Bad policy has played a role in Canada's housing crisis

By Kevin Bryan, Joshua Gottlieb and Joseph Steinberg
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Popular discussions about Canada's housing market focus on affordability. This is indeed a problem – home prices in Toronto and Vancouver have grown much faster than incomes. But, as the recent trouble at Home Capital Group has highlighted, the price boom in these regions poses dangers beyond affordability.

First, some basic facts. Since 2010, nominal house prices have nearly doubled in both the Toronto and Vancouver metro areas, two regions that account for nearly half of Canada's residential housing value. In contrast, rent growth has been restrained, with nominal two-bedroom rents up less than 15 per cent in both regions since 2010. Nor are these regions experiencing a population boom, with both cities growing only slightly faster than Canada as a whole since 2011, and both growing much more slowly than during the 1990s and 2000s.

Housing prices and rents normally increase together when demand rises faster than supply can respond. In cities such as San Francisco, a booming economy combined with restrictive construction laws has led to large increases in both rents and prices. In Canada, prices have skyrocketed but rents have not. This can happen when interest rates fall, housing subsidies increase or expected capital gains are high. Although mortgage rates have declined in recent years, academic research suggests that they have not declined enough to explain the dramatic price growth we have seen. With housing subsidies relatively constant, this points to expected price growth as the key factor.

When buyers expect house values to increase rapidly, they prefer buying at a high price to renting at a relatively low one and investing their savings elsewhere. Is this optimism rational? An elevated ratio of house prices to rents historically predicts falling rather than increasing prices. These declines can be large even in globally attractive cities. Prices fell 40 per cent in Los Angeles and more than 50 per cent in Japan in the early 1990s, 25 per cent in Stockholm after 1989, 25 per cent in Boston and 51 per cent in Miami in the late 2000s, 38 per cent in Singapore after 1996, more than 50 per cent in Hong Kong after both 1981 and 1997, and more than 40 per cent in Amsterdam in the early 1980s. Indeed, they fell more than 40 per cent in Toronto between 1989 and 1996. In each case, real house prices did not recover for 10 to 30 years.

Changes in expectations are extremely difficult to predict, hence predicting the timing of rapid house-price increases or decreases in Canada is nearly impossible. That said, artificially high current prices and potential future declines both pose serious problems for the Canadian economy.

Elevated house prices delay family formation among young people, make it hard for firms to recruit, and increase nationwide inequality by inhibiting workers from moving from low-cost, low-wage regions to higher-wage cities. They divert capital from productive uses to the housing sector: The lending portfolio of Canadian banks is now much more reliant on residential housing than it has been historically.

Falling home prices would likewise affect more than just homeowners. Declining construction and real estate activity directly affects the economy since, for example, more than 30 per cent of British Columbia's GDP is in those sectors. Indirectly, when house prices decline, homeowners stop borrowing against their house and start saving elsewhere, lowering total consumption. Though subprime lending is not at the level of the United States in the mid-2000s, Canadian housing finance has its own uniquely worrying features: the lack of long-term fixed-rate mortgages, precarious alternative lenders such as the beleaguered Home Capital, a reliance on foreign investment and taxpayers' extensive backstopping of mortgages through Canada Mortgage and Housing Corp.

So what can be done? In the short run, there is no magic bullet to stabilize housing markets without substantial risk to highly indebted households and exposed industries. That said, public access to real estate data, clear public statements about housing market risks, such as Bank of Canada Governor Stephen Poloz's recent speech, and Australia-style collection of data on foreign housing investments can help manage buyer and investor expectations about the returns to ownership.

In both the short and long run, governments should avoid ill-considered policies that counterproductively prolong price booms and increase price volatility. We ought to remove existing distortions such as favourable treatment of capital gains on real estate, provincial ownership subsidies, taxpayer-guaranteed mortgages, low residential property taxes and restrictive zoning. These policies encourage businesses and individuals to focus on real estate instead of other economic activity, exacerbate price volatility and fail to improve affordability. What better time to cut back these subsidies than when the market is soaring of its own accord and does not need artificial support?

If price growth were supported by strong fundamentals, we would not be as alarmed about Canada's housing market situation. But current prices, especially in Toronto and Vancouver, instead seem to be propped up by optimism and counterproductive policies. These high prices are already harming Canadians, and the longer we delay necessary reforms the more serious the consequences of a decline would be. Government policy makers need to take these risks, and their policies' contribution to them, much more seriously.

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