

No Urgency for Government Intervention in the Canadian Housing Market

- The key factor driving the recent acceleration in home prices is the divergence between sales and new listings. We expect listings to rise as a result of the combined impact of the Spring market and higher prices. Policymakers should wait to see how listings evolve relative to sales in the next few weeks before taking action.
- Any policy action should be designed to limit excessive speculation. It is not clear at this time how important the speculative dimension is to current market dynamics, but policymakers could raise the cost of speculation by taxing the gains from speculative activity.
- The overwhelming challenge facing the Canadian housing market remains the chronic insufficiency of supply relative to demand owing to the high rates of population growth registered in recent years. While not a near-term solution, policymakers should respond by easing obstacles to new construction for all forms of housing—affordable housing, rentals and owned accommodations. Home prices are likely to trend upward until there is a better balance between the number of homes in Canada and the number of Canadians needing housing.

Recent Canadian housing market dynamics are prompting calls for action on the part of policymakers. With year-over-year price increases well over 20% in some markets, there are fears that extrapolative expectations may be taking root. Recent indications from Bank of Canada Governor Macklem suggest policymakers are attuned to the risk, but it is not clear that action is urgently required. Speculative activity is the issue of most concern, and any immediate policy actions should be limited to reducing speculation rather than measures that impact the needs-based demand for housing.

Of immediate concern from a pricing dynamic are record-low inventories of listings relative to sales. The sales-to-listings ratio, which has historically been a very good leading indicator of future price growth, is near record levels and suggests prices will continue to rise rapidly for at least the next six months (chart 1). Months of inventories also stand at their lowest level ever. Currently elevated prices along with the arrival of Spring should lead to an increase in listings that could restore some balance and mitigate the need for more aggressive forms of policy intervention. It could also be that sales power forward despite an anticipated rise in inventories leaving the sales-to-listings ratio at elevated levels. At this time, we think it best to wait for a few weeks to better assess market conditions before undertaking any policy interventions.

Nevertheless, if policy actions are being considered, we think the measures should be very targeted. As the ultimate determinant of home prices over time is the supply-demand balance, the best option to depressurize the housing market is to increase supply. That, however, is not a practical near-term solution.

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Chart 1



We argued in [2017](#) that, in addition to focusing on policies to increase supply, government should implement policies to limit, but not eliminate, speculation in the housing market. At the time, our focus was to make speculation more costly by introducing a tax on sellers that flip a property within a certain window. Since then, the Federal Government has tried to reduce the financial incentive to flip homes by implementing a system to track purchases and sales of principal residences. More could be done on this front:

- Capital gains are not applied on the sale of a principal residence. Speculators take advantage of this tax break to treat income from the purchase and sale of residences as capital gains as opposed to its true nature, business income. This could easily be fixed by considering the sale of a residence sold within a certain period—say 12 months—as income, and not capital gains. Certain exemptions would of course be necessary such as for homeowners that need to move for legitimate reasons. However, we do not know how much speculative activity is contributing to current pricing dynamics, so the impact of such a measure is unclear.

A more significant revision to capital gains on principal residences should not be considered. The tax-sheltered gains from owning a home confer a significant advantage to homeowners versus renters. As tempting as it might be to reduce this advantage by taxing a portion of the capital gains on a principal residence, such a change in taxation would represent a significant financial blow to Canadians. Derek Holt runs through a long list of arguments against this idea [here](#). Policymakers could get around that by limiting the tax to those that purchase homes in the future, or by imposing a cap on these tax-sheltered gains but that would raise inter-generational equity issues: why would there be a differential tax treatment for new homeowners relative to existing ones? To reduce the incentive to own over renting, a better approach would be to allow a certain portion of rents to be deducted from income.

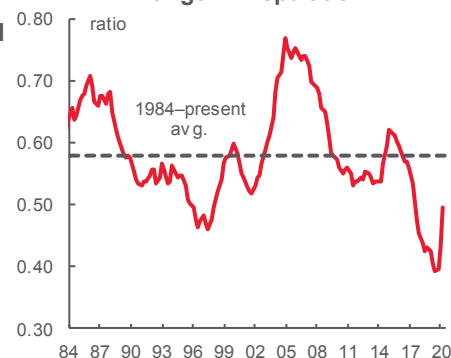
In Canada, housing supply has simply not been able to respond to demand as it should owing in large part to rules and regulations governing new construction in Canadian provinces and cities. Builders are not able to respond as effectively to price signals as should be the case. The underlying factor supporting rising prices is a chronic insufficiency of supply relative to demand: **there are fewer housing units per thousand Canadians now than there were three years ago.** Historically low interest rates obviously contributed to rising demand, but a very simple metric of completions to population growth shows how wide the supply-demand imbalance has risen since 2017 (chart 2). Completions have been rising gradually since 2012, while population growth has exploded, hitting multi-decade highs during 2017–2019. We would have been on track for another high had COVID not reduced immigration to the extent it has. Increasing supply is clearly the solution to restoring balance in the housing market, but that is not something that can be achieved overnight.

The supply bottlenecks are principally at the municipal level, flowing from rules and regulations governing the construction of new housing. At the Federal level, the Government's 10-year National Housing Strategy and the Rapid Housing Initiative seek to substantially increase the number of affordable homes across the country, but more could be done to incentivize lower levels of government to act on housing supply. **The Federal Government could, for example, make infrastructure funding conditional on achieving benchmarks in the approval process for new housing at the municipal level designed to speed up the development process and overcome not-in-my-backyard objections.**

Measures that limit demand can only have so much impact. Foreign buyers represent a small share of homeowners in Canada and taxes on them had, at best, temporary impacts on the housing market. Likewise, measures designed to protect households from themselves—such as reducing maximum amortizations, increasing the interest rate at which prospective buyers qualify for mortgages, or tightened mortgage insurance lending standards—reduce the maximum loan available to buyers in the partial hope that that will feed through to lower house prices by lowering demand. That has no doubt worked to some effect, but the underlying supply insufficiency is so large that prices continue to reflect this imbalance.

Chart 2

36-month Rolling Sum of Canadian Home Completions Relative to Change in Population



Sources: Scotiabank Economics, Statistics Canada.

An additional consideration for policymakers is the potential impact of housing market developments on financial stability. As Governor Macklem has noted, there has been a decline in the share of insured mortgages and a rise in high loan-to-value (LTV) mortgages. The rise in high LTV mortgages could pose a problem if house prices were to fall sharply but we believe that is an unlikely outcome given our view that low supply relative to demand will put upward pressure on prices until there is a better balance between the two. The decline in the share of insured mortgages may be viewed as worrisome by some, but uninsured mortgages require a down payment of at least 20%. This provides a substantial buffer against declines in home prices. It also means home equity remains high, with [Mortgage Professionals Canada](#) reporting that average equity represents 73% of home values for all owners and 56% for homeowners with a mortgage.

Likewise, measures to increase affordability, such as an expansion of the First Time Homebuyer Credit or the Home Buyers' Plan are unlikely to have a material impact on affordability at the aggregate level. In any case, as appealing as these programs might be to policymakers, making it easier to purchase a home exacerbates the supply-demand imbalance.

Housing is a fundamental need. Government policies should focus primarily on means to enhance the responsiveness of supply to demand, particularly when an imbalance results from rapid population growth. With immigration set to rise dramatically this year and in the future, we can expect further challenges on this front. Current developments should compel all levels of government to address the lack of supply with more urgency. In the meantime, prices are likely to remain on an upward trend, though it is clear the current pace of house price increases is unsustainable. **We are hopeful that listings will rise in coming months, COVID-19 lockdowns permitting, and that that will restore a better balance between sales and inventory. If that does not occur, some form of action might be required.** We favour measures that go directly to the underlying concern of extrapolative price movements by focusing on policy interventions that increase the cost of speculation.

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