TD Bank Financial Group

TD Economics

Special Report

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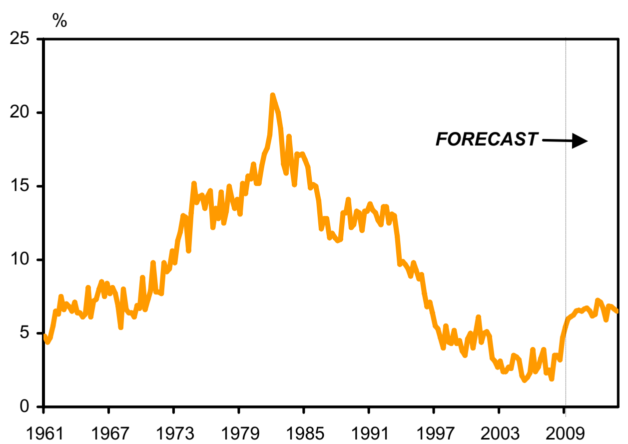
SHIFT TO THRIFT

Over the five years that preceded the current recession, Canadians had been on a shopping spree. Households bought new cars, fancy home furnishings, the latest fashions, and ate out at their favourite restaurants. During this time, households overspent relative to their income, became over extended with debt and saved too little. Now, with the Canadian economy in recession, it is of no surprise the period characterized by consumerism has ended. Households have constrained their spending considerably, and the savings rate rose to a 6-year high of 4.7% by the end of 2008. The combination of plunging stock markets, falling home prices, considerable job losses, and sour consumer confidence has led consumers to tighten their purse strings. However, a more important question is whether Canadians will resume their shopping spree once the economy emerges from the recession, or whether there be a sustained shift towards thrift? Based on our long-term outlook for the national economy, and determinants of the personal savings rate, we believe that the personal savings rate will remain elevated in the coming years, with a new long-run average in the 6-7% range as thrift comes back into style.

HIGHLIGHTS

- **The personal savings rate is expected to average around 6-7% over the next five years, double the rate of the last five years.**
- **The increase in the personal savings rate will reflect less willingness to count on capital gains to provide for future savings, a slower trend rate of consumer spending, and lingering memories of the recent drop in home and equity prices.**

CANADIAN PERSONAL SAVINGS RATE

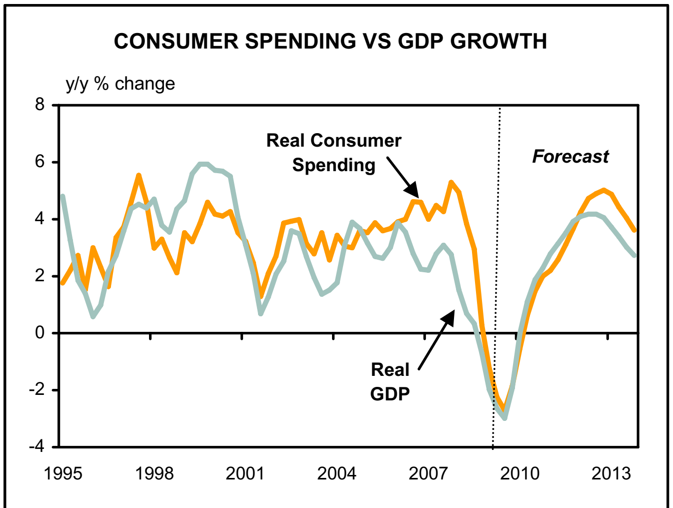


Source: Statistics Canada, Haver Analytics, Forecast by TD Economics as of March 2009

A Historical Perspective on the Savings Rate

To put the forecast into context, it is useful to have an appreciation of the historical experience. In the 1960s, a decade that was characterized by relatively low and stable inflation, the personal savings rate averaged 6.7%. The personal savings rate then soared during the unstable economic and inflation backdrop of the 1970s and 1980s, with a peak of 20% in 1982. Over the quarter century ending in 1995, the personal savings rate averaged 13.7%.

However, the Bank of Canada developed considerable credibility as an inflation fighter in the 1990s and this had an influence on personal savings. The low and stable inflation created a greater sense of certainty around future income and its purchasing power. Thus, there was less need for precautionary savings. It also created a win-win situation for both borrowers and lenders, raising demand for credit and boosting supply of credit. Consider that if you bought a home in 1975, the average mortgage rate was 12%. However, when a five-year mortgage came to



Source: Statistics Canada, Haver Analytics, Forecast by TD Economics as of March 2009

refinancing again in 1980, it had risen to 16% — a 4 percentage point increase. In contrast, with the Bank of Canada able to anchor inflation expectations at close to 2% in the second half of the 1990s and the 2000s, there was more certainty around what your interest rate would look like in five years time. The reduced interest rate volatility also reduced the risk faced by creditors, and credit conditions loosened up. This meant that Canadians were less constrained by cash balances, and no longer had to save as much for big purchases that could now be financed at very little extra cost. As such, the personal savings rate was slashed in half in the second half of the decade, averaging only 6% from 1995-1999, versus a 12.1% in the previous five years.

Wealth accumulation drove the personal savings rate down even further

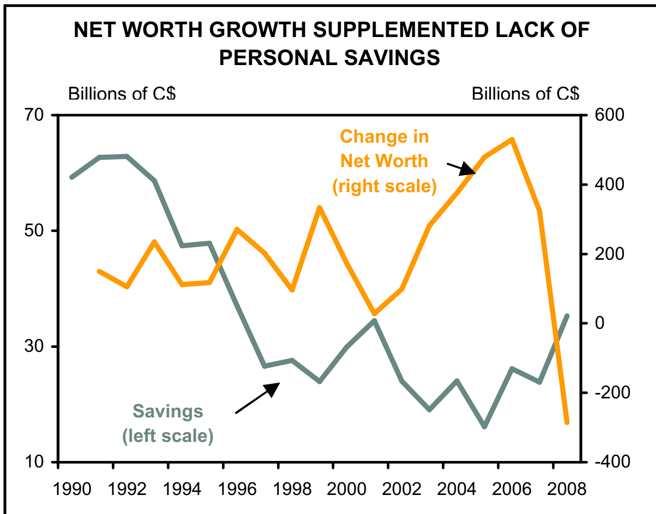
However, the personal savings rate continued to decline in the current decade and averaged a mere 2.9% over the five years ending in 2008. During this half-decade time span, real personal consumption grew at an average annual pace that was more than one-third faster than overall economic growth. The question is why this occurred, since the adjustment to a low interest rate and inflation environment should have been complete. A key part of the answer was influence of rapid personal wealth accumulation.

The personal savings rate is an imperfect measure of actual savings because it does not capture income/savings from capital gains on real estate and financial assets. Despite a record low savings rate, household assets soared by an annual rate of 9.5% over the five years prior to the recession. This reflected the fact that home prices averaged an annual gain of 10.2% from 2003 to 2007, compared to the more sustainable 4.1% in the prior five years. This lead to substantial gains in home equity, which households viewed as a source of savings. Moreover, from 2003-2007, Canadian stock prices grew an average 16%, which is quite remarkable relative an average of 6.6% growth in the 1990's. Some of the asset accumulation was financed through debt. Indeed, over 2003 to 2007, personal liabilities increased on average by 9.0% annually, but the faster growth in assets meant that personal net worth climbed by 8.7% over the period. The implication was that the household asset to liability ratio rose from its low in 2002.

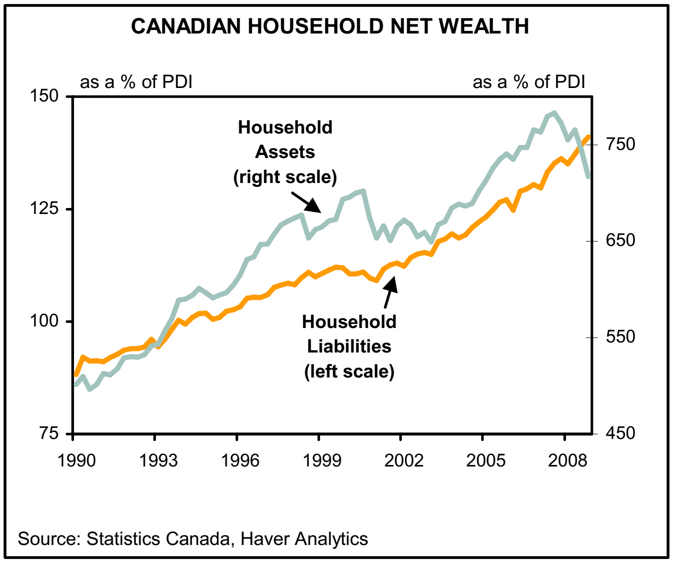
The wealth accumulation meant that households felt more financially sound and it likely had a significant impact in the willingness to save less out of personal income. The downside was that it also left households more vulnerable to wealth corrections.

As of February 2009, home prices had fallen by 13.4% from their peak in 2007, and are expected to fall further in the year ahead. The stock market plunged by 48% from its peak in June of 2008 before staging a 26% rally in April 2009. However, remember that it will take a 96% increase from the low to return to the 2008 peak.

In response to the wealth correction and the economic recession that following the financial crisis, there was a shift towards thrift, with the personal savings rate spiking 1.5 percentage points from the low of 1.9% in the fourth



Source: Statistics Canada, Haver Analytics



quarter of 2007 to 4.7% in the fourth quarter of 2008. However, the increased savings can only have a modest impact on repairing the damage done to personal balance sheets. And, the outlook for real estate prices and corporate profits suggest that it could take several years for the capital losses to be fully reversed.

The wealth correction is likely to have two effects. First, the lengthy recovery in real estate and financial assets suggests that households may choose to save more out of personal income in the coming years. Second, the memories of the asset price correction will linger and the households may be less inclined to rely on capital gains in the future.

Less willingness to accumulate debt will boost saving

There are other factors that might also support the shift towards thrift. A more modest willingness to accumulate debt may also help to facilitate a higher rate of personal saving. Since 2003, household credit has grown at an astonishing average annual pace of 9.0%, nearly twice as fast as the 5.3% increase in personal disposable income. Evidence that credit has become a more popular form of funding consumption includes a large spike in new credit as a share of consumption after 1992. This was partly fuelled by a low interest rate environment, which meant that the vast majority of households remained in a good position to handle the cost of these loans, even as debt grew to a historical high of 142% of PDI.

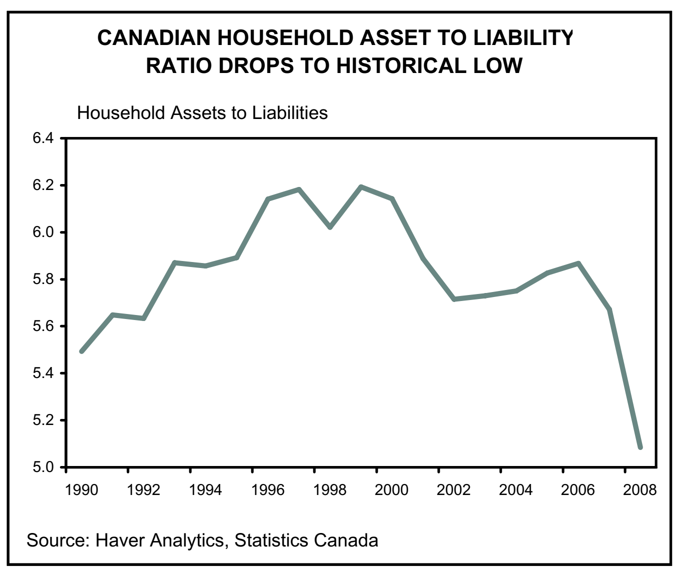
Households were likely also willing to hold a large amount of leverage because of their wealth accumulation. Despite the strong growth in liabilities, household credit has remained relatively stable as a percent of net worth. However, the asset price correction that began in 2008 has struck the Canadian balance sheet hard. The fall in asset values has left households holding a historically high amount of debt relative to their asset base, as the asset to liability ratio fell to a historically low level.

Since personal savings make up under 0.5% of total assets, households face a high hurdle when it comes to restoring their asset base through an increased savings rate, and as noted above it will take significant time for assets to recover their losses. As a result, one of the key responses that households might take to improve their asset-to-liability ratio is to scale back on the pace of liability accumulation.

Memories of recession may also temper spending and debt growth

Further, the Canadian economy had been recession free for 17 years prior to the downturn in late 2008. This created a sense of increased income security, and a heightened sense of comfort with holding larger amounts of debt. However, 2008 has proven to be a rude awakening. With the economy expected to shed over half a million jobs by the end of the recession, and the unemployment rate expected to peak at a 12-year high of 10%, Canadians have become increasingly concerned about their future prospects, as reflected in the drop in consumer confidence to a 26-year low.

Even as labour markets begin to recover in 2010, consumers will likely remain jittery, as the unemployment rate is a lagging indicator and will only slowly retreat. The memories of the worst post- war global recession will be



difficult to shake for many, and consumer confidence is not expected to bounce back to the levels witnessed over the last decade. It is expected that households will save more and borrow less during the next economic upturn, to offset some of the wealth shortfalls that occurred and to be better prepared for any future economic downturns. Even as real personal disposable income growth picks up again, the level of savings will increase.

Moreover, while credit will be readily available to consumers, the rate of growth in the supply of credit will be more modest. For example, financial institutions, particularly non-bank lenders, were willing to significant increase the availability of credit because the loans could be pooled together and sold to investors as asset backed securities. This materially increased supply of financing through credit cards, personal loans and mortgages. However, the credit crunch has led to a reversal of the trend toward increased supply of credit. For example, the ability to securitize loans has dried up and government policy has eliminated insurance on no money down mortgages and on the 40-year loans. Make no mistake, household credit will be readily available in the years ahead. But, the rate of growth in the supply of credit will not return to the pace that occurred prior to the latest financial crisis. This will be a healthy trend for both households and for the financial system. Nevertheless, the main implication is that households are likely to elect to save more for larger purchases, relative to the savings made in the last decade.

Thrift is back

The Canadian consumer shopping spree of the last decade had been funded by record low interest rates and record high capital gains. However, the recent financial crisis and ensuing recession has brought the period of profligate spending to a close. The current economic and financial crisis highlights the risks associated with savings too little and borrowing too much. A shift to thrift has already occurred in reaction to the economic downturn. However, the increase in personal savings is likely to prove sustained. Canadians are expected to slow their rate of spending relative to their growth in income, to rely less on capital gains, to remember the uncertainty of the current economic and financial times, and to work towards rebuilding their personal balance sheets through increased saving and less debt accumulation. As a result, the personal saving rate is expected to continue to climb and average at around 6-7% over the next five years.

Diana Petramala
Economist
416-982-6420