ATLANTIC COUNCIL

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THE FINANCE CRISIS:

LESSONS LEARNED FROM CANADA AND THE WAY FORWARD

Embassy of Canada ■ Washington, DC

CONFERENCE REPORT

On November 16, 2011 the Atlantic Council, Thomson Reuters, the Rotman School of Management at the University of Toronto, and the Embassy of Canada hosted a day-long conference to look at the actions and tools Canada used to so successfully weather the financial crisis.

Entitled "**The Finance Crisis: Lessons Learned from Canada and the Way Forward**," the event brought together business, government, and policy experts to analyze Canada's path through the crisis, outline the next steps for global financial regulatory reform, and look at prospects for global economic growth.

This paper summarizes the day's main themes and conclusions in order to provide policymakers, industry executives, and thought leaders important lessons from Canada's experience.

The conference featured the following topics and speakers:

Lessons for the Atlantic: How Canada performed during the financial crisis, with:

- **Sarah Dahlgren**, *Executive Vice President, Financial Institution Supervision Group*, Federal Reserve Bank of New York
- **Michael Horgan**, *Deputy Minister of Finance of Canada*
- **Clay Lowery**, *former Assistant Secretary for International Affairs*, US Treasury
- **Mark Wiseman**, *Executive Vice President, Investments*, Canada Pension Plan Investment Board

Assessing Global Financial Regulation: Will new measures prevent the next crisis?, with:

- **Tom Glocer**, *former CEO*, Thomson Reuters
- **Gordon Nixon**, *President and CEO*, RBC Financial Group
- **Ted Price**, *Assistant Superintendent*, Office of the Superintendent of Financial Institutions Canada
- **Jill Sommers**, *Commissioner*, Commodity Futures Trading Commission
- **Nicolas Véron**, *Senior Fellow*, Bruegel; and *Visiting Senior Fellow*, Peterson Institute for International Economics

Fiscal Realities on the Path to Renewed Growth, with **Robert Rubin**, *former Secretary of the US Treasury*

Creating the Conditions for Sustainable Economic Development, with Rt. Honourable **Paul Martin**, P.C., *former Prime Minister of Canada (2003-06) and former Minister of Finance (1993-2002)*

Restoring US Competitiveness, with **Melody Barnes**, *former Assistant to the President and Director of the Domestic Policy Council, the White House*

Global Return to Economic Growth, with:

- **Tim Adams**, *Managing Director*, The Lindsey Group, and *former Under Secretary of Treasury for International Affairs*
- **Craig Alexander**, *SVP and Chief Economist*, TD Bank Financial Group
- **Troy Davig**, *Senior US Economist*, Barclays Capital
- **Peter Rashish**, *VP for Europe and Eurasia*, US Chamber of Commerce
- **Alan Schwartz**, *Executive Chairman*, Guggenheim Partners

THE CANADIAN EXPERIENCE

The financial crisis led Canada into a deep recession, yet the country weathered the economic storm far better than the United States and Europe. While some of the country's relative success is unique to its particular situation, studying the reasons Canada succeeded where others failed helps shed light on how other economies should prepare for crisis. As the United States and Europe work to set new rules for their financial systems–and by extension much of the global financial system–they should look at what they can apply from the Canadian experience.

Canada performed well because it entered the financial crisis with strong fundamentals, which allowed it to mount a robust crisis response. In addition, its well-coordinated and relatively conservative financial regulatory system yielded stronger banks encumbered with less risk than its transatlantic peers.

Canada entered the financial crisis with strong fundamentals. There were four underlying strengths in the Canadian economy that prevented the financial crisis from being much worse:

1. The government enjoyed a strong fiscal position, with debt at 28 percent of net GDP, compared to 101 percent in the United States, and an average of 62 percent in the European Union;
2. Clear and effective monetary policy at the Bank of Canada kept inflation expectations anchored;
3. Managers at banks and other financial institutions were conservative, and bound within a tight regulatory framework, holding more quality capital than required by both national and Basel II standards; and as a result,
4. Subprime mortgages accounted for only 5 percent of total mortgages in Canada.

FIRST PRINCIPLES: CAUSES OF THE CRISIS

Panelists evaluated policy success and failure (in Canada and elsewhere) based on a broadly-shared agreement of what caused the crisis:

1. US macroeconomic policies, especially monetary policy, were too loose, driving large federal budget deficits and asset bubbles;
2. Excess liquidity went directly into a housing market in which financial institutions, investors, and home buyers believed prices would increase forever;
3. This belief in ever-increasing housing prices led financial institutions and borrowers to take excessive risks, and sparked unwise financial engineering in the housing market; and
4. The US regulatory framework was confusing, redundant, and at many times too weak to address problems in the financial sector.

Canada's strong fundamentals were in large part due to previous economic problems that the government addressed prior to the financial crisis. After a fiscal crisis resulted in the loss of its AAA

Thomson Reuters Digital Editor Chrystia Freeland moderates a discussion on whether new global financial regulation measures will prevent the next crisis. Panelists from left: Canadian Assistant Superintendent of Financial Institutions Ted Price; Commodity Futures Trading Commissioner Jill Sommers; former Thomson Reuters CEO Tom Glocer; RBC Financial Group CEO Gordon Nixon; and Bruegel Senior Fellow Nicolas Véron.

Former Prime Minister of Canada Paul Martin speaks with Economist *Correspondent Madelaine Drohan about creating conditions for sustainable economic development.*

credit rating in the early 1990s, Canada enacted meaningful entitlement reforms and implemented tough budgetary measures. These helped restore the government's finances along with its credit rating. The Bank of Canada battled back bouts of high inflation (upwards of 10 percent) during the 1980s with inflation targeting and sound monetary policy decisions. And a few major bank failures in the 1980s forced Canada to implement rigorous financial reforms.

> *"Most regulators...are trying to craft regulations for a market that we don't have a lot of experience with."*
>
> *- Jill Sommers*

In addition to these changes, the mortgage-lending model in Canada was quite different from the United States'. Canadian financial institutions held on to mortgages instead of securitizing and passing them on to other investors. This practice meant that loan officers more heavily scrutinized the fundamentals of each loan, which led to wiser lending decisions.

Not only did entitlement reform help Canada avoid the worst of the financial crisis, it actually led to the Canadian pension program realizing profits in the midst of market meltdown. The creation of the Canadian Pension Plan Investment Board (CPPIB) significantly helped the government's finances. A reserve fund that acts as a buffer for the Canadian pension program, the CPPIB was set up as independent from the government and was therefore off the government's balance sheet prior to the crisis. The CPPIB's management took a long-term approach to the crisis: as markets bottomed out at its height, the CPPIB made large equity purchases and experienced large profits as these markets subsequently rebounded. While benefitting from wise investment decisions during the crisis, it simultaneously acted as a major provider of liquidity to struggling financial institutions.

Canada's strong fundamentals allowed for a robust response to the crisis. A strong fiscal position resulting from early reforms allowed both the national and provincial governments to carry out strong fiscal stimulus packages. All in all, the Canadian government provided stimulus measures

PAUL MARTIN, former prime minister of Canada, on what Canada can teach the United States on managing budget cuts and restructuring:

"Our argument – and this is crucial for the United States – was not that we were doing this in order to clean up a balance sheet. Our argument to Canadians was, 'You want to preserve your social programs? Then we have to do this now or your social programs will go down the drain.' The second argument was that 'this is for your children.'"

"We sold the Canadian people on the argument that their social programs were in jeopardy. This argument could have been made if the [US] Congress and the administration hadn't made such a hash of it over the course of the last year, but I'm not sure if it's within their capacity to make that argument now."

"I think there was a major mistake made in the United States when they did not embrace [the] Simpson-Bowles [commission report]."

THE WAY FORWARD
EMBASSY OF CANADA, WASHINGTON, DC
NOVEMBER 16, 2011
Embassy of Canada
Ambassade du Canada
Joseph L. Rotman School of Management
University of Toronto

Panelists emphasize that a return to global growth will require greater political will on both sides of the Atlantic. From left: United States Chamber of Commerce Vice President for Europe and Eurasia Peter Rashish; Guggenheim Partners Executive Chairman Alan Schwartz; former US Under Secretary of Treasury Tim Adams; TD Bank Chief Economist Craig Alexander; and Barclays Capital Senior US Economist Troy Davig.

of about 2 percent of GDP in 2009 and 2010, compared to 5.9 percent in the United States, 1.5 percent in the UK, and 0.7 percent in France.

The Bank of Canada loosened its monetary policy by cutting its main interest rate by 4.5 percent. Legislation also allowed Canada's central bank to provide extraordinary financing operations to struggling financial institutions. Although it drastically cut interest rates and aided the financial sector with extraordinary financing, the Bank of Canada stopped short of carrying out quantitative easing measures.

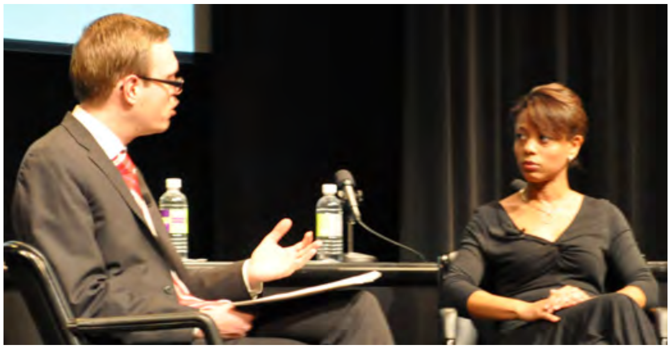
Canadian banks were stronger than US banks. US financial institutions were much more interconnected and complicated than their Canadian counterparts. When the crisis hit, this only exaggerated its effects. US banks also held less capital than those in Canada, which compounded mounting liquidity pressures as markets collapsed. Overall, management decisions were better in Canadian financial institutions than they were in the United States.

WHAT NOW FOR REGULATION?

As Peterson Institute for International Economics and Bruegel Senior Fellow Nicolas Véron observed in the session on the future of financial regulation, "we're now no longer in an era of deregulation, but of reregulation." This poses significant challenges for regulators across the globe as they try to balance their mandate to enforce new domestic legislation with ensuring thriving international financial markets. The severity and reach of the financial crisis has also forced policymakers to show that they are committed to fixing all of the trigger points that led to such a massive global chain of events. Unfortunately, this emphasis on fixing the past may blind us to the future.

> *"We're now no longer in an era of deregulation, but of reregulation."*
>
> *- Nicolas Véron*

Current financial regulation looks to the past in order to plan for the future. Ted Price, Assistant Superintendent in the Office of the Superintendent of Financial Institutions Canada, said, "By and large the rule-making process is backward looking. We as regulators have a very difficult job to do, which is to regulate to avoid future events when we don't know what the future is going to look like." In order to address this challenge, regulators are



Former White House Director of the Domestic Policy Council Melody Barnes speaks with Financial Times *US Economics Editor Robin Harding on the Obama Administration's plan to restore US competitiveness.*

ROBERT RUBIN, former secretary of the US Treasury, on the state of US politics and the main priorities for US policymakers:

"Functionality [of the US political system] seems to be at the lowest point since I became aware of how political systems function."

"It has become a matter of faith that anything that increases taxes will undermine growth. And this isn't new…We must have significantly increased revenues if we're going to have a sound fiscal situation. I do not think that we can have sustained and lasting growth in the United States until we reestablish a sound fiscal trajectory."

"We [the US] have a dynamic society, a dynamic and entrepreneurial culture, we have enormous natural resources…we have good demographics compared to Europe and China, and we have the rule of law well-established."

"We have to do three things. We have to fix our fiscal situation. We have to have strong public investment in education, basic research, and infrastructure—within the context of a sound fiscal situation. And, we need reform in education, immigration, healthcare and a lot of other areas that are critical. Those are all doable substantively, but will require political will."

forced to base their rules on assumptions of how they believe the market will evolve. This makes rulemaking inherently difficult.

Regulators are also charged with overseeing new markets where they do not have much experience, which only compounds the inherent difficulties of regulation. As Commodity Futures Trading Commission (CFTC) Commissioner Jill Sommers observed, "Most regulators…are trying to craft regulations for a market that we don't have a lot of experience with." She outlined three distinct challenges for regulators going forward:

1. Putting in place consistent, effective regulations across the globe;
2. Synchronizing the implementation timing of new rules across multiple jurisdictions; and
3. Deciding how regulations will be applied internationally.

Regulators must coordinate their actions to avoid conflict and creating loopholes. The inherent difficulty in doing this is generating uncertainty in markets.

Regulation works better when it is cooperative and principles-based. Canadian regulation defines the end state that authorities want to see and leaves much of how to get there to the discretion of financial institutions. This leads to a cooperative environment where regulators can work alongside banks to meet these goals. The US regulatory system, by contrast, tends to focus heavily on proscriptive measures that require banks to carry out specific actions, resulting in the tension we see between the banking sector

Rotman School of Management Dean Roger Martin moderates a discussion on Canada's performance during the crisis, with Canada Pension Plan Investment Board Executive Vice President Mark Wiseman, Federal Reserve Bank of New York Executive Vice President Sarah Dahlgren, Canadian Deputy Finance Minister Michael Hogan, and former US Assistant Secretary of the Treasury for International Affairs Clay Lowery.

Former US Treasury Secretary Robert Rubin stresses the need for fiscal reforms to put the United States on a sound trajectory. Thomson Reuters Digital Editor Chrystia Freeland moderates the conversation (photo credit: REUTERS/Kevin Lamarque).

and regulators in the United States. As former Thomson Reuters CEO Tom Glocer said, "You can see it in the interplay between principles-based regulation, and the US obsession with attempting to go to absolute ground truth in rule-making."

Complex and excessive regulations impede financial institutions from extending liquidity and helping businesses and consumers raise and form capital. For example, there is a case to be made that proprietary trading, which the Volcker rule disallows, was actually very profitable for banks during the crisis and helped provide liquidity in the markets. Prohibiting such activities will only push them into places like the shadow banking system, which is unhelpful in stabilizing a future crisis.

Western nations are at different points on the road to regulation. The United States until recently has led the regulatory process, but as it moves from the legislative to the regulatory phase, it is falling behind Europe in a number of core areas. This could lead to regulatory arbitrage or competitive disadvantage, and makes intentional coordination across multiple jurisdictions crucially important. Ambitious proposals put forward by the G20 and other international authorities have required a good deal of time, as regulators try to analyze their effects, allow financial institutions time to adapt, and figure out how best to implement them.

National priorities will rule the day. This may not be a bad thing, as long as regulators are driving at the same broad principles. As Price observed, "The thing that's most effective to rebuilding confidence in the global financial system are well-managed, sound, well-capitalized, low-leveraged banks, and that's the responsibility of every regulator on the planet." As reregulation proceeds, some rules will naturally drift towards local implementation, while others are taken up internationally. Despite the global scope of markets, effective supervision must begin at the local level, as laws and problems tend to be local in nature.

"You can see it in the interplay between principles-based regulation, and the US obsession with attempting to go to absolute ground truth in rule-making."

- Tom Glocer

But global regulatory fragmentation is a distinct threat. Gone are the days when a bank crisis was constrained by national borders. Paul Martin, the former Canadian prime minister—and key architect of Canada's financial reforms—stated, "our supply chains are so integrated that everyone catches cold when anyone sneezes." This tension between national priorities and an international financial system makes it very difficult to develop meaningful rules at the international level. Véron further pointed out, "When you talk about mutual recognition among China, India, and the US, it becomes much more difficult because you have these huge differences of philosophies, of history, of traditions, that make it much more difficult

"The thing that's most effective to rebuilding confidence in the global financial system are well-managed, sound, well-capitalized, low-leveraged banks, and that's the responsibility of every regulator on the planet.."

- Ted Price

to reach an agreement.” Ultimately, individual jurisdictions will still dictate most of the important financial stability policies.

THE FUTURE OF GROWTH

In Europe and the United States, continued deleveraging by households and financial institutions will dampen growth for at least the next five years. Despite relatively strong post-crisis performance, China and other emerging markets will suffer from resulting weak external demand and growing challenges to domestic growth. A return to growth will take time, and require the right balance of structural reforms and continued stimulus, and much greater political will on both sides of the Atlantic.

Austerity measures will dampen demand and growth in Europe and the United States. Both sides of the Atlantic are due for a period of paying down debts after borrowing binges sparked by the technology and housing bubbles. As TD Bank’s Senior Vice President and Chief Economist Craig Alexander said, “…part of the saving mechanism to avoid a depression was actually to open fiscal policy, which means now you have to pay the fiscal price, you have to rebalance fiscal policy. So we avoided a depression, but what we’re going to end up with is slow rates of economic growth for a really long time.” This is also true at the household level, where there has to be “a downscaling of future expectations” for growth because “we’ve been living on bubbles and have a distorted view of what growth should be,” according to Troy Davig, senior US economist at Barclays Capital.

> *“We’ve been living on bubbles and have a distorted view of what growth should be.”*
>
> *- Troy Davig*

The Eurozone needs to unleash growth. Austerity slows growth, by definition, so governments have to strike the right balance of short-term support with responsible medium- and long-term fiscal planning. This is challenging in Europe, where Germany, in particular, has resisted further fiscal or monetary easing to relieve debt pressure across southern Europe. They may be going too

Former Thomson Reuters Senior Vice President and former Under Secretary of State for Democracy and Global Affairs Paula Dobriansky addresses conference attendees (photo credit: REUTERS/Kevin Lamarque).

MELODY BARNES, assistant to the president and former director of the White House Domestic Policy Council, on where the United States needs to invest to spark growth:

“I can tell you any number of governors and chief executives that I’ve spoken to who raise education as being a primary concern with regard to the future growth and competitiveness of our country. If you’re going to innovate, you’ve got to educate future innovators.”

“The objective of the Jobs Act is to try to create and spur demand in areas where we can invest in smart places in the US. So, you look at the components that deal with infrastructure—we can put construction workers back to work. At the same time, we know that we have ailing infrastructure that we need to address. …We also know that it is important to build on our investments in education, so putting teachers back in classrooms, as opposed to at home collecting unemployment.”

“At the same time, even though we focus on jobs, jobs, jobs, the president has also said, ‘We have got to focus on our long-term fiscal problems, and deal with the deficit.’”

Reuters News Editor-in-Chief Stephen Adler opens the conference (photo credit: REUTERS/Kevin Lamarque).

far. As the US Chamber of Commerce's Vice President for Europe and Eurasia Peter Rashish put it, "[Germany has] benefited from higher purchasing power and a lower exchange rate in the southern countries than they would have had if they'd had the Deutsche Mark, and that's been incredibly helpful for German exports...If the German public understood that more they'd be a little more understanding why they need to be part of a collective effort to make sure the Eurozone stays together."

At the same, Germany is reaping benefits from the tough labor market reforms it made under the Schroeder government from 1998 to 2005, and other countries will have to follow suit. Southern Europe, in particular, will need to unleash its productivity. This will include reforms like opening the so-called "closed professions," which benefit from a tangled web of regulations that keep prices and wages inflated. While Europe's labor force will always have greater protections than the United States or the United Kingdom, it will have to eliminate the corrosive and sclerotic restrictions that have built bloated bureaucracies and corrupt patronage systems.

> ***"We in the United States have much easier issues to deal with [than Europe]...and yet we are completely paralyzed on policy."***
>
> ***- Alan Schwartz***

> ***"When it comes to a choice, you either show leadership on the issues or the market will dictate it to you. And you don't want the market to dictate it to you."***
>
> ***- Craig Alexander***

Emerging markets will feel the pinch, and will need to confront domestic challenges. The slow-down in demand from Europe and the United States is already affecting growth in China, despite that country's strong stimulus program. It will now need to manage a soft landing that curbs inflation while reorienting the economy more strongly toward domestic growth.

While this is not news to China, it has been frustratingly slow to make long-promised changes that would reorient the economy toward domestic-led growth. Former Under Secretary of the Treasury for International Affairs Tim Adams, who is now managing director of the Lindsey Group, attributes this in part to a Chinese political system that has grown used to an export-led model and is unsure how to change: "...they're stuck with an export investment model that they've grown used to and the political system has grown used to it. And they can't break out of that model." Adams underscored this kind of political entrenchment is not unique to China, and that its politicians are responding to a well-established incentive structure, which is "about state-owned enterprises, investment, and export, and until you change the incentive structure the political process is going to keep on producing the same results."

The United States has work to do, too, and we should prepare now for future growth. Political gridlock in the United States is preventing it from making decisions that will accelerate growth. As former Bear Stearns CEO Alan Schwartz noted, "We in the United States have much easier issues to deal with [than Europe]...and yet we are completely paralyzed on policy." While the United States has so far avoided the consequences of its

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>
> ***- Rt. Hon. Paul Martin***

ratings downgrade, Alexander suggested that at some point our luck will run out: "When it comes to a choice, you either show leadership on the issues or the market will dictate it to you. And you don't want the market to dictate it to you."

We have to start planning for the future now. Understanding that growth will be anemic in the short term, developed and emerging economies will need to begin developing policies now for long-term growth. Prime Minister Martin underscored, "What governments do today will show up in ten years. It's what governments did ten years ago that shows up today." Schwartz echoed this idea, declaring "I think policy should be less focused on how we get a really good decade of growth now, but how do we create the foundations, that as we de-lever, we are making the right investments in creating a growth path."

As developed economies work through this process, Alexander warns this will inevitably involve revising the promises governments have made about what they can deliver: "the industrialized world has to get healthy. We can't afford everything we promised people in the past…It doesn't mean you have to give up your social goals, but have to revisit how you're going to deliver them." Revising this social contract will be a serious challenge for our political systems and societies, and will define much of the agenda for 2012 and 2013 as the United States and a number of core European countries go through elections. But the lesson from Canada is clear: if governments can bring citizens together with a compelling vision of the future–one that justifies and clarifies that cuts are the route to preserving social goals–then the economy can make a strong comeback, and will be well-prepared for any future surprises.

MARCH 2012

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