Canadian Housing Fire Needs a Response

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

The extreme strength of the Canadian housing market has been well documented, and bubble talk is raging. We believe the market has long been smoldering thanks to fundamentally-driven pressure from demographic and supply-side factors. Now, fuel has been poured on the fire in quantity. Record-low interest rates have lowered mortgage costs, and central bank guidance is cementing expectations that there is little to stop prices from moving higher.

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At the same time, employment has rebounded swiftly in higher-paying industries, while fiscal policy is providing broad support to the economy. And, the blind-bidding process in extremely tight markets is adding another layer of upward momentum.

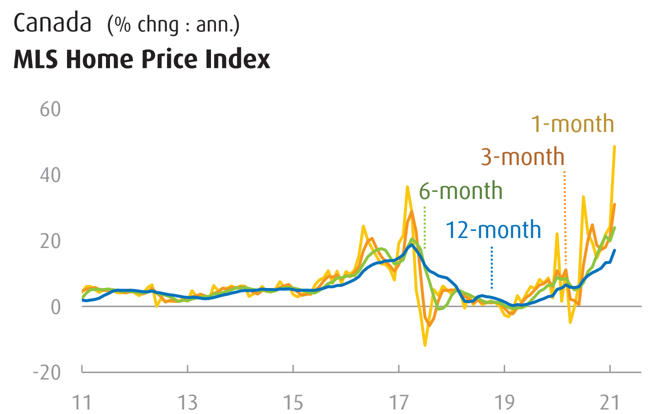
We believe **policymakers need to act immediately**, in some form, to address the home price situation before the market is left exposed to more severe consequences down the road. As it stands now, prices are going parabolic across a number of markets (*Chart 1*), and the price strength appears to be feeding on itself.

While development policy has created supply-side issues for a decade or more, and affordability for younger households is always a policy concern, **the acute issue today is market psychology**. According to the latest Mortgage Professionals Canada survey (taken in January/ February), expectations for home price gains are the highest in at least a decade; while expectations for mortgage rate changes are the lowest in at least a decade (*Chart 2*).

The action needed today is one that immediately breaks market psychology and the belief that prices will only rise further. That would dampen the speculation and fear-of-missing-out that those expectations are creating.

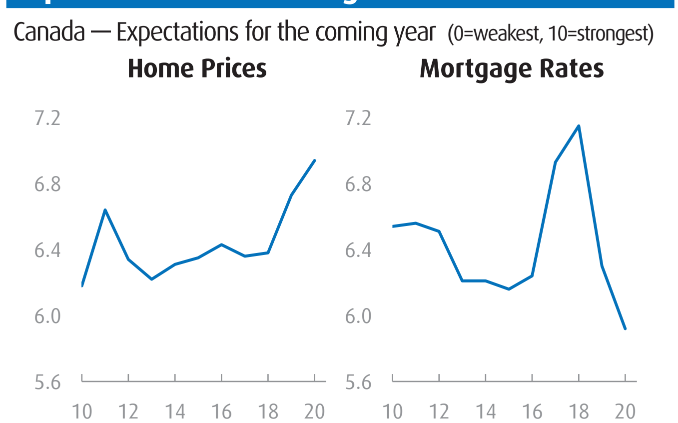
We have been asked by many for views on what policy measures could be used to cool the market. Without making a definitive recommendation, we outline a number of possible measures that are, or should be, on the table for policymakers, some effective and some not. It's clear that no single measure is perfect.

Chart 1
Prices Going Parabolic



Sources: BMO Economics, Haver Analytics

Chart 2
Expectations Reinforcing Market Move



Sources: BMO Economics, Mortgage Professionals Canada

Breakdown of Potential Measures

BoC interest rates/guidance

- The Bank of Canada could hike rates, or at least back off from its commitment to hold policy rates at near-zero until 2023.
- Interest rates and the Bank of Canada's commitment to keep them low for years are arguably the key drivers behind the meteoric surge in home sales and prices across large swathes of the country. A move here would have an immediate, clear and notable impact to cool housing.
- A recent example is 2015, where two BoC rate cuts set off markets not impacted by the oil shock at that time. They only cooled after the BoC shifted its policy stance back toward tightening (local tax measures and OSFI rules played a role as well).
- However, interest rates are a blunt tool and impact more than just housing. The economy has yet to return to pre-pandemic levels of activity, and tightening credit conditions will only lengthen the recovery. In addition, higher interest rates would likely strengthen the Canadian dollar, providing yet another drag on growth.
- Rather than being targeted, the breadth and depth of the impact of rate moves have historically prompted policymakers to use macroprudential measures to lean against housing froth.

Impact: **VERY HIGH**

Complexity: **LOW**

Spillover: **HIGH**

Real estate bidding process

- Implement an offer system that eliminates blind bidding in real estate transactions.
- This could use open bidding among agents and/or standardized escalation clauses for the price component of offers.
- This would keep the sale price from settling well above the price of the next willing buyer, and keeps the comparable more appropriate for the next property to list in that location. While this won't cool the market on its own, it would limit the ballooning that we're now seeing in a very tight market.
- This measure would likely have to filter through provincial real estate associations.

Impact: **HIGH**

Complexity: **LOW**

Spillover: **LOW**

Speculation tax

- A special capital gains tax on the sale of residential real estate purchased from today forward, with the rate falling to zero over five years of holding the asset.
- On non-principal residences, the maximum capital gains tax would become the current rate (e.g., about 26% in Ontario) plus the speculation tax.
- On principal residences (if applied), the speculation tax would effectively become a capital gains tax that fades through the five-year window.
- This could easily crowd out speculation, and alter market psychology. A similar concept was used in Ontario in the 1970s, and it weakened the market overnight.
- Such a measure would have a moderate impact on user demand such as longer-duration second properties which are extremely heated today. It also might cause supply to get held back.

Impact: **HIGH**

Complexity: **MEDIUM**

Spillover: **LOW/MEDIUM**

Broadly increase capital gains inclusion rate on real estate

- For example, allow all capital gains on non-principal residences to be taxed at the full marginal income tax rate. The maximum capital gains tax with full inclusion would become about 53% in Ontario versus 26%.
- Would discourage flipping of non-principal residences and temper some investment demand. It would also make second properties less attractive longer term.
- However, such a measure would also discourage all forms of real estate investment, not just flipping. For example, it would reduce the incentive to own long-duration rental property, which could work against much-needed rental supply.

Impact: **MEDIUM**

Complexity: **VERY LOW**

Spillover: **MED/HIGH**

Increase single-detached supply (outside core areas)

- Refocus development on much-demanded single-detached housing.
- Outside the core urban areas (such as the Greater Golden Horseshoe), there is much more available land for single-detached development. The work-from-home movement also makes this more feasible than in the past (hence the demand surge in many of these markets).
- However, this is a long-term fix for a problem that needs a fast response. And, it would need to be complemented by significant infrastructure investment in areas such as broadband internet access and roads/highways.

Impact: **MEDIUM**

Complexity: **HIGH**

Spillover: **MEDIUM**

Increase single-detached supply (major urban areas)

- Refocus municipal intensification targets to allow more single-detached development within major urban centres.
- This is a challenging proposition given that it would turn against roughly 15 years of policy that has (predictably) put us where we are now. That can't be undone quickly. And, in many areas, it could require pushing into environmentally-sensitive areas.
- This is also a long-term fix for a problem that needs a fast response.

Impact: **MEDIUM**

Complexity: **VERY HIGH**

Spillover: **MEDIUM**

National non-resident tax

- Implement a national non-resident buyers tax similar to those currently imposed in B.C. and parts of Ontario. In the Greater Golden Horseshoe of Ontario, the tax is 15% on the purchase of residential property by individuals who are not citizens or permanent residents of Canada or by foreign corporations.
- A national tax could simplify the policy (i.e., one uniform measure rather than a patchwork of regional rates), and potentially cool markets outside Toronto and Vancouver that are extremely strong.
- While it's unclear to what extent non-resident buyers are playing a role, the issue now appears largely domestic-demand driven, which might limit the immediate impact of this measure.

Impact: **MEDIUM**

Complexity: **MEDIUM**

Spillover: **VERY LOW**

Tighten mortgage standards further

- This is a well trodden path, with measures implemented in various stages over many years in order to ensure borrowers can cope with higher interest rates.
- Beyond the stress tests, gross & total debt services ratio maximums can be cut.
- This would lower the leverage individual households can take on, which, in turn, could act to cool the housing markets.
- The current qualification rate is already well above market rate and past rule changes have already insulated the financial system from systemic/interest rate risk. This may not change buying behaviour, only the qualifying amount. Past changes have had modest/temporary impact at most.

Impact: **LOW**

Complexity: **VERY LOW**

Spillover: **VERY LOW**

Limit equity takeout

- For example, limit financing to 65% (or some alternative) instead of 80%.
- This would limit the leverage homeowners can take on using their home as collateral, perhaps for second properties or investment.
- It would leave homeowners with less financial flexibility. And, it would do nothing to temper first-time demand or trade-up demand.

Impact: **LOW**

Complexity: **VERY LOW**

Spillover: **VERY LOW**

Remove principal residence exemption

- End the exemption of principal residences from capital gains taxes.
- Canada is one of very few countries that fully exempts principal residences from capital gains with no limit. Paying tax on capital gains will ensure that all housing transactions are taxed, with no ability to shelter gains. This would change the equation on long-term housing gains and make housing a less attractive investment.
- However, for generations, Canadians have used their homes as a key asset in their financial planning. Changing tax rules now, would throw those plans into disarray and be a huge burden on many if not grandfathered.
- Long-duration purchase decisions also might not be much impacted by a capital gains tax years down the road. And, such a measure could require interest deductibility (which could *increase* prices today via lower after-tax carrying costs); and/or capitalization of improvements (which gets complicated).

Impact: **LOW**

Complexity: **VERY HIGH**

Spillover: **MEDIUM**

Help affordability

- Measures that provide mainly first-time homeowners with increased incentives and ability to borrow to fund home purchases. These could include tax-free RRSP withdrawal limits and equity sharing programs.
- In theory, such measures have been used in the past to make housing more affordable for younger Canadians.
- The reality is that such measures do very little, and often just get built into prices or strengthen demand, and are therefore counterproductive. Also, borrowing from assets only puts households further behind on their retirement/other savings.

Impact: **VERY LOW**

Complexity: **LOW**

Spillover: **HIGH**

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