

## Canadian Financial Conditions: (Nearly) All Systems Go

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Financial conditions for Canadian households and companies have improved substantially this year due to falling interest rates, rising asset values and firming commodity prices. With household finances still in reasonably good shape (see, July 24 Focus Feature "Canadian Consumers Drive While U.S. Consumers Idle"), consumers are well positioned to take advantage of the improved financial backdrop to pull the economy out of recession.

If history is any guide, whenever real interest rates are this low and the yield curve this steep, a return to decent growth is almost certain (Chart 1). And, with the central bank likely on hold until next summer—as some of the excess capacity needs to get sopped up before the excess liquidity will need to get mopped up—interest rates should stay low well into next year.

Nowhere is the benefit of record-low rates more apparent than in the housing market, where resales have jumped 57% in the past five months to June (and look solid again in July). Though five-year fixed mortgage rates have crept up, they remain 1½ percentage points below their post-Lehman highs. The sharp drop in mortgage rates has almost single-handedly returned housing affordability to its long-term norm from the worst levels in 17 years.

Businesses are also enjoying lower borrowing costs. Due to waning risk aversion, corporate credit spreads continue to contract (though they remain wider than normal). Average long-term corporate rates, which spiked after Lehman's failure, have fallen from 6% late last year to 4.5%. New debt issuance has found strong investor demand, even for some lower-rated investment-grade issues. For financial companies, the overnight lending market has normalized, suggesting banks are lending freely to each other.

Cheap money and a soaring money supply have supported credit expansion. The narrow money aggregate, M1, is up 14% y/y, the strongest in a quarter century. Household credit is expanding at a faster-than-normal rate of 8% (unlike in the U.S. where it is contracting), though it has slowed from the double-digit pace of previous years (Chart 2). By contrast, companies remain cautious because of excess capacity. Business credit growth has more than halved to under 3%, though this is still faster than in previous recessions.

CHART 1  
YIELDING INDICATOR

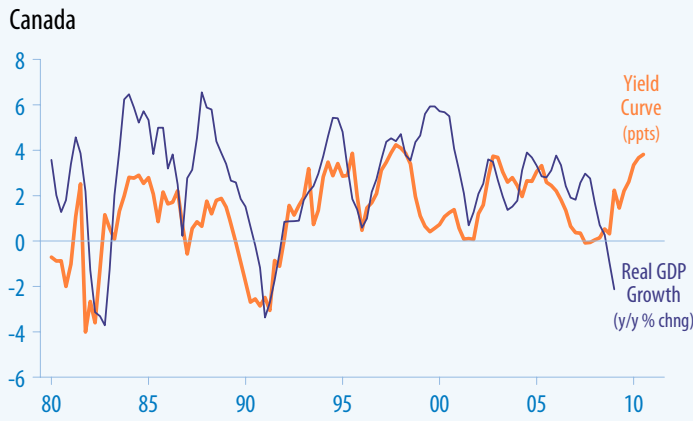
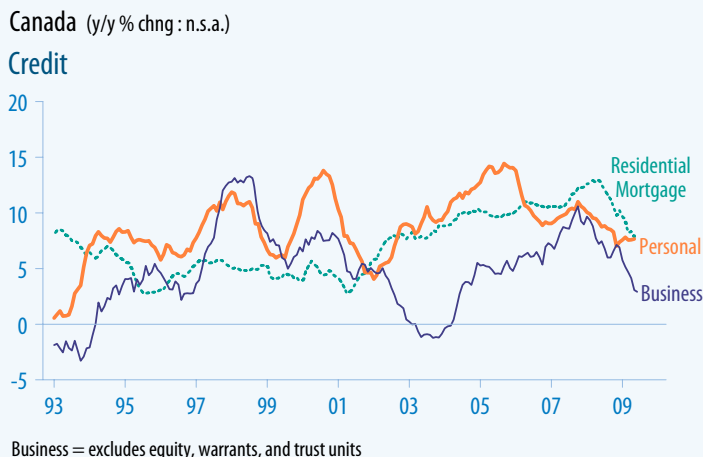
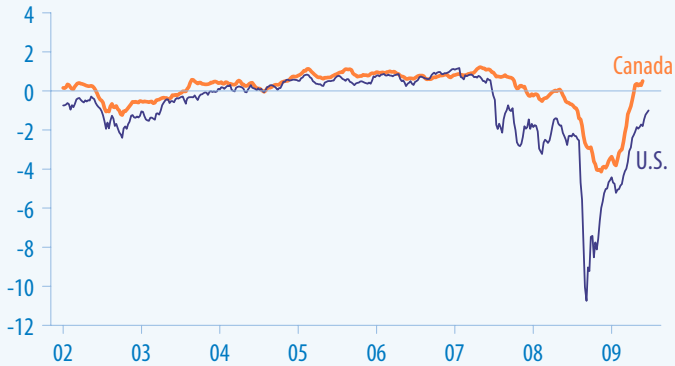


CHART 2  
GIVING CREDIT TO HOUSEHOLDS



**CHART 3**  
**V-RECOVERY?**

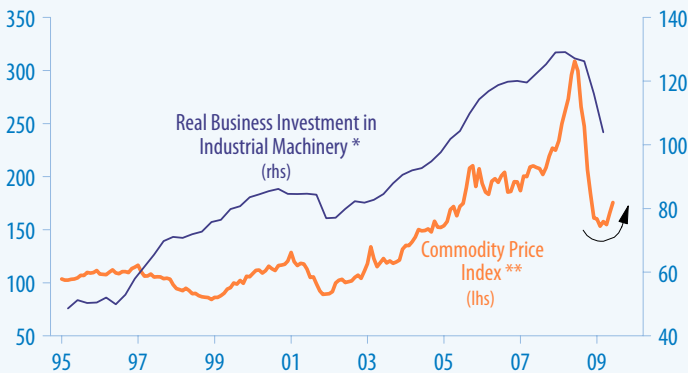
Financial Conditions Index



Canada = BoC Financial Conditions Index U.S. = Bloomberg Financial Conditions Index

**CHART 4**  
**RESOURCE INVESTMENT SHOULD HOOK UP**

Canada

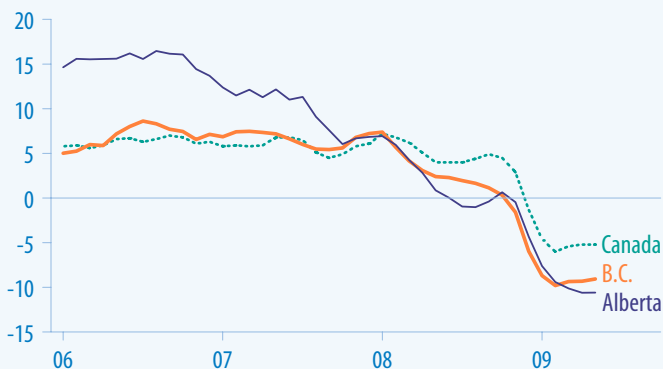


\* (blns of chained 2002 dollars : s.a.a.r.) \*\* (1982-90 = 100)

**CHART 5**  
**THE WEST TAKES A REST**

Canada (y/y % chng : 3-mnth m.a.)

Retail Sales



Of course, borrowing from the future comes at the cost of increasing financial stress, with personal delinquency and bankruptcy rates turning up recently, albeit modestly. However, it's comforting to know that at least household assets are on the rise again. The previous downdraft in equity markets and home prices had slashed household wealth by \$382 billion or 7% in the past year to Q1, carving an estimated 2 per cent from consumer spending (this is still a far cry from the estimated 5 per cent negative wealth effect that Americans faced). However, household wealth has snapped back due to the 45% rebound in the TSX since early March and a nearly complete reversal in home prices, suggesting the negative wealth effect will be greatly reduced, if not reversed by next year.

A few hurdles remain, however. Many firms still have difficulty getting credit. The *Business Outlook Survey* found that banks tightened their credit standards further in Q2, though the restraint has become less widespread and more industry-specific. In addition, the currency's 12% trade-weighted appreciation this year will keep exporters on the ropes.

So, where do we stand? As a useful summary measure, the central bank's financial conditions index—which includes interest rates, credit spreads, house prices, equity values, lending standards and the exchange rate—has fully retraced its post-Lehman swoon to slightly above-normal levels (*Chart 3*). Financial conditions are more favourable in Canada than in other developed countries, which partly explains the shallower recession here and the anticipated faster recovery. A similar measure for the United States has also rebounded, albeit less so than in Canada, providing some hope for Canadian exporters.

Though not included in the financial conditions index, commodity prices have also started to move in Canada's favour after nose-diving 50% from peak levels (*Chart 4*). The higher prices should revitalize investment plans in the resource patch, notably for oil sands developers, helping to spur a recovery in personal income and spending in hard-hit Alberta and British Columbia (*Chart 5*).

**Bottom Line:** The surprisingly rapid improvement in financial conditions, with falling interest rates and rising asset prices more than countering the drag from tight credit standards and a rising currency, points to a decent recovery led by domestic spending.

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