The one housing-market fix that Canada hasn't tried

By David Parkinson
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The Organization for Economic Co-operation and Development has come right out and said it: A lot of Canada's housing-market fever could be treated with an injection of higher interest rates.

If the international economic-policy body's new economic forecast is on target, it may get its remedy soon enough – even if the Bank of Canada isn't sold on the OECD's housing prescription.

In its semi-annual Global Economic Outlook, released Wednesday, the OECD increased its calls for Canadian policy makers to address the housing excesses in the key Toronto and Vancouver regions. After observing a spring in which the huge Toronto housing market soared to dizzying heights, propelling the economic and policy rhetoric along with it, it seems the OECD had seen enough.

It questioned the longer-term efficacy of the foreign-buyers taxes imposed in recent months in Vancouver and Toronto. It fretted about Ontario's expansion of rent controls, saying they could choke off new rental supplies and hamper poor and young Canadians. It called for tougher debt-to-income requirements for mortgage borrowers specifically targeted at "regions where house prices are inflated relative to fundamentals."

But the real attention-getter was what it had to say about the prospect for higher interest rates from the Bank of Canada.

"Raising interest rates will reduce overheating in housing markets, which poses economic and financial stability risks and has made housing increasingly unaffordable, especially in Toronto and Vancouver," the report said.

This isn't the first time the OECD has drawn a link between Canada's low interest rates and its surging regional housing prices and high household debts. But never before had it so strongly and clearly championed higher rates as a big part of the solution to Canada's housing excesses. In its previous economic outlooks and quarterly updates over the past year or so, it has largely agreed with the Bank of Canada's current low-rate policy stance, citing (as the central bank has) the evidence of tame inflation and significant excess capacity in the economy.

The OECD's position up until now has been an implicit agreement with the Bank of Canada's consistent argument that higher interest rates are not the right tool to address regional housing problems. Higher rates apply the brakes to a wide swath of economic activity and in all sectors and parts of the country, reaching far beyond one specific industry in a couple of specific regions. The central bank has instead been reserving interest rates to deal with a broader, inflation-fuelling acceleration of the economy – something that it wasn't seeing in Canada's economic data.

Until now, neither was the OECD. But the organization's economic outlook for Canada is suddenly much hotter than it used to be – hot enough, in fact, to have put a rate hike on the radar for economic reasons alone.

The OECD's new forecast calls for Canada's real gross domestic product to expand by 2.8 per cent this year. That's up sharply from 2.4 per cent in the agency's forecast update just three months ago, and from 2.1 per cent in its last full economic outlook in November.

It should be noted that the OECD is positioning itself at the bullish end of forecasters; even after last week's strong Canadian first-quarter GDP report, which showed that the economy grew at an annualized pace of 3.7 per cent in the first three months of the year, most prominent private-sector economists were still looking at growth of about 2.5 per cent for all of 2017. The Bank of Canada's own quarterly forecast, issued in April, called for 2.6-per-cent growth this year.

But if the OECD's optimism is founded, then the economy will eat up its excess capacity faster than previously anticipated – which is precisely what would compel the Bank of Canada to raise interest rates sooner rather than later. The housing sector would feel the effects of such a move, but needn't be the impetus for it.

Indeed, the OECD projected that the Bank of Canada will need to start raising rates "towards the end of 2017" – anywhere from three to six months ahead of where most other forecasters put the first rate hike. If it's right, we're only a few months away from a splash of cold water on the Toronto and Vancouver housing markets.

Is the Bank of Canada seeing the same thing? Frankly, we don't really know; in a fast-evolving economy, quarterly projections can feel very far apart. But we might have a better idea in fairly short order.

On Thursday, the central bank releases its semi-annual Financial System Review. That report will not only detail the bank's analysis of the housing market, but will be followed by a press conference in which Bank of Canada Governor Stephen Poloz will face questions from the media – some of which will surely touch on his current assessment of the economy. Next Monday, Mr. Poloz's second-in-command, senior deputy governor Carolyn Wilkins, will give a speech in Winnipeg, the title of which is Canadian Economic Update: Strength in Diversity. Those two events should shed at least a little light on the bank's next quarterly economic forecasts, which come out a little over a month from now, on July 12.

But if there's a takeaway from the OECD's report, it's that the economy's acceleration has now put a rate increase in sight. And that means that its timing may actually be close to becoming part of the housing discussion, even for officials at the Bank of Canada. It's no longer inconsistent with the direction the economy is taking the interest-rate outlook anyway.