The longer the Bank of Canada continues to look at inflation through its current lens, the longer Canadians will have to bear the weight of a heavily restrictive policy rate," Orlando wrote.