Economics
IN FOCUS

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Will higher rates derail the consumer?

by **Benjamin Tal** benjamin.tal@cibc.com and **Karyne Charbonneau** karyne.charbonneau@cibc.com

The 2017-18 hiking cycle by the Bank of Canada was the dress rehearsal. The real show is happening now. A generation of Canadians who have never experienced high borrowing costs is now being tested. The claim that even now rates are still notably low relative to previous cycles is correct but irrelevant. The entire pool of household debt was taken out in a low interest rate environment. Add to the mix an inflation rate not seen in decades and there is a legitimate reason to be concerned about the ability of the consumer to sustain the economy. A closer look, however, suggests that despite the above, the expected slowing in consumer spending will feel more like a gearing down rather than slamming on the brakes. From a macro perspective, households' fundamentals are now generally stronger than seen at the eve of previous hiking cycles and the structure of household debt will shield many borrowers from the full sting of higher rates in the coming year.

Consumers: fundamentally strong

We use Table 1 as the basis for our analysis. The table presents an array of variables aimed at assessing the position of today's consumer relative to that position before the 2004-5 and 2017-18 hiking cycles. As usual, headline numbers mask more than they reveal, so in the following note we zoom in on some of the more telling variables and assess their implications for the health of the consumer.

Debt service cost — how bad?

Let's start with the most direct link between interest rates and the consumer: the impact on interest payments. As of Q1, the debt service indicators still looked good relative to previous tightening cycles, but surely those ratios will be much higher in the coming quarters. The rapid accumulation of mortgage debt in the years prior to the pandemic, and even faster accumulation during the pandemic, suggests that households are more sensitive to higher rates relative to the past. In fact, we estimate that 100 basis points hike by the Bank of Canada today is equivalent to 150 basis points hike in 2004 in terms of the impact on interest payments. But how big is this damage from a macro perspective? To answer that we need to understand the structure of household debt.

One-third of Canadian households are completely debt free, making higher interest rates a boon for them. Of those with debt, two-thirds hold only non-mortgage credit, with the remaining having both mortgage and non-mortgage debt (the share of those with only mortgage debt is negligible). Close to 3/4 of the dollar value of all household debt is held in the form of mortgages, with consumer credit making up the rest.

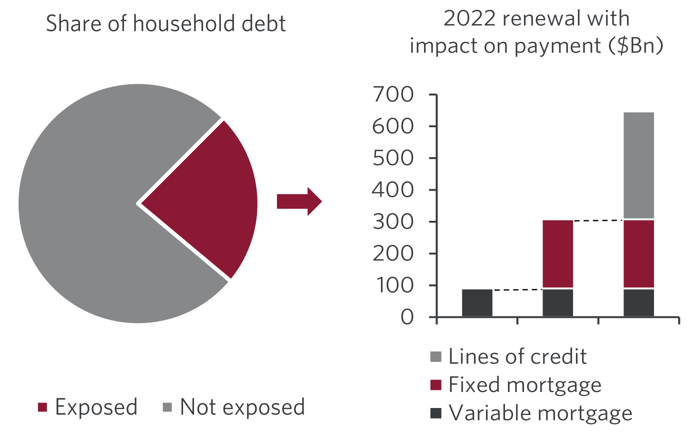
Now, sensitivity to higher rates varies widely across credit products. For instalment loans, the impact is negligible since the majority of those loans are fully amortized at the contract rate. While in theory interest rates on credit cards are

Table 1: Selected indicators of consumer health

Variables	2004 (Q3)	2017 (Q3)	Now (or latest)
Debt to income	127.13	180.56	182.47
Debt service ratio	12.41	14.22	13.48
Debt service ratio (interest only)	7.14	6.43	5.87
Real disposable income per capita (2012 $)	24409	31049	32799
Unemployment rate (%)	7.0	6.2	4.9
Duration of unemployment (weeks)	16.8	18.9	19.0
Savings rate (%)	2.6	2.8	8.1
Pent-up demand (%)	-0.3	-0.4	3.0
Pent-up demand: goods (%)	-0.6	-0.1	-3.7
Pent-up demand: services (%)	0.0	-0.7	8.4

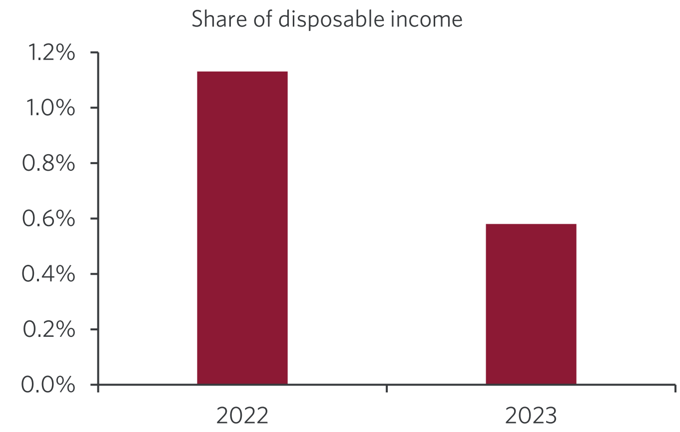
Source: Statistics Canada, CIBC

Chart 1: Exposure to immediate increase in interest payment



Source: Statistics Canada, CIBC

Chart 2: Increase in interest payment on household debt



Source: Statistics Canada, CIBC

adjustable, rates would have to rise significantly more than we expect this cycle before actual borrowing costs even budged. Lines of credit, of course, are fully adjusted to changes in the prime rate. On mortgages, 70% of variable rate debt is with fixed payments, meaning that payments don't change but amortization does. There have been talks recently about the "trigger rates" which will trigger the requirement for additional payments on that portfolio. However, we suggest that the policy rate will have to be miles above what's reasonable at this point for this factor to have any notable macro implications. As for the remaining 30% of the variable rate portfolio with adjustable rate, the impact of higher rates is full and immediate. For fixed rate mortgages, only about one-fifth will be resetting in any given year.

Putting it all together we get that out of the total household debt of $2.7 trillion, close to $650 billion (24%) face actual increase in interest payment this year (Chart 1).

Based on our expectation that the overnight rate will rise to 3.25% in September and stay at that level for the duration of 2023, and that the 5-year bond rate will average 2.45% in 2022 and 2.3% in 2023, this translates to close to $19 billion of additional debt payment this year, or a full percent of disposable income (Chart 2).

The one-third of households that are renters of course do not have to worry about rising mortgage rates, but they sure worry about higher rent inflation. We estimate that over the next 12 months rent payments will rise by an additional 0.6 percent of disposable income.

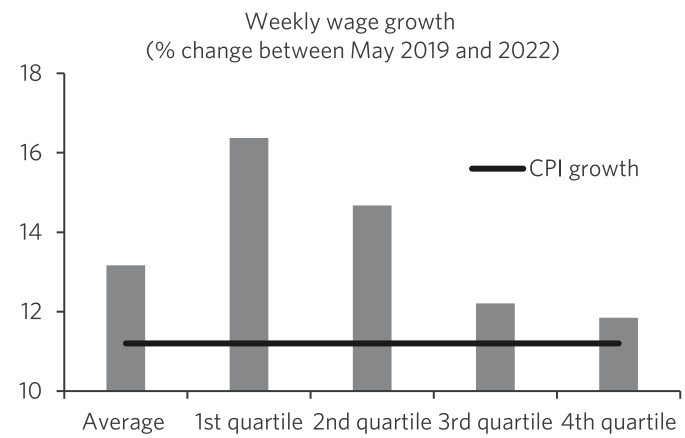
Now, there's no doubt that for a subset of households, higher interest and rent payments will be much more painful than the average number, but from a macro perspective, the sting is hardly fatal — especially given some of the fundamentals that will be discussed next.

Low wage workers enjoy the fastest pay increase

The key to being able to sustain rising interest rates is to have a good source of income. From that perspective, Canadians are better placed today than they have been in the past, in large part because of the strong labour market. The unemployment rate is historically low and participation in the labour market is high, particularly amongst prime-age individuals. This tightness has resulted in increased wage pressures.

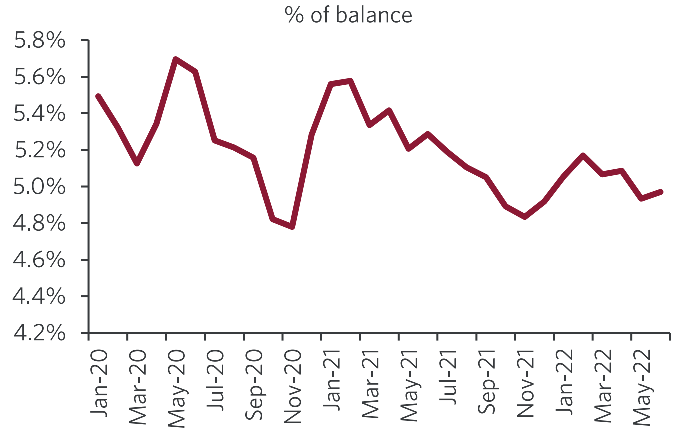
Although wages have not been keeping up with inflation recently, the average weekly wage rate, which is a function of both the hourly wage rate and hours worked, has surpassed inflation over the past three years, particularly for the lowest quartile (Chart 3). That means that many, especially in the low-income groups, are in a somewhat better position to face rising rates than they were just a few years ago. This will help offset some of the impact of rising rates and inflation.

Chart 3: Wage inflation — asymmetrical distribution



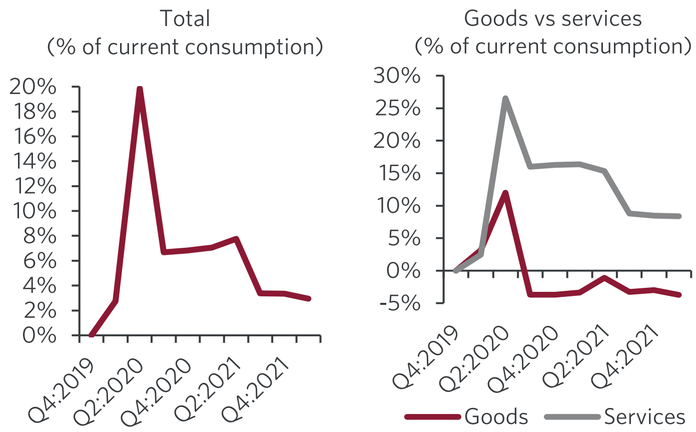
Source: Statistics Canada, CIBC

Chart 4: 30-day delinquency rate for sub-prime borrowers



Source: Equifax, CIBC

Chart 5: Pent up demand for consumption



Source: Statistics Canada, CIBC

That strength of the labour market is in full display in the insolvency statistics. In search for vulnerabilities, we look at borrowers most likely to default and where they are likely to start defaulting – in other words the margin of the margin. We find that 30-day delinquencies for sub-prime borrowers are still relatively low (Chart 4). The concern that higher rates will lead to a wave of insolvencies is misplaced. The key variable to watch here is the labour market, and at least for now, it is strong enough to support those most at risk.

$300 billion excess savings — still available

People in higher income groups may not have benefited as much from wage increases, but they have something else to help cushion the blow of rising rates and inflation: the large amount of excess savings they accumulated over the pandemic. The inability of Canadians to spend as much as they might have wanted over the past two and half years, combined with high disposable income, led to a large increase in the savings rate and a buildup of savings. Even today, the savings rate remains well above recent historical averages, and excess savings total well over $300 billion. In fact, excess savings are still growing. Were consumers to use just 10% of those excess savings, it could lift consumption by almost 2.5%. While we expect higher interest rates to work to increase the motivation to save, unlike other cycles, this will be offset by the availability of that pool of savings.

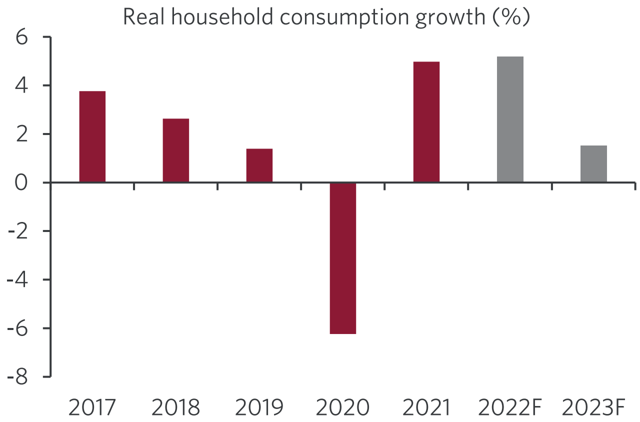
Of course, while savings increased for all income groups, most are in the hands of the highest quintiles, who typically have a low propensity to consume. However, pent-up demand, particularly for services, should keep their propensity to consume higher than normal in the coming year.

Still catching up

In a normal cycle, demand gets progressively stronger, consumption increases, and the central bank starts hiking rates. That slows consumers, particularly in their purchase of houses and durable goods such as cars and appliances. Non-durable goods (i.e. household items such as food and toilet paper) and services are usually largely immune. Of course, this is not a normal cycle. Consumption patterns in the past two and half years were dictated by forces outside of people's control, and while consumption came roaring back where possible, consumers have still not made up for lost time. There is therefore still significant pent-up demand for consumption, which we estimate at the equivalent of about 3% of the current level of consumption (Chart 5).

Service consumption was severely restricted for two years. Consequently, we estimate that relative to pre-pandemic trend, there is still a gap equivalent to about 8% of current service consumption in the form of pent-up demand. Of course, one cannot fully catch up on service consumption (you can only use so many haircuts), but there are enough ways to spend to mean that service consumption should remain strong for some time still. And while overall goods consumption was elevated during the pandemic, leaving it above its pre-pandemic trend, there are pockets of goods, such as cars, where supply chain disruptions have meant that not everybody could buy what they wanted or needed. That could support the consumption of big-ticket items in coming months despite rising rates. What will work to partly offset that pent up demand is the notable impact of the slowing housing market on spending associated with a new house, which we expect to soften alongside housing sales.

Chart 6: Consumption to slow but stay positive



Source: Statistics Canada, CIBC

Taken all together, the increased burden of rising rates and the erosion of spending power due to inflation will notably slow consumption, but Canadian households are equipped to keep consumption growing at a rate that should prevent the Bank of Canada from easing policy in 2023 (Chart 6).

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com