PERSPECTIVE

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REAL ESTATE OVERVALUATION AND CONSUMER DEBT POSE RISKS TO ECONOMY

There is consensus across economists that sustained low interest rates has led real estate in Canada to become overvalued. The debate is about how much overvaluation is present. At one extreme are forecasters predicting a 20-25% price correction at some point in the near future. At the other end of spectrum are teams, like TD Economics, that believe the overvaluation on a national average basis is in the range of 10-15%. This is an analytical assessment based on local market price trends, economic fundamentals (i.e. income, employment, interest rates, demographics, and geography) and the capacity to borrow by households. If the overvaluation was fully unwound rapidly, it would be three times the correction in the early 1990s. However, one needs a catalyst for a sharp correction. The two leading candidates would be a sharp increase in unemployment or a sharp increase in interest rates. Neither appears on the horizon in 2012 or 2013. This is why the base case forecast is for a gradual decline in sales a modest pullback in prices over the next several years. Nevertheless, one should not be complacent. We need to acknowledge that a significant imbalance has developed and it poses a clear and present danger to Canada's medium-term economic outlook. It also suggests that further actions to constrain lending growth may be prudent.

Real estate overvalued, but concentrated in selected markets

It should also be said that the imbalance does not appear evenly distributed across the country. On the basis of affordability for local buyers, Vancouver is clearly the greatest at-risk market. The challenge is that the local affordability doesn't matter to foreign buyers that view Vancouver as an attractive place to live or invest. The Toronto condo market is also of concern, primarily due to the condo building boom. As the towers are completed, there are questions about the ability of the market to absorb the new listings or find renters for all of the investment properties. Some real estate valuation models also flag risks for cities like Quebec City and Montreal. Nevertheless, beyond selected cities, it is natural to assume that it will be a shock to all real estate markets when interest rates eventually rise from their prevailing exceedingly low levels.

Sustained low interest rates have led to excessive household debt

At the same time, there are deep concerns about the rise in household indebtedness. While Canadians tend to immediately think about credit cards when they hear comments about personal debt, the vast majority of the debt growth over the past decade has been fueled by real estate secured loans – traditional mortgages or financial products like Home Equity Lines of Credit (HELOCs). Debt-to-personal disposable income is now above 150%. Although the ratio dipped in the fourth quarter of 2011, debt still rose by 6.1% year-over-year. The ratio fell due to a sharp increase in unincorporated business income (which is included in personal income) and farm income that is likely to be temporary. Debt-to-PDI is bound to resume rising in the coming quarters and it is expected to reach the 160% peak experienced in the U.S.

and the U.K. before their real estate corrections occurred by late 2013. Although as I pointed out in a Perspective note in January (What Rising Personal Debt-to-Income Tells Us) the debt-to-income ratio is a poor measure of broad financial risk, it does tell us that households are more leveraged and are more vulnerable to economic or financial shocks than ever before.

The risks from real estate overvaluation and household debt have been flagged by TD Economics for some time. The Bank of Canada has also noted the risks in speeches, in their Financial System Review publication, and in their recent interest rate decision communiqué. The Government of Canada has acknowledged the risks and should be commended for tightening the mortgage insurance regulation three times in recent years. Were it not for the government's actions, the personal debt-to-income ratio would now be at 160%. Canadians have also heard the warnings and they have responded. Personal debt growth in 2011 slowed to roughly half the pace experienced in the two years leading up to the recession. While the slower debt growth is encouraging, the outlook is for mild employment and income growth in the coming year, implying that households will gradually become more leveraged over time.

The issue now is whether further policy action is called for. We cannot do anything to address the real estate and personal debt imbalance that has developed, but we could take actions to ensure that the imbalances do not become larger.

The main incentive to borrow more for investment in real estate is the prevailing low interest rate environment, which is keeping real estate affordability attractive in many markets. However, the Bank of Canada is in a bind. It has to set the overnight rate at a level appropriate for the overall economy. And, the prospects for only gradual economic growth call for an overnight rate at roughly 1.00%. Moreover, the U.S. Federal Reserve has stated that it expects to keep U.S. short-term rates at close to zero until late 2014. If the Bank of Canada raises interest rates while the Fed is on hold, it will make Canadian cash and bonds look more attractive to investors, which would raise the Canadian dollar even further above par and lead to slower economic growth. This suggests that Canadian interest rates will remain at exceedingly low levels for some time.

In presentations I have often been asked why financial institutions cannot simply all agree to lend less. To do so would be collusion, and it is illegal. Canada also has a very competitive marketplace for financial services. The special mortgage rate offers being made in early 2012 are a clear battle for market share. Simply put, sustained significant unilateral actions by individual lenders to restrict debt growth are not possible in today's market. The fierce competition is also a reflection of the fact that Canada's lenders are financially strong to weather a real estate correction.

Risk to financial system limited, risk to economy is the concern

Canada's financial system is extremely robust. Financial institutions hold significant amounts of capital to ensure their solvency in even the most negative of economic and financial environments. Stress tests are regularly run to assess what would happen under extremely adverse scenarios, including a precipitous decline in real estate valuations. And, a large portion of the real estate tied loans are insured. Accordingly, financial institutions can continue to provide strong incentives for households to borrow, without running undue risks to their solvency.

The greater risk from the high level of consumer indebtedness and real estate overvaluation is to the overall economy. In the latest IMF annual report on Canada, the international organization states, "Adverse macroeconomic shocks .... could result in significant job losses, tighter lending conditions, and declines in house prices, triggering a protracted period of weak private consumption as households reduce their debt." Make no mistake, such a combination of forces would likely cause a recession.

A real estate correction would impact the economy through several channels. First, the construction sector would contract. Second, consumer spending, which currently accounts for 63% of the economy, would decline. This would reflect the fallout from reduced consumer confidence and lower household wealth. Loan losses by lenders would also likely lead to a tightening in lending standards, which would add to the headwinds on household spending.

Many are familiar with the concept of business cycles that characterize the behaviour of economies over time. A recovery is followed by an expansion, during which economic imbalances are developed. At some point a shock occurs, which could take many forms – such as an acceleration of inflation, an oil shock or a significant increase in interest rates. The shock causes an economic downturn, during which the imbalances are worked out of the system. When the global economic and financial shock hit Canada in 2008, the country was fortunate not to have any major domestic imbalances. What is particularly troubling today is that we know that the sustained low interest rate environment has created imbalances, making the domestic economy vulnerable to higher debt service costs or weakening of labour market conditions. When the Bank of Canada does eventually move interest rates back to more normal levels, which is two to three percentage points higher than today, it is likely to be a shock to many Canadians. We have estimated that once interest rates return to more normal levels, over 1 million Canadian households (roughly 10% of households that currently have debt) will have to devote 40% or more of their income to making their monthly debt payments – a level that the Bank of Canada deems puts households in a financially vulnerable position. The number will climb if debt growth continues at its current pace.

Further actions would be prudent

This leads to the issue of what actions could be taken to ensure the imbalance does not increase further and/or minimize the future reaction to higher interest rates. One option would be to shorten the maximum amortization on mortgages from 30 years to 25 years. Another option would be to introduce a minimum interest rate floor on all income tests, say 5.50%, when qualifying for mortgages, regardless of the amortization term and regardless of whether they are high ratio or not. It would not change the interest rate at which buyers transact, but it would ensure that individuals would be assessed against their capability to meet their financial obligations in a higher interest rate environment. A further example would be requiring more stringent income tests on all HELOCs, with the applicant being assessed on their ability to payoff the line of credit over a 20-year period. This would cut down on the maximum size of lines of credit. Finally, the minimum down payment could be raised modestly, say from 5% to 7%.

Given the economic outlook for modest economic growth and the existence of the imbalances, heavy-handed policies – like raising the minimum down payment substantially to something like 10% – are not appropriate. And, tighter standards should be imposed in a gradualist fashion to avoid triggering a sharp unwinding of the imbalances that are present. So, all of the options above should not be implemented together. A steady and incremental leaning against the further accumulation of household debt and the appreciation of real estate prices seems prudent. And, all of the options noted above are sensible for the long-term, and not just in the current environment.

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