

## **Timothy Lane: Canada's housing sector in recession and recovery – beyond bricks and mortar**

Remarks by Mr David Wolf, Adviser at the Bank of Canada, on behalf of Mr Timothy Lane, Deputy Governor of the Bank of Canada, at the Edmonton Chartered Financial Analyst (CFA) Society, Edmonton, 11 January 2010.

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Good afternoon, thank you for inviting me to speak with you today. The beginning of a new year is a good time for reflection – a chance to look back over the past 12 months and consider what may lie ahead. Certainly, 2009 saw remarkable economic and financial upheaval around the world, which plunged Canada into a severe recession. A global recovery has begun, however, and as we look ahead, we can be confident that this recovery will become more deeply entrenched as the year progresses.

Today, I will discuss some trends in the Canadian economy, focusing on a particularly important sector: housing. The strengthening of the housing market – especially in the resale market – over the past few months has been striking.

Housing is of considerable interest to the Bank of Canada, from two perspectives. First, it is important to consider the housing market when formulating monetary policy. The housing sector is a crucial part of the Canadian economy, and it typically plays a disproportionate role in economic cycles. Housing wealth provides collateral for household borrowing and spending. Increases in the cost of housing are an important element in consumer price inflation, and demand for housing is a gauge of household confidence. The housing market is also very sensitive to changes in interest rates, so it can provide an important channel through which monetary policy may influence the economy.

Second, experience shows that increases and collapses in house prices have been driving forces behind bouts of financial instability in many countries. Because the purchase of a home is the most significant reason for household borrowing, housing looms large on the balance sheets of both homeowners and financial institutions. This nexus between financial system stability and the housing sector has been vividly illustrated by the developments in the U.S. housing market over the past two years. The painful correction in the U.S. housing sector was at the root of that country's financial system turmoil that started in August 2007 and then spread around the world, triggering the global recession.

Canada has been spared such drama, both in this recession and in recent history, and this has drawn much international interest. Therefore, it's important to understand the policies affecting the housing market, and then to work to strengthen and preserve the stabilizing aspects of our system.

In my remarks today, I intend to review the implications of housing for both monetary policy and financial stability. I will begin by providing some context through a brief overview of the economic outlook for the world and for Canada. Then, I will review in more detail how Canada's housing market has managed so well through the global crisis and some of the challenges it faces in the recovery. I will also explain how we at the Bank of Canada factor developments in the housing market into our policy decisions.

### **The Canadian economy – looking back and looking forward**

The world economy was on a roller-coaster ride in 2009. It began the year in near free fall, plunging into a deep and synchronous global recession triggered by the worldwide financial crisis. While Canada fared better than many countries through the crisis, we did feel the effects through trade, confidence, and financial channels.

Aggressive, coordinated policy actions were taken in many countries to combat the crisis. These included significant measures to support financial systems, substantial fiscal stimulus, and monetary policy easing that took interest rates in all of the major advanced economies to historically low levels.

Canada played an active role in this global policy response. While we did not need to bail out our financial institutions, fiscal and monetary policies were applied vigorously. Guided by the 2 per cent target for inflation, the Bank of Canada pushed its overnight interest rate essentially to the floor – that is, to the effective lower bound of 25 basis points. We also set out a framework for unconventional policies that could be used to provide further stimulus if needed. We implemented one element of this framework – our commitment to hold rates at the effective lower bound until the end of the second quarter of 2010, conditional on the outlook for inflation – while stressing that other unconventional policies were available if needed.

The worldwide effort provided the impetus for the global recovery that began to take hold in the middle of 2009. The Bank of Canada's October *Monetary Policy Report* pointed to the start of the recovery, and the global outlook has improved modestly since then. However, significant fragilities remain, since the recovery is still heavily dependent on government support, and sustained growth driven by the private sector has yet to materialize.

Canada's economic recovery started in the third quarter of 2009, although it was weaker than had been anticipated in the October *Monetary Policy Report*. This recovery has been supported by monetary and fiscal stimulus, increased household wealth, improving financial conditions, stronger business and consumer confidence, the beginning of the recovery in the global economy, and a strengthening in the terms of trade. At the same time, the weakness of the recovery in the U.S. economy and the persistent strength of the Canadian dollar have exerted a drag on Canada's growth. The balance of these factors has tended to shift the composition of aggregate demand towards growth in Canada's domestic demand and away from net exports.

Overall, we continue to believe that Canada's recovery is likely to be more gradual than in previous cycles. While inflation is now below the 2 per cent target, the Bank expects that it will return to that target as the economy returns to potential.

### **Canada's housing market – recent developments**

From the outlook for the overall Canadian economy, let me now narrow my focus to the housing sector. First, a bit of recent history. As you know, Canadian housing activity dropped off sharply during 2008 and early 2009 as a result of the global recession. Turnover in resale markets dropped by about 40 per cent from their peaks, while housing starts declined to 118,500, well below the estimated sustainable long-run average of about 175,000. However, the housing correction here was not nearly as destructive as the collapse of the U.S. housing market. This reflects, in part, the fact that the rise in housing prices prior to the crisis was not as sharp in Canada as it was in the United States. Between 2000 and 2006, U.S. house prices appreciated by nearly twice as much as Canadian house prices. That said, Canadian house prices continued to appreciate for a longer period<sup>1</sup>.

Moreover, Canada has not had the over-investment in housing that has created the need for painful adjustments in the United States and some other countries. The steady growth in housing investment (that is, the construction of new housing units) in Canada over much of the past decade was due largely to strong employment and sustained income growth

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<sup>1</sup> Data from December 2009 Federal Reserve Bank of Cleveland economic commentary: "Why Didn't Canada's Housing Market Go Bust?" J. MacGee. Sources cited: United States, S&P/Case-Shiller (20-city composite index); Canada, Teranet 6-city composite index).

supported by rising commodity prices. There was also a degree of catch-up from under-investment during the 1990s. The favourable financing environment, marked by relatively low interest rates plus accommodative mortgage terms and conditions in that period played a further, important role. Reflecting all these factors, Canada entered the global financial crisis with a smaller housing inventory than other countries.

Behind this national picture, different regions of Canada have experienced different conditions. Housing markets in Western Canada were particularly robust during most of the past decade, as an inflow of new residents, rising income levels associated with the strength of energy prices, and a tight supply of housing combined to put upward pressure on house prices. In Alberta, this led to a strong supply response, with house-building activity rising sharply.

But with the recession and tumbling commodity prices, a housing market correction was inevitable. For Canada as a whole, prices for resale housing dropped by about 9 per cent<sup>2</sup> and for new homes, by about 3.5 per cent<sup>3</sup> compared with their 2008 peaks. The correction was much steeper, though, for regions that had previously experienced the largest increases. Here in Alberta, as you know, the drop in prices has been larger. There was also a fall-off in activity – both resale and construction.

Despite that correction, many are asking why Canada's housing market in general has tended to be less turbulent than housing markets in other countries. An important factor is Canada's housing finance and regulatory system. Canada's mortgage market is national, with similar lending conditions and mortgage products across most regions. It is dominated by domestic players, especially the six major banks, although a number of new competitors have entered the Canadian market in recent years.

Canada's mortgage credit culture has tended to be quite conservative. Mortgage insurance is compulsory for federally regulated financial institutions when the loan-to-value ratio is over 80 per cent. Further, mortgage insurance providers tend to set the lending standards for the industry as a whole. Only about 30 per cent of mortgages in Canada are securitized, so most lenders have ongoing exposures to the mortgages they originate, and that gives them an incentive to be more prudent in their lending practices. Borrowers in Canada also have reasons for prudence: mortgage interest on primary residences is not tax deductible in Canada and (in most provinces) lenders have full recourse to borrowers in the event of default. Thus, a combination of factors contributes to a more stable mortgage market.

With Canada's economic recovery, the housing sector has been experiencing a strong rebound. Sales of existing homes have reached a new high, and prices are now almost back to 2008 peak levels. Housing starts have also revived, although they remain below their long-run levels. The rebound has been strong in most regions: in Alberta, resales were up more than 50 per cent in November compared with a year earlier, and housing starts have been increasing at rates of over 20 per cent for the past two quarters.

The revival of housing activity is a reflection of the historically high level of affordability that is associated with the current record-low interest rates. Another important factor has been the rebound in consumer confidence, as many Canadians see their economic prospects brightening. But the housing rebound is also partly a matter of timing, rather than a permanent increase in housing demand. Some pent-up demand has been unleashed as many families that a year ago, were too concerned about the future to commit to so large a purchase as a new home, are now willing to take that plunge. There is also an element of pull-forward of demand, as buyers see this as a particularly attractive time to purchase a home.

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<sup>2</sup> Resale housing prices for 2009 measured by Teranet from August 2008 to March 2009.

<sup>3</sup> New Housing Price Index from September 2008 to June 2009.

At the Bank of Canada, we follow these developments closely, both at a national level and through the work of our regional offices. We know that what happens in the housing market can have important effects through the macroeconomy, and these implications need to be taken into account as we set monetary policy to achieve our inflation target. At the same time, as I have said, the housing market and related financing have important implications for financial stability. Let me elaborate on both of these aspects of policy.

### **Policy implications**

As Canada's economic growth moves towards its potential, it is expected that a robust housing market, supported by exceptionally low interest rates, will continue to work as an important engine pulling the Canadian economy out of recession. This has implications for monetary policy, which, as I've said, aims to achieve the Bank's inflation target of 2 per cent over the medium term. It's important to remember that this target is *symmetrical*; that is, we are equally concerned about whether inflation is above target or below target – as we expect it to be until 2011. The revival of the housing market is one factor that is helping us to achieve our inflation target, and it is a powerful means through which monetary stimulus affects the economy. Of course, we need to keep a close eye on the housing market, along with all other sectors of the Canadian economy, to ensure that we are providing the right amount of monetary stimulus. In setting monetary policy, we view housing – or the exchange rate, the energy sector, the auto industry, or any other factor – through the prism of our inflation target.

Developments in the housing market are also an important element in the Bank's assessment of financial stability. The current rebound in the housing sector is taking place in tandem with a very rapid rise in household indebtedness: the household debt-to-income ratio reached a new high of 142 per cent in the second quarter of 2009. Household debt-service ratios remain moderate, but that is because interest rates are currently extraordinarily low. These high debt levels make households vulnerable to increases in borrowing costs, which will inevitably occur.

To illustrate the vulnerability of households, both to increases in borrowing costs and to further growth in indebtedness, the Bank conducted a series of stress tests, which we published in the December issue of our semi-annual *Financial System Review*. Using the current path of household indebtedness, and alternative assumptions about how quickly interest rates may increase, the simulation generates a scenario indicating that, by the middle of 2012, almost one in ten Canadian households would have a debt-service ratio that makes them vulnerable to economic shocks.

These projections are not forecasts of what will happen, of course, but they provide an early warning of what *could* happen, to help us all better understand the downside risks that could generate stress in the Canadian financial system. Consumer difficulties with rising mortgage payments can also lead to wider problems with other consumer loans, such as credit card debt. Consumers may also have to curtail other spending to cope with their debt burdens, creating adverse spillovers to the real economy. This is an illustration of how problems in one area, such as housing, can quickly spread throughout the economy and through the financial system.

In addition, some observers have pointed to the risk of a housing bubble – a situation where the level of house prices is based primarily on extrapolative expectations that house prices can only rise further. Housing bubbles are usually fuelled by credit expansion, as borrowers and lenders take false comfort from exaggerated house prices. Generally, when there is a rapid rise in asset prices, including house prices, one should always ask whether they have increased too far, too fast.

In the Bank of Canada's view, it is premature to talk about a bubble in Canadian housing markets. Recent house price increases do not appear to be out of line with the underlying

supply/demand fundamentals. Moreover, with housing starts below long-term demographic requirements, inventories are still declining. It is likely, though, that a significant part of the surge in housing sector activity is associated with temporary factors – notably the historically low borrowing costs, as well as pent-up and pulled-forward demand – which cannot continue to drive increases in house prices and activity. Thus, we see the housing market as requiring vigilance, but not alarm.

This discussion leads to the following question: if the Bank did see the housing market posing a possible threat to financial stability, what should we or other authorities do about it? Some observers – those who see a housing bubble forming – have said that since low interest rates have stimulated housing market activity, the Bank should now raise interest rates to dampen that activity.

But that poses a problem. As I've stressed, we have a mandate to use our key interest rate to achieve our inflation target – and the housing market is only one of several factors that influence inflation. If the Bank were to raise interest rates to cool the housing market now – when inflation is expected to remain below target for the next year and a half – we would, in essence, be dousing the entire Canadian economy with cold water, just as it emerges from recession. As a result, it would take longer for economic growth to return to potential and for inflation to get back to target. This is why we say monetary policy is a blunt instrument for achieving financial stability.

So what other instruments are available? An array of supervisory and regulatory instruments can be used by the government to restrain a build-up of systemic risks. These include capital requirements for institutions, leverage ratios, loan-to-value ratios, terms and conditions for mortgage insurance, and a variety of other measures. These instruments can be targeted to risks to the entire financial system that stem from particular markets or institutions.

Using these instruments to safeguard the whole financial system – not just individual institutions – is the essence of the macroprudential approach. Macroprudential supervision is one of several concepts in a current global initiative to strengthen supervision and regulation in the wake of the global financial crisis. In Canada, a system-wide, or macroprudential, approach is the shared responsibility of the Department of Finance and all of the federal financial regulatory authorities, including of course the Bank of Canada, the Office of the Superintendent of Financial Institutions, and the Canada Deposit Insurance Corporation. Ultimately, it is the Minister of Finance who is responsible for the sound stewardship of the financial system.

## **Conclusion**

Prudent, conservative policies have provided significant support to Canada's housing market, through both good times and bad. This point has been amply demonstrated, during the recent recession – where many countries saw imbalances roil their housing markets – and in the ongoing recovery here in Canada. The current revival in our housing sector was a desirable, and intended, part of Canada's economic recovery, but like all good things, it must be carefully monitored to ensure that it doesn't go to an extreme.

You can be sure that the Bank of Canada will be closely watching developments in the housing sector and taking them into account in our decisions on monetary policy and in assessing financial stability. In setting interest rates to achieve the inflation target, housing developments need to be weighed along with all the other factors influencing economic activity and inflation. In assessing financial stability, we focus on the potential risks to the whole financial system. In carrying out these responsibilities, we are committed to promoting the economic and financial welfare of Canada, by fostering confidence in the value of money, and in the safety and efficiency of our financial system.

With that, I wish you a happy and prosperous 2010.