ECONOMIC VIEWPOINT

Higher Interest Rates Are Having an Uneven Effect on Canadian Households

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Many Canadians are under serious pressure as they face high inflation, high interest rates and high debt levels. The economic accounts indicate that, on average, household disposable income and consumption expenditures are up, which has allowed the household saving rate to remain higher than it was before the pandemic. But a breakdown of the data reveals growing disparities between households. Annual savings for higher-income households peaked in 2023, but wage growth hasn't kept up with the rising cost of household consumption expenditures for the three lower income quintiles.

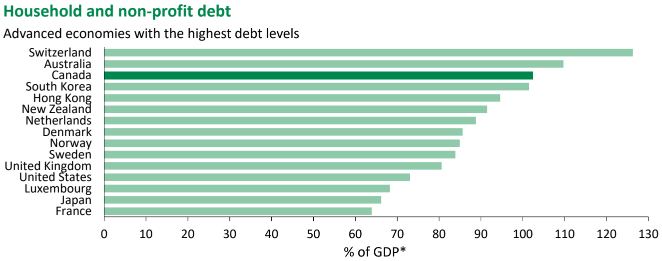
In the coming quarters, the financial pinch could get worse for many households as they renew their mortgages at higher rates—even if the Bank of Canada (BoC) continues to loosen its monetary policy. The higher cost of servicing debt can make households more vulnerable to economic and financial stress. To get a better understanding of these vulnerabilities, it's useful to look at how debt is distributed among households in various income quintiles.

Canadians Are Struggling with Some of the Highest Household Debt Levels in the World and a Historic Spike in Interest Rates

The BoC recently cut its policy interest rate, kicking off what is expected to be a gradual cycle of reductions. But at 4.75%, the key rate is still high from a historical perspective. This cut comes after a period of aggressive monetary tightening, both in terms of scope and speed, during which the policy rate shot up from a low of 0.25% in March 2022 to 5.00% in July 2023—all while Canadians found themselves saddled with some of the highest levels of household debt among advanced economies (graph 1). In Canada, more than half of all debt (mortgage and consumer) is carried by households in the two highest income quintiles (graph 2). That said, 45% of total debt is held by households in the three lower income quintiles, whose share of Canada's mortgage debt has been growing since 2019 (graph 3 on page 2).

The debt-to-disposable-income ratio is a lot higher for this group and particularly for people who are still working, as retirees

Graph 1
Canada Has the Third-Highest Household Debt in the World



* Calculated as a percentage of GDP at purchasing power parity, data from Q4 2023.
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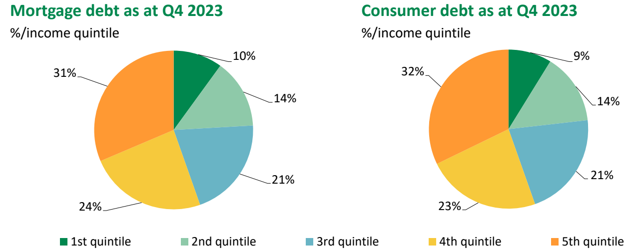
Graph 2
Most Canadian Debt Is Attributable to the Top 2 Income Quintiles



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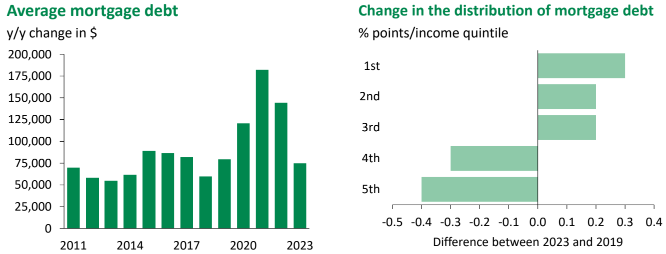
Graph 3
The Share of Mortgage Debt Held by Lower-Income Households Has Risen since 2019



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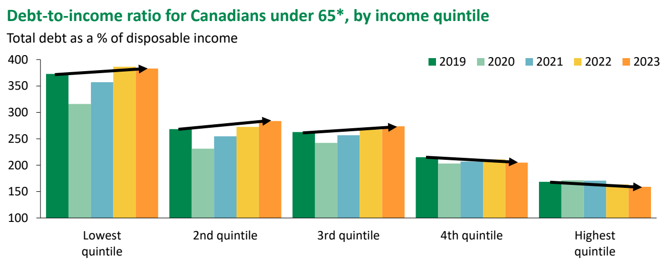
are more likely to have already paid off their debts. In the first three income quintiles, people under the age of 65 not only have a higher debt-to-disposable-income ratio, but they've seen this ratio go up since 2019 (graph 4). The debt service ratio is markedly lower for people ages 65 and over, but it also recently increased, surpassing its previous peak (graph 5).

Since households don't rely on a single year's income to pay off their debt, the debt-to-income ratio isn't the most important factor in determining households' financial vulnerability. What matters is that households have enough money to cover the cost of servicing their debt. The recent rate hike cycle led to a substantial increase in the share of income allocated to minimum interest payments. Across all income quintiles, the average percentage of disposable income dedicated to interest payments is much higher than it was before the pandemic. The proportion has gone up even more sharply for households in the lowest income quintile, who allocated more than 18% of their income to interest payments in 2023 (graph 6). However, to get a better idea of how households are faring from a financial standpoint, and how prepared they are to withstand an economic shock, we need to consider the other side of the balance sheet: their assets.

Canadians Have as Much Liquid Assets as Liabilities

If households find that debt payments start eating too much into their income, they could theoretically liquidate some assets to pay back what they owe. Certain assets, such as life insurance policies, annuities and non-financial assets, can't be sold quickly. But even if we only consider Canadians' more liquid assets, like currency and deposits, on average these holdings outweigh their total liabilities—and this is true in all income quintiles (graph 7). The average by income quintile is an imperfect measure when it comes to identifying the most vulnerable households, as many individuals with low incomes also have low levels of debt. Dividing the population by quintile of accumulated wealth yields a slightly different result. By this definition, the lower quintile has a negative wealth on average, meaning that total assets are less than the total liabilities for this group. If we look specifically at more liquid assets, then only the top two quintiles in terms

Graph 4
Households in the 3 Lowest Income Quintiles Now Have a Higher Debt Ratio than before the Pandemic



* People ages 65 and over have been excluded to limit the bias between debt and retirement income.
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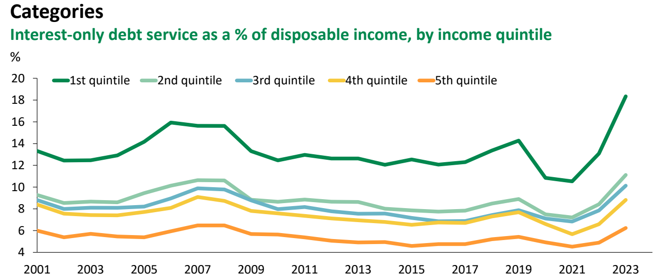
Graph 6
Debt-Interest Costs Have Gone Up for Households in All Income Categories



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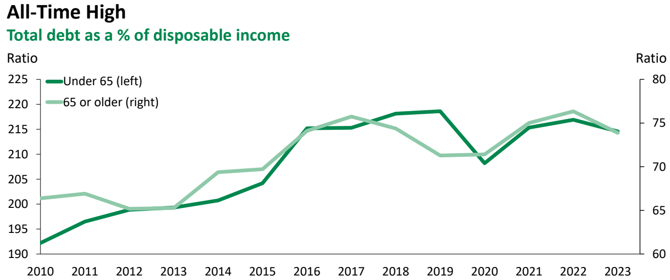
Graph 5
Senior Families Have Seen Their Debt Levels Fall, but They Remain at an All-Time High



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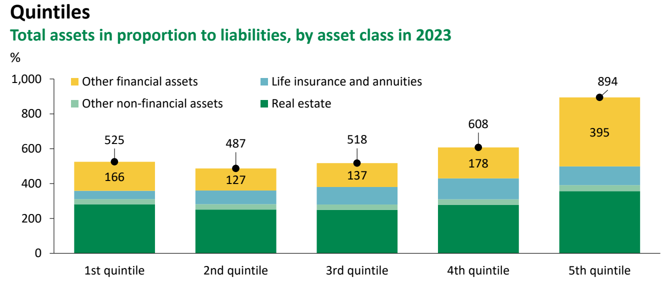
Graph 7
On Average, Assets Outweigh Liabilities for Households across All Income Quintiles



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of wealth have other financial assets greater than their debt on average.

While people may find it reassuring to know they can draw on their accumulated wealth to get through financial tough times, the ideal scenario is to earn enough to cover household expenditures and debt payments, with some left over for savings. Any changes to these variables serve as a good indicator of the pressure that households face as they deal with a budget pinch.

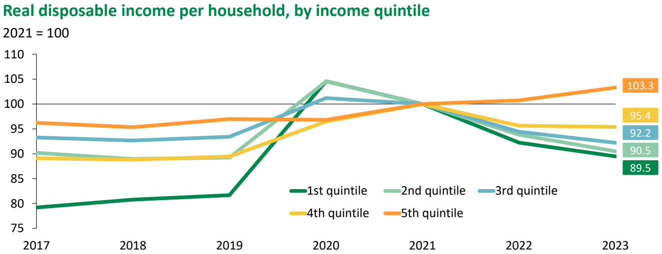
Real Disposable Income Has Declined for All Canadians except Those in the Top Income Quintile

Since 2021, only the wealthiest households have seen their real disposable income go up (graph 8), and the income gap between this group and the rest of the population reached a record level in 2023 (graph 9). One of the reasons behind this growing disparity is that higher interest rates affect income distribution, benefitting the rich. Since the monetary tightening cycle began, the returns on savings products have more than offset the increased interest payments for households in the top quintile (graph 10).[1]

Graph 8

Since 2021, Real Income Has Fallen for All Canadians except Those in the Top Quintile

Real disposable income per household, by income quintile



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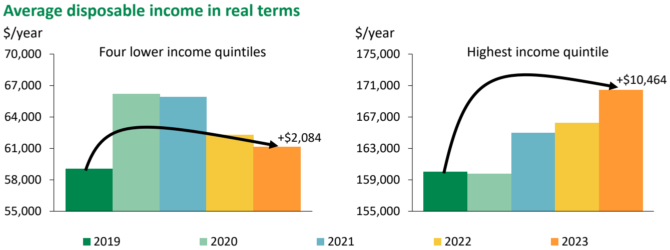
Graph 9

The Gap Is Growing between the Top Income Quintile and the Rest of the Population…

Average disposable income in real terms



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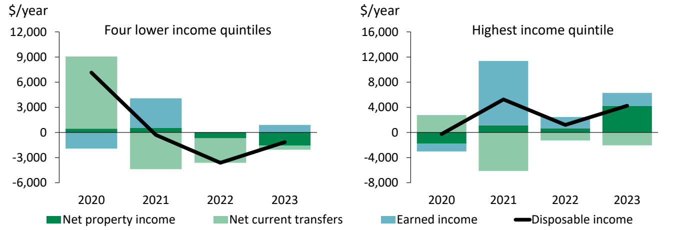
Graph 10

… and the Disparity Is Increasingly Attributable to the Effect of Interest Rate Hikes

Change in average disposable income in real terms



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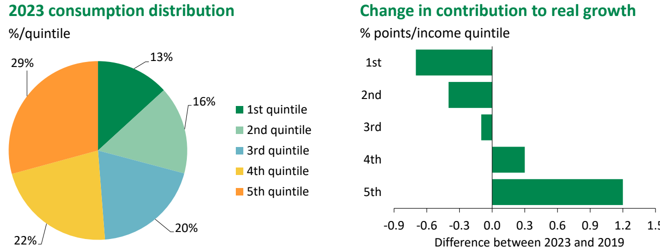
These findings clearly illustrate the previously described vulnerabilities, as households with lower debt ratios are the most likely to experience a rise in income—which they can use to bolster their spending, service debt or grow their wealth.

Lower-Income Canadians Spend Mainly on Necessities

Consumption is more evenly distributed across the population than income or assets. Households in the three lower income quintiles made up 60% of the population and accounted for 49% of consumption expenditure in 2023 (graph 11). Changes in the average consumption expenditure reflect changes in the cost of everyday needs, such as housing, transportation and food. Since these expenses are relatively incompressible, their contribution to total consumption growth has remained stable over time for all income quintiles. In contrast, consumer discretionary spending is more volatile. In 2023, real consumption declined as households across the board cut back on discretionary spending (graphs 12 and 13 on page 4).

Graph 11

Lower-Income Households' Contribution to Spending Growth Has Fallen since 2019



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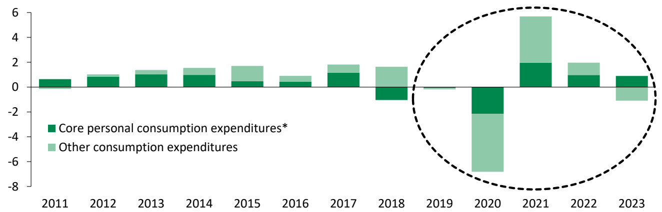
[1] Net property income includes, among other things, investment income as well as interest payments linked to credit products and thus captures the effect of interest received and paid by households.

Graph 12
Household Spending Growth Is Driven by Core Needs…

Contribution to growth by expense type

% points in real terms



* Include housing, transportation and food costs.
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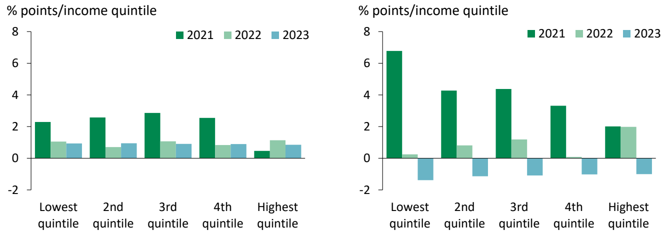
Graph 13
… and This Type of Expense's Contribution to Total Expense Growth Is More Stable than Other Expenses

Core expenditures* – contribution in real terms

% points/income quintile

Other expenditures – contribution in real terms

% points/income quintile



* Include housing, transportation and food costs.
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Even though core personal consumption expenditures make up a similar proportion of total consumption across all income brackets, this expense segment is overrepresented in the budgets of households in the lower income brackets. In fact, this group spends all of their disposable income on core personal consumption expenditures (graph 14). As a result, they're not only unable to save, they're also more likely to have to take out loans because their other consumption expenditures, while compressible, aren't zero. Being able to save allows people to prepare for their financial needs at every life cycle stage, whether it's pursuing a post-secondary education, buying a home, starting a family or enjoying a comfortable retirement. If households are unable to save, they may be forced to postpone major life decisions. Putting money aside is the key to building wealth over time and to transferring wealth from one generation to the next.

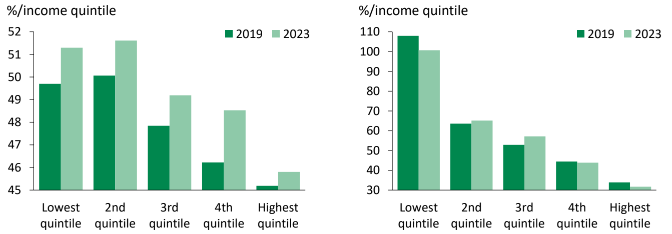
Graph 14
Share of Core Personal Consumption Expenditures*…

… in household spending

%/income quintile

… in disposable income

%/income quintile



* Include housing, transportation and food costs.
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Dis-Saving Is Worsening for 60% of the Canadian Population

Soaring interest rates and cost of living have crimped Canadian households' ability to save. But there are major disparities between income brackets. For example, since 2020, households in the top 40% of disposable income distribution have been able to save more per year, while net dis-saving has gotten worse for the remaining 60% of the Canadian population, as their income hasn't kept up with the rising cost of living (graph 15). After accounting for inflation, the wealthiest households saved, on average, more than $35,000 each in 2023. This growth in annual savings is primarily being driven by younger people (i.e., those under the age of 45). One explanation for this is that younger households need to save more in order to get into the housing market. As we presented in various analyses, including a series of studies on youth, housing is much less affordable for today's younger adults than it was for previous generations, and the effect of this issue could start to show up in the data. In recent quarters, mortgage balances have fallen for households under the age of 45, regardless of income, while the total has risen by $75 billion over the same period (graph 16). This finding

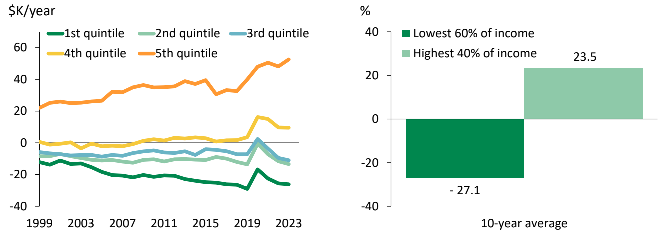
Graph 15
Annual Savings for Households with the Highest Income Has Reached a Record High

Savings in real terms

$K/year

Average saving rate

%



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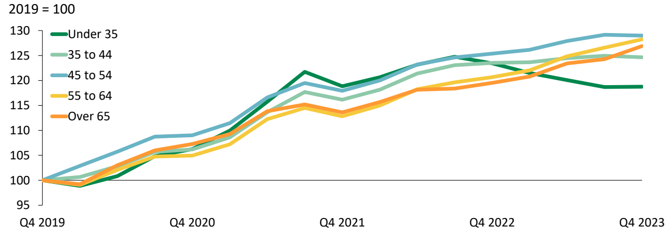
Graph 16
Younger Households' Mortgage Debt Is Declining

Mortgage debt by household, by age group

2019 = 100



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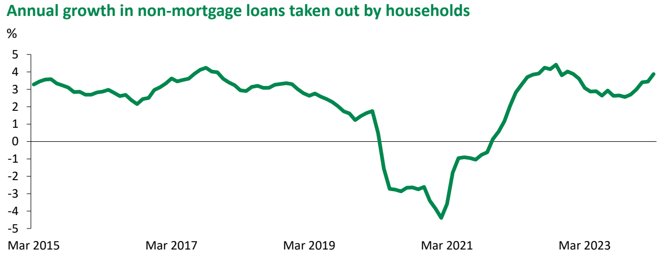
highlights the fact that buying a home remains out of reach for many young families.

A Fragile Situation

A detailed analysis reveals that a minority of households is behind Canada's high savings rate. This may be worrisome, considering that between 2019 and 2023, households in the three lower income quintiles increased their share of mortgage debt and that rising interest rates have made it substantially more expensive to service this debt. The recent rise in the cost of living means some households are already having to make tough choices to meet their financial obligations. There are limited options for making ends meet; households can curb their spending, take on more debt or make debt repayment a priority. These behaviours are reflected in recent data. While real consumer spending fell on a per capita basis in 2023, credit market debt growth accelerated for a fifth consecutive month in March 2024 (graph 17), and the 60-plus delinquency rate for non-mortgage loans returned to its 2019 level (graph 18). That said, the household insolvency rate remains below 2019 levels, indicating that households are currently managing to avoid severe financial distress. However, the situation remains fragile as many Canadians will be renewing their mortgages in the next 18 months, which means they have yet to experience the full effect of high interest rates. The most indebted Canadians will get some relief as interest rates gradually come down over the next few quarters, but income will also have to go up in order for them to absorb the shock.

Graph 17
Non-mortgage Debt Continues to Climb

Annual growth in non-mortgage loans taken out by households



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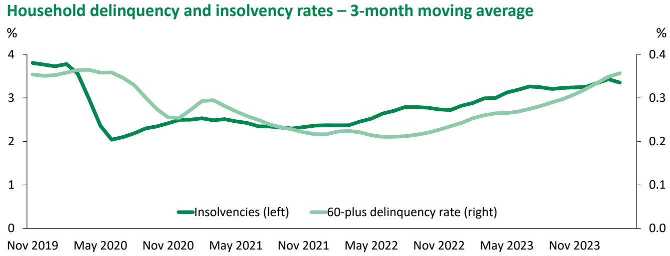
Graph 18
Delinquencies Are on the Rise, but the Insolvency Rate Remains below 2019 Levels

Household delinquency and insolvency rates – 3-month moving average



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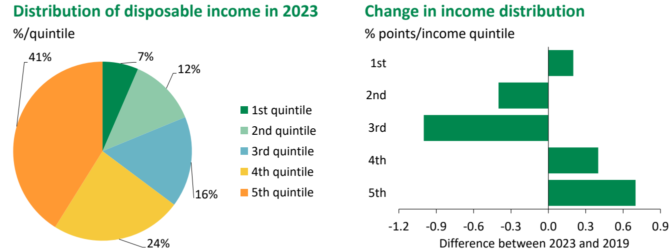
An increase would be particularly welcome for the lowest income households, as the gap between the poorest and richest Canadians continues to widen. Households in the three lower income quintiles make up 60% of the population, but just 35% of income and assets belong to them (graphs 19 and 20). They also spend money and take on debt in proportion to their demographic weight. This is the direct result of the findings outlined above, indicating that households in the lower-income brackets either have negative real savings or a higher debt ratio. This population is therefore more vulnerable to various economic or financial shocks, a situation that threatens broader financial stability. That's why this issue must be addressed, ideally by improving income for the demographic groups in question.

Graph 19
The Share of Disposable Income Earned by Lower-Income Households Has Declined since 2019

Distribution of disposable income in 2023 | Change in income distribution



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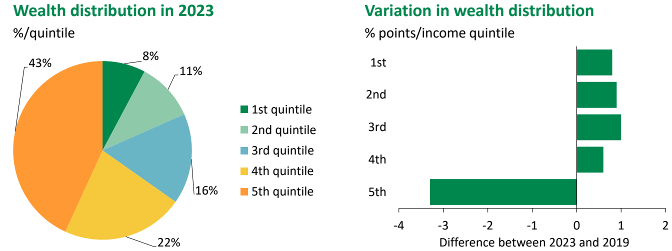
Graph 20
Low-Income Canadians Are Underrepresented in the Distribution of Household Wealth, but Their Share Has Increased since 2019

Wealth distribution in 2023 | Variation in wealth distribution



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How Can We Make Lasting Improvements to the Incomes of Financially Vulnerable Groups?

In today's environment marked by high inflation, margin pressures on businesses and deteriorating public finances, governments need to take measures that will effectively and sustainably address income inequality.

Investing in training or retraining is one of the best ways to prepare the workforce for the most in-demand occupations and those with the best compensation prospects. A good example of this is outlined in our recent analysis on gender inequality.

As a demographic group, women experience severe income inequality compared with men. To reduce these gaps, we need to increase women's representation in high-growth, high-income industries. For instance, the science, technology, engineering and mathematics (STEM) sectors are expected to grow faster than other fields due to digital transformation initiatives and the transition to clean energy. Channelling more women into these sectors could increase their income and, as a result, boost household incomes overall. We also need to pay more attention to other groups, such as Indigenous people and immigrants, that also face significant income gaps compared with the rest of the population. The measures in place to support the income of people unable to work and the elderly also remain essential for supporting more vulnerable households.

Supporting Real Income by Limiting Rising Housing Costs

While they don't directly influence incomes, housing-related issues have a major impact on the standard of living for financially stretched households. Measures promoting housing affordability and supply can help Canadians in the lowest income quintiles who already spend a substantial share of their budget on housing. Improving the overall supply of residential units can also help limit the rise in house prices, which will have a beneficial impact on household indebtedness. The federal government's new housing plan is a step in the right direction, but it remains to be seen whether it will be sufficient to resolve the current housing crisis in Canada. Shelter cost inflation reached 6.4% in May 2024, while rented accommodation inflation alone stood at 8.6%, a peak not seen since 1983. Limiting the rise in these costs could help bolster real income for households for whom housing is the main expense.

Productivity Gains Are a Key Factor in Raising Incomes

Governments also need to encourage businesses to invest in worker upskilling and reskilling so that these individuals can be more versatile and productive, and access better-paying jobs. Even though the overall job vacancy rate has fallen, many businesses are still having a hard time filling specialized positions. This proves that governments need to review the programs set up in recent years to see if they're delivering the desired results. Another priority should be supporting entrepreneurship. For example, immigrants start more businesses than the Canadian-born population, but they often face obstacles when trying to grow their enterprises. (See our note on the economics of youth for more information.) By providing Canadian-born and foreign-born business owners with the support they need, we could help them earn more and grow their wealth faster.

In light of Canada's current demographic trends and productivity challenges, it makes sense to address gaps in opportunity and income. Doing so will improve financial security for households and lead to a more stable and prosperous future for Canada.