

Addicted to Debt

Tracking Canada's rapid accumulation
of private sector debt

David Macdonald





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Executive summary

SINCE 2011, CANADA has added \$1 trillion in household and corporate debt, driving up its private sector debt-to-GDP ratio from 182% to 218% over that period. This increase of a fifth in only five years is the fastest growth of any of the world's 22 advanced economies over that same timeframe.

Canada has never before led advanced economies in private debt accumulation. The closest it has come was third place in the early 1990s, just as real estate prices plummeted and stayed down for a decade.

Aside from the speed of its accumulation, Canada's private debt at 218% of GDP is very high — the eighth highest of advanced countries today. For comparison, in September 2008 Canada's ratio was 168%, essentially equal to the United States' ratio of 169%, just as Lehman Brothers collapsed almost taking the entire financial system with it.

This puts Canada in the danger zone of having both a high private debt-to-GDP ratio (over 150%) and rapid debt accumulation (more than 17% in the past five years). If the rate of growth of our private debt slows even a small amount, it will immediately have outsized impacts on our economy and asset markets. Canada is presently the only advanced economy running such a risk.

Rapidly rising household debt is a well known issue in Canada. It has risen \$315 billion since 2011, almost all of it is due to rising mortgage debt, which is up \$243 billion over that period (in 2016 dollars). The quick rise in mortgage debt is the flip side of rapidly rising house prices. Rapidly rising mortgage debt plays a large role in making fast-rising house prices pos-

sible. Non-mortgage loans and consumer credit have also been increasing, but at roughly the rate of economic growth.

What has been much less examined in Canada is the rapid accumulation of corporate debt, up \$671 billion since 2011 (in 2016 dollars). In other words, the corporate sector is responsible for two-thirds of the large accumulation of private debt in Canada. This huge buildup in corporate debt was almost entirely spent on real estate or mergers and acquisitions. Since 2011, the asset value of commercial real estate rose by \$269 billion, and the value of land by \$226 billion. The value of equity and investment shares rose \$348 billion over the same period, and productive investments in machinery and equipment rose only \$60 billion, half of the amount that corporate cash holdings increased. In other words, little of this corporate debt binge was spent making Canada more productive, but was more akin to speculation.

Canada's economic growth has become addicted to private sector debt. Weaning us off it should be our primary public policy concern. Foreign buyers taxes in Toronto and Vancouver are steps in the right direction. However, they may well prove to be insufficient with housing prices already rising again in Vancouver. The next step should be a speculators' tax of 20% for those selling a secondary residence within one year of purchase, which phases out over longer ownership periods. Using corporate debt for speculative purposes, particularly on mergers and commercial real estate, remains little examined and methods to rein it in deserve further study. Finally, governments have an important role to play here because the flip side of government deficits is a surplus for households and corporations. Thus, governments should be continuing to run deficits in order to create surpluses on the private sector side. And rather than continuing mergers-and-acquisitions roulette, private sector surplus can also be used to pay down private sector debts.

Introduction

PRIVATE SECTOR DEBT, which includes household and non-financial corporate debt, can be an important contributor to economic growth. In the short term, mortgage debt can drive residential construction, and consumer debt can lead to improved consumer spending, both of which directly drive GDP growth. In the longer term, corporate investment in machinery and equipment can enhance productivity and, therefore, long-term GDP growth.

However, if private debt is increasing far more rapidly than economic growth, this can signal a problem. At the very least, it indicates that the private sector is becoming more leveraged and, therefore, exposed to much smaller changes in key variables like interest rates or unemployment. If the acceleration of debt is fast enough and the level high enough it also likely signals a dangerous trend towards asset speculation and a heavy reliance on private debt to drive short term economic growth.

The growth in debt becomes an integral part of rapid appreciation in asset values and their GDP derivatives like new house construction. Sudden drops in the growth of private debt can directly translate into a fall in asset prices. Speculation can easily turn to desperation when asset prices don't continue their upward trend. And when speculation turns, it can mean painful falls in real estate and stock prices with a subsequent drag on GDP.

Once the private debt load is large enough, even small decreases in its growth rate can have outsized impacts on asset markets and economic growth. Private sector debt can continue to grow, but once economies be-

come addicted to that growth, even having it grow a little less quickly causes major problems. For a numeric example see Appendix 1.

Private sector debt, as well as the financial sector in general, are excluded from economic models in Canada and abroad. Tracking private debt has often been a blind spot among economists, which is why so many of them completely missed the 2008 great recession. For instance, Chairman of the Federal Reserve Ben Bernanke concluded in March 2007 that “...the impact on the broader economy and financial markets of the problems in the sub-prime market seems likely to be contained.”¹ And in August 2008 — one month prior to the collapse of the Lehman Brothers, the largest banking collapse since the Great Depression, the head of the IMF, Olivier Blanchard famously proclaimed “The state of macro is good”².

Unchecked Canadian private debt

CANADA'S PRIVATE SECTOR is running up debt faster than any other advanced economy.³

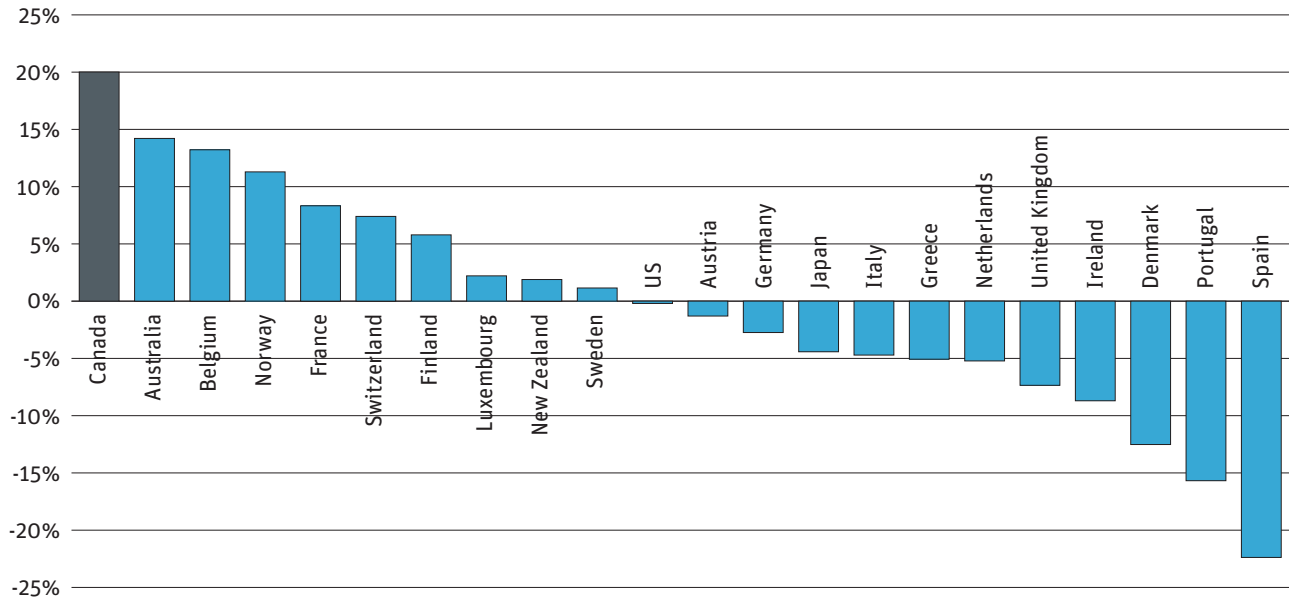
Over the past five years, Canada's private sector debt-to-GDP ratio has increased by 20.0% from 182% of GDP to 218%. This amounts to our private sector adding an incredible \$1.0 trillion in new debt over this period, from \$3.4 trillion to \$4.4 trillion since 2011.⁴

The next closest advanced economy is Australia, which increased its private sector debt ratio by 14.2% above the 2011 level.⁵ Several countries including Spain, Portugal, Ireland and Greece, have seen substantial reductions in their private debt-to-GDP ratios over the past five years as their economies painfully adjusted to declining private debt.⁶ The United States for its part has seen a small 0.2% decrease in its ratio since 2011.⁷

Canada has never before led advanced economies in debt accumulation. The last time it came close was in the early 1990s when it stood briefly in third place — only to see housing prices plummet and stay depressed for a decade.

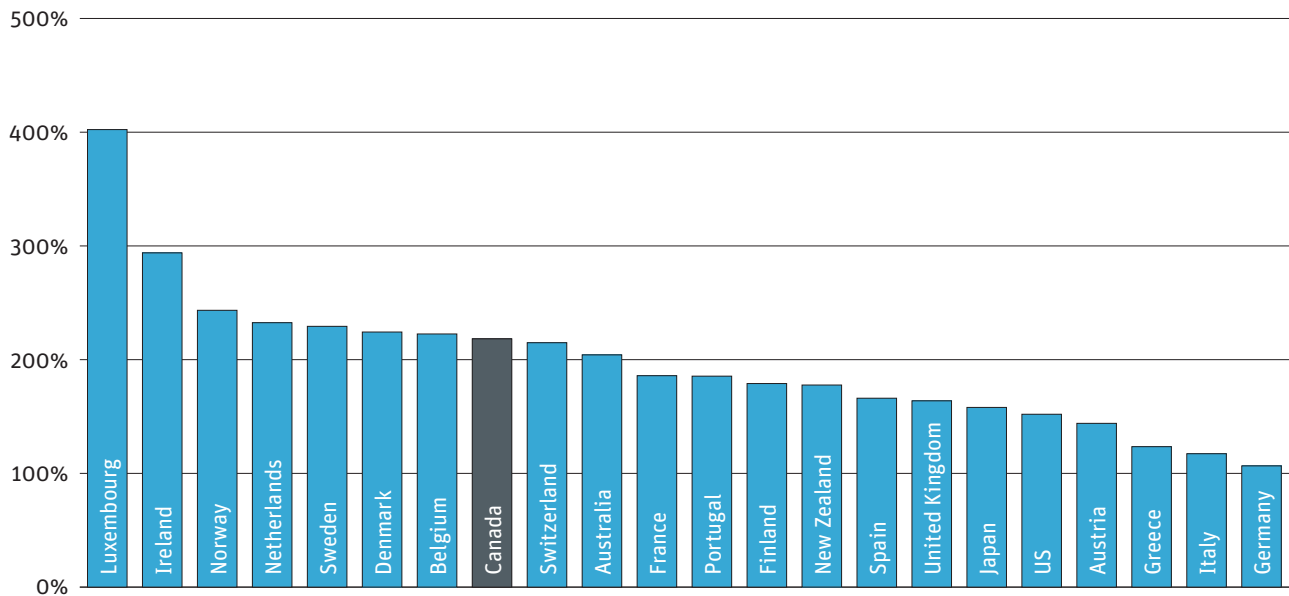
Historically when countries match or exceed Canada's current private debt ratio growth, catastrophic consequences are the likely result. Japan saw five-year growth in its private debt-to-GDP ratio of 28% by 1990, after which its economy remained depressed for a decade. Five-year private debt-to-GDP growth in Portugal and Spain topped 50% in the 2000s, which ended in calamity following the 2008 financial crisis.

FIGURE 1 Private sector debt-to-GDP change in advanced economies (past 5 years)



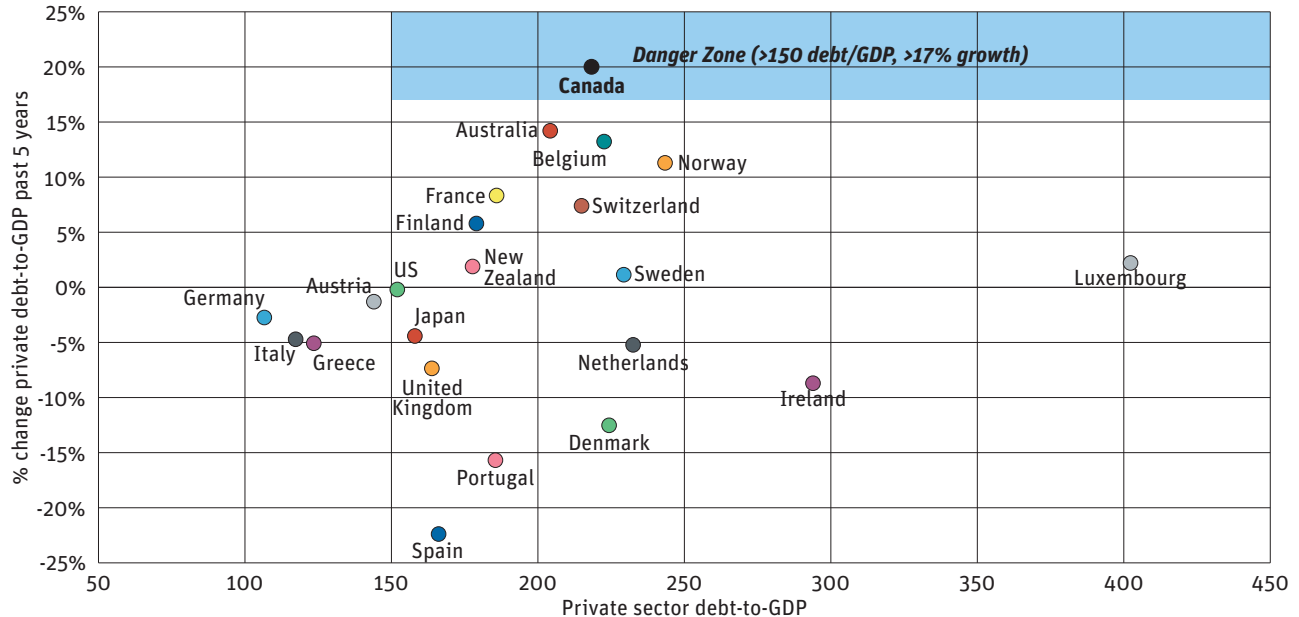
Source Bank of International Settlements and author's calculations. Data to Q4 2016.

FIGURE 2 Private debt-to-GDP in advanced economies



Source Bank of International Settlements and author's calculations. Data as of Q4 2016.

FIGURE 3 Private debt-to-GDP ratio and growth rate over past 5 years (advanced economies)



Source Bank of International Settlements and author's calculations. Data to Q4 2016.

In fact, the tipping point for private sector debt appears to be growth of over 17% in the debt-to-GDP ratio over the previous five years⁸ — a level Canada reached mid-way through 2016.

Canada's private debt-to-GDP ratio is not the highest among advanced economies. Instead, it ranks eighth at 218%. However, this is far higher than the peak the U.S. hit at 169% in the fall of 2008. In fact, Canada had very similar private debt-to-GDP ratios of 168% in the third quarter of 2008. Since that point, Canada's ratio has risen substantially to 218%, and America's has fallen to 152% of GDP.

Both Ireland and Denmark have higher absolute private debt-to-GDP ratios than Canada's, although they have also seen substantial declines over the past five years with negative results on both economic growth and asset prices.

Countries with absolute debt-to-GDP ratios over 150% are at substantial risk of an economic downturn⁹, a position in which most advanced economies now find themselves. Lower debt servicing costs driven by record low interest rates around the world may provide an additional cushion, although the level of interest rates themselves are not a particularly good predictor of financial crises.¹⁰

Figure 3 combines both the absolute private debt-to-GDP and its growth over the previous five years. Here we can see the precarious position in

which Canada finds itself, located squarely in the “danger zone”¹¹ with private debt-to-GDP of over 150%, and growth in that ratio of over 17% in the past five years. At present, Canada is the only advanced economy to be in the private debt “danger zone”.

Once an economy becomes as addicted as Canada’s to continually increasing private debt levels to fuel growth, there are limited avenues of escape. Deleveraging is painful, with substantial impacts on both economic growth and on individual household and corporate balances sheets. Often the public policy answer is to kick the can down the road and see how long a country can continue with ever higher private debt loads. Obviously this merely makes the situation worse in the long run.

The anatomy of debt accumulation

THERE HAS BEEN a \$315 billion increase in general household debt over the past five years.¹² Non-mortgage loans increased at roughly the rate of GDP growth, only rising slightly from 5% to 6% of GDP over the past five years. For its part, consumer debt stayed constant as a proportion of GDP at 29% in both 2011 and 2016.

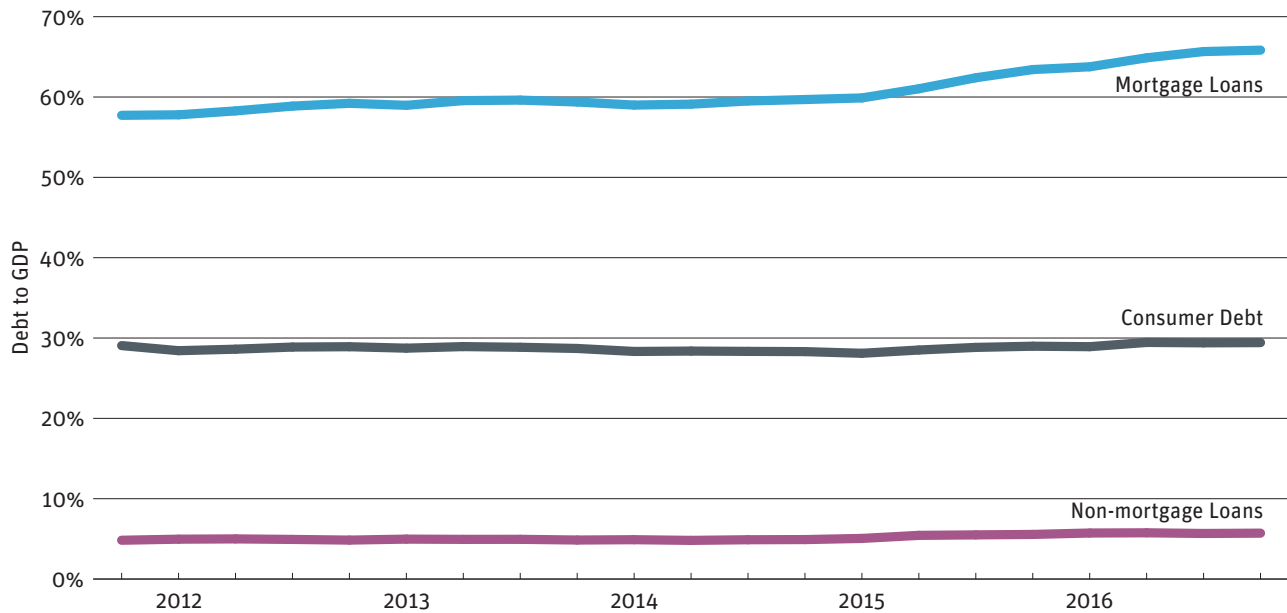
However, mortgage debt has grown substantially as a percentage of GDP since 2011, and it is in the past two years when most of this increase occurred. Prior to 2015, mortgage debt was accelerating at roughly the rate of economic growth, and as a result the ratio remained unchanged. However, mortgage debt-to-GDP rose from 58% in Q4 2011 to 66% in Q4 2016 which, in inflation adjusted terms, amounts to an increase of \$243 billion since Q4 2011.¹³

The increase in mortgage debt makes up most of the \$315 billion increase in general household debt since 2011

Canadian non-financial corporations have been gorging themselves on new debt, racking up an incredible \$671 billion in new debt since Q4 2011.¹⁴ The main drivers are non-mortgage loans, debt securities and loans for corporate claims. Mortgage loans and government loans have not played a significant role.

Non-mortgage loans have risen dramatically, from 17% to 26% of GDP. In dollar terms, this amounts to an inflation adjusted increase of \$217 billion since Q4 2011.¹⁵ Debt securities (corporate bonds and commercial paper)

FIGURE 4 Household debt in Canada



Source Cansim 380-0063, Cansim 378-0121 and author's calculations

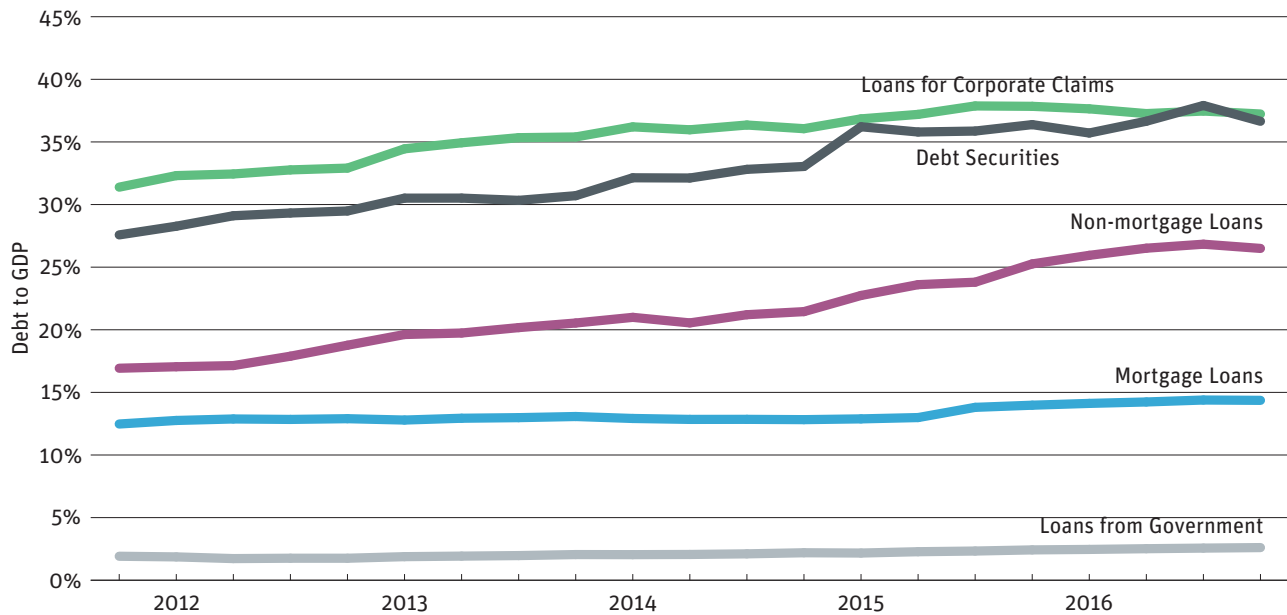
have risen a similar amount, increasing \$221 billion¹⁶ from 28% of GDP in Q4 2011 to 37% by Q4 2016.

Loans for corporate claims have increased by \$161 billion¹⁷ over the past five years, rising from 31% to 37% of GDP. This has likely been a source of funding for Corporate Canada's mergers and acquisition boom, worth between \$100 and \$200 billion a year since 2011.¹⁸ Mergers and acquisitions, like rapidly increasing house prices, are using debt as a means of asset speculation, rather than for long term productivity growth.

Unlike household mortgage debt that is linked to an asset, i.e. real estate, much of the corporate debt increases are not directly linked to a particular asset. In other words, its not immediately clear from the debt categories on what Corporate Canada spent the \$671 billion in new debt. Examining changes in corporate assets provides a better picture of where that money went, although there won't be a one-to-one relationship as aggregate asset values can also change because they are appreciating, not just because a company purchases more of them.

The major changes on the asset side of corporate balance sheets were in the categories of "equity and investment shares", "non-residential structures", "land" and "natural resources". The value of equity and investment

FIGURE 5 Corporate debt in Canada



Source Cansim 380-0063, Cansim 378-0121 and author's calculations. Including only non-financial corporations.

fund shares is up \$348 billion since 2011 (in 2016 dollars).¹⁹ This is the flip side of the loans for corporate claims examined above. Those types of loans were used to purchase equity and investment fund shares. Over this period, the value of non-residential structures and land are up \$269 billion and \$225 billion respectively.²⁰ The corporate stock of natural resources, related to lower oil prices, has plummeted \$722 billion since 2011 (in 2016 dollars).

By comparison, the corporate stock of machinery and equipment has increased only \$60 billion since 2011, an amount far less than even corporate cash holdings, which increased \$112 billion over the same period.²¹

As such, the corporate debt boom was largely spent on real estate (either buildings or land) as well as mergers and acquisitions. Almost none of it was spent on machinery and equipment, which would have been more likely to drive long term productivity growth and, therefore, GDP growth.

Conclusion

CANADA HAS NEVER experienced private debt this high, nor has it ever led advanced economies in private debt accumulation. And while much attention has been paid to ever-higher mortgage debt for households, very little has been paid to the debt boom in the corporate sector. The net result of these related trends is setting Canada up for a crisis when this growth slows or even reverses itself — as it inevitably must.

Certainly high indebtedness leaves individual companies and families more exposed to sudden changes in economic circumstances. However, this over-leveraging will almost certainly reverberate to economic growth generally. An economy addicted to ever higher levels of debt to achieve only mediocre growth — as Canada's is today — is in for a rude awakening. There is an upper limit to how much debt the private sector can be burdened with. The United States reached its upper limit of private debt in 2008. Today, Canada finds itself at a much higher level, in large part due to record low interest rates.

Governments need to continue to keep up pressure on real estate markets with the goal of freezing home prices at current levels, particularly in Toronto and Vancouver. If prices continue to increase either there or elsewhere, additional measures should be immediately adopted. A likely next step after a foreign buyers tax should be a speculators tax on secondary residences that starts at a relatively high value — like 20% — in the first year but declines to 0% over five years. The goal is to reduce domestic speculation through secondary residences, hopefully allowing primary residence buyers lower priced access to the housing market.

The dramatic corporate debt accumulation is much less examined because it is a more recent phenomenon, starting in earnest in 2011. The use by Canadian corporations of cheap credit for mergers and acquisitions as well as real estate purchases should be closely watched.

Government balance also has an important role to play in creating net savings (or not) in both the household and corporate sectors. If governments want to run surpluses, they must extract those surpluses from the private sector, forcing households and corporations to spend more in taxes than they receive in services. Government surpluses mean private sector deficits, and running a private sector deficit makes it much harder to pay down private sector debt.²² Canadian governments overall have been running deficits since 2007. This alone won't reduce private sector debt, but extracting a surplus from the private sector to balance government books will only make matters worse.

It should be explicit government policy to slow Canada's excessive private debt accumulation to avoid what history shows is an almost inevitable future crisis. Canada must be weaned from its private sector debt addiction.

Appendix 1: Debt impact on demand²³

THE EXAMPLE DEVELOPED in *Table 1* attempts to illustrate the impact of private sector debt growth slowing to only the rate of GDP growth of 2.8%. In previous years, private debt grows at the much higher rate of 7.5% a year; the rate that Canada has seen over the past five years. Private debt at no point decreases in this example. It only increases more slowly in the fifth year.

The starting assumptions are the approximate values for Canada in the fourth quarter of 2016. The growth rates of nominal GDP and private debt are the average values for the past five years in Canada. The table assumes that all new debt is used exclusively to purchase assets and therefore has no impact on GDP. For instance, new debt is not used to purchase a newly built home (whose construction would show up in GDP). New debt is only used to purchase a pre-existing home, which does not count towards GDP.

Demand here is not only GDP, but also the demand for assets, like real estate and stocks. The demand for assets is excluded from GDP calculations generally, except insofar as it might induce behaviour (e.g., high house prices might encourage builders to build more houses).

In year 5, the private debt-to-GDP ratio remains at the same debt that it stood at in year 4. In other words, private debt is still growing — it is just growing at 2.8% instead of 7.5%. However, the impact on demand growth is substantial, pushing it strongly into negative territory. As we're assuming that all debt is used to purchase assets, this would likely have a substan-

TABLE 1 Example of debt impact on demand

Annual nominal GDP growth	2.8%	Canadian Avg Last 5 years			
Annual private debt growth	7.5%	Canadian Avg Last 5 years			
Years	1	2	3	4	5
GDP (\$bil) (starting at Cdn 2016 value)	\$2,027	\$2,084	\$2,142	\$2,202	\$2,264
Private debt (\$bil) (starting at Cdn 2016 value)	\$4,425	\$4,757	\$5,114	\$5,497	\$5,651
Private debt/GDP ratio (starting at Cdn 2016 ratio)	218%	228%	239%	250%	250%
Private debt growth		\$332	\$357	\$384	\$154
Combined GDP + Private debt growth		\$2,416	\$2,499	\$2,586	\$2,418
Demand growth (including GDP and assets)			3.4%	3.5%	-6.5%

tial impact on housing prices, for example. If the private debt-to-GDP ratio merely stops growing, even though the nominal level of debt continues to grow, the impact for Canada would still be substantial.

Notes

1 Ben S. Bernanke, “The economic outlook: Before the Joint Economic Committee, U.S. Congress”, March 28, 2007 (<https://www.federalreserve.gov/newsevents/testimony/bernanke20070328a.htm> accessed on May 30th, 2017).

2 Olivier Blanchard, 2009. “The State of Macro,” Annual Review of Economics, Annual Reviews, vol. 1(1).

3 As defined by the Bank of International Settlements.

4 In 2016 dollars. Cansim 385-0032, 326-0020 and author’s calculations. Includes both the household and non-financial corporate sectors.

5 Bank of International Settlements, “Total Credit to the non-financial sector”, <http://www.bis.org/statistics/totcredit.htm> Accessed on June 7th, 2017.

6 Ibid.

7 Ibid.

8 See Richard Vague, “The Next Economic Disaster: Why It’s Coming and How to Avoid it”, University of Pennsylvania Press, 2014, pg 20.

9 See Richard Vague, “The Next Economic Disaster: Why It’s Coming and How to Avoid it”, University of Pennsylvania Press, 2014, pg 20.

10 Ibid, pg 22.

11 Steven Keen, “Can we Avoid Another Financial Crisis?”, Wiley Publishing, 2017.

12 Ibid.

13 Inflation adjusted to \$2016. Q4 2011 through Q4 2016. Cansim 378-0121, 380-0063.

14 Ibid.

15 Ibid.

16 Ibid.

17 Ibid.

18 In US dollars. All Canadian mergers and acquisitions minus Abroad to Canada mergers and acquisitions Source: Institute for Mergers, Acquisitions & Alliances (<https://imaa-institute.org/m-and-a-canada/> Accessed on May 30th, 2017).

19 Cansim 378-0121, 380-0063 and author's calculations.

20 Ibid.

21 In 2016 dollars, Ibid.

22 This assumes a current account balance of 0. The current account balance has been negative since 2008 working against a private sector surplus (see Cansim 376-0103).

23 This section is a modified version of the example provided on page 82 of Steve Keen, "Can we avoid another financial crisis," Polity Press, 2017.



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