Intelligence MEMOS

From: Ed Devlin, Thomas Rowlands and Parisa Mahboubi

To: Canadian real estate watchers

Date: August 16, 2021

Re: **Immigration Remains the Key to Housing Prices**

Canada's housing market is among the hottest in the world.

The continued strength in the market, despite the pandemic and higher construction costs, has fueled debate around restrictions on housing supply. However, the recent soaring housing prices could also lead to overbuilding, which could be followed by a housing slump reminiscent of the early 1990s collapse related to huge speculative investments.

While addressing housing supply is important, investors and policymakers should also closely track factors influencing demand to ensure the current situation does not lead to a bursting bubble.

Soaring house prices are indicative of excess demand or shortages that can be driven by factors such as shifts in preferences or imbalances between housing completion and family formation – the term used by economists to define the number of housing units required by an economy.

Pre-pandemic forecasts suggested a continuing excess demand in Canada's housing market over 2017 to 2021 as household formation was expected to outpace housing construction. High international immigration since 2016 was projected to increase average annual household formation to more than 200,000 during the period 2019 to 2023 – an increase of roughly 40,000 families per year compared to the previous comparable period – while housing completions were less than 200,000 units in 2019 and 2020.

However, household formation forecasts are more difficult when long-term fundamental drivers such as immigration, interest rates and urbanization collide with an extreme short-term factor such as COVID-19.

Population aging in Canada, due to declining fertility and lifespan increases, has triggered higher immigration target levels in recent years, boosting family formation. However, pandemic-related restrictions have short-circuited the immigration flow, which is the main contributor to Canada's population growth. Fewer than 185,000 newcomers arrived in 2020 – representing a roughly 46 percent shortfall in the 340,000 target level. And the 2021 plan to significantly increase immigration to more than 400,000 might also be hard to achieve, which may put even more pressure on absorption of housing in coming years.

Although the demand side of the housing market greatly depends on immigration, the strong housing market during the pandemic shows there are other important factors at play.

First, given the structure of the Canadian mortgage market, the most important interest rate for housing is the five-year mortgage rate. That rate has not recovered to its pre-pandemic level, and nor, given recent guidance from the Bank of Canada, should we expect it to for another year or so. Low mortgage rates translate into cheaper housing costs, which drive up demand.

Second, the pandemic has affected housing preferences. Due to the ability to work remotely and spending more time at home, there has been a shift toward single family homes particularly in areas surrounding large urban centres that provide relative affordability and better quality of life. Canada's three largest cities – Toronto, Montreal and Vancouver – continued to grow, but were far outpaced by growth in surrounding Census Metropolitan Areas.

Family formation dynamics, which operate in concert with demand for housing, have been very much in flux since the start of the pandemic. They should be taken into account when evaluating whether Canada's housing market is over-priced, in addition to factors such as interest rates, mortgage credit markets (both quantity and quality), and the outlook for the economy, among others.

Once investors and policymakers have a better handle on post-COVID trends in household formation and workplace transformations, they can better assess the state of the housing market and specific segments within it.

But, overall, our analysis of the main determinants of household formation do not currently support the current predictions of a housing price crash.

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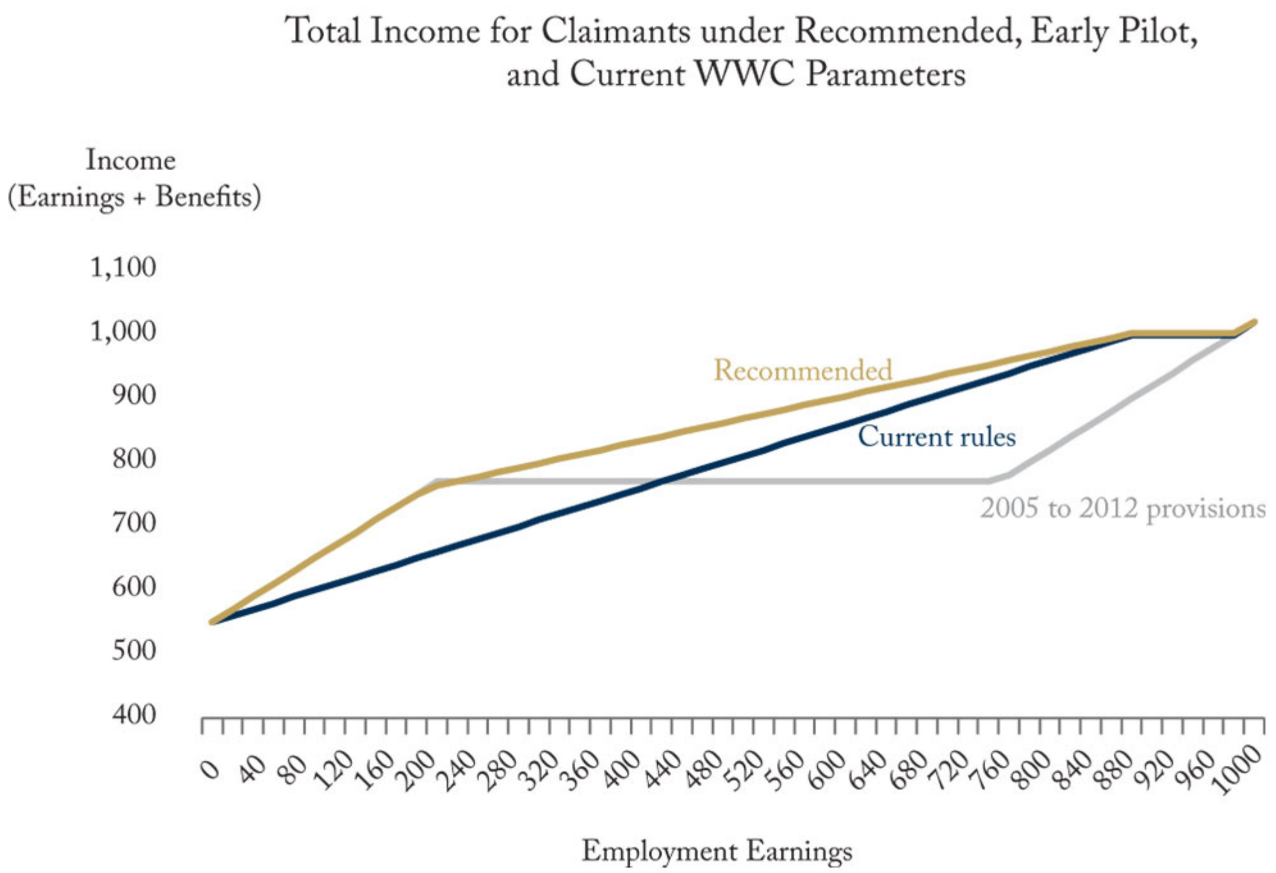
Figure 1:


Total Income for Claimants under Recommended, Early Pilot, and Current WWC Parameters
Income (Earnings + Benefits)
1,100
1,000
900
800
700
600
500
400
Recommended
Current rules
2005 to 2012 provisions
0
40
80
120
160
200
240
280
320
360
400
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560
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640
680
720
760
800
840
880
920
960
1000
Employment Earnings