

POLICY BRIEF

How to Prevent the Next Crisis: Lessons from Countries that Weathered the Storm Better

In an effort to learn from countries that withstood the recent economic crisis relatively well, The North-South Institute brought together policymakers, regulators, and other experts from Commonwealth countries and China for a two-day workshop in Ottawa, Canada in June 2010. The focus was specifically on the impacts of macroeconomic policy and financial sector regulation.

This brief highlights the key conclusions spelled out by the workshop participants:

- **Countercyclical fiscal policies are important because they free up more room to respond in a crisis;**
- **Monetary policy can be complemented by a broader policy toolkit; and,**
- **Financial sector regulation needs to be strong, independent and coordinated.**

Seen against the backdrop of the G20 summit in Korea in November, this set of prescriptions takes on greater urgency. As the world's primary forum for global financial stability, economic growth and development, the G20 has set its sights on providing a comprehensive response to the recent financial meltdown. And yet, momentum for policy reform is disappearing the further we move from the precipice on which the global economy so recently seemed to teeter. Nevertheless, learning from the past two years remains critical to avoiding or at least mitigating another such crisis. This brief closes with some thoughts about the role of the G20 in that process.

Macroeconomic Policy

The aggressive fiscal response to the crisis clearly suggests that most policymakers learned a lesson from the early countercyclical attacks on the Great Depression in the 1930s. That response, however, also laid bare underlying structural vulnerabilities built up over years in the world's core economies. While both fiscal and monetary policies are

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The North-South Institute
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implicated, our workshop discussions determined that the former may better explain why some countries fared better.

Risks were compounded in economies such as the United States and the United Kingdom that ran chronic and substantial deficits even in good times. These countries are now constrained in their ability to respond to the current crisis. The UK, for example, would need to widen deficits even further to provide stimulus in case of a renewed (double dip) recession.

On the other hand, those countries that had previously gone through a process of fiscal consolidation were better positioned. Mauritius, for example, preemptively consolidated its public finances between 2006 and 2008 and was thus able to stimulate its economy through sizeable short-term measures.

Canada’s successful fiscal consolidation in the late 1990s is another example. It went from a deficit of 9.1 per cent of GDP in 1992 to a surplus of 2.1 per cent by 2000. Heavy reliance on spending cuts to balance the books was a key aspect of Canada’s experience, with federal government total outlays falling by more than 12 per cent of GDP over that period. Despite this, economic growth remained strong, driven by external demand for its resources, putting Canada in an enviable fiscal position when the crisis hit.

Some emerging economies, like China, viewed the crisis as an opportunity to undertake deeper structural rebalancing. China has unleashed the most extensive stimulus program in the world at 13 per cent of GDP, an accomplishment made easier by its tremendous store of reserves. Even India, not known for fiscal discipline, was better prepared because of its efforts at fiscal consolidation in the mid-2000s.

The conclusion is that broad countercyclical fiscal policy – constrained in good times and looser when necessary to stave off a downward spiral – provides far greater latitude for response in a crisis.

Monetary policy also played a role. In the years running up to the crisis, some central banks focused excessively on one target – inflation – and short-term interest rates as the one instrument to control it. A belief that financial markets would self-correct led policymakers to ignore bubbles in

the financial, housing and consumer credit sectors. As one of our workshop participants put it, however, “macroeconomic stability cannot simply be limited to price stability.”

The experience of countries that better withstood the crisis represents a victory for pragmatism through use of discretionary, even unconventional, measures to address risks linked to specific sectors. Their experience suggests that the traditional toolkit of interest rates and capital requirements can be complemented by such “macro-prudential” tools as:

- **Caps on leverage, liquidity measures and reserve requirements;**
- **Administrative and other curbs on lending to the construction and housing sectors; and,**
- **Selective controls on volatile and speculative capital inflows.**

Some central banks, such as the Reserve Bank of India, used a broader policy toolkit to good effect in helping mitigate crisis impacts. While initially criticized for doing so, they are now widely lauded as examples of good economic management. The lesson is that policymakers need to consider a broader set of instruments to prevent credit booms that fuel asset bubbles.

Banking and Financial Sector Regulation

It is widely accepted that inadequate banking and other financial sector regulation, especially in the U.S. and other advanced economies, was one of the roots of the crisis and contributed to the depth and duration of the downturn that those countries experienced. Conversely, countries that fared better were distinguished by:

- **A comprehensive regulatory regime based on well-articulated principles;**
- **An independent regulator with a clear mandate but ample discretion to attain broad stability objectives; and,**
- **A high degree of coordination among regulators.**

Canada serves as a good example. The Office of the Superintendent of Financial Institutions, the main banking regulator, is independent of both political and private pressures and has a clear mandate with a singular focus on prudential risk. The regulatory framework is outcomes-focused and principles-based.

The Superintendent has access to senior management as well as boards of directors at financial institutions, and can issue extensive guidance, backed by legal authority, to compel action when needed. The Office is complemented by the Financial Consumer Agency of Canada, which focuses on consumer protection and education.

A similar model, made up of an independent prudential regulator plus a consumer protection agency, has worked well in Australia. The Australian Competition and Consumer Commission was strengthened considerably in the run-up to the crisis, after consumers bore most of the brunt of domestic financial sector crises in the late 1990s. While India and South Africa use a different model, in which the central bank is the main banking regulator, their approach seems to have worked equally well. Thus, while no single institutional framework is guaranteed to work everywhere, in each case, independence of the regulator and comprehensiveness of coverage emerged as key success factors.

Regulatory coordination is a further key factor. In Canada, the Financial Institutions Supervisory Committee, made up of officials from the federal regulatory bodies and the finance ministry, and the Senior Advisory Committee, comprised of the same officials but chaired by the deputy minister of finance and focused on policy issues, act as a platform for regular interaction and communication.

The Canadian government plays an important role in ensuring the soundness of the housing finance market. The Canada Housing and Mortgage Corporation (CMHC), a federal agency, requires insurance on any mortgage financing more than 80% of the purchase price, with the rate based on the degree of leverage, and acts as the insurer. The aim is to reduce the risk to lenders on high-ratio mortgages. The government also guarantees securitized mortgages covered by CMHC and under the National Housing Act, and has approval over which financial institutions may issue those securities.

Canada's approach has led to a conservative but stable housing market which boasts a home ownership rate of close to 70%, comparable to other advanced economies. Reliance on securitization is much lower (about half that in the US) which means Canadian banks, which dominate mortgage lending and are tightly regulated, hold a large share

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of mortgages on their balance sheets. Despite this, US mortgage subprime jitters did spread to Canadian markets. The response by Canadian authorities, however, was aggressive and swift, and prevented a similar collapse in Canada.¹

In a similar vein, the mortgage market in Australia, where the home ownership rate is as high as Canada's, was also resilient to the crisis. As in Canada, mortgage insurance is required when the down payment is less than 20% of a house's purchase price. One difference, however, is that the Australian government has completely privatized both mortgage insurance and securitization. Nonetheless, when necessary the government may intervene, as it did aggressively in September 2008 through the Australian Office of Financial Management, to restart the frozen residential mortgage-backed securities market. The lesson from the Canadian and Australian experience suggests that no matter how sophisticated the mortgage finance system, ultimately resilience depends on prudent lending standards which helps assure the quality of underlying assets, which in both Canada and Australia were far higher than in the US.

Stricter supervision of financial products in general provides another valuable lesson. The Reserve Bank of India's 2006 guidance on regulation of securitization is a case in point.² Going against foreign pressure to deregulate, India tightened regulation of securitization years before the crisis hit, proving its fears to have been well-founded. Similarly, the over-the-counter (OTC) derivatives market in India is also subject to greater oversight than in other countries. One of the counterparties in every OTC trade must be an entity regulated by the Reserve Bank and all trades must be reported within 30 minutes. This increased transparency in an otherwise lightly regulated market.

1 Three important elements of Canada's response were: an aggressive insured-mortgage buy-back, a large increase in the cap on CMHC mortgage insurance and the use of the Canada Mortgage Bond program to increase liquidity.

2 Guidelines on Securitization of Standard Assets, RBI No. 2005-06/294, February 2006. <http://rbi.org.in/scripts/NotificationUser.aspx?id=2723&Mode=0>

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Beyond regulation, the structure and external linkages of the financial sector in each country inevitably influenced outcomes. Jurisdictions with lower exposure to troubled markets tended to fare better. Canada, for example, has in place strong restrictions on foreign bank activities, the most important of which is that foreign banks are not allowed to offer retail deposits. This suggests much greater caution is warranted when proceeding with financial sector liberalization, especially in emerging economies where pressure to open up could increase as the crisis recedes.

Conversely, the need to coordinate regulation across borders is clear. Risks are global, but regulation is still predominantly national. What did exist at the global level going into the crisis, such as the Basel Accord on capital adequacy, represented minimum standards. The standards in those countries whose financial sector weathered the crisis better tended to be far higher.

Progress to date on two important issues has been limited: how to deal with cross-border banking regulation and mechanisms on winding down large, interconnected financial institutions that get into trouble and threaten the entire system. A number of ideas – from levies, transaction taxes and stability funds to the Volcker Rule³ – are under discussion, yet there is little global consensus.

Global Challenges and the G20

The clear themes that emerged from the workshop call for concerted action at a global level. While the G20 has emerged as a main platform for discussion, and there are several positives in the shift from the G8 to the more representative G20, there remain ongoing concerns.

Most critically, maintaining a common stance in the face of competing interests is increasingly problematic. At the last G20 summit in Toronto, differences over continued stimulus and deficit containment emerged very publicly. Meanwhile,

³ Named after Paul Volcker, former Governor of the US Federal Reserve and Chair of President Obama's Economic Recovery Advisory Board, the rule would limit proprietary trading, bank ownership of hedge funds, private equity and other private capital pools, and overall size of bank balance sheets.

progress on regulatory reform is either delayed or at a halt.

A large part of the problem is that, given its informal nature, no one is quite sure of the remit of the G20, especially around broader economic issues including, for instance, sustainable development and the priorities of non-G20 countries, several of which are the poorest and least developed. This raises the question about whether the group, in its present form, is best positioned to discuss those larger issues. There are also concerns with the group that go beyond the issues discussed in the workshop. Achieving real and lasting progress at a global level, not just in the area of financial sector regulation but to support sustained economic development, may well require other avenues.

This November, South Korea, the first non-G8 country to host the G20, has a tremendous opportunity to show the value that emerging economies bring to the G20 by demonstrating international leadership on such issues as controls on volatile capital flows and reform of international financial institutions, including the IMF. That would go some way in helping to advance the G20's global agenda and ensuring its long-term success. ☪

For more information on PRUF's research findings, including analysis on Canada's experience of the crisis go to: <http://www.nsi-ins.ca/english/research/progress/61.asp>



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