Household Debt: Too Soon to Kick the Habit

by Avery Shenfeld and Emanuella Enenajor

Encouraged by ultra-low interest rates, Canadians have been piling on debt to buy homes and consumer goods at a pace that has well outstripped their paycheques. That clearly can't go on forever, but it's too soon for Canadians to kick the habit if our economy is to make further progress towards full employment.

Shouldering the Burden of Growth

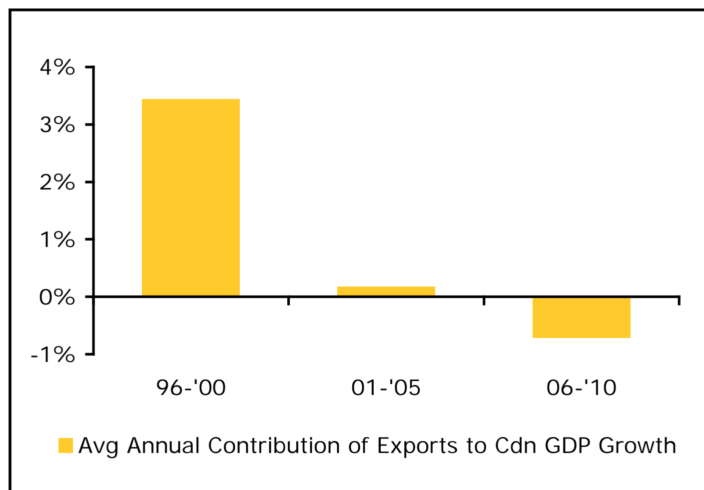
Indeed, for the past half-decade, a housing and consumption binge, financed by necessity through a growing debt burden, has been key to keeping the Canadian economy from the deep dive in employment suffered by its neighbour to the south. The reason for that dependence is that in a volatile and oft disappointing global growth climate, and an era of a strengthening Canadian dollar, exports have failed to pull their historic weight (Chart 1).

Having staged an initial rebound from a nearly unprecedented dive during the last recession, exports are likely again to face headwinds in the next couple of years. Emerging markets have emerged, but the ebb and flow of Canada's exports is still closely tied to US economic growth (Chart 2).

Our second-quarter export dive was, in large measure, due to temporary production disruptions in energy and

Chart 1

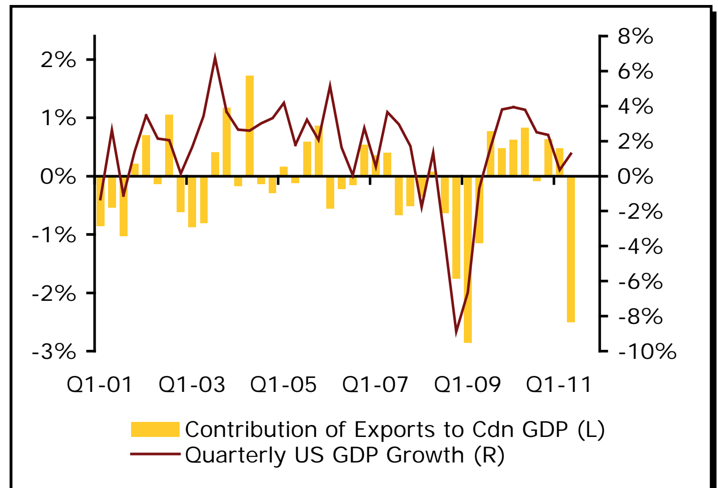
Diminishing External Drivers of Canadian Growth



Source: Statistics Canada, Haver Analytics, CIBC

Chart 2

Canadian Trade Not Pulling its Weight When US Economy Slows



Source: Statistics Canada, US Department of Commerce, US Bureau of Economic Analysis, CIBC

autos. Fires and other twists of fate hit oil sands activity in the quarter, but we know that even at today's prices, the sector's output is poised for a trend advance. The fate of the auto sector will be more cyclical than secular, although it was depressed by parts shortages from Japan.

But beyond a Q3 rebound, the prospects for American demand are not encouraging. Barring passage of a new stimulus package, fiscal restraint is poised to squash US growth in the next two years. Even if Obama wins approval for soon-to-be unveiled stimulus measures, trend growth stateside looks to be no better than 2% for now, implying lacklustre Canadian export growth.

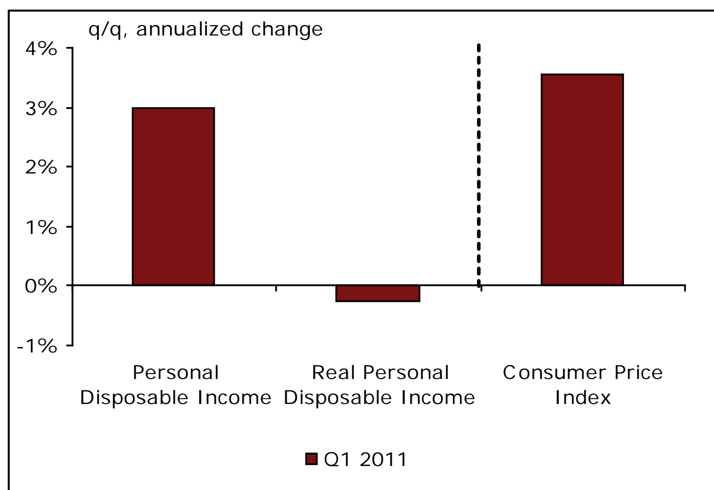
Add in Canada's own shift to government restraint, and even more of the burden of keeping the economy aloft will fall on the shoulders of an already indebted household sector. Business investment spending has also been firm, but ultimately, corporates need customers, at home or abroad, to justify spending more on equipment or space.

A Penny Saved is a Penny Not Spent

Of late, Canada's consumption engine has sputtered. Part of the blame owes to a spike in energy and food

Chart 3

Rising Prices Squeezed Purchasing Power



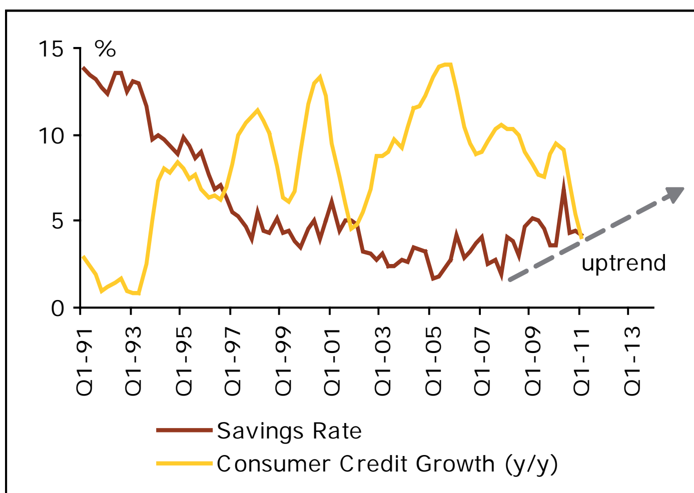
Source: Statistics Canada, CIBC

prices that pushed up the CPI but not domestic wages. The result was that in Q1, a decent climb in disposable income translated into a cut in its real purchasing power (Chart 3), and second-quarter consumer spending looks to have seen only modestly better gains. That problem should ease up in the latter half of the year, as weaker global growth cools pressures on gasoline and other cyclical commodities.

But there was another, less transitory source for the consumption slowdown—a gradual turn to more savings, and a corresponding cooling in the growth rate for consumer credit (Chart 4). Mortgage outstandings have seen less of a deceleration, lending support to home building.

Chart 4

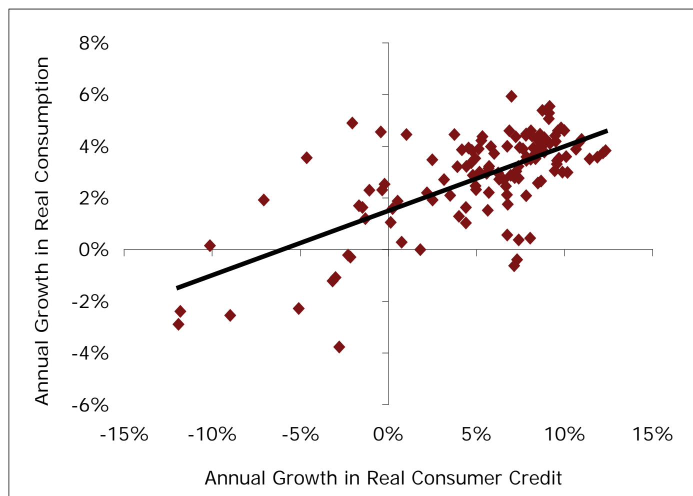
As Pace of Borrowing Slows, Savings Rate Rises



Source: Bank of Canada, Statistics Canada, CIBC

Chart 5

Credit Drives Consumption



Source: Statistics Canada, CIBC

But other forms of credit to households are moving to a different drumbeat. The growth in non-mortgage debt is now running at less than a third of its earlier pace. Historically, there is a statistically significant relationship between how much debt Canadians tack on in the form of consumer credit, and consumption gains (Chart 5).

Ottawa has taken some action to stem the growth in mortgage credit, by tightening the rules on mortgage insurance. There's been no similar regulatory measures hitting consumer debt, but perhaps Canadians have been listening to warnings from Governor Carney about being prudent in their use of credit, given the risks of higher interest rates down the road.

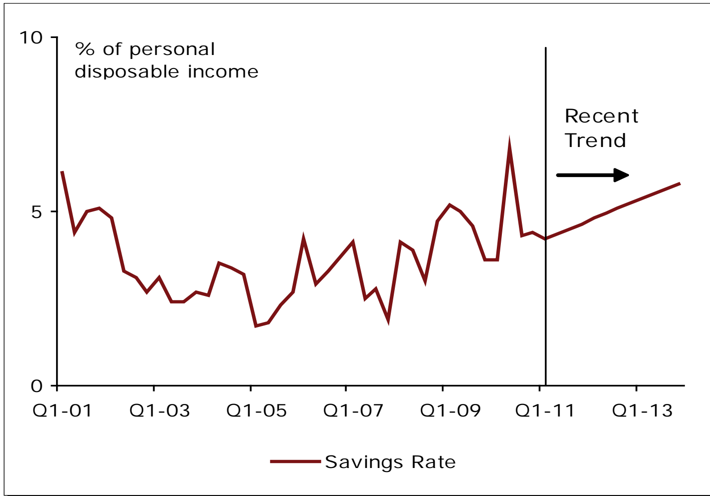
Carney is right of course, at least in the long run. But he can't afford too many Canadians to take him up on the advice to save rather than borrow and spend just yet.

Consider how real consumption would fare under the scenario in which the savings rate continues on its recent gradual uptrend, which would take it to 5.8% by the end of 2013 (Chart 6). Consumers will benefit from the end of the oil price spike, but recent trends suggest that wage growth will roughly match CPI gains at a 2% annual climb. With no tax or transfer policy shifts, the rising savings rate would see consumer spending decelerate to less than 1% growth by 2013 (Chart 7), making it unlikely that Canada could continue to progress towards full employment.

Oddly, we need to nip in the bud that seemingly prudent trend towards more savings, less credit, at least until

Chart 6

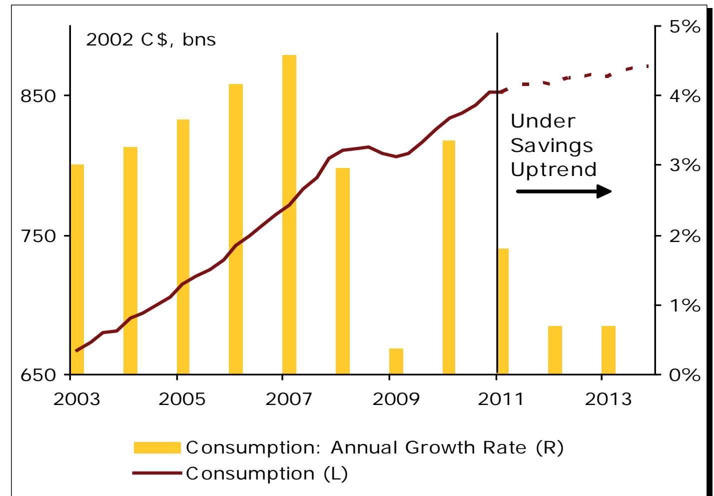
If Savings Rate Stays on Trend .....



Source: Statistics Canada, CIBC

Chart 7

..... It Spells Trouble for Real Consumption



Source: Statistics Canada, CIBC

our trading partners are in a higher gear. Sustained low interest rates would play a role in that regard, by making borrowing enticing and saving much less so. The Bank of Canada is likely to back off short-term rate hikes for a couple more quarters, and even if there is a marginal tightening in 2012, real overnight rates will still be negative next year. That might be enough to prevent much of a further deceleration in consumer credit, or a further rise in the savings rate.

Can We Put Off Virtue?

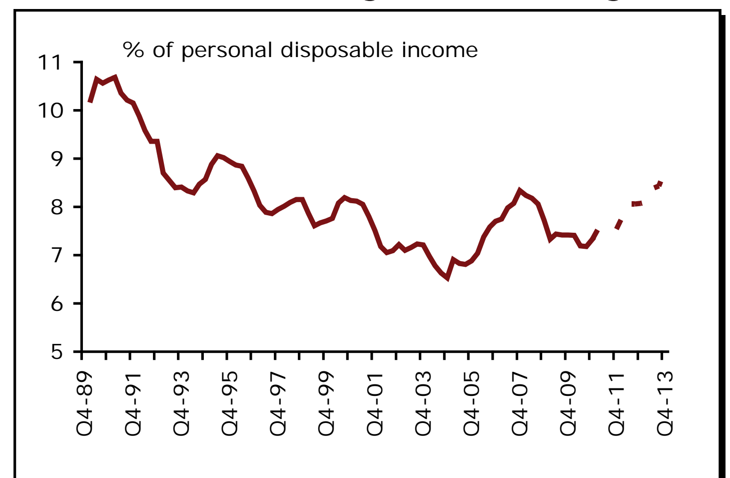
That raises the question of whether Canadians can afford to continue their high-debt, low-savings habit for another year or two. Both the performance of household credit, in terms of low default rates, and the historically modest share of incomes going to debt service suggest no immediate threat in putting off the day of reckoning. Barely more than 6% of all mortgages are held by Canadians facing interest payments in excess of 40% of their incomes, a share that is not particularly elevated by historic standards.

Sustained low interest rates are critical in that regard. We are projecting only 50 basis points of overnight hikes in 2012. If the overnight rate reaches only 2% in 2013, and both consumer and mortgage credit advance at their current year-on-year pace, interest as a share of after tax income would be no higher at the end of 2013 than it was in 1995 (Chart 8).

Of course, deeper into the cycle, when exports might be doing better, fiscal restraint will be tailing off, and wage gains will be more supportive for spending, real overnight rates are likely to be well into positive territory. Having effectively tempted Canadians to take on a lot of debt in the service of their country's economy, the Bank of Canada will have to take a slow path to squeezing them out of that habit with higher interest rates. As with other more nefarious addictions, given the potential for withdrawal symptoms in the economy at large, this one can't be safely kicked cold turkey.

Chart 8

Debt Burden Still Manageable in Coming Years



Source: CIBC, Statistics Canada, Bank of Canada