Canada's New Federal Mortgage Rules: Right Diagnosis, Wrong Medicine?

For some time, the Bank of Canada, international organizations and financial analysts have expressed concern at Canada's rising house prices and related household debt levels. Some have even suggested risks similar to that of the housing bust that devastated the US economy a decade ago. UBS, the Swiss financial services company, has rated Vancouver as one of four world metropolitan areas most vulnerable to the risks of a real estate bubble. House prices have also skyrocketed in Toronto and have risen well above incomes across the rest of the country. University of Waterloo economist Jean-Paul Lam recently expressed the concern that: "The housing market remains one of the biggest downside risks to the Canadian economy."

Federal Finance Minister Bill Morneau recently announced measures that are intended to moderate the house price increases in the nation's "pockets of risk." The Canada Mortgage and Housing Corporation (CMHC) insured mortgages between $500,000 and $1,000,000 will now require a 10 percent down payment, up from the previous 5 percent, on amounts after the first $500,000. Minister Morneau made it clear that the measure was principally aimed at the "elevated" housing prices in the Vancouver and Toronto areas.

Yet, the new rules may not slow the price escalation in the two markets. The Canadian Press noted that the federal government has "tightened mortgage rules in recent years" and required stricter management of loans. Yet house price increases have continued to increase well above inflation and incomes in Vancouver and Toronto and to a lesser extent, elsewhere.

Derek Burleton, with TD Economics, expressed doubts, noting that the previous rule changes have simply induced buyers to migrate away from CHMC financing to conventional mortgages.

The new rules do not get to the heart of the problem. BMO senior economist Robert Kavcic noted that: "The bigger-picture fundamentals driving home price gains in Toronto and Vancouver — restricted detached-home supply, demographic demand, low mortgage rates and inflows of foreign wealth — remain firmly in place."

Already, average detached house prices in metro Vancouver are soaring toward $1.7 million and have risen above $1 million in the city of Toronto. The new rules seem unlikely to slow these increases, since most mortgages for such expensive houses would be beyond their impact. Amounts above $1 million are above the CMHC maximum for mortgage insurance and so are not impacted by the new rules.

Calgary, however, is another matter. CIBC economist Benjamin Tal explained the concentration of house prices in the $500,000 to $1,000,000 price range could have a much greater impact in Calgary than in either more expensive Vancouver or Toronto. CIBC estimates indicate that only 2.5 percent of the sales in metro Vancouver will be affected by the higher down payment requirements and 5 percent in the Greater Toronto area. In contrast, CIBC estimates that nearly 10 percent of new home sales will be affected in the Calgary area. Edmonton would also be harder hit, with approximately 6 percent of its sales affected. The last thing the challenging economy of Alberta needs is impediments to economic activity, such as discouraging house sales.

Meanwhile, previous experience, not only in Canada, but also in Australia and New Zealand, suggests that measures such as these could do little to halt rising house prices. Excessive house price inflation has been going on for four decades in Vancouver, and since 2000 in Toronto. Today, building a detached house, like most buyers prefer, costs approximately 25 percent more in Vancouver than in Edmonton, according to the Altus Cost Guide. This would suggest that the difference in prices between the average detached house in the two metropolitan areas would be similar. However, the Vancouver house costs nearly 300 percent more, according to the latest real estate board statistics. The difference is land values, which have been pushed up in Vancouver by land use regulations that make building detached housing exceedingly expensive.

House prices in Vancouver and Toronto are likely to continue rising faster than household incomes until there are reforms that ease the costly land use regulations. As noted above, this could conceivably do serious damage to the entire economy. Much of the problem can be tied to provincial and metropolitan land use policies. Despite Ottawa's rightful concerns and good intentions, the solution is in Vancouver and Toronto, not Ottawa.

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