

# Canada's Ticking Time Bomb

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There is a widely-held belief in “Canadian exceptionalism”: Canada was one of the few countries that survived 2008 unscathed due to strong regulatory oversight of its housing and financial markets; a national Canadian housing bubble is impossible due to structural differences between the housing and financial markets in Canada and the U.S; and Canadian bankers, regulators, and consumers are more prudent than their counterparts anywhere else in the world.

I will focus on what makes Canada unexceptional rather than on supposed structural differences that are superficial at best and mythical at worst. Given the continuing confusion regarding the cause of the Great Financial Crisis it may be helpful to reiterate the great economist Murray Rothbard's inquiry into the cause of recessions:

If ... the market economy has a built-in natural selection mechanism for good entrepreneurs [i.e. profit and loss], this means that, generally, we would expect not many business firms to be making losses. And, in fact, if we look around at the economy on an average day or year, we will find that losses are not very widespread. But, in that case, the odd fact that needs explaining is this: How is it that, periodically, in times of the onset of recessions and especially in steep depressions, the business world suddenly experiences a massive cluster of severe losses? A moment arrives when business firms, previously highly astute entrepreneurs in their ability to make profits and avoid losses, suddenly and dismayingly find themselves, almost all of them, suffering severe and unaccountable losses? How come?

The occurrence of recessions in turn raises another crucial question: what is common to entrepreneurs in a given economy that could mislead all of them at once? The answer is this: everyone uses the same monetary system.

Austrian Business Cycle Theory (ABCT) implies that the credit cycle is the business cycle: booms and busts are caused by an artificial and unsustainable expansion of debt by the financial system that exceeds the underlying savings in the economy. Savings-induced growth is sustainable, while artificial credit expansion causes the boom-bust cycle.<sup>1</sup>

When the supply of credit is artificially expanded, entrepreneurs and consumers receive false signals about the state of the economy and make unsustainable decisions: a “clustering of errors” (or “malinvestments”). Imagine that the “true” market rate of interest is 10% based on the supply/demand of savings (“loanable funds”), but the Fed artificially fixes the rate at 1%: nearly every DCF/NPV calculation would now appear profitable.

The false signals are endemic, therefore many entrepreneurs and consumers are simultaneously misled into committing mistakes. The result is a boom in borrowing and “investing”. No additional wealth (capital or labor assets) is created, only illusory, inflated paper claims on pre-existing wealth: i.e., more money and debt. Resources are always scarce; therefore the economy cannot create new enterprises without diverting capital from other projects. It is this misallocation of resources across industries and sectors that must inevitably be resolved in a bust.

The Canadian monetary system is essentially the same as that of every developed nation post-Bretton Woods II: all are predicated on fiat money and fractional reserve banking. Canada is entirely unexceptional in this regard, and therefore its economy is as susceptible to booms and busts as any other. This shared monetary foundation explains the precarious state of the Canadian economy in 2013 despite supposed “structural differences” and “Canadian exceptionalism”:

	Canada 2013	US 2007
House Prices : Rents	200%	127%
House Prices : Incomes	12x	8x
House Prices : Per Capita GDP	7x	6.5x
Home Ownership Rate	70%	69%
FIRE* % GDP	20%	18%
Residential Construction % GDP	7%	6%
FIRE* % Stock Market Earnings	46% (TSX)	30% (SPX)
HELOC** % GDP	12%	4.5%
FIRE+related Employment % GDP	14%	11%
Household Debt % GDP	95%	94%
Household Debt % Disposable Income	164%	128%
Govt. Sponsored Entities % GDP	~30% (CMHC)	~33% (FNM/FRE)

\*FIRE: Financials, Insurance, & Real Estate

\*\*HELOC: Home Equity Line of Credit

1 Austrian Theory of the Trade Cycle, <http://mises.org/tradcycl.asp>

The Canadian credit bubble that began in the late 1990s and accelerated from 2007 to the present is a classic example of Austrian Business Cycle Theory. The Bank of Canada's artificially easy credit policy – coupled with taxpayer-subsidized lending practices – resulted in an unprecedented boom in debt and real estate. Housing is the most leverageable consumer asset and therefore housing bubbles are frequently symptomatic of an underlying credit bubble disease. During a debt-fueled housing bubble, consumers are misled into taking on risky loans to buy houses at inflated prices and “extracting” equity from their homes.

Canada added a unique fuel to their monetary and credit bonfire: government-sponsored credit insurance via the Canadian Mortgage and Housing Corporation (CMHC). Credit insurance is analogous to co-signing on a loan. If the borrower defaults, the credit insurer is responsible for the payments. CMHC insures and holds mortgages on its balance sheet equivalent to nearly one third of GDP over a ~2% sliver of equity.

This is widely believed to make Canada *more* safe than the U.S. Indeed, CMHC reports infinitesimal loan losses, which begs the question: why would anyone pay premiums for their services? My contention is that credit insurance rests on a fatally flawed foundation and that CMHC is at least as risky as the complex mortgage securitization schemes popularized in the US; CMHC has yet to weather a major housing downturn with such an extended balance sheet and therefore the risks have remained concealed.

Certain criteria must be fulfilled in order for an insurer to be able to pool its risk across a portfolio of insureds, perform actuarial calculations, and calculate a suitable premium. Generally this implies that the loss should be random in nature (otherwise the insureds may engage in adverse selection, moral hazard, and/or be sufficiently correlated that losses occur systemically), that the existence of the insurance be independent from the results of the insured event, and that the risk be non-catastrophic (i.e. not so large that no insurer could pay for the loss).

None of these criteria are met under fractional reserve banking and therefore credit is not technically insurable.<sup>2</sup>

It is impossible to insure loans extended by the fractional reserve banking system during its expansionary phase, since the necessary independence between the existence of the insurance and the results of the insured event is lacking; the events “going bankrupt” are not independent, uncorrelated elements with an identifiable class probability; the losses are non-random; and the risk is both systemic and catastrophic.<sup>3</sup> There is no insurance premium that can be charged that is sufficient to offset the risk incurred.

To compound the issue, the very *existence* of credit insurance will artificially exacerbate a boom followed inevitably by a self-fulfilling credit collapse that will generate catastrophic losses for the credit insurer. The existence of insurance for financial products – where the cycle itself is affected by the existence of the insurance – brings about the very bust that the insurer is incapable of withstanding.

As we learned in 1987, “portfolio insurance” was a fundamentally flawed concept. Writing naked puts on the stock market is seemingly brilliant until there is a large drawdown in equities and the portfolio insurer is rendered insolvent. It is impossible to pool or diversify the risks away: the losses affect all of the insureds simultaneously since they were all exposed to the same catastrophic event (a stock market slump). The existence of portfolio insurance exacerbated the very thing that it was supposed to protect against: it artificially drove stock prices higher, and then when the bubble popped selling into a declining market by the portfolio insurers exacerbated losses to the downside.

Just as equity investors believed that they could safely buy overvalued stocks due to “portfolio insurance”, the banks in Canada believed they could lend with reckless abandon against overvalued houses due to CMHC insurance. Much like “insuring” against a slump in the stock market, CMHC is in fact “insuring” against an acute downturn in the Canadian housing market and/or economy. CMHC is simply writing naked, out-of-the-money puts on the Canadian housing market and economy.

The true risk lies not in the ~\$560bil on CMHC's books – most of which will not default – but rather in the degree to which the very existence of CMHC insurance distorted the structure of the Canadian economy. When fractional reserve debt is insured, it removes constraints to artificial credit expansion. Credit insurance exacerbates the illusion that an artificial, credit-driven boom is sustainable, savings-driven growth: it gives the appearance that more factors of production are available than there are in reality, and therefore magnifies the boom–bust cycle.

Canadian banks parked risky mortgages on their balance sheets – safe in the knowledge that Canadian taxpayers are on the hook for any losses – without having to bother with sophisticated securitization schemes to offload the toxic assets. Canadian banks now boast some of the highest unadjusted balance sheet leverage in the world. Yet on a risk-weighted basis, Canada appears safe because of CMHC-insured product's zero capital risk weight on the banks' balance sheets.

Absent CMHC involvement, banks risking their own capital would charge higher interest rates for the riskiest home buyer. When CMHC insures the mortgage, however, the Canadian government guarantees the profit to the banks and socializes the losses to the taxpayers. In the topsy-turvy world of Canadian finance, therefore, the riskiest borrower becomes

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2 Jesús Huerta de Soto. *Money, Bank Credit, and Economic Cycles*, pp. 598–600.

3 Mises, *Human Action*, pp. 105–19; Hans-Hermann Hoppe, “On Certainty and Uncertainty, Or: How Rational Can Our Expectations Be?,” *Review of Austrian Economics* 10, no. 1 (1997): 49–78; “The Limits of Numerical Probability: Frank H. Knight and Ludwig von Mises and The Frequency Interpretations,” *Quarterly Journal of Austrian Economics* 10, no. 1 (2007): 3–21.

the safest and pays an artificially low interest rate. For the banks this “mortgage lending” is equivalent to underwriting risk-free government bonds while profiting from an outsized spread. As a result of this moral hazard, Canadian banks have created CMHC-insured mortgages nearly as quickly as they received applications, with little regard to underwriting, and house prices have exploded.

It is commonly held that it will require an increase in unemployment or an “exogenous” shock to trigger a housing correction and recession in Canada. However, Austrian theory teaches us that a decline in the availability of credit will reveal the investment errors that occurred during the artificial boom.

The recession is the inevitable readjustment by which the market liquidates the unsound malinvestments that occurred during the false boom and returns to the consumption/ investment proportion based on the

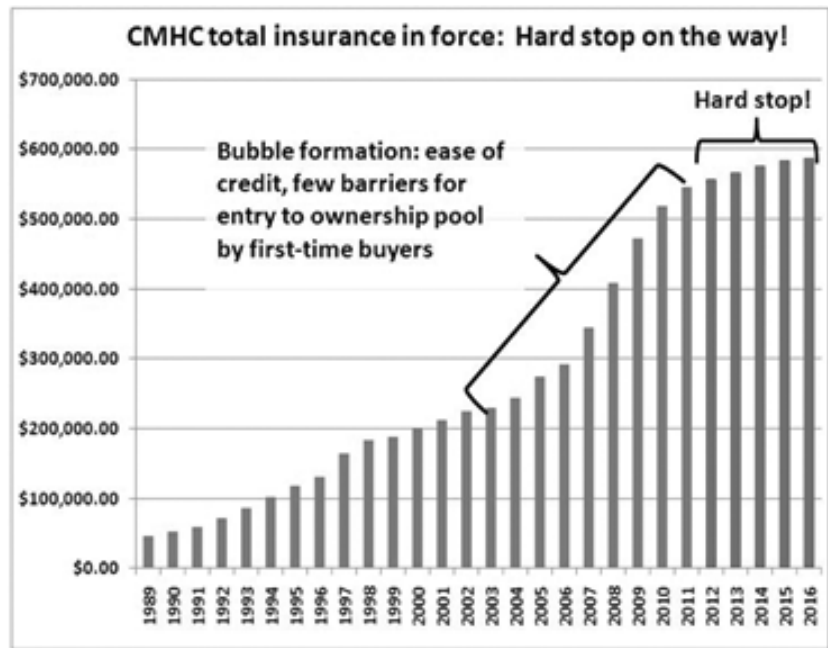
true savings rate in the economy. Anything that decelerates the rate of credit growth: e.g., limitations to CMHC insurance, further restrictions to the Canadian mortgage underwriting rules, or a rise in interest rates could trigger a recession.

Given its scale, a deceleration in the growth of CMHC’s balance sheet could seize up much of the credit creation in Canada. This is not merely a hypothetical issue: CMHC is rapidly approaching a parliamentary-imposed mortgage insurance cap of \$600bil (see Figure 1).

The repercussions of credit tightening could be particularly severe: despite longer (typically 30-year) amortization periods, virtually all mortgages in Canada have terms of 5 years versus 30-year loans in the U.S. It was the fall-out from such short-term mortgages during the Great Depression that led to the advent of 30-year mortgages in the US: “The 30-year [fixed rate mortgage] was originally designed to avoid the refinancing risk that contributed to the banking crisis during the Great Depression.”<sup>4</sup>

During the recession, increased unemployment, falling house prices, rising loan losses, systemic bankruptcies, and liquidations of unsuccessful investment projects will reveal the errors committed during the artificial boom. This will in turn reveal the latent insolvency of CMHC and greatly increase the odds of a financial accident.

Figure 1 Canadian Mortgage and Housing Corporation (CMHC) Total Insurance in Force, 1989–2011 (estimates for 2013–2016)



Source: Ben Rabidoux/North Cove Advisors

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4 Federal Reserve Bank of San Francisco Economic Letter, December 29, 2006. John Krainer, <http://www.frbsf.org/economic-research/publications/economic-letter/2006/december/mortgage-innovation-and-consumer-choice/>