

ECONOMICS: CANADA PERSPECTIVES—FEBRUARY 19, 2010

New Mortgage Rules Are Unlikely to Change Policy Course

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Tightening mortgage standards is an important step toward preventing a future housing bubble, but we doubt that these new rules will deter the Bank of Canada from raising official rates this year, possibly in June.

This week, Canadian finance minister Jim Flaherty announced three new regulatory rules aimed at supporting the long-term stability of the housing market. Some commentators suggested that these changes will alter the interest-rate outlook. We disagree. While we applaud the new standards as prudent, preventive measures, they are unlikely to change the course of the Bank of Canada's monetary policy, which we see becoming less accommodative by midyear.

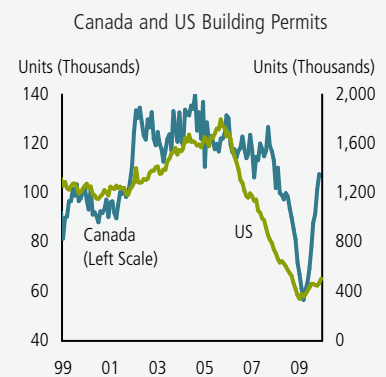
The Canadian housing market has staged a spectacular rebound in recent months, helping to lift the Canadian economy out of recession. But it has also sparked fears of another housing bubble that could create future problems for policymakers. While stressing that it sees no evidence of overheating currently, the finance ministry is moving to avoid that outcome by cracking down on speculators and discouraging homeowners from taking on too much debt. Arguably, the risks of a systemic meltdown would have been greatly mitigated if other countries had implemented similar regulatory changes

prior to the crisis. We continue to view Canada's regulatory framework as one of the strongest in the developed world.

The new rules apply to all government-backed mortgages, which would encompass nearly all mortgages with a loan-to-value ratio of more than 80%. First, all borrowers must be able to qualify for a five-year fixed rate, only a marginal tightening in standards since banks test on a three-year fixed rate currently. Second, mortgages for homes not used as a primary residence will require a 20% down payment. Third, Canadians will not be allowed to withdraw more than 90% of their home's value in a refinancing, versus 95% today.

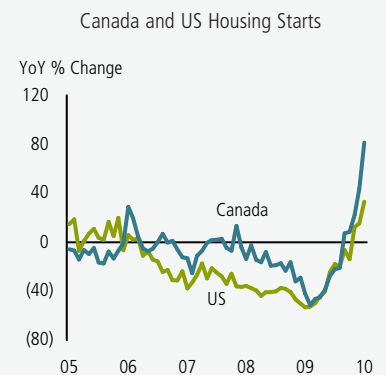
In our view, the most positive aspect of the new rules is that two of the three are aimed squarely at the root of the problems that emerged in past periods of rising home prices—the purely speculative buying of homes and the excessive use of home equity to extend credit. Nonetheless, we can't be certain how much of a dampening effect these measures will have

Display 1
Permits Have Bounced Back Faster in Canada than the US...



Source: Haver Analytics, Statistics Canada and US Census Bureau

Display 2
...and So Have Housing Starts



Source: Canada Mortgage and Housing Corporation, Haver Analytics and US Census Bureau

on the Canadian housing market because we don't know how much of its strength stemmed from these types of activity.

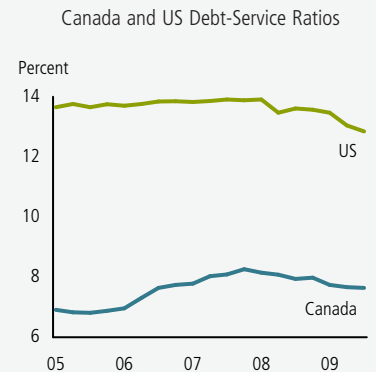
No question, prudent regulatory measures would be helpful. **Displays 1 and 2, previous page,** show how much stronger the resurgence in single-unit housing activity has been in Canada than in the US, in terms of building permits and starts. Canadians have responded far more vigorously to interest rates close to zero than their neighbors to the south.

But should anyone be shocked by this development? After all, Canadian consumers entered the recession in much better shape than their US counterparts. Debt-service ratios for the average

Canadian were roughly half as large as that of the average American leading into the downturn (**Display 3**), so it makes sense that a dramatic drop in funding costs would trigger a stronger rebound.

For these reasons, we don't expect the rule changes announced this week, while welcome, to significantly weaken the economic recovery. Hence, in a few months' time, the Bank of Canada is unlikely to view these steps as restrictive enough to influence the timing of the rate-hiking cycle. We continue to expect that cycle to begin at the central bank's June meeting, even if the US Federal Reserve has still not raised rates at that point.

Display 3
Canadian Consumer Debt Ratios Are Far More Manageable



Source: Haver Analytics, Statistics Canada and US Federal Reserve Board

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