Sure, study the market, but interest rates are central to the housing boom

By Alex Sloat
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There's been a lot of talk lately about the market for housing in Toronto and Vancouver. People say it's a bubble, they say that it's unsustainable, they say it's foreign investors buying up lots of property. Thursday morning, federal Finance Minister Bill Morneau announced a study group to look into the issue in depth.

I certainly approve of the government looking into this issue, but I hope they look at some factors that are usually omitted from this discussion. Most importantly, the role that interest rates play is a huge and underappreciated factor in the housing boom. Too many observers make the fundamental mistake of ignoring this. They look at the cost of homes, but very few people open their wallets and pay the cost of the home – they pay their mortgage.

The limiting factor on how much mortgage you can afford, and on how much you can get the bank to give you, isn't the face value of the home but the monthly payment. A substantial portion of the monthly payment is interest, and interest rates are at historic lows. That means that for any given payment, more goes to the principal, and thus the face value can be higher without making the home less affordable.

In 1993, my parents bought a house and got the bargain rate of 8.95 per cent on their mortgage. Today, you can quite reasonably get a mortgage at 2.49 per cent. That cuts the price of a standard 25-year mortgage almost in half. Canadians are also significantly better off than they were then – adjusting for inflation, median family household income was $64,200 in 1993 and $74,740 in 2013 (the most recent year available), which naturally means that people can afford more expensive homes.

Combine these two factors and you'd expect an average home's price to have gone up 115 per cent since 1993, over and above inflation. In Toronto, where I practise, you could get an average home for an inflation-adjusted $310,946 in 1993, while it'd cost you $666,300 last month. That's an increase of 114 per cent.

In other words, it's just as easy for the average Toronto family to afford today's average mortgage payment as it was when my parents bought almost a quarter of a century ago. This isn't an unsustainable market or a wave of Chinese investors pricing Canadians out of their homes. It's exactly what you'd expect to see in a healthy housing market. The law of supply and demand is still in effect, and more demand will bid up prices if all else is equal. But the large amount of new construction we've been seeing seems to have kept up with increased demand over the long term.

There are, admittedly, some complications to this. First, down payments get harder to put together as the face values of homes go up. That does genuinely make it more difficult for new homeowners to afford a first home, and I've seen clients struggle with this. Likewise, land transfer taxes and the taxes on Canada Mortgage and Housing Corp. fees go up as well, increasing a buyer's costs.

Second, what the Bank of Canada giveth, the Bank of Canada can taketh away. If interest rates ever go up significantly, we'd expect prices to fall, just like prices have risen as rates fell. That could leave homeowners with major losses on their most valuable asset. On top of that, a lot of people will be faced with mortgages that they would have difficulty paying when you combine our current high prices with possible high rates in the future, and house-heavy retirement plans might be imperilled.

Third, it's looking like there's a bubble in people's minds, even if prices still seem generally in line with fundamentals. Rates haven't dropped much in the last few years, but prices keep increasing quickly, and the swarms of offers that sellers routinely get are pointing to a very hot market. Human psychology being what it is, this might easily create a self-sustaining feedback loop that drives prices well beyond fundamentals, as happened in the United States a decade ago – and the eventual crash could hurt.

Finally, simple geography imposes its own limits. There's not enough land in Toronto or Vancouver to build a detached house for every family that wants one, so those that exist are a hot commodity. A lot of people are buying starter condos, when 50 years ago they'd have bought starter houses.

On the whole, it's about as easy for ordinary Canadians to afford a home today as it was in the past. That's not to say it's a breeze – plenty of people borrow from their parents to get a down payment, although we forget that plenty of people had to do that in previous decades, too. But when you stop looking at the easy number (home prices) and start looking at the meaningful number (mortgage payments), the narrative of foreigners bidding up property to unsustainable prices doesn't hold up.

I hope Mr. Morneau and his colleagues give this data the consideration it deserves, and don't simply bow to the political pressure of a popular but inaccurate narrative. Let's not be so quick to blame outsiders that we forget what Ottawa's doing.

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