The sudden rally in Canada’s residential real estate market is surprising and troubling

However, this is not a bubble yet!

The effects of the recession did not last very long in Canada’s housing market. In fact, it has seen such a boom in the past year that some people are talking about an overvalued market, or even a real estate bubble. Housing starts quickly picked up and set a more sustained pace, but it is mainly the spectacular rebound in the number of transactions and the prices of existing properties that have some people worried. After a correction during the recession, the price of properties has shot up by more than 20% on average for Canada as a whole in less than a year, and transactions are up by more than 60%. The average price of properties in this country is now 6% higher than it was before the recession. The concerns are especially great given that interest rates, currently at an historic low, may start heading up before the end of the year and throughout next year. The Governor of the Bank of Canada, Mark Carney, has actually advised the public recently to give due consideration to this possibility before making borrowing decisions. Such a warning should encourage people to analyze the impact of a possible rise in interest rates on their mortgage payments, before they commit to purchasing a property.

This analysis seeks to take stock of the current situation of Canada’s real estate market. The numbers seem to indicate that there is currently an unusual amount of activity in this sector, which projects the picture of an overheated market and even suggests to some people that a bubble is starting to form in the housing market. This is a delicate question since a bubble, when it becomes over-inflated and suddenly bursts, can cause serious damage to the economy, as the American experience recently demonstrated. In a market economy such as ours, the adjustment mechanisms for restoring balance are effective, but sometimes abrupt and violent. Imbalances can sometimes be anticipated, and actions taken to soften the return to a balanced state. In light of our cross-Canada analysis, there is no reason to worry unduly about current developments in the Canadian residential real estate sector, but we must remain vigilant because the situation could change suddenly. The actions that Finance Minister Flaherty recently took provide a clear indication that “a stitch in time saves nine.”

WHAT IS THE SOURCE OF THE CONCERNS SOME PEOPLE HAVE?

Canada’s residential real estate market experienced some stagnation during the major part of the 1990s. Not only did the recession that held sway at the beginning of that decade lead to major job losses as well as a decline in consumer confidence, but mortgage interest rates had risen considerably while the monetary authorities began the process of taking control of inflation. Moreover, the Canadian market at that time was faced with a surplus of supply, be it for new dwellings or existing properties. This decade of relative stability was followed by exceptional growth at the turn of the millennium: sales of existing properties skyrocketed by approximately 70% between the end of 1999 and the beginning of 2007 (graph 1 on page 2).

This flurry of activity naturally triggered a significant upswing in prices, which reached their peak in December 2007, with total growth of nearly 100% compared to the end of 1999. The financial crisis that struck in 2008 and the ensuing recession reversed that trend. The correction that was observed in 2008 resulted in a plunge in sales of nearly 40% and a 13% drop in...
the average price of properties in Canada. This downward trend did not last long, however, and a significant rally has been underway since the start of 2009. Thanks to an increase of 22% since January 2009, the average price of properties quickly surpassed the level reached before the recession and the financial crisis, and this is sparking renewed worries about a possible overheating of the real estate market.

As shown in graph 2, growth in prices has varied from one province to another in recent years. The prairies and British Columbia have seen much more spectacular increases than Québec, the Atlantic provinces and even Ontario. The regional disparities across Canada and the situation of the Québec market in particular were analyzed in another Economic Viewpoint entitled “Is Québec in a real estate bubble?”1 However, the present analysis is looking at the Canadian situation as a whole.

New homes construction has also fluctuated considerably in recent years. The vitality of the real estate market through most of the first decade of the new millennium encouraged quite a high volume of housing starts (graph 3). As was the case in recent recessions, the number of housing starts plunged dramatically in 2008 and the beginning of 2009. Just as in previous economic recoveries, the last few months have seen a sharp acceleration in housing starts, although this does not seem to be enough to calm the market for existing properties.

THE RISK OF A CORRECTION APPEARS TO BE LIMITED
One indicator that is often used to determine whether the real estate market is overheated is the relationship between the average price of properties and disposable household income. This ratio has jumped considerably lately and is now quite some distance from its historical average (graph 4). In fact, it has been growing strongly since the beginning of this century, which is rather puzzling. A household now spends approximately 3.3 times its disposable income to acquire a house, compared to the average of around 2.3 times during the 1990s. However, the signal conveyed by this ratio is sometimes influenced by other factors, such as interest rate trends.

Box 1
Index of existing house prices

The series on the average price of existing houses, compiled by the Canadian Real Estate Association, which is customarily used as a benchmark when analyzing real estate price trends, can sometimes generate confusion. This is because the average is compiled based on the transactions that are carried out in each period. Consequently, if the real estate market is more active in a given region, a large number of transactions occurs, which increases the relative weight of that region in the calculation of the national average. There are large regional disparities in real estate prices across the country. For example, the average price of existing homes was $194,112 in the Atlantic provinces last January, while it was $499,843 in British Columbia.

Relatively speaking, the activity in the real estate market was much livelier in the western provinces and in Ontario. Accordingly, the weight of those regions in the calculation of the national average was greater in recent years. It so happens that it was also those provinces that recorded the highest prices, a phenomenon that helped to inflate the average price for the country as a whole.

Obviously, this method of compiling the national average does not always produce a fair picture of the value of Canada’s real estate inventory overall. A more appropriate way of obtaining an evaluation of the average value of all existing houses in Canada would be to base calculations on the relative weight of the number of properties in each region. To achieve that, we estimated the quantity of properties in each province based on the number of households and the percentage thereof who reported that they owned their homes. Graph A shows the deviation in the evaluation of the average price of existing houses in Canada, according to the Canadian Real Estate Association’s calculations and to those of Desjardins Group Economic Studies. Not only is the average price as calculated by Desjardins lower, but it has shown smaller fluctuations in recent months.

Graph A – Price of existing properties in Canada

![Graph A – Price of existing properties in Canada](image)

Graph B – Comparison between two methods of estimating the average price of existing properties in Canada

![Graph B – Comparison between two methods of estimating the average price of existing properties in Canada](image)

To make up for these weaknesses, an econometric model based on the long-term relationship between property prices and disposable income, as well as interest rate trends, has been compiled. The model also includes short-term economic fluctuations and past variations in property prices. Furthermore, to correct a bias that exists in the current method of calculating the average price of existing properties in Canada, a new evaluation of that average price has been devised to take into account the considerable regional disparities in property prices across the country. The box 1 above provides more details on the adjustments that were made and the results.

Contrary to the simple ratio of average property price/disposable income, the estimate of an equilibrium value based on the econometric model indicates that the average property price in Canada shows a certain imbalance which is slightly conducive to a rise in prices (graph 5 on page 4). For a good grasp of the current situation, though, we must ask whether this imbalance is likely to create an overvaluation of the market.
which could subsequently become a bubble, or whether it is merely a temporary imbalance in the market that will gradually work itself out due to the forces of supply and demand.

Strictly speaking, there are no criteria with which to define a real estate market that is lively, or slightly imbalanced, or overheated, or in a bubble situation. For the purposes of our analysis, the deviation between the average price observed and the equilibrium price was calculated. This enabled us to estimate the standard deviations compared to the equilibrium value. If we hypothesize that the values observed are below one standard deviation, the market could be considered slightly imbalanced. Between one and two standard deviations, the market would be overheated. If the difference compared to the equilibrium price is greater than two standard deviations, there is reason to believe that a bubble may be forming, and the risk of a prolonged stagnation or a correction is higher. Based on these criteria, it is appropriate to conclude that Canada’s current real estate market is approaching a position that is deemed overvalued, but still far from a bubble. However, the deviation that existed in 2006 and 2007 probably could have posed a risk for the creation of a bubble. In fact, a relatively severe correction did ensue, due to the financial crisis and the recession.

**SELLERS CLEARLY HAVE THE UPPER HAND**

Apart from econometric models, many other indicators can be used to assess the state of the real estate market. Of these, the ratio of sales of existing properties over new listings is the most telling (graph 6). According to the Canada Mortgage and Housing Corporation (CMHC), the real estate market is deemed to be balanced when this ratio falls between 35 and 50, which makes it possible to contain pressure on prices.

However, when the ratio climbs above the threshold of 50, be it through increased sales or slower growth in new listings (relatively speaking), the market becomes favourable to sellers and to more forceful growth in prices. In fact, after dwindling somewhat from 2008 onward, this ratio has quickly returned to a zone that favours rising prices.

Clearly, there are currently too many buyers in relation to the number of properties newly put up for sale, creating upward pressure on prices. In principle, in a very fluid market, the supply should quickly adjust to demand; but in the real estate market, such adjustments take time to materialize. Building projects cannot be started at the drop of a hat; the purchase of land by developers, the issuance of permits and all the requirements that have to be met take time. If the supply takes too long to react, the pressures in the market can increase to the point where they are hardly bearable. This does not necessarily mean that the market has become irrational, however.

**DEMAND IS BEING STIMULATED BY VERY FAVOURABLE CONDITIONS**

In response to the financial crisis and the recession of 2008-2009, the Bank of Canada slashed its key interest rates in recent quarters. At 0.25%, the target for the overnight rate is at a record low. Interest rates in the financial markets have also followed this downward trend. This environment of low interest rates has, of course, led to a substantial cut in mortgage rates. For example, the posted rate for a closed, five-year mortgage has fallen from around 7.5% at the beginning of 2008 to nearly 5.4% at present, and the rates that are granted in practice are sometimes a bit lower. This drop in interest rates was even greater for shorter terms and for variable rates.

It goes without saying that lower interest rates greatly benefit the real estate market since they reduce mortgage payments. This means that buyers can afford more expensive houses with the same monthly payment. If interest rates had remained

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2 The standard deviation represents the average of relative deviations between the average observed price and the balanced price.
steady since the start of 2008, the average price of existing properties in Canada would doubtless have risen at a slower pace. A simulation conducted with our econometric model suggests that a price deviation of 4.4% is currently attributable to the low interest rates (graph 7). In addition, we must consider the “hurry up” factor: many households are probably inclined to purchase a home sooner than they otherwise might do, in order to take advantage of the current interest rates before they head back up.

The harmonization of the provincial sales tax with the federal Goods and Services Tax, planned for next July in Ontario and British Columbia, could raise certain costs, especially in conjunction with the purchase of an existing home. For example, realtor services, legal fees and moving costs will become entirely taxable. We may therefore suppose that some households in Ontario and B.C. are bringing forward, or will bring forward, their purchase by a few months in order to avoid those extra costs, generating greater demand between now and mid-year. It is therefore possible that some degree of slowdown may make itself felt thereafter, but there is no guarantee that the market will cool off sufficiently to moderate price growth to a level that would be more sustainable in the long term.

Changes to Canadian regulations have expanded access to home ownership for many households that otherwise might never have dreamed of embarking on such a venture. For example, in 2006, the maximum amortization period for mortgage loans was extended from 25 to 40 years, and the rule requiring a minimum down payment of 5% is now required. On the other hand, the federal government has also introduced an income tax credit for first-time property buyers and for renovations. We must also not forget the increase in the maximum amount that may be

Apart from low interest rates, the upturn in consumer confidence has probably stimulated the market. After a substantial drop during the financial crisis and economic recession, Canadians’ confidence has risen sharply since the beginning of 2009. Standing at 88.3 last February, the consumer confidence index had almost regained the level observed prior to its drastic plunge (graph 8). Naturally, this renewed confidence is leading many households to become active in the real estate market. Moreover, pent-up demand accounts for some of the real estate market’s recent exuberance. Many households that remained on the sidelines during the recession have got their confidence back and are currently inflating sales. In addition, the recent stabilizing of the unemployment rate along with a slight upward trend in employment are also having positive effects on the real estate market.

Of course, this resurgence of activity is possible thanks to abundant mortgage credit. Indeed, the Canadian banking system is increasingly being held up as a model because it managed to get through the recent crisis without too much damage. As a result, Canadian financial institutions have not encountered much in the way of liquidity problems. Consequently, housing credit has not been so tight in this country, so the amount of mortgage credit outstanding never lost ground.

Upcoming changes in the taxation systems of certain provinces are giving added stimulus to the real estate market.
withdrawn from an RRSP (from $20,000 to $25,000) under the Home Buyers’ Plan.

DO WE NEED TO DAMPEN BUYERS’ ENTHUSIASM?
The current vitality of the real estate market would probably be difficult to curb, since many favourable factors will continue to have a real effect in the short term. On the supply side, the number of newly completed but unoccupied single-detached and semi-detached houses currently stands at a level slightly below its historical average (graph 9). In this situation, the supply of available new dwellings might no longer be able to meet today’s strong demand for properties. For multiple-unit dwellings, there are more units available (graph 10). However, these figures include not just condos for sale, but also apartments for rent and those for seniors. It is therefore difficult to reach conclusions about completed and unoccupied multiple-unit dwellings. On the other hand, the option of buying a home rather than renting seems to become more attractive because the drop in the ratio of the average mortgage payment over average rent (graph 11) toward its historical average, despite strong surges in the price of properties. This may partly account for the increase in inventory of newly completed and unoccupied multiple-unit dwellings. People would rather buy than rent.

Finally, the ratio of mortgage payments over disposable personal income is currently close to its historical average, which means that buying a home is still a relatively affordable proposition (graph 12). In fact, the Desjardins affordability index for Canada as a whole (graph 13 on page 7) currently stands close to its historical average thanks to an improvement that has occurred since the beginning of 2008. This constitutes another factor that encourages the buying of property.

Today’s mortgage rates are exceptionally low from a historical perspective, but it is only a matter of time before they begin heading back up. Our most recent forecasts call for key interest rates to begin rising in late summer or in fall, which should slow demand on the real estate market. But this does not definitively answer the question, because by the fall, the private sector will have regained strength, jobs will be more plentiful and consumer confidence will rise, while home-buying conditions will continue to be just as favourable. This still leaves plenty of room for property prices to keep going up.
If we combine our scenario of rising interest rates with the Desjardins affordability index, we can see the extent to which the affordability of properties is likely to diminish in the years to come, assuming that the other variables of the index remain constant (graph 14). Higher interest rates could discourage prices from rising, causing them to stagnate or even decline. The current deviation between the actual price and the estimated equilibrium price could easily be absorbed, but if that deviation widens further in the next few months, the adjustment might happen either gradually or quite abruptly, depending on the impact of higher interest rates on the estimated equilibrium price.

HOUSEHOLDS’ FINANCIAL SITUATION ADDS TO THE SUSPENSE

The vitality of sales in recent years, combined with rising prices, has generated a considerable increase in outstanding mortgage credit. If we compare the relative size of outstanding mortgage credit with disposable personal income (graph 15), an upward trend has been observed since the mid-1980s. Today, the size of outstanding mortgage credit is equivalent to almost the total disposable personal income earned over a year. The picture is even more grim if we add consumer credit to the equation. Consequently, as the Bank of Canada recently mentioned, the sustained increase in household debt compared to income could make consumers more vulnerable to an adverse shock in the event of a significant interest rate hike.

Already, the number of households having difficulty making their mortgage payments has risen in the past few quarters (graph 16). That said, despite the increase in the number of overdue mortgage loans that has been observed of late, that number is still below that which was recorded during most of the 1990s. Still, an upturn in household bankruptcies could lead to an acceleration in the number of homes available on the resale market. That would be equivalent to an accelerated increase in supply and a reduction in the pressure that is currently being exerted on prices.

A SITUATION THAT WARRANTS CLOSE MONITORING

For the time being, the gap between the average observed price of properties and the equilibrium price suggests a moderate risk of having an overvalued market, but the situation is still far from a real estate bubble. The recent strong price rally is mainly due to a convergence of favourable factors that are stimulating demand, but those factors will moderate
in the months to come and should bring transaction prices back to the equilibrium level.

Recently, the federal Finance Minister, Mr. Flaherty, announced three measures intended to moderate the ebullience of the real estate market by reducing accessibility and curbing transactions of a speculative nature (see box 2). In imposing these new measures, the Minister hopes to avoid the development of real estate speculation, that is, purchasing properties solely for the purpose of selling them for a higher price a few months later. This initiative has been welcomed, but it is hard to know whether it will be enough to quell the current enthusiasm in the residential real estate market. Still, the Minister was careful not to declare that there was a real estate bubble in Canada. Instead, he said that there was no compelling evidence of a bubble.

We cannot rule out the possibility that the deviation between the observed price and the equilibrium price for properties in Canada may increase further, particularly since a long amortization period and a relatively low down payment requirement are being maintained. The farther prices stray from our estimated equilibrium value, the more the risk of a correction will climb. Abnormally high prices generally stimulate the building of more units, which helps to push prices back to the equilibrium level. Depending on the speed of such adjustments, a long period of price stagnation may occur, rather than a correction. In either event, serious consequences would ensue for the Canadian real estate market, and on households’ balance sheets, particularly those that recently acquired a property. The situation therefore warrants close monitoring.

**NO URGENCY ABOUT REINING THE MARKET IN FURTHER**

Bringing today’s historically low interest rates back to more neutral levels, faster, could help push the average price back to the equilibrium level. However, the Bank of Canada’s mandate is to limit growth in consumer prices overall, not just for real estate. An interest rate hike could have serious consequences for the strength of the country’s economic growth.

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**Box 2**

**New federal measures announced on February 16, 2010**

1. Borrowers will have to meet the qualification criteria for a five-year, fixed-term mortgage loan, even if the loan they actually take out is for a shorter term or at a variable rate.
2. Borrowers wishing to refinance their property and withdraw some of their equity will not be able to contract a loan exceeding 90% of the value of their property (compared to 95% in the past).
3. Buyers of a property that will not be their residence will have to make a down payment equivalent to at least 20% of the selling price.

Note: These measures will not come into force until April 19, 2010.

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**Box 3**

**Factors that are currently conducive to a continued rise in the average price of properties in the short term**

- Current and future economic conditions (employment, consumer confidence, etc.).
- The release of pent-up demand from the recession period.
- Low interest rates.
- Anticipations of mortgage rate increases in the months ahead may encourage people to buy a home sooner.
- Availability of liquidity at financial institutions.
- Harmonization of the sales tax in Ontario and British Columbia, effective July 1, 2010, which promotes purchasing a home sooner rather than later in those provinces and temporarily increases demand.
- The new rules imposed by the Canadian government on February 16, 2010 will not take effect until April 19, 2010, which may encourage purchasing a home sooner rather than later, and temporarily increase demand.
recovery, besides adding extra upward pressure on the Canadian dollar. Unless the exuberance of the real estate market affects consumer prices overall, the Bank should not intervene directly, especially since other solutions do exist.

Given the measures announced by Canada’s Finance Minister on February 16, there seems to be no urgency about intervening further in the real estate market, at least for now. They represent a step in the right direction as they will reduce accessibility, especially for households whose financial situation is more precarious. This should not only reduce demand, but make borrowers less vulnerable. Clearly, it is essential to keep a close eye on price trends because the Canadian market could get close to overheating. Should the situation worsen, we could consider reversing certain measures that were adopted to promote the accessibility of home ownership, such as the longer amortization period and the smaller minimum down payment. So far, the maximum amortization period has been cut to 35 years, which is still fairly lenient. Caution is therefore the order of the day, since the goal is to prevent the formation of a bubble in the market, not to curb residential investment too strongly, at the risk of jeopardizing the economic recovery.

The table 1 above sums up the different variables that were used to analyze the current status of the Canadian real estate market. We note that of the nine variables that were analyzed, only four could have led us to anticipate the existence of a real estate bubble. Five other variables gave no indication in that direction. Nevertheless, several other factors are still conducive to rising prices in the residential real estate market (see box 3 on page 8). We must be on our guard, monitor market trends and be watchful for any sign of change that might exacerbate our concerns.

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