Why Toronto's price shock is Canada's problem

Real estate figures in the country's largest city are at red-hot levels, and the rest of Canada will ultimately have to pay for it

By Barrie McKenna and David Parkinson
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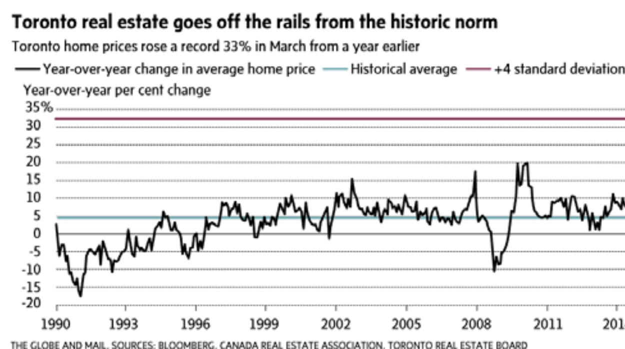
Desmond Brown has been buying and selling real estate in Toronto for 19 years. In all that time, he has never seen a market like this.

It's hot enough to melt ice. In October, he sold a unit in a townhouse complex in a traditionally working-class neighbourhood a few kilometres northwest of the downtown core for $586,000. Last month, he sold a virtually identical unit for $765,000 – a 30-per-cent price jump in just a few months.

"This January, February and March, we've seen numbers like we've never seen before, and especially for a winter," said Mr. Brown, a sales representative for Royal LePage Estate Realty. "All of us are blown away."

"I'm not sure what people are doing, why the prices are going wild. Are people feeling that they have to buy today, in fears that prices are going to go up even higher tomorrow?"

For nearly a decade, policy makers and economists have fretted about the rise of Canada's housing market. Initially, it was a generalized concern about most large cities. Then, the focus shifted to Vancouver and the influx of Chinese buyers. Gradually these anxieties faded away. The oil price shock killed the Alberta boom. Even Vancouver's market has cooled, thanks in part to a tax that penalizes foreign buyers, although it remains one of the priciest real estate markets in the world.



That has left Toronto – and a cluster of red-hot cities around Ontario's Golden Horseshoe – alone at the centre of the national housing obsession. It's here that experts and government officials worry most about the consequences of a possible bubble and its aftermath.

Anything that threatens Toronto's economy would have radiating effects across the country – on wealth, consumption, job creation, interest rates and even the dollar. Toronto's real estate problem is rapidly becoming Canada's problem. The seriousness of the threat has ratcheted up several degrees: Toronto is a different beast, by virtue of its size and role in the national economy. The reverberations from a bubble here would be felt far beyond the shadow of the CN Tower. A crash in Vancouver or Calgary would have been bad, but nothing like one in the country's largest city:

"If it crashed, it's big enough to have a national effect," warns economist and former top federal Finance official Don Drummond, now an adjunct professor at Queen's University. "It is a national problem, in the sense that a retrenchment and a default on mortgages would definitely have national implications."

"If you look what happened with Calgary when oil prices fell, it was almost enough to cause negative growth [nationally] for two quarters. You could see Toronto being even greater,

given the sheer size," says Jeremy Kronick, senior policy analyst at the C.D. Howe Institute, a Toronto-based economic think tank. "Toronto is such a big city, and Ontario is such a big province, that it's hard to see no spillover effects."

The Greater Toronto Area is home to more than a fifth of Canadians and a similar share of the country's wealth. The area's economic output – $330-billion in 2013 – is roughly equal to the entire province of Alberta and narrowly behind Quebec, according to Statistics Canada. Its economy is bigger than the economies of Newfoundland, Nova Scotia, New Brunswick, Prince Edward Island, Manitoba and Saskatchewan combined. It is home to five of the country's Big Six banks, the hub of the manufacturing base and home to more head offices than any other Canadian city.

That explains why this week, federal Finance Minister Bill Morneau called for an urgent meeting with his Ontario counterpart, Charles Sousa, and Toronto Mayor John Tory. In a letter, Mr. Morneau cited the "problematic conditions" in the GTA and said it's time to "take stock of its implications for our largest urban area."

The appeal comes amid signs of stress, not just in greater Toronto, where the average selling price in March of $917,000 was up 33 per cent from a year ago., but in a clutch of satellite cities that feed off the GTA economy. Gains exceeded 20 per cent in cities such as Hamilton, Kitchener-Waterloo, Barrie and Peterborough. The frenzy has even spread as far as the once-depressed markets of Windsor and London, where prices are similarly running 20 per cent above last year's levels.

"What's really changed in the past year is that not only are we seeing detached homes going up at a very fast pace, but now we are also seeing the condo market booming," says Craig Alexander, chief economist at the Conference Board of Canada. "The narrative changed – from rational to irrational gains. There are now bubble-like qualities to the market."

The primary problem is affordability, and the excessive debt loads that a growing number of homeowners are taking on in these overheated markets.

Speaking to reporters last month after a speech in Oshawa, Ont. – an industrial hub east of Toronto that has evolved into a bedroom community for the city with its own soaring real estate prices – Bank of Canada governor Stephen Poloz acknowledged that speculation is becoming a problem in the Toronto region as the real estate market becomes disconnected from economic fundamentals, such as job growth, immigration and family formation.

"If people are buying homes purely on the expectation that their prices are going to rise further, then that's not fundamental demand," Mr. Poloz explained. "And it's the sort of riskier type of transaction in a market that can go down, as well as up."

The Bank of Canada highlighted the GTA problem in its most recent Financial System Review, issued in December. In the report, the central bank acknowledged that Toronto is now a bigger concern than Vancouver and, most worryingly, much more heavily indebted.

"This was a very important signal of how important the Toronto housing market had become to the setting of interest-rate policy," says Frances Donald, senior economist at Manulife Asset Management in Toronto. "It was the first time the Bank of Canada identified Toronto as the largest housing-market problem."

The implication is that the central bank's decision-making on interest rates is now coloured by what's happening in Toronto. Raise interest rates and you might pop the bubble, while at the same time raising borrowing costs for everyone and putting upward pressure on the Canadian dollar. Lower them in an effort to stimulate the economy, and you encourage consumers to

take on even more mortgage debt and risk even more overheating.

"The Toronto real estate market is probably one of the reasons you have a long hold on the current [Bank of Canada] interest rate," Ms. Donald argues. "You can't apply regional interest rates. So the Toronto housing market is helping to dictate monetary policy being applied in places like Saskatchewan and Nova Scotia."

For the Bank of Canada, a housing correction tops its list of risks facing the financial system. The central bank has warned that a sharp rise in unemployment could set off a series of unfortunate events, including a house-price correction that would be particularly severe in the Toronto and Vancouver. That would trigger a spike in mortgage defaults, putting pressure on lenders and mortgage insurers and eventually affect all borrowers through higher interest rates.

Toronto's pain would be felt across the country – just as the oil shock reverberated well beyond the oil patch. Like Mr. Brown, the real estate agent, roughly 15 per cent of Ontarians work in sectors tied to real estate, including construction, finance and insurance. There would also be a wealth effect, as lower prices reduce consumers' net worth and weigh on their buying power.

Much of the risk lies in the huge amounts of debt that home buyers have been taking on as already expensive prices have soared to dizzying heights. Canada's ratio of household debt to disposable income, the key yardstick for the debt burden that homeowners are shouldering, is a record 167 per cent, and the Bank of Canada has been warning for some time about the rising number of people at the extreme end of this measure – those with mortgage-to-income levels north of 450 per cent. The bank's Financial System Review identified the Toronto region as the epicentre of this growing debt problem, even showing a "heat map" to visually illustrate how the prevalence of these highly indebted homes has dramatically spread and multiplied over the past couple of years.

Central-bank policy is not the only way Toronto and Vancouver are infecting the rest of the country. Ottawa has moved multiple times since 2008 to cool excessive mortgage lending, most recently by tightening the rules for obtaining mortgage insurance and closer oversight of mortgage approvals.

Remember that most of the country doesn't have a real estate problem. With the exception of the greater Toronto and Vancouver areas, prices are either falling or rising modestly. That means that all Canadians are paying the price for pockets of overheating through policies that make it tougher to get mortgages and limit house-price appreciation.

"You really do have two separate real estate markets in Canada," points out Mr. Drummond of Queen's University. "There are the Toronto and Vancouver areas, and everything else is reasonably balanced."

But the Metropolitan Toronto market is such a huge part of the Canadian economy that its successes, and risks, carry special significance in the national economic picture – especially since the crash in oil prices took the wind out of resource-driven regions of the country. Toronto has been responsible for nearly half the country's employment growth over the past two years. The Conference Board of Canada estimated that Toronto's economy expanded by a brisk 3.4 per cent last year – implying that it accounted for nearly half of the entire country's 1.4-per-cent growth in real GDP in 2016. The housing boom played a big part in that success, fuelling strong growth in construction, real estate services and the financial sector, as well as wealth-effect gains in consumer spending.

A sharp correction to those runaway prices would similarly reverse the impact on growth, turning an economic engine into a drag. The Bank of Canada has been projecting that the housing sector will subtract from overall gross

domestic product this year, solely on expectations that tighter mortgage-lending rules put in place by Ottawa last fall would temper the key Toronto and Vancouver markets.

But that would be just the tip of the iceberg if the Toronto region were hit by the kind of downturn that the Bank of Canada and some economists fear, where an economic shock triggers the tumbling of the dominoes of the housing and debt excesses.

"I think the big question is whether a meaningful correction in home prices morphs into a default experience and becomes a financial event," says David Rosenberg, chief economist at Gluskin Sheff + Associates Inc., who was one of the first Wall Street economists to foresee last decade's U.S. housing meltdown that triggered the Great Recession in 2008. "That's where the second-round impact comes into the economy."

The rising debt burdens have left a growing number of mortgage holders at elevated risk of slipping into default if an economic shock were to put them out of work, or if interest rates were to rise significantly, pushing up the costs of their monthly mortgage payments, or if a price correction left them holding mortgages bigger than the market value of their homes.

That sort of spillover could weigh on the country's financial industry, which employs roughly a quarter-million Torontonians and is a major driver of the region's economy. The big banks are generally comfortable that their loan books could weather a housing correction, noting that their loan-to-value ratios in the neighbourhood of a healthy 50 per cent, and roughly half of their portfolios are insured. The portfolios are regularly stress-tested, and direct losses on mortgages would likely be modest.

"I think our adjudication practices have stood the test of time through multiple cycles," said Dave McKay, chief executive officer at Royal Bank of Canada, after the bank's annual meeting on Thursday.

But bank executives' bigger concern is about the potential for a broader economic slowdown. If there were to be a housing-market crash, coupled with higher unemployment, the impact could leak over into auto loans and credit-card loans, which could lead to higher losses on those portfolios.

There may be some lessons to be taken from the last time Toronto experienced a housing collapse. Some current homeowners are old enough to have gone through 1989 – when housing prices that had been riding years of 20-per-cent-plus annual increases took a precipitous fall, followed by a national recession. The economy bounced back, but the market spent the next decade in the wilderness, before prices finally began to recover their losses.

But economists are quick to note that Toronto's 1989 housing collapse was triggered by a sharp increase in interest rates by the Bank of Canada, which was trying to snuff out surging inflation. While there is talk today of the potential for small rate increases starting next year, inflation is decidedly tame and a repeat of the late 1980s looks highly unlikely.

"The good news, if you're concerned about the economy, is that the Bank of Canada seems to have no intention of raising interest rates," Mr. Rosenberg says. Still, he knows from experience that the economic fallout from housing corrections can be messy and unpredictable.

"I've never seen a bubble burst that was contained; I've never seen it operate smoothly," he says. "The transition will be tough."