Canada can cope with higher interest rates

By Craig Alexander
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The Bank of Canada is gradually raising interest rates. The decision to hike the overnight rate by a quarter point in January follows a half-point increase in the second half of last year. The reduction in monetary stimulus is well supported by current economic data.

In 2017, the economy grew at a strong 3-per-cent pace and created more than 400,000 net new jobs; the unemployment rate plunged to the lowest level since the mid-1970s and wage growth picked up. Moreover, inflation is sitting very close to the bank's 2-per-cent target.

In many respects, the judgment to raise rates is a vote of confidence in the health of the Canadian economy. While it is undoubtedly a positive signal, some are worried about what a rising rate environment will do to the financial well-being of heavily indebted Canadian households.

The sustained low-interest-rate environment of recent years has provided a powerful incentive to borrow. Growth in consumer credit has far exceeded income gains, with the result that household credit as a percentage of disposable income climbed to a whopping 171 per cent in late 2017.

Although this metric grabs a lot of headlines, it is actually a very poor indicator of financial risk. The debt-to-income ratio compares the stock of debt to the annual flow of after-tax income. Most households don't pay off their financial liabilities in a single year. It also compares debt with the disposable income of those with and without debt. Removing the income of households without debt produces a dramatically higher ratio. As a result, it is hard to know what 171 per cent means.

Interest and principal payments as a share of after-tax income is a better measure. The latest data show the debt service ratio at just less than 14 per cent. To give a sense of financial risk, the debt burden for an individual household becomes severe when debt service costs get close to 40 per cent of disposable income. At the economy-wide level, these data imply that households can cope with higher interest rates.

There are, however, individual households that will be put at risk from higher rates. The low-interest-rate environment has encouraged all Canadians to take on more debt. Most have behaved responsibly and can meet their commitments when rates rise, but around 7 per cent to 10 per cent of households are extremely leveraged. This group, numbering more than one million households, is the one at risk from higher interest rates, but those in it should adapt if the increase in rates is slow.

Extremely leveraged households are a minority, but all households across the country will be affected by the reduction in monetary stimulus. As the bank hikes rates, more household income will go to interest payments, which will leave less money available for the purchase of goods and services. Given that consumer spending is roughly 60 per cent of the economy, a rebalancing of monetary policy will slow economic growth. The question is, by how much?

So long as the North American free-trade agreement stays in place, the Conference Board of Canada expects the Bank of Canada to hike rates by a quarter point two more times in 2018. Including the January hike, this will lift variable mortgage rates and the prime lending rate by a total of 75 basis points this year. Fixed mortgage rates would rise by less, as they are more affected by movement in bond yields. Credit card rates are not affected by

changes in monetary policy. Even still, our models suggest that rising debt payments will consume about 0.7 per cent more disposable income by the end of the year, limiting consumer spending and lowering the pace of economic growth by about 0.4 per cent.

The rise in rates will increase business borrowing costs. But, the effect is likely to be modest since many firms are operating at close to full capacity and will need to invest even if rates are a touch higher.

A potentially bigger impact could be on real estate markets. Mortgage applications are now being assessed on the ability to meet financial payments at two percentage points higher than the rate they secure or the average five-year posted rate. The combined effect of the income stress tests and higher borrowing costs is likely to lead to a reduction in home sales this year and constrain home price growth. But, it is unlikely that modest interest-rate hikes will cause a significant correction in real estate.

It is good news that the Canadian economy no longer needs emergency-level interest rates. Higher rates will raise debt service costs, but most Canadians can cope if rates rise gradually. There is, however, an economic price to be paid. In recent years, the Canadian economy has been too dependent on consumer spending and real estate to drive growth. The rebalancing of monetary policy will shift the drivers of growth more toward investment and exports, but it will also contribute to a more sustainable pace of expansion in the overall economy.

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