



CENTRE FOR
Canada's Future

The Moose in the Room

Insight into Canadian consumer
debt and deleveraging scenarios

MAY 2019



Executive Summary

? Why are we interested in deleveraging?

- We're not "predicting" a major deleveraging in Canada
- Predicting economic cycles is notoriously difficult, and most Canadian economists continue to forecast positive (albeit slower) growth
- Nonetheless, it is valuable to examine the potential impact of a major deleveraging cycle
- It has been so long—over 40 years—since Canada's last such cycle and most Canadian executives have not managed this type of event
- Even if we only see a mild slowdown or shallow unwind instead of a major shock, thinking through how to future-proof your business against a major shock is a worthwhile exercise

↻ What can we learn from past cycles?

- We examined 27 past deleveraging events from 18 advanced, open and high-income OECD countries dating back to 1970
- While some cycles were shorter and less severe, 18 were "major shocks" in which either the growth rate or the absolute volume of household debt declined sharply over a two-year period
- We looked at how these events rippled across the economy and, in particular, their impact on consumer spending

⚡ What can your company do to prepare?

- Companies that take action now can blunt the worst effects and use the disruption as an opportunity to gain competitive advantage
- Responding faster than competitors: Invest in superior analytics to better predict consumer behaviour during a downturn, streamline supply chains to reduce cost and boost flexibility, or develop more responsive pricing strategies aimed at gaining share in a declining market
- Surviving longer and invest more than competitors: Grinding down costs to increase pricing flexibility, secure access to cash or pay down debt, invest in new products while competitors flounder, or look across the M&A pipeline for attractive future opportunities

🔍 How exposed is Canada to a debt shock?

- Over the past 20 years, Canadian consumer debt loads have grown 5X faster than incomes and 1.5X faster than net worth
- If fact, Canada is the only country among 18 peers we examined that has not had a single year of negative growth in household debt since the 1980's
- Mounting debt increases our exposure to asset price and interest rate shocks
- Canadian household debt is now over 100% of GDP. This is higher than most peer countries in our study, and a number—but not all—with debt loads of this size saw significant deleveragings afterwards

💵 How big could the impact be on Canada?

- Major shocks tend to be followed by steep and prolonged pullbacks in consumer spending.
- Severity can vary, but if Canada experienced a median decline (based on the 18 cycles we studied) it would result in \$650 billion of foregone consumer spending over 5 years
- Durable and non-durable consumer goods would likely be hardest hit, with motor vehicles, furnishings, and clothing especially impacted
- Services spending tends to be more cushioned, but not immune. In peer countries, sub-categories such as transport and recreation saw significant declines

About this Report

Message from the authors:

Rising household debt is a hot topic in Canada, and for good reason. That debt is now a bigger percentage of our economy than it was in the United States before their financial crisis.

While much of this debt is related to housing, Canadians have also run up substantial amounts of other debt. All of this has economists, pundits and regular Canadians debating some big questions. Do we have “too much” debt? Will we face a reckoning, as other countries have in the past? And, if so, how bad could it be?

Deleveraging events can be triggered by many factors, such as housing bubbles, bank crises or other economic shocks. We’re not going to try to predict if, when or exactly how severe a deleveraging in Canada might be. But since few of today’s executives were running businesses in the 1980s (the last time household debt declined year on year), we believe it’s worth thinking through how to future-proof your business – and being ready for a major shock is a good way to do it.

Furthermore, BCG’s global client work has revealed another important fact: business leaders who are well positioned before a downturn can do more than survive a downturn. They can drive long-term advantage over less-prepared competitors.

To get at the underlying facts, we looked at data from 18 countries over the last 50 years. Our goal was to address a key question: if Canada were to experience a major shock, what would it look like and how could Canadian companies prepare?

If a major shock occurred, it would reverberate across our economy. The good news is that there is still time to plan. While policymakers will need to consider socio-economic impacts, consumers their family finances, and banks their consumer and commercial lending portfolios, we focused our recommendations on the consumer goods space. We hope that the insights presented here will help decision makers get a head start in reducing their exposure and preparing their businesses for the strategic opportunities that downturns can present.



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While most economists continue to predict growth, Canadian consumer debt is sparking concern

A sampling of 2019 headlines



Many economists are still forecasting sustained if slower growth for Canada ...



Federal Budget 2019

“Forecast consensus growth among private sector economists for 2019 was 1.8%...”

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IMF

“Projected economic growth downgraded slightly, but still estimated at 1.5% in March 2019...”

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... but there is rising concern about high consumer debt and that Canada’s long run of relatively good economic performance may end with something more serious than a ‘soft landing’

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Bloomberg

“A top-performing hedge fund is shorting Canada banks on housing...”

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“Canadians weighed down by lines of credit they don’t understand...”

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With debt outpacing incomes, Canadians are more exposed to asset price and interest rate shocks

While household debt per capita more than doubled over the past 20 years, real income per capita has grown by only 22% over the same period.

In other words, debt grew five times faster than incomes!

Debt can be a force for good. Access to capital has allowed the Canadian economy to enjoy robust growth over the past two decades. Businesses have used debt to expand, families have used it to buy homes, and

governments have sought it to fund critical infrastructure and social programmes.

But, too much debt can be destabilizing. Two scenarios are especially concerning. One is that the swollen debt load will become more difficult to service if interest rates rise back to historical ranges. The other is that heavy debt volumes will make Canadians more vulnerable to asset price shocks.

The net worth of the average Canadian household has soared 87% since the late 1990s; a significant rise, but not as fast as debt. A sharp drop in house prices or stock market values would erode that net worth significantly while leaving debt untouched.

Both scenarios have the potential to create significant pain. Canadian families will be forced to tighten their belts quickly while retailers and consumer goods companies will be left to cope with reduced demand and higher consumer price sensitivity.

Growth in key Canadian consumer metrics (Indexed to 1997, adjusted for inflation)



Source: StatsCan, OECD, BCG Analysis

Canada is in a small club of countries that has dodged major deleveraging

A deleveraging cycle is considered “major” when the rate of debt growth declines precipitously over two years or when absolute debt levels contract over an extended period.

Canada has not experienced a major shock like this since the 1980s. That’s nearly 40 years ago!

Many of our peer countries have not been as lucky. The US, Ireland, Spain and many other nations went through major deleveraging events after the 2008 financial crisis. Several Nordics suffered severe crises of their own in the 1990s. Japan has had multiple cycles over the past two decades. The list goes on.

We’ve come close—during the 2000 internet bubble recession and the 2008 global financial crisis, especially—but the Canadian economy proved resilient each time, and consumers did not materially deleverage during either of those shocks.

That is highly unusual. Of the 18 peers we examined (advanced, open, high income OECD countries), only Australia and France have similar records. Even there, Canada has been more fortunate. We are the only country among our peers without a single year of negative growth in household debt since the 1980s.

While everyone else was re-trenching, however, Canadian consumers kept borrowing. Metrics like the debt servicing ratio suggest Canadian household debt remains manageable overall, Canada’s run up in household debt is now similar to what many of our peers saw before they were hit by a deleveraging event.

Forty years is a long time—and since the majority of Canadians are too young to remember that painful 1980s recession—we wanted to explore what impact a sudden and steep fall in household debt could have.

Canada’s household debt higher than most peer countries at greater than 100% of GDP

Household debt to GDP (%)

150

100

50

0

1970

1980

1990

2000

2010

2018

1985

end of last major Canadian deleveraging

1989-1998

Norway deleveraging after banking crisis which started in '88

2008-Today

US deleveraging cycle during 2008 financial crisis

2000-2009

German deleveraging post-2000 recession and during labour market reforms in early 2000s

Norway
Canada

US

Germany

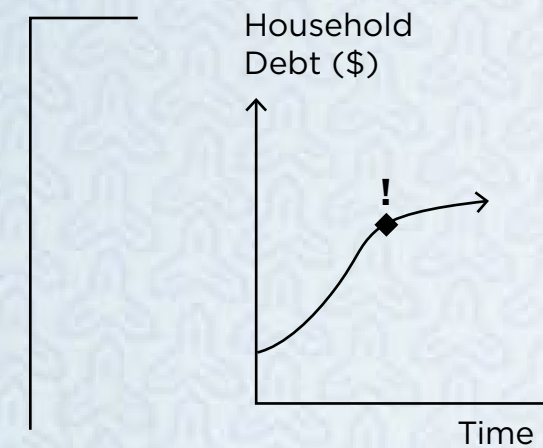


A note on our approach

We analyzed household balance sheet data from 18 peer countries over the last 50 years focusing on two types of “major shocks”

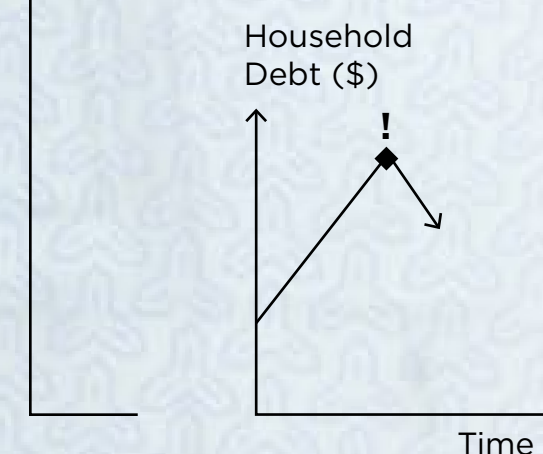
We looked at household debt data since 1970 for a group of 18 advanced and open OECD countries with high-income economies according to the World Bank. The countries were selected based on their comparability with Canada and data availability.

Major Shock — OR
n = 18



A major deceleration in the growth rate of household debt

Any two-year period where the growth in household debt falls by more than 6pp in the first year and by a total of 12pp or more over both years, e.g., Finland and Sweden in the late 1980s.

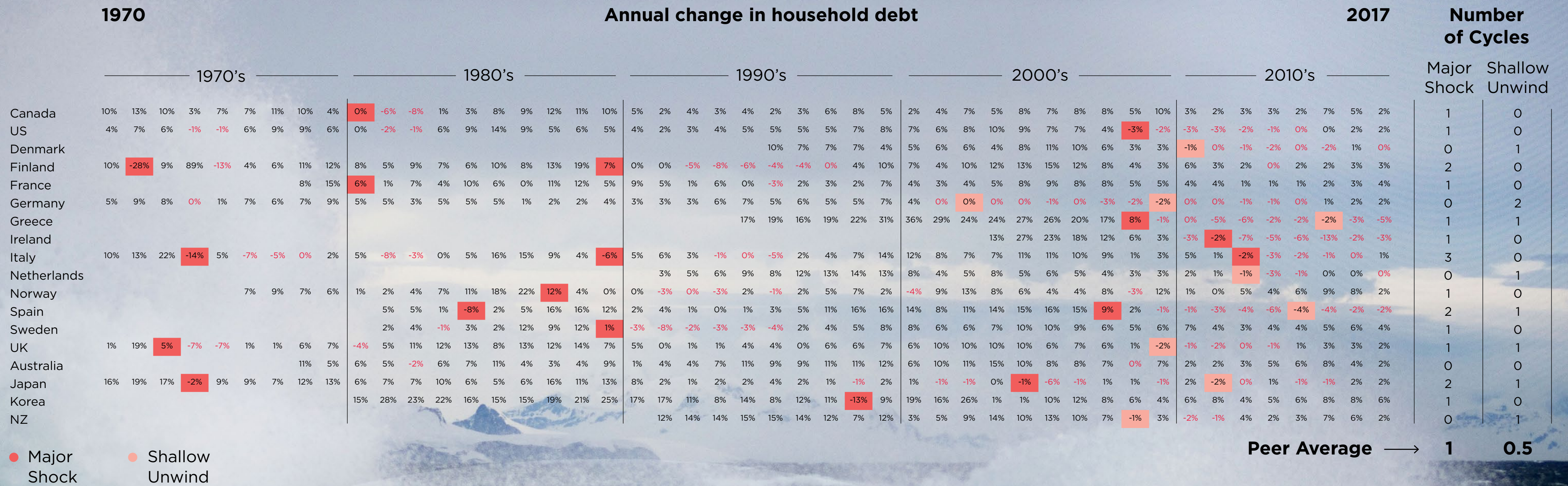


A major drop in level of household debt

Any two-year period where the absolute amount of household debt falls by an amount similar to the United States during the 2008 financial crisis, i.e., by at least 4.5%

Shallow Unwind
n = 9

Beyond major shocks, we also flagged shallow unwinds, or periods of sustained, but less significant decline in household debt



We looked at 27 deleveraging cycles in Canada and elsewhere

Looking back at 50 years of data, we were able to identify 27 past deleveraging events, caused by a wide variety of triggers including debt bubbles, banking crises and other economic shocks. Of these, 18 are what we call major shocks and 9 were “shallow unwinds.”

Source: Bank of International Settlements, BCG Analysis

There was an average of one major shock per country over the period.

The shocks came in different shapes and sizes. Some were rapid and chaotic, while others were slower and more orderly. Some were localized events such as the International Monetary Fund crisis in Britain during the 1970s, while others

were part of a broader wave, such as Germany’s deleveraging during the global recession in the early 2000s, or the shared pain experienced across the US and many EU countries following the global financial crisis in 2008.

Nonetheless, these major shocks were all characterized by one of two events—a sud-

den decline in total household debt, such as in the US in 2009, or a rapid deceleration in debt growth, such as in Finland or Norway in the late 1980s.

Durations can vary. Some deleveraging events are short-lived. South Korea, for instance, suffered a sharp, but brief knock during the Asian financial crisis, while other countries endured

much longer downswings. The US experienced six years of negative household debt growth following the 2008 financial crisis, and Germany and Japan weathered more than a decade of negative or anemic debt growth before their economies finally recovered.

Short or long, every deleveraging event packed a heavy punch.

Major shocks slam the brakes on consumer spending

Motor vehicles, clothing and transport are especially impacted

Consumer spending took a material hit during most of the deleveraging cycles that we examined. Of the 11 major shocks where detailed data was available, the median level of consumer spending was still 2% lower than the pre-crisis peak five years later.

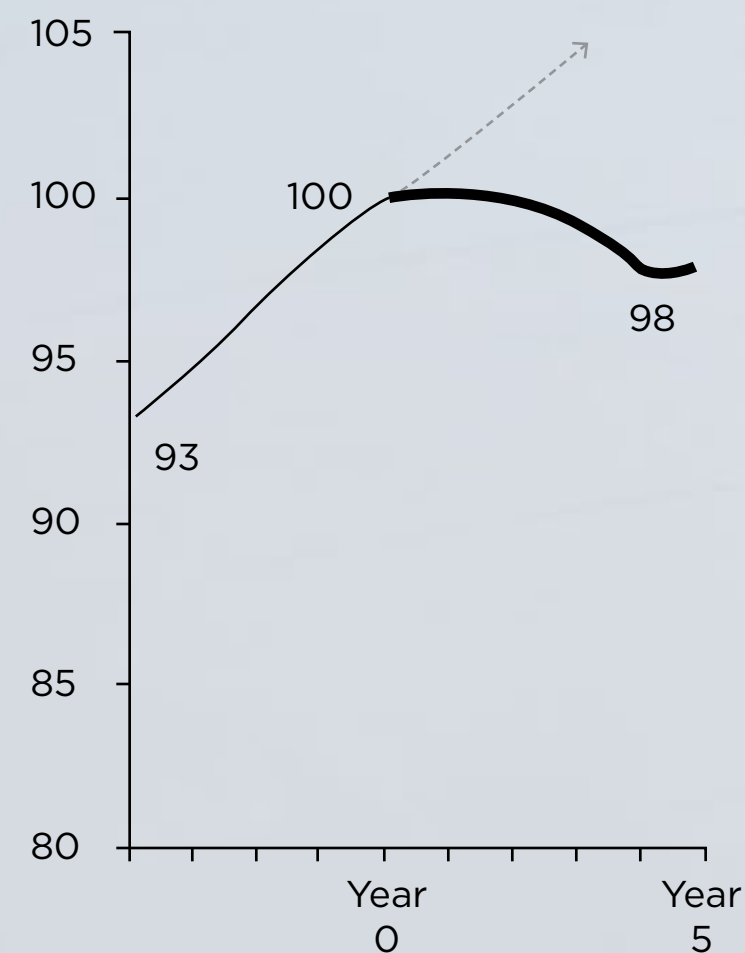
While this may not sound catastrophic, when compared with healthy pre-crisis trends, a five-year period of flat or

negative consumer spending growth can create a yawning gap in revenues—one that can take companies years of later growth to close.

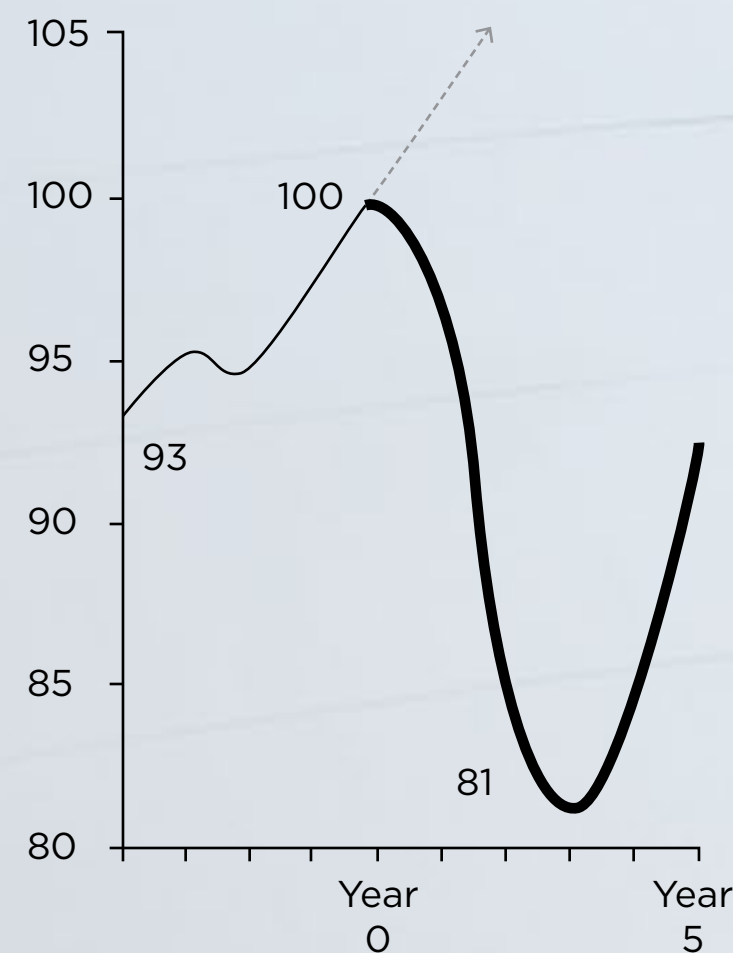
Durable and non-durable goods ranging from motor vehicles to clothing are typically hardest hit in major shocks. Spending on services tends to be less impacted—however, a few sub categories, including recreation and expenses related to the operation of vehicles, often see significant declines.

Total Consumer Spending

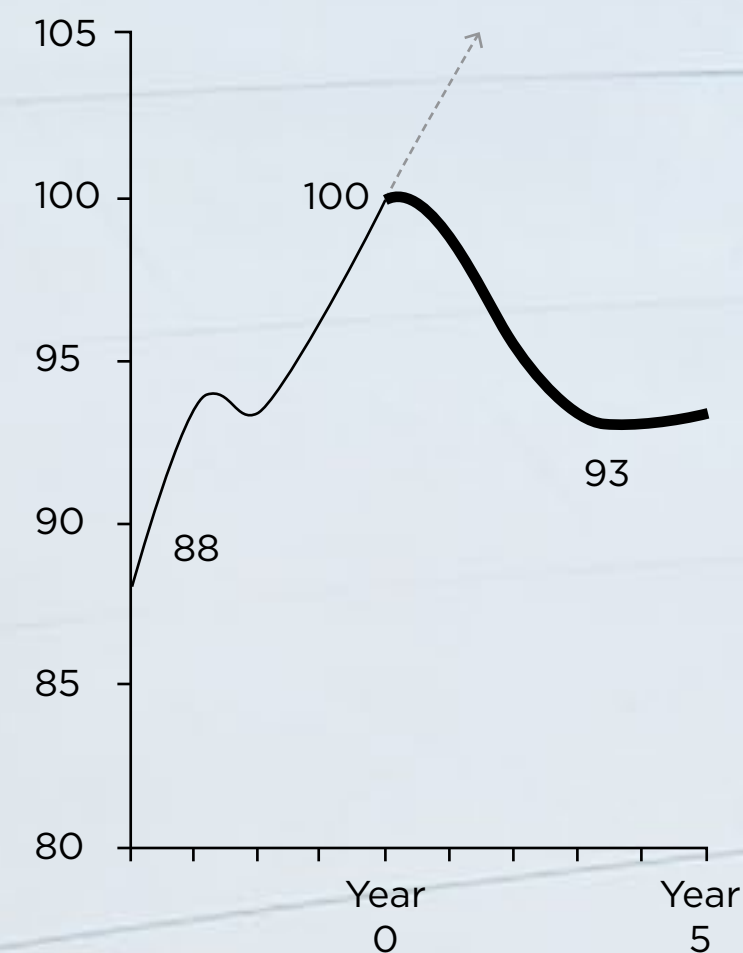
Nominal dollar Growth Indexed to Year 0



Motor Vehicles

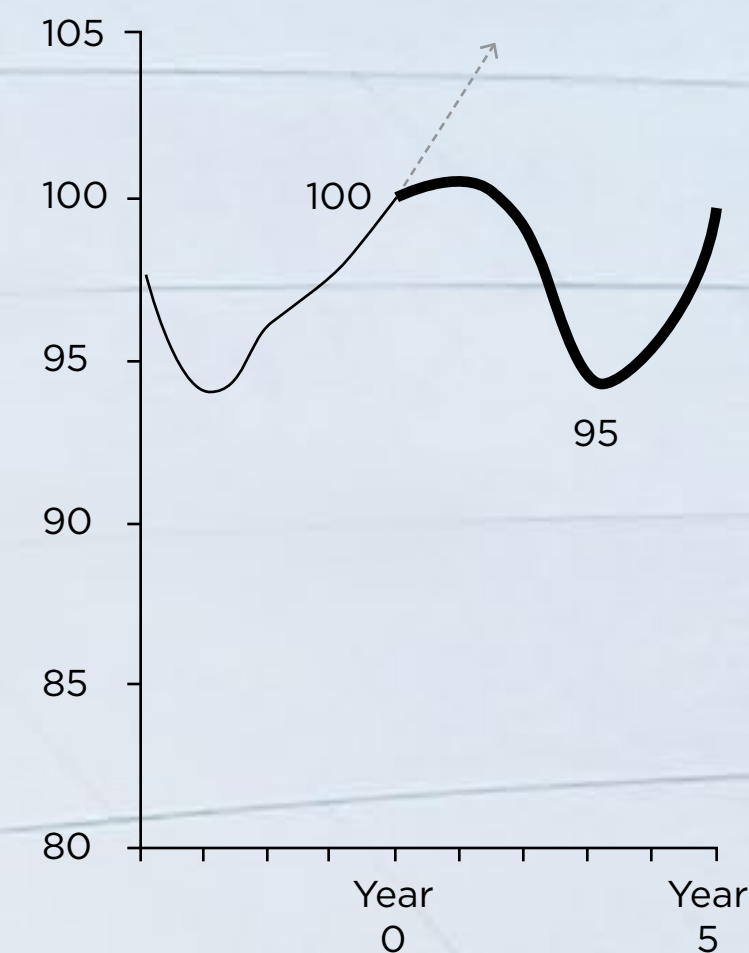


Clothing & Footwear

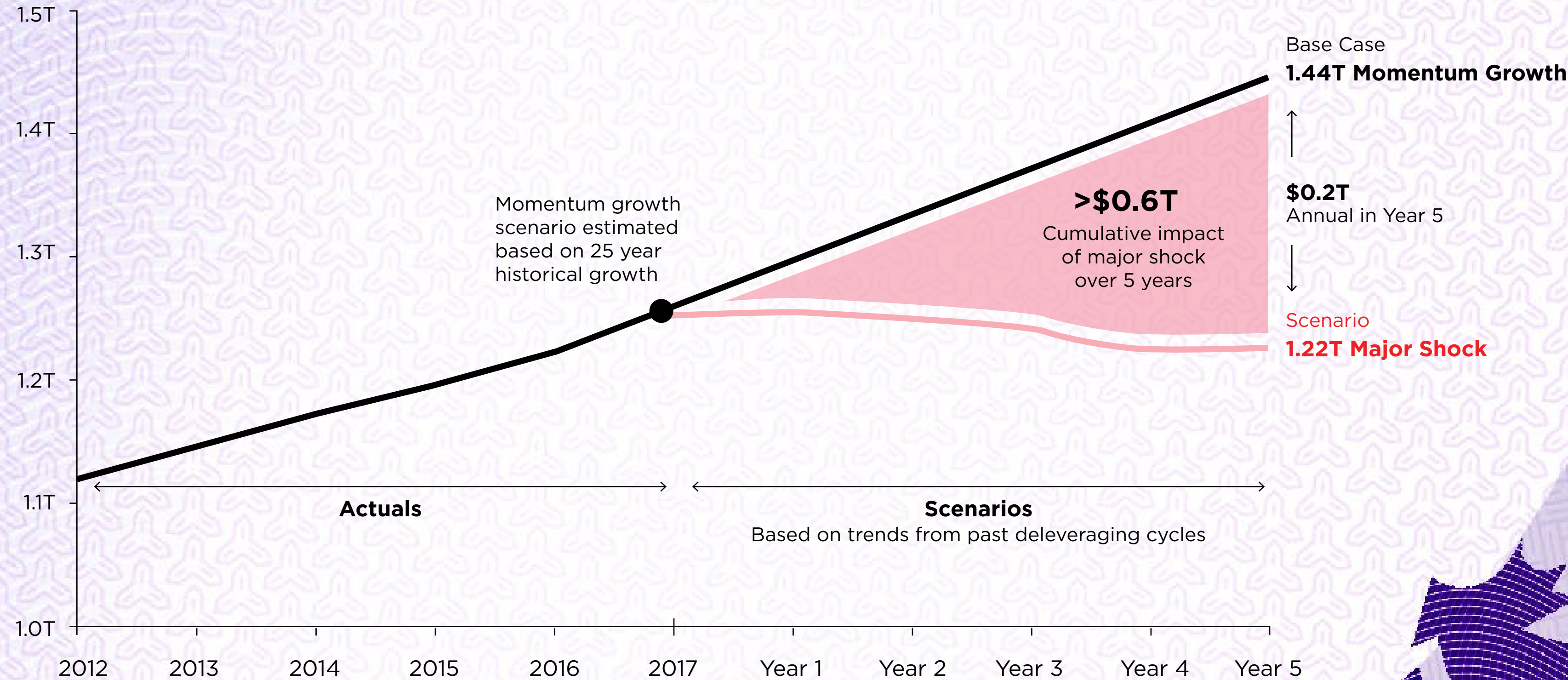


Transport Services

Including passenger transport by air, rail and other means



A major shock scenario



Source: Bank of International Settlements, OECD, BCG Analysis

A Major Shock Scenario Could Create a Gap of \$0.6T in Cumulative Consumer Spending Over 5 Years

A major deleveraging event could have far-reaching implications for the Canadian economy, for both residential investment and consumer spending.

Looking at consumer spending, the chart shows the difference between consumer spending under the 3% annual “momentum growth” scenario that Canada has enjoyed over the past 25 years and the cumulative impact of a major shock.

This impact is based on the 18 major shock cycles in our peer group, which saw a median spending drop that, adjusted for the size of Canada’s economy, would work out to nearly \$650 billion over five years.

The snowballing effects of that decline mean that by “Year 5” the annual impact could amount to over \$200 billion—almost 15% of what consumer spending would have been had pre-cycle trends continued.

That’s sobering.

Given the fact that consumer spending accounted for nearly 58% of GDP in 2017, a steep drop would ripple through the Canadian economy, affecting everything from corporate sales targets to credit availability and government tax revenues. However, the most immediate impact is likely to be felt by consumer goods companies.

In Canada, a major shock would affect spending on all categories, but especially vehicles, furnishings, and clothing

Category		Growth rates in consumer spending by category					Cumulative impact (\$B)	
		Historic Canadian Growth			Major Shock		\$ Impact	
		25YR	10YR	5 YR	Next 3YR	Next 5YR	Over 5YRs	
Services	Electricity & Gas	0%	0%	0%	-2%	-1%	-5	→ Small category with small % impact → Large category with small % impact → Large category with large % impact
	Communications	5%	3%	2%	5%	4%	0	
	Education	3%	3%	3%	1%	0%	-6	
	Health	4%	3%	3%	0%	0%	-37	
	Housing	3%	3%	3%	3%	2%	-40	
	Transport Services	3%	4%	4%	-2%	0%	-14	
	Vehicle Operation	2%	2%	3%	-1%	-1%	-37	
	Recreation	2%	0%	0%	-3%	-1%	-29	
	Hospitality	2%	2%	3%	0%	1%	-25	
	Other	4%	3%	4%	0%	0%	-100	
Goods	Electronics	8%	5%	3%	2%	4%	-23	
	Furnishings	3%	2%	3%	-3%	-1%	-59	
	Motor Vehicles	4%	4%	5%	-7%	-2%	-114	
	Clothing	4%	4%	3%	-2%	-1%	-51	
	Alcohol & Tobacco	1%	1%	0%	-1%	-2%	-11	
	Food & Beverages	2%	1%	2%	-1%	0%	-33	
Total		3%	2%	3%	0%	0%	-630	

The accompanying chart shows how spending grows or shrinks in a major shock scenario compared to historic averages in that category.

Some categories will continue to expand, albeit more slowly. Others will suffer. The most devastating impacts will be felt by businesses with high fixed costs and those that have relied on steady revenue growth to make up for un-addressed structural issues.

De-averaging is crucial. For instance, the motor vehicle industry is likely to be among the hardest-hit. In contrast to the sector's five-year annual growth rate of 5% in Canada, a major shock would lower that rate to -2%. The total impact of lost motor vehicles sales over a five-year period would be over \$100B. That is big news for manufacturers, auto dealers and auto-finance players.

Furnishings and clothing would also be heavily impacted over a multi-year horizon. Even categories that some consider counter-cyclical, such as food and beverages, won't be immune. Five years of no growth in food and beverage spending, for example, would open up a multi-billion-dollar gap between the momentum growth and major shock scenarios.

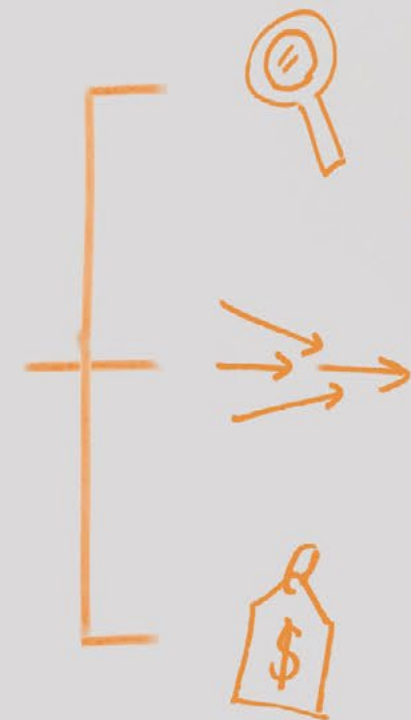
Spending on select services is likely to be more cushioned from a fall off. For example, expenditures on core services such as housing and rent are relatively more sticky. However, areas that rely on disposable income, like recreation and travel, will be impacted substantially. As consumers travel less, "staycation" more and flock to cheaper entertainment activities, recreational spending could fall by over \$30 billion. Vehicle operation and related services spending are also likely to shrink as consumers reduce discretionary driving.

By acting now, Canadian companies can respond faster and emerge stronger in the event of a downturn

Competitors that act early can soften the most severe impacts while opening up new opportunities to create competitive advantage.

the art of possible

Respond Faster Than Competitors



Invest in superior analytics to spot early warning signs of an impending downturn and get a jump on competitors

Streamline supply chain to link consumer demand more closely to production decisions, e.g., reduce inventory

Develop flexible pricing strategies to gain share in shrinking markets, e.g., if sector volume is down 15%, keep your loss to 5%

Use digital to 'expand art of the possible'

Survive Longer and Invest More Than Competitors



Grind down cost base to gain flexibility and limit crisis losses

Secure access to cash and optimize capital structure to sustain losses and sustain investments

Preserve firepower for growth initiatives and M&A to build long-term advantage over cash-strapped competitors and to seize consolidation opportunities

respond faster

survive longer

Past examples of companies that reacted effectively

Responding Faster than Competitors

McDonalds during 2008 crisis

The stock market had a tough 2008, with the Dow losing 30% in value. McDonald's was one of only two companies to end the year with a gain—growing worldwide sales by over 5%. Investments in consumer analytics helped McDonald's track spending globally and get an early read on whether people were buying cheaper value meals or skipping their morning coffee. Those insights allowed McDonalds to adjust its strategy accordingly. The company also trialed dynamic pricing systems that allowed it to cut prices for some meals by as much as a third at lunch hour. Flexible pricing kept volumes high and protected company revenues.

Source: Global news publications

Surviving Longer and Investing More Than Competitors

Ford during the 2008 crisis

During the 2008 recession, Ford saw its sales plummet by nearly 20%. Unlike GM and Chrysler however, Ford was the only player to keep its financing arm afloat, which allowed it to support continued demand for its vehicles. Ford also had the foresight to maintain strong lines of credit—securing an additional \$24B prior to the downturn. The company also exercised strong cost discipline, restructuring operations early on and spinning off three non-core brands. These efforts limited losses and made Ford more crisis resilient.

Expanding the art of the possible

New opportunities in digital

Innovation in AI, AR/VR, robotics and other technology is further expanding the option set for companies. Reaping the benefits will require companies to continue investing in future capabilities. For example, McDonald's has continued to innovate and digitize post-2008. They recently spent ~\$300M to acquire an Israeli startup specializing in personalized online shopping experiences. McDonald's plans on using the technology to create tailored menus for customers using its drive-thru, in-store kiosks and mobile app. Variables such as the weather, time and restaurant traffic will be combined with store sales data to predict and upsell relevant products to customers.

About BCG's Centre for Canada's Future

BCG established the Centre for Canada's Future in 2017 to contribute to the national dialogue on key economic issues, help shape the country's agenda, and identify the greatest opportunities for Canada.

The centre is dedicated to serving as a catalyst that moves Canada forward by identifying, analyzing, and leading action on the nation's greatest opportunities.

More on this topic from BCG: Advantage in Adversity Report

BCG's Advantage in Adversity report highlights challenges & opportunities in a downturn based on a study of 5000 US companies during the last five US downturns. The report shows that average revenue growth fell from +8% the year before a downturn to -1% the year during. Increased volatility is also

identified, with the rate at which businesses jump into (or fall out of) the Fortune 100 rising by 50%. Interestingly however, 14% of companies in the last four downturns did more than just survive; they managed to both grow revenues and improve margins. Read more insights from the report [here](#)



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