



May 31, 2011

HIGHLIGHTS

- **Canadians have eased off the throttle on debt accumulation. Annual personal credit growth has slowed from an average double-digit pace of 10.9% during 2004-2008 to a year-over-year rate of 6.4% in April of this year.**
- **The pace of borrowing over the last three quarters has moved more in line with income growth, helping to stabilize the debt-to-income ratio. Meanwhile, other measures of indebtedness have also started to improve.**
- **Both secured and unsecured debt growth has moderated. The former reflects the soft-landing in real estate activity. The latter suggests that Canadians have responded to the calls for greater prudence in managing their debt.**
- **Despite the recent positive trends, personal finances remain stretched and are vulnerable to a future rise in interest rates.**
- **Consumers cannot be the main engines of economic growth over the next couple of years. Instead, the economy will have to rely on other sources of growth, such as exports and business investment.**

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CANADIANS TAKE ON GREATER PRUDENCE TOWARDS DEBT

Over the past few years TD Economics has been warning that Canadian personal debt has become excessive and was an increasing risk to the economic outlook. Our view has been that debt growth would slow as the Bank of Canada normalized interest rates. However, even without the catalyst of significant interest rate hikes, households have already pared back on their rate of borrowing. Secured debt growth (i.e. housing-related debt) has cooled as Canadian home sales dipped. Unsecured debt growth (e.g. credit cards, personal loans and lines of credit) is proceeding at a slow pace, suggesting that Canadians have responded to the calls for greater prudence in managing their debt. While the recent moderation in debt accumulation is positive, personal finances still appear stretched, implying that consumer spending will not be the engine of economic growth in the coming quarters and the inevitable future rebalancing of monetary policy will be a shock to many households.

Households temper their borrowing...

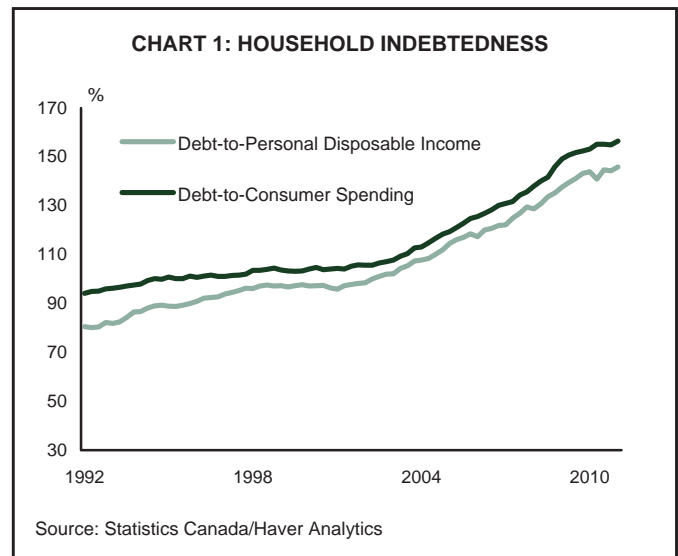
Since 2007, personal debt rose at a pace that was double that of personal disposable income.

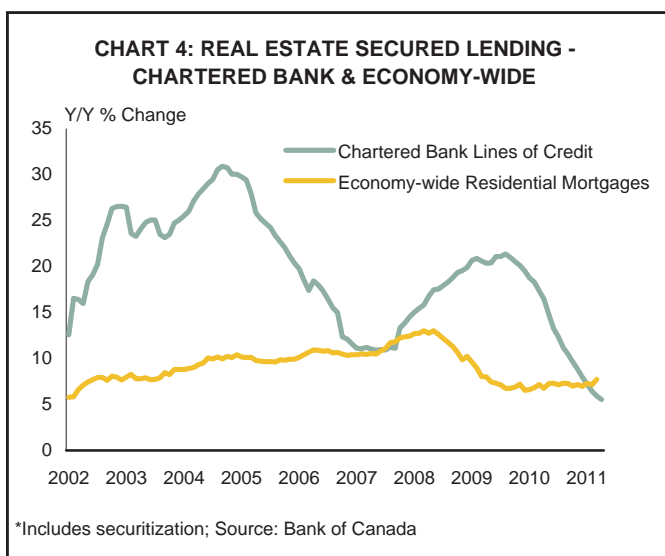
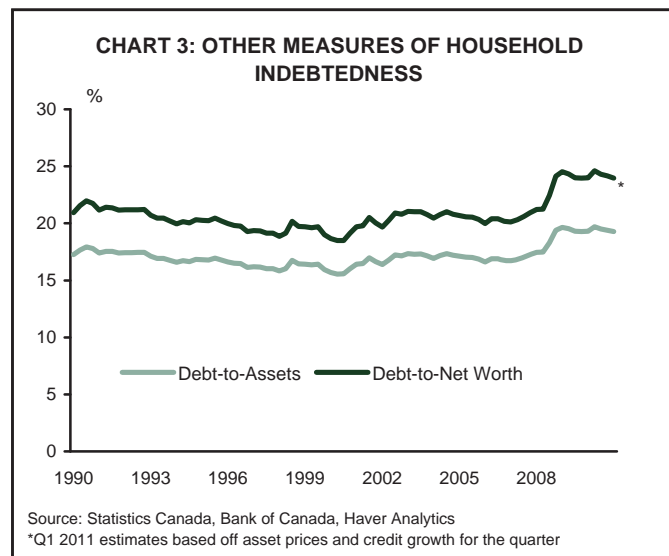
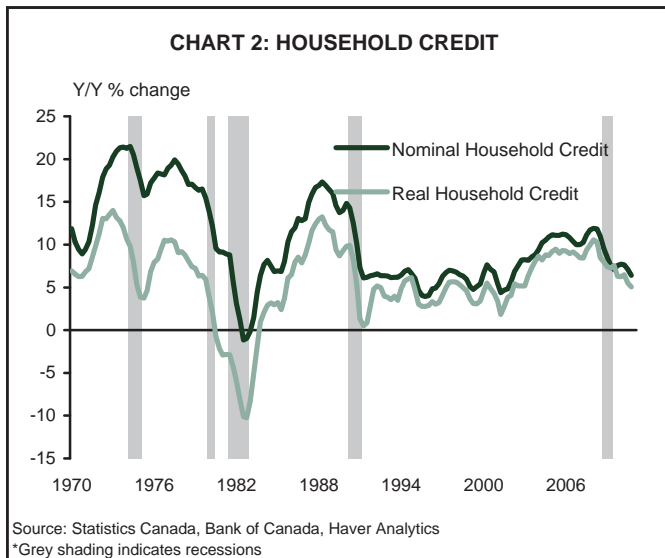
The trend continued through the most recent economic recession and subsequent recovery, as extraordinarily low interest rates created a buy now, pay later mentality. As such, the household debt-to-income ratio rose to a high of 147% (chart 1). In a special report entitled "Canadian Household Debt: A Cause for Concern", TD Economics argued

that personal debt growth had become excessive. Based on economic and financial fundamentals, a more appropriate level for the debt-to-income ratio is in the range of 138-142%.

TD Economics was not alone in warning that consumer finances had become stretched. The Bank of Canada repeatedly warned Canadians that the prevailing level of interest rates would not persist indefinitely. The Government of Canada also took prudent action to minimize the risk of a problem down the road by tightening mortgage insurance rules.

The good news is that households have eased off the debt accumulation throttle. Annual household credit growth has slowed from an average double digit pace



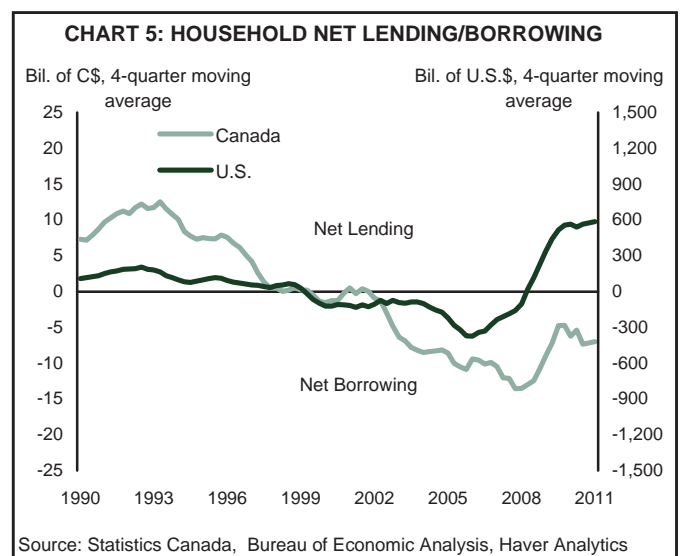


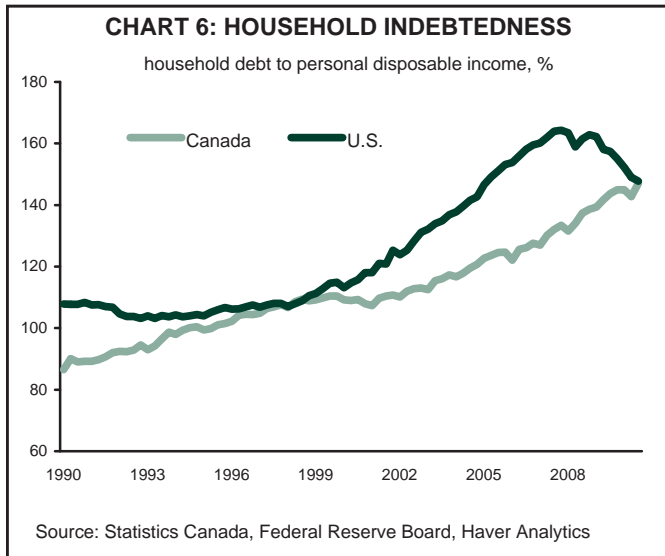
of 10.9% during 2004 to 2008 to a year-over-year rate of 6.4% in April of this year (chart 2). The pace of borrowing over the last three quarters has moved more in line with income growth, helping to stabilize the debt-to-income ratio. Meanwhile, there is also some evidence that the household balance sheet is on the mend. Other measures of indebtedness, such as the debt-to-asset and debt-to-net worth ratios (chart 3) improved in the last quarter of 2010. And, a further improvement is anticipated in the first quarter of 2011 and in future quarters. Furthermore, at its current rate of 4.2%, the personal savings rate has doubled since the start of the recession. The rise in the personal savings rate reflects an increased willingness among households to temper their spending relative to their income growth and prepare better for future financial needs.

... but Canadians are not deleveraging

The moderation in credit growth has been evident in all measures of debt. However, the brunt of the cooling in debt accumulation is being experienced in non-mortgage lending products, such as credit card borrowing and personal lines of credit (predominately home equity lines of credit) (chart 4). The debt obligation on these instruments is typically very flexible, meaning that outside of interest payments, consumers are not limited to how much principal they wish to pay off in any given month or year. This is in contrast to mortgages where monthly payments are generally fixed, and one's ability to pay down principal is often limited by the terms of contract. This provides some evidence that households are trying to work down high debt levels.

While households are clearly pulling the brakes on debt accumulation in the wake of record debt levels, they are not deleveraging. First and foremost, households are





still net borrowers, meaning they borrow more than they save. The net borrowing position of Canadian households has improved somewhat since the start of the 2008/2009 recession – an indication that households are becoming more cautious. However, the U.S. experience shows that deleveraging coincided with households moving into a net lending position, meaning that they are saving more than they are borrowing (chart 5). This abrupt change brought about severe negative economic repercussions.

The deleveraging process in the U.S. also resulted in the marked decline in other measures of indebtedness, such as the debt-to-income ratio which fell 15 percentage points. In Canada, while the relentless rise in the debt-to-income ratio has flattened, the jury is still out on whether the ratio has peaked. Strong income gains over 2010 can help to explain the tapering off in Canadian household indebtedness. However, some of those gains were driven by temporary measures, such as increased government transfers from the 2009/2010 stimulus package. Outside of these temporary measures, sustainable personal disposable growth is likely in a range of 4.0-4.5%. Credit continues to grow at a pace that is two percentage points above that. This implies that debt growth needs to slow further.

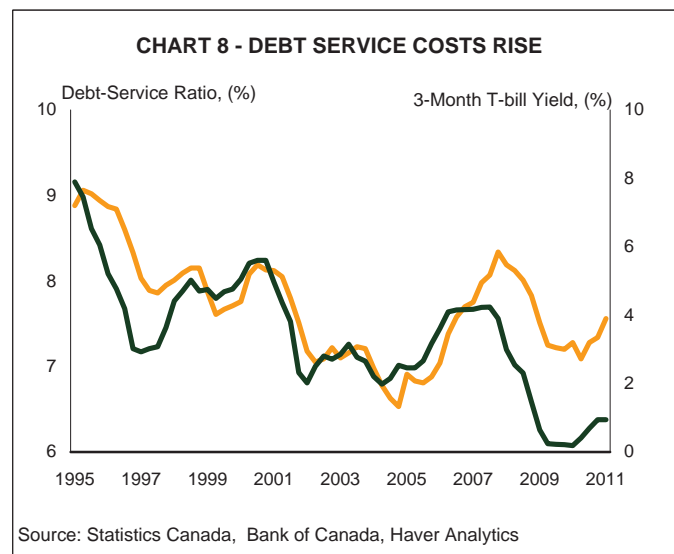
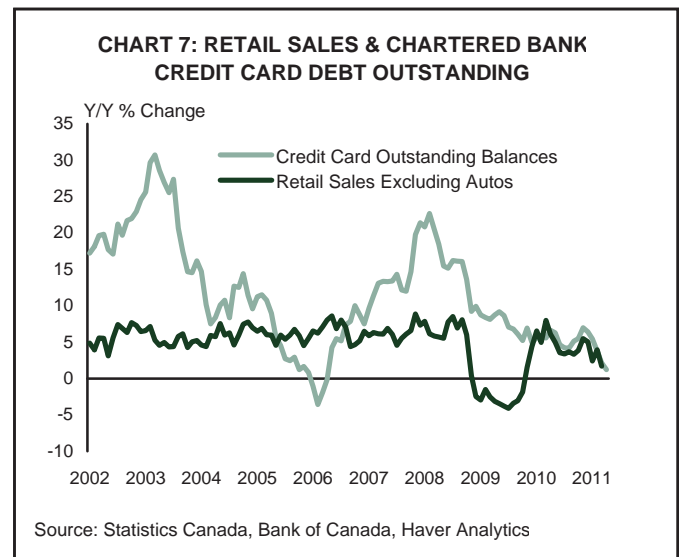
Debt accumulation should decelerate further

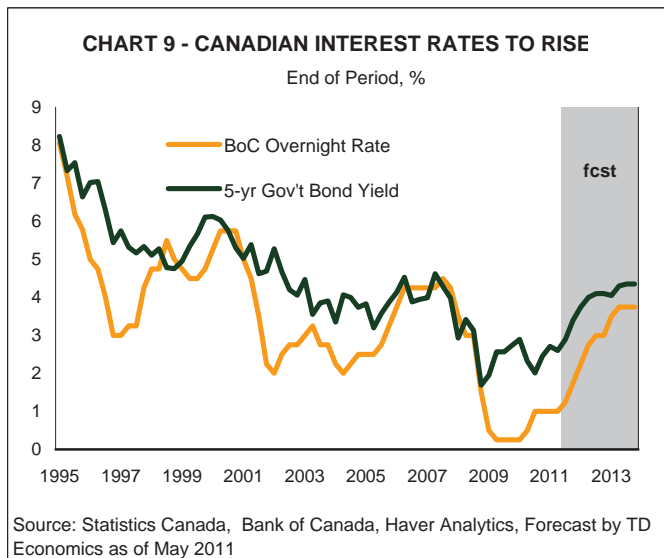
A number of factors are likely to keep a lid on credit growth over the next few years.

Firstly, households are likely fatigued after borrowing and spending like gang busters over the last five to ten years. Indeed, the recent slowing pace of borrowing has come in lockstep with a marked deceleration in consumer spending on discretionary items and a soft landing in the Canadian

housing market. The two go hand in hand. Fewer purchases require less debt, and the desire to accumulate less debt leads to less purchases. The ratio of household debt to consumer expenditures has also stabilized at a high 155%, indicating that consumers remain reticent of funding further consumption growth through credit.

Secondly, households may be preparing for the future rise in interest rates, which they should. Even with the moderation in personal debt growth, debt costs are climbing. The debt-service ratio, the interest households must pay on their debt each month as a share of personal disposable income, climbed to a two-year high of 7.6% in Q1 2011, despite still record low interest rates. Over the next year and a half, the expectation is that a future rise in interest rates will lift this ratio to the highest level in more than a decade. The Bank of Canada’s forecast is that the slack in the economy (i.e. the output gap) will be eliminated by mid-2012. We





agree with this projection and this augurs for higher interest rates. Indeed, when the slack in the economy is eliminated, the overnight should be close to 3.00% -- two percentage points higher than today. Not only does the sheer level of debt leave Canadian households more sensitive to the future rise in interest rates, but households have been carrying a greater share of variable rate debt instruments. As of the first quarter of 2011, over 46% of household debt is tied to a variable rate product, up from 30% at the start of 2009. The interest cost on these instruments will increase with the rise in short-term interest rates.

Lastly, stricter mortgage insurance rules over the last few years have likely constrained how much debt some households can carry. In particular, the move to raise the minimum down payment to 5%, the decrease in the allowable amortization period on insured mortgages to 30 years from 40 years, alongside capping mortgage refinancing to 90% of the value of a home, and prohibiting CMHC from

insuring home equity lines of credit, likely worked to limit how much mortgage debt households can take on. To be clear, these policy changes were prudent and act to help limit risk in Canadian real estate.

In our view, the combination of all three factors should temper household borrowing further in the coming years.

Bottom line

The recent deceleration in personal debt growth is positive, but is only a start. The level of household debt remains excessive. The good news is that Canadians have responded to the calls for greater financial prudence. The pace of debt growth has slowed, and there is a compelling argument that it will cool further in the coming quarters. The best news is that the moderation is occurring without the economic pain that comes from outright deleveraging. Instead, Canadians are bringing down their pace of debt accumulation more in line with income. The main question is how households will respond to the eventual rebalancing of monetary policy? In our opinion, many Canadians will experience a financial shock when interest rates eventually rise, but the vast majority of households should be able to cope so long as interest rates rise only gradually. The worst scenario would be one where interest rates are left too low for too long, which necessitates a more rapid tightening of monetary policy that would pose a greater shock to personal finances. Regardless of the path of monetary policy, the main message is that consumers cannot be the main engines of economic growth over the next couple of years. Instead, the economy will have to rely on other sources of growth, such as exports and business investment.

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