



## Tough Times, Aggressive Actions

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There is growing evidence that the global economic slump is deepening and that consumer and business access to credit is shrinking. The latest economic data for the United States, China, Japan and Europe show that manufacturing is contracting rapidly. The housing market in the U.S. remains precarious and credit losses and writedowns at financial institutions worldwide are now approaching \$1 trillion, clobbering bank stocks, especially in the U.S. (*Chart 1*).

Analysts continue to cut profit forecasts and negative pre-announcements outnumber positive

ones by a ratio of about four-to-one. Government bond and bill yields have fallen sharply, but corporate spreads off government bonds remain historically wide. Trouble is also brewing in the commercial real estate sector as prices have fallen sharply and CMBS spreads have blown out (*Chart 2*). The U.S. ten-year Treasury bond yield recently hit an all-time low of 2.70% and the three-month bill rate is a mere 1 basis point. People are more concerned about the return of their money than the return on their money. At 3.15%, the Canadian ten-year yield is 45 basis points above the U.S. despite the explosive increase in U.S. bond issuance. The Treasury market is still seen as the global safe haven, driving U.S. yields down and the U.S. dollar up. There is little doubt that the U.S. recession, which is now officially dated to have begun last December, will be one of the most severe in the postwar period. It is already the longest U.S. contraction since 1982.

The Institute for Supply Management's (ISM) factory index for November dropped more than forecast to 36.2, the lowest level since 1982. A reading of 50 is the dividing line between expansion and contraction. Similar measures from China, the U.K., the Euro area, and Russia all dropped to record lows. Business confidence is down and we are forecasting a global recession well into 2009 (*Chart 3*).

Consumers, reeling from the housing collapse, stock market plunge and job losses, are pinching their pennies.

Chart 1

### Banks Clobbered

2008 (January 2, 2008 = 100 : as of December 1, 2008)

#### Bank Stock Indexes

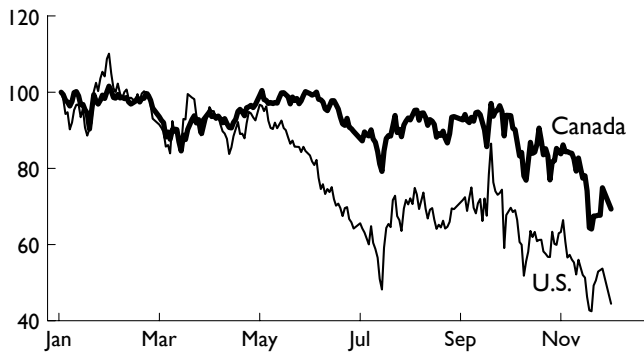
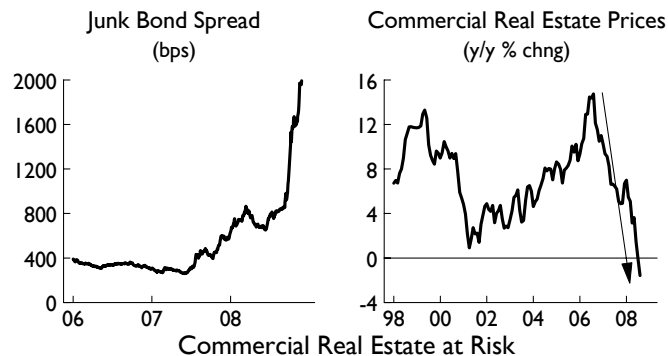


Chart 2

### Corporate Credit Spreads Rise

United States



Junk Bond Spread = Merrill Lynch High Yield Corporates minus Treasuries  
Commercial Real Estate Prices = S&P/GR Commercial Real Estate Index

Chart 3

## Global Recession

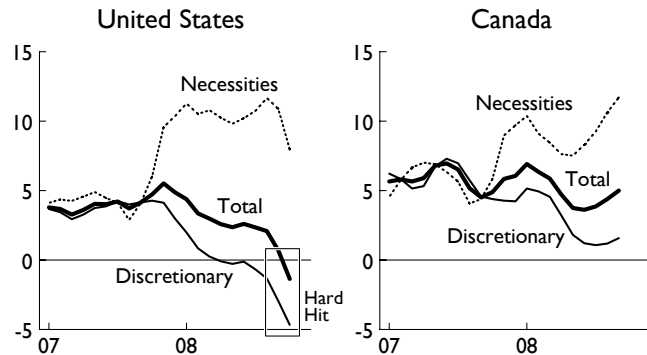
(y/y % chng)



Chart 4

## Discretionary Spending Crimped

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



Necessities = food, health care, gas

Table 1

## Policy Responses Wear Off after a While

Dow Jones Industrial Average

Date	Event	Level	Date	Event	Level
<b>2007:</b>			<b>2008 (continued):</b>		
Aug 17	Discount rate cut [50 bps]	13,079	Sep 16	AIG takeover	11,059
Aug 31	FHIA Secure unveiled	13,358	Sep 19	TARP announced	11,388
Sep 18	Fed Funds rate cut [50 bps]	13,739	Oct 2	Senate passes TARP	10,483
Oct 10	'Hope Now' unveiled	14,079	Oct 6	Pay interest on reserves	9,956
Oct 15	Super SIV	13,985	Oct 7	Commercial Paper Facility unveiled	9,447
Dec 12	TAF	13,474	Oct 8	Coordinated global rate cut	9,258
Jan 22	Intermeeting FFR cut	11,971	Oct 14	TARP II	9,311
Feb 7	Fiscal stimulus passed	12,247	Oct 21	MMIFF	9,034
Mar 11	TSLF	12,157	Nov 24	Citigroup guarantee	8,443
Mar 13	Dodd-Frank bill	12,146	Nov 25	Buy GSE debt, TALF	8,480
Mar 16	Bear takeover	11,972			
Mar 16	PDCF	11,972			
Sep 7	GSE takeover	11,511			

In both Canada and the U.S., data suggest a marked decline in the pace of discretionary spending and, thanks to the fall in gasoline prices, spending for necessities has slowed as well (*Chart 4*). Consumer confidence has dropped sharply and employment has been falling in the U.S. all year. Early evidence of the vigour of holiday sales is mixed; but where there was heavy buying, prices had been slashed so drastically that analysts fear additional profit erosion in the already-battered retail sector.

### The Policy Response

Government response all over the world has gone well beyond traditional monetary and fiscal easing. The U.S. Treasury and the Federal Reserve (along with many other central banks) have introduced countless programs and initiatives to shore-up financial institutions, enhance depositor and investor confidence and to thaw the credit freeze (*Table 1*). Governments are backstopping, guaranteeing, and making loans, as well as providing capital injections to banks and other financial institutions. The Fed has more than doubled its balance sheet; the Bank of Canada has expanded its balance sheet as well, but to a proportionately smaller degree. Canadian banks are the strongest in the world. But this quantitative easing has had little impact on spending. Even though the U.S. monetary base has risen by more than 35% year-over-year as of October 31, the money multiplier and the velocity of money have plunged; this is typical of a period of very low confidence. Households and banks are hoarding cash to rebuild their savings and capital; this is what the textbooks call a liquidity trap, where the demand for money is exceedingly high and transactions are very low (*Chart 5*).

The government rescue plans have been far more successful in easing liquidity in the overnight interbank market than for consumers or business lending (*Chart 6*). There are signs of broad-based declines in consumer access to capital. Credit card companies are expected to cut loans by more than \$2 trillion over the next 18 months according to some analysts. And while the commercial

Chart 5

## Federal Reserve Injections Don't Spur Lending United States

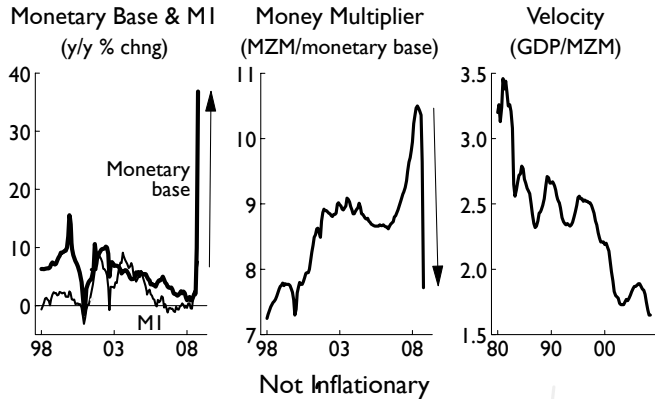
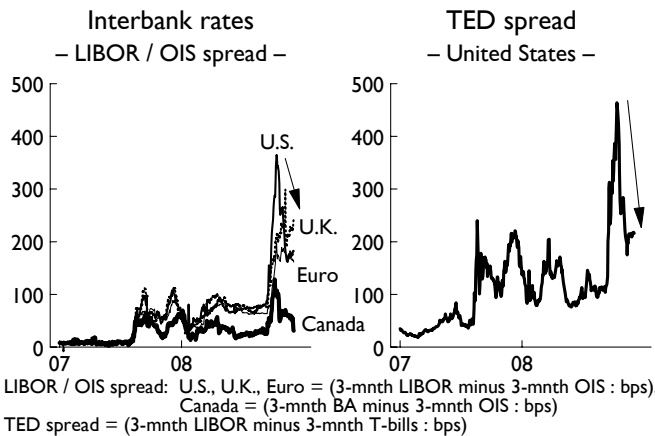


Chart 6

## Financial Crisis Eases for Interbank Lending



paper market has begun to revive, many businesses in the U.S. are having trouble raising short-term operating capital. With the plunge in auto sales, many plants will be closed without pay for longer than usual over the holiday season, and the Detroit Three automakers will return to Congress soon with the hope of government bridge financing. Instead, the Congress might well choose to broker a pre-packaged bankruptcy for GM (and maybe Chrysler).

Long-term capital for business has been available only for investment grade borrowers and this capital is expensive. The dramatic fall in commodity prices, reflective of the global recession, has also triggered investment project cancellations, notably in the oil sands and mining industry. Energy producers have been hard hit as oil tumbled to less than \$50 a barrel and OPEC said slowing global growth means demand will be “much lower” than expected a month ago. Crude oil for January delivery declined to a 3½-year low in New York. OPEC deferred a decision to reduce output until its next meeting on Dec. 17.

The Fed and the Bank of Canada will undoubtedly cut interest rates at least 50 basis points when they meet later this month. There is even a chance that the Fed will cut a full percentage point, leaving overnight rates at zero. But the effective fed funds rate has been trading at a rate much lower than the 1% target, reflecting the significant rise in excess reserves. Chairman Bernanke acknowledges that

while monetary easing has likely offset some of the negative effects of the financial crisis, the offset has been “incomplete” as credit spreads widened and lending standards became more restrictive. So the Fed provided additional liquidity to financial institutions, lending cash secured with relatively illiquid assets. The Fed also increased bilateral currency swap agreements with 14 central banks and has committed to preventing the failure of “systemically important” firms.

### Additional Steps to Avert Deflation

Chairman Bernanke states publicly that the U.S. economy remains under “considerable stress” and that labour market conditions have “worsened further in November.” He minces no words regarding the likely longevity of this slowdown and the need for non-

traditional Fed action as well as fiscal stimulus. No doubt the Obama team will be poised to introduce aggressive fiscal stimulus quickly following his January 20 Inauguration.

The Fed now makes it clear that it is willing to provide liquidity beyond lending to banks through the use of its balance sheet: buying longer-term U.S. Treasury or agency securities on the open market in “substantial quantities” to reduce yields on these securities and thereby stimulate aggregate demand. Yields fell from record-low levels on the announcement alone. The Fed has already announced its intention to purchase GSE debt and GSE mortgage-backed securities over the next few quarters, which also triggered a drop in mortgage rates.

As well, the Fed can provide backstop liquidity for certain markets, as it did in the commercial paper market, bypassing banks and primary dealers, lending directly to borrowers or investors in key markets. The Fed and the Treasury already announced a new facility that would lend against asset-backed securities collateralized by student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. This will enhance credit availability for households and small businesses.

**The Bottom Line:** The Fed is willing to do whatever it takes to ensure financial market stability and a rebound in U.S. and global economic activity. Concerns about inflation, potential credit losses on their balance sheet, or the burgeoning budget deficit are of far less importance, and will be addressed when the financial and economic ills heal.

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