A Word from the Economist

By Paul Cardinal - Manager, Market Analysis

October 2010

Housing Bubble: Let's Stop Comparing Ourselves to the United States

The existence or non-existence of a housing bubble in Canada is once again a hot topic in the news. Some organizations, such as the CD Howe Institute[1], Desjardins[2], the Bank of Canada[3] and the International Monetary Fund[4], have commented on the subject and have rejected the housing bubble hypothesis. Other organizations argue that not only are we in a housing bubble, but this bubble will imminently burst and lead to a decrease in property values of more than 30 per cent in some urban centres, including Montréal. In our opinion, this scenario is unlikely.

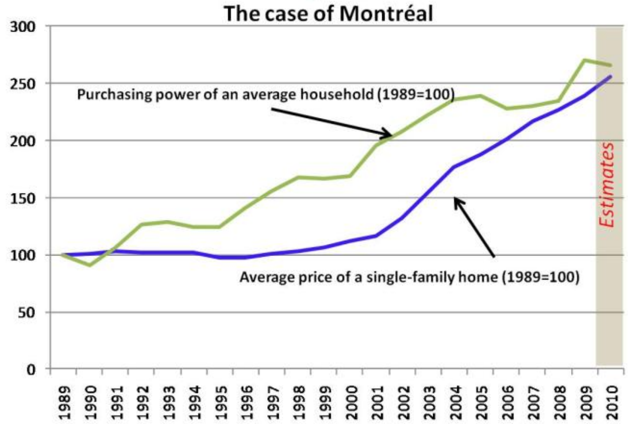
It is true that residential property prices have increased significantly over the past two decades. In the Montréal Metropolitan Area, the average price of single-family homes increased by 140 per cent between 1989 and 2009. But this is not enough to cause a housing bubble. For there to be a bubble, the increase in housing prices must move significantly away from the "fundamental" factors, which are[5] 1) income growth, 2) interest rates, 3) population growth.

Between 1989 and 2009, consumers' purchasing power increased faster than property prices.

The first two factors are particularly interesting, as they dictate changes in consumers' purchasing power. It goes without saying that when consumers' income increases, they can afford a more expensive property. The same also applies when interest rates decrease, as the purchase of a home is normally financed over many years. As a result, it is incorrect to compare property prices with household income. It is the monthly mortgage payments that must be compared to household income. The proportion of income that is allocated to these monthly payments is referred to as the affordability ratio.

Let's return to the situation of Montréal. Based on realistic assumptions, we can show that an average consumer's purchasing power increased more over the period of 1989 to 2009 than property prices. Suppose that a consumer puts down a 10 per cent down payment, amortizes his/her mortgage loan over 25 years and chooses a term of five years. If this consumer could afford to buy a single-family home for $100,000[6] in 1989, thanks to the increase in his/her income and the decrease in interest rates[7], this same consumer could buy a $270,000 home in 2009, using the exact same affordability ratio. But on the real estate market, a house that was selling for $100,000 in 1989 was selling for an average price of $240,000 in 2009 (see figure 1). Thus, between 1989 and 2009, consumers' purchasing power increased faster than property prices. This means that properties are actually more affordable now than they were in 1989.

Figure 1
The case of Montréal



Sources: Statistics Canada and QFREB calculations

Using the year 1989 as a point of comparison is no accident. The last period of soaring property prices in Montréal ended in 1989. In the following year, mortgage rates increased and the economy went into a recession. The number of MLS® sales decreased but it was not until 1992 that an impact was felt in terms of property prices. Between 1992 and 1996, the average property price decreased by 4 per cent in the

[1] Not Here? Housing Market Policy and the Risk of a Housing Bust, CD Howe Institute, August 2010.

[2] Is a real estate bubble on the horizon for Québec?, Economic Viewpoint, Desjardins, March 2010.

[3] Remarks by David Wolf, on behalf of Timothy Lane, Deputy Governor of the Bank of Canada, January 11, 2010.

[4] Is the Canadian Housing Market Overvalued? A Post-Crisis Assessment, IMF, October 2009.

[5] Fortin et Leclerc, L'Actualité économique, September 2002.

[6] This is slightly below the average price at that time ($116,250) in the Montréal region.

[7] Annual average, 12.1 per cent in 1989 versus 5.6 per cent in 2009.

Montréal area. This certainly does not resemble a housing bubble burst, but rather a cyclical decrease following a setback in economic conditions.

> The increase in property prices has not significantly moved away from the evolution of the fundamental factors.

As for the current cycle, the increase in property prices has not significantly moved away from the evolution of the fundamental factors. However, with interest rates likely to increase (most experts are forecasting a maximum increase of 1 per cent within 18 months), the rate at which property prices are currently increasing in the Montréal area (about 9 per cent annually) is expected to gradually slow. But because the 2008-2009 recession is behind us, because the market remains clearly a seller's market and because the number of mortgages in arrears remains low (see figure 2), it is highly unlikely that the Montréal market will experience a collapse in housing prices, although we cannot completely rule out the possibility of occasional price decreases.

Figure 2
Proportion of Mortgages in Arrears in Québec

Source: Canadian Bankers Association

Observers who predict the opposite are drawing on the situation that was recently observed in the American real estate market. It is incorrect to compare Canada's situation with that of the United States because the conditions that led to the housing bubble in the U.S. are not present here in Canada.

In the United States, the situation was first and foremost a mortgage bubble. Like all bubbles, it was being fed by widespread anticipation, from both buyers and lenders, that real estate prices would continue to increase rapidly in a short time. Thus, beginning in 2001, the conditions for granting a mortgage were significantly relaxed. Money was being lent to households that had tainted credit records (subprime mortgages). At the same time, new products were being developed, allowing consumers to borrow up to 110 per cent of the value of their property, for example, or to pay only the interest for the first year (interest that is tax deductible). Furthermore, these loans often had a promotional interest rate for the first year and became variable-rate loans after this. Subprime loans proliferated and reached close to 15 per cent of all mortgages in the United States[8].

> It is highly unlikely that the Montréal market will experience a collapse in housing prices.

Then, interest rates increased significantly in the United States from 2004 to 2006. The rate of mortgage payment defaults and the number of repossessions therefore exploded. The mass amounts of repossessed properties were then put back on the market. The supply of properties for sale skyrocketed, which threw the market off balance. Prices began to fall dramatically, and this was amplified when the demand for properties gradually decreased as lending institutions understood the need to tighten credit, as they repossessed properties whose value no longer covered the balance of the mortgage.

> In the United States, the situation was first and foremost a mortgage bubble.

Canada did not have a mortgage bubble. The lending practices of Canada's financial institutions were much more conservative. Also, thanks to better regulation, the majority of mortgages with a high loan-to-value ratio are insured by insurers such as the Canada Mortgage and Housing Corporation, that rigorously check the borrower's ability to pay. At its worst, according to the Bank of Canada[9], near prime loans, which are less risky than subprime loans, represented less than 5 per cent of Canada's mortgage market. We therefore did not experience the excesses of the U.S. mortgage market and, as a result, the number of repossessions remains low in Québec[10].

In conclusion, the situation in Canada and Québec can in no way be compared to that of the United States.

---

[8] La crise financière : ses origines américaines et ses répercussions canadiennes, QFREB, June 2009.
[9] Financial System Review, Bank of Canada, December 2008.
[10] Taking Stock of Foreclosures in the United States and Québec, QFREB, May 2010.