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Commentary

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Yes we are back to growth, but trouble is looming

Canadians seem to have difficulty learning past lessons about high debt levels and the boom and bust cycle of the economy

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Highlights

Canada's real GDP rose by 0.9 percent in the first quarter, continuing an uptick that began last year. After two years of sub-par growth, Canada's economy will likely return to its post-2009 average of about 2 percent at annual rates.

First quarter growth also revealed concerns about its sustainability. First, there was a reliance on inventory, with firms rebuilding stocks after strong fourth quarter sales. Second, housing continues to be the fastest growing sector, led by Toronto's housing market.

Yet the composition of spending is not the only cause for alarm. More significant is the continued expansion of debt, which covers all sectors of the economy—households, governments and businesses. A good indicator is the ratio of total debt outstanding to nominal GDP, the ratio of which surged 36.3 percent in just the last two years. Even as incomes slumped during the oil price crash, all domestic sectors borrowed more and saved less.

All sectors have been affected. Between 2006 and 2016, household debt grew by 85 percent; governments by 83 percent; non-financial corporations by 98 percent; and financial corporations by 93 percent.

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Importantly, this debt was not invested in assets to generate higher income in the future, which could be used for both debt repayment and to raise standards of living. Instead, much of it has gone towards bidding up home prices and increasing government spending on its employees and transfers to households.

The risk of indebtedness is even greater for Canada, given that its economy is exposed to large swings in its export earnings. This is visible in both its natural resource base, as demonstrated by the sharp fluctuations in the energy sector over the last two years, and in its highly-cyclical manufacturing sector. This risk is compounded by the higher cost of servicing debt denominated in US dollars, as the exchange rate devalues, as well as the volatile boom and bust cycle of Toronto's housing market.

One sector that remains relatively stable is Canada's banking sector, although the Bank of International Settlements found that Canada met three of the four early warning indicators for stress in its domestic banking system.

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Overview

The Canadian economy posted higher growth in the first quarter. However, doubts about the sustainability of faster growth are raised by its reliance on inventory rebuilding and Toronto's housing market. The surge in house prices is only one symptom of a broader dependence on debt to finance spending by all sectors of the Canadian economy since 2006, fuelled by historically low interest rates. Moreover, much of this debt was dissipated on government consumption and higher house prices, not invested in acquiring more assets that can generate future income. The risk of debt is that it requires payments even when incomes slow or prices decline, as the US and many European and emerging market nations learned in recent years despite low interest rates.

First Quarter Growth Driven by Inventories and Housing

Economic growth picked up in the first quarter, with real GDP rising by 0.9 percent. However, the composition of growth raises doubts about its sustainability. Much of the increase in the supply of goods from higher production and imports went into inventories, with firms rebuilding stocks after surprisingly strong sales in the fourth quarter. Meanwhile, housing remained the fastest growing sector, led by Toronto's red-hot housing market where average home prices joined Vancouver's at about $1 million. However, export volumes continued to fall and are 2 percent below the level of a year ago. One welcome development in the quarter was a tentative upturn in business investment, as spending on oil and gas began to recover following a 50 percent drop over the previous two years.

The unsustainability of the first-quarter surge in growth was reflected in the Macdonald-Laurier Institute leading indicator. Its growth had picked up to 0.8 percent last December, presaging the first-quarter upturn in growth. However, the leading index decelerated to a 0.4 percent increase by April. This suggests that after two years of sub-par growth as Canada adjusted to the drop in oil prices, growth is likely to return to its post-2009 average

of about 2 percent at annual rates. Housing remains the most robust sector within the leading indicators, as the actions taken in May by Ontario's government to dampen Toronto's housing market have not yet taken effect.

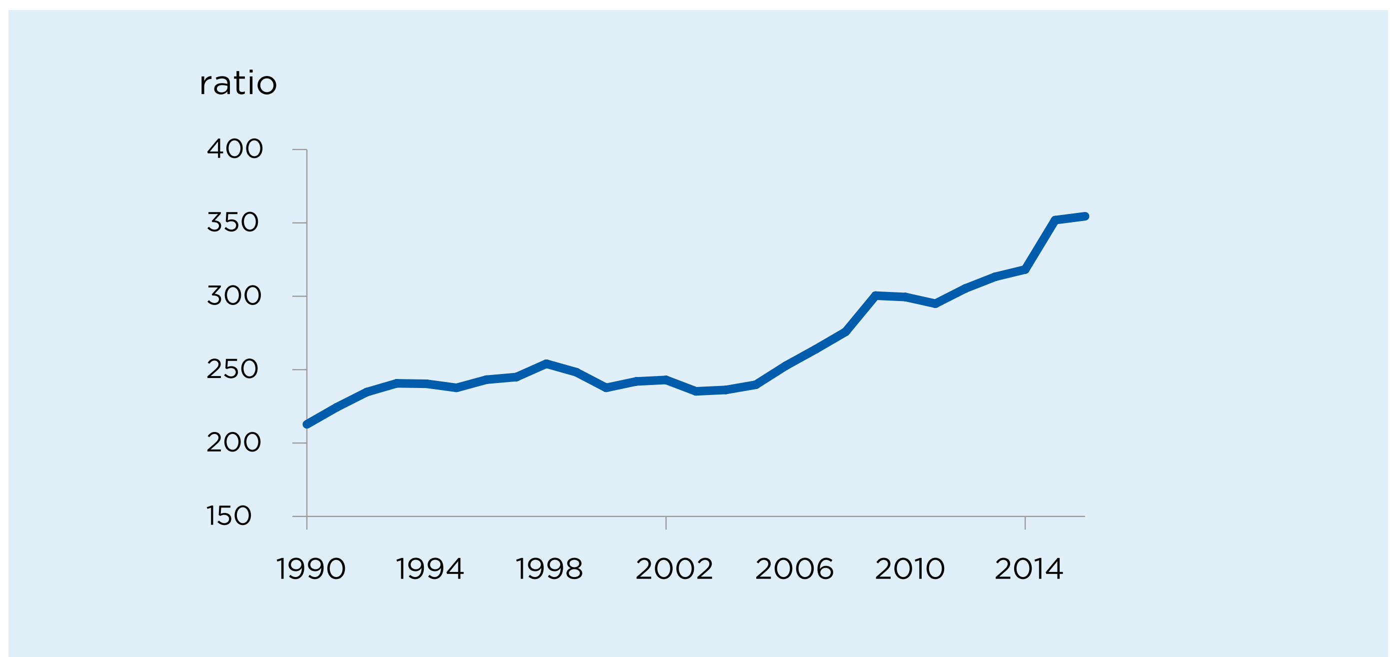
However, the most unsustainable feature of growth in Canada's economy does not originate in the composition of spending but in the continued sharp expansion of debt. All sectors of the economy—households, governments and businesses—have taken on large amounts of debt, despite the obvious lessons on the perils of debt-financing from the US experience leading up to its financial crisis in 2008 and in Europe with its own debt crisis beginning in 2010.

Indebtedness Continues to Increase Faster than GDP

The indebtedness of all Canadians continues to increase rapidly, as measured by the ratio of total debt outstanding to nominal GDP. Adair Turner, the former chairman of the Financial Services Authority which oversaw Britain's banking system, called the ratio of debt to GDP the best measure of leverage in an economy, warning that "beyond some point, the more potentially fragile become both the financial system and the macroeconomy" (Turner 2012, 168). In Canada, this ratio has surged 36.3 percentage points in just the last two years, as all domestic sectors borrowed more and saved less to sustain spending even as incomes slumped due to the oil price slump.

Canada did not always rely on debt to finance economic growth. After a slight increase in the ratio of debt to GDP during the 1990-92 recession, the ratio fell from 240.7 in 1993 to 239.7 in 2005 (figure 1). However, indebtedness began to increase slowly after 2003 and then rapidly starting in 2006, interrupted only by a temporary pause in 2010 and 2011 when the federal government adopted austerity in response to running large deficits during the recession. Overall, the debt to GDP ratio stood at 354.5 in 2016, up 102 percentage points in just a decade.

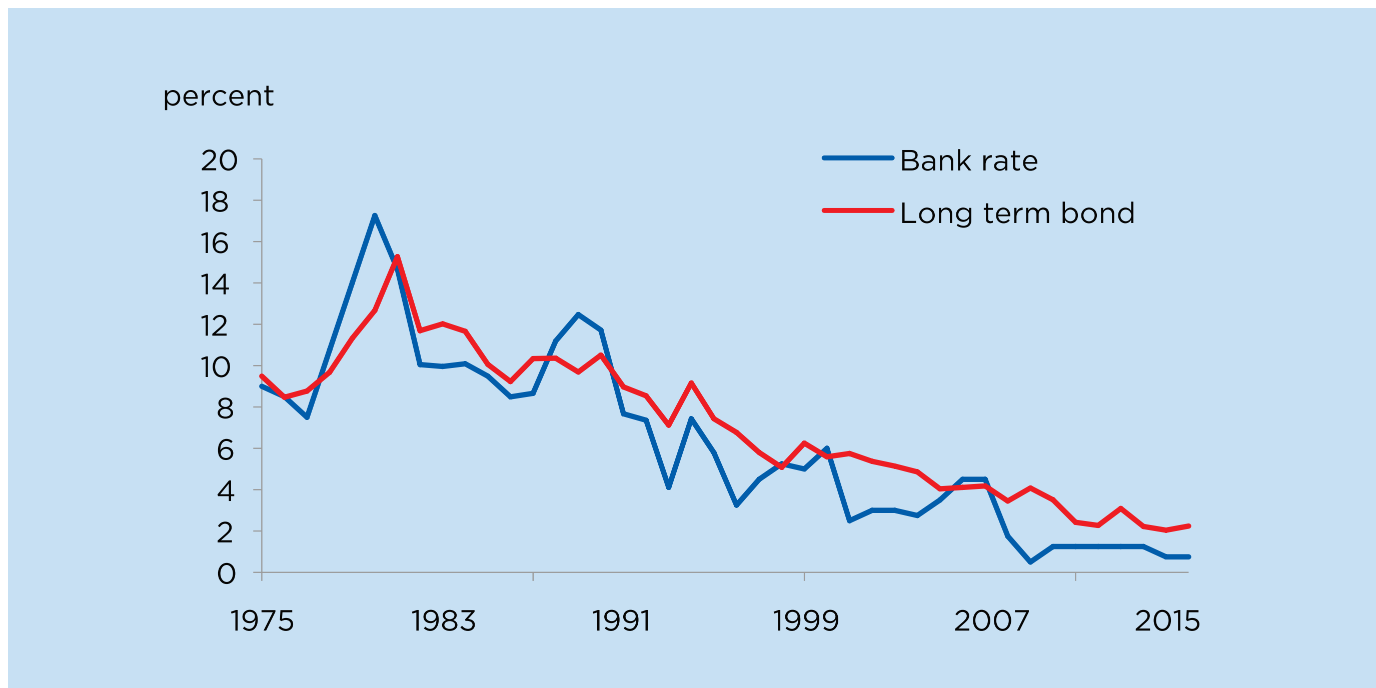
Figure 1: Ratio of Debt to GDP in Canada



Source: Statistics Canada, CANSIM table 378-0122 and 380-0063

The increase in Canada's indebtedness after 2002 coincides with an extended period of low interest rates. Since the Great Financial Crisis started in 2008, we have lived with what William White (a former Chief Economist at the Bank for International Settlements) calls "ultra easy monetary policy" (White 2012). White characterized this period as "ultra easy" because it followed a period before 2008 that itself was notable for its persistently low interest rates (figure 2). Many theories were circulated at that time to explain why interest rates were so low, including the notion of a global "savings glut" favoured by Ben Bernanke, former chair of the US Federal Reserve Board. Another theory advanced by the Bank for International Settlements is that central bank monetary policy was too focused on the low inflation rate of the Consumer Price Index, ignoring soaring asset prices.

Figure 2: Bank Rate and Government Long Term Bond



Source: Statistics Canada, CANSIM Table 176-0043

Whatever the reason for low interest rates, it is not surprising that Canadian society has gone deeply into debt. All sectors of the economy have participated about equally in the orgy of debt finance. Between 2006 and 2016, household debt grew by $932 billion (or 85 percent); governments by $755 billion (or 83 percent); non-financial corporations by $713 billion (or 98 percent); and financial corporations by $778 billion (or 93 percent).[1] Nor is it surprising that the final spike in house prices in Vancouver and Toronto occurred after the Bank of Canada surprised financial markets with an unexpected cut to interest rates in January 2015, signalling that its tentative moves to normalize interest rates were over. From August 2011 to January 2015, house prices in Vancouver rose a modest 4.9 percent, but then surged 46.4 percent; the comparable figures for Toronto were a 21.2 percent increase followed by a 54.6 percent jump (Real Estate Association, 2017).

Apologists for more debt financing point out that debt is not necessarily burdensome if it is invested in assets that generate higher income in the future that can be used both to repay the debt and raise our standard of living. This is not the case for Canada. Since 2006, Canada has deployed most of its growing debt to bid up home prices and lavish government spending on its employees and transfers to households. Since 2006 the stock of housing has increased by 16.0 percent in volume, while prices were bid up 31.7 percent.[2] Over the past decade, government spending rose by $252 billion, of which $170 billion went to purchases of goods and services

(mostly civil service pay and benefits), $76 billion was for higher transfers to households and only $26 billion went to infrastructure.[3] Some tangible assets were acquired in other sectors of the economy over the same period, notably a 40 percent increase in consumer durable goods and a 29 percent rise in the stock of capital held by corporations (almost half of which was in mining, notably the oilsands). However, government spending and housing together are almost four times as large as consumer durables and business investment, so they were the recipients of most of the debt-fuelled spending.

The Risks Posed by Higher Debt

The rapid run-up in Canada's debt poses several problems. A recent review of research by the International Monetary Fund and the Bank for International Settlements found that the precursor of all financial crises "was that domestic private credit had grown faster than the economy for a significant length of time" (Sharma 2016, 299). Ruchir Sharma refined this observation by drawing on his research as head of emerging markets and chief global strategist at Morgan Stanley Investment Management, concluding "The single most reliable indicator I have found is the negative one on the kiss of debt rule, which shows that a major economic slowdown has always materialized when a nation's debt has grown more than 40 percentage points faster than GDP over a five-year period" (Sharma 2016, 360). Recalling figure 1, Canada's ratio of debt to GDP has risen from 294.9 percent in 2011 to 354.5 in 2016—an increase of 59.6 percentage points in the last five years, easily surpassing Sharma's 40 percentage point threshold that signals a major slowdown. Another red flag Sharma found was that a nation's housing market was due for a correction when it surpassed 5 percent of its GDP; residential construction in Canada now accounts for 7.1 percent of its GDP (Sharma 2016, 223).

The risks of indebtedness are even greater for an economy like Canada that is exposed to large swings in its export earnings. This volatility results not only from its large natural resource base, important that may be, as demonstrated by the energy sector over the last two years. Canada's manufacturing sector is also highly-cyclical, notably industries such as autos, lumber and of course the high-tech sector which set a record for a boom followed by a bust at the turn of the century. The point is that an economy whose income is subject to volatile swings should be prudent in taking on new debt, since the burden of servicing the debt increases sharply when exports decline.

"The risks of indebtedness are even greater for an economy like Canada that is exposed to large swings in its export earnings."

The burden of debt in Canada is compounded by the higher cost of servicing debt denominated in US dollars as the exchange rate devalues. Given the limited size of capital markets in Canada, firms have always borrowed extensively from US capital markets. New data from Statistics Canada shows that firms and government in Canada hold $488 billion of US dollar-denominated debt.[4] This is more than the $402 billion of Canadian dollar denominated debt in 2015 (most of which issued by governments). Corporations issued most of the debt denominated in foreign currency.

Another recurring source of volatility in Canada is Toronto's housing market, which is prone to regular cycles of boom and bust. Between 1966 and 1976, house prices in Toronto rose 90 percent faster than inflation, and a similar increase occurred between 1986 and 1989 (Suttor 2016, 81). In the past three years, average home prices in Toronto have risen by 64 percent. The Bank of Canada found that 49 percent of borrowers in Toronto and 39 percent in Vancouver had very high loan to income ratios of over 450 percent, compared with a Canada average of 18 percent (Bank of Canada 2016, 5).

Despite all the volatility in Canada's income and asset prices, Canada's banking system has been the most stable in the world (especially compared with our American neighbours). This prudence has been ingrained by repeated exposure to the vicissitudes of the global business cycle and the legacy of a banking system with branches across the country, limiting its exposure to downturns in any one region or industry. This history suggests that the inevitable downturn in the economy or in house prices will not precipitate the sort of crisis that swamped the US banking system in 2008. Nevertheless, the Bank of International Settlements in its last quarterly review found that Canada met three of the four early warning indicators for stress in its domestic banking system (Bank of International Settlements 2017, 20).

Conclusion

Canadians since 2002 and especially after 2006 have borrowed at record levels, pushing the ratio of debt to GDP to what many analysts regard as a dangerous level. The dangers of excessive debt were evident in the US, which experienced a financial crisis from which it is still recovering slowly as it works down its debt. Another recent example was the financial crisis spawned in the European Union in 2010, when several governments saw bond markets increasingly shunning their debt, forcing them to renegotiate their debt, apply for bail-outs, and cut back spending.

Given these high profile reminders of excessive debt triggering a financial crisis and an extended period of little or no growth, it is natural to ask the question why Canadians did not take to heart the lessons they teach. The answer seems to be that every generation has to learn these lessons for themselves and not from the experience of others. It is why the business cycle and periods of boom and bust in financial, commodity and housing markets never disappear for more than a generation.

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Endnotes

1 Statistics Canada Cansim Table 378-0122. Available at http://www5.statcan.gc.ca/cansim/.

2 Statistics Canada Cansim Table 031-0008. Available at http://www5.statcan.gc.ca/cansim/. The latest data on capital stock are for 2015.

3 Statistics Canada Cansim Table 380-0080. Available at http://www5.statcan.gc.ca/cansim/.

4 Statistics Canada Cansim Table 376-0146. Available at http://www5.statcan.gc.ca/cansim/.

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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