
Jake Wright

Credit where credit is due

An analysis of Jim Flaherty's response to the Global Financial Crisis

Stanley Hartt suggests that credit is due to late former Finance Minister Jim Flaherty for the deft management and pragmatic measures he demonstrated in an effort to keep Canada insulated from the worst effects of the Global Financial Crisis.

Stanley Hartt

When Jim Flaherty ended his spectacular run as Canada's, and, arguably the world's, most successful Minister of Finance, some commentators suggested that Canada had reacted too late to the great recession which commenced in 2007/2008 and soon engulfed the entire globe. Others pointed out that our ultimate determination that massive stimulus was needed by the time of Budget 2009 was an over-reaction and, by running excessive deficits, obliged us to embark on an austerity binge that would otherwise have been unnecessary. Both arguments are wrong.

Let's remember how all this began: some of the world's leading financial institutions, notably but not exclusively in the U.S., effectively blew their brains out by allowing themselves to become enamoured with financial engineering and create, and sell to the public and to each other, sub-prime mortgage-backed securities in what were called Structured Investment Vehicles (SIVs). Credit enhancement techniques – creating tranches bearing different levels of risk and compensated at varying rates of return – were used to create senior tranches rated as AAA (because they would have been the last to absorb losses), but poor, often non-existent, underwriting ignored the obvious fact that, when the entire edifice is rotten, the top is not materially safer than the bottom. The collapse of the market for these inherently unsound offerings led to disastrous loss of value and brought the world economy to the brink, compromising the banks' very existence.

Canadian banks were only peripherally involved, not by originating these dodgy securities, but sometimes by buying them from the big-name bulge bracket firms as a "sound" investment. Other Canadian institutions eschewed the opportunity to join the dance party and demonstrated the discipline to distance themselves from the profit frenzy their U.S. colleagues were embracing and encouraging.

Our own asset-backed commercial paper (ABCP) crisis arose not from the sale of investments whose underlying value was questionable, but from the mismatch of longer-term assets being financed with short-term commercial paper. The 9-to-15 year leases behind the asset-backed securities were solid enough, but the paper funding them had to roll every 60 or 90 days, and the one connection between the American SIVs and our own ABCP was that, when the credit crisis hit, the appetite in the market to back securitized *anything* froze. Canada's solution, under the able leadership of Purdy Crawford, was entirely independent of what was engulfing the rest of the world's credit markets.

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But when the ill-conceived American instruments destroyed that country's housing market and all those with a stake in extending credit to it or participating in it, the pain spread rapidly. The question was, would Canada slip into recession alongside its trading partners because the sharp contraction of available credit transcends borders quickly.

It is often said that Minister Flaherty assumed that Canada would skate safely past the crisis, but that is also untrue. In his Economic Statement of November 27, 2008, Minister Flaherty demonstrated that he was acutely aware of the scope and extent of the crisis, and pointed out that, "An unexpected credit crunch in the summer of 2007, and a U.S. recession sparked by a plunge in the American housing market, have spread throughout the world." Although, based on a consensus forecast of private sector economists, he predicted only a modest recession for Canada, (a "technical recession, with negative growth in the fourth quarter of 2008 and the first quarter of 2009"), he introduced extremely significant measures to counter the downturn.

He pointed out that stimulus was already inherent in the government's prior budgets, represented by lower debt levels, tax reductions, a program to purchase existing mortgage pools from lending institutions and the creation of an assurance facility to offer insurance on a temporary basis on wholesale term borrowing by Canadian banks. Borrowing limits for the EDC and BDC were also increased.

The most important take-away from the Economic Statement was its declaration that, "Businesses need credit to invest or to meet their payrolls. Families need it to take out mortgages and loans." So when the extent and severity of the crisis became more apparent with time, and the private sector consensus forecast weakened dramatically, Flaherty acted, in Budget 2009.

Aside from stimulus provided by direct spending on such things as infrastructure and a long list of other initiatives, Minister Flaherty was focussed on access to financing. He understood that no business, large or small, tends to keep enough liquid cash on hand to finance inventories and receivables, cover overheads, and manage payroll costs. Even the most credit-worthy borrowers could, if credit became difficult enough to obtain, be faced with liquidity crunches bordering on insolvency. When credit markets imploded, some of the largest U.S. money-centre banks took self-protective measures restricting their operations and exposure to risk. Treasurers drew committed lines of credit, paying higher costs for the assurance that the cash was in their jeans rather than in a contractual obligation from a bank. Some U.S. institutions left Canada altogether, as a way to circle the wagons around the "mother-ship" at head office.

To combat the phenomenon of a deteriorating credit environment, Budget 2009 created the Extraordinary Financing Framework, consisting of up to $200 billion in strategically targeted measures to keep credit flowing to creditworthy borrowers. The mortgage purchase program was enhanced by a further $50 billion, to bring the total, with the previously announced facility, to $125 billion. $13 billion was added to the resources of CMHC, BDC and EDC, including a $5 billion Business Credit Availability Program, to be deployed in cooperation with private sector lenders. The deadline applicable to the insurance program for banks was extended and a similar facility created for insurers.

Then there was the Canadian Secured Credit Facility (CSCF)

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of $12 billion, intended to replace the now dried-up conduits whereby large and small originators of loans or leases for the purchase or leasing of vehicles and equipment had securitized their paper, so as to generate fresh capital to deploy. This facility was handed to the BDC to administer.

In the budget of January, 2009, Jim Flaherty also announced that, "To help manage the EFF, the Government will form the Advisory Committee on Financing", a group of ten Chairpersons, CEOs and CFOs (chaired by the author of this article). The Chair of Manulife Financial, the CEOs of GE Canada, Sobeys, AIMCO, and the Montreal Exchange, the CFOs of Enbridge, Great West Life and BCE, were joined by an outstanding representative of the small business community. When the Committee found that the CSCF was not adequately ensuring that credit was available to smaller originators of leases and loans for vehicles and equipment, intended to benefit from this program, Minister Flaherty created a new $500 million facility in Budget 2010, to be matched by the private sector, which provided much-needed relief and encouraged the commencement of the return to normalcy of markets for this kind of paper.

One of the most important features of this comprehensive list of initiatives is that very little of it represented a structural change in government outlays and programs and most of it was able to be phased out at predictable sunset dates as the various aspects of the stimulus were scheduled to expire.

So the accusation that the Canadian plan was too much too late is inaccurate in the extreme. The Minister arranged for credit to be available to Canadians when it otherwise would not have been and for this deserves the credit to which his legacy is entitled. The return to fiscal balance has not been easy, but the nation is now in the fiscal year where the deficit will be eliminated. What remains is one of the most solid financial systems in the world, impacted, of course, by the events of the Global Financial Crisis, but strong and intact to a significant extent because of the form and breadth of the measures Jim Flaherty summoned up to address them.

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