Economics

IN FOCUS

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Higher rates will not cure what ails Canadian housing

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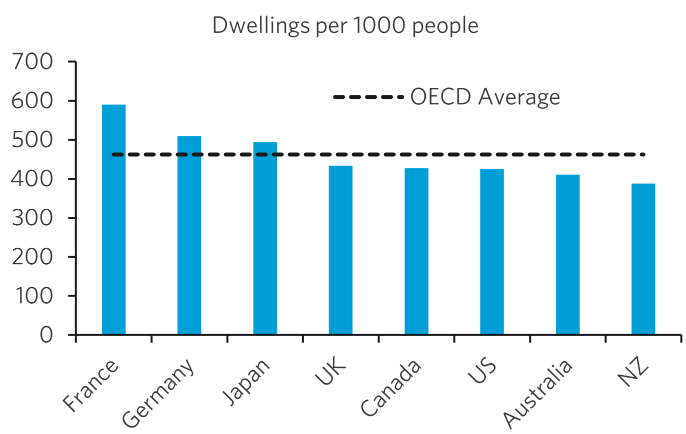
Interest rates are on the rise, and the ultra rate sensitive Canadian housing market is responding. Sales are falling fast, and prices will follow. The adjustment in the market will be directly linked to the speed and magnitude of future rate hikes. However, the return to balanced conditions or even a buyers' market will not cure what ails the Canadian housing market. It will just ease the symptoms for a short period of time. In fact, if history is a guide, the slowing ahead might worsen the supply-demand mismatch in the market.

Therefore, entering a more relaxed housing environment should not ease the urgency in which the chronic lack of housing supply in the Canadian market is dealt with. After years of fighting supply issues using demand tools, governments at all levels finally recognize that over time, the housing affordability crisis will worsen without adequate supply policies.

Chart 1: Housing supply in an international context—a misleading picture



Source: OECD, CIBC

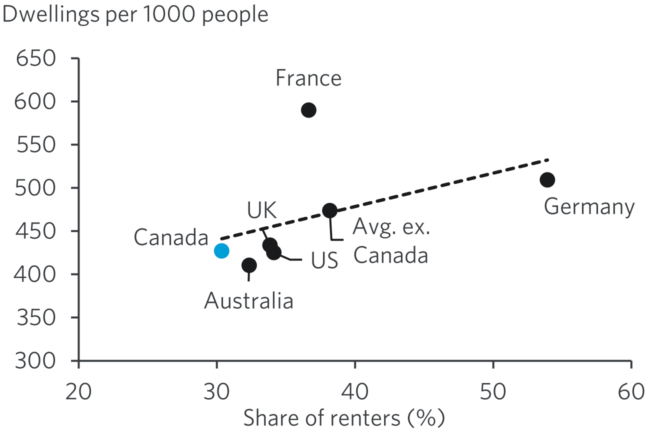
But how big is the supply issue? And where is it concentrated? That determination is a precondition to any successful future housing policy. And the reality is that current methodologies and estimates are based on inaccurate assumptions and are too simplistic to be used as a base for any housing policy. After all, how can a supply policy be designed without knowing the real demand situation? Beyond that, the ambitious plans by the federal and provincial governments to dramatically increase the supply of housing in a relatively short period of time don't account for the industry's lack of capacity to achieve those ambitious goals.

International comparisons should not guide policy

The most popular approach to illustrate the supply issue facing the Canadian housing market is a simple comparison of the housing stock to the population using the OECD's database. In fact, that approach was used in the 2022 budget, which compared Canada to peer countries (Chart 1). Admittedly, the chart is a convenient way to make the point. But as is often the case, the cost of simplicity is too high. While Canada does fall slightly below the average on that score, the comparison is diluted by differences in the definitions of concepts across countries as well as demographics and patterns in household formation related to cultural differences.

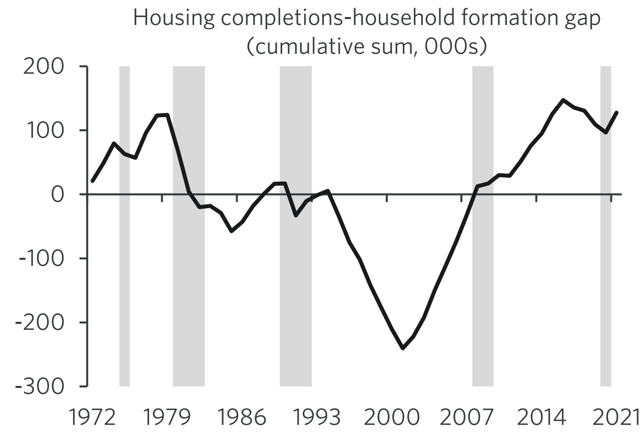
In fact, we doubt that the OECD researchers that are behind those numbers would bet their paychecks on how accurate that comparison is. The organization itself posits that cross-country comparisons using its data are ill advised, stating that "*data are not available for the same reference year(s) across countries, and data are not always up to date*", and "*national definitions do not always allow for cross-country comparison*". Furthermore, taking

Chart 2: Countries that rely more on renting have higher supply of housing



Source: OECD, CIBC

Chart 4: Based on official numbers: Over the past 50 years, more housing units were built than households were formed

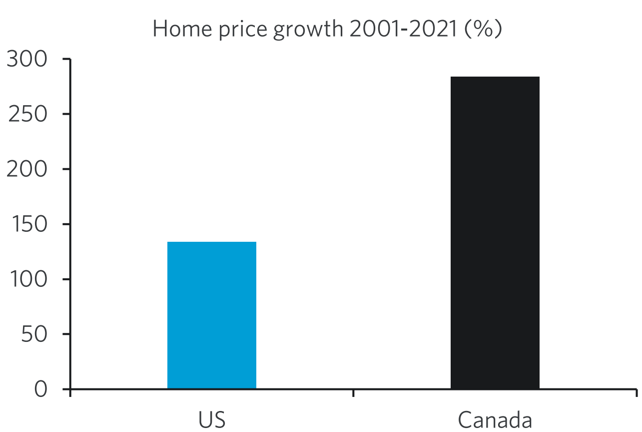


Source: Statistics Canada, CIBC

housing stock as a share of the population doesn't account for differences in demographics or cultural preferences that shape household sizes or formation rates. Nor does it account for the different propensity to rent, as countries with higher shares of renters generally have more abundant housing supply (Chart 2).

Even if we ignore the rest of the OECD and compare Canada to something closer to home, the US market, things are still not so simple. Take another look at Chart 1 (the one used in the budget). According to the OECD, the supply situation in Canada and the US is basically the same (and we will forgive the fact that the US numbers are for 2019 and the Canadian numbers are for 2016). So if the supply situation is roughly the same, why have prices in Canada risen twice as quickly as in the US over the past 20 years (Chart 3)? Yes, the US went through the financial crisis, but has had ample time to recover from it. So something else is happening here. In short, this simple (and convenient) comparison is hardly one that housing policy in Canada should be based on.

Chart 3: Home price growth in Canada double US pace over past two decades



Source: OECD, CIBC

Digging deeper

These shortcomings of international comparisons suggest that it's more informative to look at Canada's housing market in isolation to determine what's behind the market's imbalance. Looking back at the cumulative number of housing completions relative to household formation since the 1970s (Chart 4), we can see that on a cumulative basis, more housing units were built than households were formed. That is true even when accounting for the fact that some completions replace existing structures.

Accordingly, this observation makes it seem that all of the noise about supply is much ado about nothing. Warning: Don't stop reading now. The rest of the piece explains why that's not the case.

Housing demand is grossly undercounted

When it comes to looking at the mismatch in the housing market, the variable to focus on to measure housing demand is household formation. And we assume that this number is measured accurately and is written in stone. After all, municipalities rely on those estimates heavily when they make decisions regarding land release and building permits. But the household formation numbers are far from accurate. They are derived by the CMHC by translating population growth into the number of households using estimates of headship rates, or the number of households created from a given number of people. However, plenty of information is being lost in that translation, leading to a gross underestimate of the real number of households in Canada, and thus demand for housing. And if demand is undercounted, then of course the supply released by municipalities to meet that demand will be inadequate. In the past, we've highlighted some of these issues, and here we summarize our concerns with the current methodology used to estimate household formation in Canada.

1. 2021 Household formation projections are based on 2016 data and materially understate the number of immigrants and non-permanent residents (NPRs) since 2016

The official number of households in the 2021 CMHC estimate is derived from Statistics Canada's Population Projections and is based on 2016 census data. All subsequent years are projections. The assumptions of immigration are based on the 2019-2021 Immigration Plan presented by the Minister in 2018. NPR projections were derived by consultations with Statistics Canada's Demographic Division around the same time period (2018). However, the actual number of new immigrants and NPRs during that period was notably higher than those estimates, suggesting a material undercounting of housing demand in the official CMHC household formation figures.

2. Expired NPR Visas not counted as residents or households

Statistics Canada's Demographic Division policy is to count all expired NPR visa holders as having left the country 30 days after the expiration of those visas. However, during Covid, NPRs with expired visas were allowed to stay in the country through extensions as announced on Immigration Canada's website, including those with pending Permanent Resident applications. Therefore, those individuals are not a part of any official statistics—but they still require housing.

3. Usual place of residence

Based on the census, the usual residence of post-secondary students is that of their parents, if they return to or are assumed to intend to live with their parents in the future, even if they live elsewhere while attending school or while working a summer job. This of course leads to a major undercounting of demand for housing (mostly rental units) by students during the academic year. As a side note, we should mention that the US counts post-secondary students differently and doesn't seek to identify students' intent to return to a parental home. Those students are counted as part of the overall demand for housing. Another reason to be very careful to not compare Canadian and US statistics without proper adjustments.

4. Undercounting headship rate for new immigrants and NPRs

CMHC calculations assume the same headship rate for new immigrants, NPRs, and long-term residents/citizens. That's problematic. For example, the headship rate of immigrants and NPRs in their late teens and 20s is likely to be substantially understated, as the census materially overstates the share of that age cohort that remains in its parental home. And the growing share of young adult immigrants suggests that this undercounting will be even more significant in the future.

There is no way to precisely quantify the magnitude of the undercounting of housing demand due to the factors discussed earlier. Our conservative educated guess is that that number is close to 500,000 households. That is, official household numbers often used to estimate the demand in the market undercount the real demand for housing by about half a million households.

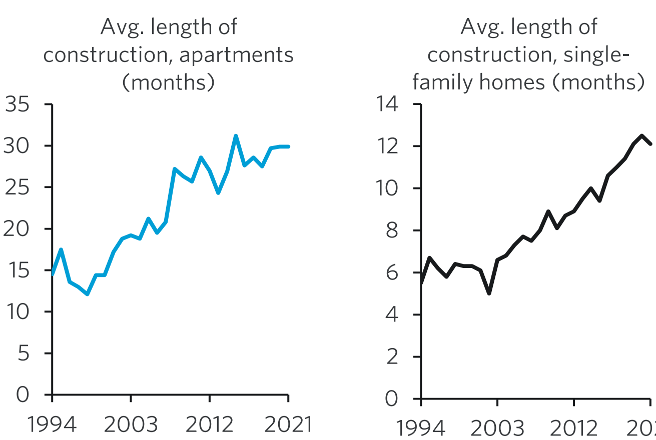
But we won't have to guess for long. While changes to the methodology and collection processes for the 2026 Census are necessary to resolve the undercounting, the upcoming releases of disaggregated household and dwelling data for 2021 from the long-form census will better inform us about the shortfall in the numbers used by CMHC to make household projections, and therefore should be used as a base for any supply-related policies.

Construction industry doesn't have the capacity to meet governments' elevated targets

The undercounting of demand means that the supply issue is real and needs attention. There is no shortage of ideas and suggestions to address this problem, and we have discussed many of them in the past. The most direct policy response by governments at all levels is a commitment to quickly build many more units. But not enough consideration is given to the simple fact that the industry's capacity to reach those elevated targets is questionable at best. Our focus here is on one aspect of the issue: the rising cost and length of construction due to a lack of labour and trades. Chart 5 tells the tale.

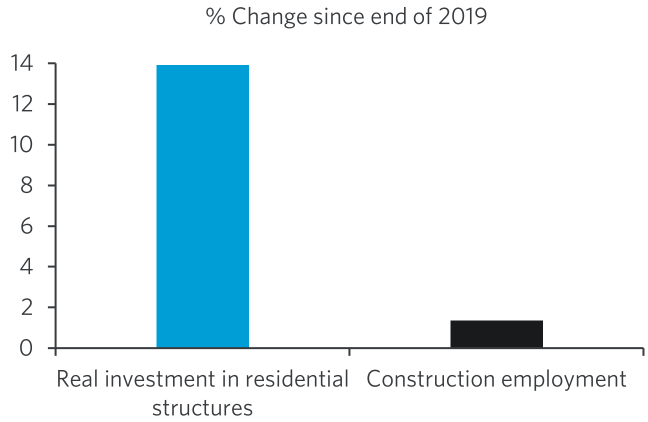
If time is money, then the ongoing increase in the average length of time for completions is a major challenge facing the market. It takes twice as long to complete both low-rise and high-rise units today than it did two decades ago. And a lack of labour supply is a major cause of those delays. While large developers are usually able to secure their own labour pool, that's not the case for mid-sized and small operators that

Chart 5: Time is money



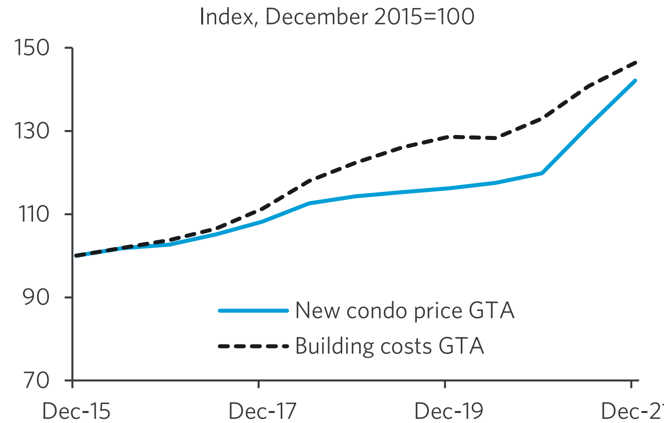
Source: CMHC, CIBC

Chart 6: Labour supply issues amplified during pandemic as demand grew



Source: Statistics Canada, CIBC

Chart 8: Higher building costs eroding developers' margins

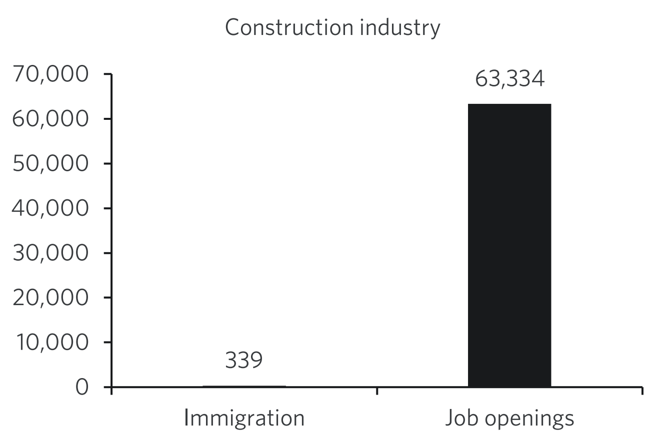


Source: Altus, Urbanation, CIBC

account for 30-40% of activity. Increased competition for labour due to the growing number of large-scale infrastructure projects underway has added to the challenges in recent years. And the pandemic exacerbated that labour shortage. While demand for homes and renovations was supported by rock bottom interest rates and the shift to working from home, employment in the construction industry didn't reach its pre-pandemic level until January 2022, as higher wages started to attract employees. That compares to residential investment which more than recovered by the third quarter of 2020, and stood 14% above those levels as of Q4 2021 (Chart 6) in after-inflation terms.

While overall immigration in 2021 was very strong, it didn't even come close to denting the labour supply issue in the construction industry, as hardly any of the 400,000 new immigrants that arrived last year worked in construction (Chart 7). Clearly, in order to address the supply issue in housing, an immigration component is needed. In addition, policies aimed at training young Canadians in skilled trades would help to ease the labour shortage.

Chart 7: Construction industry (2021) hasn't benefitted from higher immigration



Source: Statistics Canada, CIBC

Moreover, higher labour costs combined with supply chain disruptions and higher fuel prices for transporting building materials have added to construction costs during the pandemic. Chart 8 illustrates that issue. Since 2015, the cost of construction in Toronto has risen by 46% while the price of a newly built condo unit has risen by 42%. That narrowing in profit margins is starting to impact supply by making developers think twice before committing to projects. Higher interest rates will add to development costs, while at the same time it will work to reduce demand. Without a dramatic reduction in the cost of construction, look for overall new supply to soften notably in the near future.

Even an undersupplied market can adjust or correct under the weight of rapidly rising interest rates. The ongoing slowing in housing activity will bring some sanity back to the market. The pause should be used as an opportunity to continue to implement and fine tune housing policies aimed at preventing a retightening in market conditions as we reach the other side of the current market slowdown. A much more accurate measure of housing demand is an absolute precondition here. Our rough estimate that current housing demand is undercounted by 500,000 households illustrates the potential size of the problem. The upcoming release of the disaggregated household and dwelling data from the long-form census should provide us with some necessary information here, and the 2026 census should be redesigned to overcome the issues raised above. Finally, the labour shortage is likely to ease as the market slows, but a long-term solution is needed. It's easy to propose a significant increase in the supply of housing on paper, but it's much more difficult to do it in practice when you don't have enough trained workers to do the job.

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