Why '14.1' means Canada still risks a financial crisis

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June 26, 2017 – *The Globe and Mail*

Canada remains at risk of a financial crisis, though a key gauge of that threat has eased noticeably.

Indeed, Canada is one of the countries that stands out among those studied by the Bank for International Settlements.

The annual report released Sunday by the BIS, a body made up of the world's central banks, shows an early-warning indicator eased in the fourth quarter of 2016 but remains above the threshold for probable stress on a banking system.

Known as the credit-to-GDP gap, it measures the ratio of debt to gross domestic product, compared to its long-term trend.

In Canada, according to the latest reading, it stands at 14.1 percentage points above the long-term average, declining from 17.4 in the third quarter.

That's a significant decline, to be sure. Not only that, 14.1 is the lowest level in several quarters, and isn't particularly elevated, either. But what's more important than whether the number rises or falls is whether it's above 10, which signals the possibility of a crisis within three years.

The BIS measure includes all credit to the non-financial sector, and thus takes in loans and other things like debt securities, and is meant to help guide the level of capital buffers among a country's banks.

Canada has also breached a "critical threshold" at least once in the past five years where real estate is concerned, with a separate measure that looks at property price aberrations, also from the long-term trend.

This should be no surprise given the inflated home prices in the Vancouver and Toronto.

Also flagged by the BIS is another measure that looks at how we juggle our debts when interest rates rise.

The debt-service ratio isn't particularly troublesome now, but would be in the red zone should rates rise by 2.5 percentage points.

The Bank of Canada was not immediately available to comment, but should be at least pleased that the measure is heading in the right direction, down.

The central bank has said the gap is just one tool that factors into its thinking, and that it studies several indicators for signs of vulnerability.

In fact, it warned of high household debt levels and inflated home prices in its recent review of the financial system, though it isn't calling for a meltdown.

Repeated in Sunday's annual report, the BIS had released the gap figures earlier in June, when it also flagged the run-up in Canadian home prices.

Such concerns are hardly new in Canada, where federal and provincial governments have moved to tame housing markets, particularly in Vancouver and Toronto.

Worth noting, though, is that most observers don't fear a meltdown, like the great one in the U.S. that few will ever forget. Also worth remembering is that Canada's banks are deemed sound, though were recently downgraded by Moody's for these very reasons.

Keep in mind, too, however, that the Bank of Canada has signalled interest rates could rise earlier than expected, and that the many vulnerable households across the country should prepare for that.

"Concerns about household financial vulnerability are also prominent given the expectation that interest rates will rise from their historically low levels," Canada's Parliamentary Budget Officer said in a report last week.

Like other observers, the PBO flagged the fact that the ratio of debt to income in Canada has been at or near record levels. And it's going to rise as home prices climb and lending rates stay relatively low even when they rise.

"Over 2019 to 2020, household debt relative to disposable income is projected to be 10 percentage points higher on average," the report said.

Like the BIS, the PBO also looked at what is now a stable debt-service ratio.

"Based on PBO's April 2017 outlook, we project that household debt-servicing capacity will be stretched even further over the medium term as interest rates return to more normal levels."

"We are projecting that the household sector will become increasingly vulnerable to negative shocks," the PBO report said.

The Fitch Ratings agency also weighed in on this a few days ago, and, like other observers, it doesn't see an American-style crash because of the differences in the markets and the fact that the "quality" of loans in Canada is strong.

But there's always a but.

"Fitch continues to believe that home price declines will be tempered by the proactive measures taken by the Canadian government, close regulatory oversight and sound underwriting principles, supportive macroeconomic conditions and strong housing demand," the agency said.

"However, measures taken to date to slow price growth appear to have had a temporary effect and the price trajectory in Toronto and Vancouver is likely to continue," it added.

"For this reason, Fitch believes a more severe correction is increasingly likely especially if there is an unexpected sharp rise in interest rates or unemployment."

There has been a noticeable cooling in Toronto, though observers wonder if that will simply be temporary, as was the case in Vancouver.