Entrepreneurs first

economic LETTER

APRIL 2012

DO WE NEED TO WORRY ABOUT THE RISE IN CANADIAN HOUSEHOLD DEBT?

The increase in Canadian household debt has been widely covered in the media, especially when it exceeded its counterpart in the U.S.. In general, however, the conclusions of the analyses published on the topic are far more varied than what is being reported in the media. Economists admit that household debt levels could hinder economic growth in Canada, although most believe the risk to be limited.

The debt level reported by the media is the percentage of disposable income that is owed in debts. However, this ratio is not an accurate measure of the risk to which debt ridden households are exposed. Other, more appropriate measures exist to gauge this risk, such as the household debt-to-asset ratio, which considers both sides of the coin: what people owe compared to what they can provide as collateral. While this ratio has increased over time, it is still quite low, rising from 17.6% in Q1 1990, to 20.4% in Q4 2011 (see graph).

The debt repayment ratio, also called the debt load, is the interest and capital payable as a percentage of income, and is also an excellent indicator of a household's financial health, since it reflects its ability to repay its loans. A household with a debt repayment ratio over 40% is considered to be in a precarious situation.

To clearly understand the situation that households are in, we need to analyze debt based on detailed data and according to different household characteristics, such as age or income. Statistics Canada conducted a study using detailed information on the household sector's balance sheet.[1] Based on relevant debt measurements, such as the debt-to-asset ratio and the debt repayment ratio, its analysis reveals that the financial situation of Canadian households is generally healthy, but that certain groups are at greater risk, specifically young people and low income households. Using similar data, Desjardins arrived at largely the same conclusions for Quebec households.[2]

Obviously, while the financial situation of households is currently healthy, it could deteriorate. This is a concern for the Bank of Canada, which believes that if the unemployment rate were to rise three percentage points and the average period of unemployment were to extend by six months (which is similar to what happened during the recession in the early 1990s), the proportion of household loans overdue by three or more months could double (from 0.6 to 1.3%). The rise in interest ▼

1 Statistics Canada, "Debt and family type in Canada," Canadian Social Trends, April 2011.
2 Desjardins Economic Studies, "Financial situation in Québec households," Economic Viewpoint, October 2011.

BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to April 8. Reliance on and use of this information is the reader's responsibility.

rates and a strong housing market correction are additional risks facing debt-plagued households. In the former case, households would need to allocate more of their income to repaying their debts, and in the latter, the assets provided as collateral for their debts would decrease in value.

While we can't deny the existence of these risks, the likelihood that they will come to pass, at least in the near future, is low. Although we're anticipating a decline in activity on the Canadian housing market in 2012 and certain local corrections are possible, the market is doing well overall. Canada's economy made it through the recession and has resumed a moderate but sustainable level of growth. If interest rates rise, which is not expected to happen in the next few months, it will be due to increased economic activity, in which case we can expect jobs and incomes to increase, allowing households to repay their debts more easily. ■

Debt Ratios

Source: Statistics Canada

CANADA

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The latest data indicate a largely positive portrait of the Canadian economy. Consumer and business confidence is on the rise, consumption is progressing and the outlook for corporate profits is encouraging. After several months of stagnation, the rebound in employment obviously bodes well for the economy in the coming months.

Real GDP increases slightly

After a 0.5% jump in December, the real GDP by industry rose by 0.1% in January. Downturns in forestry, mining and petroleum production and in the construction sector were more than offset by growth in public services and manufacturing, which has enjoyed renewed vigour in the past few months, increasing for the fifth month in a row in January. This is excellent news, given the beating that the manufacturing sector has taken in recent years due to the rising Canadian dollar, increased competition from emerging countries, and, more recently, the serious recession that followed the financial crisis in 2008 (graph).

Manufacturing Output

Source: Statistics Canada

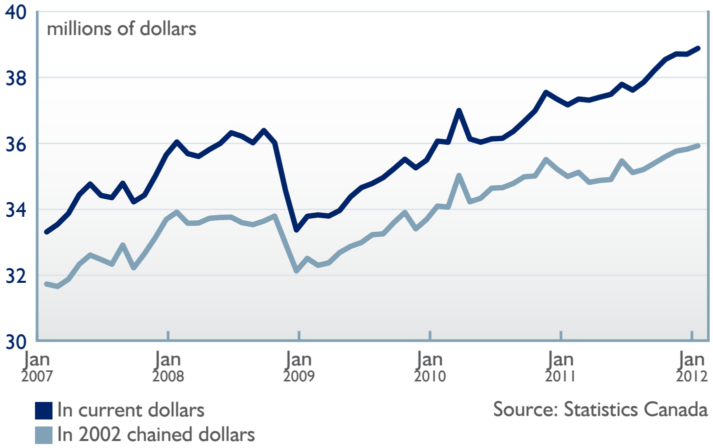
Employment rebounds

After remaining at a standstill for several months, the employment rate rose sharply in March, posting 82,300 gains, most of which were full-time positions. The unemployment rate declined 0.2 percentage points to 7.2%. The healthcare and information, culture and recreation sectors posted the highest growth, and the manufacturing sector registered a positive gain for the fourth month in a row. At the regional level, Ontario saw the most new jobs created (46,100), followed by Quebec with 36,400 jobs, which partially makes up for the 61,000 jobs lost in the last quarter of 2011.

Retail sales continue to advance

The Conference Board's Consumer Confidence Index rose slightly in February, but is still well below its pre-recession level. Poor labour market performance since July 2011 has negatively affected Canadian consumers' confidence. Yet, retail sales rose 0.5% in January compared to the previous month, mainly due to sales of motor vehicles and parts (3.7%). If we exclude this sector, however, retail sales declined 0.5% in January. In terms of volume, retail sales increased 0.3% in January for the sixth consecutive month after many months of inactivity (graph). ▼

Retail Sales



Source: Statistics Canada

Outlook gradually brightens for corporate profits

The Conference Board's Leading Indicator of Industry Profitability (LIIP), which decreased five consecutive times since July 2011, continues to rise but at a very slow pace. After increases of 0.05% and 0.03% in December and January, respectively, the LIIP rose a further 0.08% in February–results that bode well for a reversal of the downward trend. Only 13 of the 49 sectors covered by the LIIP posted declines in February. The economic recovery in the United States is giving a boost to several sectors, especially motor vehicle sales. The Canadian automotive industry should continue to reap the benefits of the pent-up demand that has accumulated since the recession in the United States.

UNITED STATES

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The most recent indicators are promising with regard to the U.S. economy's growth outlook. Employment continues to advance, retail sales are progressing at a brisk pace and the housing market, although still fragile is gradually improving.

Employment continues to advance

Employment continued to rise in March, although at a slightly slower pace: after posting an average of 246,000 new jobs over the previous three months, this figure declined to 120,000 in March. The unemployment rate fell slightly, from 8.3% in February to 8.2% in March. The manufacturing sector continues to gain jobs, with 37,000 new positions created in March. On the other hand, the construction industry is still losing ground, especially in the residential housing sector, which lost 5,000 jobs, completely negating the 3,100 gains posted in the previous month. With the increase in March, the private sector has now recovered almost 50% of the losses suffered during the recession.

Housing market still fragile

Housing starts decreased by 1.1% in February. In the multiple-unit housing segment, housing starts increased 28.7%, but declined 9.9% in single-family homes. Despite the decrease in February, the results aren't as gloomy as they seem, as the January data were revised sharply upward, with monthly growth rising from 1.5% initially to 3.7% after the review. Sales of existing homes were down 0.9% in February, but despite short-term volatility on the market, sales in this sector continue to progress (graph).

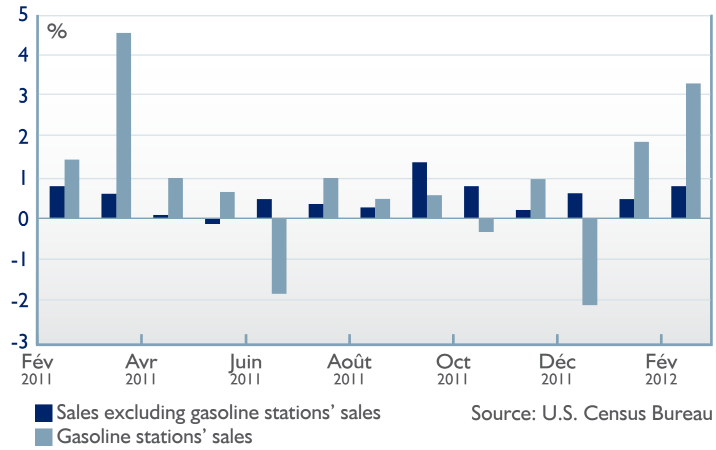
Existing Home Sales

Source: U.S. National Association of Realtors

Retail sales increase at a good pace

After a 0.6% increase in January, retail sales rose a further 1.1% in February. Motor vehicle sales rebounded, completely offsetting the 1.6% decline from the previous month. The impressive 3.3% growth in gas station sales mainly reflects the rise in gas prices and not an increase in demand. If we exclude gas station sales, which are highly variable, the retail sales sector nevertheless posted solid growth over the last six months (graph).

Monthly Change in Retail Sales



Source: U.S. Census Bureau

INTEREST RATES

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Key interest rate should remain unchanged in 2012

The Bank of Canada will announce the key interest rate on April 17, following which, on April 18, it will publish its Monetary Policy Report detailing its economic forecasts and associated risks. Even though the U.S. economy is picking up and risks associated with the European sovereign debt crisis have subsided, forecasters don't expect the central bank to raise the key interest rate in 2012. The U.S. economy still isn't quite on solid ground and it would be premature to raise interest rates.

OIL AND THE LOONIE

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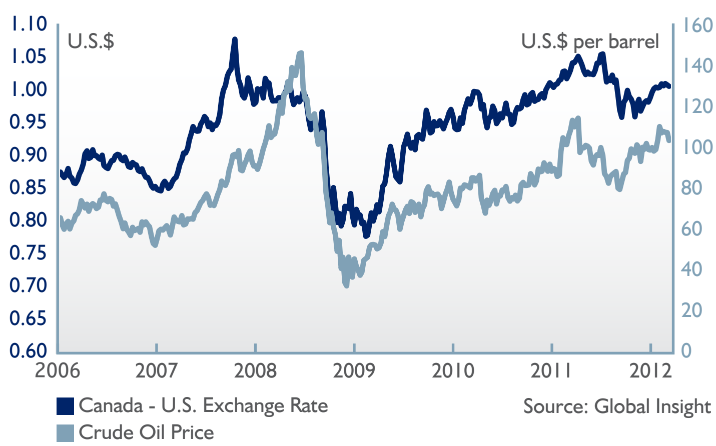
The price of oil and the Canadian dollar remain high

The price of crude oil has remained high in recent weeks due to the risk of a strong drop-off in exports from Iran–tensions between Iran and the West remain very high. Nevertheless, crude prices are very volatile: after rebounding following publication of the Purchasing Managers' Index for the U.S. manufacturing sector, which was up, they declined in response to fears of decreased demand for oil, fuelled by the lower demand for gas in the U.S. in January. As for the Canadian dollar, it continues to keep pace with the price of oil.

Crude Oil Price and Canada-U.S. Exchange Rate



Source: Global Insight

SME CONFIDENCE

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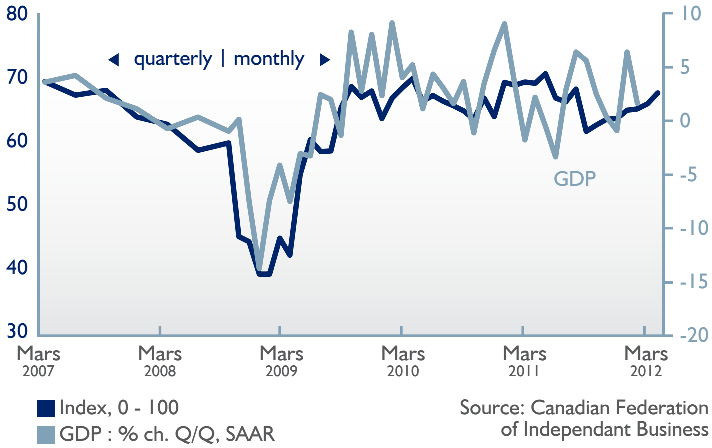
SME confidence up

The CFIB's Business Barometer Index climbed 1.7 percentage points to 67.7 in March, regaining almost all the ground lost since its brutal drop in August 2011, at the peak of the European sovereign debt crisis. Owners of small and medium sized businesses seem to think that the risks of the European debt crisis worsening are now weaker; as a result, the business climate has improved. Owners in the Prairies continue to be the most optimistic in the country, but confidence is growing in Ontario and Quebec. The index rebounded in the arts, entertainment and information sectors, and in manufacturing, where it reached its highest level since April 2011. Lastly, note that the short-term outlook for businesses (expected results in the next three or four months) is much brighter.

CFIB Business Barometer and Real GDP Growth
(Index of 50 = equal balance of stronger and weaker business expectations)



Source: Canadian Federation of Independant Business

BUSINESS CREDIT CONDITIONS

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Banks' business credit increases

The increase in credit granted to businesses by the chartered banks, which had slowed down considerably in the second half of 2011, has gradually picked up steam in the last few months. The three-month growth rate rose from 0.6% in November 2011, to 7.3% in February 2012. The annual growth has remained relatively stable, settling at 7.1% in February. Short-term credit, which accounts for 87% of total banking credit, has risen 7.0% in the last 12 months, whereas long-term credit increased by 7.9%.

Business Credit from Chartered Banks

Source: Bank of Canada

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2011				Latest		Forecasts	
	2007	2008	2009	2010	Q1	Q2	Q3	Q4			2012	2013
Real GDP (% growth)	2.2	0.7	-2.8	3.2	3.7	-0.6	4.2	1.8	Jan	0.1	2.1	2.3
Machinery and Equipment Expenditures (% growth)	4.2	-0.5	-19.5	11.8	15.5	30.2	-11.8	2.7			4.5	6.3
Pre-Tax Corporate Profits (% growth)	1.9	11.0	-33.1	21.2	20.7	-5.1	18.3	21.4			7.6	6.2
Industrial Production (% growth)	-0.5	-3.1	-9.5	4.9	6.1	-4.0	7.8	2.4	Jan	0.2	2.7	3.2
Industrial Product Prices (% growth)	1.5	4.3	-3.5	1.0	9.6	5.4	0.2	0.7	Feb	0.2	2.4	3.0
Non-Residential Construction (% growth)	2.3	7.9	-22.2	2.8	15.9	0.9	17.4					
Housing Starts (' 000 units)	229	212	148	191	177	192	205	199	Feb	201	183	179
Personal Expenditures (% growth)	4.6	3.0	0.4	3.3	0.6	2.0	1.8	2.9			2.0	2.1
Consumer Price (% growth)	2.1	2.4	0.3	1.8	3.3	3.4	1.0	2.9	Feb	0.4	2.0	1.9
Employment (% growth)	2.4	1.7	-1.6	1.4	2.2	1.6	1.2	-0.3	Mar	0.5		
Unemployment Rate (%)	6.0	6.1	8.3	8.0	7.7	7.5	7.3	7.5	Mar	7.2	7.4	7.2
SMEs Confidence Index (CFIB)	67.2	56.1	57.7	66.7	69.2	68.0	64.2	64.1	Mar	67.7		
Manufacturers Confidence Index (CFIB)	68.8	52.7	56.0	68.6	72.6	71.0	63.5	61.8	Mar	73.6		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.