Residential investment has a big weight in the economy

Canada’s housing market has kept up a very fast pace for growth in recent years, advancing much more quickly than the economy’s other components. Since the start of the millennium, the ratio of residential investment to nominal GDP has increased substantially. At 7.1% in the second quarter of 2015, the ratio was close to its historic peak and well above its average. New construction is partially responsible for the increase in the ratio over the last few years. But the bulk of the increase stems from spending on renovation and the transfer costs associated with existing property transactions. The surge by real estate prices also factors in, of course. Once expressed in constant dollars to exclude the impact of the change in relative prices, the ratio of residential investment to GDP is much more stable over time.

As Bank of Canada Deputy Governor Lawrence Schembri remarked last week, Canada is not the only industrialized nation to see its housing market shoot up. Among other things, the boom is due to population growth, in particular first-time home buyers between 25 and 34 years old, greater urbanization, and improved credit terms (drop in interest rates, liberalization and financial innovation). However, the fact that Canada shares the honour of a booming housing market with other nations does not mean it is safe from an eventual correction.

Implications: The rise by the residential investment to GDP ratio attests clearly to how very important the housing market has become in Canada’s economy and, as a result, its sensitivity to a potential correction. That being said, the restrictions on mortgage credit the Canadian government gradually introduced seem to be paying off as the real estate market has slowed substantially in Quebec and the Atlantic Provinces. The market is also down in the Prairies because the problems in the energy sector are affecting demand. In short, only Ontario and British Columbia are still advancing swiftly. For now, gradual slowing remains the most likely scenario for these regions, as the factors that stimulated demand should abate.