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Canada: Leverage Magnifies Risks

Canada faces short-term challenges but favorable long-run prospects.

By Ryan James Boyle

On a recent trip to eastern Canada, I learned of the Newfoundland custom of “having a yarn” – telling stories in detail, often with creative embellishment. The current state of Canada’s economy is an interesting tale even without any exaggeration.

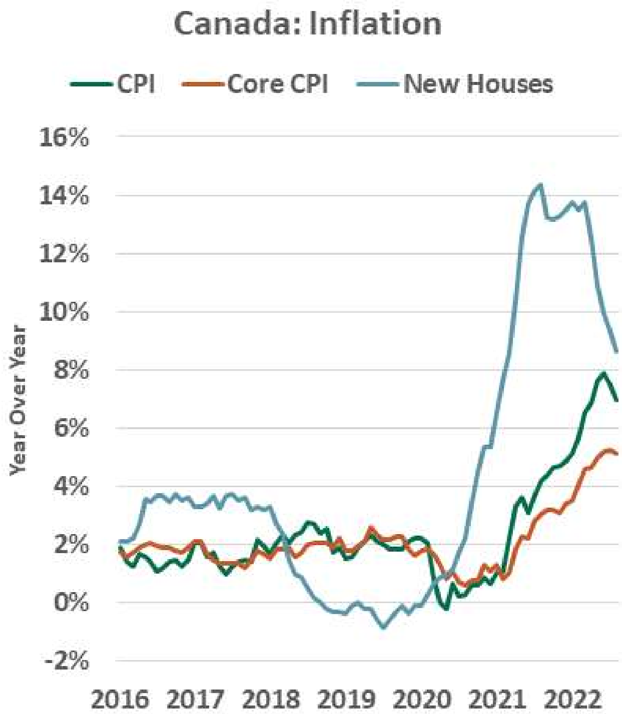
The challenges facing Canada will sound familiar. The nation suffered a decline amid COVID-19, then a rebound in 2021 as restrictions were lifted. Inflation has taken off, initially driven by supply chain complications that pushed up goods prices, but now proving persistent as most categories inflate. The Bank of Canada (BoC) is reacting quickly: From a lower bound of 0.25%, the target overnight rate has risen in large increments to 3.25% today, with more hikes likely. This familiar tale becomes a proper yarn with the addition of Canada's especially high degree of leverage. Household debt has continuously risen, driven by the nation's hot housing market. Housing has long been in high demand, but the pandemic provided a further surge, supported by low interest rates. Total household debt is hovering perilously around 100% of gross domestic product (GDP).

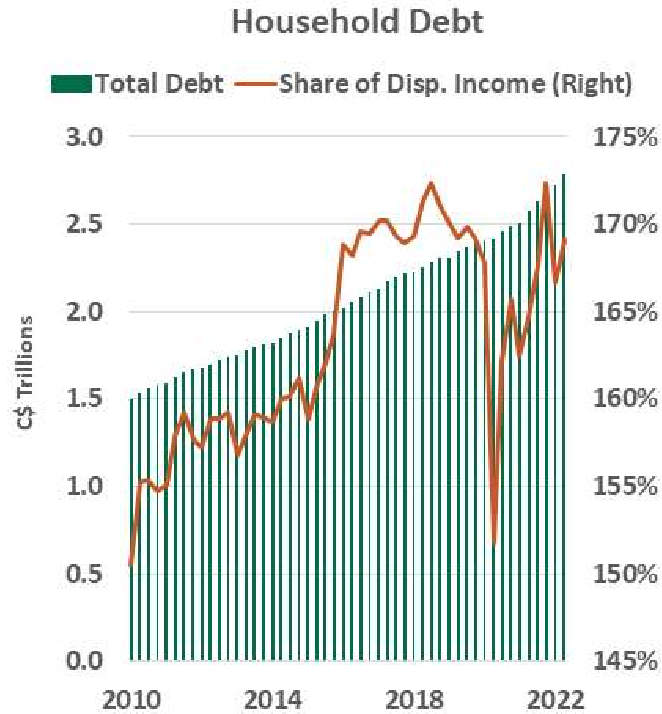
The BoC's recent rate hikes are not only slowing purchase activity, but will bring serious consequences to households in the years to come. Unlike the U.S. fixed-rate regime, Canadian mortgages reset their interest rates every five years. The change will be significant: from a low of 3.2% last summer, the average interest rate on a new five-year loan has risen to 5.6%, with further room to run. This higher financing cost has cooled house prices, with a sustained decline likely throughout the current cycle of loan refinancing.

The Canadian economy also is more volatile due to its exposure to fossil fuels. The energy sector represents 5% of Canada's GDP, a share even higher in its more mineral-rich provinces. Before the pandemic, the boom in hydraulic fracturing was a particular benefit to employment and output. But bankruptcies following the 2020 oil price crash have left a lasting mark on this sector; oil production and jobs have been slow to recover.

Canadian yarn-spinners have joined the worldwide speculation of an imminent recession. As we explored this week, likelihood of recession is on the rise across developed markets. The reopening surge has run its course, and many countries are facing an interval of decline. Whether Canada enters a recession is a close call. Under the current circumstances, the nation enjoys similar advantages as the U.S.: autonomy in energy and food production which has helped to blunt the worst risks of inflation and rationing. Higher interest costs for homeowners will be a burden, but if workers stay employed, they may prove tolerable.

High household debt adds to the pain of job losses.





Sources: Statistics Canada, Haver Analytics

The labor market in Canada is tight. The unemployment rate fell to a 50-year low of 4.9% in July, though a three-month streak of job losses may indicate the peak of labor demand has passed. The labor force continues to grow, and weekly earnings are rising at an annual rate of 3.5%—a healthy gain, but not fast enough to spur an inflationary wage-price spiral. Canada has a policy commitment to welcoming immigrants, which will help keep its labor force growing. However, the nation has underinvested in its capital stock. Business gross investment in fixed capital peaked in 2014, the height of the fracking boom, and has held at a lower level ever since. Measures of the nation's industrial production, capacity utilization and productivity all show little growth.

Opportunities for investment are ample. The nation has a wealth of natural resources which are in high global demand. Aside from energy, Canada's top exports include gold, uranium, iron ore, copper and potash. And part of the driver of the nation's house price bubble was under-building houses. More residential investment can help to bring equilibrium to the housing market and provide more space for newcomers.

In sum, Canada has the potential to thrive in the long run. But its outsized risks are no yarn.

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