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Financial Services

Grasping the Nettles

Clearing the Path to Financial Services Reform in Canada

David Laidler

In this issue...
While Canada's banks face a regulatory framework whose politicization and unpredictability rules out efforts at consolidation, the country's securities markets operate in a unique regulatory morass. It is time for politicians to grasp these nettles.

The Study in Brief

Anything that undermines the financial system's stability or ability to adapt quickly and smoothly to an ever-changing environment adversely affects Canada's overall economic performance. Regulatory rigidities therefore need removing from the Canadian system. They are nettles that can choke growth elsewhere in the economy, and policymakers must grasp them firmly and soon.

The Canadian financial system's stability is largely looked after by inflation targeting supported by a flexible exchange rate (a desirable arrangement in today's fragmented international economy), but this stability comes at a cost. Canadian markets lose international transparency when linked to the rest of the world through a foreign exchange market and when local macro-policy decisions must be monitored by foreigners wanting to assess their riskiness. This unavoidable cost makes it all the more important to deal with other sources of inefficiency in the system.

Between them, Canada's commercial banking sector and its securities markets account for some 85 percent of financial system activity, and both need regulatory reform. A politicized approval process effectively prohibits mergers between big banks, limits their ability to exploit available efficiency gains, and narrows their ability to respond to new competitive challenges emanating from the world marketplace. At the same time, ownership rules and restrictions on the activities of foreign banks in Canada buffer domestic banks against competition at home. Some of the latter regulations perhaps help ensure that the large institutions, through which stabilizing monetary policy is conducted, especially in time of crisis, remain under Canadian control. Nevertheless, the case for allowing more freedom of manoeuvre to actual incumbents and more freedom of entry to potential competitors in commercial banking is overwhelming. As to Canada's securities markets, these are currently regulated by 13 agencies, one for each province and territory, with predictable effects on their transparency and the costs of doing business in them. A single national regulator is surely called for, as is a separate and effective enforcement agency.

The economic aspects of both sets of issues are well understood, yet the longstanding unpopularity of the large banks among the public at large makes it difficult for politicians to address their problems. Meanwhile, securities market reform is hampered by fears among other provinces and territories about the intentions and power of the Ontario and federal governments. These obstacles are preventing regulatory changes that would increase the financial system's efficiency and help to ensure the Canadian economy's continued competitiveness. The political will to overcome them is urgently needed.

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In Canada's national accounts, financial services are treated as a sector of the economy, on a par with, for example, manufacturing or education. From the national income accountant's viewpoint this is reasonable: the firms, institutions and other agents that make up the sector sell services to their customers and distribute the proceeds of their sales to their employees and owners. From a policymaker's point of view, the classification also makes a certain amount of sense, because this sector presents challenges similar to those arising elsewhere: how to encourage its domestic and international competitiveness, to promote its productivity, and enhance its capacity to respond to a rapidly changing technological and economic environment.

Special Characteristics of the Financial Sector

And yet, if we look beyond accounting definitions to the particular role that the financial sector plays in economic life, it is quickly apparent that it also raises unique public policy issues. As the *Introduction to the 1997 Final Report of Australia's Financial System Inquiry* (Commonwealth of Australia, 1997) put it, "The stability, integrity and efficiency of the financial system are critical to the performance of the entire economy. The financial system is an essential component of the infrastructure of commerce." As such, this sector of the economy is a natural object for the attention of government, and one where it is essential to design policies with their economy-wide effects kept firmly in view.

A long history of trial and error — a great deal of the latter — has ensured that the most fundamental policy problems facing Canada's financial system are dealt with reasonably well, so much so that their very existence is sometimes overlooked as new concerns emerge and are addressed. These problems have not been finally settled, however. Rather, they are being coped with, and they continue to influence the manner in which new challenges within the system present themselves. Current ways of coping with these issues, furthermore, are not themselves immutable, and they interact with the means available to deal with others.[1]

This Commentary's Purpose

Any discussion of current policies towards Canada's financial services sector runs the risk of being inadequate and even error-prone if it ignores these facts. Policymakers need to be self-conscious about the overall environment in which policies are to be applied if the right choices are to be made; and, because those

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1 David Longworth (2006) provides a succinct account of these issues seen from the perspective of a central banker.

policies must be implemented through political processes, it is important that they also have the support of a well-informed public.

These problems have well-understood economic aspects, but they present serious political difficulties. And yet, it is important that these political nettles be grasped, because our failure to do so threatens the efficiency and adaptability of the financial sector and will ultimately impair the Canadian economy's overall competitiveness.

This *Commentary* aims at bridging some of the gaps in understanding about the role of the financial system that seem to separate policymakers from the public at large, in the hope of creating a greater sense of urgency than now exists about certain pressing problems that beset the system. After giving a brief overview of the system's role in Canada's economic life, this study discusses the political and regulatory impasse that exists with regard to merger activities involving chartered banks, and the difficulties that the absence of a single national regulator and of a separate and effective enforcement agency currently create for the country's securities markets. It concludes by regretting that, though the recent Federal White Paper on Financial Services (Department of Finance 2006) pays attention to the second of these issues, which is mainly a matter for provincial and territorial governments, it entirely ignores the first, which falls entirely under federal jurisdiction.

Coordinating Economic Activity in a Market Economy

As the commonly used phrase has it, ours is a *market economy*, whose most fundamental characteristic is the generation and distribution of wealth, not just by the production of goods and services, but crucially by their voluntary exchange. Almost as fundamental, but so obvious as often to go unremarked, is the fact that, overwhelmingly, the voluntary exchange in question is indirect and mediated through a monetary and financial system.

The Role of the Financial System

Autoworkers do not barter work for SUVs and hybrids, which they then drive to the mall to swap for food and clothing with the supermarket, and to offer as mortgage payments or retirement savings plan (RSP) contributions to the trust company. Though this surreal scenario does, on some fundamental level, characterize the ultimate nature of some of the exchanges that take place in a market economy, the transactions by which these are realized are very different. To continue with our example, autoworkers are paid wages in money, which their employers obtain by selling cars (or by borrowing in anticipation of such sales). At the mall, the autoworkers buy goods and services with that money (or perhaps on credit which they will later pay off by a transfer of money to the lender), and make money payments that reduce their mortgage debt and/or increase their RSP balances.

The economist's "market" is, in effect, a metaphor for a monetary and financial system whose unique social function is to facilitate the multilateral and indirect exchanges upon which economic life depends. The system's most primitive task, of which the elementary textbooks still make much, is to provide a common means of exchange that also serves as a unit of account in which prices are stated, so that goods and services may be indirectly traded in spot markets. But of far more significance in any modern economy is the system's role in transactions that involve the passage of time. In those same textbooks, the former task is assigned to the system's "monetary," and the latter to its "financial" component, but this pedagogically useful division is artificial, and therefore less helpful for the practical analysis of policy issues.[2]

In today's advanced economy, it is the transfer of deposit liabilities of financial institutions that typically consummates spot transactions — currency is merely small change — so there is no sharp distinction between the means of exchange used for current transactions and financial claims on the future. More fundamentally, when a family saves, it is, on some abstract level, trading with itself over time, exchanging current against future consumption. The transactions through which this trade is realized typically involve the transfer of money, which could have been used to buy consumption goods in the immediate present, to some other agent, such as a bank or publicly traded company, in exchange for a claim on money at some time in the future. Current and planned future transactions are thus inextricably linked when saving decisions are executed, as they are on the other side of the same transactions as other agents use the borrowed money to invest in resources that are to be used to produce goods for sale in the future.

Time and Uncertainty

Enabling agents to cope with the passage of time and uncertainty about the future are central functions of the financial system. All economic decision making is, to a greater or lesser extent, forward looking, and it is therefore inherently risky. Different agents have different attitudes towards risk, different capacities for assessing it and for valuing it. Because it is the financial system that coordinates those agents' activities, it is through its workings that they seek to overcome what John Maynard Keynes called "the dark forces of time and ignorance" in whatever ways they deem best for themselves. That is why modern systems provide myriad possibilities for linking consumers with producers, savers with investors, and for coordinating their plans, why these different possibilities enable these agents to share in the risks involved in any decision in different ways, and it is also why the financial system is continuously evolving new means of dealing with these matters.

It is well understood that, if market mechanisms are to work like Adam Smith's "invisible hand" to ensure that the actions of self-interested individuals lead to desirable social outcomes, the information and incentives facing those individuals must reflect the genuine social costs and benefits of their actions. The information and incentives in question are transmitted through the financial

2 In what follows, therefore, the phrase "financial system" will be used to refer to this "monetary and financial system."

system. Such communication through prices stated in terms of money has often and aptly been compared to the use of a common language to communicate ideas. Just as ambiguity and deception in the use of language are sources of trouble, so too are misleading messages about the present, and false promises about the future, delivered by money prices.

Government and the Financial System

The financial system is a set of social arrangements whose performance has a profound influence on our economic well-being. Even those libertarians who do not accept that this fact makes the system a proper object for the attention of government must agree that, for good or ill, it has ensured such attention. Hence, the principles that guide policy in this area also deserve close scrutiny.

Financial Stability

The first of these principles must be the maintenance of stability within the system so that it is able to coordinate economic activity. The degrading effect of inflation on economic performance is well established and needs no long discussion here. It will suffice to remind readers of the debates that accompanied the great inflation of the 1970s and '80s and its conquest in the 1990s, and their role in re-establishing widespread understanding of the harm that even moderate inflation can do in a complex modern economy. Of course, the adverse effects of moderate inflation pale in significance when compared to those of hyper-inflation, which disrupts the transmission of market signals to the point at which individuals find it impossible to formulate coherent plans for themselves, let alone coordinate their execution with the activities of others. Thus, low, stable and predictable inflation, is a basic component of financial stability, and the fact that this goal is enshrined in Canada's inflation targeting regime does not change its continuing importance one iota.[3]

Although low inflation contributes to financial stability, it does not guarantee it. Neither the Wall Street crash of 1929 and the subsequent Great Contraction, nor the banking problems and stagnation that followed the bursting of the Japanese asset market bubble in the early 1990s were heralded by any upsurge in inflation. Nor were a number of lesser financial crises, such as the stock market crash of 1987 and the more recent collapse of the high-tech market. Even so, these episodes explain why central banks, whose main mandate is to maintain low inflation, accept that doing so may not always be sufficient to maintain stability in either the financial sector or the economy in general, and are prepared to act on this understanding.[4]

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3 Peter Howitt (1990) remains the classic study of the costs associated with moderate inflation. On the destructive powers of high inflation, see Daniel Heymann and Axel Leijonhufvud (1995).

4 There is no space here to discuss competing proposals for how an inflation targeting central bank might take on this extra task. Some would like to see it attempt to preempt potentially destabilizing financial bubbles as they begin to get under way, while others would prefer to rely on the bank's lender of last resort powers should the bursting of a bubble threaten to destabilize the system. This author's support for the latter strategy is defended in David Laidler (2004).

Regulation and Supervision

Public sector involvement in the financial system cannot end with maintaining its overall stability. Financial transactions typically involve the transfer of property rights or promises of such transfers in future, so the legal system — that establishes and regulates property rights, and adjudicates disputes when they arise — necessarily extends its reach into the financial sphere.

From this consideration stems the case for government involvement in regulating the sector to ensure its probity, and overseeing it to ensure that regulations are followed and those who violate them are punished.

There are strong arguments for extending government's regulatory role to encompass the prudence as well as the honesty of agents within the sector. Those agents' dealings will often be with lenders and borrowers who lack financial expertise, or will be executed by them on behalf of relatively badly informed clients. Even when there is no question of their probity, there may be doubts about whether the judgment that they exercise is properly aligned to the desires of those doing business with them; and there is also the question of whether all customers can reasonably be expected to monitor the risks to which they are exposing themselves with the knowledge and resources at their disposal. The case for the mandatory provision of insurance for small bank deposits, and for granting a degree of regulatory and supervisory authority to the insurer — as with the Canadian Deposit Insurance Corporation (CDIC) and its provincial partners in Canada — rests on such considerations.

Efficiency and Adaptability

But given the case for public regulation and supervision of the financial system, it is important that such activities promote rather than disrupt its capacity to serve the economy efficiently, a principle whose precise meaning is complex enough to require a little more discussion.[5]

Here it is helpful to begin with the economist's notion of *allocative efficiency*, and to argue that the system's workings should encourage an allocation of the productive resources available to the economy that maximizes some measure of collective economic well-being. In order to work in this way, the financial system itself should be efficient in two other specific senses. First, to return to a comparison used earlier, like a useful language, it must be capable of transmitting clear and unambiguous messages to all who can gain from receiving them. It must display *informational efficiency*, in the sense that prices are clearly stated, easily visible, and readily interpreted by those whose decisions depend upon them. Second, its own costs of operations, both in terms of the actual resources that it employs, and in terms of any inconvenience that its clients encounter in using its services, should be reduced to the point at which, on the margin, they equal the benefits for the system's users. The system should therefore display *transactional efficiency*.

5 The following discussion draws on ideas discussed in much more detail by Gregory Bauer (2004), and Scott Hendry and Michael King (2004).

It is all too easy to think of economic efficiency in the context of an environment in which resource endowments and the technology available to exploit them are given. But, particularly when dealing with a sector where the passage of time and the risks inherent in this fact are all important, we must go beyond this, and venture into a broader dynamic context. Here, efficiency is less rigorously defined by economic theory, and perhaps it would be better to refer to *adaptability*, because what is required of the financial system is that it should support the easy movement of resources among the sectors of an ever-changing economy, and in the right direction too, as new and more productive prospects for their use open up, and old ones decline or even disappear.

The system should, for example, help (or at least not hinder) entrepreneurs with new and relatively more productive projects in mind as they try to outbid less productive competitors for the funds needed to finance them, while also encouraging savers voluntarily to provide more of those funds by ensuring that they capture a share in the returns generated. This goal might involve enabling more adventurous savers to seek higher returns in new undertakings at the risk of incurring losses, but it might also require that those who are averse to taking risks with their wealth be provided with safer havens, where individual risks are pooled in diversified portfolios. In this context also, informational efficiency is crucial. The system must be able to translate news about fresh developments that are relevant to the economy into changes in the structure of prices that not only reflect the new opportunities implicit in those developments, but are also clearly visible to all who participate in it so that they can respond if they so choose.[6] Furthermore, the technical means available to provide financial services are themselves open to change, so the system itself must also be adaptable if it is to remain transactionally efficient over time. Its members must be encouraged constantly to seek out better and less costly ways of doing business, and to adopt them when they are discovered.

In short, if the financial system is to promote efficiency and adaptability throughout the economy, it must itself display these characteristics. It is well understood that the forces of competition, perhaps particularly as they appertain to the freedom of new firms to enter old lines of business and of old firms to enter new lines, lead to just such an outcome. Hence, a second key principal, complementary to the maintenance of stability, for policy towards the financial services sector emerges: that its regulation and supervision should encourage competition, actively promoting, or at least not limiting, the sector's ability to offer whatever variety of services the diverse requirements of investors and savers call for. Crucially, its regulation and supervision should not obstruct the system's ability to adapt its offerings as these requirements change, or as the technology available to the sector itself changes.

6 To use a well-worn but apt metaphor, informational efficiency, considered dynamically, requires that the time for which twenty-dollar bills remain on the floor after they have been dropped must be short, that they nevertheless stay there long enough to give passersby an incentive to keep an eye out for them, and that what look like twenty-dollar bills are, as often as possible, the genuine article.

The International Context

The Canadian economy is deeply integrated into that of the world and of North America in particular, and the Canadian financial system is linked to the financial systems that serve these larger entities. This international background therefore needs some attention before we take up specific domestic policy issues.[7]

The Incomplete International Financial System

Here, one fact is of overwhelming significance: although the financial system's critical role in enabling market economies to function makes it a proper object for public policy, there exists no well-developed and widely recognized authority able to make such policy at the international level. That the international financial system is, in the main, based on national currencies is a leading illustration of this fact.[8] This system is, nevertheless, more than a mere collection of national systems, because trade and capital movements across national boundaries need the support of financial arrangements that also extend across national boundaries.

In the absence of a supra-national money, such as perhaps was gold in the years before the First World War, the means of exchange and unit of account used within today's system is mainly the US dollar, with some competition, mainly regional, from the yen, the euro, sterling, and the Swiss franc. National central banks long ago recognized that their policies should be calibrated to the needs of the economies that their currencies serve. For its part, however, the Federal Reserve system, which emits the US dollars that serve the international economy, is governed by a mandate that confines it to pursuing purely domestic policy goals. To say this is to criticize neither the Fed nor the legislation that governs it, because the US dollar's global role is the consequence of a myriad of choices made by individual agents engaged in international transactions and not of any deliberately calculated US policy. It is, however, to draw attention to a fundamental tension between the configuration of the world economy's monetary system, and of the political environment in which it functions. This tension is also manifest in the fact that private institutions that mediate international transactions are subject to local regulation and oversight wherever they operate rather than to any comprehensive, worldwide code of conduct.

The financial system we are here discussing is inter- rather than supranational. As a corollary, it is also incomplete and therefore more fragile than need be. An endless succession of international conferences and agreements on international monetary and financial matters attests to the fact that this has long been

7 For a recent and rather comprehensive description of the system, see Department of Finance (2005) The international background as it relates to banking has been explored in some detail by Tim O'Neill (2003).

8 Europe is unique in being a major economic zone which has in place a common currency that serves no fewer than 11 countries. There are other currency unions, among former French colonies in Africa and former British colonies in the East Caribbean, for example, and a few small Latin American countries use the US dollar domestically, as does Liberia. Overall, though, the rule of one country/one currency that applies to Canada is a reliable first approximation to a worldwide reality.

recognized. While there have been some successes along the way, the creation of a financial system to support the world economy that could claim the same degree of coherence as that of a national system such as Canada's, and that could therefore conceivably supercede distinct national systems, remains very much a work in progress.[9]

The Domestic Policy Significance of International Factors

These facts impinge on Canada in a number of ways. In particular, its current monetary order, based on a separate national currency underpinned by inflation targets and a flexible exchange rate, should be seen as a political and economic response to the challenges they present, and one which also has implications for other characteristics of the domestic financial system.

To begin with, and other things equal, Canadian financial institutions would be a little more efficient, and more internationally competitive, too, were there a single world, or even — a more realistic alternative — a single North American currency. To return to an analogy used earlier, when the same language is used on both sides of a border, costs of translation, not to mention risks of information becoming garbled in that process, are eliminated. But other things are not quite equal, and under current arrangements Canada enjoys more political accountability on the part of policymakers, and more domestic financial stability as well, than it could achieve under any common currency arrangement that would be politically feasible at present.[10] This is no small advantage, given the extent to which Canada's financial system is both open to shocks emanating from the world economy and well capable, under a different monetary regime, of amplifying them.[11]

Nevertheless, there is no more reason to believe that Canadian households and firms will always want to obtain all of their financial services from domestic suppliers, regardless of circumstances, than there is to believe that the range of automobiles built locally is sufficiently wide, and produced at a low enough array of prices, to satisfy all potential domestic customers. Conversely, there is no reason

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9 Among the successes, at least if institutional longevity is valued, one might list the creation of the IMF and the World Bank, set up under the 1944 Bretton Woods Agreement and still in business, and of the BIS, which, set up in 1934 to cope with the overhang of First World War debts, now plays an increasingly active role in promoting stability in financial systems. The Basel accord on capital requirements for banks is a recent result of its efforts. The creation of the euro and the European System of Central Banks should also be mentioned here, but any list of successes, even drawn up by the most ardent advocate of the creation of supranational financial institutions, will be a short one. The failures have been too many to mention.

10 This is not the place to discuss and defend Canada's monetary policy regime in any detail. Readers seeking further detail are referred to Laidler and William Robson (2004).

11 To illustrate this point, it will suffice to note, first, that every episode of potential financial instability in the Canadian economy since the early 1990s seems to have originated in financial events abroad — the EMS crisis of 1992, the Tequila crisis of 1994, the Asian and Russian crises of 1997-98, the near collapse of Long Term Capital Management in the wake of the latter — and secondly that, as the credibility of the domestic monetary order has increased over time, the severity of the impact of these events has diminished. To return one last time to the analogy of language, a local dialect evidently has its uses when it comes to communicating information about matters that are of particular domestic interest and in coordinating responses to them.

to believe that Canadian suppliers of financial services will never be able to find profitable markets abroad. Thus, if Canada's overall financial stability is bought at some cost in terms of the efficiency and adaptability of financial markets in mediating interactions with the rest of the world, policymakers need to be particularly careful to keep to a minimum other obstacles to such activity.

The Canadian regulatory system, by and large, lets agents make their own decisions about these matters. With the recent removal of the "foreign content rule" from income-tax-deferred pension portfolios, for example, there are essentially no regulatory obstacles to Canadian residents holding assets abroad in the currency of their choice. Nor are there any Canadian restrictions on households or firms borrowing abroad, though there may well be issues here that arise from taxation practices as opposed to the regulatory environment. Firms are free to borrow and to raise equity abroad, although they must, of course, conform to whatever regulations are in place in the foreign markets where they do so. This is a significant matter in some instances, as when Canadian companies listed on the New York Stock Exchange must abide by US regulations concerning accounting, auditing and reporting practices.

Apart from those implicit in tax-reporting requirements and routine domestic prudential regulations, there are no Canadian-made obstacles to Canadian agents selling financial services abroad. Some important financial institutions — commercial banks and life and health insurance companies being the prime examples — do indeed generate a significant proportion of their revenue in foreign markets; in 2003, a little over 30 percent in the case of chartered banks, and close to 60 percent in the case of the insurance companies. Foreign-owned institutions nowadays also have reasonably easy entry into some segments of the Canadian market: no less than 62 percent of property and casualty insurance premiums paid in Canada went to foreign firms in 2003, as did 27 percent of life and health premiums. In banking, however, only 7 percent of domestic revenue accrued to foreign banks (Dept. of Finance 2005, 6-8). This suggests that there remain some significant obstacles to free trade, some of which seem to arise from local regulations impinging differentially on the competitiveness of domestically and foreign-owned institutions. Some obstacles are implicit in the sheer cost of establishing branch networks that could compete with those domestic incumbents.

Were the Canadian financial system not on the whole performing well, however, the economy's current stability and the high levels of output and employment that go with it would be inconceivable. Nevertheless, while the system is reasonably stable, it is neither as efficient nor adaptable as it could be, and some of the policy problems that it presents have been awaiting a solution for far too long, as we shall see below.

The Configuration of Financial Systems

Modern financial systems have evolved a variety of institutional arrangements whereby efficient and adaptable coordination of saving and investment decisions is achieved, and the inherent risks are shared. Banks and other institutions accept deposits and lend them on, and assume the risks of the losses that are incurred when particular investment projects go wrong. Securities markets, on the other hand, enable savers and investors to interact directly, or perhaps through the mediation of mutual funds, and permit a wide variety of risk-sharing arrangements to be made. By facilitating trade in existing financial instruments, these markets also enable individual savers to rearrange their portfolios without disturbing the underlying pattern of investment that their past savings have financed.

No single overall pattern of such arrangements defines a “best practice” financial system. Successful economies display considerable variation in the extent to which they rely on particular types of institutions, even when it comes to the broad division of responsibility between financial intermediation and securities markets for the coordination of saving and investment. Thus, a recent study of 26 developed countries (OECD 2006, chap. 5) shows ranges for this division running from a ratio, in percentage terms, of about 20:80 for Finland to one of roughly 70:30 for Austria. There are equally large differences among countries in the extent to which intermediation is confined to commercial banks, as opposed to other intermediaries, as well as in the relative importance of bonds and shares in their securities markets. The main implication of this OECD study is that the configuration of a country’s financial sector matters less for its economic performance than do the sector’s competitiveness, the costs of transacting in it, and its probity.

Where Canada Stands

Canada falls in the middle of the pack when it comes to the relative importance of financial intermediation and securities markets as means of coordinating saving and investment. The ratio here is roughly 43 percent to 57 percent. Canada is, however, more of an outlier when it comes to the importance of non-banks in financial intermediation: they account for about a quarter of such activity — presumably reflecting the importance of caisses populaires, credit unions, trust companies and insurance companies in the Canadian scene. Corporate bonds, too, are relatively unimportant, accounting for less than 20 percent of its securities markets — perhaps reflecting the cumulative crowding-out effects of past government borrowing in this market.

Canada is also in the middle of the pack when it comes to the OECD’s chosen indicators of the competitiveness of its commercial banking system, which suggests that there is room for improvement. Although this study ranks Canada’s securities markets as second only to New Zealand’s, the indicators used — contract enforcement, access to credit, investor protection and bankruptcy procedures — relate more to the legal and consumer protection framework surrounding the securities business than to the actual regulatory and supervisory framework in force in its stock and bond markets. The fact remains that Canada is the only major nation to lack a single securities market regulator, relying instead on no fewer than 13 agencies. As well, as recently noted by James Baillie (2004, 443-5) it is the object of well-deserved suspicions about its capacity or willingness to investigate and prosecute dubious behaviour. Consequently, there is room for improvement in this sector, too, the OECD’s favourable ranking notwithstanding.

These weaknesses are surely causes for concern, given that Canada's commercial banking sector and its securities markets between them account for about 85 percent of total financial sector activity, as measured by the sum of total loans to the private sector, plus stock and bond market capitalization. More perturbing is the fact that these weaknesses are neither new nor the product of any profound and unforeseeable changes in the economic environment that require careful analysis before a policy response is implemented. With due allowance for old platitudes about the devils that always lurk in the details of administrative and legal arrangements, the causes of these weaknesses, and the economic content of their solution, are already reasonably well understood. What is needed to get them tackled is political energy, and if these already well-understood issues cannot be dealt with, there is little hope of bringing about any other important changes that might be required as the opportunities and challenges facing the financial system continue to evolve.

Commercial Banks

Canada relies a little less on its commercial banks to coordinate savings and investment than do the majority of countries studied by the OECD. For 18 out of 26 of these countries, this sector accounted for 40 percent, or more, of such activity, but in Canada for only about 35 percent. Like the banking systems of most countries these days, Canada's is nevertheless dominated by a few large institutions.

In both of these respects, the United States, with which Canadians are most used to comparing their own economy, is even more of an outlier. There, financial intermediation overall coordinates about 40 percent of saving and investment flows, only slightly less than in Canada, but commercial banks have less than half of this business. Furthermore, according to John Chant (2004, 263), in 1999, Canada had 69 commercial banks, while the United States, with an economy more than 10 times larger, had over 10,000 (this number seems by now to have fallen to somewhere a little over 8,000). In that same year, the five largest banks in Canada accounted for 88 percent of all banking assets, and in the United States for about 21 percent. Commercial and industrial loans of Canadian banks amounted to 18 percent of annual GDP, as compared to less than 11 percent for the outstanding business loans of US banks. And although both countries have corporate bond markets, the value of such bonds outstanding in Canada amounted to 15 percent of annual GDP in 2000, with the comparable figure for the US being 29 percent.

Whether the US is an outlier or not, however, comparisons with the US have considerable political relevance in Canada. The countries' financial histories have long interacted, and tradeoffs between the stability that large banks create, and the monopoly power to which their existence can give rise, not to mention an important populist political tradition marked by suspicion of large banks, have long featured prominently in policy debates in both nations. These same forces have played out very differently in the two countries, however, with commercial banks north of the border emerging as both more important for the inter-temporal resource allocation mechanism and much more concentrated. Even so, they continue to create policy dilemmas in Canada. Though the stability of Canada's large individual institutions can nowadays be taken more or less (but never totally) for granted, and is surely appreciated by the public at large, this attractive feature of the Canadian system is accompanied by widespread suspicion that it has been bought by conferring undue monopoly power upon them.

The Issue of Mergers among Large Banks

Small wonder, then, that when two pairs of the five largest banks proposed mergers in 1998, the matter was contentious, the mergers were disallowed, and the very fact that they had been proposed led the government of the day to lay down explicit guidelines about the factors that would influence its decisions about such matters in future. Unfortunately, these guidelines go beyond the remit of the two agencies — the Competition Bureau and the Office of the Superintendent of Financial Institutions (OSFI) — that would normally advise on the economic desirability of mergers, and introduce an explicitly political component into the approval process.

The four large banks that proposed mergers in 1998 must bear some responsibility for having brought this consequence upon their industry. At that time, the MacKay Task Force on the financial services industry was at work, and the minister of finance had already asked that all merger proposals be put on hold pending his receipt of its report. In ignoring this request, and in giving the minister essentially no prior warning of their intentions, these banks appeared to be trying to force him into accepting a *fait accompli*. It is not surprising that, in such circumstances, he asserted the government's authority in the only unambiguous way available to him; namely, by turning them down. Furthermore, the minister's decision was, and seems to remain, politically popular, appealing as it did to the public suspicions about the big chartered banks' monopoly powers mentioned earlier. These suspicions were to some extent reinforced by the Competition Bureau's 1998 technical work on the proposed mergers, which emphasized questions related to the industry's high degree of concentration when assessing the likely effects of mergers on the banking system's competitiveness.

Competitiveness, Concentration and Contestability

Even so, there are features of commercial banking in Canada that run counter to these suspicions of monopoly power. The five biggest Canadian chartered banks face competition in various segments of their domestic market, not just from 63 other domestic or foreign banks, but also from 30 trust companies and about 1,100 credit unions and *caisses populaires*. Furthermore, in 2005, the second-, fourth- and seventh-largest financial services companies in Canada, as measured by market capitalization, were not chartered banks at all, but insurance companies, which had ranked sixth-, seventh- and eighth-largest only two years earlier.[12]

12 These data come from the Canadian Bankers Association's (CBA's) submission to the Government of Canada concerning the 2006 financial services review, and from the Government of Canada's June 23, 2003 response to the Report of the House of Commons Standing Committee on Finance Report on Large Bank Mergers in Canada.

Evidence from the international marketplace also raises doubts about just how powerful the five biggest Canadian banks are these days. Back in 1990, again as measured by market capitalization, the largest of them, the Royal Bank of Canada, ranked 46th worldwide and the smallest, the Toronto Dominion Bank (before its merger with Canada Trust) ranked 95th. In 2004, the Royal remained the biggest Canadian bank, and still stood at number 46 worldwide, while the smallest of the big five, now the Bank of Montreal, ranked 63rd. But this seemingly solid showing must be seen in the context of the decline in ranking of Japanese banks. In 1990, the 10 biggest banks in the world were all Japanese, and 20 Japanese banks outranked the Royal, while by 2004, only one Japanese institution remained in the top 10, and a mere five remained larger than the Royal.[13] To put it more directly, when these broad international comparisons are made, the effects of the Japanese financial crisis of the early 1990s on that country's banks tend to mask the fact that Canadian banks have clearly failed to keep up with the growth of their US and European competitors over the intervening 15 years.

If Canadian commercial banking is viewed at a particular moment then, its most obvious feature is a high degree of concentration that raises suspicions of monopoly. However, if attention is given to how the system is changing over time, its biggest members appear to be facing direct competition from an increasing number of small entrants to the banking business, while shrinking in importance, not only relative to their closest foreign competitors, but also relative to other domestic financial institutions, notably insurance companies. In 1998, static considerations were emphasized by the Competition Bureau and, to the extent that economic factors played a role in the minister of finance's decision to veto the proposed mergers, were probably uppermost in his mind as well. In 2006, however, there is a strong case for paying more attention to the dynamics of the industry.

The big Canadian banks' relative importance has declined not because they have shrunk absolutely, but because their competitors have grown, largely as a result of mergers. Unless financial sector mergers can be shown mainly to increase the monopoly power of the institutions involved, rather than their capacity to generate profits by better serving their customers, then the inability of Canadian banks to grow by these means like their competitors must be presumed to have left them neither as efficient as they could be, nor as well positioned to serve the economy's capacity to adapt to the rapidly changing circumstances of the international economy. Furthermore, we now have, as we did not in 1998, some evidence of economies of scale in Canadian banking that even the largest institutions are currently too small to exploit (Jason Allen and Ying Lee 2005). Consequently, it is now possible to argue that mergers would promote the financial system's informational and transactional efficiency.[14]

When concentration ratios were the only readily available economic indicators of monopoly power, it was not surprising that they were used; although it was

13 The rankings were made by the *American Banker*, presented in 1990 as "The Top Hundred Banking Companies of the World" and in 2004 as "World's Largest Banking Companies by Asset Size."

14 Carol Ann Northcott (2004, 9-10) notes that early studies of economies of scale in banking, which used US data, failed to find much evidence of them in large banks, but that more recent and elaborate studies of US banks are beginning to cast doubt on this finding.

always unwise to rely too heavily on them when assessing the competitiveness of banking. This remains the case because of the particular importance of spatial factors in the business. A system in which a thousand small banks each serve a single town is likely to be much more in the grip of monopoly than one in which five large banks each have a branch in every town. Recently, however, as Carol Ann Northcott (2004) has documented, when economists are assessing the competitiveness of banking, they have come to lay increasing stress on indicators of the ease with which new entrants can enter the business — the contestability of its markets — rather than simply on the actual number of firms present at any moment. This extension of economic understanding is particularly relevant to the current Canadian situation, because recent regulatory revisions, introduced since 1998 in response to the work of the MacKay Task Force, have made it easier both for foreign banks to enter the Canadian market and for small domestic institutions to be created. To this we may add that the degree of competition that the large banks face in certain lines of business is of an altogether greater order of magnitude than it was in the 1990s, owing to the consolidation that followed de-mutualisation in the insurance sector.

The idea of contestability focuses attention on the market behaviour of banks, rather than merely on their size, and in particular on the extent to which they deviate from perfectly competitive norms in the pricing of their services. Investigations of these matters clearly need to be treated with care because relevant yardsticks are inevitably tricky to construct. International comparisons of banking systems, nevertheless, seem to have established rather firmly that traditional concentration measures have nothing to do with the prevalence of monopoly-like behaviour. In work cited by Northcott (2004 Tables 1 & 2), for example, the Netherlands' banking system, which is far more concentrated than Canada's, still comes considerably closer to exhibiting perfectly competitive behaviour. As well, the United States' much less concentrated system shows a greater tendency to monopoly pricing than does Canada's. These conclusions are confirmed in the 2006 OECD study cited above.

These studies, nevertheless, do not show the Canadian system to be so close to the perfectly competitive norm that traditional concerns about monopoly power within it, such as influenced the Competition Bureau in 1998, should be totally set aside; and some less formal evidence also supports such doubts. If, for example, the domestic profitability of Canadian banks really was the consequence of deploying superior management skills in a keenly competitive environment, it is hard to see why their ventures into the US should not have had similar outcomes on average. As O'Neill (2003) notes, however, though Canadian banks generate a great deal of their revenue abroad, they have had a poor profitability record in United States ventures. Furthermore, banks in a close to perfectly competitive system would usually do business with all comers at posted prices, but Canadian banks do not. Rather, they are well known to discriminate among individual customers in the pricing of their services.[15]

15 The reader's attention is drawn to the fact that it is perfectly competitive firms in the textbook sense that do not price discriminate. Such behaviour is a commonly used tactic in competition between oligopolistic firms, and can, moreover, be economically efficient. Indeed, perfect price ...

Suggestions for Policy

This mixed evidence nevertheless supports some rather straightforward conclusions. First, to the extent that we can be confident that there are unexploited economies of scale in Canadian banking, and that the degree of concentration displayed by banking in various countries is unrelated to any tendencies towards monopoly behaviour, there is no general case to be made against permitting further consolidation in the Canadian industry simply on the grounds that it will increase concentration. The second conclusion, though pointing in a different policy direction, is that there are also enough signs of monopolistic behaviour on the part of the large chartered banks, particularly in domestic retail markets, that there should be no presumption that any new proposal for a merger should be approved. Even if our views of how it ought to be assessed have changed in recent years, a merger would still have to be judged on its specific economic merits.

But this qualification forces us to ask whether the current degree of contestability of banking markets in Canada might be further enhanced so as to make it safer to allow mergers that would permit the industry to exploit the economies of scale available to it. Even though the entry of new banks into the system has been made easier in recent years, a case can be made that the process should be easier still, particularly for entrants from abroad.[16] Christine Hinchley (2006) shows that between 1997 and 2004, foreign banks increased their market share of deposit taking in Canada from only 5.7 percent to 7.9 percent and that the 1999 change in regulations that permitted foreign banks to set up full-service branches in Canada, rather than just subsidiaries as before, appears to have contributed little, if anything, to this modest growth. The probable reason: the branches of foreign banks, unlike their subsidiaries, are restricted to taking deposits only in excess of $150,000 and, hence, are effectively excluded from retail deposit banking.

At first sight, then, a further easing of restrictions on branching by foreign-based banks seems like an attractive option. However, any such move needs to be approached with caution. It arises in an area where the institutional choices that Canada has made in the interests of providing overall stability to the domestic financial system — a separate currency overseen by a central bank charged with promoting such stability — potentially interact with the options available to promote its efficiency and adaptability. Canadian subsidiaries of foreign banks are regulated in Canada, their retail deposit liabilities are subject to the insurance requirements administered by the CDIC and, as Canadian entities, they would have access to the Bank of Canada's lender-of-last-resort facilities should they get into difficulties. The stability of branches of foreign banks is, however, primarily the responsibility of their parent companies, which are regulated not in Canada but in their home countries, where they rely on central banks for lender-of-last-

footnote 15 cont'd.

... discrimination does not distort the allocation of resources, but merely redistributes the gains from trade towards the discriminator. It is nevertheless a behaviour pattern available only to firms with monopoly power.

16 Apparently, Chart 5-6c of OECD (2005, Chap. 5), which shows Canada having higher barriers to foreign entry than any other country, is based on out-dated information, and is due to be revised.

resort support. Some thorny consumer-protection questions, and others having to do with the ability of the Canadian authorities to underwrite the stability of the Canadian financial system, therefore need to be considered in deciding how much extra scope should be granted to branches of foreign banks to compete in Canadian markets.[17]

Related issues arise in the context of the so-called "widely held rule," which prohibits any single entity from owning more than 20 percent (until recently 10 percent) of the shares of any large Canadian bank. It is hard to dismiss entirely suspicions that this rule helps to insulate the big chartered banks' managers and boards from the discipline that large shareholders could bring to bear on them, and perhaps also protects those institutions from takeover by buyers who might be able to run them more efficiently.[18] The prohibition of highly concentrated ownership might be desirable in a banking system whose market was non-contestable, and hence subject to monopolization, and where self-dealing might therefore be a major problem. However, its benefits are less obvious when the entry of competitors is relatively easy, and when each institution is, in any event, subject to strict prudential regulation. Thus, there is certainly a case to be made for further relaxation of the widely held rule in Canadian banking as a means of increasing the system's competitiveness.

Here again, however, there is a potential conflict between the pursuit of competitiveness and the need to promote the financial system's stability. Among the likely bidders for close control of large Canadian banks, were this to become available, might be large foreign financial services firms. These large Canadian banks are, however, central to the day-to-day implementation of monetary policy, and would inevitably be involved were the Bank of Canada to find it necessary to organize private-sector efforts to preserve financial stability in a time of crisis. It is at least arguable that their foreign ownership might complicate both of these tasks for the Bank. Apart from New Zealand, it is difficult to think of any advanced monetary system (not country, for foreign ownership from within the euro-zone is becoming a feature of the European scene) where widespread foreign ownership of commercial banks is currently permitted, presumably for reasons such as this. These considerations at the very least suggest that any measures taken to relax further the widely held rule need to be carefully designed.

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17 There is also the possibility that regulatory differences between countries might create an uneven playing field on which Canadian and foreign-based banks compete, but the Basel accords on capital requirements have presumably gone some way towards alleviating this problem.

18 As Chant (2004) points out, agency problems are endemic to the governance of joint stock companies. Devising incentive structures so that managers pursue the interests of shareholders is always a difficult business, but this task becomes even more challenging in widely held corporations, where directors who are supposed to represent the concerns of shareholders are more vulnerable to being co-opted by management into serving narrower interests. As Chant also argues, such tendencies perhaps explain why individual Canadian banks tend to lend more to firms whose officers and directors are represented on their own boards than to others, and why an important subset of those loans — those made to firms with officers on the lender's board — tend to under-perform.

The Role of the Minister of Finance

The foregoing considerations are relevant to the merger issue because the fewer tools that are available to increase the banking system's competitiveness, the stronger become the economic objections to any merger. However, they do not undermine the general presumption, forcefully developed by David Bond (2003), that mergers should always be open for approval, or not, on their economic merits. Unfortunately, in Canada they are not, mainly because of the role currently assigned to the minister of finance in the regulatory process.

Under current rules, any proposed bank merger would not only have to be examined by the Competition Bureau and OSFI to ensure that it threatened neither to reduce competition, nor to create prudential risks for the system. It would also have to face the scrutiny of House of Commons and Senate committees, and then be adjudicated by the minister of finance. This complex approval process is supported by the claim that bank mergers raise unique matters of public interest that require special political attention. But consider the specific issues that have been identified as falling into this category, and on which the minister would have to pronounce: (a) access to services in rural and low-income communities; (b) choice among providers for small businesses and individuals; (c) growth prospects for the newly merged institution at home and abroad, for its potential customers, not to mention for the Canadian economy more generally; (d) deepening and broadening of the Canadian capital market; and (e) fair treatment of employees.[19] These issues seem either to be ones that the usual regulators would concern themselves with (a, b, and d), or that the institutions themselves would take into account when deciding for or against a particular merger (c, as well as e).

The minister's ability to act independently of the recommendations of the Competition Bureau and OSFI thus gives him what amounts to a veto power over any proposed bank merger without serving any recognizable over-riding public interest. Its main effect is to provide the minister with space in which to move with whatever political winds might happen to be blowing at the time he comes to exercise his powers. Given the long-standing political unpopularity of the large banks mentioned earlier, his powers introduce a degree of uncertainty into the approval process that effectively prevents any merger proposal being formulated, let alone submitted for approval. This characteristic of the regulatory environment thus seriously limits the options open to large chartered banks as they try to adapt to an economic environment that is changing rapidly, both at home and abroad.[20] Given their central place in coordinating the saving and investment choices of Canadians, and given the critical role that these choices will play in determining the economy's future performance, this impediment to the financial system's overall efficiency is far too high a price to pay in order to punish particular institutions for past arrogance, and ought to be removed.

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19 See Government of Canada (2003).

20 And it robs the system of much of the adaptability built in to it by the fact that its governing legislation must be reviewed every 10 years. On the advantages of this legislative adaptability, see Charles Freedman (1998).

Securities Markets

Savers are free to buy and sell securities of various sorts anywhere in the world, and large companies can and do shift their bond issues and stock listings across national boundaries. Canadian securities markets, however, are hampered in attracting business from abroad. From a foreign perspective, there are costs implicit in the existence of a local currency whose exchange rate fluctuates, and whose domestic stability is the outcome of economic policies that agents located abroad cannot easily monitor. Those markets can therefore ill-afford the extra disadvantages imposed upon them by (i) the regulatory morass in which they currently operate, and (ii) what many might feel to be an unsatisfactory record of enforcing probity and punishing dishonesty.

The Current Regulatory Regime

It is a simple fact that Canada is the only country in the advanced world whose stock markets do not have a single national regulator. Rather, there are 13 of them, each with its own rulebook, and only loosely coordinated.[21] But foreign savers looking for markets in which to place their funds have limited resources available to gather information about the probity and prudence with which Canadian markets operate. If the local regulatory regime is not easily assessed, they will take their business elsewhere. One result is that firms — both foreign and domestic — considering whether to list their shares on a Canadian stock exchange instead of, or in addition to, one located elsewhere — New York, London, etc. — will be less likely to find it worthwhile to do so. James Baillie (2005) has recently noted that, as more and more Canadian firms seek foreign listings and therefore submit to foreign regulations, Canada's power to set its own accounting and audit standards is evaporating.

The attractions of deep and liquid foreign markets to firms with well-established international presences are obvious enough, so the loss of domestic control that Baillie documents is to some extent simply a cost of doing business in the 21st Century's global economy. But it is still regrettable, and certainly no excuse for tolerating any features of the local landscape that are actually exacerbating these tendencies. A single Canadian securities regulator with its own single, clear set of rules, consistently and firmly enforced throughout the country, would surely help to attract business to Canadian markets from domestic and foreign agents alike. Here, then, is a case where the promotion of economic efficiency would also promote, rather than detract from, Canadian governments' scope to make their own decisions about important questions.

21 No single event better illustrates the problems implicit here than the failure of Canadian regulators even to respond to US requests for comments on the regulatory changes, usually summarized under the label Sarbanes-Oxley, which were hastily — over-hastily in the eyes of a growing number of critics — enacted there in the wake of recent corporate scandals. Canadian regulators were simply unable to reach agreement about what to say quickly enough to offer comments and, therefore, lost any chance to influence the outcome of US deliberations, even though the new US measures impinge directly on Canadian firms with US listings for their shares, and, hence, on firms whose shares are among the most important listings on Canadian markets. See James Baillie (2005).

A Passport System versus a Single Regulator

Securities regulation has been widely discussed in Canada for many years. No one likes the chaotic status quo, and the establishment of a so-called passport system would be a considerable step forward. Under such a scheme, firms would no longer need multiple approvals for prospectuses, or the manner in which they present accounts, etc., in order to raise funds nationwide. It would suffice to gain approval in the jurisdiction in which they are based, with other provincial and territorial regulators deferring to that decision. This arrangement would certainly simplify the process of issuing securities, but its operations would leave markets less than ideally transparent to those buying them.[22] That is the main reason why the Wise Persons Committee that reported to the federal government in 2003 concluded that a passport system would be distinctly inferior to the alternative of endowing a single regulator with the power to administer and enforce a single set of rules across the entire country (Wise Persons Committee 2003).

The only economic argument against this conclusion with a shred of validity rests upon the possible benefits of competition among local regulators in encouraging innovative solutions to new problems, as and when they inevitably arise. To apply this argument to Canada, however, as if it were a closed financial system, is to miss the point that there already exists regulatory competition among the securities markets of various countries, in which Canada's currently fragmented system seems to be operating at some disadvantage, both to itself, and the economy it serves. Baillie (2004, 442-3) concludes, indeed, that "if these international concerns predominate in the analysis, a single securities regulator might be the only feasible response" for Canada. But, warning against the temptation of letting the international tail wag the domestic dog in matters of securities regulation, he also notes that it is politically much more difficult to create a single national regulator in Canada than to set up a passport system. He also points out that the Ontario government's decision not to pursue a passport system therefore risks sacrificing a feasible improvement to the current system to the pursuit of what might be turn out to be an unattainable, even if better, alternative. Certainly, this Ontario decision, and the federal government's recently expressed support for it in the face of opposition from every other provincial and territorial government, has significantly raised the stakes in current debates about the reform of Canada's securities markets.

The political obstacles to the creation of a single national securities regulator arise from two factors: first, fears elsewhere in the country that any such agency would be dominated by and serve the interests of Ontario; and, second, the desire of provincial and territorial governments to defend their jurisdictions against federal incursions. These considerations explain why the recent report issued by the Ontario Government's Crawford Panel (Government of Ontario 2006) goes to great pains to show how a new Canadian Securities Commission can be configured so as to ensure that the Ontario government exerts no more influence

22 For example, otherwise similar securities issued by different firms, based in different provinces, and therefore operating under different accounting and auditing standards, could end up being traded in the same market.

over it than any other — by giving every province and territory only one vote in its governance. They also explain why the Crawford Report pays careful attention to the means whereby such a commission can be created without federal leadership — the enactment of a common bill defining the regulator's powers and *modus operandi* by all provincial and territorial governments, which would then agree among themselves on a location for its headquarters. Even if the federal government were one of the governments adopting the bill, as the Crawford Panel envisages, the Commission would not be its creature, but rather that of each jurisdiction in which it operates (thus perhaps making it acceptable to Quebec) where its powers would derive solely from local legislation. And the relevant bill would not have to be adopted everywhere for the Commission to come into being and begin its work. It could take up its responsibilities piecemeal as each jurisdiction adopted the relevant legislation to replace currently existing local arrangements.

The Crawford Panel also proposes a separate Canadian Securities Tribunal to hear cases brought by the new Commission, thus tackling a serious weakness on the enforcement side of Canada's currently dominant securities regulator, the Ontario Securities Commission (OSC). In the OSC, the roles of regulator, prosecutor, and adjudicator are combined within a single organization, giving rise to the appearance of a fundamental conflict of interest that is further exacerbated by the fact that the OSC also relies on revenue from the fines it levies to pay its operating expenses. These arrangements create incentives for the OSC to pursue relatively minor infractions where convictions are likely to be easy to obtain, while much-harder-to-convict perpetrators of truly serious offences go unpunished for long, even indefinitely so, periods.[23] The creation of a Canadian Securities Tribunal, properly implemented, would do much to enhance Canadian securities markets' international reputation, and hence their competitiveness.

The Crawford proposals are so far just that, put forward as a basis for discussion among the relevant governments, and it is too early to speculate about their likely success. However, as noted above, the federal government has recently endorsed the idea of a single national regulator, and the Ontario government seems to attach enough importance to getting it in place that it has expressed its willingness to see a new Commission's headquarters located outside of the province — Montreal or Calgary have been suggested as possible locations (Joe Oliver 2006). Although this support has not yet been matched by action, and although there can be no question that the process of actually negotiating a common bill to be adopted nationwide presents huge challenges, these early signs of support are surely encouraging. Note, moreover, that the Crawford proposals can be put in place piecemeal, and so seem to leave open the possibility that jurisdictions initially unwilling to join the system might be able to negotiate passport agreements with those that do so. This would enable the national system

23 For a critique of the OSC's governance and procedures, see Joel Fried (2004). For a list of "egregious frauds, flimflams and fiscal follies in Canadian markets" that reveal weaknesses in the enforcement mechanism, see Harry Koza (2006). Of course, not all blame for lax enforcement is to be laid all at the door of the OSC. Where criminal activity is involved, for example, some of the responsibility here rests with the RCMP.

of securities markets regulation to be successively simplified as it moves towards what everyone agrees would be its best destination.

Finally, but critically, because the Crawford proposals put the main onus for making progress on provincial governments, they reduce the risk of overloading the federal government's agenda for the regulation of the financial system at a time when the issues concerning the chartered banks, as discussed earlier, must still be addressed. Hence, (and with due attention to difficulties in their details that further discussion may reveal) they deserve support.

Concluding Comments

This *Commentary* began by discussing the special role of the financial sector in economic life and outlining the policy implications that seemed to follow from this: (i) that the system should be configured so as to minimize the chances that it will itself be a source of economic instability, but also, in an open economy, so as to provide an effective buffer against instability that originates abroad; and (ii) that the system should promote the efficiency and adaptability of the economy by itself being efficient and adaptable. These criteria give rise to a degree of tension when applied to Canada, which for quite compelling political and economic reasons has in place a monetary order based on a separate national currency, whose defining policy goal for the last 15 years, successfully achieved, has been low and stable domestic inflation. At the same time, however, its firms, financial institutions, and securities markets routinely compete head on with rivals based abroad, and particularly in the United States, whose national currency is also the principal money of the wider international economy, a fact that gives those competitors a perhaps small, but nevertheless distinct, head start in many contests.

The appropriate Canadian policy response here is not to abandon the existing monetary order and the domestic stability it has brought, but rather to improve it where possible, while taking extra care about minimizing the presence of other sources of inefficiency and rigidity in the financial system. Unfortunately, as we have seen, such other sources are not hard to find. Among other problems: the efficiency and adaptability of Canada's large commercial banks, which play a particularly important role in linking the economy's would-be borrowers to potential lenders, are adversely affected by a regulatory framework whose politicization and unpredictability effectively rules out any efforts on their part to adapt to a changing environment through consolidation. For their part, the country's securities markets are operating in a unique regulatory morass that not only reduces their international competitiveness, but also their capacity to serve the domestic economy efficiently.

These specific issues have long attracted attention, most recently in the OECD's (2006) report on the Canadian economy (see especially, pp. 67-71 dealing with capital markets) and the means whereby they can be resolved are well understood. It is therefore time for politicians to grasp these particular nettles. The federal government should mount a two-pronged attack on the problems of the big chartered banks: first, and most importantly by de-politicizing the approvals process for mergers among them; and second, by exposing them to as much extra competition as is compatible with the pursuit of domestic financial stability.

Furthermore, Canada's governments should work expeditiously towards creating a single national securities market regulator, and a separate enforcement agency as well. It is regrettable, therefore, that though the recent federal White Paper on the Financial System (Department of Finance 2006) expresses support for the second of these tasks, it totally ignores the first of them, the very one that falls most clearly within its jurisdiction.

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