BANK OF CANADA
BANQUE DU CANADA

Opening Statement
Sylvain Leduc
Deputy Governor
House of Commons Standing Committee on Finance
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Ottawa, Ontario

Good afternoon, Mr. Chairman and committee members. Thank you for the invitation to appear before this committee. My colleague Don Coletti, who is an advisor to the Governor, is joining me today.

We are pleased to be able to contribute to your timely study on the Canadian real estate market. The Bank of Canada has a mandate to keep inflation low, stable and predictable. Given the importance of a well-functioning financial system in achieving our inflation goal, we provide our assessment of the stability of the Canadian financial system twice a year through our *Financial System Review*. Let me thus focus my remarks on financial stability.

Our assessment starts by identifying the financial system's most significant vulnerabilities; this is important since financial vulnerabilities can help propagate and amplify shocks to the economy, leading, among other things, to larger deviations of inflation from our 2 per cent target.

Over the past few years, we've highlighted two key vulnerabilities that are relevant to your study: high levels of household indebtedness and housing market imbalances. These two vulnerabilities clearly interact with one another, as households borrow more to buy more-expensive homes.

Let me briefly discuss these two vulnerabilities in turn. The first one, indebtedness, is well known. The ratio of debt to disposable income in Canada is now approaching 170 per cent. This ratio has been rising steadily since the early 2000s. Additionally, the aggregate number masks worrisome patterns regarding how this debt is distributed. For example, our analysis shows that debt has become more concentrated over time in households with higher levels of indebtedness. Compared with their less indebted counterparts, these households tend to be younger and have lower incomes.

The second vulnerability concerns house prices, which now stand at a record of almost six times the average household income on a national basis. What's most concerning here are the imbalances in some cities, most notably Toronto and Vancouver. The price increases we've seen in those cities have been caused by a number of factors, ranging from demographics to low interest rates to constraints on land use. We have also highlighted our concern that expectations of future price growth may be a contributing factor. Because these expectations can change rapidly, the imbalances that have emerged make it more likely that shocks to the economy could cause a drop in prices.

In light of these vulnerabilities, the most important risk to the financial system remains a large and persistent rise in the unemployment rate across the country, which creates both financial stress for many highly indebted households and a correction in house prices. In this scenario, households significantly cut back their consumption spending, while a rise in defaults and a decline in collateral values exert stress on lenders and mortgage insurers. Although we see a low probability of this risk materializing, its impact would be substantial if it were to occur. This is why we judged this risk to be “elevated.”

That said, I hasten to add that we’ve conducted model simulations to analyze the effects of such a shock and found that the buffers in the Canadian financial system would be sufficient to absorb its impact. So while there would be stress, the financial system would remain resilient.

As you know, the federal government made important changes to housing finance rules last fall. These changes should reduce the rise in highly indebted households over time by ensuring that borrowers are more resilient to potential future headwinds. We are not expecting the regulatory measures to lessen this vulnerability overnight because it will take time for the number of highly indebted households to decline significantly.

It’s also worth emphasizing that, under the new mortgage finance rules, the ability of all insured borrowers to make debt-service payments must now be assessed using an interest rate that is higher than the prevailing market rate. As well, applicants must show they can cover the costs associated with servicing not only their mortgage but also their total consumer debt. We expect this more stringent test will reduce vulnerabilities not only in Toronto and Vancouver, but also in cities where house prices aren’t as high relative to incomes, such as Montréal, Halifax and here in the Ottawa–Gatineau region.

The last point I’ll make is that the Bank of Canada can best contribute to long-term financial stability by keeping inflation low, stable and predictable. To achieve our inflation mandate, we cut interest rates after the financial crisis and have done so twice since 2014, after oil prices collapsed. Our actions supported income growth and the economic recovery we’ve seen, helping mitigate households’ financial stress along the way. This policy, coupled with other macroprudential tools aimed directly at financial vulnerabilities, is helping to preserve the stability of our financial system.

Thank you. We will be happy to answer your questions.