The Credit Crisis in Canada: The First Six Months

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The 2007 credit crisis irrupted in Canadian financial markets in mid-August. The immediate backdrop to this was the growing concern in financial markets about the value of assets underlying commercial paper, and especially the extent to which these assets were connected to a deteriorating real estate market in the United States. The subprime mortgage sector in particular was facing increasing degrees of delinquency, and growing appreciation of the extent of increasingly problematic mortgages. In conjunction with great uncertainty about the extent to which commercial paper and other securities were exposed to this troubled mortgage sector, confidence in the quality of a wide range of financial assets dramatically eroded.

The greed that underpinned the search for yield was quickly displaced by the fear that fuelled a need for liquidity. With the irruption, the risk premium on short-term commercial paper zoomed upwards and non-liquid asset prices plummeted. For some securities, the market froze and trading ceased. Non-market crisis options were hastily arranged, most notably the Montreal Accord which sought to convert the short term assets of 23 commercial paper trusts into longer term assets through a negotiation process under the auspices of major banks and other institutional investors, such as the Caisse de depot et placement du Quebec.

THE GROWTH IN CREDIT MARKETS

It is significant that one aspect of the larger economic environment underlying these events is the relatively sustained period of solid economic growth. Beginning in 2004, the real annual growth rates of the Canadian economy have been slightly better than 3%. For capital, however, profitability, rather than growth per se, is the objective. By this measure, recent years have been especially rewarding. Net corporate profit, after recovering from the slowdown of 2001 and 2002, jumped to a record $102.6 billion in 2003 and then continued to new heights of $132.3 billion, $157.6 billion and $168.2 billion in 2004, 2005 and 2006 respectively. Figures for the first three quarters of 2007 show a further $131.5-billion (unless noted, data is from Statistics Canada). The return on capital employed, which had fallen to 5% in 2002, has rebounded strongly and has averaged better than 8.5% between 2005 and the 3rd quarter of 2007. The return on equity in 2005, 2006 and the first 3 quarters of 2007 was 12.6%, 12.5% and 11.9%, respectively, levels which had not been realized since 1988. The figures suggest that, in Canada at least, these have been good times for capital.

A breakdown of the aggregate figures shows that the finance and insurance sector has in fact done even better than the Canadian average. After virtually no growth between 1995 and 2002, the net profit of the finance and insurance sector in Canada has increased sharply. The $25.6 billion in net profit received by this sector in 2003 appears quite modest beside the $43.8 billion recorded for 2006. A further $35.5 billion were racked up in the first three quarters of 2007, with the $12 billion sum for the third quarter being the highest on record. Beginning in 2006, the return on capital employed has been at its highest level since Statistics Canada began compiling those returns back in 1988. For the second and third quarters of 2007, the return exceeded 10%, markedly better than the 8.5% average for the Canadian corporate sector as a whole. Finance and insurance also did better than the national average when assessed by the return on equity. Through the first three quarters of 2007 the sectoral returns have been consistently 0.4% to 1% higher.

Although low and falling profit rates can directly contribute to increased economic instability and increase the probability of some disturbance or miscalculation precipitating a crisis, the 2007 credit crisis underlines the point that a bout of low and falling rates are not necessary preconditions. Simply put, high and rising profit rates are no guarantees against the outbreak and spread of economic crisis. Economic instability and the possibility of crisis are rooted in the structure of capitalist production. The development of the credit system, and the increasing complexity of financial markets incidental to the development of capitalism, offer flexibility and considerable elasticity for the agents involved in the myriad circuits of capital. These developments offer new opportunities for favoured agents to appropriate portions of newly produced value, but they cannot guarantee that the atomistic decisions of private participants will necessarily be appropriate or timely. There is always the possibility that purchases will not smoothly follow sales, that sales will not be followed by payments, and that any of the many individual circuits of capital may be ruptured.

CREDIT CYCLES AND FINANCIAL INSTABILITY

The strong economic conditions for capital that preceded the crisis of 2007 induced behaviour in the financial sector of the sort identified and analyzed by theorists and critics ranging from Karl Marx and Thorstein Veblen to John Maynard Keynes and Hyman Minsky. The expectations of agents representing financial capital are essentially endogenous and are powerfully shaped by yesterday's events. Rising profits and profitability induce expectations of further rises, resulting in increased demands for financing on one side, along with the relaxation of credit standards and risk assessment on the other. An expansion of credit is the result. To this general tendency, then, is added the specific elements that characterize the setting of financial markets today in Canada and worldwide.

First is the regime of low interest rates, nationally and globally, which settled in after national governments and their central banks, supported by the interests of wealth holders, successfully lowered inflation rates in most of the leading industrialized countries from the mid-1980s onward. The success of this initiative – waged at the expense of the working class through slow employment growth, attacks on unions and workers' rights, and repressed real wage gains – was visible by the mid-1990s. Low interest rates encouraged private sector demand for credit. Much of this demand, especially in Canada and the USA, emanated from consumers. Upper income and economically well-off households availed themselves of the more favourable borrowing rates. But the growth in credit demand was not confined to the privileged strata. The harsh regimen imposed on workers through the 1980s and 1990s had not nullified their desires to at least maintain the standard of living identified with the 'middle-class.' Nor in many cases had it sufficed to negate the material success associated with the American dream. Extended credit at lower rates offered an attractive means by which income restraints imposed by a more austere labour market could be relaxed, if not altogether transcended.

On the supply side, the financial sector was more than forthcoming. Through a combination of instruments, including personal loans, personal lines of credit, credit card balances and primary and secondary mortgages, household credit in Canada more than doubled between 1996 and 2006, and exceeded the $1 trillion mark for the first time in 2006. More than two-thirds of this total is mortgage credit, although the fastest growing component is the non-mortgage portion (referred to as consumer credit by Statistics Canada), which tripled in size over the same period. Similar expansion of household debt occurred in the U.S., where total outstanding values of household mortgages doubled between 1999 and 2005 and increased a further 10% in 2006 (Federal Reserve Bank, *Statistical Supplement to Federal Reserve Bulletin: January 2004* and *October 2007*).

Falling interest rates tend to reduce interest rate spreads. One response of credit issuing institutions to the fall in rates and spreads was to try to increase volumes, which meant aggressively seeking new clients. And as the pool of prime customers is drained, those with less sterling credentials are courted.

The Minskyian theories of financial fragility mentioned above emphasize the subjective shifts of the demanders and issuers of credit as the expansion phase gathers momentum. As noted above, on the supply side, conventional valuations of risk are revised downward as credit is extended. The run-up to the 2007 crisis, however, added to this by introducing new financial instruments. These new instruments constitute the second specific ingredient distinguishing the current credit crisis. These financial innovations are a subset of the larger market of financial derivatives – a market which has been growing rapidly since the liberalization of financial markets in the early 1990s. Taken as a whole, the market for derivatives is approximately $516 trillion (US) and comprises about 75% of global liquidity ("Knowing the known unknowns of a possible market disaster," *Globe and Mail* 24 November 2007).

THE CREDIT DERIVATIVES MARKET & SUBPRIME MORTGAGES

A subset of this market consists of credit derivatives – marketable securities that have been cobbled together from a smorgasbord of smaller assets such as various consumer loans and mortgages. Financial innovators perceived that the relatively high risk that was attached to some of these components could be diluted and spread widely through the bundling and marketing of these new derivatives. Furthermore, by tagging them as short-term securities and identifying an active market for those securities, their higher risk could be rendered more acceptable to buyers due to the belief that the securities possessed high liquidity. For the issuers of high-risk credit, the possibility of creating and then selling a credit derivative offered the tempting prospect of removing that risk from their balance sheets.

Gabriel Kolko ("Weapons of mass financial destruction," *Le Monde diplomatique*, October 2006) has pointed out that the credit derivatives →

market was virtually nonexistent as recently as 2001. Up to 2004, it expanded slowly, but rapid expansion occurred over the next couple of years and by June 2006 these new derivatives were valued as $26 trillion (US). As of November 2007, estimates value this market in the neighbourhood of $51 trillion (US). Underlying the expansion, however, was the more fundamental effort by financial institutions to deliver more and more credit to less and less well secured segments of the market ("Explosive derivative growth expected to withstand credit crunch shockwaves," *Globe and Mail*, 23 November 2007).

The most telling instance of this was the recent increase of non-prime mortgages in the US. In 2003, non-prime mortgages for US households comprised 21% of all new household mortgages issued and about 40% of these (or 8.5% of all household mortgages) were of the subprime variety. Over the next 3 years, the total value of newly issued prime mortgages in the U.S. fell, while the value of nonprime mortgages increased. In terms of numbers, the non-prime share rose to over 50%. Subprime mortgages continued to comprise about 40% of the nonprime category. But in 2006 they made up 20% of all new mortgages issued (Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2007*).

The speed at which new credit was extended was, from 2004 well into 2007, matched by the eagerness with which the newly minted securities were snapped up. Any lingering reservations by potential buyers about the downside dangers that might be lurking in the higher risk securities were significantly offset by various "insurance policies" in which large institutions, primarily banks, were prepared to buy back the securities in the event of serious market disruptions. The consumer-supported economic expansion continued despite growing polarization of income and wealth. As long as debt payments were current, financial capital had opened up an effective new channel through which the circuit M – M' (money begetting more money) could, with the assistance of workers' consumption, seemingly bypass the necessity of production altogether.

Mainstream economic theory stood to provide intellectual support for these developments by emphasizing the improved efficiencies associated with the proliferation of derivatives. Specifically, innovation and the introduction of new financial instruments could be understood as meeting the demands of the market for ever more nuanced ways to manage and distribute risk. As various investors place derivatives in their portfolios, the availability of these new assets and the evident desire of agents to acquire them imply superior outcomes for profit maximizing or utility maximizing agents. The intertemporal maximization of consumer utility is, according to theory, impaired by credit market imperfections. The extension of credit to consumers and homebuyers, especially those who otherwise faced credit limits or even the denial of credit altogether, is interpreted by theory as evidence of the market overcoming these imperfections. In the derivative market, the pricing of securities is understood as the pricing of risk and, given the buyers' willingness to bear risk, optimal financial portfolios can then be assembled.

A second and newer strand of mainstream economic theory emphasizes the presence of asymmetric information between buyers and sellers in markets. This is especially relevant to financial markets, and even more so when the growth of new derivatives

results in composite securities with significant degrees of opaqueness. However, faith in the market's ability to price assets appropriately, combined with an impressive flow of profits to financial sector firms, favoured the positive efficiency-based assessment of new financial developments over the more unsettling implications of the dissenters from the alternative camp. Consequently, it was the former assessment that informed the outlook of various spokespersons for financial capital. As expressed by Finance Minister Jim Flaherty in a speech on June 27, 2007 to the Conference on Securities Law Enforcement: "The evidence is clear: economies with the most dynamic capital markets enjoy the strongest growth over the long run."

THE OUTBREAK OF THE CREDIT CRISIS & THE CENTRAL BANKS

The outbreak of the crisis in August 2007, and its persistence and subsequent spread, has rocked the complacency of the financial elite and their political bagmen. The Finance Minister was compelled to issue a statement on August 16 acknowledging that "Canada is not immune to fluctuations in global financial markets. Clearly there are stresses in some corners of the Canadian money markets." The dissolution of complacency, however, did not imply a rejection of the underlying ideology. The Finance Minister pointedly issued a call for private sector players in the financial sphere to "pursue orderly market solutions to this liquid situation" (available at www.fin.gc.ca/news07/07-065e.html). The Minister reaffirmed this position in a speech to the Canada West Foundation on August 30, 2007: "But the Canadian economy is the strongest it has been in a generation. That fact, along with important initiatives taken by the Bank of Canada and the private sector, have supported the functioning of the market. … Our government and the Bank of Canada continue to monitor the situation closely as it unfolds."

The Bank of Canada's support of the functioning of the market amounted to more than rhetoric and monitoring. As early as August 9, the Bank publicly announced that it was willing to provide the necessary liquidity "to support the stability of the Canadian financial system and the continued functioning of financial markets," emphasizing that this was part of the Bank's "normal operational duties relating to the stability and efficiency of Canada's financial system." The commitment to provide liquidity was continually re-affirmed in the weeks that followed. Events have required the Bank to act on this pledge.

The Bank had undertaken a number of liquidity interventions in the overnight market in June and July, with injections totaling $5-billion and $7.5-billion respectively. An additional $1.3-billion was provided in the first week of August, followed by a further $4.3 between August 9 and 15. This seemed to stabilize pressure on the bank's overnight lending rate for a while, but another $4.3-billion infusion was provided in the September 27 to October 3 span. The Bank attributed part of this to routine increased liquidity requirements at the end of the third quarter.

However, in its *Monetary Policy Report: October* 2007 the Bank provided data showing that these interventions continued well into the middle of the month. Another wave of liquidity injections were unleashed in mid- to late-November, totaling at times up to $2-billion per day ("Bank urged to extend liquidity provisions," *Globe and Mail*, 27 November 2007). These developments suggest first of all that the liquidity problems confronting Canadian financial institutions and, implicitly, the liquidity problems of other businesses and institutions that lie behind those in the financial sector, has become a chronic rather than episodic problem. Liquidity interventions have been undertaken by the Bank of Canada's counterparts in the U.S. and Europe over this period as well. Unlike these other central banks, however, the Bank of Canada has confined its interventions to the overnight market (less than 24 hours).

While these actions help keep the overnight lending rate close to its desired target, they have been less successful in pulling down the short term and midterm interest rates. Spreads have widened, forcing the Bank to reconsider not just its means of providing short-term liquidity, but also its entire monetary policy stance. It is significant that the bank reacted by not raising its target for the overnight rate through the fall of 2007, and that it then felt compelled to actually lower this rate by a quarter of a percentage point on December 4, 2007. This is the first reduction of interest rates delivered by the Bank since early 2004. The fact that it comes at a time when employment levels are rising, when unemployment rates have fallen to a 33-year low, and when wage gains have exceeded increases in the CPI (Statistics Canada, "Latest release from the Labour Force Survey," November 2, 2007) signals that suddenly the Bank is more worried about a recession and the consequences of a deepening crisis than about inflationary pressures.

Loathe as the bank may be to admit it, this is a change in its monetary policy stance. The belated reaction of the Bank in terms of significant rate cuts reflects its reluctance to renounce its previous contention that, given time, the markets will correct the mispricing of risk with minimal fallout. The deepening crisis, however, also points to the real possibility that there are limits to what monetary policy can do to stabilize an economy.

In the USA, the Federal Reserve has been much more aggressive in reversing its pre-crisis policy of raising and sustaining interest rates. After rising sharply from mid-2004 to mid-2006, the U.S. federal funds rate had been held at 5.25% from mid-2006 through the emergence of the crisis in the summer of 2007. Heightened concern about the seriousness of the crisis precipitated a 50 basis point reduction in September and a further 25 point reduction at the end of October. Minutes from the Fed's Open Market Committee meetings of October 30-31 reveal that the Fed believed that these reductions should serve to "forestall some of the adverse effects" of the credit hand housing crisis on the broader U.S. economy."

THE DEEPENING CRISIS

This more vigorous action on the part of the U.S. central bank, in comparison to the Bank of Canada, reflects in part the larger and more direct exposure of U.S. financial institutions to the →

problems associated with American real estate markets. However, recent events suggest that the 'adverse effects' have not been mitigated, but are in fact are gaining momentum. The woes in American real estate market have continued to deepen. The October figures revealed another drop in existing home sales – down 1.2% from September (seasonally adjusted) and down 20% from September 2006 (at www.realtor.org/press_room/news_releases/2007_q1.html). Lenders reported another 225,451 foreclosures in October, with estimates reaching 1.4 million for 2008 ("Foreclosures like 'one Katrina' a month: economist," *Globe and Mail,* 1 December 2007).

THE SUB-PRIME ICEBERG

In its mid-November Beige Book report on the U.S. economy, the Federal Reserve Bank noted lower construction levels and falling prices for both new and existing homes. It called the residential real estate market "depressed" and identified "only a few tentative and scattered signs of stabilization amidst the ongoing slowdown." Moreover, problems emanating from the subprime and nonprime mortgage markets were poised to escalate further in the months ahead, due to the fact that many of these mortgage rates are scheduled to be reset at higher rates. The November OECD report, *Financial Market Trends*, indicates that the bulk of mortgage resets are slated for the first seven months of 2008. These adjustable rate mortgages comprise about half of the entire U.S. subprime mortgage market, and the total value of subprime and nonprime mortgages slated for resets in 2008 amounts to $1.9 trillion (US). The delinquency rate for subprime resets is already 16% and the report calculates total losses in the subprime and nonprime markets that could run into the $200 billion to $300 billion range (Adrian Blundell-Wignall, "Structured Products: Implications for Financial Markets," *Financial Market Trends,* No. 93, 2007).

Through November, newspaper reports recorded the cumulative effects of the deepening crisis at the apex of American financial capital. Significant write-downs of the values of financial assets on their balance sheets were announced by a number of leading financial firms, including Bank of America ($3 billion), Bear Stearns ($700 million) and Merrill Lynch ($8.4 billion). Citigroup, which had just announced a $5.9 write-down in October, warned of the possibility of a further write-down for the fourth quarter in the range of $8 billion to $11 billion. Freddie Mac, the second largest buyer and guarantor of home loans in the U.S., announced a $2 billion third quarter loss. The carnage extended to the resignation of the CEOs of both Citigroup and Merrill Lynch.

The deteriorating situation and the prospect of more damage ahead underlined a growing appreciation of the need to exert some control over the crisis. Central bank provisions of short-term liquidity and recent and expected future reductions in the bank rate, combined with the 'normal' efficient functioning of markets, could no longer be relied upon to protect the interests of capital. Reality punctures ideology and non-market alternatives are called upon. The Montreal Accord, initiated back in August by some of the most heavily exposed financial institutions to the Canadian commercial paper crisis, is one notable and early example of players opting to transcend the market in the management of the crisis. It is significant that both the Bank of Canada and the federal government explicitly voiced their support for this private sector initiative.

The belated U.S. counterpart was the formation of the so-called multi-billion dollar 'super-fund', orchestrated by Citigroup, J.P. Morgan and Bank of America, to buy securities that were formerly viewed as being highly liquid, but which had become virtually impossible to sell at anything more than a fraction of their original value. Equally significant have been the efforts of the US government, led by Treasury Secretary Henry Paulson, to work with some of the largest banks, mortgage investors and consumer groups to freeze mortgage rates for existing homeowners who have mortgages that are in line for rate escalation in the upcoming months. A plan involving a five-year rate freeze for eligible households was announced by the administration on December 6, 2007 ("Mortgage freeze has critics dreading thaw," *Globe and Mail*, 7 December 2007).

Such extra-market initiatives hope to effectively "freeze" certain market developments in a joint quest for stabilization and an orchestrated and voluntary apportioning of the costs and losses. Such arrangements cannot, however, transcend the vested interests of the parties seated at the table, so the inherent economic and political power of the parties will shape the contours of the agreement. Furthermore, without a single dominant player or one with coercive power, agreement can remain elusive. The Montreal accord, which froze the assets of some 23 commercial paper trusts, was initially scheduled to produce its asset management plan in mid-October. As of early December, only one of the 23 trusts has had its situation resolved.

PROGNOSIS

The development of the credit system can, in 'normal' times, provide welcome flexibility for agents in the sequence and timing of their many buying and selling activities. The credit system is, however, prone to escalation which amplifies the economy's expansion, and capable of sharp contraction, ushering in a period of cold economic reckoning. In capitalism, however, the implied optimality and tranquility of 'normal' times are best understood more as a convenient fiction redolent in abstract theory than as a description of an actual state of the world. Turbulence is the rule, not the exception, but the interplay and outcomes of these economic forces have their own conjunctural characteristics and implications.

The weakening of the U.S. housing market has been apparent throughout 2007, but the crisis is dated in the summer of 2007 due to dramatic reactions and adjustments in financial markets, hence the label 'credit crisis.' The adverse effects of the crisis on the balance sheets of financial corporations have become increasingly apparent. As noted above, the November news was less favourable than the reports from previous months, and the downside risk for the months ahead has been rising. Nevertheless, 2007 was an exceptionally good year for the financial sector.

In Canada, fiscal year-end financial statements for the big six Canadian banks show that their combined profits exceeded $19.5-billion (up from the $19-billion for fiscal 2006), despite their incurring credit market-related writedowns of more that $2-billion ("At CIBC, the bad old days are back," *Globe and Mail*, 7 December 2007). Wall Street and Bay Street firms also had a good year, aided by lucrative fees and commissions from record levels of mergers and acquisitions has characterized the first six months of 2007. Shareholders, as whole, will be unhappy only insofar as the excellent financial performance over the first two quarters had led them to anticipate even higher earnings.

The major financial institutions appear to be sufficiently well capitalized to be able to sustain their current credit woes into the first half of 2008, although this may result in some reduction in share prices and earnings per share. Lower grade bond holders are more at risk as the credit crisis spreads, and the markets have already witnessed the flight to quality. The majority of wealth holders, however, have diversified financial portfolios, so the accumulation of losses from assets directly implicated to troublesome real estate markets will be offset by other portfolio holdings. Their larger concern is the weakening of the macroeconomy as a whole, as the contagion effects from the real estate/credit crisis spills over to the wider components of domestic demand. This can be sure to adversely affect profits in 2008.

For the working class, especially in the U.S., the prospects are bleaker. They carry the bulk of home mortgages, especially those in the nonprime category. The cuts in central bank lending rates have not trickled down to their mortgage rates, or their credit card rates, and, as noted above and notwithstanding the U.S. government's new mortgage freeze proposal, many homeowners will be facing rate rises in the months ahead. The negative demand effects emanating from the crisis have yet to run their course, but already it looks as if the rate of job creation of previous years is unlikely to be replicated in 2008.

Wealth holders can and do protect themselves to some extent from risk and unexpected shocks through a strategy of asset diversification. For much of the working class, their only real assets are their home and their capacity to work. This is a portfolio which cannot be diversified. They are not protected from a crisis that hits residential real estate markets and the exposure imposes considerable hardship on many and extreme hardship on some. Furthermore, a slowdown in job creation, and the real possibility of net job losses, at least in the U.S., as the spectre of a U.S. recession looms ever larger, implies that for workers the value of their other asset – their capacity to labour – will also take a hit. Inevitably, the distribution of this burden will be felt unequally across working class households and communities.

The costs of adjustment are likely to escalate in 2008 and the potential severity of the credit crisis is also likely to widen the range of state involvement. It is imperative that labour and other progressive organizations mobilize in order to avoid assuming most of the burden and to ensure they secure a leading role in constructing a way out. **R**

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