

# O Canada, We Stand on *Guard* for Thee

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Canada withstood the Great Recession and credit crisis better than most other countries. Unemployment rose far less than in the U.S., credit growth remained strong, and housing markets made a near miraculous recovery. The consensus expects several years of sturdy growth, once our major trading partner (the U.S.) regains a solid footing. **However, it's worth noting several worrisome trends that, though likely to improve over time, could dampen the medium-term growth outlook and increase the nation's vulnerability to adverse shocks.**

**1) Household debt is rising faster than income:** Household credit has grown twice as fast as personal income since 2002 (9.0% on average per annum versus 4.6%), raising the debt-to-income ratio by one-third to a record 102% in Q2 (*Chart 1*). If recent trends persist, the debt ratio could breach that of the U.S. (113%) within three years, possibly making consumers susceptible to the same deleveraging facing Americans. Thankfully, the quality of Canadian mortgages is much higher than in the U.S. As well, credit growth is slowing, and should fall in line with long-run income growth (about 5%) when interest rates normalize. However, should credit continue to outpace income, households could become increasingly vulnerable to rate increases.

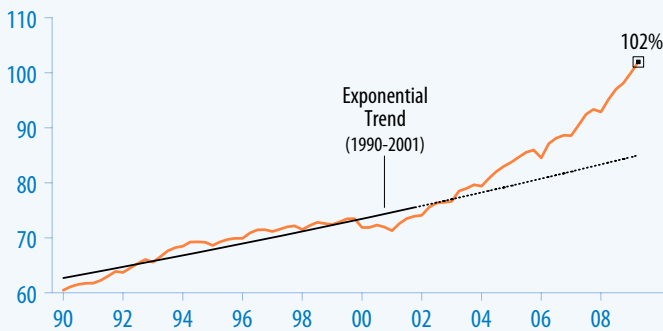
**2) House prices are rising faster than income:** Except for last year, existing home prices have outrun personal income every year since 2002, by 8% on average versus 5%. After climbing 87% in the past seven years, prices are at record highs relative to income, an estimated 6.4-times personal disposable income (per labour force member<sup>1</sup>) versus a 20-year average of 4.7-times (*Chart 2*). While classic bubble indicators (like condo flipping, "buying on spec", and loose lending standards) aren't flashing red, houses are by no means cheap. When interest rates normalize, affordability will weaken (barring a lengthening of amortization periods). Buyers with 5% down on an average-priced existing home (\$343,000 in October), financed over 25 years at current variable rates of 2.25%, could see their monthly mortgage payments jump 50% (\$714) to \$2,133 if rates climb 4 percentage points, a reasonable assumption given estimates of the neutral overnight rate. In all likelihood, as affordability declines in

<sup>1</sup> This measure likely understates household income somewhat since it doesn't fully account for the growing number of double-income households.

**CHART 1**  
**SAVING FOR A RAINY DAY, NOT!**

Canada (% of personal income)

### Household Debt

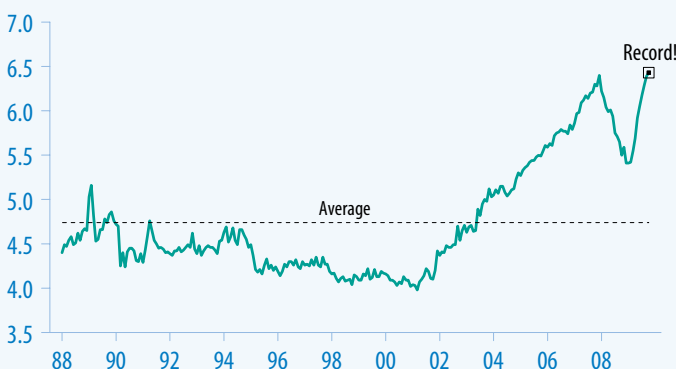


Mortgage and Consumer Credit only

**CHART 2**  
**LOFT-Y**

Canada (ratio to personal disposable income per labour force member)

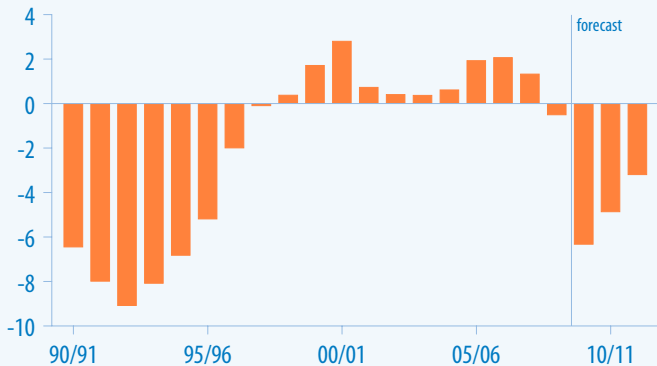
### Existing Home Prices



**CHART 3**  
**THAT '90s SHOW**

Canada (percent of GDP)

**Combined Federal and Provincial Balances**



**CHART 4**  
**LOONACY**

(US\$/C\$)

**Canadian Dollar**

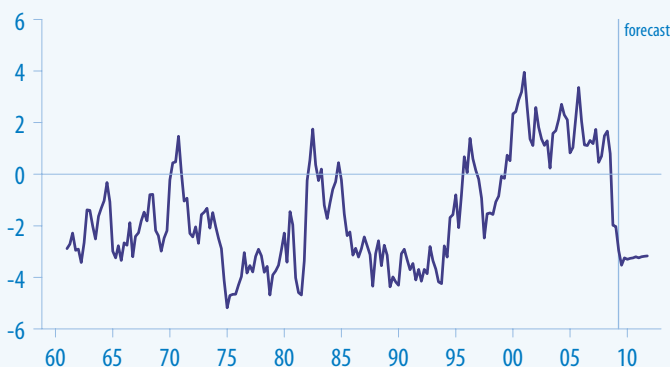


\* based on a version of the Bank of Canada exchange rate model

**CHART 5**  
**BACK IN RED**

Canada (percent of GDP)

**Current Account Balance**



response to higher prices and rates, demand will soften and price increases will moderate. However, if prices continue to leap-frog incomes in coming years, the odds of a market correction will escalate, especially if interest rates exceed neutral levels.

**3) Governments are spending more than they receive:**

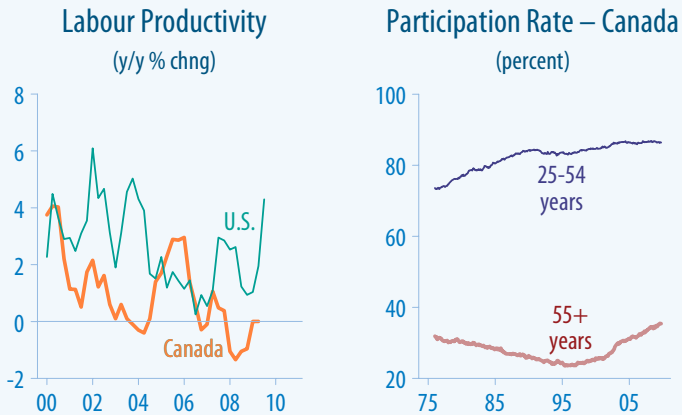
The federal and provincial governments will run combined deficits of about 6.3% of GDP in the current fiscal year (versus a peak of 9.1% in the early 1990s), and will continue to run large, albeit shrinking, shortfalls in the years ahead (Chart 3). The Parliamentary Budget Office estimates a “structural” federal deficit of \$19 billion (over 1% of GDP), while Ontario has yet to detail a plan to bridge its gap. Most likely, governments will address their fiscal imbalances once the economy strengthens. This should stabilize the net public debt/GDP ratio at under 40%, lower than the expected OECD average of 60% in 2010. But, if governments aren’t up to the challenge, we might be forced to stomach hefty 1990s-style spending cuts and tax increases down the road. Either way, fiscal policy is set to become restrictive in the medium term, damping economic growth.

**4) The loonie is likely overvalued:**

The dollar’s latest appreciation to 94 cents US has taken it above levels that can be justified by relative price differentials (about 85 cents US) and fundamental drivers like commodity prices (about 90 cents, see Chart 4). And, if the greenback continues to slide in response to concerns about the U.S. economy and deficits, the loonie could test parity soon. This means more pain for manufacturers, some of whom won’t survive a further loss of competitiveness.

**5) The nation is spending more than it earns:**

The strong currency and penny-pinching Americans have pushed Canada’s trade deficit into record territory. The country will likely run current account shortfalls of 3% of GDP (rivaling those of the early 1990s) in coming years (Chart 5). Thankfully, nine straight annual surpluses have helped erase the net foreign debt (for the first time since records began in 1926), so the deterioration is from a strong base. Moreover, there is no sign that the nation is having difficulty funding its external shortfall, as foreign demand for Canadian assets remains strong. However, if large

**CHART 6  
POTENTIAL PROBLEMS**


external deficits persist in the medium term, they could increase the nation’s vulnerability to swings in global investor sentiment—meaning we might face tougher credit conditions when the next financial crisis strikes.

**6) Productivity has stalled:** Partly because of the costs of reallocating workers and capital from a weak manufacturing sector to the service and resource sectors, labour productivity has stopped growing in the past three years (*Chart 6*). In all likelihood, productivity will improve, possibly in line with the quarter-century norm of 1½% per annum, as restructuring ends and companies take advantage of lower borrowing rates and cheaper imports to buy capital equipment. Rising productivity will support long-run potential growth, which is set to slow as an aging population reduces labour force participation (*Chart 6*). However, if productivity doesn’t improve, Canada could face a further loss of competitiveness and steady decline in relative living standards.

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