

FIPA Speech
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After the Crisis: Economic and Financial Reform in the Americas

It is one year now since the collapse of Lehman Brothers investment bank and a little over two years since BNP-Paribas indicated that they could not value three of their funds that contained structured products. The financial storm that swirled around these and other related events has had wide-ranging unprecedented consequences. Even in countries where the financial system has come through this rather well and the strength of the supervisory system has been evident, the record is not entirely unblemished. In Canada, recognized by the World Economic forum as having the soundest banking system in the world, a third of the asset-backed commercial paper market seized up in 2007, and several financial institutions faced significant losses although none that threatened their survival or required direct public investment.

Compared to eradication of poverty, human migration, food security and health care, to name a few of the issues facing the Americas, some might argue whether the promotion of sound financial systems globally and financial market development locally should be a big priority. At best, one might argue, it is something to be left to technical experts to deal with, not a parliamentary issue.

But the extraordinary financial and economic crisis we have been living through over the past two years has put the spotlight on financial reform. The global reach, rapidity and longevity of the crisis have been shocking. The economic toll and human suffering have been heart-wrenching.

It has been all the more difficult to deal with coming on the heels of such an extended period of global economic expansion that was led by many developing countries; a period when it appeared that we may have finally got the formula for economic prosperity right. Some may be feeling rudderless, as the crisis has raised questions about the market-based economic growth model that was seen to have underpinned that expansion. Others who hadn't bought into that growth model may now feel more certain that it was entirely wrong.

I am in neither of these two camps. I believe that the errors were more in the execution than in the framework for growth and prosperity. For that reason, the way forward and priorities for action are actually quite clear, although still incredibly complex. In the financial sphere, it will take some time and careful analysis and deliberation to sort through all the details and strengthen the institutions necessary to do a better job of supervision, oversight, and leaning against excesses and human greed. In the economic sphere, development models that rely on export-led growth, or import substitution at the expense of consumers and growth in domestic demand also need to be reconsidered. In both spheres, excessive leverage and unsustainable debt-financed consumption need to be curbed. It is imperative that these matters be tackled as a cornerstone for the agenda for growth and prosperity in the Americas. It would be most unfortunate if the nascent signs of recovery and improvement in confidence lull us into complacency.

But first we must understand: how did we come to all this grief? Then we need to determine: what must be done to avoid it happening again?

Most blame our current economic difficulties on the financial crisis that originated in the United States and Europe, brought on by the collapse of excessive credit growth and leverage (you can't keep blowing up a bubble forever), insufficient supervision, inadequate corporate governance and risk management, and greed. However, it didn't start there. The origins were in the build-up of global imbalances – too much debt-financed consumption and inadequate savings in industrialized economies, and too little domestic demand and an extraordinary build-up of savings in many emerging economies. And it didn't end there either. The financial crisis destroyed wealth and sharply reduced credit availability in the industrialized world, which restricted economic activity. This in turn reduced the global demand for exports, the driver of much of the growth in emerging economies over the past 10 years. The financial crisis also shook consumer, business and investor confidence. The result was an abrupt global downturn. High commodity prices and monetary policy which had to act against the inflationary forces that inevitably arise in a bubble environment when everyone is trying to operate above capacity and excessive credit creation is fuelling the fire, also contributed to the severity of the global recession. This is often the necessary case when other forces are not able to hold booms in check.

Since the financial crisis was most intense in the developed world, and many of those countries had to intervene to prop up their financial systems, they have felt compelled to reconsider their regulatory frameworks and how they are enforced. Countries in the rest of the world were impacted indirectly by the financial crisis via the widening of spreads and reduced investor appetite for risk, and by changes in the behaviour of foreign institutions operating in their jurisdictions. Furthermore, many countries have had to deal with some serious isolated difficulties with firms or segments of the marketplace that were burned by their involvement in complex derivative or structured products where the risks were not fully understood and came home to roost.

There is an old saying in political and policy formulation circles: "Don't let a good crisis go to waste." Just because many countries were not as badly affected as those at the centre of the crisis, it does not mean that they shouldn't also be reconsidering and taking action to improve their regulatory frameworks. Indeed, the G-20 has truly come into its own in this crisis as a forum to work through global economic and financial regulation issues, reflecting this recognition that there are times when we all have an interest in cooperating in devising solutions and taking concerted action. And this is one of them.

As for the business cycle downturn which has affected most countries in the world directly, the international focus to address this crisis has been on expansionary fiscal and monetary policy. Equally important are steps to avoid trade protectionism, and in fact go further and revitalize the Doha round of multilateral trade talks to increase free trade in areas such as services where there still are serious protectionist restrictions globally.

It is now generally understood that trade is a positive contributor to growth and a country's well-being. Yes, "globalization" carries with it the risk of being infected by problems in other countries, but it also contributes to economic prosperity and cannot be unwound without a severe, long-term reversal of people's standard of living. Debilitating trade restrictions worsened the depression in the 1930s. A repeat of this is something to avoid at all costs.

"Contagion" of financial crises across developing countries used to be thought to work through trade channels (via the current account, as devaluation in one country changed terms of trade, leading to competitive devaluations in other countries competing for key export markets). Successive incidents since the Mexican peso crisis in 1994 have shown that financial crises spread quickly through financial

channels (the capital account), especially in the markets for cross-border transactions between financial institutions and with institutional investors, which can dry up quickly when there is a loss of trust in counterparties, or more precisely, in the ability of counterparties to honour their commitments. While this has been evident for many years now, it does not seem to be well understood among the general public and in the political discourse around globalization. It is why measures to address financial system stability at the global level are so important.

If one of your objectives is to eradicate poverty and redistribute wealth to those most in need, you have to first create that wealth on a continuous sustainable basis. Trade is incredibly helpful in this regard, but in addition to facilitating it, what else can parliamentarians do?

- (1) assure there is a sound fiscal and monetary framework ,
- (2) support the provision of public goods that are essential to growth such as education and infrastructure, and ensuring that economic activity is environmentally sound,
- (3) recognize there is merit in all things in moderation, such that export-led growth is complemented by support for domestic demand, for example, and
- (4) have an efficient and safe financial system that can intermediate fairly, extend credit wisely, and provide risk mitigation services that truly work.

Looking around the Americas region, countries that have proved the most resilient are integrated with the world economy, have actively developed local currency financial markets, and have sound monetary and financial sector supervisory policies. This is not to say that they have avoided a severe negative hit to their economies. Some, like Mexico and Chile, have seen sharp GDP contractions. However, they have avoided a full-blown financial crisis that could have exacerbated the business cycle downturn and caused solvency problems across their own banking and financial systems. The economy may be suffering, but the sense of crisis-related chaos is absent, creating a reasonably stable basis for the conduct of economic policies to address the real economic issues.

Most countries in the region face a variety of development challenges: education, training and social development needs, and personal security concerns, for example. In this context, supporting financial market development and globalization initiatives might be far down the list of priorities for parliamentary attention. It may feel like catering to elites at the expense of dealing with more broadly-based challenges. This crisis has shown that this could be short-sighted thinking, that in fact, in a highly integrated world with abundant opportunity for innovation and growth, development of sound and efficient financial markets that facilitate cross-border flows is a necessary condition for effectively addressing many other economic development challenges. It is an important step to help ensure that a country does not lurch from crisis to crisis, and maintains, as much as possible, an open channel to continue financing a reasonable fiscal agenda and support both economic and social investment.

Indeed, perhaps financial market development should be seen as a populist issue, because ordinary people suffer the most from economic and financial crises, while many of the financial elites find ways to continue to profit by pursuing opportunities in underdeveloped or mispriced markets.

At the heart of any framework for financial reform there must be a focus on integrity. As we have seen so clearly these past two years, a financial system cannot function efficiently without confidence in the integrity of the system, the soundness of counterparties and the fairness in treatment of all investors, big and small.

To achieve this requires not only a clear understanding of the rules of the game and that they will not be changed retroactively, but also transparent information and a fair price discovery process so that all participants believe that they are not going to be disadvantaged and thereby are encouraged to participate.

But clear rules of the game alone are not sufficient. Confidence can only be fully achieved and sustained if there is competent and rigorous enforcement of the rules.

The incentives in the financial system need to be properly aligned to militate against greed and the taking of undue risks. Here we mustn't overestimate the ability of individual investors and savers to do all the due diligence necessary, especially when there is insufficient transparency and inadequate financial literacy. In my view, the first focus should be on good governance, with Boards that are independent, take responsibility for risk management and the fair representation of the financial position of the firm, and ensure that incentives such as the compensation regime are properly aligned with all stakeholders' interests.

At the national and global level, central banks, together with financial authorities and regulators, need to be able to monitor and evaluate systemic risks, and take action to prevent their build-up or advise others to do so in their domains, not just wait to clean up after the crisis erupts.

There also needs to be good regulatory oversight of financial institutions with a professional supervisor. New capital measures and other risk mitigation techniques to lean against excessive periods of enthusiasm and pessimism through the economic and financial cycle will need to be adopted. This should be complemented by powers enabling early intervention to deal with troubled institutions and wind up systemically important institutions over a weekend, while there is still value in the firm, and customers can get their money back. International colleges of supervisors are required to ensure sufficient information sharing and concerted action for financial firms operating in several countries.

Local players with diverse points of view are necessary to form the core of the investor base. At the same time there needs to be sufficient competition from international investors to create checks and balances in the local system. To do this the investment regime, taxes, ability to act on collateral, and internationally connected payments infrastructure are all important considerations.

Conclusion

This might seem to be an extensive list of requirements, but it is just the framework, with much work remaining on the part of technical experts to flesh out the details. There also is much work required in terms of building and enhancing institutions –as well as reducing regulatory fragmentation and increasing regulatory cooperation - to adequately implement it all.

At the same time, I hasten to add that it is important to not overreact with the regulatory reform agenda. It takes great judgment and courage for legislators to get the balance right when cleaning up after a crisis, particularly when the public simply wants to penalize those that they believe have wrought such havoc. Clearly reform is required to reestablish confidence in the financial industry, but when considering increased capital requirements and new compensation measures, the industry's long-term viability must also be in the forefront of the analysis in order to be able to continue to support economic activity and social progress.

The exciting point about this reform agenda is that although it is focused on flaws discovered in the financial system, tackling these matters could have important spinoff benefits for economic activity and society more generally. The investment, tax, and bankruptcy policies necessary to promote development of local financial systems can also suggest new approaches for business regulation more generally that can further promote economic growth. A focus on integrity and enforcement in the financial system can have equally important spinoffs more generally in society by reinforcing peoples' confidence in the rule of law and willingness to make investments and to grow businesses.

Most important, however, will be the ability to put the financial crisis and global contagion behind us so we can devote even more energy to the fundamentally important priorities of assuring human dignity, personal security and eradication of poverty, confident that it will not be sideswiped by unforeseen financial calamity with serious economic and social consequences, not in the near future at least if we are successful.