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International Policy Responses to the Financial Crisis: A Canadian Perspective

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- The recent crisis demonstrated how quickly and devastatingly problems originating in one market can spread to others, and how interventions in one country may help or hurt others.
- The relative soundness of our domestic financial system throughout the crisis suggests that Canada's regulatory framework does not require a major overhaul. But Canada could benefit if other countries introduced reforms to improve their macroeconomic stability.
- On the multilateral front, global stability could be improved if there were agreed principles on monetary policy focused on inflation control and targeting. Improved risk management practices, through better credit ratings systems and more diversified measures of capital adequacy, should also be on the agenda.

Introduction

The recent financial crisis has prompted governments around the world to respond with both conventional and unconventional economic policy tools. It has also given rise to calls for greater international coordination, or even a complete overhaul of the global financial regulatory architecture. This *e-brief* summarizes how governments around the world have responded to the current financial crisis, and draws some short- and long-term lessons for Canada.

Review of Government Interventions

Among the first government responses were monetary interventions; that is, reductions in **monetary policy interest rates** and **provision of liquidity** to the banking system. Almost every country reduced its policy interest rate. Canada, which reduced its rate by 75 basis points starting at the beginning of September 2008, reflected both the international trend and policy coordination among major central banks.

Steps to provide liquidity to the banking system have varied (Table 1). The Bank of Canada and most others have directly increased liquidity available at regular auctions. Canada and Australia widened the range of assets the central bank can accept as collateral when lending and others, such as Indonesia and Saudi Arabia, have lowered the reserve requirements for banks.

Government purchases of bank assets also provide liquidity to the banking system. The United States originally pledged more than $700 billion to buying distressed assets – the plan is now refocused on buying equity stakes and boosting consumer credit availability. Canada's plan was different – an initial schedule to buy $25 billion (now $75 billion) of government-insured mortgages from banks, healthy assets for which the government was already the guarantor of default risk. Australia also announced a plan to purchase residential mortgage-backed securities from banks.

Table 1: Review of Current Conditions and Government Responses in Selected G-20 and Other Countries

Conditions	ARG	AUS	BRA	CAN	CHN	EU	FRA	GER	IND	IDN	IRE	ITA	JAP	RUS	SA	SK	SPA	SWE	UK	USA
Bank Regulatory Capital to Risk-Weighted Assets 2008 (percent)[1]	16.8	10.5	18.1	12.3	7.7[3]	-	10.1[3]	-	12.6	20.5	-	10.4[3]	12.3	15.3	21.8[3]	12.0	11.4[3]	10.0	12.6[3]	12.8
Estimated Inflation 2008 (percent)[2]	9.0	4.4	5.8	2.8	6.4	3.3[4]	3.2	2.8	7.9	10.3	4.0	3.5	1.7	14.0	8.5	4.9	4.5	3.7	3.8	4.3
Interest Rates (3-month latest, percent)[2]	21.50	5.13	13.65	1.75	3.99	4.66[4]	4.66	4.66	7.42	12.38	4.66	4.66	0.64	11.00	4.10	5.87	4.66	3.25	5.58	1.95
Change in Policy Rate Since August 2007 (basis points)	-	-100	-	-225	-81[5]	-75	-	-	-25[6]	-	-	-	-20	-	-150	-75	-	+25	-275	-425

Type of Government Intervention	ARG	AUS	BRA	CAN	CHN	EU	FRA	GER	IND	IDN	IRE	ITA	JAP	RUS	SA	SK	SPA	SWE	UK	USA
Policy Rate Change in central banks' monetary policy interest rates.		✓		✓	✓	✓[7]	✓[7]	✓[7]	✓		✓[7]	✓[7]	✓		✓	✓	✓[7]	✓	✓	✓
Liquidity Provision Expanding the amount of money available in the banking system by directly increasing liquidity available at central bank's auctions, expanding the types of collateral accepted, reducing reserve ratios, or loaning money directly to banks.		✓	✓	✓	✓	✓[7]	✓[7]	✓[7]	✓	✓	✓[7]	✓	✓	✓	✓	✓	✓[7]	✓	✓	✓
Lending Guarantees Guaranteeing commercial bank lending – interbank lending or other bank securities.		✓		✓			✓	✓			✓	✓		✓[9]		✓	✓	✓	✓	✓
Bank Recapitalization Government purchases of equity stakes in commercial banks to increase banks' capital bases.							✓	✓	✓			✓				✓	✓	✓	✓	✓
Bank Deposit Guarantees Expanding the amount of government-insured deposits held at banks.		✓				✓[8]	✓[8]	✓		✓	✓	✓					✓	✓	✓	✓
Unusual Asset Purchases Purchases of bank assets, such as commercial paper or mortgage-backed securities.		✓		✓																✓
Regulatory Interventions and Forbearance Atypical regulatory actions (e.g., restrictions on short selling) or changes or relaxation of rules and regulations for distressed firms.	✓	✓		✓			✓	✓		✓[10]		✓				✓	✓		✓	✓
Induced Mergers and Acquisitions Provision of government incentives for mergers involving distressed financial institutions.			✓																✓	✓

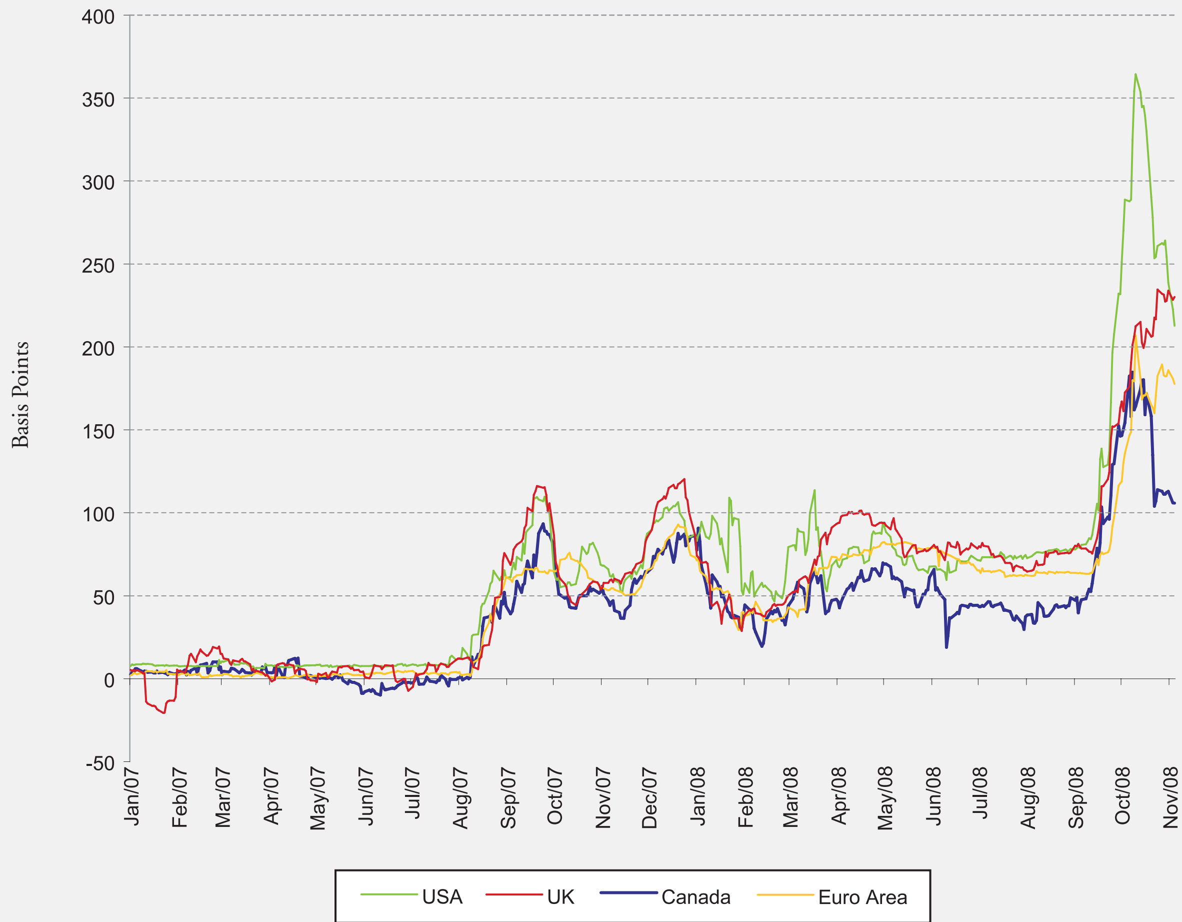
Notes: (1) Source: International Monetary Fund, Global Financial Stability Report, October 2008. (2) Source: *The Economist*, November 6th, 2008. (3) 2007 value. (4) Euro Area. (5) One-year lending rate. (6) Repo rate. (7) European Central Bank intervention. (8) European Union-level intervention. (9) The central bank will partially compensate three major banks for any losses sustained as a result of lending money on the interbank market. (10) The stock market closed for 3 days; 10% limit on price swings; banks no longer have to use mark-to-market valuations for their bond holdings.
Sources for Government Interventions: *Financial Times*, Reuters, and other media. **Countries Listed:** Argentina (ARG), Australia (AUS), Brazil (BRA), Canada (CAN), China (CHN), European Union (EU), France (FRA), Germany (GER), India (IND), Indonesia (IDN), Ireland (IRE), Italy (ITA), Japan (JAP), Russia (RUS), Saudi Arabia (SA), South Korea (SK), Spain (SPA), Sweden (SWE), United Kingdom (UK) and United States (USA).

Table 2: Leverage Ratios for Selected Large Banks, as of Q2 2008

Bank	Bank Total Assets to Total Equity Ratio (Leverage Ratio)
Dexia	59.9
Deutsche Bank	59.1
ING Group	45.7
Barclays	41.6
Commerzbank	39.9
UBS	39.7
Credit Agricole	35.4
Lloyd's	33.2
BNP Paribas	32.4
HBOS	32.2
Fortis	32.0
Morgan Stanley	29.9
Merrill Lynch	27.8
Societe General	26.7
Nordea Bank	25.0
CIBC	24.7
Lehman Brothers	24.3
Goldman Sachs	24.3
Credit Suisse	23.3
BMO	22.1
ScotiaBank	21.2
Royal Bank of C anada	20.5
KBC Group	20.4
National Australia Bank	19.6
BBVA	19.4
Westpac Banking	19.1
HSBC	19.0
Standard Charter	19.0
RBS	18.8
Commonwealth Bank of Australia	18.7
ANZ Banking	18.3
Unicredito Italiano	17.8
Banco Santander	16.3
TD Bank	16.0
Citigroup	15.4
National Bank	15.3
JP Morgan Chase	13.3
Intesa Sanpaolo	12.2
Bank of America	10.6
EU banks	**28.8**
US investment banks	**26.5**
UK banks	**23.5**
Australian banks (largest 4)	**20.0**
Canadian banks (largest 6)	**19.8**
US banks (largest 3)	**12.9**

Sources: Institutional websites, authors' calculations.

Figure 1: Spreads between 3-month LIBOR and Overnight Indexed Swaps, January 2007 to November 2008



Sources: TD Bank; Bloomberg.

Reductions in policy rates and liquidity provisions did not quickly reduce international financial institutions' reluctance to lend or borrow, as reflected by very high interbank lending rates (Figure 1). In part, the high leverage of large banks is an important contributing factor to this credit freeze. Canada's large banks have leverage ratios – bank assets to equity – in the low end among international financial institutions, meaning they were relatively well capitalized entering the crisis. Others, such as Barclays, ING Group, Deutsche Bank and Dexia, had leverage ratios well above that of Canadian banks (Tables 1, 2).

Concern over high leverage ratios has been magnified by uncertainty about the quality of assets held by some banks; European banks, for example, tended to hold shaky US-origin mortgage-backed assets. They also had been large purchasers of private credit insurance: the near demise of AIG sent a shock to the global financial system, as banks had relied on private credit insurance to maintain their regulatory capital at acceptable levels.

France, Germany, the US and the UK, among others, also undertook **bank recapitalization**, buying equity stakes in numerous large institutions, typically in the form of preferred shares. European governments' recapitalization plans could amount to about US $2.5 trillion while the US plans could amount to less than $700 billion. Many countries offered **lending guarantees**: Ireland, France, Germany, Australia, Canada and others offered guarantees on interbank loans. Italy and South Korea offered to guarantee new bond issues and external debt, respectively. The US and the UK offered to guarantee bank issues of debt.

Governments have also increased the thresholds on savings eligible for **deposit insurance**. All European Union member-countries agreed for one year to guarantee savings of €50,000 or more. Australia guaranteed the deposit base for three years, and Ireland guaranteed €400 billion of retail and corporate deposits at the country's six largest institutions. The United States increased the deposit guarantee to $250,000 from $100,000 per depositor.

Governments have also pursued extraordinary **regulatory actions**. Restrictions on short selling were imposed in several countries, including in Canada, Australia, United Kingdom, France and Germany, following the United States lead. Argentina announced plans to nationalize $30 billion in private pension funds. In the United Kingdom, Brazil and the United States, governments encouraged **mergers and acquisitions** of weakened financial institutions.

What Canada Has Recently Done

On November 12, the Bank of Canada announced a series of term loan auctions, at which non-mortgage loans would temporarily be accepted as collateral, on terms implying a 40 percent "haircut." The Department of Finance announced an expansion of its purchases from banks of mortgage-backed securities, improvements on the terms under which it would insure banks' wholesale lending, and a relaxation of the definition of bank capital for the purpose of meeting regulatory standards. The stated rationale for these actions was to ensure Canada's "financial system is not put at a competitive disadvantage by developments in other countries."

These actions should improve Canadian credit market conditions – however, they are clearly also responses, in the first instance, to external policy actions.

What Canada Should Still Do

On the domestic front, the Bank of Canada should continue to supply liquidity to financial markets as necessary; the existing supply of liquidity may need to be drawn back as the crisis ebbs, to avoid future inflation. Meanwhile, the C.D. Howe Institute's Monetary Policy Council recently recommended that the Bank of Canada's overnight interest rate target be further reduced, to 2.0 percent.

If these actions prove insufficient in improving stability in credit markets, then Ottawa should consider the following actions:

- Ease the de facto prohibition on large financial sector mergers, and remove existing restrictions on foreign ownership in the sector. This approach would permit strong institutions to subsume weaker ones, and would also represent a market-oriented solution. Government purchases of equity stakes in financial institutions would remain a subsequent option.
- Maintain a flexible approach to interpreting capital adequacy requirements, recognizing the need to rely on a diversity of standards. In the Canadian case, this includes nuanced assessment of lending risks, so that capital set-asides appropriately reflect risks to which lenders are in fact exposed.

At the multilateral level, it bears repeating that private and public balance sheets in Canada, notably in the financial sector, were in relatively good shape going into the crisis. For that reason, Canada can and should act differently from other countries – in particular, avoiding fiscal interventions that are extremely costly or raise the threat of politicized allocation of credit now and in the future.

At the same time, however, the crisis has demonstrated how quickly and devastatingly problems originating in one market can spread to others, and how interventions in one country may help or hurt others. For example, the US government's rescue of AIG has been beneficial not only to the US financial system, but to European financial institutions which relied on the company's credit insurance. By contrast, extensions of deposit insurance or bank lending guarantees in some countries have prompted shifts of deposits or credit flows away from others. These positive and negative spillovers suggest the advantages of international policy cooperation in responding to financial market crises.

The relative soundness of our domestic financial system throughout the crisis suggests that Canada's regulatory framework does not require a major overhaul. Regulatory spillovers, however, suggest that Canada could benefit if other countries introduced reforms to improve their macroeconomic stability.

In Canada, for example, protecting the inflation-targeting framework underpinning our monetary policy is of paramount importance; it should be retained, and other nations encouraged to adopt it. Global stability could be improved if there were agreed principles on national monetary policies focused on inflation control and targeting. Multilateral agreement on principles underpinning the monetary framework and on regulatory oversight could also be helpful in the following areas:

- principles guiding national policies on consolidated and comprehensive regulation of all financial market participants and activities;
- improved risk management practices, through better credit ratings systems and more diversified measures of capital adequacy, including the recognition of differing risks as between retail and wholesale lending; and
- increased transparency and disclosure, especially with respect to the balance sheets of large, highly leveraged institutions.

As to new multilateral regulatory and supervisory institutions, such as those proposed by France and others, obstacles remain, owing to uncertainty over what responsibilities would be assigned to a new body, what authority it would have to act on those responsibilities, and what accountability mechanisms would govern such oversight powers. This raises questions about national sovereignty and could pose challenges to domestic legislation and regulation, given the need to reconcile a new body with existing federal and provincial institutions that provide prudential and conduct oversight.

Conclusion

Throughout the storm that recently hit global credit markets, the Canadian banking sector has exhibited resilience. The federal government and the Bank of Canada should remain ready to provide additional support for Canadian credit markets as needs arise. While better multilateral policy coordination is desirable, a selective approach, with respect to international calls for changes to the regulatory framework, seems wisest.

This *e-brief* is a publication of the C.D. Howe Institute.

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