Canada's Housing Bubble: Higher Interest Rates Won't Bust it

Description

Many experts believe that Canada is in the midst of a housing bubble. In February, the average price of a Canadian house hit $816,000 — up 20% compared to the same period a year before. It was a big jump for an already hot market. House prices rose over 20% in 2021 and have been trending upward for decades.

A recent *Financial Post* article explored a study by *Canada Economics at Oxford* that predicts a 24% correction. The study's authors say that even last year, house prices were beyond the borrowing capacity of median Canadian families. Today, they say, the situation is much worse, and the market could come crashing down as soon as 2024.

That may indeed come to pass. But there is one factor that is unlikely to cool the housing market on its own: *higher interest rates.*

Although higher interest rates discourage borrowing, their effect can be overpowered by other factors. And this year, those "other factors" are significant.

Why higher rates might not be enough

One reason why higher interest rates might not cool the housing market is because people just aren't selling. A recent study showed that while Canada's housing stock is, in fact, growing — rapidly — people are not selling their homes. One reason given for the behaviour is that people are leveraging their current homes to make down payments on rental properties. Rent, like housing prices, is going up. So, higher interest rates might not be enough to cool the speculative behaviour that is driving prices higher. If rent goes up more than rates, then buying rental properties is still worth it.

They could even add to the problem

It's even possible that higher interest rates could discourage people from selling their homes. If you own a home and you sell it, you don't capture the full sales price. You typically have to pay a capital gains tax on it. So, if someone sells a house, they will most likely have to borrow again, at higher rates, to buy another house that's the same price as the one they just sold. This fact could actually keep housing "supply" — the supply for sale, not the stock — low.

Banks

Banks play a unique role in Canada's housing market. As the primary mortgage lenders in the economy, they dictate the amount of money that's available to borrow. Potentially, policies aimed at banks could cool the housing market somewhat. If, for example, banks were banned from issuing mortgages for speculative purposes (i.e., loans to buyers who hold houses just to profit later), then that could potentially take a bite out of the speculation that has taken hold of the housing market.

The downside is that this would be bad for the banks. Canada's large banks, like **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM), make up a huge percentage of Canadian retirees' portfolios. Many retired Canadians invest in Canadian index funds, and such funds are heavily weighted in banks. CM is a worthwhile bank to mention here, because it's the most "Canadian" of Canada's big banks. Unlike its competitors, it does not have a huge presence in foreign countries. So, efforts taken to cool Canada's housing market via restrictions on lending could harm CM and, by extension, the Canadian equity markets.

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