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TD Economics

Release: Level and concentration of debt still the biggest risk for the Bank of Canada

- Bank of Canada Deputy Governor Lawrence Schembri spoke in Guelph today. The topic of his speech was household debt and the risks that it poses to financial stability.
- As Schembri explains, policy easing in response to the 2009 downturn led to a rebound in economic growth, but at the same time fueled rising debt levels that have not yet abated. As a result, while monetary policy achieved its goals, it created new vulnerabilities in the economy at the same time, as high debt levels amplify negative shocks.
- The growth in household debt was not uniform, rather, debt has become more concentrated in 'highly indebted households' (those with a debt to income ratio of above 350%). These households represent about 8 per cent of the total, but hold nearly 20% of overall household debt.
- These highly indebted households tend to be concentrated in B.C., Alberta, and Ontario. They also tend to be younger and have less education or training, making them more vulnerable to losing their jobs in a downturn. Low interest rates have made servicing debts much easier for these households, but they tend to have very small financial buffers – around 6.5 months of debt payments.
- The debt situation does not yet look like the pre-crisis United States, but nevertheless remains the key risk to the Canadian economy due to the expected severity should a risk scenario be triggered via a sharp uptick in unemployment or decline in home prices.
- The Bank of Canada does not consider economic growth alone as sufficient to mitigate this risk, and continues to view enhanced financial regulation and macroprudential measures as key to managing and reducing the risk from materializing.

Key Implications

- High household debt levels remain front of mind for the Bank of Canada. Today's speech provides additional information on the nature of the risk, but as in the past, the Bank emphasized that although monetary policy has helped spur debt growth, it is just one piece of the puzzle when it comes to reducing the risk. Equally important are the strength and regulation of the financial sector, as well as macro-prudential policies, such as the recent tightening of mortgage rules.
- Although the downside risks created by household indebtedness are significant, today's speech reiterated that they are manageable. The strong health and capital positions of Canadian banks, supervisory framework, and structure of the housing market all enhance the resiliency of the Canadian economy and financial system to such a shock. Implicit is also the role of the government in managing the losses in a downturn via the Canada Mortgage and Housing Corporation (CMHC).
- The Deputy Governor's speech ended with a re-emphasis on the importance of keeping monetary policy focused on the inflation target. The Bank of Canada believes that there are other measures better suited to reducing vulnerabilities rather than the blunt tool of the policy interest rate. This reconfirms our view that the Bank is likely to maintain its policy rate at its current level of 0.5% into 2018.

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