Debt loads are soaring

$22,000 per capita and counting

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Canadian consumers marked a major indebtedness milestone this year. For the first time, the debt-to-income ratio passed 100%. That means the average Canadian now owes more -- 0.1% more, to be precise -- than they are earning. It also means that if the economy heads south and they lose their jobs, or if interest rates spike, bankruptcy looms for many.

Already, 90,000 Canadians go broke every year, says Frank Bennett, bankruptcy lawyer and author of Bennett On Going Broke. That's twice the level of 20 years ago. With the spread between low deposit rates and high credit card rates near record highs, bankruptcies will continue to rise, he predicts.

A real Canadian debt crisis could be sparked by more ominous trouble brewing south of the border. Even two-income American families are declaring bankruptcy in record numbers, argues Elizabeth Warren in her book, The Two-Income Trap. She blames credit card companies for dangling temptation before those least equipped to resist it.

Credit cards are the bane of Canadians too, representing the leading cause of bankruptcy here. But we also carry significant amounts of debt in mortgages, car loans and lines of credit. Total consumer debt reached a record $204.3-billion in 2002, according to Statistics Canada. Mortgage debt hit an all-time high of $491.2-billion, for a combined total just shy of $700-billion. That's double what Canadian consumers owed in the late 1980s.

While mortgage rates are half that of credit cards, homes still account for the lion's share of indebtedness in Canada. The mortgage debt-to-income ratio of 69.5% in 2002 is below the all-time high of 70.9% reached in 1997. But the consumer credit debt-to-income ratio of 28.9% has never been higher.

The scary statistics just keep on rolling. Household debt in Canada is now $22,078 per capita, startling but still better than the US$29,000 in the United States. The higher U.S. figure may be one reason why more American pundits are sounding the alarm on debt. Throughout the roaring 1990s, American savings fell as debts soared.

Unlike the Chinese, who save up to 30% of their incomes, the average American now saves nothing at all. Lured by tax deductions on mortgage interest, Americans continue to borrow on their homes to gamble on the stock market. As a result, the U.S. economy is being "crushed by an unprecedented debt load," says superbear Nick Guarino in his newsletter, The Wall Street Underground.

The American consumer is 333 times more in debt than in 1943, Guarino says. Combined with corporate and federal debt, the total is US$34-trillion, or a US$119,000 IOU for each and every U.S. citizen. (Comparable Canadian figures are slightly less frightening. Total debt across the Canadian economy is $2.1-trillion, or $67,140 per capita, says Pat O'Hagan, director of the income and expenditure accounts division of Statistics Canada.)

The doomsayers worry about what will happen if such debts are repudiated, as occurred in the 1930s. "All debt must be paid off, refinanced or reneged on. I think we'll see a mixture of all three," says Richard Russell, editor of newsletter Dow Theory Letters. "When this economy runs out of gas, handling the giant edifice of U.S. debt will become a crushing problem."

Even the respected and usually optimistic Sir John Templeton cautions that the massive debt levels spell trouble. The 92-year-old investing legend warns that the U.S. dollar may correct by 40% and real estate may be the next bubble to deflate.

"I am worried about the record debt," he told reporters, because highly leveraged homeowners can ill afford a plunge in the value of their main investments. Few people "grasp the lasting damage and corrective impact which will continue to linger from the greatest financial crash in world history," Sir John said, referring to the post-bubble plunge.

Admittedly, such views aren't shared by mainstream economists and professional optimists like mutual fund managers.

But Guarino, who views Wall Street as a pied piper luring investors to certain destruction, believes the stock market debacle of 2000 to 2003 was just the prelude to a coming widespread repudiation of debt. He warns bond investors could suffer losses if interest rates start skyrocketing, bringing bond prices down and leading some companies to renege on their corporate debt.

If rates start to move up, as they did in late summer, homeowners with variable-rate mortgages and those paying only monthly minimum payments on credit cards will soon feel the pain.

Guarino's top recommendation is: "Get out of all debt now."

Debt repayment is always a prudent investment, but it's doubly so in this era of low interest rates and single-digit equity returns. There are no mutual funds that can deliver a guaranteed after-tax return of 12% to 18% -- the return you get for eliminating credit card debt.

Any disposable income should be deployed in this order: pay off credit cards, then car loans and lines of credit, and finally the mortgage. Interest paid on traditional long-amortization mortgages can end up doubling the original purchase price of the home. Increase your payments and their frequency so at least half goes to reducing the principal.

Once debt-free, start saving: first inside RRSPs, then in non-registered plans. If there is any debate on priorities, it's only between paying off mortgages and building RRSPs. Many two-income families do both simultaneously. For the less flush, a compromise is to make the RRSP contribution and apply the resulting tax refund to paying down some of the mortgage.

If the economy lags and job loss strikes, the debt-free have an easier go of it. If stocks and real estate fall, those with cash scoop up bargains and profit mightily when boom times return.

Those still in the hole must get serious about credit cards. If addicted to plastic, switch to debit cards, which provide only cash you've already earned. As Guarino puts it, "When a debit card says no, that means no, because you don't have any more money in the account."

Credit-counselling bureaus in most major cities can help. They'll tell you to rip up all but one major card and consolidate debts into one lower-interest bank loan. "The credit counselling system does very well in terms of rehabilitating consumers, but we need broader education," Bennett says. "It has to go back to the schools: to teach how to be far more responsible."

CANADIANS OWE MORE THAN THEY EARN: Debit to income ratio:

1993: 88.3%

1994: 89.6%

1995: 90.5%

1996: 92.9%

1997: 95.0%

1998: 95.4%

1999: 96.5%

2000: 94.4%

2001: 96.7%

2002: 98.4%

2003: 100.1%

Source: Statistics Canada, National Post

Consumer credit, outstanding balances of selected holders, compounded annual total (in millions of dollars).:

2002: $2.6 trillion

2001: $2.5 trillion

2000: $2.3 trillion

1999: $2.0 trillion

1998: $1.9 trillion

1997: $1.7 trillion

1996: $1.5 trillion

1995: $1.4 trillion

1994: $1.3 trillion

1993: $1.2 trillion

Source: Bank of Canada