OBSERVATION

TD Economics

August 26, 2013

CANADIANS ARE SAVING MORE, BUT DEBT BURDEN REMAINS

Highlights

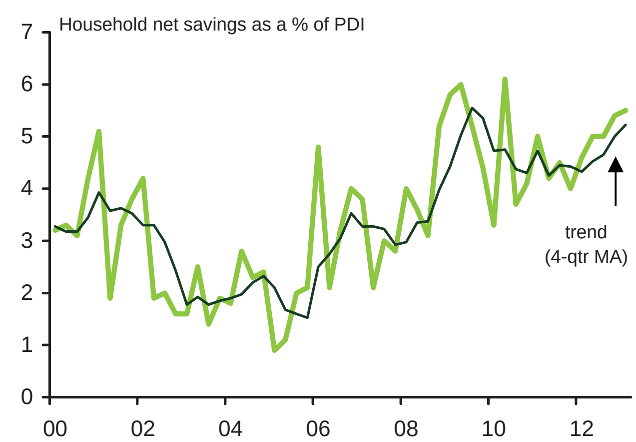
- Despite the focus on the high absolute level of household indebtedness, it is apparent that households in Canada have shifted towards greater thrift. The conventional measure of the savings rate is now at its highest point, outside of a recession, in 16 years.
- An alternative measure of the savings rate, which takes into account changes in net worth relative to income, also suggests that households have recently become more frugal.
- Flows data confirm that households are putting money into equity and investment funds and into deposits. A relatively high share of currency and deposits among total financial assets suggests continued risk aversion among Canadians. Households have also dramatically pared back their debt accumulation, and repayments of mortgage principal have also increased.
- The quarterly savings rate is highly volatile, and we could see some give back in the coming quarters, but overall we expect the savings rate to increase further next year. Despite this shift to thrift, Canadian households remain highly leveraged, and it will take quite some time for measures of leverage to return to historical norms.

The personal savings rate – as measured by what's left over from personal income once taxes and other non-discretionary expenses are paid – has fluctuated over the past few years, rising sharply during the recession and pulling back in the wake of recovery. Over the past three quarters, the rate has risen back close to a 16-year high (see Chart 1). This trend suggests that households have been taking action to improve their longer-term financial prospects.

Focusing on the most recent up-tick in the savings rate, income trends have remained fairly steady (see Chart 2), but household spending growth has decelerated quite dramatically. That has happened for a host of reasons. Consumers have been experiencing spending and debt fatigue. After reaching record levels of debt relative to income, households have dramatically pared back their pace of debt accumulation. In particular, consumer credit, which excludes mortgages, is trending at its slowest pace in almost 20 years. Demographics are also likely at play. The largest bulge in Canada's population pyramid (towards the tail end of the baby boom cohort) is currently in their early 50s, at a stage in the lifecycle where saving for retirement is becoming a far more salient reality.

Perhaps the most important influence behind the increased desire to save out of income is related to asset values. In par-

CHART 1. HOUSEHOLD SAVINGS RATE ON THE RISE



Source: Statistics Canada

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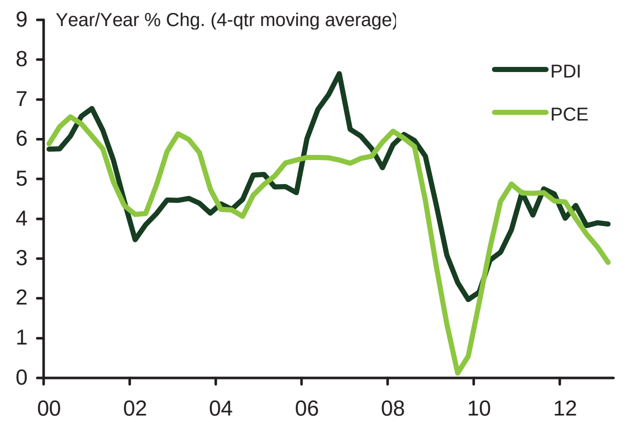
CHART 2. SPENDING HAS SLOWED MORE THAN INCOME



Source: Statistics Canada

ticular, rising values of homes and other personal assets had been doing much of the "saving" for Canadians over the past decade. But, with Canadian equity markets being sub-par since the recession and, over the past year, home prices gains having cooled, actively saving out of income has had to take up the slack (see Chart 3).

In the past, the personal savings rate has tended to be inversely related to returns on cash. Periods of high interest rates increase the opportunity cost of spending out of current income, and increase the incentive to sock money aside. However, in recent years the negative impact on savings from the current ultra-low rate environment is clearly losing out to the other positive influences noted above.

An alternative savings measure

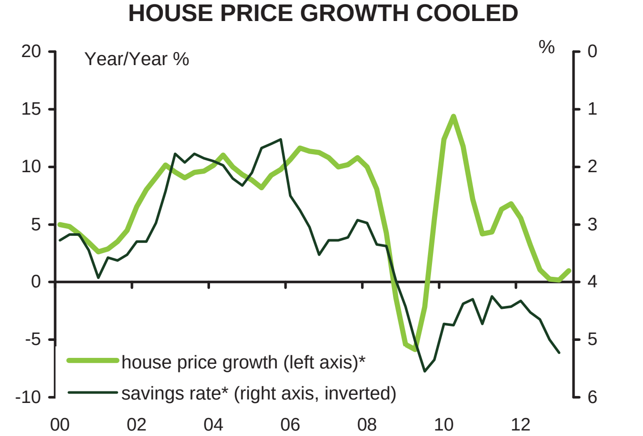
The fact that this common measure of the savings rate is the residual between income and spending and, hence, does not directly factor in changes in asset values that are key to building up a retirement nest eggs is a limitation. There are other shortcomings of the measure[1]. Consumer spending on durable goods is treated as consumption, when in reality they are assets that will be "consumed" over a period of years, like a car. Finally, it is distorted by inflation.

One alternative measure of the savings rate uses the change in household net worth, from the national balance sheet accounts, relative to household income, which is arguably closer to the theoretical concept of savings[2]. Calculating the change in real (inflation-adjusted) net worth divided by real disposable income, you see a much more volatile measure of household savings, based on the national balance sheet accounts (see Chart 4). Looking at a 12-quarter moving average to smooth out some of the volatility, the savings rate has rebounded strongly from recession in tandem with asset values and is currently running above its long-run historical average.

Where have the savings been going?

Both measures of the savings rate suggest Canadian households are saving more. To figure out where this money has been going recently, we need to look at the financial flow accounts of households. Quarterly financial flows data are quite choppy, but if you add up flows over the past four quarters, and compare it to previous four-quarter periods, it is clear that flows into financial assets which would typi-

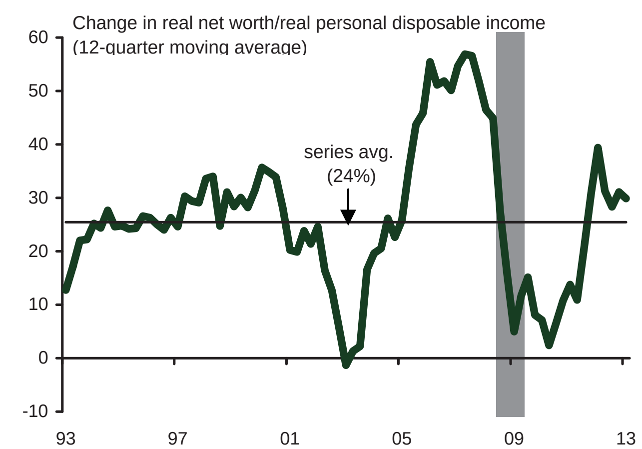
CHART 3. SAVINGS RATE HAS RISEN AS HOUSE PRICE GROWTH COOLED



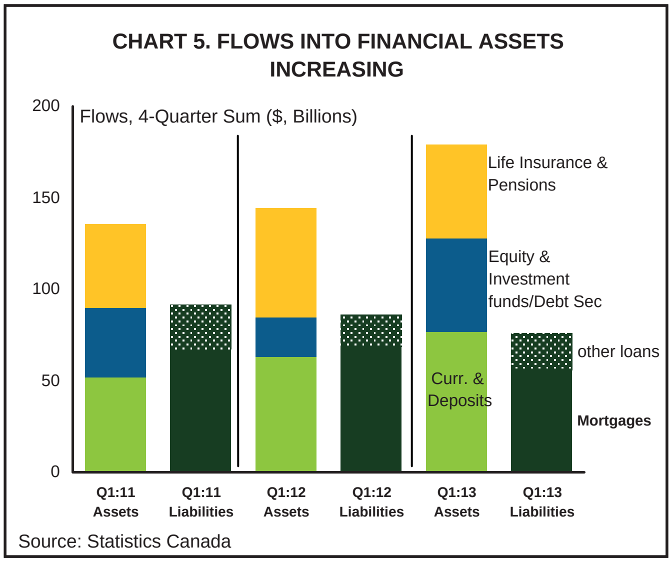
Source: Statistics Canada, CREA

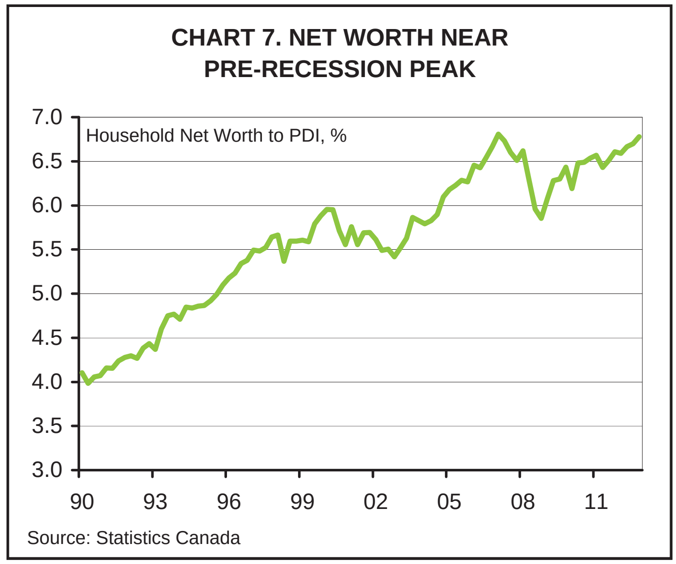
**Both measures 4-quarter moving averages*

CHART 4. BALANCE SHEET SAVINGS RATE



Source: Statistics Canada, TD



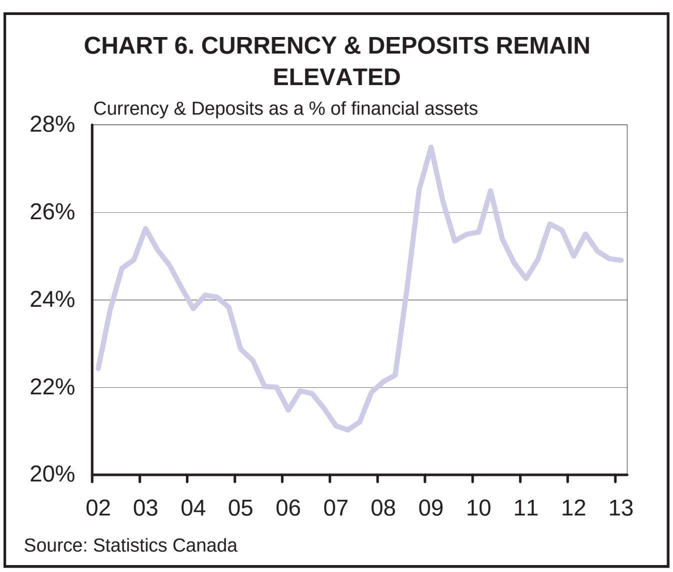


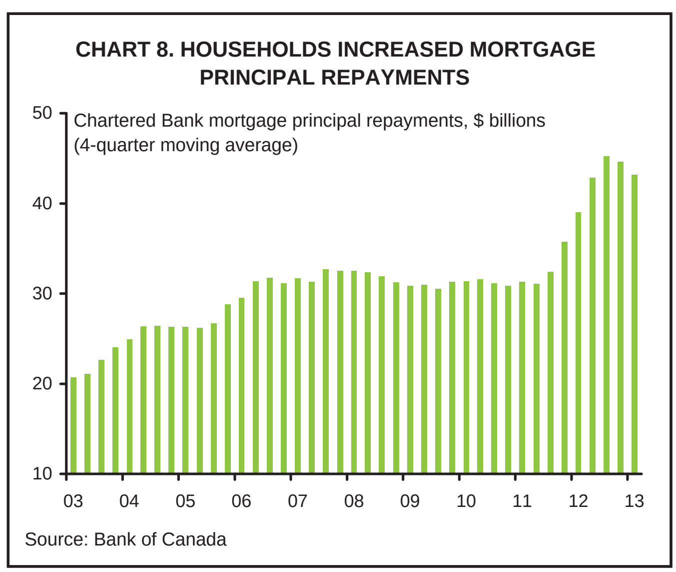
cally be thought of as "savings" (i.e. equities and investment funds, debt securities and insurance and pensions) have been increasing (see Chart 5).

In the past four quarters the biggest increase in flows were into equity investment funds/debt securities, but flows into this category are historically quite volatile. Over the past eight quarters the biggest increase in flows has been into currency and deposits, which likely speaks to the high degree of uncertainty about the economy and financial markets that has persisted since the recession. Households are choosing to keep a significant share of their savings liquid. Currency and deposits as a share of financial assets remains elevated above its pre-recession levels (see Chart 6).

The other side of the coin for financial flows is that liabilities, and more specifically mortgages, are building up at a much slower pace. A more conservative pace of liability growth, combined with flows into financial assets has resulted in a steady increase in net worth as a share of personal disposable income (one measure of household "wealth") since the financial crisis. However, it has yet to surpass its pre-recession peak (see Chart 7).

While we don't have data on how much mortgage principal is being repaid for the Canadian economy as a whole, we do have principal repayments on mortgages held by chartered banks. Chartered banks account for over three-quarters of the mortgage market, so this data is a good reflection of the country as a whole. Those repayments have notably increased in recent quarters (see Chart 8). It is clear





that when it comes to their mortgage debt, not only have Canadians slowed their pace of accumulation, they are taking a more active stance towards paying existing debt back.

Where is the savings rate going from here?

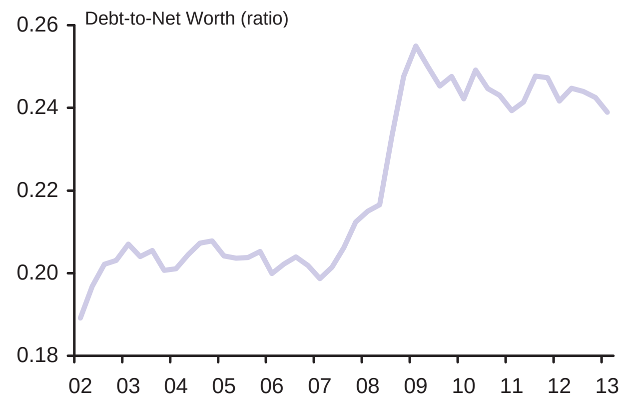
On a quarter-to-quarter basis the savings rate is quite volatile. In the near term, we would expect the savings rate to tick down as consumer spending picks up from the very weak start to the year. Thereafter, we expect it to start edging up again in 2014 as personal income growth increases alongside better economic growth, while high debt levels keep consumer spending growth comparatively modest. Looking further out to beyond 2014, the expectation of higher short-term interest rates in Canada will provide support to the savings rate. Lastly, there appears to be little scope for rising asset values to take pressure off households to set aside cash for savings over the next several years. In particular, home prices look likely to remain relatively stable over the next several years and equities to turn in only moderate returns.

Add it up and we expect the personal savings rate to rise further to around 6% by the end of 2016. The higher savings out of after-tax income alongside continued constraint in household debt growth is also expected to sustain the alternative measure of the savings rate – the change in real net worth over income – above its long-term average.

Are Canadians' debt woes over?

The increase in the personal savings rate does not erase the vulnerability of household finances to the large build up of debt over the past decade. Ratios of leverage or indebtedness have stopped worsening, but progress is much slower. Looking at debt-to-net worth, similar to a company's measure of leverage, we see that households have made some progress, but are still highly levered on a historical basis (see Chart 9). Furthermore, an improvement in these measures is going to take a long time. These large debts won't disappear overnight, and in an environment of slower asset price growth – be it house price appreciation or modest financial market gains, it will be a long slow process for measures of household leverage to return to historical norms.

CHART 9. DESPITE GAINS IN NET WORTH DELEVERAGING SLOW



Source: Statistics Canada

Bottom line

After approaching household savings from a variety of angles, it does seem that Canadians have increased their savings activity further since the recession. This has helped household net worth (as a share of income) come very close to its pre-recession peak. Looking beyond what could be a near-term down-tick in the personal savings rate in the next couple of quarters, we expect the personal savings rate to increase further to 6% over the forecast horizon.

In light of concerns related to adequate retirement savings and excessive debt-loads, this trend to higher savings represents a good step forward. That said, it is going to take quite some time to return to more normal levels of leverage. In addition, the moderate jump in savings is unlikely to address the broader challenge of insufficient retirement savings for a large slice of Canadian households. So while the increase in the savings rate indicates that consumers have turned the wheel in the right direction, it is going to take a lot longer to turn their financial boats around.

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Endnotes

1 Horner, Keith. 2009. "Retirement Savings by Canadian Households." Department of Finance. Report for the Research Working Group on Retirement Income Adequacy.

2 Bérubé, Gilles and Denise Côté, 2000. "Long-term Determinants of the Personal Savings Rate: Literature Review and Some Empirical Results for Canada". Bank of Canada Working Paper 2000-3.