



June 20, 2013

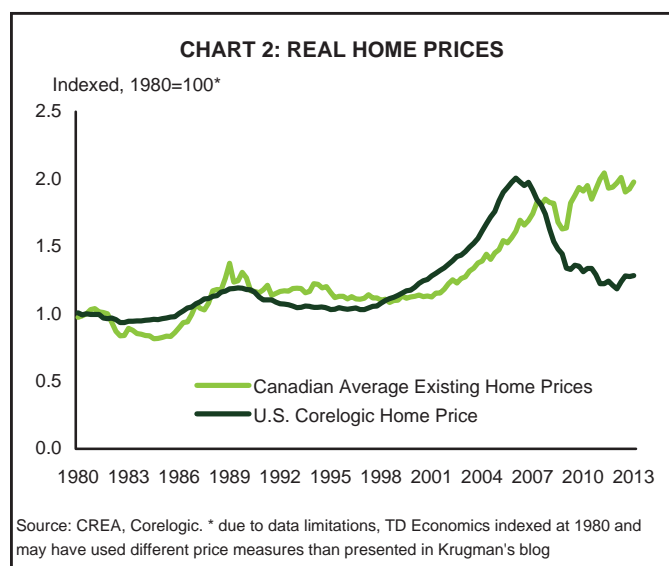
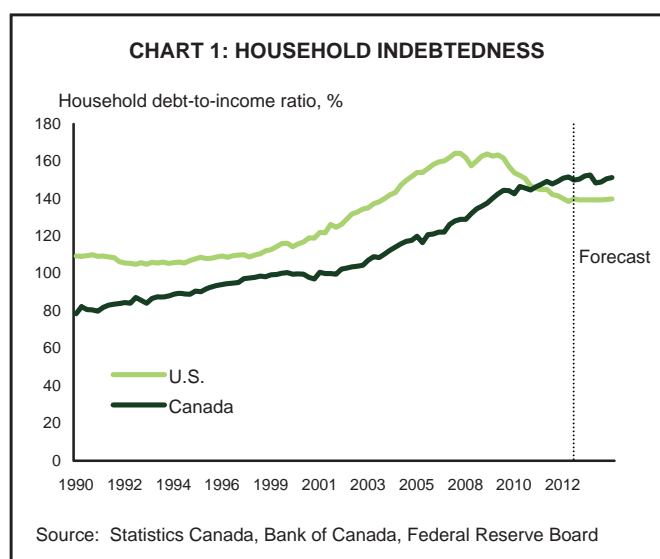
DEBUNKING DOOMSDAY PREDICTIONS FOR THE CANADIAN ECONOMY

There is no shortage of detractors when it comes to the Canadian economy these days. The often-heard view is that Canada faces a day of reckoning resulting from over-valued housing markets and excessive household leverage.

The Nobel prize winning economist Paul Krugman echoed this sentiment in a [blog written for the New York Times](#) this past weekend. Krugman wrote that “Canada ought to be quite vulnerable to a household deleveraging shock”. Chart 1 and 2 were the basis for Krugman’s argument. The concern is that since the crisis hit in 2008, Canadian home prices and household indebtedness (debt-to-personal disposable income ratio) continued to escalate, while many other economies, the U.S. in particular, unwound excesses associated with housing and debt. Now, Canadian home prices have risen more than they did in the U.S. and the Canadian debt-to-income ratio is steadily headed to levels reached south of the border right before the crisis hit.

While risks do surround Canadian household debt and the housing market, there are some important counter-arguments to Mr. Krugman’s thesis that we felt deserved highlighting. Ultimately, the sustainability of debt and an overvalued housing market boils down to households’ ability to manage their monthly debt payments. On that front, there were some warning signs heading into the U.S. financial crisis (see chart 2 and 3). Mortgage interest costs started to increase – peaking at the onset of the crisis in late 2007. Meanwhile, the delinquency rate on mortgages started to edge up alongside the rise in household indebtedness.

The charts show that Canadian households are far less financially vulnerable than their U.S. counterparts were heading into the crisis. Largely owing to a continued low interest rate environment, mortgage interest costs as a percent of personal disposable income have fallen despite the sharp rise in the debt-to-income ratio. Meanwhile, while mortgage

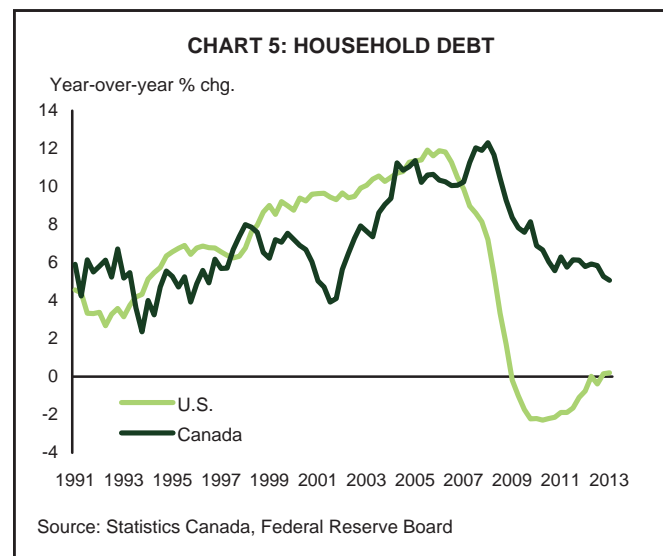
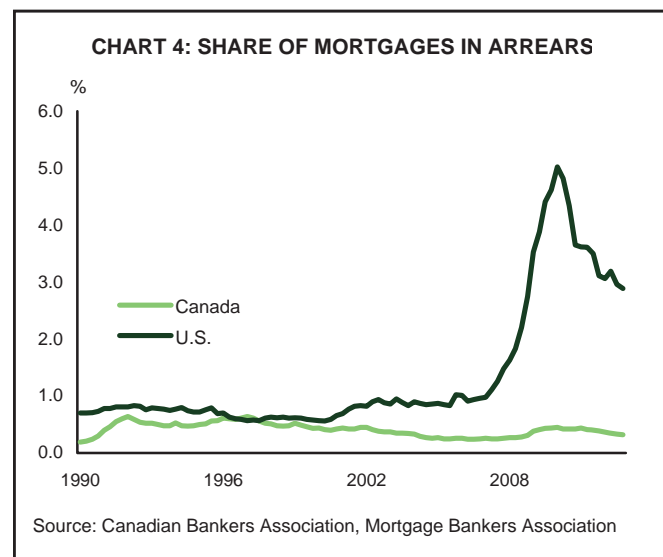
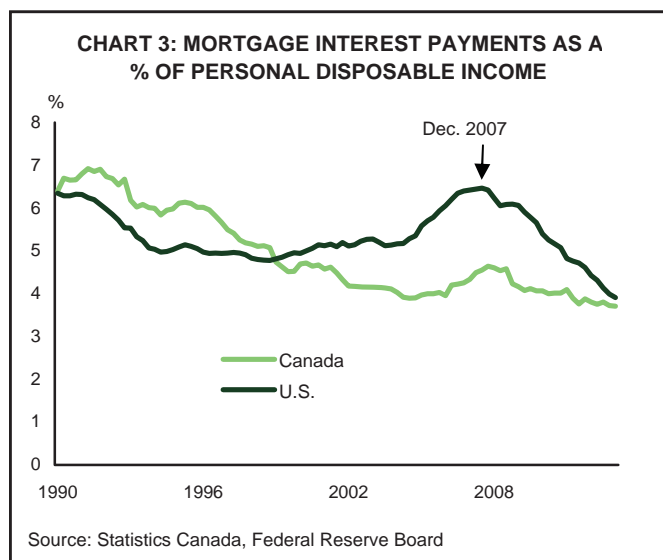


delinquency rates in Canada and the U.S. were similar during the 1990's, the percent of mortgages in arrears 90 days or more in Canada is about a third of what they were in the U.S. leading up to the 2008-2009 crisis. These trends reflect the steeper run-up in U.S. debt, as well as the riskier lending practices in the 2002 to 2007 period.

Most importantly, the release of Q1 2013 national balance sheet accounts indicated that excesses associated with high household debt and Canadian real estate appear to be unwinding in an orderly fashion. The federal government and banking regulator, OSFI, have imposed tighter lending standards for both mortgages and home equity lines of credit which have helped temper credit growth and reduce the amount of risk associated with excessive debt accumulation. As a result, debt growth has cooled to its slowest pace since 2003 (see chart 5) to a pace more in line with income gains and the debt-to-income ratio fell for a second consecutive quarter during the first three months of this year.

Admittedly, Chart 2 does look scary, but it is important to note that while Canadian home prices have grown faster than those in the U.S. since the recovery took hold in late 2009, incomes were also rising faster in Canada. In fact, in 2012, income growth outstripped price growth, helping to unwind some of the recent overvaluation in Canadian real estate. This contrasts to the U.S., where households hit a debt wall – quite hard and fast– driving a more abrupt drop off in borrowing and housing activity.

We are not denying the fact that household debt in Canada remains elevated. And, the Canadian housing market continues to show pockets of froth, particularly in large condo markets. The implications, however, are that households are vulnerable to an increase in the unemployment rate or a shock to interest rates. And indeed we would be concerned should we see a further increase in household indebtedness or an acceleration in home price growth – both of which are certainly a risk given a continued low interest rate environment. However, absent of a negative economic shock, excesses are expected to continue to unwind in an orderly fashion.





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