PRB 03-49E

IN BRIEF

Parliamentary Research Branch
Library of Parliament

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2 February 2004

Saving or Spending: A Matter of Growth

In the *Update* to its *Monetary Policy Report*, released on 20 January 2004, the Bank of Canada pointed to the need to sustain aggregate demand as justification for lowering its target for the overnight interest rate by 25 basis points. The Bank stated that the Canadian dollar's rise in comparison with the U.S. dollar means that, in 2004, economic growth in Canada will need to come primarily from domestic demand rather than net exports. The Bank projected a growth of 2.75% in Canada's economy in 2004, a forecast that places a great deal of responsibility on consumers, whose personal expenditures on consumer goods and services accounted for 61.5% of Canada's gross domestic product (GDP) in the third quarter of 2003.

THE VITAL ROLE OF CONSUMERS

To date, the Canadian economy has benefited very little from the rebound in the U.S. economy, because Canadian exports are penalized by the increased value of our dollar. Considering the key role played by Canadian consumers in the economy, it is not surprising that Canadian monetary authorities are pinning their hopes on them. In any event, the Bank of Canada cannot really count on the other components of aggregate domestic demand to support economic growth in 2004. In fact, even buoyant business investment (some 17% of GDP) will be inadequate to sustain economic growth, especially since part of the forecast expansion in this sector will likely involve increased imports of equipment and machinery from the United States.

In addition, provinces and municipalities will generally lag behind in terms of growth in 2004, as they struggle to curb their deficits or to keep their budgets balanced. Forecast budget cuts and fee hikes will even have a negative effect on consumers' disposable income and on growth. The same applies, but to a lesser extent, to the federal government, whose tight fiscal discipline in reaction to the forecast reduction in the size of the surplus will likely mean a smaller contribution to economic growth. In its quarterly forecast report (Winter 2004), the Conference Board of Canada anticipated a growth of 2.5% in the government sector in 2004, in comparison with 3.5% in 2003. It should be noted, however, that the Conference Board's main forecast scenario did not take into account the latest budget difficulties of the governments of Ontario (with a forecast deficit $5.6 billion) and Quebec.

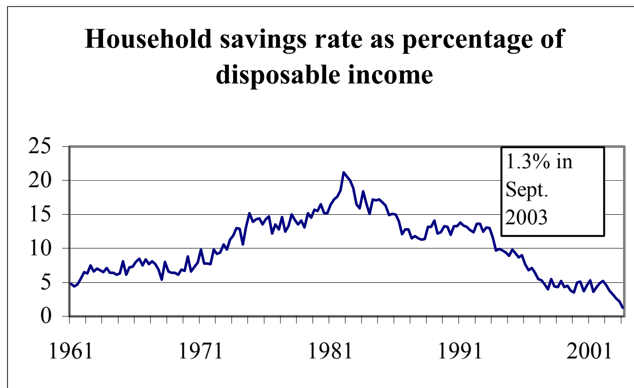
RECORD DEBT

To support growth, the Bank of Canada is relying on households, whose level of debt has risen from 70% of disposable income in 1985 to 115% today. All experts agree that raising interest rates would have serious implications for households and by extension for the economy. In this context, easing the monetary policy gives a helping hand to households. For the time being, as long as households are able assume their debt servicing costs (7.5% of disposable income today, as compared with 12% in 1990), the worst can be avoided.

Household debt has increased dramatically over the last few years because of short-term interest rates, which stand at their lowest rate in 40 years. Higher prices for housing, and aggressive marketing in the automotive industry and in the bank loans sector, also explain the increase.

SAVINGS RATE OF 1.3%: AN ALL-TIME LOW!

Over the short term, ironically, it is the savings rate, not the debt load, that is of concern. In the third quarter of 2003, the savings rate fell to 1.3% of households' disposable income. This historical low threatens economic growth. As the savings rate can hardly go any lower, it is likely that household savings will be rebuilt, resulting in reduced household consumption.



Source: Statistics Canada (graphic produced by the Parliamentary Research Branch, Library of Parliament).

The simulation below (see table) shows, for instance, that an increase of 0.5% in the household savings rate – from 1.3 to 1.8% – would result in a reduction of approximately 0.5% in consumer spending, meaning that the rate of growth in consumer spending would fall from 3.5 to 3%. Given the current low level of the savings rate, such an increase is plausible, and it could well be even higher (+2%).

Impact of an Increase in the Savings Rate

Savings Rate (Variation)	Increase in Consumer Spending*	Contribution to Economic Growth (Percentage Points)
1.8 % (+0.5)	3.0 %	1.8
2.3 % (+1.0)	2.5 %	1.5
2.8 % (+1.5)	1.9 %	1.1
3.3 % (+2.0)	1.4 %	0.8

Source: Library of Parliament, Parliamentary Research Branch.

* Compared to a level of 3.5% over 12 months if the savings rate remains unchanged, that is, at 1.3%.

THE DILEMMA

The Canadian and North American economies are faced with a dilemma: how can household debt be reduced (or at least not made worse) without impairing economic growth? A lower interest rate certainly makes household debt easier to bear, but it only delays finding a solution to the problem. While part of the debt can be attributed to asset acquisition (real estate, securities), the fact remains that Canadian household consumer debt represents the equivalent today of 27% of households' disposable income, as compared with 22% in the United States. This is a disquieting situation, and households will have to get out of it by increasing their savings rate over the short or medium term.