

ECONOMICS: CANADA PERSPECTIVES—JANUARY 6, 2012

Canada's Mounting Mortgage Debt Raises Concerns

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Mounting household mortgage debt in Canada is, in some ways, collateral damage from the disruptions of the global recession and financial crisis. Canada's central bank leader, wearing a new global hat, is increasingly sounding the alarm.

As Mark Carney, Canada's central bank governor, takes the helm of the new Financial Stability Board (FSB), which oversees the global financial system, he seems to have adopted a more global perspective on capital flows and deleveraging. This shift was evident in his recent warnings about mounting household mortgage debt in Canada.

Canada has been experiencing an extended housing rally—nationally, home prices have risen 29% since February 2007. This strong updraft stands in stark contrast to a 32% drop over the same period in the US, which is still struggling to find a bottom and absorb a glut of foreclosed homes in an environment of tight credit. Unlike the US, Canada had very low leverage in mortgage debt as the global recession began. Its interest rates were also at record lows: banks were ready to lend and households were happy to take on more debt.

As a result, housing prices have soared, a trend that's most pronounced among existing homes. Price gains have been

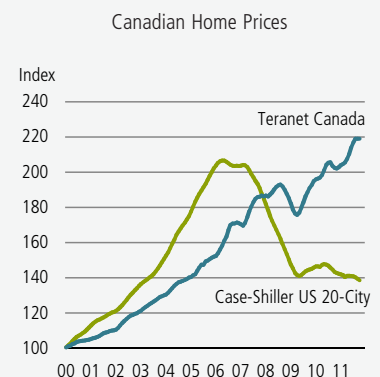
concentrated in Vancouver, British Columbia, and more recently Toronto, Ontario. The relentless run-up in asset prices (**Display 1**), accompanied by the related increase in mortgage debt, seems to be a growing concern for Carney, who retains his responsibilities as the head of Canada's central bank.

Collateral Damage from the Global Recession

As Carney points out, Canada's home price boom and growing mortgage debt represent another form of the seemingly endless collateral damage stemming from the global recession and financial crisis.

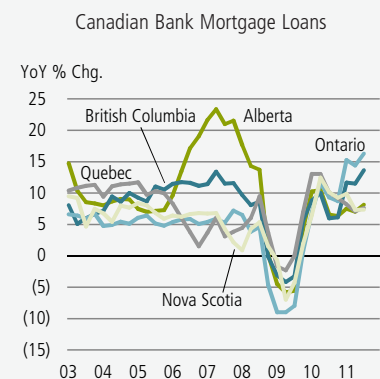
One area of disruption: US interest rates remain at rock-bottom levels to ease the strains of deleveraging. With US rates extremely low, the Canadian dollar rallies whenever rates in Canada are expected to rise. That upward pressure on the Canadian dollar has been compounded by the global movement toward risk-free assets. To investors at times desperate to replace higher-risk European bonds in their global portfolios, Canada's increasingly

Display 1
A New Peak for Canadian Housing



Through January 3, 2012
Source: Bank of Canada and Haver Analytics

Display 2
Borrowing Is Back



Through January 3, 2012
Source: Bank of Canada, Bloomberg and Haver Analytics

rare AAA credit rating makes its government debt appealing. The resulting capital inflows have financed a growing current account deficit, as Canada's rising currency has eroded its trade balance by making exports more expensive and imports cheaper.

Low Canadian interest rates that result from Canada's high currency value have a big impact on the country's housing market, as they make mortgages affordable even at higher-than-normal home prices. In fact, mortgage payments remain near historical averages even as home prices have jumped to 4.8 times household disposable income, compared with the historical average of about three times household disposable income.

Cheap credit has encouraged home buying, which has inflated prices, as it has in every similar episode through history. A closer look at the chartered-bank residential mortgages held in bank portfolios reveals that the credit boom has

increasingly funded home buying in British Columbia and Ontario (**Display 2, previous page**).

Global Spending Imbalances and Debt Substitution

As Carney notes, the decades-long global credit cycle has been supported by heightened spending of borrowed money. That borrowing, often by those in pursuit of investment gains, has enabled significant spending imbalances to develop across countries and sectors. These dislocations seem vulnerable now, when some credit sectors are contracting globally.

When one part of the global financial system seeks to reduce debt when its hand is forced by nervous lenders, another part has to make up the difference, unless overall credit-backed demand is allowed to decline. Canada's uncommonly strong housing rally in some ways represents this process of leveling: Canadian mortgage rates are low because US rates are low due

to feeble US credit demand. Capital inflows from risk-averse global investors reflect concerns about excess borrowing in parts of Europe.

So Canada's financial markets and home buyers are essentially working overtime to help rebalance global credit demand. As they do, the overvalued Canadian dollar has shaved about C\$30 billion from net exports to the US, according to Governor Carney, which is equivalent to about 1.8% of Canada's gross domestic product (GDP), a common measure of economic output. Canada is too small, though, to have a major impact on the US—the same net export gain is merely 0.2% of US GDP.

What may be more pressing for Canada than lower exports to the US, however, is the risk of a housing correction, which might be avoided by instituting tighter loan requirements and other measures. ■

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