Fears of a global economic slump on the rise

By Barrie McKenna
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Fears that a global economic slump could impair the financial system are up sharply since the summer, according to a Bank of Canada survey of banks, insurers, pension funds and other market players.

Roughly 40 per cent of respondents said they fret about a deterioration in global economic conditions, up from 25 per cent in June, when the central bank conducted its first financial system survey.

"What the survey is picking up is what people are reading in the news," Bank of Canada senior deputy governor Carolyn Wilkins told reporters in Ottawa Wednesday.

Those headlines include rising U.S.-China trade tensions, as well as economic struggles in Argentina, Brazil, Turkey and other emerging markets, Ms. Wilkins said.

The threat of cyberattacks remains the top concern of respondents, as it was in June, according to the bi-annual survey.

Meanwhile, worries about disruptions in trade have eased since the last survey – a drop that bank officials attributed to the conclusion of negotiations on the new U.S.-Mexico-Canada trade agreement at the end of September.

The survey is based on responses from 41 market participants, conducted between Sept. 24 and Oct. 12.

Respondents were also asked about the threat of a big rise in five-year mortgage rates over the next 12 months. And roughly a quarter of respondents said a rise of 1.5 to 2-percentage-points would trigger a major house price correction or a large spike in household debt defaults across Canada. Half of respondents said that kind of jolt would "severely impair the Canadian financial system."

And yet just 5 per cent of those surveyed expect a spike of that magnitude to actually occur, in spite of recent rises in mortgage rates and other loans in recent months. The Bank of Canada's key interest rate now stands at 1.75 per cent after five quarter-point hikes since July 2017.

A majority of respondents said they expect rates to rise by a maximum of a percentage-point over the next year.

Ms. Wilkins reiterated the central bank's view that Canadians are generally adjusting well to higher interest rates and tighter federal and provincial mortgage rules.

"Lending – household borrowing – is slowing," she said. "It seems to be tightening in a way that we had anticipated."

Ms. Wilkins pointed to another report, released Wednesday by the bank, that shows slowing mortgage activity and a sharp drop in new heavily indebted borrowers since the end of 2016.

The share of new mortgages deemed high-leverage – where people are borrowing 4.5 times their annual incomes – has dropped to roughly six per cent, down from more than 20 per cent in 2016.

Also on Wednesday, the Bank of Canada released a study of what would happen if national house prices tumbled 20 per cent, paced by declines in Toronto and Vancouver.

"House price growth has slowed significantly in these markets over the past year," the bank said. "Although house prices in these markets are supported by strong demand and limited supply, it is possible that the price increase were fed, in part, by unsustainable expectations of continued price growth. If this were true, prices could reverse rapidly."

In spite of recent cooling, prices in Toronto and Vancouver are still 40 per cent and 55 per cent higher, respectively, than they were three years ago.

A 20 per cent price correction would put many households and lenders "under stress," with ripple effects throughout the economy and the financial system.

Such a plunge would be "nationally significant" because Toronto and Vancouver account for around half of housing transactions in Canada's main cities, and also "spill over" to other regional markets, according to the central bank.

Still, the bank said the probability of a major housing correction remains low. And if it did happen, the effects would not be large enough to trigger funding withdrawals or asset fire sales at the country's Big Six banks thanks to their international diversification and high retained earnings.

Nonetheless, the Bank of Canada said that other financial institutions – particularly those with a lot of uninsured mortgages – could be forced to take "corrective actions and reduce their supply of lending."

For the Big Six banks, a major house price correction would send profits tumbling 14 per cent, trigger $24-billion in credit losses and knock 1.2 percentage-points off average capital ratios.