Agathe Côté: Household finances and economic growth

Remarks by Ms Agathe Côté, Deputy Governor of the Bank of Canada, at the Canadian Club of Kingston, Kingston, Ontario, 10 January 2011.

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Introduction

Good afternoon and Happy New Year. Thank you for your invitation to speak to the Canadian Club. This is my first public speech as a Deputy Governor of the Bank of Canada, and I am delighted to be delivering it in the historic city of Kingston. In my remarks I will focus on the state of the Canadian economy, with an emphasis on household finances.

Why does household financial health matter to the Bank of Canada? It matters because *how* Canadians spend and *how much* they spend affect both the conduct of monetary policy and the stability of the financial system. Sound household finances are vitally important for a balanced economy.

Collectively, households play a significant role in the functioning of the economy. Household spending accounts for about 60 per cent of aggregate demand in Canada, and was critical in lifting the Canadian economy out of the recession. At the same time, however, Canadian household finances have become increasingly stretched.

Today, I will touch briefly on growing household indebtedness and the risks that it poses to Canada's financial stability, but my comments will centre mainly on the macroeconomic outlook and the linkages between household finances and spending. I will start with an overview of current economic conditions and how the economy evolved during the financial crisis.

Recovering from the great recession

In mid-2009, the world economy began to emerge from the most severe financial crisis since the Great Depression. In Canada, the recession lasted for three quarters, from the latter months of 2008 to mid-2009. Our exports fell dramatically in response to a steep drop in U.S. demand. Firms cut back on employment; some 417,000 jobs were lost. In response to the weaker labour market, declines in net worth and increased uncertainty, household spending also fell. Government spending was the only consistent source of growth throughout this period.

Despite these challenges, Canada's recovery has been stronger than that of our G-7 peers. By mid-2010, Canadian output had returned to its pre-recession level and all of the jobs that had been lost were regained. Since then, almost 46,000 positions have been added.

Canada entered the recession with critically important advantages. Our public debt burden was the lowest of the G-7 countries. Our monetary policy was highly credible. Our financial institutions were in good health, owing to the quality of public supervision and private risk management. Corporate balance sheets were robust. Finally, Canadian household finances were not as stretched as they were in some other advanced countries. Relative to the situation in the United States, in particular, the personal savings rate in Canada was higher and household debt was lower.

These favourable conditions meant that the Bank of Canada could respond aggressively with substantial monetary easing, while keeping inflation expectations well anchored. They also allowed governments to roll out extraordinary fiscal stimulus, while maintaining fiscal sustainability. The fact that our banking system was well capitalized meant that Canadian banks did not face the same pressures to deleverage, and were able to maintain the supply of credit, although they did tighten the terms and conditions of lending to businesses.

Because the financial system in Canada was functioning well, the cuts in the policy rate were transmitted to other interest rates in the economy, and effective borrowing costs for both households and businesses declined to exceptionally low levels. This helped cushion the downturn and fuel the recovery in household spending, with the result that consumption surpassed its pre-recession level as early as the third quarter of 2009. In contrast, business investment was unusually weak during the recession, and its recovery has been subdued.

In the United States, the situation was, and still is, much worse. Of course, the United States *was* the epicentre of the financial crisis. The recovery in the labour market there has been weak, restraining the growth in labour income. Household balance sheets remain under pressure from elevated debt levels and the dramatic collapse in home prices. Hence, the level of consumer expenditures has just recently reached its pre-recession peak and, following a sharp contraction, the housing market has yet to rebound. Overall, the pace of recovery in U.S. private domestic demand has been slow. Since the United States is Canada's largest trading partner, our exports have also been slow to recover. Weak external demand, combined with the deterioration in Canadian competitiveness in recent years, has led to sharp contractions in Canada's trade balance and a return to current account deficits.

Thus, despite the advantages I noted a moment ago, Canada's recovery has been relatively modest in comparison with previous cycles, and has relied heavily on household and government spending.

Going forward, the Bank expects that the composition of demand will shift away from government and household spending toward business investment and net exports. In that regard, the surge in business investment that began last year is an encouraging start. The strength in net exports will be sensitive to currency movements, the expected recovery in productivity growth, and the prospects for external demand.

Household finances and spending

From the outlook for the overall Canadian economy, let me now narrow my focus to the household sector and, in particular, to the links between household spending and household finances.

As I mentioned at the outset, the resilience in household spending helped propel the economy out of the recession. A number of factors contributed to the rebound in consumer expenditures and housing investment, including the recovery in employment and labour income, the improvement in consumer confidence, and temporary fiscal measures, most notably the tax credit on home renovations.

Equally important, consumers took advantage of low borrowing costs and, in doing so, pushed household debt levels to record highs. Since the trough of the recession, household credit has grown about twice as fast as personal disposable income. By the third quarter of 2010, the debt of Canadian households had reached 148 per cent of disposable income.

In addition to low interest rates, rising house prices and home-equity extractions have played a role in the growth of credit in recent years and, therefore, have helped to boost household spending. Why is this? The main channel through which increases in house prices can raise household spending is called the financial-accelerator effect. When the value of a house rises, the owner can borrow against the increased equity through a home equity line of credit, a home equity loan or by simply increasing the size of the mortgage (an option for homeowners when they renew their mortgage, provided they have sufficient equity). The funds can be used to finance home renovations, a second house, or other goods and services. Such expenditures can accelerate the increase in house prices, reinforcing the growth in collateral values and access to additional borrowing, thus leading to a rise in household spending. Of course, this accelerator effect can also work in reverse: a decrease in house prices tends to reduce household borrowing capacity, and amplify the decline in spending.

Research conducted at the Bank of Canada and elsewhere suggests that the financial-accelerator effect is economically significant.[1] This finding is also consistent with reduced-form evidence of a correlation between consumer spending and housing wealth.[2]

In the last decade, lending based on housing collateral has risen as a share of total Canadian household credit. According to Bank of Canada calculations, the volume of home-equity lines of credit and loans has risen by as much as 170 per cent–or almost twice as fast as mortgage debt–and now accounts for 12 per cent of the overall stock of household debt. Since these secured loans are offered at a lower interest rate than unsecured loans, consumers have used part of the funds to pay down other debts. Microdata suggest that roughly one-third of the loans are used to that effect, while about 20 per cent are used to invest in financial assets. The remaining half is spent on current consumption and renovating or purchasing another property. Over time, there has been a marked increase in the share of home-equity-backed debt held by older households, an outcome that may not be too surprising since older households have generally owned their houses longer and have significant equity in them.[3]

The overall conclusion based on the microdata and the research is that lower interest rates for secured lending and increased access to credit as house prices rose have helped fuel net increases in credit and have supported household spending in Canada in recent years.

Going forward, house price gains are unlikely to provide the same support to household wealth as they have in recent years. This, combined with the fact that the level of household debt has reached a record high, leads us to expect that the growth of household expenditures will slow to a pace closer to that of income.

There are risks, on both the upside and the downside, to the outlook for Canadian household spending. On the upside, household spending could be stronger than expected if growth in incomes were to rebound more rapidly than the Bank projects, or if borrowing continues to exceed income growth. In our projection, we expect slow growth in personal disposable income owing to the withdrawal of fiscal stimulus, announced compensation restraints by governments and a slow recovery in average hours worked.

On the downside, if there were a sudden weakening in the Canadian housing sector, it could have sizable spillover effects on other areas of the economy, such as consumption, given the high debt loads of some Canadian households. While residential investment declined in the second half of 2010, it still remains near historically high levels. The Bank expects some further weakening into 2011, reflecting subdued income growth and declining affordability, but not a major correction.

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1 See M. Iacoviello, "House Prices, Borrowing Constraints and Monetary Policy in the Business Cycle" The American Economic Review 95, No. 3 (2005): 739–64. See also: M.B. Roi and R. Mendes, "House Prices, Residential Mortgage Credit and Monetary Policy," Bank of Canada, December 2004 (Available at: http://www.bankofcanada.ca/en/conference_papers/housing_macroeconomy/roi.pdf); and J. Campbell and J. F. Cocco, "How Do House Prices Affect Consumption? Evidence from Micro Data," (Harvard Institute of Economic Research Working Papers No. 2045, 2004)

2 See L. Pichette, "Are Wealth Effects Important for Canada?" Bank of Canada Review (Ottawa, Bank of Canada, Spring 2004). Available at: http://www.bankofcanada.ca/en/review/spring04/r04-2-ec.html

3 Part of the increase may also reflect the general aging of the population. Microdata indicate that from 1999 to 2009, the share of home equity lines of credit (HELOCs) held by households in the 50-plus age group increased from 33 per cent to 54 per cent.

Household finances and financial stability

Household finances also have important implications for financial stability. While the rapid expansion of household credit during the recession and the early stages of the recovery is in part a testament to the resilience of Canada's financial system, it is also a source of risk. As discussed in the Bank's most recent *Financial System Review*, the proportion of households with stretched financial positions that leave them vulnerable to an adverse shock has grown significantly in recent years.

At an aggregate level, the risk is that a shock to economic conditions could be transmitted to the broader financial system through a weakening in the credit quality of loans to households. This could prompt a tightening of credit conditions and, in turn, set off a mutually reinforcing deterioration of real activity and financial stability.

There are welcome signs of moderation in the pace of debt accumulation, but credit continues to grow faster than income. Without a significant change in behaviour, the proportion of households that would be susceptible to serious financial stress from negative income or wealth shocks will continue to grow.

To better assess the risks associated with growing household indebtedness, the Bank regularly undertakes stress tests. In the December *Financial System Review*, we conducted a partial stress-testing simulation to estimate the impact on household balance sheets of a hypothetical 3-percentage-point increase in the unemployment rate. The results suggest that the associated rise in financial stress among households would double the proportion of loans that are in arrears three months or more.

Even without adverse shocks, household debt-service ratios would be expected to increase when borrowing costs return to more normal levels. It is the responsibility of households to ensure that, in the future, they are able to service the debts they take on today. Similarly, financial institutions are responsible for ensuring that their clients do not take on unmanageable debt loads.

Policy implications

In response to the global financial crisis and the recession, the Bank of Canada lowered the target interest rate rapidly over the course of 2008 and early 2009 to its lowest possible level, and provided exceptional guidance on the future path of rates through its conditional commitment. These measures delivered considerable stimulus to the economy during a period of very weak economic conditions. Since last spring, with improvements in the economy, the Bank has removed the conditional commitment, and raised the overnight rate from ¼ of one per cent to 1 per cent. This still leaves considerable monetary stimulus in place, consistent with achieving the 2 per cent inflation target in an environment of significant excess supply.

Some have asked if increasing interest rates poses such a threat to households, why raise them? Yet others have asked if household debt is such a concern, why not raise rates and discourage borrowing?

The cornerstone of the Bank's monetary policy is its inflation-control agreement, the goal of which is to keep inflation near 2 per cent. In setting interest rates to achieve the inflation target, developments in household finances need to be weighed along with all the other factors influencing economic activity and inflation. Canadian monetary policy is set for overall macroeconomic conditions in Canada.

The Bank recognizes that low interest rates, while necessary to achieve our inflation target, create their own risks.[4] Prudence on the part of individuals and financial institutions is the first line of defence against these risks. Supervision of financial institutions can also be effective in limiting excessive concentration of risk. The development and use of selected macroprudential tools constitute another line of defence.

In the housing market, the federal government has already taken important measures to address household leverage. These include a more stringent qualifying test that requires all borrowers to meet the standards for a 5-year fixed-rate mortgage as well as a reduction in the maximum loan-to-value ratio of refinanced mortgages and a higher minimum down payment on properties not occupied by the owner. In addition, the Bank of Canada's interest rate increases reminded households of the interest rate risks they face. These measures are beginning to have an impact.

As part of our research for the renewal later this year of our inflation-control agreement with the Government of Canada, the Bank is examining whether there may be cases in the future where monetary policy should play a supporting role to these other lines of defence by taking pre-emptive actions against building financial imbalances.[5]

Conclusion

Sound household finances are a key element of a balanced economy. They are essential to keep household spending and overall economic growth on a sustainable track and to maintain the stability of our financial system. This is why the Bank is closely watching developments in this area.

I hope my comments have provided some additional insight into the Bank's economic outlook and the determinants of household spending and offer you some guidance about the risks. The clearer our understanding of the nature of the risks we face, the better able we will be to make informed decisions to address them. Thank you.

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[4] See M. Carney, "Living with Low for Long" (speech delivered to the Economic Club of Canada, Toronto, 13 December 2010). Available at: http://www.bankofcanada.ca/en/speeches/2010/sp131210.html.

[5] See M. Carney, "Some Considerations on Using Monetary Policy to Stabilize Economic Activity" (speech delivered at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 22 August 2009). Available at: http://www.bankofcanada.ca/en/speeches/2009/sp220809.html. See also: J. Boivin, T. Lane and C. Meh, "Should Monetary Policy Be Used to Counteract Financial Imbalances?" Bank of Canada Review (Ottawa, Bank of Canada, Summer 2010). Available at: http://www.bankofcanada.ca/en/review/summer10/boivin_summer10.pdf.