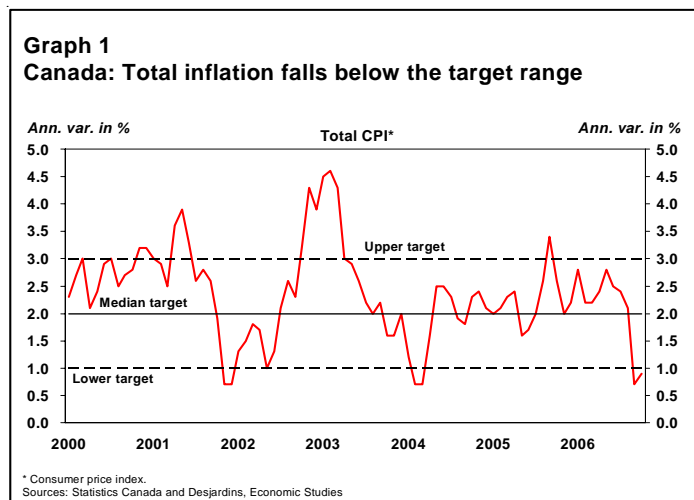


December 7, 2006

Must the Bank of Canada avoid reducing key rates due to rising prices for real estate?

In this *Economic Viewpoint*, we isolate the elements that have had the most influence on price growth over the last few months and pinpoint the consequences for future price evolution. One of the things we note is that, aside from energy price fluctuations, the inflation trend is based on only a few major elements, including rising real estate prices in western Canada. Under these conditions, it is essential, in the conduct of the monetary policy, to distinguish temporary factors from medium- and long-term trends.

As shown in Graph 1, the Consumer Price Index (CPI) has been on a rollercoaster over the past few months and the total annual inflation rate recently fell below the lower limit (1%) of the Bank of Canada's target range. This situation does not, however, seem to be pushing monetary authorities to reduce the target for the overnight rate. In fact, they are instead judging that the downside and upside risks to price evolution are balanced.



Dropping energy costs reduce inflation

Note that energy prices have fluctuated substantially in the last few years. Specifically, there have been large movements in prices for crude oil and natural gas on international markets over the last few months and these bumps inevitably passed through to consumer prices. For example, the average price at the pump for regular gas in Canada hit a peak of ¢126 per litre as of

the federal government's weekly report for September 6, 2005. Remember that, at the time, the hurricanes in the Gulf of Mexico region were making a strong contribution to acceleration by energy prices. The total annual inflation rate was thus at 3.4% in September 2005, slightly above the Bank of Canada's target range. A year later, fears associated with the oil supply have eased substantially. Not only was the 2006 hurricane season much less devastating, but signs of less robust economic growth are increasingly emerging around the globe, particularly in the United States. At the time of writing, the price of oil per barrel (WTI: West Texas Intermediate) was in the neighbourhood of US\$60, as opposed to just over US\$75 last August. This decrease was good for Canadian consumers as the average price for regular gas sank to around ¢90 per litre, reducing the total annual inflation rate to just below 1%.

The price of natural gas on financial markets has also been particularly volatile over the last few months. Apart from the usual fluctuations associated with weather and demand, it was also subject to much speculation due to transactions associated with a hedge fund. The price for natural gas on the international markets has therefore dropped by about 50% from where it peaked on December 13, 2005.

The lower energy prices explain much of the decline by the total annual inflation rate seen over the last few months. What's more, as Graph 2 on page 2, the annual variation in the CPI that excludes energy has not kept pace with the decline by the total index. Inflation's

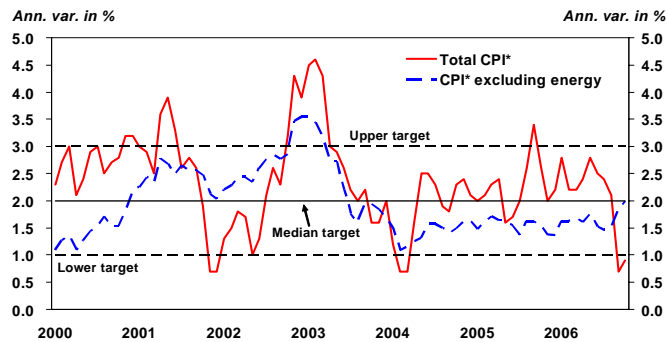
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Graph 2
Canada: Inflation's slide stems primarily from energy



* Consumer price index.
Sources: Statistics Canada and Desjardins, Economic Studies

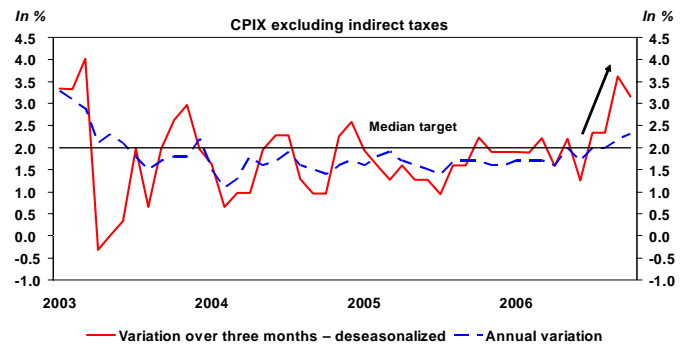
decrease was also amplified when the 1% cut (from 7% to 6%) in the federal tax on good and services (GST) came into effect on July 1. According to Statistics Canada's estimates, this GST cut, combined with a small increase in excise taxes on tobacco products, triggered a 0.5% decline in the CPI.

The downward impact on the CPI of fluctuations in energy prices and changes to indirect taxes should only be a temporary, passing phenomenon, however. Under these circumstances, it is easy to understand why the Bank of Canada disregards these developments in conducting its monetary policy. To do this, the monetary authorities use the benchmark index, the CPIX, which excludes the eight most volatile components¹ (including gas and natural gas), as well as the effect of indirect taxes. The evolution of the core index provides a more accurate picture of where inflation is heading in Canada and, as a result, it is very important in orientating the conduct of monetary policy.

Core inflation picks up speed

As shown in Graph 3, the core index's advance has remained fairly stable since 2004. There has been some acceleration in the last few months, however, indicating that upward pressure on underlying inflation

Graph 3
Canada: Growth by core inflation picks up speed



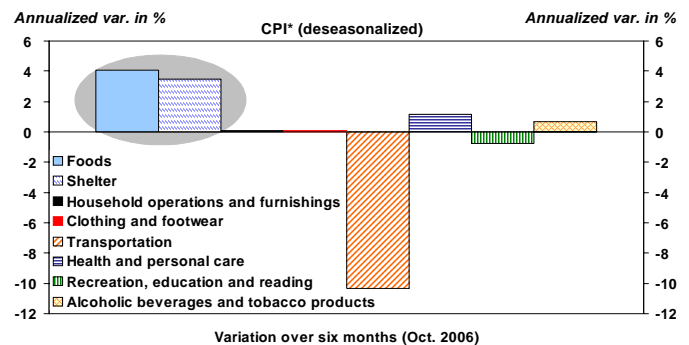
Sources: Statistics Canada and Desjardins, Economic Studies

has intensified slightly. There is no doubt that this constitutes an overly fast surge, and so a risk to the Bank of Canada's scenario, especially if it should persist.

Inflation and new home prices

Where is this recent acceleration coming from? An analysis of the progress by the main components in the CPI basket indicates that food and housing are the components that have been posting the fastest growth in recent months (Graph 4). For food, the increase stems mainly from prices for fresh fruits and vegetables. However, these two components are excluded from the CPIX, and therefore do not explain its recent advance.

Graph 4
Canada: Food and housing prices accelerate

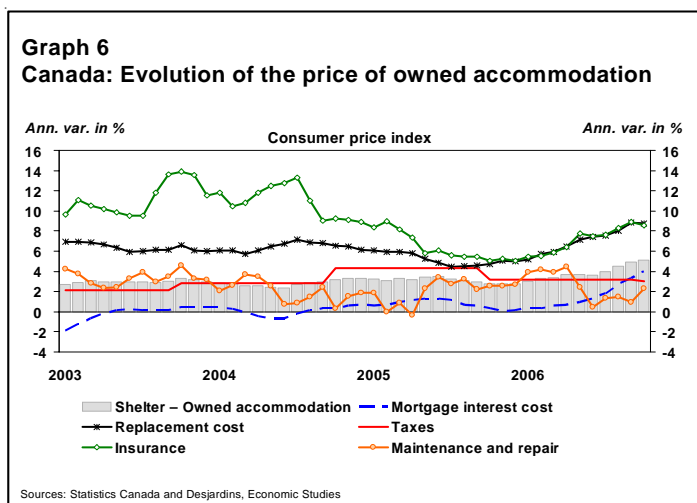
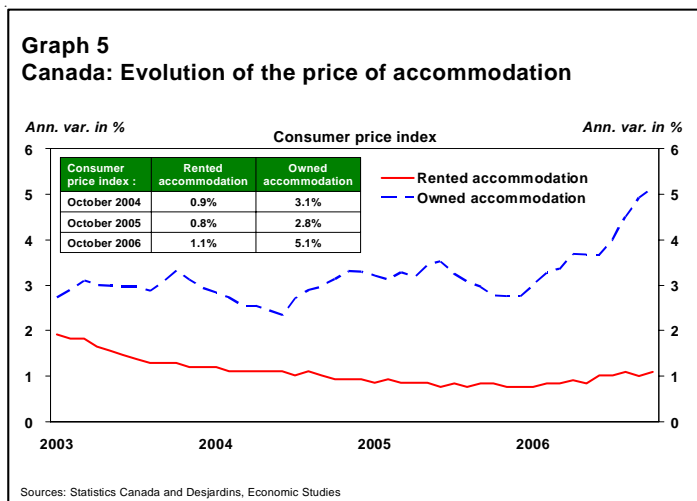


* Consumer price index.
Sources: Statistics Canada and Desjardins, Economic Studies

¹ The Bank of Canada identifies the eight following components as the most volatile: Fruit, fruit preparations and nuts; vegetables and vegetable preparations; mortgage interest cost; natural gas; fuel oil and other fuel; gasoline; inter-city transportation; tobacco products and smokers' supplies.

That means that core inflation's recent acceleration is largely due to the shelter component. As the increase in costs associated with rented accommodation has barely changed in the last few years, much of the housing

component's recent fluctuation comes from prices associated with owned accommodation (Graph 5). The increase in prices for owned accommodation is mainly due to three factors: 1) interest costs; 2) insurance premiums; 3) replacement costs (Graph 6).

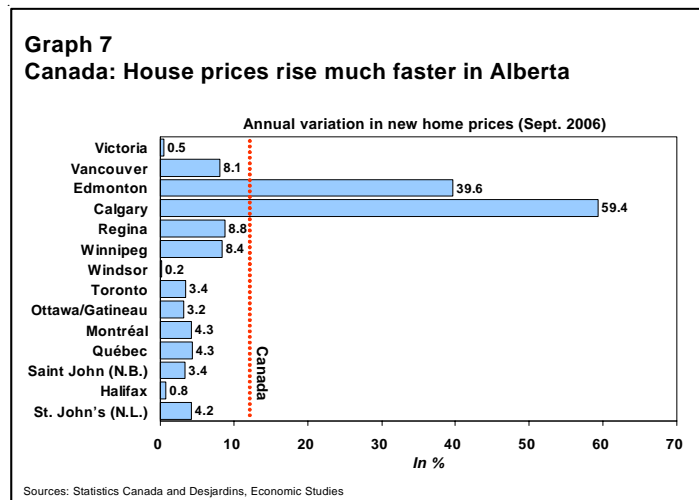


After having been close to zero since mid-2003, annual growth in interest costs has accelerated in the last few months under the combined effect of the Bank of Canada's key interest rate increases and higher bond rates. The prime rate at financial institutions, which had been only 4.50% in October of 2005, was 6.00% one year later, an increase that immediately rippled into most variable mortgages. As for closed mortgage rates, even though a slight downward trend seems to have been materializing lately, the fact that bond rates were on the ascent until last summer has encouraged the rates in force at financial institutions to go up over much of the last twelve months. Current closed mortgage

rates are thus higher than those recorded in October of 2005. We should add, however, that the advance by mortgage interest rates cannot explain acceleration by the Bank of Canada's core index as this is one of the eight highly volatile components that are excluded from the calculations.

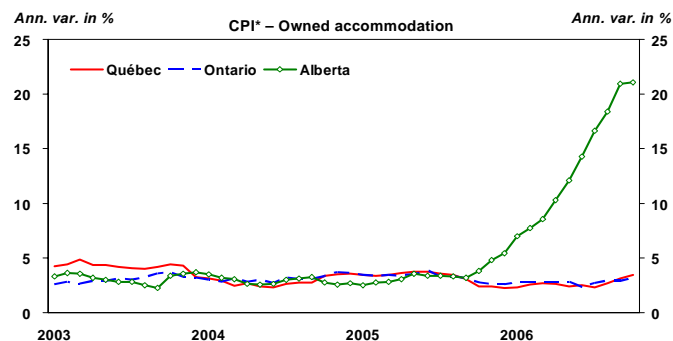
We therefore have to look to two other factors in the rising cost of owned accommodation: insurance premiums and replacement costs. The replacement cost, which represents the worn-out portion of housing, is estimated using new housing prices, excluding land. The house price increase that has occurred in recent years has therefore triggered a substantial increase in this component of the CPI. Home insurance premiums are also tied to property values. The more a home costs, the more it costs to replace it, so insurance premiums get bigger.

When all is said and done, much of the recent acceleration by the Bank of Canada's core index therefore stems from the rise by home prices. However, there are currently major regional disparities in home values nationwide. Specifically, Alberta home prices are growing fast and price increases there are much higher than the average for the other regions in Canada. That means that a large proportion of the acceleration by the owned accommodation component of the CPI derives from this western province.



However, the owned accommodation component only constitutes 14.91% of the total CPI basket for Alberta, while this province's weight in the total Canadian CPI basket is only 10.93%. In the end, the relative weight of

Graph 8
Evolution of inflation associated with owning property in Québec, in Ontario and in Alberta

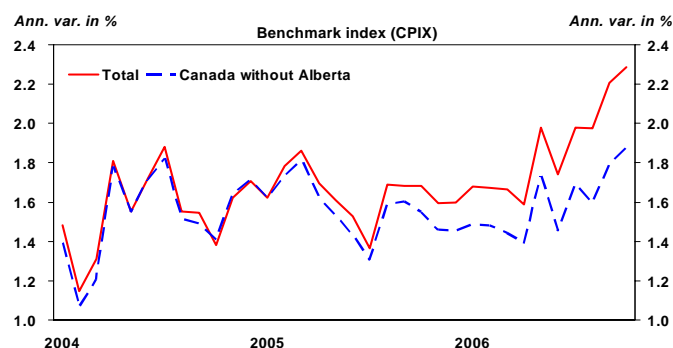


* Consumer price index.
Sources: Statistics Canada and Desjardins, Economic Studies

Alberta's owned accommodation in the whole Canadian CPI basket is not very large: only 1.6%. In contrast, the relative weight of Ontario's owned accommodation is 7.1%. In spite of everything, the increase in home prices in Alberta is so large that it is still having a significant impact on the national CPI. For example, a 20% increase in the cost of owned accommodation in Alberta contributes an increase of about 0.3% to the total CPI for Canada.

Rising prices in Alberta also influence the Bank of Canada's core index (CPIX), which, as we stated earlier, recently picked up speed. As shown by the annual variation in the national version of the CPIX and in the CPIX which excludes Alberta, the province is in fact responsible for a deviation of about 0.4% between these two versions (Graph 9). What's more, this deviation only began to be noted in 2005, when real estate prices began to accelerate in Alberta. Thus, annual growth in the CPIX that excludes Alberta is currently at a level

Graph 9
Alberta price growth magnifies core inflation

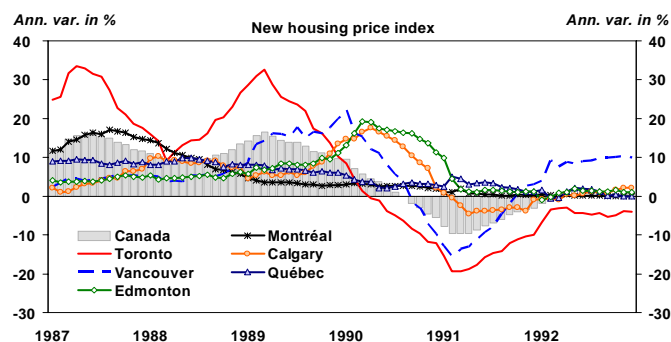


Sources: Statistics Canada and Desjardins, Economic Studies

similar to that seen at the start of 2005; the national version, on the other hand, is at a level that has not been seen since May 2003.

This is not the first time the country has seen real estate prices go up sharply. In Toronto, for example, prices for new homes had shot up at the end of the 80s, and, moreover, resulted in some acceleration by inflation (Graph 10). The Bank of Canada even brought its interest rates up substantially. However, any comparison between that episode and the current situation is risky. At the time, total annual inflation was holding at relatively high levels, and the launch of a new monetary policy (in 1991) intended to keep price growth within a target range had contributed to key interest rate firming. It should also be noted that Ontario has a very large weight in Canada's economy, so that evolution by prices there has a greater impact on the national average. What's more, this price increase had been fanned by a large increase in wages for Ontario public service employees. Another thing that characterized the end of the 80s was questionable fiscal responsibility, with most governments posting budget deficits.

Graph 10
Canada: Real estate bubble at the end of the 80s

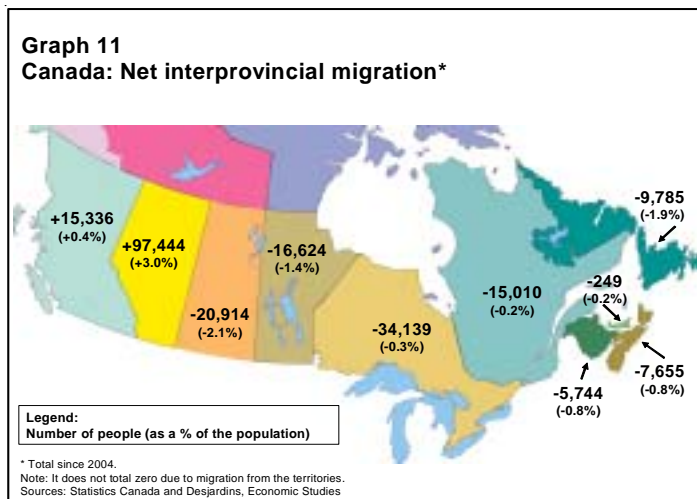


Sources: Statistics Canada and Desjardins, Economic Studies

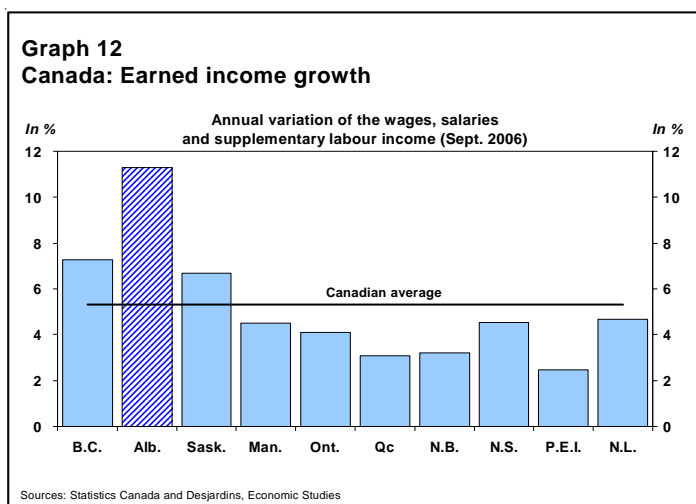
We should also mention that, although the increase in real estate prices started in Toronto, a number of urban centres also subsequently saw their prices go up fairly quickly. This time, the increase in real estate prices seems to be more isolated, and the deviation between the annual variation in new home prices in Alberta and other provinces is much larger than the deviation seen as the 90s approached.

Limited pass-through

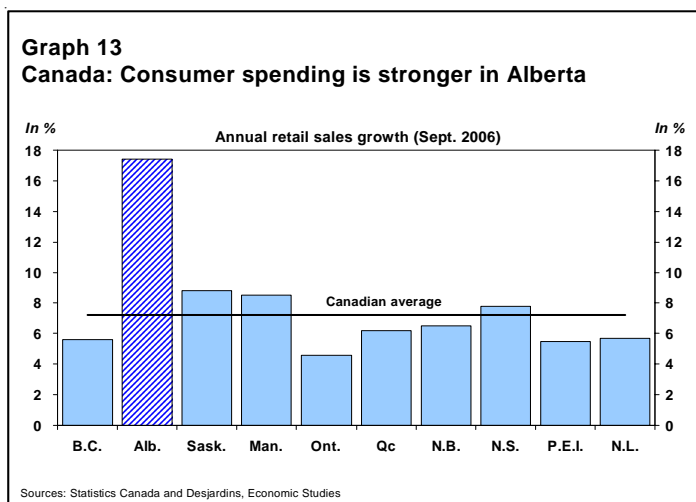
We can thus conclude that, as long as the price increase is limited to the Alberta real estate market, fears of substantial acceleration by Canadian inflation are likely to be fairly small. From the perspective of managing the monetary policy, the danger stems more from the inflationary pressure's pass-through potential. On one hand, the strong demand being seen in the Alberta real estate market could spread to the other provinces. This risk is fairly small, however. Even though many provinces are seeing substantial increases in new home prices, their growth rates are well below those being seen in the west. What's more, exploding real estate prices in Alberta are largely due to the strong energy sector, which is not only attracting many workers, but also generating rapid wage growth. As most of the other provinces are not benefiting from the energy sector's vitality, this phenomenon is limited. In fact, the loonie's lively appreciation is generating many difficulties in other provinces, such as Ontario and Québec, a situation this is clearly not conducive to strong growth by the real estate market. Growth by new home prices in Alberta is therefore the result of a localized intensification in demand that derives from the adjustments currently unfolding in the Canadian economy. For example, data on interprovincial migration clearly show that almost all provinces have seen some of their population migrate to the west (Graph 11). Alberta in particular has, since 2004, seen 97,444 new inhabitants arrive from other provinces, equal to 3% of its population. This phenomenon has intensified in the last few months, as close to 50% of the total gain has been recorded after the end of 2005.



Another pass-through effect could stem from pressures on the job market. With the unemployment rate at a historic low, Alberta's job market is undeniably experiencing a shortage, which is being translated into rapid growth in earned income (Graph 12). The abrupt growth by wages is, however, primarily concentrated in Alberta, so that it does not appear to be rippling through to the other provinces to any extent. Here again, the disparities between the provinces are a good illustration of the impact of the energy sector's vitality and of the adjustments underway in the economy.

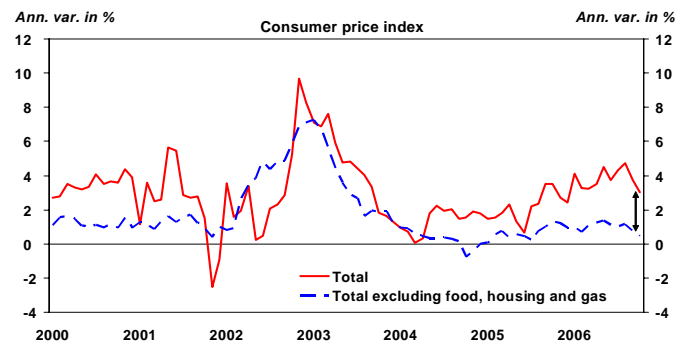


Finally, a third possible effect concerns strong domestic demand in Alberta, which is evidently benefiting from the energy sector's solid performance, as well as from growth in earned income (Graph 13). What's more, as occurred in the U.S., Alberta households saw their real estate assets grow substantially as home prices increased, and this wealth effect could also play a role in consumer spending growth in the province. There is



reason to be concerned that lively consumer spending could cause pressures on the province's prices to intensify. The annual variation in Alberta prices excluding the food, gas, and housing components—all of the factors that have seen particular fluctuation in the last few months—is, however, showing greater stability than total inflation (Graph 14). That means that the current fluctuations are nowhere near generalized. Among other things, this is due to the large proportion of imported goods and services—like the other provinces, Alberta has a very open economy. As inflationary pressures are largely under control elsewhere in North America, prices for the goods and services imported into the province are fairly stable, keeping the overall price increase limited. What's more, trade with the rest of the world is now more important than it was previously; Alberta businesses are competing at the planetary level, which limits their ability to raise their prices. We can therefore deduce that the risk of a general acceleration by inflation in Alberta is fairly small, even if consumer spending is booming.

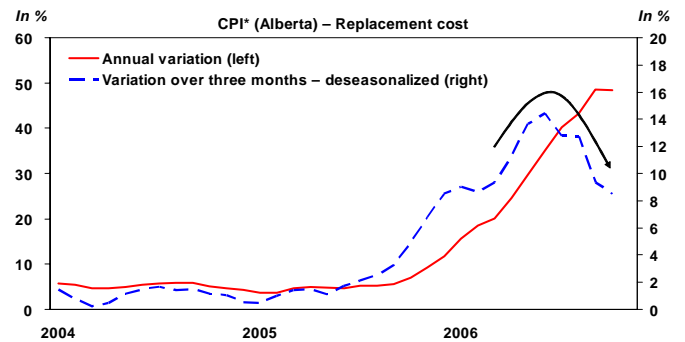
Graph 14
Alberta: Inflation excluding volatile components is fairly stable



Sources: Statistics Canada and Desjardins, Economic Studies

What conclusions can we draw? On one hand, core inflation's recent acceleration is highly localized; it is primarily due to faster growth by Alberta real estate prices. Yet it would be astounding to see the annual increase in new home prices get bigger—it is already at almost 60% in Calgary. In fact, price evolution in the last few months is instead indicating that the advance by new home prices is tending to fade in the province (Graph 15). Under the circumstances, the Alberta real estate market's impact on Canada's prices as a whole is not likely to increase.

Graph 15
Alberta: The lively increase in home prices seems to be easing



* Consumer price index.
Sources: Statistics Canada and Desjardins, Economic Studies

Moreover, the risks appear quite small that the inflation pressure noted in the Alberta real estate market will spread to other goods and services in Alberta and elsewhere in the country. It should be said that, while the pace of Alberta's economic expansion has picked up in the last few years, its growth potential is also higher due to a shift in economic activity from other provinces, interprovincial migration, and much investment, reducing the risk of overheating.

From a more general perspective, we should also note that the American economy's weakness is a downside risk for demand for Canadian—and therefore Albertan—goods and services. This could translate into slower price growth, which would cause current pressures in Alberta to resolve.

Implications for the Bank of Canada

The Bank of Canada conducts its monetary policy based on the needs of the country as a whole. Consequently, the inflation target is based on the total national CPI, which considers average inflation pressure nationwide. However, Alberta represents only 15% of the whole Consumer Price Index basket. As a result, this province has less of an influence on monetary policy than Québec and Ontario, whose combined weight totals more than 60% of the CPI basket.

What's more, the performance of Canada's monetary policy in recent years has been fairly good, as shown by inflation remaining within the target range. The Bank's credibility in this respect has grown visibly since the

early 90s, so that the monetary policy's reactions to various shocks are not as large today. Here, it is easy to believe that monetary authorities will not have as strong a reaction to real estate price growth in Alberta as they would have had in another era under similar circumstances, as in the situation of the Toronto real estate market at the end of the 80s.

Because of their caution, we can understand that Canadian monetary authorities will continue to maintain a balanced risk scenario with respect to inflation. In our opinion, the threat associated with Alberta real estate prices should, however, fade gradually, so that the downside risks could become predominant. The Bank of Canada could therefore opt to ease monetary conditions, and the target for the overnight rate would consequently have to be lowered several times in 2007 (probably two reduction of 0.25%). However, our scenario is for economic growth to accelerate starting in mid-2007, so that monetary easing should be limited and temporary. In fact, the improving economic outlook should pave the way for a return to a rising trend for key interest rates in 2008 and 2009.

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