

# CANADA AND THE ECONOMIC MELTDOWN

## Introduction

### Focus

In the fall of 2008 the United States' economy was in danger of collapsing. Major U.S. banks had declared bankruptcy, the stock market had dropped to levels not seen since the Great Depression, and hundreds of thousands of people were facing foreclosure on their homes. Since Canada's economy is closely tied to that of the United States, it wasn't long before Canadians began to worry about their own savings and whether or not this country was heading for a recession. In this *News in Review* story we'll look at what caused the economic crisis, how it might affect Canada, and try to predict how it will all turn out.

### Did you know . . .

In the United States, mortgage interest on your house is tax deductible. This often encourages people to take on higher mortgages and thus higher risk.

It was impossible to escape the bad news. Headlines throughout September and October of 2008 talked about a “financial tsunami” and an “economic Pearl Harbour.” What these headlines were referring to was the fact that the U.S. economy was facing collapse. Average citizens were confused. How could the economy collapse? What was going on? And what impact would the economic crisis have on their lives?

These were all good questions, and as the answers started to emerge, public confusion turned to public anger. People became angry because it turned out that the economic problems were seemingly a result of greed and mismanagement on the part of financial institutions in the United States. For years, U.S. banks had been allowing people who had very little money to get mortgages to buy homes. The banks had devised special loans that had very low mortgage payments, payments that would jump dramatically after a couple of years. The banks said that by the time the mortgage payments increased, the value of the person's house would have increased and that the increase in value, or equity, could be used to refinance the home and lower the payments again.

The problem with this risky idea was that it was dependent on continued increases in housing prices. As it turned out, this was not the case. So when the mortgage payments increased, and house prices had not increased, thousands of people could no longer afford their homes. The banks then either foreclosed,

or people just walked away from their homes. In either event, banks were stuck with billions of dollars of bad debt.

Adding to this problem was the fact that the banks had sold off the mortgages to other investors as a way to make even more money. When the mortgages went into default, the investors discovered that their investments were worthless. As a result, large investment banks actually ran out of money, and stocks plummeted in value. This had a major impact on the global economy, because investors and financial institutions in other countries had sunk a great deal of money into the U.S. market.

The U.S. government had to bail out the banks by injecting USD\$700-billion into the economy. Time will tell if it is enough to stabilize the economy. And time will tell if that money is ever returned to American taxpayers.

The Canadian economy is closely tied to that of the United States, so Canadians braced themselves for the worst. Canadian stock markets soon plunged. Although the Canadian stock market has been erratic, by the end of October the economy had remained relatively stable. The Canadian government made its own \$25-billion injection into the economy but refused to call it a bank bailout. In the days following the Canadian intervention, Canadian stock markets recovered somewhat. Observers hope it is enough to prevent the economy from sliding into a recession or worse—a full-fledged depression (severe economic downturn).



# CANADA AND THE ECONOMIC MELTDOWN

## Video Review

### Did you know . . .

The National Community Reinvestment Coalition—an association of more than 600 community-based organizations that promote access to basic banking services to create and sustain affordable housing and vibrant communities for U.S. families—estimates that as many as 1.5 million Americans could lose their homes by the time the economic crisis is over. To learn more about the Coalition’s perspective on the current economic crisis, visit their Web site at [www.ncrc.org](http://www.ncrc.org).

### Pre-Viewing Activity

Before watching this *News in Review* story, select a partner or join a small group and record responses to the following questions.

1. What do you know about the current economic crisis?
2. Has anyone in your family been directly affected by the crisis (for example, lost money in the stock market or been laid off)? If so, describe the situation.
3. Has your family, or anyone else you know, made changes in spending plans because of the economic situation (for example, cancelled plans for a vacation or spent less on important holidays and celebrations)?

### Viewing Activity

Respond to the following questions as you watch the video.

1. When is the last time the economy faced a crisis of this size?  
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2. Cleveland is a “typical” blue-collar city in the U.S. As a result of the economic crisis, one in 10 homes is in foreclosure there. Describe three things that happen to property after it is foreclosed on.  
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3. Explain how the U.S. residential real estate market is linked to the general economic crisis.  
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4. Why does Jim Rokakis, a County Treasurer in Cleveland, say that the residential foreclosures are the result of “fraud on an unprecedented scale”?  
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# CANADA AND THE ECONOMIC MELTDOWN

## *The Meltdown*

### Definition

*Fannie Mae* is the nickname of the Federal National Mortgage Association. *Freddie Mac* is the nickname of the Federal Home Loan Mortgage Corporation. Both companies buy loans from banks or mortgage firms and resell them as mortgage-backed securities (investments). Together, they owned or guaranteed about half of all U.S. mortgages.

### Quote

"This really is an economic Pearl Harbour. That sounds melodramatic, but I've never used that phrase before." — Warren Buffet, billionaire and investor *News in Review* video

### Did you know . . .

The current (October 2008) budget deficit for the United States is estimated at \$455-billion. More alarming, the total debt for the U.S. has been set at \$10 000 000 000 000. What is this number in words?

The current economic crisis is the result of a number of factors, most of which originated in the United States. This section begins with a timeline outlining the economic collapse. An in-depth exploration of some of the major factors that led to the collapse follows. All financial figures, unless otherwise stated, are in U.S. dollars.

### Timeline of 2008 Events

**September 7** U.S. government seizes Fannie Mae, Freddie Mac: Fannie Mae and Freddie Mac are the two largest mortgage companies in the United States. The government took control of the companies after they announced an imminent collapse. It is estimated that the mortgage companies held over \$5-trillion in bad debt.

**September 14** Bank of America buys out Merrill Lynch: After Merrill Lynch announces financial difficulty, the Bank of America pays \$50-billion to buy the brokerage house.

**September 15:** Lehman Brothers files for bankruptcy: When this investment bank filed for bankruptcy it was the largest bankruptcy filing in the history of the United States, at an estimated \$639-billion.

**September 17** U.S. government bails out AIG (American Investment Group): The government provides an \$85-billion loan to rescue AIG after they announce they are near financial collapse. The bailout gives the government nearly 80 per cent of the equity in the company.

**September 18** President George W. Bush announces bailout plan: The government unveils a \$700-billion

program to buy hundreds of billions of dollars in bad loans. The Dow posts its biggest rally in six years.

**September 21** Goldman Sachs, Morgan Stanley become bank holding companies: Investment banks Morgan Stanley and Goldman Sachs are transformed from investment banks into bank holding companies to allow them access to government assistance.

**September 26** Washington Mutual collapses: The failed company recently held \$307-billion in assets.

**September 29** Wachovia Bank collapses: The bank (formerly called First Union Bank) collapses and is bought by Citigroup for \$2.1-billion in stock.

**September 29** Bailout package rejected 228-205: The \$700-billion rescue bill drafted by the Bush government is defeated in the House of Representatives.

**September 29** U.S. stock market plunges: As news gets out that the rescue bill is being defeated in the House, the Dow falls 777.68 points. This is the largest one-day point drop in U.S. history. (The Dow is a stock market index that consists of 30 of the largest and most widely held public companies in the United States.)

**October 3** Bailout package becomes law: A new version of the \$700-billion rescue bill is passed by the House of Representatives. The bill, passed by the Senate two days earlier, is signed into law by President Bush.

**October 10** Canadian government takes action: Federal Finance Minister Jim

### Definition

The term *subprime* does not refer to the interest rate being charged on a mortgage. It refers to the risk associated with a borrower. So a subprime mortgage is one that is negotiated between a lender and a customer with a below-average credit rating. Subprime mortgages are risky investments.

### Quote

"Didn't anyone of importance say, 'These kinds of mortgages are wrong. These appraisals are inflated'? Didn't any executive observe that the leverage requirements were so far out of line with banking and securities reserve requirements that they were in effect dangerous and fraudulent? Didn't any brokerage firm or executive crack down on naked short-selling? So far as I can tell, none, or very few, did. Instead, they followed the 'business model' of 'the highest level of short-term profit possible by any means allowable under the law.'"  
— U.S. writer L.E. Modesitt Jr. in his blog ([www.lemodesittjr.com/blogs/blog/index.html](http://www.lemodesittjr.com/blogs/blog/index.html))

Flaherty announces that the Canadian government will provide CAD\$25-billion to banks to ease the credit crunch being experienced by them. Flaherty calls it a prudent economic policy, not a bailout.

**October 23** Canadian government guarantees commercial bank debt: The Canadian government takes steps to guarantee as much as CAD\$218-billion of commercial bank debt to revive lending and match bank bailouts offered by other governments.

### Major Factors Contributing to the Economic Meltdown

#### The Subprime Mortgage Fiasco

Perhaps one of the greatest contributing factors to the current economic crisis was the use of subprime mortgages in the United States. Subprime mortgages are housing mortgages offered to people with poor credit ratings who normally would never be able to buy a house. These people were told that they could buy a house, get a mortgage worth more than the value of their house, and that the bank would keep their mortgage payments very low for the first year or two. After that initial period the mortgage would be reset at prevailing rates. But the lenders said that because the value of the house would have increased in that time period, the equity could be used to refinance the mortgage and keep the mortgage payments low.

It didn't work out that way. As the easy initial mortgage terms expired, interest rates were usually reset at much higher levels. Home prices failed to go up as anticipated, and many Americans simply couldn't afford the higher mortgage payments. As a result, they walked away from the homes, or the banks foreclosed on them, leaving a host of unpaid debt. By 2007, nearly 1.3 million properties were subject to foreclosure in the United

States. This was an increase of over 70 per cent from 2006. It is estimated that up to one quarter of U.S. homes may be worth less than the value of the mortgages on them.

### Changes in the Financial Industry: Securitization

Alan Greenspan, the former chairman of the U.S. Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov)), blames the securitization of home loans for people with poor credit—not the loans themselves—for the current global credit crisis. But what is securitization?

Traditionally, banks loaned money to homeowners for their mortgage and then retained the risk of default of the mortgage. Called credit risk, this meant that if a homeowner defaulted on their mortgage payments, the bank would be on the hook for the default. However, due to changes in the financial industry, banks can now sell rights to mortgage payments to investors through a process called securitization.

The securities that the investors purchase are called mortgage-backed securities, or MBS. This new banking model means that credit risk is distributed broadly to various investors. So if homeowners default on their payments, investors and businesses holding MBS are significantly affected, perhaps finding their investments worthless. The effect of this is magnified if an investor or business carries high debt levels.

### Questionable Ethics and Greed

Some analysts, including economist and Nobel Prize winner Joseph E. Stiglitz, believe that poor regulation of the financial industry has allowed questionable ethics and greed to flourish. Take for example, the issue of mortgage-backed securities. Due to securitization, a bank that provides a loan does not

**Quote**

“With economic growth currently at a dreary one per cent, there is already an immense gap between what we are now producing and what we could be producing if this crisis had not occurred—a cumulative loss I estimate will be in excess of \$2-trillion.”  
 — Joseph E. Stiglitz, Professor of Economics at Columbia University, and winner of the 2001 Nobel Prize in Economics (*Harper’s*, November 2008)

**Quote**

“The story of the credit-rating agencies is a story of colossal failure. The credit-rating agencies occupy a special place in our financial markets. Millions of investors rely on them for independent, objective assessments. The rating agencies broke this bond of trust, and U.S. regulators ignored the warnings signs and did nothing to protect the public.” — Henry Waxman, chairman of the House Committee on Oversight and Government Reform (*International Herald Tribune*, October 22, 2008)

have to hold the risk for that loan. Instead, the bank passes that risk off to other investors. Since the banks no longer carry the loan risk, they actually lower their lending standards to increase the number of loans they award. This practice increased the banks’ profits and resulted in hundreds of thousands of loans being awarded to people who had little hope of repaying them.

**Rating Agencies**

One area of the finance industry that is being accused of corruption by leading economists is rating agencies. A rating agency is a company that grades the quality of securities so that investors

can decide which securities to purchase. A conflict of interest exists between rating agencies and investors, however, because rating agencies are paid by the companies whose financial products they are supposed to evaluate.

It was the large rating agencies in the United States that announced that subprime mortgages were safe enough to be held by pension funds. Stiglitz believes that “without this collusion, the whole system of deception would not have worked; there would not have been the flow of funds that sustained the subprime mortgage industry” (“Realign the interests of Wall Street,” *Harper’s*, November 2008).

**Follow-up**

1. Review the timeline of major events and identify the three that you believe played the greatest role in the 2008 economic crisis. Record the events and your reasons for selecting them. Compare your selections with a classmate. Were they similar or dissimilar? Why?

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2. Update the timeline with any major events that have occurred since October 23, 2008.

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3. Do you believe that the people employed in the financial industry involved in questionable investment deals and practices should be held personally accountable for the current crisis? Why or why not? If you believe they should, what might be a reasonable punishment?

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4. How might the financial industry be reformed to prevent this type of economic crisis from occurring again?

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# CANADA AND THE ECONOMIC MELTDOWN

## *The Bailout*

### Quote

"They knew they had to pick a number with a lot of zeros. Eight hundred billion seemed too close to a trillion, so they picked \$700-billion."  
— An unnamed source (quoted in Margaret Wente's column "Financial turbulence: Pass the airsick bags," *The Globe and Mail*, September 27, 2008)

### Definition

A *golden parachute* is an agreement between a company and an employee (usually an upper executive) specifying that the employee will receive certain significant benefits if employment is terminated. These benefits may include severance pay, cash bonuses, stock options, or other benefits.

USD\$700-billion. \$700 000 000. Seven hundred billion dollars. No matter how you write it, it is a lot of money.

### The Rejected Plan

On September 18, 2008, the U.S. government unveiled a plan to buy hundreds of billions of dollars in bad loans to rescue banks and lenders and stabilize the collapsing U.S. economy. Reaction to the bailout package was mixed. Some economists praised the package, saying that it was necessary to prevent greater collapse. But many average Americans were furious about the planned bailout. They viewed the bailout plan—which could theoretically cost each working taxpayer \$5 000—as an outrage. American taxpayers were not responsible for the economic collapse and they resented having to bail out the financial companies and executives on Wall Street who were responsible. Partly because of public outrage, partly because of the rushed nature of the bailout package, and partly because of political squabbling and posturing, the proposed bailout bill was defeated.

### The Accepted Plan

On October 3, 2008, George W. Bush signed a revised version of the original \$700-billion bailout package into law. The bailout plan allows the U.S. government to spend billions of dollars to buy bad mortgage-related securities and other devalued assets held by financial institutions. After the Treasury buys up those troubled mortgages, it will

try to resell them to investors. The belief is that, if successful, the package should allow frozen credit to begin flowing again and prevent a serious recession.

Some of the highlights of the plan include:

- The bill authorizes \$700-billion for the program. The Treasury Secretary has immediate access to the first \$250-billion. Following that, an additional \$100-billion can be authorized by the President. The last \$350-billion has to be requested through Congress.
- The Treasury will seek to implement a plan that is designed to maximize assistance for homeowners and encourage the servicers of the underlying mortgages to take advantage of available programs to minimize further foreclosures.
- Any company receiving more than \$300-million from the Treasury would face limits on the compensation paid to their executives and "golden parachutes" for departing leaders.
- The Treasury department will establish a federal insurance program, funded by the banks, that would guarantee banks and other firms against loss from any troubled asset.
- The cap on federal deposit insurance will rise from \$100 000 to \$250 000 per bank account.
- About \$110-billion in tax breaks will be aimed at small businesses and the middle class.



# CANADA AND THE ECONOMIC MELTDOWN

## *Canada's Economic Situation*

### Quote

"The sky is not falling, the sky is still there, the sun is still coming up every day, and the Canadian economy is still functioning."  
— Bank of Canada Governor Mark Carney (*The Globe and Mail*, October 23, 2008)

### Further Research

In early October 2008, the World Economic Forum ranked Canada's banking system as the strongest in the world. Learn more about the Forum at [www.weforum.org/en/about/index.htm](http://www.weforum.org/en/about/index.htm).

Canada's economy is closely linked to that of the United States. In fact, the United States buys three-quarters of Canada's exports. That is a huge percentage. It is understandable then that economic problems in the United States would have a significant impact on the Canadian economy. Once economic problems start in one area, they have a ripple effect through other areas of the economy.

Take the lumber industry, for example. Lumber is one of Canada's chief exports. But when the residential real estate market in the U.S. crashed, Americans stopped building new houses—and they stopped buying lumber from Canada. The Canadian lumber industry then started to lay off workers. The purchasing power of those unemployed workers plummeted—and they stopped shopping. As retail sales declined, employees working in the retail sector were subsequently laid off—and they stopped spending. And so on.

Complicating this process even further is the fact that as the economy starts to slide into a recession, the value of many stocks starts to drop. This hurts investors in the stock market. Those investors aren't just wealthy Canadians; they are also average Canadians who own stocks in their retirement savings and pension plans. Those who have already retired and are drawing on their savings have lost a lot of money. The value of these stocks will likely not recover in their lifetime. As well, as the value of savings and pension plans drop, many Canadians who have not already retired may well have to postpone their retirement. This makes an already tight job market even tighter.

But many economists and observers believe that Canada is in a good position to ride out this economic storm. One reason for this is that Canadian banks are more tightly regulated than those in the United States. As a result, the subprime market share is much smaller. About 20 per cent of all U.S. mortgages are subprime, as compared with five per cent of Canadian mortgages.

Another reason Canada's financial industry is more secure than that of the U.S. is that all high-ratio mortgages in Canada—those with less than 20 per cent down at the time of purchase—must be secured by mortgage insurance. As well, Canadian financial institutions do not finance more than 100 per cent of a home's purchase price, and the value must be verified through a separate appraisal. As a result, Canadian banks do not carry the same level of risky or bad debt as U.S. banks.

Experts give two other reasons why they believe the Canadian economy will be able to ride out this downturn: the unemployment rate remains near a three-decade low and the economy is still slowly growing. Statistics Canada ([www.statcan.ca](http://www.statcan.ca)) reported that in September, Canada recorded 107 000 new jobs. The new jobs were mainly part-time positions in the health-care sector, and most went to young people. Economists warn that statistics like these can be misleading, however, and that it is better to look at job creation over a number of months, rather than focus on one particular month.

One area of the Canadian economy that is still experiencing growth is the resource sector. Resource-rich provinces like Alberta and Saskatchewan

**Quote**

"I think if we don't panic here, we stick on course, we keep taking additional actions, make sure everything we do is affordable, we will emerge from this as strong as ever. We are not going to get into a situation like we have in the United States, where we're panicking and enunciating a different plan every single day." — Prime Minister Stephen Harper, Yahoo Canada News ([http://ca.news.yahoo.com/s/afp/081003/canada/us\\_banking\\_finance\\_canada\\_harper](http://ca.news.yahoo.com/s/afp/081003/canada/us_banking_finance_canada_harper), October 4, 2008)

continue to do well. While the drop in commodity prices will likely slow down development of Alberta's oil sands, a further \$110-billion is still expected to be invested in oil extraction. The Alberta government ran a half-page ad in *The New York Times* in early October to try

to lure American workers north. Brad Wall, the Premier of Saskatchewan, was in Toronto in September trying to persuade new immigrants to move to Saskatchewan because of the economic boom that province is experiencing.

**Analysis**

On October 10, 2008, the federal government announced a \$25-billion takeover of bank-held mortgages. The government stated that this move is not a bailout of Canadian banks.

Instead, the problem in Canada is that the country's financial companies are having trouble getting money to borrow because banks and other lenders in other countries are not offering up enough money. So the government's action is designed to ease the growing credit crunch faced by the country's financial institutions.

In your opinion, does this action by the government support or refute the argument that the Canadian economy is in good shape? Explain your answer. You may want to hold a mini-debate on this issue with a small group of your classmates.

# CANADA AND THE ECONOMIC MELTDOWN

## Activity: The Great Depression of the 1930s

### Further Research

To learn more about Canada during the Great Depression, visit the CBC Digital Archives at [www.cbc.ca/archives](http://www.cbc.ca/archives) and explore the audio-visual files "Devastating dry spells: Drought on the Prairies," "On to Ottawa," "Black Monday hits world stock markets," and "R.B. Bennett: Triumph in Canada's great dark days."

Those of you who have studied Canadian history will be aware that Canada went through a difficult economic depression in the 1930s. This period is now known as the Great Depression. In September and October of 2008, many of the major investment banks in the United States declared that they were bankrupt, and the stock market crashed. This raised concerns among many observers that the world was headed for another great depression, or worse.

Compare the information about the 1930s depression and the 2008 economic crisis in the chart below and then complete the activity that follows.

Factor/Event	1930s Depression	2008 Economic Crisis
<b>Stock-market crash</b>	Historically considered to be the "trigger" of the depression.	Occurred after major investment banks in the U.S. declared bankruptcy.
<b>Reaction to the stock-market crash</b>	Citizens flocked to banks to remove their savings. Citizens wanted to hoard or protect their cash.	Citizens not trying to remove savings, but banks are reluctant to lend money, even to other banks. Banks want to hoard or protect their cash.
<b>Economic recession</b>	Between 1929 and 1933 the U.S. economy shrank by more than 25 per cent.	The U.S. economy is expected to experience a "mild" recession.
<b>Unemployment and poverty</b>	In 1933, unemployment hit 25 per cent. Many of those working had only part-time jobs. At least one in three families did not have enough food to eat.	Unemployment in the U.S. is currently just over six per cent. It is expected to rise to just under 10 per cent.
<b>Government intervention</b>	The government was reluctant to intervene after the stock market and the economy stalled. The president at the time wanted to balance the federal budget. Many economists today believe this helped to push the economy into a full depression.	The government decided to move quickly to bail out the collapsed banks by buying up much of their bad debt. The \$700-million bailout was the largest in history. Even those who disagree with government intervention in the free market believe the bailout was necessary to prevent an economic depression.

Information excerpted from: *The Economist*, October 4, 2008

## Analysis

1. In your opinion, is the economic crisis of 2008 likely to result in another full-fledged depression? Explain.

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2. What is similar about the 1930s depression and the current crisis?

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3. What is different?

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4. How might the experience of the Great Depression help us as we face the current crisis?

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