

Canadian Financial Conditions Improving

Summary:

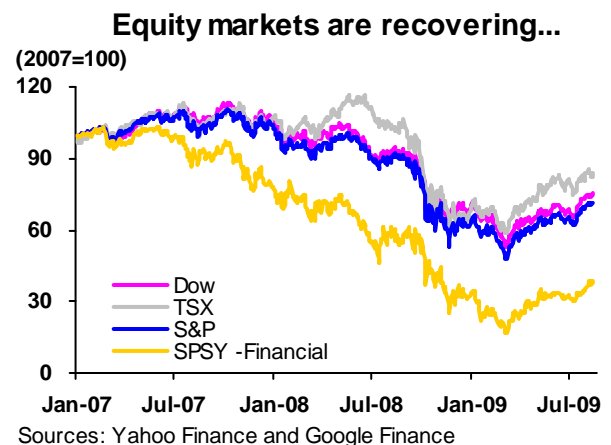
Canadian financial conditions have improved significantly in recent months as the global financial system has stabilized and global economic recovery moved onto a more solid footing. Borrowing costs for businesses and households are declining and access to credit is less restrictive. Credit conditions, however, remain tight by historical standards.

Global Financial System Stabilizing...

The global financial crisis turned to the worst after the collapse of Lehman Brothers last September. Equity markets experienced sharp declines as investor confidence plunged. Credit virtually stopped flowing as financial institutions and households repaired their balance sheets. Economic fundamentals deteriorated rapidly and the world economy fell into the worst recession since the World War II.

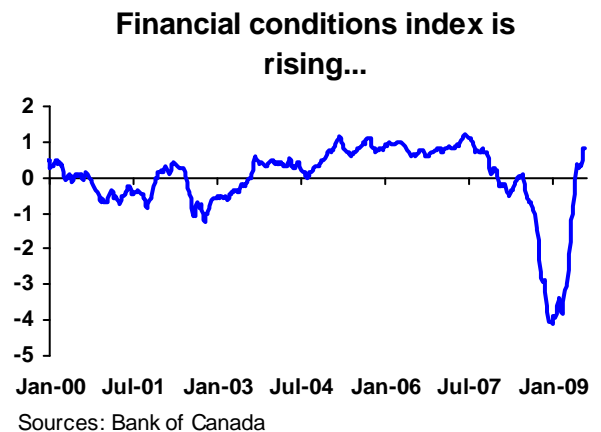
Thanks to the prompt and aggressive policy actions taken by governments around the world, there are now increasing signs that the global financial system is stabilizing. Following the sharp sell-off in late February and early March, equity markets have rebounded substantially. Major indexes in North America are up more than 40% from their March lows. Some emerging markets have experienced an even stronger rebound.

The financial sector, which is at the epicenter of the current crisis, has also recovered handsomely. Since March, the S&P 500 financial sub-index has more than doubled (+130%) as major financial companies reversed losses and posted multi-billion dollar profits in the first half of the year. Capital positions at the major US banks continue to improve. The stress-tests conducted by the US government in the second quarter of 2009 showed better-than-expected results. Only 10 of the 19 largest US banks were required to raise an additional US\$75 billion in capital. Furthermore, 10 major banks, including Goldman Sachs, JP Morgan and Morgan Stanley, have already paid back the bailout funds under the Troubled Asset Relief Program (TARP) to the US government.



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The financial situation in Canada has also improved significantly in recent months, as indicated by the sharp rebound in the Bank of Canada's Financial Conditions Index (FCI). The FCI is a weighted average of key financial variables such as interest rates, credit spreads, stock prices,



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housing prices, real exchange rate and lending standards. The impact of each variable on the overall index is consistent with its impact on economic activity (**Table 1**). For instance, the lower the interest rates, the higher the index value as low interest rates provide stimulus to economic growth.

The FCI is normalized to have an average of zero; values above zero indicate that conditions are better than average and vice versa. Downward movements in the index indicate that credit conditions are tightening and upward movements show that credit conditions are improving. When the global financial crisis intensified at the end of 2008, the FCI slipped to a record low of -4.1. Since then, the index has fully recovered and currently stands above its normal level at 0.9. The following sections will look at factors that have contributed to the improvement in the FCI.

Interest Rates Declining...

With the overnight target rate standing at a historical low of 0-0.25% and excess liquidity flowing in the financial system, the cost of borrowing has fallen considerably for both businesses and households. Since October 2008, the effective interest rate for business has fallen from 6.0% to the current level of about 3.6%; the effective interest rate for households also has dropped from 6.2% to 4.1%.

Credit Spreads Narrowing...

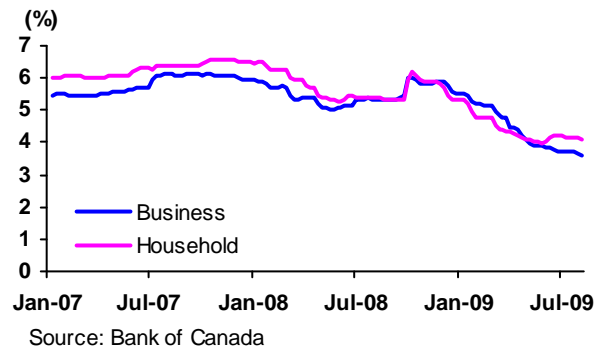
Canadian credit markets have also improved, as evidenced by the recent decline in yield spreads on corporate bonds and the increased issuance of corporate bonds. According to the Bank of Canada's latest Financial System Review, yield spreads for high credit-quality issuers have declined by almost 145 basis points since their peak in early 2009. The spread compression was even more significant for lower-quality issuers.

Asset Values Recovering...

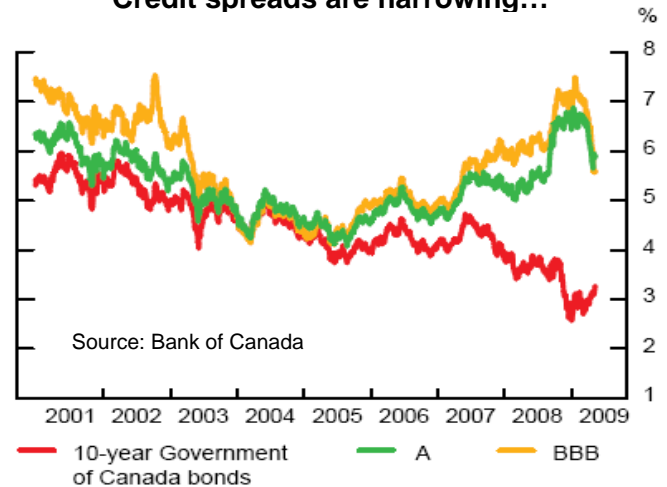
Reduced uncertainty about the global economic outlook, combined with firming commodity prices and improving investor confidence, have contributed to a 43% jump in the TSX since its March low. Meanwhile, the Canadian housing market is showing signs of stabilizing. After recording double digit declines in late 2008 and early 2009, average resale prices have fully recovered. Over the five-month period between January and June 2009, the average resale price jumped almost 19% from \$274,766 to

Interest Rates	Negative
Credit Spreads	Negative
Stock Prices	Positive
Housing Prices	Positive
Real Exchange Rate	Negative
Lending Standards	Negative
Source: Bank of Canada	

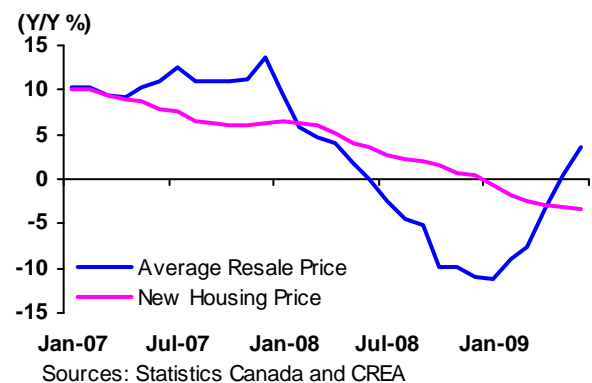
Effective interest rates are falling...



Credit spreads are narrowing...



Housing prices are stabilizing...



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\$326,613, the highest level on record. The decline in new house prices also appears to have stabilized.

Increasing risk tolerance, combined with rising stock prices, have improved companies abilities to raise capital in the open market. Since January 2009, the total gross amount of bond issuances has more than tripled for the non-financial sector and has almost doubled for the financial sector. Investors also greeted new equity issues with warm welcome. In the first half of 2009, net new equity issues rose 65% for the non-financial corporations and were up 38% for the financial sector, compared to the same period last year.

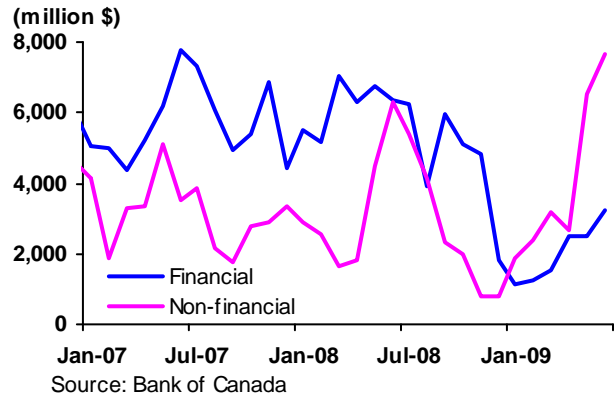
Nonetheless, Credit Conditions Remain Tight...

Most respondents to the Senior Loan Officer Survey (SLOS) reported continued tightening in lending practices, although the percentage has moderated from the record high set in the first quarter of 2009. Businesses responding to the Business Outlook Survey (BOS) also reached the same conclusion.

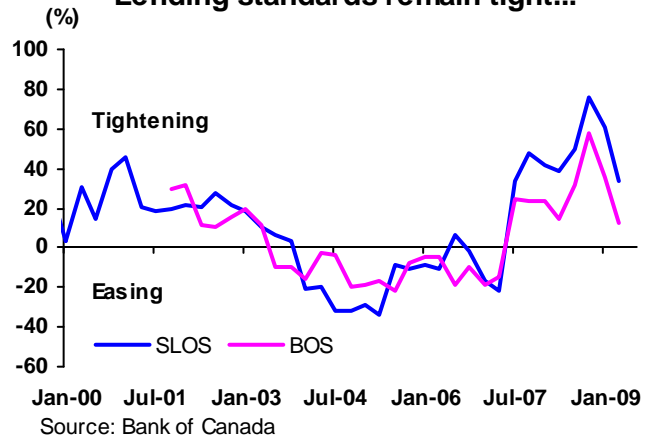
Furthermore, lending conditions continue to be restrictive in specific sectors. Industries such as auto manufacturing and forestry products still have difficulties accessing credit. This largely reflects lenders' continuing concerns over the financial position and profitability of these industries. For instance, the financial situation of the North American auto industry has worsened considerably since the middle of 2008, with two of the largest auto makers, Chrysler and GM filing for bankruptcy protection in April and June, respectively. Although both companies emerged from bankruptcy about a month later with the help of government, private investors and lenders remain skeptical regarding a turnaround of the auto makers.

Despite improved financing conditions in the corporate bond and equity markets, companies continue to face headwinds in the short-term financing market. The amount of commercial paper issued by non-financial corporations dropped 13% in June compared to the same month last year, its eighth consecutive year-over-year decline. The shrinkage in the asset-backed commercial paper (ABCP) market was even more dramatic, down 37% from a year ago in June. The size of the ABCP market is back to 1998 levels.

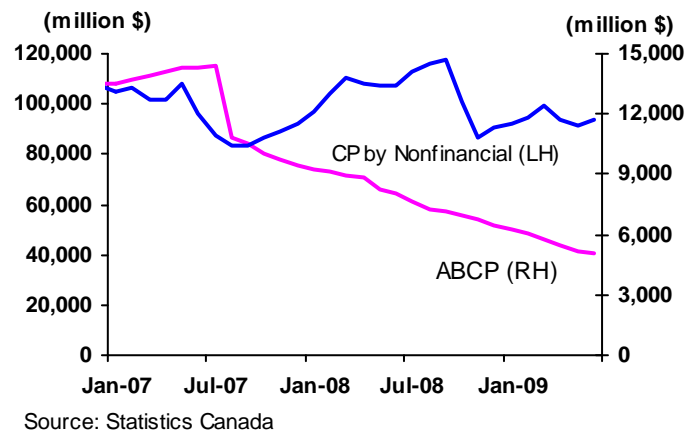
Bond Issuances are rising...



Lending standards remain tight...

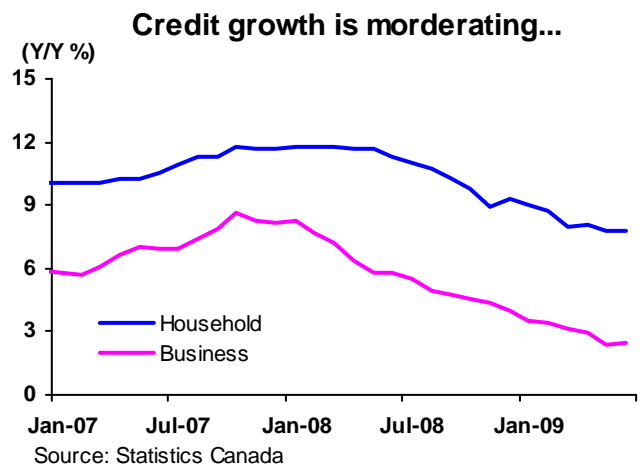


Commercial paper market is weak...



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Although total credit continued to expand in Canada, credit growth has moderated in recent months. Growth in household credit hit a seven-year low of 7.8% in June, while growth in business credit reached a five-year low of 2.5%. This slowdown is partially due to the tight credit conditions and declining demand for credit. A number of indicators have shown that Canadian households continue to face financial challenges. The total number of personal bankruptcies has increased significantly since the third quarter of 2008, as a result of a weakening labour market. The number of households falling behind on their mortgage payments also rose substantially, as the percentage of residential mortgages in arrears increased to 0.42% in June from 0.27% a year ago. These factors will continue to weigh on credit demand in the near future.



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