International Roundtable on Reducing Vulnerability to Financial Meltdown: Assessing Alternatives

Introductory Remarks

by Roy Culpeper, President, The North-South Institute

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Background to the Roundtable

• Welcome to all; apologies for last-minute arrangements. My task is to provide a background to this event plus an introduction to our discussion.
• This third and final Roundtable is part of NSI’s “Policy Responses to Unfettered Finance” (PRUF) project (copies of Policy Brief are available in kits)
• In our first roundtable (Columbia University, New York, February 2009) we focused on systemic issues: the international regulatory and capital adequacy framework; the role of the IFIs; key issues and opportunities for “development-friendly” systemic reform; the roles of financial innovation and new emerging market actors; the roles of the G20 and the UN Expert Panel in spearheading reform.
  o We had participants from the academic community, the IFIs, Wall Street, civil society, some from Latin America
• In our second roundtable (Geneva, June 2009) we focused more on the impact of the crisis in low-income countries. The discussion included an Alternative Vision for Sustainable Economic Activity; transmission channels of the crisis to low-income countries; assessment of responses, reform proposals and processes affecting developing countries to date; implications of trade and trade finance contraction in LICs; employment impacts in developing countries; rethinking financial regulation from the perspective of developing countries; integrating development into regulatory reform discussions; and private sector and civil society perspectives.
  o Participants were from UNCTAD, the ILO, the World Bank, the Commonwealth Secretariat and Commonwealth Foundation, the World Economic Forum, academia, civil society organizations, some from sub-Saharan Africa.
• It should be evident that from the beginning of our project on the crisis we have given priority in our analysis and discussions to the perspectives and concerns of developing countries, particularly those that are not part of the G20.
• Subsequent to the second roundtable, our principal sponsor of the project, the Ford Foundation, asked if we would consider extending our work by examining the reasons for Canada’s relatively less turbulent experience in the crisis and identify possible lessons for crisis prevention and mitigation from Canada for other countries.
  o Although we do make occasional forays into an examination of Canada’s domestic policies, we do so typically in a wider context of international development (e.g. we have examined Canada’s temporary foreign workers immigration program).
  o Subsequently we spoke to the Commonwealth Secretariat about the possibility of sharing perspectives, experiences and lessons learned among a group of
Commonwealth countries—from both South and North. This resulted in the Secretariat’s enthusiastic support for our final roundtable.

- We also felt that we should get a perspective from China, given its systemic significance (“too big to ignore?”) even though it is not a member of the Commonwealth.

Plan for this Roundtable

- Since this event was precipitated by a demand to examine Canada’s experience more closely to figure out whether it has been different and why, a significant portion of the agenda has been earmarked to that end. And we begin our deliberations this morning by looking at the Canadian experience, presenting the work of members of the NSI, and perspectives of officials from the Department of Finance and the Bank of Canada.

- After lunch we will hear from our distinguished colleagues from the Commonwealth, beginning with Sir Dwight Venner, Governor of the ECCB; Sunil Benimadhu from the Mauritius Stock Exchange; Alan Carter from HM Treasury, UK; and Indira Rajaraman from the Indian Statistical Institute.

- Tomorrow we shall hear from Michael Lim Mah Hui from Malaysia; Greg Farrell from South Africa; Deborah Ralston from Australia; and Wenran Jiang from the China Institute at the University of Alberta (although Wenran has just flown in from Beijing).

- As in our previous roundtables, we have brought together a group comprising researchers, academics, practitioners and civil society members. A diversity of backgrounds and perspectives, we find, helps induces greater clarity and avoid recourse to insider talk and jargon. It also stimulates debate, which is important since the issues surrounding the crisis are complex and no-one has a monopoly on the truth.

- We have not asked our distinguished guests to present papers, unless they happen to have a recent paper to hand; but rather since they are all acquainted with their respective countries’ experience in the crisis to speak about what their country may have to offer by way of possible lessons learned (both what worked and what did not).

- One thing I want to stress is that what may (seem to) work in one country may not necessarily work in other countries, for a host of reasons. Nonetheless there is value in sharing experiences and perspectives to enrich our understanding of how financial markets work and how they occasionally fail.

- Finally there will be opportunities to talk to each other informally over coffee, lunch and tonight’s dinner. Our aims for this roundtable, in conclusion, are:
  - To enhance our understanding of how to help prevent financial crises and to mitigate them when they inevitably erupt;
  - In particular, to identify the role of macroeconomic and regulatory policies in crisis prevention and mitigation;
  - And, if possible, to identify lessons learned that can be shared across this varied group of eight Commonwealth countries and China. Learning should be multi-directional:
developing countries, emerging market countries, and industrial countries should all be willing to learn from each other. Alternatively, we should articulate why policies that worked to good effect in one country may not be replicable in others.

- A larger perspective
  - On the eve of the G8 and G20 meetings hosted by Canada we are on the cusp of what could be sweeping reforms of the international financial and regulatory architecture.
  - The G20 proved its worth in coordinating a decisive response to the financial crisis in 2008-9 in the form of liquidity injections and significant fiscal stimulus in order to arrest the credit crunch and prevent what could have been a major economic depression.
  - That is the good news. The bad news is now that the threat of a major depression has passed, there is less incentive to identify and eradicate the root causes of financial fragility and a temptation to revert to business as usual—the status quo ante.
  - Moreover, going forward there is considerable disarray among G20 members as to whether or what kinds of reforms are required.
  - The focus of policymakers is also being diverted by the growing debate on when and how to unwind the stimulus through expenditure cuts and/or tax increases. This distracts attention from the issues we are focusing on at this roundtable: what are the lessons for macroeconomic and regulatory policy from the experience of the last ten years?

- Ground rules, outputs
  - First, it is understood that this is not an official meeting among governments trying to reach agreement. We are all here in a personal capacity, and not here to represent the official positions of any governments, organizations or agencies we may be associated with. What is said here is not for attribution.
  - Second, our discussion will result in a short policy brief drafted by our rapporteur Arne Rukert. Unless there are objections we would like to include a participants’ list.
  - Third, we typically have more to say than time allows. I shall moderate the discussion and ensure that we all keep to our time limits. I shall also avoid lengthy introductions to save time.

- Words of thanks to key organizations (Ford, Comsec, CIDA, IDRC) and individuals.

The Canadian “Exception” to the Financial Crisis?

- I shall now kick off our discussion by presenting a very short summary of the paper I prepared on whether Canadian macroeconomic policy played any role in reducing vulnerability to financial crisis on the scale experienced by (say) the U.S. or the U.K.
In the paper I examine monetary, fiscal and exchange-rate policies implemented by Canada particularly over the last decade with a view to ascertaining whether or the extent to which these mitigated Canada’s vulnerability to the crisis.

- The conceptual framework for the analysis is the Minsky financial instability hypothesis, which posits a tendency by investors and borrowers during extended periods of prosperity to resort to increasingly risky and speculative positions.
- Loose monetary policy over extended periods of time is often associated in this framework with asset bubbles driven by debt-fuelled investment in search of higher and ultimately unsustainable yields, and equally with unsustainable borrowing.
- The analysis compares Canada with the U.S. in particular; it does not provide an exhaustive comparison with (say) other G20 countries.

The paper first examines Canadian monetary policy, with particular emphasis on the years after the “dot.com” crash in 2001.

- In comparison with U.S. monetary policy, there is little evidence to support the view that Canadian policy was significantly tighter. Although the Bank of Canada’s target interest rate was somewhat higher relative to the U.S. Federal Reserve’s Fed funds rate between 2001 and 2005 (despite higher unemployment in Canada), in absolute terms the Bank’s target rate was at low levels (less than 4 percent) unknown for several decades in Canada. From the beginning of 2005 Canadian interest rates tracked those of the U.S. quite closely.
- The conclusion drawn is that if low U.S. interest rates helped to fuel asset bubbles and risky investment, Canadian interest rates were hardly any better. Indeed, the Bank has deplored the growth of household debt and the housing bubble in Canada. Therefore Canadian monetary policy cannot be credited with reducing Canada’s vulnerability to the crisis.

The paper next examines Canadian fiscal policy, where the story is different.

- From 2002 to 2007 Canada was the only G7 country whose central government was running fiscal surpluses. The contrast between Canada and the U.S. is particularly striking, with modest fiscal surpluses in Canada and growing deficits in the U.S.
- Using the Minsky model we argue that in Canada, tight fiscal policy eased the overall growth of debt and with it the search for higher yields in riskier assets more evident in the deficit-driven U.S. Put differently, in Canada fiscal surpluses helped counteract the growth of credit and asset bubbles fed by low interest rates, whereas in the U.S., expansionary fiscal policy reinforced these tendencies.

Finally the paper examines the role of exchange-rate policy and the current account balance.

- We argue that Canada’s floating exchange-rate policy, along with the commodity boom, has served to constrain its current account deficits and thereby help reduce, indeed eliminate Canada’s net foreign indebtedness for the first time since 1926.
- In contrast, the role of the U.S. dollar as the world’s key reserve asset and a “safe haven” against financial turmoil has made it possible to expand U.S. foreign indebtedness without limit, as long as other countries such as China are able and willing
to buy dollars indefinitely. This has fuelled the growth of U.S. debt more generally and stimulated investors to seek higher yields than Treasuries.

- In other words, exchange rate policy helped to check the growth of overall debt accumulation in Canada while in the U.S., the lack of a foreign exchange constraint stimulated greater indebtedness.

- In a nutshell, an examination of macroeconomic policy suggests that while monetary policy differences between Canada and the U.S. cannot be invoked to explain why Canada experienced a less acute financial crisis (Canada, in that sense, was and remains as culpable as the U.S. for its low interest rate policy), fiscal and exchange-rate policy differences may explain the greater tendency toward greater leverage and higher risk-taking in the U.S. than in Canada.

- That said, we are not arguing that such macroeconomic policies were the most important elements in explaining Canada’s relatively more benign experience in the crisis, compared to regulatory policies and structural factors. Indeed, we have not yet done an analysis to rank-order which factors were more and which less important. We will return to this question after our discussions at this roundtable.