The increase in U.S. defaults in lower quality mortgage credit (subprimes), further bankruptcies by firms operating in this sector, and the emergence of new general concerns have had tangible impacts on the financial markets in recent days.

What’s more, increased demand for liquidity from the companies that are caught up in this issue and from the other segments of the markets has created an imbalance between supply and demand, especially in Europe, where a number of financial institutions are exposed to U.S. subprime credit. Some central banks (including the Bank of Canada) have responded by making sizeable sums available to financial institutions in order to increase the supply of liquidity. By doing so, the central banks hope to recreate some stability in the money market so that the upward pressure on short-term interest rates can gradually ease off.

The liquidity crisis could, however, have some repercussions for central banks’ key interest rates. In the United States, the U.S. Federal Reserve (Fed) may reconsider its status quo while, in Canada, the monetary firming that is now under way could be put off. While economic conditions here may continue to push for another increase in the target for the overnight rate in September, it will be hard for monetary authorities to inject liquidity while simultaneously raising their key rates. A second Canadian key interest rate hike could thus be postponed if the current liquidity problem were to last.

Also, the fears of the last few days have prodded many investors to flee toward less risky securities, especially federal bonds. Not only have federal bond rates dropped by several basis points as a result, but demand for corporate bonds and provincial government bonds has also declined, simultaneously increasing rate spreads. The stock markets have also paid the price for these concerns, with most indexes pulling back substantially.

However, we must still distinguish between the crisis’s financial aspects and the economy’s actual situation. This is, of course, an important event, financially speaking, but the economic risks associated with U.S. mortgage credit are not new. To date, the U.S. and Canadian economies have stood up very well to the problems associated with real estate, and this will likely continue to be true for the months to come.

Eventually, these economic outlooks should soothe the financial markets, so the impacts of the current crisis could slowly fade. It should also be noted that, by nature, the financial markets are highly volatile, especially during the summer.
Despite these rather reassuring forecasts, there are still some risks associated with this scenario:

1. The real estate market’s situation is already really hampering U.S. economic growth. Given the magnitude of the problem, it could continue to have a substantial direct impact on growth for the rest of this year and in 2008. As the graph on the right shows, we are at the heart of the problem where reduced-rate mortgage renewals are concerned.

2. Tightening credit conditions and the more delicate situations facing some institutions are also raising difficulties for U.S. consumers’ borrowing plans. The robust household purchasing that has been seen for the last few years was enormously dependent on the ability to borrow easily and at very low interest rates. Mortgage refinancing and the acquisition of lines of credit that are financed by home values could become less and less popular, especially in areas in which house prices are plummeting.

3. The spread of mortgage credit problems to financial markets, especially equity markets, could have a ripple effect that would further sap U.S. households’ bottom lines. Consumers are saving less and less, which has been offset by a rapid increase in stock market and real estate holdings. If the value of these assets were to stop appreciating as quickly as it has in the past, U.S. households could show more prudence and save more, simultaneously curbing their consumption and the economy’s overall growth.

4. Tightening credit conditions and the increase in corporate bond rates could also affect corporate investment plans. Already, the wave of mergers and acquisitions seems to have been slowed. Note, however, that numerous businesses could turn to their substantial earnings to finance some investments.

If one of these risks were to materialize, we could, of course, expect slower economic growth in the United States and, by implication, in Canada and the rest of the world. The deterioration of the economic outlook and the resulting greater fragility of the financial markets could prod the Fed to loosen its monetary policy in the next few weeks, or even the next few days.

In Canada, the negative impact of weaker U.S. demand could argue in favour of an interruption of the current monetary firming. In fact, if the crisis were to deepen substantially, the Bank of Canada could even have to retrace its steps with a few key interest rate cuts.

Under such circumstances, federal bonds would no doubt be preferred—a situation that is conducive to a decline by medium- and long-term rates, and widening credit spreads.

A flight to quality, less risky assets could benefit the U.S. dollar to the detriment of the loonie.

Stock markets could correct substantially.

In light of the recent responses by central banks, however, there does not appear to be a possibility of a major, prolonged liquidity crisis that would touch off a recession in the United States.
• **Canada is less vulnerable to a mortgage crisis:**

1. Why would Canada be safe from a mortgage crisis like the one hitting the United States? Firstly, there are few subprime loans here: they represent about 5% of the new mortgage credit extended each year. Growth in this area was also slight from 2001 to 2006, unlike the growth seen in the United States, where the proportion of subprime credit went from 7% to 22% over the same period.

2. The Bank of Canada views the subprime mortgage loan market as still being in its infancy on this side of the border. According to the latest estimates, subprime mortgage loans constitute about 5% by volume of all new loans granted last year in Canada, but currently account for less than 3% of current mortgage credit outstanding. In comparison, the percentage was close to 13% last year in the United States.

3. Canada is thus much less exposed to a crisis in the mortgage market than the United States. Also, mortgage loan default rates have already skyrocketed in the United States, whereas they have remained low in Canada. It should be said that the price drops that have occurred in the American real estate market, owing to a large imbalance between real estate supply and demand, has pushed the default rate up.

4. In Canada, the residential sector is in much better shape and is in no way afflicted by an imbalance that would bring prices down. In fact, the resale market shortage is gradually being resolved, which is trimming price increases. Price increases remain sustained, however, going as high as 10.3% in the first semester of 2007 over the same period last year. While the provinces in western Canada are pushing the national average up, the increase was still 6.7% in Québec and 5.9% in Ontario.

5. Unlike the U.S. housing market, the Canadian, Québec and Ontario housing sectors seem to be safe from a decline in prices. The market is far from having the kind of surplus that prevails in the United States. At most, a gradual return to equilibrium by Canada’s resale market argues in favour of less sustained price growth. Only a shock like a recession or surging interest rates could make demand flag and trigger price decreases here.

6. In short, the existence of few subprime mortgage loans in Canada and a strong housing market make the country almost immune to a crisis like the one the United States is going through. Canada is, however, vulnerable to the indirect repercussions the American crisis could have on its economy, as well as on international financial markets. In particular, slower economic growth in the United States would put the brakes on exports, sapping real GDP growth in Canada, especially in the central provinces (Québec and Ontario) that are more dependent on a healthy U.S. economy.

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**Canada: The resale market is far from the kind of surplus that would make prices come down, as in the early 90s**

![Graph showing the ratio of sales to new listings in Canada from 1990 to 2006, indicating a shortage rather than a surplus.]

**Home prices are falling in the United States, but still climbing in Canada**

![Graph comparing annual percentage change in home prices between Canada and the United States from 2001 to 2007, showing a decline in the United States and a steady increase in Canada.]

*Sources: Canadian Real Estate Association and Desjardins, Economic Studies*