Living beyond our means

Extravagant, reckless, debt-ridden—Canadian consumers have maxed themselves out after a decade-long spending spree. When did we start to be like Americans?

by Chris Sorensen

The wind-up of Sears Canada's flagship store in downtown Toronto was a sorry sight. Deal-hunters roamed the cavernous and half-empty building in search of deep discounts on everything from watches to washing machines. Even the dented fixtures were sold off at cut-rate prices—all while an army of suddenly unemployed mannequins looked on.

Over the next two years, the tired, three-level department store will be overhauled in preparation for the arrival of Nordstrom, a U.S. retailer that serves a decidedly higher-end crowd. Meanwhile, at the other end of Toronto's Eaton Centre, a new Saks Fifth Avenue store will open inside the old Hudson's Bay building, whose U.S. parent bought the luxury retailer for US$2.9 billion last year.

The mall's changing face, where $2,000 handbags threaten to crowd out affordable housewares, reflects Canada's increasingly well-to-do image. Nordstrom stores are slated for Calgary, Vancouver and Ottawa, while as many as seven Saks are slated for Canadian cities. Brynn Winegard, a Toronto-based marketing consultant, says the shift stems from Canadians' growing preference for "prestige shopping," the act of buying one's socks and underwear at Wal-Mart and then splurging on a $400 pair of jeans from Holt Renfrew.

The aspirational attitude extends far beyond Canadians' wardrobes. Luxury vehicles are now the fastest growing segment of the Canadian auto market, which had a record year in 2013. Nearly 70 per cent of Canadian households own their own home, which is about four percentage points higher than in the U.S. and about the same as in America before the crash. For households maintained by someone age 25 and under, the home ownership rate in Canada is a lofty 24 per cent, compared to 15 per cent in the U.S. That's even more astounding given Canadians in that age group face an unemployment rate twice the national average of seven per cent. Moreover, our houses are fancier than ever thanks to a decade-long housing boom that, due to the soaring popularity of condominiums, reset expectations of urban living to include gourmet kitchens and luxurious amenities like juice bars and splash pools.

We've got so much stuff, we're paying others to hold it for us. Canada now boasts the biggest self-storage industry in the world outside of the United States—an achievement worthy of our very own Storage Wars Canada TV franchise, which debuted last August. All that, and more than 2,000 people managed to scrounge up $40 each to attend a grilled cheese sandwich festival last month (and then had the audacity to complain on Twitter that they hadn't gotten their money's worth).

It's conspicuous consumption of the sort normally associated with free-spending Americans, not practical-minded Canadians. And it's not being fuelled by growing paycheques so much as by the wallets of maxed-out credit cards. While a recent Statistics Canada study found Canadian families' median net worth rose nearly 45 per cent, to $243,800, over the past nine years, when adjusted for inflation, the gains have been almost entirely on paper thanks to recovering pension portfolios and skyrocketing home prices. At the same time, Canadians carry close to $1.7 trillion in consumer and mortgage debt—$1 trillion more than in 2003. In other words, there's growing evidence to suggest we merely feel richer than we used to, thanks to the wealth effect of soaring house prices, and are using a ready supply of cheap money to pursue an affluent lifestyle.

There's certainly evidence Canadians, even more than Americans, see their homes as ATMs from which they can draw for spending money. At the end of 2013, according to the Office of the Superintendent of Financial Institutions, Canadians had borrowed $225 billion through home-equity lines of credit (HELOCs)—a figure that doesn't even include loans from credit unions and other lenders. That's just less than half the US$500 billion Americans owe in HELOC debt. But America is a far larger economy. Down there, HELOCs amount to 2.9 per cent of GDP, and only reached five per cent at the peak of the U.S. housing bubble. In Canada, though, that figure is 14 per cent, and is up from 12 per cent in 2012, showing that even though Canada's economy has grown, the pace at which homeowners tapped their properties for cash grew even faster.

Banks and other mortgage lenders point to default ratios that are less than one per cent as evidence everything is okay. The same goes for figures that show the pace of debt accumulation among households has slowed, rising 4.6 per cent last year, compared to nearly 10 per cent in 2011. But, as the U.S. experience showed, default rates can suddenly skyrocket if the economy falters, and Canadians' already considerable debt load could be difficult for individual families to manage if interest rates were to rise. Some believe the entire economy could suffer. Eric Lascelles, the chief economist at RBC Global Asset Management, points to the $65 billion gap between what Canadians consumed and what they produced last year (including net flows of money) as evidence the country is collectively living beyond its means. "Canada now runs a pretty meaty current account deficit, just about the biggest we've seen going back the past few decades," he says. "It's ominously similar to the one we sported in the early 1990s, which was one of the things that demanded such aggressive consolidation at the federal government level and required people to really get down to business." Not only is it unsustainable, but the cost of servicing that debt as interest rates rise threatens to suck money from more productive areas of the economy, he says.

Once lauded for self-restraint and a sober approach to finances, Canada's spendthrift ways suggest we haven't learned all that much from the U.S. experience leading up to the crash. We now risk undermining the very qualities that saved us from economic calamity in the first place.

Whether they can afford it or not, the responsibility for growing the Canadian economy has come to rest uncomfortably on the shoulders of shoppers. Household spending in Canada now accounts for 56 per cent of GDP, according to Statistics Canada. While that still pales in comparison to the consumer-driven U.S., where households contribute to 69 per cent of GDP, it's still well above the roughly 51 per cent average Canada maintained for the past three decades.

The heavy reliance on consumer spending for GDP growth can partially be blamed on businesses not pulling their traditional weight. Before he left to head the Bank of England, former Bank of Canada governor Mark Carney in 2012 urged Canadian firms to start spending their cash hoards, which he dubbed "dead money." Canadian companies, Carney said, were being overly cautious and needed to start reinvesting in their businesses in order to take advantage of the global recovery. Two years later, however, some on Bay Street blame Carney for the conundrum, suggesting he allowed the dollar to become overvalued. By keeping interest rates low, he kept the housing market booming, all the while adopting a hawkish tone that fuelled the dollar's rise. "In effect, monetary and exchange rate policy traded off more condos for fewer factories, and we see the signposts of that in recent data trends," wrote CIBC chief economist Avery Shenfield in a recent report.

Regardless of who is to blame, the fact consumers continue to spend at heightened levels is worrying. Household spending on goods and services grew by 2.2 per cent in 2013, slightly faster than the economy as a whole. Perhaps shoppers bought in to the foreign accolades about our sound banks and vast resources. Or maybe it was because the once-soaring loonie made us feel richer when shopping online, or going on vacation—according to the World Tourism Organization, Canadians now rank third in international travel spending when measured on a per capita basis, spending $1,007 each and putting us just behind Germany and Australia.

Either way, the trend is set to continue: "Retail sales have been surprisingly robust, especially in light of modest job gains, lacklustre wage growth and slowing household credit growth," the Canadian Chamber of Commerce said in its 2014-15 outlook.

Steven Scott has had a front row seat to Canadians' changing behaviour. The CEO of Access Storage says the company has more than doubled the number of self-storage facilities it operates in Canada to 50 locations in just the last five years. Ranging in size from 25 to 300 sq. feet, the lockers are used to shelter everything from old furniture to barely used fitness machines. Scott says most customers come looking for extra space during a big move or renovation, but end up keeping their belongings there much longer than they originally plan—either because they're lazy or because they end up buying more things and can't bring themselves to part with their old stuff. With costs for a 50 sq.-foot locker ranging from $99 to $135 a month, depending on the location, that means a good chunk of the population is shelling out as much as $1,620 a year just to house their unused desktop computers and camping gear. That would go a long to help pay off the $27,300 in non-mortgage debt that credit-monitoring agency TransUnion says is currently owed by the average Canadian—a figure that's up 43 per cent from six years ago. Or to buy a new car, which is far more likely these days.

A key factor driving such uncharacteristic profligacy is that we are a lot more comfortable with debt than we used to be. The country's debt-to-income ratio already sits at close to a record 164 per cent, or $1.64 for every dollar of after-tax income. A slight decline in the ratio last week, from 164.2 to 163.97 drew cheers from economists, yet it remains the highest rate in the G7 and among the highest for developed nations as a whole. By contrast, 10 years ago, Canadians owed closer to one dollar for each buck available to spend.

As is the case with any addict, it's easy to point to someone with a bigger problem. For Canadian consumers, that's historically been our American counterparts. However, a December report by TD Economics found that Canadians have significantly narrowed the consumer spending gap between the two countries since the recession, with Canadians shelling out about $17,000 per year each on average, compared to $17,900 in the U.S. When it comes to debt, as measured relative to disposable incomes, Canadians still have a way to go before they reach the levels hit by American households prior to the crash. After adjusting for discrepancies in the way the two countries gather figures, TD Bank estimated last year the Canadian debt-to-income ratio stands at around 156, compared to 177 in the U.S. in 2007. Then again, the adjusted ratio in Canada that year was just 131, showing again just how fast its risen in recent years. Meanwhile, it's the Americans who've found frugality in the intervening years—the debt-to-income ratio in the States has fallen to 152.

It's perhaps no surprise, then, that American retailers see Canada, in the words of one analyst, as "a 51st state." In addition to Nordstrom and Saks, a long list of U.S. stores have announced plans to occupy Canadian malls and shopping centres in recent years. New arrivals include: Brooks Brothers, J-Crew, Ann Taylor, Kate Spade New York. Even Target, which suffered $1 billion in losses due to its first year in Canada, still plans to operate 133 locations here by the end of this year, up from 124 now. Not to be outdone, Wal-Mart recently announced a $500-million expansion in Canada to boost the number of stores to 395 next year, up from 389 today.

Car purchases, fuelled by cheap loans amortized over up to eight years, are another spending category that has roared ahead. TD found Canadians spent slightly more than Americans on vehicles in 2012 on a per capita basis, although that's mostly because cars, trucks and SUVs generally cost more in Canada than they do in the U.S. Even so, there's no denying that Canadian dealerships are moving more than their fair share of metal. Carmakers sold 1.7 million vehicles in this country in 2013, an all-time high, while gains by luxury carmakers like BMW and Mercedes-Benz outstripped those south of the border. "The boomers are retiring in record numbers and they're treating themselves to a luxury vehicle," says industry analyst Dennis DesRosiers.

Nowhere is Canadian profligacy more evident than in the real estate market. In Toronto, for example, frenzied buyers recently drove up the price of a semi-detached house full of fluorescent lighting and old linoleum tile to more than $1 million. "This is shocking," wrote one commenter on a popular real estate blog. "I'm thinking now is the time to put [my house] on the market and move to somewhere more affordable . . . like Malibu." A few weeks earlier, a similar-sized house in a formerly industrial neighbourhood made headlines when it drew 33 offers and sold for nearly $850,000—$200,000 over asking. In Vancouver, meanwhile, home sales rose 30 per cent in January and the benchmark price for a detached house was just shy of $1 million. For homes on the city's west side, the price more than doubles. Across Canada, the Teranet-National Bank Composite House Price Index showed the price of a single-family home rose nearly half a percentage point last month from December, the largest gain in five months.

To many observers, though, the boom in condos is fast becoming the most dangerous asset bubble. Toronto's skyline is festooned with cranes as developers erect towers as fast as construction workers can build them. With names like Chaz and Yonge+Rich, the tiny, cookie-cutter units are marketed as the key to a hip lifestyle. But critics have raised concerns about heavy-handed sales tactics—most units can be had with as little as a five per cent down payment, and even that can be financed in some cases (one enterprising Vancouver developer is offering to let prospective buyers trade in their cars). CIBC deputy chief economist Benjamin Tal recently estimated that there were as many as 1,000 too many units being built every year in both Toronto and Vancouver, creating fears of a glut.

The spending doesn't stop once home buyers have been handed the keys, either. Buoyed by the popularity of TV shows like Holmes on Homes and Property Brothers, Canadians have boosted their spending on renovations and other home improvements by an average of seven per cent per year since 2003, according to another TD report last fall. Even though economists predict the pace will slow over the next few years as the housing market loses steam, the bank still expects home-renovation spending to amount to $45 billion in 2015, about double what it was in 2005.

How much is too much? Consumer confidence—and the spending it fuels—is key to determining whether an economy thrives or falls into recession. On the other hand, if spending isn't underpinned by companies investing and adding jobs, there's a risk the whole enterprise will crash down. Although many economists expect the Canadian economy to finally receive a boost this year from the U.S. recovery, so far there has been disturbingly little evidence of increased demand for Canadian exports—even with a US90-cent loonie that should make Canadian goods more competitive. At the same, the employment picture in Canada remains unclear at best. The country shed 7,000 jobs in February. Last year employers added roughly half the number of monthly jobs they did in the previous year.

As for that widening current account deficit, the real issue isn't that it exists, but what's causing it. Current account deficits are common among developed nations and occur when the value of goods and services they import exceed the value of goods and services they export. It's also impacted by flows of money across borders, including interest and dividends paid out on investments, as well as transfers like foreign aid. Where deficits become worrisome is when the gaps are persistent and growing over time, suggesting an uncompetitive economy.

Ailish Campbell, the vice-president of policy and international and fiscal issues for the Canadian Council of Chief Executives, recently advised those fretting about Canada's trade deficits to remember that they are offset in the current account by "positive and significant capital inflows, which feed the long-term growth of the Canadian economy." In other words, we should feel good about the fact foreigners are effectively lending Canada money that can be used to fund future growth. For example: factory owners who borrow to buy new technology and machinery to modernize their operations. Where countries run into trouble, by contrast, is when that foreign capital is simply being used to fund high levels of consumer consumption, as was the case in Greece prior to the debt crisis.

Canada, of course, isn't Greece. But all that debt-fuelled spending could still have undesirable effects on the economy just the same. At the moment, interest rates are low and Canadian households don't have trouble making their monthly payments. But that will change when interest rates inevitably begin to rise, particularly if they're not accompanied by corresponding increases in wages. Indeed, that was the conclusion of an unreleased report prepared for the federal government and obtained by Canadian Press. It found wages for middle-income workers had stagnated between 1993 and 2007, making the middle class "increasingly vulnerable to financial shocks." Many in the middle class, it warned, are "mortgaging their future to sustain their current consumption."

In effect, Canada's economy is now running on borrowed time. While much of the rest of the world is now positioned for growth after going through a painful period of deleveraging—housing foreclosures, shuttered banks, bankrupted companies and belt-tightening consumers—Canadians will be forced to look on from the sidelines while they nurse a collective hangover brought on by a debt-fuelled party that went on for several years.

"I view high debt as both a friction and vulnerability," RBC's Lascelles says. "The friction is that Canadians will be spending money on servicing debt that could otherwise be spent on goods and services. It's money squandered, in a sense." Meanwhile, it leaves Canadian households exposed to a financial crisis, he adds. They will still have those onerous interest payments to make, but "they will be grappling with very high debt loads relative to diminished incomes—perhaps amid falling asset [house] prices." In addition, Lascelles says Canadians will likely soon begin to feel poorer than we actually are as a cheap loonie makes online shopping from U.S. websites and foreign travel more expensive.

None of it sounds like much fun, but it's a fitting outcome for a once-modest but hard-working country that came to think of itself as a world-beater: all those hewers of wood and drawers of water who deluded themselves into thinking it was reasonable to wear $400 jeans.

http://www.macleans.ca/economy/money-economy/living-beyond-our-means/