



TD Economics

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Data Release: Financial Risk Growing

- In today's Winter Financial System Review, the Bank of Canada expanded on its well-known view that international events have significantly increased risks to the Canadian economy and financial system.
- The on-going European financial crisis, slowing global growth and the resulting flight into safe haven investments are key causes for concern. These events have constrained access to funding for financial institutions in advanced economies, pushed credit spreads higher and led to a sharp decline in global equity values.
- The Canadian financial system has fared better. The hit to equity values has been less severe and banks' ability to access funding has not been impaired. Canada's exposure to European sovereign debt is small. The amount of periphery European debt held by Canadian institutions is roughly 10% of tier 1 capital. However, further deterioration in global events remains a major risk to the Canadian outlook. There was a special focus on pension and life insurance funds. Low interest rates have lowered the returns on their investments putting their ability to meet future financial obligations at risk. Second, a worsening in global conditions would deliver households a blow they are not well prepared for. Even assuming a moderation in credit growth, stable interest rates and a slight pick-up in household income, the Bank estimated that the share of loans in arrears will double by 2013. A further deterioration in home and equity values and a rise in the unemployment rate would put additional stress on households.
- Europe is already believed to be in a recession, and in order to stop the economic and financial bleeding, European leaders need a credible plan to help Banks access credit markets and ease the financial burden of debt-laden governments. The central bank also reiterates that carefully implementing new Basel III reforms is important to the future health of the global financial system.

Key Implications

- The Bank of Canada's report reinforces our view that the global economy and financial system is clearly in a fragile position. We are not optimistic that European leaders will get their act together any time soon. It is our view that the European financial crisis will likely worsen into the first half of 2012, global growth will slow further and risks will continue to increase.
- Canada will largely be impacted by falling commodity prices, a hit to confidence and weaker export growth. Nonetheless, these events are likely to push the Canadian unemployment rate higher and asset values lower— hitting the household sector at a time when they have become more vulnerable to such shocks. The shock will be mild enough to avoid a household deleveraging, but will certainly constrain household expenditures.
- Overall, financial and economic stresses will continue to worsen through the first half of 2012 and the Bank of Canada is unlikely to raise interest rates in this environment. However, barring a recession, the Bank of Canada is unlikely to cut rates either.

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