Rising rates, high debt could lead to financial crisis in Canada, report warns

By Ian McGugan

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Canada risks a financial crisis within three years as rising interest rates collide with already lofty levels of indebtedness, a Citigroup report warns.

Several other countries are also vulnerable, according to the Citi report titled, "Are we headed for a global debt crisis?" It estimates that governments, households and corporations around the world have amassed a mountain of loans roughly three times as large as the level of 20 years ago.

"The outsized amount of debt, as well as the seeming pick up in the pace of accumulation, has raised concerns that the world is primed for a debt crisis," writes a team of analysts headed by Dana Peterson.

Canada, Hong Kong, Japan, Lebanon, the Nordic countries as well as those on the periphery of Europe, Singapore and South Korea have the most troubling levels of indebtedness when the level of borrowing in each is measured against the size of their domestic economies, Citi estimates.

In Canada, households have gone on a borrowing binge in recent years, in large part because of soaring home costs. Canada's energy producers, manufacturers and other non-financial companies have also gone deeper into hock as prices for oil and other commodities have faded.

The combination of high household debt and elevated borrowing among non-financial companies has boosted the private sector's debt-service ratio, a measure of how much of the cash it generates must go to meet payments on outstanding loans.

Citi views this trend with concern and points to research by the Bank for International Settlements (BIS), an international organization of central banks. The BIS has estimated that if the debt-service ratio in a country's private non-financial sector climbs above that country's long-term average by 2.5 percentage points, there is a 68-per-cent chance of a financial crisis within three years.

The BIS's numbers do not indicate that Canada is at risk of financial crisis, but Citi's own calculations, based on what it describes as "a more robust set of measures," paint a darker picture. "Canada's current debt-service ratio suggests risk of financial crisis within three years, by our estimates," the Citi report says.

It warns that rising rates could pose a particular threat to Canada, as well as Norway, Sweden, Australia and the Netherlands. In each of these countries, debt is high compared with the size of the underlying economy, and borrowing has been expanding rapidly compared to income growth. In addition, "house prices are also relatively high and may correct if interest rates rise," the Citi analysts say.

On a more encouraging note, both Citi and the BIS agree that most large economies are not facing imminent debt crises. The United States and China, for instance, both have massive amounts of outstanding loans, but neither country is flashing a warning signal when that debt is expressed as a share of the underlying economy. "China and the U.S., which possess the greatest store of total global debt outstanding, are not necessarily the smoking guns" in terms of financial risks, Citi says.

However, it warns that rising rates could change the picture quickly. It cautions that most advanced economies and many of the larger emerging markets remain vulnerable to an unexpected surge in borrowing costs. According to the Citi analysts, most governments "continue to have more work to do to shore up their financial systems, and render themselves more robust to shocks."