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Economic Research

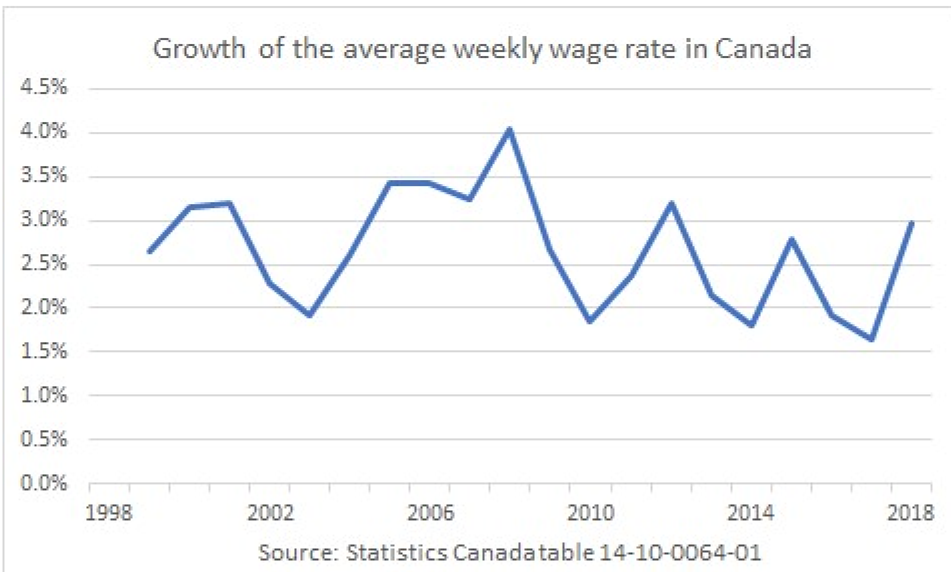
The Federal Government's Attack on Home Ownership

In the March 5 Toronto Star, Mr. Evan Siddall, the President and CEO of Canada Mortgage and Housing Corporation (the housing agency of the federal government), commented on the mortgage stress tests (which are widely acknowledged to have caused a sharp slowing of housing activity in Canada). He equated the discomfort caused by the stress tests to a bad-tasting medicine. The core of his argument is that "short-sighted people" are making "a faulty assumption that house prices will keep increasing". [1]

He has mis-characterized the arguments. They do not require any assumptions about house price growth. Contrary to Mr. Siddall's overly-simplified narrative, there are at least four elements of criticism:

- The tests fail to consider the income growth that will occur by the time mortgages are renewed.
- They have negative consequences for the broader economy.
- They prevent Canadians from pursuing their long-term best interests.
- Suppressed production of new housing will worsen the shortages that have developed.

<u>*Income Growth*</u>



During the past 20 years, the average wage in Canada has increased every year. The lowest growth rate was 1.6% and the average for the entire period was 2.7% per year. During the past five years, the average change has been 2.2% per year (a total rise of 11.6% during the 5-year period). The stress tests assume that there will be no income growth.

The stress tests are concerned with mortgage borrowers' ability to make payments once they renew their mortgages (which will usually occur in five years). The tests include a low-probability event (that in five years interest rates will be 2 points higher) but ignore a high-probability event (that the borrower's income will be at least 10% higher). If future interest rates are indeed two points higher, that would be because the economy is very strong. In that case, it is extremely likely that there will be income growth, which will somewhat offset the higher future mortgage payments.

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[1] The article is here: https://www.thestar.com/opinion/contributors/thebigdebate/2019/03/05/are-current-mortgage-rules-too-strict-no.html

Failure to take account of income growth means that the stress tests overstate the challenges that will result from future mortgage renewals.

This is the most important criticism of the stress tests and Mr. Siddall has ignored it.

Economic Consequences

Mr. Siddall comments that "houses in Canada are now 3.4 per cent cheaper than they would have been without it" [the stress tests]. So, he has done some evaluation of the impacts. That evaluation can and should include an assessment of how much housing activity has been affected. (In fact, if he can estimate how much prices have been reduced, in the process he must have estimated the magnitude of the reduction in housing activity.)

Let's look at some data:

- In 2018, there were 11% fewer resale homes sold than in 2017, and 15% fewer compared to 2016. The reduction versus 2017 will cause employment in Canada to be about 20,000 lower than it would otherwise be.
- Housing starts are slower to respond to changing conditions, but the process of adjustment has begun. By the second half of 2018, starts of low-rise homes in urban areas were 18% lower than during 2017.
- Apartment starts take even longer to adjust. Recent construction starts for apartments reflect conditions that existed during 2016 and 2017. It looks very likely that a reduction will occur during this year, and that by the final quarter of this year, apartment starts might be 10% lower than in 2017.
- The reductions in housing starts, once adjustments have fully occurred, will reduce employment in Canada by 90,000 to 100,000.

In the past, Mr. Siddall spoke favourably about a book titled *House of Debt*. One of the main take-aways from that book is that in a modern economy, in which there is a large volume of consumer mortgage debt, one of the most dangerous things that can happen is for house prices to fall[2]. This is because the reduction of home equity negatively affects consumer confidence. This impairs consumer spending, which has employment impacts. (Secondly, and much worse, the negative effects of falling prices can spin out of control.)

The stress tests have reduced house prices, in Mr. Siddall's estimation. There will be negative economic consequences from the price impacts that have already occurred, and any future reductions in prices will have additional consequences. If Mr. Siddall can express an opinion on how much prices have been affected by the stress tests, he can surely also express an opinion on the costs in jobs.

[2] Atif Main and Amir Sufi. Published by University of Chicago Press:
https://www.press.uchicago.edu/ucp/books/book/chicago/H/bo20832545.html
The most important sentence in *House of Debt* (page 138) might be "The dramatic loss in wealth of indebted home owners is the key driver of severe recessions."

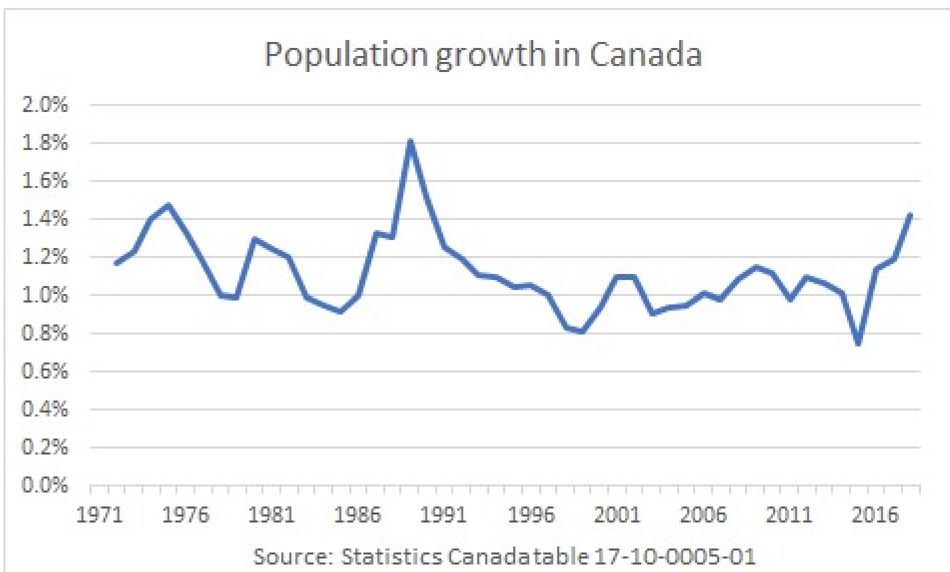
Combining the effects of reduced housing activity with the "negative housing wealth effect", the mortgage stress tests will cause employment in Canada to be at least 200,000 lower than it would otherwise be, once adjustments have fully occurred.

Long-Term Interests

In the short-term, it costs more to own than to rent an equivalent dwelling, because of large mortgage payments. But, the payments involve large amounts of repayment of mortgage principal, which is in effect a form of saving (in the first mortgage payment, about 40% is principal repayment and 60% is interest). Taking this "forced saving" into account, the initial cost of owning, even in today's circumstances, compares favourably to the cost of renting. In the long-term, the balance shifts in favour of home ownership. Rents increase; for home ownership, the largest element of costs (the mortgage payment) is fixed (usually for the first five years). The total monthly cost of renting will rise more quickly than the cost of owning.

In consequence, over the course of a life-time, the cost of home ownership is lower than the cost of renting equivalent housing, based just on the monthly costs. This does not require any assumptions about house price growth.[3]

Worsening Housing Shortages



By the fourth quarter of this year, the pace of housing starts in Canada will be sharply lower, likely about 15% to 20% lower than the total for 2017. This is despite the fact that Canada is now experiencing an acceleration of population growth (1.25% per year during the past 3 years, versus a long-term average of 1.1%). To accommodate this, there is a need for housing construction to expand. The mortgage stress tests are working in the opposite direction. Long-term, the stress tests will add to the pressures that Canadians are already experiencing in the housing market.

[3] I have explored this in "Owning versus Renting a Home in Canada", published last September by Mortgage Professionals Canada and available here: https://mortgageproscan.ca/docs/default-source/government-relations/owning-vs-renting-2018.pdf

The mortgage stress tests have major adverse consequences, and are based on a combination of events (a sharp rise in interest rates, but with no income growth) that has an extremely low probability. That is bad policy and it needs to be fixed.

What's More…

This discussion is about the impacts of the stress tests on home buying. I'm not going into the absurdity of forcing existing mortgage holders to prove that they can afford a 2-point rise in their interest rate. Another time…

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