Are Canadians mistaking home equity with wealth?

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As we brace for a housing slowdown, it is a fitting time to ask how the prolonged upward surge in housing prices has affected Canadian homeowners. The answer is, for the most part, not much.

The general view is that those fortunate enough to have ridden the uptrend in the housing market have reaped a huge windfall. My friends, Vic and Amy, for example, are the proud owners of a charming two-storey, three-bedroom house they purchased in midtown Toronto about 10 years ago. They are happy to guide guests through the living room with its large wood-burning fireplace, up to their impressive master bedroom and out onto the deck overlooking their carefully tended garden. But what excites them more than showing off their home is calculating the wealth they have accumulated as a result of the approximate doubling in the value of their property. They are not unique. Across Canada, house prices increased 109 per cent from 2000 to 2011, according to the Teranet-National Bank composite index of 11 main cities. A survey by Environics Analytics found that between 2006 and 2011 the net worth of Canadian households rose from $330,000 to $363,000, with almost all of this accounted for by the increase in housing equity.

The problem is that these figures only tell part of the story. What is left out is the impact of rising house prices on the costs Canadians must pay for shelter services. This cost, which for owners who occupy their homes is essentially the rent they forego by living in their dwelling rather than renting it out, increases as housing prices rise. In tandem with the increase in house prices, households experience a rise in the cost they incur over time for housing services.

Families that are settled in their own home are protected from this growing liability; with the gains that come from the appreciation of their residence, they will be compensated for the increase in shelter costs they must incur now and in the future as a consequence of the rise in housing prices.

Homeowners who have all the housing they require are therefore no worse off. But, contrary to general perceptions, neither are they better off. Unlike gains made in the stock market, the gains that Vic and Amy and other long-time homeowners have made from exceptionally strong real estate markets are not a windfall that can be used to support a more lavish lifestyle.

While those that have satisfied their housing needs are little affected, rising housing prices do create winners and losers. The winners include real estate investors and speculators, and elderly households that require more modest shelter accommodations than in the past and can partially cash in their gains. The losers consist of young families that have bought a house recently or have not yet purchased a residence, along with those who are in a starter home and hope to acquire a larger residence that better meets their family needs. The increased costs of home ownership for young Canadians who are already facing significant challenges because of a difficult job market and earnings prospects that are dimmer than those of their parents' generation is one of the more unfortunate consequences of the run-up in housing prices.

Although the economic circumstances of most households have not changed, a strong housing market has encouraged Canadians to spend more. The evidence is mixed on whether this is partly due to homeowners' mistaken belief that, as a result of increasing housing wealth, they are better off financially or whether it is simply because increases in home equity have made it easier for households to borrow the money needed to finance their purchases. It is clear, however, that, along with low interest rates, rising home prices have been a factor underlying the growth in spending and the unsettling rise in Canadian household indebtedness.

What does all this mean for the coming period of expected falling house prices? A slowing in housing activity and a reduction in spending by households that need to adjust to a decline in housing wealth are not welcome developments for a country trying to re-ignite its economy. These effects will impact, directly or indirectly, on all Canadians. But, in themselves, lower prices are clearly good news for prospective buyers and those looking to increase their housing. At the same time, the vast majority of homeowners who are not leveraged to the point where a drop in housing prices could lead to a risk of default can draw encouragement from past experience. Just as rising home prices do not lead to an improvement in living standards, falling prices do not translate into a loss of economic well-being. So, if you are an owner that's settled in your home and not needing to cash out, hold on, sit back and relax as the Canadian housing roller coaster rounds its peak.