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Reflections

Partners in Capital Growth

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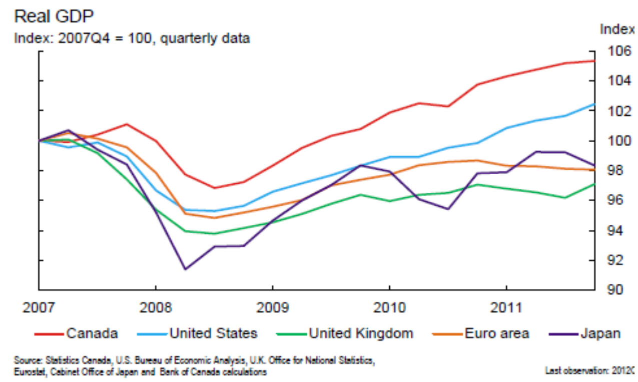
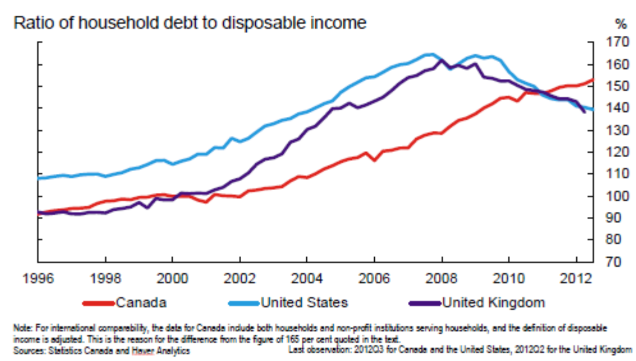
The Canadian Housing Market: possible risks for the Canadian economy

Summary:
Following the Great Recession of 2008-2009, the Canadian economy proved resilient. Among advanced economies, Canada had the “shortest recession and the strongest recovery” (*Graph, Bank of Canada*[1]). However, this was achieved through policy actions that helped propel housing prices to new highs and facilitated equity withdrawal by homeowners to finance consumption. While this was helpful to mitigate the impact of the Great Recession, housing prices and household indebtedness cannot increase forever and will have to correct.



Yet, Canada is not at risk of a housing debacle like the one the US experienced. A much smaller number of risky mortgages were contracted, and in any case the great majority of all mortgages are guaranteed by the Canadian Mortgage and Housing Corporation (CMHC), a Crown Corporation – that is to say by all taxpayers. Mortgage issuers and our financial system are therefore at little *direct* risk from mortgage defaults.

Nonetheless, the unprecedented level of household indebtedness (*Graph, Bank of Canada*[1]) has increased the vulnerability of the economy to declines in housing prices and / or increases in unemployment. Should housing prices start declining abruptly or unemployment rise, the willingness of overstretched households to consume will be reduced. As households account for about 65% of economic activity, this would directly impact economic growth and ultimately add further to unemployment, which is already above its long term trend.



Domestically, high housing valuations together with excess construction especially of condominiums make a correction highly probable, although the timing is unknown. Abroad, continuing economic instability in Europe and uncertainties as to the future strength of the US recovery present risks to commodity prices, export demand and ultimately Canadian employment. In any adverse development, by how much household demand would decline would depend on the unexpectedness and extent of the changes households experience – factors that are unpredictable as they will be driven mostly by consumer and investor psychology at the time. A mild “soft landing” from the housing excesses is what everyone hopes for. However, the possibility of more adverse developments up to a recession cannot be eliminated.

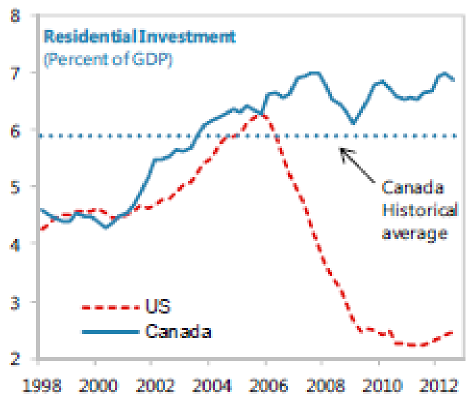
The purpose of this paper is to describe the current state of and risks within the housing market, the related vulnerability of households, and how they could affect the economy.

The Canadian housing market - 1999-2012.

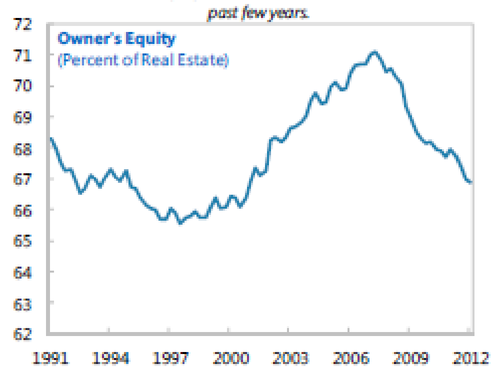
That the Canadian housing market is of concern to economists and policy makers is made obvious by the amount of reports that address its issues. Recently, both the Bank of Canada and the International Monetary Fund, in its annual analysis of Canada, have focused on the risks attached to the housing market. These studies are worth reading. Newspapers, especially the Globe and Mail, have also written many stories, some highlighting potential issues that were only politely alluded to in official reports. The present paper draws information and illustrations from all these sources, as referenced.

Housing prices have been increasing since the late 1990s, and were given a boost in 2006-2007 as CMHC loosened up progressively the conditions attached to mortgage insurance. This loosening up, well documented in the IMF study, meant that mortgage lenders (mostly banks) could now loan 100% of the purchase price of a home over 40 years and in some cases with interest-only payments for up to 10 years and still get their risk covered by having the mortgage insured by CMHC – i.e. the government. Needless to say, this brought many marginal buyers to the market, buyers who had not had the means to enter the market earlier. The additional demand pushed up prices further and residential investments, as a percentage of total economic activity, reached a high of 7%[2], well above historical average. Note that by that time the US decline had already started (*Graph: IMF*).

Residential investment is way above its historical average...

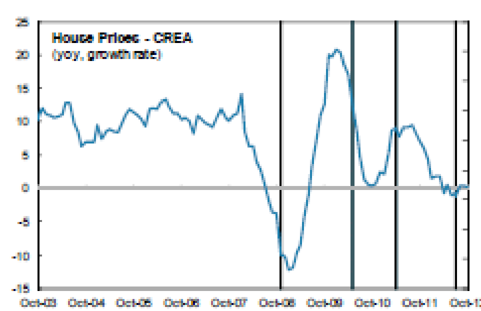


Households' equity in real estate has declined over the past few years.



At the same time, these new conditions facilitated the marketing of 'Home Equity Lines of Credit' (borrowings secured by real estate) and mortgage refinancing where the size of the mortgage was increased. Protected by CMHC insurance, lenders were keen to promote the withdrawal of equity to finance consumption, renovations or other investments. From 2007 to 2012, owner's equity in Canada decreased from 71% to 67%[1] (*Graph: IMF*).

After a brief lull in demand following the 2008 crisis, much lower mortgage rates rekindled home purchases. Increasing prices justified further equity withdrawals, likely partly to compensate for diminished purchasing power after the crisis. The Bank of Canada estimates that equity withdrawals over the last 10 years have averaged 60 billion per year, or about 5% of total consumer spending, a large amount that has been key to funding the Canadian recovery after the crisis.



The 2008 crisis made obvious that the loose lending parameters used by CMHC had to be tightened, and in four rounds of tightening the government completely reversed the actions allowed in 2006-2007. While the first two had only limited effects, the third and fourth (July 2012) seem to have slowed the growth of housing prices and in some areas prices have slightly declined (*Right hand graph, showing the change in the rate of growth of house prices since 2003: about +10% a year till 2008, variable after - IMF*[3]).

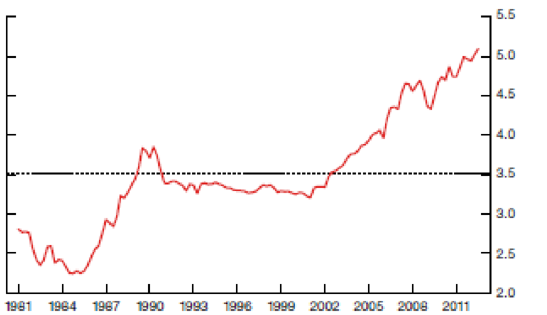
Where the market will go from here is uncertain. Some believe that after the current pause buying will resume and prices will move up again. This however would only increase the size of the current imbalances, imbalances that will have to be corrected eventually. Others are not so sure. They point to the high level of consumer indebtedness and believe housing demand is now bound to decline, which will lower prices.

The Canadian housing market - 2013.

The activity of the past 10-15 years has left us with:

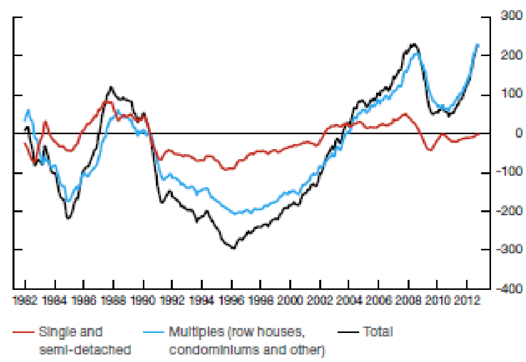
- housing prices overvalued by about 10% as per the IMF, 15% or more as per others;
- consumer debt at an unusually high level (latest: 163% of disposable income – see graph page 1);
- unsold housing built or being built (construction exceeds household formation – see especially IMF[3]);
- an expanded construction sector (*Graphs: Bank of Canada[4], Globe & Mail[5]*).

Chart 22: House prices in Canada are still high relative to disposable income...
House-price-to-income ratio

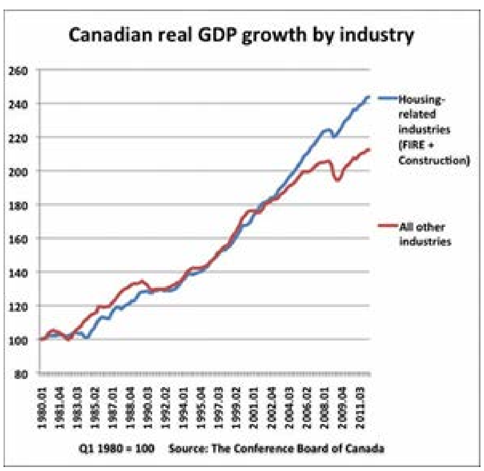


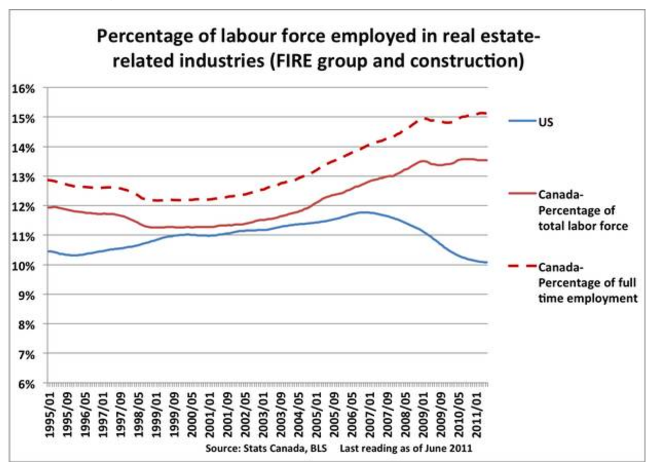
Note: The broken line indicates the historical average from 1981 to the present.
Sources: Teranet-National Bank, Statistics Canada, Canadian Real Estate Association and Bank of Canada calculations
Last observation: 2012Q3

Chart 24: The supply of multiple-unit dwellings under construction is significantly above its historical average
Deviation from historical average, per 100,000 people (aged 25+ years), major metropolitan areas



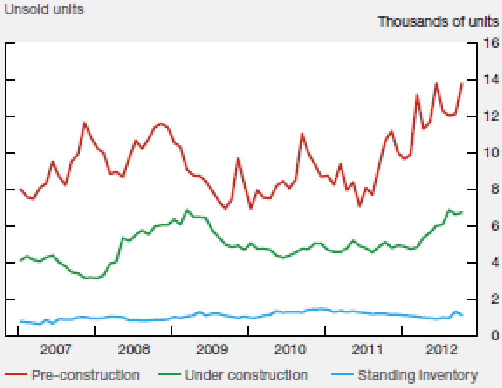
Sources: Canada Mortgage and Housing Corporation, Statistics Canada, and Bank of Canada calculations
Last observation: October 2012





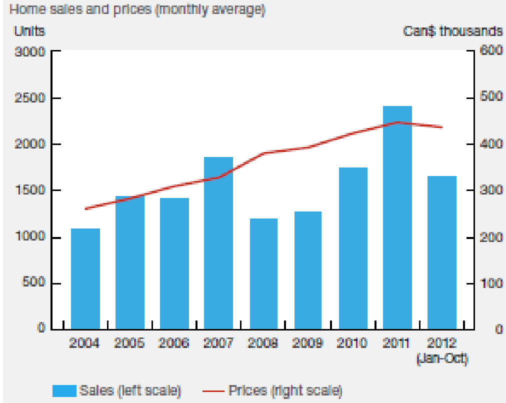
Specifically in Toronto:

Chart 3-A: There is an increasing number of unsold high-rise units in the pre-construction stage and under construction...
Unsold units



Source: RealNet Canada Inc. Last observation: October 2012

Chart 3-B: ...while prices for high-rise units are flattening and sales are declining
Home sales and prices (monthly average)

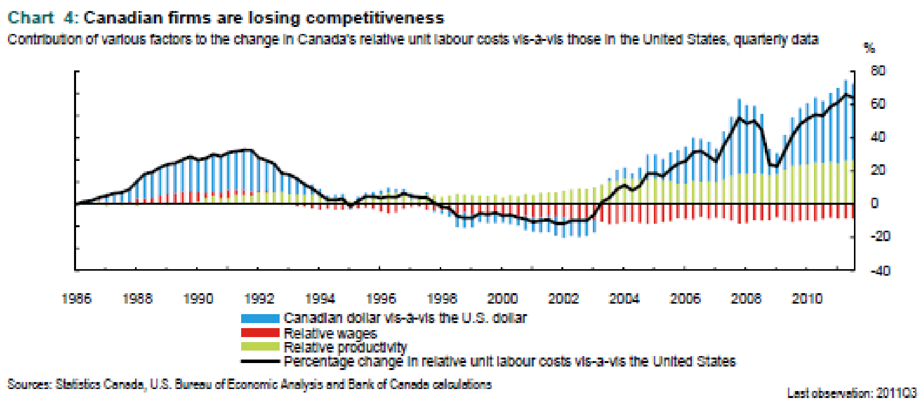


Source: RealNet Canada Inc. Last observation: October 2012

The hope of a soft landing, or a soft undoing of these imbalances, resides in an orderly slow decline in house prices, an absence of panic from speculative buyers (especially condominium buyers), a slow retrenchment of households consumption to reduce their debts, and to compensate for the decreased economic activity of households and of the construction industry (which will raise unemployment) an increase in Canadian exports to pick up the slack.

The need for additional exports has been mentioned by both the Bank of Canada and the IMF. However 75% of our exports go to the US, and how strong the US recovery will become is uncertain given their budgetary issues. Another 12% of exports go to other developed countries, mostly Europe and Japan where demand is weak and exports are also seen as a potential salvation. Only the remaining 13% go to emerging countries where the rate of growth over the last few years has been markedly higher than for developed countries.

Finally, Canada's export competitiveness is being hindered by the strength of its currency, mostly related to the increase in energy exports (*Graph: Bank of Canada*[6]):



This does not affect exports of raw materials and energy which are priced in US$ and account for about 55% of total exports (oil accounts for 46% of these exports in value). However, an increase in commodities exports may have only a limited impact on unemployment.

To conclude

Overall, it seems that housing activity has begun to decline, although a further rebound while ultimately unsustainable is still possible. Hopefully this decline will be orderly and increase only slowly the pressure on demand and employment that declining household spending and reduced construction activity would cause. That a sufficient increase in exports will materialize to pick up the slack in the economy depends on factors Canada has no control upon: mostly a stronger recovery in the US.

Our biggest vulnerability might be the high level of indebtedness of Canadians. Another crisis in Europe or a recession in the US could reduce exports and affect the funding of our financial system, leading to higher unemployment, tightened lending conditions, declining economic activity and in turn additional unemployment and losses from overleveraged borrowers. A similar scenario could play out should housing prices decline abruptly: loss of confidence, reduced economic activity, increase in unemployment, etc. This last scenario would be 'preferable' as it would leave our export potential intact.

The silver lining is that the Federal government has the financial room necessary to intervene forcefully in the markets should financial conditions tighten excessively, and should they desire to do so. It would postpone the balancing of the budget, but faced with a crisis there might be little choice.

J-Dominique Sellier
February 27, 2013

[1] Bank of Canada, Regearing Our Economic Growth, January 10, 2013,
[2] IMF, 2012 Article IV consultation, Staff Report, February 2013
[3] IMF, 2012 Article IV consultation, Selected issues, February 2013
[4] Bank of Canada, Financial System Review, December 2012
[5] Globe & Mail, Why a 'soft landing' for housing could still hurt the economy, February 12, 2013
[6] Bank of Canada, The Evolution of Canada's Global Export market Share, October 2012