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Opinion **Lex**

Canada: Debt of a Nation

Watch the debt service ration to get a clear view of possible trouble ahead

Betting against Canada's banks has long been a mug's game. Every so often, a hedge fund manager in a fleece vest will pitch up in a big Canadian city, observe the high density of cranes and fast cars, then start positioning for a collapse of the property-led debt binge. Meanwhile the likes of Toronto-Dominion and Royal Bank of Canada have kept grinding higher.

But for how much longer? Four increases in the Bank of Canada's benchmark interest rate over the past year are beginning to bite. The country's debt service ratio — total obligated payments of principal and interest as a proportion of household disposable income — has been steady for about a decade, at just under 14 per cent. But the BoC has implied that it expects the ratio to rise to 14.9 per cent next year, according to calculations by ***Veritas***, a Toronto-based research house. That would match the all-time high of 2007. The Parliamentary Budget Office has gone further, predicting a ratio of 16.3 per cent by 2021.

Historically, there has been a roughly two-year lag between rises in the ratio and a deterioration in credit quality. ***Veritas*** reckons the cycle will be shorter this time, compressed by higher absolute stocks of debt and a new accounting standard forcing banks to provide for expected losses earlier.

Meantime, the housing market is wobbling. A new stress test has made mortgages tougher to get, while foreign money has been beaten back by higher taxes. Last month saw a record low 111 single-family home sales in Vancouver.

Real strains in banks' loan books may not be imminent. Fourth-quarter results next month are expected to show consumer portfolios in mostly rude health. But watch that debt service ratio, which has been a better guide to trouble ahead than traditional metrics such as unemployment. If it keeps climbing, losses will follow. And Canadians will no longer be able to chuckle about all those dumb foreigners getting it wrong.