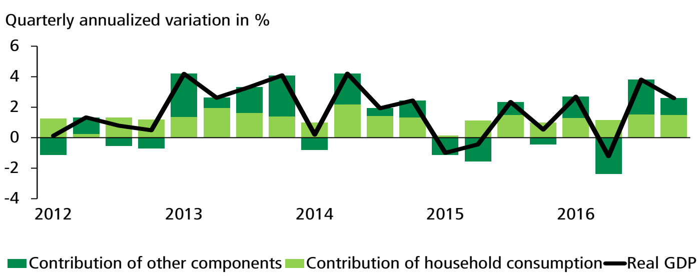
ECONOMIC VIEWPOINT

Canada: Consumers Remain the Cornerstone of Growth

The combination of several favourable factors seems to be driving recent advances in household consumption spending. Despite the presence of certain risks, households' contribution to economic growth should therefore remain fairly high in the next few quarters. We do, however, expect households to run out of steam in mid-2017 when some positive factors could start to dissipate.

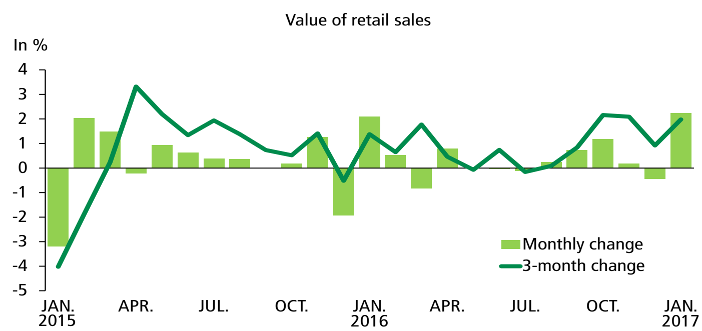
Canada's economic growth has been somewhat volatile in the last few years, in tune for the most part with the unpredictability of non-residential investment and international trade. Through this period, the Canadian economy nevertheless continued to benefit from the great resilience shown by household consumption spending. As such, the contribution of household consumption spending to the quarterly change in real GDP has remained fairly stable and relatively high (graph 1). For some time now, fluctuations in the quarterly change in real GDP have stemmed mainly from changes in other demand components.

GRAPH 1
Contribution of household spending to economic growth remains steady



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 2
Retail sales have made fairly strong advances in recent months



Sources: Statistics Canada and Desjardins, Economic Studies

Is Household Consumption Set to Accelerate?

Consumption spending has been an important economic growth driver in the past few quarters. In this context, the most recent results for retail trade are very promising, with retail sales posting fairly energetic monthly advances last fall (graph 2). In January 2017 alone, the value of retail sales surged 2.2%—one of the sharpest monthly increases since we started tracking this economic indicator in 1991. As a result, the annual growth of the value and volume of retail sales has recently started to ramp up.

We can wonder, however, if this is a temporary jump in consumption spending or the start of a more robust trend? To answer this question, recent changes in the main underlying factors that influence household demand provide some interesting insights.

First off, the labour market has racked up substantial gains in the last few months. Since August 2016, a total of 273,700 new jobs have been created, representing an average monthly increase of 34,200 positions (graph 3 on page 2). This level of job creation in such a short period of time had not been seen since spring 2007. As a result, the unemployment rate fell sharply, from 7.2% in January 2016 to 6.7% in March 2017. The labour market situation is also less precarious—97% of the jobs created since last August are full-time positions. This type of upswing in the job market is obviously very favourable to movements in household spending.

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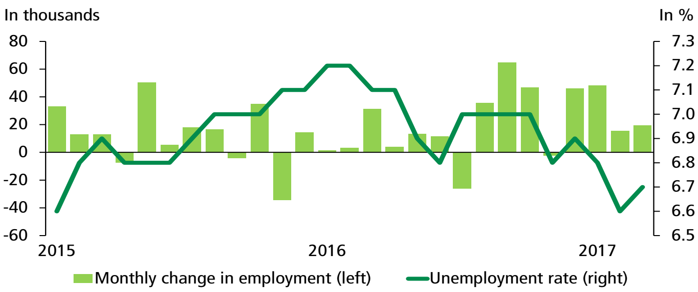
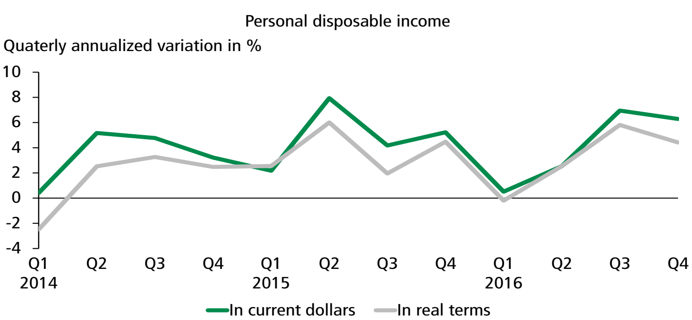
GRAPH 3
Major strides in the labour market in recent months



Sources: Statistics Canada and Desjardins, Economic Studies

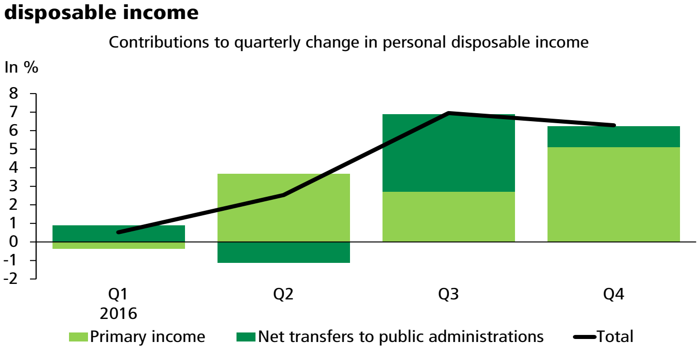
Secondly, after having slowed in the first half of 2016, the growth of households' disposable income accelerated as of mid-2016 (graph 4). This faster growth is driven in part by improvements in primary income (employment income), and by a sharp spike in the transfers from public administrations and a slight drop in the transfers to public administrations (graph 5). Cuts to reduce the tax burden on households introduced in the 2016 federal budget are largely responsible for this improvement. Households clearly used some of this additional income to grow their net savings, which pushed the savings rate to 5.8% in the fourth quarter of 2016, compared to a rate of only 4.7% in the first quarter of that year. On the flip side, the data show that households also used some of this extra income to increase their consumption spending.

GRAPH 4
Strongest disposable income growth since summer 2016



Sources: Statistics Canada and Desjardins, Economic Studies

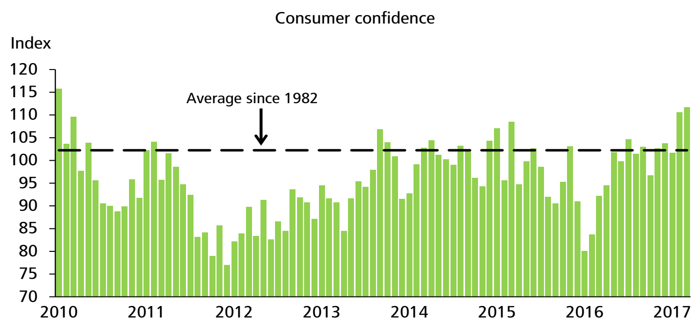
GRAPH 5
Spike in current transfers from public administrations inflates disposable income



Sources: Statistics Canada and Desjardins, Economic Studies

Lastly, Canadian household confidence has greatly improved in the last few months (graph 6). As such, the index rose to 111.7 in March, a level that far exceeds its historical average. This will clearly provide more support for advances in consumption spending, especially for durable goods.

GRAPH 6
Household confidence up sharply since the start of 2017



Sources: Conference Board of Canada and Desjardins, Economic Studies

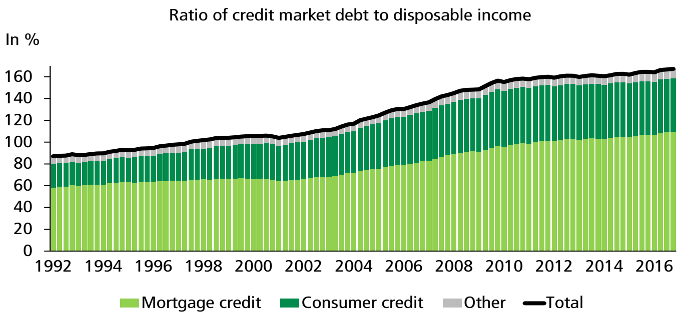
Under such conditions, we have to admit that several factors currently argue in favour of consumption spending, suggesting that this acceleration could carry over through the next few months. Therefore, household consumption will continue to be a major driver of economic growth.

Risks to Keep an Eye On

That said, despite the outlooks that are by most accounts favourable, some factors could hurt consumption spending in 2017. On one hand, the benefits of households' reduced tax burden will gradually start to fade over the next few months. The resulting slowdown in households' disposable income could weigh on consumption spending growth by the end of 2017.

On the other, despite the increase in the household savings rate at the end of 2016, their debt levels are still quite high. According to Statistics Canada, the ratio of household debt contracted on the credit market vs. their disposable income reached 167.25% in the fourth quarter of 2016; a historical peak (graph 7 on page 3). This situation should not create too many concerns for households at the moment since interest rates are very low. Gradual cuts to the average interest rates on household debt have reduced the portion of the debt service that is the interest payment. This has offset the increase in the portion applied to

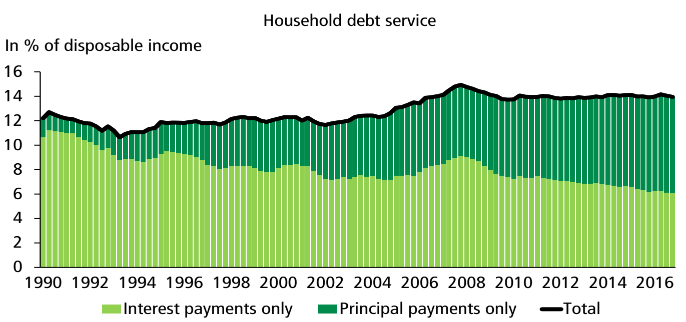
GRAPH 7
The household debt ratio is very high



Sources: Statistics Canada and Desjardins, Economic Studies

the capital, which is rising because of the increase in outstanding debt. Total household debt service has remained stable as a result, in spite of rising household debt levels in recent years (graph 8). What if interest rates rise and push debt servicing to higher levels? This is the concern. Based on our estimates, the average interest on household debt would only have to go up about 65 basis points to put the debt service ratio above its historical peak. Therefore, if households had to set aside a bigger slice of their income to pay debts, this could have major repercussions on future consumption advances.

GRAPH 8
The household debt service ratio is relatively steady



Sources: Statistics Canada and Desjardins, Economic Studies

This risk is fairly low at the moment. For one thing, interest rates are showing some resilience with fixed rates that in some cases extend over several years (for example, 5-year mortgage terms or automobile loans). This will delay the impact of a potential rate increase on the credit market.

What's more, most forecasters do not anticipate a key rate increase in Canada before 2018. In the short term, the risk of high household debt on changes in consumer spending therefore seems fairly weak.

One last factor to consider is weak wage growth. Despite the upswing in the labour market in recent months, and especially the significant drop in the unemployment rate, wage growth is still relatively modest. Expressed in real terms, the annual change in the average hourly wage has been almost flat since spring 2016. The data on average weekly earnings expressed in real terms point to the same conclusion, with an annual change in February of 0.3%. If this weak wage growth continues, it could partially erode the benefits of surging job creation on consumption spending growth.

Households Set to Keep Contributing Over the Next Few Quarters

Despite certain risks, the growth outlooks for household consumption spending in the next few quarters are very good. If we also take residential investment into account, which continues to rise in spite of the new restrictive measures introduced by the federal government last fall, households' contribution to economic growth should be quite strong in the first half of 2017. The benefits of tax relief could then start to fade and drag down advances in household consumption spending. What's more, other restrictive measures (for the Toronto area especially) for the housing market are likely to be ordered sometime this year, which could rein in residential investment's contribution to economic growth in the second half of 2017, which would by extension lower households' contribution to changes in real GDP.

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