Intelligence MEMOS

From: Paul R. Masson

To: Canadian Housing Watchers

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Re: **Goldilocks Interest Rates Needed to Help Housing Affordability**

In the current debate about how to make housing affordable in Canada, there is a curious omission: The role of monetary policy, which was excessively loose in creating the problem and can be more responsibly applied to solve it.

The global financial crisis of 2008-09 led central banks around the world to reduce interest rates to historically low levels, which made perfect sense during the crisis, but then to keep them there for more than a decade, which sowed the seeds of our current affordability crisis. Low rates were justified in two ways. Inflation was low, so they seemed appropriate, or at least not harmful, in their role in inflation-targeting. Second, banks and other lenders that had invested heavily in US mortgage-backed financial instruments needed the relief of low rates to gradually repair their balance sheets and resume lending in the recovery from the US housing crash.

Although Canada was not hit as hard as the US and Europe, the Bank of Canada also kept interest rates low. As a result, our house prices did not fall and our banking system remained in good shape.

This loose monetary policy kept Canadian mortgage rates hovering around 5 percent for more than a decade. The five-year fixed rate only rose above 6 percent in June 2022, after the Bank of Canada started raising its overnight rate to deal with inflation. Before that, however, mortgage rates were much lower than the annual rate of increase of house prices, making property investment a one-way bet: Borrowing at 5 percent to buy an asset that's appreciating at well above 5 percent is a sweet deal.

So the property boom picked up steam and house price inflation ramped up. From May 2015 to December 2019, the Teranet average house price index for 11 Canadian urban centres increased at a more-than-brisk annual pace of 12.4 percent. Over the next 30 months, it hit a dizzying 15.6 percent. Average urban house prices more than doubled from 2012 to 2022.

In retrospect, as some of us **pointed out** at the time, the Bank should not have kept interest rates so low for so long. Rates that were negative in real terms created distortions in financial markets and perverse incentives for savers and investors. And goods-price inflation clearly was not dead.

The massive rise in house prices that resulted from "too low for too long" has favoured older generations, whose homes have risen impressively in value. Many young households, who don't have high incomes or savings but do have kids and critical housing needs, have been completely priced out of the market. With starter homes costing a million dollars or more, buying is impossible for people who don't work in tech or finance or have parents with deep pockets. By stimulating property speculation by older households and rich foreigners, low interest rates may have reduced the supply of housing for those who need it most. These investors may be responsible for 30 percent of house purchases, according to one recent **estimate**. Many houses are owned by people who may not occupy them full time, if at all.

Over the past 18 months, the world's central banks, Canada's included, finally raised interest rates to rein in the post-pandemic spike in inflation. In the short run, those rates make things even more challenging for young households with only modest down payments. Meanwhile, governments, desperate to be seen to be addressing affordability, have enacted or proposed measures that are unlikely to be adequate until house prices decline substantially. Some, like subsidies to first-time homebuyers, may actually keep starter home prices high. Reducing the permissions builders need for construction will help, but is unlikely to have a dramatic effect on the price of land. And high land prices seem to have led to bigger and bigger homes, as developers justify the overall price by providing luxury accommodations. Such homes won't be bought by most young households.

In the longer run, however, higher interest rates will eventually exert downward pressure on house prices. To make housing affordable again, however, that pressure will have to continue until prices fall by enough to make mortgages affordable. Low current house sale volumes indicate investor enthusiasm has pulled back drastically. But, so far, prices have moved only a little. It will take time for them to fall further.

Finally, as the Bank of Canada ponders when to start its rate cuts, it is crucial to avoid a lost decade like the 1970s by preventing a return of the post-2008 era of unsustainably low rates. The target needs to be the Goldilocks interest rate: high enough for a time to bring house prices down but then not so low as to enable inflation to rise from the dead again.

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