

The financial and housing sector correction in Canada and Europe: Why so different? What does this mean for recovery?

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Securities

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Key takeaways

- The spark for the global financial and economic crises was the sudden and dramatic correction in the U.S. housing sector
- Seeds of the crises were sown in the post-tech bubble era of easy credit
- It could be argued that the European housing market bubble was much bigger than in the U.S.
- Exposure to the Central and Eastern European economies (CEEE) has added another dimension to the European banking system crisis
- The Canadian banking and housing sectors have been spared the sudden correction that has plagued their European counterparts

U.S. housing bubble

- Housing
 - NINJA (**N**o verification of **I**ncome, **J**ob status, or **A**ssets) loans
 - High risk borrowers offered exotic loans
 - Speculation in home prices
- Financial alchemy
 - Old mortgage lending model discarded
 - Mortgages bundled and sold
 - The securitization of mortgages led to loose lending standards
- The bottom fell off
 - Mortgage defaults and foreclosures skyrocketed (jingle mail)
 - Value of mortgage-backed securities (MBS) plunged
 - MBS went from exotic to toxic

The bursting of the bubble

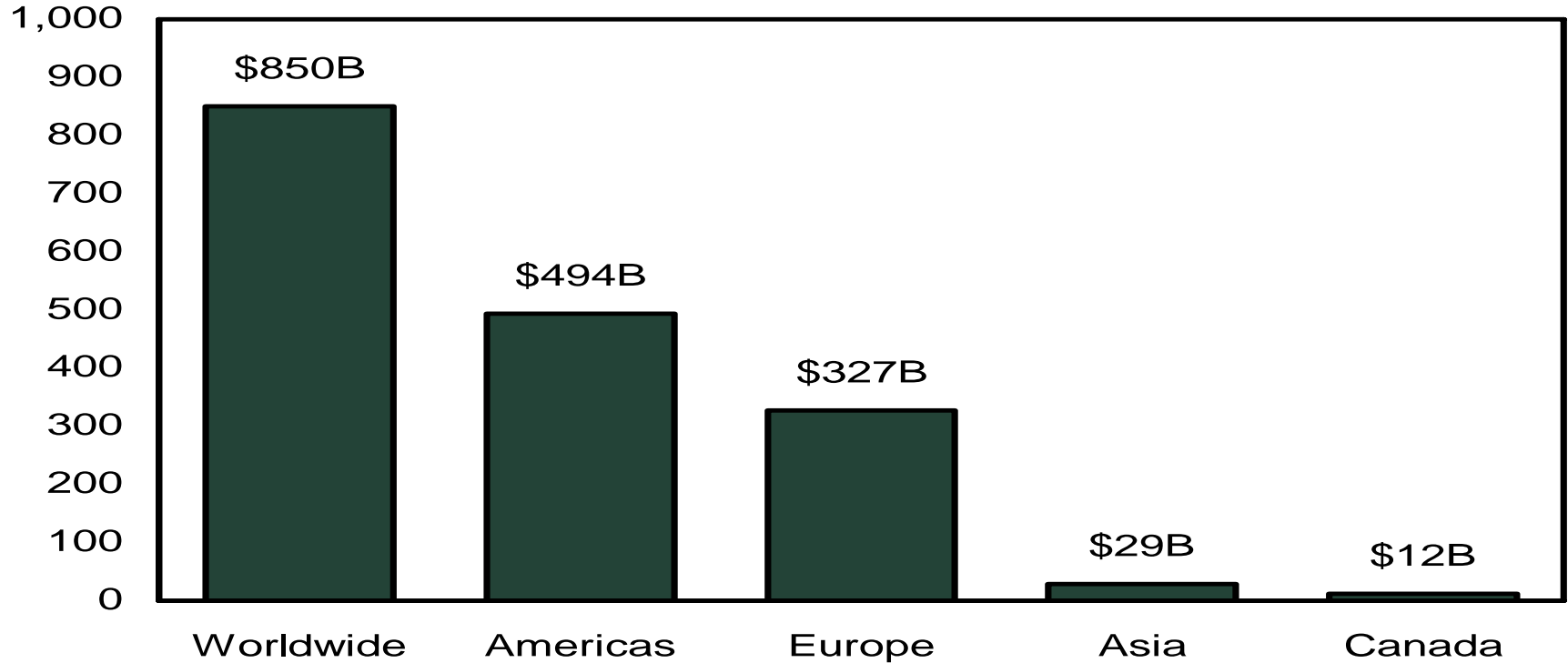
U.S. Home Prices



Banks take it on the chin

Writedowns Due To U.S. Housing Crisis

US\$ 'billion



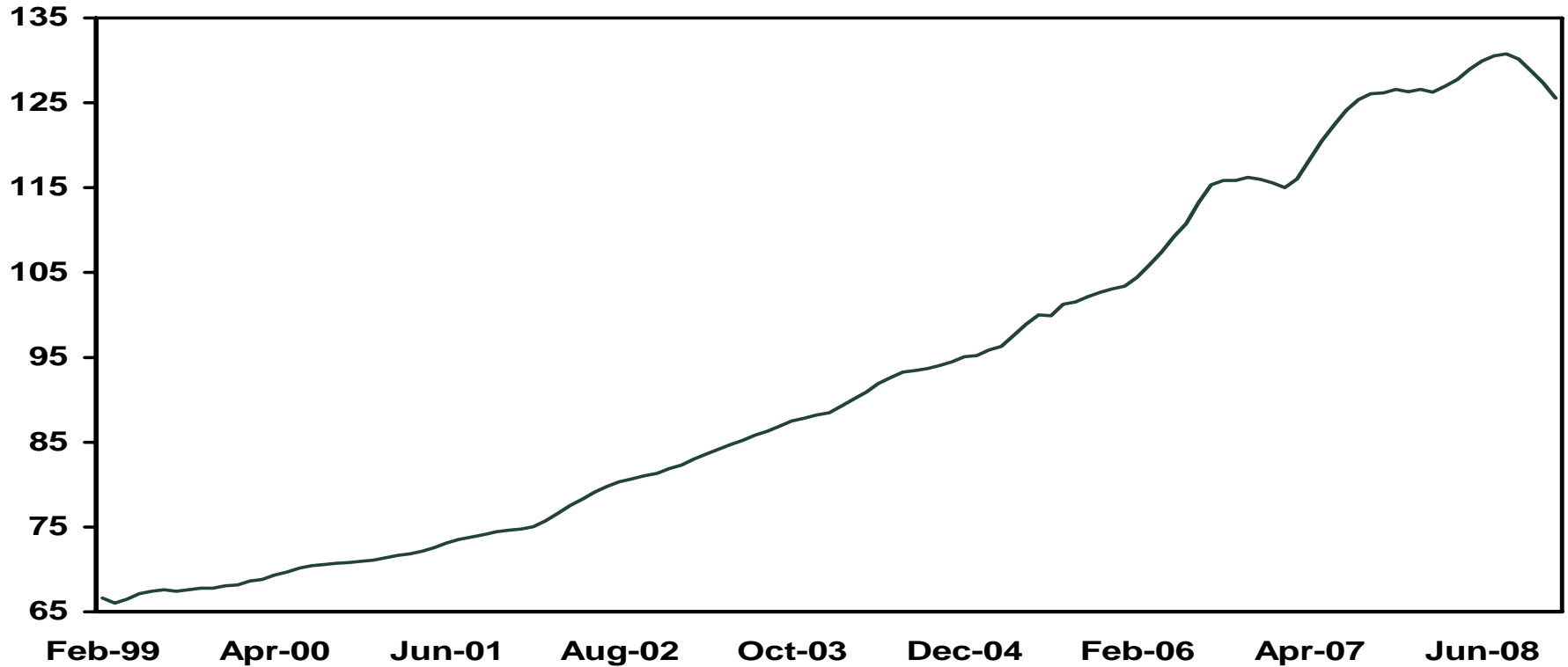
Source:

Why no Canadian banking crisis?

- Market structure
 - Deposit-oriented
 - Conservative lending practices
 - Captive market (oligopolistic in nature)
 - Competition vs stability
- Regulatory environment
 - No allowance for domestic mergers (or foreign takeovers)
 - Deposit and mortgage insurance helpful
- Hit from subprime crisis manageable
 - Limited exposure to U.S. MBS
 - Modest domestic housing correction

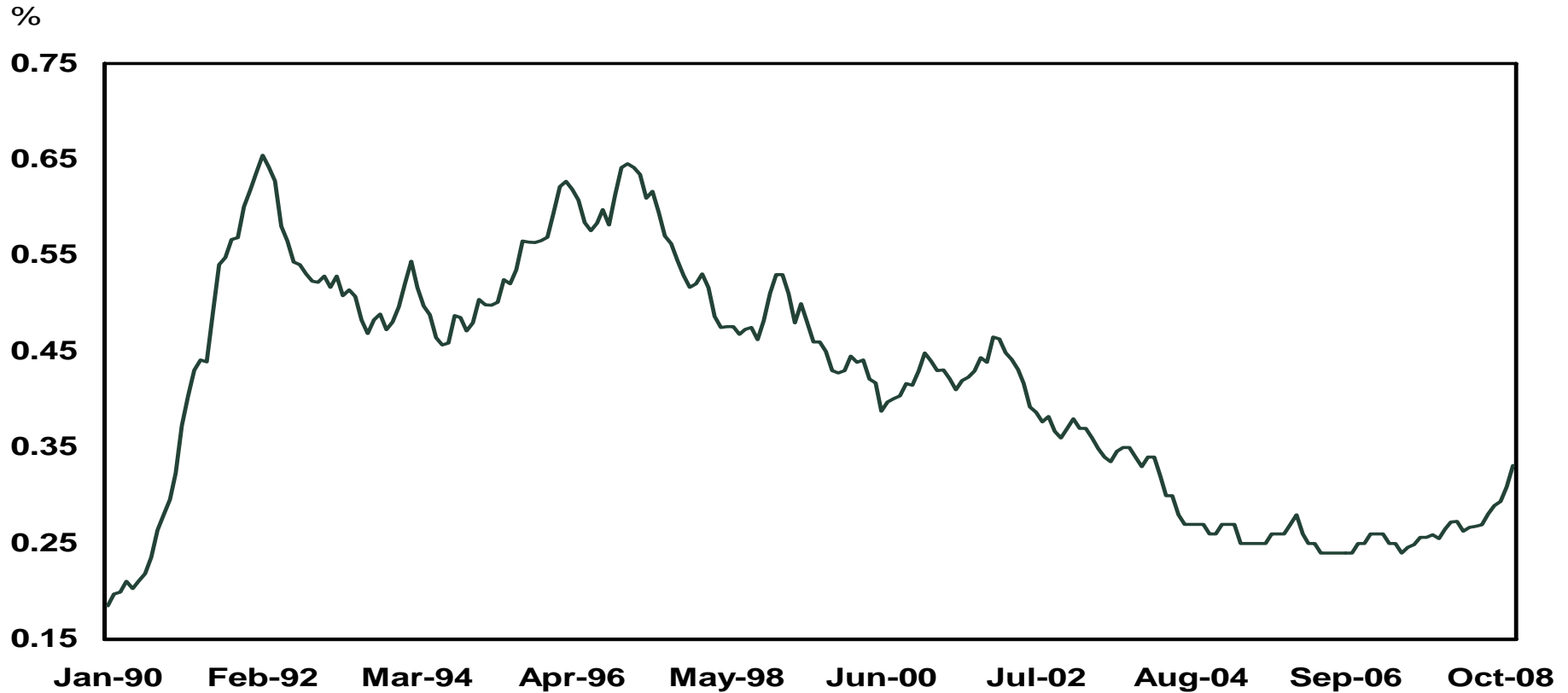
Canadian Housing Price Correction Remains Modest

2005:6 = 100



Source: Teranet, National Bank

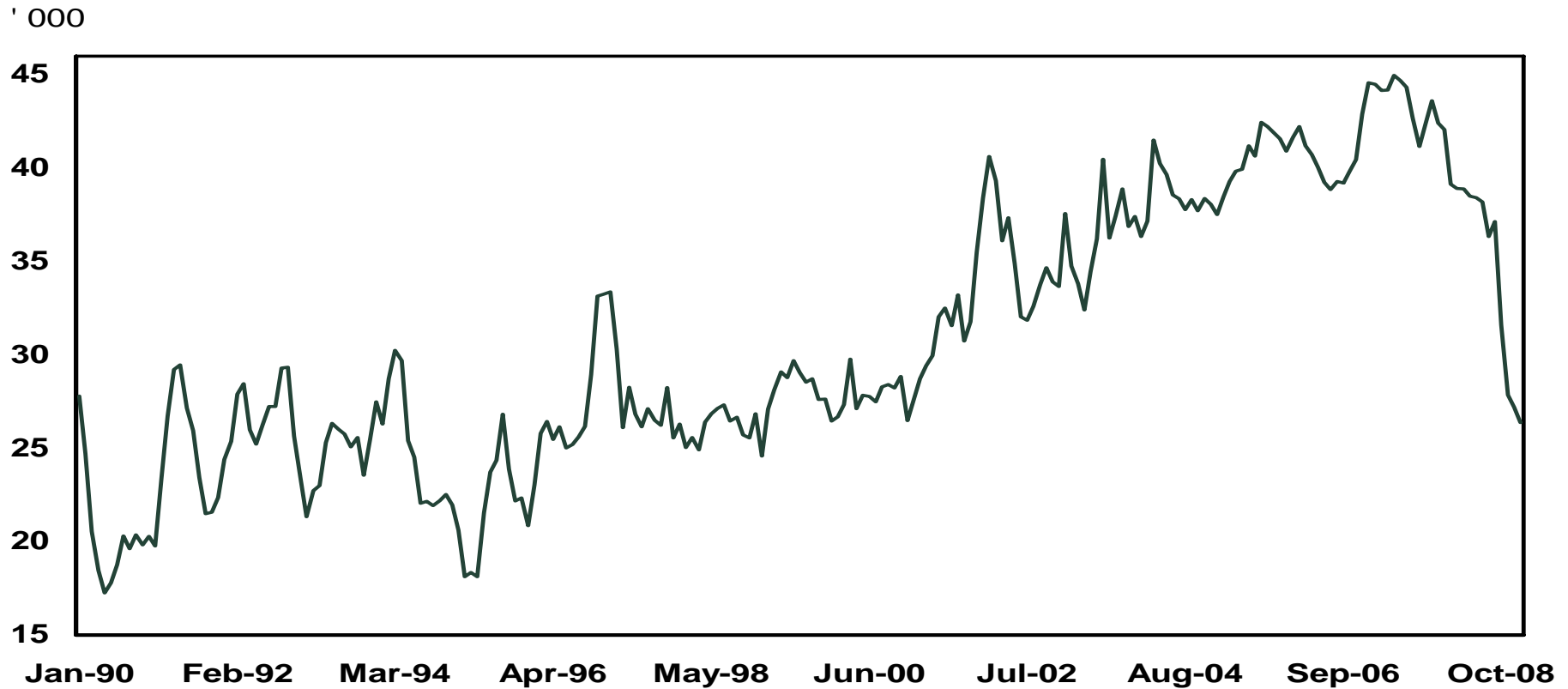
Canadian Mortgage Arrears Remain Low



Source: CBA

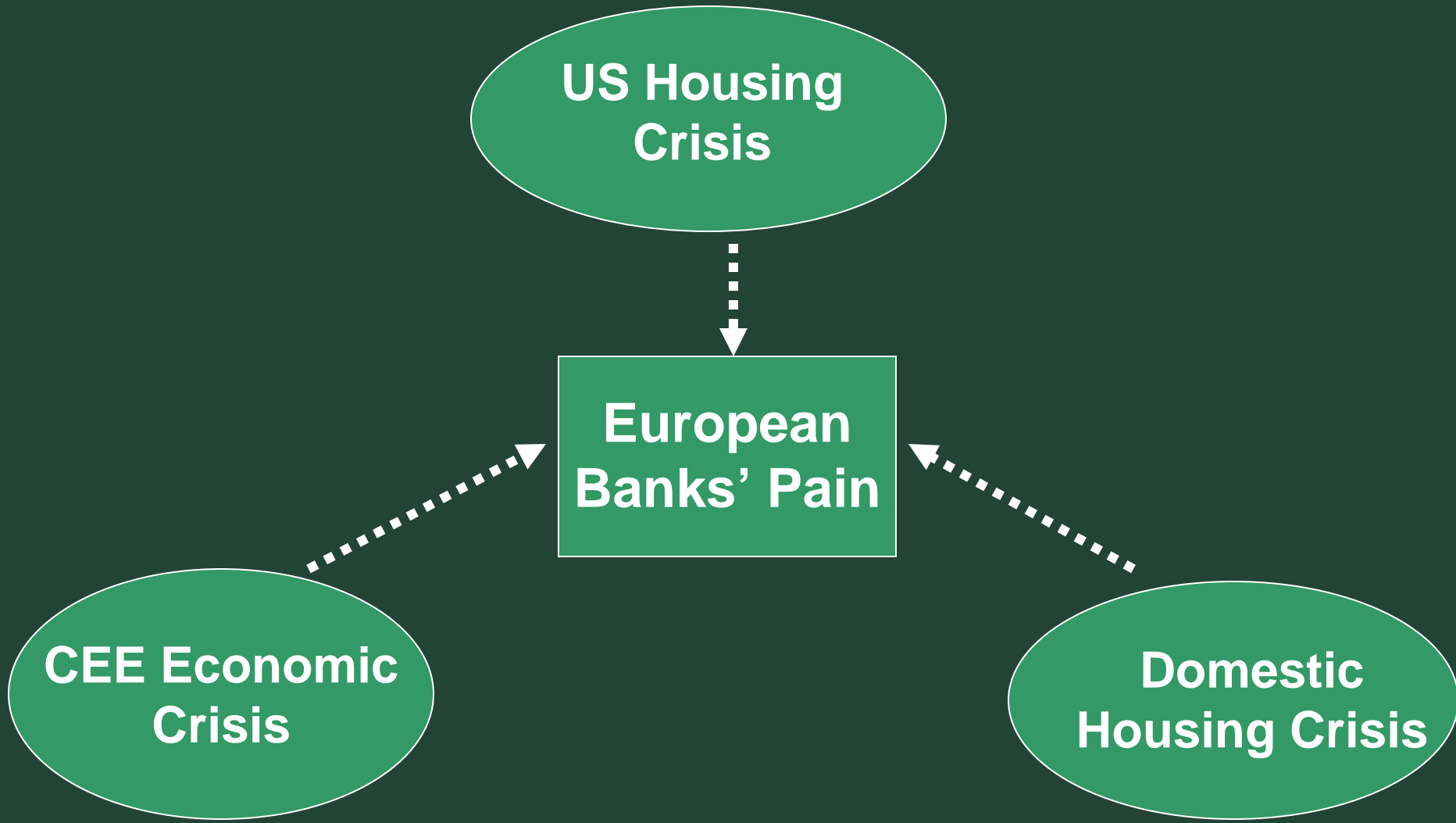
The bursting of the bubble

Canadian Home Sales Crash



Source: CREA

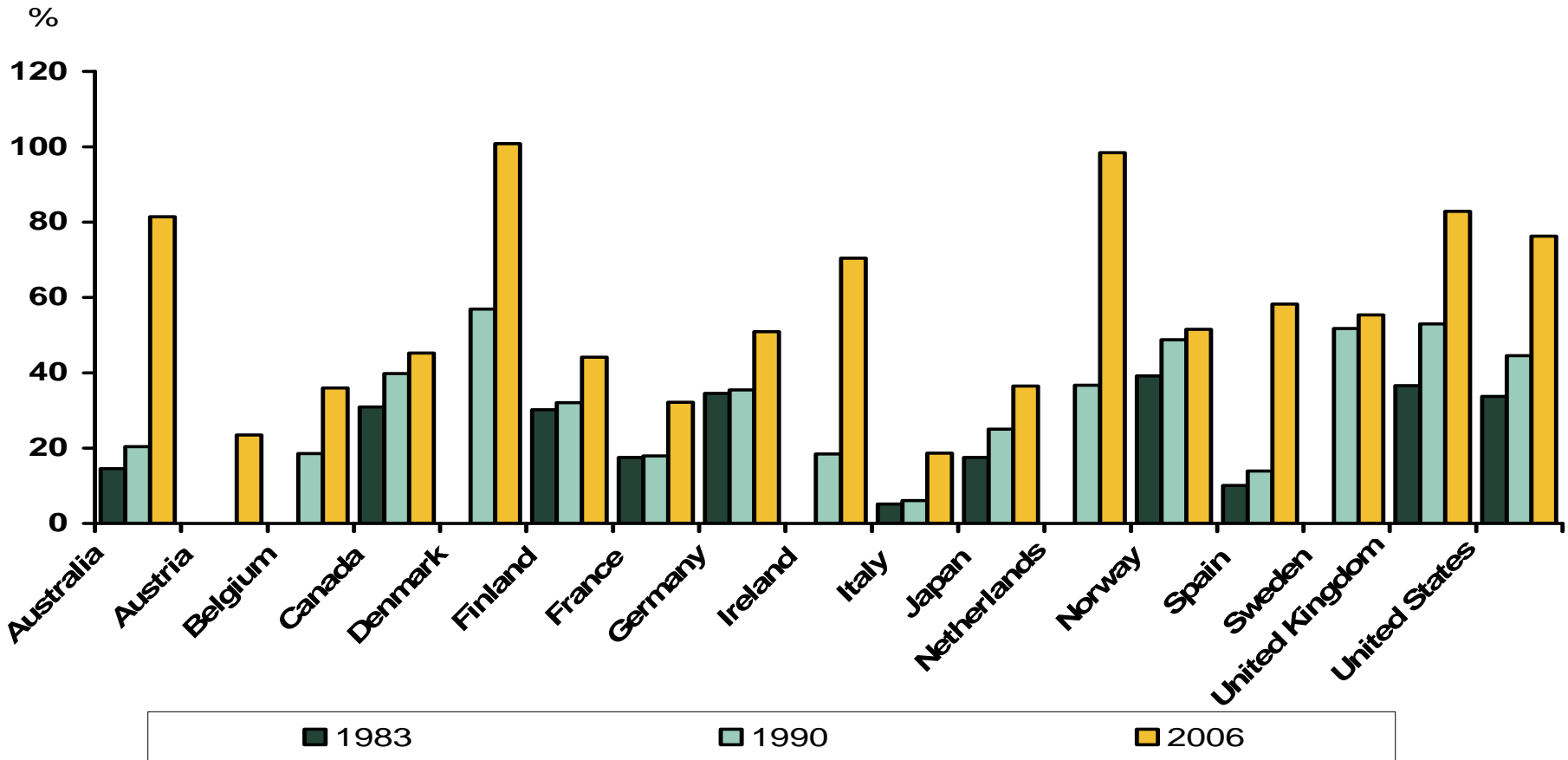
European banks being squeezed



European housing crisis

- Housing boom
 - Housing sector bubble bigger than the U.S
 - Deregulation in the 1980s and 1990s, and Euro introduction
 - Non-banks were able to issue mortgages
 - Application procedure loosened
 - Low interest rates
 - Ireland, Spain and the U.K. main culprits
 - Spain built more homes in 2006, than Germany, France and UK (combined)
- Credit-powered growth
 - Credit binge bolstered economic growth
 - Banks were more leverage than their U.S. counterparts
 - EU lacks institutional framework to handle banking crisis

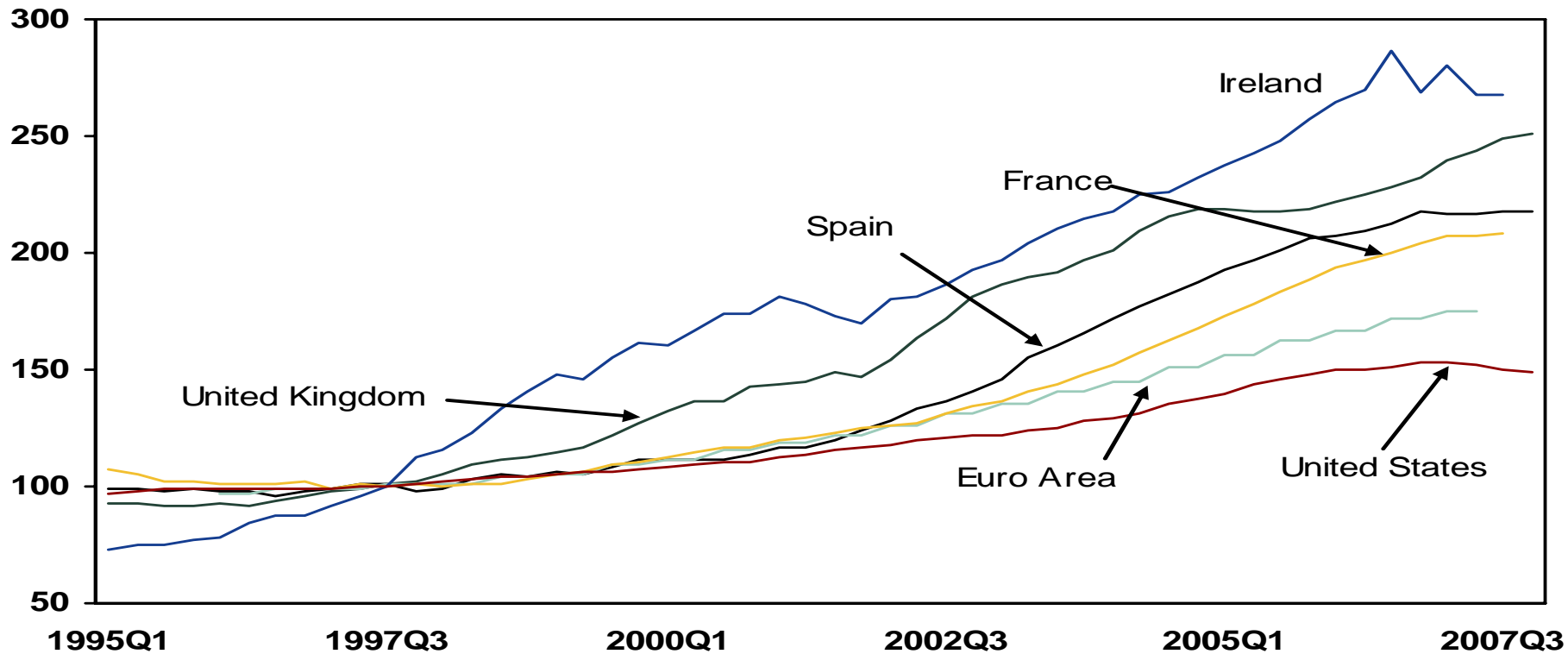
Mortgage Debt to GDP



Source: IMF

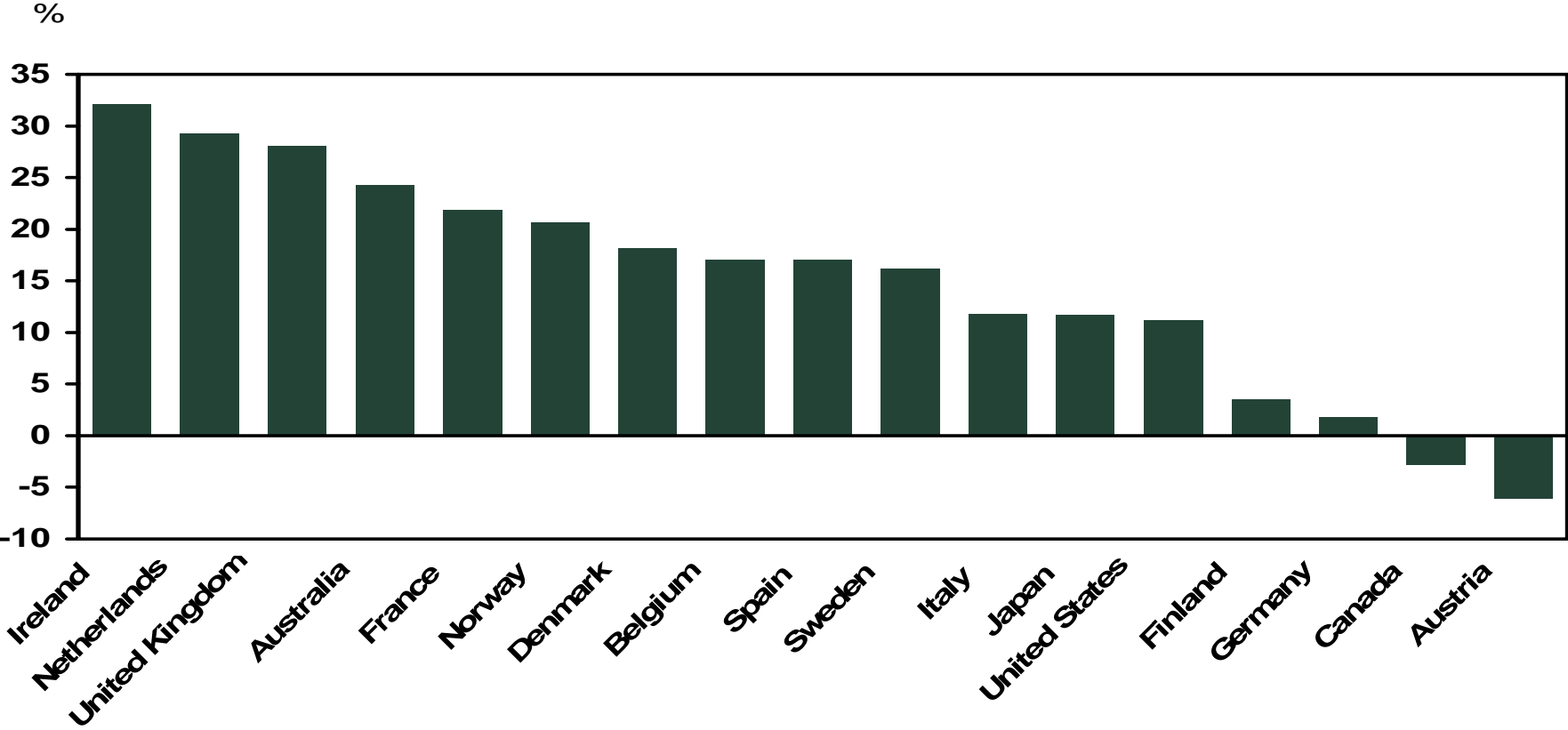
European Real Home Prices

1997 = 100



Source: IMF

House Price Gap

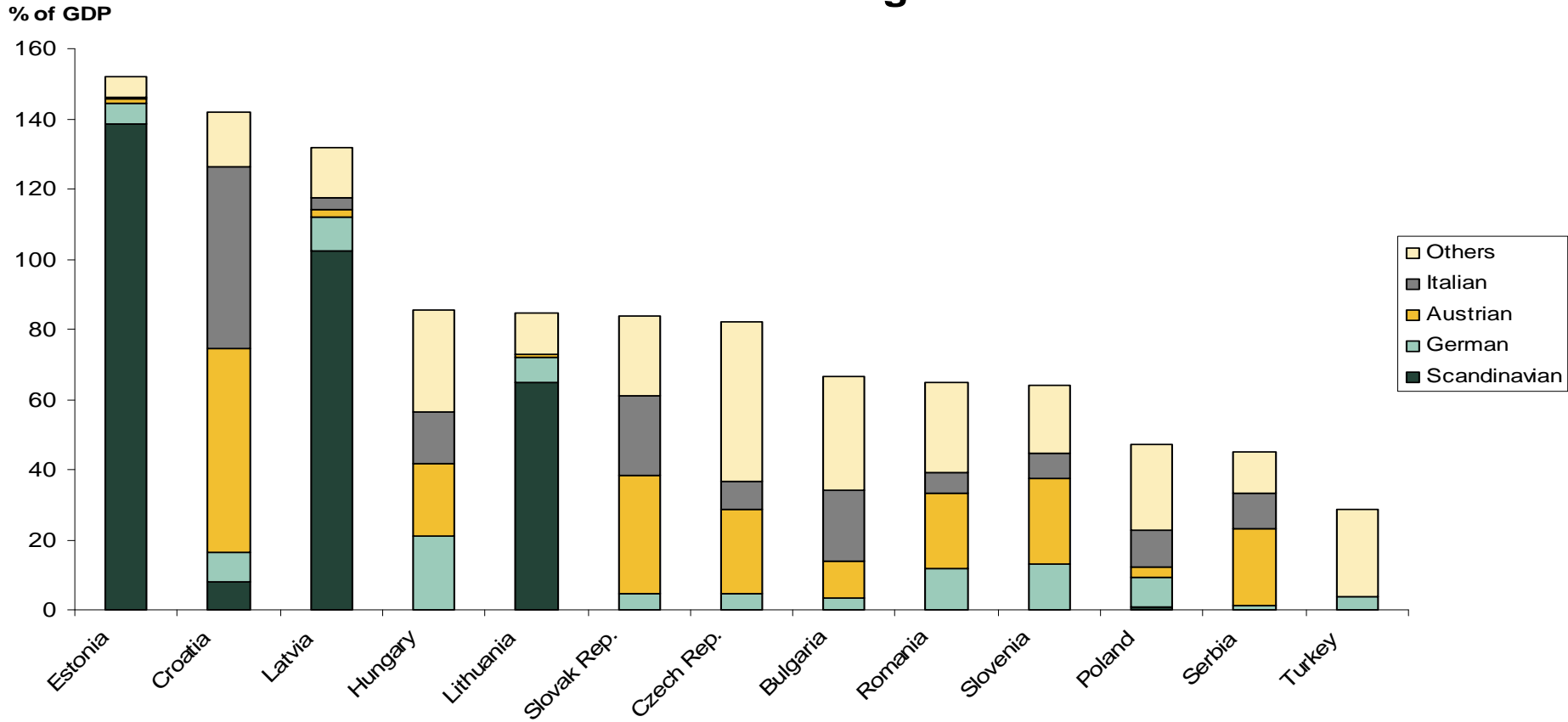


Source: IMF

Economic contagion

- CEE growth opportunity
 - Credit-starved economies seen as “green pastures”
 - Credit binge: credit flowed like water (over US\$1.7T borrowed)
 - Housing sector boom ensued
 - Unhedged foreign currency loans soared (Euro or SWF popular)
- The hangover
 - CEE economies slowed
 - Domestic currencies plummeted
 - Debt-ridden consumers default
 - Impact on Western Europe is expected to be profound

Liabilities To Foreign Banks



Source: IMF

Response betrays crisis

- Fiscal response to CEE crisis
 - Support for CEE economies an imperative
 - Political vs economic costs
 - Fortunes of East and West intertwined
- National response to financial crisis inadequate to resolving a European problem
 - Exposes soft under-belly of the EU financial sector
 - May be a factor in exacerbating the problem
 - Small countries suffer from inadequate scale and resources

The way forward

- Coordinated fiscal response required
- Canadian model has virtues that may be relevant
- Unified regulatory/supervisory framework a necessity
 - Financial sector supervisory and regulatory functions remain fragmented and need to be consolidated
 - “Beggar thy neighbour policies” will lead to “race to bottom”
- European financial stability fund?
 - A number of countries has similar funding vehicles

The bottom line

- Canadian housing and financial sector correction is expected to be modest
- Mitigating the adverse impact of the economic crisis in the CEE will require significant financial resources
- Despite the aggressive actions so far, further losses and bank failures remain likely
- The way forward for Europe will be increased coordination in both fiscal and prudential policies
- A turning point in the financial crisis will come about when home prices begin rising



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