

# Housing Market Digest

Greater Toronto Area, April 2017

***So much has been written about the market, that anything I have to say has already been said by at least seven other people. That said, this is my job. My bottom line here: the provincial government has broken the planning process. It owes it to the people to fix it, and NOW.***

*'If the reason that the price is high today is only because investors believe that the selling price will be high tomorrow - when "fundamental" factors do not seem to justify such a price - then a bubble exists.'*

Joseph Stiglitz. "Symposium on Bubbles," Journal of Economic Perspectives, Volume 4, Number 2, Spring 1990, pages 13-18.

The defining attribute of a bubble is that expectations about price growth have become too influential in decision-making. In the housing market, expectations about price growth can reasonably play a minor role, so long as the primary consideration is "what do I need and what can I afford". Based on the recent numbers, I suspect that we are seeing more "speculative attitudes". More on this later, but first:

## ***Deteriorating Affordability***

I have long held to a minority position that housing affordability has been excellent in the GTA.

Other analysts' affordability measures have said otherwise. The difference of opinion has two main elements:

- Firstly, the calculations should employ the interest rates that can actually be obtained in the market, rather than the posted rate.
- Secondly, the calculations should use only the interest part of mortgage payments and exclude the portion that results in repayment of principal (which is a form of saving): in terms of the consumer's bottom line, the real cost of finance is the interest part.

The chart (above, right) shows how affordability has varied over time. It shows relative changes, but doesn't draw any conclusions on the absolute level of affordability.

Affordability was (in comparative terms) extremely good until just a few months ago. Low interest rates created "affordability space" in which house prices could rise. How much they actually do rise depends on the balance between supply and demand. In the GTA, the affordability space has now been used-up.

From this perspective, strong housing demand and rapid price growth have been explicable as

the consequence of the economic fundamentals. Until this year, I have resisted using the B-word in discussing the GTA housing market.



But, that doesn't mean all is good: there is just too little available to buy in the market. I would argue that the stresses that have been felt by home buyers over the past few years haven't been so much about affordability, as they have been about the hyper-competitiveness of the market. And, as shown by the sales-to-new-listings ratio, the situation has gotten vastly worse. (In the GTA, the threshold for a balanced market is a ratio somewhere in the low 50s: the GTA is almost always a "sellers' market".)



## ***Failure of Supply***

In many ways, housing markets in Canada operate exactly as they should, according to the neo-classical micro-economics we were taught in our *Introduction to Economics* courses: prices are determined by the actions of many buyers and many sellers who act independently according to their own needs. In resale market transactions, both the buyer and seller are "price takers". But, at

the same time, by a magical process all of those independent actions cause demand and supply to be brought into balance (eg. if at the prevailing price level there are more people who want to buy than who want to sell, then prices rise to “clear the market”, etc.).

As an aside, there aren't very many major sectors in the modern economy that perform as they are supposed to: for example, you did not get your smart phone in such a market. This is part of what makes housing market analysis exciting to me: I can understand what is happening using simple concepts that I was taught a really long time ago. For example, this chart shows that in the GTA there is a very satisfying relationship between the supply-demand balance and price change.



One of those simple concepts from *Econ 100* is that when prices rise there should be responses for both demand (less of it) and supply (more of it).

But, in the low-rise housing sector (single, semis, and town homes, but excluding apartments), the supply response has not been working the way it should, for almost a decade. For much of the period in this chart, the supply response worked as it should, but clearly that is no longer the case.



Under-production over the past decade means that there is an inadequate supply of housing on the ground that could be sold. The shortfall has steadily worsened and is now getting dangerous.

We are now seeing increasingly sophisticated commentary on the supply situation. What I hear in those discussions is that there is a very large supply of lands within the GTA that are “designated” for low-rise development, but not enough of it is becoming available to get built-on. A major culprit is a more complex and lengthy approval process. The supply crisis needs to be fixed, and desperately.

### What about the Demand Response?

My thoughts are still developing on this. I am increasingly convinced that housing demand isn't very responsive to prices – the main driver of housing demand is whether people have jobs and confidence in their own futures. In order to meet what they consider their reasonable needs for housing, when prices rise, they are willing to make many other sacrifices.

Therefore, as the supply crisis has brought increasing price escalation, the consequence is increasing distress for people whose perspective is that they just want to meet their basic needs.

This brings me to the point about “speculative attitudes”. Speculation isn't just about people who flip houses. More generally, when people's decisions are too-strongly influenced by opinions about future prices, that is speculation. If they buy now because they believe something like “I have to buy now because the situation will be even worse next year”, that is a variant of “speculation”.

Recent data from the market suggests that this has started: rising prices may now be artificially boosting demand.

I doubt very much that the recent announcements by the provincial government are enough to tame these “speculative attitudes”. The best hope is for the government to prove that it will solve the supply crisis.

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