

Implications for the International and Canadian Financial Services Industry and their Governance Of Varying Future International Scenarios

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Foreword

This Working Paper is one of six case studies on the scenarios for global and regional integration now being released by the Institute of Intergovernmental Relations. The Institute embarked in 1999 on a multi-year research program on the effects of and challenges for Canadian federalism of global and regional integration. This project proceeded from an assumption of continuing and possibly accelerating international integration and governance, and that policy matters within provincial government jurisdiction will increasingly be the subject of international negotiation. The broader objective of the project has been to examine whether the institutions and dynamics of the Canadian federal system can continue to effectively manage this change. The central issue we have been investigating is under what circumstances continued *ad hoc* adjustment to the processes and institutions of the federation would remain the appropriate course of action; and under what conditions more systemic reform would be the preferred or even the essential course to take. For more information of the research output and findings of the project

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overall, please consult the Institute's website at www.iigr.ca.

Our research program has consisted of several components: the development of a set of scenarios for the world in 2015; a baseline study of Canadian federalism and international relations; a set of papers applying the scenarios and comparing integration challenges in other federal systems; and these six case studies. The case studies cover the following policy sectors: Biodiversity, Climate Change, Health and Health Care, Agriculture and Agri-foods, Aboriginal Governance, and Financial Services. They were initially prepared for discussion with the policy sector communities. Most of these discussions were sponsored by the Government of Canada through the relevant departments.

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Finally, as Director I wish to acknowledge the role that Douglas Brown, Institute fellow, has played in the overall coordination of these case study papers and in our Global and Regional Integration project as a whole.

Harvey Lazar
Director
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INTRODUCTION

The purpose of this paper is to discuss the likely impact that four possible scenarios of global change over the next 15 years would have on the international and Canadian financial services industry². Those international political

²The paper is a contribution to the project on *The Future of Global and Regional Integration* sponsored and directed by The Institute of

and regulatory scenarios, briefly described below, are referred to as "shared governance", "global club", "regional dominators" and "cyberwave". The paper includes consideration of the implications of the scenarios for the regulation or governance of the international system and for governance of the Canadian financial system in a federal structure.

Some considerable attention, it was thought, should be paid to what would happen to the Canadian financial system and its governance within a federal structure if current trends in the international and Canadian financial services environment and in Canadian regulatory policies continued into the future. While those issues are included in this paper, they are discussed more comprehensively in a companion paper.³

Existing evidence suggests strongly that the principal forces shaping the international and Canadian financial systems over the next fifteen years will be the impersonal forces of the market place and not the discretionary decisions of domestic and international regulatory authorities. The principal challenge of the latter will be to ensure that the regulatory framework, both international and domestic, is such as to result in stable and efficient financial systems within the context of those impersonal market forces.

In order to consider the likely impact of the various scenarios on the international and domestic financial systems and their governance it is essential at the outset to have an understanding of the nature of those systems, the environment in which they find themselves, and their governance. I refer to this as the "base case". This, among other things, includes identifying the weaknesses in the financial systems that have

been revealed through recent experiences, such as the "Asian financial crisis", and the responses that were prompted by them and are now shaping governance structures and policies internationally and domestically.

The "base case" that emerges from this will provide the stage on which to judge how the various prescribed scenarios might modify that current outlook. Indeed, it turns out that the trends now evident in the "base case" resemble those of one of the four scenarios outlined by the Institute of Intergovernmental Relations more than do the others--- namely, the "shared governance" scenario. As a result the "shared governance" scenario to some extent amounts to the working out of the trends evident in the "base case". This is less so with the other scenarios.

OUTLINE OF THE STUDY

First, there is a brief outline of the four scenarios of the future global environment that The Institute of Intergovernmental Relations has identified and asked me to consider.

Second, the various aspects that make up the "base case" are discussed. These include:

- (1) the fundamental forces that have begun and will continue to drive financial system changes internationally and in Canada;
- (2) the weaknesses in the international and Canadian financial systems that those fundamental new forces are revealing and the prerequisites for financial system stability and efficiency that will require attention in the period ahead. This can be done most effectively by first examining the nature of recent financial crises, and in particular the "Asian Financial Crisis";
- (3) the responses of the international financial system and its governance to the weaknesses revealed by that crisis and by the challenges of globalization;
- (4) a summary of the characteristics of the international "base case", and of the Canadian "base case".

Intergovernmental Relations, Queen's University, Kingston, Ontario. The scenarios used are those defined and prescribed by The Institute.

³See Edward P. Neufeld, *What Kind of a Financial System Do Canadians Want?: Implications of Globalization and Current Canadian Policies For the Future of the Canadian Financial System*, School of Policy Studies, Queen's University, Kingston, Ontario, Discussion Papers Series, Discussion Paper 2000(1), April 2000.

Third, there is discussion of the likely impact that each of the four scenarios would have on the "base case" and their implications for the international financial system and for that of Canada.

SCENARIOS OF GLOBAL CHANGE

The Institute of Intergovernmental Relations has identified four possible scenarios of the global environment, but without attaching probabilities as to their likely emergence.⁴ These four scenarios are based on assumptions concerning the possible distribution of sovereign power internationally — ranging from highly aggregated in a few countries to highly dispersed among a large number of countries; and assumptions concerning the possible character of governance of the financial system — from effective control of institutions and markets to very loose and less effective control with great sway left to market forces.

More specifically the four scenarios have been portrayed as follows:

"Shared Governance" — In this scenario power is widely and more evenly dispersed among a large number of countries and the system functions through many rules and regulations and close and effective control exercised by a growing number of international organizations and arrangements.

"Global Club" — In this scenario power and wealth are concentrated in a few countries and a few hands and they club together to deal with critical issues affecting them all -- which they do through many rules and close and effective control.

⁴Taken from *The Future of Global and Regional Integration*, Scenarios Developed for the Institute of Intergovernmental Relations, Queen's University, October, 1999, pp. 1-2 .

"Regional Dominators" — In this scenario power is more dispersed but in the form of regional blocs composed of the major powers of each geo-political bloc. This scenario involves less centralized control but attempts at effective regional control.

"Cyberwave" — In this scenario power is widely and evenly distributed but rules and controls are minimal because of the inability of public institutions to keep pace with the rapid pace of technical change that is driving business and economic growth.

These scenarios are not forecasts of possible outcomes. They are intended to identify some major possible tendencies in the future global environment and the implications of those tendencies for the financial system and its governance internationally and in the Canadian federation.

However, before focussing on the various implications of these scenarios over the next fifteen years it is necessary to have a clear impression of the nature of current developments in financial systems and of the forces that are driving them. Only after having formed a detailed view of this current situation "base case" can judgements be made as to the likely implications for the financial systems of the various scenarios.

THE "BASE CASE" -- FUNDAMENTAL FORCES DRIVING FINANCIAL SYSTEM CHANGES AND THEIR IMPLICATIONS

The single most important force reshaping international and domestic capital markets is the quantity and quality of information available to them and the ease with which it is available. It has been noted that globalization of the 19th century was built around falling transportation costs — railroads, steamships, automobiles — while current globalization is built around falling telecommunications costs — microchips, satellites, fibre optics, Internet⁵ This is breaking

⁵See Thomas L. Friedman, *The Lexus and the Olive Tree*, Farrar, Straus and Giroux, New York, 1999, p.xv . This volume is an excellent reference to the many dimensions of current fast developing

down regional, international and institutional barriers between financial markets at a speed that could not have been imagined in advance.

With it is emerging increasing integration and standardization of financial services markets, of financial institutions within them, and of governance policies and regulations. Any country that attempts to oppose those trends of integration, or even simply ignores them in its policies, risks seeing its relative economic position deteriorate. It is significant that even after the impact of the Asian crisis few countries felt capital controls were the answer.⁶ A senior executive of the International Monetary Fund (IMF) recently noted that "...the imposition of extensive controls would sacrifice most of the potential benefits of international capital mobility. Despite the recent crises, almost all emerging market countries have rejected the comprehensive capital control approach"⁷.

Countries have learned that they run the risk of severe economic disruption when international market forces overwhelm domestic policies and structures that are in disharmony with international markets and developments. One close observer of current market developments

globalizations and its possible implications.

⁶Malaysia reintroduced exchange controls in September 1998 as a way of stabilizing a crisis situation which, it has argued, would not have been necessary if the multilateral institutions had been more effective, are not a substitute for sound macroeconomic policies and are not necessarily appropriate elsewhere. See Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman, Governor, Bank Negara Malaysia, Address, *Revitalizing the Asian Economy*, Tokyo, 7 September, 1999. The issue of volatile short term capital is also being discussed in the IMF but no recommendations appear to have emerged for regulations for controlling them and there is no international trend toward the reimposition of controls on capital flows.

⁷Stanley Fischer, First Deputy Managing Director, International Monetary Fund, *Presentation to the International Financial Institution Advisory Commission*, Washington, D.C., February 2, 2000.

has graphically described the swiftness of change and its implications by noting that

... only the paranoid, only those who are constantly looking over their shoulders to see who is creating something new that will destroy them and then staying just one step ahead of them, will survive.⁸

The same observer has described the current era in a way that does portray its irreversible significance:

...the globalization system, unlike the Cold War system, is not static, but a dynamic ongoing process: globalization involves the inexorable integration of markets, nation-states and technologies to a degree never witnessed before — in a way that is enabling individuals, corporations and nation-states to reach around the world farther, faster, deeper and cheaper than ever before, and in a way that is also producing a powerful backlash from those brutalized or left behind by this new system.⁹

Who, it may be asked, are the ones that can be "brutalized" in this process, as far as the financial sector is concerned. Certainly there are the individuals employed by financial institutions whose skills suddenly are made obsolete and who find retraining difficult.

Then there are the individual financial institutions that fail to understand and adjust to the new era of intense international competition, ever changing technology and new ways of delivering old and new financial products.

But there are also the financial systems of individual countries that, through the impediments of their regulatory framework, are prevented from making adjustments necessary to ensure that they will be internationally competitive in the decade of globalization that lies ahead. That they will remain viable and profitable for another few years is totally

⁸Thomas L. Friedman, *op.cit.*, pp.9-10.

⁹Thomas L. Friedman, *op.cit.*, pp.7-8

irrelevant. The only relevant question for restructuring policy to ask is, where they will be in ten or fifteen years time.

While over the short-run there remain some differences between countries in the quality and cost of even internationally traded goods and services, it is safe to assume that in time they will have been substantially reduced. Suppliers unable to meet the international price because of cost disadvantages will find it difficult to survive. Similarly, international financial activity will drift toward countries that can provide the most propitious environment including the regulatory framework.

This process amounts to a massive integration and centralization of world markets. It leaves individual institutions and regulatory systems little choice but to move in the same direction. Impersonal competitive market forces, not discretionary regulatory decisions either domestic or international, are rapidly reducing the importance of political boundaries as far as financial systems are concerned. Governance of those systems must increasingly transcend those boundaries as well, if it is to be effective.

The process is permanent and not reversible because it reflects the fundamental dynamics of competitive institutions and their drive toward greater economic efficiencies and competitive advantage, all made possible by irreversible technological innovations. The better the information, domestic and international, available to the various financial market players, the more economically efficient the market will be.

The impersonal competitive forces that are driving the generation and distribution of information and are sweeping across virtually all political boundaries appear to be unstoppable. Competitive forces will ensure that information and communications technologies and systems will be developed to make that increasingly easy; and investors will welcome and demand it as more and more of them realize that international diversification, far from increasing their risks and frustrating the achievement of their investment activities, will do the opposite.

This process of international integration and standardization is already evident in many areas and sectors -- integration that extends to monetary, fiscal, exchange rate and tax policies; to the market for financial services and the market for top level executives and valued professionals; to the characteristics of what constitutes competitive financial institutions and their "optimum size"; to regulatory regimes and codes of corporate behaviour and their governance; to the transparency requirements in public and private sector activities. It has been said, correctly, that "Globalization is not a phenomenon. It is not just some passing trend. Today it is the overarching international system shaping the domestic policies and foreign relations of virtually every country, and we need to understand it as such".¹⁰

The transformation of the international financial environment in which information systems and services are integrated across most of the globe has fundamentally changed the structure of financial institutions. The advances in communication and information technologies have opened the door to significant economies of scale and through them to equally important improvements in the quality of services and their delivery, provided that very large volumes of transactions are captured. However to realize those economies requires very large investments in electronic systems and specialized human resources, which in turn requires a large capital base. That is, the "optimum size" of international institutions has increased and past measures of it are obsolete.

This is not a conclusion that can be arrived at by measuring mathematically the current "optimum" size of an international financial institution. The situation is much too dynamic to make that possible — with market reach expanding and deepening month after month and examples of financial institutions restructuring through mergers, acquisitions and internal growth in response to those developments, appearing almost every week. A large number of international financial institutions in many

¹⁰Thomas L. Friedman, *op.cit.*, p.7.

countries have expanded their capital bases or are seeking ways of doing so in order to reduce unit costs and to enable them to develop the intercontinental systems and product ranges needed to be a significant player. This is strong evidence that there has been a major increase in the "optimum" size of international financial institutions.

Also many domestic institutions that previously served largely domestic markets have little choice but to expand their international business or be squeezed in their own market place. This is because the economies of scale made possible by modern technology can only be fully realized by having huge volumes of business, volumes so large that for smaller countries including Canada they require a market base larger than the domestic one alone. Institutions such as MBNA and ING banks are likely to be formidable competitors in many domestic markets for that reason among others.

Currently, the informed investor or depositor can as easily place his funds with a New York investment firm as with a domestic one and the number of "informed" investors will undoubtedly be in the majority in a few years time. Furthermore, the bar for acceptable quality and quantity of services being provided has been raised, and many institutions unable to meet that quality will disappear for that reason.

The view has been expressed that in future only very large financial institutions with a broad international reach and highly specialized small niche players will survive.¹¹ Some might feel that countries such as Canada have a viable choice here, that is, either have internationally prominent institutions or have a domestic system of "niche players". But on examination this is not a real choice because the increasingly significant "niche players" are large international corporations themselves. The only valid choice countries have is to develop an internationally competitive financial sectors with strong domestic bases.

¹¹Cf. Lowell Bryan "A Prescription for Failure", *National Post*, Dec. 15, 1999, p. C7.

The transformation of financial systems through the rapid emergence and application of information and communication technologies is not being achieved without difficulty. Indeed, it has created a range of difficulties in domestic and international financial systems. Those difficulties were first hinted at by the LDC (Lesser Developing Countries) debt crisis of the 1980s but were brought to light with a vengeance during the Asian financial crisis. Their character and the responses of domestic and international regulatory and market institutions to them give an indication of the nature of the "base case", that is, of where the world is at right now.

THE "BASE CASE" — LESSONS FROM PAST FINANCIAL CRISES

The "Asian financial crisis" is particularly illuminating because it is recent and because it is really the first international financial crisis in which the greatly increased size and volatility of cross-border private sector lending and borrowing played a major part.

1. Financial crises are recurring and ever changing in nature

At the outset it is worthwhile recalling that financial crises have a very long history and it is simple prudence to assume there will be more over the next fifteen years¹². By way of illustration, there was the "tulip mania" of 1634-36 in Holland; the "South Sea Bubble" in England in 1720; the Baring Crisis of 1890; the Credit-Anstalt failure in Austria in May 1931 and the collapse of the Gold Standard and of whole banking systems including that of the United States in the 1930s Depression; the recurring post World War Two sterling crises; the widespread financial disruptions of the energy crisis of the 1970s; the Lesser Developing Countries' (LDC)

¹²For an analysis of some past financial crises and their implications for domestic and international financial system policy see Edward P. Neufeld, *Confronting International Financial Shocks*, A Paper Presented to the International Seminar on "Financial Systems, Macroeconomic Stability and Capital Flows", July 21st and July 22nd, 1998, Banco Central de Bolivia, La Paz, Bolivia

debt crisis of the 1980s; the United States savings and loan crisis; the currency crisis in the European Monetary System in 1992; the second and fateful Baring crisis of 1994; the Mexican peso crisis of 1994-95; very significantly, the "Asian financial crisis" which is often dated from the Thailand devaluation of July 1997 but which in reality started in Japan in the early 1990s; the Korean financial crisis beginning in November 1997; and the Brazilian crisis of November 1998. Canada had its own mini-crises over the years over the failure of various trust and loan and insurance companies and two small banks which prompted regulatory changes.

A further over-riding lesson of past crises, particularly the "Asian financial crisis" appears to be that the solvency of the financial system is not assured automatically by the interplay of market forces. Efficient and effective systems of governance seem to be needed to maintain stability of the system.

A third lesson is that no two crises have been alike and future ones are not likely to be identical to past ones. This poses special challenges for domestic and international agencies concerned with maintaining financial system stability. The danger is that regulatory authorities and private corporations will be well prepared to "fight the last war" but not the next one. Furthermore, the character of the crisis may depend in part on which of the four scenarios, or variations of them, emerge over the next decade and a half.

2. The Asian Financial Crisis is of Significance for Future Stability of the Financial System

Being of very recent origin the Asian financial crisis brought to light significant characteristics of the current financial environment including a wide spectrum of weaknesses in international and domestic financial systems. The weaknesses it revealed have unleashed unprecedented activity at the multilateral level and within domestic financial systems for more effective governance of the international and national financial systems.

Some of the characteristics of the Asian crisis were similar to those of previous crises but it differed from them in two highly significant ways -- differences that caught both domestic and international governance agencies by surprise.

First, it was based on widespread structural, as distinct from merely cyclical weaknesses. Weaknesses emerged among private financial institutions and their governance, among domestic governance or regulatory institutions and arrangements, and among multilateral organizations responsible for protecting the stability of the international financial system.

Second, the Asian crisis emerged in an environment where the absolute and relative size of private capital flows had increased over a short period of time to unprecedented levels -- in part made possible by rapidly advancing communications and related technologies. Much of that capital went to private sector borrowers, much of it was short-term, and much of it took the form of unhedged US dollars. This differed from, say, the LDC debt crisis where loans were of longer term on average and borrowers were sovereign authorities with greater staying power than private sector borrowers, particularly since many of the latter proved to be financially weak. Also the number of sovereign LDC borrowers to deal with separately in rescheduling exercises was much smaller than in the case of the Asian crisis with its large number of private sector borrowers.

In most discussion it is assumed that the crisis began in Thailand on July 2, 1997, the day when the baht was devalued which was then followed by crises in Malaysia, the Philippines, Indonesia, South Korea and some South American countries including Brazil ---with disastrous consequences for their economies and, indeed, for the international economy generally.¹³

¹³Cf. E.P. Neufeld, *ibid.* for a discussion of the character of the Asian financial crisis and, most recently, also Timothy Lane, "The Asian Financial Crisis. What Have We Learned?", in International Monetary Fund, *Finance and Development*, Sept. 1999, Volume 36, Number 3.

However, it can be argued, given the nature of the crisis, that it really began in the early 1990s with the collapse of the greatly inflated Japanese financial and real estate asset prices. That collapse first revealed significant weaknesses in the financial institutions and institutional arrangements of Japan. The same kind of weaknesses emerged in the other South East Asian countries after the devaluation of the baht. It became very evident that the crisis was not simply a normal cyclical correction with manageable "liquidity" problems in the financial sector, but rather one raising fundamental "solvency" problems as a result of profound structural weaknesses within institutions and their governance. Less than adequate management of the crisis is in part explained by these long-ignored structural deficiencies that were superimposed on the more common and better understood cyclical distortions. It is also explained by the sheer size and volatility of international private sector lending and borrowing

Japan did not follow the collapse of its financial and real estate asset prices with swift policy responses. It delayed for a long time adjustments in its monetary, fiscal and exchange rate policies and it ignored for some years needed restructuring of its financial system. The end cost of such delays was very large. For example, in 1995, five years after the initial warnings of crisis appeared, thirteen Japanese financial institutions failed and in November 1997 Sanyo Securities sought court protection, Takushoku Bank announced its closing and the venerable and large brokerage firm of Yamaichi Securities ceased operations. To these costs must be added the inferior economic performance of Japan for almost a decade and increased foreign presence in the domestic market because of failures of institutions. Just how very long restructuring takes is illustrated by the fact that the old system of fixed commissions for securities transactions did not disappear in Japan until 1999 and cleaning up the affairs of the Long-Term Credit

Bank of Japan Ltd. through a foreign take was allowed only in February 2000.¹⁴

The character of the financial crisis was largely the same in the other South East Asian countries — with one important difference. Perhaps benefiting from the Japanese experience, the lag between the break-out of the crisis and needed policy responses, while still excessive in some cases, was much smaller than in the case of Japan. Even so the costs were high. Just by way of example, in South Korea 14 out of 30 merchant banks suspended operations and many other institutions were in great difficulty; in Indonesia 16 insolvent banks were closed; and in Thailand 58 finance companies out of 91 suspended operations. The direct costs to governments in terms of attempted "bail-outs" and, prior to devaluation, attempts at supporting unrealistic exchange rates were very large while the economic costs of lost production were much larger still.

One question arises from all this that must be addressed in order to understand the dynamics of the current international financial system. Why was it that these widespread structural weaknesses, which in fact had been present in the highly protected financial systems of South East Asia for decades, suddenly erupted to create a crisis? The answer lies in the sudden emergence of unprecedented volumes of volatile private sector international capital that was suddenly made available to a whole new range of borrowers. This was made possible by emerging information and communications technologies, as well as advances in finance theory that, combined with the calculating powers of computers, permitted the emergence of a whole new range of financial instruments — the "derivatives"¹⁵.

¹⁴See *National Post*, February 10, 2000, p.C15.

¹⁵Cf. Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Address at the Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, May 1, 1997 and also E.P. Neufeld, *ibid.*

Much has been made in discussion of the Asian financial crisis of its "contagion" effect — that is, spreading from one country to another. After the devaluation of the baht the crisis did indeed spread from one country to another, but it spread to countries having similar structural problems, of the kind discussed below. That is, the crisis by and large did not spread to countries with strong financial systems, well-developed regulatory regimes, realistic exchange rates and a stable macroeconomic environment. This is a significant reality when appraising the likely character of future crises.

But also to be kept in mind, as noted earlier, no two crises are exactly alike. One cannot exclude the possibility that having in mind the emerging highly integrated world economy, one tightly connected by a variety of complex electronic systems, that some external shock could set off a contagious crisis.

3. Financial System Weaknesses Revealed by the Asian Financial Crisis

The weaknesses revealed by the Asian financial crisis related to (1) macroeconomic policy deficiencies (2) structural deficiencies among financial institutions (3) deficiencies in corporate operations (4) domestic governance and regulatory problems (5) international governance failings

(1) Macroeconomic policy deficiencies

(a) Monetary policy was frequently late in maintaining and restoring stability: This contributed to the excessively easy credit conditions that were already being created by the ready availability of large amounts of foreign capital from international financial institutions.

(b) The system of fixed exchange rates became unsustainable: In the period prior to the floating of the currencies official authorities took strenuous measures to maintain fixed rates at unrealistic levels until official reserves were almost exhausted, and some delayed for long periods going to the IMF for assistance. The futility of maintaining a fixed exchange rate in a period of financial crisis created substantially by

deep-seated structural problems, and not simply by short-term "liquidity" problems, was not recognized early on.

(c) Fiscal policies in most cases were not the cause of the crisis: In the Asian crisis countries, with the exception of Thailand, fiscal policies were not a cause of the financial crisis while in some countries of South America they were. Therefore, it is apparent that fiscal balance is not a sufficient conditions for avoiding financial crises but imbalance can be an important contributor to creating them.

2) Structural deficiencies among financial institutions

(a) Domestic policies shielded institutions from international competition. By way of example, Japan did not begin serious structural reform of its financial system until the end of 1996 even though the weaknesses had been revealed years before including the bankruptcy of a number of financial institutions. The United Kingdom "big bang" reform had begun in 1986 but was ignored as an example to follow. The dependence of many private corporations on government support raised important problems of "moral hazard" — the feeling that bad practices need not be of concern since the government would rescue corporations and institutions in difficulty. There was typically a great reluctance on the part of government authorities to permit domestic institutions to be rationalized through mergers and acquisitions until bankruptcy threatened.

(b) Domestic financial markets were heavily circumscribed by detailed regulations.

While regulations generally shielded domestic financial institutions from international competition, those domestic institutions were themselves burdened with detailed regulations that interfered with the interplay of market forces. In many cases these included mandatory lending to borrows favoured by government policies and agencies.

(3) Deficiencies in corporate operations

(a) Absence of strong corporate governance culture and weak financial controls:

In a number of cases funds went to weak private sector corporations and to corporations with questionable projects for the utilization of borrowed funds, some bordering on fraud. Public reporting of the financial condition of corporations in many cases was woefully inadequate as was even private reporting to the lending institutions. This lack of transparency in corporate accounting practices and weak financial controls within corporations, as well as deficient bankruptcy laws, greatly increased the risks lenders were taking on and they were not deterred from doing so by their own regulatory agencies. Internal techniques and procedures for the measurement and control of risks in most cases were rudimentary.

(4) Domestic governance and regulatory deficiencies

(a) Weak public sector governance: The supervisory and regulatory agencies of both debtor and creditor countries failed to identify and regulate the risks their institutions were taking on by borrowing and lending excessive amounts of recently available short term foreign currency funds. Many of the countries had neither the regulatory nor reporting framework, nor the trained personnel to manage this newly emerging system of huge amounts of private capital flows. Nor was there an effective system of co-operation between regulatory agencies of different countries — a growing gap in the light of the increasing importance of international lending by essentially domestic financial institutions.

(b) Lack of transparency in official policy actions: Governments tended to hide bad news from financial markets for prolonged periods, such as the depletion of foreign exchange reserves, with the result that when such news finally did emerge the financial market reaction was swift and very destabilizing. The sheer size of private sector capital flows meant that official authorities needed market forces to be in harmony with desired adjustments if stability was to be restored and maintained. The historic bias toward secrecy in government policy proved to be an important part of the problem of financial market instability.

(5) International governance failings

(a) Multilateral institutions failed to respond in a timely fashion: The IMF had not evolved into the role of appraising the soundness of its member country financial markets and institutions, confining itself to macroeconomic including exchange rate matters and providing financial support in relation to them. It, therefore, was not in a position to provide prompt support to members who, in the initial stages faced “liquidity” problems. Nor did any of the other multilateral institutions fill that role. The result was that in addition to structural problems leading to many insolvencies, which became inevitable, there were “liquidity” problems that also did so and need not have done so if timely assistance had been available.

Malaysia has been cited as an example of this as noted earlier.

4. Lessons from the Asian Financial Crisis for International and Domestic Policy

(1) Retaining the confidence of international markets has become the most important factor for surviving disruptive international economic and financial developments in this new world of huge capital flows. Loss of such confidence now has a high economic price attached to it.

(2) The development of a strong domestic financial system with an efficient regulatory regime together with a strong economy based on monetary and fiscal policies that create a stable macroeconomic environment are the most important ways of retaining international confidence.

(3) Domestic policies that impede the orderly evolution of financial systems in the face of international forces and developments lead to a weakening in the structure of the system. This, in turn, as the Asian crisis illustrated, leads eventually to a breakdown in the system and high costs in terms of disorderly restructuring, numerous insolvencies, diminished domestic ownership and control, lost economic growth, unemployment, and social unrest.

(4) There is urgency in permitting such restructuring because of the enormous volume of international private sector financial flows and the speed with which competing countries are accommodating such restructuring.

(5) Regulatory systems must pay increasing attention to direct and indirect international risk exposures of the institutions they are regulating because of the large size of private sector international capital flows.

(6) The complacency that emerges from regulations that in effect protect poor performers and questionable practices lead to dangerous "moral hazard" problems. Therefore, regulatory regimes must minimize this risk. Not doing so causes market forces to magnify structural weaknesses rather than ameliorate them.

(7) The sheer size of international capital flows is such that market actions of official authorities that run counter to strong market sentiments are bound to fail. Official policy actions must be such as to cause market forces to reinforce rather than run counter to official objectives. Two prerequisites for achieving this are timely action for precluding small problems becoming large ones (eg. permitting restructuring of financial institutions when they are strong rather than when they have weakened to near insolvency and early interest rate changes if inflation threatens or exchange markets threaten to become chaotic); and substantial "transparency" of actions and policy objectives of official authorities so that markets have reliable and relevant information. Maximum disclosure by financial institutions of on going information concerning their operations and performance is now also a prerequisite for stability and efficiency of financial markets.

8) The greatly increased size and importance of international capital markets and the interdependency between countries that this has created demand a more effective system of international surveillance and guidance than existed at the time of the Asian financial crisis.

IV "THE BASE CASE" -- INTERNATIONAL ECONOMIC POLICIES AND OVERNANCE

Current developments aimed at achieving a stable and efficient international financial system draw heavily on the past experiences just discussed.

First the macroeconomic policy environment will be examined and then the highly significant policies related to restructuring financial systems and their governance.

1. The International Macroeconomic Policy Environment — Base Case

(1) Monetary policy — Base Case

The last two decades have witnessed a major change of and convergence in perceptions among the central banks of the industrialized countries as to the appropriate role and objective of monetary policy. There has also been a convergence of views concerning the appropriate relationship between central banks and their sovereign authorities. In contrast to earlier post-war decades when it was thought that a major objective of monetary policy should be to create employment through relatively easy credit even if this risked some inflation, it is now very generally accepted that the central bank can best contribute to fostering employment and growth by accepting a low level of inflation (i.e. protecting the domestic value of the currency) as its major policy objective.¹⁶ This convergence of national views on the objectives of monetary policy was dramatically illustrated by the formation of the European Monetary Union under the direction of the European Central Bank in Frankfurt.

It is also now generally accepted that there must be a strong buffer between the central bank and day-to-day political forces through making central banks relatively independent. The central banks of France and the United Kingdom, which had been under close political control have become much more independent along the lines of the US federal reserve system and the

¹⁶Cf. George M. von Furstenberg and Michael K. Ulan, *Learning from the World's Best Central Bankers: Principles and Policies for Subduing Inflation*, Kluwer Academic Publishers, Boston/Dordrecht/London, 1998.

Deutsche Bundesbank. This relative political independence has also been written into arrangements governing the new European Central Bank that oversees the management of the EURO. The Bank of Canada has always been relatively independent. A large number of smaller and less developed countries have also adopted the concept of relatively independent central banks.

Since the Second World War the Bank for International Settlements has become an important regular meeting place for the governors and presidents of the G10 central banks and this also facilitates personal communication between meetings.

The major central banks including the Bank of Canada have shifted from a strong inclination toward secrecy, to a substantial degree of transparency concerning their objectives, operating strategy, and economic assessments¹⁷. This arose from the growing understanding that for monetary policy operations to be effective, they had to be in harmony with the now enormously large forces of the market place¹⁸.

A major uncertainty in future monetary policy of relevance to the management of financial markets is the question as to whether financial asset prices should be taken into account when setting central bank inflation targets. At present they are not, and it is difficult to see how this might be done since measuring the extent to which asset prices exceed fundamental factors is difficult. At the same time there is some feeling

¹⁷For a recent exposition of the transparency measures the Bank of Canada has taken as well as its current approach to implementing monetary and exchange rate policies see Charles Freedman, Deputy Governor, Bank of Canada, *The Framework for the Conduct of Monetary Policy in Canada: Some Recent Developments*, Notes for Presentation to the Ottawa Economics Association, January 25, 2000.

¹⁸On one occasion when the Bank of Canada attempted to lower short-term interest rates marginally the market reacted sharply against the move with the result that interest rates for some months were higher than before the attempt to lower them.

that financial asset prices do become excessively inflated from time to time and that this poses problems of financial system stability.

(2) Fiscal Policy — Base Case

Just as there has been some convergence of views among the world's central bankers over monetary policy, there has been some convergence of official views over the usefulness of discretionary fiscal policy for economic stabilization purposes. Much less confidence is now placed in the ability of such fiscal policy to counter economic cycles. Forecasting difficulties, the long lags between a discretionary fiscal policy action and its impact on the economy, the political difficulty of building up surpluses during periods of growth, and the burden of growing public debt lie behind that reduced confidence. So fiscal policy for stabilization purposes has become more restrained, apart from the operation of the automatic stabilizers. Indeed, there is the question as to whether fiscal authorities will be reluctant to respond adequately should a serious cyclical economic crisis emerge.

While there is some convergence of views over fiscal policy, there is substantially less convergence of views as to the over-all role of the state and the appropriate size of the public sector. Yet market forces are not indifferent to this issue. Differing tax rates are viewed increasingly as influencing the international allocation of real and financial capital and of affecting the local supply of highly mobile human talent, capital and real investments. Higher taxes have increasingly to be accompanied by a public perception that value is being received for them. Because of some public scepticism over this it is more likely that the relative size of the public sector will decline than increase.

(3) Exchange Rate Policy — Base Case

There have been changes in perceptions concerning appropriate exchange rate policy and while there has been some convergence of views relating to it, this has not been nearly as complete as in the case of monetary policy.

North America and the United Kingdom have been more inclined to continue with floating exchange rates while continental Europe has for

long favoured fixed exchange rates — which view provided an indispensable foundation for the emergence of the EURO. The former appear in general to have taken the view that exchange rate stability should be achieved through the adoption and implementation of macroeconomic and related policies; while the latter appear to regard the commitment to a fixed exchange rate as the necessary incentive for ensuring that stabilizing macroeconomic policies will in fact be pursued. Both views can draw on historical experience for support. Over the last decade relative price stability has been achieved under both systems while in earlier decades substantial inflation was also experienced by countries pursuing the two approaches.

There has, however, emerged a broad consensus that extreme movements in the exchange rate are harmful to economic growth because they distort international capital and trade flows, cause instabilities in international and domestic financial markets and, at times, even risk the solvency of private sector financial institutions. Widely adopted policies of low inflation should result in removing some elements of instability from exchange markets. Also arrangements for greater stability are evident in the emergence of the EURO, in cases of exchange rates tied to the US dollar, in discussion of the use of various types of “crawling pegs” and most recently in the growing acceptance of “dollarization”, including by Ecuador in January 2000. The phenomenon of “dollarization” is interesting in that it could be an initial step toward closer monetary union some time in future¹⁹. However, the emergence of highly mobile private sector capital flows may offset some of the tendency toward greater stability.

¹⁹Over twenty four countries have adopted it, a number in South and Central America. The US Congress is considering bills that would lead to the US paying to “dollarized” countries amount equivalent to the “seigniorage” they have lost by not issuing their own currency. Such a move toward a formal arrangement would soon raise the issue as to whether those countries should not have some voice in the US monetary policy making process because under a system of dollarization they are directly affected by it. See *National Post*, 24 January, 2000, as reprinted from *New York Times Service*.

Conditions for establishing a world currency do not yet exist. The differences in economic structures of countries are still very great, domestic economic policies are still far from similar in all countries particularly the poorer countries, political forces of nationalism still are powerful, and the international community is far from understanding the full consequences for exchange rate systems of the free flow of international capital that has emerged in recent years.

In summary, the leading industrialized countries are likely to continue to adopt low inflation and controlled debt and deficits as the primary macroeconomic policy objectives which in turn will contribute to a degree of exchange rate stability. This enhances substantially the chances for stability of the international financial system and so of domestic financial systems.

One threat to this macroeconomic policy outlook arises from the possibility of increased political instability. Such instability could arise from inadequate political management of the social strains inherent in rapid economic structural changes and from the conditions of great social stress in countries that are left behind. Of course it could also come from central bank policy mistakes through forecasting errors or financial market prices moving far away from fundamental economic realities and then collapsing. Whether the headlong move toward a highly integrated international financial system, connected by complex electronic networks, will generate new kinds of instability remains a question as well.

2. Improving the Effectiveness of Multilateral Surveillance — Base Case

The Asian financial crisis sent a wave of fear through the international financial community and especially those responsible for maintaining international financial stability. It appeared as if the international system was crumbling through a “contagion” phenomenon, with defective domestic systems collapsing in front of the overwhelming force of the flight of international capital. The IMF, the premier multilateral

financial institution of the world, was seen by many as having failed to prepare itself for the new world of integrated international finance. It had stayed essentially with its historic concern over balance of payments problems, and concentration on monetary, fiscal and exchange rate policies relevant for those problems. It had ignored the structural deficiencies of its members' financial systems and their governance and the dangers that the explosion of international capital flows was posing for them.

There were also a number of conspicuous individual failures such as Barings that cast doubt on the preparedness of large private financial institutions for facing the forces of globalization. Globalization carried with it new kinds of risks for which neither all individual institutions nor the multilateral agencies were prepared.

These very visible wake up calls to official authorities has recently led to a number of new multilateral initiatives for trying to secure the stability of the international financial system. What stands out clearly in those initiatives is the strong belief that current globalization requires a move to greater centralized influence on and control over the international financial system and not surveillance that is internationally diffused or constructed along regional lines.

This belief and consensus was a long time coming. Only small progress had been made in preceding decades²⁰. The Bank for International Settlements(BIS) was formed in 1930, its national representatives being heads of the central banks of the leading industrial countries — later composed of the Group of Ten(G10). It had certain international banking functions and constituted a forum for the collection, compilation and analysis of data relating to international banking and central banking; and it provided a regular forum for central bankers to

discuss current central banking issues and, significantly, permitted central bank heads to learn to know each other personally and so facilitated easy communication between meetings.

In 1975 the BIS central bank heads established The Basle Committee on Banking Supervision which is composed of the banking regulatory authorities of the G10 countries (with the Office of the Superintendent of Financial Institutions(OSFI) and the Bank of Canada as Canada's representatives). Its purpose was and is to facilitate co-operation and coordination between regulatory authorities but it clearly was not a regulatory authority itself. Furthermore, not until the LDC debt problem of the 1980s revealed glaring weaknesses in the operations and regulation of the banks of the developed countries did the Committee begin to make a direct and visible impact — which took the form in 1988 of the Basle Capital Accord designed to ensure that banks operated with sufficient capital having in mind the nature of their assets and liabilities.

There were several other tentative attempts prior to the Asian financial crisis at fostering cooperation and coordination regarding regulatory issues and of operating principles at the international level. The International Organization of Securities Commissions(IOSCO) with over 130 member agencies was formed in 1974 for the purpose of fostering coordination and cooperation between securities exchange regulators relating to standards of regulation and surveillance, exchange of information, and assistance in effective application of regulations. The International Association of Insurance Supervisors(IAIS) with over 70 member countries was formed in 1994 to seek common principles on insurance regulation including those relating to cross-border business. In 1996 there was also formed the Joint Forum on Financial Conglomerates by the BIS, the IAIS and the IOSCO in order to address particularly problems arising from the emergence of conglomerates including those encompassing banking, securities and insurance activities.

These international regulatory developments taken as a whole were leisurely in character, and

²⁰See Task Force on the Future of the Canadian Financial Services Sector, *Improving the Regulatory Framework*, Background Paper Paper #5, September 1998 for helpful information on international arrangements for coordination and cooperation in regulatory and related matters.

while laying the initial ground work for future development, proved not to be up to the challenges that emerged. The LDC debt crisis was a considerable shock but appears to have been viewed as a one off event, with the Basle Capital Accord considered, until the Asian financial crisis appeared, to be an adequate response. The Asian financial crisis changed all this. It questioned the very soundness of the whole international financial system within the context of the new world of enormous international capital flows and financing activities. The October 1987 crash in world stock markets, the US savings and loan crisis and the collapse of Japanese asset values in the early 1990s provided early evidence that all was not well. So did the failure of Barings and other private corporations. Then the Mexican peso crisis of 1994-5, which required enormous international assistance to be resolved, and the devaluation of the Thai baht in July 1997 with consequent international fallout, pointed to the fragility of a large part of the international financial system. The possibility of the collapse of the international financial structure was sufficient to catch the attention of international political leaders.

The need for more effective international surveillance of the international financial system and individual systems within it was raised at the 1995 Halifax Group of Seven (G7) leaders meeting by the Canadian Prime Minister. The G7 at their June 1997 summit meeting called for improved international coordination and co-operation in regulating and supervising the international financial system. The Canadian Minister of Finance raised the issue at the September 1997 IMF/World Bank meetings and put forward some proposals at the April 1998 IMF Interim Committee meetings and the September 1998 Commonwealth Finance Ministers' meetings. The objective was both to improve the quality of domestic surveillance in member countries and to achieve more effective coordination among the various multilateral financial institutions that in a rather haphazard way had occupied themselves with bits and pieces of the over-all task of international surveillance.

This need for concrete action was finally accepted. The detailed Report of the G7 Finance Ministers to the G7 Heads of State or Government on more effective surveillance was accepted by the latter (actually the G8 meeting) at the Birmingham Summit conference of May 15-17 1998. The Basle Committee on Banking Supervision in cooperation with some non-G10 regulatory authorities had been working on developing a code for effective banking regulation which took the form of the *Core Principles for Effective Banking Supervision*. This was endorsed by the G7 heads of government at their May 1998 summit meeting.

Leadership for these initiatives, as can be seen, came from the leading industrialized countries through their rather exclusive international organizations. But a fundamental fact of the new reality of world market integration and huge capital flows came strongly to the fore: namely, in such an environment, stability depended on the co-operation and responses of a much larger number of countries and also that new rules and arrangements could not be forced upon them by the few. As a consequence of this reality the new principles, codes and rules that began to emerge were voluntary in nature and the arrangements began more and more to include a larger number of countries.

In this respect and most recently there has been formed the Group of 20 Nations (G20) which includes others than the highly industrialized countries. The group includes Argentina, Australia, Brazil, Canada, China, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States and the European Union.

It is composed of finance ministers, whose mandate includes working toward a more stable international financial system. The Minister of Finance of Canada is its first chairman and its first meeting was held in Berlin in December 1999. The fact that it is a G20 and not a G7 reflects the proven reality that international financial stability depends on players well beyond the several large industrialized nations.

This is also indicated by the formation of the Financial Stability Forum(FSF). On February 20, 1999, the G7 Finance Minister accepted a proposal of Mr. Hans Tietmeyer, President of the Deutsche Bundesbank, to establish the FSF. Its essential purpose is to assess issues and vulnerabilities affecting the global financial system and to identify and oversee actions needed to address them. Its objective was to strengthen international co-operation and coordination in financial system stability, supervision, and surveillance. As an example, a subgroup chaired by the Chairman of the Canada Deposit Insurance Corporation is studying the matter of deposit insurance.

Representation is broad including two representatives from the(IAIS), three from each of the G7 countries (finance, central bank, regulatory agency), two from the IMF, the World Bank, the Basel Committee and the(IOSCO), and one each from the BIS, OECD, the Committee on Payment and Settlement Systems (CPSS) and the Committee on the Global Financial System(CGFS). The General Manager of BIS holds the chair. This broad representation again reflects the recognition that the whole of the international financial system has become highly integrated and that its overall stability depends on harmony between and stability in its various sections — central banking, multilateral surveillance and assistance, commercial banking, insurance, securities markets and the input directly and indirectly from a large number of countries.

The G7 has also requested the International Accounting Standards Committee(IASC) to establish a world wide harmonized set of core accounting principles. It has been argued that adherence to such standards should become a requirement for listings on all major stock exchanges of the world²¹

²¹Cf. Ernst Welteke, President, Deutsche Bundesbank, "Do the Markets Need Guidance", Address to the Frankfurt European Banking Congress, Frankfurt am Main, November 11, 1999.

This concern at the highest political level over the stability of the international financial system and the quality of domestic financial systems, has led to a wide range of initiatives within the IMF. It became increasingly evident that multilateral leadership in matters of the international economy was urgently needed and the gradual evolution of events has made it clear that the leading candidate for this will be the IMF in close cooperation with the World Bank.

As if to highlight the change taking place, the name of the IMF Interim Committee has very recently been changed to the IMF International Monetary and Financial Committee. The Managing Director of the IMF made a comprehensive report on recent IMF initiatives to the Interim Committee of the IMF on September 24, 1999.²² It admitted frankly that strengthening of the international financial system was a prerequisite for sustainable and balanced growth in a world of expanding trade and capital flows. These are the highlights of the initiatives taken or contemplated :

(1) Greater transparency in IMF activities beginning with an experiment to publish its Article IV consultation reports on individual member countries as well as other documents. This reflected the growing realization, prompted by the Asian crisis experience, that lack of accurate information, whether relating to IMF operations, or financial and exchange rate activities of national authorities, or activities and financial conditions of private financial institutions, constituted a threat to the future stability of the financial system and institutions within it.

(2) Expansion of IMF surveillance activities to include areas such as member country financial sector reforms, vulnerability assessment, quality of data, debt and reserve management and capital account liberalization. This was in response to the valid criticism of the IMF that emerged during

²²See *Report of the Managing Director to the Interim Committee on Progress in Strengthening the Architecture of the International Financial System*, September 24, 1999 .

the Asian financial crisis that it had ignored the state of domestic financial systems and their governance in its past approach to its surveillance responsibilities.

(3) Preliminary discussion of appropriate exchange rate regimes and the role of capital controls. The damage done during the Asian financial crisis by maintaining unrealistic exchange rates and the view that large volatile private capital flows were undermining domestic financial stability has led to debate on these issues, with no definitive consensus in sight.

(4) There is also preliminary discussion of how to work with the private sector to resolve crises and to prevent them. The Asian crisis demonstrated once again the "moral hazard" problem that emerges when private financial institutions believe they will be substantially shielded from damage during crises and so relax standards of operations. Appropriate sharing of the costs of crises between the public sector and private sector institutions has therefore become an important issue.

(5) Encouragement of the adoption of voluntary standards by governmental authorities. These include the *Special Data Dissemination Standard* relating to international reserves and external debt; *Code of Good Practices on Fiscal Transparency* of the IMF Interim Committee; *Code of Good Practices on Transparency in Monetary and Financial Policies* as approved by the IMF Executive Board; *General Data Dissemination System* intended for countries with lesser developed data systems; *Basle Core Principles for Effective Banking Supervision*. The IMF and World Bank have begun to assess country compliance with the Basel Core Principles. This drive toward better and more transparent information recognizes the need to supply financial markets with much improved factual data so as to put market forces on the side of early adjustment and more stable markets; and it illustrates how national barriers to capital flows are being reduced through a convergence of regulatory and private sector practices.

(6) Experimentation with appraising the extent to which member countries are observing

international standards. Machinery for regularly appraising adherence to standards had not existed. The move toward IMF recognition of its role in maintaining international financial stability is also evident in its financial support arrangements. The Supplementary Reserve Facility is available in times of crisis; and the Contingent Credit Line, established in 1998, is intended to assist countries affected by the kind of "contagion" phenomenon perceived to have been a factor in the Asian financial crisis. They are a direct response to the need to strengthen multilateral machinery for confronting a crisis once it has erupted. Of course the IMF's standard financing facilities, non-conditional and conditional, remain available as well.

This concern of the IMF over the future stability of the international financial system is also reflected in the ongoing deliberations and actions of other multilateral institutions including the World Bank, the Financial Stability Forum, the Organization for Economic Cooperation and Development, the Bank for International Settlement and other groups in Basle. The World Bank is now assuming responsibilities for helping to strengthen member financial systems through the development of better regulation and supervision, better accounting and auditing and legal frameworks, and through assisting in financial system restructuring.

The World Bank and IMF have formed the Financial Sector Liaison Committee. It is designed to achieve closer collaboration between the two institutions on the strengths and weaknesses of member countries' financial systems. This in turn is expected to lead to better dialogue with member countries on reducing vulnerabilities of member financial systems, priorities for their longer term development and to the identification of technical needs assisting members in the restructuring of their financial systems. Of course this process is still in its very early states.

The need to improve the quality of the regulators themselves was illustrated many times over in the decade of the 1990s and it forms part of the programs of many of the international institutions and programs already discussed,

including the World Bank. In addition, in 1997 the World Bank announced the formation of the Toronto International Centre for Leadership in Financial Sector Supervision. It is being supported by the World Bank, Government of Canada, the Canadian Office of the Superintendent of Financial Institutions (OSFI) and York University, Toronto.

In some emerging areas particularly e-money, little real regulatory progress has yet been made. A Group of Ten working party published a report on it in 1997 to identify the policy issues involved, such as consumer protection, law enforcement and supervisory and cross-border issues²³; while the Basle Committee published a related report in 1998²⁴. But no organized actions have yet been taken. The European Union has not yet issued a directive on the subject and the United States appears to await further developments before introducing regulation.²⁵ But it appears likely that a coordinated approach at the multilateral level will eventually emerge to deal with this issue just as it is emerging in the other areas of the financial system.

There is no doubt that the internationally accepted trend is toward increasingly more centralized surveillance, with pressure on the adoption of common regulatory and business practices and much greater transparency in private and public sector activities. While most of these initiative are being taken by multilateral organizations in which the major industrialized countries are heavily represented the trend is toward increasing the circle. This is indicated particularly by the formation of the G20, but most of the other international organizations that have become active in these issues have very large country memberships: IMF, World Bank, IAIS, IOSCO, FSF.

²³Group of Ten, *Electronic Money: Consumer protection, law enforcement, supervisory and cross border issues*, Basle, April 1997.

²⁴Basle Committee on Banking Supervision, *Risk Management for Electronic Banking and Electronic Money Activities*, Basle, March 1998.

²⁵Cf. Ernst Weltke, *ibid.*

But it is important to remember that this massive move toward international integration of the regulatory or governance function is still in its very early stages. As in the past, international integration of financial markets continues to move well ahead of appropriate responses from international governance arrangements — which constitutes a continuing threat to international financial stability. In short, the direction of market and governance changes are well established but their full fruition is a long way off.

3. Improvements in Risk Management and Internal Operations of Financial Institutions

The high profile failures among international financial institutions has highlighted both the magnitude of the risks that have emerged in the increasingly integrated international financial system and the need for individual institutions to identify and measure those risks and to develop internal procedures for keeping them within manageable bounds. The increasing awareness of regulators and of external and internal auditors as to their responsibilities in the matter as well as the awareness of corporate boards of directors of their responsibilities and their exposure to financial and non-financial penalties, have caused many financial institutions to develop effective procedures for managing their exposure. However, there is no way of knowing how many private financial institutions have effective internal procedures for controlling risk; or how effective external auditors will be in appraising them, or even whether the best of them will be up to the kinds of risks that future international market developments may generate.

V SUMMARY OF THE INTERNATIONAL "BASE CASE"

1. The Macroeconomic Policy Environment — Base Case Summary

(1) **Monetary policy:** There is broad international consensus, including Canada, that the most important contribution a central bank can make is to achieve and maintain a low and stable level of inflation.

(2) Fiscal policy: Disillusionment over past discretionary fiscal policies, which resulted in excessive and economically damaging public debt burdens are widespread, and so debt burdens are likely to be much less of a problem than in the past. This also is the case in Canada although the public debt burden is still high and will take some years to decline to that of most industrialized countries.

(3) Tax policy: Integration of the international economy has begun to highlight the impact of tax level and tax structure differences between countries and this has begun to cause some convergence in them. The loss of activity to tax havens is receiving increasing attention by countries losing out to them. The impact of this on Canada is particularly great because of the closeness of the US and the close integration of the two economies.

(4) Exchange rate policy: There is a general consensus that exchange rates must be more stable than they have been but no consensus on how best to achieve this. Therefore, there will continue to be a mixture of fixed and floating arrangements but also a tendency toward more fixed rate arrangements.

2. The Financial System Environment

(1) Impersonal market forces: The reshaping of the international financial environment has been driven not by decisions of domestic and international regulatory authorities but by the impersonal forces of the market place, and this will continue to be the case. Neither domestic nor international regulations have stopped this process.

(2) Need for harmony between market forces and regulatory objectives: Regulatory actions that are not in harmony with market forces have begun to be compromised by international competition and large capital flows and through ingenious methods for circumvent them. It has become evident that effective regulation requires maximum public disclosure of timely information and generally more transparency in monetary,

fiscal, exchange rate and tax policies and in the operations of financial institutions.

(3) Information and communications technologies and competition: Market forces now functioning through rapidly advancing information and communications technologies have resulted in an increase in the penetration of domestic markets by foreign institutions, both resident and non-resident.

(4) Branches and technology: ATMs took a while to be accepted but ended up dominating routine banking transactions. Their place is now being taken by Internet Banking, with telephone banking eclipsed almost as fast as it appeared. As a result a large number of branches are being closed.

(5) Foreign ownership: International portfolio diversification has already lead to an increase in foreign holdings of domestic financial corporations.

(6) Regulatory barriers between the financial sector "pillars": These have essentially disappeared in a number of countries, and even in the US the walls between pillars that had existed for decades are now coming down. The Glass-Steagall Act provisions which, among other restrictions, separated banking and insurance and commercial and investment banking were abolished in 1999. In continental Europe those restrictions, for the most part, had never existed. Substitutability between and similarity of their products and services, as well as the development of new products with a cocktail of features, have undermined the economic logic of continued separation of the "pillars".

(7) Protecting domestic financial services sectors: The single most important challenge facing individual countries is to increase the efficiency of their domestic financial services sector so as to be competitive internationally and in that way enable a fair share of the domestic market to be retained by domestic institutions and to permit some of those institutions to be active in the international financial services market.

(8) Need for a strong regulatory framework is recognized: A major lesson confirmed by the Asian financial crisis is that the solvency of the international financial system and of domestic systems does not come automatically through the free play of market forces but requires effective and efficient regulation and surveillance. The perceived threat of an international financial crisis through "contagion" effects arising from the Asian crisis has led to major international initiatives to develop a much more effective system of international governance and surveillance – including most recently the G20 and the Financial Security Forum, as well an expanded financial services sector role for the IMF and the World Bank. The lead institution is likely to be the IMF working closely with the World Bank.

(9) Broadening of governance representation: While the ideas and initiatives for reform of the international financial system come largely from the major industrialized countries, the tendency now is toward broader country representation. The reality is that in a highly interdependent international financial system the cooperation of a large majority of the countries is needed in order to achieve accepted standards of stability and efficiency

(10) The importance of quality regulators: The Asian crisis revealed the need in many countries for more competent regulators. This need is beginning to be addressed by the multilateral institutions and domestic authorities although this process is still in its very early stages of development.

(11) Regulation in a federal system: Local financial markets in the developed countries have evolved into national market, while national markets are becoming increasingly international in character. This process, driven by emerging information and communications technologies, suggests that a federal approach to financial service regulation has become largely redundant.

VI THE CANADIAN "BASE CASE" ²⁶

²⁶For a fuller treatment of the issues referred to hear see E.P. Neufeld, *What Kind of a Financial*

1. International Pressures on the Canadian Financial System

(1) Foreign ownership of Canadian financial institutions: International portfolio distribution made possible and painless by the integration of the world's financial markets has already led to an increasing proportion of the shares of Canadian private sector financial institutions being in the hands of foreign investors. At present it appears that this trend will continue.

There is nothing much that Canada can do about this, nor is there any economic reason why it would wish to try. However, Canadian policy, if it promoted the competitiveness of the Canadian financial services sector could help ensure that the resulting companies would have the core of their operations in Canada.

(2) Foreign share of financial services activity in Canada: The competitive forces that are driving the development of cross-border information and communications technologies are facilitating access of foreign financial institutions to the Canadian financial system. Just as competitive market forces are now leading to increasing foreign ownership of Canadian financial institutions, so they will lead to increasing presence of foreign financial institutions in the Canadian financial services sector.

Because Canadian institutions resident in Canada and subject to Canadian regulations are perhaps in a better position to reflect unique aspects of the Canadian economy and its priorities, this possibility is of concern. The only protection against substantial off-shore encroachment on the Canadian financial services sector is the relative competitive strength of Canadian financial institutions. Certain aspects of current Canadian policy, particularly merger policy, impede the move toward more efficient financial institutions.

(3) Growing irrelevance of domestic concentration measures: Past measures of domestic concentration are obsolete. This is

System do Canadians Want?, ibid.

because they exclude the pervasive border eliminating power of the Internet and new technology and with it the inevitability of growing international competition. Yet Canadian policies continue to be influenced by such past measures.

(4) Changing nature of "optimum size" of financial institutions: Canadian banks have been declining steadily in their size ranking among international banks. The phenomenon of global mergers and acquisitions suggests strongly that the "optimum" size of international banks has increased substantially. This is not a random development. It is driven by the need to have very large capital bases to support costly world-wide electronic networks, to service a client base that is increasingly global in character and so to capture significant economies of scale. In recent years Canadian banks as a group have already abandoned some areas of international financial services and offices. Current Canadian merger policy is an impediment for Canadian banks to move toward "optimum size" whereas banks in most of the competing countries face no equivalent impediment.

(5) Compensation convergence of mobile senior executives: The market for superior executive officers of internationally oriented corporations is increasingly international in character. Corporations that wish to remain competitive in future will have no choice but to enter that market for superior executives. This is already happening among a number of Canadian corporations with important US and European business relationships.

There is nothing much that can or should be done about this since it is in the interests of Canadian companies to engage the best possible executives. However, it is a question today as to whether those executives and their core office establishments will be located in Canada or outside of Canada. Canadian policy can influence the outcome by its impact on the competitiveness of corporations located in Canada.

(6) Necessary convergence of economic policies: The leeway Canada has for pursuing independent and substantially different economic policies than

its competitors, particularly the US, has been materially reduced by the size and sensitive of international capital flows and the many options for the international location of new real investments and for accessing capital. The ability of policy authorities to pursue monetary, fiscal, tax and regulatory policies that are viewed by international financial markets and investors as inappropriate have been circumscribed by market reactions. Some areas of Canadian policy have already converged substantially to those of the US and other major industrialized countries --- monetary, exchange rate and fiscal; others are still substantially out of line --- personal and corporation taxes, mergers. If Canada diverges substantially from such converging trends it will face heavy economic costs in the form of capital and people outflows, loss of investment and reduced standards of living.

(7) Increased need for multilateral surveillance and support: Multi-lateral governance policies are of great importance to Canada. Being a small country it must look to solid international rules of the game to protect its national interests, whether in trade, defence and security, or financial services. The only effective way of achieving an appropriate regulatory regime for them is through international regulatory co-operation.

Canada has taken a direct interest in these developments including the Prime Minister's call for new global stabilization measures at the July 1995 G7 Summit meetings, the Finance Minister's suggestions at international fora and also his assuming the Chair of the newly formed Group of Twenty Nations at the Group's inaugural meeting on December 15-16, 1999, in Berlin.

2. The Canadian Macroeconomic Policy Environment — Base Case

(1) Monetary Policy and Exchange Rate Policy — Base Case

The stability and efficiency of the financial system depends in part on the stability of the macroeconomics environment — monetary, exchange and fiscal.

The last thirty years have witnessed a substantial change in perceptions concerning the objectives of monetary policy and how such policy is transmitted to the economy²⁷. It is now fully accepted by the Bank of Canada, and it would seem the majority of economists, that the most effective contribution monetary policy can make to economic prosperity is to maintain a very low and stable level of inflation. It is also accepted by the Bank of Canada that transparency in its operations, such as its explicit inflation target of a 1-3% range and its declared operating band for its overnight interest rate and its public explanations of actions taken, will enhance its effectiveness in a world of massive international capital flows²⁸.

The probability that such a policy will be compromised by political exigencies is reduced because of the relative independence of the Bank of Canada as provided for the Bank of Canada Act.

The Bank of Canada is also of the view that its inflation policy requires there to be a flexible exchange rate. External shocks such as a decline in world commodity prices, as well as differing inflation rates as between Canada and its trading partners, change the real equilibrium value of the Canadian dollar. Shocks arising from political uncertainties such as threatened Quebec separation from Canada also have to be absorbed. With a fixed exchange rate the necessary adjustment would have to come through a move downward or upward in the Canadian price level, which is more painful in economic terms and more prolonged than a change in the nominal exchange rate²⁹.

²⁷For an excellent description and discussion of this see Gordon Theissen, Governor of the Bank of Canada, *Then and now: The change in views on the role of monetary policy since the Porter Commission*, The Tony Hampson Memorial Lecture, C.D. Howe Institute, Toronto, Ontario.

²⁸See Freedman, *ibid*.

²⁹See Theissen, *ibid*.

Therefore, since there is still a strong possibility that the real equilibrium value of the Canadian dollar could change significantly it is difficult for Canada to give up its sovereignty in the area of monetary policy to the U.S. authorities at the Federal Reserve in Washington. The situation differs substantially from that in the European Union where sovereignty is shifted to an international institution in which each has a say. There are no such institutions between Canada and the United States and if there were they would be totally dominated by the United States³⁰.

In spite of this logic the issue of appropriate exchange rate policy is a subject of considerable discussion in Canada and elsewhere.³¹ The view that greater, not less, stability in exchange rates is desirable is also evident in a large and growing body of professional research and analysis and in the various exchange rate arrangements already referred to. And changes could occur that would argue strongly for a fixed rate. The relative importance of commodities to Canada could decline and their volatility might be reduced by low inflation and effective inventory controls; national inflation rates might converge permanently; and the threat of Quebec separation might diminish. So while the floating Canadian dollar exchange rate is firmly entrenched now, it cannot be assumed that it will be in future years.

There is some convergence of inflation policies between North American and South American countries which might help pave the way for future regional exchange rate regimes. But it is highly unlikely that the U.S., having the world's most important currency, will soon relinquish part of its sovereignty relating to it. It already has a decisive impact on the Hemisphere

³⁰See the very interesting discussion of these issues in Willem H. Buiter, "The EMU and the NAMU: What is the Case for North American Monetary Union, *Canadian Public Policy*, Vol. XXV, No. 3, 1999.

³¹Cf. *Canadian Exchange Rate Policy*, Round Table Comments by Thomas J. Courchene, John Crow, Richard G. Harris and David Laidler, *Canadian Public Policy*, September, 1999.

and the current trend toward "dollarization" and fixed rates with the US dollar, already give the US Federal Reserve substantial *de facto* power over the monetary policy of the region.

(2) Fiscal Policy and Taxation — Base Case

Canada's past experience, as that of many other countries, points to severe limitations in using fiscal policy for stabilizing the economy. Fiscal stability has been established and there appears to be no inclination in Canada to return to a deficit and debt situation that had to be corrected at considerable economic cost. Fiscal policy stabilization may come essentially from the "automatic stabilizers". The financial services sector is benefiting from this greater fiscal stability.

However particular current aspects of the current tax regime are more troublesome. Globalization has made financial capital highly mobile and has given real investment location many choices, while an increasing number of top level executives and valued professionals have international career options. It has been fully documented that the tax burden on large Canadian financial institutions is higher than that of other sectors, that it has increased significantly over the years and that it is substantially higher than taxes imposed on non-Canadian competitors, particularly those in the United States.³² Capital taxes on large Canadian financial institutions are part of the problem.

In addition it has been found that the rapid changes in corporation taxes in other countries, in part in response to the competitive forces of globalization, have put Canada in a worsening position.³³

³²See Kevin J. Dancey, *Impact of Taxation on the Financial Services Sector*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998.

³³See William B.P. Robson, Jack M. Mintz, Finn Poschmann, *Budgeting for Growth: Promoting Prosperity with Smart Fiscal Policy*, Commentary No.134, C.D. Howe Institute, February 2000, pp.26-27

Therefore the Canadian financial institutions face the competitive disadvantage of both high capital taxes and high corporate income taxes. This tax situation is negative for investment in Canada and for retaining talented Canadians. The US is a strong magnet for both.

The federal Budget of February 28, 2000, began to recognize this reality although in a somewhat modest and hesitant manner. The 5% surtax on high income taxpayers will be abolished, but only over five years, and in the meantime it will cut in at incomes of \$85,000 instead of \$65,000. Capital gains taxes will be reduced from 75% of the income tax rate to 66 2/3%. A limited amount of unrealized income gained when stock options are exercised will not be taxable, but only when the shares are sold, the limit being a market value of \$100,000³⁴. A larger closing of the gap between Canadian and US tax rates will likely be needed if Canada is to avoid the negative effects of substantial tax rate differentials in a globalized world.

A further problem is the Canadian public debt burden. In 1999 the Canadian ratio of public debt to Gross Domestic Product (GDP) was about 61%, or 10 percentage points higher than the average of the G7 countries — only Italy having a heavier burden.³⁵ The Budget of February 28, 2000, did not introduce new initiatives for reducing the size of the public debt. It stayed with the practice of allocating \$3 billion of annual contingency reserves to it, provided the reserves are not needed. It is forecast in the Budget that the ratio will fall to below 50% by the year 2004. However the other G7 countries on average appear to be lower than that already. International financial markets take debt ratios into account when determining credit standing, and so Canada remains more vulnerable to financial difficulties should a serious economic recession emerge than most of the other countries.

³⁴*The Budget Plan 2000*, *ibid.*

³⁵*The Budget Plan 2000*, *ibid.*

3. Restructuring Canada's Financial Services Sector — Base Case

(1) Quality of the Canadian regulatory system — Base Case

It is perhaps significant that apart from its impact on Canadian exports, the Asian financial crisis did not disrupt the Canadian economy very much and did not at all cause chaos in its financial system of a kind that existed in Asia. There are four major reasons for this. First, Canada's macroeconomic policies, both monetary and fiscal, had succeeded in establishing a relatively strong macroeconomic environment.

Second, its exchange rate was floating and so had adjusted to international shocks when they first emerged.

Third, the Canadian financial system had not substantially been shielded from the forces of international competition and so had undergone considerable structural change.

Fourth the financial system regulatory structure and practices of Canada, by international comparison, were of high quality and had already undergone some needed restructuring. This included amalgamation in 1987 of the federal Inspector General of Banks and the Superintendent of Insurance to form the Office of the Superintendent of Financial Institutions(OSFI) and expanding the powers of OSFI and of the Canada Deposit Insurance Corporation(CDIC) in order, among other things, to deal more quickly and effectively with financial institutions in difficulty.

The only regulatory area of concern is the Industry Canada Competition Bureau whose work on the proposed bank mergers suggested inadequate understanding of how globalization is changing the competitive environment and making obsolete past views on concentration.

(2) Federal-provincial regulation and supervision — Base Case

Regulation is of two types, market conduct and prudential. Duplication and overlapping of both types is a characteristic of the Canadian federal system.

Under the Canadian constitution the federal government has jurisdiction over banks and banking (which has never been defined); over the Credit Union Central of Canada; and over federally incorporated trust, loan and insurance companies, but excluding their activities that fall under the provincial "property and civil rights" powers, powers that have come to encompass market conduct and consumer protection. The provinces have exclusive jurisdiction over credit unions and caisses populaires; over trust, loan and insurance companies incorporated by a province and operating exclusively within its borders; and over all securities dealers. They derive their powers from general headings, and not specific financial services provisions, in the constitutions, namely, "The Incorporation of Companies with Provincial Objects", "Property and Civil Rights in the Province", and "Generally all Matters of a merely local or private Nature in the Province".³⁶

While provinces cannot incorporate commercial banks, their financial institutions particularly the trust companies, loan companies, credit unions and caisses populaires have over the years found it possible to offer virtually all the services that are offered by the federal chartered banks. Quebec has taken full advantage of this through the development of le Mouvement Desjardins (caisses populaires), a co-operative movement with a significant share of the retail banking business in Quebec, as well as insurance services, and the Caisse de depot et placement du Quebec which with assets under administration in 1999 of \$105.5 billion is a leading fund manager in Canada and among the largest portfolio managers in North America. Quebec has not delegated regulatory responsibilities relating to its financial institutions to the federal government. As a result there is today in effect a Quebec based financial system and a rest of Canada financial system. Both systems are subject to the strong forces of globalization. A major difference is that

³⁶For a description of the constitutional powers and some aspects of the Canadian regulatory system, as well as some of the issues it faces see Task Force on the Future of the Canadian Financial Services System, *Improving the Regulatory Framework*, Background Paper #5, September 1998.

the caisses populaires have the additional challenge of perpetuating a co-operative structure with objectives that do not focus exclusively on competitive rates of return, or successfully transforming it into a system that can prosper in a world of globalization.

Since many provincial trust and insurance companies operate in more than one province they are subject to a number of regulatory regimes as are federally incorporated financial institutions relating to activities covered by the "property and civil rights" power. Similarly so for investment dealers. As a result, in addition to the federal regulatory agencies (OSFI, CDIC, and in a limited way the Bank of Canada) there are also ten provincial and two territorial regimes regulating financial institutions and activities.

At the federal level the Minister of Finance reports to Parliament on the operations of OSFI, CDIC and the Bank of Canada, while the Department of Finance is responsible for Canada's representation at the multilateral financial institutions (IMF, World Bank, OECD etc.) and the Bank of Canada at the Bank for International Settlements (BIS)

The regulatory system has for some years had to face the challenges of a domestic financial system that has become national in scope with fewer and fewer cases of activities being limited by provincial boundaries, and one where the boundaries between banking, insurance, trust and investment activities have been crumbling. To this, more recently, have been added the global forces that are integrating the Canadian financial system into the international system. The issue that has arisen is not just the waste of regulatory and compliance resources through duplication but also the effectiveness of regulation itself.

The problems posed by continuing to have regional regulators, has for some time been gradually ameliorated by two concurrent developments³⁷. First, the proportion of financial

intermediation activity accounted for by federally incorporated institutions has risen steadily. For example 90% of life insurance written in Canada is written by federally incorporated companies and so, apart from the "property and civil rights" aspects of their operations, are regulated by OSFI. The major trust companies have been acquired by the chartered banks while credit unions and caisses populaires account for a small proportion of Canadian financial intermediary assets.

Second, *ad hoc* arrangements have emerged that, except for Quebec, have seen a movement toward centralization of regulation of provincial institutions. Over the years a number of the provinces have delegated to the federal government the regulation and supervision of provincial trust and loan companies. Others have taken steps to align their legislation with federal legislation relating to trust, loan and insurance companies and in the Maritime provinces there has been a move toward common legislation³⁸. Ontario has abandoned its "equals" approach to the regulation of its financial institutions which has brought it more in line with other provinces.³⁹

Each province has its own securities regulator but here too centralization has been evident. They have formed an organization, the Canadian Securities Administration, to coordinate and harmonize their regulations and regulatory activities. This arrangement is a substitute for an national securities regulator that has been strongly opposed by some of the provinces, particularly Quebec. Also, in April 1987, the federal, Ontario and Quebec government reached

prepared for presentation to the Conference on Federalism in the New Millennium, University of Toronto, 4-6 May, 2000.

³⁸See Task Force on the Future of the Canadian Financial System, *Improving the Regulatory Framework*, Background Paper # 5, September 1998, p.42.

³⁹See Task Force on the Future of the Canadian Financial Services System, *Improving the Regulatory Framework*, Background Paper #5, September 1998, p. 41.

³⁷For a very helpful account of the centralizing trends and related issues in Canadian financial regulation see William D. Coleman, First Draft: *Federalism and Financial Services*, Paper

an agreement over division of responsibilities regarding securities and related activities of federally incorporated institutions, which left the regulation and supervision of such in house activities with the federal agency. In addition new federal legislation saw all the major investment dealers being acquired by the federally chartered banks.

Centralization has also been evident in areas of provincial jurisdiction involving self-regulating sectors, particularly the stock exchanges and the mutual funds industry. On March 15, 1999 the Alberta, Montreal, Toronto and Vancouver Stock Exchanges came to a major restructuring agreement. It has led to the Alberta and Vancouver exchanges merging to specialize in junior stocks, the Montreal Exchange to specialize in derivatives (and certain smaller Quebec based companies –but settled on the Vancouver based system) and the Toronto Exchange dealing with senior stocks. The purpose of this was to reduce costs and increase efficiency through reduced duplication and to gain the benefits of specialization.

Not only was a move of this general kind probably inevitable eventually because of the complete integration of regional financial activities within Canada, but it was also necessary because of the increased competition emerging from stock exchanges outside of Canada particularly the United States. Indeed, some smaller country stock exchanges are already joining or considering joining together with those of other countries as in the case of the Baltic States, Sweden and Denmark and Norway⁴⁰ All the European countries have centralized operations in one exchange each and the London Stock Exchange and Deutsche Borse are actively working toward a merger⁴¹. The NASDAQ, second largest U.S. stock exchange, merged with AMEX in 1998, it formed NASDAQ Japan in 1999 and it came to an agreement with the London Stock Exchange and the Deutsche Borse

regarding trading in new economy company shares in May, 2000

Current developments suggest that evolution of the Canadian system of stock exchanges is far from over because of international competition and the unfolding impact of technology. NASDAQ signed a memorandum of understanding with the Quebec government in April 2000 for forming NASDAQ Canada and there have been discussions between the Toronto Stock Exchange (TSE) and NASDAQ. At the TSE an increasing proportion of volume is accounted for by trades done outside the exchange and merely recorded there. Increased inter-listing with the New York and other exchanges could lead to less trading in Canada. Recently when the TSE trading system in Nortel shares broke down, trading shifted effortlessly and instantly to New York. Alternative trading systems such as round the clock electronic trading are virtually at the doorstep of the organized stock exchanges.⁴² The TSE and other international exchanges are now considering forming an alliance to facilitate such international round-the-clock trading.

A self-regulating area where the tendency is toward *de facto* centralized regulation in spite of provincial powers in the area, is the mutual funds industry. On July 1, 2000, the Mutual Fund Dealers Association will be responsible for regulating that industry in Canada. This still requires enabling legislation of the securities commissions of Ontario, Alberta and British Columbia. Quebec, as expected, will continue to regulate its own mutual fund industry⁴³

Another self-regulating body, the Canadian Investment Dealers' Association has been national in scope for many years.

⁴⁰See *National Post*, November 26, 1999, p.C9.

⁴¹See *National Post*, May 24, 2000, p.C15.

⁴²For an interest interview on these issues with the President of the Toronto Stock Exchange see *Toronto Life*, March 2000, pp.47-52.

⁴³See *Funds Regulator in Waiting*, *National Post*, February 19, 2000, p.E9.

It can therefore be seen that the integration of Canadian and foreign financial systems and activities have forced substantial centralization of financial services regulation, with Quebec having been the most reluctant to go in that direction but not having escaped it entirely either.

The concept of competitive regulatory systems and the benefits it might bring had emerged over the years, it being thought that the existence of individual provincial regimes might lead to the development and speedy adoption of the best practices among them. However this concept was increasingly compromised with the integration of regional financial markets into one national system. Capital flows began to respond to regulatory incongruities in the system, hence the need to move toward harmonization of regulations between the provinces as well as some delegation of their powers to federal agencies.

A current challenge for Canada is to centralize the remaining part of its financial regulatory activities in order to reduce costs of administration and of compliance, and to facilitate the international evolution of its system. These costs were estimated at \$330 million in 1994, with relatively the heaviest burdens falling on the smaller institutions.⁴⁴ This is not likely to come quickly. Some provinces have even wanted to extend their regulatory reach to include the in-house securities activities of federally incorporated financial institutions, a move that would be in disharmony with the reality of an integrated Canadian financial system and flawed because of the substantial blurring of distinctions between loans and securities. Such blurring began with the emergence of commercial paper and bankers' acceptances and has become imbedded in banking organizations through combining corporate lending and corporate investment banking into one unit.

⁴⁴See Task Force on the Future of the Canadian Financial Services System, *Improving the Regulatory Framework*, Background Paper #5, September 1998, p. 40 note 52.

The greatest challenge for developing a unified system of financial services regulation within the Canadian federation relates to the fact that Quebec has developed its own comprehensive regulatory system and has promoted a core of provincial financial institutions⁴⁵. Economics alone has not driven this process. It is also being driven by strategic political considerations, including, under the current Quebec government, its policy of Quebec separation from Canada.

(3) Merger Policy and Evolution of the Canadian banking system — Base Case

The single most important current policy obstacle to enabling large Canadian financial institutions, particularly the chartered banks, from meeting successfully competition in the global economy is that relating to mergers. Current policy makes mergers exceedingly difficult, if not impossible in practice. In order to meet international competition the chartered banks will have to both greatly increase their individual capital bases and substantially reduce their non-interest costs. This can be achieved in a timely fashion only through mergers. Non-interest costs are now probably from 10%-30% higher than they would be if merger synergies could be captured; and inadequate capital bases excludes the banks from an increasing range of international businesses. International competitors face no such handicaps.

Some historical perspective on the importance of mergers is useful. Canadian chartered banks first became established in the larger urban areas — Halifax, Montreal, Toronto — with local private and some small chartered banks operating in smaller centres⁴⁶. With better transportation and telegraphic communications, emerging branch banking became possible, first in the hinterland of their own province and then in other provinces, and the banks with the required capital bases were in the forefront of that development. The economic superiority of the

⁴⁵See William D. Coleman, *ibid.*

⁴⁶See E.P. Neufeld, *The Financial System of Canada*, Macmillan of Canada, 1972.

branch system saw the displacement of the local banks. For example in the 1870s there were over 50 chartered banks and well over 100 local private bankers while by the 1930s there were 10 chartered banks and the private bankers had essentially disappeared. So mergers played a vital role in Canada developing one of the safest and efficient banking systems in the world.

In terms of domestic geographic coverage the banking system had become mature and after that its new frontier became the provision of an increasing range of services —e.g. consumer and mortgage credit and later trust and investment business. This was again made possible by having an adequate capital base. Extending this to include car leasing and distribution of insurance through bank branches is presently prohibited.

The only remaining frontier for the Canadian banks is the international frontier. But their challenges here are much more difficult than those they faced in the preceding century and a half. This frontier is one that is already fully occupied by strong competitors. Furthermore, the existing home base of the banks is increasingly being challenged by those same competitors so their ability to leverage international developments off of home base is not increasing and in time will decrease. Also, this is happening at a time when, as noted already, the “optimum size” of international banks is increasing and appears to exceed substantially the existing size of the capital bases of Canadian banks. To resolve this problem would require mergers between Canadian banks.

But the mergers between the Royal Bank of Canada and the Bank of Montreal, as well as between the Toronto Dominion Bank and the Canadian Imperial Bank of Commerce, all financially healthy institutions, were rejected by the Minister of Finance --- a rejection supported by the Competition Bureau.

The latter, in coming to its conclusions, took a two year time perspective in appraising the impact of the mergers. Such a short term time horizon is meaningless in a world in which international markets are changing continuously, generating new competitors and rapidly making

obsolete former measures of “optimum size” and “market concentration”. The Competition Bureau also ignores efficiency benefits achieved through merger synergies when appraising the desirability of a merger.

In the June 25, 1999, policy paper of the Department of Finance, the Minister of Finance outlines proposed policies and procedures for dealing with future bank merger proposals.⁴⁷ While not banning mergers, the policy outlines a long drawn out procedure for dealing with them that is fraught with political hurdles and uncertainties every step of the way. It would appear to make mergers exceedingly difficult, if not impossible in practice. There is a strong indication that the government would not permit mergers between the largest five banks or the largest life insurance companies.

⁴⁷ Canada, Department of Finance, *Reforming Canada's Financial Services Sector*, June 25, 1999, pp.22-26. The banks will prepare a Public Interest Impact Assessment (PIIA) and at present there are no detailed objective government criteria relating to what constitutes an acceptable merger. The House of Commons Standing Committee on Finance, which in the recent past has emerged as politically highly partisan in matters relating to the banks, will examine the PIIA, hold public hearings and make a report. The Competition Bureau will conduct a review, but with its two year time perspective for appraising consequences, this review will not catch how globalization is going to change Canada's financial system in coming years. Nor will the Bureau have the right on its own initiative to suggest and negotiate specific remedies to any deficiencies it finds in bank merger proposals, the authority to permit this being retained by the Minister of Finance. The Office of the Superintendent of Financial Institutions will review the proposals for safety and soundness and this is completely appropriate. All this information will go to the Minister of Finance and he will make a final decision --- which by its very nature cannot help but take short term political considerations into account, particularly since specific predetermined criteria for acceptable mergers are not available. The Minister can deny outright the merger proposals or impose conditions on it, conditions that too could have short term political considerations in mind. No tight time schedule is envisaged for this process.

So under current circumstances the Canadian banks are handicapped in mastering the only frontier remaining to them, the international frontier, and in meeting increasing international competition in their domestic market. For this to change, policy would have to move away from taking a strongly negative view of mergers between large banks and large insurance companies to facilitating them, with of course effective arrangements for dealing with transitional problems. Currently such a change in policy cannot be counted upon.

(4) Sequencing of Policy Changes: Current Canadian financial services policy seems to ignore the crucial impact that sequencing of policy changes can have on the final outcome of the restructuring of the Canadian financial services sector. The sequencing presently proposed it appears would have the effect of accelerating the foreign takeover of the Canadian financial services sector in future years. This is because in practice it prevents a speedy increase in the capital bases of individual Canadian banks through mergers between them, while going ahead with changes that will enhance foreign penetration of the Canadian financial services sector.

More specifically, the federal government policy intends to increase the individual bank shareholding limit to 20% from 10%, with ministerial approval, and to make it easier for foreign banks to operate directly through branches in Canada. Taken by themselves these changes are appropriate. However, what would happen if foreign banks saw a 20% interest in a Canadian bank together with an increasingly close alliance arrangement, as a way of preparing the ground for a merger some time in future? Canadian policy seems to have had part of this process in mind because the Minister of Finance has indicated that the move to 20% would facilitate the formation of strategic alliances and joint ventures. By not facilitating mergers between Canadian banks at the same time as opening up the system to greater foreign penetration, existing policy appears indirectly to favour eventual mergers between Canadian and foreign banks.

(5) Remaining "Four Pillar" Barriers: The government proposes to continue to maintain some barriers separating banking, trust and insurance and some restrictions as to which services can be offered "in house" and which cannot. This is in contrast to a number of other industrialized countries that have no such barriers and do not appear to need them. They constitute further barriers to the Canadian financial services industry evolving toward greater efficiency.

The Minister of Finance rejected the recommendation of the *Task Force on the Future of the Canadian Financial Services Sector* that banks be given powers of car leasing and branch insurance distribution and accepted that of House of Commons Standing Committee on Finance, a highly political body, that they not be given those powers.⁴⁸

Distribution of insurance and direct car leasing through bank branches is common practice in a number of countries. But prohibiting car leasing by banks is surprising for another reason. The vehicle leasing industry in Canada is 75% to 85% dominated by non-Canadian institutions.⁴⁹ Permitting the banks into the sector would increase the number of competitors and reduce such domination. Here is a case of *Canadian* regulations preventing *Canadian* companies from competing for business in Canada and in consequence ensuring both the continuation of foreign domination and the exclusion of added domestic competition. Policy here appears to have no economic rationale, with political considerations prevailing.

⁴⁸See *Report of the Task Force on the Future of the Canadian Financial Services Sector: Change, Challenge, Opportunity*, Department of Finance, Ottawa, September, 1998 and *Statement by the Minister of Finance*, June 25, 1999.

⁴⁹See DesRosiers Automotive Consultants Inc., *Background Report on Extending Bank Powers to Include Light Vehicle Leasing*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998, p. 31.

(6) Corporate Structures: Emerging policy would enable the banks to form holding companies so that they can shift certain activities into subsidiary entities that will require less regulation. Also it is intended to broaden the investment powers of the banks so that they, for example, can form wholly-owned subsidiaries and place non-bank activities in them. It is hoped that this will increase their ability to compete with institutions that are less regulated. These are very useful moves depending on the regulations that will surround them. The recent Task Force has rightly recommended that "[There] should be no restrictions on corporate structures available to financial institutions unless required by safety and soundness considerations."⁵⁰ Unfortunately their over-all benefits while very welcome are likely to be limited since they exclude changes enabling the Canadian banks to restructure in a way that strengthens their capital base in a significant way.

(7) The Quality of Regulatory Systems and Regulators: Canada has a structure of regulation and quality of regulators (OSFI, CDIC and Bank of Canada) that are high by international standards and Canada is playing an active role in encourage the development of increasingly effective international governance of the international financial system. Recognizing that Canada's national interest, being a relatively small country, lies in the having well established rules of the game — whether in trade, defence and security, or financial services, it is important for Canada to continue to play such a role.

While some fine tuning of the roles and operations of the federal agencies is desirable, and is envisaged by current government policy, the structure of the regulatory system is sound. This, it must be emphasized, refers to the quality of the regulators and their agencies and not to some of the regulations that they are being asked to administer.

One exception to the high quality of Canada's federal regulatory system is the provincial role in

national financial regulation and the unnecessary duplication it still entails. The national integration of regional financial activities has made much provincial regulation redundant and inefficient. The Task Force has rightly argued that further progress should be made and has identified some areas of potential progress.⁵¹ But remaining duplication is not likely to disappear, largely because of the political factors that are perpetuating a parallel system of regulation between Quebec and the rest of Canada.

(8) Harmonization of Regulations with Market Forces: Canada's approach to regulation has changed substantially over the years, with a move away from detailed prescriptions of eligible and ineligible activities and more emphasis on the "prudent portfolio" approach, meaningful and timely disclosure, and appraisal of internal procedures for measuring and containing risk, as well as minimum capital ratios. These moves are in harmony with the functioning of a free market, which requires good information and clear cut operating parameters to function well and remain stable. As a result market forces support rather than undermine regulatory objectives. An obvious example is market reaction to an institution that reveals the first beginnings of some deterioration in its activities and financial performance; or information from the central bank that convinces the market that a move upward in interest rates is economically appropriate.

(9) Transparency of Regulatory and Market Activities: As already noted the Bank of Canada has accepted the need for transparency in its operations in a world of huge capital flows. The federal budget process is more open than it used to be. Intentions of regulators and the regulations themselves, for the most part, are understood by regulated institutions. Disclosure practices of the major financial institutions reveal much more to the public than in past decades. The recent Task Force also emphasized the importance of disclosure and transparency and made useful recommendations for responding to current

⁵⁰ *Report of the Task Force on the Future of the Canadian Financial Services Sector*, op.cit. p.198.

⁵¹ Task Force on the Future of the Canadian Financial Services Sector, *Improving the Regulatory Framework, Background Paper # 5*, September, 1998.

deficiencies in this area.⁵² Not only does sound disclosure and transparency facilitate the efficient functioning of markets, it also enables consumers to make informed choices.⁵³ There appears to be general recognition, a lesson learned in the Asian financial crisis, that for regulations to be effective and economically efficient they must be in harmony with market dynamics. Disclosure and transparency is particularly important for this.

(10) Payments System: Historically, direct access to the payments system was confined to the important deposit taking institutions. The government intends to relax this and give access to institutions such as life insurance companies, money market mutual funds and securities dealers. This relaxation is fully in harmony with the functioning of a competitive market and will incrementally increase competition. However, because of the importance of confidence for sustaining a payments system, changes should not result in an increase in the risk inherent in the system. This requires that new entrants should have a source of liquidity in case of difficulty and their payments system obligations should not be subordinated to others. A remaining difficulty is that insurance company assets are subordinated to policy holders.

To be non-discriminatory in its impact, opening up of the payments system should be accompanied by the relaxation of other regulatory restrictions separating the "pillars".

(11) Non-market Control Measures: The federal government intends to introduce regulations that among other things, would

⁵² See *Report of the Task Force on the Future of the Canadian Financial Services Sector*, op.cit. pp.209-210 as well as Task Force on the Future of the Canadian Financial Services Sector, *Empowering Consumers Background Paper # 3*, September, 1998, pp.24-36.

⁵³ See Robert R. Kerton(ed.), *Consumers in the Financial Services Sector Volume 1: Principles, Practice and Policy — the Canadian Experience*, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector, September, 1998.

require the Canadian banks to provide a basic account at government stipulated charges and features. These measures would interfere with the efficiency and competitiveness of the system and, not applying to all financial institutions including those coming into Canada through cross border electronic systems, they would distort the structure of the system.

There is no question that all groups in society should have the opportunity of accessing the core financial services that they need just as they should have access to the necessities of life. This objective that is not in dispute, but how best to achieve it is. Requiring the banks to act as vehicles for the achievement of social objectives for some clients, paid for by other clients and bank shareholders, has serious economic and social policy weaknesses. Bureaucratically imposed prices and features that do not reflect costs and credit worthiness would indirectly lead to some clients and shareholders subsidizing others and would favour financial institutions outside of the regulatory net.

(12) Incentives to Small New Institutions: The government intends to ease minimum capital and ownership distribution requirements for new banks so as to enhance competition. Easing of entry conditions in a prudent way is clearly desirable and there will always be a role for smaller institutions in the system.. However, over a hundred years of Canadian banking and financial system experience suggests that it would be naive to believe that this will lead to significantly more competition. That history shows that evolution has always been toward institutions with large networks, replacing those that are less efficient. It is no surprise whatsoever that there have been few new banks formed over the last half century.

Where effective competition is coming from, and will do so increasingly, is large non-Canadian institutions coming into Canadian homes via the Internet and from large non-Canadian institutions in Canada.

Intended government policy with respect to caisses populaires and credit unions in a sense contradicts the view that future competition lies

in new local institutions. While specific proposals have not yet been put forward, the intention appears to be to facilitate such institutions moving in the direction of national systems so as to reduce costs and capture the synergies that such systems provide. The Canadian banks went through this process in the late nineteenth and twentieth century. Clearly it is appropriate to provide regulatory support for the move toward national credit union and caisses systems.

But there would be there would be no economic justification for public subsidization of such developments. There is growing evidence that an important reason for the productivity gap between Canada and the United States is that Canadian small businesses have substantially lower productivity than large ones and substantially lower productivity than small businesses in the United States.⁵⁴ Having in mind the special tax and other beneficial arrangements for small business there is growing concern that subsidies to them result in reduced national productivity --- they give small businesses a tax incentive to stay small. That would not be a desirable objective of Canadian financial services policy.

(13) The Quality of Corporate Governance:

The Asian crisis revealed the damage that can be inflicted on a financial system through weak corporate governance rules and practices. While it is difficult to measure, the impression is left that both Canadian regulators and Canadian financial institutions are not lagging in the implementation of measures designed to maintain high standards of corporate governance and of procedures and practices for controlling risk exposure. The fiduciary role, generally, of corporate directors is clearer now than in past decades and the penalties for not fulfilling fiduciary responsibilities are considerable. Maintaining high standards of corporate governance is an ongoing challenge, with new governance problems emerging frequently, but it does not appear as if this is an

area where the Canadian financial system is vulnerable. Canadian corporations have begun to include in their annual reports information on how they are adhering to Toronto Stock Exchange Corporate Governance Guidelines.

(14) Conclusions regarding the Canadian "Base Case"

It is apparent that Canada already has in place some of the various policy prerequisites for its financial system to compete successfully in the world of globalization that is emerging, including stabilizing macroeconomic policies, superior regulators and active participation in effective international regulation. But other very important ones, such as merger policy, appropriate sequencing of policy changes relating to dealing with foreign competition, regulatory barriers to efficient operations and intended use of non-market measures to direct aspects of market activity pose a threat to the future competitiveness, growth and stability of the Canadian financial services sector. In discussing how Canada might fare under the various scenarios, it is assumed that current policy will proceed as now envisaged, weaknesses and all. Of course it is possible that policy might in fact change in future but there is no assurance of this and no way of knowing what those changes might be. Hence the assumption that the *status quo* will prevail.

VII "SHARED GOVERNANCE" IMPACT ON THE "BASE CASE"

It is to be recalled that the "shared governance" scenario was portrayed as one "...characterized by widely diffused economic and political power exercised within a "balanced" system of global governance. The equality and responsibility of states is recognized. National governments balance sovereignty and independence against the need for growth and international stability. And organizations mushroom at all levels".

The central question addressed here is the following: how would the emergence of the "shared governance" scenario change the "base case" outlook for the international and Canadian financial systems and their governance by the

⁵⁴Cf. Donald J. Daly and Michael Helfinger, *Small Business in Canada-U.S. Manufacturing Productivity and Cost Comparisons*, January 2000, and the references there cited.

year 2015? The approach is to portray the situation in the year 2015 and refer to how the domestic and international systems evolved up to that year. situation.

1. Over-all comparison with the base case — shared governance

If the major forces and trends already in evidence in the base case were to continue until the year 2015, the result would resemble the shared governance scenario — more so than the other three scenarios. The impersonal market forces operating in the base case also operate in the shared governance scenario and both view the financial system as one internationally integrated system that requires centralized governance.

2. Underlying logic of the “shared governance” scenario — mutual interdependence.

The over-riding characteristic of the international financial system in the year 2015 under the shared governance scenario is its complete mutual interdependence and a high degree of power sharing that makes possible the management of that interdependent system. It is accepted unequivocally that governance of an integrated and interdependent financial system requires an integrated system of governance. This differs greatly from the regional dominator scenario where the international financial system is governed by regions separated by regulatory walls. The other two scenarios, the global club scenario and the cyberwave scenario also accept the proposition of unified governance although they differ greatly in the execution of it.

As noted, the powerful effect of impersonal financial market forces, facilitated greatly by continually improving information and communications technologies, is to bind all significant national financial markets together and create a world market in financial services. The factors involved in producing financial services are highly mobile and the services can be transferred at very little cost, so the flow of funds between national markets is unencumbered and enormous amounts of funds flow internationally every day. These impersonal market forces impose a strict discipline on the economic and financial behaviour of nation states while at the

same time there is wide awareness that financial and economic crises in any part of the system would have serious implications for the stability of the whole system.

Consumers of financial services, both individuals and businesses, make little distinction between services provided by local institutions or those provided by non-resident institutions. They are accessed electronically, and most one-on-one meetings are conducted through video facilities. Common regulatory arrangements facilitated this integration because it removed much of the risk associated with dealing with institutions of other countries. Foreign exchange risks in such transactions have been greatly reduced through a relatively stable exchange rate environment created by low and stable inflation, regional currency arrangements and bilateral fixed rate arrangements including “dollarization”

However, a world currency does not yet exist because while there is substantial convergence in macroeconomic policy world-wide, the other factors affecting real exchange rates such as differing industrial structures and the impact of capital flows driven by political and other factors are still too great for many countries and regions to forego completely the exchange rate adjustment mechanism.

International integration of markets has been accompanied, *pari passu*, by the internationalization of most financial institutions and of governance rules and arrangements, which further increase the degree of interdependence of the system. So has the emergence of an international market in senior executives and valued professionals and the international ownership, through international portfolio diversification, of most large corporations including financial institutions. Past barriers distinguishing domestic from foreign institutions have largely vanished.

A major issue over the years had been where large international corporations would locate their core head offices including support staff and research departments. Individual countries had paid increasing attention to this in forming and implementing business environment policies e.g.

taxation, technological infrastructure, skilled labour supply, social amenities, peace and order. Some countries had been much more successful than others in obtaining their share of such international business because of their accommodating policies. Other countries that had failed to see or were late in seeing the implications for their domestic financial systems of the revolution in the international financial environment, had become essentially takers of financial services, not providers of them. Their financial services sectors therefore declined in importance as employers, with jobs arising from the demand for financial services being created outside of the country.

3. Distribution of power — shared governance

A major lesson learned from past financial crises was that the free play of impersonal market forces does not in itself ensure a stable financial system. On the contrary it proved beyond much doubt that unfettered financial markets were unstable in some respects and, from time to time, risked creating major financial crises and so poor economic performance. This proposition was accepted unanimously by the highest international political and non-political authorities e.g the G7, G10, G20, IMF, World Bank, BIS, OECD and others, after the unnerving lessons of the Asian financial crisis.

But who should exercise governance of the financial system? Sheer necessity, imposed by the high degree of international market integration, gave the richest industrialized countries no choice but to share power in governance with many countries of the world. This evolved gradually over time with full fruition by 2015.

At the start the ideas, codes, principles and operational guidelines for financial system surveillance and control, and for the operation of private financial institutions, came from a small group of the richest industrialized countries -- within the G7, the G10, the BIS and close informal communications between the major industrialized powers.

But even from the start this group could not impose its recommendations on the rest of the world. (This contrasted very sharply with some

other areas of international relations, such as defence and security, where the dominant powers of the US and Europe continued to hold sway — although even here the limitations of the big powers to deal even with small insurgence was far from absolute.) Yet to protect their own national interests, in an interdependent system, they had to do something and so pushed forward with voluntary, rather than mandatory, approaches for implementation --- the only practical option available to them — a process that took much time and patience.

However, this alone proved not to be sufficient for effective governance and so the industrialized countries began to directly include more and more countries in their ongoing discussions; and they emphasized increasingly the role of the multilateral institutions, which have a very broad membership, for exercising surveillance and control and for ongoing development of the governance system. The formation of the Group of Twenty and of the Financial Stability Forum, as well as the G10 Basle Group practice on occasion of including non-G10 countries in their discussion of particular financial system issues, were early indications of this trend.

The WTO, however, proved to be largely irrelevant for the development of the international financial system. Barriers to trade in financial services usually take the form of domestic operating rules and regulations supposedly aimed at maintaining solvency and stability, but also frequently having the effect of shielding domestic institutions from foreign competition. But because these governance arrangements came to be designed and implemented through the multilateral institutions referred to above and not the WTO, the latter became largely redundant in the area of financial services. In any case the WTO had proved to be much too cumbersome to deal with swiftly moving market developments. Its role in trade of financial services was reduced to codifying market behaviour long after such behaviour, shaped by other negotiations and arrangements, had become common practice.

As for protectionist measures — a major preoccupation of the WTO and its predecessor the

GATT — these were removed from financial systems by national authorities in response to market realities. Practical experience had shown over the years that protectionist measures compromised rather than served national interests. They had led to weak institutions that foundered during adverse conditions and were reduced or discarded as part of the recovery programme following the crisis. In addition, users of financial services found it easy to source many financial services from abroad whenever domestic institutions were not competitive in their pricing and range of products. Nations accepted the reality that in an integrated world financial system the only effective protection was internationally competitive domestic financial institutions. In addition many countries had moved swiftly to reduce protectionist measures in order to have access to the services and funds of the major multilateral institutions and of international financial markets.

As a result by 2015 international regulatory power was widely distributed. No one country or small group of countries, however large, could force its will on that system. Multilateral institutions, particularly the IMF and World Bank, led the process. It had been found that only in this way could national interests be protected in a world of strong impersonal market forces.

4. International institutions — shared governance

While normal rivalries between the multilateral institutions in the interests of protecting their turf was part of the evolutionary process in the system of international governance, this had worked itself out completely by 2015. The lead role in the promotion of international rules and codes of behaviour, in surveillance of adherence to them, and in providing emergency assistance in time of difficulty was occupied by the IMF. Since assistance included assistance in restructuring financial systems the World Bank also played an important role, with close coordination of its activities with those of the IMF through their Financial Sector Liaison Committee. The previous conventions of having the Managing Director of the IMF come from one of the continental European industrialized countries and the President of the World Bank

being an American had been relaxed in response to the growing importance of countries of the rest of the world

There were also a number of more specialized multilateral institutions that focussed on particular areas and aspects of the international financial system and were active in drafting rules and regulations relating to them. For central bankers there was the BIS; for commercial banking, including the enormously important e-money market, there was the Basle Committee expanded to include all the key banking countries; for stock exchanges and stock trading arrangements generally there was the IOSCO; for insurance there was the IASA. Because of the great interdependence between the various types of institutions and regulators, the Financial Stability Forum with its broad representation had become a key annual meeting place to appraise the over-all health and stability of the international financial system.

5. Multinational and local corporations — shared governance

The world-wide integration of national financial markets together with the disappearance of regulatory barriers separating them laid the foundation for the emergence of large multinational financial corporations or groups.

At the same time there emerged a strong sub-sector of smaller financial institutions, some who provided highly specialized personalized services and other who managed to survive by confining themselves entirely to their local market. The technology they needed to carry on their businesses they were able to "out source".

The ability of the large multinational financial corporations to serve businesses and individuals in many markets with products sourced virtually anywhere on earth was the foundation of their economic existence, as was their ability to construct a capital base of sufficient size to finance and operate such a far flung system.

Their existence had been a powerful incentive for international regulatory arrangements to emerge and for close cooperation in day-to-day

regulation among national regulators through the medium of international regulatory bodies. The risk that the regulated, being very large, would come to dominate the regulators was always a possibility. However, the high degree of transparency in the regulatory process worked against this as did the presence of a large number of countries in the key multilateral institutions — the combined power of which greatly exceeded that of even global private sector financial institutions.

At the same time there was increasing regulatory concern over the choice of directors for the large multinational corporations — with increasing dissatisfaction over excessive representation from any one country and over the process by which directors were chosen. Multinational corporations responded to this by establishing country committees and by diversifying their boards across countries. International guidelines clearly spelled out the fiduciary responsibilities of the directors of such corporations and also clear guidelines relating to their compensation arrangements and those of top executives. The risk of ever-widening gap between rich and less rich had led this to become an important issue.

In spite of the existence of up to two hundred very large multinational financial institutions or groups there emerged a significant role in domestic markets for smaller local institutions. This was because of their flexibility in serving clients, their closeness to local needs and local market characteristics, their ability to continue to provide many person-to-person services and their access to state-of-the-art technologies that had been successfully adapted to serve smaller institutions. They proved to be particularly superior in resolving specific transaction problems and shaping transactions to serve special needs. They benefited greatly from the rule that “price is not everything” in the provision of personal services. Their significant presence was also assured by their enjoying strong support from local and national governments — attracting their sympathy in competing with the multinational giants and benefiting from accommodating regulations.

6. Economic growth and structure — shared governance

The nature of the macroeconomic environment proved to be of major importance in the development of a global highly integrated financial system. There was virtually complete convergence of monetary policy, with all central banks and their related international institutions agreeing that protection of the purchasing power of the currency had to be the primary objective of central banks. The earlier developing country debt crisis and the disappointing experience of developed countries with discretionary fiscal policy that had ended in harmful debt burdens, had removed much of the risk that fiscal policy would again undermine economic stability.

Finally, throughout the international economy there were arrangements directed toward achieving a high degree of exchange rate stability. In North and South America and some Asian countries currencies were directly or indirectly tied to the US dollar. There had been considerable discussion of developing regional currencies such as the EURO. Smaller countries discovered, as France for example had done prior to the introduction of the EURO, that their influence might be greater in such arrangements than it was in simply tying their exchange rate to that of a major economic power. Over-all there had been great progress in moving toward an international exchange rate system that in its stability of exchange rates resembled the gold standard of the later part of the 19th century, but without its rigidity and super-power management.

The result of all this was a macroeconomic environment of low inflation, adequate public sector balance, and relative exchange rate stability — all conducive to stable economic growth and development.

But emergence of one world currency was still a long way off. The political obstacles to achieving international agreement on going in that direction were still great. In addition the relative advantages of achieving a world currency had declined, not increased. World wide access to home country bank accounts, electronic settlement of accounts between corporations, total acceptance of credit and debit cards, relative

stability of exchange rates because of stable macroeconomic policies, and *ad hoc* local arrangements such as "dollarization" — these had the effect of reducing the costs and inconvenience of maintaining individual currencies and so reduced the need to engage the political battles that moving to a world currency would inevitably entail.

The environment was one that favoured efficient allocation of national and international resources, including the free flow of new technology. This further facilitated strong economic growth through increases in productivity. The integration of national financial markets enabled capital to flow swiftly to new attractive opportunities while the absence of inflation permitted capital allocation to be determined by real economic factors, not ones driven by inflation-protection motivations.

Not all countries shared evenly in this environment of healthy economic expansion. Countries with a local environment inhospitable to business development — for political, religious, or other reasons — not only missed out but in a sense were punished by the international environment. Mobility of capital and of entrepreneurs and valued professionals caused such countries to lose the benefit of their own savings and their own talented people, thereby making economic progress extremely difficult.

At the same time mobility of capital and of entrepreneurial talent provided great benefits, in terms of facilitating accelerated economic growth, to countries that succeeded in establishing an environment hospitable to investment. Capital from developed countries, accompanied by the latest technology and entrepreneurial skills, was readily available to countries with such an environment, driven by the quest for high rates of return on investments. There were a large number of countries in Asia and in South America that fell into this category and they saw their growth rate exceed that of the developed countries of North America and Europe. This was an important reason for the maintenance of the international cohesion needed to maintain an effective system of international governance of the financial system. That is, the

majority view around the world was that material progress was being made even though, as noted below, not all countries shared in this progress.

7. Form of Integration — shared governance

Integration of the international financial system was driven by impersonal forces in free markets and so was heavily based on price incentives. It took the form of enormous flows of international capital, the operation of perhaps two hundred multinational financial corporations or groups with very large capital bases, the ownership of those corporations in the hands of shareholders of a number of countries and run by executives from various countries, and multilateral surveillance and regulatory authorities that worked toward maintaining a stable and cohesive system. In order to achieve the latter, the regulatory authorities had learned that they had to impose regulations that were in harmony with the functioning of free markets and not ones that attempted to hold back fundamental forces. This meant emphasis on transparency, very complete disclosure, adherence to reliable internal risk management policies and procedures, and timely reporting on the part of private financial institutions, regulatory institutions and national governments.

8. Social Framework — shared governance

Social stability was strengthened by the general increase in living standards in a number of the developed and the newly developing countries. However, very severe social problems driven by poverty existed in countries unable for political, religious or cultural reasons to establish a growth environment.

The international financial institutions placed a substantial premium on internationally mobile executives, entrepreneurs and valued professional, and these groups saw their incomes rising faster than that of the population in general, thereby creating a growing income gap problem. Equalization through the tax structure could go only so far because of the threatened loss of these individuals to other countries if taxes were seen to be excessively burdensome.

The swift transformation of all sectors through the impact of emerging technologies had

displaced very large numbers of workers, and resulted in substantial social turmoil in industrial areas depending heavily on obsolete industries. For some years this proved a challenge to policy makers in terms of providing assistance of a kind that placed emphasis on retraining and mobility. Such industry restructuring also, from time to time, prompted the emergence of strong protectionist sentiments encouraged by special interest groups. However by 2015 the internationalization of so many aspects of the economy and particularly the international financial system had caused the majority of the population to accept the reality of an internationally integrated system. This was helped by social adjustment policies increasingly experienced in retraining workers and placing them in the emerging industries.

Not all countries benefited from the world of readily available international capital, technology and business expertise. The social problems in the few countries that were unable to adjust to this world, for political or religious or other reasons, were exceedingly severe. Not only were they unable to lay the basis for sustained economic growth but tended to experience a loss of highly mobile domestic capital and talent. Resulting poverty was only slightly ameliorated by gifts of sustenance from the rest of the world. But being very poor and so without much international political power, they did not threaten the stability of the rest of the world. However, when they called for external assistance they did have available to them the resources of very strong multilateral organizations in developing the prerequisites for establishing growing economies. The struggle within in them between orthodox and modernist forces was bitter and had not been resolved by 2015. This left their economies, including their domestic financial systems, far behind those of the rest of the world.

9. Role of national and provincial governments — shared governance

The basic role of national governments in governing financial systems changed markedly in the years running up to 2015. *De facto* sovereignty in this area had shifted very heavily from national governments to multilateral groups

that directly and indirectly included a large number of countries. At first this was done through the development by multilateral institutions of detailed principles, codes, and suggested rules and regulations, with voluntary acceptance of them by individual countries but on the strong recommendation of the multilateral institutions. This was followed by the development of comprehensive multilateral surveillance focussing on adherence evaluations. By 2015 the multitude of guidelines had become firm rules and adherence to them had become mandatory for any country that wished to have access to the highly efficient international financial system. For example, any corporation wishing to be included in any major stock trading arrangement had to adhere in matters of accounting conventions and disclosure practices to internationally agreed upon regulations.

However, the day-to-day governance activities of domestic financial systems had not drifted into the hands of the multilateral institutions. This remained in the hands of the domestic regulatory agencies. But since they were essentially administering internationally agreed rules and regulations, they were in the nature of branch offices of international regulatory agencies. This arrangement left room for accommodating national financial system idiosyncrasies and for being close to the regulated institutions. It also provided countries with the expertise needed in having effective representation at the meetings of the key multilateral groupings and in the permanent staff of those institutions.

Because of the high degree of integration of regional markets and the internationalization of national markets, the drift of governance activity from regions, in Canada from the provinces, excluding in part Quebec, to national authorities was largely complete. Provinces that wished to retain regulatory powers soon found that if their regulations were viewed negatively by market participants they would simply operate elsewhere. The pressure to have harmonized regulations therefore was great. Having had to accept this reality provinces gradually delegated virtually all their financial services powers to the federal government. But they insisted on co-operative

mechanisms that gave them an input into financial system governance, including joint federal-provincial boards for some of the regulatory agencies.

The process took much longer and was much more difficult in the case of Quebec. In this shared governance scenario, in which system stability was seen as depending on the cooperation of many nations, there was broad sympathy for listening to the voices of minority groups such as that of Quebec. Also since the multilateral institutions did not directly administer regulations in the member countries it had been possible for Quebec to retain its administrative structures.

While the threat of separation gradually diminished, the forces of Quebec nationalism had not disappeared. The protection afforded Quebec institutions by language and culture, as well as by provincial regulations, had for some time obscured their need to adjust to international competitive forces. In addition the evolution of the caisses populaires into a highly efficient and integrated province-wide system had been retarded by internal divisions, with one group wishing to retain original co-operative principles and values and another group holding that unless they adjusted global competitors would in time erode their market share. Their inability to compete with more efficient providers of services, including cross-border internet services, had gradually taken its toll as younger and electronically literate customers were increasingly indifferent to the original ideals and philosophies of the co-operative movement. The Quebec regulatory authorities, just as those in the rest of Canada, realized gradually that their policies and regulations could not indefinitely be in disharmony with international codes and practices and this inevitably eroded their protectionist policies. These developments worked to reduce the dominance of Quebec based financial institutions in Quebec and so increased the competitiveness of outside providers.

Since Quebec nationalists had traditionally viewed free trade as being in harmony with their national aspiration, they were inclined to ignore the growing influence of the cross-border activities of non-Canadian financial institutions in

the province. An early, although minor, indication of this was the decision of the Quebec government to permit NASDAQ Canada to establish in Quebec without consulting the rest of Canada and without regard for its implications for the Canadian market in equities.

By 2015 the position of the uniquely Quebec institutions had been eroded in their own market and in an operational sense had for the most part been integrated into the Canadian and international financial systems. Their substantial loss of identity had resulted in part from policies of provincial protectionism. Also, ideological struggles in the Mouvement Desjardins retarded for many years its acceptance of the need for radical restructuring and while it remained an important player in retail banking its dominance was much reduced. The Caisse de depot et placement du Quebec had faced growing pressure from one direction to focus essentially on economic criteria in its operations and from another direction to support government-directed industrial policy. This delayed its natural evolution, but by 2015 it had succeeded in adopting objective investment criteria which had made it little different from most other large fund managers in North America.

The difficulties experienced by the Quebec financial system in adjusting to the realities of globalization combined with the misguided policies of the federal government caused the Canadian financial system to lose significant ground against foreign competitors.

10. Implications for Canada — shared governance scenario

Implications for Canada of the shared governance scenario are important because that scenario appears to represent the most likely outcome for the international financial system by the year 2015. Furthermore, in formulating policies for the future structure and international competitiveness of the financial system and its governance it is just such a longer term perspective that needs to be taken. Short term considerations such as likely developments over a two year period are largely irrelevant.

(1) International pressures and key policy challenges — shared governance

The international pressures acting on the Canadian financial system increased steadily and were the major determinant of its structure and functioning well before the year 2015. There were a number of reasons for this:

- (a) Canadians made no distinction between financial services available from Canadian institutions, from foreign institutions operating in Canada, and those available from non-resident institutions. While this was less true in Quebec than in the rest of Canada, because of language and culture, easy accessibility of them all through the Internet, assisted by highly convenient and efficient one-on-one video conferencing, had erased the distinction for them.
- (b) All major financial institutions found that a significant proportion of their business had an international dimension to it.
- (c) Canadian institutions found that foreign institutions had become their most important competitors in their home market. Furthermore, non-resident providers had chosen the most profitable areas of operations leaving the rest to domestic institutions that were subject to domestic regulations relating to matters such as mergers and branch closings.
- (d) The larger financial institutions had a substantial majority of their shares owned by non-resident investors because of the impersonal forces of portfolio diversification and strategic investments by foreign financial groups, and this led to strong non-resident representation on their boards.
- (e) Internationalization of the market for senior executives had led to the majority of the senior executives of Canadian financial institutions being non-Canadians.
- (f) The governance rules applying to the financial system were being coded at the international level and Canada's room for deviating from them in a significant way was limited by the severe market repercussions that would follow.

Consequently, Canada had found that there was no regulatory way to shield the Canadian market and its institutions from international intrusions. Also, it had become clear that the principal policy issue had not been the assurance of good financial services for Canadians, since these by 2015 were readily available from non-Canadian institutions. Rather the principal policy issue had been whether Canada wished to have a sizable domestic financial services sector, one that provided career opportunities in Canada and was more likely to reflect uniquely Canadian needs and priorities; and whether Canada regarded it in its interest to have a few financial institutions among the one or two hundred that dominated the international financial system.

In the late 1990s and in early part of the new century, the Government of Canada had taken the decision to base its financial services sector policy on short term domestic concerns, ignoring, whether by design or lack of awareness, how global forces were bearing in on the Canada's financial system. While its policy statements had frequently referred to the phenomenon of globalization and the need for financial services sector efficiency, its actual policy positions had remained stubbornly in disharmony with those comments.

Looking back from the year 2015, it is possible to identify some of the Canadian policy measures that accelerated the demise of the Canadian financial services sector. At the top of the list was the policy that prevented Canadian institutions from building up a capital base more competitive with those that were emerging all around it in other countries through mergers and acquisitions involving large institutions. Whereas other countries had facilitated such restructuring in order to meet international competition, Canada had opposed it. It is true that Canada had introduced a merger policy, but the conditions were such as to neutralize many of the economic benefits of a merger and the political hurdles involved were so daunting that institutions felt it prudent, having in mind the high cost of failure, not to risk it.

A number of other regulatory and tax provisions that compromised the competitiveness

of the Canadian financial system were kept in place until they had caused irreversible damage in terms of the place of the Canadian institutions among international financial institutions. Some barriers between the "four pillars" were perpetuated, contrary to practice in other countries; so were barriers between activities that could be carried on "in house" and those that could not; holding companies in the financial services sector were permitted, but the net benefit of this, in the face of the other restrictions was limited, particularly since competing countries simply left the form of corporate organization to be decided by the market and driven by operating efficiencies.

Canadian policy also accelerated the relative decline of the Canadian financial system by ignoring the importance of how the removal of restrictions was sequenced. The ownership limit of financial institutions was increased from 10% per shareholder to 20%. This facilitated in the first instance strategic alliances with foreign institutions, some of them banks, before the domestic institutions had been permitted to establish a sizable capital base comparable to its foreign competitors through mergers between them. It then later on proved to be an effective base on which to build a successful merger proposal. In this way mergers between Canadian and foreign banks emerged rather than mergers between the Canadian banks themselves.

There was a period when Canadian policy looked to achieving a more efficient system through encouraging the emergence of small institutions. This was strange for two reasons. First, two centuries of experience in Canada had pointed to the futility of this and second, by far the biggest competitive threat to Canadian institutions was coming from even larger non Canadian institutions.

A number of other aspects of Canadian policy compromised, until it was too late, the economic efficiency of the Canadian financial system and worked to reduce its international competitiveness: high capital taxes, proposals for imposing social objectives onto bank operations (eg low cost accounts) and additional federal

government regulatory burdens relating to a new consumer agency and ombudsman.

As time went on the feeling grew among the managers of financial institutions that Canadian financial services policy, when it really came down to taking decisions, was determined essentially by short term political as distinct from longer term economic efficiency considerations. A particularly conspicuous example of this related to car leasing regulations. The car leasing industry in Canada was for years dominated by foreign companies, yet *Canadian* regulations prevented *Canadian* banks from entering the field and increasing competition in it. But decisions relating to the other measures (mergers, social provisions, taxes, powers etc), it was increasingly felt, had also been taken mainly on the basis of political considerations and not the long term competitiveness of the Canadian financial system. Such an unpredictable policy environment caused institutions to consider more closely their non-Canadian options when making strategic business decisions.

Again looking back from the year 2015, Canadian policy for restructuring the financial services sector, rather than strengthening it to meet growing international competition, weakened it and so accelerated the foreign domination of the supply of financial services to Canadians. By the time it was recognized that this was what was happening, it was too late. The damage done to the ability of the Canadian financial system to adjust to globalization was compounded by the equivalent adjustment difficulties of the financial system in Quebec. The swiftness of the changes taking place internationally, driven by technology and world wide competition, together with misguided policies had caused Canada to be left behind.

It is perhaps useful to reflect on how this happened. With no rapid way to increase their capital base the Canadian institutions continued to lose their position among international financial institutions until they were very far down the list. This sidelined them in many international transactions and they were even compelled to withdraw from some international territory they occupied in the past — leaving this

to more competitive institutions of other countries.

Their home base meanwhile was increasingly contested by new foreign competitors and their share of that market declined. This reduced further their ability to lever foreign operations off a strong home base. In facing increased foreign competition some of the large Canadian financial institutions encountered financial difficulties. At that point the Government of Canada readily permitted acquisition of the weak institutions. The institutions best positioned to take them over were foreign ones, who also saw this as an opportunity for establishing themselves even more strongly in Canada. Nor did the Government of Canada have much leeway in preventing this because of the need to minimize deposit insurance losses and to adhere to international codes of behaviour relating to mergers and acquisitions. The result was a further increase in foreign domination of the Canadian financial services industry.

This naturally lead to a general relaxation of rules governing restructuring of the Canadian financial system and of various regulatory measures that reduced the competitiveness of Canadian institutions. But by then competitive institutions from other countries had established such a strong presence internationally and in the Canadian market, that catching up on the part of Canadian institutions became impossible. By 2015 they had become insignificant players internationally and minority players in Canada. Foreign institutions had been and continue to be in the strongest position to offer the best merger proposals. Canadian regulatory authorities found it difficult to refuse them having in mind the need to avoid a financial crisis, to protect the deposit insurance system and to adhere to internationally agreed codes on trade and investment behaviour.

It was clear, looking back, that the most effective kind of merger policy for meeting international competition was one that facilitated mergers between healthy institutions, that is, before resources and client good will had been eroded through market fears of bankruptcy. The opposite to this was what happened. By 2015 this had led to the disappearance of a strong Canada

based financial services sector. Some of its larger financial institutions, facing competitive difficulties, had been absorbed by foreign financial institutions, those that remained had lost market share and none were consequential players among the large international financial institutions. Employment in the financial services sector in Canada had eroded with the loss of market share of the Canadian institutions.

(2) Canada's position in the international power structure — shared governance

The "shared governance" scenario proved to be the one that best protected Canada's national interests with respect both to international governance of the financial system and to providing an international environment in which, with appropriate domestic regulatory policies, Canada's domestic financial services sector can flourish. Being a relatively small country Canada's voice is best heard in an international environment not dominated by a few players, where the financial system adheres to international rules of the game, and where those rules and related surveillance come from multilateral institutions in which Canada, with its recognized expertise, can play a conspicuous part.

Because of the lead taken by the Prime Minister and the Minister of Finance in promoting international action aimed at developing a stable and efficient international financial system, Canada made an excellent start in carving out its position in this process. But in order to be permanently effective this activity needed to include active participation by Canadians in the multilateral institutions. In this Canada did not stand out and so its influence was somewhat diminished.

It was diminished for a further reason. There was a contradiction between the stance Canada took with respect to building an international financial system that could withstand the strains and stresses of international competitive forces and its domestic regulatory policy that weakened the ability of the Canadian system to withstand those same competitive forces. As the relative strength of Canadian financial institutions declined so did the credibility of Canada in discussions concerning the governance of the

international financial system, and its influence declined steadily.

(3) Canada's economic growth and structure — shared governance

Canada's broad macroeconomic policies — monetary, fiscal and exchange rate — were in most respects in harmony with international developments and provided a strong base for the development of the Canadian financial system.

The exceptions to this, having in mind the importance of Canada's close integration with the US, was the level of personal and corporate income taxes and some aspects of its tax structure. The mobility of capital found in the "shared governance" scenario left little room for taxes that caused major diversions of capital. Similarly, a progressive rate of tax that caused an outflow of talented Canadians including corporate executives was not helpful to economic growth. Nor were the capital taxes on financial institutions — a form of tax that, on the face of it, was almost designed to undermine the Canadian financial system.

The impediments to financial sector restructuring already discussed had the effect of reducing the size of the Canadian based financial services sector from it would have been without those impediments, and so reduced Canadian economic growth. What negative effects on Canada's economic development arose from foreign institutions dominating the Canadian market instead of Canadian institutions could not be accurately measured. But there was a widespread feeling that foreign institutions were somewhat more remote from Canada's special needs and priorities. Some felt that Canadian institutions with their long history in meeting Canadian needs had been in a better position than foreign institutions to address those needs and had stayed longer with Canadian clients in times of difficulty. But by 2015 this was in the nature of "crying over spilt milk".

The over-all conclusion that emerged was that Canada would have fared well under the "shared governance" scenario had its domestic policies been in harmony with international developments. Therefore, the relative decline of

the Canadian based financial services sector and its institutions was not essentially the fault of the emerging integrated international financial system, which is beyond Canada's control, but rather the fault of domestic policies that Canada did control. The negative and irreversible impact of those policies was traced as having begun in the later 1990s.

VIII "GLOBAL CLUB" IMPACT ON THE "BASE CASE"

"Global Club" — In this scenario power and wealth are concentrated in a few countries and a few hands and they club together to deal with critical issues affecting them all -- which they do through many rules and close control.

1. Over-all comparison with the other scenarios — global club

The powerful impersonal market forces shaping the structure and functioning of the international and domestic financial systems, facilitated by irreversible advances in information and communications technologies, are similar to those in the base case. Also, as in the base case, shared governance and cyberwave scenarios, it is accepted that governance must be internationally integrated. For these reasons the international financial system remains highly interdependent, a fact that no country however big and powerful, can afford to ignore. What is different is the approach to governing the international system and, because of this, the way the structure and functioning of the system is nudged away from the outcome of the base case, with resulting new tensions.

2. Underlying logic of the global club scenario — global club

How and why did the global scenario emerge? At the beginning of the new century indications were that the major powers would bring an increasing number of nations into the process of governing the international financial system and that this would be strongly promoted by the key role that the multilateral financial institutions would play in such governance. In this way governance stability would be assured and the economic benefits derived from a well-functioning financial system would be shared

very broadly — with many of the newly developing countries growing more quickly than the industrialized countries.

In the event things did not turn out that way. The IMF, World Bank and other multilateral institutions, supported by the political leaders, attempted seriously to implement regulatory changes that reflected lessons learned from the Asian financial crisis. But they failed in this. The enlarged governance groups proved to be a major obstacle to taking timely policy decisions, therefore surveillance procedures relating to member country financial system performance never became effective. Nor did procedures for assisting countries in restructuring their financial systems and their regulatory agencies and procedures. At the same time information and communications technologies advanced steadily, giving the international financial markets increasing global opportunities for operations. The result was disaster — in the form of financial crisis that everyone agreed was more severe than the Asian financial crisis of the late 1990s. The fear of collapse of the international financial through the “contagion” phenomenon, which had first emerged during the Asian crisis, returned with a vengeance.

The super powers saw few options. The shared governance approach to maintaining international financial stability had proved to be a failure in the few years following the Asian crisis and to do nothing risked a major depression in the economies of the super powers. No one was under any illusion that a crisis in one part of the world could be walled off from the rest. Their minds were clearly focussed on the reality that their national interests would be at risk if they did not step in and govern the system. Their opportunities for trade and foreign investment would be compromised if the international system collapsed or even contracted sharply.

So the super powers, meeting in emergency head of state sessions, concluded that only highly centralized control of the international financial system would be adequate to maintain its stability. They could justify their position by drawing on past experiences with crises when strong action of the super powers, as for example

the US in the case of the LDC debt crisis and the Mexican peso crisis, was needed to restore stability. They could also point to the fact that ideas and initiatives for past reforms in the banking system and international financial system generally, had come largely from the super powers, and so encouraged the belief that they had a moral duty to take the initiative. So they took it.

Centralization of power to avoid global financial crises had become the underlying rationale for opting for the global club scenario.

3. Distribution of Power, Governance, and International Institutions — Global Club

The super powers included in the central group were the US, European Union, Japan, China and Russia. Any future admissions to this group, such as India and Brazil, would depend solely on their relative economic power in the international trade and financial system. Canada was neither in the core group nor a prospective member of it in any foreseeable future.

This new G5 quickly became operational and gave instructions to finance and treasury ministers and their deputies to draw up a structure of governance. The latter concluded quickly that it was best to work through the medium of existing multilateral organizations, for three reasons. First, permanent institutions were needed to design and implement rules and exercise surveillance and those institutions already had a core of expertise; second, strong and overt alienation of the rest of the countries of the world could lead to dangerous reactions in this highly interdependent world; third, the US and Europe already held strategic positions in the institutions on which they could build quickly. So the G5 ensured that their nationals occupied the key positions of power in the multilateral institutions and directed their policies. Of particular importance was the *de facto* takeover of the IMF and the World Bank by the super powers and tight control over the BIS. Many of the other multilateral institutions were permitted to wither away because it was much easier to exercise full control over the system through a very few institutions.

The political priorities of the super powers would gradually play an increasing role in shaping their governance decisions and this would give rise to growing tensions between them and excluded nations.

4. Multinational and Local Corporations — Global Club

In formulating their approaches to international governance the super powers were not obliged to turn only to the multilateral institutions for advice, since those institutions enjoyed little independent power, and so they turned to the global financial groups of their own countries for guidance. This gave their multilateral corporations a much more prominent and influential role in shaping the international financial system and determining its rules of the game than they had previously enjoyed.

Since such advice was naturally based heavily on the interests of the stake holders of those corporations, with little need to be excessively sensitive to local political and social complications, it became a further source of increasing tensions between the super powers and some excluded governments. There emerged the fear that a new type of colonialism was emerging, one in which multinational corporations dominated domestic financial markets and the flow of capital internationally, and governance of the system was in the hands of a few super powers operating under rules also shaped by super power multinational corporations.

The greater role played by multinational corporations in the formation of financial services policies of the superpowers and the agencies they dominated, reduced the political power of smaller local financial institutions. Whenever there was an opportunity for them to be absorbed into the larger systems of the multinational corporation this tended to happen. Those that survived did so because of the valued personal services they were able to offer and not because of any official policy of maintaining a second tier system of financial institutions.

5. Economic Growth and Structure — Global Club

The pseudo monopoly power over governance enjoyed by the super powers and their global financial groups caused them to benefit economically through collecting the "economic rent" of their monopoly. They also continued with domestic macroeconomic policies that were as beneficial to economic growth as in the base case scenario. They even began to contemplate having a common currency through joining the dollar with the EURO. So as long as external tensions did not begin to have repercussions on them their national interests were well served.

However, as noted already, such tensions emerged quickly. The excluded powers, pushed by economic and political exigencies, began to consider opting out of international arrangements that in effect had been imposed on them by the super powers. The super powers through the IMF and World Bank tried hard to retain a hold on the international financial system, but this was difficult as countries simply began to ignore their direction. They began to construct substitutes and this began to compromise integrated global surveillance and governance of the international financial system. The whole system became more frail as time went by until it seemed that only a major crisis, of which there was a growing probability, could lead to its reformation.

6. Differences From the Shared Governance Scenario — Global Club

In the shared governance scenario the development of the interdependent and integrated financial system covering almost all countries of the world is matched by a governance structure that is relatively inclusive in terms of country representation; in the global club scenario impersonal market forces still cover virtually all countries but only the super powers have ownership of the governance structure, which inevitably leads to tensions in the international community.

In the shared governance scenario the IMF, World Bank and other multilateral institutions gain great power in governing the international financial system and apply relatively independent professional judgements to governance: in the global club scenario real power rests firmly in the hands of the super power national governments,

with the multilateral institutions being their administrative vehicles for implementing their policies.

In the shared governance scenario economic growth is facilitated by a stable macroeconomic environment, a move to greater exchange rate stability, removal of barriers to the flow of international capital and technology and emphasis on assisting countries with restructuring of their domestic financial systems so as to be internationally competitive; in the global club scenario economic growth is hampered by policy that is biased in favour of the super powers and their financial institutions and in general by the creations of tensions that distort and disrupt the regulatory system and the flow of international investment and technology.

7. Role of National and Provincial Governments — Global Club

The super power governments had virtually total control of the design of international governance of the international financial system; and control administration of the IMF, World Bank, BIS, and other multilateral institutions that they decided should be their vehicles for governing the international financial system. Excluded national governments were helpless bystanders, at least for a while. At first, since the super powers took over in a period of grave financial crisis, their role was reluctantly accepted by the other nations. Also the ability of a small informed group to make quick decisions gave an immediate impression that what was lost in terms of democratic administration of the system was made up for in its greater efficiency.

But this happy state did not last long. National pride grievances from being excluded arose early on. Then as financial stability began to be taken for granted and the fear of financial chaos faded, countries began to focus on how individual governance decisions taken by the super power governments affected them individually. They soon concluded that some of those decisions were against their perceived national interests.

So international tensions emerged because governance was shaped in part by the political

priorities of the super powers and the economic interests of their multilateral corporations; because of the damage to the national pride of excluded countries; because of the lack of sensitivity in the rules and administration of financial system governance to the economic and financial problems of the excluded countries; and because of the growing realization that they in effect were paying for the economic benefits that the super powers were gaining from their monopoly arrangement.

Canada's role in the international regulatory system was very limited because it simply was not part of the core group of super powers and it enjoyed little "leverage" in influencing them. Its earlier policies that had undermined the international size and competitiveness of its financial system as well as its minimal financial commitment to international areas such as defence and securities simply excluded it as a candidate for the core group. It had largely to accept the world as it was and to shape its domestic regulatory system accordingly. It could not assume that if its financial system got into difficulty it would receive external assistance and support. This environment left little room for wasteful and inefficient regulatory structures and regulations that prevented the system from surviving against super power competition.

This sense of national vulnerability to external forces greatly strengthened the hand of the federal government in relation to the provinces. In this it to some extent resembled the atmosphere of the Second World War when external threats too resulted in enormous exercise of constitutional powers by the federal government. Also while Canada's voice in international financial affairs had become inconsequential in this scenario, that of Quebec had vanished completely, and so integration of its financial system with the rest of Canada had become essential for long term survival. The fear that the dominance of the super powers and the influential role of their multinational financial groups would undermine Canada's vital interests was enough to convince Canadians that only through conserving and focussing its strength could it protect what it had achieved in past decades. Provincial regulation in the financial

services sector, for all practical purposes, ceased to exist. It had vanished much more quickly than had been envisaged in a shared governance scenario.

8. Implications for Canada — Global Club

The implications for Canada of lagging in adjusting its domestic regulatory arrangements to be in harmony with world developments are the same as in the shared governance scenario and therefore will not be repeated here. It will be recalled that Canadian domestic policy by 2015 had led to the disappearance of a strong Canada based financial services sector. Some of its larger financial institutions, facing competitive difficulties, had been absorbed by foreign financial institutions, those that remained had become “niche players” in Canada, none were consequential players among the large international financial institutions and all of any size had a majority of non-Canadian shareholders. Employment in the Canadian financial services sector had been eroded because of the reduced international competitiveness of the Canadian financial system.

The most serious implication for Canada of the emergence of the global club scenario arose from its exclusion from the small group of super powers — the group in effective control of the development and governance of the international financial system. Canada would have no voice in discussions relating to the future of the financial system and it would suffer, as would the other excluded countries, from having to operate in a system biased in favour of the economic interests of the super powers and their large financial institutions. Canada’s private financial institutions, struggling to meeting international competition, were particularly affected. This, together with the failure of its domestic restructuring policies to permit rapid adjustment of Canadian financial institutions to meet international competition, precluded the latter from becoming important international financial institutions.

There had been much discussion of what was Canada’s best approach for protecting its national interests in the global club environment. In the end Canada had no choice but to develop

exceedingly close relations with one of the super powers — obviously the US. This was necessary as a strategy to protect the interests of all its sectors, not just financial services. There was no sure protection for Canada from governance of the IMF or rulings of the WTO, since they too were dominated by the super powers. Its bargaining position with the US, of course, was weak, and so this closeness resulted in a further acceleration of Canada-US economic and financial integration. Canada also found that its tight economic and financial integration with the US required it to have a regulatory system virtually identical to that of the US. There was no means to prevent or delay US takeovers of Canadian financial institutions.

The increased uncertainty over the stability of the international financial system as a result of the built-in political tensions of the global club scenario required Canada to have regulations that were very cautious in order to be prepared for the possibility of major international shocks. This shift toward prudence and away from risk taking was negative for long term growth but there was no other choice. Survival of its institutions in the face of such potential shocks and the greater intrusion of US institutions into the Canadian market, also required regulatory authorities to not only remove all obstacles to consolidation, but also to take a leading role in facilitating orderly consolidation through mergers and acquisitions. It was also necessary for Canada to maintain a stable macroeconomic environment because, being excluded from the super power group, it would not be able to count on timely international assistance in time of economic difficulty.

It became clear that the global club scenario did not serve Canada’s national interests well. Indeed, it seemed that its perpetuation would soon or later pose threats to its existence as a relatively independent nation.

IX “REGIONAL DOMINATORS” IMPACT ON THE “BASE CASE”

“Regional Dominators” – In this scenario power is more dispersed but in the form of regional blocs with a super power country in each geo-political bloc. The scenario involves less centralized regulatory control internationally,

with fair regulatory control domestically and on a regional basis.

1. Over-all Comparison with the Other Scenarios — Regional Dominators

The regional dominator scenario is different from the other scenarios and the base case in one fundamentally important way. Whereas the other scenarios accepted the international financial system as one integrated system and so one that required centralized international governance to protect its stability and efficiency, this scenario viewed that system as being divided into regions and one that needed to be governed as such.

This, in turn, affected the dynamics of impersonal market forces and how they influenced the structure and functioning of the international and domestic financial systems. Those forces had to take into account regional boundaries as important parameters of the system. Instead of viewing the world as their natural "habitat", such forces, because of political and economic barriers between blocs, were much more inclined to see the particular region as their area of activity. Because of that they led to quite different international flows of capital and investment, location of centres of operation, appraisals of market risk and centres of political power than in the other scenarios.

2. Underlying Logic of the "Regional Dominators" Scenario — Regional Dominators

It had not been possible in advance to imagine the circumstances that led to the regional dominators scenario. But a sudden and sharp economic depression led to loss of confidence in the ability of the multilateral institutions to maintain an acceptable degree of international financial stability. The depression created serious political discords among the super powers as each struggled to minimize the economic damage that was emerging. In this way economics and politics joined to veer the system away from the base case and toward one of regional blocs.

The feeling emerged that while collective action was needed, this would not be coming forward fast enough from the multilateral institutions to deal with the crisis conditions. The

conclusion emerged that collective action by ones own region would be swifter, and more effective because it would be better designed to meet the particular difficulties of the region. Therefore each of the major regions began to treat the multilateral institutions with benign neglect, while working aggressively to arrive at regional economic and financial accords. Out of such accords emerged regional multilateral institutions, ones that were smaller and so more flexible and closer to its members than the previous multilateral institutions. Once in place this region-based system had consequences for the international and domestic financial systems quite different from those of the other scenarios

3. Distribution of Power, Governance and International Institutions — Regional Dominators

While international political power now resided firmly in the various blocs, within each bloc the distribution of it was uncertain. It could have been distributed within that bloc along the lines of shared governance, but with crisis conditions holding sway it at first was largely centred in the super power member of the bloc.

The previous multilateral institutions had no place in this world of power blocs, not even those, such as the G7 and G10, that had arisen largely to serve the superpowers. However, mindless mercantilism did not hold complete sway over the thinking of the policy makers, and so each bloc found it expedient to develop regional arrangements and institutions. These were soon needed to deal with matters of trade, coordination of monetary and fiscal policies, stability of exchange rates and regulations relating to financial institutions and financial markets. It also gave a powerful incentive to the formation of regional currencies and a regional central bank, although the first step was to tie regional currencies to that of the super power of the bloc.

4. Multinational and Local Corporations — Regional Dominators

Each bloc was very jealous of the survival of its own multinational financial groups. They were given favoured treatment in their own region and there was support from regulatory authorities for

the emergence of institutions at least equal in size to those of competing blocs. Being large and being seen to serve a regional bloc interest they had a major influence on policy relating to the regulation and governance of the financial system. Both because of their special hold on the regional market and the inter-bloc obstacles to moving outside of it, the regional corporations focussed less and less on the rest of the world market. They ceased viewing the whole world as the space in which to fulfill their destiny.

This greatly increased focus on the region rather than on the world gave smaller domestic institutions more leeway than in the case of the global club scenario even though the regional multinationals enjoyed great power and influence. International competitive pressures on them were less, policies directed toward the interests of the regions tended to favour them to a certain degree and they were closer to the centre of political power.

5. Economic Growth and Structure — Regional Dominators

The regional dominator scenario proved to be negative for both the growth and the stability of the international economy including its financial system. While growing free trade within each bloc was beneficial for economic growth, this was more than offset by growing protectionism in trade between blocs. International investments, and so the flow of technology, were severely restricted. This was particularly harmful to blocs that were not leaders in technology and that had previously depended heavily on importing it. The attempt to govern what began as a relatively integrated global trade and financial system with separated regional regulations and regulators proved to be deficient since some inter-bloc activity had survived. Difficult relations between blocs precluded cooperative efforts to deal with such crises. Some blocs were less hurt than others which increased further the tensions between them.

6. Differences from the Other Scenarios — Regional Dominators

The attempt to govern what began as an integrated world-wide financial system through divided regional regulators is unique to this

scenario and its weakest characteristic. This led to a degree of counter productive rivalry that was extremely dangerous to the international financial system—dangerous in terms of the greater risk of financial crises and reduced economic growth.

7. Role of National and Provincial Governments — Regional Dominators

Growing inter-bloc rivalry and competition, and the instinct for bloc survival, meant a tendency for power to shift from the smaller national governments within the region to the regional super power, and to the multilateral organizations formed by the bloc. However, the super power could not risk losing the support of its partner countries. To do so would greatly weaken its bargaining power against the other blocs. The risk that disgruntled countries might even consider changing blocs was enough for the super power to nurture its regional relationships. This led to mutual respect for each others institutions including those of their financial systems.

Canada, in particular, because of its proximity and importance to the US, found it could play a fairly influential role in designing and operating the regional system and its institutions. Since the US government recognized quickly that it was much more important for its national interest to retain strong and friendly relations with Canada in its geo-political bloc than with separatist tendencies in Quebec, its sympathy for the latter was even less than in the shared governance scenario.

While the provinces in general found that the smaller regional environment was sympathetic to the perpetuation of local government roles in financial system arrangements, competition within the region made it difficult to perpetuate costly administrative systems that served little economic purpose. So even in this regional bloc environment the provinces were faced with a gradual erosion of their role in financial services regulation.

The primary economic focus of the countries in the bloc was to achieve orderly regional integration through the removal of trade and financial barriers within the bloc, but to maintain

and increase barriers directed against the other blocs. Since it proved to be enormously difficult to control capital flows between blocs, the attempt to do so led to the existence of complicated and burdensome regulations and a growing bureaucracy to administer them. The efficiency of the international financial system suffered right from the start because of the barriers to financial flows that had been erected and the negative impact this had on international resource allocation.

The system also became more fragile because there was no international organization to monitor and impose discipline on the inter-bloc financial activities that had survived. Bloc rivalries made this impossible and these in turn led to serious misunderstandings. Occasional trade wars and tight controls on the flow of capital emerged and the fear that a major international economic and financial crisis would erupt was a constant of the system.

That such a crisis had not yet broken out was in part because many regional corporations had become quite comfortable in their protected home market and so there was not much of a desire among them to destabilize this comfortable position by embarking on economic conflict with neighbouring regions. That is, they had developed a vested interest in the *status quo* and the general public, seeing them as a bulwark against the threats of other blocs, tolerated them.

8. Implications for Canada — Regional Dominators

Again it is noted that the implications for Canada of lagging in adjusting its domestic regulatory arrangements to be in harmony with world developments are the same as in the shared governance scenario and therefore will not be repeated here. As noted in the other scenarios Canadian domestic policy had by 2015 led to the decline of a strong Canada based financial services sector. Some of its larger financial institutions, facing competitive difficulties, had been absorbed by foreign financial institutions and those that remained had seen their market share decline in Canada. None were consequential players among the large international financial institutions and all of any

size had a majority of non-Canadian shareholders. Employment in the Canadian financial services sector had been eroded because of the reduced international competitiveness of the Canadian financial system.

The regional dominator environment accelerated these worrisome developments. The disruption and uncertainties that accompanied the formation of regional blocs were particularly hard on the smaller and weaker international financial institutions, of which Canada because of past domestic policies, had a number.

The need to meet increased international shocks with as sound a domestic financial system as possible required Canada to discard quickly the artificial barriers to a stronger system that existed in the base case, including the bias against mergers and a redundant provincial role in regulating national institutions. Since the US dominated the region Canada had to be particularly sensitive to regulatory developments in that country — not much different in this respect than in the global club scenario. There was little opportunity for an independent regulatory regime. These developments also favoured the absorption of many of the Canadian financial institutions by larger US institutions.

Since this scenario held greater risks of financial instability than did the shared governance and global club scenarios, there was increased need for Canada to maintain a sound domestic macroeconomic environment. It had to be strong enough to deal with crises in trade, investment and financial markets arising from a world separated into competing blocs. While Canada could count on some international assistance from its regional bloc in the event of macroeconomic difficulties, including from the US, this was more limited than in the base case. Therefore, Canada had little flexibility in attempting to use macroeconomic policy to offset the shocks to the system that were inherent in the move to a world environment of regional blocks.

Canada recognized that it was in its national interest to encourage the development of regional multilateral financial institutions for governance purposes rather than permitting governance

responsibilities to be assumed totally by the bloc super power — the US. It also understood that it was in its interest to promote free trade within its bloc. Being the largest customer of the US in matters of trade and investment, its voice was heard in promoting such arrangements. The US for its part could not ignore that its interest lay in maintaining economic and financial harmony in the bloc in order to compete effectively against the other regional blocs. For this reason it worked to develop good working relations with its members. Canada was well placed to make a contribution to this because of its past experience in such matters and its importance economically to the US, while at the same time the aspirations of Quebec separatists were dampened.

The possibility of fixing the Canadian dollar exchange rate to that of the US dollar was enhanced because of the increased integration of Canada and the US, and this was eventually achieved. While a fixed rate in effect meant delegating Canadian sovereignty in monetary matters to the US Federal Reserve, this was viewed as a reversible and adjustable arrangement and so less troublesome politically than adopting a common currency. Such a currency for the region did not soon emerge, but events had clearly moved in that direction by 2015. The adoption of fixed exchange rates in some countries of the region, including Canada, and the adoption of "dollarization" by others, as well as the granting of "seigniorage" payments by the US to the latter countries, had constituted significant steps in that direction. The final step had to await the readiness of the US government to cede sovereignty in monetary matters to a regional central bank and this did not come easily. Without such a regional institution it was not possible politically for Canada, or the other countries of the region, to adopt a common currency.

X "CYBERWANE" IMPACT ON THE "BASE CASE"

"Cyberwave" — In this scenario power is widely and evenly distributed. However, rules and controls are minimal because of the inability of public institutions to keep pace with the rapid pace of technical change that is driving business and economic growth.

1. Over-all Comparison with the Other Scenarios

The cyberwave scenario as it relates to the international financial system is similar to the shared governance and global club scenario in that it envisages one highly integrated international financial system of markets, institutions and governance. In this it differs from the regional dominators scenario where the system is divided into super power blocs. It differs from all of them in that there is no attempt at effective governance of the system because market developments continually outpace the regulators, both domestically and internationally.

2. Underlying Logic — Cyberwave

The swift pace of market developments had made it impossible for regulators to establish governance systems and rules that were relevant to existing market conditions. The attempts after the Asian crisis to develop an effective system of international surveillance and regulatory guidance had proved to be much too slow and therefore ineffective.

In attempting to rationalize regulatory ineffectiveness in this real world situation, there had emerged the argument that financial markets, left essentially to themselves, were equilibrating, and that regulatory intrusions make them both less efficient and more unstable. Minimal regulation, it had been rationalized, was the best way to achieve maximum economic growth. In support of this rationalization attention was directed toward the world-wide swing away from controlled markets that had begun in the 1980s and continued throughout the 1990s and the dismal growth performance of centrally controlled economies. The Asian financial crisis too, it was pointed out, revealed the damage done to financial systems through misguided regulatory systems.

This movement toward free market dominance of the international and domestic financial systems was strongly assisted by the fact that the strongest political power, the United States, was also the one holding the strongest views relating to the benefits of free markets. Added momentum arose from the fact that not

only was the United States the strongest political power with the strongest convictions over the merits of unfettered markets, but also that its international corporations were leaders in the areas driving the new economy — information and communications technologies.

3. Distribution of Power, Governance and International Institutions — Cyberwave Scenario.

Political control of the international financial system became evenly distributed, internationally, in this scenario. But this did not mean too much in a world in which a strong system of governance did not exist. That is, it was only because no sovereign authority exercised effective control that power was evenly distributed. While both domestic and international regulatory agencies and institutions continued to exist, their lack of a meaningful mandate caused them to be ignored and they soon lost any effectiveness that they might previously have had.

4. Multinational and Local Corporations — Cyberwave

The real drivers of the international financial system were the free ranging financial markets and the multinational financial institutions and groups that operated in them and so knew them best. The temptation among them, in the absence of regulatory restrictions, to gain monopoly advantages was strong and this resulted in fierce competition between the major international financial institutions as well as between the communications corporations on whom the financial institutions depended for their global systems of operations. Indeed the trend was toward amalgamation between the global financial institutions and the communications corporations. In this fiercely competitive and rapidly changing environment, and in the absence of effective regulatory oversight, some of the major players began to compromise on previous practices of prudent behaviour.

It had been argued for a while that with technology widely distributed and available to all, this would result in a very large number of

corporations of modest size spread widely internationally. This proved not to be the case in the one area that was driving the world economy, and for a basic economic reason. To capture economies of scale inherent in emerging communications and information technologies required exceedingly large volumes of transactions and this in turned involved very large investments in real capital and in specialized and expensive human resources. Only corporations with enormous capital bases could mount such systems, and this inevitably saw the emergence of relatively few corporations but ones that spanned the globe. In a sense it could be said that communications and information technologies, by accommodating exceedingly large volumes of transactions and with them unlocking significant economies of scale, tended to cause a concentration of economic power and not a dispersal of it in that industry.

5. Economic Growth and Structure — Cyberwave

One very important element of the cyberwave scenario was that it did not prevent countries pursuing sound macroeconomic policies — monetary, fiscal, exchange rate. These did not depend on detailed regulations. Furthermore, the free flows of ideas, technologies, capital, investments, and human talent, which are an important characteristic of this scenario, more so than any of the others, provided some of the prerequisites for a high rate of economic productivity and growth. Finally there was no “moral hazard” problem in the functioning of private financial institutions because there was no regulatory framework to protect them in case of financial difficulty. They understood that they were on their own in case of difficulty. This made some users of financial services more careful in deciding where to put their savings or acquire financial services in general and made many financial institutions more prudent.

Unfortunately there proved to be other aspects of the cyberwave scenario that had the opposite effect on economic conditions. There was, of course, an increase in transitional unemployment and capital obsolescence because of unfettered industrial restructuring. But by far

the most important weakness of the cyberwave scenario was its susceptibility to financial crisis.

The lesson of the Asian financial crisis that free markets do not guarantee stability of the system was forgotten. Private financial institutions, greatly enjoying their relative freedom from regulations gradually began to be less prudent in their lending and borrowing activities and this increased as unfettered competition put increased pressure on rates of return. Some borrowing corporations permitted their capital structures to weaken in an effort to squeeze out more profits through increased leverage. Individual members of management of a few corporations even yielded to the temptation of fraudulent transactions, believing that with minimal regulatory oversight their transgressions would remain undetected.

The complicated character of international financial transactions involving the use of sophisticated financial instruments by financial and non-financial corporations with world-wide operations, had made it essential for such institutions to develop and apply effective risk management practices. Yet in the absence of regulatory oversight not all institutions had taken the initiative by themselves to do this. Such transactions had also made it exceedingly difficult for well-meaning domestic regulators alone to be effective. Close international cooperation was needed for this and it did not exist.

For financial institutions the operating principle of the system was "survival of the fittest". This had positive aspects in terms of swift disappearance of the inefficient. However, it also had negative aspects because at stake were the savings of millions of people who exercised no control over the operations of the institutions.

These structural weak points in the system were especially dangerous in the cyberwave world that had emerged. The enormous size and volatility of international capital flows and the absence of strong multi-lateral institutions for promoting cooperation, coordination and surveillance in relation to financial markets made the risk of debilitating financial crises especially

great. This weakness in international surveillance was matched by weakness in domestic surveillance because of the low level of such regulation and the international dimensions of the activities of domestic institutions.

For some time the cyberwave approach worked exceedingly well. It generated impressive economic growth through highly efficient allocation of capital and technology, with many countries benefiting from it. There seemed only to be more prosperity and profits ahead, and less and less need to pay close attention to the strength of capital structures. Many were convinced that under current conditions of perpetual prosperity past guidelines for prudent behaviour were obsolete. This was reflected in financial asset prices, particularly equities. They reached record levels as measured by price/earnings ratios in response to the market consensus that earning streams were assured for many years into the future. Central banks found they had developed no techniques for limiting the price distortions in those markets or even means to determine whether unsustainable distortions existed.

In the end this proved to be a misjudgement. High paper profits had caused consumers to get used to spending all their normal income, feeling there was no need to save. Then along came a stock market correction which in times of more normal stock market levels might have been manageable but which in this case quickly caused a cut in customer spending. There was no savings margin to cushion the impact on consumer spending. Corporations immediately cut their current capital budgets in response to weakened cash flow. The sharp decline in stock market values that emerged caught a number of financial institutions by surprise as they witnessed serious deterioration in the value of their financial asset portfolios. This included increasing non-productive loans as clients found it impossible to meet their borrowing commitments. Inevitably there followed the failure of one, and then several multinational financial institutions as well as a large number of local institutions. The resulting crisis would leave few countries untouched. It would be compounded by the absence of international arrangements for

minimizing the damage of the crisis once it had emerged.

In the end those aspects of the cyberwave scenario that were positive for economic growth and development were finally overwhelmed by the enormous economic costs of financial crises, not to mention the social costs that ushered in a prolonged period of social unrest.

6. Differences from the Other Scenarios — Cyberwave

Clearly the most significant difference from the other scenarios was its initial high rate of economic growth but along with this its severe susceptibility to severe international financial crises through the absence of effective domestic and international governance.

This would more than offset the benefits arising from the free flow of ideas, technology and resources internationally that had been so promising for economic growth.

7. Role of National and Provincial Governments and Forms of Integration

Canada needed to direct all its attention to maintaining domestic stability in a cyberwave scenario with its very high risk international environment. Exceedingly cautious macroeconomic policy was needed to minimize the impact on the economy of international disruptions, and fortunately such a policy did not depend on a strong regulatory framework. To the extent that it still had some regulatory mechanisms of partial effectiveness, Canada had to direct these toward maintaining the solvency of its financial institutions.

As free market forces raced ahead of international and federal regulatory agencies, the chances that provincial regulators could play any meaningful role at all simply vanished. Even Quebec regulators who, for political reasons, resisted the loss of regulatory influence, did not survive with any meaningful role in this free-ranging financial world. The uniqueness of Quebec institutions had disappeared much more quickly than in the other scenarios as policies of protectionism for nationalistic reasons were

simply swept away by the overwhelming forces of financial globalization.

8. Implications for Canada — Cyberwave Scenario

Unfortunately the need to focus all attention on solvency led to stances that discouraged risk taking and therefore undermined the basis for future economic growth. In addition Canadian corporations found it impossible to keep up with the large international corporations of the super-powers that, in the absence of strong international and domestic governance regimes, dominated the system. Both factors were negative for the relative strength of Canadian financial institutions. Some of them were absorbed by those international corporations which, for shareholders was often the most profitable way out, and often also for the government since the alternative in many cases was financial crisis and bankruptcy.

The final blow for Canada came when crisis descended on the cyberwave world. Having seen the new wave corporations develop elsewhere than in Canada, with head offices and core activities outside of Canada, it was without the base required to be able to regroup and move ahead. It had become a "taker" of financial services rather than a "producer" of them. Canada had learned the hard way that a country of its size does not do well in a world without clearly defined "rules of the game".

Of all the scenarios, the cyberwave scenario posed the greatest risks for Canada, followed by the regional dominators, then the global club, with the shared governance scenario being most in harmony with Canada's national interests.