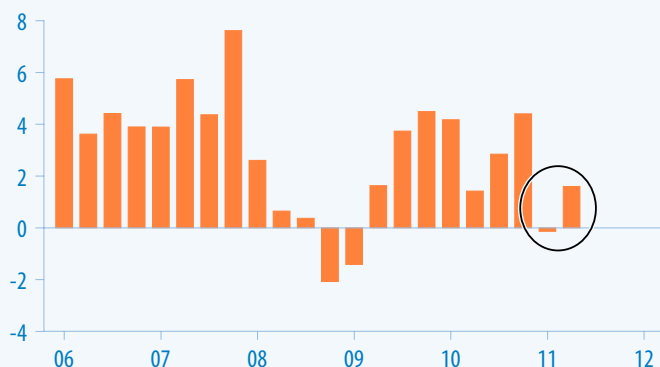


**CHART 1
STEPPING DOWN**

Canada (q/q % chng : a.r.)

Real Consumer Spending

**TABLE 1
CONSUMER SCORECARD**

| | Bogey | Birdie |
|----------------|---|---|
| Credit | <ul style="list-style-type: none"> High debts New mortgage rules | <ul style="list-style-type: none"> Low borrowing costs Presumed non-restrictive lending standards |
| Income | <ul style="list-style-type: none"> Slower job growth ahead Modest wage growth | |
| Spending power | <ul style="list-style-type: none"> High gas/food prices | <ul style="list-style-type: none"> Strong loonie |
| Wealth | <ul style="list-style-type: none"> Recent softer equity prices Expected softer house prices | |
| Confidence | <ul style="list-style-type: none"> Global recession fears | <ul style="list-style-type: none"> Low interest rates Low jobless rate Lower inflation |
| Pent-up demand | <ul style="list-style-type: none"> Limited | |

**CHART 2
EASY DOES IT**

Canada (% : balance of opinion on lending conditions for nonfinancial firms)

Senior Loan Officer Survey


Can Canadian Consumers Carry That Weight?

Sal Guatieri, Senior Economist

Lured by low interest rates, Canadian shoppers splurged last year, pulling the economy resoundingly out of recession. However, fatigue is setting in amid rising gas prices and mounting debts, even as other sectors show few signs of picking up the slack. Exporters face weak global demand and a strong currency. Fiscal stimulus is fading and will turn to restraint next year. The hot housing market is starting to cool (not such a bad thing). To be sure, business spending remains strong amid high resource prices and competitiveness pressures. However, its modest 11% share of GDP and heavy reliance on imports relegates it to a supporting role in the expansion. Indeed, the fastest capex in 15 years (31% a.r.) could not prevent the economy from shrinking in Q2. The spotlight will remain on consumers, who account for 57% of GDP, to lead the expansion. But are they up for the challenge?

After solid 3.3% growth in 2010 (a half ppt. faster than the two-decade norm), consumer spending downshifted to an average 0.7% annual rate in the first half of 2011 (*Chart 1*). The weakness was widespread, led by declines in motor vehicles, household appliances, recreational services, and food. While retail sales rose sharply in June, this reflected an incentive-driven increase in auto sales, which appears to have reversed in July. All in, consumer spending growth looks to remain below 2% in the current quarter.

As Table 1 suggests, consumers will be pulled in two opposite directions in the year ahead:

Credit: The cost and availability of credit should remain supportive well into 2012. The central bank is expected to keep overnight rates at 1% until next summer, before tightening gradually. While new mortgage insurance rules have slowed refinancing activity, lending standards have eased for businesses post-recession and, presumably, for households (*Chart 2*).

Consumers can't help but feel like kids in a candy store. **But they will need to show a little restraint in the face of grown-up obligations.** Household debt has hit a record-high 147% of disposable income, with the ratio soaring 40 ppts in

CHART 3
BORROWED TIMES

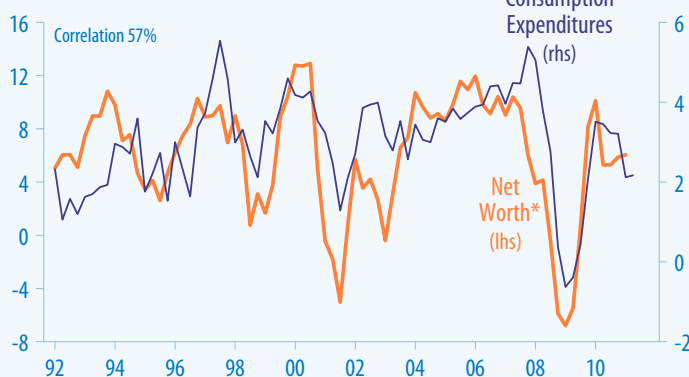
Canada (y/y % chng)

Household Credit



CHART 4
WEALTH EFFECT

Canada (y/y % chng)



* of persons and unincorporated businesses

the past decade. While the debt burden appears manageable—with servicing costs only modestly above the decade norm—a further sharp increase could strain household finances, especially when interest rates rise. High debt should tether borrowing to income growth in the 4%-to-5% range in 2012. Indeed, many shoppers have already lost their sweet tooth for credit. Household loan growth slowed to 6.3% y/y in June from the unsustainable 9% pace of the past decade, and consumer loan growth has more than halved to 3.7% (Chart 3). While residential mortgage growth remains elevated at 7.4%, it is expected to ease as housing markets normalize.

Income: Although job growth has stayed healthy this year (up 1.2% to July), it is expected to moderate as companies focus on productivity in the face of a strong dollar and soft global demand. Meantime, wage growth (of below 2% y/y in July) should remain subdued, with full employment likely more than a year away. The resource-rich provinces—Alberta, Saskatchewan, Newfoundland & Labrador—should see stronger job and income prospects than other regions, to the benefit of their shoppers.

Spending power: Gasoline and food costs could drift modestly higher in the year ahead, taking a bite out of purchasing power. However, Canadians can anticipate cheaper foreign-made goods, courtesy of an expected firmer loonie next year, though that's not necessarily a net positive for the economy.

Wealth: Rising house and stock prices lifted household net worth to record highs in Q1, supporting consumer spending (Chart 4). However, recent weaker equity markets (with the

TSX down 5% y-t-d) and expected softer house prices point to a waning wealth effect. Though up sharply from a year ago, house prices have levelled off since February, and are likely to ease modestly next year.

Confidence: After remaining near long-run norms for most of the year, consumer sentiment has ebbed in the face of global economic fears. However, expected low interest rates and receding inflation, coupled with relatively low unemployment, should buoy consumer spirits in the year ahead.

Pent-up demand: Elevated household debt and a consumption share of GDP that is slightly above the four-decade norm suggest consumers have limited pent-up demand.

The Bottom Line: Expect a middling performance from Canadian consumers through 2012. With the weight of the expansion on their debt-laden shoulders, shoppers will be walking rather than running to the stores. The economy should move at a similar 2%-to-2½% gait, with freer spending businesses offsetting tighter fisted governments.

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