



## The impact of the financial crisis in Canada

There's no missing it: the global financial crisis is on everybody's mind and creates a lot of worries. Over the last few weeks, there have been multiple bankruptcies among banks (mainly in the U.S. and Europe), major market corrections, vigorous government action, a lowering of key interest rates and a host of unconventional measures on the part of central banks. Nothing works and the effects of the crisis on credit terms just heighten the risks of a recession everywhere on the planet. Of course, Canada is not immune to this sluggish climate. The *Economic Viewpoint* shows that even if the economic outlook has darkened, Canada benefits from noticeable advantages. Generally Canadian financial institutions are in an enviable financial position and the risks of a major correction in real estate prices remain limited. In these conditions, Canadians need to keep a cool head, which does not mean that they shouldn't be asking themselves if their investment strategy is still right.

### THE FINANCIAL CRISIS IS ROCKING THE PLANET

Even if the U. S. is at the root of the current financial crisis, all financial markets are being affected by it. Stock indexes have lost a lot of ground over the last few weeks, federal bond rates are falling and most currencies are depreciating against the U.S. dollar. Despite the adoption by the Senate and the House of Representatives of the U.S. bailout plan, uncertainty remains as problems in financial institutions cross U.S. borders, particularly into Europe. In addition, worries are now focused on the consequences of this financial crisis and the economic outlook for the United States and the rest of the world. So in these circumstances, what are the impacts for Canada?

### CANADIAN FINANCIAL INSTITUTIONS SEEM IN BETTER POSITION

First off, let's be reassuring: on the whole, the financial position of the main Canadian financial institutions is relatively sound. A recent study by the *World Economic Forum* ranks Canada first in the world for the soundness of its banking system. Risks of defaulting or declaring bankruptcy are extremely low in Canada. This is reflected in part by a business model that is different from that of U.S. banks. In addition, the concept of an investment bank is for all purposes non-existent in Canada, as the major Canadian financial institutions are all-round organizations providing

services both to individuals and businesses. Bear in mind that the investment banks are mostly the ones that have been going through major difficulties in the United States.

Canadian financial institutions are in a much better position than their American and European counterparts with respect to their degree of exposure and indebtedness. According to the governor of the Bank of Canada<sup>1</sup>, major Canadian banks have an average asset-to-capital ratio of 18. The higher the ratio, the more the assets owned by a bank were acquired through indebtedness rather than through an influx of equity. In effect, it is a measure of a financial institution's indebtedness level and its exposure to the leverage effect. Bear in mind that the Canadian regulatory system requires that organizations have no more than a multiple of 20. The equivalent ratio among American investment banks is over 25, while that of European banks is approximately 30 and the ratio of the largest banks in the world is over 40. This position benefits Canadian financial institutions and minimizes capitalization risks, which lessens the threat that access to credit be restricted.

<sup>1</sup> See Governor of the Bank of Canada Mark Carney's speech for The Canadian Club of Montreal on September 25, 2008.

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The main problem of U.S. banks, i.e. a high exposure to subprime mortgages in a context of a widespread drop in real estate prices, is practically non-existent in Canada. On the one hand, Canadian financial institutions' exposure to U.S. subprime mortgages has already been disclosed for the most part and the losses absorbed. Subprime mortgages were only just beginning in Canada when the crisis surfaced in the summer of 2007. At that point, Canadian financial institutions put a damper on this type of growth limiting their exposure to this type of product. In addition, you cannot get 40-year mortgages in Canada from now and you have to put down 5% to buy a property.

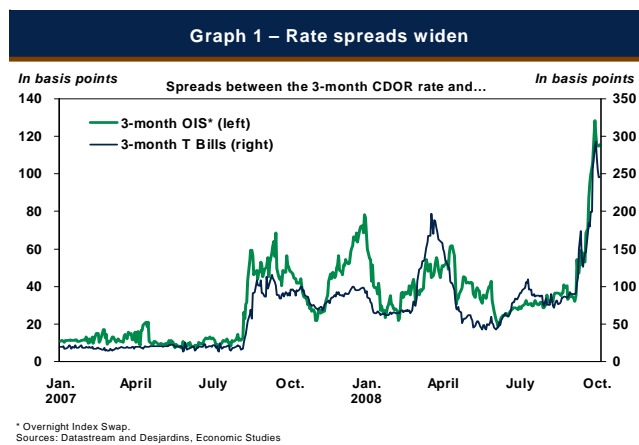
The situation of the real estate market is also very different between the two countries. While the U.S. market is experiencing significant price drops as well as increases in defaults, the Canadian real estate market situation is much sounder<sup>2</sup>. While some regions are going through a minor decline, most large Canadian cities still benefit from moderate growth in real estate prices. Price increases over the last few years were mostly attributable to catch-up increases following excess demand accumulated over the 90s. In addition, subprime mortgages clearly did not inflate the Canadian market as they did in the United States. So the odds of a major real estate price correction remain low in Canada.

In fact, there is very little risk that our governments will be forced to take action to save a financial institution, as was recently the case in the U.S. and Europe. That said, the Canadian government is not sitting back. It recently announced that it wanted to buy up to \$25B worth of blocks of insured mortgages under the *National Housing Act*. These purchases, carried out through the *Canada Mortgage and Housing Corporation (CMHC)*, will help financial institutions secure long-term funds. In addition, the Bank of Canada massively injected liquidities while broadening the range of securities held under resale agreements to help financial markets run smoothly. They also reached swap agreements with other central banks and issued additional Treasury bills. In addition, in a coordinated move with other central banks, the Bank of Canada recently cut its key interest rates by 50 basis points to support the Canadian economy in a time of crisis.

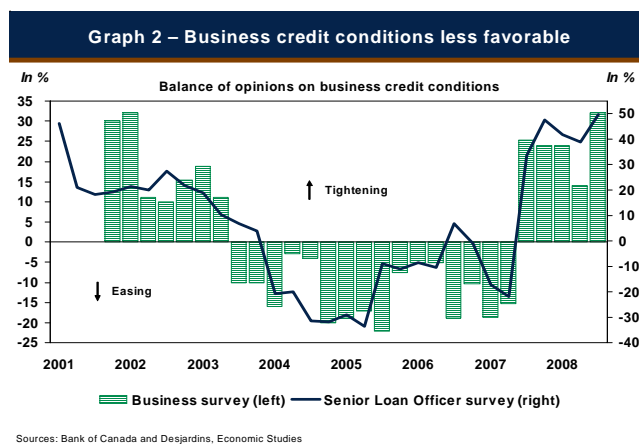
**FINANCIAL INSTITUTIONS ARE NOT HOWEVER COMPLETELY SHIELDED**

All the same, Canadian financial institutions are not completely immunized against the effects of the financial crisis.

One of main impacts of the current financial crisis is the greater scarcity of liquidities in global financial markets. For Canadian financial institutions, this means more difficult and costlier access to capital. For instance, the spread between the 3-month CDOR rate (that represents the average cost of funds on the Canadian market of financial institutions) and the 3-month Treasury Bill rate (that represents the cost of funds of the Federal Government) increased significantly since the beginning of the crisis in the summer of 2007 (graph 1). Relatively speaking, the costs of funds of Canadian financial institutions have noticeably increased over the last few weeks, which puts their profitability at a disadvantage.

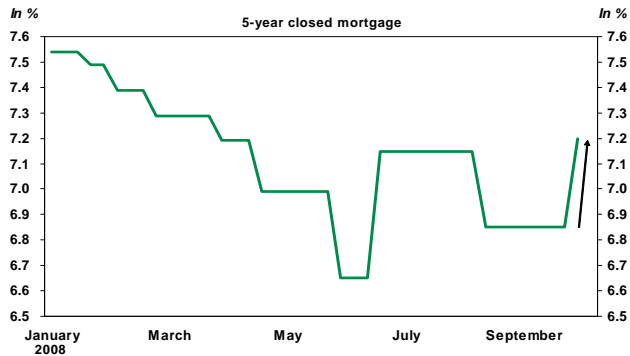


This environment affects Canadian household and business credit terms. According to two surveys carried out by the Bank of Canada among businesses and senior loan officers, credit terms have been tightening significantly for businesses over the past few quarters (graph 2). Unfortunately, we do not have any specific information about household credit terms (consumption and mortgages). However, some indexes seem to indicate some tightening of terms. Certain mortgage rates have recently gone up and the prime rate of financial institutions did not immediately decline to the same extent



<sup>2</sup> See the *Economic Viewpoint* "Far from widespread, prices for residential housing will continue to fall in some regions across the country" published on September 25 for a complete analysis of real estate prices in Canada.

**Graph 3 – Some mortgage rates have increased recently**



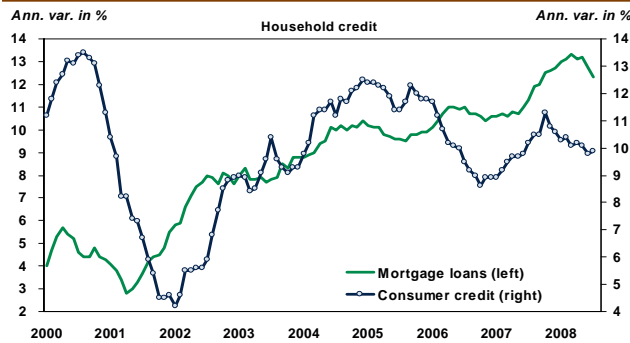
Sources: Statistics Canada and Desjardins, Economic Studies

that the key interest did when the rate cut was ordered by the Bank of Canada last week (graph 3).

**THE CANADIAN ECONOMY WILL BE AFFECTED**

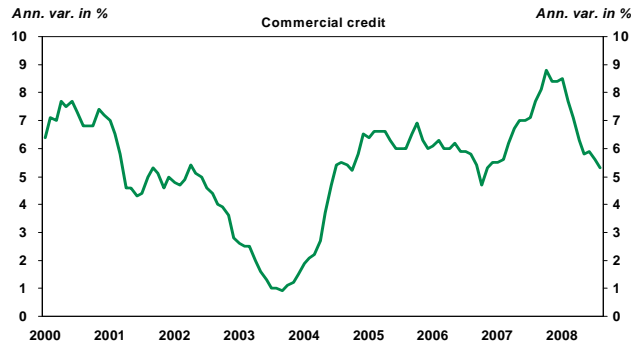
The impact of the financial crisis in Canada is not limited to financial institutions: the overall economy might be affected. First, the tightening of credit terms could indicate slower growth in consumer spending (especially durable goods) and investment. The Canadian economy is mostly driven by domestic demand, so a significant slowdown in consumer spending and investment would take its toll on the country's economic outlook. At this time, we do not have results reaching farther than the month of August about credit outstanding. For the time being, the data indicates that household credit (mortgages and consumption) is making progress rather steadily (graph 4). Even if commercial lending has been dropping for a few months, the pace of growth remains what is has been on average in recent years (graph 5). Yet poor credit terms could be tainting results in the near future. This would point to much greater problems for the domestic economy.

**Graph 4 – The progress of household credit remains relatively high**



Sources: Statistics Canada and Desjardins, Economic Studies

**Graph 5 – Commercial credit is dropping**



Sources: Statistics Canada and Desjardins, Economic Studies

Next, the indirect effects of this crisis could spill over on the Canadian economy. The problems in the U.S. financial institutions should lead to an even greater tightening of credit conditions South of the border. This will likely lead to a sharp slowdown in consumer spending by Americans. The risks of a recession have incidentally increased significantly over the last few weeks in the United States. For instance, the ISM manufacturing index has dropped to 43.5 in September, i.e. a level that comes close to signalling a decline in the U.S. economy (41.1). In these circumstances, the problems of Canadian exporters may worsen. In addition, even if the loonie has depreciated notably over recent months (especially over the last few days), it is still relatively high. The exchange rate remains a moderating factor for Canadian foreign trade.

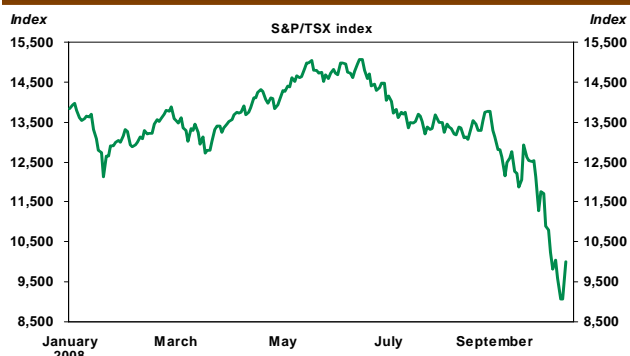
The problems of Canadian exporters are unfortunately not limited to the slowdown in the U.S. demand. As it spreads to all the industrialized countries, the contagion effect of the financial crisis is clouding over the growth outlook of the global economy and increases the possibility of a worldwide recession. Global demand for raw materials (including energy) could slow down more than expected, which would worsen the problems of Canadian exporters. The prices of raw materials are incidentally adjusting to this slowdown in demand and there has been a sharp drop over the past few weeks.

In addition, the price drop of Canadian exports should worsen the conditions of the terms of trade in Canada. The wealth effect associated with the prices of raw materials that Canadians benefited from should then change dramatically over the next quarters.

Lastly, the recent developments in financial markets could seriously impede domestic economic growth. The climate of uncertainty coupled with the drop in raw material prices leads to important declines in the Canadian stock market. At noon

on October 14, the S&P/TSX index lost 32.9% since its cyclical high of June 18 while the losses since the beginning of 2008 reach 26.9% (graph 6). Outside Canada, the S&P500 U.S. index lost 31.6% since the beginning of the year while the decline of most indexes reaches 31.9% in England, 35.5% in Germany, 35.4% in France and 38.3% in Japan. So there is no escaping it. The stock portfolio of many households as well as the holdings of pension funds have shrunk considerably over the past few months. Consumer confidence is already affected severely by the gas price hikes that hit in early 2008 worsen confidence. Luckily, the last few weeks' drop in crude oil prices is increasingly affecting prices at the pump. Even if these prices are remaining relatively high from a historical perspective, the recent decline could reflect positively on the confidence of households and so offset in part the impact of the drop in stock prices.

**Graph 6 – The Canadian stock market plunged sharply since its cyclical high of June**



Sources: Datastream and Desjardins, Economic Studies

In the end, whether through foreign trade, consumer spending or investments, a downward risk is looming over the Canadian economy. In these circumstances, the current climate of stagnation or of very weak growth could well extend over the coming months. A technical recession could also be declared during this period. In fact, we estimate at 50% the chances of a recession in Canada. However, if a recession ever occurred in Canada, it would likely be of a very limited scale.

The Québec economy has also been sluggish since the mid-2007 and the risks of a recession are always present. Despite the drop in energy prices, the confidence of consumers is lagging behind. The surge in the unemployment rate, which went from a low of 6.8% in January to 7.3% in September, is worrisome although its level remains low according to historic standards and especially far from the high of 14.2% reached during the recession of the early 90s. At a time when exports are dropping, the main pillar of domestic demand, i.e. consumer spending, may decline.

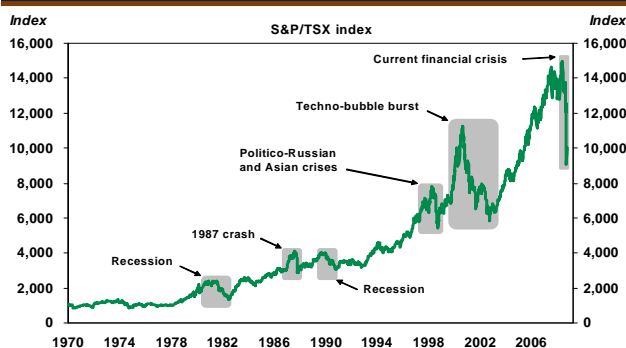
In Ontario, although the results of the spring economic accounts were higher than expected, the economic outlook has remained low. Not only will the manufacturing sector be strongly held back by the slowing U.S. and global economy, but the problems of the auto industry should worsen at a time when a growing number of consumers will be cutting back on their durable goods expenses. In this context, the probability of a recession in Ontario remains over 50%.

**RISKS FOR CANADIAN FINANCIAL MARKETS**

Despite the adoption of a number of stabilizing measures (American and European rescue plans, coordinated decline of key interest rates, influx of liquidities etc.) global financial markets remain shaky. Not only are the problems spreading among financial institutions outside the United States, but worries are focusing more and more on the possibility of a significant slowdown of the American and global economies. The climate of uncertainty will definitely last many more weeks. When and at what level will the stock market disaster stop? This is of course difficult to answer. The gradual implementation of the U.S. bailout plan, the action of some governments, the coordinated declines in key interest rates as well as other measures to be announced should nevertheless calm things over the next few weeks.

In these troubled times, investors need to keep a cool head. As seen in graph 7, the Canadian stock market has gone through many downward cycles over the last decades. At

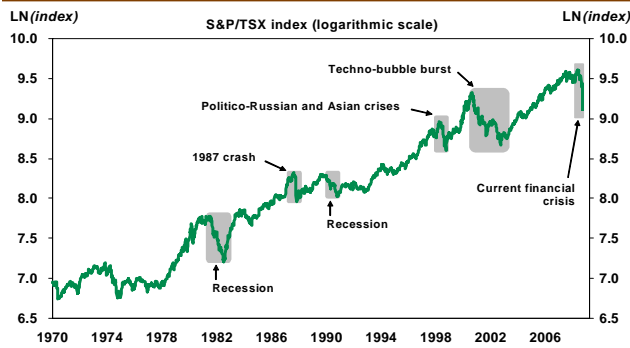
**Graph 7 – The recent market drop in perspective (1)**



Sources: Datastream and Desjardins, Economic Studies

first sight, the decline of the S&P/TSX since the beginning of the crisis seems important in comparison with previous corrections. However, the sudden fluctuations of the S&P/TSX need to be put into perspective. A decline of 1,000 points does not have the same impact in 2008 when the S&P/TSX is around 10,000 than a similar correction in 1987 when the index was around 4,000 points. To this effect, the use of a logarithmic scale (graph 8) helps compare the progress of the S&P/TSX over time while keeping the same amplitude. Two conclusions can be drawn. First, the correction

Graph 8 – The recent market drop in perspective (2)



Sources: Datastream and Desjardins, Economic Studies

of the S&P/TSX over the last few months remains as yet less significant than several major corrections in the past. Second, history shows that the ups and downs are part of the stock markets' nature and that they eventually finish by catching up lost ground. It is only a question of time. So, investors need not panic. In fact, the stock markets' downward movement will gradually bring to light some buying opportunities and some investors could even profit from them. The recent stock market plunge shows the importance of having an investment strategy in line with one's objectives, risk tolerance and investment horizon.

As for currencies in this period of great uncertainty, the U.S. securities are once again playing their role as a safe-haven. This favours the U.S. dollar to the detriment of other currencies. The loonie is impacted doubly, because the price drops in raw materials intensify its correction. Yet we remain optimistic over the longer term for the Canadian dollar. Once we have gone through the financial crisis and the economic slowdown, the upward trend of prices in raw materials should start again. The loonie could then appreciate starting in 2009.

With respect to interest rates, holding attention are the wide spreads between the government bonds and the other types of debt. The continuing climate of uncertainty over the coming months will of course favour maintaining significant spreads. The cost of funds for financial institutions will then remain under pressure, which could limit the drops in mortgage rates and other interest rates in effect in Canada, even cause new increases, although slight.

### CANADA IS RELATIVELY WELL POSITIONED TO OVERCOME THE CRISIS

In short, Canadians will not be able to avoid the direct and indirect effects of the financial crisis. But Canada has several advantages that should help it survive the crisis without too much harm. The Bank of Canada has some leeway in managing its monetary policy. With a target rate for overnight funds at

2.5%, there is some leeway to do other cuts. This contrasts with the U.S. situation, where the target rate of federal funds is already at 1.5%. Canadian financial institutions seem to have a relatively good balance sheet and the risks of a major real estate market correction are limited.

In addition, the governments are in a good position to react in case of difficulties. Both the Federal Government and most provinces have shown important budget surpluses over recent years. Even if their financial results risk worsening because of the economic slowdown, their situation remains good in comparison to most other governments in the world, which gives them some latitude. In this context, it would not be disappointing to see deficits being declared over the next years, if this is a cyclical and temporary situation. In addition, the governments of Québec, Ontario and some other provinces have already begun an important investment program in infrastructures, thus contributing significantly to economic growth. However, if the financial crisis was to impact the economy more severely over the coming months, it would be necessary to act quickly. Additional measures could be then implemented: intensification of public works, targeted sectoral support program or the influx of emergency help for households.

Finally, the monetary stability established by the Bank of Canada in the early 90s with the implementation of a target range for inflation should lessen the sudden fluctuations of the Canadian economy. So, a recurrence of the recession of the early 80s when interest rates had increased considerably due to strong price hikes is not to be feared.

To survive the crisis, the Bank of Canada in cooperation with the other central banks should nevertheless keep the money market fluid and try to lessen as much as possible the cost of borrowing for individuals and businesses. For its part, the Federal Government must make sure that it rebuilds the trust of investors towards the financial system. Among the measures that could be implemented quickly, a temporary increase of the deposit insurance limit and its application to a broader range of products, like other countries did, are simple ways that would be popular immediately.

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