The Economy and Interest Rates: A Case for Weighing Both Hands

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It's no surprise to learn that economic conditions play a significant role in the housing market. Household financial conditions and confidence are inextricably tied to housing demand. Changes in the level of employment and wages can either induce additional housing demand or reduce it, while concern for job security can cause households to delay major purchases. In addition, when BC's economy is expanding faster than other provinces, the associated labour demand can attract an inflow if migrants, increasing the number of households in the province and the amount of housing demanded.

Now that the recession is behind us, demand for labour is again growing with business not only returning existing workers to full-time status, but also beginning to hire new workers to staff expanding operations. The aging population also means that an increasing number of retirements will create a sizable number of job openings that need to be filled. By 2017, more than half of all job openings in the province are expected to result from replacement demand.

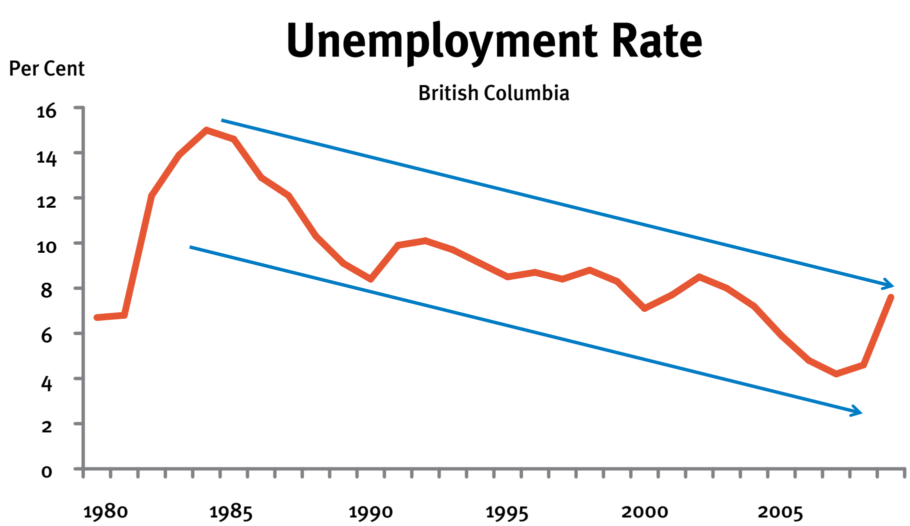
While the recession doubled the unemployment rate, it did peak at a lower level than previous downturns and is continuing on a long-term downward trend that will reveal much tighter labour markets in the future. As the recovery strengthens, upward pressure on wages will help underpin consumer confidence and housing demand. A robust economy creates jobs, rising wages, investment returns and stimulates new home construction activity.

However, the trajectory of economic recovery may be tempered by sluggish growth south of the border and in Europe, a high Canadian dollar and rising interest rates. Housing markets are particularly sensitive to interest rates. Over the past two months, the posted five-year fixed mortgage rate has climbed by a full percentage point, just the beginning of an interest normalization phase in Canada.

The Armchair Analyst should be cognizant of not only the stage of the business cycle, but also the carrying cost or affordability of housing. While a return to positive economic growth supports housing demand, rising carrying costs can offset this benefit. For example, the average home price in the province reached $504,312 in the first quarter and hit a record $516,970 in March. Rising interest rates reduce the purchasing power of households as the amount of mortgage funds a household can qualify to borrow declines. Recent tightening of borrowing qualifications for high-ratio mortgages exacerbates eroding affordability.

So what does this mean for BC housing markets? While Harry Truman famously quipped, "give me a one armed economist", this is a case where the Armchair Analyst needs both. On the one hand, improving economic conditions typically support increased housing demand through employment growth, rising wages and consumer confidence. On the other hand, record home prices combined with rising interest rates increases the carrying cost of housing and typically acts as a drag on demand. Putting both hands together, the Armchair Analyst can deduce that housing demand will unlikely set any records this year and that it may be some time before double-digit home price appreciation is a common occurrence.

In the next installment of the Armchair Analyst, we will look more closely at the components of population and household growth and what role they play in housing markets.



Source: Statistics Canada, BCREA