

Debt is not (Always) a Four-Letter Word

Michael Gregory and Douglas Porter

With the Bank of Canada now sending a very clear signal that it is preparing to raise interest rates as soon as the start of June, the focus is now rapidly shifting to the potential stress this may cause on household finances. The fact that Canadian household debt ratios continued to climb through the recession to new all-time highs has prompted a wave of hand-wringing, not to mention a public scolding of households for their lack of thrift by all and sundry. At the same time, the even bigger issue of an apparent lack of savings by individuals continues to hurtle down the mountain as the tidal wave of baby boomers begins to roll into their retirement years. In response to these concerns we would pose two questions:

- 1) Precisely what did policymakers and analysts expect would happen to household debt and savings when the Bank of Canada cut interest rates to the bone?
- 2) Has Canadian household debt reached problematic levels?

In the vast sea of commentary on rising Canadian household debt and the low level of savings, there is an incredible lack of mention of low interest rates as the driving factor. Is it really any wonder that Canadians continued to add debt and shun savings in the face of the lowest nominal interest rates on record? On the contrary, households simply responded rationally in the face of sub-zero real interest rates. If the cost of borrowing money is negative in real terms, then policy is geared overwhelmingly in favour of households taking on more debt, full stop. Additionally, if savings are rewarded with interest rates far below zero after taking inflation and/or taxes into account, then policy is geared overwhelmingly in favour of households foregoing savings, full stop.

When the Bank of Canada decided to slash overnight interest rates to 0.25% a year ago, this took rates of almost all manner to levels never plumbed before. For instance, the chartered banks' prime lending rate was also cut to 2.25%, the lowest nominal level dating back to the 1930s. This is just barely above inflation, and most short-term deposit rates are much lower and thus even further below inflation, even before accounting for any tax hit. And history shows quite clearly that savings rates do respond quite closely to nominal interest rates, with about a two-to-three quarter delay (*Chart 1*). Thus, it is hardly a mystery as to why savings remain so low and debt ratios have continued to climb (*Chart 2*).

CHART 1
NO SECRET: LOWER RATES = LOWER SAVINGS

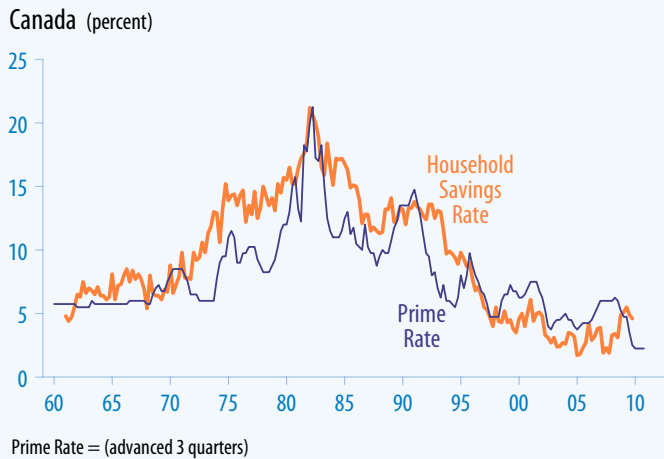
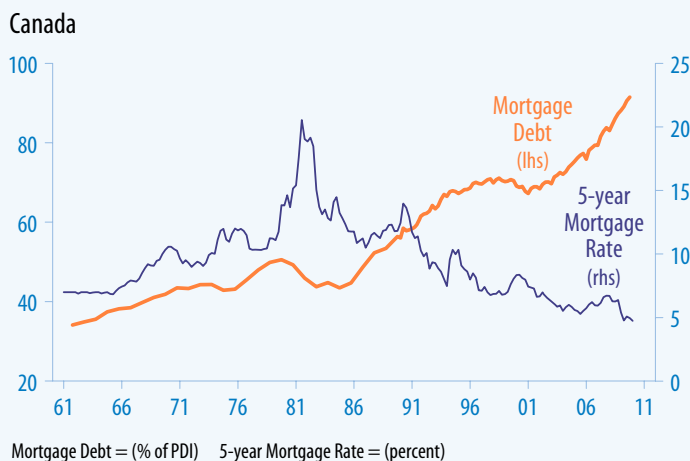


CHART 2
NO SECRET: LOWER RATES = HIGHER DEBT



Far from fretting about the relentless rise in household debt, policymakers should be delighted that monetary policy worked like a charm in the darkest hours of the recession. It is inconsistent to applaud deep rate cuts by the Bank of Canada on the one hand, as almost all did, and then turn around and complain that households started to spend and take on more debt—Canadians did precisely what monetary policy asked of them. If instead households had not responded to rate cuts, we would be currently bemoaning the fact that monetary policy was ineffective and that the Bank was pushing on a string.

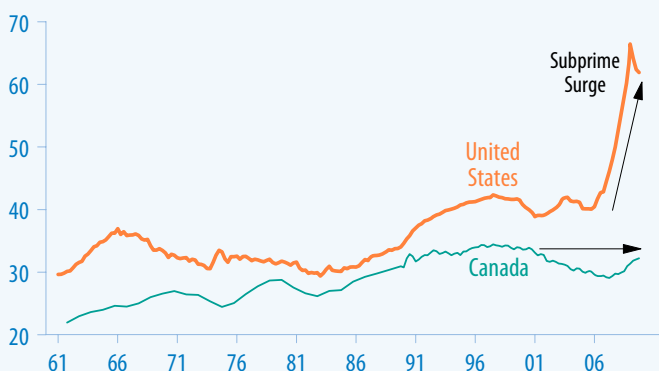
So consumers appear to have responded rationally (and, dare we say, patriotically) to ultralow interest rates, but they might have sipped too much from the spiked punchbowl the Bank of Canada brought to the party. Many are now pointing to record-high household debt as a sign that consumers indeed drank too much, and are poised for one heck of a hangover. Others point to the fact that Canadian household debt ratios are not far from American metrics, and we know the latter turned out to be devastating for U.S. consumers (not to mention the planet). Unfortunately, commentators often grab the first debt ratio they see, take it out of context, and draw incorrect conclusions.

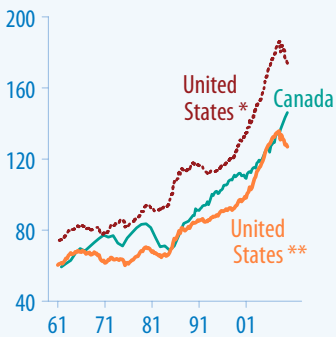
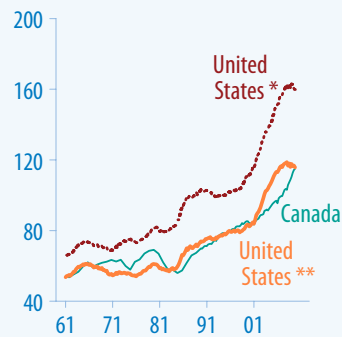
While it's accurate that Canadian household debt has soared to a record high 146% of disposable personal income, it's shoddy analysis to draw conclusions about suitability without looking at the other side of the balance sheet—household assets. Record high debt is mirroring a record high value of real estate assets. Importantly, although the aggregate loan-to-value (LTV) ratio drifted up in recent years, it has remained in line with medium-term trends and currently sits below its historic high (*Chart 3*). The relative stability of the LTV ratio is even more remarkable given that, for a short while (during 2006-2008), some mortgages were being originated with zero down payments. There is no doubt that the health of household balance sheets is vulnerable to the vagaries of home price swings, as it always has been and is likely more so now, but it is incorrect to conclude that debt levels are “outsized” given current real estate values. Canadians, it appears, drank responsibly, particularly compared to their U.S. counterparts.

The secular increase in mortgage debt occurred alongside rises in homeownership and households' net worth. The latter has usually been considered a “good” thing. To conclude that a particular debt level is “bad” is to conclude that rising homeownership is “bad”, along with its positive externalities for communities and the broader economy. Commentators look at the U.S. to see how rising homeownership led to financial instability, but this occurred as prudent lending standards persistently fell by the wayside. This was and is not the case in Canada; there are no NINJA (**No Income, No Job or Assets** needed to be documented) or reverse amortizing (borrowing one's interest payments) mortgages here.

CHART 3
CANADIANS KEEP “SKIN IN THE GAME”
(percent)

Loan-to-Value Ratio (Housing)



**CHART 4
MEASUREMENT MATTERS**
Household Debt
% of Disposable Personal Income

% of Personal Income


* includes unincorporated businesses ** excludes unincorporated businesses

Furthermore, one must be careful in comparing the Canadian and U.S. household sectors. Because the average Canadian tax rate on personal income is around 21%, double what it is south of the border, and, presumably, these extra taxes are “paying” for services Americans pay for out of pocket (like healthcare), comparing Canadian to U.S. household debt levels relative to disposable personal income biases up the Canadian figure. Currently, the U.S. household-debt-to-income ratio (pre-tax) is 158%, still a large 43 percentage points above Canada’s 115%, despite the former dropping five points from its peak (using disposable personal income, the gap is “only” 28 points: U.S. at 174%, Canada at 146%) (Chart 4).

Also, one must also be careful in comparing these two sectors because while personal income includes unincorporated business income in either case, the household sector, as directly defined in the U.S., does not include unincorporated businesses whereas it does in Canada. Some commentators do not take this into account, which biases up the Canadian figure yet again (indeed, it makes Canada look worse). We add unincorporated businesses to the U.S. total (adding in all financial liabilities) to generate an apples-to-apples comparison.

Although the relative level of Canadian household debt, per se, might not be as “bad” as some analysts argue, this does not belie the fact that recent debt additions have been strapped on at ultralow interest rates, which could pose risks to financial stability as rates rise. However, rates won’t rise in isolation. Incomes will also be rising amid the economic recovery, mitigating some of the pressure on household budgets caused by rising rates. But, consumers are still going to have to reallocate their budgets away from discretionary outlays (e.g., eating out once or twice less per month or brown bagging it to work a couple times per week) to cover higher debt service costs. As long as consumers are willing, and able, to do this, the risks to financial stability ebb. Of course, some consumers will not be able to make these adjustments, increasing financial hardship. But, to conclude that the latter will be the norm instead of the exception is to argue that Canadian consumers were not making sober decisions in taking advantage of once-in-a-lifetime low borrowing rates, but became intoxicated at the Bank of Canada’s punchbowl. The latter is to have little faith in the proven prudence and conservatism of the Canadian consumer, and Canada’s globally-respected financial system. Debt is always a risk; but it’s not always a four-letter word.

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