



# Commentary

January 2020

## Excessive debt leaves Canada vulnerable to global economic slowdown

*Debt levels continue to grow, reflecting how household and government spending remain dependent on debt-financing.*

Philip Cross

### Overview

The economy posted weak growth for the third quarter. Economic growth has also been largely driven by government and consumer spending, reflecting a failure to shift towards manufacturing exports and business investment. A decline in export prices have dampened exports. And, despite a boost from construction of the LNG megaproject in BC, investment in oil and gas remains less than half its level before the oil price crash in 2015.

Particularly worrisome has been Canada's soaring debt-to-GDP ratio, which has exceeded 300 percent. All sectors have gorged themselves on credit since interest rates were cut during and after the 2008-2009 Great Financial Crisis. Households, corporations, and governments each have raised their debt load to about 100 percent of GDP. High debt levels across households and governments mean Canada is quite vulnerable to a downturn in the global economy.

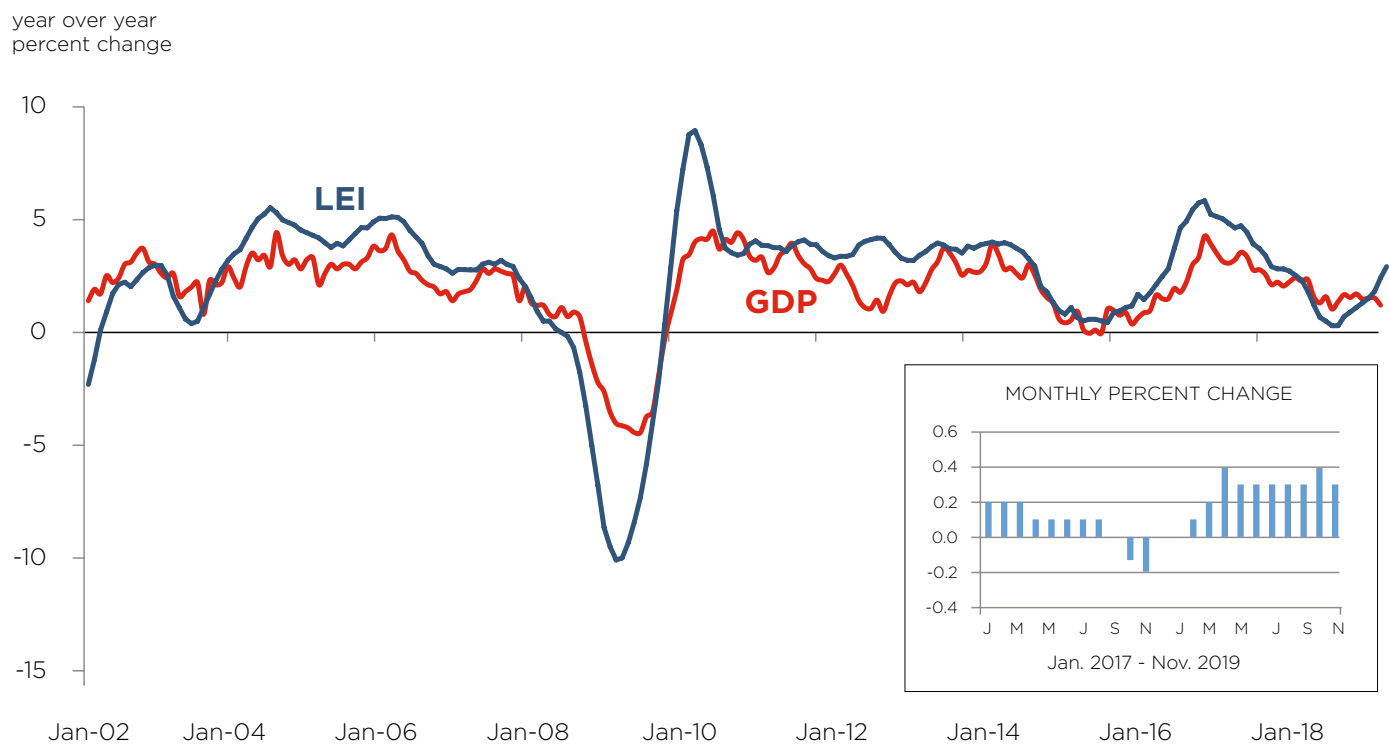
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# Introduction

Economic growth returned to a lacklustre 0.3 percent in the third quarter, after a brief recovery in the second quarter from almost no growth over the previous two quarters. The net result is that over the past year, real GDP rose by 1.7 percent, barely keeping up with population growth of 1.4 percent.<sup>1</sup>

Economic growth will continue to sputter over the near-term, according to the Macdonald-Laurier Institute's leading economic indicator (LEI) (chart 1). The 0.4 percent gain in November was largely confined to household demand, reflecting a recovery in housing and continued high levels of consumer confidence. Export and investment demand continued to restrain growth, as reflected in declines for commodity prices and demand for manufactured goods and a slowdown in the stock market. The outlook for the fourth quarter is marred by early snowfall that disrupted the harvest of crops, the end of the burst of temporary jobs related to October's federal election, a strike at CN Rail, and the permanent closing of a General Motors auto plant in Oshawa in December.

**Chart 1: MLI's Leading Economic Indicator (LEI), 2002-2018**



Source: author.

## Slow growth remains dependent on deficit-financed household and government spending

Several worrisome trends that have persisted for years continued to dominate developments in Canada's economy in the third quarter. First was the return to weak economic growth, which has continued for most of the past ten years. As noted in a recent paper from the Macdonald-Laurier Institute (Cross 2019), real GDP growth over the past decade has been as lethargic as the decade after the onset of the Great Depression in 1929. This testifies to the ineffectiveness of unprecedented monetary and fiscal stimulus in spurring long-term growth. One could argue that monetary policy is specifically tasked with stabilizing the economy in the short-term, but central banks have not been forceful in emphasizing their limited influence over long-term growth. As William White also pointed out, the endless provision of monetary stimulus reduces the urgency for governments to adopt structural reforms to increase productivity (White 2012).

Second was the ongoing failure to shift growth from household and government spending to manufacturing exports and business investment. Comparing the first three quarters of 2019 with the same period in 2018, real GDP growth has been driven by government (up 2.5 percent) and consumer spending (up 1.8 percent). Business investment fell 0.3 percent over the same period. Exports rose 2.0 percent, but almost all this growth reflected higher shipments of crude oil. Manufactured goods exports were little changed, as increases for automotive and consumer goods were offset by losses for capital goods (such as machinery and equipment and aircraft), lumber and processed mineral products.

Third, debt levels continue to grow faster than incomes, reflecting how household and government spending remain dependent on debt-financing. The Bank of Canada for five years has encouraged higher exports and business investment to reduce the economy's dependence on debt with little success. Keeping the exchange rate near 75 cents (US) via low interest rates has not boosted manufacturing exports, but low interest rates did fuel higher housing demand and prices, which require homebuyers to take on increasing amounts of mortgage debt. The result is that Canada is quite vulnerable to a downturn in the global economy, as acknowledged recently by Carolyn Wilkins, a Deputy Governor of the Bank of Canada (Wilkins 2019).

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## Housing demand rebounds from tighter mortgage regulations

Households continue to shift their spending between housing and retail goods. After the federal government tightened its regulations for mortgage lending early in 2018, housing demand fell and spending shifted to retailers. However, housing demand has strengthened over the past year, partly at the expense of a stall in demand for retail goods (chart 2). Residential construction posted its largest quarterly advance since 2012, partly due to a recovery of house sales in Vancouver and Toronto. While household disposable income grew in the second and third quarters, boosted by the Climate Action cheques from the federal government to offset its imposition of a carbon tax on several provinces, households chose to save most of this money.

## Chart 2: Retail sales, 2014-2019

billions of 2012 chained dollars



Source: CANSIM Tables 20-10-0008-01 and 20-10-0078-01

## Lower prices dampen exports and profits

Meanwhile, export volumes receded 0.4 percent after a rebound in the second quarter, leaving year-over-year growth at 1.7 percent. Quarterly demand fell for seven of the 11 components of goods exports, notably non-metallic minerals, aircraft and industrial goods. Autos provided a temporary lift before the closure of one of GM's Oshawa plants. Export earnings were further hampered by a 1.5 percent decline in export prices, notably for crude oil. This helped reduce corporate profits by 2.4 percent in the third quarter and 6.4 percent over the past year, which dampens the outlook for business investment.

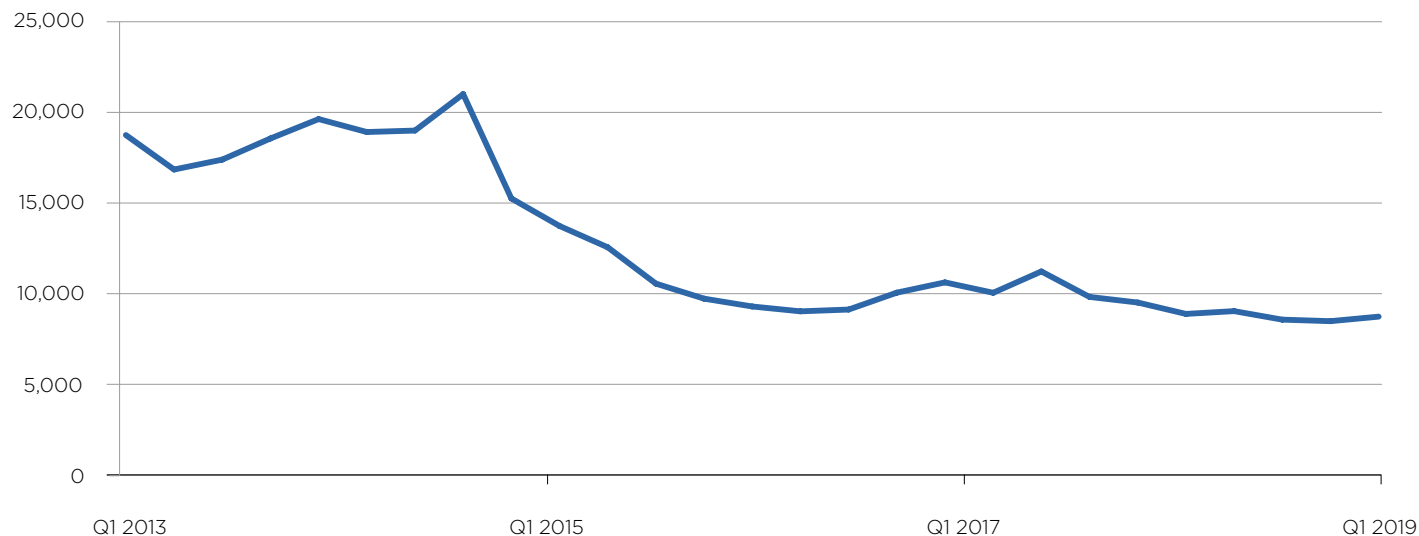
Business investment rose 1.4 percent in the third quarter, although it remains poised for its third drop in the past four years. Investment received a boost from construction of the LNG megaproject in BC, which began late in 2018. Nevertheless, investment in oil and gas overall remains less than half its level before oil prices crashed in 2015 (chart 3).

## Canada's debt-to-GDP ratio soars above 300 percent

Canada has one of the highest ratios of debt-to-income in the world. According to data from the Bank for International Settlements (BIS), total credit to the non-financial sector (what it calls 'core debt') as a proportion of GDP for Canada stood at 305.7 percent in the second quarter of 2019, the latest data available. This compares with an average of 272.3 percent in advanced market economies, including 249.7 for the US, 274.5 for the UK and 180.7

### Chart 3: Oil and gas investment, 2013 to 2019

billions of current dollars



Source: Statistics Canada, personal communication.

for Germany.<sup>2</sup> Canada's debt-to-GDP ratio has risen 32.5 percent from 230.8 in 2008, compared with an average increase of 13.8 percent in advanced market economies (led by the Euro area as debt growth in the US slowed to just 3.9 percent over the past decade). The BIS also calculated that the credit-to-GDP gap, which compares the actual ratio of credit-to-GDP to its long-term trend, stood at +7.5 percent in Canada early in 2019, the highest for any nation except Japan.

Almost all countries have increased borrowing in an era of historically low interest rates. So why are debt levels higher in Canada than most other countries? One main reason, ironically, is because our banking system and borrowing reputation were largely unaffected by the Great Financial Crisis that swept around the world from 2007 to 2010. As a result, debt levels never fell in Canada, and historically low interest rates fuelled a steady increase in borrowing. Most other countries, notably the US and most EU nations, cut back on borrowing for several years during and after the Great Financial Crisis. As a result, the recent increase in debt in most countries started from a lower level than in Canada.

The BIS differs from other international organizations such as the IMF and the OECD. It is often described as the bank for central banks. While central banks indeed own all its shares, the BIS is not a bank that makes loans, accepts deposits or sets interest rates. Instead, it has evolved into a forum where the world's central banks agree on common rules guiding how banks are financed (such as the Basel Rules for bank equity) and a place where central banks can discuss and coordinate monetary policy. Because of its unrelenting focus on banking and finance, the BIS has a unique and authoritative perspective on the role and risks of debt in financial systems and economic growth.

The BIS alone among international organizations warned of the perils of excessive debt growth and trade imbalances leading up to the Great Financial Crisis that began in 2007. Since then, the BIS has repeatedly warned about the negative consequences for long-term growth from relying on monetary and fiscal stimulus at the expense of structural reforms that enhance productivity. Most recently, the BIS has explicitly warned about Canada's debt, stating that when it came to "aggregate credit vulnerabilities...Canada, China and Hong Kong SAR stand out, with both the credit-to-GDP gap and the DSR [debt service ratio] flashing red" (Bank for International Settlements 2018, 48). In assessing credit conditions, it found Canada at risk for all four categories (the credit-to GDP gap discussed earlier, the total and household debt service ratios, and cross-border claims on its GDP) (Aldasoro, Borio and Drehmann 2018, 49). No other country was found at risk for all four indicators.

The IMF and OECD have a more conventional view of how economies function, notably the efficacy of macro-economic stimulus. For example, former IMF managing director Christine Lagarde was widely quoted as welcoming Canada's embrace of deficit-financed government spending by saying she hoped such policies would "go viral" (Speer 2016) among countries that could afford more public investments.

The problem with this view is that it assesses Canada's federal government debt in isolation from the rest of the economy. Lagarde ignored how more federal debt added to Canada's overall debt levels, all of which ultimately are supported by the same income stream (GDP), as well as the demonstration effect of more federal borrowing signalling to all Canadians more debt was positive for growth and did not entail risks (both oversights augur poorly for Lagarde's recent appointment as head of the European Central Bank). Furthermore, Lagarde was naïve in believing most federal government spending would be directed to investment. The reality, as documented by the Parliamentary Budget Office, is that little money was invested in infrastructure (partly due to the inevitable complication of federal-provincial coordination in Canada) while most was spent on higher transfer payments.

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## All sectors in Canada have borrowed more

Canada's high debt level reflects how all sectors have gorged themselves on credit since interest rates were cut to historically low levels during and after the 2008-2009 recession. Each of the three sectors of domestic demand (households, corporations and governments) have raised their debt load to about 100 percent of GDP.

Canadian households led the borrowing binge, with household debt rising to 100.3 percent of Canada's GDP.<sup>3</sup> This is the highest of any nation except Denmark (115.1 percent), and nearly twice the G20 average 59.5 percent. By comparison, the ratio of household debt to GDP in the US was 75.0 percent, in the UK 86.6 percent and 53.6 percent in Germany (the G20 average is reduced by lower debt levels in emerging markets such as China and Brazil). The Bank of Canada argues that the vulnerability of household debt has improved, because the ratio of household debt-to-income recently has stopped rising and the share of new borrowers with mortgages over four times their income has come down. The retort is that Canada's household debt-to-income ratio remains the second-highest level in the G20, which is not sustainable if either interest rates increase or incomes recede. Meanwhile, the share of new borrowers with very large mortgages fell from 20 percent to 13 percent but in 2019 edged back up to 15 percent (Wilkins 2019, 2).

Non-financial corporations in Canada have borrowed the equivalent of 118.7 percent of GDP, more than any other major industrial nation (the ratio in the US stood at 74.9 percent, 78.2 percent in the UK and 58.0 percent in Germany).<sup>4</sup> It is noteworthy that the Bank of Canada's Caroline Wilkins's discussion of the risks of debt presented a detailed analysis of household debtors in Canada, but almost exclusively cited data for the US, Europe and China when discussing corporate debt (making only a passing reference borrowing by Canada's Exchange Traded Funds) (Wilkins 2019, 4-5).

Canada's governments borrowing stood at 84.9 percent of GDP, not far behind the 97.5 percent average in the Euro area and 99.4 percent in the United States, both of who had to spend liberally to bail out their banks during the Great Financial Crisis.<sup>5</sup> Government borrowing in Canada is more skewed to the provinces because our federation is the most decentralized and because some provinces are especially vulnerable to slumps in key export markets and unwilling to adjust their spending accordingly.

## Bankruptcies already are rising

Debtors are always vulnerable to two types of shocks; one is a sharp hike in interest rates, the other is losing some income either through job loss or lower prices. The latter seems the largest threat to Canada in the short-term, given that the global economic slowdown evident for some time in Europe and Asia now seems to have spread to the United States where growth decelerated from 3 percent in 2018 to 2 percent in 2019.

It is disquieting that even with a tight labour market and low interest rates, households are going bankrupt in growing numbers. In the third quarter of 2019, the number of insolvencies of people declaring or proposing bankruptcy rose 14.5 percent from a year earlier (Innovation, Science, and Economic Development Canada 2019). The largest increases were in Ontario and Alberta. If households already are having trouble managing their record debt levels when employment is high and interest rates low, these difficulties will multiply as the global economy continues to decelerate.

The increase in bankruptcies is reflected in higher loan loss provisions at Canada's chartered banks. As a result, all banks reported lower profits (5 percent on average) in the fourth quarter (Zochodne 2019).

## Canada's high debt levels make it vulnerable to the global economic slowdown

It is a testament to the vapidness of the recent federal election that Canada's growing indebtedness was barely discussed. Federal government debt surfaced briefly as an issue, with the government arguing that it accounts for only about 30 percentage points (or one-tenth) of Canada's overall debt-to-income ratio of 300 percent. Completely ignored were the huge amount of debts accumulated in the corporate, household and provincial government sectors and the vulnerability this debt creates for a highly-cyclical economy like Canada's.

The obliviousness to debt is all the more puzzling given that the US and several countries in Europe so recently provided vivid demonstrations of the perils posed by excessive borrowing. It is easy to imagine how the dominoes might fall in the event exports slump due to a downturn in the global economy. Lower corporate earnings from exports would lead to job cuts and falling household income, in turn squeezing government revenues. Falling domestic demand would reinforce lower export earnings. On a positive note, it is very unlikely Canada's debt problems will trigger a banking crisis such as occurred in the US and Europe because our banking system is structured and financed differently.

# About the Author



Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the “Current Economic Conditions” section of the Canadian Economic Observer, which provides Statistics Canada’s view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee.



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# Endnotes

- 1 The population estimates are for July 1. See Statistics Canada Table 17-10-0060-01.
- 2 See the BIS Statistics Explorer: Table F1.1 at <https://stats.bis.org/statx/srs/table/f1.1?p=20133&c=>.
- 3 All the data in this section comes from the BIS Statistics Explorer: Table F3.1.
- 4 See BIS Statistics Explorer: Table F2.1.
- 5 See BIS Statistics Explorer: Table F5.1.



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