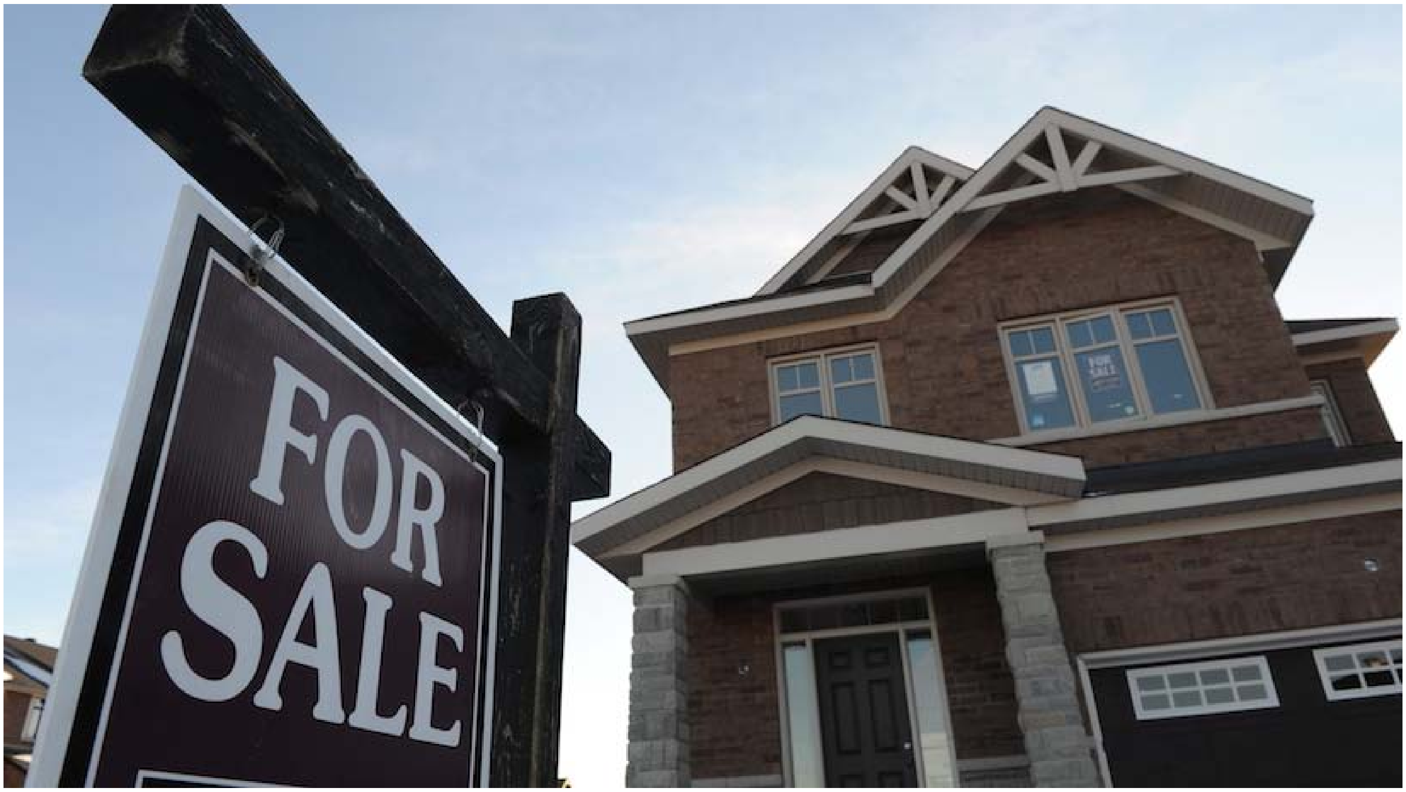
Why low rates may not be enough to save the housing market

Aside from refinancing existing loans, low rates may no longer induce households into taking on further debt

Andrew Hepburn

February 23, 2015



THE CANADIAN PRESS IMAGES/Sean Kilpatrick

With the Bank of Canada's shock January rate cut, some signs point to more borrowing by already deeply indebted households. Smaller lenders are offering rock-bottom mortgage rates that will certainly tempt more than a few people to take on more credit. Thus, at a time when house prices are sky-high, the threat of the real estate bubble growing ever larger can't be ruled out.

Looking past the very short term, however, Canadians' relationship with debt looks likely to change, with serious implications for the economy and monetary policy.

At the moment, low interest rates induce people to borrow. Cheap carrying costs encourage people to load up on debt, whether to take out a mortgage or buy a new car. With regards to the housing market, many analysts cite low rates as a factor that will continue to support prices despite obvious overvaluation. So long as rates are low, the argument goes, demand for housing will remain strong.

There's good reason to believe this view is mistaken. In a seminal book called "The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession", economist Richard Koo outlined a concept he refers to as a balance sheet recession. Japan is a main case study of this phenomenon, as its gigantic real estate and stock market bubbles of the late 1980s collapsed with severe consequences for the nation's economy.

Koo shows that after the bubble burst, a peculiar thing happened: despite rock-bottom interest rates, Japanese corporations did not borrow new money. In fact, they started paying back existing loans. The problem was that because so many companies bought real estate at vastly inflated prices during the bubble, gaping holes were left in corporate balance sheets. Assets plunged in value but the debt remained, leaving systemic insolvency in its wake. The only thing keeping the businesses afloat was positive cash flow from ongoing operations. This was used to pay down the mountain of debt from the bubble years.

Admittedly, there are important differences between late 1980s Japan and 2015 Canada. For one, in Japan it was the corporate sector that took on the most debt during the bubble. In Canada, households have that dubious distinction.

In addition, interest rate hikes by the Bank of Japan contributed to the bubble's bursting. That seems very unlikely in Canada. The Bank of Canada's window to raise rates is quite obviously closed. More rate cuts are clearly on the cards.

So the key question, particularly concerning the housing market, is whether low interest rates are sufficient to protect it from collapse. I don't think they are. For one thing, while some Canadians have been emboldened by the rate cut to jump into the housing market, many others will see the central bank's action as a worrisome sign for the economy.

In fact, concern about the economy predated the rate cut. An early January poll by Nanos Research for Bloomberg News showed that 31 per cent of respondents expected house prices to rise this year, down sharply from 47 per cent in July. The sharp drop in expectations was attributed, quite understandably, to the effects of the oil price crash on the outlook for the Canadian economy.

It's worthwhile to conceptualize the relationship between interest rates and expectations of future house prices. When interest rates are low and house prices are expected to keep rising, borrowing money to buy real estate makes a certain amount of sense. You borrow at, say, 3 per cent, and expect prices to rise maybe 7 per cent, thereby pocketing, at least on paper, the difference. In this scenario, low rates seem too good to be true.

But what if people start to believe that prices won't rise, or that they may even fall? In this event, low rates are not so tempting, even for those who did not become overextended during the bubble. Why borrow money, however cheaply, if you expect house prices to decline, whether because of the oil rout, lack of affordability or overbuilding?

All this is to say that despite some differences, Canada may very well end up somewhat like post-bubble Japan. We have a highly indebted sector (households) that has taken on huge debts to buy inflated real estate. The inevitable bursting of the housing bubble will result in a large number of households with negative equity in their houses and condos. They will be in no position to borrow more.

For all the focus on the Bank of Canada's recent loosening of monetary policy, Canadian households may simply stop responding to low rates. Aside from refinancing existing loans, low rates may no longer induce households into taking on further debt.

When this occurs, and as Richard Koo shows happened in post-bubble Japan, the effectiveness of monetary policy in Canada will sharply decline. Low rates may continue to affect the foreign exchange value of the Canadian dollar, but the Bank of Canada will not be able to convince households to continue their borrowing binge.

The housing bubble is in its final stage. After it bursts, an economy already reeling from the oil crash will be faced with an even more serious threat. Plunging home prices will send the excess borrowing and consumption of the bubble years into reverse, causing the economy to fall into a serious recession.

As in Japan, the government will have to assume the role of borrower and spender of last resort. Large deficits are certainly not ideal, but in post-bubble Canada they may well prevent the worst from happening.

Andrew Hepburn is a freelance journalist and former hedge fund researcher. He writes on commodities, the stock market and the financial industry. Follow him on Twitter: @hepburn_andrew

Get *Maclean's* on Next Issue—Your gateway to the world's best news stories. Sign up for a FREE trial.

BROWSE

Housing Market **Low Rates** **Real Estate**

ABOUT THIS AUTHOR

macleans.ca

OTHER ARTICLES

The Quiz: You vs. the Maclean's Genius

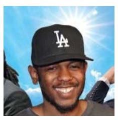
Letters: 'What good is our democracy when no one goes out to vote?'

+ 14 more posts this week

MACLEAN'S TOP STORIES

The great escape
0 COMMENTS

Damn you, sum of human knowledge
0 COMMENTS



The sunny side of the mic
0 COMMENTS

PREVIOUS
Putting micro condos to the test in Canada

NEXT
Spring housing market heats up in Toronto, Vancouver, realtors say

RELATED STORIES

The scariest chart on Toronto condo construction ever

2013 shaping up to be weakest year on record for GTA new home sales

Who earns what in real estate

When the housing bubble bursts, there won’t be a soft landing

A roadmap to Fort McMurray's tanking housing market

POPULAR ON MACLEAN'S

‹ 1 of 2 ›

The real target of Taber’s new law: Mennonites?

9 COMMENTS

Kimmy Schmidt and the end of conventional sitcoms

America dumbs down

479 COMMENTS

Stephen Harper’s veiled threat

4 COMMENTS

Photo gallery: Pop-up portraits from the 2015 Juno Awards