

OECD Reviews of Regulatory Reform

**REGULATORY REFORM
FOR RECOVERY**

**LESSONS FROM IMPLEMENTATION
DURING CRISES**



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FOREWORD

In 2008 the OECD launched its *Strategic Response to the Financial and Economic Crisis*, an organisation-wide effort to support governments in tackling the crisis and moving towards stronger, cleaner and fairer economies. This publication is the contribution of the Regulatory Policy Committee to this effort, and aims to highlight the role of regulatory reform as a strategy for recovery and sustainable long-term growth. This work is timely in the current context, as countries are looking for new and reliable ways to strengthen the recovery that will not create additional budget pressures in an already significantly fiscally constrained environment.

At the OECD, regulatory reform refers to the action of improving both the stock and flow of regulations, by reforming regulations that raise unnecessary obstacles to competition, innovation, growth and market (trade) openness, while ensuring that regulations efficiently serve important social objectives. The OECD has long fostered a multi-disciplinary approach to regulatory reform, drawing on the regulatory policy component as well as the competition and trade fields. The OECD horizontal work on regulatory reform has demonstrated that: *i*) a well-structured and implemented programme of regulatory reform contributes to better economic performance and enhanced social welfare; *ii*) economic growth, job creation, innovation, investment, and new industries benefit from regulatory reform, which also helps to bring lower prices and more choices for consumers; *iii*) linkages among competition, market openness and regulatory policies are mutually reinforcing and *iv*) regulatory reform helps countries to adjust more quickly and easily to changing circumstances and external shocks.

The present work on regulatory reform during crisis episodes was undertaken by the OECD's Regulatory Policy Committee, and has also benefitted from the collaboration of the Competition and Trade Committees. The approach taken was to derive lessons learned from a set of five OECD countries, in terms of how regulatory reform played a role in helping them recover from crisis episodes of the 1990s. Part I of this report is a synthesis which draws on materials from the study of these five countries, and a number of other OECD countries. Four detailed country case studies are presented in Part II (Japan, Korea, Mexico and the United Kingdom).

The synthesis consists of six sections. The first two sections present the objectives of the report and the methodology. A third section introduces the macroeconomic context of the crises assessed. The last three sections discuss the regulatory policy, competition and market openness implications and lessons learned for policy implementation.

Regulatory reform plays a major role in helping countries experience quicker and stronger recoveries. The countries assessed fared better when they took advantage of a crisis to engage in comprehensive regulatory reform. Although greater competition and openness do not reduce the likelihood of future crises, they increase potential long-term growth and the ability to recover more quickly from crises.

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Acronyms

APS	Asset Protection Scheme
CFC	Federal Competition Commission
CGS	Credit Guarantee Scheme
CIDAC	Centre of Research for Development
CPRR	Council for the Promotion of Regulatory Reform
FDI	Foreign Direct Investment
FETA	Foreign Exchange Transaction Act
FKI	Federation of Korean Industries
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IMF	International Monetary Fund
KIET	Korea Institute for Industrial Economics and Trade
LFCE	Federal Competition Law
MRFTA	Monopoly Regulation and Fair Trade Act
NAFTA	North American Free Trade Agreement
RRC	Regulatory Reform Committee
SLS	Special Liquidity Scheme
TRR	Temporary Regulatory Relief
UKFI	UK Financial Investments Limited

Executive summary

This study presents lessons learned from the design and implementation of regulatory reform programmes in response to a set of crisis episodes of the 1990s and compares them with policy responses to the 2008-09 crisis. It seeks to identify lessons learned in crisis situations about how regulatory reform, by enhancing regulatory quality and applying competition policy and market openness, can foster recovery and long term sustainable growth. It builds principally on case studies of regulatory reform responses to crisis episodes in five OECD countries: Japan, Korea, Mexico, Sweden and the United Kingdom. As countries are focusing their efforts on strategies for economic recovery, the findings of this study should be timely in the policy debate.

Regulatory reform increases resilience, enabling quicker and stronger recovery from shocks by making it easier to adjust and shift resources across sectors. The speed of recovery matters. Short, sharp recessions tend to be less costly in the long run than protracted, shallow ones, because in the latter case behaviours and expectations tend to be permanently changed. For example, in terms of the labour market impacts of protracted crises, the newly unemployed will find it harder to reintegrate the workplace without retraining should they be out of work for an extended period of time.

Regulatory reform represents an attractive policy option to stimulate recovery from a crisis, particularly when other policy alternatives face fiscal constraints. Regulatory reform becomes a crucial recovery tool for countries that have little room for further fiscal or budgetary interventions and are struggling to find new and reliable means of fuelling growth in a competitive global environment.

Regulatory reform has both short- and long-term economic benefits. In the longer term, regulatory reform leads to higher productivity, consumer surplus, foreign direct investment and employment. In the short term, which is also of importance when recovering from a crisis, reform can impact behaviours through anticipation of new, competitive environments. For example, regulations that improve competition and market openness may lead to efficiency gains before actual implementation, as businesses will want to be more competitive as soon as the regulations come into force, not after. This is illustrated by the case of Mexico in 1994, as businesses improved processes and reduced costs even before NAFTA was signed; this was done in anticipation of the expected increase in foreign competition that would occur once the agreement came into force.

Reform also has immediate upfront costs, which are in many cases felt before the benefits and are more visible and localised. To succeed, reform needs to have broad public support and overcome resistance from special interest groups that have enjoyed rents and protection from domestic and foreign competition under existing regulatory regimes. Strengthening the institutional capacity for regulatory oversight as well as having a whole-of-government approach that can change attitudes in government can significantly contribute to a successful reform, as was the case in Korea in 1997.

Pro-competitive reforms need not be delayed by crises. Several of the countries examined maintained the pace of reform despite the crises, confident that the long run reform strategy was sound. In many cases, the strong recoveries of economies were attributed to the extensive reforms that had greatly strengthened competition, lending support for the continuation of competition-enhancing regulatory reform even in the context of the current global crisis. Positive experiences of free trade can also boost public support for further trade-enhancing reforms. This is illustrated by the Korean example, where the experience of job saving and/or income increases in companies acquired by foreign investors brought about a remarkable shift in the public attitude towards foreign capital and trade.

Part 1

Synthesis

I. Introduction

Following the collapse of the US housing market in 2007 and the financial crisis of 2008, the global economy experienced the most severe downturn since the Great Depression. After a wave of strong monetary and fiscal interventions throughout the world, it appears that the recession may now have bottomed out, but the ensuing recovery is likely to be both weak and fragile for some time (OECD, 2009a). Once the effect of the various fiscal stimuli introduced to kick start economies in recession wears out, countries will have to turn to other measures to drive growth. In this context, regulatory reform has an important role to play in terms of building stable foundations for growth and long-term global competitiveness. Kevin Rudd, Australia's current Prime Minister, noted that in this regard setting an "ambitious agenda for competition and regulatory reform" was one of the key elements in achieving enhanced long-term productivity growth, which is "the only reliable driver of long-term improvements in national living standards" (July 2009).

The role of regulatory reform is two-fold. There is strong evidence that regulatory reform leads to enhanced long-term productivity and resilience, contributing to sustainable growth. There is also a role for principles of good regulation as a balanced view towards the roles of the state and of markets in the current climate. Because existing regulatory and supervisory structures have failed to ensure market stability in the financial sector (OECD, 2009b), there are currently numerous pressures for strong re-regulation. A rush to re-regulate may however create more losses than gains should principles of good regulation be ignored in the design phase. Regulatory reform may also have the potential to drive productivity gains in sectors that are still highly regulated in some countries, such as the retail sector or regarding land use and licenses or permits.

Against this backdrop, governments must remain vigilant not to repeat the mistakes of the past when designing an appropriate policy response to the crisis, and may learn from countries that have been successful in using regulatory reform as a tool for economic recovery. This calls for a detailed assessment of past responses to crises and lessons learned from them or as Paul Krugman argues, to "turn to patient empirical spadework, documenting crises past and present, in the hope that a fresh theory might later make sense of it all" (The Economist, 2009). Evidence of how regulatory reform has helped countries recover from crises and has led to more resilient economies will also help make the case for continued reform today, while success stories can provide practical guidance on the design and implementation of successful regulatory reform strategies.

The role of regulatory reform in enhancing long-term sustainable growth

Several OECD studies including the *OECD Reviews on Regulatory Reform* show that regulatory reform leads to higher productivity and growth, and that reducing regulatory constraints may lead to significant gains in GDP per capita. Product market reforms stimulate employment and labour productivity by curbing market power and the rents of incumbents. Less stringent product market regulation fosters innovation through increased R&D intensity. Cross-country evidence also suggests that countries which have extensively reformed product markets have experienced an acceleration of multi-factor productivity, which plays a crucial role for long-term economic growth.

While progress has been made in terms of regulatory reform across the OECD area, many countries could still improve their economic performance by strengthening competition in product markets, cutting red tape and improving openness to trade. In the context of the crisis, there are still untapped reserves of productivity which could be mobilised, as there is ample empirical evidence that such policies have the potential to increase labour productivity in the long term (OECD, 2009c).

Regulatory reform is a crucial recovery tool for many OECD countries which do not have much margin left for fiscal or monetary intervention and are struggling to find new and reliable means of fuelling growth in a competitive global environment. Comprehensive regulatory reform could boost both domestic and foreign investor confidence and stimulate investment and innovation. This would contribute to achieving more sustainable long-term growth.

The role of regulatory reform in enhancing economic resilience

Regulatory reform plays a role in enhancing economic resilience. Resilience in broad terms refers to a system's ability to accommodate variable and unexpected conditions without catastrophic failure, or "the capacity to absorb shocks gracefully" (Foster, 1993). Economic resilience in turn may be defined as the ability to maintain output close to potential in the aftermath of shocks, and comprises at least two dimensions: the extent to which shocks are dampened, and the speed with which economies revert to normal following a shock (Duval *et al.*, 2007). The quality of the existing regulatory system and reform efforts are likely to affect both the strength and duration of the effects of exogenous shocks. In addition, more flexible product and labour markets are likely to strengthen resilience to weather future downturns with less disruption to output and employment.

A "resilient" economy is not necessarily an economy where booms and busts are smoothed out and where business cycles do not exist. A resilient economy does however recover more quickly from crises. This is significant because short, sharp recessions, from which recovery is quick, could be less costly in the long run than shallow, protracted ones. When a recession drags out, even if the drop in GDP is shallow, there is a greater chance that expectations and behaviour will adapt to the lower-output conditions, leading the newly unemployed to become unemployable without extensive retraining and capacity to be permanently lost rather than temporarily moth-balled. Calvo (2009) raises a wider point about the cost of recessions in trying to set out the circumstances under which a more deregulated and faster growing economy can lead to higher welfare than a more stable and slower growing heavily regulated economy, despite being more prone to

downturns. This does not mean that no policy response should be taken in light of the current crisis: rather it serves as a note of caution regarding overzealous re-regulation. New regulatory proposals should observe best practices and regulatory reform principles, so that the flexibility of the economy is not diminished. Otherwise, innovation and a better capacity to take advantage of opportunities, factors which play an important role in speeding up recovery, may be compromised.

Given that issues in the financial sector have been one of the main causes of the current global recession, the proposed reforms of this sector are a central focus of all regulatory reform initiatives in the coming months, as illustrated by discussions among G20 countries. Specifically, as new regulations are being developed, it is important that they meet standards for high quality regulation and improved risk management and be developed in a co-ordinated way. One challenge when regulating is to offer adequate protection to investors while leaving sufficient scope for innovation. Here, parallels with previous crises caused by financial crises and lessons learned from subsequent policy responses could offer some useful insights, as some countries which have faced financial crises in the past have taken steps which have helped them better weather the effects of the current financial crisis.

Regulatory reform and competitive markets

Regulatory reform fosters competition. Thus, in the context of crisis responses, competition authorities should have a role in ensuring that regulatory proposals dealing with crisis conditions do not restrict competition unnecessarily. Competition authorities should also play a part in the design and implementation of exit strategies from the temporary measures in place that are intended to react to the immediate consequences of the crisis. In performing their usual responsibilities of assessing restrictive practices, market power, mergers and state aid, policy makers must bear in mind both the unusual conditions of a crisis situation and the later consequences after the crisis has passed.

Competition greatly benefits consumers, drives firm efficiency and stimulates innovation and competitiveness, thereby contributing to raising economy-wide productivity and growth. Benefits to consumers are realised through the increased choices, lower prices and greater quality of goods and services that competing firms are compelled to deliver, while productivity increases because of the incentives of competing firms to be more efficient than their rivals, reduce their costs and innovate. OECD research has provided empirical evidence of the positive link between the strength of competition and high productivity levels, while highlighting the negative impacts on innovation and adaptability of measures that restrict competition (Conway *et al.*, 2006).

Strengthening competition and eliminating restrictive product market regulation and anti-competitive regulation can lead to significant productivity gains. Conway *et al.* (2006) demonstrate that restrictive product market regulation and anti-competitive regulation slow the diffusion of positive productivity shocks across borders as well as the incorporation of new technologies into the production process. This loss of the ability to quickly adapt to changing circumstances can be sizeable in some of the more restrictive OECD countries; especially for those that operate at some distance from the world productivity frontier, gains from further product market reform may be considerable. Higher productivity and support for innovation and adaptability should make an economy more resilient to shocks and thus better prepared to respond to and emerge from crisis conditions.

In addition to the productivity gains from effective competition, competition tends to provide better outcomes than alternative models. Effects of introducing competition in markets previously dominated by (state) monopolies can be striking. Following deregulation, the cost of international telephone calls from the UK fell by 90% between 1992 and 2002. Increased liberalisation of the European aviation market over the same period increased flight frequency by 78% and lowered the lowest non-sale fare by 66% (Fingleton, 2009a).

Effective competition, defined as when no firms can exercise undue market power, depends on freedom to easily enter and exit markets. Entry of new, efficient, firms can force the exit of inefficient firms. This process of entry and exit spurs efficiency, innovation and productivity. While empirical studies of competition often show that a large proportion of the benefits can be traced back to the process of entry and exit, the exit process is often under-appreciated (Fingleton, 2009a). Ensuring that firms are able to enter and exit markets should be an important consideration when designing exit strategies from the crisis, as preventing exit in the short term can damage competition in the longer term, ultimately reducing productivity and growth.

During a crisis or recession, there may be pressures to relax competition policy in order to prop up ailing firms and preserve jobs.¹ The immediate costs to businesses and employees are visible, especially if concentrated in a local area, but the benefits of potentially greater efficiency in the long run are less visible. To resist this pressure, highlighting past successes can promote the acceptance and understanding of the benefits of competition.

The strong link between competition and productivity growth calls for robust competition policy. Competition authorities may need to play a major role to help the design of exit strategies from the crisis, to foster recovery and sustain long-term sustainable growth. Competition policy is central to regulatory reform, and as regulatory reform stimulates structural change vigorous enforcement of competition policy is needed to prevent private market abuses from reversing the benefits of reform.

Regulatory reform and market openness

Regulatory reform should foster open markets. Open markets allow trade and investment to flow unrestricted, leading to the most efficient allocation of resources and allowing countries to benefit from their respective comparative advantages. Protectionism on the other hand restricts trade and investment flows, thereby creating inefficient allocation of resources and lowering global welfare. Protectionism can consist of measures at the border (tariffs, quotas or other mechanisms that restrict trade or make imported products more expensive) or measures that governments can take behind their borders and that will have very similar effects – including various forms of direct subsidies. Support to one sector in one country, whatever the motivation, disadvantages competing sectors in other countries. As other countries then move “to level the playing field”, a subsidy competition is launched that in the end benefits no country. But those that receive subsidies may be better off than otherwise, and will vigorously defend their new entitlements; this explains in large part why subsidies to deal with a short term problem often prove almost impossible to remove (OECD, 2010).

While many countries in the course of economic development have had import-substitution policies in place which have led to substantive misallocation of resources, they have switched to a more open market oriented development policy as inefficiencies related to high tariffs have become clearer (OECD, 2007b). The current crisis has however seen an increase in the number of trade-restricting or distorting measures, but their impact may not be very important. In its July 2009 report, the WTO Secretariat stated that, contrary to 2008, “the number of new trade-restricting or distorting measures announced or implemented since 1 March 2009 exceeds the number of new trade-liberalising or facilitating measures by a factor of more than two”. A closer examination of the measures reveals that they have principally been introduced in specific sectors, rarely having general applicability and that according to one estimate; the new trade restricting measures affect less than 1% of the pre-crisis level of imports (OECD, 2010).

This does not mean that complacency is justified. When designing exit strategies from the crisis, governments need to remain vigilant to avoid protectionist actions that may be politically expedient in the short term but that could have devastating long-term consequences. The danger going forward is that such restrictions could build up incrementally, slowly stifling trade and ultimately weakening the effectiveness of all the anti-cyclical measures that have been introduced. Protectionist sentiments are likely to increase with persistent unemployment and mounting pressure on government finances. Moreover, once put in place, such protection measures become entrenched and increasingly difficult to undo. Retaliation may occur compounding the effects of unilateral measures. Signs of increased movement towards trade defence measures, a barometer of protectionist sentiments, warrant continued attention and vigilance. While such measures become permanent only after some time has elapsed, the interim period is fraught with risks of retaliation which could become damaging for trade and ultimately for recovery itself (OECD, 2010).

Domestic regulatory measures that operate behind the border can also act as a form of protectionism. Although harder to document, there is also reports of more restrictive implementation of regulatory measures, both at and behind borders. Stricter implementation of SPS or TBT measures, more complicated border procedures, or other less transparent devices will slow down imports and carry the same threat of corrosive retaliation that could lead to an escalation of trade tensions (OECD, 2010). There is as such a role for regulatory reform to foster market openness by reducing the number of behind-the-border trade restricting regulatory measures.

II. Study objectives and methodology

The main objective of the study is to demonstrate how regulatory reform, competition policy and market openness measures have helped a sample of OECD countries recover from financial and economic crises. The study should inform countries on the role of regulatory reform in leading to sustainable economic recovery and more resilient economies, contributing to a stronger, cleaner and fairer world economy. More specifically, the study aims to:

- Provide a comparative analysis of different regulatory reform strategies implemented during crises in the past and their impacts on recovery and long-term resilience and growth.
- Draw attention to the role of competition authorities and show how recoveries from past crises were delayed when competition enforcement was relaxed.
- Emphasise the crucial importance of open markets with the need to develop common policy orientations to keep markets open during crises, and efforts to prevent regulatory barriers to trade.
- Identify trends, common issues, implementation and political challenges encountered by case study countries in undertaking regulatory reform, enforcing competition policy and increasing market openness during crises.
- Highlight lessons learned to provide guidance to countries when designing exit strategies.

Multidisciplinary aspect

The study reflects the multidisciplinary nature of regulatory reform, where both the competition and trade elements are very important to ensure competitive markets with a level playing field. The study draws on several aspects of OECD work in those areas.

Recent OECD work on regulatory reform and the crisis has highlighted the role of quality regulation tools in financial sector regulation (Black and Jacobzone, 2009). The consensus that emerged from this work on the main regulatory shortcomings of the financial sector that led to the 2009 crisis include: *i*) the lack of co-ordinated information on macro-financial flows and on the micro-prudential supervision of individual banks, both nationally and internationally, *ii*) the lack of integration of those two sources of information and insufficiently co-ordinated action by supervisors both nationally and internationally; *iii*) the delineation of regulatory boundaries, which caused ‘black holes’ to develop which were outside the regulators’ focus, notably the developments of complex credit derivatives and the use of off-balance sheet vehicles; *iv*) the incentive structures caused by regulation itself, for example for banks to move assets onto the trading book where they would not ‘count’ towards capital requirements; *v*) significant and ultimately fatal weaknesses in risk assessments and risk management by all those

involved, including but not limited to the regulators; and *vi*) a political-economic, and hence regulatory, philosophy which in hindsight placed too much reliance on the ability of the market and financial institutions to regulate themselves and to self-correct.

OECD work on competition policy addressed the issues of competition and financial markets during a roundtable held in February 2009 (OECD, 2009d). These discussions highlighted the risk of systemic loss of trust in financial markets and the fact that the current crisis was mostly linked to failures of financial market regulation, rather than to failures of competition or competition policies. The discussions analysed how competition can help make the financial sector efficient and ensure that stimulus packages benefit the end customers. There is a role for competition authorities in crafting exit strategies from the crisis and in dealing with mergers, barriers to entry in financial markets, the sale of government stakes and government support. Additional issues may include the temporary crisis framework for the real economy and assessing the value of rescue passages to the real economy. Lessons learned from OECD countries also show that recoveries from past financial crises were delayed when competition enforcement was relaxed.

OECD work on trade policy, including *OECD's Strategic Response to the Financial and Economic Crisis* demonstrates that there is scope for international discussions to link to the crucial importance of open markets in the current crisis and to develop common policy orientations to keep markets open. Recent economic analysis highlights the benefits of trade and trade liberalisations. Although various international fora, including the G20 and the OECD are strongly advocating open markets, there has been a decrease in international trade over the recent period, partly as a result of many countries turning inwards to protect themselves from the global shocks. The only historical comparison with the current reduced levels of trade subsequent to a financial crisis is the Great Depression, when tariff increases compounded the crisis. According to Gamberoni and Newfarmer (2009), despite official calls in the recent period to continue the move towards free trade, 17 of the G20 countries have introduced measures that have effectively restricted trade. Therefore, the need to further assess and provide empirical evidence for preserving trade liberalisation and preventing creeping barriers to trade through regulatory measures remains very strong.

The OECD has also assessed the economic and trade impacts of responses to the current crisis (OECD, 2010). The report concluded that the disproportionate collapse in trade experienced by the world economy in 2008-09 can be explained by a combination of three main factors: *i*) the collapse in domestic demand; *ii*) the disproportionate fall in outputs and trade of capital goods that make up a larger share of trade than of GDP; and, *iii*) the temporary drying up of short-term trade finance, subsequently leading to lower availability and higher cost). The findings also suggest that trade finance becomes more important during times of crisis and that this was a contributing factor to the drop in trade. However, no evidence was found to support the claim that protectionism was a cause of the drop in trade. Next steps for governments would include rolling back the most obvious trade-restricting measures that have been taken such as tariff increases and import licensing, and to show restraints in initiating trade remedy actions, as such restrictions are inconsistent with all the anti-cyclical policies that have been introduced to support production. With respect to financial markets, as they return to normal, well designed and internationally co-ordinated exit strategies will be needed to ensure that financial markets are both open and supported by adequate regulation.

Scope and methodological framework

To draw out general lessons for future policy design and implementation, the study focused on five selected countries with the view of understanding countries' responses to financial and economic crises in the light of responses to previous crises. This study is relevant in the current context given that there are many common elements between these past crisis episodes and the current crisis. Nevertheless, the current global crisis differs from past crises, which in many cases were country specific, or at most regional in nature. The current report focuses primarily on national responses and reform initiatives rather than on the international perspective. Analysing the global response, including an assessment of international causes, approaches and regulatory co-operation as part of the recovery from crises would require further research.

Countries were selected based on whether they had been active in terms of developing a regulatory reform strategy and had been subject to significant OECD analysis in this regard, thus providing a rich set of information and materials as a basis for this project. Another selection criterion was to obtain a mix of countries across the main geographical areas of the OECD (Europe, Asia, America and Oceania) to reflect various institutional structures and settings.

In consideration of these criteria, Japan, Korea, Mexico, Sweden and the United Kingdom were selected for this project. These have all either experienced past or current financial crises. As way of economic background and context, Table 1 presents basic statistics on these five countries:

Table 1. OECD countries assessed, key statistics

	Japan	Korea	Mexico	UK	Sweden
Region	<i>Asia</i>	<i>Asia</i>	<i>America</i>	<i>Europe</i>	<i>Europe</i>
GDP (PPP), billions of USD (2007)	4 044	1 212	1 410	2 086	313
Population (2007), millions	127.7	48.4	105.8	61.0	9.1
Crisis assessed	2001-03	1997-98	1994-95	1990-93	1990-94**
Unemployment rate, Q2 2009	5.2%	3.9%	5.7%	8.0%	8.2%
Unemployment rate, worst quarter of crisis	5.4% (Q2 2003)	8.1% (Q4 1998)	7% (Q3 1995)	10.6% (Q1 1993)	11.9% (Q4 1993)
Debt level, Q2 2009	218.6%	27.1% (2007)	33% *	70.3%	43.6%
Debt level, worst quarter of crisis	167.18% (2003)	n/a	n/a	47.7% (1994)	72.4% (1994)
Deficit, Q2 2009	-7.8%	-1.2%	n/a	-12.8%	-3.3%
Deficit, worst quarter of crisis	-8.0% (2002)	1.6% (1998)	n/a	-8.0% (1993)	-11.2% (1993)

*. IMF Principal Global Indicators.

** For Sweden, Q1 1990 was chosen as the starting point of a crisis, as it was the peak quarter in terms of GDP, just before a first period of two consecutive quarters of negative growth (Q2 and Q3 1990). It is debatable whether the crisis actually started in Q1 1990, as already in 1989 growth had started to slow down, with two quarters of negative growth. However as these quarters were not consecutive, this would not qualify as a recession according to the usual definition (two consecutive quarters of negative growth).

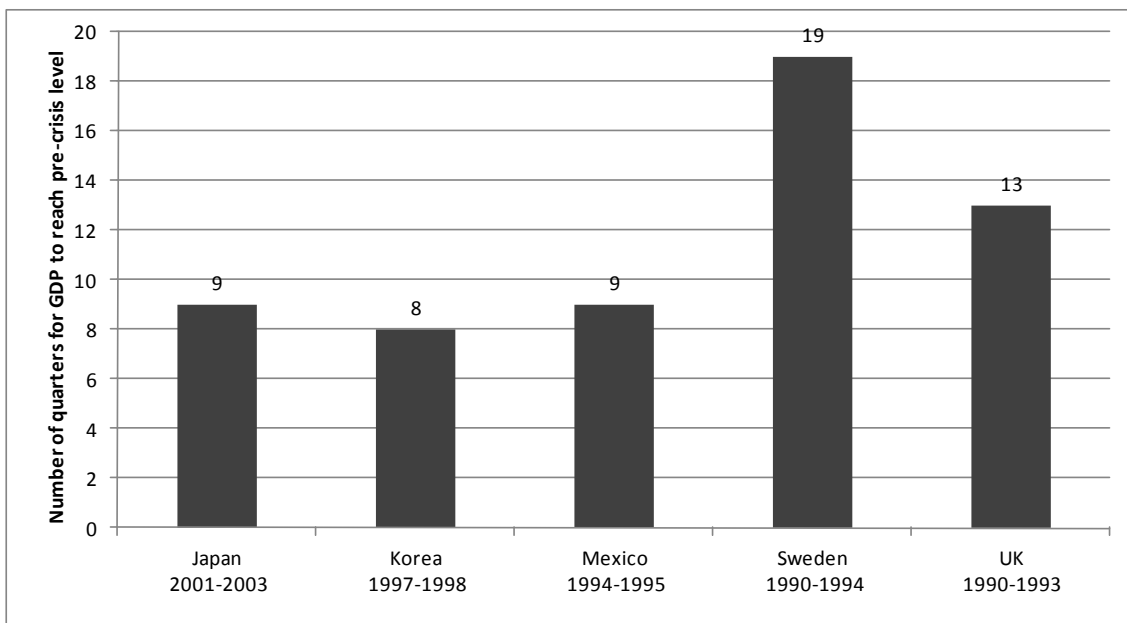
Source: OECD.Stat.

The development of the national case studies was coordinated with invited experts² from the countries selected as case studies, and it also involved a collaboration with national authorities for fact checking. Each expert was responsible for producing an analytical paper on the impacts of regulatory reform, application of competition policy and market openness on recovery from a recent and major economic or financial crisis and assessing how these efforts succeeded in making the country's economy more resilient to future shocks. The response to this past crisis was also compared to the country's response to the current crisis. Four case studies are available in Part 2 of this publication (Japan, Korea, Mexico and the United Kingdom). Work on Sweden was developed by the Secretariat based on internal and external research.³ The next sections summarise the macroeconomic context of the crises assessed and the main findings, across the policy areas of regulatory quality and governance, competition policy and market openness.⁴

III. Macroeconomic context of the crises assessed

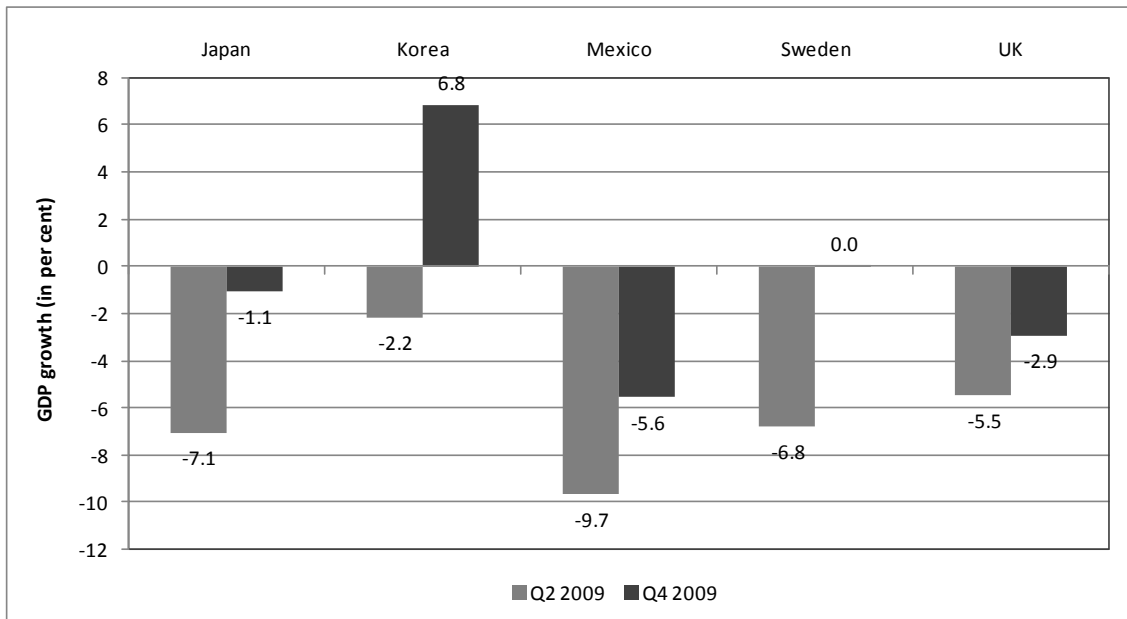
The countries assessed have experienced varying time-spans of recovery from crisis episodes. To illustrate the different recovery times, Figure 1 shows for each of the countries and crises studied the number of quarters that it took for the GDP to regain its pre-crisis levels. In this context the beginning of the crises is defined as the quarter that precedes the first two consecutive quarters of negative growth. The quickest recovery was experienced by Korea in 1997-98, where GDP recovered in eight quarters (2 years). Recovery was slightly longer in Mexico in 1994-95 and Japan (2001-03) at nine quarters for each crisis episode. Sweden (1990-94) and the UK (1990-93) took a longer time to recover, at 19 and 13 quarters respectively.

Figure 1. Number of quarters for GDP to regain its pre-crisis levels



Source: OECD (2009), *OECD Economic Outlook No. 86*.

Figure 2 presents the growth in GDP for the second and fourth quarters of 2009 by country. All countries have experienced significant declines in Q2 2009, in keeping with the global trends. Of the five countries assessed, Korea showed the lowest decline at -2.2%, while the UK and Sweden came second and third respectively. Japan (-7.1%) and Mexico (-9.7%) were the hardest hit, perhaps due in part to their strong reliance on exports to the US. In the fourth and last quarter of 2009, GDP growth has improved across the board, with Korea showing once again the highest figures in the sample of five countries, at +6.8%.

Figure 2. GDP growth (year-on-year basis, in %), Q2 and Q4 2009

Source: OECD (2009), *OECD Economic Outlook No. 86*, and Ministry of Finance, Sweden.

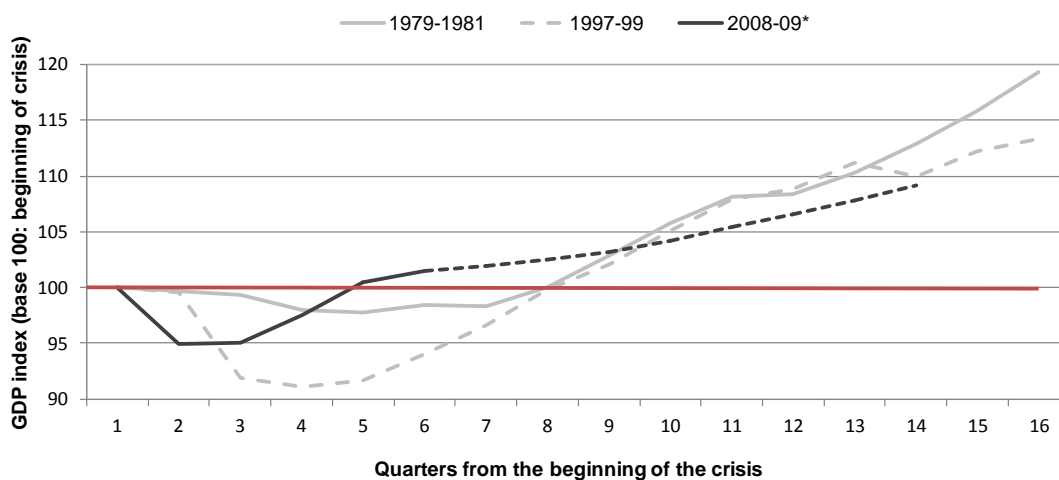
Korea

In Korea the unemployment rate has risen significantly this year, from 3.2% in the fourth quarter of 2008 to 3.9% in May, but this is still less than half the peak unemployment rate of 8% reached a year after the start of the 1997 crisis. The GDP decline was also less pronounced than that of the 1997 crisis (see Figure 3). Government response to improve financial market conditions has aided the current recovery: interest rates were cut from 5.25% in August 2008 to 2% in February 2009 and the government has injected 3.5 trillion won of capital into seven banks, while establishing a 40 trillion won (4% of GDP) fund for the purchase of non-performing loans (OECD, 2009a). At the time of writing, Korea is the country that is experiencing the quickest recovery in the five-country sample of this study, with the GDP projected to return to its pre-crisis levels in early 2010. If maintained, this recovery would mirror the quick recovery experienced in 1997-98 (Figure 3).

The crisis episode assessed in Korea is the Asian financial crisis of 1997-98. At the peak of the crisis in the first quarter of 1998 in Korea, GDP declined by a staggering 7.6%. While the crisis was partly a result of contagion from other Asian countries, it also reflected structural challenges in Korea's economic structures and regulatory frameworks, especially the overleveraged and unprofitable corporate sector and the poorly supervised financial sector (OECD 2000); despite sustained high growth, moderate inflation, high national savings, large government financial surpluses and small external deficits prior to 1997. If the crisis was remarkable by its magnitude, even more remarkable was the quick recovery: by the end of 1998, the GDP surpassed its pre-crisis levels, making Korea the first country to recover from the Asian financial crisis of 1997.

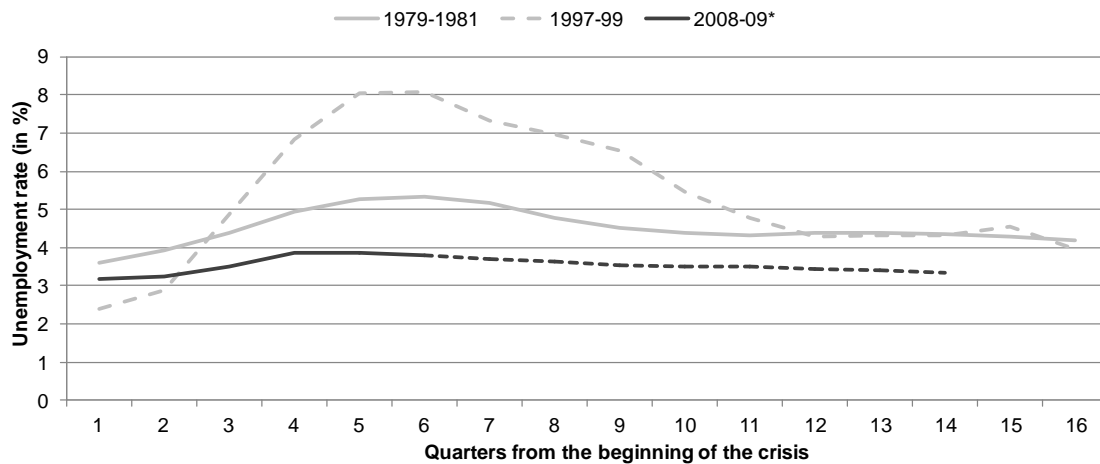
While the current and 1997 crises in Korea have different causes, the extent of reforms and speed of recovery in 1997 make it a very relevant case to support and guide reforms in the wake of the current crisis. As we can see from Figure 3, it took less than eight quarters for the GDP to recover to its pre-1997 crisis levels, and if the projections are right it seems as though Korean economic activity is now following a similar swift recovery path. Understanding what policy responses and reform efforts helped the Korean economy recover in 1997 and how exit strategies were designed and implemented can provide a useful benchmark for current policies.

Figure 3. Crisis episodes in Korea, real GDP change from peak, quarters since the beginning of the crisis



Note: For each crisis episode, the figure shows the growth of real GDP relative to its most recent peak. The “most recent peak” is defined as the value of real GDP in the quarter before the first two consecutive quarters of negative growth. The economy is considered to have fully recovered when the value of real GDP reaches the level of the previous peak. For Korea, the peak quarters before crisis episodes are Q2 in 1979, Q3 in 1997 and Q3 in 2008.

Source: OECD.Stat.

Figure 4. Crisis episodes in Korea, unemployment rate, quarters since the beginning of the crisis

This figure illustrates the evolution of the unemployment rate during recent crisis episodes. For an explanation of how the first quarter and the final quarter of each crisis episode have been defined, refer to the notes section of Figure 3.

Source: OECD.Stat.

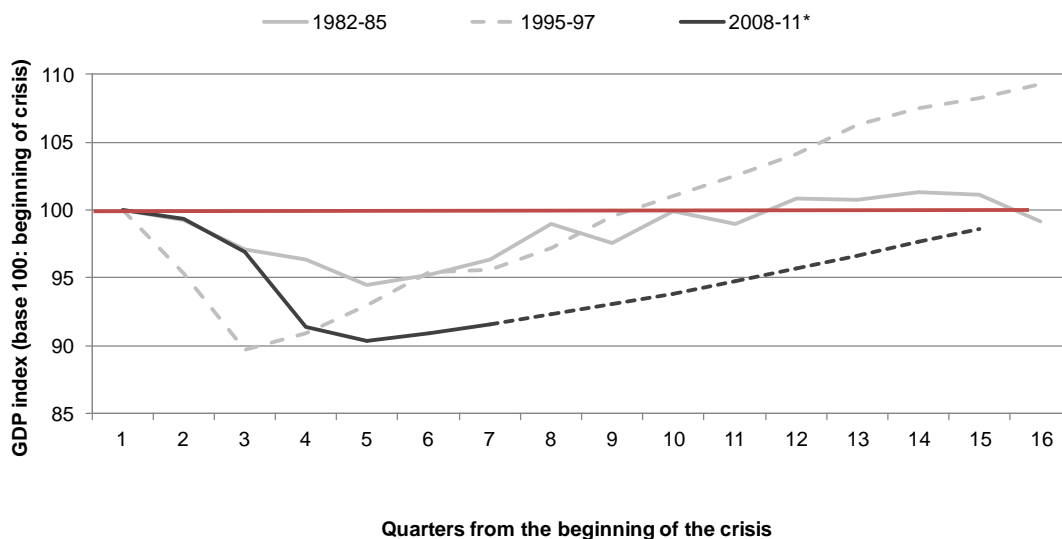
Mexico

Mexico's GDP fell sharply with growth turning negative towards the end of 2008. While not as severe as the drop during 1994-95, the current decrease is significant; projections show a somewhat slower rate of recovery than in 1995 in terms of GDP (Figure 5). It is likely that while the two crises are similar in their impacts, their root causes are different as the financial sector is not implicated in 2008. The current crisis has also resulted more from Mexico's heavy dependence on the US market (and especially the automobile sector), accentuated by the outbreak of influenza A H1N1 and a fall in tourism, rather than the structural weaknesses and external imbalances that had led to the downturn in 1994-95. Comparisons with the 1994-95 crisis are relevant in terms of the lessons learned from regulatory reform responses to the crisis and the associated impacts on recovery.

After the 1982 crisis (triggered by the collapse in oil prices and default on massive external debt) and the subsequent period of low growth, the Mexican government engaged in broad reforms and privatisation in an attempt to follow a market-oriented model of growth. The bulk of the reform efforts took place after 1988. Despite these reforms, Mexico once again experienced a major crisis in 1994-95: this was a twin banking and foreign exchange crisis, and was the worst experienced in a decade, resulting in severe consequences. The stock market crashed by 40% – and GDP fell by 6.2%, returning per capita income levels to those of 1987, while real wages, consumption, and investment fell even more. Job losses neared 800 000 in 1995. Figure 5 shows the evolution of the quarterly GDP growth rate during the 1994-95 crisis as compared to the current crisis.

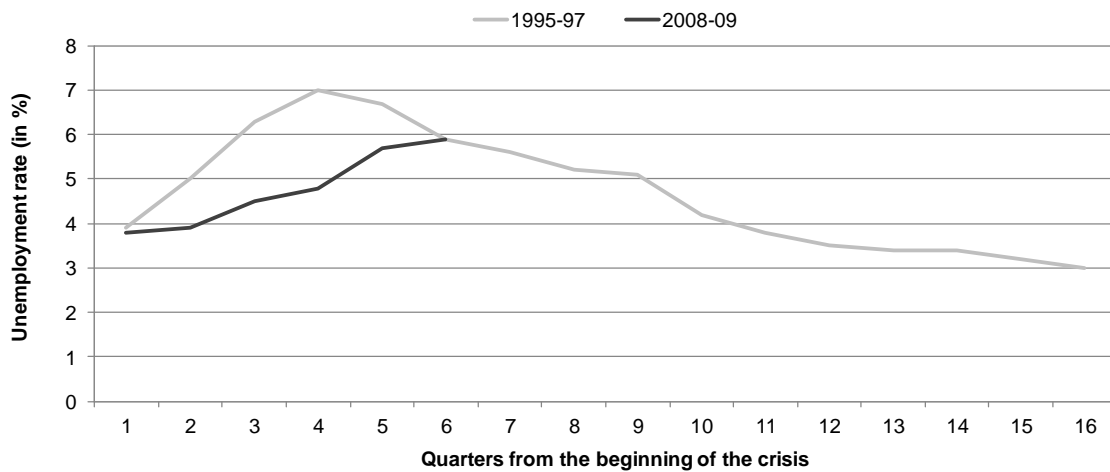
The 1994-95 crisis and subsequent instability were not attributable to reforms, with the notable and important exception of problems in the banking sector, but rather resulted from Mexico's high debt service burden, the choice of a vulnerable exchange rate regime (crawling peg with fluctuating bands), external shocks and domestic political shocks. While the ensuing recession at the end of 1994 was severe, growth resumed very quickly, surpassing its pre-crisis level as early as the end of 1995. This contrasts with the economy's slow growth and long recovery time following the 1982 and 1987 crises, when unsustainable public investment policies had led to over-employment and widespread inefficiencies. Structural and regulatory reforms, as well as the implementation of NAFTA in early 1994, appear to have played a role in explaining this rapid recovery, as the 1998 OECD Economic Survey noted that the "greater responsiveness of the Mexican economy" reflected the "increased openness of the economy as well as enhanced flexibility engendered by the structural reforms implemented in recent years". Reforms have also contributed to the sustained growth after 1995, as well as to the strong macroeconomic performance in 1998, despite a number of adverse external shocks (such as the Asian financial crisis).

Figure 5. Crisis episodes in Mexico, Real GDP change from peak, quarters since the beginning of the crisis



For each crisis episode, the figure shows the growth of real GDP relative to its most recent peak. The "most recent peak" is defined as the value of real GDP in the quarter before the first two consecutive quarters of negative growth. The economy is considered to have fully recovered when the value of real GDP reaches the level of the previous peak. For Mexico, the peak quarters before crisis episodes are Q2 in 1982, Q4 in 1994 and Q2 in 2008.

Source: OECD.Stat.

Figure 6. Crisis episodes in Mexico, unemployment rate, quarters since the beginning of the crisis

This figure illustrates the evolution of the unemployment rate during recent crisis episodes. For an explanation of how the first quarter and the final quarter of each crisis episode have been defined, refer to the notes section of Figure 5.

Source: OECD.Stat.

Sweden

Sweden experienced a severe crisis in 1990-94, comparable in depth to that of the 1930s (OECD, 1994). This crisis involved a bursting housing bubble as well as a severe banking crisis. At the time, Sweden spent 4% of its GDP to rescue ailing banks. In doing so however it forced banks to write down most losses before seeking recapitalisation, effectively draining investor capital prior to injecting cash in the banking sector. Successful sales of government stakes after stabilisation of the sector greatly reduced the total cost of the governmental intervention (New York Times, 2008), which is a good example for governments grappling with similar circumstances in the current crisis.

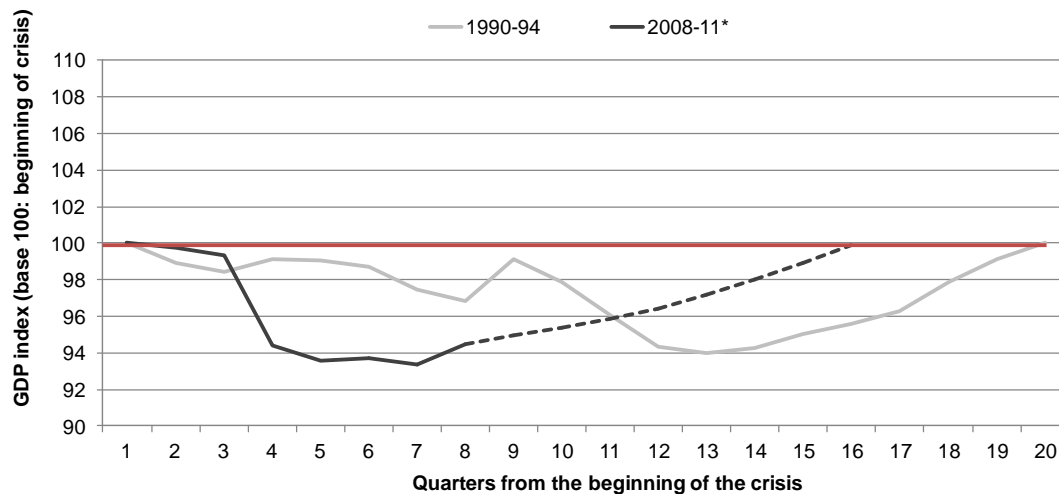
In the early 1990s, the financial crisis in Sweden was more of a domestic issue, due in large part to the improper sequencing of structural reforms in the 1980s. For one, deregulating financial markets before removing the tax incentives in favour of loan-financed consumption and speculative investment created a “bubble economy”, with overheated product and labour markets (OECD 1994). The crisis that ensued in 1990 when the bubble burst was lengthy, as it took nineteen quarters (close to five years) for the GDP to regain its pre-crisis levels, by late 1994.

The main causes of this longevity were an unusually weak domestic demand and the persistence in defending the fixed exchange rate, eventually abandoned in November 1992, which forced the Riksbank to raise interest rates at the beginning of the crisis, further depressing demand (OECD, 1994). After the fixed exchange rate was abandoned in 1992, interest rates fell sharply and the Swedish Krona decreased in value by 20-30%, which allowed exports to increase and contributed to the recovery.

But other factors were also at play. The necessary structural reforms in the tax system, agricultural support, textile imports, telecommunications and public transportation may have been introduced too late (reforms in these sectors were introduced only after 1990), as a higher growth of potential output and a more flexible supply structure would have eased adjustment to the falling saving rate, which was the most important proximate cause of the recession (OECD 1994). Once reforms were fully implemented, however, the economy experienced a strong and sustained recovery.

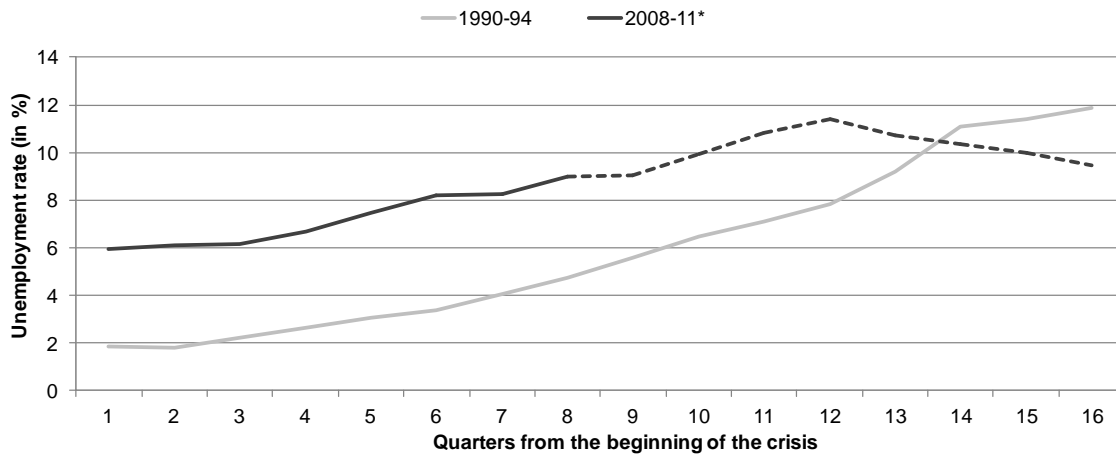
Sweden is currently facing a deeper contraction than during the domestic banking crisis of 1990-94, but the duration of the current crisis is yet to be assessed (Figure 7). Between the third quarter of 2008 and the first quarter of 2009, GDP fell by more than 5%, while during the worst part of the banking crisis in the early 1990s; GDP fell by a comparatively lower 1.15% between the third quarter of 1991 and the fourth quarter of 1992. In spite of this, many economic indicators in Sweden remain favourable. The public finances are still in good shape, the national debt has been reduced to the same level as before the last financial crisis in the early 1990s and so far the increase of the debt has been moderate. In terms of the banking sector, in the early 1990s, several financial companies, including Första Sparbanken, one of the major Swedish banks at the time, experienced major credit losses. However at the present time there is no reason to expect that the major Swedish banks will experience the same magnitude of problems. The Riksbank has undertaken stress tests on the Swedish banking system and even in the stress scenario all major banks will be able to reach the statutory minimum requirement of capital ratio (Kreichbergs and Fölster 2010).

Figure 7. Crisis episodes in Sweden, real GDP change from peak, quarters since the beginning of the crisis



For each crisis episode, the figure shows the growth of real GDP relative to its most recent peak. The “most recent peak” is defined as the value of real GDP in the quarter before the first two consecutive quarters of negative growth. The economy is considered to have fully recovered when the value of real GDP reaches the level of the previous peak. For Sweden, the peak quarters before crisis episodes are Q1 in 1990 and Q1 in 2008.

Source: OECD.Stat.

Figure 8. Crisis episodes in Sweden, unemployment rate, quarters since the beginning of the crisis

This figure illustrates the evolution of the unemployment rate during recent crisis episodes. For an explanation of how the first quarter and the final quarter of each crisis episode have been defined, refer to the notes section of Figure 7.

Source: OECD.Stat.

Japan

The global crisis has led to a sharp output drop in Japan: between the second quarter of 2008 and the first quarter of 2009, output declined by close to 6% (Figure 9) (OECD, 2009a). The OECD Economic Outlook (OECD, 2009a) suggests that structural reforms, particularly in the service sector, remain a priority to improve living standards in the current circumstances in Japan.

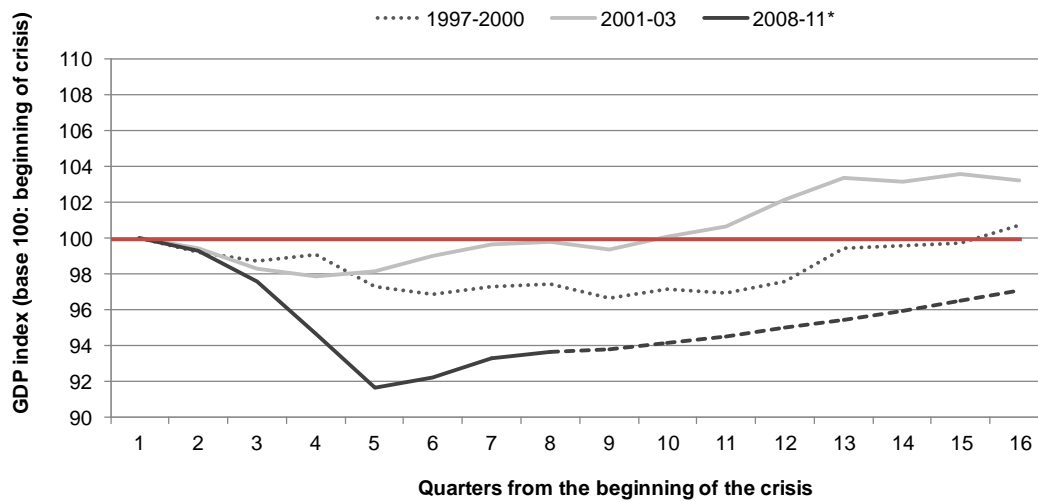
Shrinking exports due to a sharp decline in trade volumes in world markets were an important factor in this crisis. The more fundamental factor was the vulnerability of Japan's economy to external shocks as Japan's leading industries are concentrated in manufacturing (which is heavily export oriented) rather than the agriculture or the service sector. Thus, despite the second largest economy after the United States, the decline in demand and employment in the export sector in Japan cannot be easily offset by other sectors. Particularly in the most recent crisis, the projected decline in Japan's GDP in 2009 is much larger than those of the US (-2.8%) and the Euro area (-4.8%) despite the fact that the loss in Japan's financial institutions by the world-wide collapse in values of securitised assets is the lowest.

This mainly comes from a "dual structure" of Japan's industries; a highly productive manufacturing sector on the one hand, and less productive agriculture and service sectors on the other. The average productivity in Japan's service sector was slightly less than 60% as compared to the United States over the 2000-04 period, and the gap was particularly large in distribution, transportation, and other services (Table 2). This "dual structure" is not new: it has been closely related with an increase in foreign direct investment outflows through the liberalisation of capital markets in the 1990s. The outflows of investment by manufacturing industries are also linked to increased opportunities in the context of globalisation. At the same time, the share of highly

productive sectors, mainly in manufacturing, has decreased in the domestic economy, as is the case in other OECD countries. This has a downward effect resulting in lowering the average productivity.

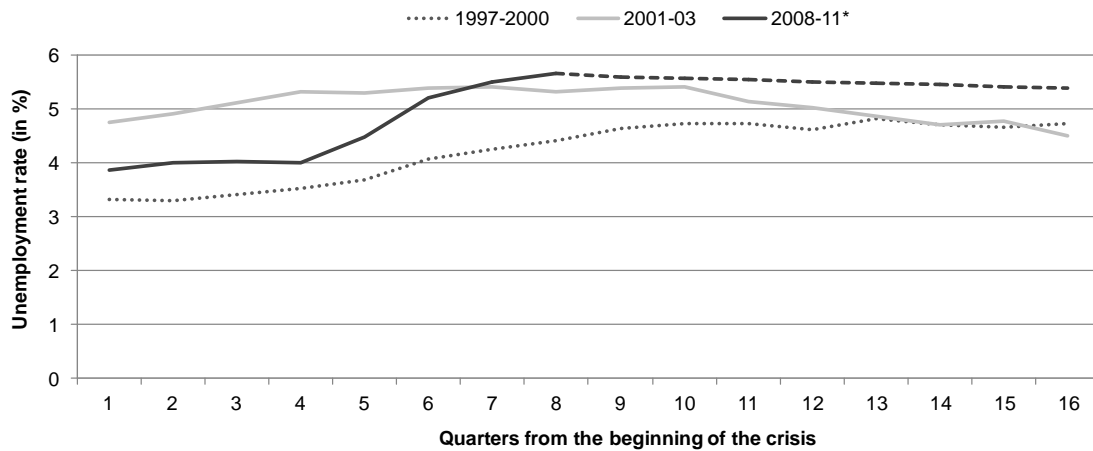
Regulatory reform has a long history in Japan, and was used extensively to help overcome the long-run economic stagnation of the 1990s (the so-called “lost decade”). The case study of Japan’s experience with regulatory reform in times of crisis focuses on regulatory reform responses to the external shocks of 1997 (Asian financial crisis) and 2001 (burst of the dotcom bubble and ensuing worldwide recession). In 1997, the Asian financial crisis caused several bank failures, which prompted the government to respond with a large fiscal stimulus to counter deflationary effects. After the worldwide recession at the end of 2001 however, the authorities relied more on regulatory reform for recovery.

Figure 9. Crisis episodes in Japan: Real GDP change from peak, quarters since the beginning of the crisis



For each crisis episode, the figure shows the growth of real GDP relative to its most recent peak. The “most recent peak” is defined as the value of real GDP in the quarter before the first two consecutive quarters of negative growth. The economy is considered to have fully recovered when the value of real GDP reaches the level of the previous peak. For Japan, the peak quarters before crisis episodes are Q1 in 1997, Q1 in 2001 and Q1 in 2008.

Source: OECD.Stat.

Figure 10. Crisis episodes in Japan: unemployment rate, quarters since the beginning of the crisis

This figure illustrates the evolution of the unemployment rate during recent crisis episodes. For an explanation of how the first quarter and the final quarter of each crisis episode have been defined, refer to the notes section of Figure 9.

Source: OECD.Stat.

United Kingdom

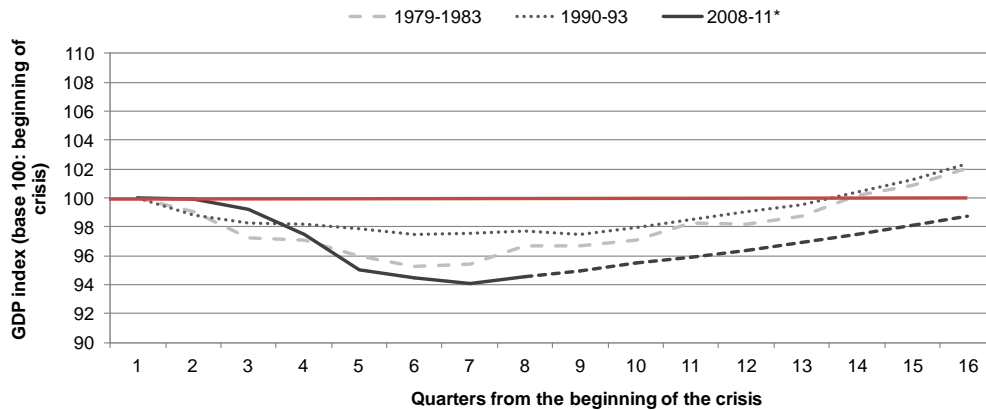
In the UK, GDP fell by close to 5%, compared to the OECD average of 4% from the first quarter of 2008 to the first quarter of 2009 (Figure 11). In terms of unemployment, the UK entered the crisis with a low unemployment rate of 5.3%, which rose to close to a current level of 9% and is projected to reach 10% in 2010 (OECD, 2009a).

It could be expected that the flexibility and resilience of the UK economy that have been fostered by the continued regulatory reforms engaged throughout the past 30 years will serve it well now and help the country recover from the current crisis. It is useful in this context to understand how regulatory reforms have helped the UK recover from previous crises. The most recent example would be the Exchange Rate Mechanism (ERM) crisis of 1992, where the UK ultimately had to withdraw from the ERM.

During the recession of the early 1990s in the UK, output fell only during the third quarter of 1990, thereby falling a quarter short of the usual definition for a recession. However, unemployment was much higher, peaking above 10% in 1992. As the ERM system fixed exchange rates within a certain range, the UK could not use expansionary policy as a recovery strategy. External shocks forced the currency out of the ERM later in 1992, leading to a depreciation which eventually proved to be beneficial by making UK exports much more attractive and thereby fuelling recovery. This recovery was impressive, as in 1994, real GDP growth was a solid 3.8%, with inflation the lowest in 27 years, and unemployment falling significantly. This balance of output growth and low inflation suggested that the UK was “at a benign phase of the business cycle”, that the widespread structural reforms launched in the 1980s had made the UK economy more flexible, competitive and less inflation-prone (OECD, 1995).

The ERM crisis did not directly result in specific or significant changes to the regulatory policy. Authorities instead pursued the reform efforts that had been underway prior to the crisis and which followed the broad and comprehensive deregulation of the early 1980s. As a result, the UK has acquired considerable regulatory experience and a strong capacity to assure high quality regulation. This highlights that regulatory reform is not a “one-off” exercise and must be pursued continuously.

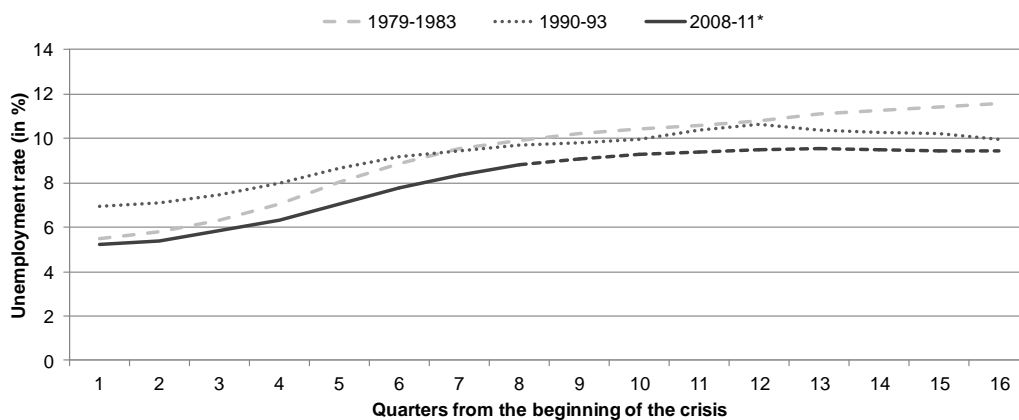
Figure 11. Crisis episodes in the UK: Real GDP change from peak, quarters since the beginning of the crisis



Note: For each crisis episode, the figure shows the growth of real GDP relative to its most recent peak. The “most recent peak” is defined as the value of real GDP in the quarter before the first two consecutive quarters of negative growth. The economy is considered to have fully recovered when the value of real GDP reaches the level of the previous peak. For the UK, the peak quarters before crisis episodes are Q4 in 1979, Q3 in 1990 and Q1 in 2008.

Source: OECD.Stat.

Figure 12. Crisis episodes in the UK: unemployment rate, quarters since the beginning of the crisis



Note: This figure illustrates the evolution of the unemployment rate during recent crisis episodes. For an explanation of how the first quarter and the final quarter of each crisis episode have been defined, refer to the notes section of the GDP Growth Graphs.

Source: OECD.Stat.

IV. Implementing regulatory reform

Regulatory reform can play an important role during crisis episodes. A well designed regulatory system facilitates market exit thereby helping to ensure that those firms exiting the market will do so with least possible damage to the sector as a whole. It also facilitates market entry and contributes to the economic recovery as new business opportunities reappear. Improving regulatory quality increases investors' confidence in the regulatory environment, and reducing regulatory constraints and burdens can speed up the rate at which stimulus packages can be channelled through the economy, as investment in major infrastructure may face regulatory hurdles.

This section presents an overview of the main regulatory reform responses to crisis episodes in each of the five OECD countries assessed, as well as the key lessons learned from the implementation of these reforms. The overview of reform responses and lessons learned draws on country-specific materials and the four detailed case studies of Japan, Korea, Mexico and the United Kingdom available in Part 2 of this study.

Overview of regulatory reform responses to crises

Korea

The 1997-98 crisis led to a wide-ranging and impressive programme of regulatory reform, spearheading important deregulation efforts as well as ambitious policies to improve regulatory quality and the cost-effectiveness of social regulations. The reform initiatives were supported by a strong commitment derived directly from the authority of the President, with the objective of a 50% cut in the number of regulations to set the scene. These reform initiatives were more ambitious and broader than the IMF requirements at the time, and helped foster change in attitudes within agencies and bring an end to the tradition of political intervention in the economy and business; this essentially had the effect of re-establishing government-business relations. A new Regulatory Reform Committee (RRC) was established to oversee the comprehensive deregulation programme with a mandate to address the large volume of low quality regulations which were hindering economic activity. The RRC also had to monitor the implementation of the government's regulatory policy; this was accomplished with the adoption of RIA in keeping with OECD best practices, sunset review mechanisms and an increase in transparency. A new growth model was established that shifted away from the previous corporatist model that allowed large companies (*chaebols*) to be more competitive and adapt to markets instead of having to rely on government support and regulation. Pro-competitive and pro-market reforms were accompanied by a strengthening of social safety nets.

In the context of the current crisis (2008-09), Korea has maintained its commitment to reform and introduced new reform programmes, including the "Temporary Regulatory Relief" (TRR) programme (May 2009). This programme suspends and delays for two years the application of 280 regulations; essentially until after the economy has recovered

from the crisis.⁵ The aim is to bolster private sector investment and consumption and to reduce the regulatory burden on small and medium enterprises. The TRR was launched to quickly address relevant issues in the context of the crisis, rather than wait for the three to five-year sunset reviews. Given the difficulties and political resistance to outright deregulation, the TRR is viewed by the Korean government as a workable surrogate mechanism. While it is early to assess the impact of the TRR, public support appears to be strong. Recent surveys have indicated that the appreciation (defined as the number of respondents “highly satisfied” and “satisfied”) for the government’s regulatory reform efforts has increased by 20%, from 29% in the first quarter of 2009, before TRR was introduced, to 49% in the second quarter, after its introduction. The TRR may also have had immediate impacts at the local level: an internal report prepared by the Provincial Government of Kyunggido, for example, estimates that because of the TRR programme, more than 20 investment projects, amounting to a total of KRW 150 billion (USD 120 million), have now been undertaken due to the lighter regulatory environment.

The crisis was generally seen as an opportunity for reform in Korea and reforms brought significant benefits. Generally, the Korean reforms in 1997-98 have increased FDI inflows, reduced compliance costs and administrative costs. It is estimated that the 1998 measures alone generated 680 000 jobs, mainly through increased inflow of FDI, which would have amounted to USD 27 billion. The measures also resulted in a cut of regulatory compliance costs by KRW 18 690 billion (USD 15 billion), which amounted to 4.4% of GDP in 1997, in addition to the government’s administrative cost savings of KRW 590 billion. The benefits of reform were high as the economic environment was highly regulated when the crisis started in 1997. There may however be diminishing returns to future target-based deregulation efforts (*e.g.* reduction of the number of regulations by 50% in 1997), as after the easy-to-spot problematic regulations have been repealed, it becomes more difficult to make such obvious progress.

Korean reforms in 1997-98 were supported by decisive executive leadership which strengthened credibility with both domestic and foreign investors. Strong leadership can provide more scope for governments to pursue broad policies and reforms that can lead to the best outcomes in terms of recovery and growth.

Japan

In the 2001-02 crisis that followed the dotcom bubble, regulatory reform became the main focus of the exit strategy as it was budget neutral. Indeed, the stimulus package for the 2001-02 crisis was small compared to previous crises in Japan. Overcoming weaknesses in the financial sector was a top priority for regulatory reform. Key measures included increasing the transparency of non-performing loans owned by banks through special inspections, and providing banks with wider options for dealing with non-performing loans such as easing debt/equity swaps. These measures had a positive net impact as the benefits from reducing the number of non-performing loans outweighed the costs related to some additional bankruptcies. Regulatory reform was used to strengthen the supply-side and reduce the economy’s output gap by limiting government control of demand and supply in quasi-markets. Economic regulations were not the only target of reform efforts; challenging sectors such as agriculture, health and welfare services, where government intervention was traditionally strong, were also targeted for reform. Given the strong resistance to reform in these sectors, innovative mechanisms were developed, such as special zones for regulatory reform. These special zones were experiments in decentralisation as they depended on initiatives by local authorities and not imposed by

national ministries, and did not involve any tax-waivers or subsidies. One may surmise that competition between local authorities to establish special zones would lead to more efficient outcomes than having the central government impose them on a political basis. Examples of special zones include allowing private corporations to manage agricultural businesses, flexible school management and more flexible fire regulations that account for technological change in the methods of preventing fires. These projects are just a few examples of regulatory reform that could not have been realised outside such special zones. The special zones are estimated to have increased private investment by 0.6 trillion yen and employment by 18 000. However, the interest in special zones seems to have dropped in recent years.

In Japan, the Cabinet office has estimated that regulatory reform has increased the consumer surplus by an accumulated increase of 18.3 trillion yen in 2005, which amounted to 5% of National Income for the 1990-2005 period. As a result, the aggregate contribution of regulatory reform to GDP growth has been estimated at 0.6% of GDP between 1997 and 2002, and 0.5% of GDP between 2002 and 2005. These are broad impacts of reform, and not necessarily those associated with reforms enacted during crisis episodes.

The Japanese experience shows that some changes may lead to political challenges, illustrated by the labour market, where partial deregulation is thought to have brought about increasing income disparities. Though this may be partly due to a misreading of the actual situation, a key element emerging from the policy debate may perhaps be the “unbalanced regulatory reform” which can lead to misallocation of resources through incorrect incentives. As an example, the public has been persuaded that the increasing number of temporary workers without the benefit of the public safety-net has been a result of so-called “excessive regulatory reform”. Though not unique to Japan, this trend illustrates the challenges of regulatory reform in a context where some societal groups enjoy specific protections. For example, the company-based labour unions are against expanding employment opportunities for temporary workers as an antidote to rising unemployment. Small firms oppose removing the barriers to entry of large firms as a policy response to increasing income disparity. Overcoming these challenges requires strong political leadership, as well as balancing all competing interests.

The Japanese example also illustrates the importance of considering a sufficient safety-net for the various categories of the unemployed, as part of a condition to create a common understanding and acceptance of reform. In Japan, many part-time or temporary workers are not originally covered under the unemployment insurance scheme, even if some reforms have been made to improve the situation.

Sweden

In Sweden, the 1990-94 crisis triggered a wide ranging policy response, including significant structural and regulatory reform efforts. These reforms were long overdue, as significant outputs gaps and lack of flexibility in the late 1980s had made adjustments to changing demand patterns more difficult. This was a major factor behind the recession and its longevity (OECD, 1994). As the crisis unfolded however, and given the very large budget deficits, comprehensive reforms were undertaken. Traditional monopolies were opened to greater competition, the competition law was strengthened, regulations governing the taxis, civil aviation, telecommunications, rail, postal services and electricity sectors were reformed, and the government maintained a strong policy of market openness. These actions, also helped by accession to the EU in 1995, led to a remarkable recovery. The OECD (2007) has estimated that the more flexible product

markets and increased competition made possible by regulatory reform delivered a considerable productivity dividend, estimated to have directly added 0.45% to annual productivity growth between 1988 and 2007.

With respect to the financial system, the early 1990s was a period where all major Swedish banks experienced a rapid increase in credit losses primarily due to the sharp fall in real estate prices. In the fall of 1992 the government and financial authorities became aware that the financial system was experiencing significant difficulties. By 1992 the government issued a general guarantee for the entire banking system. The guarantee was seen as a necessary measure to restore confidence in the banking system. However, it was not a promise to rescue stockholders. In return for financial support to the banks, the government demanded an equivalent share of equity. Eventually, two of the major banks, SEB and Handelsbanken, managed to get by without help from the government, but two other banks were nationalised (Nordbanken and Gota Bank) at a total cost of SEK 44 billion.⁶

The situation is different in the current crisis as the problems of the financial market are shared with the rest of the world. Sweden has not lagged behind in growth in the years prior to the crisis, and the public finances are in much better shape than in the nineties. Therefore, there is also the possibility to use fiscal policy to stimulate the economy. The extensive regulatory reform of the 1990s and early 2000s, completed before the crisis, suggests that Sweden may experience a good recovery of productivity growth and overall employment. However, there is still scope to develop the potential for self-employment and entrepreneurship, by further reducing the administrative and regulatory burdens on small enterprises. Indeed, lowering the threshold to self-employment can be an important ingredient in handling an economic crisis that may provide surprisingly large contributions to employment (Kreicbergs and Fölster, 2010).

Mexico

Many reform efforts were undertaken early on (prior to 1994), especially after the development of an explicit national regulatory policy under President Salinas in 1989. The 1994 crisis offered an opportunity to accelerate the implementation of previously-engaged reform programs and regulatory reform was central to the Mexican recovery strategy. There was a call towards broader programmes as opposed to selected targets that also tackled social and environmental as well as sub-national regulations. In the context of a budgetary crisis, regulatory reform was seen as the least fiscally demanding option in terms of public resources. In November 1995, Mexico launched a broad review programme for new regulations and existing formalities through the executive order Acuerdo para la Desregulación de la Actividad Empresarial (ADAE) (Agreement to Deregulate Business Activities). The ADAE gave the UDE (Mexico's Central Regulatory Oversight body, currently named COFEMER) greater review powers, created an Economic Deregulation Council (CDE) and, most importantly, established an oversight process for new regulatory proposals and existing formalities. The goal was to limit bureaucratic discretion, and to reduce uncertainty in commercial transactions due to obsolete laws, enhancing the transparency of the regulatory process. At the same time the administration also launched a co-operative programme to help states and municipalities improve their regulatory frameworks.

As a result, a full catalogue of federal official procedures was established to make an inventory of all requirements that businesses had to comply with. This also helped to review and simplify these procedures. Other measures to deal with the 1990s financial crisis included bank restructuring, increasing the role of stronger foreign competitors in the market. The competition authority, the CFC, resisted arguments that anti-competitive combinations should be permitted, notably in airlines, due to the financial distress of the implicated parties.

On the whole, reforms in Mexico illustrate a strengthening of the commitment to reform, which evolved from a one-off exercise before the crisis to a systematic and permanent review process after the crisis. The pace of reform was challenging and the ADAE was a very ambitious programme. Measures implemented by the ADAE, including the introduction of RIA in draft regulations, helped change the administrative culture, promoted transparency, decreased the number of cases of administrative discretion and increased assurance of the rule of law. This contributed significantly to the expansion of the private sector, which by the end of the 90's contributed nearly to 90% of the GDP.⁷

United Kingdom

In the UK, the only other recent significant crisis which could be compared to the current one is the exchange rate mechanism (ERM) crisis of 1992, which did not lead to substantial regulatory changes, with the exception of pulling out of the ERM. A case can be made that the UK regulatory system, especially in the financial sector, has been relatively untested to this day. Given this situation, the study of the UK has focused on the response to the current financial and economic crisis as the UK was one of the first countries to experience it. Most lessons learned are derived from the responses to the current crisis to date.

A first aspect of the UK's experience is the fact that the legislative process has allowed rapid and radical change in a way that has contributed to strengthened consumer confidence. The inherent majority of the government in Parliament allows for bills that can be passed very rapidly. Further, the ability of ministers to use statutory instruments and other orders means that they can act first and inform Parliament second as there is a requirement to bring these before the Parliament at some point. The clearest example is the Banking (Special Provisions) Act 2008, which was passed within three days. In addition, many of the actions with respect to the banking system can be executed by administrative order.

The UK experience shows that by choosing a straightforward approach to resolving the current crisis, the UK authorities have maximised the chance that it will be short lived. This would be a positive outcome as short sharp recessions tend to be less costly in the long run than shallow protracted ones. Part of the ability to respond to shocks depends on flexibility – the ability to switch resources across sectors, both in terms of capital and labour markets. This is a prominent feature of the UK system.

Another aspect of the recent crisis is the need for cross border co-operation, given the spillovers across countries in the EU, and beyond, for example in Iceland. Not only were the Icelandic banks too big for the home country to cope with deposit insurance costs, but under the EU's home-host rules the UK had serious difficulties in retaining stability. This had to be followed by joint EU action to be resolved. More generally, for reform to be effective in an internationally competitive and mobile industry such as finance the major ingredients need to be agreed to at the international level.

The UK's institutional system was well placed to act swiftly. Given the small number of institutions involved it was also able to ensure internal co-ordination. However, what the crisis made clear is that agreements, such as memorandum of understanding between institutions, cannot really be tested in so called normal times. It takes a crisis to test them. Another challenge for the future is that the way in which actions are implemented is difficult to institutionalise, given staff changes over time; a degree of learning by experience is inevitable.

An issue highlighted in the context of the crisis is the forbearance by the supervisory authorities. The consequences for supervisors of intervening unnecessarily tend to be viewed as having higher consequences for them than from intervening too late and imposing higher losses as a result. This is an issue of incentives, which is difficult to rebalance. The UK also mostly chose to fix operational rules and tools rather than modify the institutional framework itself.

Implementing regulatory reform: summary of lessons learned

Crises are opportunities for reform...

In most of the countries studied, governments have tended to view crises as an opportunity to reform. In Korea, the crisis offered a window of opportunity as it justified a comprehensive restructuring. During the 1994-95 crisis, the Mexican government took the opportunity to introduce a clearly articulated and far-reaching program of regulatory reform that simplified and eliminated business formalities, and paved the way for the widespread employment of RIA analysis for most federal draft regulation. Clearly, the crisis created a state of shock which facilitated bolder reforms.

Crises represent an opportunity to pass reforms that would not otherwise have enough support and that suddenly become possible given the heightened sense of urgency. At the very least, crises represent a time to discuss reforms and options for moving forward by bringing together important stakeholders because they often facilitate consensus around what reforms to undertake. As an example, despite severe hardships, countries like Iceland are also recognising the opportunities involved in re-launching the economy and rethinking the basis of their prosperity, in part through a higher emphasis on better regulation.

A crisis is an occasion to “test” institutions and regulatory environments. Countries that have best used past crises to push tough reforms and introduce more robust systems have fared better in the current crisis than countries that did not, or did not experience similar crises in the past. However, the “vaccination effects” of reform introduced in past crises tends to fade away with the gradual loss of knowledge and expertise, and with rotation of government staff. This highlights the need to preserve reform as a continual process and to maintain capacity to learn from past crises.

There are also other examples of countries that have taken advantage of crisis episodes to introduce comprehensive regulatory reform, besides the five countries assessed in this study. Turkey is such an example – the country experienced a severe economic crisis in 2000-01, which revealed extensive weaknesses in Turkey's regulatory system, including an ineffective regulatory framework that led to the banking crisis and eventually huge welfare losses (OECD, 2002b). Regulatory reform was seen as a crucial exit strategy, both in the ailing banking sector and throughout the economy. As such

Turkey embarked on a very ambitious regulatory reform programme, including the creation of several independent sectoral regulators, the adoption of regulatory management best practices such as increased transparency and the strengthening of the mandate and institutional capacity of the banking sectoral regulator, the Banking Regulation and Supervision Agency (originally established in 1999) (Banking Regulation and Supervision Agency, 2009 and OECD, 2002b). Similarly to what Korea and Mexico experienced, the consequences of the crisis increased awareness of the importance of reform, as well as support for it, and led to a very strong recovery. While initially the reform programme lacked central oversight and a coherent, strong political leadership, it proved a much more successful effort than the reform programme of 1999, which had failed to address problems and regulatory deficiencies in the banking sector. Indeed, in 1999 and 2001, the economy shrunk by 3.5% and 6% in real terms (OECD.Stat, Quarterly National Accounts), but once the comprehensive regulatory reform programme took hold after 2002, growth picked up strongly, averaging an impressive 6.3% per annum in real terms over 2002-07.

Decisive political leadership is essential for success

Decisive executive leadership and the government's willingness to undertake structural reforms in the face of external shocks can play a critical role in establishing credibility with both domestic and foreign investors. This can provide more scope for governments to pursue sound macroeconomic policies that can help recovery.

This was clearly the case in the Korean and Mexican reforms which were articulated and supported at the highest political level. This was also clear in Japan when reforms were pushed through during the period of the Koizumi government. This political support is essential if reforms are to overcome the pressures arising from special interests.

Regulatory reform brings many benefits...

Regulatory reform benefits were significant for the countries studied. Successful regulatory reform programmes led to increases in FDI inflows, productivity growth, consumer surplus and a reduction in compliance and administrative costs. In Korea, the impact of the 1998 reforms was estimated at 680 thousand new jobs, about half of which can be attributed to the increased inflow of FDI which amounted to USD 27 billion at the minimum. The reforms were estimated to have reduced regulatory compliance costs by KRW 18 690 billion (USD 15 billion), which amounted to 4.4% of GDP in 1997, in addition to the government's administrative cost savings of KRW 590 billion.

In Sweden, productivity growth accelerated from 1.2% annually in 1980-1990 to 2.2% between 1991 and 1998. Sweden thereby went from a low labour productivity growth by international standards to a relatively high growth. Empirical evidence gathered by the OECD suggests that regulatory reform in Sweden since 1988 has directly added 0.45% to annual productivity growth, and more if indirect effects are taken into account (OECD, 2007).

In Japan, the effects of regulatory reform were estimated to have increased consumers' surplus by 18.3 trillion yen in 2005 or 5% of National Incomes, for the 1990-2005 period. The aggregate contribution of regulatory reform to GDP growth has been estimated at 0.6% of GDP between 1997 and 2002, and 0.5% of GDP between 2002 and 2005. These are broad impacts of reform however, and not necessarily those associated with reforms enacted in crisis episodes.

In Mexico, the expansion of the private sector was another benefit of reforms. The improvement of public accountability, the promotion of a government culture of transparency, the reduction of administrative discretion and the assurance of the rule of law, contributed significantly to the expansion of the private sector, which by the end of the 1990s contributed to nearly 90% of the GDP, higher than the ratio for many OECD countries.

... but these benefits are diffuse and not always seen immediately

Among the other lessons that can be drawn from the implementation process of regulatory reforms in Sweden during times of crisis, is that the benefits of the reforms are not visible immediately. It is crucial that solid political groundwork precedes regulatory reforms. Favourable public opinion and vigorous support is necessary to sustain reform efforts. A high level of social protection can also contribute to the acceptance of reform by the workers, as has long been the case in the Nordic countries, such as Sweden.

In Korea, a clear public perception of the benefits of reforms, with a rapid recovery from the 1997-98 crisis helped to maintain support for regulatory reform. Clear benefits such as free trade and access to previously difficult to obtain luxury products (*e.g.* high-quality wine) has also had a direct impact on the public consensus.

Conversely, benefits were probably less directly visible in Japan due to a protracted recovery, which did not help to mobilise public support for reforms.

Benefits of regulatory reform are significant in highly regulated environments but further reforms yield diminishing returns

The level of the benefits also depends on the regulatory baseline. In highly (or poorly) regulated economies, the direct benefits of regulatory reform can be significant. However, once the “low-hanging fruits” have been picked, further reforms, and especially those targeting reductions in the number of regulations, may bring diminishing returns.

Korea is a prime example of the big yields that significant reforms can bring when economies are strapped with command-and-control economic regulatory environments. Several improvements in terms of regulatory quality included a new regulatory oversight system, reinforced by mandatory registration of regulations were implemented in Korea. This, combined with broad structural reforms in the financial and corporate sectors, is likely to have played an important role in the ensuing quick and strong recovery, although this is difficult to quantify.

Similarly, further reforms may yield more marginal results, as was the case with the pronouncement regarding “cutting the number of regulations by 50%” in Korea. Once the easy-to-spot problematic regulations have been addressed, it becomes harder to make progress. The role of reform then turns more towards ensuring the quality and coherence of the system and avoiding regulatory creep. Setting targets may still be important in helping garner crucial public support, which is essential as a counterweight to special interests. Proper regulatory reform helps change the attitude of government officials toward regulations and their tendency to rely on regulations excessively in the name of administrative efficiency in particular.

A prolonged period of uninterrupted growth may lead to overestimating the productivity gains that will continue into the future

The case of the UK illustrates this tendency towards over optimistic projections. The 1992 ERM crisis was not accompanied by substantial regulatory change as the focus was only on the exchange rate. However, in other respects the entire economic cycle that took place up to the downturn in the early 1990s was the consequence of the huge regulatory changes of the post 1979 ‘Thatcher’ era in the UK. Once the harsh consequences of the initial shakeout were complete in the early 1980s, the economy enjoyed more than six years of uninterrupted growth and faced the usual dilemma for the authorities in such circumstances. To what extent was the growth simply catching up for the earlier losses and then moving into territory where it was not sustainable from the momentum? Or was it the result of a change in the fundamental sustainable rate of growth caused by the massive deregulation that led to a permanent increase in the rate of productivity growth? The risk is that governments in the UK and in other countries overestimate the extent to which a prolonged period of uninterrupted growth is the result of productivity gains that will continue into the future. While the major deregulation efforts of the 1980s had positive impact, it is clear that the productivity surge was over by the time of the crisis in 1992.

Regulatory reform in the non financial sectors continued through the period of the ERM crisis and through the economic downturn that preceded it in the UK; these extended to electricity in 1990, Gas in 1991; and telecommunications following the 1991 review. Reform of the rail monopoly followed in 1994-95. After the 1992 crisis, the economy continued to enjoy relatively strong growth and productivity gains, which may have led to overoptimistic anticipations over the 2008-10 crisis.

Broad public support is essential for successful reform implementation, and the transition costs of reform should be considered by governments

Public support was instrumental to Korea’s success with regulatory reform in 1997-98. The case of Korea is an interesting example of how the government was able to make a sufficiently strong case for regulatory reform and how collectively the public saw that the benefits of reform outweighed the costs. In Sweden, regulatory reform programmes also benefitted from strong public support, and were facilitated by agreements with the Unions which supported these reform efforts in exchange for adequate worker protection.

The transition costs of reform are not insignificant: efficiency and productivity gains can lead to a temporary increase in unemployment, as production shifts to different economic sectors. It is important that these transition costs be considered by governments as they can undermine public support if left unchecked.

An example of how reducing transition costs can strengthen public support for reforms can be found in Sweden. In Sweden, the presence of strong safety nets for workers and adequate compensation for the unemployed meant that Unions were much less inclined to oppose regulatory reform than in other countries, where perhaps safety nets were not developed as much. This regime where the labour market is flexible, yet workers can benefit from adequate compensation should they be temporarily unemployed as a result of reforms proved instrumental to the implementation of regulatory reform.

In contrast, Japan faced a growing difficulty in bringing the message of regulatory reform to voters in the 2000s, in particular in terms of the labour market, as some deregulation efforts created a public perception that these reforms were the cause of increasing income disparities. In addition to considering the transition costs of reform, this policy debate also highlights the importance of ensuring that reforms are not partial or unfinished, as this can create biased incentives. In Japan for example, temporary workers' regulation was reformed, while that of permanent workers remained unchanged. This stimulated the demand for temporary workers by firms because they now had fewer protections than permanent workers, and led to an increase in the ratio of temporary to permanent workers. At one point, more than 30% of all employees were temporary. This created a public perception that the increasing number of temporary workers without public safety-nets was a result of so-called "excessive regulatory reform". Whether legitimate or not, this perception undermined support for further reforms.

Removing rents through reform can lead to significant political pressure

Regulatory reform and open-market policies are key to stimulating competition. However, stimulating market access and eliminating regulatory protections also results in the removal of the rents previously granted to particular groups through regulations, as is the case for example in the taxi industry. Similarly to trade liberalisation, the benefits of regulatory reform are at the economy-wide level, while the costs are concentrated on particular groups which may be well organised and wield significant political power. Thus, clearly articulating and communicating the benefits of reform through credible, quantitative evidence is important to overcome political pressure and increase public support for reform.

The fiscal position may influence the decision to choose regulatory reform as a strategy for recovery

Regulatory reform is an attractive proposition from a fiscal point of view as it is generally not very costly to administer and can deliver large savings for the government, as well as stimulating recovery and growth by allowing for a more flexible regulatory environment. As such, regulatory reform could also be a crucial recovery tool for many OECD countries which do not have much margin left for fiscal intervention, and which are struggling to find new and reliable means of fuelling growth in a competitive global environment.

During the crisis of 1992-95, Sweden was in a challenging fiscal position, and chose regulatory reform as a central strategy for economic recovery. Sweden was less exposed in the 2008-09 crisis and also had a much better fiscal position at the beginning of the crisis. In 2008-09, automatic stabilisers provided a major part of the stimulus needed for recovery, and while the government took other measures to stimulate the economy⁸, in terms of regulatory reform these were not as comprehensive as in 1992-95.

The 2008-09 crisis has also focused attention on the financial sector, and less on measures to increase labour supply. While the economic potential for regulatory reforms that remove obstacles to self-employment and increase flexibility in the labour market are large, they are politically much more controversial. This may explain the different policy mix in terms of government interventions during the 2008-09 crisis.

V. Supporting competition

Aspects of competition policy play an important role during crises. Common questions to be addressed for this study include, if competition enforcement was relaxed during crises, did relaxation delay recovery? Did governments seek or choose the least anti-competitive measures to respond to crisis conditions? The application of competition policy and the role of competition authorities are considered here with respect to dealing with cartels, mergers and acquisitions and temporary measures such as government aid and subsidies, drawing on country specific materials, including the case studies available in Part 2.

Crisis conditions have been an occasion to strengthen competition policy, not to postpone it

Crisis conditions do not necessarily relax pro-competitive reform. On the contrary, several of the countries examined maintained the pace of reform despite the crisis, confident that the long run reform strategy was sound.

In Korea, responses to the 1997 crisis showed an increasing willingness to rely on the market to correct business failures and to drive growth. The failure of one of the largest *chaebols*, Daewoo, marked an end to the “too big to fail” policy for the biggest *chaebols*. This signalled that decisions on market entry and exit would be left to markets and thereby increased the credibility of the competition regime. Korea’s competition authority, the Korea Fair Trade Commission (KFTC), has worked to eliminate monopolistic and anti-competitive behaviour, especially where that was encouraged and protected by political and bureaucratic influence. This led to actions in Korea on the following issues:

- Cartel exemptions: The breadth of competition policy, and its increasing acceptance as a central principle, was confirmed by the Omnibus Cartel Repeal Act in February 1999 which removed legal exemptions for 20 cartels under 18 different laws. Two problems remained: small businesses protection and inconsistency between the KFTC and sectoral regulators.
- Horizontal restraints: These are usually considered the most serious and difficult competition issue in developed economies. Korea’s basic competition law, the Monopoly Regulation and Fair Trade Act (MRFTA) was amended to erect a stronger presumption against them, and enforcement attention shifted toward horizontal issues. Over time, this led to a significant increase in the sanctions against horizontal restraints (OECD 2000).
- Merger control: This is a potentially important KFTC tool in the process of chaebol restructuring; however, the KFTC encountered some industrial-policy challenges in addressing the “big deals”, some of which appeared to create dominant positions in the Korean market. The “failing firm” doctrine was added to the MRFTA in 1999; it was invoked to permit the combination of Hyundai and Kia.

Interventions were not limited to the field of competition law. Principles of market competition were also integrated into other important policy regimes, notably in the financial sector and corporate governance, and drove reforms to open markets to trade and lower barriers to foreign investment.

In Mexico, both the mid-1990s financial crisis and the current crisis have been occasions for the government to move to strengthen the basic competition law and enforcement. Measures to deal with the 1990s financial crisis included bank restructuring. This resulted in a more concentrated domestic market but also, and more importantly, introduced stronger foreign competitors into the market. The competition authority, the CFC, resisted arguments that anti-competitive combinations should be permitted, notably in airlines, because of the parties' financial distress.

In Sweden, the contribution of product market deregulation of the early 1990s to the recovery of the economy has been substantial. Some recent work (OECD, 2007b) shows that product market reform has added 0.45% to annual productivity growth since the early 1990s. Further reforms in the 1990s across a range of sectors removed barriers to market entry, dismantled price regulations and abolished controls on the number of market players. This, combined with stronger competition legislation and improvements to regulatory quality and market openness, has allowed the Swedish economy to become one of the most liberalised in the OECD at that time, as evidenced by the 2003 Product Market Regulation Indicators (OECD, 2007b).

Some of the pro-competitive reform measures that were undertaken during the 1991-94 crisis in Sweden include:

- Removal of price and entry regulations in the taxi industry in 1990: this led to drastically lower queue times during busy periods (Holmlund and Muren, 2002).
- Deregulation of domestic civil aviation (July 1992) and telecoms (1993 Telecom Act).
- Deregulation of rail passenger transport and postal services in the early 1990s.
- Deregulation of the electricity market.

On top of national regulatory reform efforts undertaken prior to 1995, the accession of Sweden to the EU in 1995 also had some implications for existing regulatory frameworks. In many cases, such as postal or rail services, reform in Sweden was already further along than the EU. Nevertheless, EU accession brought Swedish standards into harmony with EU-wide standards, which also contributed to Sweden's recovery.

In Japan, stronger competition law enforcement is a long-term trend, which has not been tied to crisis conditions or response, except indirectly. Antitrust enforcement was gradually strengthened during the decade following the bursting of the housing and assets bubble of 1991. That trend has continued, as the JFTC's budgetary and human resources are in an upward trend despite the recent political movements seeking smaller governments.

Cartel enforcement is no longer postponed in recession conditions

Exemptions for output-restraining cartels during depression conditions are now rare; decades ago, these exemptions were more commonly granted. Instead, the tendency is to make cartel laws even stronger. To achieve a per se effect, the relevant language of Korea's MRFTA was changed in 1999, from "substantial" restriction to "unjustified" restriction. An internal guideline about surcharge levels lists nine kinds of cartels, from hard-core cartels (4) to less serious ones (5). Since 1999, the KFTC has not approved (that is, exempted) any cartels. The KFTC's guidelines about collective action warn that conduct which is not grounded on legislative authority risks violating the MRFTA, and the KFTC has taken corrective measures against agreements in beer, pesticides and property insurance that the parties had claimed were authorised by administrative guidance (OECD, 2004).

This temptation has not disappeared. In theory, Korea's law still enables depression cartels, so "cartel activities that have been pursued to overcome an economic downturn may be allowed". Recently the KFTC stated that some competitors could be allowed to form cartels, provided that this did not result in direct price-fixing. Nevertheless, the KFTC has never exempted a depression cartel until the current crisis.

Application of "failing firm" doctrines must preserve long-term competition

Government-led resource allocation, in terms of directing business swaps and mergers and acquisitions may slow recovery. Responses to the 1997-98 crisis in Korea differed from best practices in terms of failing firm doctrines and merger control. The government took an active role in deciding which activities and businesses would be merged. This introduced distortions that may have slowed recovery (Lee, 2004, 2009).

In Korea, the major restructuring intervention was named the "Big Deals". The five biggest *chaebol* conglomerates were encouraged to swap assets in eight key industries. While ostensibly the reason was to reduce chronic excess capacity, the effect was also to establish more concentrated industry structures (Lee, 2004). That condition may lead to future competition problems that would be more difficult for the KFTC to deal with. For example, the KFTC approved Hyundai Motor's acquisition of shares of Kia Motors in April 1999, because it determined the latter company as a non-viable firm. After the merger, their combined market share has stayed well above 70%, raising concerns about the health of competition in the sector, especially in the small car segment, for which there is less foreign competition. The Big Deal solutions raised lingering concerns about the neutrality and role of the state and the credibility of a policy of moving to a market based economy (OECD, 2000). Lee (2004) contends that as of 2001, the Big Deals had failed in terms of economic performance. Most of the newly merged businesses were in dire financial straits or had failed to return any profits or attract foreign investment.

Other, more competition-friendly measures and strengthened antitrust enforcement following the 1997 crisis reflected a will to establish a competitive market structure, which according to Ik Son (2009) led to booming exports and an advanced IT industry.

In financial sector crises, stability is a key parameter of governments' decisions

In the UK, the merger of Lloyds-TSB and HBOS in September 2008 was not assisted *per se*, although the government was pleased to see it take place. The merger was permitted by the Secretary of State on the newly legislated public interest ground of maintaining the stability of the UK financial system.⁹ The OFT produced a report setting out its concerns about its impact on competition. The OFT was given a month to report on whether the merger would be expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services. The OFT made the case that there was a realistic prospect that the anticipated merger will result in a substantial lessening of competition in relation to personal current accounts (PCAs), banking services for small and medium sized enterprises (SMEs) and mortgages, at the national (Great Britain, Scotland) and local level.

The OFT's report and concerns regarding the potential anti-competitive impacts of a merger were balanced against the policy objective of financial stability. The Secretary of State allowed the merger on the basis of financial stability, which eventually took place in January 2009. This has further increased concentration in the financial sector, and may lead to calls for divestment from EU authorities. Divestment may be required so that even large banks can be resolved effectively, and that none are too big to fail.

Government aid and subsidies for short-term rescue that distort competition must be unwound promptly

As state aid can delay exit of marginal firms, it is likely to distort allocation of resources. In Korea's battle against the current crisis, the government is considering giving direct financial aid to the automobile, semiconductor and other industries. This approach should be taken with extra care for its potential anti-competitive effects (Ik Son, 2009). In 1991-92, Korean banks were nationalised. Ito (2009) argues that nationalisation was an appropriate response and that the exit from nationalisation is more important from a competition policy perspective than actual occurrences of nationalisation.

VI. Increasing market openness

The section on market openness focuses on how regulatory reform can keep markets open during crises, and the role played by trade policy in the design and implementation of exit strategies. Specific aspects for investigation included whether restrictive measures had been put in place (both on trade and investment) and if so, a description of their impact on trade flows and on the recovery. Insights were obtained on whether there was significant political pressure to implement protectionist regulations and how they were dealt with. The issues of national champions and export credit measures also were to be addressed.

The goal of the discussion is to assess the overall contribution of trade and trade policy to crisis recovery and enhanced economic resilience and compare the past strategy in terms of trade policy to the response to the current crisis. The key lessons learned are provided below, while detailed country responses in terms of trade policy are discussed in Part 2.

Strong trade linkages serve as a transmission mechanism during crises ...

Experience from past, as well as the current crisis shows that the strengthening of trade linkages leads to a higher synchronisation of business cycles. This means that a recession in one country can be transmitted to trading partners more easily, but also that the links to partners in expansion can help a country recover and grow again. A similar phenomenon can be observed as regards FDI flows, with important FDI inflows occurring during expansions and significant FDI outflows occurring during recessions. The empirical evidence on the intensity of this business cycle synchronisation abounds (Chiquiar and Ramos-Francia, 2004). The fact that by end-2008 more than 90% of OECD countries simultaneously recorded trade reductions was an important factor explaining the unprecedented magnitude of world trade collapse during the current crisis. Likewise, global FDI has fallen sharply since the onset of the crisis (14% in 2008 and a forecast of 30-40% in 2009), despite the fact that only a few FDI restrictive measures seem to have been taken worldwide. OECD(2010)

... leaving economies more vulnerable to external shocks ...

Strong trade linkages with partners in recession serve as a transmission mechanism of the economic slowdown. This is precisely what has happened to the Mexican economy in the current international crisis, since the strengthened post-NAFTA trade linkages between the Mexican and the US economies have made the Mexican economy more vulnerable to US shocks. For example, Sosa (2008) estimated that the correlation coefficient of the Mexican GDP to the US GDP is about 0.8, and that this positive correlation is even higher when Mexican GDP is analysed with respect to US industrial production (0.85). The higher synchronisation between the business cycles of the Mexican and US economies means that US output shocks have a much more powerful influence on the evolution of the Mexican economy. Sosa (2008) has also estimated that an increase in one percentage point in US industrial production growth would typically

imply an increase of 0.9 percentage points in Mexican GDP growth. This strong influence of the US economy on the Mexican business cycle has been mainly observed during the post-NAFTA period. At the same time, a lower amount of FDI inflows into the Mexican economy has had a severe impact on the domestic business cycle, since it has been observed that FDI flows from the US to Latin America have been highly pro-cyclical (IMF, 2009a).

The current slowdown of the Mexican economy seems thus to be a direct consequence of its high synchronisation with the US business cycle deriving from significant trade and investment linkages between these two countries. Likewise, the relatively open trade and investment framework prevailing in Sweden and the UK has contributed in transmitting the slowdown, even if the effect was not as marked as in the case of Mexico. In the UK, the extent of the integration of international financial services, which has been one of the main growth areas in the period between the 1992 ERM (European Exchange Rate Mechanism) and the current crisis, has led to the extent of the present crisis, first in exposure to the problems in the United States and second in exposure to the Icelandic banks. In response to the crisis, the Financial Services Authority (FSA) has been very active in discussions at a European level to find a solution to the problems with the European single market in banking, whereby host state regulators have very little regulatory power over the activities of foreign banks' branches, instead relying on the home state regulator. The FSA has suggested that a potential solution may lie in obliging banks that wish to operate in the UK to set up a standalone subsidiary, which could be regulated by the FSA, and required to satisfy its own capital and liquidity requirements. Some of the gains from such a solution would of course be offset to some extent by losses to efficiency, as global banks would have less ability to distribute capital around the group as they saw fit.

... but also enabling quicker post-crisis economic recovery and growth ...

As the recovery of the Mexican economy in the aftermath of the 1994-95 financial crisis shows, trade liberalisation can be an important driving force for economic recovery and growth, particularly in contexts in which main trading partners are on economic expansion. A similar impetus was experienced in other reviewed countries, such as Sweden and Korea.

There is no doubt that trade liberalisation via NAFTA,¹⁰ which occurred practically at the same time as the 1994-95 crisis, had a positive impact on Mexico's growth performance in the aftermath of the crisis. For example, exports of goods and services increased from USD 74 billion in 1994 to USD 126 billion in 1997, an increase of 70.3% in only three years. It is true that this substantial increase is due to trade liberalisation but it should not be forgotten the important role played by the real depreciation of the currency also observed during those years. Given the importance of NAFTA for Mexico, the Mexican government was prompted to emphasise its strong commitment to trade liberalisation and pro-market policies in the aftermath of the crisis. For example, several limitations on foreign ownership of financial institutions were eased after the financial crackdown in order to send a signal to the market that the Mexican government was fully committed to free trade and financial liberalisation reforms. The aftermath of the 1994-95 financial crisis was then characterised in general by free trade policies, notwithstanding the increase in import tariffs that Mexico implemented for non-NAFTA countries. Export credit measures were also practically unnecessary, since the drastic depreciation of the exchange rate left Mexico better positioned to take advantage of its trade liberalisation policies.

Covering a longer period of time, Mexico's exports to the United States and Canada more than doubled in dollar terms between 1993 and 2002 and Mexico's trade —sum of exports and imports— with NAFTA partners rose from 25% of the GDP in 1993 to 51% in 2000. Another interesting indicator of the impressive increase in trade observed in the aftermath of the crisis is that, during the period 1993–2002, the increase in total world exports in dollar terms was roughly 75% whereas the increase in Mexico's exports was around 300% (Kose, Meredith and Towe, 2004). This increase in trade was not only NAFTA-specific, since Mexico's trade with non-NAFTA countries increased almost threefold during 1993–2002. The following table shows some of the impacts that trade liberalisation in the aftermath of the 1994-95 crisis had on the Mexican economy.

Table 2. 1994-95 Crisis recovery indicators, Mexico

Period	Average export growth rate	Average import growth rate	Average trade openness	Average GDP growth	Average investment growth
Pre-NAFTA (1980-1993)	7.4%	5.8%	32.0%	2.2%	0.1%
Post-NAFTA (1994-2002)	12.9%	11.6%	58.2%	2.9%	4.3%
Crisis-Adjusted (1996-2002)	9.7%	14.0%	61.0%	4.0%	8.5%

Note: Trade Openness is defined as Exports + Imports as a percentage of GDP.

Source: Kose, Meredith and Towe (2004).

The average rate of growth of exports increased from 7.4% during the period 1980-1993 to 12.9% during the post-NAFTA period —and hence, the post-crisis period. The table also shows a much more interesting indicator: the average GDP growth observed during these two periods. The average rate of growth of GDP in the aftermath of the crisis was significantly higher, particularly when the critical years of 1994 and 1995 are excluded from the sample. Of course, a fraction of this GDP increase can be attributed to trade openness, but not entirely.

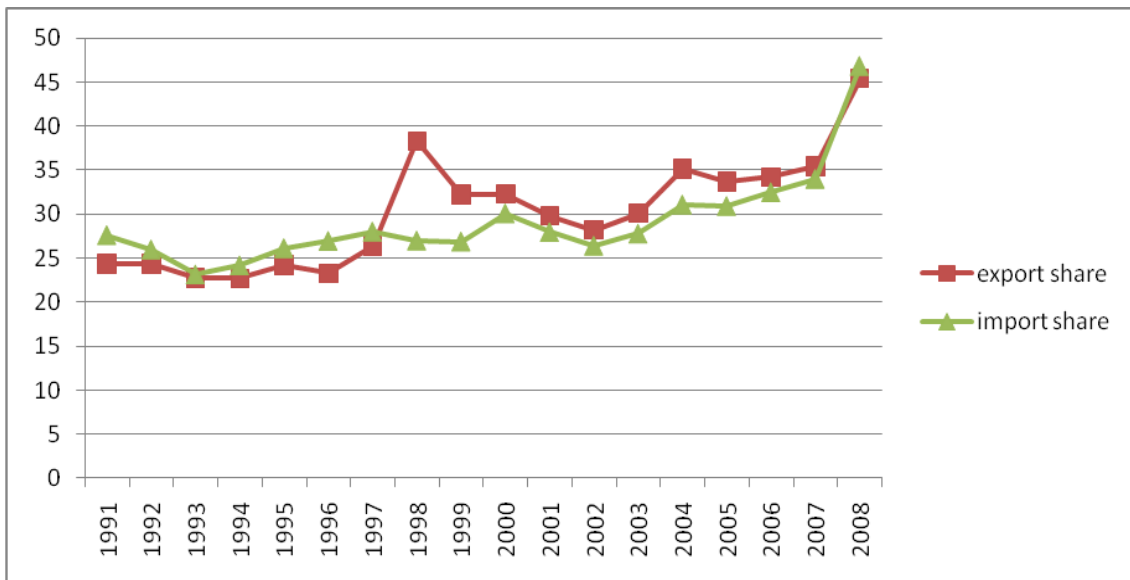
The most important question is to what extent trade policies implemented in the aftermath of the 1994-95 crisis have been a relevant factor to improve the long-run growth prospects of Mexico. Kose, Meredith and Towe (2004) have found that the contributions of exports and investment to GDP growth in Mexico have doubled since 1994. For example, while the contribution of investment (exports) was less than 0.5 (1.5) percentage points before NAFTA, it went up to 1.5 (3.0) percentage points during 1996–2002. Other studies have also found that trade policies via NAFTA had an important impact on the performance of the Mexican economy. Kouparitsas (1997) argued that trade policies since 1994 increased Mexico's steady-state level of GDP by 3.3%. In a related study, Arora and Vamvakidis (2004) concluded that half of the increase in Mexico's growth during the second half of the 1990s was attributable to the growth performance of its NAFTA partners.

The implementation of market openness policies in Mexico was particularly important to speed up the process of economic recovery, as it is clear that the speed of recovery was much faster during the 1994-95 crisis than during the 1982 crisis, in terms of GDP growth (see Figure 5, on page 26). Since one of the core differences between the public policies implemented during these two crises was the degree of trade openness, then a fraction of this 'speed up effect' can be attributed to the implementation of free trade policies. Based on these lessons, the Mexican government has continued

implementing trade liberalisation measures notwithstanding the current international crisis. On December 24th 2008, the government published a decree that reduces exports and imports tariffs as a part of an extensive programme of foreign trade simplification. In particular, this measure has implied a reduction in average tariffs from 10.4% in 2008 to 8.3% in 2009. The goal is to reach an average tariff of 4.3% by 2013. The programme has also planned to reduce the tariff dispersion from 9% in 2009 to 6.4% by 2013.

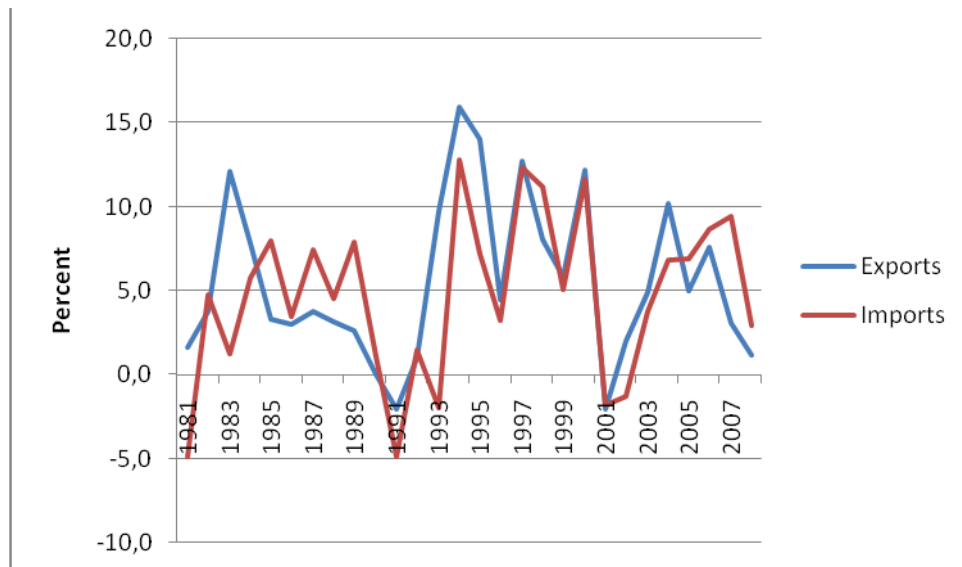
In Korea, the steep increase in exports contributed greatly in the process of recovery from the crisis in 1998-99. As shown in Figure 13, the share of exports in GDP increased to 38.3% in 1998 from 26.4% in 1997, helped also by the significant weakening of the Won. A similar phenomenon is observed in the current crisis, where the share of export and import reached historic levels of 45.4% and 46.8% in 2008, respectively.

Figure 13. Trend of trade dependence of Korea



Source: www.kita.org.

In Sweden, the recovery in the middle of the nineties was also made possible as a result of increased trade. Although the fall of the Swedish Krona led to a rapid increase in Swedish net exports, it is important to notice that the growth of net exports was not due to a slow development of imports. Instead, both exports and imports grew much faster than during the eighties.

Figure 14. Yearly growth of Swedish exports and imports

Source: National Institute of Economic Research, Sweden.

However, it should be noted that the speed of recovery from recessions which are highly synchronised across countries—as the present one—is relatively slow, according to a recent IMF study (IMF, 2009a), which found that exports play a more limited role as a driver of the recovery when compared with recessions characterised by a low degree of synchronisation. This finding is important because it implies that the economic recovery from this international crisis in countries like Mexico will be slower since the role of exports as growth drivers critically depend on the speed of the recovery observed in the US economy.

... and increasing resilience.

The resilience of the Mexican economy to external shocks has improved since market openness reforms made the economy less vulnerable to movements in international capital flows. This is because when there is a large imbalance between the size of capital flows (large) and the size of trade flows (small), the economy tends to be extremely sensitive to changes in capital movements. An increase in trade flows then reduces the vulnerability of the economy to sudden changes in the capital account. There is some evidence supporting the idea that macroeconomic volatility in Mexico declined in the aftermath of the 1994-95 crisis via NAFTA. Kose, Meredith and Towe (2004) have found that Mexican output volatility decreased by 30% between the 1980-1993 and 1996-2002 periods and that the volatility of investment fell by 40% during these two periods.

Investment liberalisation can also contribute to recovery

In Mexico, the aftermath of the 1994-95 crisis was also accompanied by an intense inflow of foreign capital. In particular, the 1998 decision by the Mexican government to remove the remaining restrictions on FDI in banking facilitated the prompt capitalisation of the banking system. The capital to assets ratio started to rise steadily since then and reached 14% in 2004, hence reducing the vulnerability of the financial system. The elimination of legal restrictions on foreign investment was only part of the story since FDI flows between Mexico and its NAFTA partners also increased sharply. FDI flows to

Mexico increased from USD 12 billion over 1991–93 to USD 54 billion in the 2000–02 period. This increased the share of FDI flows in domestic gross fixed capital formation (investment) from 6% in 1993 to 11% in 2002. Cuevas, Messmacher, and Werner (2002) have found evidence that shows that Mexico's participation in NAFTA led to a 70% increase in FDI flows.

In Korea, the Foreign Investment Promotion Act (effective as of November 1998), representing a resolute policy shift from control and regulation to promotion and support,¹¹ has allowed foreign participation in hostile M&A and land acquisition by foreigners. These measures were of the highest symbolic value, since they had been considered as the last measures that Korea would take. As of 2008, only three sectors—television and radio broadcasting, and nuclear power generation—are fully closed to foreign investors and 26 sectors are partially restricted out of 1 083 business lines. It is no wonder that this policy shift greatly stimulated the inflow of FDI, which jumped to USD 5.3 billion in 1998 and USD 10 billion in 1999, amounting to 1.54% and 2.25% of GDP, respectively. The sharp increase in FDI inflow also contributed greatly to rebuilding foreign exchange reserves, supporting the restructuring process of Korean companies.

No significant protectionist moves were triggered by the crises

During the crisis episodes reviewed in the selected countries, countries generally refrained from adopting protectionist regulations, it being understood that open markets are an integral part of getting their national and the world economy out of the crisis. On the contrary, a number of trade opening measures were taken, as a means of promoting recovery.

In Sweden, despite the severity of the crisis in the 1990s, the government did not impose any protectionist regulations and there was no strong political pressure to do so either. On the contrary, the political efforts were concentrated on liberalising trade, although it is hard to assess how much of this orientation was due to the crisis, as there is a political consensus among all parties in favour of free trade. If anything the crisis may have influenced the outcome in the referendum on EU-membership in 1994 and thereby lead to more international competition.¹² At the same time, the negotiations of the Uruguay Round were in the final stages. Even though many large Swedish manufacturing companies had great difficulties, they wanted the Swedish government to work for as much trade liberalisation as possible in the negotiations. During the current crisis pressures on the government to impose protectionist regulations have remained limited, but there has been a much stronger debate on whether the government should intervene to rescue important businesses, particularly in the automotive sector.¹³ In December 2008 the government launched a special programme for the automotive industry, making available a total of SEK 28 billions, but so far the programme has not been utilised by the automotive companies, partly because the programme involves compensation for companies that want to use the loans and credit guarantees.

The UK has championed openness to trade in services as it is a substantial exporter, particularly of financial services. However, while financial services transactions are primarily electronic and can be undertaken without a physical presence in the country, the development of London as a major world financial centre has entailed openness to foreign banks, encouraging them to open branch offices, subject to the same rules as their UK counterparts. Indeed part of the attractiveness of London has been the relatively light-handed nature of the regulation, which has encouraged banks to use London as their European base. There has however been no unusual effort to encourage the localisation of such services as there has in Luxembourg and to a lesser extent Ireland. The UK has

made no attempt to use favourable tax treatment or secrecy to promote financial services, although it does allow those who are not domiciled in the UK to avoid the taxation of residents. The Financial Supervisory Authority (FSA) has gone to some trouble to differentiate between 'light-handed' and 'soft-handed' regulation. The former is a deliberate attempt not to over-regulate, while the latter would imply weak monitoring and enforcement of the regulations that did apply.

Outside the financial sector the UK has joined the general trend of supporting the car industry even though in this case these are not national champions as they are actually foreign owned. The concern is simply over the extent of the employment involved and the belief that the problems in the industry are purely cyclical and not enduring. The scheme was to encourage people to trade in cars more than 10 years old. Under this measure announced in the Budget in April 2009 the government provides a GBP 1 000 subsidy and the participating manufacturers the same. The scheme expires in March 2010 or earlier should the limit of 300 000 cars be reached. It does not discriminate in favour of national manufacturers and since most cars in the UK are either foreign made or made in foreign-owned factories this will be a trade encouraging step as well as one designed to lower pollution and greenhouse gas emissions. It follows similar measures in a number of other countries.

On the whole the UK has not sought to favour domestic firms over foreign enterprises but it is inevitable that their efforts to stabilise and recapitalise the banking system will effectively favour domestic institutions as most such institutions are domestic. Perhaps the most important indication of their openness was the fact that the Santander Group was able to buy Alliance and Leicester in July 2008, while the crisis was in progress. There was no attempt to dissuade investment in Barclays from overseas interests and sovereign wealth funds have not been excluded. Intervention to support the Northern Rock institution implies that the government's willingness to step into the banking system was rather more extensive than many people expected from the prevailing behaviour on the Too Big to Fail issue. In the case of the failed Icelandic banks, the UK authorities transferred the deposits in two of them to ING because it made the best bid, showing no favouritism towards UK owned institutions.

In Korea both the 1997-98 and the current crisis have provided strong external impetus for reforming trade and investment regimes in a way that would have otherwise been impossible. The success of these reforms has in turn allowed the economy to recover quickly, surpassing expectations.

In Japan, important targets were set for Economic Partnership Agreements (EPA) before the current crisis, for further liberalisation of trade and investment. These initiatives do not seem to have been slowed by the crisis. EPAs came into effect with 11 countries and regions, which accounted for 16% of Japan's total trade in June 2009. Negotiations are under way with an additional five countries, which would account for another 22%. The official target adopted in 2006 was to have EPAs with countries accounting for at least 25% of Japan's total trade by the end of 2010.

When reforming, selection of long-term social gains should prevail

The Mexican experience also shows that when a government is forced to choose between short- and long-run gains during a process of reform, the selection of long-run social gains should prevail. The case in reference is the liquidation of the holding company Cintra. As discussed before, the competition authorities were pushing for a separate selling of the two airline subsidiaries in order to preserve competition in the market. However, other members of the government thought that selling Cintra as a whole would be a better option since it would allow the maximisation of revenues. The Mexican government was then faced with a trade-off: the maximisation of revenues (short-run gains) from selling Cintra as whole would jeopardise the objective of preserving competition (long-run gains) in the market. At the end of the day, the objective of promoting competition prevailed over the tempting revenue-maximising option so that social welfare was preserved.

Experience of free trade benefits can boost public support for further trade-enhancing reforms

In Korea, the turnaround in the public's attitude toward foreign capital and trade is of particular importance and represents a major change in the context of Korean trade politics. The experience of job saving and/or income increases in the companies acquired by foreign investors played a central role in bringing about this change. The Korean people's support of more liberal policies was in turn instrumental in the Korean President's unambiguous stance against protectionist measures at the G20 summit in April 2009. Apart from big business that fared best in the post-crisis periods, most of the Korean people have now come to understand and realise the real benefits of market openness. From their point of view, it not only helped to restore economic stability, growth, and the international competitiveness of Korean firms, but also made available for them all sorts of favoured consumer products represented best by Chilean wine, made available through the Korea-Chile FTA. This remarkable change in attitude guarantees that political support for trade and investment liberalisation will not go away or backtrack easily, but will rather serve as a strong political force requiring and making the fuller integration of Korean economy to the global economy possible.

The best lesson that Korea has learned from the crisis seems to be the respect for credibility, its relative importance and the factors that affect it: in a globalised world, transparency, abstaining from discriminatory practices, and credit rating, among others, are all increasingly important elements. Koreans have begun to join the global economy wholeheartedly. This change owes greatly to the self-confidence restored and earned from fairly successful experiences of overcoming the crisis.

VII. Conclusion

Countries worldwide have launched a wide range of measures to address the broad economic, social and institutional consequences of the global financial and economic crisis that began in 2008. As stabilisation measures have reached their goal and economies are showing signs of recovery, the attention of policy makers is turning to more structural long-term responses, to facilitate recovery while also getting back on a path of higher long term sustainable growth.

The country examples examined in this paper illustrate some of the key features of regulatory reform related to strategies that facilitate economic recovery, foster resilience and enable long term sustainable growth. These examples highlight both the benefits and the limits of best use of regulatory reform in times of crisis. Lessons learned from these experiences may provide useful insights to policy makers in order to develop robust regulatory reform programmes that strengthen recovery while also making economies more resilient to future external or internal shocks.

Benefits of regulatory reform

Amongst various policy tools available to governments to stimulate recovery and long term growth, regulatory reform is a highly effective option. It is fiscally light-handed, while leading to significant, measurable impacts that enhance a country's competitiveness in a global economy. Country examples show that strengthening regulatory quality, opening trade and applying competition policy during crises leads to gains in long term growth through greater productivity, increased foreign direct investment flows and consumer surplus. This study also highlighted the potential for regulatory reform to increase resilience, enabling economies to recover more quickly from shocks by making it easier to adjust and switch resources across sectors.

Lessons from implementation

When crises occur there may sometimes be a temptation to halt reforms which could be perceived as too costly or disruptive. Country insights reveal that regulatory reform during a period of recession may be difficult to pursue given the political will required for change. If reforms are postponed until after an economy recovers however, this may be too late as there is usually less incentive to reform. Therefore, regulatory reform requires a continuous effort over the business cycle, while *ad hoc* fiscal policy measures to support declining private demand can play a counter-cyclical effect.

Countries have generally fared best when they have used the crisis as an opportunity to accelerate reforms rather than slowing them. For example, Korea seems to have been the most resilient to the current crisis, with growth projected to reach its pre-crisis levels in early 2010.

Regulatory reform, by fostering market openness, increases the synchronisation of the business cycles. As a result, it may leave economies more vulnerable to external shocks but also enables quicker recoveries, which is what matters the most to growth. The UK's experience is a lesson in terms of the benefits of keeping the economy flexible. Indeed, there is evidence that a more deregulated, open and faster growing economy such as the UK can lead to higher welfare than a more stable and slower growing heavily regulated economy, despite being more prone to downturns.

As illustrated through OECD reviews, high level political support, complemented by public support is instrumental to the success of the reforms. The experience from the selected countries demonstrates that a commitment to market principles at the highest political levels provides support for all market enhancing policies, including competition, reducing barriers to trade or regulatory management. In Korea (1997) and Mexico (1995), strong support for regulatory reform at the Presidential level was instrumental to the successful implementation and effectiveness of broad reforms.

High level political support needs to be complemented by communication efforts and evidence based policy making. Removing the rents of some participants is costly and needs to be well argued. Thus, providing quantitative evidence of the benefits of regulatory reform is important to overcome political pressure against reform. Publicly available RIAs that clearly articulate the benefits of reform can also help increase public acceptance and support for reform. In addition, concrete experience of the benefits, for example access to previously expensive imported goods, can help to bring a turnaround in public attitudes toward foreign capital and trade. This was the case in Korea and represents a major change in the context of Korean trade politics. The experience of job saving and/or income increase in the companies acquired by foreign investors also play a central role in bringing about this change. This was in turn instrumental in the Korean President's unambiguous stance against protectionist measures at the G20 summit in April 2009.

Therefore, underlining the role of regulatory reform in the context of G20 discussions requires a multi-pillar, well balanced approach. Quality regulation is required in many sectors, particularly in the financial sector, as part of an exit strategy from a crisis. Countries that have subjected themselves to this discipline, and have applied it systematically in terms of their institutions, laws and regulations as well as reform of their regulatory stock, have generally enjoyed the benefits of greater and sustained growth and reduced likelihood of experiencing prolonged downturns.

Finally, the studies illustrate that regulatory reform needs to be articulated as part of a coherent whole-of-government approach, together with specific sectoral responses when these are needed, as is the case in the financial sector. What is important is the coherence of the approach, and the consistency of the macroeconomic policies with those aiming at improving prudential, structural and microeconomic issues. This is a matter of balance, between empirical assessment and political consideration of a range of interests, which needs to be formulated and integrated into a long term vision. Those countries in the study that have been able to pursue such policies in a coherent manner have generally enjoyed sizable benefits, in terms of increased prosperity, welfare as well as trust in their government.

Key questions for policy makers

Three key questions emerge from this study, which are worth being brought to attention of policy makers when addressing the consequences of a crisis:

- The choice to pursue regulatory reform is clearly influenced by a country's fiscal position. In a more fiscally constrained environment, countries are more likely to consider these policies as part of the way out to the crisis. *What is the appropriate timing and sequencing of various policy interventions, between short term fiscal stimulus packages and long term investments in regulatory reform?*
- The benefits of regulatory reform are higher in more regulated economies. As many OECD countries have already made progress, the returns to further investment are likely to be more modest if the low hanging fruits have been picked, while the intended changes can be very complex, and political resistance is likely to occur. Therefore, there is a need to look at the benefit to cost ratio of reforms, to focus efforts where reforms are likely to yield the greatest benefits. *How can the case for regulatory reform be made giving impetus for change in the post crisis context?*
- Forming consensus to ensure public support for reform is key to success. This requires balanced reforms, as opposed to partial reforms (*i.e.* reforms that single out a particular group), which may create a perception of inequality. Balanced reforms need to be put forward as a basis of a whole-of-government strategy, paying attention to distributional effects and with due compensations and safety nets to facilitate change. *How can politicians nurture consensus and ensure that reforms will be as balanced as possible?*

Notes

1. Examples include, in Japan, the policy measures taken to counter recessions in the 1950s and 1960s, and, in the US, the relaxation of enforcement against cartels during the Great Depression. In Japan, measures during the crises of the 1950s and 1960s included the introduction of ‘depression’ or ‘rationalisation’ cartels, which allowed firms to co-ordinate production and service, reduce capacity, or even co-ordinate price levels. These measures were considered to have serious anti-competitive effects on the economy in the medium and long term and were later abolished. In the US, enforcement against cartels fell away in the Great Depression. One of the measures introduced by the Roosevelt Administration under the “New Deal” was the National Industrial Recovery Act of 1933. The Act reduced competition through antitrust exemptions and raised wages through labour provisions. The Act was declared unconstitutional in 1935, but activities implemented there under continued. Studies have concluded that these New Deal policies were important contributory factors to the persistence and depth of the Great Depression. For example, Cole and Ohanian concluded that ‘the [New Deal] policies reduced consumption and investment during 1934-39 by about 14% relative to competitive levels.
2. These experts were selected by the Secretariat and contributed in their personal capacity; the views expressed are their responsibility and do not necessarily reflect those of the national authorities of the respective countries.
3. Drawing extensively from a recent paper by Johan Kreichbergs and Stefan Folster (2010).
4. Unless otherwise noted, the sources for the facts and figures in the remaining sections of the document (sections III to VII) are the country case studies (available in Part 2 of this publication).
5. The TRR programme bears some resemblance to the regulatory moratorium imposed by the Task Force on Regulatory Relief in the early Reagan years. The TRR is however distinct in that it applies to existing regulations and not to proposed new regulations.
6. Drawing on materials prepared by Kreichbergs and Folster (2010).
7. World Bank’s Foreign Investment Advisory Service, 2006. Case Studies on Reform Implementation Experiences: Regulatory transformation in Hungary, Mexico and South Korea. Draft for discussion. Washington DC.
8. These measures include SEK 17 billion to support local authorities in order to buffer welfare and expanded in-work tax credit (Sw. jobbskatteavdraget), SEK 10 billion in the fourth step), a temporary deferment of tax payments for employers and tax credit for building repairs, maintenance and improvement work. The Government has also, in the Budget Bill for 2010, presented a reduction of the social security contributions for the self-employed (effective from 2010 onwards). A special programme for the automotive industry, making available a total of SEK 28 billion for R&D-linked risk capital and state guarantees for EIB-loans. These measures may carry multiple

dimensions, including financial stimulus for the economy, as well as more long-term structural measures. For example, the in-work tax credit (Sw. jobbskatteavdraget), and the tax credit for building repairs, maintenance and improvement work. Some other measures could also be mentioned such as changes in the labour market policy; infrastructure investments; credit guarantees during the building period, amounting to SEK 10 billion and aiming to increase residential building.

9. Enterprise Act (2002), s. 58(2)/(2D); which came into force on 24 October 2008.
10. Negotiations leading to NAFTA started in June 1991. Since the member countries had held bilateral discussions earlier, negotiations moved forward quickly and were completed in August 1992. The United States and Mexico passed the NAFTA legislation in November 1993, and Canada did the same in December 1993. NAFTA entered into force on January 1, 1994. Since Mexico's tariffs were higher than those of US and Canada, it implemented the largest reductions in tariff rates —the average Mexican tariff rate fell from 12% in 1993 to 1.3% in 2001. Since US tariffs on imports from non-NAFTA partners were much higher than those on imports from Mexico, the agreement gave Mexico a considerable tariff advantage. In the following, the impact of market openness on the Mexican economy is reviewed in the context of the 1994-95 and 2007-09 crisis and its role as instrument for crisis recovery and economic resilience is assessed.
11. Despite ample evidence for the benefits of integration of local financial markets into international markets, Korea had maintained extensive controls on international capital flows until it joined the OECD. Korea's plan to liberalise capital flows failed to go a long way toward it until the onset of the 1997 financial crisis. It was only after the crisis that Korean government accelerated the reform of foreign direct investment regime, with a view to rebuilding the foreign exchange in shortage and securing the fund needed for economic reforms. In fact, the liberalisation of international capital flow constituted one of the key elements in the IMF reform package. It forced the Korean government to expand the ceiling imposed on equity investment by foreigners, to allow foreigners' to buy shares of Korean banks, to remove the restrictions on short-term financial products and investment in the domestic bond market, to streamline the procedures to be applied to FDI, and to allow borrowing of domestic firms from abroad.
12. 54% of Swedish voters thought that a membership in the European Union would benefit the Swedish economy.
13. During the crisis of the nineties the government was very reluctant to rescue suffering businesses, drawing the lessons from failed and costly rescue operations of national companies during the seventies economic downturn.

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Annex I. Discussion Highlights, Meeting of 5 November 2009

This annex is a summary of the discussions that took place during a thematic session on regulatory reform, recovery and long-term sustainable growth, held at the Inaugural Meeting of the OECD's Regulatory Policy Committee, on 5 November 2009.

Key interventions during the discussion focused on the short and long-term benefits of regulatory reform. While the long term benefits of regulatory reform are better known, short term benefits may also be significant. In the short term, when attempting to stimulate recovery from a crisis, reform can have an immediate impact on behaviours through anticipation of changed economic conditions in the future. Private sector expectations that future regulations will improve market conditions may result in short term efficiency gains, as businesses will prepare for more competitive markets. For example, when reforms in Mexico were announced in the wake of the signature of NAFTA in 1994, businesses anticipated that markets would be more open and competition would increase when the new regulations would come into effect. They then started changing their behaviour immediately as a result, focusing on improving efficiency and productivity to be more competitive. Regulatory reform can also produce short term benefits when wide-ranging and comprehensive programmes are implemented to cut red tape, giving businesses immediate relief in terms of their "paperwork tax".

Timing and implementation represent significant challenges for regulatory reform. Regulatory reform efforts may be easily derailed given that they often lead to immediate, upfront costs, which are generally felt before benefits can be realised. As such, broad stakeholder consultation with the view of forming a consensus to ensure public support for reform is key to success. Paying attention to the distributive consequences (between stakeholders and across time) of reform can also be important to facilitate change. This can represent a way to bring about consensus through a good understanding of how reform will affect stakeholders, providing adequate attention to the potential losers, and possibly offering compensation to facilitate acceptance. In parallel, strengthening central regulatory oversight bodies as well as having a whole-of-government approach that can change the mindset within government are essential in order to successfully implement reform, while maintaining its course over time.

A crisis often offers a window of opportunity to put through reforms that would not otherwise have enough broad based support during periods of relative stability. The heightened sense of urgency for action that typically prevails during times of crisis is favourable to reforms. At the very least, the crisis is a time to initiate discussions on priority areas for reform and to start to define the post crisis regulatory period by bringing together key stakeholders. For example some countries (*e.g.* Iceland) recognise the current opportunity for reform in terms of revitalising the economy and rethinking the basis of its prosperity, through increased emphasis on better regulation. The current crisis has also been an opportunity to pursue otherwise difficult to implement green policies in order to promote alternative paths of growth. For example, Japan has introduced a series of subsidies to promote the use of non-fossil energy, in a bid to reduce the country's carbon emissions while stimulating economic recovery. But these subsidies would not be

permanent: to avoid longer term inefficiencies, Japan's intention would be to phase out the current subsidies in favour of a carbon pricing mechanism such as a cap and trade system, when public concern about environmental sustainability has increased. This is an example of a gradual approach to reform.

A crisis is also an occasion to "test" institutions and regulatory environments. Countries that have best used past crises to push through tough reforms and introduce more robust systems have fared better in the current crisis. This is also true in relation to countries that did not experience similar crises in the past. However, the "vaccination effects" of reform introduced in past crises tends to fade away, with the gradual loss of knowledge and expertise, and rotation of staff in the government apparatus. This highlights the need to preserve reform as a continual process and to maintain the capacity to draw upon lessons learned from past crises.

Balancing regulatory impact analysis requirements and the need for quick regulation to stabilise the financial sector appears to have implied some trade-offs. For example, in the UK, standard procedures and processes were followed while in Iceland they were set aside for the most urgent cases (those requiring overnight legislation), even if the regulatory quality tools were reintroduced after the economy stabilised. While principles of regulatory quality were generally followed in some other countries, there were also significant political pressures to re-regulate without enough consideration for economic consequences, with particular implications for the financial sector.

A distinction needs to be made between countries where there are structural economic challenges (or a perception of structural challenges) and countries with a structurally sound economy which are facing a temporary crisis. However, the difference is often hard to assess at the time of a crisis. When significant structural reforms are to be undertaken, it is important for the government to show a commitment to carry out and implement regulatory reform as a way of restoring confidence, including in the financial markets.

Experiences of countries in times of crises have shown that the flexibility offered by a high quality regulatory framework, open markets and strong competition allows a better absorption of external shocks. These factors also raise long term potential growth and make it more likely that a country will quickly recover from a crisis.

Novel approaches to regulatory quality and management have been implemented, even during the crisis. For example, the UK has recently (as of August 2009) launched a powerful, new regulatory management tool – the Forward Regulatory Programme. This forward programme (or plan) is to be publicly released on a rolling six-monthly basis and is intended to provide an overview of all upcoming regulatory initiatives and associated monetised costs and benefits for the next two to three years as a way of improving transparency and predictability. This will also give a sense of the potential cumulative effects of all proposals and help to prioritise them. Despite that it is still in the early stages, there have already been some results as the tool has proven to be useful not only for the general public but also for Departments and Ministers, as a snapshot of the potential cumulative effects of all regulatory proposals. As a result of this increased transparency, several proposals that were considered too costly etc. have been delayed or scrapped. Those delayed would be introduced after the economy recovers, when presumably businesses and consumers are better able to bear the costs.

The discussion highlighted key initiatives regarding regulatory reform, which have been developed as part of a structural agenda by the European Commission (EC). For instance, there is a large burden reduction program which is intended to simplify the existing Community rules and is likely to generate large savings to small and medium size companies at a minimum cost to taxpayers. These measures are anticipated to have a net positive impact on the economy in the long term without adding to government deficits.

The importance of developing co-operation between authorities at the international level is also key. Norway stressed that economic integration and globalisation have created stronger interdependence in many respects – between various economic sectors, between different countries, and between various policy areas. This makes stronger co-ordination necessary between various regulators, between regulators and macro-economic institutions, and between regulation at the national and international level. This may also have implications for the future shaping of the broader agenda for regulatory reform at the international level, highlighting the need for stronger co-ordination and exchange of practices and information.

Part 2

Case Studies

Case Study 1 – Japan

This case study was prepared by Professor Naohiro Yashiro of the International Christian University in Tokyo.¹ The views expressed in this document are those of the author and should not be attributed to the OECD or to the national governments of the countries studied.

This case study assesses Japan's experience with regulatory reform during three crises: in 1991-95, 1998-2000 and 2001-02. Responses to these crises are compared with the policy response to the 2008-09 global financial and economic crisis. The different reforms implemented in terms of improving regulatory quality, competition and market openness are contrasted with their impacts on recovery. Particular attention is devoted to Japan-specific measures such as special zones for regulatory reform. The study shows that regulatory reform is important in Japan, and will be instrumental in raising the performance of low productivity sectors outside manufacturing.

Introduction

This case study presents a comprehensive overview of Japan's recent regulatory reforms by providing examples of key measures and their main impacts. It also describes the evolution of regulatory reform policy within the macroeconomic and political environment. In Japan, regulatory reform has been generally pursued as a long-term strategy to raise the potential growth of the economy while monetary and fiscal policies have been used to stimulate demand during recessions. In this paper, we discuss four economic crises since the early 1990s, which took place after the significant slowing down of Japan's medium-term economic growth, and thus increased the need for regulatory reform to strengthen the supply-side of the economy.

The 1991-95 crisis is the first of the four crises studied; it was triggered by the bursting of the land and stock price bubbles in 1991, and led to a significant increase in the number of non-performing loans. At the time, the consequences of the bursting of the bubbles for the broader economy was not well acknowledged as there were expectations that the economy would return to the high growth path of the 1980s. The optimistic view of an automatic recovery faded away due to the subsequent 1998-2000 recession (caused by the East Asian currency crisis), coupled with negative GDP growth. In this light, the need for regulatory reform was advocated.

The 2001-02 crisis was induced by the world-wide information and communication technologies (ICT) recession, and at a time when the newly installed Japanese government was active in dealing with non-performing loans. In this instance, regulatory reform was used as a major strategy for crisis recovery, and was successful given that reform was supported by global economic recovery. However, in the case of the response to the most recent crisis of late 2008, traditional fiscal stimulus has taken precedence over regulatory reform as a policy package. This is despite the fact that Japan had the highest ratio of public debt to GDP among the OECD countries.

Such a shift in policy reflects a growing difficulty in bringing the message of regulatory reform to voters, particularly with respect to the labour market, as previous deregulation is thought to have increased income disparities. Though this may be partly attributed to an unclear understanding of the outcomes of previous reform efforts, a key element emerging from the policy debate could be regarding "unbalanced regulatory reform" which has purportedly created biased incentives to market participants toward misallocation of resources. The public has been persuaded that the increasing number of temporary workers without the benefit of a public safety net has been a result of so-called "excessive regulatory reform."

Under these circumstances, it is important to show that regulatory reform is a common strategy for crisis recovery in OECD countries, and particularly critical for a country like Japan already burdened with a substantial amount of public debt. Regulatory reform is also essential for levelling up Japan's low productivity in sectors outside of manufacturing, which is still governed by various implicit regulations preventing the entry of newcomers including foreign affiliates. The current study will also mostly focus on the product market regulation aspects.

Macroeconomic context

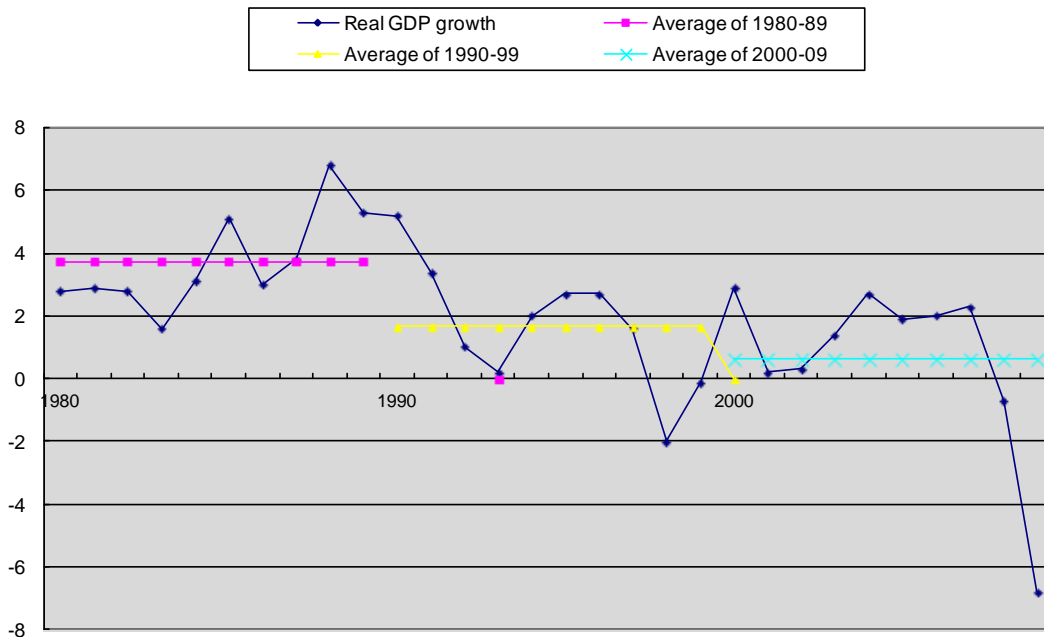
Overview of the macroeconomic development in the 1990s and beyond

GDP growth fell sharply in the early 1990s. The average real growth rate for the 1990-99 and 2000-09 periods was 1.5% and 0.6% respectively, which is quite low compared with the 5% GDP growth rate experienced in the latter half of 1980 (Figure 1.1). The sharp deceleration of the economy in the 1992-95 period had been once considered as a simple recession resulting from the bursting of the asset price bubble in 1991. As the bubble had pushed up GDP growth to an excessively high level for a mature economy, it was thought to be natural that the cyclical decline in GDP as a reaction could be unavoidable. However, as multiple crises subsequently hit the economy in the 1990s, economic stagnation continued much longer than originally anticipated, eventually lasting well over a decade.

The causes of the prolonged economic stagnation in Japan are still the subject of debate. Some point to demand-side factors, particularly the failure to provide enough stimulus through monetary and fiscal policies that may have been effective against subsequent external shocks. Others point to supply-side factors, such as the lack of reforms in social institutions and regulations which are no longer applicable under changing economic circumstances as the underlying factor for lowering potential growth.

These differing views on the economic stagnation are reflected in the policies that have been implemented in past economic crises. In most cases, policy packages were mainly based on fiscal stimulus *i.e.* an expansion of public investments or tax cuts. But some regulatory reform measures were taken during the 1998-2000 recession, which were fully implemented in terms of the supply-side policy to raise the potential growth of the economy in the 2001-02 recession, while at the same time fiscal expenditures were minimised.

Figure 1.1. GDP growth rates, Japan, 1980-2009 (in %)



Source: Cabinet Office, National Accounts.

Past economic crises in the last two decades

Since the early 1990s, Japan's economy has suffered four economic crises; one was domestically driven, and the others were caused by external shocks. The main factors that contributed to each crisis respectively are as follows:

- The first crisis was triggered by the bursting of the asset price bubbles in 1991, as a result of the tightening of monetary policy against the excessive land price hikes. Contrary to the expectation that this would be a minor recession, this action resulted in economic stagnation for the next three consecutive years. The asset price hike of the late 1980s that preceded the shift in monetary policy was mainly attributable to expansionary monetary policy, which aimed at overcoming the negative impacts of the large yen appreciation triggered by the Plaza Agreement in September 1985.
- The second crisis in Japan was due to the Asian currency crisis which started in third quarter of 1997 with the large depreciation of the East Asian currencies caused by the sudden outflow of capital. Although Japan was not directly hit by the crisis and its exchange rate remained basically stable vis-à-vis the US dollar, Japan's exports to the ASEAN4 (Thailand, Indonesia, Malaysia, Philippines) and Korea fell substantially from the fourth quarter of 1997, resulting in negative GDP growth in 1998. This recession came before the economy had fully recovered from the previous recession and forced large firms, which had previously expected that the economy would sooner or later return to its high growth rate, changed their outlook and started to shed excess employees.

- The third was the global decline in ICT production in the third quarter of 2000, which substantially lowered Japan's exports, and pushed GDP growth rate to close to zero in 2002-03. Bank balance sheets, still carrying lots of non-performing loans, deteriorated, and banks cut back new lending to firms, putting a damper on private investment.
- Finally, due to a synchronised contraction of the world economy that started in the third quarter of 2008 initialised by the US subprime loan problem, Japan's export volumes are likely to fall by 32% in 2009, resulting in a sharp decline in GDP close to 7% (OECD, 2009). This will be the largest recorded fall in Japanese economic activity in the post-war period.

Macroeconomic measures implemented

Below is an overview of the economic policy packages that were implemented in response to the economic crises of the 1990s and beyond:

- The first economic crisis in the 1990s was generally accepted as somewhat inevitable, because the 5% GDP growth in the late 1980s was unsustainable. Thus, the fiscal stimulus packages instituted in response and that amounted to over 7% of GDP was to support shrinking private demand. Regulatory reforms were implemented, but not necessarily used as a part of the policy package to counter the economic crisis.
- The external shock over 1997-98 came before the Japanese economy had been able to fully recover from the previous 1992-94 recession. As such, this event caused particularly serious impacts on the financial markets, and several major banks had to file for bankruptcy. Banks had accumulated non-performing loans that resulted from the large fall in asset prices, but failed to dispose of them in the expectation that the economic recovery would automatically solve the problem. In order to counter the deflationary effects coming from both external and domestic markets, a substantial fiscal stimulus exceeding that of the previous recession, and amounting to 7.8% of GDP, was implemented (Table 1.1).
- In contrast, the size of fiscal expansion was minimal and accounted for just 0.7% of GDP in the second external shock during 2002-03. This was due to the Koizumi regime's strong leadership which recognised that fiscal policy was not effective, and only led to an accumulation of public debt. Instead, regulatory reform in the financial markets was adopted in order to force the major banks to dispose of their non-performing loans. Also, several other regulatory reforms were made to enhance economic activity. Such policies were partly motivated by the public expectation that the economy would no longer automatically recover to historical 3-4% growth levels without the implementation of any major sectoral reforms.
- The most recent recession of 2008-09 is characterised by the largest decline in economic activity in the post war period. The government resorted to fiscal stimulus again by increasing public investment and supplying public funds to prevent liquidity shortages of firms and financial institutions. As the result of the sizable fiscal packages, public debt is projected to increase from 172% of GDP in 2008 to close to 190% in 2009 (OECD, 2009).

- Room to manoeuvre for monetary policy has been limited in these four cases, except for the first crisis, because of historically low short-term interest rates that were close to zero (although real interest rates remained at 1-2% due to continuous deflation). The Bank of Japan has provided ample liquidity to the financial system, which was the only available means of monetary policy for the last three crises.

Table 1.1. Scale of the fiscal stimulus policy packages

Trillion Yen

	Total	Public investment 1.	Tax cuts 2.	1. + 2. % of GDP	Public debts (% of GDP)
1992-95	59.4	29.8	6.1	35.9 (7.2)	86.7
1998-2000	61	27.3	11.3	38.6 (7.8)	135.4
2001-02	24.7	3.5	0	3.5 (0.7)	152.3
2008-09	56.8	15.4	0	15.4 (3.0)	189.6

Notes: Total amount of fiscal policy packages includes loans to small firms, income transfers to local governments or purchases of land for public use.

Public debts indicated are those in the final year.

Source: Cabinet Office, OECD (2009), *Economic Outlook 85*, June.

The macroeconomic impacts of the various fiscal policy packages were partly reflected in the change in the output gap and unemployment rate. The fiscal stimulus reduced the output gap in 1992-95, but not to the same extent as in the 1998-2000 period. On the other hand, the economy gradually recovered after bottoming out in 2001 without a major fiscal stimulus, and the narrowing output gap and lowering unemployment rates were supported by a buoyant world economy (Figure 1.2). The expansion continued up to late 2008, the longest cyclical upturn in the post war period. The contrasted pattern of the economic recovery from the external shocks was reflected in the variation in industrial outputs. Fiscal policy packages based mainly on public investment stimulated the construction industry in local areas, while the benefits from the export-led economic recovery and regulatory reform were concentrated in the export oriented-sectors.

Figure 1.2. Output gap and unemployment rates, 1991-2009



Source: OECD (2009), *Economic Outlook 85*, June.

Implications of past economic crises

Shrinking exports due to a sharp decline in trade volumes in world markets was an important factor in the 1998-2000, 2001 and 2008-09 crises. However, a more fundamental factor was the vulnerability of Japan's economy to the external shocks. Japan's leading industries are concentrated in manufacturing rather than the agriculture or the service sector. Thus, despite being the second largest economy after the United States, the decline in demand and employment in the export sector in Japan cannot be offset by other sectors. Particularly in the most recent crisis, the projected decline in Japan's GDP in 2009 is much larger than those of the US (-2.8%) and the Euro area (-4.8%) despite the fact that the loss in Japan's financial institutions by the world-wide collapse in values of securitised assets is the lowest.

This mainly results from the "dual structure" of Japan's industries: a highly productive manufacturing sector on the one hand, and less productive agriculture and service sectors on the other. The average productivity in Japan's service sector was slightly less than 60% of the United States between 2000 and 2004, and the gap was particularly large in distribution, transportation, and other services (Table 1.2). The largest productivity gap existed in the business service sector in areas such as accounting, legal services, software and consulting, which have been rapidly growing in the OECD countries. The low productivity overall is attributable to the concentration of small firms, where labour productivity is generally low, dragging down the national average. For example, most of Japan's lawyers are self-employed, while those lawyers who are employed by law firms were only 5% of the total in 2008. Large scale law firms covering a wide range of specialised services that provide intensive training to employees as is the case with manufacturing firms are rare in Japan.

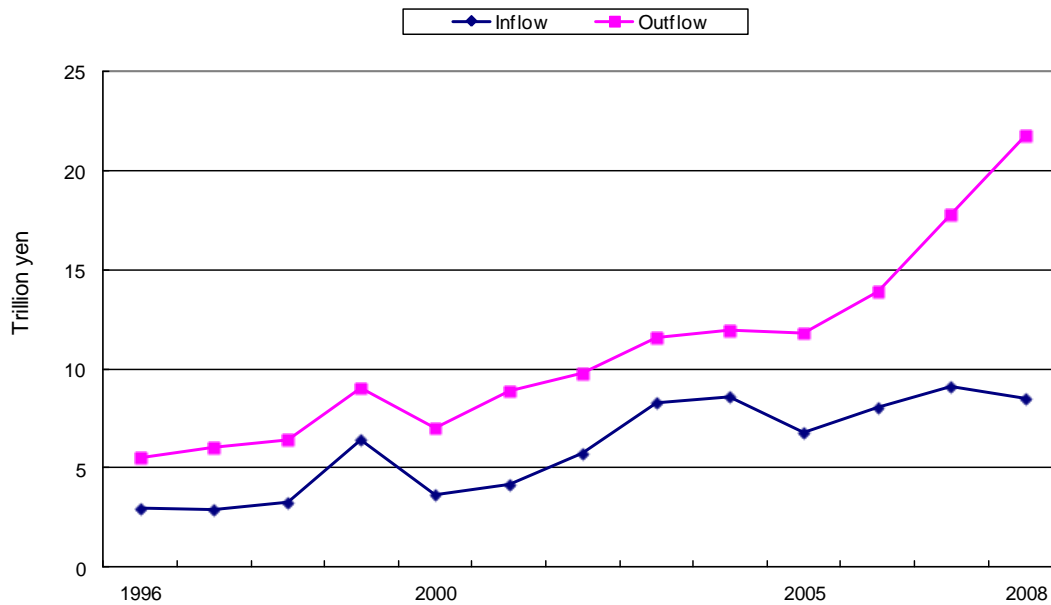
Table 1.2. Labour productivity by industry (average of 2000-04)

	Labour productivity (USA=1)	Share of employment (% of total employed)
Electricity & gas	1.05	0.3
Financial services	0.88	2.8
Construction	0.74	9.4
Communication	0.70	0.9
Distribution	0.51	18.2
Transportation	0.49	4.9
Restaurants & hotels	0.43	7.4
Business services	0.28	9.9
Other services	0.46	4.2
Total service industry	0.59	58

Source: Council on Economic and Fiscal Policy.

This “dual structure” is not new: it has been closely related to an increase in foreign direct investment outflows through the liberalisation of capital markets in the 1990s. The outflow of investment by manufacturing industries is also linked to increased opportunities in the context of globalisation. At the same time, the share of highly productive sectors, mainly manufacturing, has decreased in the domestic economy, as is the case in other OECD countries. This in turn lowers the average productivity for a country. The gap between outflows and inflows of foreign direct investment has been growing, indicating that investing in Japan is becoming less profitable for both domestic and foreign firms (Figure 1.3). It is more serious in local economies, which have depended on manufacturing companies for employment. This widening gap has not necessarily been due to domestic factors alone, but to the economic development in external markets such as China and other Asian countries. The average economic growth of China in the last decade was 9.4% compared with 1.0% in Japan. Without sufficient positive adjustment policies under changing economic and social circumstances, including regulatory reform, it is hard to expect an increase in inflows of foreign direct investment and the correction of such an imbalance.

Figure 1.3. Foreign Direct Investment in Japan (1996-2008)



Source: Ministry of Finance (Japan).

Role of regulatory reform

Overview

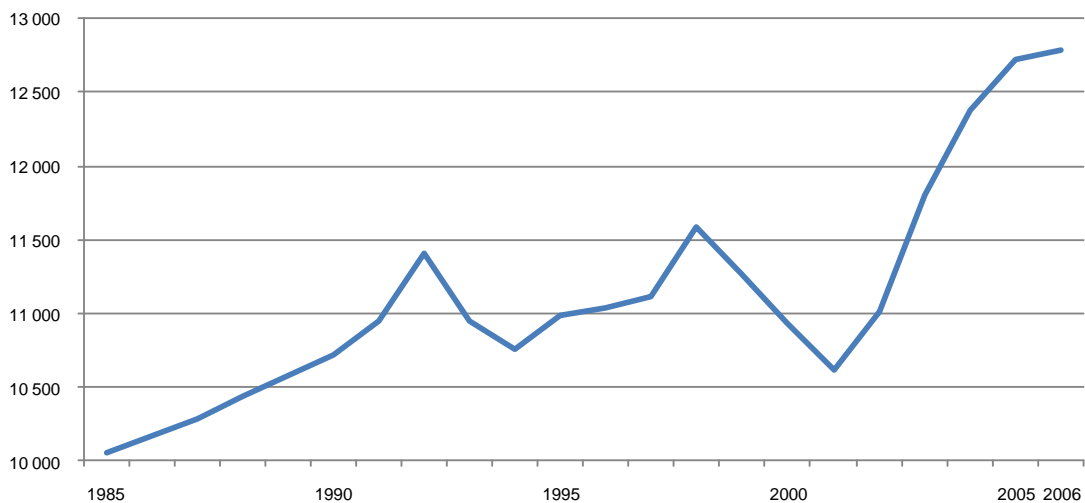
Major regulatory reform initiatives in Japan started in 1981 when the Provisional Commission for Administrative Reform was established under the strong leadership of the Prime Minister Nakasone. Major steps were taken towards deregulating and privatising government enterprises in areas such as communications, railways and tobacco production. But domestic support for reform faded with the 1987-91 economic boom (OECD, 1999). The appetite for regulatory reform returned when policy makers and the public saw it as an antidote to Japan's "lost decade" of economic stagnation in the 1990s, and was further strengthened when external economic crises hit the country in 1997 and 2000.

Although many agree that regulatory reform is needed, implementation is more challenging due to the decentralised power of national ministries where there is less of policy co-ordination by the Prime Minister. This decentralised governance structure appears to have changed under the Koizumi regime, as this regime was successful in carrying out the strong agenda setting seen in other countries. However, Koizumi's style of top-down policy making was only temporary and Japan returned to its traditional style of a weak leadership.

Regulatory reform in Japan was originally focused on lowering business costs by removing regulations on business activities that became obsolete by changing economic circumstances. Nevertheless, reform eventually expanded to include social regulations related to lifestyles by not only focussing on reducing regulation but also to reforming economic institutions to become more consumer-oriented. Compared with the reform of business regulations the reform of social regulations related to labour, education, health, and welfare have been more controversial. In particular, there is a lively debate as to what extent Adam Smith’s “invisible hand” is appropriate for the allocation of social resources. For example, the introduction of market competition implicitly assumes consumers’ sovereignty, but there is asymmetric information between physicians and patients, or between teachers and students. This logic may justify some public intervention to overcome this asymmetry, such as creating an independent organisation for evaluating the quality of the professional services.

It is important to note that the progress of regulatory reform is not necessarily measured by the number of regulations. For example, deregulation does not necessarily reduce the number of texts or provisions of a law; it may well increase them if it takes the form of increasing the items for exemption from laws regulating private activity. Regulatory reform usually takes the form of shifting from “hard” regulations (*e.g.* licences) to “soft” regulations (*e.g.* reporting requirements), but regulation seldom disappears completely. Indeed, the total number of regulations including both hard and soft types in Japan did increase over time (Figure 1.4).

Figure 1.4. Number of regulations in Japan (1985-2006)



Note: Due to the major reform of government ministries, there is a break in data for 2001.

Source: Cabinet Office (Japan).

The overall strength of regulatory burden on the private sector is better measured by the Cabinet Office's regulation index,² which indicates the strength of regulations on a scale of zero to one. The index shows an overall reduction in the strength of regulations since 1995, although this finding varies across sectors. This is consistent with the OECD studies on product market regulations on Japan (Conway *et al.*, 2005). The manufacturing sector showed the largest decline, while the non-manufacturing sector also showed a modest decline since 1995, though only a modest progress has been observed in the agricultural sector. It should be noted that regulation of the manufacturing sector started off at a lower level, so the reduction of regulations in the non-manufacturing sector should have a larger impact.

A cross-section analysis relating changes in the regulation index and the total factor productivity (TFP) by industry indicates that a 10% decline of the average regulation index is associated with a 0.073% annual increase in TFP. Limiting the sample to the non-manufacturing sector, the corresponding TFP increase would be 0.19%, indicating a higher marginal rate of return to regulatory reform (Cabinet Office, 2006).

Table 1.3. Declining strength of regulation, by sector

Regulation Index by Industry (1995=1)	1999	2002	2005
Agriculture	0.923	0.768	0.805
Mining	0.659	0.718	0.723
Manufacturing	0.322	0.261	0.227
Non-manufacturing	0.611	0.460	0.326
Construction	0.550	0.775	0.849
Electricity	0.388	0.285	0.277
Urban Gas	0.531	0.439	0.388
Water supply	1.012	1.265	0.992
Disposal	0.861	1.198	1.318
Wholesales	0.235	0.234	0.225
Retails	0.274	0.296	0.287
Finance & insurance	0.831	0.709	0.427
Real estates	0.505	0.554	0.558
Railway	0.466	0.445	0.218
Road haulage	0.321	0.209	0.184
Water transport	0.525	0.392	0.332
Air transport	0.874	0.686	0.727
Other transports	0.671	0.566	0.502
Communication	0.662	0.121	0.073
Other public services	1.122	1.061	0.864
Other business services	0.566	0.414	0.275
Other personal services	0.474	0.448	0.376
Total industry	0.483	0.447	0.394

Source: Cabinet Office, 2006.

Core institutions for regulatory reform in the 1990s and beyond

Institutions promoting regulatory reform discussed below were set up as independent organisations under the Prime Minister in order to persuade the concerned ministries to revise existing laws or regulations. However, it should be noted that any revisions to the law requires the full consent of the relevant ministries.

- The Regulatory Reform Committee (RRC, 1998-2001) was set up on a temporary basis in the Cabinet. It typically publishes a comprehensive annual report on regulatory reform at the end of December, which is incorporated into the 3 Year Deregulation Plan of the Cabinet the following March (the end of the fiscal year) and then implemented in the revision of the laws in subsequent years. The Plan includes only proposals which have been agreed upon by the concerned ministry, in accordance with Japan's tradition of decentralised policy making and the independence of each ministry. The Committee has no authority for enforcement. In this sense, the role of RRC is largely informal and the Committee's effectiveness largely depends on the leadership of the Prime Minister. The Council for the Promotion of Regulatory Reform (CPRR, 2001-10)³ was established within the Cabinet Office, succeeding the role of RRC, and largely following the same procedures.
- The Council on Economic and Fiscal Policy (CEFP) was established within the Cabinet Office in 2001, and is broadly responsible for economic and fiscal policy, including regulatory reform and open market policies. This institution has a dual nature: first, it is simply an advisory board to the Prime Minister consisting of four private sector experts, five ministers⁴ and the governor of Bank of Japan. Secondly, it is a *de facto* decision making body on major economic policies where the Prime Minister provides clear direction on specific policies that have been discussed amongst the CEFP members, and the record of which is to be published a few days later. The role of CEFP in policy making process was quite important in the case of Prime Minister Koizumi who often issued clear policy directives, but this has not been the case with other Prime Ministers.
- The Fair Trade Commission (FTC) is responsible for competition policies. The role of FTC has been recently strengthened by the revision of the Antimonopoly Act (AMA) enacted in 2005 and 2009, the only major revisions since 1977.

Major regulatory reform measures undertaken in response to the 1998-2000 crisis

Overview

The economic policy packages of 1998-99 included the reform of the financial sector for the stabilisation of the economy, increasing the flexibility of employment, and the promotion of competition in network industries. Specifically:

- A key aspect of financial sector reform was to encourage major banks to write off their existing non-performing loans. The plan for recapitalising the banking system was implemented in order to prevent systemic risk. The Resolution and Collection Corporation (RCC) for purchasing of non-performing loans from sound banks was also established in 1999. These measures were closely related to on-going financial market reforms which are discussed below.

- Measures for increased flexibility in employment were needed given the sharp increase in the unemployment rate during the recession. Liberalisation of the market for temporary employment was enhanced with the agreement of the Regulatory Reform Council that was established for the creation of employment opportunities.
- The policy measures for stimulating competition in the telecommunications sector were initiated in order to lower prices, which were relatively high by international standards. This led to the Telecommunication Business Law in 2001. The Law expanded the asymmetrical regulation of telecommunications based on the large gap in market power between the incumbent (NTT) and its competitors, and forced the dominant carriers to open their networks. This measure promoted new entrants and led to price competition for local phone calls, stimulating investment in this sector.

Although not directly related to these reforms, the net increase in consumers' surplus by various regulatory reforms between 1997 and 2002 was estimated by 7.6 trillion yen (2.1% of the National Income in 2002). For details, see Table 1.5.

The institutional context and details of the regulatory reform in the various sectors are described in the subsequent paragraphs:

Financial markets

Major regulatory reform was initiated in 1996, and targeted a drastic liberalisation of the financial markets by 2001. This was known as the Japanese “Big Bang”, and was intended to revitalise domestic financial markets which had fallen far behind overseas markets. It was mainly done by removing the barriers between different bank categories, and stimulating the competition which was confined in the fragmented financial markets.⁵ Another policy objective was the better utilisation of large financial assets in the household sector, of which cash and bank deposits accounted for over 50% of the total household asset values in 2006. This skewed portfolio management is a good indicator, demonstrating the inefficiency of the financial markets.

The major elements of the Financial System Reform Laws which took effect in 1998 and 1999 are the following;

- Enabling the opening of a foreign currency account at ordinary banks through the revision of the Foreign Exchange Law; this provided a variety of financial assets with higher returns.
- Liberalisation of the commission fees for stock market transactions started in 1994, initially for large scale traders and which was expanded to all participants in 1999. The entry of new security companies using internet trading has lowered commission fees by stimulating competition; the average commission fees fell from the peak of 0.56% in 1992 before the liberalisation to 0.24% in 2000, and fell substantially to 0.07% in June 2009 with an expansion of internet trading.

- Removing the ban on over-the counter sales of investment trusts by banks.
- Amendment of the Anti-trust Law which had prohibited the establishment of holding companies by financial corporations for preventing a strong monopolistic power in the markets.⁶

Labour markets

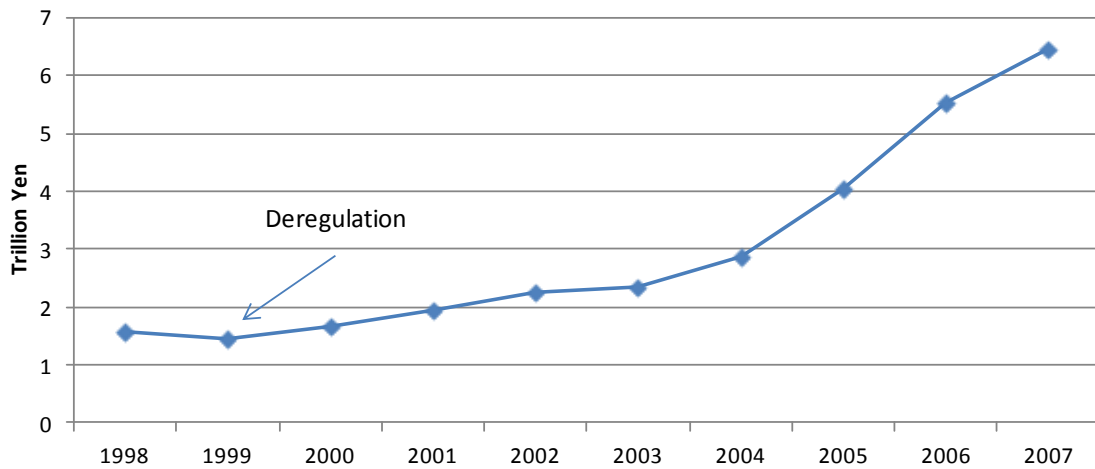
The rigidity of Japan's labour market is a major factor preventing the mobilisation of the labour force from low productivity to high productivity sectors and also sustains disparities in wages and employment across industries. The so-called Japanese specific employment practices which are based on long-term employment security, seniority-based wages and firm-specific labour unions, have brought about a “duality” between insiders and outsiders in the labour markets. The insiders (or regular workers) are those who are granted lifetime employment, and the outsiders are non-regular workers consisting of part-time or temporary workers⁷ with considerable job turnover. Jobs of regular workers (insiders) are guaranteed even during periods of recession, while employment adjustment is mainly achieved through reducing or eliminating the jobs of non-regular workers on fixed-term contracts. The protection enjoyed by regular workers during recessionary periods could be considered a rational system during periods of high economic growth as it kept the unemployment rate at a relatively low level. But with the sharp deceleration of economic growth since 1990s, the system was no longer viable, and unemployment rates have gradually picked up.

Against this backdrop, the government started to reform traditional labour laws to make the labour markets more flexible. In particular, the expansion of the mid-career job markets was targeted in order to create more employment opportunities, even if they are less stable over the business cycle. Some of the actual measures taken are the following:

- The deregulation of job-placement businesses, which had long been severely regulated for as they were considered as “worker exploitation” organisations as they charged high commission fees. Until 1996, private temporary help agencies had been prohibited in principle, with exceptions for 29 specific occupations. After 1998, private job-placement became basically free to operate, with few exceptions.
- Deregulation of the mobility of “temporary workers” such as those who are employed by firm A (often represented by a company that is specialised in dispatching additional labour), but sent to firm B for work on a temporary basis. The Revision of the Law for Temporary Workers in 1999 widened their job opportunities by shifting from the traditional “positive list (restricted to listed 26 job categories)” system to “negative list (free operation but for 5 listed job categories)”.

The increasing supply of temporary labour has been met by an increase in demand by firms favouring workers whose employment could be easily adjusted when economic conditions change. This demand was partly a result of the response of firms to the increasing exposure to the risk of hoarding workers during recessions. The risk has become larger with the longer recessions associated with the declining average economic growth. From the supply-side, there have been increases in the number of workers who value flexibility and shorter working hours over employment stability with long working hours. As the result, temporary labour services doubled in the last 7 years, supported by deregulation for widening the jobs for temporary workers in 1999 (Figure 1.5).

Figure 1.5. Usage of temporary employment firms (1998-2007)



Source: Ministry of Health Labour and Wealth (2008).

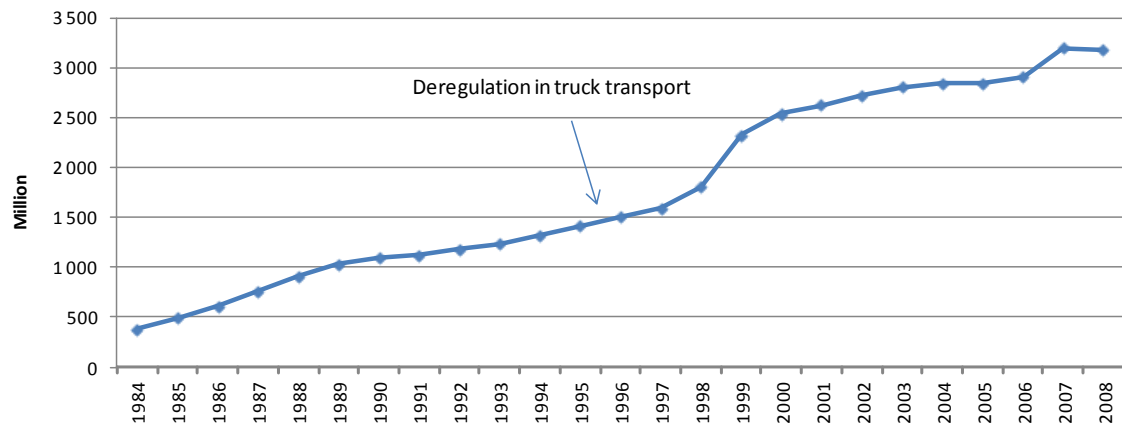
Transportation sector

One of the classic type of regulation in Japan is the “demand and supply balancing” regulation which is particularly prominent in the transportation and distribution sectors. It is a scheme under which the responsible ministry estimates the demand by firms and households for goods and services in each specific sector, and controls the supply accordingly by setting a quota on new entries. Such policies are usually not efficient, because it is difficult to predict future demand even if prices are regulated by government. Also, such a regulation often leads to a controlled market under government auspices (*e.g.* monopoly, oligopoly), which is managed for the benefit of producers at the expense of consumers by limiting the entry of competitors.

In 1996, the Ministry of Transport committed to abolishing the “demand and supply balancing” scheme in the domestic airline, railway, passenger ship, bus, truck, taxi, and domestic cargo sectors. Also, regulations on setting the prices of these transportation services are devolved from government authorisations to notification or price cap schemes.

The industry which benefitted the most from such regulatory reform is the road transportation sector which previously had been highly regulated with regards to operating routes, designated areas, and prices. The regulatory reforms of 1990 and 2003 have been associated with an expansion in courier services of small packages nationwide using ICT (Figure 1.6). The regulatory reform allowed the creation new markets among households in addition to the traditional markets for businesses. Also, it has stimulated the rapid development of the sale of goods and services through the internet.

Figure 1.6. Expansion of courier services (1984-2008)



Source: Ministry of Land, Infrastructure, Transport and Tourism (2008).

Distribution sector

The labour productivity in the retail sector has been low, reflecting the large number of very small stores which are often family-operated. The large number of such stores is partly due to the traditional day-to-day shopping style within a walking distance of Japanese consumers, but is also the result of the policy aimed at balancing demand and supply that is intended to protect existing small stores. The Large Scale Retail Law which had restricted floor size and opening hours of department stores or supermarkets used to be a symbol of such regulation, but was replaced in 2000 by the new law providing for the procedures to protect the “local living environment”, which means to provide enough parking spaces for the customers etc. However, the content of the new criteria in the 2000 Law was left ambiguous, and as such was open to interpretation by local authorities – this has often been affected by political considerations (OECD, 2008).

The restrictions on opening a new liquor store, which were also based on the demand and supply balancing concept were relaxed in 1998 and 2003 respectively, and abolished completely in 2005. The rationale for the regulations was to prevent an excessive alcoholic consumption, but *de facto* provided protection for small liquor shops from competition from large-scale discount stores.

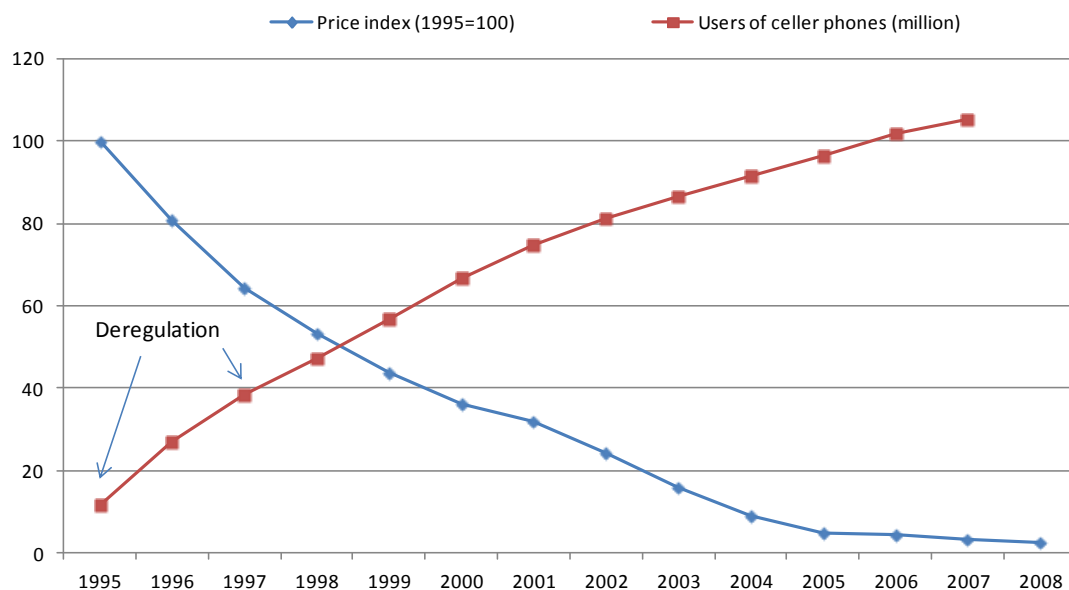
In 1999, the prohibition on the sale of pharmaceuticals, unless it was under the auspice of a pharmacist was slightly relaxed through 15 exemptions to the law. This resulted in benefits to the consumer such as increasing the number of health drinks in ordinary stores, many of which previously only available at drug stores now being available. A study on the effect of this deregulation indicated that the expansion of establishments as points of sale rather than falling prices accounted for 90% of the increase in consumer purchases (Unayama and Hirota, 2008).

Telecommunications

The telecommunications industry is characterised by the rapid evolution of technology which quickly makes existing regulations obsolete. The role of regulation in this sector is to enable the development of competition in local markets, while protecting other public interests such as reliability, universal service and consumer interests (OECD, 1999). Though the government had opened up the telecommunication markets for various providers in 1985 with the decision to privatise the Nippon Telegram and Telephone (NTT) Public Corporation, market competition was not initially efficient, partly because the dominant position of NTT which owned the basic infrastructure of telephone networks. Nevertheless, with the entry of various competitors, the prices of long distance calls have gradually fallen.

The cost of telecommunications has been falling even more prominently for broadband service consumers, and the cost is now among the lowest in OECD. However, the room for competition between various providers depends on the connection charge set by the NTT which is still a dominant provider of the telecommunications network. Prices of cellular phones under competitive markets fell substantially between 1995 and 2008 by mitigating the regulations on sales and price settings in 1994 and 1996 respectively.⁸ As a result, the population of the cellular phone users expanded from 12 million to 105 million during the period (Figure 1.7).

Figure 1.7. Usage and price of cellular phones (1994-2008)



Source: Ministry of Internal Affairs and Communications (2009), Bank of Japan (2009).

Rental Housing

The average house size in Japanese urban areas is small by international standards. This is mainly attributable to the fact that most rentals are small houses intended for single tenants with higher than average mobility coupled with the scarcity of large houses for family use. This is partly the result of the Rental Land and House Law which makes eviction quite difficult even after the contract for rent has expired. The Law intends to protect tenants' rights at the expense of the owners, but it ends up causing large distortions in the housing market.

As it was politically difficult to remove the existing regulation, a new law on Fixed-term House Lease which guarantees the right to evict fixed term tenants was established in March 2000. Research indicates that not only has housing construction in urban areas been stimulated, but the average size of rental housing under the new law is larger while the rent per square metre is lower, reflecting the smaller risk premium of the owner (Ohtake and Yamashika, 2001). However, the fixed-term contract is not applicable to existing housing for rent for the time being, though no positive actions have been made to replace the old-type rental contracts.

Major regulatory reform undertaken as a response to the 2001-02 crisis

Overview

After the short-lived recovery from the 1998-2000 recession, regulatory reform was utilised as a part of an exit strategy. The 2001 policy package indicated that the top priority was to streamline the regulatory framework to overcome financial sector weaknesses which posed a major constraint for sustainable economic growth (OECD, 2002). Increased transparency regarding non-performing loans owned by banks through the special inspections, the provision to banks of expanded options for dealing with non-performing loans such as easing debt/equity swaps are some examples. The effects of the regulatory pressures above were favourable to the economic recovery, with the positive impact from the reduction of non-performing loans exceeded the negative effects from an increase in bankruptcy and unemployed (Table 1.4).

Also, regulatory reform was utilised as a tool to strengthen the supply-side of the economy to bring the economy back up to its potential growth rate. Thus, the target of regulatory reform in the 2000s has expanded from economic reform to social reform including agriculture, health and welfare services where the persistent queues or waiting lists were pervasive. This mainly stems from government intervention which had been common practice and controlled demand and supply in the social service markets. The use of price mechanisms and competition is limited, and public funding is provided to non-profit institutions in exchange for setting minimum national standards.

As the resistance to regulatory reform is particularly strong in these areas, a new method for implementing regulatory reform such as special structural reform zones was introduced. Also, market testing (competitive tendering between public and private enterprises) to stimulate market competition in public services was applied to the business-like activity by the national ministries (so-called government-driven markets) which then became the new target for reform.

Although most of the effects of these reforms described above might not be easily quantifiable, the net increase in consumers' surplus by various regulatory reforms between 2002 and 2005 was estimated at 3.8 trillion yen (1.0% of the National Income in 2005) – see Table 1.5 below for details.

The institutional background and detailed explanation of regulatory reform in respective sectors are as follows:

Table 1.4. Effects of dealing with the non-performing loans

		2002	2003	2004
Amount of Non-Performing Loans to be off-balanced	Trillion yen	11.7	8	10.2
Workers who had to leave the company	1 000 persons	150	75	41
Increase in unemployment	1 000 persons	72	33	16

Source: Cabinet Office, 2005.

Financial markets

After the bubble burst in the financial markets in the early 1990s, the major banks experienced prolonged difficulties. The long-lasting imbalances were partly attributable to negative GDP growth in 1998 which required further adjustments with increased non-performing loans. However, a major challenge faced by Japanese banks was the low level of capitalisation, and the failure to provision for their non-performing loans. This problem was aggravated by the banks' "ever-greening" policy, which refers to rolling over loans or giving interest concessions to those firms with poor repayment prospects. Such policies had caused large distortions in the financial markets. With the increase in bank lending to stagnating industries like construction and real estate which were most seriously harmed by falling land prices, new loans to other promising sectors were crowded out. Unless the "balance sheet problem" was dealt with, insufficient funding to other industries would continue, and deter the recovery of investment.

The banks' practice was based on the previous experience whereby a cyclical upturn of the economy and the subsequent recovery of asset prices will automatically reduce the value of non-performing loans, as was the case in the previous recessions up to 1980s. The tradition of long-term relationship banking, under which each firm has its own "main bank" – not only its largest lender but its own individual "lender of last resort". As the "main bank" takes responsibility for financial support of the firm in times of stress, it was difficult to dissolve the relationship. However, the "wait and see" attitude of many banks, which had worked during the period of high economic growth up to the 1980s, turned out to be a critical factor contributing to the prolonged economic stagnation of the 1990s.

The government policies for dealing with non-performing loans were the following:

- The recapitalisation policy based on the Prompt Recapitalisation Act of 1998. The government bought subordinated debts and preferred shares of major banks using public funds; these were later returned after banks accumulated sufficient internal funds. The amount of the aggregated capital injection since the early 1990s amounted to 12.4 trillion yen.
- Stopping the practice of ever-greening by stricter enforcement of the capital-ratio regulation. This was initiated after the second crisis under the strong leadership of the Koizumi regime.
- Establishment of the Industrial Revitalisation Corporation of Japan (IRCJ) in 2003. Unlike other government-funded asset management companies, IRCJ bought up non-performing loans from banks, but instead of selling them in the markets, they were aimed at restructuring the debt-load of the firm. The primary role of the IRJC was to co-ordinate among various lenders with a view to reducing non-performing debts of the firm in cooperation with the “main bank”.

The Act for Strengthening Financial Functions of 2004 allowed capital injections of public funds into financial institutions without justification, in order to prevent a possible bankruptcy which might lead to financial crisis. The law was primarily directed at local financial institutions whose non-performing loans could not be easily written off because of concerns that local firms would be weakened and therefore disrupt the local economy. In 2006, The Financial Instrument and Exchange Law was established as a new legislative initiative intended to provide investor protection and was subsequently revised in 2008 and 2009. The continued development of financial technologies has led to the creation of some financial products that are not covered by the current regulations; in fact, existing regulations are compartmentalised by types of various financial institutions. Thus, it is necessary to establish comprehensive and cross-sectoral rules for consumer protection and to enhance fairness and transparency in accordance with international standards in order to attract foreign investors.

Land use

A Law limiting the establishment of new factories and universities in certain metropolitan areas of Tokyo and Osaka (the two largest cities in Japan) had been in place since 1959 in order to prevent further population concentrations in urban areas. The original intent of this law was to distribute factories to rural areas in order to achieve “balanced growth across regions”; this was combined with the distribution of public infrastructure resources for outputs such as highways or railways in order to encourage private investment in local areas. However, these policies have often resulted in the misallocation of public infrastructure funds which do not reflect market demand, and which are partly responsible for the decline of the Osaka economy which had been mainly dependent on manufacturing. In the Tokyo region, the number of factories within the restricted areas declined from a peak of 69 000 in 1969 to 35 000 in 1999, and from 44 000 in 1985 to 28 000 in 1999 in the Osaka region (Hatta, 2009). This Law was finally abolished in July 2002 as a part of the package of policies intended to stimulate the economy through regulatory reform.

Health care services

Public health insurance basically covers all the people living in Japan, and free access to hospitals and clinics without gatekeepers is guaranteed. Health expenditures have steadily increased with the advancement of medical technology and the ageing of the population. The government has tried to contain the expansion of expenditures by affecting the incentives of patients and providers towards making the best use of limited resources. However, room for a further rise of the co-payment ratio from the current 30% (20% for the elderly) is limited because it is socially not acceptable to discourage the patients really in need for the consultation to doctors. Also, the government policy for limiting increases in the number of hospital beds in regions with excess supply, which is considered a major cause of rising health care costs, is not desirable as it would create economic rents to existing hospitals being protected from the competition.

With the severe budget constraints of the government, an expansion of the costs of the public health care insurance have to be limited by setting a clear boundary beyond which private health care should cover. However, the current rule set by the government is that all health care services costs have to be in principle covered by public health insurance. There is a rigid interpretation of this rule, and in cases where doctor's prescriptions or treatments exceeds the range allowed by public insurance, the patient has to bear the total costs, *i.e.*, not only the remaining costs uncovered by the public health insurance, but also those originally covered by the public insurance. This is known as the rule of "prohibiting the mixed billing between public and private insurance". This is rationalised by an egalitarian principle that it is undesirable that the wealthy benefit more from better treatment within the public health insurance system. However, the wealthy already have access to higher quality health care services that are not covered by the public health insurance at all. Nevertheless, removing the regulation on mixed billing could benefit the middle class, who could afford to pay additional costs for better health care services, but not the total costs.

Currently, there are several exceptions to the prohibition of mixed billing. They are basically categorised as amenities (comfortable room etc.) or highly technological treatments not yet included in the public insurance plan which are selected in detail by the government; the physicians' room to manoeuvre within these regulations is quite limited. In this respect, the Regulatory Reform Committee (RRC) agreed with the Ministry of Health, Labour and Welfare in December 2004 to widen the range of health care services which are exempted from the prohibition of mixed billing, and to simplify the administrative procedures for some qualified hospitals. These were important steps for the future of regulatory reform.

Long-term nursing care services

Long-term nursing care had been mainly undertaken within the family, and only those who are not cared for by family members are provided care services or accommodated in nursing homes managed by the local authorities or non-profit organisations. As the supply of nursing homes is limited, small hospitals are used as an alternative. In order to avoid a misallocation of health resources as well as the resulting increases in health care costs, nursing care insurance for the frail elderly was established in 2000.

At the same time, there was a major reform in the regulation of the elder care services. Before the reform, the elderly were provided nursing care by the local government as a part of the welfare program; but after the reform, the elderly became consumers of services financed through nursing care insurance, and could choose the

providers by themselves in competitive markets. In addition, the markets for the elderly care services, which had previously been monopolised by the public sector and the Social Welfare Corporations, which is the non-profit organisation under strict government control, have been opened to private corporations. As part of nursing care insurance, the users are first granted a certain qualification based on screening of their physical condition, and provided the ceiling of the benefits available from the public insurance. Then, the consumer can purchase the nursing care services in the marketplace with a copayment ratio of 10%.

The establishment of the nursing care insurance through the regulatory reform in the nursing care services has created additional demand and employment; the employment in health and welfare industries increased by 1.4 million, and the share of the total labour force increased from 7.1% in 2002 to 9.1% in the first half of 2009. There is less restriction on mixed billing, so consumers can purchase extra services at their own cost beyond what is made available through public insurance. However, the price of each nursing care service is strictly fixed by the authorities, and officially-set prices are sometimes revised downwards, primarily to reflect fiscal constraints.⁹ As such, the circumstances surrounding the providers of the nursing care services are not favourable, despite the fact that the demand for nursing care services will grow with the continuous increase in the elderly population.

Nursery schools

Unlike the case of nursing care services for the elderly, nursery schools for children are included in Japan's government welfare programme, and are not considered as market services. The idea behind this is that small children are to be brought up by the family, and only those children who are not well taken care of should be protected by the government. However, this belief is no longer suitable in the current social context, with an increasing number of working mothers with small children. Also, there are severe shortages of nursery schools in urban areas, while there is excess supply in rural areas, reflecting the imbalances in the number of children. Nevertheless the re-allocation of nursery schools has been largely constrained, because the majority of the staff of nursery schools are local government employees with strong employment guarantees and seniority-based wages.

Uniform standards and regulations apply to the nursery schools subsidised by the national government in terms of the spaces or number of staff per child. This represents an obstacle to increasing the supply in urban areas where land prices are particularly high. Those nursery schools managed by private corporations which do not meet these detailed standards are not eligible for subsidies, even though they often provide childcare services during the late evenings or on weekends; these are services often not provided by public nursery schools.

These standards relate to traditional issues of levelling the playing field of nursery schools which provide childcare during working hours as a part of the welfare program, and kindergartens which operate during limited hours and target the market of full-time housewives and mothers. They are both providing similar services to children under age of 6, but there is a large gap in public subsidies between them.¹⁰ While there are an increasing number of women participating in the labour market, the number of children in kindergarten decreased by 100 000 during the last decade despite of a long waiting list for the nursery schools. As a result, the government in 2006 established a third category of institutions to accommodate nursery schools and kindergartens, though the number in 2008 was just 229 out of 22.9 thousand nursery schools and 13.6 thousand kindergartens.

Introduction of new methods for implementation of regulatory reform

Special zones for structural reform

The special zone for structural reform is a unique example of a place-based approach to regulatory reform established in 2002. This is a scheme under which certain regulations can be eased or lifted within geographically limited administrative areas (mainly within a city, town or prefecture) as a testing ground. After the careful examination of the effects by an evaluation committee, the regulatory reform in the special zones would be implemented at the national level. In these cases, the criterion for judgment is *not* whether the respective reform was effective, but whether there were explicit damages or demerits with the reform. If the effects of the reforms were in a gray-zone (no merits or demerits detected), they will be implemented nation-wide as an alternative to existing policies. This “two step” approach of “social experiments” is needed, as nationwide reform is usually difficult to co-ordinate. Particularly in the case of social regulations, national ministries often point out the possible risks arising from changing the current regulations as an excuse for not carrying out necessary reforms.

The introduction of the special zone is also an experiment for decentralisation, as the social experiment in a specific region is based on the initiative of the local authorities, not by a national ministry. There are no tax-waivers or subsidies provided by the national government for special zone initiatives, in contrast to similar schemes in Ireland or China. Both Dublin’s Dockyard Financial Service Centre and the special economic zones in China’s Coastal Areas, which opened up to foreign capital, are examples of national place based projects given favourable tax treatment by the government.

A major reason why local authorities rather than national ministries are empowered to establish these special zones is to avoid political pressure favouring fiscal incentives without solid basis for development with regulatory reform. A typical example is the case of the Financial Special Zone in Okinawa, which is based on an entirely different scheme, with certain tax advantages. However, there is no rational reason other than political ones why Okinawa, an isolated island far from Tokyo where financial institutions are concentrated, would be selected as a financial special zone. Removing the fiscal incentive for special zones also has the merit of establishing them without the consideration for the fiscal costs, but rather being dependent on the local initiatives with no limitation of the numbers.

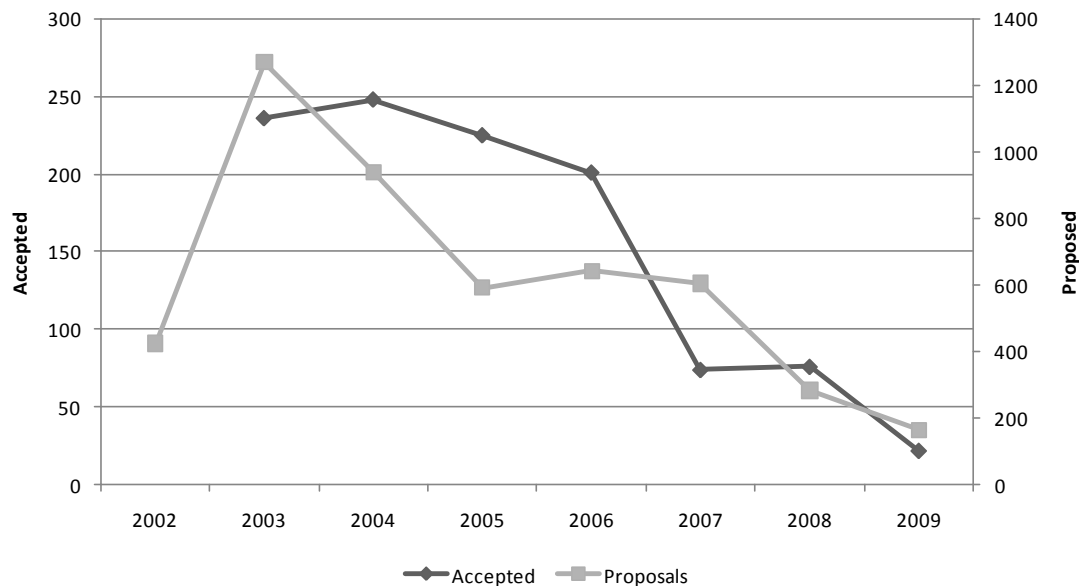
Major examples of the special zone are the following:

- An exception to the ban on private corporations in agriculture: Corporations can manage agricultural business by leasing land from the local government (not directly from farmers). Local government in a sense play a role of an agent smoothing the transactions;
- Flexible school management: As school curriculums are dictated in great detail even to private schools by the Ministry of Education, 2000 schools were able to take advantage of this scheme in order to use flexible curriculums by FY2008. Also, universities managed by private corporations were allowed for the first time to operate.

- An exception for fire regulation in the petrochemical industrial complex. The Fire Law makes it mandatory that roads in the industrial complex have to be wide enough for fire engines to pass through. The regulation was replaced by a more efficient device (a water curtain to prevent fires in the special zone), and the land space of the complex was largely reduced.

These projects are just a few examples of deregulations that could not have been realised outside such special zones. Since their inception, special zones are estimated to have increased private investment by 0.6 trillion yen and employment by 18 000. However, interest in the special zones seems to have been dropping recently; both the number of proposals for deregulation and to create special zones have declined recently (Figure 1.8).

Figure 1.8. Numbers of proposals for special zones and numbers of proposals accepted (2002-09)



1. The number of proposals submitted, and the number of those that were accepted is for the months until the end of September for the year 2009.

Source: Cabinet Office (2009).

Market Testing

There are many business-like activities managed by government organisations, for example, housings, schools, hospitals, job-placements or garbage collection. Even though some of these services may need to be supplied publicly, they do not have to be directly provided by the government *i.e.* using public employees with higher costs, but could be either privatised or entrusted to private corporations providing similar services. Market testing is a competitive tendering process between public and private enterprises in terms of prices and the quality of services, in comparison with the traditional tendering process that only takes place between private corporations. If a private corporation proves to be more efficient and effective, the business activity would be awarded to the private sector under the responsibility of the government, while in the case where a public institution

wins, nothing changes. According to the experiences of local administrations in the United States, the result of the competitive tendering process was more or less even, although the efficiency of public services was likely to have improved due to pressures from the competition with private corporations.

The law for market testing was established in 2006, and it was applied to various fields like collection of contributions or Social Security Administrations call centres that provide information, and subsidiary organisations of the national employment offices. However, market testing is only done indirectly to date *i.e.*, some government offices are entrusted to private corporations while other benchmarked government offices are as they were, and thus compared their costs and services between private and public offices. Through this method, the results generally favoured the government rather than private corporations who had less experience and often changed every year through the process of tendering between private corporations. In addition, since only the subsidiary parts of the business activity of a public institution were entrusted to private corporations, there would be less room for them to manoeuvre.

Major regulatory reform undertaken as a response to the 2008 crisis

The U.S. subprime mortgage issue developed into a global financial crisis in the autumn of 2008, leading to a rapid increase in uncertainty about the economic outlook and financial asset valuation. Financial institutions had deepened concerns over counterparty risk in the interbank markets, and liquidity dried up. As the result, lending policies became more stringent for the non-financial sector, which led to deterioration in funding conditions for households and companies, which also made them risk averse.

Although the effects of the adverse feedback between the financial and real sectors became evident worldwide, the shock of the financial sector in the recent cyclical downturn was less prominent than that in the real sector in Japan; it was reflected by the relative small size of falling stock prices to those of output than the cases in the previous recessions, and bank lending was basically maintained. This resulted as the securitised products in Japanese markets remained relatively simple, and their risks have been identified rather easily. Over-the-counter (OTC) derivatives markets have only recently expanded, though it is still small amounting to USD 25 trillion compared with USD 500 trillion in the global markets in 2007.

The following are major regulatory reforms during this period:

- First, the Act for Strengthening Financial Functions of 2004 was revised in December 2008 and was included in the policy package implemented in late 2008. The new law is ready for speeding up capital injection of public funds, which is projected to increase from 2 trillion yen to 12 trillion yen. The Working Group on Distributions of Securitised Products held discussions to fix the self-regulatory rule about enhancing the transparency of transactions of securitised products by ensuring traceability to the underlying assets in the end of 2008. This represents a preventive measure. Under the new rule, distributors of securitised products are required to ensure internal procedures, and to give their customers relevant information on the nature and risk of the underlying assets. Moreover, the working group developed standardised information reporting packages (SIRPs) to provide a common platform for individual items that would be necessary to disclose for major securitised products. The new rule is scheduled to take effect after the public consultation process.

- Second, the Law on Unemployment Compensation was revised at the end of 2008 as a safety-net for an increasing number of unemployed individuals. The coverage of the insurance was extended to those who work more than 6 months in the same company instead of the previous 1 year timeframe. This is intended to benefit temporary or part-time workers who accounted for one-third of all employees in 2008.
- Third, monetary policy was reformed. Against the deterioration in economic conditions triggered by the financial crisis, major policies by the central bank included discount rate cuts, an increased provision of liquidities, guarantees on bank liabilities and capital injections, and purchases of assets from financial institutions whose functioning had been significantly compromised. A major policy change of the central bank that was implemented in December 2008 was an active use of so-called “non-traditional monetary policy” which widens the range of financial assets to be purchased by the authorities, including the more risky assets like commercial paper (CP). This is needed because of the deterioration in the corporate financial markets by increasingly risk-averse investors. After the intervention of the Bank of Japan (BOJ), the CP markets have been stable in the first half of 2009. This policy, however, may cause a substantial loss for the BOJ if the market value of the risk assets fall further, the costs of which will eventually be borne by the taxpayers. In addition, the purchase of the CP issued by a particular company may distort the resource allocation in the market.

A major characteristic of the most recent policy packages as a response to the 2008 crisis was less reliance on regulatory reform as a supply-side oriented policy tool, compared with the 2001-02 crisis. The major emphasis of the policy package was regarding fiscal stimulus; the positive experience in the previous crisis with respect to regulatory reform was not taken into account. This is closely related with the changing political environment.

Effect of regulatory reform

Regulatory Impact Analysis (RIA)

RIA on establishing, revising or abolishing regulations is an important policy tool for ensuring efficient regulatory reform. The Regulatory Reform Programme of 2004 mandated ministries and administrative agencies to prepare RIAs on a trial basis before making RIA mandatory for all regulations (OECD, 2004). The RIA, which is intended to reveal the costs and benefits, became mandatory in 2007 and since then, 273 items have been reviewed by FY2008. However, the processes of self-review by the very ministries which make the regulations have been often just for formality or not objective at all.¹¹ This is reflected by the recent recommendation by the authorities responsible for RIA indicating that the evaluation of costs and benefits of a regulation should be quantified in pecuniary units as much as possible, implying that most of the current RIA had been not conducted on a quantitative basis.

There have also been cases where effective regulation is imposed by the ministry’s administrative guidance which is not under regulatory ex-ante evaluation. For example, the surveillance areas where the authorities are particularly interested in affecting the numbers of taxi cabs were increased from 67 to 537 (83% of the total) by the ministry’s guidance on July 2008, which is de facto the strengthening of the regulation; but this was not the subject of a RIA (RRC, 2008).

Macroeconomic effects of regulatory reform

A major impact of regulatory reform is to lower prices or to improve the quality of goods and services by stimulating market competition. With falling prices, consumers would increase the purchases of goods and services, and the net impacts could be measured by the increase in the consumers' surplus from the base year when the regulatory reform had started. Using this method, the effects of regulatory reform were estimated by the Cabinet office several times, and the most recent estimates in 2007 were for 1990-2005 on the various fields listed in Table 1.5. In 2005, the accumulated increase in consumers' surplus was 18.3 trillion yen or 5% of National Income (NNP)¹². Also, the net annual increase between 1997 and 2002, and that between 2002 and 2005 was 1.5 trillion yen and 1.3 trillion yen respectively.

The macroeconomic impact of the increase in consumers' surplus by regulatory reform could be estimated based on the assumption that they would eventually be spent as consumption. The aggregated contribution to GDP growth by the regulatory reform in the above periods would be 0.6% and 0.5% respectively.¹³ Note that the effects of regulatory reform in Table 1.5 do not necessarily correspond to the ones as the response to economic crises; the full effects of the reform have not been captured yet.

The major items of regulatory reform with large economic impacts are the following:

- Reform of cellular phone market in order to ease the entry of newcomers was undertaken in 1994 and 1996 respectively; though the resulting effects of significant falls in prices have been decaying recently;
- Regulation regarding new entrants to the sector and with respect to prices of truck transports was removed in 1990 and 2003 respectively. This has largely expanded small package courier transport services, which seem to have become saturated in the 2000s;
- Reform in electricity market to allow new entrants and the ability to enable free price setting for large-scale customers was undertaken in 1995 and 2000, resulting in significant price reductions.
- Regulation regarding the opening of gasoline service stations based on the demand-supply balancing policy was removed in 2002. Most of the regulations for self-service gasoline stations were removed in 1998, but it accounted for just 16% of the total gasoline stations in 2008, despite the high wage costs. There is a possibility that additional obligations imposed on self-service stations may well discourage more rapid increases

Table 1.5. Accumulated increase in the consumers' surplus by regulatory reform (10 million yen)

	Base year	1997	2002	2005
Cellar phones	1994	13 177	26 297	27 876
Domestic airline	1993	1 915	2 730	1 206
Railway	1997	42	2 604	4 840
Taxi cab	1997	28	77	125
Truck	1991	15 667	32 312	34 308
Car inspections	1995	5 331	8 350	8 642
Electricity	1995	10 542	26 405	56 630
Gas	1995	308	2 275	4 579
Petroleum	1994	15 130	22 660	21 410
Stock sales commissions	1994	1 494	4 695	5 291
Insurance premiums	1996	575	2 135	3 155
Rice sales	1995	1 702	5 267	6 249
Liquor sales	1992	3 145	8 742	7 957
Cosmetics & drugs sales	1997	173	807	1 182
Total		69 227	145 355	183 452
(as the ratio of national income, %)		1.8	4.0	5.0

Notes: The consumer surplus of respective regulatory reform indicates the net increase from the base year without reform.

Decline in CS is due to the *ad hoc* consumption reduction.

Source: Cabinet Office, 2007.

Political background: the conservatives strike back

Overview

While regulatory reform had proceeded steadily during the Koizumi regime, the environment changed following the 2007 election. There has even been hesitation to reverse the regulatory reform of the past. This is mainly due to a widespread view that regulatory reform to stimulate competition in the markets might be a major cause for increased income disparity.

Indeed, income disparity has gradually expanded over time, but it is mainly a consequence of an ageing population as an increasing share of the elderly population whose income disparity is largest,¹⁴ while income disparities within each age group have remained relatively stable (Ohtake, 2008). An exception is the youth (age 20 to 29) whose income disparity is growing, which is mainly due to a shrinking of full-time employment opportunities; this arises mainly from the long-run economic stagnation that has been in place since the early 1990s, and a general practice of long-term employment security which concentrates the burden of employment adjustment on the youth by reducing new recruitment during recessions.

A typical example of regulatory reform that is suspected to have increased income disparity is the expansion of temporary worker jobs with lower wages. However, the fundamental factor that has led to an increasing share of non-regular workers without long-term employment protection has been the prolonged economic stagnation that has been in place since the early 1990s. Regulatory reform in the labour markets was intended to create additional employment opportunities for this group of workers which could also result from “unbalanced regulatory reform” *i.e.* deregulation of temporary workers while keeping the rigid regulation of regular workers. This has accelerated a shift in demand by firms towards non-regular workers particularly among the youth employment.

Examples of reversing regulatory reform

Labour market re-regulation

With the revision of the Law for Temporary Workers which opened up employment opportunities in 2000, those number of individuals who work in low-paid jobs with short-term employment contracts have increased. While the majority of these workers are voluntarily employed, those who have no other sources of incomes may well be below the minimum subsistence level. While there are no guarantee that those workers can be hired under better condition jobs simply by forbidding temporary employment, the government submitted a revised version of the Law for Temporary Workers in the autumn of 2008 which bans temporary work of less than 30 days, except for a few professional jobs; the Bill was eventually abolished along with the dissolution of the House of Representatives. The Democratic Party of Japan, which was the opposition party at the time, but later became the ruling party, had submitted the more radical revision of the Law, *i.e.* only skilled workers are allowed in manufacturing jobs, and only those who have job guarantees by employer are allowed in other jobs.

The basic idea behind the re-regulation of temporary workers is that life time employment is desirable and as such fixed-term employment contracts have to be restricted. However, demand by firms for temporary workers is based on its structural need to protect the employment of regular workers during the recession. Rather than restricting the hiring of temporary workers, their employment conditions could be improved, for example, through giving larger responsibility to the firm that actually uses the temporary workers,¹⁵ and through increased employer sponsored training opportunities to upgrade their skills.

The job placement business, for both regular and non-regular workers in Japan, is still underdeveloped compared with other OECD countries. The development of this industry could enhance the job mobility of workers in order to shift from stagnating industries to growing ones, which should contribute to higher potential economic growth. An expansion of job-placement businesses with further regulatory reform would create large employment opportunities.¹⁶

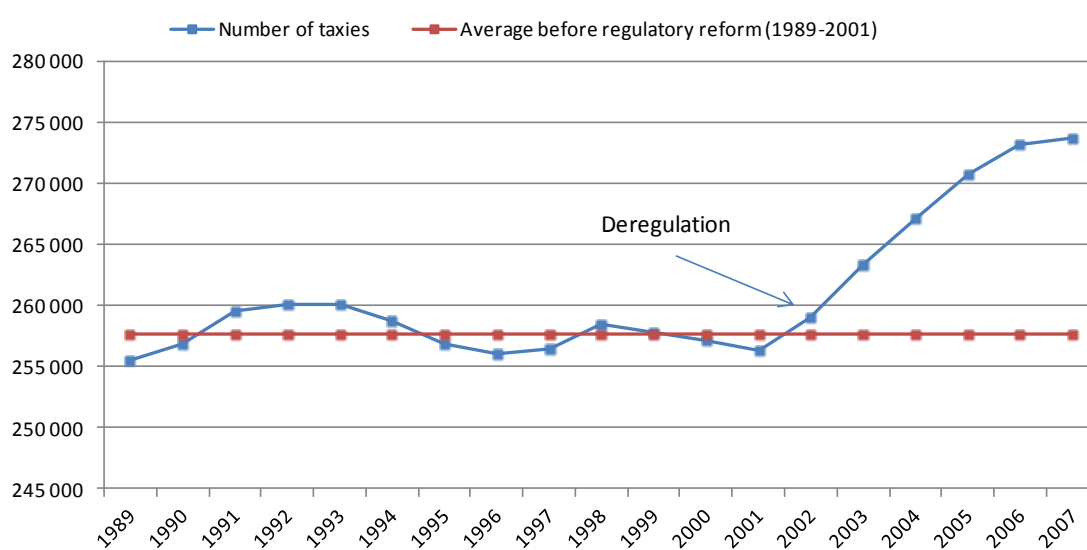
Revival of “demand and supply balancing regulations” in taxicab services by region

Regulations restricting new entrants in the taxicab industry were removed in 2002. This resulted in an increase in the number of taxicabs by 16000 (6.2%) by March 2008, which provided additional job opportunities for newcomers and wider choices for consumers (Figure 1.8). Nevertheless, the price of taxi fares has not fallen. They even

rose in 2007, because of the concerns that the falling incomes of taxi drivers may lead them to take on longer working hours, resulting in more accidents. However, the higher taxi fares have only led to further decreased usage of taxicabs in urban areas.

As a result, the new law for controlling the supply of taxicabs in selected large cities was passed by the Diet in June 2009. This enables the government to reduce the number of existing taxicabs if their numbers are considered to be excessive. This measure is treated as an exception to the Anti-Trust Law. However, such re-regulation could prevent price competition and the provision of a variety of value-added services which have started since the opening up of the taxicab markets to new entrants.

Figure 1.9. Number of taxicabs – before and after regulatory reform (1989-2007)



Source: Ministry of Land, Infrastructure, Transport and Tourism (2008).

A freeze on the privatisation of government owned banks

The Development Bank of Japan (DBJ) was established as a government owned bank to finance long-term investments of private corporations. When Japanese industries matured, however, it was decided in 2007 that the DBJ would be privatised in 5-7 years by selling the stocks owned by the government. However, a recent decision by the government was to freeze the sales of such stock, based on the logic that the government still needs its own bank in order to help private corporations that experience a shortage of funds at the time of the current financial crisis, implying a major revision of the privatisation aspect itself.

Role of competition policy

Overview

Regulatory reform in various fields could be more effective when combined with policies for maintaining fair market competition. It is particularly important in the Japanese markets where cartels and bid-rigging are still prevalent.

Revision of the Antimonopoly Act (AMA)

In this respect, the AMA was revised in 2005 – the first major revision since 1977 – to strengthen market competition in the following ways:

- The surcharge rate (penalty for cartels and bid-rigging) on large manufacturing firms was raised from 6% to 10% of the sale of goods or services, while those of large retail and wholesale industries was raised from 2% to 3% and from 1% to 2% respectively. In addition, the surcharge rates were increased by 50% for repeat offenders within the limitations of 10 years.
- A leniency program was introduced, offering lighter sanctions to those who violate the law but come forward early under certain conditions¹⁷: This creates an incentive for lawbreakers to report voluntarily to the FTC, and makes cartels or bid-rigging more difficult.

The AMA was further revised in June 2009, raising the penalty on cartels further:

- The types of conduct subject to surcharges was expanded: In addition to the existing unreasonable restraints of trade and control type of private monopolisation, new categories of “exclusionary type of private monopolisation (surcharge of 6%), “concerted refusal to trade (3%)” “discriminatory pricing(3%)”, “unjust low price sales(3%)”, “resale price restriction (3%)” and “abuse of superior bargaining position (1%) were established.
- Higher penalties for cartel leaders were introduced. Surcharge rates were increased by 50% for instigators of the illegal schemes.
- In criminal cases, the maximum jail term for individuals convicted of engaging in collusion was extended from 3 years to 5 years.

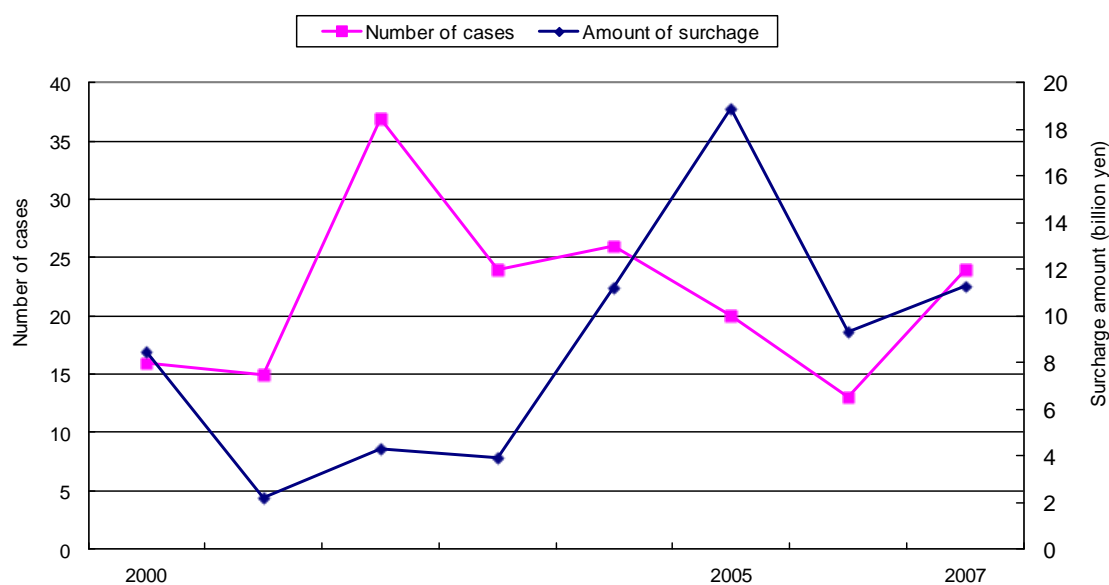
Assessment of the revision of the Antimonopoly Act

The effects of the 2005 revision (effective from January 2006) are still not clear, and the number and amount of surcharges remains low (Figure 1.10).

- While the revision of the AMA is obviously favourable for making competition policies more effective, more can be done to strengthen it. Even after the increase in penalties for violations, they are not necessarily higher than the illegal profits from cartels (on average 16.5% estimated by FTC), implying that the cartels are still profitable even when accounting for the risk of being detected. Also, the maximum imprisonment of 5 years is still short compared with 10 years indicated in the United States Antitrust Law.

It is also noteworthy that a surcharge for “unjust low price sales” was inserted in the amendments. The original intent of the AMA was not for the protection of small firms, but rather for the protection of consumers who might suffer from predatory pricing by monopolists after eliminating all competitors. As the definition of “unjust low price sales” is not clear, it is important that the actual implementation of the surcharge penalty should not be applied too strictly so as to impede price competition in the markets. The 2009 AMA revision expanded coverage of the surcharge to encompass a wide area of violations other than hard-core cartels. The expanded area includes “unjust low price sales”, abuse of superior bargaining position, etc. Such an expansion of the surcharge to violations other than hard-core cartels could discourage aggressive price competition which benefits consumers.¹⁸

Figure 1.10. Surcharges by the FTC (2000-07)



Source: Annual Report of Fair Trade Commission (2008).

Application of competition policy to social issues

In Japan, it has become conventional wisdom that basic social services like education, health, welfare and even agriculture should be exempt from competition policy. Regulation of these sectors generally favours “non-profit” entities and prohibits or discourages the entry of for-profit firms. Such policy discourages competition between various providers, and leads to products and services with fewer alternatives to consumers, deterring the development of the better alternatives. The examples are as follows:

- In agriculture, commercial firms are not allowed to own farmland and may only enter the agricultural sector by leasing land. Even the latter only became possible in 2003 after a trial in one of the special zones for agricultural reform.¹⁹ This policy gives private corporations little incentive to invest in farmland and prevents them from achieving economies of scale through, for example, purchases of adjacent or nearby farms. This policy is based on a strict interpretation of

agricultural law which states that only those who actually engage in farming can own farmland.²⁰ However, this adherence to the letter of the law actually ignores the spirit of its intent, since some commercial firms are arguably more legitimately engaged in farming than the many individual “farmers”, most of whom are past retirement age and who abandon their farmland without cultivating it (Godo, 2006). Such abandoned plots accounted for close to 40% of the total farmland in 2005. Thus, this regulation *de facto* works to exclude large farming by private corporations in order to protect small farmers.

- In the field of healthcare, the idea that hospitals should not be profit-seeking, nor subject to such pressures from shareholders, has led to a prohibition on equity financing. However, this has not led to a similar ban on debt financing from banks. This regulation *de facto* protects small hospitals or clinics from competition with large hospitals that could issue stocks and gain access to cheaper financing. An important implication of removing this regulation would be to stimulate mergers and acquisition of smaller hospitals to establish larger hospital groupings which might be able to provide quality health care services while saving on the costs of drugs or other medical inputs through economies of scale.
- With respect to other social services such as elder care and nursery schools or afterschool child care, there are no explicit barriers to private firms entering the market, but they are not on a level playing field with existing non-profit organisations which are licensed and regulated by the government and receive large public subsidies. Decisions on selecting providers for those services are up to the local councils, which often include representatives of these “non-profit” providers (OECD, 2004).

Role of trade policy

Overview

With the globalisation of the world economy, a linkage between developed economies is growing; this trend became particularly evident after 2000. Maintaining free trade is particularly important for Japan, a country with few natural resources which is largely dependent on imports for energy and raw materials and with a demonstrated comparative advantage in the production of manufacturing products. Policies for maintaining open markets in the face of the previous economic crises have succeeded in many areas. An exception is agriculture; in particular, the tariff on rice remained at an exceptionally high level of 778% which was set at the Uruguay Round negotiations (1986-95). Maintaining this high level of protection for a long period would likely have discouraged the incentive for the revitalisation of the agriculture sector.

Economic Partnership Agreements

Japan’s Economic Partnership Agreements (EPA) for free access of trade and investment have made progress through an increase in the number of agreements enacted. The EPA came into effect with 11 countries and regions²¹ which have combined trade values accounting for 16% of Japan’s total trade. Negotiations are under way with an additional five countries and regions, which would account for another 22%. The official

target adopted in 2006 was to have EPAs with countries accounting for at least 25% of Japan's total trade by the end of 2010. But this figure is still low compared with the Free Trade agreements of the US (37.7%) and EU (73.1%). Negotiations of EPAs with major trading partners like the United States and China, which together account for 34% of Japan's trade, have not yet started. A major obstacle is the domestic issue regarding protection of the agriculture sector.

The EPAs already in place with the Philippines and Indonesia were ground-breaking in that they include provisions allowing foreign nurses and care givers to work in Japan. Japan's immigration law accepts "skilled foreign workers," but the scope of "skilled" is limited to a certain ad hoc job statuses. Social pressures had led to nurses and care givers being excluded from the scope of categories of skilled labour. Under the EPAs, nurses and care givers from the Philippines and Indonesia are treated as exceptions. However, conditions on the right to remain in Japan are strict. While working as trainees when they first arrive, the entrants under this program must pass Japan's national examinations, in Japanese within 3-4 years. In the first year, only 283 persons from the Philippines and 208 persons from Indonesia were able to take advantage of the program. These low numbers are likely due to the strict conditions which discourage many hospitals or nursing homes accepting foreign trainees. With the ageing of Japan's population, the demand for these workers will increase over time, while the supply of domestic workers in these fields is limited. Clearly a more open stance toward accepting qualified foreign workers could ease the situation in these occupations.

So far, the counterparties of the EPAs have been relatively small economies; agreements with larger countries would do even more to expand trade and open up domestic markets. The EPA negotiation with Australia (a major exporter of agricultural products) began in 2007. These particular negotiations are significant not only because of Australia's economic importance, but because a successful agreement will require co-ordination with the domestic agricultural sector.

Issues in agricultural markets

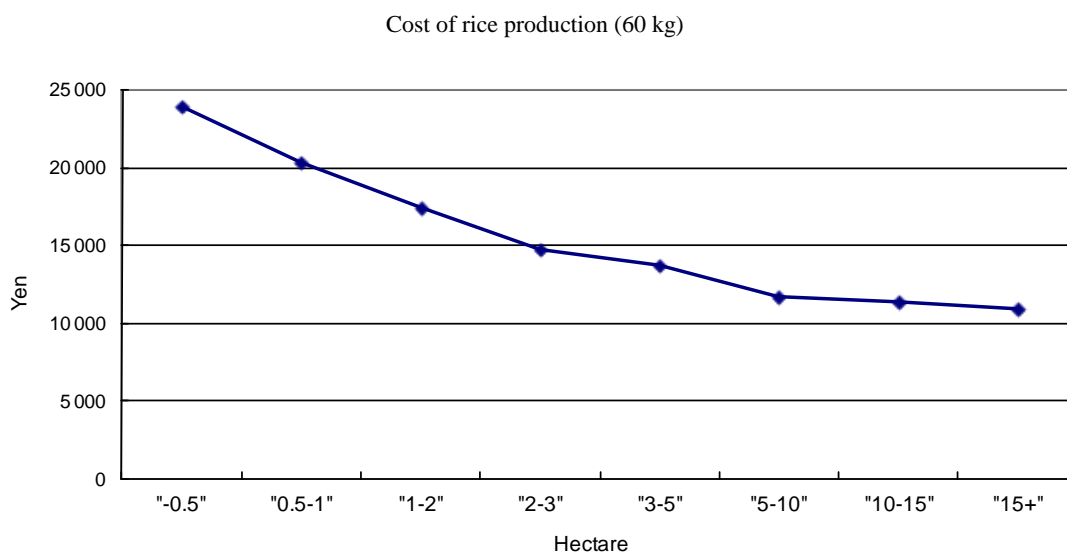
One of the main arguments against opening up Japan's agricultural sector to foreign competition is Japan's low and declining self-sufficiency ratio. On a caloric basis, Japan's food self-sufficiency ratio has declined from 60% in 1970 to 40% in 2007.²² But the lack of competition in the domestic agriculture market has resulted in low productivity and high food prices, giving foreign agricultural products an edge in Japan's market which in turn has contributed to their market share. In 2005, the average annual production per farmer in Japan was USD 24 226, this is very low when compared with other countries at similar levels of development such as the United States (USD 56 431), France (USD 49 803), and Australia (USD 57 377). This productivity gap mainly comes from the large market share held by small farmers in Japan, despite the fact that the production costs of rice, Japan's major agricultural product, fall as the scale of the farm it was produced on increases (Figure 1.10). This implies that the large-scale farmers operating on more than 3 hectares would be more competitive in international markets, but in 2005 they accounted only 3% of the total farms in Japan.

Despite concerns about Japan's falling agricultural self-sufficiency ratio, the production of rice has been cut by 40% through government quotas in order to maintain higher prices for farmers; this is the equivalent of a government-led cartel. The quota has been imposed uniformly, so large-scale farmers are suffering more productivity losses. Clearly, this policy is not intended to stimulate productivity in agriculture through economies of scale, and it offers protection to small farmers, most of whom are only part-time farmers with their major source of income coming from other activities. While similar policies can be found elsewhere, Japan's agricultural protection policies actually hurt the most productive farmers. This is in contrast to the experience of other OECD countries, which usually aim to strengthen the competitiveness of domestic farmers in the world market.

Four key reforms to the current agriculture policy were advocated by a working group within the Council of Economic and Fiscal Policy advisors in 2008. First, immediately halt rice production quotas and let prices adjust according to market mechanisms. Second, replace the quota system with direct subsidies to productive farmers for a limited period of time and encourage less productive farmers to exit the sector. Third, stimulate the sale of farmland between farmers to pursue economies of scale in production. Finally, provide private corporations the right to own and cultivate farmland in Japan.

At first glance, the factors resulting in low productivity in the agriculture sector are confounding given Japan's moderate climate and sufficient water resources. With Japan's declining population and increasing urbanisation, there is plenty of farmland and highly educated human resources to use it. Therefore, this may be due to the level of competition in this market.

Figure 1.11. Scale economy of rice production (2007)



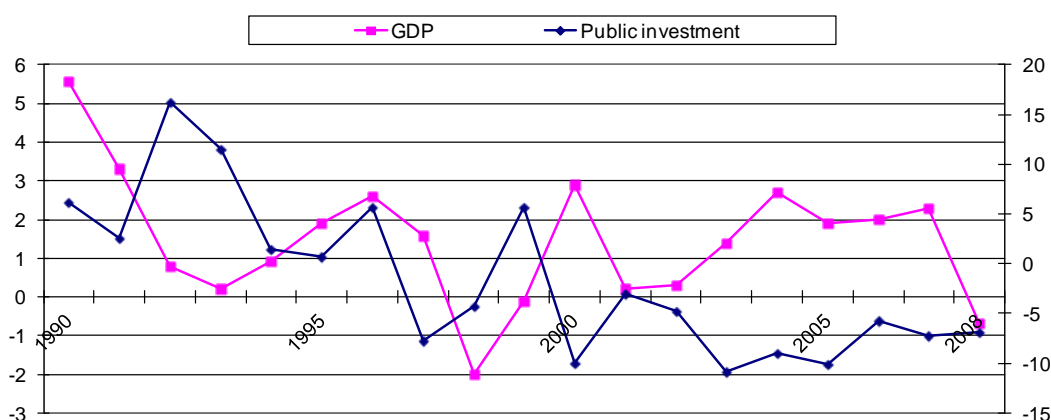
Source: Ministry of Agriculture (2007).

Implementation challenges: lessons from reforming at a time of crisis

Key institutional and policy challenges faced

When comparing the four economic crises since the early 1990s, one difference that emerges in the policy responses taken by the government is the role of public investment. In the first crisis, fiscal stimulus was an important policy response after the bursting of the asset price bubble, and the contribution of public investment to GDP growth was close to 1%. Fiscal stimulus was also used in the subsequent crises, but not in the third case in 2001; contrary to the previous cases, public investment fell continuously to 2008 (Figure 1.12). During that period, exports and domestic demand were stimulated by various regulatory reforms leading to long run economic growth.

Figure 1.12. Relationship of the growth in public investment to GDP (1990-2008)



Source: Cabinet Office; National Accounts (2008).

Understanding the effects of regulatory reform usually takes a long time due to lags in the recognition of wider opportunities and the implementation of private sector activities. Furthermore, the cumulative effects of the combination of various regulatory reforms are important, but gradual. For example, the development of small package courier services that has resulted from the liberalisation in the truck transportation sector, combined with information and communication technology innovation. The accumulated consumers' surplus arising from falling prices due to increased competition stimulated by regulatory reform should increase consumption and subsequently production and investment. This virtuous cycle could be amplified by the free entry of new providers, either domestic or foreign. Regulatory reform of competition policy preventing cartels, and trade policies for opening domestic markets is important for sustainable economic growth.

Nevertheless, the implementation of regulatory reform in past crises was confounded by opposition from unions. For example, company-based labour unions are against expanding employment opportunities for temporary workers as an antidote to rising unemployment. Small firms oppose removing barriers to entry for large firms as a policy response to increasing income disparity. Further opening to foreign affiliates may also face some difficulties.

These challenges had been somewhat overcome under the strong leadership of Prime Minister Koizumi, who advocated structural reform as a major tool for enhancing consumers' interests and sustaining economic growth in the 2001-02 crisis, but this policy was not sustained. Rather, there was a backlash against reform in the most recent recession. In order to overcome this reaction, political leaders need to appeal to the consumers' interests rather than that of producers.

In this respect, stimulating competition in the so-called "silver markets" for elderly consumers is a major challenge for regulatory reform. This is the market for the growing population of the elderly and has a high potential for growth. However, the needs of this consumer group lie largely within the service sector which is currently under heavy government regulation in Japan, and infamous for its lack of competitiveness.

Important features of the silver markets are the following:

- Markets for health care services could grow significantly through the removal of the ban on mixed billing. For example, the RRC suggests that qualified hospitals acknowledged by the authorities could provide better services which are not restricted within the range of the public health insurance system, and charge patients additional costs based on their consent. This would give hospitals the incentive to improve the quality of their services in order to qualify for mixed billing. In the event that a hospital convinces a patient to purchase unnecessary drugs or treatments not covered by the public insurance plan, the hospital's qualification would be revoked.
- With a projected increase in the elderly population by 6.7 million in the coming decade, the market size of nursing care services for the elderly could be expanded, if such services were liberalised from current government controls. For example, nursing care prices could be set more flexibly and according to the quality of services, while the value of the reimbursement by the public insurance plan could remain fixed. This would stimulate private corporations to provide sufficient services in both quantity and quality in order to meet the increasing demand of an ageing society.
- The demand for childcare services is also expected to grow with more women continuing to work. Major issues for reform raised by the RRC are that the direct contract between nursery schools and the users should replace the current scheme by which local authorities assign applicants to a nursery school; government subsidies should be directed to the users as opposed to the nursery schools so that the users can have a choice of nursery schools;
- Labour markets need to facilitate the shift of workers from low-productivity sectors to high productivity sectors, while still providing sufficient safety-nets for the unemployed.

Tax policies

Low productivity in the agriculture and service sectors partly results from Japan's distorted tax structure. High corporate taxes penalise efficient, profitable firms. A consumption tax which would be more neutral for production is just 5%, which is particularly low by the OECD standard. Favourable tax treatments for non-profit institutions in exchange for extensive regulations have been a major factor preventing the entry of private corporations in nursing care or other welfare service sectors.

Low property taxes are a key factor preventing the efficient use of land. In rural areas, low property taxes enable inefficient farmers to continue to farm, at least in name, and block the entry of more efficient producers. In urban areas, the inefficient use of land can be seen as well. Visitors to Tokyo are often struck by the sight of many small, two-storied houses located directly in the city centre. This quaint practice is a result of the reduction of property tax rates for small houses. The tax system which implicitly protects existing inefficient land users at the expense of other more efficient potential users has the same effect as a regulation barring new entrants.

Trade-offs between short term and long term, and between various interest groups, between regulatory and fiscal policy tools

There is a trade-off between strong vested interest groups and majority consumers with larger overall benefits, but individually representing only a small interest. This is a major factor preventing both trade liberalisation and regulatory reform of domestic markets. Those who are protected by high tariffs or regulations are those who would suffer the most under reform, such as the owners of small retail shops who protest that they are at a disadvantage to larger competitors. However, the traditional use of regulations as a tool for income redistribution is likely the major cause of Japan's low productivity in the service sector. Policies that soften adjustment costs across industries, in particular encouraging the smooth exit of unproductive firms, could be implemented alongside regulatory reform.

Another trade-off is between regulatory reform (the benefits of which are usually only evident in the long-term) and short-term fiscal policy tools. Reformers are often told that regulatory reform during recessionary periods is too fractious so that it is better to postpone such reform until the economy recovers. However, there is usually less incentive to reform after an economic recovery. Ideally, as in the case of the 2001-2 crisis, regulatory reform would be implemented continuously over the business cycle, while ad hoc fiscal policy measures to support declining private demand would be counter-cyclical.

Conclusion

Changing circumstances for regulatory reform

Japan's economy and society have been under strong pressure to change by an increasingly globalised economy, an ageing population, and widespread information and communication technologies (ICT).

- A globalised economy means that domestic private corporations can choose the places for better production across the country, accounting for various production costs. This stimulates the “competition for domestic regulations and taxes” in the world markets. Unfortunately, it seems that Japan has been lagging behind with the apparent increase in outward foreign direct investment which is exceeding inward investment (see Figure 1.3).
- While an ageing population is common to many OECD countries, the speed at which it proceeds is particularly high in Japan which has a falling total fertility ratio to 1.3 coupled with increasing life spans to the highest level in the world. A declining population of individuals of a productive age has occurred after a peak in 1995; this should exert significant impacts on Japanese society which had been accustomed to an abundant young labour force. The labour market practices of guaranteed long-term employment and seniority-based wages, which had been established at the time of rapid economic growth in the past, may well be changed in the coming years.
- Widespread ICT makes traditional technologies or workers' skills rapidly obsolete, placing strong pressure on the economy which is based on long term trading relationships between firms, or banks and firms, and a firm and its workers. The gap in productivity between those who can make the best utilisation of ICT and those who do not has continuously increased, and is a contributing factor to income disparity.

Such changes in economic conditions obviously create pressures for change in traditional regulations, but implementation itself is faced with challenges. This is primarily due to the fragmented administrative power of ministries and the weak function of co-ordination at the centre. Though the decentralised scheme had worked well up to the 1980s when Japan's economy had led world economic growth with relatively fair income distribution, this successful memory of the past represents a major hindrance for reform.

While empirical evidence of the effects of regulatory reform as a recovery tool from crises are scant, the government's estimates of the accumulated increase in consumers' surpluses through falling prices and the associated expansion of consumption since 1990 amounted to 5.0% of National Income in 2005. This could be translated into a contribution to annual GDP growth of 0.5-0.6% over 1997-2005.

In the late 1990s, particularly after the first external shock of 1997, regulatory reform had progressed with the consensus of overcoming the long-run economic stagnation; this process was accelerated by the second shock of 2001. However, after the government changed in 2006, the countervailing forces have gradually gained confidence. The

implications in terms of widening income disparities also became a matter of concern. This shifted the policy environment, with less attention given to additional regulatory reform, and even extended to consideration of reversing existing reforms in order to solve social problems.

Possible explanations for those changing perceptions of regulatory reform include:

- First, the policy for fiscal consolidation, combined with regulatory reform initiatives was obviously necessary in order to overcome large fiscal deficits and mounting public debts. However, the continuous reduction of public investment has led to the deterioration of the local economy which had largely been dependent on public works or other form of fiscal transfers from the central government. The deflationary impacts from the decline in public works could have been offset by regulatory reform to create new demand and employment in the local area, but the efforts were not sufficient. Another challenge was the uniformity of fiscal consolidation; for example, reduction in the expenditures for urban development and agriculture were applied equally and independently for all ministries, rather than through re-allocation of resources.
- Second, the policy to reduce social security expenditures from the baseline, which had been growing automatically with the ageing of the population, has been quite unpopular. The policy was originally intended to stimulate regulatory reform in order to remove wasteful health care expenditures. However, as the reduction in health care expenditures was uniform, it has aggravated the shortage of manpower resources in emergency hospitals, while clinics where the “physician led demand” was prevalent were less affected. Again, the situation regarding the misallocation of resources has not been improved.
- Third, the continuous policy of monetary easing was also necessary to increase the demand for investment and to keep the exchange rate at a relatively low level, stimulating exports of manufacturing sector products. This policy was in a sense quite successful in raising the profits and wages of the export sector which consists mainly of large firms, although benefits have not spilled over to small domestic firms; this has led to a divergence of profits and wages across industry.
- Finally, the so-called Japanese employment practices had been considered as one of the core mechanisms for redistributing incomes among employees in the firm. However, they have worked in opposition since the late 1990s, when large firms severely curtailed new recruitment of school graduates in order to protect existing employees in times of shrinking demand. This has led to millions of young temporarily workers who were not employed as regular workers; these practices are also a source for increasing income disparity among youth. This was a result of the fact that partial deregulation did not address the issue of the protection of “regular workers” (OECD, 2007b). This approach was advocated as a result of a lack of policy coordination that deregulating the labour laws for opening up of temporary jobs in the early 2000s on one hand, while maintaining rigid rules on laying-off regular workers on the other, resulting in a shift of firms’ demand from regular to temporary workers. The lack of safety-net measures for temporary workers was also highlighted as a matter of concern.

In summary, the benefits from the economic growth over 2001-08 period have been concentrated in particular exporting sectors, while fiscal consolidation policies have damaged declining industries or local economies. As a result, public perceptions are that the associated regulatory reform has been conducive to widening income disparities. Thus, there was a loss of momentum for regulatory reform.

Lessons for other OECD countries

Regulatory reform and open-market policies are keys for stimulating competition in the markets and strengthening firms to obtain more profits, maintain or increase employment and improve earnings. However, stimulating competition is equivalent to removing the rent previously granted to a particular group through regulation. These groups often complain about “being sacrificed by the regulatory reform”. As with trade liberalisation, the merits of regulatory reform spread widely through the economy, while the costs are concentrated among particular groups which may be organised and yield significant political power. Thus, calculating and communicating the quantitative results of the merits of regulatory reform is so important to overcome the political pressures against such reform. Adequate and public RIAs that clearly indicate the benefits of reform could also help to move the agenda forward.

Another element could be “unbalanced regulatory reform” like the above case of labour markets by removing temporary workers’ regulation while leaving permanent workers regulation untouched. In addition, the exemption of social security contributions for many part-time workers by firms should work as an implicit subsidy for their employment. Also, deregulation allowing the entry of taxicabs while leaving in place the inefficient incentive schemes of taxi companies, leads to an “excess supply” of taxi cabs. As the structure of regulations is multi-layered, partial regulatory reform may well worsen resource allocation, which suggests that more systematic regulatory reform remains strongly desirable.

Finally, ensuring a sufficient safety-net for the various types of unemployed individuals is a precondition for regulatory reform. A major problem with unemployment compensation in Japan is the “insurance scheme” in which some part-time or temporary workers are not initially covered. The comprehensive minimum income maintenance program is rather out-dated, and is not well utilised by those who are not eligible for unemployment insurance. Some reforms have recently been made, such as shortening the qualifying period for unemployment insurance so that more temporary job workers may be covered, and expanding official job training program with a minimum income level guaranteed during the training period. However, the further expansion of public training schemes is required given the increase in the number of part-time workers who are not necessarily eligible for on-the-job training within the firm.

A unique invention regarding regulatory reform initiatives in Japan is the special zone for regulatory reform. When pursuing regulatory reform, a typical objection would be the possible associated risk or uncertainty. In this case, a natural solution to this challenge is a social experiment that limits reform measures to a certain region, and then evaluates the outcomes. In this case, the experimental region voluntarily undergoes reform, and is not to be granted tax advantages or subsidised; this allows for a true assessment and enables an understanding of the net effects of a regulatory reform initiative. This scheme could be useful in those countries where a highly centralised administrative structure leaves limited scope for experimentation.

Notes

1. The author thanks Toshiaki Takigawa (Kansai University School of Law), Heather Montgomery (International Christian University) and Naomitsu Yashiro (University of Kyoto) for their comments.
2. The regulation index is based on the stringency and administrative classification. Different weights are used between general prohibition and mere notification for stringency, and between a law and just a public notice for administrative classification.
3. The name of the committee changed from the Council for Regulatory Reform (RRC, April 2001-March 2004) to the Council for the Promotion of Regulatory Reform (CPRR, April 2004-March 2010), but the basic role has not changed.
4. Six ministers participated as permanent members: the Prime Minister, the Chief Cabinet Secretary, the Minister for Economic and Fiscal Policy, the Minister for Finance, the Minister for Economy, Trade and Industry, and the Minister for Internal Affairs and Communication. Other ministers are invited when policy issues related to respective ministries are discussed.
5. A traditional regulation on banks was to compartmentalise their activity such as banking and securities, long-term and short-term lending, deposits and trustees, specialising in financing to small firms or foreign exchanges.
6. The prohibition was for the prevention of the resurgence of Zaibatsu (major company grouping in the pre-war period) which was thought one of the major actors for starting the World War II.
7. Part-time workers in Japan does not necessarily mean those who work in shorter hours a week, but in a renewable fixed-term work contracts without long-term employment security.
8. Falling price of cellular phones may well be overstated as it does not account for the effect of discounting the prices in exchange for the higher fees for monthly communications.
9. The FY2009 revision has revised the officially-set prices upward, but they are still below the initial level.
10. A major factor for this is that kindergartens are under the jurisdiction of the Ministry of Education, Culture, Sports, Science and Technology (MEXT), while nursery schools are under the Ministry of Health, Labour and Welfare (MHLW), which is a typical example of a compartmentalisation of national administrations.
11. A typical example is the RIA on the recent regulation on banning short-term temporary works (MHLW, 2008). According to the Ministry, the costs for implementing the regulation is only those administrative one for notification, and possible social costs arising from the regulation like an increase in unemployment or shrinking of business activity are “considered to be non-existing”.
12. NI (National Income) is the same as NNP which is GNP minus depreciation, and is often used as an indicator for aggregated income. Here, NNP is the better indicator for comparing with the consumer surplus. GDP is usually used as an indicator for aggregated demand.
13. The multiplier of 1.93 of the public investment in the accumulated three years estimated by the Cabinet Office is used here.
14. Major causes for the large income disparity in the elderly households are earnings (those who are still in the labour market or not), earnings-related pensions (the higher wage earners get higher pension benefits), and dissolution of the three-

- generation households *i.e.*, the poor elderly who used to be taken care by their children has become independent.
15. The current law only indicates the responsibility of the employer of temporary workers, not of their actual user.
 16. For example, temporary work for medical doctors, nurses and other professionals in the health service sector or legal services, which are typical fields in other OECD countries, are still not allowed in Japan.
 17. For example, before the investigation starts, the first informer to the FTC receive a 100% reduction of surcharge and the second receives 50%, while up to three informers get a reduction of 30% after the investigation starts.
 18. One of the popular cases for appearing to “unjustly low price sales” is gasoline sales stand. But consumers hardly suffered, as it is nearly impossible that a certain gasoline sales stand can set predatory pricing after expelling nearby competitors by “unjustly low price”.
 19. This was possible by the nation-wide implementation of deregulation in the special zones for structural reform.
 20. This post-War regulation intended to exclude the landowners who allowed many small tenant farmers to cultivate the farmland to destroy any remnants of the feudal system in Japan
 21. Japan has an Economic Partnership Agreement with the following countries and regions: Singapore, Mexico, Malaysia, Chile, Thailand, Indonesia, Brunei, Philippine, ASEAN, Switzerland and Vietnam.
 22. The self-sufficiency ratio of agriculture in the value basis, which is the more commonly used in OECD, was still 68% in 2006.

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1. Publications with an asterisk are in Japanese.

Case study 2 – Korea

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This case study assesses Korea's experience with regulatory reform during the 1997-1998 Asian financial crisis. The response to the 1997-98 crisis is compared with the response to the 2008-09 global financial and economic crisis, in terms of improvements to regulatory quality, competition and market openness. The broad reforms implemented in Korea in 1997-98, including the setting of a bold target of a 50% cut in the total number of regulations, are contrasted with their impacts on recovery from the crisis. The case study shows that regulatory reform was instrumental to Korea's strong recovery from the 1997-98 crisis, and impressive economic performance thereafter.

Introduction

The Republic of Korea seems to have rebounded from the recent global economic crisis far earlier than expected.² It is impressive not only because Korea already had a very quick recovery following the 1997 Asian financial crisis, but more importantly because the quick recovery now runs counter to the widely-shared predictions that an economy which is so dependent on exports would not be able to be so resilient. It is only natural then to ask what factors have contributed to the resilience and swift rebound of the Korean economy in the context of the global economic downturn.

The pursuit of a consistent macroeconomic policy tends to be singled out as the most important contributing factor. This involves little intervention into the foreign exchange and capital markets, leaving foreign exchange rates and interest rates to be largely determined by market forces, combined with an expansionary budgetary policy (made possible due to the sound fiscal position). No doubt this sound macroeconomic policy management helped the economy to revive. But a more interesting and important question to ask is what allows the Korean government to pursue such sound macroeconomic policies and make them stick in the first place.

This paper takes the view that the key factor is the decisive executive leadership and the government's willingness to undertake structural reforms and thereby establish credibility with both domestic and foreign investors in the face of external shocks. It is beyond question, in turn, that the external shocks helped to lay bare the high vulnerability of the economy and that the resulting sense of national crisis has afforded the government a virtually unlimited room of manoeuvre to undertake a wide variety of reform measures, especially because most of them were, in fact, overdue. Contrary of expectations, those reforms undertaken during economic crisis tended to have enduring effects in two ways.

First, the Korean government has made it a basic principle that the burden resulting from restructuring and reform ought to be shared equitably in such a way that the big businesses including *chaebol* bear the brunt of it. Second, as the fallout of the first, big businesses tended to learn the lesson that the time that they could rely upon government's favours and privileges has been fading rapidly and there remains no other way than to strengthen their ability to stand alone and adapt fully to market fluctuations, global and domestic. In short, the reduction in political uncertainties was welcome as giving a clearer environment for businesses. Obviously, the change of attitude on the part of big business has left much larger room for the government to induce small and medium-sized enterprises to support with the fairly pro-competitive and pro-market reforms by tilting them slightly in their favour, while strengthening the social safety net for those who are to be left out in the cold.

In general, it is possible to say that Korea is in a constant process of reform. But there clearly exists a policy reform cycle. The progress of regulatory and competition policy reform, for instance, is a clear proof of that. If we can say that the acme of Korea's pro-competitive, pro-market reforms was reached in the earlier period of the first economic crisis in 1997-98, the low point was reached during the earlier period of President Roh's rule (2003-04),³ from which the current Lee Myong-bak government seems to have been reviving the reform momentum once again in the face of the global economic crisis.

Both Presidents, Kim Dae-jung and Lee Myong-bak, who found themselves charged with the duty to overcome the national crises invariably asserted that it was time to push forward market-oriented reforms and converge toward global standards, not to go back and relapse into more government intervention and protection. “We should and can turn the crisis into opportunity” was the catchword. No doubt it is very difficult for them to hold up the cause before the people in dire economic and social situations, but the general public generally rallied behind. Incidentally, it seems that the Korean people have become quite acquainted with making such a big policy turnaround, too. As the Korean economy depends heavily on foreign trade (and investment) and suffers not infrequently from its extreme vulnerability, they have come to learn to distinguish between the moments when they have to acquiesce and relent and those when they can afford to oppose the government’s pro-market reform initiatives.

Regulatory reform in times of crisis: two episodes

It is no accident that the high tide of regulatory reform in Korea has coincided with the onset of economic crisis. Although the source, nature, and magnitude of each economic crisis is different, regulatory reform has been looked upon as a useful and effective means to overcome the crisis, regain international competitiveness, and strengthen resilience of the economy. The “50% reduction of existing regulations” drive in 1998-99 and the “Temporary Regulatory Relief (TRR)” Programme in 2009 would represent Korea’s uniquely drastic approach to regulatory reform in this light.

The “50% reduction of existing regulations” drive: The first episode

The first significant regulatory reform drive during 1998-99 was undertaken when the Korean economy plunged suddenly into the deepest recession in history. The crisis was triggered by the continued exhaustion of foreign exchange reserves.⁴ It not only reflected the loss of credibility of foreign lenders and investors in the Korea’s short-term economic policy management, but more importantly, in the politico-economic system of Korea itself and the Korean economy’s ability to recoup from the economic crisis in the foreseeable future.⁵

With the Korean government’s decision to ask the IMF to come to its rescue, a drastic macroeconomic policy change and massive structural reforms of unprecedented degree and magnitude was a *fait accompli*. While there were some last-minute wheeling and dealing between the Korean government and the IMF, the IMF Stand-by Arrangement was reached swiftly.⁶ As expected, the IMF’s demands for structural reform were wide-ranging: from financial and corporate sector restructuring to labour sector reform and to reform of trade and foreign direct investment policies.

In this sense, it may be debated whether the direction of the Korean government’s plan to overcome the economic crisis was dictated by the IMF. While the observation cannot be entirely dismissed, it would be unfair to fully describe the process in such a way. First, most of the “key reforms contained in the IMF agreement had been on the agenda of the Korean government for many years – notably, cleaning up the financial system, slimming the *chaebol*, and introducing greater transparency in corporate governance”,⁷ although they were blocked by the unfavourable political conditions at the time. Second, there was a difference between the sorts of reform the IMF required and those that the Korean people thought were necessary. Whereas the IMF package was focused on making Korean economy solvent and converge to global trade and investment

standards, the Korean people tended to think it was the time to end the illegitimate political intervention into the economy and business, re-establish the government-business relations, and to pursue regulatory reform much further and deeper than what the IMF called for.

This requires further explanation. With a tradition of government-led development for decades, regulations have come to be intertwined with government planning indistinguishably. The government's plan of all sorts and variety tended to be translated directly into laws, and the laws, in turn, to be composed of regulations designed to put plans into actions. Given the necessary fact that the government's plans tend to be at variance with the ways in which the free markets would function, those regulations tend to restrict the economic freedom of actions and decisions of business and the people concerned. Moreover, this tendency grows stronger in the process of promulgating the implementing legislations such as presidential decrees and directives of all sorts, as the bureaucrats tended to put the concrete details in them over which the administration, in lieu of the legislature, has the full authority.

It is thus quite natural that considerations for bureaucratic expediency and administrative efficiency tended to take precedence over those for the easiness and convenience of the regulated. In addition, the need to respond to the opportunistic behaviours on the part of the regulated (*i.e.*, regulatory avoidances and circumventions) more swiftly and flexibly has constituted another reason why the bureaucrats tended to favour to follow this avenue. The end result has been a tight web of regulations that tend to increase the regulatory compliance costs and burden more than need to be. (Incidentally, this nature of regulatory system in Korea tends to allow an ample space for effective regulatory reform by the RRC, a point to which we will return later.)

For these reasons, especially when the economy slowed down, complaints about the tight web of such regulations mounted again and again. The case in point was the situation just before the onset of the first economic crisis of 1997-98. "High cost, low efficiency" was a buzzword describing the nature of economic and business environments. It is needless to say that this characterisation was pointed to the outmoded regulatory structure and practices. It is no wonder, therefore, that such complaints have turned into revolts in 1997-98 in the face of economic crisis in history.

The Korean people were shocked and dismayed by the unbelievable fact that the erstwhile buoyant Korean economy required IMF rescue. With their self-respect being irreparably damaged, Korean people chose Kim Dae-jung, a long-time opposition leader, as its next President at the election held just a few days after the IMF's Stand-by Arrangement was signed.⁸ With the "genuine" transfer of power in four decades, the pre-existing political and economic establishments fell into disgrace and the mode of governing the state was cast into doubt. In short, the stage was thus perfectly set for the new President to institute a new governance system in Korea. After all, the wide-ranged structural reform package demanded by the IMF was at hand, and Korea's commitment to the IMF package was crucial in restoring confidence from the outside world.

Within months after his inauguration, President Kim directed the cabinet to cut down the existing regulations by half. The initiative had been taken by the newly-created Regulatory Reform Committee (RRC), co-chaired by the Prime Minister and a civilian. According to the "Basic Law of Administrative Regulations," which came into full force in February 1998,⁹ and bolstered by the President's order to push strongly ahead the regulatory reform, the RRC asked each of 35 ministries and agencies to submit "Plan to Streamline Existing Regulations" under its jurisdiction. Upon the RRC's report at the

Blue House Meeting, in which all the cabinet members participated, finding that the plans submitted by the ministries and agencies proved far from adequate, the President ordered each ministry and agency to resubmit the plans so that the existing regulations could be cut down by more than 50% by the end of the year.¹⁰

The presidential directive with specific target was simply unprecedented. It startled the whole bureaucracy, while giving large powers to the RRC. In this extraordinary circumstance, each ministry and agency had no choice but to prepare a revised plan in an effort to ensure that it could reach the target while minimizing the risks of being subjected to the oversight by the RRC. On its part, however, the RRC selected and classified those regulations, the jurisdiction of which were overlapped across ministries and had thus proved extremely difficult to make progress, into the so-called “specific (sectoral or thematic) tasks”¹¹ and subjected them to its intensive review.¹²

As of the end of 1998, the number of existing regulations was, indeed, cut down almost by half from 11 125 to 5 695.¹³ The kind of regulations hit hardest was those that had resided mainly in implementing legislations subordinate to laws, lacking clear legal base or mandate. About one third of those regulations that were eliminated outright (namely 1 840 out of 5 430 regulations) belonged to this category. Given their presumed arbitrariness, the beneficial effect would be immeasurable. Moreover, this outcome sent a strong and clear message to the bureaucracy that such regulations would have no place in the new system of regulatory oversight, reinforced by the “regulations registration” system, also provided for in the Basic Law.

Together with the structural reforms in the financial and corporate sectors, as called for by the IMF, this massive regulatory reform in 1998 and thereafter must have greatly contributed to the quick recovery from the economic crisis, although it is very difficult to provide quantitative evidence. According to a benefit analysis, projected for the span of five years (1999-2003), of the major regulatory reform measures in 1998 alone, the impact was substantial indeed.¹⁴ It was estimated that it would generate at least 680 thousand new jobs, about half of which can be attributed to the increased inflow of FDI, which amounted USD 27 billion at the minimum.¹⁵ Also, it was estimated to reduce regulatory compliance costs by KRW 18 690 billion (USD 15 billion), which amounted to 4.4% of GDP in 1997, in addition to the government’s administrative cost savings of KRW 590 billion.

Temporary Regulatory Relief (TRR) programme: The second episode

As such, Korea’s unique new system of regulatory reform has since been well established and maintained solidly at least before the Roh Moo-hyun’s “participatory government” came to power in February 2003. By then the economy fully recovered from the economic crisis to the extent that the painful memory of adjustment to the crisis sank into oblivion in the minds of people, and the claim that Korea had not needed to undergo such a painful and disgraceful period gained some audience. Accordingly, the impetus for regulatory reform waned rapidly and even backpedalled, as the course of the national policy was set in almost opposite direction. The Roh government explicitly gave policy preference to equality over freedom and redistribution over growth.

As the economy began to show clear signs of going down and the unusually high youth unemployment increasingly became a major political concern around 2005, however, the government began to look back to regulatory reform as an effective vehicle to reinvigorate the slackening economy. But the main vehicle it decided to rely on was

different. It added a new system, namely the so-called “ministerial meeting of major regulatory ministries,” to be supported by the “regulatory reform task force,” established alongside the Office of Regulatory Reform in the Prime Minister's Office.

With a strong initiative by the Prime Minister (co-chairman of the RRC), the new body was charged to select the so-called “regulation bundles” and prepare proposals to reform them in a package. The “regulation bundles” were of such nature that they were so highly interrelated and the legal authority was dispersed among related ministries, and that the business found most cumbersome but proved resistant to reform efforts in the past. Moreover, to speed up the reform process, these proposals were submitted to the “ministerial meeting of major regulatory ministries,” chaired by the Prime Minister.

Of course, the final reform proposals were also presented to the RRC for formal review. In this sense, the RRC was also involved in the process. But it was inevitable that the RRC's role was largely circumscribed to review regulations to be introduced anew or strengthened through its RIA review process, although the legal authority to reform existing regulations, including the “regulation bundles,” still rested in the RRC. Despite such renewed reform efforts, however, the number of regulations registered rose from 7 724 at the end of 2002 to 8 084 at the end of 2006.

It was against this background that President Lee Myong-bak was elected in 2008 with a philosophy of “practical centrism”. He was elected on a campaign pledge that he would turn Korea into a first-rate advanced country by making laws, institutions, policies, and practices of Korea converge fully to the global standards. As soon as he took office, he declared that his government would be a business-friendly government.

Although President Lee has given top priority to regulatory reform with a view to reinforcing a free market economy, the RRC's relative status remains pretty much the same as before. While the “ministerial meeting of major regulatory ministries” is no longer in existence, the “regulatory reform task force” has been moved to the newly created Presidential Commission on National Competitiveness (PCNC), as its arm to monitor the business grievances and complaints about regulations and suggest remedial actions. On the other hand, the PCNC has been charged with some responsibility to undertake reform of “regulation bundles.”

Of course, regulatory reform is not the sole responsibility that the PCNC has been charged to take. Given the wide-ranging mission of the PCNC's, however, it has come to play a significant role in regulatory reform process in the current government, because, among other reasons, most of the PCNC's reform agenda tend to belong to this category, directly or indirectly. For example, the issues that the PCNC has dealt with include a further freeing of foreign direct investment measures especially for free economic zones, deregulation of various kinds of restrictions applied to Seoul metropolitan areas, and improving procedures related to employment of foreign labour.

In view of this, one may say that the institutional structure for regulatory reform of Korea has been reshuffled again. But it would be fair to say that a new division of labour has emerged, because the PCNC, a temporary institution whose mandate is merely based on the Presidential decree, tends to take up regulatory reform issues that have been politically contentious and thus tended to provoke a higher level of bureaucratic resistance to reform efforts, while the RRC, the legally formal institution for regulatory reform, tends to resume, over time, its previous role and status to the fullest extent. It seems that there are dark sides and bright sides to this new division of labour, though.

On the dark side, one may argue that there tends to arise some confusion among the public and the business as to which institution holds the main key. But it is obvious, however, that the RRC does, since what the PCNC has decided has to be subject to the RRC review process nonetheless. On the bright side, it should be noted that, as the PCNC tends to take up regulatory reform issues that have been politically contentious, it tends to help strengthen the image of the RRC as the gate-keeper ensuring and upgrading the quality of regulations, making possible the full use of reform mechanisms such as RIA, registration of regulations, and sunset review, among others. In this sense, the new division of labour would be a welcome development.

Indeed, the recently instituted "Temporary Regulatory Relief (TRR)" programme represents a prime example of the RRC's accomplishments in its effort toward reforming *existing* regulations as well as the regulations being newly introduced or strengthened. In the midst of deepening global financial crisis, the Korean government, along with the majority of OECD countries, has actively undertaken a series of counter-measures. Treading on the heels of USD 28 billion fiscal package, on May 27, 2009, the Korean government (and the RRC) released a list of 280 regulations, the application of (or part thereof) which will be suspended or delayed for two years, when the stagnant economy is supposed to bounce back on its track.

This bold initiative, called "Temporary Regulatory Relief" (TRR) programme, aims at overcoming economic crisis and protecting (and increasing) jobs, among others, by bolstering private sector investment and consumption, and taking regulatory burden off the shoulders of small and medium-sized enterprises, self-employed businesses, and the citizens. Korea's TRR represents an unprecedented experiment in the history of regulatory reform both within and out the country. Bearing some semblance with the regulatory moratorium undertaken by the Task Force on Regulatory Relief in early Reagan years, though, this programme is distinct in that it applies to existing regulations, not to new regulations in the pipeline.

Judging that fiscal package alone would not be sufficient to boost private sector investment and consumption, the RRC, on its part, devised TRR as an institutional supplement to it. Without aligning it with extraordinary regulatory reform measures of commensurate proportion, its influence would be short-lived. Thus the RRC has turned its eyes to reforming those regulations that look more egregious at the time of extreme economic difficulties, given their presumed inhibiting effects on doing business, consumption and investment.

In fact, the PCNC adopted a plan early this year to subject more than 1 000 existing regulations to sunset review. But the RRC has found this measure needed further action in the short term, as the sunset review could bear fruit only after the deadline reaches, which generally means 3 to 5 years from the time of imposition. Against this background, The RRC and the Office of Regulatory Reform under Prime Minister, a standing unit for the RRC, embarked upon a search for a breakthrough, and reached to a conclusion that more urgent measures were needed to adopt a more flexible approach to the application or enforcement of regulations and to turn the regular sunset review into a new mechanism more suitable to the current economic situation.

In a nutshell, TRR amounts to a mirror image of sunset review mechanism. Put differently TRR is a different form of sunset review turned upside down. While sunset review generally applies prospectively, under TRR the regulations would lose the whole or part of their legal force before the sunset review is undertaken to determine their fate. Under the TRR programme, the Korean government suspended or delayed the application

or enforcement of those regulations that look most inappropriate especially in the light of dire economic situations facing the country. Given the difficulties of and political resistance to outright deregulation, the Prime Minister's Office has come to the judgment that it would constitute a workable surrogate mechanism for regulatory reform. Representative examples are provided in Annex 2.A1.

The TRR's impact on the economy has not been collected widely. Yet there is some evidence that indicates its beneficial impact may be huge. For example, affirmative rating ("highly satisfied" plus "satisfied") for the government's regulatory reform efforts has gone up by 20% from 29.1% in the first quarter of 2009, namely before TRR, to 49.0% in the second quarter.¹⁶ Especially noteworthy is the fact that the people surveyed specifically expressed their high satisfaction with the TRR Programme. The internal report prepared by the Provincial Government of Kyunggido, for example, the economic impact of TRR is estimated to be substantial. In that Province alone, more than 20 investment projects, that would otherwise have been abdicated due to prohibitive regulations imposed, for example, on the expansion of existing plant facilities, or postponed due to overly burdensome regulations, have come to be embarked upon by virtue of TRR. In a couple of month's period, the total new investment would amount to at least KRW 150 billion (USD 120 million).¹⁷

Although the number of regulations registered tends to stabilise at the level of around 5 100, the RRC's efforts and contribution in preventing bad or low quality regulations from being instituted must not be downplayed.¹⁸ The RRC is now doing best to prevent the ungrounded and low-quality regulations from being instituted in the aftermath of the huge and prolonged 2008 protests against the decision to reopen beef imports from the U.S. This was falsely charged as being likely to put the public health in jeopardy. It is our belief that there can virtually be no other institution that would stand up boldly against the attempt to institute such bad regulations in Korea.

In 2008, for instance, 228 out of 974 (23.4%) new regulations proposed by the ministries was selected as "major" regulations to be subjected to the RRC's review process, and among them, 17 (7.5%) new regulations were withdrawn, whereas 108 (47.4%) regulations were required to be improved on.¹⁹ By contrast, in 2007, under the previous government, 397 out of 1 259 (31%) new regulations were classified as "major" regulations, and among them, 25 (6.3%) were withdrawn, while 218 (55%) were required to be improved on. It is noticeable that the number of new regulations proposed declined sharply in the meantime, although the decision rule of the RRC appears highly consistent, despite the changes made in the composition of members of the RRC.

Implications

It is no doubt very difficult to measure the impacts of the massive regulatory reform drive on the recovery from economic crisis. More difficult is the measurement of economic benefits resulting from the ordinary process of regulatory reform conducted constantly. From the institutional perspective, however, we can offer some important and interesting lessons. After all, we believe, the true intention behind regulatory reform is not so much to reduce the number of the existing regulations as in changing the attitude of government officials toward regulations and their tendency to rely on regulations excessively in the name of administrative efficiency in particular.

First, it was the economy in deep trouble that provided such a strong impetus for massive regulatory reform. Generally speaking, a crisis offers a window of opportunity for such reform. It necessitates and justifies a comprehensive reform. What counts, however, is getting timing right, as the process of setting up a new institution responsible to undertake a comprehensive reform takes much time. In this regard, it was really a boon to the Kim Dae-jung government that an institutional apparatus like the RRC, fully equipped with a full array of advanced reform tools and procedures such as the mandatory review process for new regulations in the form of regulatory impact analysis (RIA), regulatory sunset review, and mechanisms to streamline existing regulations, had already been put in place.²⁰

More important is the legitimacy and reputation of the newly created reform institution, given that it is impossible to carry through reform packages without such institutional assets. In the case of Korea, with most of the important and powerful stakeholders, such as big business and the political parties, being discredited as the direct parties that caused the economic disaster; it was only natural that new institution like the RRC could gain the legitimacy and reputation as a reform institution. In addition, happily or not, as the faithful implementation of the IMF package became an imperative to regain credibility in Korean economy from the outside world, the RRC's guiding principles of pro-market, pro-competitive reform could be hardly challenged.

With the successful accomplishment of the first mission, namely the “50% reduction of existing regulations,” the status of the newly-created RRC has since been established. It was remarkable and even legendary, indeed, given the fact that the RRC, a legally formal administrative body but designed to be operated foremost at the private sector's initiatives. It demonstrated that as long as sufficient political backing is guaranteed, the RRC, albeit being instituted in such a peculiar form, can serve as an effective vehicle for regulatory reform.²¹

Second, the strong commitment by the political leaders plays a decisive role. In the case of Korea, the directive of the “50% reduction of existing regulations” was not the sole case that showed the President's personal commitment to reform. He reiterated the importance of swift and continuous regulatory reform on innumerable occasions such as the National Council meeting and the ministerial report conferences to the President of the Ministerial Annual Operating Plans. In addition, he regularly asked for monthly progress report at the weekly meetings with the Prime Minister. Of particular importance was the President's special directive issued October 1998, which called for the reform efforts to be stepped up in light of the fact that the 50% target was still afar.

All of his words and actions as such caught the attention of the press, reinvigorating the participation in the reform process by the private sector such as economic associations. It not only put the bureaucracy generally on the defensive, but made the National Assembly go along with the reform. For instance, finding that the National Assembly showed signs of taking a back step in the process of deliberating on reform legislations submitted by the administration partly on the pressure by the private interest groups, the President declared that he would veto the laws tapered as such.

Third, the successful experience of massive reform of existing regulations contributed to the successful institution of the RRC's another powerful weapon in its arsenal, namely the mechanism of reviewing *ex ante* new regulations or regulations. In 1998, even in the midst of economic crisis, 573 new regulations went through this review process. Among them, the RRC determined 51 new regulations to be withdrawn, and 112 to be improved upon by adopting alternative approaches to regulation. With this result, the RRC not only

demonstrated that it could serve afterwards as a bulwark against the bureaucracy's habitual dependence on command and control-type regulations and regulatory enforcement styles,²² but made the principles of regulatory reform applied to as consistently as they could be.

Fourth, it is generally said that especially in crisis situations the focus of regulatory reform tends to be focused more on alleviating the regulatory costs and burden immediately to help the business stay alive than on introducing the market forces in an effort to revive and strengthen international competitiveness of industries and businesses, since these reform attempts tend to exacerbate the difficulties facing them. This has not been case for Korea. While having much in common, the problems with economic regulations in Korea, especially from the perspective of the business and the people, differ much from those with social regulations. Not unlike in other (advanced) countries, the key problem with social regulations is an unnecessarily high compliance costs and burden resulting from the regulatory standards set so uniformly and enforced so rigidly. As for economic regulations, however, the problems with them in Korea may well be said to consist in the intrusive nature of some government intervention and interference into the decision-making of business, which accompanies high degree of uncertainty and lack of predictability.

In this respect, there seems to be little benefit to distinguish between reform of economic and social regulations. As far as the nature of the problems of economic regulations belongs to such variety, it would entail as its integral part the strengthening of economic regulations to prevent the rent-seeking activities and moral hazard problems. The case in point may be the prudential regulations. It is exactly this course that the Korean government took in reforming financial and corporate sector regulations, to which we now turn to.

Competition policy

Restructuring of the corporate sector

As briefly mentioned above, the most direct cause of the economic crisis in 1997 was the precipitous fall of foreign exchange reserve, which, in turn, was triggered by the failure of merchant banks and commercial banks to roll-over their huge short-term loans borrowed from foreign financial institutions and lent to equally heavily indebted firms, and conglomerates, in particular. It is a matter of course that this precarious financial sector needed a major surgery. What was more evident was the fact that excessively highly-leveraged corporate sector could not withstand the ordeal in the face of unprecedented financial crisis.

The source of the problem was that the combination of easy access to capital and implicit government guarantees of conglomerates' investments encouraged the Korean corporate to borrow heavily, leading to high debt-to-equity ratio.²³ In 1997, the average debt-to-equity ratio for corporate in manufacturing sector were 396%, compared with 154% in the U.S., and 194% in Japan. Operating in a slowing economy and unable to generate sufficient cash flow to service their short-term debts, eight of the top 30 *chaebol* had effectively become insolvent by July 1997.²⁴

Reflecting the debt servicing difficulties of the corporate sector, ten of Korea's 26 commercial banks posted losses in the first half of 1997. The crisis continued to snowball. By the end of October 1997, the total amount of bad loans held by suspended merchant banks amounted to 51% of their total loans. Evidently corporate failures prompted the banks to begin redeeming commercial paper discounted by merchant banks, which in turn called in their short-term loans to companies.²⁵

In response, the government prepared a reform package for the financial sector, focused mainly on strengthening prudential regulation, in July and sent it to the National Assembly for the revision of the Bank of Korea Law and other 13 financial reform-related laws. The laws were only passed on December 29, 1997, when the Korean economy had already been hit by the crisis contagion in the region. The bureaucratic conflict between the Bank of Korea and the Ministry of Finance and Economy also delayed the process.

If belated, it was nonetheless an imperative to restructure the corporate sector, *inter alia*, conglomerates, *chaebol* in Korean, above all else. The focus was placed on converging corporate governance system to the global standard, which included auditing procedures, shareholder rights, the composition of boards of directors, access to corporate control (*e.g.*, hostile takeovers) and insolvency procedures. Debt guarantees between *chaebol* affiliates was prohibited, while encouraging companies to improve their financial structure by reducing debt. The government required the top five *chaebols* to submit their capital structure improvement plans with a threat of applying sanctions to noncompliance. As for other 58 *chaebols*, debt was restructured in the framework of workout.

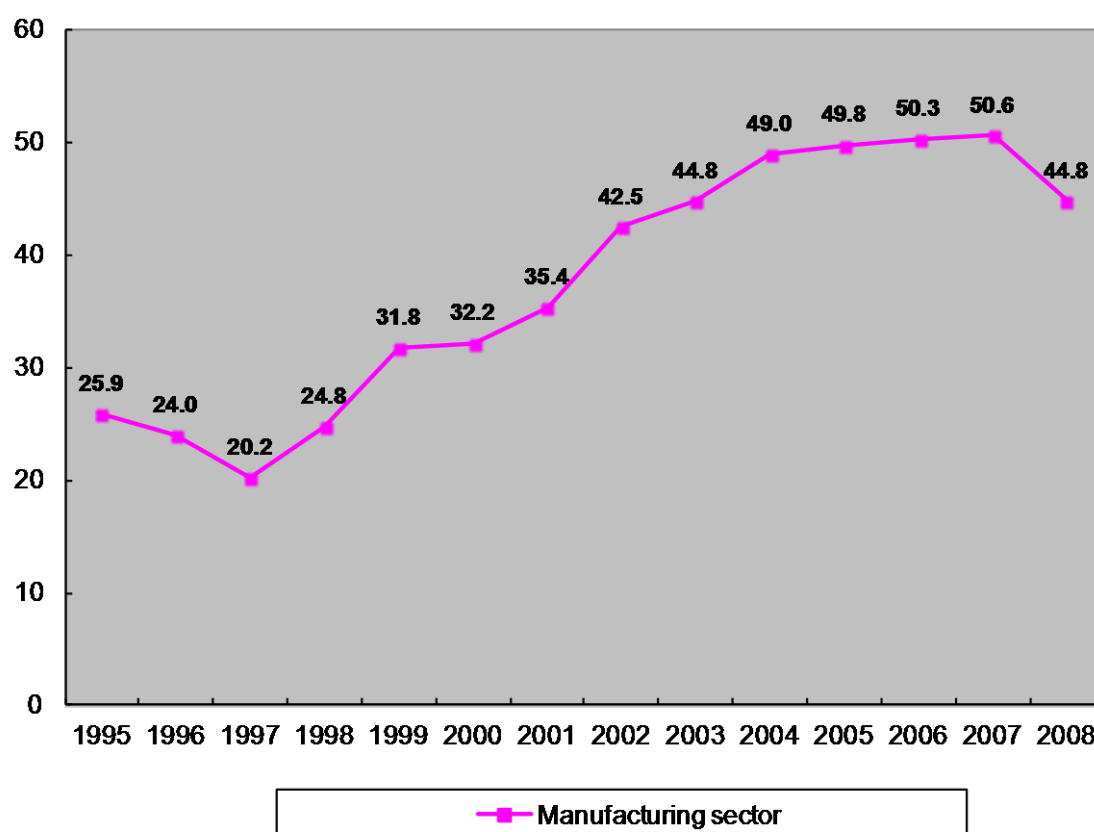
In response, the top five *chaebols* and their creditor banks formulated capital structure improvement plans with a focus on reducing debt-to-equity ratios. Meanwhile the government prepared a swap of affiliates between *chaebols*, covering eight major industries, including semiconductors, aircraft, railroad vehicle, vessel engine, power generation facilities, petrochemical and oil refining industries. The so-called 'Big Deal,' a sort of forced M&A, was meant to streamline overlapping investments made by *chaebols* in those sectors, since they were met with severer trouble. After all, M&A was not yet active in Korea by that time in Korea.

Of course, concerns were raised about what kinds of consequence the Big Deal, undertaken by government fiat, would bring eventually. Leaving the issue of the legitimacy and the propriety of the government's attempt at the Big Deal, given the fact that the better course to take was to let the market decide, their potential anti-competitive effects was hotly debated. In addition, there were other issues concerned with the government's liability in the future when its decisions would be found faulty and excess capacity problem that would not go away instantly with the Big Deal.²⁶ M&A of Hyundai Motors and Kia Motors is the case in point. To this controversy and the implications of this attempt we will return below.

The most significant event was the dissolution of Daewoo Group, the fourth largest *chaebol* in Korea. The bankruptcy of Daewoo Group in 1999 and its subsequent liquidation process, which was really harsh, served as a landmark showing that no company in Korea was 'too big to fail.' Whatever the true reasons behind this decision, it is safe to say that such myth has since gone away effectively with Daewoo Group.²⁷

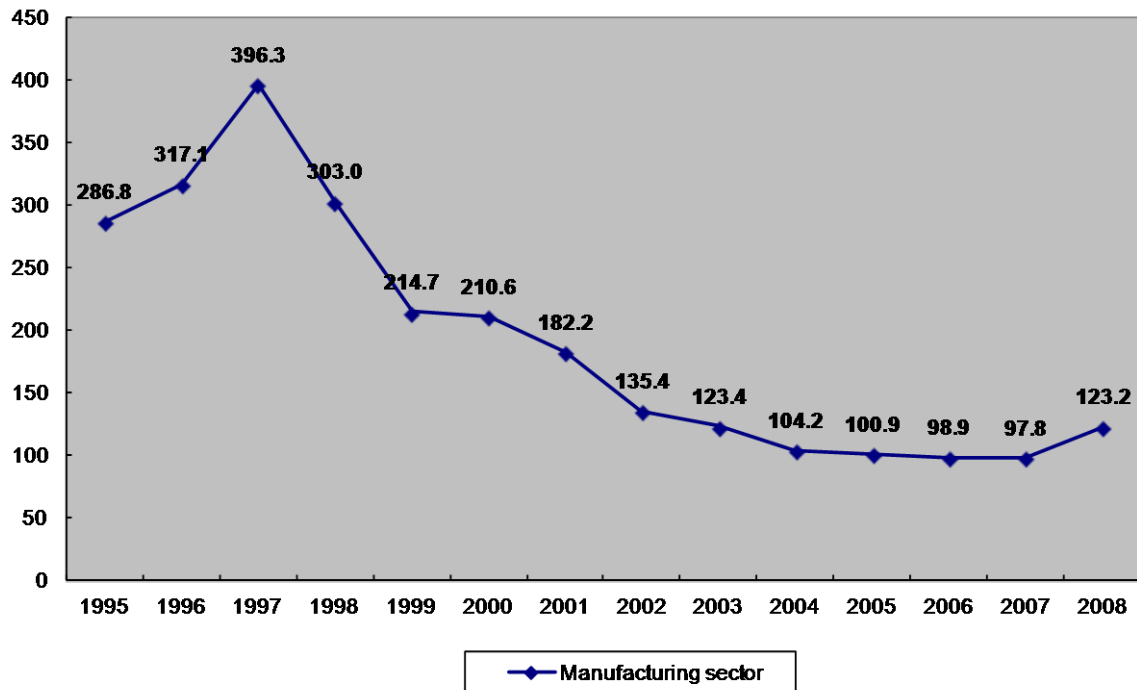
Moreover, it was a foregone conclusion that other *chaebols* had no choice but to go along with the restructuring exercises. In 1998 alone, 17 out of the top 30 *chaebols* either went bankrupt or forced into workout programmes, and the remainder had their major subsidiaries spun off. As a result, the average debt-to-equity ratio of the survivors among the top 30 *chaebols*, which had risen sharply to 519% in 1997 from 348% in 1995, dropped precipitously to 116% in 2003. It was a remarkable achievement, indeed. As a matter of course, both the shareholders' equity ratio and the debt-to-equity ratio of corporate sector improved significantly, too. The shareholders' equity ratio in its manufacturing sector, which continued to fall down to 20.2% in 1997, soared continuously to reach 49.7% in 2008(see Figure 2.1). At the same time, the debt-to-equity ratio of the same sector fell continuously from 396% in 1997 to 215% of 1999 and then to 123% in 2008. The 181 percentage points drop made during 1997-99 was impressive (see Figure 2.2).

Figure 2.1. Shareholder's equity ratio, manufacturing sector (%)



Source: Bank of Korea, Financial Statement Analysis, various issues.

Figure 2.2. Debt-to equity ratio, manufacturing sector (%)



Source: Bank of Korea, Financial Statement Analysis, various issues.

Table 2.1. Financial soundness indicators of corporate sector

Shareholder's equity ratio (%)									
	1995	1997	1998	1999	2000	2005	2008	Japan* (2008)	U.S. (2008)
All-industry	24.7	19.1	22.9	29.8	31.1	47.4	43.5	33.5	-
Manufacturing Sector	25.9	20.2	24.8	31.8	32.2	49.7	44.8	43.8	40.6
Debt-to-equity ratio (%)									
	1995	1997	1998	1999	2000	2005	2008	Japan* (2008)	U.S. (2008)
All-industry	305.6	424.6	336.4	235.1	221.1	110.9	129.8	198.2	-
Manufacturing Sector	286.8	396.3	303.0	214.7	210.6	100.9	123.2	128.2	146.6

*. End-March 2008.

Source: Bank of Korea, Financial Statement Analysis, various issues.

The improved financial position had strong beneficial effects. It not only helped to overcome the crisis sooner, but strengthened their international competitiveness greatly. In addition, the favourable changes in the shareholders' equity ratio and the debt-to-equity ratio were found to have increased total factor productivity in those business lines in which they were key players.²⁸ It can be debated whether the reduction in the debt-to-equity ratio went too far so that long-term investment growth and the growth potential may have suffered from it.²⁹ This remains fairly uncertain. But given the fact that Korean firms, and *chaebols* in particular, had long relied more heavily on debt financing than on internal and external capital, such concern may have some ground, since the ratio of the manufacturing sector in Korea recorded 123.2% as of the end of 2008, whereas it stood at 128.2% in Japan, and 146.6% in the U.S. (see Table 2.1). After the dust settled, the government enacted the *Corporate Restructuring Promotion Law* in 2001, and the business restructuring gear has since been changed into a normal mode.

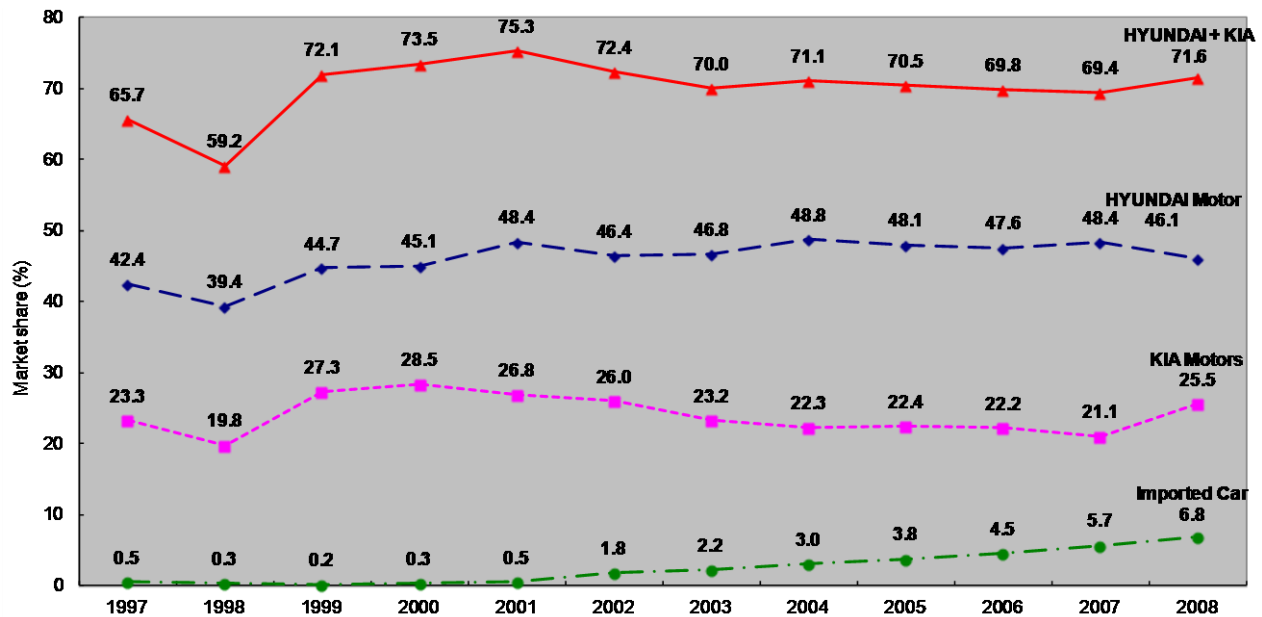
Along with restructuring the corporate sector, the government embarked on privatizing public enterprises in the same spirit from July 1998, *inter alia*, in the utilities sector such as electricity, gas and telecommunications. By the end of 1999, all or part of state-owned stakes in 13 public enterprises or their subsidiaries were sold off. Compared to the previous attempt in the Kim Young-sam government, pursued mainly to replenish government revenues, it was focused more on improving the level of efficiency by making them more fully incorporated into the market system, and thereby strengthening their accountability. To ensure that privatisation would not end up merely changing public monopolies into private monopolies, the Korea Fair Trade Commission (KFTC), Korea's antitrust watchdog, was called in to oversee the process.

Competition policy reform and 'big deal' as an abnormality

In the face of the economic crisis, the Korean government enacted the Monopoly Regulation and Fair Trade Act (MRFTA) in February 1999 with a view to facilitating M&As of non-viable firms. Pursuant to Article 12-4 of the Enforcement Decree of the amended MRFTA, mergers of failing firms could be treated exceptionally in the review process by KFTC. To this category belong the cases where the firm's production facilities are too difficult to utilise in the relevant market but for the concerned merger and/or where there is no other possibility to exist that would have less anti-competitive effects than the merger in question.

According to these stipulations, the KFTC approved Hyundai Motor's acquisition in shares of Kia Motors in April 1999, because it determined the latter company as a non-viable firm. As Hyundai Motor's market share being 44.7%, while Kia Motor's 27.3%, it might as well be assumed that some possibility of monopolisation in the relevant market was open. In fact, their combined market share continued to rise from 72.1% in 1999 to 75.3% in 2001, when M&A came in vogue, reflecting the buoyant business climate at that time and the vaults of big business that had been enriched in the post-crisis period.

Figure 2.3. Trend of the market share in the Korean automobile market



Source: Korea Automobile Manufacturers Association, Monthly Automobile Statistics, various issues.

While this figure has since continued to fluctuate, it tended to be stabilised at the lower level, however. It stood at 72.4% in 2002, and 71.6% in 2008 (see Figure 2.3). It seems difficult to argue that the M&A of Hyundai Motors and Kia Motors approved in the wake of the crisis, played havoc with market competition in the short term. However, there are dissenting views that this might result in a near monopolisation of the domestic auto market in the long run if changes in market share are insignificant.³⁰ This could lead to price increases especially in the small-size segment of the market, which is less exposed to competition from imported cars, with potential negative implications for consumer welfare.

Of particular importance was the radical change in the KFTC's policy stance toward cartel. In fact, controversies arose around the possible justification of exempting cartel activities from competition law application in times of severe economic distress, let alone the economic crisis. Whatever the truth may be, the KFTC chose to strengthen its competition policy. It is remarkable, indeed. According to *the Package Clearing Act of Cartels*, enacted in February 1999, the KFTC outlawed (or required some supplementary actions toward) 20 cartels, which had been at work under 18 other laws, and eliminated 17 other collusive fee-setting arrangements in 9 professional services. Along with these efforts, with the intention of a clearer *per se* rule approach against horizontal price fixing, the relevant language in Article 19 of the *MRFTA* amended in February 1999 was changed from whether a restriction is 'substantial' to whether it restricts competition 'unfairly', was intended to achieve a *per se* approach. As cartels were regarded to reduce competition inherently with in this context, since then there has been no need to carry out the market analysis of effect in particular cartel cases.³¹ As such, the prohibition of horizontal cartels has been on top of the reform list in terms of competition policy.

Recent developments

Since President Lee Myong-bak, once a top CEO at Hyundai, took office in February 2008, significant changes have been made. Most prominent of them are the passage of two amendments of concerned laws in the face of opposition.

One is the elimination of the ceilings imposed on equity investments in domestic firms by big businesses including conglomerates in pre-circumscribed lines of business in March 2009. Subject to this peculiar regulation had been 31 in total. Some of them were affiliates of conglomerates with over KRW 2 trillion in terms of total asset, and others were big business group with KRW 10 trillion or more. The regulation, first introduced in 1986, had been abolished in 1998, but was reintroduced in 2001, albeit with small changes in its content. Whether the ceiling of 40% had been indeed inhibiting new investments by big businesses is not clear. Nonetheless, the big business groups accused the system on the grounds that there is no such thing in advanced countries, and that it acts in the direction of discriminating the domestic business against foreign firms. On the other hand, critics argued that it would promote economic concentration, making Korea's financial structure more vulnerable to external shocks.

Whatever the merits of each side, it is fair to say that this reform, representing the most hotly debated regulatory reform issue in Korea for a long period of time, has been made possible owing mainly to the onset of global economic crisis. How much it would contribute to bringing forth new investments, alleged to have been pent up due to the regulation, remains to be seen. Also in question is the effect of the abolition of ban on cross-affiliate investments among big business groups, given that it has been argued that it would serve as a vent for the conglomerates' renewed entrepreneurship.

The next step was the deregulation of the rules, finalised in July this year, which prohibited outright major businesses' holding of ownership in commercial banks in Korea. This rule had been put in place in fear of concentration of economic power in the hands of a few businesses and the possibility of monopolizing bank credits.

The line distinguishing conglomerates between regulated and unregulated has been redrawn in the way to subject fewer of them to the first category by increasing the threshold from KRW 2 trillion to KRW 5 trillion in terms of their assets. It has resulted in the big drop from 79 to 41.

Pro-competitive steps have also been taken especially in such industries thus far heavily regulated as finance, broadcasting & communication, tourism, and medical care, among others. Regulations that had discriminated service industries in favour of manufacturing industries have been relaxed, too, in an effort to prevent the distortion in the investment market, among others.

Implications

Competition policy in Korea can now keep abreast with those of advanced countries more fully, mainly due to the current government's abolition of some of peculiar business regulations, such as the investment ceiling system, thus far imposed on big business group in the name of preventing economic concentration. As pointed out above, with the elimination of the most controversial stipulations, Korea's competition law could be enforced with far greater consistency.

In times of distress, business managers facing intense pressure to keep their business afloat, tend to be more susceptible to the temptation to engage in unfair, anti-competitive, and restrictive practices or conducts. Nonetheless, the Korean government seems to succeed in disseminating the notion that, without competition, there cannot be competitiveness at all. The need for greater discipline by market forces has been understood better and more widely shared than it had been before the first economic crisis. Thanks to this change in mood, the regulatory framework to cope with economic crisis has continued to be upgraded to keep pace with new developments in OECD countries.

We believe that Korea deserves credit in this respect. We are inclined to regarding ‘Big Deal’ as not being commendable, since it not only took as much time as it might when it was left to market, but left legacies that were politically thorny. Leaving this episode aside, the application of competition law has been nearly impeccable. By and large, the Korean government has been successful in putting market discipline at work, and we believe, this is what has made the Korean economy more resilient and thus able to overcome the ongoing crisis earlier than expected and faster than other OECD member countries.

Recent success business stories in the midst of global economic crisis about the brilliant performance of Korea’s leading companies such as Samsung (semi-conductors), Hyundai (automobiles), and LG (home appliances), among others, help boost Korean people’s self-confidence. The corollary is that they would support market-driven reforms more fully.

Finally, it should be noted that in Korea all the regulatory proposals have to be reviewed or examined by the RRC, and in its review process the examination of their potential and real anti-competitive effects has been received attention. From the beginning of this year, however, the RRC has strengthened this procedure by seeking *ex ante* review by the KFTC and giving the highest preference. It means that all government regulations have come to be subject to scrutiny based on the principles of market competition. After all, the KFTC and the RRC have much in common in trying to make market more competitive and conducive to increasing efficiency in the market mechanism.

Market openness

From the macroeconomic point of view, it is certain that the prompt correction of misaligned foreign exchange rates at the incipient stage of economic crisis both in late 1997 and 2008 contributed greatly to bolstering exports, stabilizing the foreign exchange position, and restoring the credibility toward the economy’s external sector’s balance and stability. One may say that it was simply an imperative in view of the economy’s extremely high dependence of foreign trade. It is true. But what has to be recognised is the fact that the Korean government has since the first economic crisis put significant and continuous efforts to reform the foreign trade and investment regime with a view to making the economy capable of adjusting to the global market forces more easily.

Korea’s trade liberalisation process that started in the mid 1980s was slow and lagged much behind high expectations of major trading partner countries. Liberalisation of foreign direct investment was weaker still, even though some liberalisation measures had been taken in the process of Korea’s joining the OECD in 1996. The level of market openness and institutional transparency had been relatively low compared to other developed countries, as evidenced by many complaints made by foreign governments and businesses.

In this sense, it is no surprise that the financial crisis in 1997 became watershed in the history of Korea's trade and foreign investment policies. Although it is true that the IMF, the U.S., Japan, and other major countries brought enormous pressure to bear on Korea to move quickly in the direction of liberalizing trade and foreign direct investment, which was also the course that the Korean government should take on its own in an all-out effort to overcome the crisis and to make Korean industries sustain its competitiveness in the rapidly globalizing world market.

Trade and transparency

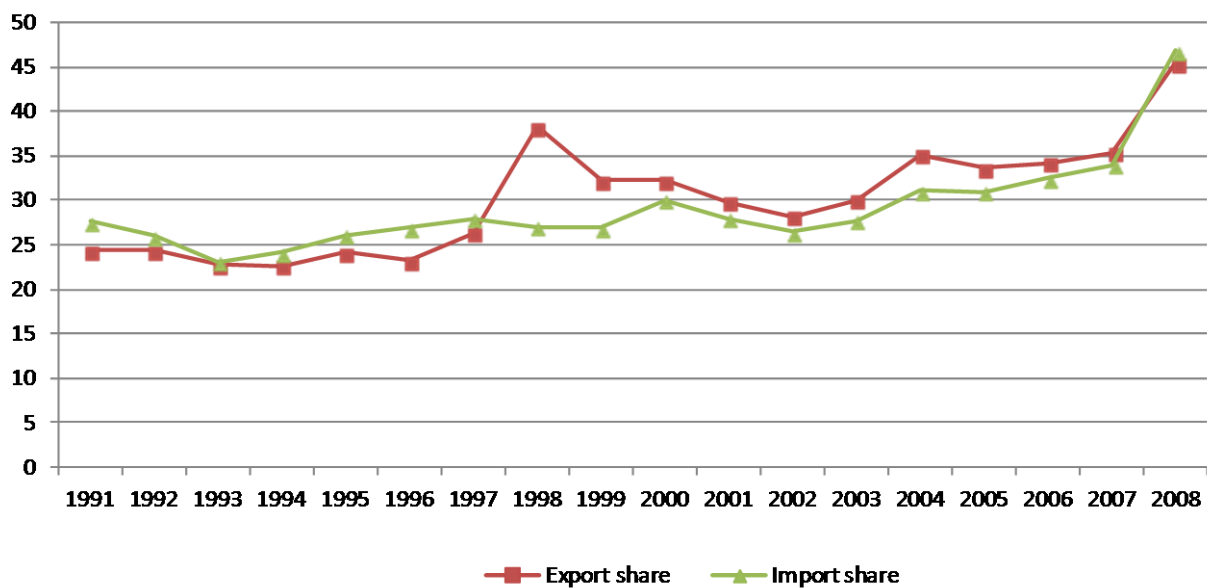
The reforms that the IMF Stand-by Agreement of 1997 required the Korea government to undertake in accordance with its commitment to the WTO were four-fold: the abolition of export-related subsidies, import licensing system, and the import diversification programme, along with the increased transparency in import certification procedures. For all of these, the government implemented the requirements faithfully. After all, they were demanded due mainly to their disbelief in or dissatisfaction with the dubious intention behind those systems and the way they were operated, whether this disbelief or dissatisfaction had any real base or factual evidence, and therefore, it was understood that the faithful implementation was all the more important.

As demanded, the government abolished three export-related subsidies earlier than committed to WTO, phased out the import diversification programme swiftly in June 1999 to alleviate special concerns of Japan, also earlier than scheduled.³² In addition, Korea Customs Service (KCS) streamlined and modernised its customs procedures to such an extent that it has later come to be praised for standing at the cutting edge of international best practice. Thanks to these efforts over time made foreign business enter into Korean market far more easily, for the benefit of enhancing consumer welfare and competition in the Korean market.

Given the fact that the steep increase in exports contributed greatly in the process of recouping from the crisis in 1998-99, it seems necessary to look at the movements of trade and export dependence. As shown in Figure 2.4, the share of export in GDP increased to 38.3% in 1998 from 26.4% in 1997. Evidently, the shocking rise of foreign exchange rate helped the exports greatly, indeed. It is vindicated again in the current crisis. The share of export and import reached to a historic level, 45.4% and 46.8% in 2008, respectively.

It is also noteworthy that Korea-Chile FTA negotiations started in December 1999, two years after the financial crisis. It was initiated by President Kim Dae-jung, who argued that era of economic diplomacy had come, and Korea should not be left outside alone in the rapidly growing web of FTA's. In selecting Chile as its first FTA partner country the judgment that it would not present as many difficulties as it would with other countries that are geographically close to Korea, or with major trading partners. If expected to proceed smoothly, though, the negotiation took a long time until it was ratified in February 2004.

Figure 2.4. Trend of trade dependence of Korea



Source: *www.kita.org*.

It was mainly due to strong opposition and resistance of farmers, as it was seen that major imports from Chile would apparently be agricultural products. According to the bilateral commitment to concessions, Korea was to eliminate tariffs on 96.3% of its tariff lines (HS 86) within ten years. Special features included were liberalisation of investments, the expansion of trade in services, and a special safeguard mechanism in anticipation of the possibility of surge in agricultural products.

The effects of Korea-Chile FTA turned out to be much more profound than initially anticipated.³³ The most conspicuous effect has been the extremely high level of consumers' satisfaction with Chilean wine. It was significantly low-priced. As a result, its import surged by 174.2% in 2005, one year after the FTA came into force.³⁴ Although not as much recognised by the public as for the case of wine, imports of several agricultural products such as grape and pork jumped, too. On the other hand, Korean companies' exports also soared in a variety of product lines, and mobile phone and TV, in particular. Total export to Chile has since increased at the rate of 42.4% annually on average. This favourable result helped turn the public opinion in support of FTA's decisively, clearing the way forward to negotiate more FTAs.

Bolstered by this successful experience, the Korean government adopted a goal to become 'FTA hub' as its major trade strategy. By August 2009, effective FTAs are with Chile, Singapore and ASEAN. FTAs with U.S., EU and India are ready for National Assembly's ratification. FTAs with Canada, Mexico, New Zealand, Australia, Peru and GCC are under negotiation, while joint studies are going on with other countries such as China and Japan. The share of Korea's trade with the FTA partner countries in Korea's total trade in 2008 has risen to 12.1%, next to the U.S. (34.0%) and China (19.7%). When the FTA's with the U.S., EU, and India come into force, the trade share will increase sharply to 35.3%.³⁵

In addition, due to diverse commitments made in relation to FTAs, Korean market will become more open and transparent. It is noteworthy that even tariff and non-tariff barriers to sensitive products are committed to be reduced or phased out. Openness of Korean Market, in fact, goes beyond what can be observed in the WTO MFN tariff rate or those bounded in the GATS.³⁶

Presently, the ratification of Korea-U.S FTA is pending, while negotiations with China and Japan are at the incipient stage. The impact of FTA with Korea's neighbour countries is estimated to be profound. Currently, they are in delay for political reasons. If successfully concluded, they would place Korea as the front runner in the rush toward FTA's these days.

With respect to transparency, Korean government achieved significant outcome, in addition to what has been mentioned above. It has implemented policies to enhance transparency actively by streamlining and improving the standardisation and certification system. Korea's system of standards and conformity certification procedures has once cumbersome, generating many complaints from many of its trading partners. The foundation has been set since the Basic Act on National Standardisation was enacted in 1999. It shows that Korea is fully committed to bring the procedures related to the conformity with international standards. For this purpose, Korean government has been encouraging negotiations to reach mutual recognition agreements (MRA's) with trading partners. The Korean Agency for Technology and Standards, a national standardisation agency affiliated to Ministry of Knowledge Economy, now has approved MRAs with 44 accredited bodies of 35 countries.

Capital flow

Despite ample evidence for the benefits of integration of local financial markets into international markets, Korea had maintained extensive controls on international capital flows until it joined the OECD. Korea's plan to liberalise capital flows failed to go a long way toward it until the onset of the 1997 financial crisis.³⁷ It was only after the crisis that Korean government accelerated the reform of foreign direct investment regime, with a view to rebuilding the foreign exchange in shortage and securing the fund needed for economic reforms.

In fact, the liberalisation of international capital flow constituted one of the key elements in the IMF reform package. It forced the Korean government to expand the ceiling imposed on equity investment by foreigners, to allow foreigners' to buy shares of Korean banks, to remove the restrictions on short-term financial products and investment in the domestic bond market, to streamline the procedures to be applied to FDI, and to allow borrowing of domestic firms from abroad.

In response, Korean government promulgated the *Foreign Investment Promotion Act* (effective as of November 1998). It represented the Korean government's resolute policy turnaround – from control and regulation to promotion and support.³⁸ Foreign participation in hostile M&A and land acquisition by foreigners, among others, were of the highest symbolic value, since both measures had been considered to be the last measures that Korea would take. It is needless to say that more industry lines have been open to foreign investment. With 24 industries being partially liberalised and 4 industries being wholly shut out of 1 058 industries, the liberalisation rate of FDI soared to 99.6% as of April 2000 from 90.7% in 1995. As of 2008, only three sectors – television and radio broadcasting, and nuclear power generation – are fully closed to foreign investors and 26 sectors are partially restricted out of 1 083 business lines.

It is no wonder that this policy turnaround greatly stimulated the inflow of FDI. It jumped to USD 5.3 billion in 1998 and USD 10.0 billion in 1999, which amounted to 1.54% and 2.25% of GDP, respectively. The sharp increase in FDI inflow also contributed greatly to rebuilding foreign exchange reserve, supporting Korean companies' restructuring process.

Of particular importance was another turnaround in the public's attitude toward foreign capital. The experience of job saving and/or income increase in the companies acquired by foreign investors played an instrumental role in bringing about this change. Little did they think that foreign investors would provide them with jobs that the local companies could not. Even those who first accepted FDI policy perform eventually came to believe in the benefits of FDI.

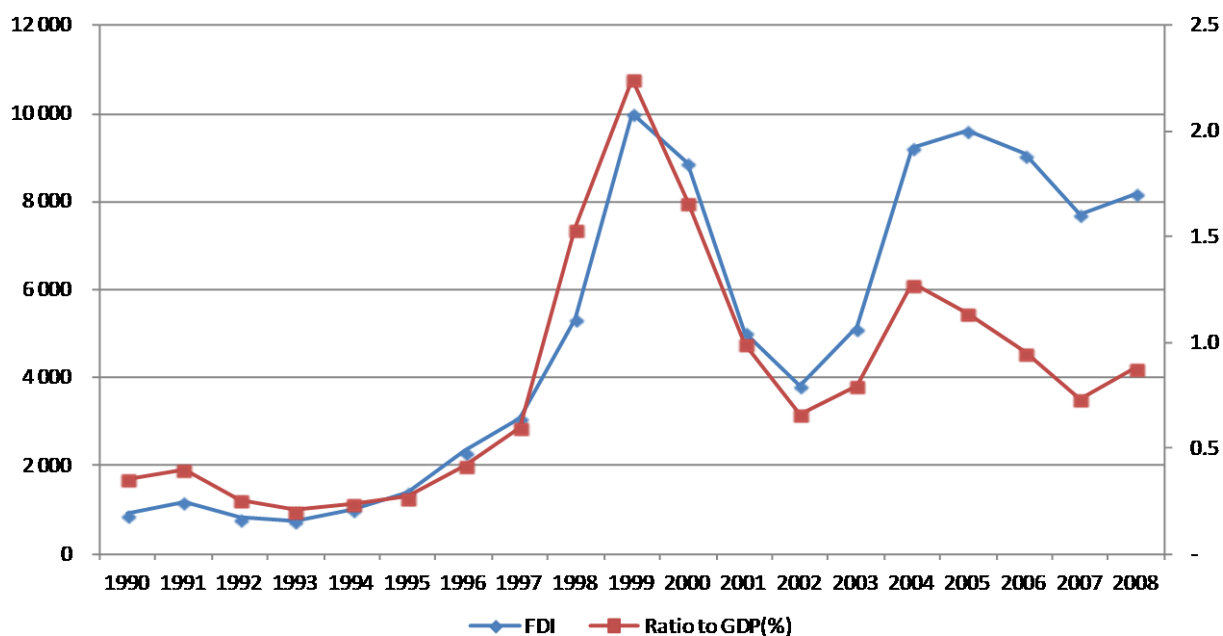
Other related changes include the establishment of the "ombudsman office" in October 1999 to address the grievance of foreign investors, designation of Free Economic Zones (3 zones in 2003, and additional 3 zones in 2008), the continued improvement of business environment and living conditions for foreign investors in residence, and the continuous expansion of a variety of incentives to foreign investors including cash grants.

As such, Korea has come a long way toward full liberalisation of capital flows. In the face of the current crisis, which once again led Korea to face disturbances in external sector, Korean government has stepped up the ongoing liberalisation process. A greater emphasis has been put on expanding incentives, and on improving business environments and living conditions for foreign investors and their families. The PCNC,³⁹ for example, has decided in May 2009 to ease eligibility restrictions further and increase the amount of cash grants, and to establish the semi-cabinet-level FDI Promotion Committee, in which representatives of foreign investors and investor groups.

Owing to these continued efforts and eagerness to improve Korean FDI environment, the FDI inflows has shown a sign of stabilizing at the level of around USD 10 billion annually. In addition, it is notable that while the increase of capital inflow in 1999 and 2000 were caused by foreign minority partners' buying binge of Korean companies, thus its nature being 'temporary',⁴⁰ the recent inflow of FDI tend to partake of the longer-term nature.⁴¹ This stability owes partly to the government efforts keenly interested in maintaining credibility of foreign direct investors.

If we turn to portfolio investment, the picture is quite different. It has proved that there are two aspects. In one aspect, it constitutes a significant source of crisis, in the other, a contributing factor speeding up the recovery from the crisis. The financial crisis in 1997 led initially to a sharp depreciation of Korea's currency (won), triggered by massive foreign capital outflows. In response to deprecation, started from 16 December 1997, Korea shifted from a managed to a free floating exchange rate system, allowing the exchange rate of the won to be determined by changes in supply and demand in the market. As restrictions of foreign investment on Korean equities had been lifted,⁴² and domestic bond and money markets was opened to foreigners through a series of liberalisation measures during 1997-98, Korea's equity market has become more fully integrated to all kinds of markets abroad.⁴³ Furthermore, with the enforcement of Foreign Exchange Transaction Act (FETA), enacted in April 1999, the movement of capital across borders has been facilitated. Korea pursued liberalisation of all foreign exchange transactions partly to be in line with a new free floating system and market openness in the real sectors.

Figure 2.5. Trend of FDI in Korea



1. The statistics of FDI is on the arrival basis.

Pursuant to this new Law, adhered to the negative list system, virtually all the current account transactions have been liberalised. In addition, since 2001, all foreign exchange transactions except those related to international peace and public safety have been liberalised. This gradual approach has been evaluated as helpful in enhancing the efficiency of foreign exchange market, while transactions attracted by those measures tending to cause fluctuations in foreign exchange rate.⁴⁴ Now the Korean government is planning to liberalise completely the capital account by the end of 2009.⁴⁵

As such, liberalised markets arguably helped foreign portfolio investors return, albeit slowly, thereby contributed to stabilizing the financial markets in the process of recovery. It has been true for both crises. The foreign portfolio investment recorded a net outflow of USD 1.7 billion for the fourth quarter of 1997 and USD 35.3 billion for the second half of 2008, but they returned, if slowly. What matters is the pace of moving in and out.

As it did before, in this crisis, the massive outflow of portfolio investors provoked sharp depreciation of Korea's currency (won), in stark contrast to the situations in neighbouring countries, shaking the crisis mentality further. Of course, this massive outflow was provoked due mainly to doubts about the stability of financial institutions, in particular, the banks, as it had been the case before. Whether the doubt is true or not, it only reiterates the absolute importance of transparency and the level of trust in the supervisory system.⁴⁶

Implications

Admittedly, market openness has two sides. On the one side, market openness is the powerful source of growth. It is conducive to increasing efficiency in resource allocation, raising productivity,⁴⁷ and enhancing consumer welfare. On the other side, it exposes the economy to all kinds of political and market vagaries, disturbances, and fluctuations. Which way to go is always a really difficult choice to make. Curiously enough, Korea's choice has tended to be made belatedly, despite the fact that it has had no other viable option than to make the best use of the open world market.

Fortunately, however, the opening of the economy, whether forced or voluntarily pursued, has invariably brought large benefits with it, surpassing its expectations. Both crises are no exception to this rule. The crisis has come from outside, and the crisis in turn has provided the strongest impetus for the reform of trade and investment regimes, which would not been made available, and with successful reforms the economy has revived fast once and again.

Given the fact that especially in times of distress, these regimes tend to be regressing, it is remarkable that Korea has invariably embraced the free trade and investment regime wholeheartedly. In the first economic crisis in 1997, there was no other viable option than to be faithful to the demands of the IMF and major players in the world market. The case with the current crisis is different. As mentioned above, it was the Korean President who warned against the temptation to rely easily on protectionist policy at the G20 summit.

What has made him outspoken was the Korean people's support in his initiative. It represents a sea of change in the context of Korean trade politics. What he counted on was probably this change in the political landscape. Apart from big business that fared best in the post-crisis periods, most of the Korean people have now come to understand and realise the real benefits of market openness. From their point of view, it not only helped to restore economic stability, growth, and the international competitiveness of Korean firms, but also made available for them all sorts of favoured consumer products represented best by Chilean wine. It has not been conceivable to see the market share of imported cars reach as high as 6.04% in 2008, a big leap from 0.42% in 2000.⁴⁸

This remarkable change in attitude guarantees that their political support would not go away or backward easily.⁴⁹ Rather, it would serve as a strong political force requiring and making the fuller integration of Korean economy to the global economy possible.

The best lesson that Korea has learned from the crisis seems to be the respect for credibility. They now understand its importance well. Moreover, they have learned what makes the credibility go up or down. For example, they understand that in the globalised world, transparency, abstention from discriminatory impulse, and credit rating, among others, are all increasingly important elements. Korean people have begun to join the global economy wholeheartedly. And this change owes greatly to the self-confidence restored and earned from fairly successful experiences of overcoming the crisis, whether it was its own creation or forced from outside.

Conclusion

In hindsight, the first economic crisis, in which the Korean economy was driven to a corner and left with no other viable option than to call the IMF in, was indeed a blessing in disguise. Of course, the business and the people had to suffer much pains and hardships

that the extraordinarily radical and harsh structural restructuring and adjustment accompanied in the short run, however, the painful experience helped the Korean government, business, and the people alike to face and respond to the current global economic crisis with composure and a certain level of confidence in its ability to overcome it. Underlying this confidence and ability is, no doubt, the fairly successful structural reforms pursued continually since the first economic crisis, although the impetus for reform was at times slowed down.

As analyzed by *The Economist* so pointedly, the Korean economy's "astonishing rebound" would not have been made possible if its financial and corporate sectors had remained in such a weak and precarious situation as it did in 1997.⁵⁰ In other words, if Korea somehow had managed to get away with such reforms then and, as a result, the financial and corporate sector had remained fraught with all kinds of fragility and vulnerability, it is certain that the Korean government, in the face of the current global economic crisis, would have been pressed hard to a far greater extent than it has been to put them in order before and above all else.

Indeed, in the face of the current economic crisis, however, the Korean government has instead taken expansionary countermeasures both in terms of fiscal and monetary policy, along with reinforced social safety nets. It is remarkable that, in light of the global nature of the current crisis, President Lee Myong-bak pressed hard at the G-20 summit conference, for example, that all the advanced countries go hand in hand to undertake such economic policy direction and keep away from protectionist impulse at least however severe it may become. This is a clear evidence for Korean government's confidence in its ability to recover from the economic crisis only if the global economy would not be plunged into deep recession by the short-sightedness of major countries as it had been widely manifested in the 1930s. Needless to say, what has made President Lee stand up squarely before the unprecedented global financial crisis and speak up is the state of health and resilience of Korean economy laid down fairly firmly through the painful process of structural restructuring and reform undertaken in the midst and aftermath of the crisis.

It is certain that Korea learned an invaluable lesson from the first economic crisis, and rightly. What had led Korea to pursue earnestly and painstakingly such a harsh and radical reform package was the strict but priceless lesson that the era of the government-led economic development and growth had come to a close. The time had come to let the market forces put to work as fully as possible, while having the private sector bear full responsibility for their decisions and outcomes. In the minds of most of Korean people, competition, market openness, and innovation rather than government's direction and interference, protection, and assistance were upheld as the right solution for continued and stable economic growth and the effective antidote to political-economic rent-seeking activities and corruption, pervasive moral hazards problems, and illegitimate redistribution of social costs and burdens resulting from faulty meddling by the government with the business.

As illustrated in this case study, most of the reform and restructuring attempts in Korea thus far have been made generally in accordance with market principles. Of course, although there have been some exceptions here and there, the fact that Korea really learned the important lesson from the economic crisis remains unmistakable, however. In the current crisis, the Korean government has abstained itself from any kind of political and bureaucratic intervention.

Warren Buffet is quoted to have said that “It’s only when the tide goes out that you learn who’s been swimming naked.” The current crisis once again exposed what there remained still as weak points in the Korean economy despite the structural reforms undertaken continually thus far. Some parts of the financial sector and the capital market have earlier been left adrift for a while at the mercy of foreign lenders and credit-rating companies, whose judgment was proved faulty. Certainly the government mentioned and reiterated the need for and the importance of a further restructuring of financial and corporate sector as to, for example, the shipbuilding, sea freight, and construction industries. But the government has issued no specific plan or directives, leaving the problems to be solved by the private hands.

It represents nothing but a warning and a strong signal that the government would not intervene as it did over decades. What is left moot is that it is a matter for the private business and the financial institutions concerned to solve for themselves. The government’s stance not to intervene in the recent Ssangyong Motor Co.’s plant takeover is a case in point, which stands in stark contrast to the case of Kia Motors Co. in 1997.

This remarkable change of attitude of the government, we believe, would serve as a living lesson for the public that the market-driven reform is indeed legitimate in the sense that it leaves no space for political or bureaucratic favouritism whatsoever. Regulatory reform, competition policy, or market openness reforms have been undertaken basically in accordance with market principles, ruling out the possibility to favour big business at the cost of small and medium-sized business sector or the public at large, contributing greatly to upholding the legitimacy of such reforms.

It is no surprise, therefore, that the level of consciousness of the general public has been changing quite speedily in the direction of favouring and supporting the market-driven or market-oriented reforms. The fact that the government has faced no or little significant protest or opposition to the conclusion or negotiation of FTA’s appears to attest this. Now, in Korea, expensive foreign imported cars are not hard to see around on the streets, drivers of which seem to feel no threat from doing so as before.

It is not a small achievement, given Korea’s economic history. What has made this remarkable change possible in a short span of time? This study concludes that this is the result of a virtuous circle of legitimate reform. As stressed in the section on regulatory reform, the existence and the performance of the RRC should be noted again here. There has never been a time when the business – either big or small – has praised the achievement made by the RRC and the government ministries at large. They have continued to mount complaints and grievances that the progress that has been made is far from satisfactory.

Often the strength of complaints tends to be understood as indicating the failure of the regulatory reform process. By contrast, we claim that this is the prime motor of reform in Korea, because it is such complaint that serves as the most important and powerful political base from which the RRC could step up its reform efforts, generating the next round of complaints of higher degree necessitating the upgraded answers. A virtuous circle is at work, indeed, quite nicely in the political economy and the continuously democratizing governance system in Korea. “What are the best practices?” or “What is the global standard?” is the question most people in business as well as the government are asking and looking for.⁵¹

Notes

1. The case study of Korea's experience with regulatory reform during the crisis episode of 1997-98 and the 2008-09 global financial and economic crisis has been prepared by Byung-Sun Choi, Professor, Graduate School of Public Administration, Seoul National University, Young-Seop Shim, Senior Research Fellow, Korea Institute for Industrial Economic and Trade (KIET) and Byungki Ha, Senior Research Fellow, Korea Institute for Industrial Economic and Trade (KIET).
2. "An astonishing rebound," and "Briefing: Emerging Asian economies", *The Economist*, August 15, 2009.
3. The OECD Review on Korea (2006).
4. While the crisis was dubbed as the "economic" crisis outside, within Korea it was called "foreign exchange" crisis or simply the "IMF crisis," the latter of which is a misnomer.
5. While the Asian financial crisis became increasingly contagious in the region and the rumours were around that Korea might be the next victim, the Korean politics went on as usual as if no such thing would happen to Korea. In anticipation of upcoming presidential election a few months away, Korean political (and bureaucratic) leaders, whether in the ruling party or opposition party, hesitated and failed to let Kia Motors, which came to the brink of bankruptcy in June 1997, go its way. Instead, the government introduced a new system of delaying the liquidation of defaulted firms by the lending banks in the aftermath of default of Hanbo Iron and Steel in January, which was embroiled in political corruption scandal. This posture was hardly understandable from the viewpoint of foreign lenders, investors, and experts, indicating only that Korea had neither willingness nor commitment to undertake a fundamental change in the government-business relations or in its style of managing the economy, far outmoded in the era of the rapidly globalizing world.
6. See the "Memorandum on Economic Programme," and the "Letter of Intent (attached to the IMF Stand-by Arrangement)." Dec. 3, 1997.
7. Cited from Heather Smith, "Korea," in Ross H. McLeod and Ross Garnaut (eds.), *East Asia in Crisis: from being a miracle to needing one?* (London, Routledge, 1998), p. 83; Kang, Mansoo, "An Insider's view on Korean Economy in Three Decades," Samsung Economic Research Institute, 2005. (Incidentally, he was Vice-Minister of Ministry of Finance and Economy at the time of crisis coming in 1997).
8. The catchphrase he used from the beginning was "democracy and market economy," the meaning of which is not necessarily clear. But what is clear is that he intended to end the authoritarian rule and open a new era in which the people, not the government, could enjoy the sovereignty.
9. The "Basic Law of Administrative Regulations," on which the President's directive is based, was enacted August 22, 1997, months before the onset of economic crisis, by the previous government, while its implementation regulation (that is, the Presidential Decree) come into force February 24, 1998, the day before the President's inauguration day.
10. The rationale behind setting the target of 50% was notoriously simple. Since there were so many and duplicative regulations, the President thought that it would be the good first step to make the mess cleaned up and then waiting for the all the dust coming down, proceed with the next step in a more schematic fashion. Interview with a former official who served as a junior advisor in the Blue House.

11. See Annex 2A for the list of “specific (sectoral or thematic) tasks,” usually dealt with by “bundles.”
12. Through this avenue, the RRC could exert its influence and authority to the fullest extent and put at work the same guiding principle as manifested in the IMF’s structural reform package.
13. Of course, this number can hardly be accepted at face value, since apples (major and important regulations) and oranges (minor ones) cannot be compared. Furthermore, this figure was somewhat beguiling, for among other reasons, some ministries apparently played with numbers. They tended to group the regulations that they considered to be essential and thus must remain, while dividing those that they considered less important and thus could be dispensed with.
14. See Ha, Byungki, “Cost Benefit Analysis on Korea’s Regulatory Reform in 1998,” Korea Institute for Industrial Economic and Trade (KIET), October 1999. This report calculated three types of costs and benefits on the reform measures; effects on employment, private burden ease and government saving. The measures were chosen for analysis among all the measures to be taken considering importance and calculability and categorised into four groups as foreign investment, job creation, business burden easing, citizen convenience and anti-corruption based upon characteristics. The calculations were initially done by government officials according to the manual, and summarised with some amendments by the author of the report.
15. The same investigator recently conducted the same analysis again by putting real, rather than projected, parameters. It shows that these figures were overestimated. The FDI inflow amounted only to USD 21 billion, and it helped create (or keep) 113 thousand new jobs at the minimum.
16. Federation of Korean Industries (FKI), “A Survey on the Satisfaction with the Regulatory Reform,” in April and August 2009. It should be mentioned, however, the subject for the survey and the survey method are different. In the first survey, 355 business firms answered, whereas in the second, the opinions of 51 experts from the big businesses, research institutes, and academia were solicited for the survey. Such a positive evaluation is corroborated by a few of the international institutions. See IMD’s World Competitiveness Report, and the World Bank’s “Doing Business” Report.
17. The Provincial Government Office of Kyunggido, “Report on the Beneficial Effect of Deregulation on Firms in the Region,” August 2009.
18. The number of regulations registered dropped precipitously from 8 084 at the end of 2006 to 5 114 at the end of 2007. This sudden drop owed to the big change in the regulations classification and registration system itself in February 2007. The current government has started with 5 247 regulations and, as of the end of July, it went down to 5 088.
19. From January to August 2009, 110 out of 600 new regulations proposed by the ministries have been selected as “major” regulations to be subjected to the RRC’s review process, and 13 out of 110 (12%) new regulations were withdrawn, 52 (47.2%) regulations were required to be improved on. For the review, the RRC met 13 times, whereas it’s two subcommittees (dealing with economic regulations and social regulations respectively) 10 and 8 times each.
20. In retrospect, the IMF reform package turned out to be a bitter medicine for the good and long-term health and competitiveness of the Korean economy. But without the RRC apparatus being in place, the course of reform would have been far different, reducing the effectiveness of the medicine.

21. From our perspective, this was an proven fact. Unfortunately, however, this fact has been defied from time to time afterwards, as will be explained below.
22. For this phenomenon the bureaucracy is not solely responsible, since what justifies their approach is the tendency of the people to attribute all the responsibility of social and economic ills to the government.
23. Joh, Sung Wook (1999), *The Korean Corporate Sector: Crisis and Reform*, Korea Development Institute.
24. Net earnings of those companies fell 28%. Following the collapse of Hanbo Iron and Steel in January, the interest rates over the LIBOR that banks and firms had to pay in the international money market rose, albeit slightly. See Smith, *op. cit.*, p. 77.
25. *Ibid.*
26. OECD (2009), DAF/COMP/WD15/ADD1.
27. Incidentally, the economic term “moral hazard problem” has since become a familiar term used by the general public.
28. Kim, Won Kyu (2007), “The Effect of Industrial Restructuring Policy: Post-Financial Crisis,” *KIET Industrial Economic Review*, Korea Institute for Industrial Economics & Trade, Vol. 12, No. 5.
29. *Ibid.*
30. Park, Byung Hyung & HoYoung Lee (2007), Case Studies on the effects of merger remedies.
31. See OECD (2007), *Korea: Progress in Implementing Regulatory Reform*, OECD Reviews of Regulatory Reform, p.77.
32. In passing, it is interesting to note whether the abolition of the import diversification programme, which had been accused because it was instituted to protect local electronics companies from Japan, helped Korean electronics companies such as Samsung Electronics and LG Electronics to have led the electronics market in the world in such products as LCD TV and mobile phone. In the midst of current global financial crisis, these companies gained their market shares and surprised economists by recording huge operation surplus, while Japanese rivals showing deficits. Business Week, “Why Korean Tech Firms Make Money But Japanese Tech Firms Don't,” July 31, 2009
33. It is to be noted that the tariff rates for 391 agricultural product items were left to what would obtain through the outcome of the Doha Development Agenda.
34. Jung, Jaehwa (2006), “Analysis on Export and Import Two Years after Korea-Chile FTA”, March, Symposium Memo.
35. Ministry of Strategy and Finance, Press Releases, 22 July 2009.
36. The simple average MFN rate of Korea is 12.8% in 2008 with 91.5% tariff lines bounded. Average tariff varies significantly across and with sectors, especially high tariff in agriculture products. In regard to market openness, it is not the average tariff rate, not that high compared with other countries though, that matters but severe protection by tariff peaks mainly in agriculture products, which is not easy to be reduced on the political grounds, as easily observed in other countries. This difficulty is one reason, among others, why Korea government has vehemently pursued FTA strategy as a way for further market openness. Currently, Korea maintains import of only one product, rice, to quantitative restrictions, while tariff quotas for beef were replaced by a tariff from January 2001. See WTO, Trade Policy Review-Republic of Korea, WT/TPR/S204, September 2008.
37. Noland, Marcus (2005), South Korea’s Experience with International Capital Flows, 21 January 2005, p. 17.

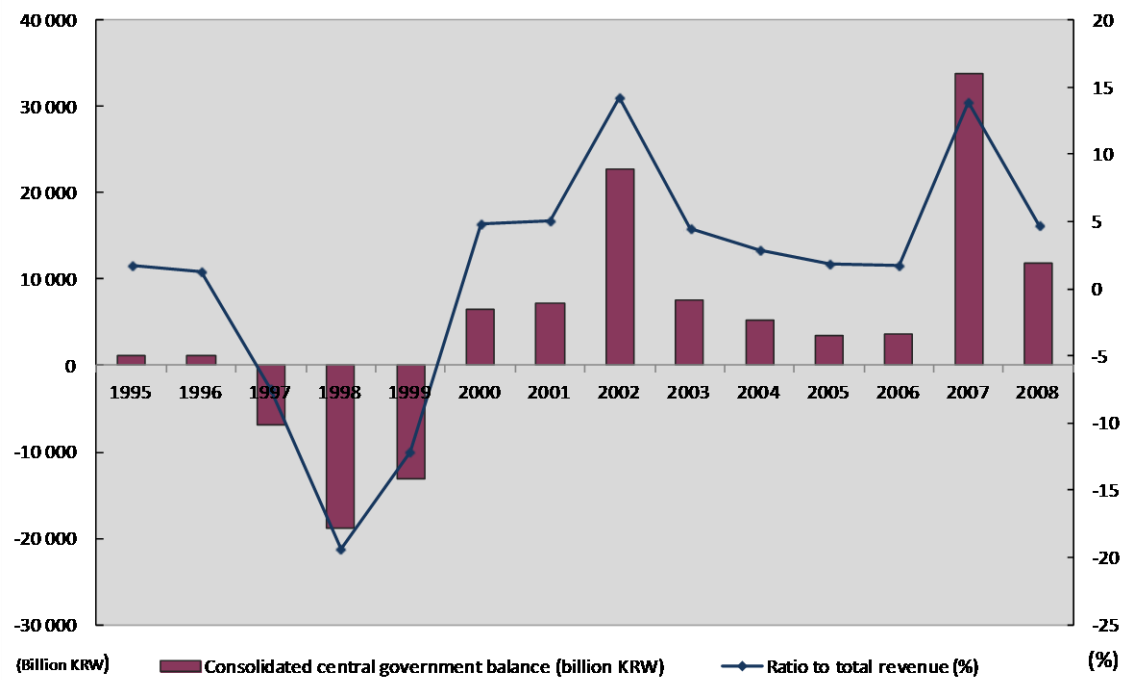
38. This can be clearly seen in the name of the new law of FDI. It was the first time that the word "promotion" replaced the term "introduction," used in the old FDI law, *Foreign Capital Introduction Act*.
39. Among the PCNC's members, there are four foreigners; most of them have direct or indirect relations with their countries' Chamber of Commerce and Industry in Korea.
40. Noland, Marcus (2005), *South Korea's Experience with International Capital Flows*, 21 January.
41. The statistics for FDI, quoted in this paper and reported by MKE, is expressed by the amount on the arrival basis, which thus exclude retreats. On the other hand, Bank of Korea reports FDI statistics including retreats which appear on the balance of payments. The gaps between the two have been large in 2006, 2007 and 2008. Most of recent retreats are related with foreign investors' selling of foreign invested companies mainly to realise investment profits, one example of which being Phillip's sell of LG Display co. Ltd. shares in the stock market.
42. Ceilings on purchases of Korean stocks remain for some companies, such as KT telecom and KEPCO.
43. Noland, Marcus (2005), *South Korea's Experience with International Capital Flows*, 21 January.
44. KIEP, *Foreign Exchange Market Liberalization; The case of Korea*, 2001.
45. WTO (2008), WT/TPR/S204.
46. Currently Korea government, by forming a committee, has been working on the improvement of financial supervision system.
47. It is estimated that 1% increase in trade dependence rate raised total factor productivity by 0.3% during 1970-2005 in Korea. See Kim, Won kyu (2006), *Market Openness and Productivity*, e-KIET Industrial Economic Information, September 2006. Another study showed that the increase in import and FDI in Korea contributed to enhancing total factor productivity with larger effects in manufacturing sector than in service sector, and the enhancing effect in the group of industries with more import and FDI is larger than the one in the other group of industries. See Lee and Kim (2003), "The effects of Opening Market on Productivity", *The Bank of Korea Monthly Bulletin*, March.
48. Sales of foreign invested companies, such as GM Daewoo, Samsung Renault and Ssangyong motor companies are not included in the imported cars.
49. Since Sovereign Asset Management threatened to take-over SK in 2003, the negative perception of foreign capital arose again. High yields have also led to a widespread concern over the nature of speculative foreign capital. Companies invested by foreign investment banks and private equity funds such as New Bridge Capital, Lone Star Funds, Sovereign Asset Management are prime examples of high return. Criticism on the speculative foreign capital was highlighted by disputes on the legality of Lone Star Funds' acquisition of Korea Foreign Exchange Bank.
50. *The Economist* pointed out that relatively low private-sector debt made firms (as well as households) more likely to spend government handouts under the expansionary fiscal policy framework to cope with the crisis. See "An astonishing rebound," and "Briefing: Emerging Asian economies." *The Economist*, August 15, 2009.
51. Incidentally, the local autonomy system re-established since 1993 appears to have contributed considerably to this change in attitude, which is another matter we have no space here to touch upon.

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Annex 2.A1. Government balance, Korea

Figure 2.A1.1. The Korean government's balance



Annex 2.A2. Representative examples of regulations reformed by “bundles”

(Regulations related to ...)

2004

Constructing Productions Facilities
Constructing Golf Courses
Large Scale Distribution Stores
Traditional Market Modernisation

2005

University Administration
Airline Industries
Creativity in Culture and Arts
Private SOC Investments
Surface Freight Transportation
On-the-Job Training
E-Commerce
Tourism and Leisure Industries
Software Industries

2006

Small and Medium-Sized Companies in the Industrial Complexes
Higher Education Institutions
Taxation Procedures
Supervision of Financial Institutions
Use and Reuse of Industrial Wastes

2007

Improving the Competitiveness of Financial Industries
Food Safety
Assistance to Small Merchants
Discrimination against Foreign Business and People

2008 -09 (by the PCNC)

Operation of Industrial Complexes
Investigation of Cultural Treasures
Administrative Penalties
Utilisation of Lands
Competitiveness of Tourist Industries
Upgrading of Construction Industries
Upgrading of Traffic Signal System
Various Charges and Levies for Regulatory Purposes
Traditional Liquor Industries

Case study 3 – Mexico

This case study was prepared by Victor Pavon-Villamayor, Economist, PhD, Instituto Tecnológico Autónomo de México (ITAM).¹ The views expressed in this document are those of the author and should not be attributed to the OECD or to the national governments of the countries studied.

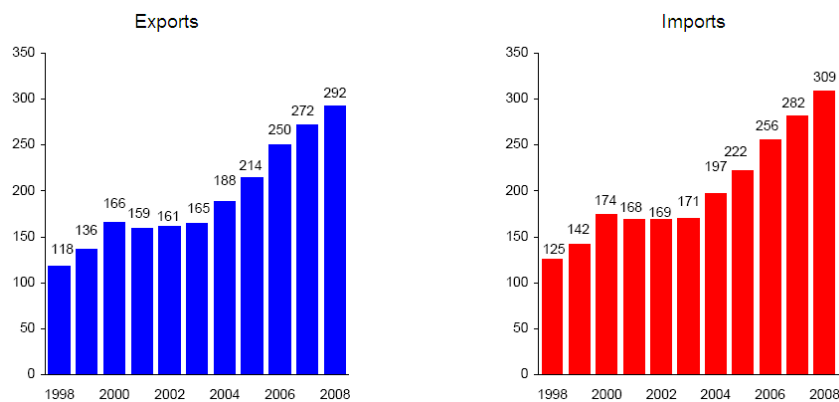
This case study assesses Mexico's experience in using broad regulatory reform as a response to the 1994-95 "peso" crisis. Mexico's response to the 1994-95 crisis, in terms of structural and regulatory reform, is a great example of how proper design and implementation of broad reforms can speed up the recovery from a crisis and improve growth and resilience. This case study discusses the different reforms implemented in 1994-1995 in terms of improving regulatory quality, competition and market openness and their impacts on recovery. These measures are contrasted with the policy response to the 2008-2009 global financial and economic crisis.

Macroeconomic context

Mexican economic profile

Mexico is a medium size economy with strong commercial links with its neighbouring economies through the North American Free Trade Agreement (NAFTA). In 2007, the International Monetary Fund (IMF) ranked Mexico as the 13th largest economy in the world but its position is expected to be reduced two places by the end of 2009. During the last decade, Mexican trade – exports plus imports – has increased significantly from USD 243 billion in 1998 to USD 601 billion in 2008.

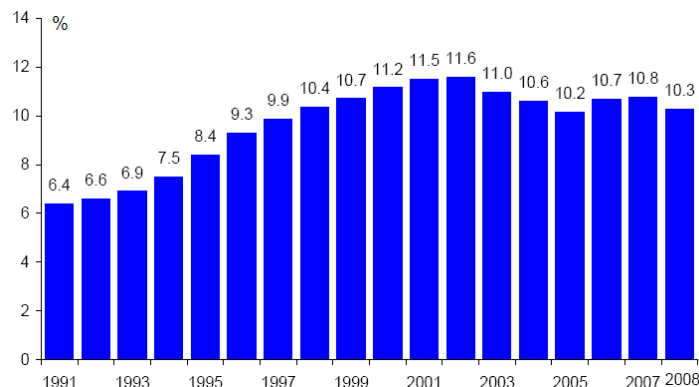
Figure 3.1. Mexican exports and imports, USD billions



Source: Banco de Mexico (2009a).

The US is by far Mexico's largest trading partner since more than 80% of Mexico's exports are channelled to the US economy and about 50% Mexican's imports come from the US. The participation of Mexican exports in US total imports have also been increasing during the last years.

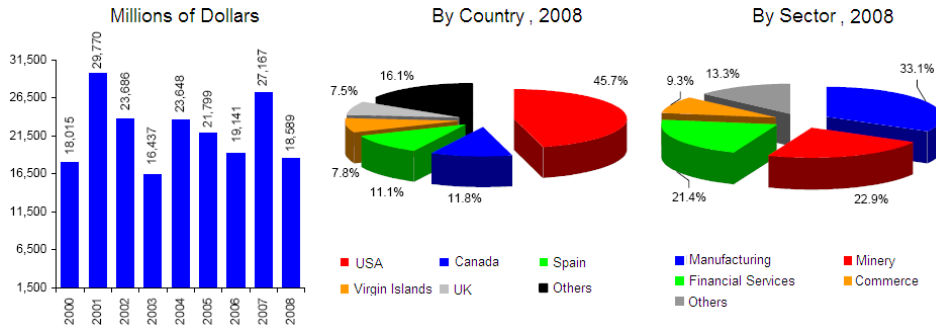
Figure 3.2. Participation of Mexican exports in US imports, %



Source: Banco de Mexico (2009a).

The current account balance of Mexico showed a deficit of 1.4% of GDP in 2008 and the deficit by the end of this year is estimated to be around 2.5% of GDP (IMF, 2009a). Foreign Direct Investment (FDI) inflows have also been an important feature of the Mexican economy during the last decades. By the end of last year, FDI in Mexico represented approximately USD 18 600 millions, although in 2007 it reached an amount close to USD 27 170 millions.

Figure 3.3. Mexican FDI

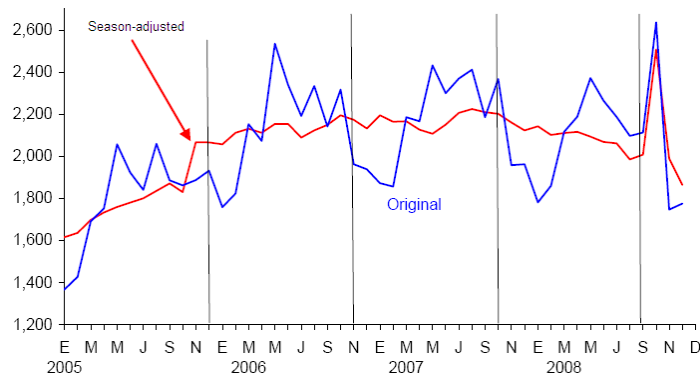


Source: Banco de Mexico (2009a).

During 2008, the most significant FDI flows came from the US, Canada and Spain to fund mainly activities in the manufacturing, mines and financial sectors.

During the last years, the intense economic links between Mexico and the US has also been reflected in a significant inflow of remittances from (mainly) Mexican residents in the US, as illustrated in Figure 3.4.

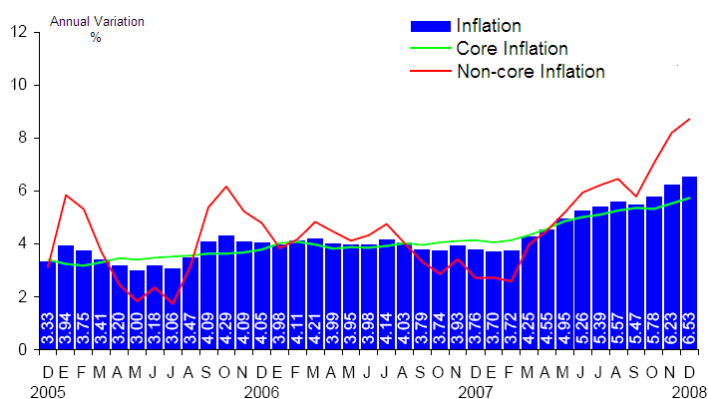
Figure 3.4. Remittances to Mexico, USD millions



Source: Banco de Mexico (2009a).

In general, and before the current international crisis hit, the Mexican economy had been growing on a stable, albeit slow, path of economic growth. Inflation, for example, had been maintained under strict control during the previous years to the current crisis.

Figure 3.5. Inflation rate, Mexico



Source: Banco de Mexico (2009a).

In sum, Mexico can be characterised as a medium size economy broadly opened to trade and with strong economic links with its neighbouring countries, mainly the US.

The 1994-95 crisis²

Crisis impacts

One of the key elements of the pre-NAFTA stabilisation programme implemented in Mexico was to use the exchange rate as a nominal anchor for inflation. By allowing the appreciation of the exchange rate, the evolution of inflation was kept under control. At the same time, and in order to take advantage of the relatively higher interest rates in Mexico, the economy absorbed a large amount of capital inflows which reinforced the appreciation of the currency. This strong appreciation affected the tradable sector of the economy which started to observe a significant trade deficit. The vulnerability of the economy started to be evident when, during the course of 1994, a number of political shocks induced a reversion of the large capital inflows that had entered the Mexican economy during previous years. The central bank attempted to stabilise the fluctuations in the exchange rate through massive interventions, inducing a drop in foreign exchange reserves from USD 30 billion in February 2004 to USD 12 billion in December 2004. In order to avoid a sudden increase in interest rates, the fall in foreign reserves was sterilised through an expansion of domestic credit, a measure that was complemented with the issuance of short-term dollar denominated bonds – named as Tesobonos – aimed at reducing the expectations of a possible sharp devaluation. Since Tesobonos' stock increased from USD 1.2 billion in December 1993 to USD 29 billion in December 1994, it was clear that the government had become illiquid because the amount of foreign reserves was able to cover roughly 40% of the recently issued bond debt at the end of 1994. The new federal administration, in charge from December 2004 onwards, tried to adjust the exchange rate by 15% but this ended with a final speculative attack on the currency. The drain in foreign exchange reserves was so high and intense that the central bank stopped defending the currency and declared its free flotation.

The economic consequences of the crisis were significant. In 1995, Mexican GDP fell 6% in real terms and two of the most important non-tradable industries, construction and commerce, observed sharp output declines (about 28% and 22%, respectively). It is worth noting that even by the first quarter of 1998, construction and commerce had not yet attained their pre-crisis levels of production. The crisis also generated a sharp increase in the rate of inflation. The annual inflation by the end of 1995 reached 52%. Undoubtedly, one of the most important impacts of the 1994-95 crisis was the huge increase in the peso-denominated debts of banks. By December 2004, foreign currency loans represented about 33% of total loans made by Mexican banks so that when the depreciation of the exchange rate hit, banks started to face a significant increase in their levels of nonperforming loans. The significant increase in interest rates that followed the crisis also affected the financial situation of the Mexican banking system, since most interest rates on credits were tied either to one-month government's bonds rates (Cetes) or to interbank interest rates. Hence, when interest rates increased to levels as high as 80% during the first quarter of 1995, payments to banks ceased and the number of nonperforming loans increased substantially. This, in turn, reduced the risk-weighted capital ratios of Mexican banks below the critical level of 8%.

Recovery measures

The Mexican government reacted to the 1994-95 financial crisis with a broad stabilisation program based on the following measures:

- *Inflation Control Plan.* In January 1995, the government signed up an agreement with labour unions and representatives of the private sector to determine caps on price increases in administered prices, wages and output.
- *International Credit Facilities Plan.* To convince markets that the government had enough resources to honour its financial obligations, a credit facility by USD 52 billion was negotiated with the US and Canadian governments and multilateral organisations. The credit facility was composed by USD 20 billion from the US government in the form of short-term swap facilities and long-term guarantees; USD 17.8 billion from the IMF in the form of a 18-month stand-by arrangement and some additional credit facilities provided by the government of Canada, the World Bank and the Interamerican Development Bank.³
- *Banking Rescue Plan.* The government implemented a bailout programme of the banking system that included: *i)* a mechanism to provide immediate dollar liquidity to banks through a central bank's dollar credit window at penalty interest rates; *ii)* public absorption of a share of commercial bank's non-performing loans through an exchange of loans by non-transferable ten-year government bonds;⁴ *iii)* the recapitalisation of banks through a special trust fund – named PROCAPTE and,⁵ *iv)* a relief programme aimed to reduce the financial burdens to borrowers.

The banking rescue plan was the key measure implemented by the Mexican government to address the consequences of the crisis and, although it was originally conceived as a temporal measure, the subsequent evolution of the crisis made it some sort of permanent. In 1995, the estimated cost of the bank bailout was about 5.5% of GDP and 8.6% by 1996. By 1998, the Mexican government recognised that most of the loans acquired as part of the rescue plan were irrecoverable so that they should be converted into public debt. By 2006, the total cost of the bank bailout was estimated to be approximately at 17% of GDP.

The crisis and its aftermath

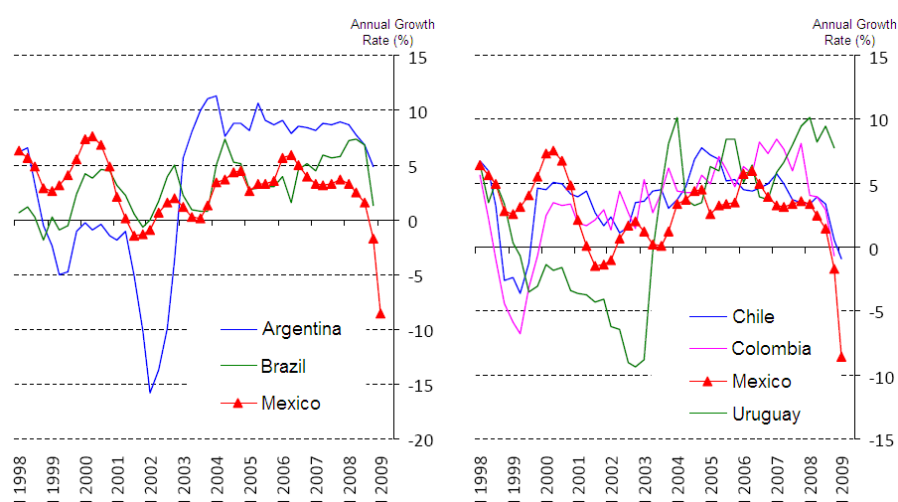
The immediate impacts of the crisis on the economy was that Mexican real GDP fell 9.2%, 8% and 7% during the last three quarters of 1995. However, the recession was short-lived since GDP began to increase again in the second quarter of 1996 and kept growing at average annual rates above 5% until the first quarter of 1998. GDP decreased more sharply in 1994-95 than it did during the crisis of 1982, but it bounced back faster. For example, in the aftermath of the 1982 crisis, investment did not return to its pre-crisis level before 1991 while, in the 1994-95 crisis, this happened just after two years. The recovery was not, however, uniform across the economy. As noted by Krueger and Tornell (1999), the tradable sector grew strongly in the post-crisis period, whereas the non-tradable sector of the economy observed sluggishness. The asymmetric response of the tradable and non-tradable sector was, in the opinion of the same authors, a consequence of the different post-credit conditions that faced these two sectors: the tradable sector was able to have access to credit in international markets while the non-tradable sector's activity was restricted by the credit-crunch prevailing in Mexico.

The 2007-09 crisis

Crisis impacts

Mexico, as many other countries around the world, has been impacted by the economic international crisis originated in the US mortgage-backed financial market. The international crisis has affected the performance of the Mexican economy through a set of different variables, particularly the reduction in exports, remittances, FDI flows, tourism's revenues and last but not least, funding restrictions deriving from the credit crunch in international markets. As a consequence of these negative impacts (and also of several country-specific shocks as the outbreak of influenza AH1N1) the Mexican economy was already slowing down during the last quarters, as depicted in the figure below.

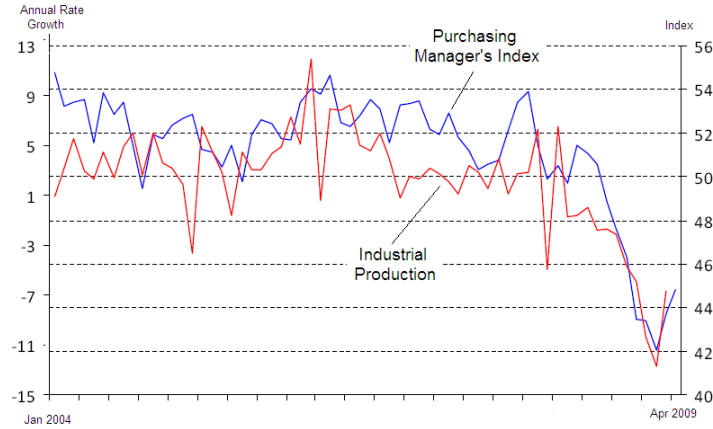
Figure 3.6. GDP in selected Latin American countries, annual growth rates



Source: Banco de Mexico (2009).

The evolution of industrial production in Mexico shows a similar story in tandem with early economic indicators of the performance of the manufacturing sector (PMI Index):⁶

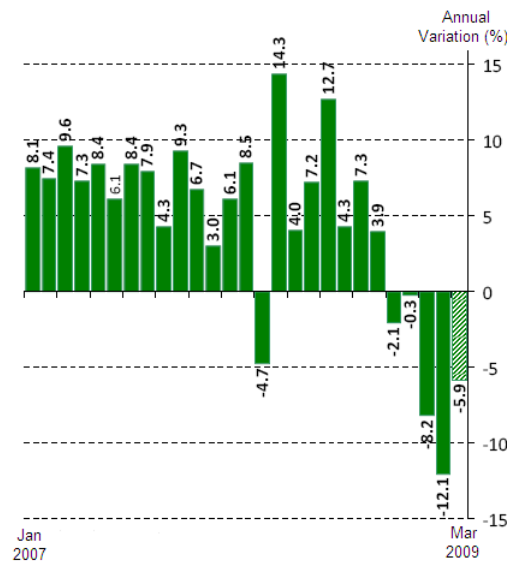
Figure 3.7. Industrial production/PMI in Mexico, growth rate & index



Source: Banco de Mexico (2009).

The current slowdown of the economy has also affected the actual rate of investment. By February 2009, gross fixed investment had decreased by 12.1% with respect to the level observed one year before.

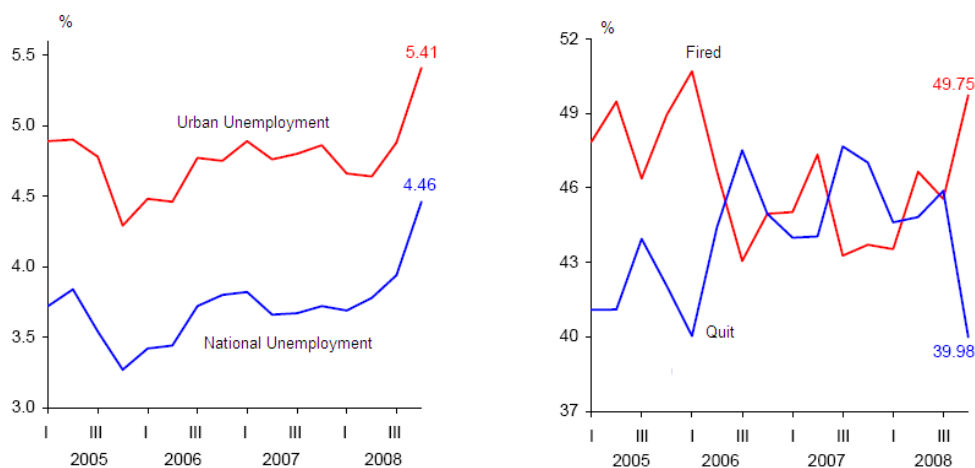
Figure 3.8. Gross fixed investment, annual variations



Source: Banco de Mexico (2009).

Naturally, the decrease in the economic activity has been increasing the rate of unemployment, which is projected to reach levels similar to the ones observed during the 1994-95 crisis (OECD, 2009). The following figure show a sharp increase in unemployment rates starting in the second quarter of 2008 in tandem with an increase in the proportion of the population that has been fired during the same period of time.

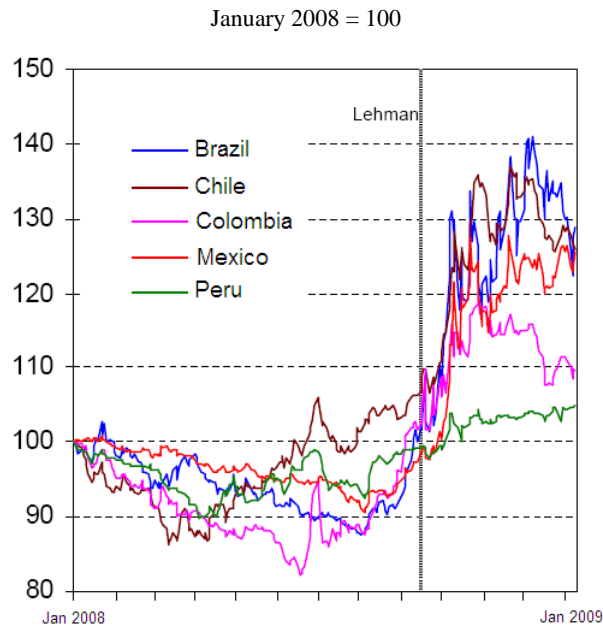
Figure 3.9. Unemployment rate as a percentage of the active labour force, and unemployment causes as a percentage of the unemployed population with professional experience



Source: Banco de Mexico (2009a).

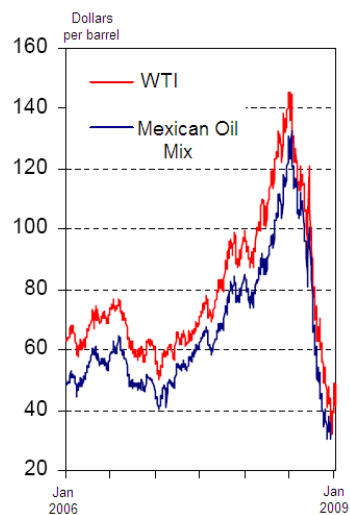
The most recent figures from the United Nations Economic Commission for Latin American and the Caribbean show that, during the first semester of 2009, the urban unemployment rate in Mexico reached 6.3%.

Another important impact of the current international crisis on the Mexican economy is the reduction in the volume of capital inflows. This contraction has induced a drop in equity prices, higher interest rate spreads and, of course, larger pressures on the exchange rate. The following figure shows the depreciation of the Mexican peso during the entire year 2008 in the context of the depreciation observed in other Latin American economies.

Figure 3.10. Nominal exchange rates in selected Latin American countries

Source: Banco de Mexico (2009).

The impact of the international economic crisis in Mexico has been mainly driven by the poor performance of the external sector since non-oil export volumes have been weakened by the US recession and oil export revenues have also been decreasing because of falling oil prices and lower volumes of oil production in Mexico.

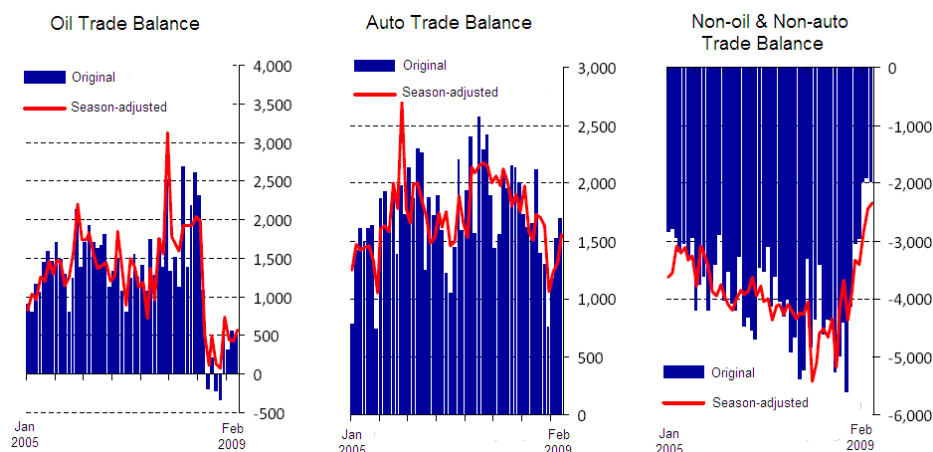
Figure 3.11. WTI & Mexican oil mix prices, dollars per barrel

Source: Banco de Mexico (2009).

The reduction in oil revenues is an issue for Mexican public finances, since they represent 40% of total revenues. The scenario of decreasing oil revenues is not expected to improve in the short-run. The average oil production per day during 2010 is expected

to be around 2.5 millions of barrels, a decrease of 0.9 million barrels per day with respect to the average production registered in 2004. Since the 2010 budget estimates an average oil price for the Mexican mix of about USD 53.9 per barrel, this means that Mexico is expected to receive USD 17 460 million less in oil revenues during 2010.⁷

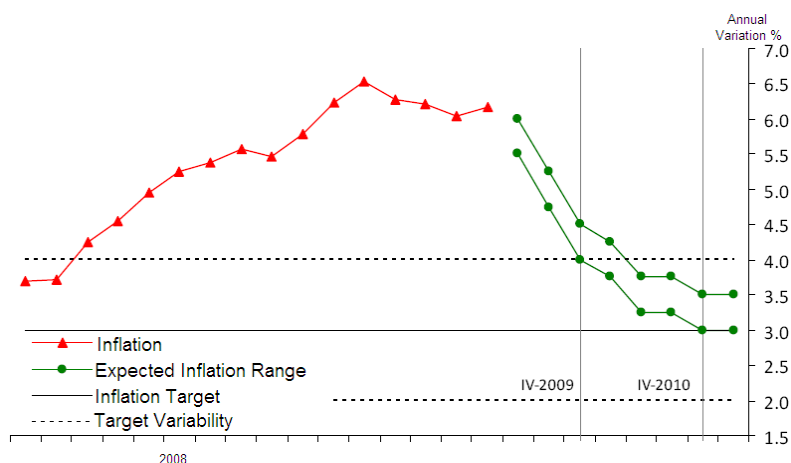
Figure 3.12. Mexican trade balances, million dollars



Source: Banco de Mexico (2009).

The international crisis has also affected the evolution of inflation in Mexico, which has been on the rise during 2009 but it is expected to close between 4.0% and 4.5% by the end of the year.

Figure 3.13. Mexican inflation, annual variations



Source: Banco de Mexico (2009).

The current international crisis has had a reduced impact on the stability of the Mexican financial system thanks to its low exposure to foreign assets. Therefore, the banking system remains well-capitalised and strong. However, a threat for the stability of the Mexican banking system is a potential increase in the number of non-performing

loans that could be generated by the difficulties faced by consumers and firms to fulfil their financial obligations as the economy weakens (OECD, 2009).

During the second quarter of 2009, the economy activity in Mexico decreased 10.3% on a yearly basis and decreases of about 6.8% and 3.7% during the third and last quarter of 2009 are expected.⁸ Overall, the IMF expects that the Mexican GDP will fall between 6% and 8% this year while the United Nations Economic Commission for Latin America and the Caribbean and the World Bank, in turn, have estimated a 7% fall. It is expected that the Mexican economy will start its recovery from the present crisis during the second half of 2010 as the economic activity in US resumes.⁹

Recovery measures

On the financial side, the Mexican government has reacted to the crisis with measures aimed to solve liquidity problems as foreign exchange interventions and decreases in interest rates. At the beginning of 2009, the government also acquired credit lines from international institutions in order to support the stability of the economy. For example, a credit line with the IMF was contracted by an amount near to USD 49 450 millions.¹⁰ On the real side of the economy, the Mexican authorities have responded with a fiscal stimulus to support demand, which has been complemented with special support measures to specific sectors – *e.g.*, airlines, tourism, and pork industry – in order to compensate for the Mexican-specific shocks on the economic activity stemming from the influenza outbreak (OECD, 2009). The fiscal stimulus has been implemented through two core economic packages announced in October 2008 and January 2009, respectively.

The first economic package – Growth and Employment Fostering Programme – was announced on October 8th 2008.¹¹ The package contained a set of structural and temporal economic measures. The temporal measures were mainly related with increases in public expenditure, mainly infrastructure, and with the expansion of credit guarantees in the system of development banks in order to support the provision of credit. The structural measures were focused on measures to accelerate the expenditure in infrastructure and to improve the participation of small and medium enterprises in public procurement. The package also contained other important measures as a legal change in the investment regime of the Mexican oil monopoly (PEMEX). The main components of this first package were as follow. Concerning temporal measures, the Mexican government decided to:

- *Increase expenditure in infrastructure* by an amount of MXN 90 300 millions, equivalent to 0.7% of GDP. This additional expenditure included the expenditure associated with the construction of a new oil refinery by PEMEX;
- *Expand the credit facilities delivered by development banks*. In particular, two of the main development banks (Nafin and Bancomext) were mandated to provide MXN 35 000 millions in credit lines and guarantees to the business sector;

- *Expand the credit facilities channelled to the infrastructure, agricultural and housing sectors.* Banobras is expected to provide MXN 30 000 millions in credits to fund infrastructure projects while the National Fund for Infrastructure is expected to generate MXN 125 000 millions in new investments during the next three years. In the agricultural sector, a new scheme of guarantees is expected to provide MXN 20 000 millions in additional funding whereas the housing sector is also expected to get MXN 40 000 millions in extra funding.

The most important structural measure associated with this package was to:

- *Increase the participation of small and medium enterprises in public procurement.* The Mexican government mandated that a minimum of 20% of the total value of acquisitions by the government during 2009 will be acquired from small and medium enterprises.

In total, the government estimated that this first package would imply a fiscal stimulus and resources for project's funding and additional credits by MXN 255 000 millions.

On 7 January 2009, the Mexican government announced a second economic package aiming at:

- *Increasing the expenditure in employment support programmes.* The measures included: *i)* a 40% expansion of funds for the programme of temporal employment; *ii)* the provision of MXN 2 000 millions to support firms that temporally suspended activities with no employee firing; *iii)* an expansion of the safety net for unemployed workers.
- *Increasing credit facilities for the population of low incomes and reducing/freezing the price of basic goods.* Credit lines for the acquisition of popular housing and the replacement of domestic appliances were increased. The price of *gas LP* was reduced 10% while the price of gasoline was frozen during the entire 2009.
- *Reducing the prices of electricity for industrial consumption and additional funding support for businesses.* Among other measures to support the expansion of credit facilities to the business sector, a MXN 5 000 millions trust fund was created to support the participation of small and medium enterprises in public procurement associated with the oil industry.
- *Supporting the expenditure in infrastructure.* An additional MXN 17 000 millions were assigned to PEMEX to expand its investments and the federal states were assigned MXN 14 000 millions in extra funding for infrastructure investment.

The Mexican government has also implemented a programme of direct subsidies for the replacement of old cars. The subsidy – MXN 15 000 per vehicle – is given to owners of 10-year-old (or more) cars subject to the condition that they destroy their old units. However, there is a perception that the programme has fallen short of its initial objectives. As of the end of September 2009, 700 cars had been destroyed when the initial objective was to reach 8 000 units at that point.

In general, the fiscal stimulus amounting 1% of GDP for the present year has been well-received, although questions remain given the magnitude of the economic slowdown.

Comparison of the macroeconomic trends over the 1994-95 and 2007-09 crises

There are, at least, three core differences between the macroeconomic contexts in which these two crises took place. A first difference is the exposure of the Mexican financial system to crisis-related assets. In the 1994-95 crisis, the Mexican banking system was highly exposed to foreign currency-denominated assets – the crisis-related asset – so that, when the sharp devaluation of the exchange rate occurred in December 1994, the banking system became immediately insolvent. In contrast, the current international crisis occurred in the context in which the exposure of the Mexican financial system to crisis-specific ‘toxic’ assets was low, so that the impact of the crisis on the Mexican financial system has remained limited. A second important macroeconomic context difference between these two crises is the role played by the exchange rate as an ‘absorption mechanism’ of shocks. In 1994-95, the pre-crisis exchange rate was virtually fixed since the currency remained practically pegged to the upper bound of the flotation’s range. Since the exchange rate could not adjust to pressures on the capital market, its capacity as absorption mechanism to shocks was severely reduced. The current exchange rate regime of ‘flotation’, in contrast, has reduced some of the financial pressures that have been observed during the present crisis. Finally, a third important difference between the macroeconomic contexts associated with these two crises is related with the credit conditions prevailing in world markets. Krueger and Tornell (1999) have argued that the huge expansion of exports in the aftermath of the 1994-95 crisis was fundamentally related with the fact that the tradable sector of the economy could finance its operations in international markets when the credit-crunch in Mexico was at its peak.¹² The current crisis, in contrast, is characterised by a credit crunch of global magnitude so that it will be more difficult for any Mexican firm to expand its activities in the aftermath of the crisis on the basis of external credit.

Regulatory management and reform policy

The Federal Commission for Regulatory Improvement (COFEMER, formerly named UDE) is the regulatory oversight body that was responsible for regulatory management and reform in the current and past crises. The COFEMER is the main oversight body for regulatory management and reform in Mexico. Its creation followed the reforms of the Federal Law of Administrative Procedure in 2000. COFEMER has as some of its main mandates to review RIAs for most draft regulation at federal level to ensure cost-effective regulation; review the stock of regulation and propose simplification and improvement measures; and establish, maintain, and update a federal catalogue of formalities. It replaced the Economic Deregulation Unit (UDE) which had been created by Presidential Decree on 1989. UDE participated and was a key actor in the drafting and introduction of several laws which promoted legal certainty for economic activity, regulatory quality and competition, amongst them: laws on standards and measures, on consumer protection, and on competition policy.

The 1994-95 crisis

Regulatory management was developed as a policy response to the 1994-95 crisis. In May 1995, the Mexican government announced a program of modification of the regulatory framework. This program was based on a normative approach supported in three principles: (1) The regulation must protect society's welfare and promote competition in a free market framework; (2) the State must concentrate exclusively in the regulation of the opening and operation of businesses that undertake activities that represent significant risks for the population; and (3) the promotion of self-regulation and shared responsibility of all businessmen in the complying of laws

With this set of principles and after consultation between the government and the business community, a program of actions of federal deregulation was designed. This programme called the *Acuerdo para la Desregulación de la Actividad Empresarial* (ADAE), was published on the 24th of November of 1995 by the President Ernesto Zedillo. Its main objectives were the elimination and simplification of federal formalities and the creation of a unique catalogue of federal formalities.

The ADAE boosted the UDE programme by reinforcing its administration capacities. The ADAE included most of the principles of good regulation established in the 1995 OECD Council Recommendation on Improving the Quality of Government Regulation. In December 1996, the policy was strongly reinforced, when the UDE was empowered to manage a broad programme of regulatory impact analysis (OECD, 1999)

ADAE's first goal was to establish a mechanism to review the stock of existing federal formalities affecting businesses. The purpose was to guarantee legal certitude and reduce burdens for businesses, benefiting mostly small and medium sized enterprises which are disproportionately affected by heavy regulation. In this way, it would be easier for entrepreneurs and businesses to take advantage of business opportunities and bring the economy back into the growth path. The second major element of ADAE was aimed at improving draft administrative and legislative regulation. A new oversight system was established to review and improve the flow of proposals. This move helped to introduce cost-benefit analysis of draft regulation, thus improving regulatory quality, which was later strengthened by the establishment of a full-scale RIA programme at the federal level (OECD, 1999).

Early resistance within the federal government had to be overcome to guarantee success for both policies. It was important to work closely with officials in charge of enforcing the formalities and producing draft regulation. Dedicated officials and contact points for the deregulation efforts were named in each ministry and government body, who would be responsible for following up the review of the federal formalities, enforce the simplification efforts, and ensure that a cost-benefit analysis together with draft regulation was sent to UDE.

These measures were complemented with the establishment of the Council for Economic Regulation (CDE). The CDE was chaired by the Minister for Trade and Industry who reported directly to the president. In practice the CDE acted as Mexico's supreme regulatory policy forum. Other standing members of the CDE at that time were the Comptroller General as vice-chair, the Ministers of Finance and Labour, the Governor of the Bank of Mexico, five representatives of the business sector, four representatives of the academic sector, three from the labour unions and two representatives of rural workers. Between 1996 and 1999 the full CDE met approximately six times a year. During these meetings, proposed reforms and reports on the implementation of previously approved reforms were discussed and agreed upon (OECD, 1999).

Finally, with the purpose of promoting the deregulation at state and municipal level, agreements of coordination with some governments of several federal states were signed during the 1995-97 period. With the participation of the private initiative, work groups of economic deregulation were set up to supervise the application of the state programs of deregulation and administrative simplification. One prime example of UDE's direct involvement with local governments was the 1995-97 programme to improve Mexico City's regulatory framework. A far-reaching co-operative project involving UDE, the 1994-97 Mexico City administration, and the General Comptroller (which became later the Ministry of Public Administration) permitted the elimination of nearly 40% of formalities and the reform of more than 14 major laws and regulations (OECD, 1999)

The 1994-95 crisis set the conditions for the establishment of the first articulated efforts for administrative simplification through the review of business formalities, and the introduction of cost-benefit analysis for draft regulation in Mexico, which gave way to the use of RIA analysis later on. The review and reform of formalities, including information requirements, licenses, and permits, proceeded systematically throughout the immediate years after the crisis. By 1998 ten out of the twelve ministries subject to the process had been reviewed, and two-thirds of the business formalities had been reviewed, although an overall measurement of burden reduction was never carried out. Additionally, introduction and widespread use Regulatory Impact Analysis was established when the ADAE review powers were supplemented in 1996 and 1997 by modifications to the Federal Law of Administrative Procedures and the Federal Law of Metrology and Standardisation (OECD, 1999).

In 2000 reforms were passed on by Congress to the Federal Law of Administrative Procedure, creating the Federal Commission of Regulatory Improvement (COFEMER) which replaced UDE, and institutionalising the federal programme of regulatory quality management in Mexico. Key recommendations from OECD in the 1999 regulatory review were also introduced in this reform (OECD, 2004). Under the responsibility of COFEMER, regulatory reform in Mexico experienced significant progress, including the consolidation of the catalogue of formalities, the development and improvement of RIA and increase in transparency due to the implementation of regulation and alternatives to traditional regulation (OECD, 2004).

The introduction of the ADAE after the 1994-95 crisis helped to achieve two types of objectives. In the short run, it allowed businesses and entrepreneurs to benefit from the simplification and streamlining of formalities, hence contributing to a speedier economic recovery; and in the medium to long term it served as the basis for a strategy of establishing a system for regulatory quality management.

The 2007-09 crisis

At the time the crises started, Mexico was already embarked in a project to improve competitiveness through regulatory reform in cooperation with the OECD. This project has turned into a vehicle to implement some of the strategies of the plan of President Calderon to advance transformation in Mexico and recover from the crisis. Moreover, the crisis has served as the trigger to gather the necessary political backing to push for the continuation of the project until 2011, even in the face of severe budgetary restrictions, which was initially set to finish at the end of 2009.

Before the beginning of the crisis, in 2007 the Mexican federal government represented by the Ministry of Economy, and the OECD, had agreed to cooperate in a programme to strengthen competitiveness in Mexico, by reforming and modifying the regulatory and institutional framework. Taking advantage of its expertise and knowledge on best international practice, the OECD is advising and collaborating with the federal Government to improve competitiveness in Mexico. The programme started formally in mid 2008, at the outset of the crisis, and is currently under way. The objective of the regulatory reform pillar of the co-operation is to improve the business environment by making it easier for businesses to start, function, and grow, hence promoting an increase in productivity, job creation, lower prices, and increased output, feeding into GDP growth and wealth creation.

The first achievement of the cooperation is the portal “tuempresa.gob.mx”, an on-line site that allows entrepreneurs to comply with the five federal formalities needed to legally constitute a commercial entity in a simplified and streamlined manner. The portal was designed and implemented in the framework of this project. Prior to the implementation of the portal, entrepreneurs needed to visit different government offices, fill several forms and questionnaires supplying the same information several times, wait in line to submit information, and wait several hours or days to receive an official response. With the portal tuempresa.gob.mx, entrepreneurs complete just one single form online, and after visiting a notary or an authorised commercial broker, they receive and are able to download official responses from the website.

Tuempresa.gob.mx represents a significant step in simplifying administrative procedures to start a business. According to OECD calculations, the portal “tuempresa.gob.mx” reduces the administrative burden faced by entrepreneurs when complying with the necessary formalities to constitute a legal enterprise in Mexico by 65%. With the portal, Mexico improves the business environment by easing the opening of businesses, gaining in relation to other OECD countries that have carried out aggressive simplification programs through the establishment of one-stop shops, such as Spain and Portugal.

This contributes to the ten-point plan of President Calderon to advance transformation in Mexico and help Mexico recover from the crises, announced at the start of September 2009. They include: (5) A profound economic reform to achieve a more competitive economy, and (8) A profound regulatory reform to have a zero-based regulation that facilitate the lives of citizens.

In addition, in October 2008 and January 2009, President Calderon announced several measures to weather and minimise the effects of the economic crisis, amongst them programmes to increase spending on infrastructure, and to increase access of SMEs to Government procurement. However, the opportunity to amplify the effects and speed of impact of such programmes were lost when such programmes were not accompanied by a simplification of rules, procedures, and regulation with incidence on these activities.

An example of how the impact of programmes to boost the internal market can be enhanced when they are accompanied by efforts to simplify the rules and regulation that surround them, comes from the programme for the replacement of old cars announced during the first half of 2009 by the Ministry of Economy. Amid claims that the replacement of old cars was not hitting the targets due to stringent requirement on car

owners, in October 2009 a simplification of the rules were announced by the Ministry of Economy. Amongst them, the requirement of the original invoice of the car was eliminated. The problem arose from the fact that current owners of old cars are unlikely to hold the original invoice, because most of the cars are second hand cars. The owners now have the option to demonstrate ownership through other legal documents.

Comparing the 1994-95 and 2008-09 crises and regulatory management policies as a tool for crisis recovery

There are significant differences between the current measures, which are building on an existing architecture, and the situation during the 1995-96 crisis, which helped to establish regulatory reform as a response to the economic downturn and to implement some government-wide programmes for regulatory management. During the 1995-96 crisis, the Mexican government took the opportunity to introduce an articulated and far-reaching program of regulatory reform that simplified and eliminated business formalities, and paved the way for the widespread employment of RIA analysis for most federal draft regulation. The medium and long term effects of these measures were the creation of a dedicated body that manages the regulatory quality efforts in Mexico. In turn, the 2007-09 crisis has helped to boost an ongoing program aiming at strengthening competitiveness in Mexico through regulatory reform.

Competition policy

As part of the negotiations leading to NAFTA, Mexico committed to adopt policies proscribing anti-competitive business conduct. On June 1993, the Federal Competition Law —LFCE— was enacted and the Federal Competition Commission (CFC) was born.

The 1994-95 crisis

The enforcement of competition policy in the aftermath of the 1994-95 crisis followed two distinct lines of action. The first focused on continuing the enforcement of ‘standard’ competition policy principles while the second involved addressing many of the competition issues that derived from the financial crisis. These two lines of action are discussed in more detail below.

Enforcement of ‘standard’ competition principles

Most of the enforcement of competition policy in Mexico in the aftermath of the 1994-95 crisis was focused on the implementation of ‘standard’ antitrust procedures and principles. In the particular case of coordinated effects, for example, there is no evidence that processes of cartelisation were permitted to stabilise markets. Therefore, the nature of the anti-cartel policy in Mexico didn’t react to the financial crisis in the form of allowing depression cartels. In fact, there is evidence that the Mexican competition authority —CFC— enforced an active post-crisis anti-cartel policy. During a period of two years (1995-97), for example, the CFC fined a number of industry associations that were caught in price fixing (CFC, 1996, 1997).¹³ A well-known case in this area occurred in March 1995, when the competition authorities fined the National Road Transport Chamber for establishing a mechanism that facilitated the setting of minimum prices (OECD, 1999).¹⁴

The CFC also plays an important role in the supervision of the terms and conditions associated with either the privatisation of former public enterprises or the allocation of concessions to private agents in order to make all these procedures compatible with sound competition principles. In this area too, the CFC was particularly robust in the enforcement of standard competition principles. During 1995-96, for example, the CFC actively participated in the design of auctions and concessions in the port industry for the provision of cargo and cruises services and for the allocation of rights for the exploitation of the *Administradoras Portuarias Integrales* (APIs) of Puerto Vallarta and Acapulco. In its review of this case, the CFC's assessment did not limit the participation of interested parties in the concessions for cruises services and APIs, but either blocked the participation of some interested parties or conditioned the terms of such participation in the case of concessions for cargo services (CFC, 1996).

Competition policy reaction to the crisis

Competition policy in Mexico also reacted to the consequences of the 1994-95 financial crisis in the form of allowing concentrations for financial restructuring purposes. In its 1995-96 Annual Report, the CFC explicitly acknowledged that the Federal Competition Law —LFCE— permitted the implementation of 'safeguards' measures in order to preserve competition in the market. One of these safeguards measures is the clearing of concentrations for financial restructuring purposes. Some of concentrations cleared by the competition authorities for financial restructuring purposes were competitive-neutral in the sense that they never represented a serious threat to the competitive *status quo*. The approval of these transactions had the advantage of not only preserving competition but also helping the financial restructuring of firms that had been affected by the turmoil of the crisis. A good example of this type of transaction occurred in December 1995, when the CFC cleared the concentration of three firms that were active in the hotel industry in Mexico City (CFC, 1995). By clearing a concentration that did not pose a serious threat to market competition, the approval helped the financial restructuring of one the firms and avoided the cancellation of an ongoing project that would imply some sort of asset destruction.

The aftermath of the 1994-95 crisis was also characterised by an intense process of bank restructuring which implied several mergers, mainly between national and foreign banks. The first two years after the crisis, the CFC reviewed several acquisitions of national assets by foreign banks, which increased the foreign asset ownership of the Mexican banking system from 1.4% in 1994 to 15.6% in 1996. The CFC did not block any of these mergers because the competition authorities believed that these foreign acquisitions brought both more competition and financial strength (OECD, 1999).

One of the most important (and peculiar) transactions for financial restructuring purposes that the CFC was in charge of supervising occurred in the airline industry. Before the LFCE was issued in 1993, *Aeromexico* —one of the two major commercial airlines in Mexico— acquired control over its most important competitor, *Mexicana*, under the supervision of the Ministry of Communications and Transport. However, the 1994-95 crisis affected the financial viability of these airlines and, as a temporal measure aimed at facilitating their financial restructuring, creditor banks assumed the ownership of these airlines through a holding company, Cintra. The subsequent banking bailout implemented by the Mexican government (see below) forced the government to take over 63% of the ownership of Cintra through its bank deposit guarantee agency, IPAB.¹⁵ Since the creation and operation of this holding company posed a challenge for the enforcement

of sound competition principles, the CFC mandated the implementation of a set of conditions intended to maintain the competition between these two subsidiaries. The most important of these measures were the implementation of separate accounting systems, independent management and periodic monitoring of the market conditions. Over the years, however, the airlines belonging to this holding company gained market share, acquired a dominant position and increased average fares. When the post-crisis conditions in the market improved, the disintegration of Cintra was raised as a matter of priority by the competition authorities. On the one hand, the CFC was of the opinion that the airlines should be sold off separately to preserve a sound competition in the market, while other members of the government thought that selling Cintra as a whole would be a better option since it would allow maximise revenues.¹⁶ The Mexican government was then faced with a trade-off: the maximisation of revenues from the selling of Cintra implied less competition in the market. Notwithstanding the temptation for taking the revenue-maximizing option, the objective of promoting competition prevailed and the two airlines were finally sold off separately.

Competitive neutrality of emergency measures

The 1994-95 crisis had a huge impact on the Mexican banking system, which had been showing signals of undercapitalisation since 1993. The currency depreciation, the increase in interest rates, the excessive levels of debts and the reduction of output stemming from the financial crisis increased the amount of non-performing loans and, as a consequence, the level of capitalisation decreased. By December 1995, the level of capitalisation of the banking system was below 8%, the minimum level according to best international practices. The insolvency of the Mexican banking system was confronted with two core measures. First, the provision of liquidity support to banks in the form of dollar credits since the foreign currency-denominated debt of Mexican banks was high and the depreciation of the currency reduced their capacity to service it. The central bank then supplied liquidity to banks at above-market interest rates. Second, the Mexican government implemented two capitalisation programmes—the Temporary Capitalisation Program (PROCAPTE) and the Loan Purchase and Capitalisation Plan—in order to improve the asset balance of the banking system.¹⁷ PROCAPTE, launched in February 1995, was a programme that allowed banks to issue and sell to FOBAPROA five-year convertible bonds in order to improve their balance sheets and raise their capital-to-assets ratio. The banks that participated in the programme were prohibited from issuing other subordinated debt until they exited the program and the government was entitled to take over those banks that were unable to fulfil their commitments with the programme. The programme was considered a success since by June 1995 all with the exception of one bank had exited PROCAPTE.¹⁸ The second capitalisation programme, the Loan Purchase and Capitalisation Plan, allowed banks to exchange delinquent loans for ten-year non-tradable government-issued bonds aimed at improving also the balance sheets. The programme established the commitment of banks to increase their capital by one peso for every two pesos of bad loans transferred to the government.¹⁹

The banking rescue was an unavoidable measure but was it neutral in terms of competition. Vickers (2008) has argued that a competitive-neutral rescue package should: *i*) provide a non-discriminatory access to the financial support; *ii*) be limited in terms of scope and duration and, *iii*) contain a set of clauses that avoid the abuse of the support scheme. According to these three criteria, the rescue banking package implemented in the aftermath of the 1994-95 crisis fulfilled the non-discriminatory principle and, partially, the second attribute regarding scope and duration. The area in which the rescue package

clearly failed was in the determination of conditions that avoided the abuse of the financial support given by the government. The package was ill-designed in terms of the type of loans that could be transferred to the government, which created incentives for transferring all types of bad loans. As a consequence, the government ended up with a broad portfolio of non-performing loans both crisis-specific and non-crisis-specific. From this perspective, the banking rescue programme implemented in the aftermath of the 1994-95 failed the competitive-neutral test.

*The 2007-09 crisis*²⁰

This section reviews the general principles that have guided some of the activities of the competition authorities during the recent crisis. First, competition regulations in Mexico do not recognise the *Failing Firm Defence* (FFD) doctrine explicitly, although the firms' financial conditions may be taken into account in the evaluation of a possible harm to competition.²¹ There has been some discussion on the 'appropriateness' of formally adopting the FFD doctrine— as a competition tool in the Mexican competition regime. The core discussion has taken place in the context of the airline industry. The impact of the current crisis on the volume of national passengers in addition to the reduction in airline traffic as a consequence of the influenza outbreak have reduced the level of activity of the main commercial airlines in the country: *Mexicana* and *Aeromexico*. Although the extent to which the current crisis has threatened the financial viability of these two airlines is not clear, the "urgent" need to relax the enforcement of merger policy was discussed in the media to allow the concentration of these two companies as a matter of public interest.²² The fact that competition law in Mexico does not recognise yet the FFD doctrine gives room for discretion in the assessment of whether a concentration involving a failing firm should be allowed. As has been expressed elsewhere:

A party's financial weakness may count in the assessment of likely competitive effects, but beyond that there are no principles describing how it is to count, and what presumptions, if any, are applied. This leaves a great deal of room for non-transparent discretion. Some transactions, in banking and the Cintra combination in particular, have probably been motivated by concerns about disposing of assets in virtual bankruptcy. The CFC's reported decisions note that motivation and the concern that failure would diminish competition, but...the factual basis underlying that reasoning should be made clearer.²³

In this context, it has been proposed to modify the current competition legislation — in particular, articles 16 and 18 of the LFCE— in order to fully embrace the FFD doctrine as a competitive tool during stressed times (Pavón-Villamayor, 2009). The adoption of the FFD doctrine by the Mexican legislation should clearly specify the set of conditions under which this defence might be used in order to guarantee an effective protection of competition. The complementary discussion of legalising the operation of depression cartels in Mexico during the present crisis has never taken place.

In general, the enforcement of competition policy in Mexico during the present crisis has not been distorted. For example, in the current design of the spectrum auctions that the Mexican government is working on, the CFC has been particularly active in the enforcement of sound competition principles. In 2007 the government announced the implementation of a programme of spectrum auctions for the provision of PCS, WiMax, mobile broadband and short-distance high-capacity services. The design of the "rules of the game" that will allocate these rights is work in progress. On August 2009, the CFC

released a binding resolution mandating a spectrum cap *per* operator of 80 MHz for the frequencies of 800, 1700 and 1900 MHz. This mandate has been grounded on the principle of avoiding excessive concentration of spectrum in the hands of a small number of large operators and facilitating the potential entry of a new major operator. The discussion regarding the introduction of potential distortions on competition has taken place in other sectors. Indeed, it has been a matter of contention the competitive effects that derive from the 10% reduction in the price of gas LP that was implemented by the government in January 2009 as part of its crisis package. The core aspect of the discussion is that, for some segments of the market, gas LP competes directly with natural gas so that the price reduction in the former distorts competition between these two types of gas.

Finally, the current international crisis has elevated the role played by competition policy as an instrument for economic recovery and resilience. During the recent release of the budget 2010, President Felipe Calderon announced that the Mexican government will implement a new reform to the LFCE in order to increase the legal powers and to improve CFC's enforcement tools. In the words of the President, the goal is to improve competition policy enforcement in Mexico and hence to enhance the competitive environment of the economy. The forthcoming competition law reform surely will contain improvements in the following key areas:

- *Higher Fines for Violations to Competition Law.* This has been a recurrent theme in the discussion regarding the improvement of competition law enforcement in Mexico. Currently, the maximum fines that the CFC can charge per company amounts to 82 (absolute monopolistic practices) and MXN 49 (relative monopolistic practices) millions. In order to put these amounts in context, the European Commission's fine to the German company *ThyssenKrupp* in 2006 was 72 times higher than the maximum amount that the CFC can charge by the same violation. Currently, the Mexican Senate has a reform proposal intended to increase fines in Mexico to a maximum of 10% of total revenues.²⁴
- *Implementation of jail sentences for managers involved in collusive agreements.* Currently, a proposal on this matter is being analysed by the Senate, but lobbying pressures has made it little operational. Indeed, the reform in hands of the Senate establishes that collusive practices can be punished under the terms of the reform (jail) provided the demonstration of market power. According the best international practices, however, collusive practices are prosecuted *per se* so that there is no need for proving market power for prosecution purposes.
- *Antitrust damages.* The (limited but important) discussion in this matter has followed two different channels: *i*) improvement of the legal process for the execution of compensation demands due to antitrust violations and, *ii*) expansion of compensation to possibly class actions schemes.

Competition policy as a tool for crisis recovery & economic resilience

Competition policy can represent an important tool for improving the conditions under which crisis recovery is paved and resilience to external shocks is strengthened. In particular, competition policy can improve the conditions for crisis recovery through two different channels: avoidance of asset destruction and reduction of asset's under-utilisation. In times of crisis, the risks that assets are destroyed—in other words, that assets are no longer exploited productively—is particularly high, as demand shocks can

reduce the financial viability of firms. The financial vulnerability of firms can make them targets for either acquisitions or mergers. In these conditions, a “sensible” competition policy is called for since by applying a strict FFD doctrine is possible to avoid an anti-competitive destruction of assets. Preserving competition through the avoidance of asset’s destruction also improves the conditions for economic recovery since strengths the installed capacity of the acquirer’s firms and prepare them for the next expansion cycle in a cost-effective way. Competition policy can also improve the conditions for crisis recovery through the enforcement of strict anti-cartel policies in the industry. Indeed, the output restrictions that derive from the operation of cartels mean that assets are underutilised, so that the next cycle of expansion could be harmed if these capacity restrictions are not removed during the crisis’ aftermath.

The enforcement of sound competition policy principles can also improve the resilience of an economy to future crises. For example, the implementation of competitive-neutral rescue packages avoids distortions in the competitive process so that the competitive *status quo* in the market remains unaltered. A market structure that remains competitive and less concentrated reduces its vulnerability either to internal or external non-common demand shocks, so that the global resilience of the industry and the economy to economic crises increases.

The response of competition policy to these two economic crises in Mexico differs. During the 1994-95 crisis, competition policy was primarily concerned with the financial restructuring of firms that otherwise would had been force to exit (consider the case of the airline holding company *Cintra*). In other words, competition policy in Mexico in the aftermath of the 1994-95 crisis was particularly concerned with the problem of asset destruction deriving from the economic turmoil. In a subtle contrast, it seems that Mexican competition policy throughout the present crisis has been more careful in the assessment of whether is appropriate to accept a financial restructuring argument to clear a concentration. For example, in the context of the impact of the current international crisis and the influenza outbreak on the volume of airline traffic, the question was raised whether the two main commercial airlines, *Mexicana* and *Aeromexico*, should proceed to merge and whether the competition authorities should allow them to do so. The fact is that competition authorities seem to remain sceptical on the merits of this transaction since they are unsure that the case would involve an effective destruction of assets.

Market openness

Mexico started a comprehensive process of trade liberalisation and economic reform program in the late 1980s. Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986 and undertook a series of reforms to liberalise its trade regime. In particular, the maximum tariff rate was reduced from 100% in 1982 to 20% in 1988 and the average tariff rate was lowered to 10% in 1988 from 25% in 1985. In addition, a comprehensive privatisation and deregulation program was undertaken during the period 1988–1994.

Negotiations leading to NAFTA started in June 1991. Since the member countries had held bilateral discussions earlier, negotiations moved forward quickly and were completed in August 1992. The United States and Mexico passed the NAFTA legislation in November 1993, and Canada did the same in December 1993. NAFTA entered into force on January 1, 1994. Since Mexico’s tariffs were higher than those of US and Canada, it implemented the largest reductions in tariff rates —the average Mexican tariff rate fell from 12% in 1993 to 1.3% in 2001. Since US tariffs on imports from non-

NAFTA partners were much higher than those on imports from Mexico, the agreement gave Mexico a considerable tariff advantage.²⁵ In the following, the impact of market openness on the Mexican economy is reviewed in the context of the 1994-95 and 2007-09 crisis and its role as instrument for crisis recovery and economic resilience is assessed.

The 1994-95 crisis

The 1994-95 financial crisis occurred practically at the same time that the implementation of NAFTA. Given the importance of this agreement for Mexico, the Mexican government was prompt to emphasise its strong commitment to trade liberalisation and pro-market policies in the aftermath of the crisis. For example, several limitations on foreign ownership of financial institutions were eased after the financial crackdown in order to send a signal to the market that the Mexican government was fully committed with free trade and financial liberalisation reforms. The aftermath of the 1994-95 financial crisis was then characterised in general for free trade policies, notwithstanding the increase in import tariffs that Mexico implemented for non-NAFTA countries.²⁶ Export credit measures were also practically unnecessary, since the drastic depreciation of the exchange rate left Mexico better positioned to take advantage of its trade liberalisation policies. This section discusses the impact on the Mexican economy of both trade and capital liberalisation policies in the aftermath of the 1994-95 financial crisis.

Trade liberalisation

Trade liberalisation via NAFTA had a positive impact on Mexico's growth performance in the aftermath of the 1994-95 crisis. For example, exports of goods and services increased from USD 74 billion in 1994 to USD 126 billion in 1997, an increase of 70.3% in only three years. It is true that this substantial increase is due to trade liberalisation but it should not be forgotten the important role played by the real depreciation of the currency also observed during those years. Covering a longer period of time, Mexico's exports to the United States and Canada more than doubled in dollar terms between 1993 and 2002 and Mexico's trade —sum of exports and imports— with NAFTA partners rose from 25% of the GDP in 1993 to 51% in 2000. Another interesting indicator of the impressive increase in trade observed in the aftermath of the crisis is that, during the period 1993–2002, the increase in total world exports in dollar terms was roughly 75% whereas the increase in Mexico's exports was around 300% (Kose, Meredith and Towe, 2004). This increase in trade was not only NAFTA-specific, since Mexico's trade with non-NAFTA countries increased almost threefold during 1993–2002.²⁷ The following table shows some of the impacts that trade liberalisation in the aftermath of the 1994-95 crisis had on the Mexican economy.

The average rate of growth of exports increased from 7.4% during the period 1980-1993 to 12.9% during the post-NAFTA period —and hence, the post-crisis period. The table also shows a much more interesting indicator: the average GDP growth observed during these two periods. The average rate of growth of GDP in the aftermath of the crisis was significantly higher, particularly when the critical years of 1994 and 1995 are excluded from the sample. Of course, a fraction of this GDP increase can be attributed to trade openness, but not entirely.

Table 3.1. 1994-95 crisis recovery indicators, Mexico

Period	Average export growth rate	Average import growth rate	Average trade openness	Average GDP growth	Average investment growth
Pre-NAFTA (1980-1993)	7.4%	5.8 %	32.0%	2.2%	0.1%
Post-NAFTA (1994-2002)	12.9%	11.6%	58.2%	2.9%	4.3%
Crisis-Adjusted (1996-2002)	9.7%	14.0%	61.0%	4.0%	8.5%

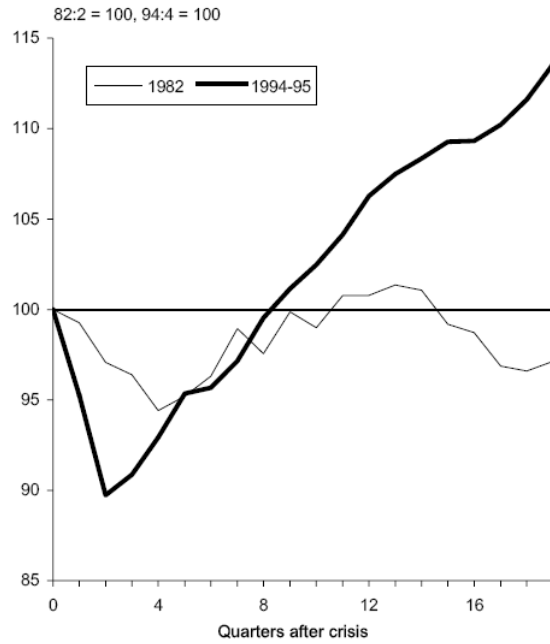
Notes: Trade Openness is defined as Exports + Imports as a percentage of GDP.

Source: Kose, Meredith and Towe (2004).

The most important question is to what extent trade policies in the aftermath of the 1994-95 has been a relevant factor to improve the long-run growth prospects of Mexico. Kose, Meredith and Towe (2004) have found that the contributions of exports and investment to GDP growth in Mexico have doubled since 1994. For example, while the contribution of investment (exports) was less than 0.5 (1.5) percentage points before NAFTA, it went up to 1.5 (3.0) percentage points during 1996–2002. Other studies have also found that trade policies via NAFTA improved the performance of the Mexican economy. Kouparitsas (1997) argued that trade policies since 1994 increased Mexico's steady-state level of GDP by 3.3%. Arora and Vamvakidis (2004) concluded that half of the increase in Mexico's growth during the second half of the 1990s was attributable to the growth performance of its NAFTA partners.

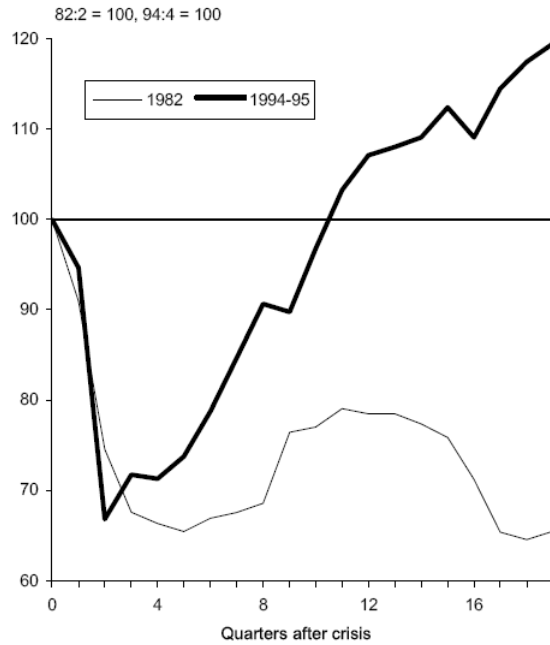
The implementation of market openness policies in Mexico was also particularly important to speed up the process of economic recovery. The following two graphs show the evolution of GDP and investment flows in the aftermath of the 1982 and 1994-95 crises. It is clear that that the speed of recovery was much faster during the 1994-95 crisis. Since one of core differences between the public policies implemented during these two crises was the degree of trade openness, then a fraction of this 'speed up effect' can be attributed to the implementation of free trade policies.

Figure 3.14. GDP response, 1982 and 1994-95



Source: Kose, Meredith and Towe (2004).

Figure 3.15. Investment response, 1982 and 1994-95



Source: Kose, Meredith and Towe (2004).

The impact of trade on growth was not the only relevant effect observed in the aftermath of the crisis. Some studies have found that the implementation of NAFTA also contributed to total factor productivity in Mexico. Lopez-Cordova (2002) analyzed the period 1993–1999 and found that NAFTA raised total factor productivity in Mexico by 10%.

Investment liberalisation

The aftermath of the 1994-95 was also accompanied by an intense flow of foreign capitals. In particular, the 1998's decision of the Mexican government to remove the remaining restrictions on FDI in banking facilitated the prompt capitalisation of the banking system. The capital to assets ratio started to rise steadily since then and reached 14% in 2004, hence reducing the vulnerability of the financial system. The elimination of legal restrictions to foreign investment was only part of the story since FDI flows between Mexico and its NAFTA partners also increased importantly. FDI flows to Mexico increased from USD 12 billion over 1991–93 to USD 54 billion in the 2000-02 period. This increased the share of FDI flows in domestic gross fixed capital formation (investment) from 6% in 1993 to 11% in 2002. Cuevas, Messmacher, and Werner (2002) have found evidence that shows that Mexico's participation in NAFTA led to a 70% increase in FDI flows.

The 2007-09 crisis

Trade liberalisation

As the recovery of the Mexican economy in the aftermath of the 1994-95 crisis shows, trade liberalisation can be an important driving force for economic growth, particularly in contexts in which main trading partners are on economic expansion. However, as trade linkages are strengthened, this leads to a higher synchronisation of business cycles. This means that a recession in one country can be transmitted to trade partners more easily. This is what has happened to Mexico in the current international crisis since the strengthened post-NAFTA trade linkages between the Mexican and the US economies have made much more vulnerable the Mexican economy to US shocks. The empirical evidence on the intensity of this business cycle synchronisation abounds (Chiquiar and Ramos-Francia, 2004). For example, Sosa (2008) estimated that the correlation coefficient between the Mexican and the US GDP is about 0.8, and that this positive correlation is even higher when Mexican GDP is analysed with respect to US industrial production (0.85). The higher synchronisation between the business cycles of the Mexican and US economies means that US output shocks has a much more powerful influence on the evolution of the Mexican economy. Sosa (2008) has also estimated that an increase in one percentage point in US industrial production growth would typically imply an increase of 0.9 percentage points in Mexican GDP growth one quarter after the US shock.²⁸ This strong influence of the US economy on the Mexican business cycle is mainly observed during the post-NAFTA period.

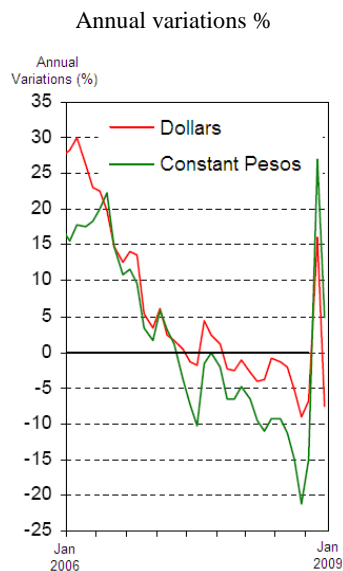
Notwithstanding the current international crisis, the Mexican government has continued implementing trade liberalisation measures. On December 24th 2008, the government published a decree that reduces exports and imports tariffs as a part of an extensive programme of foreign trade simplification. In particular, this measure has implied a reduction in average tariffs from 10.4% in 2008 to 8.3% in 2009. The goal is to reach an average tariff of 4.3% by 2013. The programme has also planned to reduce the tariff dispersion from 9% in 2009 to 6.4% by 2013.²⁹

No doubt that trade liberalisation can be an important driving force for post-crisis economic recovery and growth but it is also important to recognise that there are circumstances in which strong trade linkages with partners in recession serves as a *transmission mechanism* of the economic slowdown. This is precisely what has happened to the Mexican economy in the current international crisis.

Investment liberalisation

The importance of trade linkages as a transmission mechanism of external economic shocks is only part of the story. There are other economic vehicles of transmission through which the Mexican economy has been impacted by the current international crisis, such as FDI flows. A lower amount of FDI inflows into the Mexican economy has a severe impact on the domestic business cycle, since it has been observed that FDI flows from the US to Latin America have been highly pro-cyclical (IMF, 2009a). This means that business cycles in Latin American countries to be more pronounced due to the fact that important FDI inflows occur during expansions and significant FDI outflows occur during recessions. There is also another financial vehicle having a relevant impact on the performance of the Mexican economy: remittances. Sosa (2008) has estimated that the more than 10 million Mexican immigrants residing in the US sent remittances for about 2.7% of the Mexican GDP during 2007.

Figure 3.16. Remittances to Mexico



Source: Banco de Mexico (2009a).

Naturally, a reduction in the amount of these remittances as a consequence of the US recession reduces the growth prospects of the Mexican economy. Last but not least, it is also likely that the large presence of international banks in the Mexican banking system – around 80% of assets – might create an additional channel of transmission of the international financial conditions into the performance of the Mexican economy. The argument here is that the demand for liquidity from large international banks may induce credit restrictions in markets where subsidiaries operate (Mexico). However, there is no evidence that this channel of transmission has affected the Mexican economy so far.

Market openness as tool for crisis recovery and economic resilience

The implementation of trade and investment liberalisation policies in the aftermath of the 1994-95 crisis has had a positive effect on the economic recovery of the Mexican economy. The intense process of trade liberalisation via NAFTA that followed the 1994-95 crisis helped Mexico to make the most of a devaluated exchange rate and therefore, to significantly increase its exports. Hence, trade turned into an growth machine that supported the prompt recovery of the Mexican economy. The resilience of the Mexican economy to external shocks also improved since trade deepening made the economy less vulnerable to movements in international capital flows. When there is a large imbalance between the size of capital flows (large) and the size of trade flows (small), the economy tends to be extremely sensitive to changes in capital movements. An increase in trade flows reduces the vulnerability of the economy to sudden changes in the capital account. There is some evidence supporting the idea that macroeconomic volatility in Mexico declined in the aftermath of the 1994-95 crisis via NAFTA. Kose, Meredith and Towe (2004) have found that Mexican output volatility decreased by 30% between the 1980-1993 and 1996-2002 periods and that the volatility of investment fell by 40% during these two periods.

The current slowdown of the Mexican economy is a direct consequence of its high synchronisation with the US business cycle deriving from significant trade and investment linkages between the two countries. Mexico is now in a better position to face the impacts of the current international crisis thanks to its better macroeconomic management. However, the strong trade and investment links of the domestic activity with the depressed US economy makes an economic downturn inevitable. Therefore, market openness can also embed potential risks of crisis transmission.

The IMF has recently revealed a study showing that the speed of recovery from recessions highly synchronised across countries – as the present one – is relatively slow (IMF, 2009a). It also found that exports play a more limited role as a driver of the recovery when compared with recessions characterised by a low degree of synchronisation. This finding is important because it implies that the economic recovery from this international crisis will be slower since the role of Mexican exports as growth drivers critically depend on the speed of the recovery observed in the US economy.

Implementation challenges: lessons from reforming at a time of crisis

The implementation of reforms at a time of crisis requires both good policy and good timing. In the aftermath of the 1994-95 crisis, the Mexican government implemented its banking rescue plan at the right time but its policy design failed. Indeed, when the banking rescue plan was designed in 1995, the belief was that as the economy would come out from the recession, GDP growth would reduce the number of non-performing loans that banks had on their financial portfolios. However, just the opposite occurred as the number of non-performing loans increased during the following years and banks were facing difficulties to increase their capital. Since public support to banks turned out not to be a once-and-for-all event the banking rescue plan evolved – unintentionally – from a “temporal” programme to a formal bailout. This experience highlights the importance of designing reforms appropriately in order to avoid posing unnecessary and costly burdens on taxpayers.

The Mexican experience also shows that, when a government is forced to choose between short- and long-run gains during a process of reform, the selection of long-run social gains should prevail. The case in reference is the liquidation of the holding company Cintra. As discussed before, the competition authorities were pushing for a separate selling of the two airline subsidiaries in order to preserve competition in the market. However, other members of the government thought that selling Cintra as a whole would be a better option since it would allow the maximisation of revenues. The Mexican government was then faced with a trade-off: the maximisation of revenues (short-run gains) from selling Cintra as whole would jeopardise the objective of preserving competition (long-run gains) in the market. At the end of the day, the objective of promoting competition prevailed over the tempting revenue-maximizing option so that social welfare was preserved.

The policy challenges of implementing reforms at a time of crisis are more complicated when analysed in the context of public budget constraints. The announced Mexican budget for 2010 has been controversial since it proposes an increase in taxes in order to compensate a revenue fall equivalent to MXN 300 000 millions for next year. The increase in taxes has been questioned by different actors since there is a perception that the fiscal policy should not be restrictive in 2010 in order to support demand. So far, fiscal policy in Mexico has been prudently implemented through a policy of balanced budgets but the efficiency of maintaining this policy has been questioned recently. The debate remains open. The government is facing a trade-off: increasing its deficit in order to promote aggregate spending on the one hand, and at the same time, keeping it low enough to preserve the market confidence on the other hand.

The Mexican government has also focused its fiscal stimulus on infrastructure expenditure. However, there is a perception that the speed of this spending has been extremely low due to regulatory constraints —*e.g.*, the regulatory process to allocate public funds to specific projects seems to be too slow for a time of crisis. The implication is that the fiscal stimulus is not affecting the economy at the required speed. Hence, the Mexican experience also highlights the importance of implementing the fiscal stimulus at the same time as cutting red tape to accelerate the impact and effectiveness of the fiscal stimulus.

Conclusions

The world economy is facing the most severe recession since the Second World War. It has been estimated that the world GDP will decrease 1.3% during 2009 (IMF, 2009a). This international crisis has been particularly severe for emerging economies, since apart from the effects of the global recession there have been significant capital outflows from these markets by an amount equivalent to 1% of their GDP.

The Mexican economy has also been affected by the evolution of the current international crisis but its resilience to external financial shocks has increased since the stability of its financial system has remained practically unaltered throughout the evolution of the present crisis. Indeed, the fact that the Mexican financial system was not openly exposed to ‘toxic’ assets protected it from the financial turmoil. Therefore, one lesson that the international community can learn from the Mexican experience is the importance of having a sound banking system in order to increase the resilience of the economy to future shocks. In the particular case of Mexico, a sound banking system was the result of the implementation of a bank rescue plan in the aftermath of the 1994-95 crisis but also of improvements in financial regulation. Overall, a sound financial system reduced significantly the vulnerability of the Mexican economy to the external shocks that were occurring since 2008.

The main impacts of the current international crisis on Mexico’s performance have been through the real sector of the economy: exports, remittances and FDI flows, mainly. It is true that the vulnerability of the Mexican economy to shocks in these external variables has increased, as the current domestic recession shows. However, it is a short-run phenomenon linked to the present US recession and it also presents opportunities for the future.

In the long-run, however, the resilience of the Mexican economy to external *real* shocks would have increased because no other external factors apart from the evolution of the US economy will affect its economic growth and aggregate stability. The Mexican experience gives encouraging lessons, as options to face the crisis are not to distort competition and trade, but to promote reforms that reinforce them.

Notes

1. This case study was prepared by Victor Pavon-Villamayor, Economist, PhD, Instituto Tecnológico Autónomo de México (ITAM). The contribution of Manuel Flores Romero, PhD (OECD Mexico) is gratefully acknowledged for the section on Regulatory Management and Reform.
2. The 1994-95 Mexican crisis was preceded by another major crisis in 1982. In 1976 Mexico made important oil discoveries which allowed the government to follow expansionary fiscal policies based, partially, on foreign borrowing. Between 1978 and 1981, the economy grew more than 8% annually thanks to public expenditure but manufacturing output grew only modestly. By mid-1981, and as external indebtedness exploded, Mexico had to face an international environment characterised by falling oil prices and higher interest rates in circumstances in which internal inflation was raising and the exchange rate was overvalued.

The deterioration of the Mexican external balance, along with a significant reduction of Mexico's international reserves, forced the government to devalue the currency in 1982. The devaluation further increased inflation and raised private sector's burden in servicing its dollar-denominated debt. As no sources of external credit were available for the Mexican government, in August 1982 it was declared a moratorium on debt payments and later Mexican banks were nationalised. As a consequence of the crisis, Mexico's GDP grew between 1983 and 1988 at an average rate of 0.1% per year and inflation escalated. During those years, total investment fell at an average annual rate of 4%. The contraction of output lasted two years and then real GDP slowly recovered. In the aftermath of the crisis, Mexico established prohibitive restrictions on imports, such as 100% tariff increases and licensing requirements on all imports.

3. Mexican authorities used these credit facilities to redeem maturing dollar-indexed Tesobonos; to refinance commercial banks' foreign currency liabilities and to increase foreign exchange reserves.
4. In this loan exchange programme, banks remained responsible for collecting the interests and capital associated with the loans transferred.
5. The capitalisation scheme established that the public amounts transferred that were not repaid within five years would be converted to ordinary capital and then sold by the government.
6. The Purchasing Manager's Index (PMI) measures business expectations on the performance of the manufacturing sector.
7. Reforma (2009), "El Costo de la Imprudencia", 2 October, p. 6, Mexico.
8. El Financiero (2009) "Sombrío Panorama para el Cierre del Año", October 2nd 2009 (p. 1), Mexico.
9. The latest official figures show that the Global Indicator of Economic Activity (IGAE) observed a monthly increase of 2.45% during July 2009. This is the second consecutive month that this indicator has shown a positive evolution, since it also increased by 0.41% during June 2009.
10. El Financiero (2009) "Apoyos del FMI Mitigan Efectos de la Crisis", September 28th (p. 7), Mexico. The US Federal Reserve has also provided extra credit line facilities to Mexico. The World Bank opened a credit line for USD 3 000 millions for 2009 while the Interamerican Development Bank gave a loan by an amount of USD 1 000 million to be employed in the social programme Oportunidades.
11. "Programa para Impulsar el Crecimiento y el Empleo".
12. In contrast, firms in the non-tradable sector were adversely affected by the lack of credit as these firms had no access to international financial markets.
13. The industries involved in these illegal practices were, among others, purified water, road transportation, maritime and airport cargo services and customs brokerage services.
14. The mechanism concerned the distribution of a reference price guide for negotiations between users and motor carriers.
15. Instituto para la Protección al Ahorro Bancario (IPAB).
16. During this debate, it was also argued that the separation of the two airlines would reduce the chances of these companies to compete effectively in foreign markets. On this particular matter, the CFC argued that it was not acceptable for Mexican consumers to pay higher tariffs to subsidise foreign routes.
17. The original names (in Spanish) of these programmes were: Programa de Capitalización Temporal (Procapte) and Programa de Fortalecimiento de Capital con Compra de Cartera.

18. A total of six banks participated in PROCAPTE. Two of these were later intervened (Bancen and Oriente) and three required further capitalisation (Serfin, Bital, and Confia). Scotiabank acquired the remaining bank, Inverlat.
19. A total of ten banks participated in this second programme. Six of them required government support twice (Promex, Serfin, Bital, Atlantico, Banorte and Probrusa) and one was later intervened by the authorities (Serfin).
20. The latest reform to the Mexican competition legislation occurred in June 2006, when the Congress approved a set of reforms to the LFCE. Amongst other changes, the new competition law allowed the CFC to implement visits to firms' premises as part of its investigations, to pose limits on the maximum time that investigations for monopolistic practices can last and to implement a fast track procedure for the notification of low-risk mergers. The law reform was followed up by changes in the Code of Practice of the CFC — Reglamenteo de la Ley Federal de Competencia Económica— published on October 12th 2007, a necessary legal step after the implementation of the 2006 LFCE reform. All these changes, however, occurred before the crisis impacted the Mexican economy.
21. In 2001, for example, the CFC made its approval for a merger in the soft drink industry involving the acquisition of Mundet by FEMSA. The transaction was characterised by high levels of *ex ante* concentration (FEMSA had 67% of the pre-merger market whereas the next close competitor had 19%) and the presence of significant barriers to entry stemming from advertising and distribution networks. However, the transaction was approved because there was enough evidence that: *i*) Mundet tried to sell its assets to competitors others than FEMSA unsuccessfully and, *ii*) if the transaction was blocked, the assets of Mundet had to exit the market. The transaction was then approved under the principles that govern the FFD doctrine.
22. Milenio, "Mexicana va por una fusión total con Aeroméxico", April 29th 2009, p. 26.
23. OECD (1999), p. 16.
24. The reform was proposed by Senator Creel on April 2009.
25. NAFTA also includes two additional side agreements: the North American Agreement on Labour Cooperation, which promotes effective enforcement of domestic labour laws and the North American Agreement on Environmental Cooperation, which ensures that trade liberalisation and efforts to protect the environment are mutually supportive.
26. Mexico maintained preferential tariffs with NAFTA partners, but increased outside tariffs from 20% to 35% in 1995, which caused Mexican imports from non-NAFTA countries to fall 66% (1994-96), while those from the US increased 47%.
27. See Kose, Meredith and Towe (2004).
28. The same study reveals that the influence of a US economy shock on the Mexican business cycle last over six quarters after the shock.
29. On March 2009, Mexico increased the trade tariffs of 90 products imported from the US — equivalent to 1.7% of US imports— as a response to a NAFTA violation in the area of international transport. This tariff increase was not related at all with the developments of the current international crisis.

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Case study 4 –United Kingdom

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This case study reviews the United Kingdom's experience with regulatory reform during the 1990-93 crisis, as well as the response to the 2008-09 crisis. Because the United Kingdom did not engage in comprehensive regulatory reform in 1990-93, given an already advanced regulatory environment, the case study focuses on the response to the 2008-09 crisis, which "stress-tested" institutions and regulatory systems. This case study discusses the different reforms implemented during the two crises assessed in terms of improving regulatory quality, competition and market openness and their impacts on recovery.

Executive summary

This Report contrasts the role of regulatory reform in the present financial crisis in the UK since 2007 with that in the previous crisis in the UK, the “ERM crisis” of 1992. The two crises are very different in character. The ERM crisis was a foreign exchange crisis, when the UK was forced out of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) by heavy speculative pressure against sterling. It was similar to the previous exchange rate crises in 1949 and 1967 where the UK was forced off an unsustainable exchange rate peg. It was not a banking crisis. Indeed the UK has been free of major banking crises for a very long time. The last significant bank run was in 1866, when Overend Gurney collapsed with debts of around GBP 1 billion in present day values.

The ERM crisis was a traditional exchange rate crisis

The ERM crisis occurred at the bottom of an economic cycle and the resulting depreciation in the exchange rate was an important contribution to the recovery, which was both swift and sustained. The crisis occurred after more than a decade of vigorous regulatory reform and reinforced the determination in the UK to follow a flexible, open and relatively lightly regulated regime. It led directly to a change in the monetary policy regime to inflation targeting, an approach that has been followed to the present day. The crisis thus occurred during a period of regulatory reform. It did not have much effect on the speed of such reforms outside monetary policy.

The present crisis is a banking crisis which is without recent precedent in the UK

The present crisis, however, is a banking crisis that has led to an economic crisis. The crisis is global and the proximate causes lie in the collapse of the sub-prime mortgage market in the US but the fragility of the banking system in the UK cannot be ascribed to external forces. It is clear that the problems with the banking system can be ascribed largely to regulatory issues. Not only were there failures to detect problems in some key exposed banks, Northern Rock in particular, but two of the five largest banks, HBOS and RBS had been allowed to become seriously overleveraged as a result of aggressive growth. Regulatory reform in the financial sector has not surprisingly been a major feature of the response to the crisis.

Before the main shock struck the rest of the world the UK found it had major problems with its financial regulatory system

The crisis had two distinct phases. In August/September 2007, a year ahead of the main crisis in the OECD countries, the UK found itself coping with the problems of Northern Rock, the country’s eighth largest bank, and a bank run followed. Many facets of the crisis management system were found wanting: emergency liquidity support, early intervention, deposit insurance and co-ordination among them; but the biggest problem was that the UK did not have the appropriate powers and tools for intervening in a troubled bank in a way that would minimise the losses particularly to the taxpayer and maintain overall stability. Eventually it had to nationalise Northern Rock.

A thorough review has resulted in a special Resolution Regime for banks

Over the course of the next eighteen months the UK undertook a thorough review of all these aspects and instituted a fundamental reform of financial regulation, some of which is still to be completed. The key feature of this reform is the introduction of a Special Resolution Regime for banks – temporarily in the Banking (Special Provisions) Act of February 2008 and then more permanently in the Banking Act of February 2009. This Act conveys comprehensive powers on the Bank of England to intervene in a troubled bank before all its capital is eroded and transfer securities or assets, form a bridge bank or as a last resort nationalise it.

Deposit insurance and the quality of banking supervision have also been addressed

The characteristics of the deposit insurance scheme that contributed to the bank run – coinsurance, coverage and the inability to offer access to accounts without a material break – have largely been dealt with but the issue of funding the scheme is still under discussion. The Financial Supervisory Authority (FSA) has embarked on a major Supervisory Enhancement Programme.

The second phase of the crisis was much more severe

When the second phase of the crisis struck in September/October 2008 following the failure of Lehman Brothers in the US, the UK was much better prepared. This phase had two main ingredients, first the failure of the main Icelandic banks, one of which, Landsbanki, had extensive branch operations in the UK. Second, two of the largest banks, HBOS and RBS (Royal Bank of Scotland) came under severe pressure. Although HBOS merged with Lloyds-TSB to form a new Lloyds Banking Group, both banks required large capital injections.

It resulted in major state ownership of banks

As a result of these injections, the government is the majority shareholder in RBS and a substantial shareholder in Lloyds. Although these shareholdings are being managed at arm's length by a special company, UK Financial Investments, the government has been exercising some direct control over these banks beyond normal regulation. A key feature of the state intervention has been an asset protection scheme, guaranteeing the banks against secondary loss, paid for by the issue of shares to the state. It is not clear as yet how soon this ownership can be ended and the banks returned to the private sector.

Further stages of review and reform are being undertaken

The process of regulatory reform in response to the present crisis is by no means complete. The government has commissioned two further reviews: the Turner Review of financial supervision and the Walker Review of governance of financial institutions. The government has also issued a White Paper in July 2009 on ‘Reforming Financial Markets’ in which it sets out how the authorities can implement more effective macro-prudential supervision to head off future crises, implement the findings of the two reviews and a programme of financial education to try to instil the principles of risk management in the public at large.

International co-operation is required to complete the process

The collapse of the Icelandic banks vividly illustrated the problems of regulating and crisis handling for cross border banks. Not only were the banks too big for the home country to cope with deposit insurance costs but under the EU’s home-host rules the UK had serious difficulties in retaining stability. This cannot be resolved unilaterally; joint EU action is needed to resolve this. More generally, for reform to be effective in an internationally competitive and mobile industry such as finance the major ingredients need to be agreed across countries through the Basel Committees.

The UK has not resorted to protectionism in its efforts to resolve the problems

A common response to crises is to introduce temporary trade barriers and to try protecting the domestic market, particularly for employment. This route was not followed in the UK in either crisis. Indeed since London is one of the main financial centres in the world openness is an essential ingredient for its success. However, in line with behaviour in other countries the UK has supported the motor car industry, both without regard to origin in providing a joint subsidy with manufacturers to encourage the scrapping of old cars and their replacement by new more environmentally friendly vehicles and in trying to find a route to keeping General Motors’ plants operating.

Concentration in an already concentrated industry has increased

With the merger of the fourth and fifth largest banks, the failure of the tenth largest, the nationalisation of the eighth largest and the merger of the seventh largest, Alliance and Leicester, with Abbey, the industry has become much more concentrated.

While the impact on longer term debt may be substantial the economic downturn is not among the largest in the OECD

While the UK has been hit hard by the crisis, particularly in terms of the debt obligations it is likely to incur, the economic downturn has been more limited than in many other OECD countries, despite the fact that there has not been any major fiscal stimulus.

The ERM crisis has contributed to increasing the longer-term rate of growth in the UK

The change in monetary policy and the other regulatory changes over the period in which the ERM crisis fell have contributed both to increasing the UK's rate of subsequent growth and in making the process of growth more stable until the present crisis. It is more debatable whether the present crisis will enable those same rates of growth to continue. In part it has become clear that an unsustainable fiscal policy was being run, as there were no surpluses when the economy was performing well.

The legislative process in the UK has allowed rapid and radical change in a way that has not dented confidence

In a crisis swift action is required and it is important that intended actions can be seen through without contradiction. The inbuilt majority of the government in parliament means that bills can be passed very rapidly. Further the ability of ministers to use statutory instruments and other orders means that they can act first and inform parliament second. The clearest example is the Banking (Special Provisions) Act 2008, which was passed within three days.

Introduction

One of the reasons that the present crisis has hit the UK so hard is that it has not experienced the threat of serious financial crisis since the Great Depression and hence had untested mechanisms for crisis management and amelioration. Indeed it had introduced new mechanisms without the older ones being tested. It has experienced asset price booms in the past, particularly for housing but also in the stock market; however these were not financial crises per se. Neither of the two house price booms in the 1970s were followed by price falls, although both saw prices double in the space of three years. The second of these booms ended during the recession that accompanied the major structural reform period of the early Thatcher years at the beginning of the 1980s. Even the recovery from the sharp stock market crash of 1987 was quite rapid. The most striking experience was however the recovery from the dotcom boom that peaked in 2000. Despite the fact that stock prices halved in three and a half years they rose again to the same heights by the onset of the present crisis. Over the same period there was continuous growth in GDP, albeit falling somewhat from its 4% peak but not sinking below 2% a year in real terms. This performance was rather better than the average of the old EU member states and hence contributed to a strong feeling that if the business cycle were not dead it was at least subdued to the point that it was no longer a substantial problem for economic policy.

The UK had however experienced a number of exchange rate crises, principally those involving the devaluations of 1949 and 1967 and the ERM crisis of 1992. It also came under pressure in the latter part of the 1970s when it had to apply to the IMF for short-term financing. Of these only the 1992 experience can realistically be expected to have had much impact on the collective memory and hence be a significant influence on present day policy. Indeed 1992 was the last time there was a recession in the UK in the sense of GDP falling, not just the normal NBER definition of falling in two consecutive quarters. The primary consequence of that experience was to reconfirm the perceived value of operating a rather free and open market approach to economic management, as the economy recovered quickly once the exchange rate was floated. Therefore, not only did the UK insist upon an opt out from the requirement of the Maastricht Treaty to participate in the third stage of EMU in the EU but it received a strongly reinforcing shock, emphasizing the benefits of floating exchange rates. Even with the opt out the Treaty was ratified by the narrowest of margins in Parliament and would almost certainly have been rejected had there been a referendum on the subject. Thus while a traditional foreign exchange crisis may involve the imposition of restrictions both in the initial attempt to fight to retain the exchange rate peg and in the process of nurturing recovery, this was not the characterisation of the UK experience in the years round 1992. It was if anything a determination to continue with the reduction in barriers after the end of the 5-year period of Europe-wide reduction under the ‘single market’ programme. The subsequent rapid growth of the financial sector and the position of London as a world financial centre emphasised the benefits of openness and a light-handed approach to regulation.

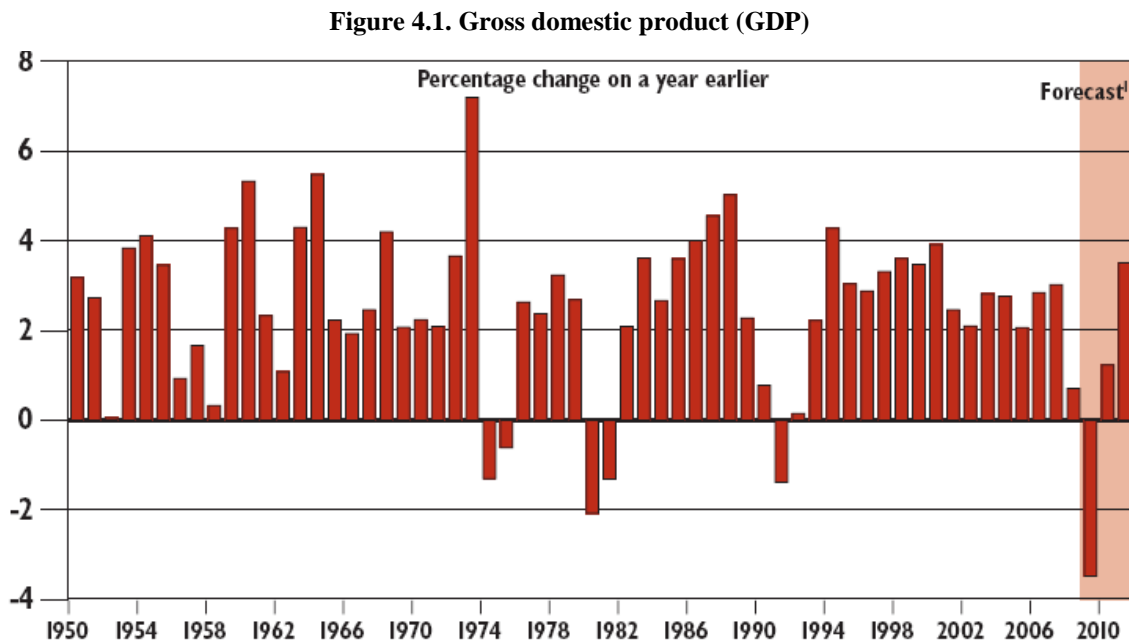
This report therefore primarily concentrates on the present crisis where the impact has been substantial and it has been thought necessary to take crisis measures that overwrite some of the normal rules of open competition.

Macroeconomic context

The nature of the UK experience

Prior to the 2007 financial crisis, the UK had enjoyed a prolonged period of continuous economic growth, with annual growth positive in every year since 1991 (Figure 4.1). UK GDP growth had been stronger than the G7 average in every year bar one since the previous crisis, when the UK withdrew from the Exchange Rate Mechanism in 1992. In 2007, no G7 country recorded stronger growth than the UK's figure of 2.6%.¹

The UK entered the crisis with lower unemployment than the other major European economies, with 5.3% unemployed in 2007 compared with 8.4% in Germany, 8.3% in France, 6.1% in Italy, and 7.4% for the euro area as a whole. The US and Japan had lower levels of unemployment (4.6 and 3.9% respectively).²



¹At mid-points of forecast ranges.

Source: HM Treasury (2009), p. 200.

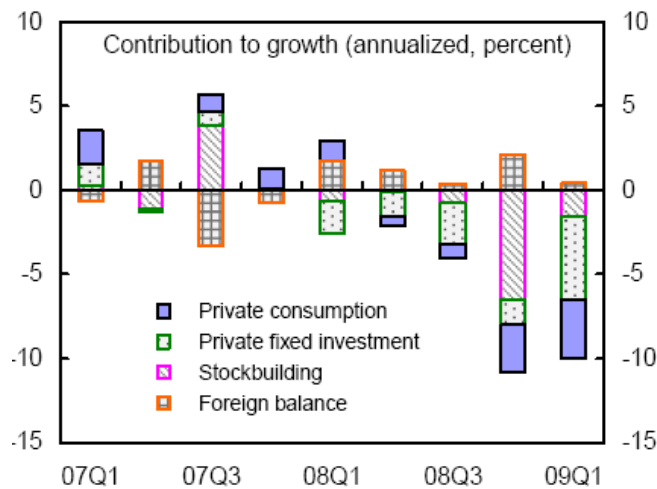
But despite the outwardly rosy economic picture, imbalances and balance sheet strains were emerging in the UK economy. These included overheating in property markets, low domestic saving rates, high current account deficits, large external liabilities, rising (albeit still low) public debt despite the economy growing above trend, and significant increases in the leverage of financial sector.³ Household balance sheets had also become highly leveraged. In the run-up to the crisis household debt increased to 175% of disposable income – one of the highest levels among advanced countries. The rise in debt was matched by an increase in the value of housing, pension funds, and other financial assets held by households. However, the precipitate fall of asset prices since the

beginning of the crisis has eroded the value of household portfolios. Net household wealth in the UK is estimated to have declined by about 15% in 2008, and may fall further in 2009.⁴

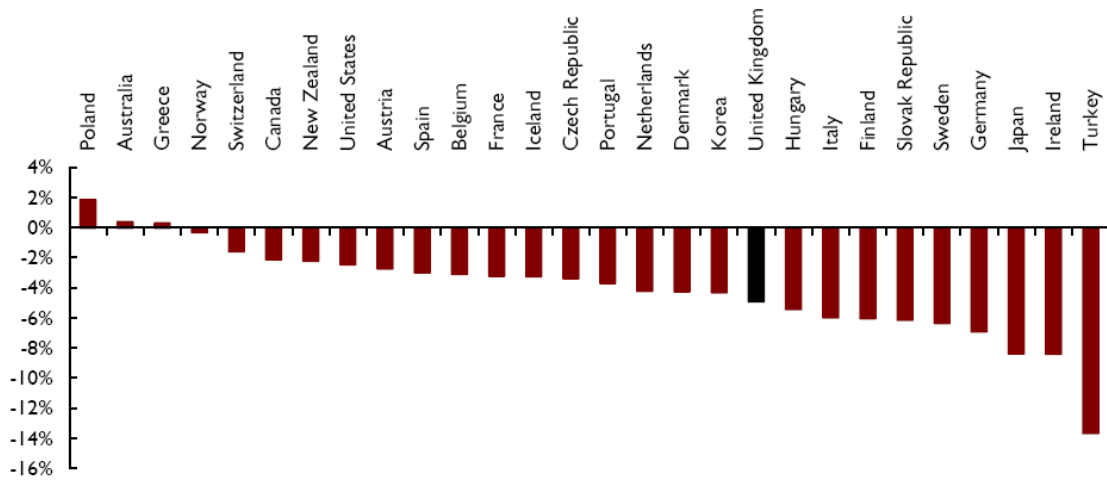
The macroeconomic impact of the financial crisis on the UK

Economic activity has contracted sharply across the world as a result of the financial crisis. In 54 out of 57 countries for which data are available, industrial output fell in the fourth quarter of 2008, for example. But the United Kingdom in particular has been hit harder than many by the global financial crisis (see Figure 4.2). The economy was particularly exposed to the crisis because of its large financial sector, high household indebtedness, and strong cross-border links. Consumer spending has weakened as wealth has fallen, unemployment has risen, and credit availability has tightened. Over the past year, adverse feedback loops have developed between worsening financial conditions and the wider economy. Banks, facing higher capital requirements and a very difficult funding environment, reduced lending to both residential mortgage customers and private firms. As house prices continued to fall, the value of pensions and other financial assets declined, and job security waned, consumers cut back their spending. The decline in consumption, in turn, reduced business profits and depressed investment, leading to further falls in employment and income.⁵ In the UK, output fell 0.7% in the third quarter, and 1.6% in the fourth quarter, of 2008, which was broadly in line with the US and euro area.⁶ Output in the first quarter of 2009 contracted 2.4% further, the second worst quarterly figure since records began in 1955.⁷ Viewed across the last year, the UK has fared worse than many other leading nations, although not as badly as some. Of the twenty-eight countries for which the OECD provides quarterly data, average output fell by 4% between 2008 Q1 and 2009 Q1. In the UK it fell by 5% while in Germany it decreased by 7% and in Japan by over 8% (Figure 4.3). What is noticeable from Figure 4.4, which shows quarterly GDP figures in the UK, USA and euro zone, is that, of these three, the US, where the financial crisis occurred first and is concentrated has shown the smallest recession, while the UK and the euro area have shown similar profiles despite the much greater financial sector problems and imbalances.

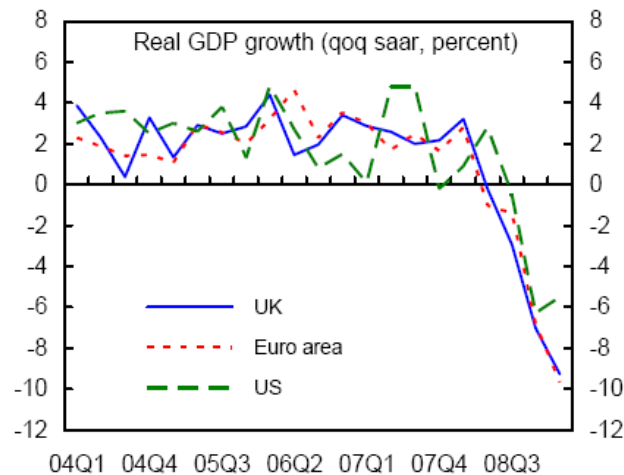
Figure 4.2. UK GDP growth



Source: IMF, p. 7, Figure 1.

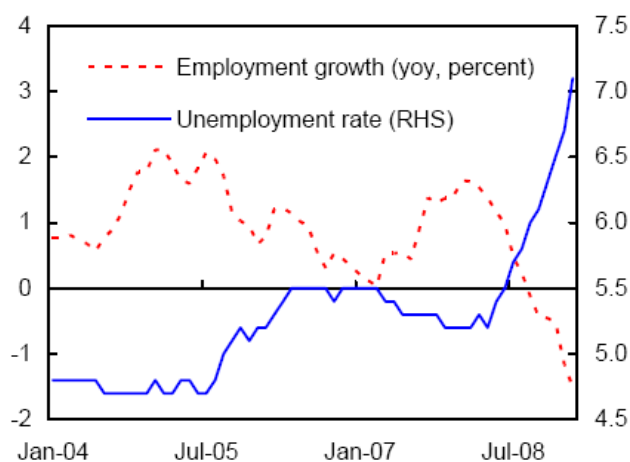
Figure 4.3. Change in GDP: international comparisons 2008 Q1 to 2009 Q1

Source: NIESR (2009), National Institute Economic Review, No. 209, July.

Figure 4.4. Real GDP growth in UK, Euro area and US

Source: IMF, p. 7, Figure 1.

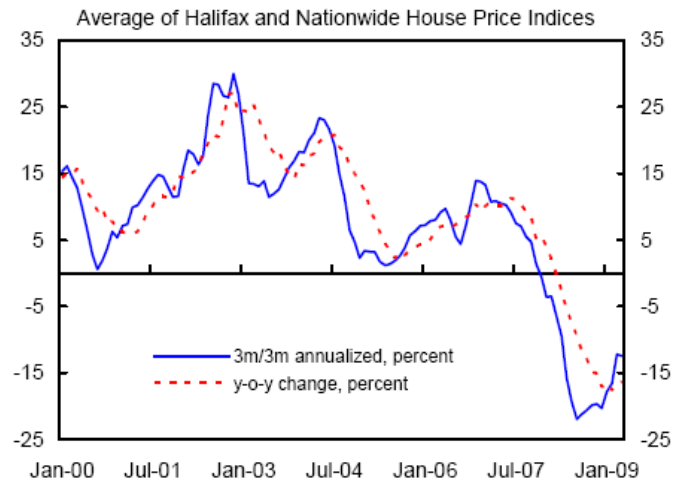
As the world economy has contracted, and companies have struggled with the drop off in consumer demand, and jobs have been lost, with the average G7 unemployment rate rising to 6%. In the UK employment is declining, and the unemployment rate reached 7.2% in the three months to April 2009 (Figure 4.5). The NIESR has forecast that unemployment will peak at 9.3%, just shy of 3 million people.⁸

Figure 4.5. UK employment and unemployment

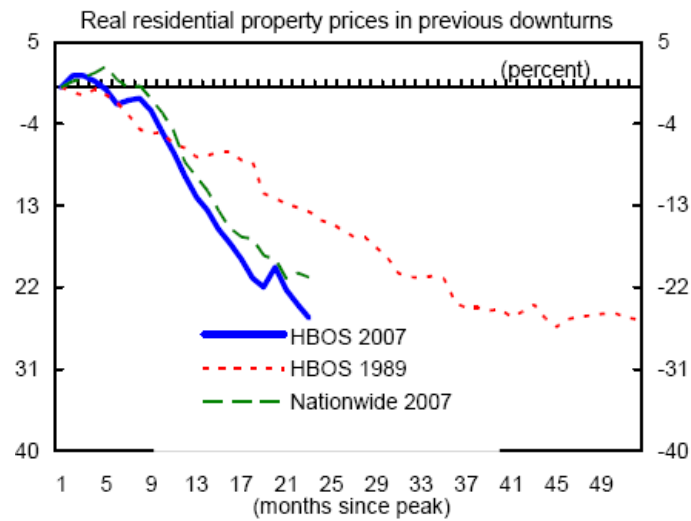
Source: IMF, p. 7, Figure 1.

The financial crisis has affected not just the demand side, but also the productive capacity of the economy. The IMF has suggested that the cumulative loss of potential output over 2008-10 could be as large as 4 to 5 percentage points (a similar figure to that assumed by the UK Treasury in the 2009 Budget).⁹ In the medium term, the IMF has forecast that the potential growth rate may be 0.5 to 0.75 percentage point below the pre-crisis growth rate.¹⁰ This does not imply any adverse structural impact just simply that some of the growth in recent years was unsustainable.

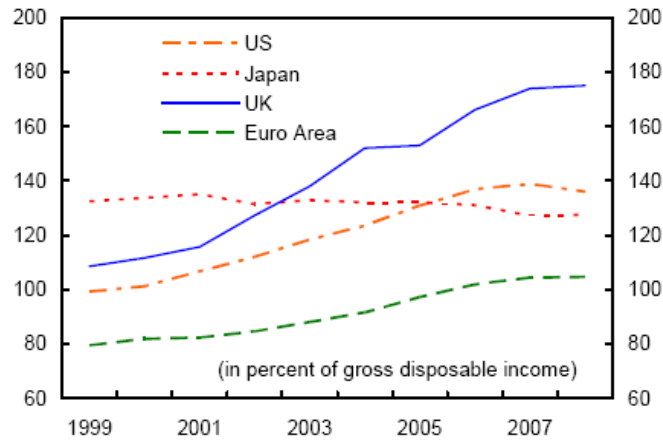
Property prices have plunged during the financial crisis (Figure 4.6). House prices have dropped by more than 20% from their peak and commercial real estate prices are down by 40%. The house price decline on this occasion has been steeper than on the previous occasion (the downturn that ended in the ERM crisis) but not, thus far, deeper (Figure 4.7). Mortgage arrears and bank repossessions of properties have increased, although they are still relatively low as a share of existing mortgages. The foreclosure rate in 2008 was only 0.35%, compared to 4.25% in the United States. Despite some recent positive news, the housing price adjustment does not yet appear complete, with the NIESR predicting real terms price decline until mid-2012.¹¹ A hangover from the property boom is the markedly high level of household indebtedness (see Figure 4.8).

Figure 4.6. Average of Halifax and nationwide house price indices

Source: IMF, p. 12, Figure 4.

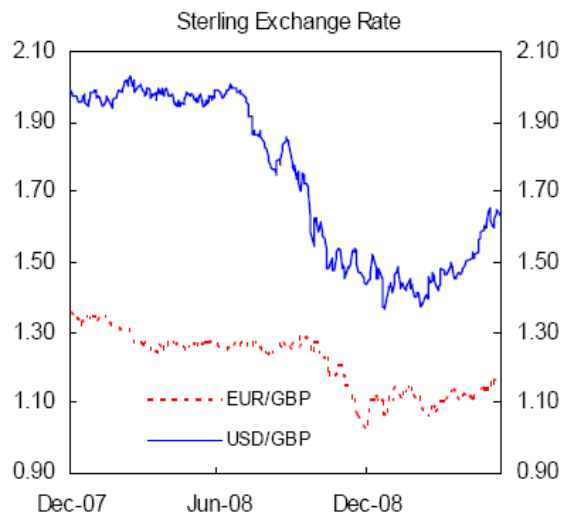
Figure 4.7. Real residential property prices in previous downturns

Source: IMF, p. 12, Figure 4.

Figure 4.8. Household financial liabilities

Source: IMF, p. 11, Figure 3.

The depreciation of sterling has helped improve the UK's external position. Reflecting an increased risk premium, sterling depreciated by 27% between mid-2007 and April 2009 in real effective terms (see Figure 4.9). The trade deficit has narrowed, reducing the current account deficit from a peak of GBP 43.8 billion in 2006 to GBP 25.1 billion in 2008. Since April, some of the depreciation has been reversed. The UK is closely integrated with the world economy, through both trade and financial links. On the trade side, the currency depreciation and the limited dependence on durable goods exports have helped mitigate the decline in export demand. Nonetheless, with the global economy in a deep recession and income effects dominating the price effects, export volumes dropped by 20% annualised in the last quarter of 2008 and the first quarter of 2009.¹²

Figure 4.9. Sterling exchange rate

Source: IMF, p. 19.

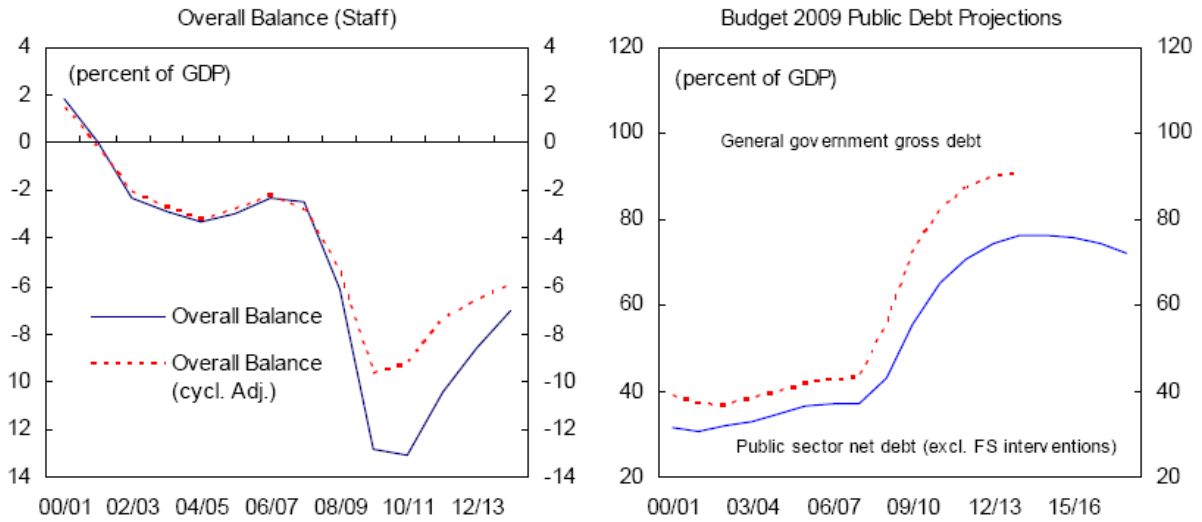
The crisis in the UK needs to be seen in context. The euro area has also been affected in terms of domestic confidence and labour markets, and by falling global trade, affecting domestic and external sources of demand. Net exports subtracted significantly from growth in the final quarter of 2008, while weak demand and the effects of house price corrections in some European countries caused investment to fall sharply. Thus some euro area countries have been heavily hit – Ireland through asset prices and financial services, Finland through the decline in demand for investment goods as has Germany where a general decline in exports has ensued, much as in the Asian countries.

On the other hand, the adjustment of private consumption in the US has led other advanced economies, and has so far been the most severe. Since mid-2007, falls in equity prices have reduced household financial wealth by over USD 4 trillion, equivalent to 40% of annual household disposable income, and this has contributed heavily to the reduced consumer demand. Retail sales declined by 10% in the year to February 2009, as the saving ratio increased from around zero to 4.25%. Businesses have responded to weakening demand by cutting back investment, reducing demand for credit and bearing down on other costs. This has included cutting 5 million jobs, pushing the unemployment rate up from 5% to 8.5% since December 2007. Job losses have dealt a further blow to consumer confidence, increasing the precautionary motive for saving. GDP fell 1.6% in the final quarter of 2008 and monthly indicators suggest the US economy was similarly weak in early 2009. Industrial production fell 5.4% in the first quarter.

Although the Japanese economy was relatively insulated from the tightening in credit conditions in the early stages of the credit shock, the subsequent effect on confidence and global demand has had a powerful impact. In February 2009, export volumes contracted by an unprecedented 45.5% on a year earlier. Unemployment in Japan has now reached 4.5%, and there are signs that domestic demand is also weakening. GDP fell by 3.2% in the final quarter of 2008. According to the UK Treasury, Japan is likely to experience the deepest recession among the G7 economies.

Government debt levels in the UK were below the European average prior to the crisis, albeit rising, and the UK's debt portfolio is characterised by long maturities and minimal rollover amounts. But the financial crisis and the recession have led to a sharp deterioration of public finances. Revenue in the UK is sensitive not only to the economic cycle, but also to asset prices and the level of financial sector activity, so the synchronised downturn of the economic and asset price cycles led to a rapid decline in income and corporation taxes, VAT, and asset price-related revenues. The headline deficit in 2008-09 was 6.5% of GDP and deficits of about 13% of GDP are projected for 2009 and 2010 (Figure 4.10).

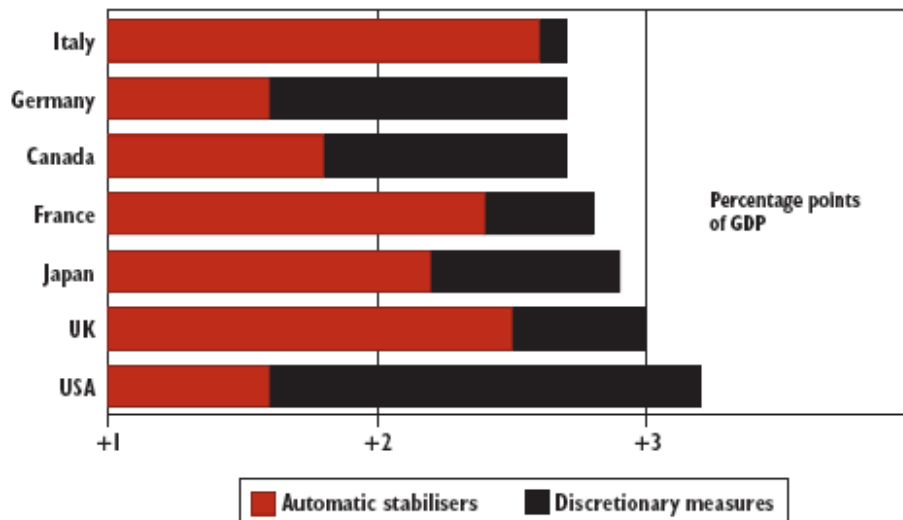
Figure 4.10. Public finances



Source: IMF, pp. 16-17.

A discretionary fiscal stimulus of 2% of GDP is being implemented aimed primarily at consumers; thus it will have few obvious negative consequences for other countries, trade or competition policy. The main components of the stimulus package are a temporary reduction of the VAT rate, larger personal income tax allowances and pension transfers, and advancing of planned capital expenditure. Nonetheless, the size of the discretionary stimulus and its impact on debt levels is small compared with the effect of automatic stabilisers and the loss of asset price-related revenue (Figure 4.11).¹³

Figure 4.11. G7 automatic stabilisers versus discretionary fiscal measures



Source: International Monetary Fund, HM Treasury (2009), p. 28.

Public debt is rising fast. The structural fiscal position was already weak at the onset of the crisis – government expenditure as a share of GDP has increased substantially in the last decade, while some of the revenue streams financing the increase have proven to be unsustainable. Sizable fiscal deficits were recorded even as the cycle reached its peak (Figure 4.12). Thus by starting the crisis from a position of fiscal weakness the UK has found it more difficult to respond other than through the automatic stabilisers and the support for the financial system that was necessary to prevent an enduring collapse in confidence. The post-crisis increase in public sector net borrowing is projected to result in a peak this year of 12.4% of GDP.¹⁴ At the same time, contingent liabilities of the government from financial sector interventions have increased sharply. Gross resources committed to financial sector support measures so far have exceeded 60% of GDP, although the net cost to taxpayers is likely to be much smaller (see Table 4.1) both because the government intends to sell many of the assets it has acquired and because other liabilities are only contingent and may not be realised.

Table 4.1. Selected financial sector interventions

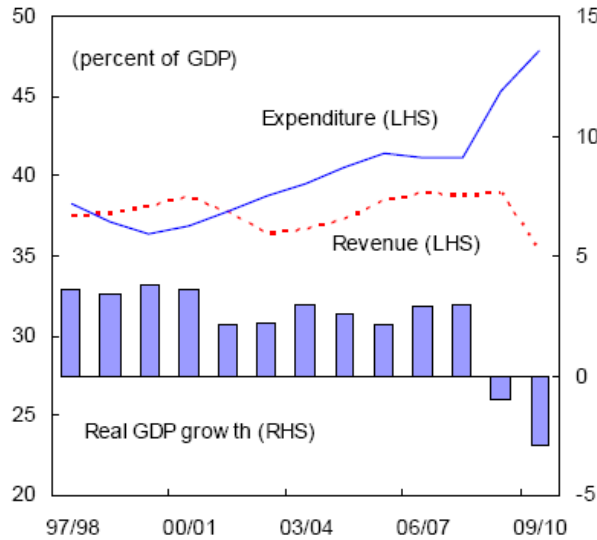
	Public sector exposure	
	£ billion	percent of GDP
Financial sector support	126.6	8.8
Northern Rock 1/	14.6	1.0
Bradford & Bingley 1/	24.0	1.7
Kaupthing Singer & Friedlaender	3.3	0.2
Landsbanki	4.5	0.3
Heritable	0.5	0.0
Dunfermline	1.6	0.1
Bank recapitalization	78.1	5.5
Increase in contingent liabilities	777.3	54.3
Credit Guarantee Scheme	250.0	17.5
Working Capital Scheme	11.5	0.8
Asset-Backed Securities Guarantee Scheme	50.0	3.5
Asset Protection Scheme 2/	465.8	32.5
Total exposure	903.9	63.1
Memo items		
Special Liquidity Scheme (SLS)	185.0	12.9
Asset Purchase Facility (APF)	150.0	10.5

1. Initial liquidity support from BoE amounted to GBP 149 billion, but was subsequently replaced by Treasury funding.

2. Net exposure after first tranche of losses.

Source: Bank of England, Budget 2008, 2009, 2008 PBR and Fund staff estimates; IMF, p. 18.

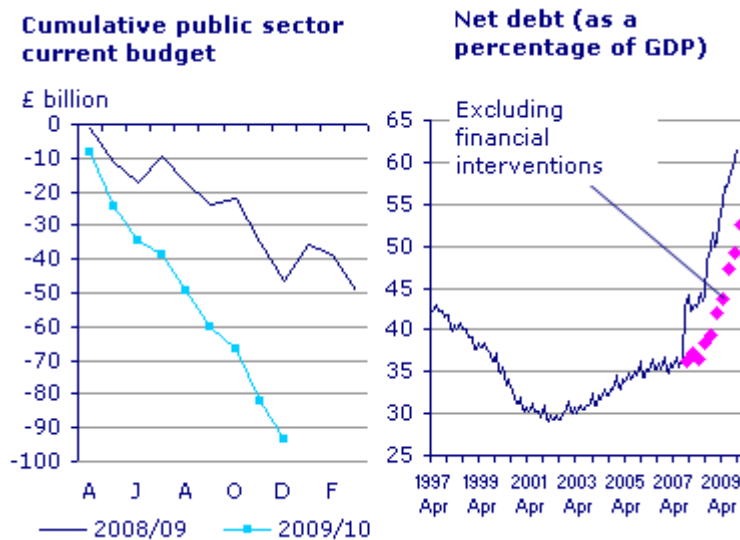
Figure 4.12. Public sector revenue, expenditure, and real GDP growth



Source: Office of National Statistics.

The 2009 Budget judged that the structural component of the budget deficit was almost 10% of GDP, or about 80% of the total deficit in 2009-10. The budget envisaged a moderate consolidation in the public finances, which would bring the cyclically-adjusted current account into balance by 2017-18. Net public sector debt is projected to peak in 2013-14 at 76.2% of GDP,¹⁵ double the level of five years previously (see Figure 4.13).¹⁶ This still compares favourably with other G7 countries (see Figure 4.14) although it will breach the 60% target set by the EU.

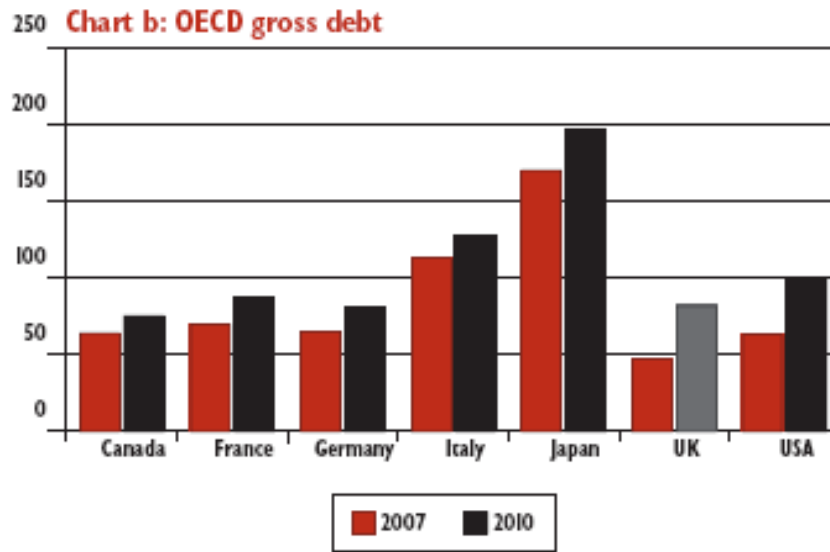
Figure 4.13. Public finances



Note: Figure shows cumulative public sector finance and net debt.

Source: www.statistics.gov.uk/cci/nugget.asp?ID=206.

Figure 4.14. OECD gross debt

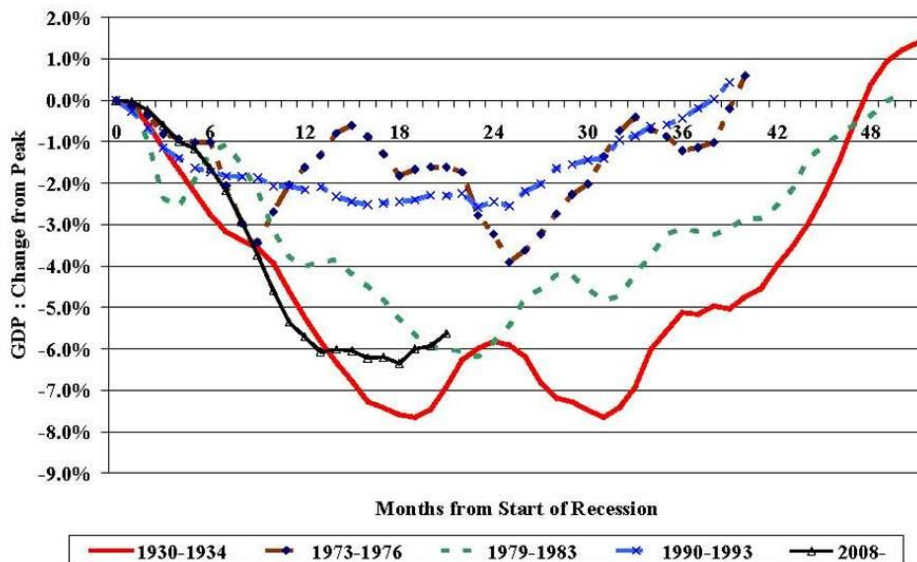


Source: HM Treasury (2009), p. 29.

Comparison with ERM crisis

The current downturn is forecast to be much deeper than that associated with the ERM crisis of the early 1990s, with GDP forecast to contract by 4.5% by late 2009, compared with a fall of 2.5% in the early 1990s (see Figure 4.15). The background to each period, and the policy response required, differ in several ways.

Figure 4.15. Profile of the recession: months from the start of the recession



Note: Calculated from three-month moving averages of monthly GDP.

Source: NIESR, January 2009, www.niesr.ac.uk/pdf/130110_143645.pdf.

The current recession came at a time when the UK economy was operating close to trend, inflation was close to target and interest rates were below 6%. This contrasts with the late 1980s' overheating domestic economy, which generated high inflation. In order to bring inflation under control, interest rates were raised sharply, peaking at 15% in 1990. When the ERM crisis struck the UK economy was already beginning to emerge from the bottom of the recession – the third quarter of 1992 was the first to show positive growth both over the previous quarter and over a year earlier.

Compared to the early 1990s recession, the current crisis has already seen a much larger macroeconomic stimulus. Compared with the month prior to the first quarter of falling GDP, sterling oil prices are down 50%, Bank Rate has been cut by 4.5 percentage points and sterling has depreciated by around 16%, each well in excess of the change over the first nine months of the 1990s recession. The fiscal stimulus provided since the start of the current crisis has also been larger, providing greater support to the economy at a time when the private sector is retrenching. The extent of macroeconomic stimulus, and the assumption that this stimulus progressively takes hold during 2009 and 2010, underpins the Budget 2009 forecast for an earlier, more sustained and stronger recovery than seen in the 1990s. Experience of that recovery points to the possibility that recovery can deliver strong growth rates for a number of years as spare capacity is brought back into productive use. For example, GDP growth was strong in the five years from 1993, averaging 3.25% a year.¹⁷

Figure 4.15 shows that the ERM crisis had a very limited effect on the UK compared to other major recessions, particularly the present one which is tracking the 1929 recession more closely. What is particularly interesting about this comparison is that in each case thus far the economy took roughly the same length of time to turn round although the depth was different. What distinguishes the ERM recession, in part no doubt because of its shallowness, is that it was over more rapidly.

The recession starting in 1979, which was not a financial crisis per se but rather more the result of a sharp policy shift away from an unsustainable position, is not only more comparable in economic terms with present circumstances but was relatively fresh in people's minds. Hence the ERM crisis was regarded as more minor by comparison, which in itself contributes to explaining the milder policy response than that of the present circumstances.

A brief review of the causes of the crises

The principal cause of the ERM crisis was unsustainable macroeconomic policy. The UK along with its EU partners had recently negotiated and signed the Maastricht Treaty committing the member states to progress to economic monetary union by stages, which included maintaining their exchanges with respect to the ECU within a narrow band (the exchange rate mechanism, labelled ERM). Although the UK and Denmark (the latter as the result of a referendum) had negotiated the right to opt out of the final stage, all countries began, even during the negotiation stage that followed the decision to go forward in December of 1989, by trying to adhere to the ERM, the UK included. Unfortunately, this initial period coincided with the development of the problems in Germany of assimilating the former GDR, which was proving much more costly than expected. The budget deficit rose to over 13% of GDP in Germany in 1990 (11% in 1991) and interest rates were raised by 300bp in 1991-2. Although technically all countries had a weight in the ERM equivalent to their GDP in practice the system was largely influenced by Germany because of the large countries it had the best inflation record.

Also, although in theory, both countries that were facing a rising exchange rate that threatened to exit the ERM parity band and those that were facing a falling exchange rate that threatened to exit the other side of the band should both have intervened to prevent this, the onus was on the depreciating countries. The appreciating country could always accumulate reserves while the depreciating country might run out of them. Adjustment outside the use of foreign exchange therefore involved first having a compatible monetary policy but also having a compatible fiscal policy so that inflation prospects were aligned with those of Germany.

In this period, the cyclical needs of UK monetary policy (and those of many other EU countries and applicants, such as Sweden) therefore differed from those of Germany, with the UK needing a relative decline in interest rates and hence in the exchange rate. The UK economy had peaked in 1988 and in 1992 was in the low part of the cycle, where correspondingly low interest rates would normally have been applied. Thus macroeconomic policy in the form of ERM membership made this economic cycle diverge from the normal foreign exchange driven problems where devaluation and the period of disinflation normally coincide. In this case much of the fiscal adjustment had already taken place, with four consecutive tight budgets and even the 1992 budget was only mildly expansionary, although the expected deficit was large given the recession. Inflation had however proved rather difficult to reduce, assisted by the first Gulf war, hovering around 7% in 1990-91 on the CPI measure. The current account deficit, having risen sharply in the late 1980s from GBP 570 million to GBP 25.5 billion in 1989, fell back again to GBP 10.6 billion in 1991 en route to a low point of less than GBP 1 billion in 1997.¹⁸

As the misalignment increased and the current account deficit rose it became increasingly clear that a devaluation was likely. The member states were unwilling to agree to a realignment of the official parities in the ERM as this would imply that the monetary union posed problems before it even started. Other countries' currencies had also come under pressure¹⁹ and when the 'speculators', famously including George Soros, made their attack on what has been labelled 'Black Wednesday',²⁰ 16 September 1992, the Bank of England was not able to hold out for long as the foreign exchange reserves were quickly depleted (the Treasury estimated the loss to be of the order of GBP 3.3 billion).²¹ This was thus a classic example of a foreign exchange crisis when a 'fixed' peg becomes unsustainable. 'Speculators' effectively face a one way bet – either there will indeed be a devaluation where they will make a substantial profit or there will not in which case they only have to carry the transactions costs and the small interest costs of taking a position.

It could be argued that the UK had joined the ERM at an unfortunate juncture. The period 1990-91 was characterised by an economic downturn and interest rates were high at that point. The German problems meant that Germany probably needed to revalue but this was proving difficult for German partners. Hence the crisis was in many respects an issue of European macroeconomic policy rather than just idiosyncratic difficulties in the UK. Nevertheless there was considerable debate about whether the exchange rate at which sterling had gone into the ERM – effectively 2.95DM – was appropriate for long run stability and figures nearer 2.60 received wide support. As it turned out, a figure of around 2.95 was sustained for about a decade from 1996 to 2006.

The present crisis on the other hand had causes that were primarily financial, supplemented by macroeconomic ones macroeconomic. The principal *proximate* driver was the financial problems in the United States, which spilled over into the UK and other

foreign markets, both with the initial drying up of wholesale markets in August 2007 and the general collapse in confidence in September 2008. This was combined with two main sources of fragility in the UK banking system. Some banks such as Northern Rock, Bradford and Bingley and HBOS were too exposed to higher risk areas of the property sector and too dependent on wholesale funding rather than deposits. Other banks, particularly RBS but also HBOS (again) were overleveraged as a result of aggressive growth. The third main ingredient in precipitating the crisis was an asset price bubble in both stocks and housing. This was part of a more general departure from sustainable financial behaviour with a rapid build up in household indebtedness and very limited saving. Hence as soon as the bubble was pricked asset prices dropped rapidly and capital values were quickly eroded. Some more detailed aspects of the vulnerability of the financial sector also contributed to making the reaction to the unfavourable external shocks a crisis rather than a more normal cyclical adjustment. These included insufficient attention to liquidity and a general problem of a system of capital requirements that was highly procyclical.

In an important sense public policy was also an issue. Although the main risks had all been identified they were not perceived as threatening. Micro-prudential supervision by the FSA did not point strongly to the existence of problems that would cause concern in individual financial institution. While risks had been set out both in the Bank of England's *Financial Stability Report* and the FSA's *Financial Risk Outlook* they did not convey any sense of a drastic problem looming. Fiscal policy was expansionary rather than being cautious and consolidating in the extended upturn, while monetary policy, focused on an inflation target, only reacted firmly as inflationary pressures emerged. It is arguable that the long period of sustained growth and low inflation that preceded the crisis contributed to it considerably by lulling people into the belief that the period of continuing favourable growth would not end.

The macroeconomic measures implemented to accelerate recovery

Probably the most important outcome of the ERM crisis was the switch to inflation targeting. During the 1980s, despite some of the attraction to money targeting as the operational objective, the UK had tried to maintain financial stability by a fair measure of managed floating, trying to avoid wide fluctuations in the exchange rate – initially with the US dollar but increasingly with respect to the ERM basket, generating a series of mini “crises” in 1985, 1986 and particularly in 1989 when the Chancellor of the Exchequer, Nigel Lawson, resigned. During that period there were clear tensions in the government between pegging the exchange rate and allowing the exchange rate to help in smoothing the economy. When the UK entered the ERM in October 1990 the argument was effectively settled in favour of fixity. The ERM crisis ended that and flexibility has been the regime ever since. The Government set a target for (RPI) inflation of 1 to 4% a year excluding mortgage payments making the UK one of the early adopters of inflation targeting after New Zealand and Canada. The main subsequent policy measure was to reduce interest rates, with bank rate falling from 10% before the crisis to 6% in early 1993 and the exchange rate fell by 15%. Fiscal expansion was limited, although there were targeted measures to tackle the rapidly rising unemployment, focusing on training and what in more modern parlance would be described as activation. The main reason for the restraint was simply that both automatic stabilisers and discretionary measures taken earlier in the recession were already cutting in. Thus the PSBR had changed from a fractional surplus in 1990-91 to 2.5% of GDP in 1991-92 and 6% in 1992-93 and 7.2% 1993-94 rather than expanding rapidly thereafter. There was only a small increase in

public sector investment. By modern standards the fiscal impact was strong through the cycle but the UK was one of the early adopters of a medium term approach to public sector budgeting and had reacted strongly against traditional Keynesian expansions over a decade earlier as part of the ‘Thatcher’ revolution in economic policy making.

A comparison of the macroeconomic context of the ERM crisis with that of the current crisis

The current crisis is very different in character; it is a financial crisis not an exchange rate crisis. Indeed the floating exchange rate is one of the mechanisms that have made the crisis less harsh than it might otherwise have been. The current crisis is also typical of a financial crisis rather than the previous series of exchange rate problems in that before the crisis financial risks had been built up, which were then realised when the downturn took place. The macroeconomic context was an unsustainable boom leading to a sharp downturn as both domestic policy to contain inflation and an adverse external shock from the sub-prime crisis in the US combined to bring a sharp recession and realised losses.²² The ERM crisis on the other hand came towards the end of the downturn, although this in itself followed a boom, also one where asset prices had expanded rapidly after the longest period of sustained growth for many years. One important feature of that boom was that it was underestimated by the statistics of the time so that what appeared to be rather rapid but possibly sustainable would have rung alarm bells had the true measures been available. The statistical service in the UK was substantially overhauled as a result and measurement in the present crisis are likely to have been rather more precise even it is too early to tell.

While monetary policy had been contractionary in the build up to the present crisis both in response to internal pressure and the boom in world commodity prices, particularly oil, fiscal policy had remained reasonably accommodative hence the economy went into the recession with only limited scope for fiscal easing.

A brief description and informal chronology of the present crisis

The present crisis broke for the UK in August 2007, when Northern Rock got into difficulty following the virtual freezing of wholesale markets on 9 August. The main part of the crisis did not hit until September 2008 following the failure of Lehman Brothers. There were thus two phases and the UK had a year to put into effect reforms following the Northern Rock shock.²³ The main regulatory changes had to be implemented in February 2008 when Northern Rock was nationalised following the passing of the Banking (Special Provisions) Act.

In the first phase of the crisis Northern Rock, with the help of the authorities initially tried to obtain alternative refinancing through the private sector through a variety of means including takeover but when this failed it had no alternative but to receive temporary financing from the Bank of England on 13 September 2007. The announcement of this arrangement led to a retail run on the bank that was only halted when the Chancellor of the Exchequer announced a guarantee for all claims against Northern Rock on the advice that it was solvent. Of course the wholesale run had already occurred, reflected in the freezing of markets that led to Northern Rock’s immediate difficulties.

The period that followed involved intensive discussions by the authorities in an effort to reform and restructure the arrangements for handling a financial crisis and a parliamentary inquiry into what had gone wrong and what should be done (described in more detail below). The early legislative action, the Banking (Special Provisions) Act 2008, was triggered by the failure to find a satisfactory private sector solution for Northern Rock after months of negotiation and the bank was nationalised on 20 February 2008, after the rapid passing of the necessary legislation in the previous three days. Work continued thereafter on agreeing more permanent arrangements and replacement legislation, as the Special Provisions Act deliberately had only a one year lifetime. Some additional measures were introduced by the Bank of England to help markets operate more effectively, including the Special Liquidity Scheme in April 2008 that enabled banks to swap illiquid assets temporarily for Treasury bills.

The second phase of the crisis followed Lehman Brothers' filing for bankruptcy on 15 September 2008. Three days later on 18 September the merger of HBOS and Lloyds-TSB was announced. The merger was completed on 19 January 2009. HBOS, then the UK's fifth largest bank, had an unfortunate combination of being the UK's largest mortgage lender with some 20% of the market and also choosing to finance over half of its lending through wholesale markets.²⁴ In addition the quality of its loan portfolio was known to be low – although not as low as has turned out to be the case subsequently. Its merger with Lloyds-TSB, which at the time was in a relatively healthy position created a larger group that was rather strained. On 29 September Bradford and Bingley was resolved, with its retail deposit business and branch network being transferred to Abbey, itself part of the Santander Group. Bradford and Bingley, like Northern Rock and, was particularly exposed to the residential property sector but it had chosen to specialise in the buy to let market and in lending to those with weaker credentials – both higher risk activities. The bank had been in difficulties for some months and this was the first example of the new arrangements for bank resolution being used in practice, albeit under the Special Provisions Act.²⁵

The UK was particularly badly affected by the Icelandic banking crisis. On 7 October Landsbanki failed in Iceland, and the following day the UK issued a freezing order²⁶ to try to stop Landsbanki's assets being repatriated to Iceland as Landsbanki's main UK operation was through a branch, called IceSave, and not through a subsidiary where the UK authorities would have been able to control its actions.²⁷ On the same day, a second Icelandic bank, Kaupthing, Singer & Friedlander was resolved, with its UK deposit book being mainly transferred to the ING bank branch in the UK.²⁸ Heritable Bank, which was a Landsbanki subsidiary, was also resolved with its deposits and retail business also being transferred to ING. This dramatic period was ended by the introduction of a major support package for UK banks, also announced on 8 October. Under this the remaining large banks, now down to eight with HBOS and LloydsTSB counted separately were offered a package of support measures that had three main parts:

- a Bank Recapitalisation Fund that would purchase preference shares in the banks to assist in their recapitalisation;²⁹
- an extension of the Special Liquidity Scheme (SLS) which became a GBP 200 billion facility operating for three years
- a Credit Guarantee Scheme (CGS) of up to GBP 250 billion, designed to offer guarantees for the financing of any of the banks' maturing debt until markets recovered.

Only RBS, HBOS and Lloyds decided to participate in the Recapitalisation Fund, the latter simply because of the merger. The recapitalisation was designed to raise Tier 1 capital above its prevailing levels, which were compliant with Basel 2, so that the banks could be stronger in the difficult economic times ahead and more able to raise other finance as a result. The shares acquired by the government are being held by a new entity called UK Financial Investments (UKFI), which is wholly owned by the Treasury but operated on what is described as an “arms’ length basis”, as “an actively-engaged institutional shareholder”, under which several conditions have been imposed on the banks.

On 19 January 2009 the government introduced a further package of support. The principal ingredient of this was the Asset Protection Scheme (APS) under which banks could purchase protection from the government for 90% of the losses after the first loss. Only RBS and Lloyds Banking Group signed up to this, where the fee took the form of further equity capital.³⁰ In return the banks had to agree to expand lending by specified amounts, principally to business and to support residential mortgages. The APS was thus the UK approach to handle so-called ‘toxic assets’. The assets to be assigned had to be valued and approved by the Treasury. However, the assets remain with the banks and there was no attempt to buy the assets outright and place them in an asset management company, or ‘bad bank’ as it is sometimes referred to. Other parts of the package included extending the Credit Guarantee Scheme which relates to the interbank market and extending the maturity of assets that could be swapped through the Bank of England’s discount window. Furthermore the package set up the opportunity for the Bank of England to begin ‘quantitative easing’ through the purchase of high quality assets.³¹

The new Banking Act 2009 passed into law in February 2009, replacing the Special Provisions Act on its expiry. It implemented the Special Resolution Regime (SRR) which lies at the heart of the ability to handle problems banks at the minimum risk to financial stability. The SRR was first used on 30 March for the resolution of the Dunfermline Building Society, whose retail operations and wholesale deposits were transferred to the Nationwide, the UK’s largest and dominant building society, with a special social housing portfolio transferred to a bridge bank³² and the residual left in the receivership. More is promised in the regulatory response to the crisis in a Treasury White Paper entitled “Reforming Financial Markets”, following a wide ranging review of the necessary regulation by Lord Turner the Chairman of the FSA and of the corporate governance of financial institutions by Sir David Walker. (These are discussed in Section 2.) The Banking Act also includes provision to extend the Special Insolvency Regime to investment banks.

The extent of the crisis in the UK is clear in the light of the actions just described. The second largest bank, Royal Bank of Scotland, has required extensive intervention and is now 80% government owned.³³ The fourth largest, HBOS, has been taken over by the fifth largest, LloydsTSB and this combined entity has also required intervention with government ownership of over 40%. The eighth largest, Northern Rock, failed and had to be nationalised, while the tenth largest, Bradford and Bingley, has also failed, been dismembered with the help of government support and been partly sold to the private sector and partly nationalised. When the Icelandic banks failed, intervention was also required into Kaupthing Singer and Friedlander, Landsbanki and Heritable Bank and one building society, Dunfermline, has also failed and been resolved. The joint cost of these (GBP 126 billion) is dominated by the support for RBS and the new Lloyds Banking Group formed from Lloyds-TSB and HBOS (GBP 78 billion). Eventually the cost of this latter support may be recovered with interest when the crisis is over and the banks are

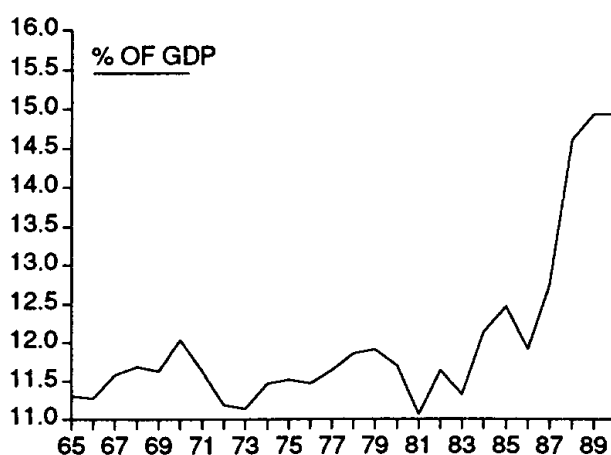
returned to the private sector. On top of this assistance for the banks in the form of guarantees and protection for possible loss from impaired asset backed securities lays the government open for a potential loss of over GBP 750 billion should all assets default and be a total loss. While the amounts may appear considerable, at first sight, the current gross cost is in fact less than 10% of GDP and could be considerably smaller when the shares are sold – the government’s current estimate is that it will not exceed GBP 50 billion, which is 3.5% of GDP. This is much lower than in many other countries that have experienced financial crisis in the 1980s and 1990s.

Role of regulatory reform

Core changes to the regulatory institutional setup

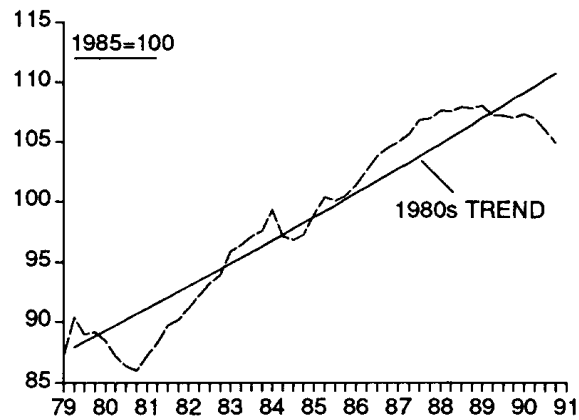
The ERM crisis was not accompanied by substantial regulatory change and was only caused by it in the sense of a change in the macroeconomic paradigm in focusing on the exchange rate. However, in other respects the entire economic cycle that took place up to the downturn in the early 1990s was the consequence of the huge regulatory changes of the post 1979 ‘Thatcher’ era in the UK. Once the harsh consequences of the initial shakeout were complete in the early 1980s, the economy enjoyed more than six years of uninterrupted growth and faced the usual dilemma for the authorities in such circumstances. To what extent was the growth simply catching up for the earlier losses and then moving into territory where it was not sustainable from the momentum? Or was it the result of a change in the fundamental sustainable rate of growth caused by the massive deregulation that led to a permanent increase in the rate of productivity growth? The normal experience is that governments, along with others, overestimate the extent to which a prolonged period of uninterrupted growth is the result of productivity gains that will continue into the future. It is clear from Figure 4.16 that the Thatcher era reforms had a major positive impact on investment, contributing to growth but that the productivity surge was clearly over by the time of the crisis (Figure 4.17).

Figure 4.16. The increase in business investment



Source: Budget Statement (1992).

Figure 4.17. Productivity growth



Source: Budget Statement (1992).

Regulatory reform continued through the period of the ERM crisis and through the economic downturn that preceded it. Electricity was reformed in 1990 with both vertical and horizontal separation in the industry on privatisation to provide effective competition. 1991 saw the beginning of competition in supply with British Gas and by the end of 1992 some 20% of total industrial demand was met by these competitors. In 1993 alternative companies started to provide land based telephonic services in competition with British Telecom following the 1991 review “Competition and Choice: Telecommunications Policy for the 1990s”. Reform of the rail monopoly followed in 1994-95, following the same approach to privatisation as in other utilities with the separation of the network from the railway operators and the overseeing of the system by an independent sectoral regulator, Rail Regulator, set up in 1993 under the Railways Act of that year.

The pressure for regulatory reform has continued in the UK with the Regulatory Reform Acts of 2001 and 2006. The 2006 Act operates under the principles that

- regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent;
- regulatory activities should be targeted only at cases in which action is needed.

Consultation is required on the basis of all draft proposals for regulation. The purpose of the 2001 Act was to enable deregulation to take place through ministerial action, after consultation, without the need to take the process through parliament with the same process as other legislation. Orders under the Act have to be laid before parliament and are hence subject to approval.

Regulatory reform in the finance industry

While inflation targeting was adopted as the direct consequence of the ERM crisis, the main changes affecting the finance industry occurred with the creation of the Financial Services Authority in 1997 out of the Securities and Investment Board, with banking regulation transferred from the Bank of England and a range of smaller, largely self-regulating bodies for various parts of the finance industry. This change was

fundamental, involving not just a change institutions but the development of a new regulatory culture, with clear objectives and principles. The four objectives laid down in the 2000 Financial Services and Markets Act (market confidence, public awareness, consumer protection and reduction of financial crime) gave the FSA a much wider remit than simply prudential regulation and may of itself have contributed to the difficulties in the run up to the present crisis. However, the six principles³⁴ bear a clear relation both to competitiveness and the need to ensure innovation and competition. Taken together with the need to ensure that the impact on the industry is proportionate to the welfare benefit, the principles should tend to encourage the continuing competitiveness of the financial industry in the international context that is essential to London as a world financial centre. Given the recent statements by the Chairman of the FSA, Lord Turner,³⁵ that the industry had grown faster than its social benefit one might wish to question the balance that had been placed on these principles.

The present crisis

The present crisis has not surprisingly triggered major change in the regulatory institutional set up as failures in that set up were a major contribution to the development of the crisis. The regulatory failure had six main elements to it:

- supervisory failure by the FSA
- emergency liquidity support failure by the Bank of England
- co-ordination failure among the tripartite authorities
- absence of a dedicated bank resolution framework
- failure of the deposit insurance scheme
- failure to maintain financial stability

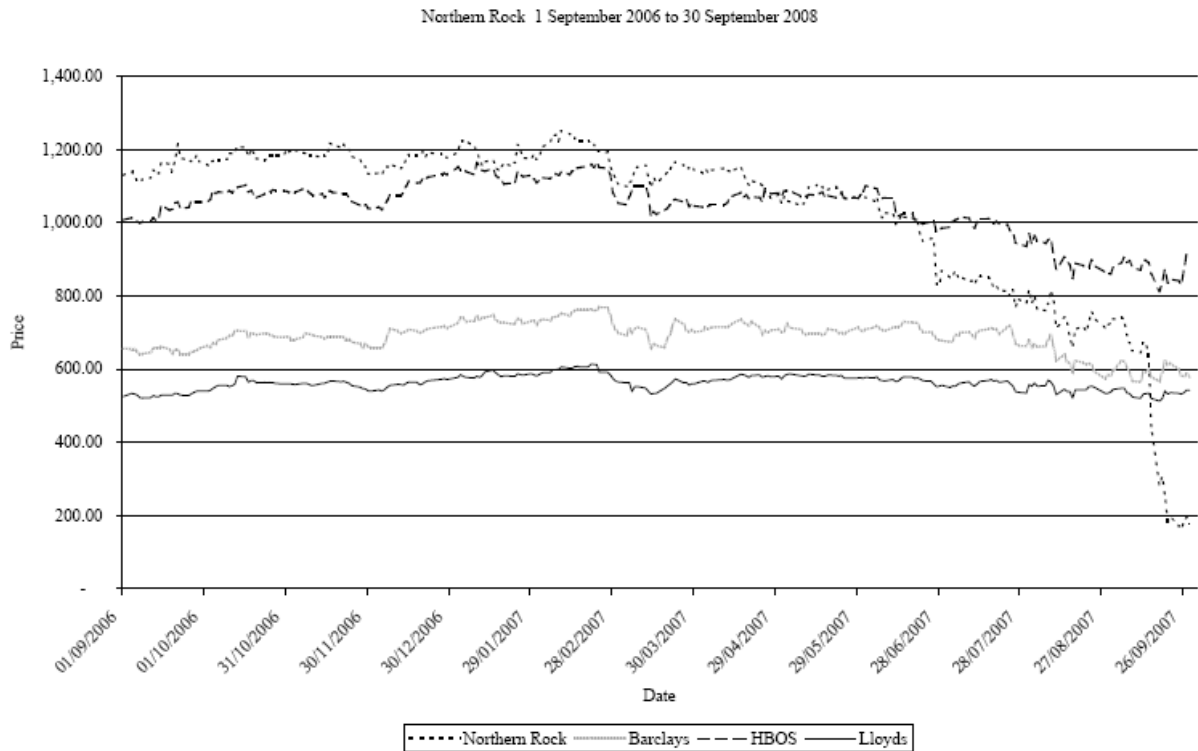
Although to these should be added:

- The general problems with the Basel framework that affected all countries, including procyclicality and the lack of developed guidelines on liquidity buffers to match those on capital and
- The failure of European cross-border rules in the internal market to insulate the UK from external supervisory errors, particularly those in Iceland.

Supervisory issues

The responsibilities for the lack of appreciation of the extent of the exposure of the UK economy to the sub-prime problem in the US remains debated, as both the FSA and the Bank of England had some responsibility for macro-prudential supervision. However, it is clear that the FSA did not fully appreciate the considerable risks of a number of the more exposed of the individual financial institutions for which it was responsible. This became immediately clear in the case of Northern Rock by August 2007, when that bank had to seek emergency liquidity assistance from the Bank of England because of its major dependence on wholesale funding. This dependence was not only no secret but a deliberate policy decision by Northern Rock that enabled it to grow rapidly in the market for mortgage lending. Principally through securitisation, which represented half of its funding in 2007, it was able to increase its mortgage lending by 20% a year, increasing it six-fold in a decade. In the first half of 2007 it was responsible for 20% of the increase in mortgage lending in the UK although its market share was only 8% and its share of retail deposits, 2%.

A parliamentary inquiry highlights the supervisory issues over Northern Rock (House of Commons, 2008). The FSA also published its own internal audit department report (FSA, 2008a). Northern Rock was reviewed under what the FSA labels its ARROW process of assessment, which takes the form of a broad based assessment of risks by a formal committee, on 20 February 2006. The ARROW process had been revised and its new form (ARROW 2) was introduced progressively starting the month after the Northern Rock review. Although the committee noted aspects of Northern Rock's special risk characteristics it felt comfortable enough with the position that it did not require Northern Rock to take any major action under a Risk Mitigation Review and it put off the next ARROW review for the maximum 36 months. It did however write to the bank's director as is normal practice after such a review pointing out where the risks lay. Over the following year some 10 visits were paid to Northern Rock as part of the programme to get Basel 2 implemented but these did not lead to any reappraisal of the risk. Indeed when the review was completed in June 2007, Northern Rock was allowed to move to the Advanced Approach using internal ratings. It is noticeable from the chart of Northern Rock's share price during this period (Figure 4.18) that the market had already formed the view that was an increasingly risky prospect and when this information was released there was a sharp drop in its share price, amounting to over 25% over 3 months. As is also clear from the chart, there was no general decline in the view of the market about the risks of the banking sector. Within two months Northern Rock was in crisis.

Figure 4.18. Northern Rock, 1 September 2006 to 30 September 2008

The FSA (2008a) internal audit review concluded that general processes under ARROW 2 were adequate and that the failures over Northern Rock were an extreme case. Seven main recommendations were made:

- FSA senior management to have increased engagement with high impact firms;
- FSA to increase the rigour of its day to day supervision;
- FSA to increase its focus on prudential supervision, including liquidity and stress testing;
- FSA to improve its use of information and intelligence in its supervision;
- FSA to improve the quality and resourcing of its financial and sectoral analysis;
- FSA to strengthen supervisory resources; and
- FSA senior management to increase the level of oversight of firms' supervision.

While the report was quite critical of the way in which established procedures were undertaken, it recommended their improvement and not wholesale changes to the framework of regulation. The Turner Review discussed below has tackled that.

In response the FSA has accepted these recommendations, sharpened up its procedures and responded by taking on a substantial number of staff; these activities it describes as a ‘Supervisory Enhancement Programme’ (FSA, 2008b). (The number of supervisors actually fell by 5% in the previous 2 years.) However it has not changed its view that the framework of risk-based, outcome driven supervision is correct. It is perhaps worth contrasting this with the conclusion of the Treasury Committee (2008, 42) ‘We regard this as a substantial failure of regulation.’

The Treasury Committee went on to signal the failure of liquidity regulation in particular. Evidence both from the Bank of England and Charles Goodhart confirmed that there had been a general lack of agreement within the Basel Committee upon rules for liquidity adequacy in the same way that they had been agreed for capital adequacy. Despite this discomfort the UK had followed general international practice and not introduced tighter rules for liquidity.

The UK is tightening up liquidity requirements in line with the developing international agreements. The idea is to introduce liquidity requirements in a form akin to capital requirements. Banks are therefore to be required to have in place an adequate system of liquidity risk assessment and management in addition to the necessary liquidity, which is to be assessed on a firm by firm basis and relate not just to individual entities but to the financial group as a whole. Liquidity is to be to counter Wholesale funding risk; Retail funding risk; Intra-day liquidity risk; Intra-group liquidity risk; Cross-currency liquidity risk; Off-balance sheet liquidity risk; Franchise-viability liquidity risk; Marketable asset risk; Non-marketable asset risk; and Funding diversification risk. As with capital requirements there is a standardised and a more advanced model. Under the standardised regime firms will have to have sufficient liquefiable assets to cover a 13 week period of liquidity demand in the face of the shutting off of wholesale markets and a slow drain of retail liquidity. This therefore requires a considerable ability to estimate the requisite flows over such a period in the face of both idiosyncratic and market wide shocks.

The implementation of the regime is in its final consultation phase with responses due by the end of July 2009 and implementation in October 2009. This follows an initial discussion paper by the FSA in late 2007 and a Consultation Paper in December 2008. The three-month buffer that is envisaged would give time both for a reorganisation in the shock is firm specific or an economy wide response to the shock if it is general. Clearly it is important to take full account of correlated shocks in these simulations. All this would apply before a firm needed to apply to the Bank of England for Emergency Liquidity Assistance.

Emergency liquidity support failure by the Bank of England

Up until the Northern Rock case there had not been a major bank run in the UK since Overend Gurney in 1866.³⁶ Indeed, the UK is the home of Bagehot who is widely credited with setting out the principles for liquidity support for the banking system in his book *Lombard Street* in 1873. The idea is straight-forward; there should be a lender of last resort with adequate resources who can provide liquidity temporarily to banks against good collateral at above the previous market rate of interest. This operation was demonstrated clearly in 1890 during the first Barings’ crisis, when the Bank of England, after determining that it thought Barings solvent, made it clear that it would advance all the liquidity that might be needed by the banking system (against suitable collateral). In the case of Northern Rock it did not do so in the prescribed manner as initially it tried to

avoid the lending since it was concerned about the moral hazard and then its provision was too slow and people got to hear about the need for such lending through the television news and the run ensued.

In its defence the Bank of England argued that there were two main problems:

- it could not keep the specific lending secret
- it could not lend to the market on a sufficient scale

If the market is functioning properly then any bank that needs to borrow from the others should be able to do so if it can post adequate collateral. In July 2007 wholesale markets started drying up and the Bank of England would have needed to lend on a major scale to cover the gap. In August the banks asked the Bank of England to provide extra liquidity but not at penalty rates. This request was rejected. However in September, shortly before the run on Northern Rock, liquidity was increased (and again after the run). At the time the amounts sounded implausible. After the event the support to the market in 2008-09 has made these amounts sound reasonable. With the benefit of experience this particular problem should not occur again.

When an individual bank needs to borrow when it is closed out of the market, the Bank of England needed to reveal within a week that such lending had taken place and argued further that European law (the Market Abuse Directive) required it to reveal what was happening. Northern Rock was also advised that it would have to reveal the loan as a consequence of being a listed company. Whereas such lending is supposed to inject confidence to the market because the Bank of England will only lend to solvent institutions that can provide suitable collateral the market has treated this as a stigma, a sign that a bank is in really serious trouble that such a last resort mechanism has been used.

The Bank of England has got round the problem in two respects. First of all it has been established that the disclosure worry is unnecessary and secondly the Banking Act 2009 has removed the obligation that it has to report on its emergency lending weekly. What it has not got round so readily is the stigma element. If emergency lending were more common then it would not be interpreted so adversely. But then this would imply that markets did work properly on a fairly frequent basis. Attempts to get round this in the US by getting other banks to borrow from the emergency facility have not worked and the use of the standing facilities in the Eurosystem does not seem fully adequate in this regard either.

Further, it is unresolved what the borrower, on the assumption that it is a listed company, will have to reveal to the financial markets.

The seizing up of wholesale markets led the Bank of England to rethink the whole scale of possible support for markets. On one hand it has created a range of facilities that allow banks to improve their access to liquidity in part on a temporary basis and all on terms that would encourage the banks to use market opportunities first.³⁷ However, it has also faced the problem that traditional monetary policy reached the lower bound of a zero nominal interest rate. It has therefore wished to inject liquidity into the banking system not just to keep the banks functioning normally as part of its financial stability function but also to try to expand an economy that is in recession and facing deflation. Both the US and Japan have found it necessary to go down the same route (which the Japanese pioneered as part of their own crisis in the 1990s). By expanding the range and maturity

of assets that the Bank of England will purchase it has possible to inject more liquidity into the system, effectively depressing the yield curve further out. The most recent extension of this facility, introduced in January 2009, enables the Bank to purchase the very longest dated securities.

Co-ordination failure among the tripartite authorities

The UK authorities had gone rather further than many of their counterparts in other countries by concluding a Memorandum of Understanding between the Bank of England, the FSA and the Treasury in March 2006, updating a 1997 agreement, on the responsibilities and the means of co-ordination among them in the event of a crisis. The division of responsibilities is based on four guiding principles:

- Clear accountability – Each authority must be accountable for its actions, so each must have unambiguous and well-defined responsibilities;
- Transparency – Parliament, the markets and the public must know who is responsible for what;
- Avoidance of duplication – Each authority must have a clearly defined role, to avoid second guessing, inefficiency and the unnecessary duplication of effort. This will help ensure proper accountability;
- Regular information exchange – This helps each authority to discharge its responsibilities as efficiently and effectively as possible.

In a crisis, the Financial Services Authority would, according to the Memorandum of Understanding, be responsible for “the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities” which it may undertake by “the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties”. However, the Bank of England would remain in charge of “official financial operations ... in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.”

There were a number of difficulties with the arrangements in the Northern Rock case such as conflicting statements but the principal problem came from the lack of information for the Bank of England on the size of the problem and in its ability to judge how it could act. According the parliamentary review (House of Commons, 2008, 284) there was a lack of clear leadership and of communication. It is also clear from the result that the division of responsibility between the FSA and the Bank could be improved.

In part this has been addressed in the Banking Act 2009 with the setting out of which of the tripartite authorities is responsible for what in the process towards resolving problem banks. The Bank of England has been given the objective of contributing ‘to protecting the stability of the financial systems of the [UK]’ and a Financial Stability Committee headed by the Governor has been set up as a sub-committee of the Bank’s court of directors. The other members of the committee are the Deputy Governors and four directors of the Bank appointed by the chair of the court. The committee has a monitoring and advisory role. But it still remains the case that the FSA is responsible for detecting the problems among individual institutions and, if it deems a bank to be failing,

then the Bank of England takes over in resolving the problem while the Treasury has to be involved if the proposed method of resolution requires taxpayer funds. Perhaps the best test of this relationship has been in the resolution of the problems in Bradford and Bingley and Dunfermline Building Society, the first dealt with under the 2008 Special Provisions Act and the second under the Banking Act. In these cases there were no obvious problems.³⁸ But the test was a modest one, as these institutions were not complex, and the authorities on the watch for trouble.

The current opposition party in Parliament (Conservatives) has proposed a more drastic institutional reorganisation in a recent Paper,³⁹ whereby the prudential supervision of banks and insurance companies would be transferred to the Bank of England, which would also be responsible for the resolution regime as under the Banking Act 2009. A new Financial Stability Committee would be set up as a counterpart to the Monetary Policy Committee, with a similar structure of those with responsibility inside the Bank of England and independent members. The FSA would be replaced by a Consumer Protection Agency to focus on conduct of business regulation including the regulation of consumer credit, which is currently covered by the Office of Fair Trading (OFT). The Paper also addresses the issue of competition, calling for a careful review of the increased concentration in the sector and for action to reduce the barriers to new entry (the last new building society was created in 1981). The Paper supports the idea advocated by the Governor of the Bank of England that banks should have a ‘living will’ to enable swift resolution without disturbing financial stability.

Much of the complaint to which the Paper reacts, whose accuracy has been confirmed by the FSA itself, is that the FSA focused too much on conduct of business issues and not enough on prudential issues, particularly not enough on the aggregation of risk taking by individual financial institutions. It argues that two very different philosophies are required for running these two activities and that managing risk and checking compliance are antithetic. The Paper argues that in the previous regime no organisation had clear responsibility for macro-prudential regulation nor the tools to implement it.

The Turner Review, discussed below also offers a view on how the tripartite arrangements need to be developed so that macroprudential stability can be achieved: either the FSA and the Bank of England need to work together or the Bank of England would identify problems and the FSA address the risks with the tools it has or finally the FSA might act just as an agent for the Bank of England, which would decide not just on the existence of the problem but also on the form of its solution.

Absence of a dedicated bank resolution framework

The principal problem thrown up in the early stages of the crisis was that the UK did not have an effective mechanism for handling non-trivial problem banks. In the UK, ordinary insolvency law applied to banks at the time of the crisis. Hence if the troubled bank could not engineer a rescue or the authorities broker a deal that would save the bank with the agreement of its shareholders then there would be no alternative but to withdraw the bank’s licence and place it in insolvency through application to the courts. This takes a very long time. Such an option was not feasible for Northern Rock as it was judged by the government to be too large to be placed in insolvency. The political consequences of so many people losing money and their concentration in one part of the country (the North East of England) alone were thought too great even without regard to the potential contagion to other weak banks such as Bradford and Bingley and possibly HBOS.

The previous well-known example of this procedure was BCCI, although this was closed for reasons other than overwhelming losses. In these circumstances the insured depositors are paid out in due course by the FSCS (Financial Services Compensation Scheme) – the FSCS is not funded⁴⁰ so it takes a while to raise the funds from the rest of the banking system but it also takes time to identify who the insured depositors are and the extent of their insurance as the UK not only had co-insurance up to a limit, described in the next section, but only covered the net deposit so any loan needed to be identified and subtracted. The remaining creditors are then paid out in tranches, respecting their order of priority (seniority) as the assets of the bank are realised until the last claims and counter-claims through the court are dealt with. BCCI was closed in 1991. By 2009 creditors had recouped 75% of their losses.⁴¹ Not surprisingly, as was the case with the second Barings’ failure in 1995, the most popular solution is a sale, in Barings’ case for GBP 1 to ING so that it is not necessary to sell of all the assets slowly to satisfy the claims of the creditors.

These problems have been addressed first of all in the Banking (Special Provisions) Act 2008 but more enduringly in the Banking Act 2009, which sets out a Special Resolution Regime for banks and building societies.⁴² The key ingredients of the SRR, as set out in the 2009 Act, are that

- Banks fall under one of three circumstances
 - Normal “green” conditions where they comply with all regulatory requirements and are not thought to pose any risks that are of concern for their health, that of others or the financial system problem “orange” conditions, where heightened supervision is necessary and a close dialogue with the institution is required in order to make sure that the bank concerned resolves its problems.
 - A “red” zone where the bank has to be resolved by the authorities.⁴³
- In the red zone the authorities, in the form of the Bank of England, have the power to step into banks if the FSA, the supervisory agency, thinks that they no longer meet the conditions for registration as a bank (or will shortly fail to meet them) and that is not likely that actions will be forthcoming to restore the conditions (without intervention) – these “threshold conditions” relate to the usual requirements for bank registration that apply round the world: capital adequacy, fit and proper directors and lack inappropriate connections, ability to pay etc.⁴⁴ The condition is not insolvency and the expectation in the Act is that intervention will take place before that point is reached in the bank’s decline⁴⁵

If a bank is deemed by the FSA to have reached the point where the SRR is triggered the expectation is that the bank will be closed and insolvency will follow unless it is deemed by the Bank of England that what are described as ‘the stabilisation powers’ should be invoked in the public interest in

- The stability of the financial systems in the UK.
- The maintenance of public confidence in the stability of the financial systems in the UK.
- The protection of depositors.⁴⁶

In making this judgement and deciding what to do the Bank of England has to consult the FSA and the Treasury.⁴⁷ However, these conditions apply only to the use of the transfer to the private sector and to a bridge bank powers described below. The conditions for temporary public ownership are more onerous, namely “to resolve or reduce a serious threat to the stability of the financial systems in the UK”.⁴⁸

The three main stabilisation powers are

- The ability to transfer assets and liabilities, whether as a whole or in part to another registered service provider.
- The ability to create a bridge bank⁴⁹ for the whole or part of the failing institution.
- The ability to nationalise the whole or part of the operation should either of the above fail.⁵⁰

The SRR contains two procedures: an insolvency procedure if the bank is simply to go into insolvency and a “bank administration procedure” if the stabilisation powers are to be used. When stabilisation involves the transfer of part of the previous entity either to a private sector party or a bridge bank, some of the essential services will still be provided by the residual entity. It is therefore not possible simply to liquidate it without regard to the viability of the parts that have been transferred. To this end therefore the Act provides for the appointment of an administrator to run the “residual bank” that contains these essential services. Such an administrator is appointed by the court on the application of the Bank of England. This administrator is crucially different from the liquidator for a small bank that is allowed to fail and move into simple insolvency in that in addition to providing the necessary services the secondary objective is “rescue the residual bank as a going concern”. He should only seek to wind up the bank if that would achieve a better result for the creditors. A liquidator would also try to sell the bank as a going concern if that were the best option for the creditors but this is of course much more difficult if the bank has been closed by the authorities.

Given that transfer of depositors is likely as the only route that will provide continuity of access but may well pose problems through the operation of the IT systems involved, some continuation of functions in the existing bank seems likely and therefore this form of administration may well be required.⁵¹ A similar duty is placed on other parts of the banking group – a ‘continuity obligation’ – where they have to ‘provide such services and facilities as are required to enable a transferee to operate the transferred business, or part of it, effectively’. Of course the obligation to provide these services ‘is subject to a right to receive reasonable consideration’. The Bank of England decides what these services are and indeed can modify the arrangements and transfer property, rights and liabilities with the consent of the Treasury. Such transfers can be of items not previously transferred or ‘onward’ transfers to a third party of items already transferred, with associated obligations.⁵²

The Act is careful to try to protect the rights of those involved but with some provisos. It enables the making of transfers without the triggering of netting, close out or other clauses that might otherwise have occurred on the failure of the bank.⁵³ When transfers take place there should be independent valuation of any compensation that should be made to those whose rights are thereby overridden. If a residual bank later enters insolvency, the creditors of the bank are not to be made worse off than they would have been had insolvency taken place before the residual bank was set up.

Failure of the deposit insurance scheme

The deposit insurance scheme did not prevent a bank run by those whose deposits were insured. This occurred for three main reasons. The first was that the UK applied co-insurance. After the first GBP 2 000 only 90% of the remaining deposit was insured up to a maximum of GBP 35 000. The idea was that this would give depositors an incentive to monitor their banks and to move funds if they were dissatisfied with the bank's risk management. However, when the risks appeared for Northern Rock depositors had some of their funds at risk, so the only sensible course was to withdraw them all, leading to the run. The second was that even if they had been fully insured there was no realistic prospect of being paid out soon and no clear information about when such a payout might occur. Lastly some people had deposits over the insurance limit.

These problems have been partly solved by removing coinsurance, extending the limit to GBP 50 000,⁵⁴ making eligibility depend on the gross not the net deposit, so there is no need for the delays in trying to match depositors and borrowers, and by moving towards funding by allowing contingency funding from the government in the Banking Act 2009. Pre-funding by the industry is not to come into effect before 2012 at the earliest. The main changes proposed are set out by the FSA in 'Banking and Compensation Reform'.⁵⁵ While the new EU Deposit Guarantee Schemes Directive⁵⁶ requires member schemes to pay out within 20 working days (as opposed to the previous 9 months) the target in the UK is for the FSCS to give insured depositors access to at least a proportion of their balances within a week. It is intended that there shall be some limited pre-positioning in the sense that deposit takers should have identified all eligible account holders on a continuing basis, making it easier for the FSCS to determine who should be paid out without any need for them to enter a claim. The FSA have developed the concept of a 'Single Customer View' in which all the facets of a customer's relationship with an insured institution are collected and are available to the FSCS in a specified electronic format – this should get over the problem of having different trading names within the same entity. Of course many resolutions will result in the transfer of depositors to another institution or even a bridge bank in which case depositors should receive almost uninterrupted access to their balances. There will also be a campaign to explain to the public the extent of their insurance and the role of the FSCS, mainly achieved by regular disclosure by the deposit takers themselves. Most banks cannot yet implement the single customer view, however, so it is doubtful if the objective of at least partial payout within a week could be realised in the immediate future.

However, one further problem remains over the insurance of deposits in branches of banks owned elsewhere in the EU/EEA. If that bank fails and the deposit insurer does not or is unable to pay out then the consequences for financial stability still remain unless the host country chooses to step in as was done with the Icelandic banks. Changing these arrangements cannot be done by the UK acting alone but requires EU legislation. The problem of 'regime shopping' whereby depositors can place their funds with banks whose

home insurance is more generous still exists, although with the UK provided above average cover the risk of destabilisation is smaller and would not be of the system threatening proportions of the experience of Parex in Latvia.⁵⁷

Regulatory reform

The principal regulatory changes have been/

- In legislative terms, the Banking Act 2009 that implemented the new Special Resolution Regime, the reform of deposit insurance, and of the tripartite arrangements particularly with regard to macroprudential supervision and financial stability; and with the special provisions enacted to enable the nationalisation of Northern Rock
- In practical terms at the FSA with the implementation of the Supervisory Enhancement Programme

The changes in Banking Regulation

The Banking (Special Provisions) Act 2008 (came into force on 21 February and used on that day to nationalise Northern Rock). It was used subsequently to handle the resolution of Bradford and Bingley (whose mortgage portfolio was nationalised and deposits transferred to Abbey), Heritable Bank (a Landsbanki subsidiary) and Kaupthing Edge. In the last two cases the deposits were transferred to ING. This temporary legislation only lasted for a year and was replaced on 21 February 2009 by the Banking Act 2009.

The Act enabled the Treasury to act with respect to any authorised deposit-taking institution⁵⁸ if otherwise there were to be a threat of serious financial stability, or in the public interest where public funds have already been advanced. It could transfer securities, property, rights and liabilities, *i.e.* it related to institutions deemed to be failing. Compensation where appropriate is to be independently determined.

Banking Act 2009. While the 2008 Act was very much summary legislation to enable the UK authorities to handle failing banks in the crisis, the 2009 Banking Act was intended as a lasting replacement and as a result was only formulated and then enacted after a period of consultation and discussion with domestic and foreign advisors and interested parties. The new Special Resolution Regime was used for the first time in the case of the Dunfermline Building Society in March 2009. Comparable reforms to ease the resolution of other failed financial institutions, such as investment banks, are currently being considered.

The reform to the FSA

In some respects the reform of procedures in the FSA has represented the more striking change as these apply under normal conditions and are not simply special provisions that come into play purely in the event of a future crisis, which in any case it is hoped to avoid. The FSA's own internal audit department conducted a review of the FSA's supervision of Northern Rock and found many failings. In response, the FSA launched a Supervisory Enhancement Programme, which has involved the recruitment of several hundred additional staff to supervise high impact financial firms particularly large

complex banks, training of existing staff and a new, more questioning and invasive approach to the monitoring of firms' business plans and strategies, requiring greater information key areas of risk such as liquidity. The measures are summarised as:

- Work with its international counterparts to strengthen capital and liquidity requirements – the rules that banks must follow to ensure that they have sufficient financial resources to deal with the risks that their business involves – for example, by:
 - Increasing the quality and quantity of capital held by banks;
 - Increasing the capital requirements for riskier trading activities;
 - Introducing a backstop “leverage ratio” that ensures minimum capital levels are maintained, to stop banks from becoming over-extended; and
 - Increasing the focus of regulation on liquidity – the extent to which bank assets can be turned into cash, if necessary – alongside the ongoing strengthening of the capital regime;
- Continue to increase the effectiveness and intensity of its supervision of banks, monitoring their business and their risk to ensure that they remain stable and secure, through the FSA's Supervisory Enhancement Programme (SEP) including:
 - Increased regulatory resources in the FSA;
 - Increasing focus of these resources on large, complex, “high impact” firms;
 - Focusing on the business models and strategies of firms, as well as the systems and processes they put in place to support them;
 - A shift in the approach to the assessment of approved persons, with a focus on technical skills as well as probity; and
 - Investments in specialist skills, with supervisory teams able to draw on enhanced central expert resources;
- Reduce the incentives for excessive risk taken by banks by tackling the problem of bankers' pay and bonuses, so that they are effectively rewarded for long-term, sustainable growth, not short-term, paper profits. The FSA is consulting on a Code to cover remuneration practices, and will be incorporating this Code into its regulatory guidelines.

The Turner review

Lord Turner, the Chairman of the FSA since September 2008, conducted a review of the supervision of financial services firms.⁵⁹ His Review and an associated discussion paper (FSA, 2009) provides a comprehensive exposition of the crisis, particularly as it hit the UK, and of the regulatory shortcomings. The 32 principal conclusions from the

review are included as Annex 5.A1, since much of the Review contains proposals for regulatory change rather than changes that have actually been implemented. However, many of these changes in any case require international co-ordination if they are to be implemented and cannot be undertaken satisfactorily by the UK authorities acting unilaterally. The review maps a series of reforms to regulatory structure and practice, covering

- improved capital adequacy, with counter-cyclical buffers and a maximum gross leverage ratio as a backstop to restrict excessive growth
- liquidity regulation of matching importance to capital regulation
- regulatory coverage that matches the principle of economic substance and not legal form
- extension of regulation to all significant unregulated financial institutions such as hedge funds
- comprehensive deposit insurance coverage (implemented)
- an SRR (implemented)
- supervision of credit rating agencies particularly in regard to structured finance
- remuneration restructured to avoid incentives to risk taking
- clearing and central counterparties for standardised CDS contracts
- macroprudential analysis in collaboration with Bank of England and IMF
- implementation and enhancement of the FSA's Supervisory Enhancement Programme (discussed in the previous section)
- improvement of international co-ordination of bank supervision through:
 - supervisory colleges and pre-emptive development of crisis co-ordination and contingency plans;
 - requirements for greater capitalisation of subsidiaries;
 - a new independent European level body with regulatory powers and a focus macro-prudential analysis to replace the Lamfalussy committees;
 - reforms to EU deposit insurance to ensure prefunding and to limit the right collect deposits through foreign branches.

The Discussion Paper associated with the Turner Review translates each of the bullet points into proposals on which comments are requested. On the whole these proposals are fairly general. A notable feature of his Review is its rejection in its underlying analysis of much of modern finance theory. This has as yet attracted little comment.

The Government's White Paper

In July 2009 the Government published its white paper *Reforming financial markets* which endorsed the Turner Review. It also proposed the transformation of the Tripartite Standing Committee of Chancellor of the Exchequer, Governor of the Bank of England and chairman of the FSA into a Council for Financial Stability of the same three parties, chaired by the Chancellor of the Exchequer. The CFS would be established on a statutory basis and would publish minutes of its meetings. The existing “Financial Stability Report” by the Bank of England and the ‘Financial Risk Outlook’ by the FSA would form the basis of the work but they would be extended by suggesting what should be done to counter the risks identified. The proposals are intended to clarify responsibility for financial stability and improve co-ordination between the authorities.

The main proposals for trying to prevent a repeat of the present problems fall under four headings:

- more effective prudential regulation and supervision of firms;
- greater emphasis on monitoring and managing system-wide risks;
- greater confidence that the authorities are ready and able to deal with problems when they do arise; and
- greater protection for the taxpayer when an institution needs to be resolved.

The first of these is to be achieved by extending the FSA’s powers including given it an explicit objective of maintaining financial stability – thus both the Bank of England and the FSA will have this responsibility but approaching it from different directions, the FSA from its responsibility for individual institutions but now placing more emphasis on system wide issues. The FSA will get new powers not just to make new rules but also to discipline non-compliant institutions. The White Paper recognises that the 2009 Banking Act has been rather more successful in organizing the resolution of small banks than for the large systemically important ones and argues that the authorities must ensure that processes are in place for resolving each of them should they be required. Furthermore since the risk of using taxpayer money is greater in these cases they should be subject to stronger regulation than the smaller banks. The White Paper rejects the idea that there should be a limit to the activities that such banks can undertake in order to limit their complexity, unless this were part of an international agreement. Acting unilaterally would simply damage their competitiveness in the international markets in which they operate.

Other proposals tackle various aspects of the increased risks that have been observed, including limiting counterparty risks in derivative markets by encouraging central counter parties and commodifying the products where possible. In encouraging the use of a leverage ratio as a backstop and cyclically varying requirements in addition to the enhanced capital and liquidity buffers, the White Paper reviews the ideas for having special access to capital either through insurance or junior debt that can be converted into equity in the event of a problem and hence effectively increase the capital buffer.

The White Paper also raises a structural issue, namely the division of responsibility between the Office of Fair Trading (OFT) and the FSA. The OFT is responsible for second mortgages for example. If a regulated institution sells its mortgage book it may sell it to an unregulated institution thus leaving the mortgagor with less protection. It seems likely that the responsibility will be concentrated on the FSA. The White Paper invites comments by 30 September, after which more concrete proposals and draft legislation can be expected.

Short-selling

When the crisis was at its height the stocks of various of the banks came under pressure as stockholders faced rumours about the possible future losses. These stock price movements were enhanced by the practice of ‘short-selling’ which is the undertaking of contracts where the seller does not currently own the securities but seeks to obtain them before the settlement date, if needed at what the seller hopes will be a more favourable price. On 18 September, after the Lehman collapse but before emergency measures were needed for UK banks the FSA banned short selling in financial sector stocks for the period up to 16 January until such time as markets calmed down. Some authorities view the practice of short selling as undesirable per se but the FSA viewed this only as disruptive in extreme conditions. The FSA has however extended the requirement to disclose significant⁶⁰ short positions to the market.

Wider regulatory change

While the present crisis has led to extensive regulatory change in financial services, this has not been seen as part of a wider regulatory failure except perhaps in the area of corporate governance. However, the UK has taken a lead in trying to improve corporate governance generally, with the Cadbury Review appearing in 1992 at the time of the ERM crisis. However the timing is coincidental and reflected a number of corporate governance failures in the preceding years. Nevertheless, these concerns have continued in recent years. The issue of directors’ remuneration was tackled explicitly by the Greenbury Committee in 1995. However, while this tackled the process by which remuneration should be determined in an effort to prevent people deciding upon their own salaries, it did not resolve the widespread feeling outside that remuneration in many cases was excessive. Further reviews, notably by Hampel in 1998, have led to the promulgation of a Combined Code, initially in 2003 that provides the guidelines for registered companies in the UK.

It is also noticeable that the change in government in 1997 did not lead to any striking change in arrangements for regulation outside the financial sector, with the creation of the FSA and the removal of prudential regulation of banks from the Bank of England. One area of change was labour market regulation, with the introduction of a minimum wage and the attempt to broker a new deal so as to offer a better incentive structure and active job search and training assistance and remove people from long-term unemployment and benefit.

The net costs of the regulatory reform efforts and the resources needed for development and implementation

It is difficult to assess the costs or indeed the benefits of the regulatory reforms in any accurate manner. The gross cost of the support for the financial system can be assessed but the cost of regulatory reform can only be assessed in two obvious ways. The first is simple to look at the increase in the numbers of staff involved, some 280 in the FSA alone, with expansion also in the Bank of England. Such reforms require an impact assessment which may prove useful in adding some quantification and there may be some scope for estimating opportunity costs.

The FSA Discussion Paper accompanying the Turner Review has an Appendix entitled ‘The costs and benefits of regulatory capital requirements’ (where the quantitative work has been done by the NIESR), which describes the problem neatly. It is possible to make an assessment of how much capital requirements may cost simply in terms of the cost of finance. Obtaining the extra capital imposes a cost. But it has secondary indirect costs. The first is the cost of the finance provided to others goes up and hence there will be less lending and borrowers will find their activities less profitable. Since capital requirements will increase spreads the NIESR argues that there may also be a loss to savers. If this were the only effect, NIESR estimates that the cost to the economy over the period since 2001 might have been as much as 8% of GDP. This is a very substantial cost and reflects the importance of such bank finance to the development of the economy.

However, this form of analysis implies that there is no downside risk and hence that the regulation is just a burden. It assumes, in other words, that the additional capital simply slows growth. It may smooth it, preventing “busts” as well as reducing booms. If we assume that having the extra capital enables banks to manage risk better so that they can absorb adverse shocks and hence the strong downturn of the crisis is avoided then the gain may be substantial. If we look at the net losses in crises then numbers as high as 50% of GDP can be obtained (Hoggarth and Saporta, 2001) and NIESR suggest that a figure as high as 30% is possible. Unfortunately this is entirely speculation as the collapse of banks comes not so much because they do not currently have enough capital or indeed liquidity to meet present demands but because counter parties fear that they may not have in future and hence either fail to roll over funding or withdraw their capital. Hence one has to simulate confidence to make these net estimates plausible. Further, while it seems clear that volatility is costly it is not clear that structural adjustment can be more readily achieved without some form of major downturn. Thus both the recession of the early 1980s and the ERM crisis may have been important steps in achieving a faster rate of growth for the UK economy. It is unlikely that the changes in the years after 1979 would have been achieved unless they had been concentrated as the political support for change would have evaporated had there been a period of slow growth and no sharp recovery. As it was the subsequent growth more than offset the downturn both in 1979 and in 1992. It might appear at present that the current downturn was so deep that it is difficult to see it being offset either by future growth or a portion of the past growth that would not otherwise have taken place. The case of the Finnish crisis that occurred at the same time as the ERM crisis is instructive. The Finnish economy was hit even harder than the UK economy in the present crisis (unless forecasts are completely erroneous) yet the subsequent recovery between 1994 and 2008 has provided Finland with a period of unparalleled growth even despite the substantial current recession because of the decline in demand for exports.

There are thus no simple answers that are not context dependent. Expected values are not going to be very helpful assessments of tail events where probabilities are difficult to assess. There is however one obvious cost for a bank that gets into difficulty. Even if it obtains finance from the state it will pay a risk premium for a number of years for its capital after a serious downturn. Even those banks that have managed to recapitalise themselves through the market have paid substantially more for both debt and equity than they would in normal times. It is arguable that larger buffers are required now to restore public confidence even though there was extensive public confidence before the crisis with the lower buffers and indeed even if the buffers are practice of no use in offsetting the risks that the banks chose to take over the coming few years.

One item that is of considerable interest in the UK case is the impact of the new Special Resolution Regime (SRR). Granlund (2004) shows that where people think that banks will not fail, as in Germany, because there is intervention either by the rest of the banking system or by the taxpayer this will have a noticeable impact on funding costs, perhaps by up to 50 basis points. The SRR now makes it less likely that smaller banks will be bailed by the taxpayer although it is moot whether they will the chance of a private sector solution less or more likely. Theory suggests that a private sector solution becomes more likely when current owners and managers know there is no chance of a taxpayer bailout. The only way they have to retain at least some value in their equity or possibility of keeping their jobs is to agree a sale, even at a disadvantageous price. Since the position of the larger banks is still in doubt it is difficult to assess the outcome. If a ‘shelf-bankruptcy’/‘living will’ approach is followed then one could expect the cost of capital to increase as the implicit subsidy is removed. If this is simultaneous with an increase in the amount of capital that has to be held then costs will rise from two points of view.

It is rather easier to examine the detailed impact of the different forms of support given to failing or troubled banks and how this can be assessed in the future. Unlike the US the UK has not got a specific objective in the SRR such as minimizing the cost to the FSCS. Hence it will be more difficult to assess the success of policy against any specific criterion but it is possible just to set out how the costs and benefits accrue. For example if one adopts the Modigliani-Miller theorem as a simplifying assumption and restructuring simply takes the form of swap of debt for equity (as would be the case under New Zealand’s Bank Creditor Recapitalisation in their SRR) then the only loss to society as a whole is the original loss that places the bank in difficulty. However, the nature of the return to the government will change according to whether their holding is debt or equity or indeed debt that becomes equity upon failure to pay. If equity is used then the government has a stake in the upside gains. Secondly it is normally accepted that the dead weight loss will be greater if the bank is dismembered rather than being sold as a going concern. Not only is the progressive selling off of the assets by a receiver more expensive in terms of the fees but the asset prices tend to be lower. The SRR clearly makes it easier to organise the resolution process in such a way that assets are sold on a going concern basis.

The government has undertaken an impact assessment of the likely costs of the further measures set out in the White Paper “Reforming financial markets”.

The major gain is seen as coming through the programme of consumer education entitled ‘Money Guidance’ which is designed to make sure that those below median income get better advice so they can avoid taking on unmanageable debt burdens. Experience in other countries suggests that it is very difficult to increase financial literacy so these gains maybe optimistic. The costs are to be financed partly through the industry and partly directly by the taxpayer. These gains come both from better quality information and from avoiding the costs of bad decisions. These costs apply not just to the consumers but also to the providers as they have fewer problems to unwind. The taxpayer also benefits to the extent that with better advice and decision making, consumers will be better off and hence less reliant on pensions and other government support for those on low incomes. The other area of any significant benefit comes from the disclosure regime for short selling. While the FSA still has the powers for an outright ban the review argues that simply have disclosure of all significant short selling position will make it easier to raise capital and hence avoid the costs of failed capital raising exercises.

Table 4.2. Summary of costs and benefits

Policy proposal	Total cost (PV)	Total benefit (PV)	Net benefit (NPV best estimate)
Additional powers for FSA to suspend and fine certain persons	£9m	£31m	£22m
Short-selling powers	£61m	£912m - £9,176m	£4,132 m
National roll-out of money guidance (Time period = 52 years)	£1,374m -£2,659m	£24,662m -27,914m	£24,248m
Consumer education body (Time period = 52 years)	£24m	The benefit of the consumer education body is contained within the overall benefit for money guidance. There will also be additional benefits which are non-monetised at present.	
Collective redress	£452m	£1,549m	£1,097m
Expanding the role of FSCS to facilitate payment to UK customers if foreign banks default.	N/A	£1m	£1m

Note: Time period used for present value calculations is 10 years unless otherwise specified.

Source: HM Treasury (2009), *Reforming Financial Markets*, July, London.

Measures undertaken to address sectoral challenges

The emphasis in the present crisis has been focused on the financial sector. While other sectors have got into difficulty as a result of the downturn they have not in general been subject to special intervention. The problems with one of the rail operation franchises for example has merely been the exercise of existing provisions for handling failure to perform at the agreed standards. However, the government has encouraged people to trade in environmentally unfriendly motor cars, which has acted as a stimulus for the heavily depressed motor vehicle industry. This scrapping scheme involves a GBP 2 000 subsidy from the purchase of a new car or van, when an older model is traded in at the same time. It comprises GBP 1 000 from government with matched funding from vehicle manufacturers. The scheme was officially launched on 18 May and will run until March 2010 or until the government funding has been used. By 10 August over 150 000 new cars had been purchased under the scheme contributing to a 13.5% jump in car manufacturing and the first growth in new car registrations since April 2008.⁶¹

Given their ability to influence the banking system through their provision of support, the government has attempted to use it in a number of directions. First they have encouraged the maintenance of lending to SMEs, which have few lines of access to finance other than bank lending. Second, they have tried to limit the impact on the housing market by trying to get banks to maintain lending at 2007 levels.

While there has been some surge in infrastructure spending, with the bringing forward of public sector capital projects as part of the macroeconomic stimulus, the infrastructure of the financial sector, such as the payment system, has stood up well under the crisis and not required intervention.

Strategies for cutting red tape, facilitating market entry and exit and restructuring the economy

The changes made have had little impact on the ease of entry, although the increased concentration in the industry both with the creation of the enlarged Lloyds Group and the takeover of a number of smaller building societies by the Nationwide will make entry more difficult. In any case the building society industry has been in slow decline compared to the banks for some time and the new capitalisation measures imposed on some of the weaker building societies may well act as a threat to their mutual status. However, if the proposals of the Turner Review are carried through at European level there will be a requirement to ensure that the organisational form of any foreign-owned financial institutions will be such as to ensure that the UK authorities can maintain financial stability. This would effectively prevent foreign banks from running their operations in the UK through significant branches and would require them to use properly capitalised subsidiaries. It would also inhibit the ability of banks to run highly integrated operations across borders in such a way that the operations in individual countries cannot be resolved separately.

The emphasis is very much on facilitating exit rather than entry as the problem experienced during the current crisis is that it has not been possible to allow significant banks to fail. It has been possible to dismember smaller institutions, such as the Dunfermline Building Society and Bradford and Bingley but larger institutions have been dealt with by purchase of preference shares (or merger) thereby allowing the existing shareholders to continue to maintain their interest. However, it has not been suggested that the major UK banks actually became insolvent, simply that they became serious undercapitalised to the extent that in many cases it was not possible to obtain the necessary extra capital from the private sector.

The Special Resolution Regime goes a long way towards being able to achieve orderly exit for the general run of banks but this is insufficient for the larger banks. Thus far there has been no agreement on the way forward and the Bank of England and the FSA are proposing different approaches. The Bank of England does not believe that any bank should be too big to fail and is approaching the problem directly by arguing that for any bank to be allowed to operate it must in effect be able to say how it would be resolved in the event of failure. Thus it must have structures that are sufficiently transparent and simple that essential functions can be maintained, whether through transfer or through a bridge bank while the less essential can be unwound as in any other insolvency. This is akin to the concept of ‘shelf bankruptcy’ proposed by Rajan (2009) and has been described by the Governor of the Bank of England as a ‘living will’. A different version is used in New Zealand where all of the significant banks (as determined by the regulatory authority) have to organise themselves and their contractual arrangements in such a way that should any essential function fail, be it provided by a third party or the parent (as all such banks are foreign owned) it or a statutory administrator under the authority’s control can be restarted within the value day so that there is no effective break in services. The FSA on the other hand is arguing on the basis

that there is no alternative to public support in these circumstances and that banks that are too big to fail should instead both hold enough capital to reduce the risk and effectively pay for that protection. These approaches are not mutually inconsistent.

Clearly some arrangement of this form for handling large complex financial institutions is required as otherwise small and larger banks are not treated equally and the larger have an advantage on the one hand making entry more difficult and on the other encouraging merger so as to achieve this status of ‘too big to fail’. The implication of the Bank of England’s approach is that some of the larger banks might be broken up. One issue that has not been picked up by the government is whether there should be any attempt to create a number of narrow banks that do not take on the riskier activities or to insist that banks offer no risk, fully insured accounts, where the funds are only used for a limited range of purposes. This might imply some form of return to Glass-Steagall style restrictions which inhibited the international competitiveness of many US banks and such suggestions have been floated.

Notwithstanding the damage caused to the real economy by the financial crisis, there is little evidence of a significant will to diversify the economy away from the financial sector.⁶² However, the Budget 2009 did however announce a package of measures to ‘support the adjustment towards renewed economic growth and improve the UK’s competitiveness, including a GBP 750 million Strategic Investment Fund to support advanced industrial projects of strategic importance, of which a third of the funding will be earmarked specifically for low carbon projects’.

The overall impact of the regulatory reform strategy on crisis recovery and enhanced economic resilience

The reforms implemented thus far focus on the Special Resolution Regime and hence are likely to have a major impact on the ability to recover from crises and also to increase resilience in part by decreasing moral hazard as it is now clear that there are plausible powers in place to resolve banks without bailing out the shareholders or junior debt holders. Both of these groups and the managers that would lose their jobs will have a strong incentive to monitor the risks the bank is running and ensure actions are taken if the risk management appears weak. However, the SRR is only part of the package of change and most of the other reforms to make the chance of future crises lower are still in the process of implementation or agreement.

The banks face the usual problems of deleveraging, enhanced by the higher capital adequacy standards that are being introduced and this will tend to hold back recovery until it is fully implemented. By choosing a forthright approach to resolving the crisis the UK authorities have maximised the chance that it will be short lived but much of the length of the crisis will depend on the resilience of demand in the rest of the world and hence is outside the UK’s control except insofar as it can exercise influence in international fora. It is also normally accepted that short sharp recessions tend to be less costly in the long run than shallow protracted ones, as then the expectations and behaviour have time to adapt, the newly unemployed become unemployable without extensive retraining, capacity is permanently lost rather than moth-balled and people adjust to a lower standard of living.⁶³ This approach has been facilitated by the switch to inflation-targeting monetary policy, which, since it is forward-looking can respond rapidly to changes in demand pressures. The same policy tends to head off recessions, as is clear from Figure 4.1, where despite the shocks since the ERM crisis, particularly the

collapse of the dot-com boom, GDP has continued to grow.⁶⁴ Part of the ability to respond to shocks depends on flexibility – the ability to switch resources across sectors. This requires both flexible capital markets, which the UK clearly has established and flexible labour markets, where the UK is more flexible than some of its European neighbours, with greater ability to use short-time working, for example, in order to ride out a short downturn with the minimum number of redundancies.

The combination of the intervention by the Bank of England in widening the opportunities for liquidity both by expanding the quantity and the range of assets that it is prepared to accept as collateral in its various operations and the direct guarantees to the banking system mean that the chances of recapitalisation for those that merely face the closure of wholesale markets is considerably enhanced. Despite the alarming extent of the crisis it is still the case that the majority of the banking system has only required external help in getting markets operating again rather than direct intervention. It is therefore just a matter of time before recovery can take place. Even with the other large banks, RBS and the new Lloyds Group the problem has largely been one of acquiring new capital given the extent of the losses and not insolvency. The chances of being able to sell the government's shares at a good profit are therefore considerable. The outright failures: Northern Rock, Bradford and Bingley, Dunfermline Building Society and the Icelandic banks are few in number and not extreme in cost.

A comparison the past strategy in terms of regulatory reform to the response to the current crisis

The ERM crisis did not generate rapid regulatory responses with the exception of exiting from the ERM itself. Extra measures were not deemed necessary beyond the normal fiscal responses and an enhanced focus on the labour market. Since the present crisis is primarily a financial crisis, although other factors contributed, where regulatory failure was one of the most important contributions, it is therefore not surprising that regulatory reform is playing a major role in the response to the present crisis. For while crises may be inevitable there are many aspects of the present one that could have been avoided even if existing regulation had been applied more effectively. Hence much of the change is being applied within the FSA rather than changing the entire framework except in the case of problem resolution. More substantial reform of institutional powers and responsibilities is not excluded in the longer term.

Role of competition policy

The role that competition policy and law enforcement played in coping with the crisis and in exiting from it.

The intervention in the banking sector has been unprecedented, comprising:

- nationalisation
- extensive preferential shareholding
- assisted merger
- assisted transfer of undertakings

- the creation of bridge banks
- loans

Hanging over the whole discussion has been the idea of ‘too big to fail’. Prior to the new Banking Act 2009 the authorities had few options for handling a large bank that got into difficulties. If the continuing operation of many of the functions of the bank was thought necessary in order to preserve financial stability, there was little alternative to some form of open bank assistance or even outright nationalisation as in the case of Northern Rock.

The extent of focus on trying to preserve functions of financial companies very much reflects the structure of the Enterprise Act of 2002, that governs competition law in the UK, insofar as it revises bankruptcy law in an effort to reduce the number of cases where the company is simply dismembered and the parts sold for the greatest benefit of claimants. The Act seeks to increase the ability to sell all or part of the company as a going concern, thus not only preserving employment but avoiding unnecessary closures and loss of skills and destruction of useful capital. The UK has no equivalent of Chapter 11 in the US bankruptcy code under which a firm can obtain period under which it can try to organise a workout of its problems, while being protected from its creditors. While the creditors must approve the proposal for it to be implemented, the firm continues under the existing management until that point is reached – and may continue to do so under the terms of the agreement. The bulk of the Act covers fair trading and the rules for mergers and acquisitions, heavily influenced by the structure of EU competition requirements.

Nationalisation

Outright nationalisation was applied in the cases of Northern Rock and Bradford and Bingley. In the case of Northern Rock, the firm was nationalised in its entirety after the firm itself had first tried to find a buyer or substantial investor in the period from the time difficulties became clear in the second half of 2007 up to the point that it required emergency lending and suffered the run in September. Thereafter the government participated in the attempt to find a buyer as it then had exposure to the bank. Although interested parties were found it was not possible to obtain a suitable deal that did not effectively result in the government bearing much of any first loss and the acquirer then obtaining the gain, offset by any further losses. Not surprisingly therefore the government concluded that if it had to bear the first loss it should participate fully in any potential gains and therefore took over the bank under the terms of the Banking (Special Provisions) Act 2008, which was enacted in February 2008 to enable this. Northern Rock was judged to be too large simply to fail and the Special Resolution Regime was not then in place.

The other outright nationalisation related to the second bank to reach the point of failure but on this occasion the authorities saw the problem coming and were there able to implement a resolution under the Special Provisions Act as a forerunner to the full SRR. This bank was Bradford and Bingley in September 2008 as the crisis reached its high point. The government chose to nationalise the bank and then sell the savings business and branch network to the Santander Group, who would operate it through its UK subsidiary, Abbey. This left the government holding the mortgage and loan portfolio. The government has paid for the insured deposits through the FSCS, which will recoup the cost from the banking industry, as needed; under the normal ex-post funding arrangement

with the banking industry that scheme follows. The uninsured deposits have been covered by a transfer from the Treasury. As the loan and mortgage portfolios are wound down then it should be possible to repay the Treasury and the other claimants. A guarantee was issued to cover all but the junior claimants. This route was followed as the government did not regard Bradford and Bingley as insolvent but merely unable to raise sufficient capital to continue as a bank – the FSA determined that it no longer met the threshold conditions.

Extensive (preferential) shareholding

In the case of the merged Lloyds-HBOS and RBS the problem was that both banks were making extensive losses and further losses were expected. The banks therefore became undercapitalised and needed to raise further funding in October 2008 when the crisis was at its height and funds for bank recapitalisation difficult to come by. The government decided that the only way that these two banks were likely to be able to raise sufficient capital was through the government taking a stake. As these banks were not entering a resolution process they had to agree to the injection of capital. In the case of the Royal Bank of Scotland after it had attempted to raise funding through a rights issue when this failed the government stepped in October 2008, purchasing GBP 5 billion in preference shares and underwriting an issue of GBP 15 billion of ordinary shares. In the event almost none of these ordinary shares were taken up so the government ended up owning some 58% of the bank. As noted below this holding has been increased as a result of RBS's participation in the Asset Protection Scheme (APS). The preference shares were converted into ordinary shares in January 2009 with the agreement of UKFI (discussed below) which manages this shareholding (and that in Lloyds Group) on behalf of the government.

The case of Lloyds-HBOS was more complicated and had two stages. In the first instance, HBOS, which was making substantial losses, decided that the only route to survival was merger with a stronger partner. It quickly concluded negotiations with Lloyds-TSB in September of 2008 shortly after the Lehman Brothers collapse. The shareholders of the two companies agreed in November and December and the new Lloyds Banking Group incorporating HBOS was formed in January 2009. In the second phase, at the same time as the government injection in RBS in mid-October, the government purchased GBP 4 billion in preference shares and GBP 13 billion in ordinary shares in Lloyds-HBOS. This represented a shareholding of 43% and not a majority holding as in RBS. The preference shares, while non-voting, attracted a premium on their return. As a result Lloyds took the opportunity in June 2009 when prospects had improved to buy back the preference shares and pay for them with a rights issue, 87% of which was taken up by existing shareholders and the remainder successfully placed in the market. However, Lloyds also participated in the APS, which involved the sale of further shares to the government to cover the cost.

Assisted merger

As described above the merger of Lloyds-TSB and HBOS was not assisted per se, although the government was pleased to see it take place, as it removed a likely major concern in the form of HBOS, a very large bank, failing. As noted below the Secretary of State intervened and permitted the merger on the newly legislated public interest ground of maintaining the stability of the UK financial system⁶⁵, although the OFT has raised some reservations about its impact on competition. It is debatable whether the share

injection, just described, should be viewed as support for the merger. The injection was known at the time the two groups of shareholders agreed to the deals, although the agreement in principle to merge had taken place nearly a month beforehand.

Assisted transfer of undertakings

On the failure of Heritable Bank (a Landsbanki subsidiary) and Kaupthing Edge (a Kaupthing subsidiary) in early October 2008, the deposits were transferred to ING Direct and the rest of the bank placed in administration, with the deposits being covered by the FSCS. Similarly in the case of Dunfermline Building Society, which is discussed next, its deposit and mortgage business were transferred to Nationwide.

The creation of bridge banks

With the exception of the Dunfermline Building Society the transfers were made under the 2008 Special Provisions Act whereas Dunfermline was the first resolution undertaken using the framework of the 2009 Banking Act. Here an additional technique was used as part of Dunfermline was transferred to a new bridge bank set up by the Bank of England to manage the social housing part of the portfolio while a suitable buyer was found. As social housing portfolios can only be managed by agreed institutions this transfer was more difficult to engineer than the transfer of the mortgage and savings business. On 1 July 2009, the Bank of England sold the social housing portfolio to the Nationwide building society.

UKFI

The UK government now owns the entirety of Northern Rock and the rump of Bradford & Bingley, as well as majority shareholdings in Royal Bank of Scotland and Lloyds Banking Group raising obvious questions of competition policy. The government has gone to some trouble to ensure that it behaves as a normal shareholder, following commercial principles, by placing all its shareholdings in the bank in an arms-length institution labelled UK Financial Investments, set up in November 2008. Northern Rock and Bradford and Bingley are not currently overseen by UKFI pending the conclusions from the EU competition authorities and are currently still under more direct control by the Treasury. The objective of the company is to ‘protect and create value for the taxpayer as shareholder, with due regard to financial stability and acting in a way that promotes competition’ while also ensuring that the banks they own provide “competitively priced” loans to small businesses and homeowners “at 2007 levels”.⁶⁶

The intention is to return to the banks acquired to private ownership “The Government will not be a permanent investor in UK financial institutions and will over time seek to dispose of the investments in an orderly way, through sale, redemption, buy-back or other means, in accordance with the Urfa’s objectives.” In addition, the basis on which nationalised banks are returned to the private sector is of importance. The OFT considers that promoting choice and competition would need to be an important element of any impact appraisal by Government when deciding the basis on which the banks are returned to the private sector, or where any alternative routes are contemplated.

However, the extent of the arms-length arrangement is somewhat unclear as the government has also made plain its determination to try to influence the governance of the banking system – in particular its behaviour with regard to remuneration. The

discussions thus far have been more in terms of moderating the system of remuneration rather than in trying to ensure that it should be less pro-cyclical and short term in character. However, it is normal practice for large commercial shareholders, such as pension funds, to express views on this subject

The Walker Review

Corporate Governance has been viewed as a major issue leading to the present crisis and therefore the UK government has ordered an independent review chaired by Sir David Walker, focusing specifically on the risk management of banks. The final report is not due until November but the interim report was released in July (Walker, 2009). The decision over which recommendations to implement and the means of doing so will not be made until the final report is released. The interim report contains some 39 recommendations under five headings:

- board, size, composition and qualifications

Here the main recommendations are to ensure that all board members are properly qualified (fit and proper persons, as assessed by the FSA) and non-executives devote sufficient time and are given sufficient resources to undertake their task properly. How the ‘fit and proper’ test will be implemented is not yet clear. In the past it focused primarily on probity. While that is an important attribute of a bank director it is not however the only one.

- functioning of the board and evaluation of performance

This section reflects the conclusion in the report that it is not some much what boards do but how they do it. Hence more diligence, better leadership and more self evaluation is called for.

- the role of institutional shareholders

A different way of casting the task of the Walker Review is to suggest that it needed to make suggestions as to how market discipline could be made to work better. In this section the main conclusion is that the institutional shareholders should endorse and act upon the best practice principles for good stewardship that have already been developed.

- Governance of risk

The report advocates the establishment of a board risk committee to whom the Chief Risk Officer (CRO) in the bank reports direct and that the CRO should only be subject to dismissal by the board and not by the CEO.

- Remuneration

Remuneration is the area that has attracted by far the most popular attention in view of the large bonuses/pensions that have been awarded where executives have performed poorly. The review focuses on those executive members whose remuneration exceeds the median of that group. It requires not only that they should have a stake in the company at least equivalent to their accumulated

income but that at least half of their pay should take the form of long term incentives where at most half is vested after three years and the remainder after five. Shorter run incentives are also permitted. Not surprisingly there is a strong emphasis on transparency and the adoption of clear principles. No evidence has been adduced to support the proposals on remuneration.

The white paper on reforming financial markets

Chapter 9 of the White Paper addresses competition issues. It acknowledges that both the OFT and the Competition Commission have identified ‘significant barriers to entry’ and suggests that state assistance has led to some businesses continuing when otherwise they would have failed. It there proposes to take action on four fronts

- ensuring that new rule-making pays full regard to the issue of market access
- supporting competition and choice, particularly through ensuring a strong mutual sector, through transparency and by ensuring that switching is not unnecessarily impeded
- intervening where the market does not provide, through the Innovation Fund and through social investment
- ensuring an orderly exit from its interventions particularly the sale of the equity stakes.

The White Paper suggests that the low frequency with which people change the banks that provide their services indicates a lack of competition in the industry, although not one that is exacerbated by the degree of concentration in the industry. It is simply a consequence of the switching costs some of which are set up for completely different purposes, such as anti-money laundering. The OFT market study on Personal Current Accounts (PCA) as well as the Competition Commission report on the supply of banking services by clearing banks to small and medium-sized enterprises (SMEs) highlight that these markets are characterised with high barriers to switching. In the OFT market study on PCA it was found that a significant proportion of consumers believe that it is complex and risky to switch accounts, with the result that switching rates are very low. In essence, the OFT reported that the market may be stuck in an equilibrium that does not work well for many consumers. A significant number of consumers do not know how much they will effectively pay in bank fees or how individual elements in the charging structure will be implemented, either before or after they are incurred. This limited understanding of key account elements, combined with low confidence in switching, means that the banks have less incentive to provide better offers on insufficient funds charges and interest. Without better offers from banks, however, consumers have little incentive to switch. The CC report found the markets to be characterised by a reluctance on the part of SMEs to switch banks, the reasons for which included the perceived complexity of switching for little financial benefit; the perceived significance of maintaining relationships with a particular bank or particular relationship manager; and the ability of the existing bank to negotiate lower charges or otherwise respond if there is a threat of switching. The government is planning a review to see which of these costs can be reduced.

Of the government's various schemes for the support for banks, the Special Liquidity Scheme ends by January 2012, the Credit Guarantee Scheme ends in October 2009 and the securities issued under it will mature by April 2014, the Asset Backed Securities Guarantee Scheme only lasts six months, expiring in October 2009 although the guarantees themselves last 5 years and the Asset Protection Scheme for Lloyds and RBS as also fixed term. The Asset Purchase Facility, which operates both for extending monetary policy and for reopening credit markets will extend until the need recedes, while the RBS and Lloyds shareholdings will be sold 'as soon as possible'. 'It is likely that this will take some time' but disposals will be progressive where three criteria will be borne in mind:

- protecting and creating value for the taxpayer
- financial stability
- promoting competition

Competition law enforcement

The principal change that took place was the introduction of a new public interest ground under section 58 of the Enterprise Act 2002 (the Act) – maintaining the stability of the UK financial system – which enabled the Secretary of State to allow the merger of Lloyds TSB and HBOS. Some previous attempts by Lloyds to expand had been blocked on competition grounds and it may still be the case that the EU competition authorities will insist on some divestment. Indeed Lloyds itself will probably take such steps so that it can chose the disposals that make best business sense. It is not completely clear how this 'financial stability' public interest ground will be applied in practice as assessing the affects of indirect contagion is extremely difficult to do in quantitative terms. It is possible to make an assessment of direct contagion by looking at the importance and interconnection of a particular institution in the rest of the financial system. Indirect contagion, however, is a matter of confidence. While it is possible to model this, most readily by considering a form of regime switching and models that permit multiple equilibria there has until the present crisis been a lack of suitable data. Such models are being increasingly used in stress tests and hence some quantification will be possible in exercising this particular defence in future. In the new arrangements both the Bank of England and the FSA have an explicit objective in regard to maintaining financial stability so their analyses will be relevant in this regard. The proposed Council for Financial Stability may also be a suitable vehicle for high level appraisal.

Cartels

Cartels achieved a bad reputation in the US in the recovery from the Great Depression and there has been no easing of the rules in this regard on the present occasion. The increased concentration in the financial industry will make cartel like activity somewhat easier but there is no indication the OFT and the Competition Commission will be any less vigilant in their efforts to combat it. The activities of the European Commission in this regard lie outside the UK's competence and for cartels that run across countries it is the attitude of the EU authorities that will apply.

Mergers

In the building society sector there has been clear encouragement of merger to resolve problems, with the largest building society, Nationwide, resuming its acquisition of smaller troubled building societies,⁶⁷ assisted in one case in the resolution strategy.⁶⁸ In the banking sector there is also one very clear example with the merger of Lloyds-TSB and HBOS. The Lloyds-HBOS merger was facilitated by a change to the Enterprise Act which added ‘maintenance of the stability of the UK financial system’ to the public interest considerations that could be taken into account by the Secretary of State for Business, Enterprise and Regulatory Reform when deciding whether to allow a merger to proceed on public interest benefits grounds.

On 18 September 2008, Lloyds TSB Group plc and HBOS plc announced that they had reached agreement on the terms of a recommended acquisition by Lloyds of HBOS. On the same day, the Secretary of State intervened in the case by issuing an intervention notice on public interest grounds to ensure ‘the stability of the UK financial system’. The notice required the OFT to investigate and report on whether it believed that it was or may have been the case that a relevant merger situation had been created and, if so, whether it was or may have been the case that the creation of that situation may have been expected to result in a substantial lessening of competition within any market or markets in the United Kingdom for goods or services. The Secretary of State requested the OFT to report to him by 24 October 2008. As part of its report, the OFT was also required to summarise any representations about the case that it received and which related to the public interest consideration specified in the intervention notice – namely the stability of the UK financial system. The Order specifying the stability of the UK financial system as a public interest consideration under section 58 of the Enterprise Act 2002 was laid before Parliament on 7 October. It was subsequently approved by the House of Lords on 16 October and by the House of Commons on 22 October, and came into force on 24 October.

The OFT argued that:

- there is a realistic prospect that the anticipated merger will result in a substantial lessening of competition in relation to personal current accounts (PCAs), banking services for small and medium sized enterprises (SMEs) and mortgages
- the OFT's concerns on PCAs and mortgages are at the national (Great Britain) level, while its concerns on SME banking services are focused on Scotland. In addition, the OFT cannot exclude competition concerns arising at the local level in relation to PCAs, SME banking services and mortgages,
- no further competition concerns are considered to arise in relation to the other identified overlaps between the parties in retail banking (savings, wealth management, personal loans, credit cards and pensions), corporate banking (banking services to large corporations, asset finance/fleet car hire) and insurance (PPI, life, general), and
- in the absence of any offer of remedies from the parties, it would not be appropriate to deal with the competition concerns arising from the merger by way of undertakings in lieu of reference to the Competition Commission.

However, one merger in particular, that between Abbey (owned by the Santander Group) and Alliance and Leicester, subsequently augmented by Bradford and Bingley's retail operations, indicates an increase in external competition. It has not so much been that external acquisition is discouraged simply that it would be difficult to organise except for the second-order banks, such as Alliance and Leicester and now virtually all such banks have been merged or, in the case of Northern Rock, taken into public ownership.

In many respects the present crisis has shown up the folly of excessive acquisition strategies in the past, particularly by the Royal Bank of Scotland, resulting in over-leverage. It is therefore highly likely that mergers will be discouraged by the leverage rules and indeed that divestitures may be required as a result of the wish to make sure that even large banks can be resolved effectively, so that none are too big to fail.

Failing firm defence

The OFT has applied the “failing firm” defence five times under the Enterprise Act 2002:

- Anticipated acquisition by First West Yorkshire Limited of Black Prince Buses Limited 26 May 2005 (failing firm defence met in respect of a bus business as a whole);
- Anticipated acquisition by Tesco Stores Limited of five former Kwik Save stores (Handforth, Coventry, Liverpool, Barrow-in-Furness and Nelson) 11 December 2007 (failing firm defence met in respect of individual local grocery stores);
- Completed acquisition by the CdMG group of companies of Ferryways NV and Searoad Stevedores NV 24 January 2008 (failing firm defence met in respect of target business);
- Completed acquisition by Home Retail Group plc of 2 leasehold properties from Focus (DIY) Ltd 15 April 2008 (failing firm defence met in respect of an individual DIY store); and
- Anticipated acquisition by HMV of 15 Zavvi Stores 28 April 2009 (failing form defence met in relation to four stores).

The OFT states that “as a legal and policy matter, the OFT will not, regardless of prevailing economic and market conditions, relax the ‘sufficient compelling evidence’ standard”. The OFT has made it clear that it will only clear a transaction based on 'failing firm' claims where it has sufficient compelling evidence that all of the following conditions are met.

- Inevitable exit of the target business absent the merger
 - The target business would inevitably have exited the market in the near future. This will often be because the business in question is in a parlous financial situation, even if not yet in liquidation, but may be for some other reason such as a change in the seller's corporate strategy.

- Having demonstrably explored such options, there is no serious prospect of the target business being reorganised; this takes account of the reality that even businesses in receivership often survive and recover.
- No realistic and substantially less anti-competitive alternative
 - There are no other realistic purchasers whose acquisition of the target business would produce a substantially better outcome for competition. Even if such a purchaser may not pay the seller as high a purchase price or otherwise benefit the target business, the OFT will take into account any realistic prospect of alternative offers above liquidation value.
 - Alternatively, in some cases it may also be better for competition that the target business fails and the remaining players compete for its market share and assets rather than being transferred wholesale to a single purchaser.

The most recent case in which the failing firm defence was applied by the OFT, HMV/Zavvi, was decided during the current crisis in June 2008. In that case, the OFT took into account the lack of liquidity in funding markets – a prominent feature of the current financial crisis – in deciding that there was unlikely to be a suitable purchaser willing to buy the entire the Zavvi business under the ‘inevitable exit’ limb of the test.

Where there is doubt as to whether the failing firm criteria are satisfied the OFT will refer the case to the Competition Commission and as in the case of *Thermo/GVI*⁶⁹ the acquisition can be unwound.

Merger legislation has also changed as the result of a private member’s bill permitting mergers between mutual organisations. Co-operative Financial Services and the Britannia Building Society are taking advantage are taking advantage of this. However, the proposal agreed in principle in January 2009 is still to be agreed by the members.

Government aid / subsidies

In the ERM crisis it was not necessary to use any extraordinary measures but in the present crisis most of the measures in the toolkit were used and the toolkit itself expanded. Throughout, since the UK is a member of the EU, all such measures were subject to scrutiny by the European authorities in Brussels. The EU authorities issued a set of guidelines early in the crisis⁷⁰ which were designed on the one hand to permit immediate action to preserve financial stability but on the other to ensure that the principles of fair competition and the avoidance of preferential state aid were adhered to. These exceptions to the normal rules, which include decision-making within 24 hours in the case of a failing bank, are set to expire in 2010 but would presumably be extended if the crisis deepened.

The assistance provided in the UK can be categorised under the following headings:

Liquidity support

Liquidity support provided by the Bank of England was advanced under “normal” terms, whether to the market in general or to individual institutions such as Northern Rock. “Normal terms” in this context means at a margin over what would have to be paid were the funds available in the market (the Bagehotian rules) and thus far from being

“aid” a penalty is imposed for accessing the facility. In the early stages this was actually a problem as transparency meant it was reasonably easy to determine who was receiving such support and banks’ share prices and other borrowing lines were hit by speculation that they were in sufficient difficulty that they required emergency support from the Bank of England. The extent of this transparency has been reduced by the Banking Act 2009 such that the normal *temporary* borrowing by a bank in difficulty would have been replaced by a more permanent and acknowledged facility emanating from the Treasury (or from the Bank of England backed by the Treasury) before use of the temporary facility became known. Thus such a bank would have an opportunity to sort out its problems in an orderly manner. If a problem but not its longer term solution is revealed then there will be a run on the bank as was revealed graphically in the case of Northern Rock.

As the crisis progressed it became necessary to move beyond traditional short-term lending at above market rates to somewhat longer term facilities. For example, the Dunfermline Building Society. While these facilities have not all been unwound they are also intended to be replaced by debt or equity from the private sector.

However, this crisis has been unusual in two respects. First, wholesale markets have dried up in a manner not previously experienced so that it has been difficult for both banks and non-financial firms to raise bond finance at a time when bank lending was also under severe pressure. The Bank of England has therefore attempted to offset this market failure by “credit easing”, *i.e.* buying high quality commercial debt in the secondary market. Second, the crisis has been sufficiently severe in a world of low inflation rates that it has been found necessary to implement ‘quantitative easing’. In practice quantitative easing in government paper and credit easing in corporate bonds and other instruments are difficult to distinguish. It will therefore be a fine judgement as to the extent the credit easing has been monetary policy, part of a concerted move to get markets, or a form of limited support for larger corporations.

Guarantees

The government has developed guarantees in two main areas. The first is for depositors in the light of the difficulties with the deposit insurance system, assisted by the issuing of similar guarantees elsewhere in Europe, which would otherwise have affected the cost of credit to banks. The second has been for banks themselves as they have sought to raise finance from the private sector both at home and abroad.

Assisted purchase

Both the Banking Act 2009 and the Banking (Special Provisions) Act 2008 permitted assisted purchase and this facility has been used. The form of use has been to try to establish a fair value for the assets to be transferred and then provide assistance to cover the remaining loss [the case studies will be covered here]

Provision of extra equity – normally in the form of preferential shares

The option was available to all the main banks but only taken up by RBS and Lloyds-TSB and HBOS. The main reason for the lack of take up was the conditions it imposed, which were:

- maintaining, over the next three years, the availability and active marketing of competitively-priced lending to homeowners and to small businesses at 2007 levels;
- support for schemes to help people struggling with mortgage payments to stay in their homes, and to support the expansion of financial capability initiatives;
- remuneration of senior executives – both for 2008 (when the Government expects no cash bonuses to be paid to board members) and for remuneration policy going forward (where incentive schemes will be reviewed and linked to long-term value creation, taking account of risk; and restricting the potential for "rewards for failure");
- the right for the Government to agree with boards the appointment of new independent non-executive directors; and
- dividend policy,⁷¹ in addition to the 12% coupon it placed on the investment. In some respects therefore the investment was decidedly a mixed blessing and since the banks who could manage to avoid drawing on it did, even if, as the case of Barclays, they had to pay a substantial cost for raising private sector finance, this implies that it did constitute what could be described as a subsidy and indeed was designed to encourage the banks out of this government participation as rapidly as possible. Thus although this may have been a subsidy in these sense that it was the only source of finance available at tolerable cost initially it rapidly became a tax and hence was something banks exited from as soon as possible, thus meeting the normal criteria for such support.

Loans

On the whole the UK has tried to avoid the use of loans to support the banking sector, either providing insurance for which there has been a charge, liquidity at above market rates or outright share ownership so that the taxpayer has a stake in the upside when the market improves.

Other facets of government support

One competitive issue worthy of note however is the development of Northern Rock under public ownership. The OFT published a report on Northern Rock and found that public support for Northern Rock had no significantly adverse impact on competition during the period February 2008 to February 2009. Since the OFT completed its analysis, revisions to Northern Rock's business plan have taken place which fell outside the period of the report. As is to be expected Northern Rock tried to regrow its depositor base, offering slightly above market rates, while initially not seeking to expand its lending base. Thus by working out the poor quality loans it would be able to achieve a better balance between sources of funding and a higher quality loan portfolio to make it more saleable. However, the government changed its mind and encouraged Northern Rock to expand its lending.

The OFT has an important role in ensuring competition is effective in the financial services sector and has, as reported in the Pre Budget Report 2008, published a Financial Services Strategy which was open for consultation in March 2009 followed by a Financial Services Plan. It is anticipated that work conducted under the Plan will cover both consumer and competition issues across the financial services sector including, where appropriate, consideration of competition issues relating to public support to banks, including where relevant Northern Rock. Given the very significant change in circumstances since the original commitment was made the OFT has agreed with HM Treasury that a specific annual report on Northern Rock would not be necessary. The OFT will consider competition issues under the wider remit of the Financial Services Plan as appropriate, focusing on short term commitment to promoting fairness and responsibility, as reflected in the work OFT is doing on high cost credit, debt advice/management, irresponsible lending and in particular second charge lending guidance, as well as longer term advocacy for choice and competition in the sector.

At the same time Government has concluded agreements with the Lloyds Group and RBS to expand their lending in return for guarantees against losses on their troubled assets. (Since the government owns Northern Rock it has already taken on full exposure to its troubled assets.)

The impact of competition policy on crisis recovery and economic resilience

The need to follow EU rules, particularly with regard to state aid as well as in terms of competition initially led the authorities to hold back but greater understanding of what would be permitted has enabled major interventions and significant support. It is still not clear whether some of this may have to be unwound.

The past competition policy strategy in comparison to the response to the current crisis

The more limited nature of the ERM crisis and particularly the lightness of the problems for the banking system have meant that there were not the tensions for competition policy on the first occasion. Nevertheless even in the present crisis the implications for competition policy have been limited particularly outside the banking sector.

Role of Trade Policy

There was really no role for trade policy in either crisis except insofar as openness helped cause the crisis and most certainly helped the recovery

Restrictive measures

The government did not enact trade reducing measures in either the ERM or the present crisis. Indeed, even before being required to do so by the Maastricht Treaty the UK had opened up capital flows and encouraged the opening of foreign bank branches in London as part of its role as an international centre.

Under the Common Agricultural Policy some restrictions were imposed here at the European level, which the UK was compelled to adopt as a result of its membership of the EU.

In response to the crisis, the FSA has been very active in discussions at a European level to find a solution to the problems with the European single market in banking as highlighted in the case of the Icelandic bank failures. Currently banks based in the EU (or EEA such as the Icelandic banks) are able to operate in other member states through branches. Host state regulators have very little regulatory power over the activities of such branches, instead relying on the home state regulator. If the parent bank fails, the home state has an incentive to ringfence the assets of the whole banking group, even those abroad. As the Governor of the Bank of England has commented, banks are global in life, but national in death. The FSA has suggested that a potential solution may lie in obliging banks that wish to operate in the UK to set up a standalone subsidiary, which could be regulated by the FSA, and required to satisfy its own capital and liquidity requirements. Some of the gains from such a solution would of course be offset to some extent by losses to efficiency, as global banks would have less ability to distribute capital around the group as they saw fit.

National champions

On the whole the UK has not sought to favour domestic over foreign enterprise but it is inevitable that their efforts to stabilise and recapitalise the banking system will effectively favour domestic institutions as most such institutions are domestic. Perhaps the most important indication of their openness was the fact that the Santander Group was able to buy Alliance and Leicester in July 2008, while the crisis was in progress. It is not clear what would have happened had Santander got into difficulty. The presumption is clear – the primary responsibility for a cross-border bank lies with the authorities in the parent country. Hence it would have been expected that Spain would act first. If there was a problem with this then the UK authorities would have expected a call from the Spanish authorities first. In the event failure then the SRR could be applied to the Santander subsidiaries: Abbey (including Bradford and Bingley) and Alliance and Leicester. Clearly it will be more difficult to unwind these subsidiaries in this way as they become more closely integrated into the Santander Group over the coming year. Nevertheless there was no attempt to dissuade investment in Barclays from overseas interests and sovereign wealth funds have not been excluded. The saving of Northern Rock implies that the government's willingness to step into the banking system was rather more extensive than many people expected from the prevailing behaviour on Too Big To Fail. In the case of the failed Icelandic banks, the UK authorities transferred the deposits in two of them to ING, because it made the best bid, showing no favouritism towards UK owned institutions.

Outside the financial sector the UK has joined the general trend of supporting the car industry even though these are not national champions as they are foreign owned. The concern is simply over the extent of the employment involved and the belief that the problems in the industry are purely cyclical and not enduring.

Export credit measures

This area was not exploited.

The overall contribution of trade and trade policy to crisis recovery and enhanced economic resilience

The UK has championed openness to trade in services as it is a substantial exporter, particularly of financial services. However, while financial services transactions are primarily electronic and can be undertaken without a physical presence in the country, the development of London as a major world financial centre has entailed openness to foreign banks, encouraging them to open branch offices, subject to the same rules as their UK counterparts. Indeed part of the attractiveness of London has been the relatively light-handed nature of the regulation, which has encouraged banks to use London as their European base. There has however been no unusual effort to encourage the siting of such services as there has in Luxembourg and to a lesser extent Ireland. The UK has made no attempt to use favourable tax treatment or secrecy to promote financial services, although it does allow those who are not domiciled in the UK to avoid the taxation of residents. The FSA has gone to some trouble to differentiate between ‘light-handed’ and ‘soft-handed’ regulation. The former is a deliberate attempt not to over-regulate, while the latter would imply weak monitoring and enforcement of the regulations that did apply. While the experience of the crisis might lead people to dispute the lack of a soft hand, the subsequent regulatory changes imply both heavier and a harder hand.

It was the attempt to fix exchange rates that was the main contribution to the ERM crisis. The solution came from allowing exchange rates to float freely, permitting a clear devaluation that improved the competitive position of UK suppliers and contributed in no small part to the recovery. The development of international financial services has been one of the main growth areas in the period between the two crises and indeed to some extent it has been the extent of this integration that has led to the extent of the present crisis, first in exposure to the problems in the United States and second in exposure to the Icelandic banks.

In the present crisis the government has implemented a scheme to encourage people to trade in cars more than 10 years old. Under this measure announced in the Budget in April 2009 the government provides a GBP 1 000 subsidy and the participating manufacturers the same. The scheme expires in March 2010 or when 300 000 cars have been sold under it. It does not discriminate in favour of national manufacturers and since most cars in the UK are either foreign made or made in foreign-owned factories this will be a trade encouraging step as well as one designed to lower pollution and greenhouse gas emissions. It follows similar measures in a number of other countries.

The past strategy for trade policy in comparison to the response to the current crisis

There is one clear area of controversy in the present crisis. The laws governing the insolvency of cross-border banks are international and the instruments for implementing a resolution and a recovery are similarly national. The EU Winding Up directive is one counter-example as it requires the use of home country proceedings for foreign branches and the financial group as a whole. The other jurisdictions join their claims to those proceedings. One of the problems in such circumstances is that each country can only

handle the assets and liabilities that lie within its own jurisdiction. The first step therefore is to ring-fence these assets, in particular to prevent them migrating to the home country in the last desperate attempt to save the group and thereby concentrating the problems in the other, ‘host’, countries. Indeed to a large extent countries try to set up what is described as ‘*ex ante* ring fencing’ (Basel Committee, 2008) which tries to make the organisation of the bank and its activities within each jurisdiction relatively easy to control. The use of subsidiaries with independently subscribed capital is an obvious case in point. In the case of the Icelandic banks in the UK this was not the case as under EU law it is not possible to compel banks to operate with subsidiaries rather than branches.

Landsbanki had chosen to operate as a branch in the UK and with 300 000 depositors (almost the same as the entire population of Iceland) and UK deposits of around two thirds of Icelandic GDP it was clear that when failure looked inevitable and that the Icelandic authorities would be unable to protect depositors as required under the Deposit Insurance Directive the UK had no option but to act to try to limit the shock to financial stability. It was however found at this point that the only effective legislation was a freezing order under the terms of the Anti-Terrorism, Crime and Security Act 2001. While the terms of the order conformed to normal international practice the title of the Act was to say the least unfortunate. The Icelandic authorities and Icelanders in general were affronted by the image it projected. This was compounded by confusion in the short run while counter parties worked out what the freezing order meant, some thinking it applied to Iceland and the Icelandic authorities as a whole and not just to the claims relating to Landsbanki. As a result it briefly interrupted Iceland’s access to international markets.

It provided a clear illustration of the deficiencies of international law in handling cross-border banking failures and by its graphic nature may well lead to improvements generally and not just in the UK. The example of New Zealand, which is one of the few countries to have taken action in this regard in advance of the crisis, may well be followed.

Implementation challenges: lessons from reforming at a time of crisis

Key institutional and policy challenges faced

In the present crisis the authorities found that because they had failed to act early they needed to act both vigorously and in a hurry. After the initial problems they acted effectively in the short run, introducing the Banking (Special Provisions) Act 2008 but then also moved rapidly to institute the special resolution regime, both taking extensive external advice, quickly issuing a stream of discussion papers, revising them in the light of comments and then taking the process through to legislation in the space of 15 months. A schedule of events follows:

- September 2007 emergency assistance to Northern Rock
- January 2008 first discussion paper
- 21 February 2008 The Banking (Special Provisions) Act 2008 to enable the nationalisation of Northern Rock
- April 2008 second discussion paper

- July 2008 third and fourth discussion papers
- October 2008 Bill laid before parliament
- February 2009 Banking Act 2009 passed into law

Because the UK is part of the EU it has been restrained in some of the changes it can make and has focused on what could be done without the danger of external requirements for reversal.

The key institutional challenges were two-fold: on the one hand to enable the authorities to act swiftly and on the other to ensure co-ordination among them. The UK was in good position in this second regard as the number of authorities involved was small, since the UK has had a unified financial regulator throughout,⁷² and there was a clear agreement among them that took the form of an MoU. What the crisis made clear is that such agreements cannot really be tested in normal times. It takes a crisis to test them. Even in the future some problems may remain as high level co-ordination is dependent upon the individuals concerned. Not only do they change as time passes but the memory of how such actions are implemented is difficult to institutionalise and a degree of learning by experience is inevitable.

At the individual institutional level, in financial crises one of the main problems tends to be forbearance by the supervisory authorities. The consequences for supervisors of intervening unnecessarily tend to be viewed as having higher consequences for them than from intervening too late and imposing higher losses as a result. This late action occurred in the FSA despite their existing procedures and this has been tightened up. Reviews in the future will be confidential as they affect the commercial success of financial firms so it will be relatively difficult to appraise the effectiveness of change. The Bank of England was also reluctant to act in providing emergency lending. This latter reflects the normal conundrum of moral hazard. Before the event ELA needs to appear something that will only be provided in exceptional circumstances otherwise banks will be tempted to behave less cautiously as they can always access this part of the safety net. At the time however it has to be used to preserve stability. The Bank of England and FSA are attempting to get round this by trying to make sure that ordinary measures to assure the availability of liquidity are more effective.

In Canada they have attempted to get round the problem of forbearance by giving the CDIC responsibility for resolution and hence separating the resolution authority and the supervisory authority to try to make the incentives more compatible. The UK has chosen not to follow this route although it is the Bank of England that becomes the resolution authority once the SRR is triggered. Nevertheless it is still the FSA that is responsible for triggering. They have thus followed the route of strengthening the existing institutions rather than setting up new ones. In other words their diagnosis is that it was operational rules and tools that were at fault rather than the institutional framework itself.

The other major challenge was the framework for fiscal policy where it was realised that the basis for a sustainable path over the future was wrongly calibrated despite the following of golden rules and other aspects of a prudent framework. It assumed a faster rate of growth was sustainable and that volatility was not likely to be considerable. It therefore did not have much margin for stabilisation in the event of a major shock nor the leeway to have a major expansion of debt in a crisis without building up considerable problems for the future.

Tradeoffs between short term and long term, and between various sectoral interests, between regulatory and fiscal policy tools

It is clear in the crisis that the policy responses have first focused on the short term exit strategy in the UK. The initial concern has been to avoid a repetition of the Great Depression where a more active approach might have avoided the recession being so deep and long-lasting. Given the size of the immediate fiscal deficit there will be substantial problems if more traditional Keynesian style intervention is required later. There are thus constraints on the balance of regulatory and fiscal instruments in addition to the need for regulatory change to put right the deficiencies revealed in the framework for crisis avoidance and management.

The problem with the extensive bailout of the financial sector is twofold. The first is simply the problem of meeting the cost through future taxation; although the more successful the recovery the more the taxpayer is likely to receive when UKFI sells the substantial shareholdings it has accumulated. The second is that it will be very difficult to persuade not just those running banks and their shareholders and counterparties but society at large that should the country be unlucky enough again to experience a financial crisis the government will not be there offering taxpayer support to prevent the threat to financial stability. The new supervisory regime will make it more difficult for banks to run risky strategies, become overleveraged and readily threatened by liquidity shocks, while the SRR will offer a rapid way out should banks fail to get recapitalised in the face of problems, at limited potential cost to the taxpayer and the rest of the financial system. However it remains that it is rather more difficult to find satisfactory solutions for large institutions and this is still being addressed.

There will be a clear difficulty when the time comes to consider selling the government shareholdings in the banking system. In order to provide the best return for the taxpayer there will be a strong temptation to wait until financial markets are back to normal and even then to sell the shares in relatively small parcels to avoid disrupting markets. On the other hand there is a strong motivation to reduce the costs of debt servicing, which would encourage earlier sales. In any event it is always possible that a future government will decide that state ownership of systemically important institutions is a worthwhile objective in its own right.

Speed and needs of the political and administrative environment

One of the advantages of the UK's legal framework and legislative approach is that changes can be made very rapidly when needed. Many of the actions with respect to the banking system can be executed by administrative order. Thus, although such decisions need to be laid before Parliament they can be acted upon first and considered by Parliament second. The Banking (Special Provisions) Act 2008 is the most obvious example as this went through parliament in just three days, from tabling to royal assent. Secondly the use of administrative procedures and independent processes for working out compensation means that many of the swift actions required can go through without the need to contest them in the courts. The procedures employed have all been mindful of the provisions of the European Charter of Human Rights, particularly with regard to shareholders, and this has been built specifically into the Banking Act 2009, for example. The speed with which measures can be passed through parliament reflects both parliamentary procedure, where the second chamber, the House of Lords, traditionally does hold up such legislation unduly and the majoritarian nature of UK democracy whereby the government normally has a clear majority in parliament and hence will be able to pass key legislation readily.⁷³

The Treasury has gone to some lengths to make sure that its actions are transparent and widely and rapidly communicated to those who might be affected. One of the advantages of modern technology is that decisions cannot simply be communicated rapidly through the internet but they can be done through interactive web pages in such a way that people can get answers to the obvious questions immediately.

The UK has not implemented a regime of mandatory Prompt Corrective Action and it still relies largely on the initiative of the supervisory authority for action, informing the other authorities and triggering the Special Resolution regime – although the Bank of England can also suggest to the FSA that the SRR be applied. The UK has however addressed the issue of ensuring that depositors can be paid out rapidly and by extending the scope of insurance should ensure that the chance of any bank runs again remains small following the shock of Northern Rock. While a number of techniques can be applied it seems that the transfer of deposits to another provider works swiftly and effectively provided that the necessary computer systems are available. The proposed requirement for all banks to have a clear profile on each customer so that the extent of insured deposits can be identified without any need for cross-matching, netting or other set-offs should be very helpful in this regard.

Conclusion

Assessment of the country's resilience through the past crisis and assessment of recent trends.

The UK emerged from the ERM crisis in a strong position that was not challenged until the onset of the present difficulties. Having been a relatively poor performer compared to the other major European countries for nearly 5 decades the UK has recently done rather better than its counterparts. The main question which arises is how much this was due to the major regulatory reforms of the Thatcher era and how much to the changes introduced subsequently. Subsequent analysis, Geroski and Gregg (1993) suggests that firms were able to be more flexible during the recession than previously, postponing capacity investment and advancing cost reductions. It is the shallowness of the recession which indicates a difference in performance.

It has also been clear for some time that the fiscal policy that has been run since 1997, with a slow gearing up of the public sector contribution, has implications for long term sustainability. The fiscal problems revealed by the crisis might well have emerged even in a more minor downturn.

It is too early to say how the present crisis is going to pan out. Comparison with previous serious recessions including that of 1929 suggest that the economy should be reaching the bottom round about now, the third quarter of 2009. Hence discussion of 'green shoots' is only to be expected. However whether the recovery will also come soon or whether it takes a while to emerge as the rest of the economic consequences, particularly for unemployment, work their way through the economy remains to be seen. The UK is an open economy and unless domestic recovery is matched by recovery in the rest of the world progress is likely to be relatively slow. Unlike some of the other European countries that were not so heavily hit by the financial crisis, the UK has not devoted much to fiscal expansion – not only has its balance sheet been heavily affected by the need to support the banking sector, with the adverse implications for future debt and its servicing being quite sufficient to deter the government from major stimulus

packages, but the fiscal situation had been deteriorating even as the economy grew favourably before the crisis. It also remains to be seen how fast the financial sector will bounce back. One of the issues has been that lending, particularly to SMEs, has not recovered as rapidly as the authorities would like and they have attempted to boost this through the banks they can control or influence.

One of the clear problems in exiting from the crisis under the new rules for increased capital and liquidity that are being proposed and applied for banks is that there has to be substantial deleveraging by the banks. Insofar as this can be achieved through the injection of new capital there is no need for lending activities to be wound down. However, it seems clear that there will now be much more emphasis on Tier 1 capital as only Tier 1 capital acts as a cushion when a bank is still operating. If Tier 2 capital, subordinated debt, is to be used, the bank will effectively have to go into resolution procedures for this to happen; although it has been suggested that one way round this is to make Tier 2 capital automatically convertible into equity should the Tier 1 buffer face exhaustion. If this or other such proposals for ‘contingent capital’ are implemented then the immediate demand for funding will be lower and hence the ability to return to more normal behaviour in financial markets greater. However, the principal requirement for recovery in capital markets is confidence. Counterparties need to be convinced that the extent and location of probable losses has been identified and that they will be repaid when any contracts they write mature. In the short run therefore there has to be a realistic expectation that the government will step back in if the recovery were to exhibit a second dip.

While there were considerable problems in previous arrangements both in micro-prudential and macro-prudential supervision for detecting the impending crisis early and acting upon it in order to reduce its probable impact, the regulatory response has been rapid and to the highest international standards. The UK has resisted the temptation to take measures that restrict competition or trade, although it has had to implement the restrictions on agriculture under the terms of the Common Agricultural Policy as a result of its membership of the European Union.

Unlike previous crises the present crisis has encountered the ‘zero bound’ where there is no scope for further lowering of nominal interest rates. In Japan in such circumstances monetary policy was able to make little further contribution to the recovery and continued problems of an adverse debt-deflation spiral ensued. In the present case the Bank of England has used a number of new measures including quantitative easing – buying a wider range of government stock – and credit easing, which involves the purchase of private sector claims, particularly those for which the market has dried up. If successful this should speed up the recovery. However, the reason for caution is that similar methods were applied by the Bank of Japan after they reached the zero bound but with apparently very little impact. The new funds need to be lent out beyond the institutions that receive them if they are to have any effect on the behaviour of households and firms. As yet the Bank of England has not shown that it wishes to exit rapidly from this programme. Quantitative easing has its real effect if people expect there will be a period of inflation as a consequence and hence despite the nominal rate of interest being virtually zero, the real rate of interest will be clearly negative, thereby encouraging borrowing. At present the outlook for inflation is subdued but clearly positive as rising import prices caused by the devaluation of sterling have offset domestic deflationary pressures.

Notes

1. HM Treasury Pocket data bank, July 2009, Table 19
2. HM Treasury Pocket data bank, July 2009, Table 22
3. IMF, p. 6.
4. IMF, p. 10.
5. IMF, p. 13.
6. Budget, 2009.
7. The NIESR has argued that, if the measurements had been taken on a consistent basis, 2009 Q1 output figures would actually be the worst since records began. Indeed, they speculate that Q1 2009 may have been the worst quarterly economic performance in the UK since the 1926 General Strike. See NIESR Review July 2009
8. NIESR Review, July 2009, *The UK economy*.
9. HM Treasury Budget, 2009, p. 194.
10. IMF report.
11. NIESR Review, July 2009, *The UK economy*.
12. IMF p19.
13. IMF p16.
14. Treasury, Budget 2009, p. 222, Table C2.
15. Treasury, Budget 2009, p. 222, Table C2.
16. IMF, pp. 36-37.
17. Budget, p. 200-201.
18. HM treasury pocket databank, Table 1 and Table 9
19. Finland, which was shadowing the ERM, was forced to float the Markka early in September 1992, followed by Italy. Spain, Portugal, Sweden and Norway all had to change their parities after the UK.
20. Those who regard this move to floating exchange rates as a source of the UK's subsequent economic success and an essential move despite the unfortunate cost have labelled this ironically as 'White Wednesday'.
21. Freedom of Information Disclosure 10 February 2005.
22. Other external factors also contributed to the crisis such as the extent of global imbalances.
23. The first major worries about the problems with wholesale financing of banks, such as Northern Rock, that were making extensive use of securitisation and related methods to fund their lending (on mortgage) crystallised in April 2007 and Northern Rock itself soon began to alter its strategy, ending its period of strong growth and seeking to restructure itself away from the worst parts of the dependence.
24. Much of HBOS's problem had occurred through growth. HBOS was formed through the merger of Halifax and the Bank of Scotland in 2001. Halifax had been the UK's

largest building society, which was demutualised in 1997. Thus HBOS was exposed on the one side to the erosion of the value of its collateral as house prices contracted and on the other by a drying up of key sources of its funding.

25. Bradford and Bingley was the last one of the 10 building societies that decided to demutualise following the 1986 Building Societies Act (that enabled this change) that had remained independent. Alliance and Leicester agreed to acquisition by Santander in July, 2008 – the transaction was completed in October 2008 in tensest part of the crisis. All of the others had either been taken over by other by other banks (merged in the case of Halifax or failed – Northern Rock). This is an interesting reflection on this earlier measure of deregulation that was designed on the one hand to provide a wider range of services to customers and on the other to provide a more effective challenge to the incumbent banks that had been making major inroads in the residential mortgage sector. That challenge has ended, except insofar as it has allowed Santander into the UK market with its purchase of Abbey, Alliance and Leicester and Bradford and Bingley. Those who used their new position more aggressively have all ended in difficulty.
26. This order issued under the Anti-Terrorism, Crime and Security Act of 2001, caused great controversy and exacerbated already difficult relations with Iceland. (See Section 4 for a more detailed explanation.)
27. This distinction between a branch and a subsidiary is important in the context of EU law. Subsidiaries are controlled by the host country authorities whereas the prudential control of branches remains with the home country. In an insolvency all the assets and claims of a branch are dealt with by the home country as is deposit insurance. The UK realised that the extent of the Icelandic collapse was going to be so large that there was no chance of the claimants in the UK receiving much in the way of compensation, since the Icelandic authorities had decided to save only the operations in Iceland. Indeed there was no realistic way they could have done more. Hence as is normal practice in these circumstances, in the absence of any international legal arrangement for this form of insolvency, the UK authorities attempted to ring fence Landsbanki's assets in the UK, if only to improve their bargaining position. See Basel Committee (2009) for a good discussion of the issue of ring fencing.
28. Being a subsidiary, the UK authorities were responsible, including for deposit insurance and hence could deal with the whole problem on their own initiative.
29. Unlike the support packages offered in many other countries, this was clearly at penalty terms (12% coupon) and came with a set of other obligations, discussed in more detail in section 4. Thus in many respects it was part of a recovery package for the economy and not simply support for the banks.
30. RBS paid GBP 6.5 billion to protect GBP 325 billion of assets after a first loss of GBP 19.5 billion and Lloyds GBP 15.6 billion to protect GBP 260 billion of assets after a first loss of GBP 25 billion.
31. By August 2009 the Bank of England had purchased GBP 125 billion of such assets, longer-dated gilts, and had authority to buy a further GBP 50 billion of which half had been announced.
32. This was the UK's first use of the concept of a bridge bank, which has been used on a number of occasions in the US. Such social lending portfolios that are designed to help the disadvantaged can only be held by a small group of approved lenders and it had not been possible to find a buyer by the time Dunfermline failed. The portfolio was subsequently successfully sold and the bridge bank thereby closed.

33. The main cause of the RBS's problems occurred after the crisis had already begun. During 2007 there had been a battle to purchase ABN-AMRO, headquartered in the Netherlands, which had been underperforming. Barclays, in the UK, initially put in a successful bid but this was countered by a consortium led by RBS of itself, Santander (Spain, UK) and Fortis (Belgium, Netherlands), which was ultimately successful in October 2007 but only at the cost of very extensive leverage.
34. The principles relate to *i*) the need to use resources in the most efficient and economic way; *ii*) that the prime responsibility for risk management lies with the senior management of the institution concerned; *iii*) that the restrictions the FSA imposes on the industry must be proportionate to the benefits that are expected to result; *iv*) the desirability of facilitating innovation; *v*) the desirability of maintaining the competitive position of the UK. *vi*) the need to minimise the adverse effects on competition.
35. The actual remarks made to Prospect Magazine on August 9th 2009 are rather stronger in nature http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6815137.ece
36. There was a very limited local run in 1878 when the City of Glasgow Bank failed, which it did as a result of fraud, but the contagion quickly subsided.
37. The Asset Purchase Facility, authorised by the Chancellor of the Exchequer in January 2009 exists to buy high-quality assets financed by the issuance of Treasury Bills. Eligible assets include investment grade sterling commercial paper, corporate bonds, bank-issued bonds, gilts, and investment grade sterling asset-backed commercial paper securities. Credit Guarantee Scheme facility, under which the Bank of England would purchase small quantities of bank-issued bonds, has not yet been activated, and will only be so when the Bank deems it necessary.
38. Although there was strong criticism in the second case that the FSA had given little indication that it saw any particular problems with Dunfermline's business model until the last moment, House of Commons 2009. On this occasion the inquiry was undertaken by the Scottish Affairs Committee and not the Treasury Committee as this was a Scottish financial institution.
39. 'From Crisis to Confidence: Plan For Sound Banking', available at www.conservatives.com/News/News_stories/2009/07/Our_plan_for_sound_banking.a_spx
40. The financial services industry funds the FSCS through levies charged according to anticipated insurance payouts. If more funds are needed than anticipated, the industry receives additional levies to make up the difference. During the recent crisis, arrangements have been established to ensure that, were a major bank to collapse, the FSCS could instantly receive a loan from the Treasury from which depositors could be reimbursed, which the industry would eventually pay back in time.
41. www.deloitte.com/view/fr_CA/ca/services/conseilsfinanciers/case-study/4e0d899a961fb110VgnVCM100000ba42f00aRCRD.htm
42. There is a provision for extending this to investment banks that has not as yet been exercised.
43. Clearly a bank may move directly from the orange to the red zones if the authorities do not detect the problem in advance. The SRR, therefore, while allowing the opportunity for problems to be sorted out over a period of time, can cope with

surprise events where there is no time to provide a full assessment of problem, evaluate the losses and prospects for recovery etc.

44. These threshold conditions are set out in the FSA’s “COND” sourcebook.
45. The FSA’s approach to handling problem banks is not essentially changed by the Act. The UK does not apply either Prompt Corrective Action (PCA) or Strategic Early Intervention and Resolution (SEIR) per se as in the United States. It is for the FSA to determine whether a bank is likely to breach its conditions for registration and hence how to handle the difficulty. There is thus very considerable discretion up to the point of deciding on whether the bank should enter the SRR.
46. These triggers and their likely application are rather general and it would be difficult to be clear how that might be applied in any instance with a borderline case. At the same time that the Act was passed the Government also issued a Code of Practice (Treasury, 2009, February) to try to elucidate this. It is possible to can a little more insight from this. For example in choosing which option to use the Bank of England will take into account:
 - the existence of, or likelihood of finding, a private sector purchaser;
 - the likely saleability of assets and liabilities of the failing banking institution, including whether a whole institution sale is viable;
 - the likely speed of FSCS payout to eligible depositors, and the method by which this would be achieved under the bank insolvency procedure;
 - the feasibility of effecting a partial transfer in compliance with the safeguards set out in primary and secondary legislation;
 - the operational risks of managing a bridge bank, and the amount of public funding that may be required to keep it operational, including consideration of State Aid issues; and
 - the time available to implement a private sector sale, including for due diligence by potential purchasers.
47. There is a second circumstance, where the Treasury is already providing financial support to the bank in order to deal with a serious threat to financial stability in the UK. In which case the Treasury can recommend to the Bank of England that stabilisation powers be used (and the Bank agrees).
48. There is also the same second condition as in previous footnote.
49. A bridge bank is a temporary company set up by the Bank of England and registered by the FSA that manages all or some of the assets and liabilities of the failing bank until such time as the entity can be sold back to the private sector. It provides an opportunity to continue to operate all or part of the institution where continuing as a going concern is thought to be less costly than closure. It implies that the losses of the bank will not exceed the claims on the FSCS and so only temporary financing by the Bank of England is required. If the problems are more serious and the bank needs to be saved, then outright public ownership will be required and the bank nationalised but this is a last resort.
50. An important distinction between a bridge bank and nationalisation, spelt out by Brierley (2009), is that in the case of a bridge bank the Bank of England acquires control for a temporary period until sale to the private sector (or insolvency) it does not acquire the economic rights and on sale these are assigned to the shareholders and creditors following the normal priorities.

51. In the first use of the Act in the case of the Dunfermline Building Society this procedure was used when the retail business was transferred to the Nationwide Building Society, the social housing portfolio was transferred to a bridge bank and the administration procedure used for the residual bank that contained the commercial lending portfolio. (There is a specific treatment of building societies as opposed to banks under the Act but the arrangements are the same.) The administrator is KPMG.
52. Negative actions are also permitted in terms of the termination of contracts between the transferred bank and other parts of the group.
53. These are covered by a Safeguard order that protects counterparties in the event of transfers. In particular:
 - a broad safeguard for set-off and netting arrangements;
 - a broad protection for secured liabilities;
 - protection for structured finance arrangements (such as covered bonds and securitisations);
 - a requirement to establish a compensation scheme which has regard to ensuring that no pre-transfer creditor is “worse off” than they would have been had the institution gone into an insolvency process;
 - restrictions on reverse partial transfers, which prevent the Bank of England or the Treasury from transferring certain types of financial contract from the solvent ‘newco’ back to an insolvent ‘resco’, in the interests of ensuring those transferred to ‘newco’ can have confidence in their position;
 - protection for default rules of clearing houses and investment exchanges and market contracts, reflecting protections under Part VII of the Companies Act 1989;
 - an express bar on action in contravention of Community law;
 - prohibition on use of the powers to provide for continuity of intra-group services and facilities in a way which would contravene the key safeguards provided for in the Safeguards Order; and
 - targeted protections for termination rights under financial contracts (that are relevant for set-off and netting).
54. The Deposit Guarantee Schemes Directive currently envisages a EU-wide harmonised level of EUR 100 000 being introduced by the end of 2010, in which case the UK will switch to that level then. Arrangements are also being made to cover temporary high deposits.
55. Policy Statement 09/11, July 2009.
56. 2009/14/EC of 11 March 2009.
57. In the case of Parex, the Swedish authorities issued a guarantee for Swedish banks, some of whom operated in Latvia. As a result depositors in Latvia switched to the Swedish banks, making the position of Parex, the largest domestic bank, which was already facing a rise in non-performing loans, impossible. The Latvian government however could not afford credibly to offer a similar guarantee to Latvian banks and the problem was only resolved at great fiscal cost and an IMF loan.
58. This includes both banks and building societies.

59. Published by the FSA in March 2009.
60. More than 0.25% of the issued value of the stock.
61. Department for Business, Innovation and Skills press release, 10 August 2009.
62. Treasury press notice ‘Report sets out vision for UK financial services sector’, 7 May 2009
63. Calvo (2009) raises a wider point about the cost of recessions in trying to set out the circumstances under which a more deregulated and faster growing economy can lead to higher welfare than a more stable and slower growing heavily regulated economy, despite the greater proneness to downturns.
64. In the US this was an explicit policy in the Greenspan era and has been employed again in present circumstances.
65. Enterprise Act (2002), s. 58(2)(2D), which came into force on 24 October 2008.
66. www.hm-treasury.gov.uk/press_114_08.htm
67. Cheshire and Derbyshire Building Societies.
68. Dunfermline Building Society.
69. OFT Decision Completed acquisition by Thermo Electron Manufacturing Limited of GV Instruments Limited 15 December 2006 and CC Report: A report on the completed acquisition of GV Instruments Limited by Thermo Electron Manufacturing Limited (2007).
70. Communication from the Commission — The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, (2008/C 270/02).
71. HM Treasury 13 October ‘Statement on financial support to the banking industry’, www.hm-treasury.gov.uk/press_105_08.htm
72. There is some enduring division of responsibility in conduct of business between the FSA and the OFT in respect to aspects of consumer credit but this is being addressed.
73. This is in sharp contrast to the US where there was considerable opposition in Congress to the original TARP proposals, which in itself had an adverse impact on confidence. It should also be noted that other democratic structures can also move rapidly when needed – Iceland passed the legislation necessary to nationalise its banks within a day.

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Annex 4.A1. The proposals from the Turner Review

Capital adequacy, accounting and liquidity

1. The quality and quantity of overall capital in the global banking system should be increased, resulting in minimum regulatory requirements significantly above existing Basel rules. The transition to future rules should be carefully phased given the importance of maintaining bank lending in the current macroeconomic climate.
2. Capital required against trading book activities should be increased significantly (*e.g.* several times) and a fundamental review of the market risk capital regime (*e.g.* reliance on VAR measures for regulatory purposes) should be launched.
3. Regulators should take immediate action to ensure that the implementation of the current Basel II capital regime does not create unnecessary procyclicality; this can be achieved by using ‘through the cycle’ rather than ‘point in time’ measures of probabilities of default.
4. A counter-cyclical capital adequacy regime should be introduced, with capital buffers which increase in economic upswings and decrease in recessions.
5. Published accounts should also include buffers which anticipate potential future losses, through, for instance, the creation of an ‘Economic Cycle Reserve’.
6. A maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size.
7. Liquidity regulation and supervision should be recognised as of equal importance to capital regulation.
 - More intense and dedicated supervision of individual banks’ liquidity positions should be introduced, including the use of stress tests defined by regulators and covering system-wide risks.
 - Introduction of a ‘core funding ratio’ to ensure sustainable funding of balance sheet growth should be considered.

Institutional and geographic coverage of regulation

8. Regulatory and supervisory coverage should follow the principle of economic substance not legal form.
9. Authorities should have the power to gather information on all significant unregulated financial institutions (*e.g.* hedge funds) to allow assessment of overall system-wide risks. Regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like features that threaten financial stability and/or otherwise become systemically significant.
10. Offshore financial centres should be covered by global agreements on regulatory standards.

Deposit insurance

11. Retail deposit insurance should be sufficiently generous to ensure that the vast majority of retail depositors are protected against the impact of bank failure (note: already implemented in the UK).
12. Clear communication should be put in place to ensure that retail depositors understand the extent of deposit insurance cover.

UK Bank Resolution

13. A resolution regime which facilitates the orderly wind down of failed banks should be in place (already done via Banking Act 2009).

Credit rating agencies

14. Credit rating agencies should be subject to registration and supervision to ensure good governance and management of conflicts of interest and to ensure that credit ratings are only applied to securities for which a consistent rating is possible.
15. Rating agencies and regulators should ensure that communication to investors about the appropriate use of ratings makes clear that they are designed to carry inference for credit risk, not liquidity or market price.
16. There should be a fundamental review of the use of structured finance ratings in the Basel II framework.

Remuneration

17. Remuneration policies should be designed to avoid incentives for undue risk taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of UK and global codes.

Credit Default Swap (CDS) market infrastructure

18. Clearing and central counterparty systems should be developed to cover the standardised contracts which account for the majority of CDS trading.

Macro-prudential analysis

19. Both the Bank of England and the FSA should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as countercyclical capital and liquidity requirements should be used to offset these risks.
20. Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.

FSA supervisory approach

21. The FSA should complete the implementation of its Supervisory Enhancement Program (SEP) which entails a major shift in its supervisory approach with:
- Increase in resources devoted to high impact firms and in particular to large complex banks.
 - Focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes.
 - Focus on technical skills as well as probity of approved persons.
 - Increased analysis of sectors and comparative analysis of firm performance.
 - Investment in specialist prudential skills.
 - More intensive information requirements on key risks (*e.g.* liquidity)
 - A focus on remuneration policies
22. The SEP changes should be further reinforced by
- Development of capabilities in macro-prudential analysis
 - A major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements.

Firm risk management and governance

23. The Walker Review should consider in particular:
- Whether changes in governance structure are required to increase the independence of risk management functions.
 - The skill level and time commitment required for non-executive directors of large complex banks to perform effective oversight of risks and provide challenge to executive strategies.

Utility banking versus investment banking

24. New capital and liquidity requirements should be designed to constrain commercial banks' role in risky proprietary trading activities. A more formal and complete legal distinction of 'narrow banking' from market making activities is not feasible.

Global cross-border banks

25. International co-ordination of bank supervision should be enhanced by:
- The establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions.
 - The pre-emptive development of crisis co-ordination mechanisms and contingency plans between supervisors, central banks and finance ministries.
26. The FSA should be prepared more actively to use its powers to require strongly capitalised local subsidiaries, local liquidity and limits to firm activity, if needed to complement improved international co-ordination.

European cross-border banks

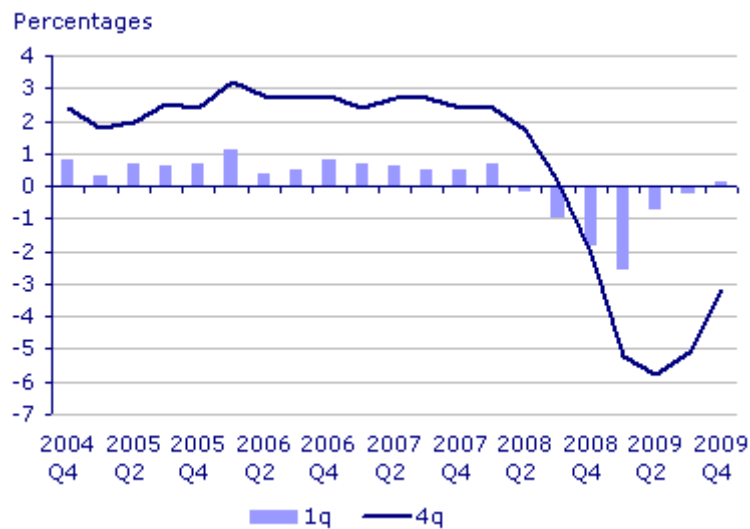
27. A new European institution should be created which will be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and will be significantly involved in macro-prudential analysis. This body should replace the Lamfalussy Committees. Supervision of individual firms should continue to be performed at national level.
28. The untenable present arrangements in relation to cross-border branch pass-
porting rights should be changed through some combination of:
- Increased national powers to require subsidiarisation or to limit retail deposit taking

- Reforms to European deposit insurance rules which ensure the existence of pre-funded resources to support deposits in the event of a bank failure.

Open questions for further debate

29. Should the UK introduce product regulation of mortgage market Loan-to-Value (LTV) or Loan-to-Income (LTI)?
30. Should financial regulators be willing to impose restrictions on the design or use of wholesale market products (*e.g.* CDS)?
31. Does effective macro-prudential policy require the use of tools other than the variation of countercyclical capital and liquidity requirements *e.g.*
 - Through the cycle variation of LTV or LTI ratios.
 - Regulation of collateral margins ('haircuts') in derivatives contracts and secured financing transactions?
32. Should decisions on for instance short selling recognise the dangers of market irrationality as well as market abuse?

Figure4.A1.1. GDP growth



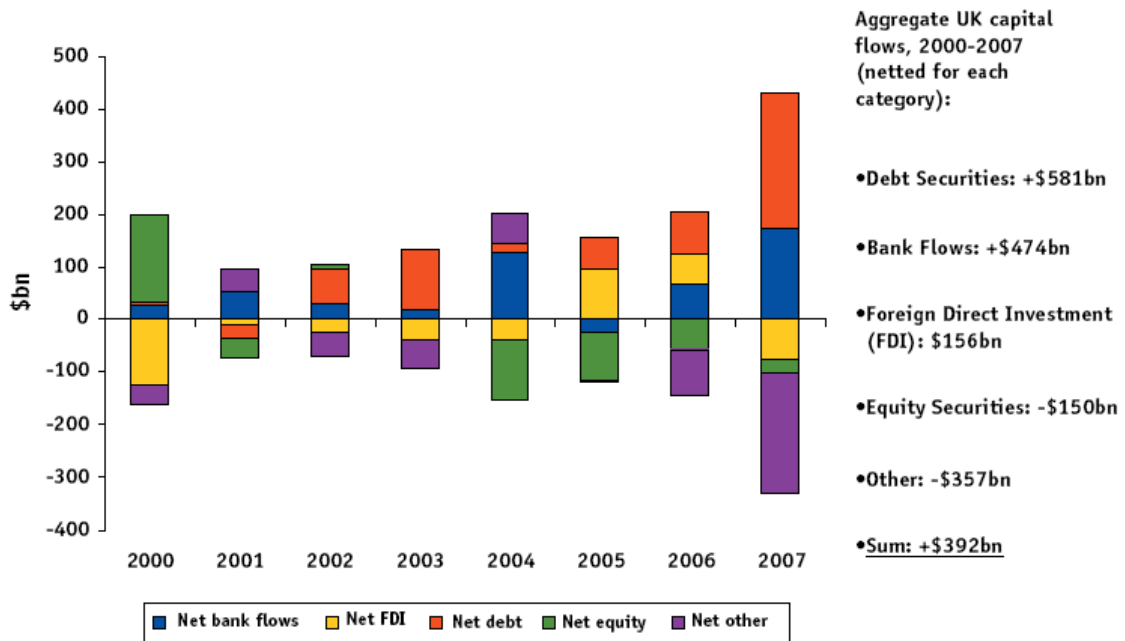
Source: www.statistics.gov.uk/cci/nugget.asp?id=192.

Figure 4.A1.2. Employment



Source: www.statistics.gov.uk/cci/nugget.asp?id=12.

Figure 4.A1.3. Composition of UK Capital Flows 2000-07



N.B. Positive numbers represent inflows, negative numbers represent outflows.

Source: IMF, FSA calculations

Source: Turner Review (2009), p. 35.

OECD Reviews of Regulatory Reform

REGULATORY REFORM FOR RECOVERY

LESSONS FROM IMPLEMENTATION DURING CRISES

Does regulatory reform play an important role in helping countries recover from crises? Do crises pose particular challenges for the implementation of regulatory reform programmes? This study aims to answer these questions based on case studies of OECD countries' regulatory reform responses to past crisis episodes. As countries are focusing their efforts on strategies for economic recovery from the global financial and economic crisis of 2008-09, the findings of this study should be timely for policy makers seeking to design, adopt and implement regulatory reform.

Part I highlights the benefits of regulatory reform, the importance of undertaking reform in a crisis and what lessons can be learnt from reform implementation. Lessons draw from several case studies and OECD country responses to crises of the 1990s and early 2000s, with a focus on Japan, Korea, Mexico, Sweden and the United Kingdom. Part II presents the detailed case studies of Japan, Korea, Mexico and the United Kingdom.

Further reading:

Risk and Regulatory Policy: Improving the Governance of Risk (2010)

Regulatory Impact Analysis: A Tool for Policy Coherence (2009)

Indicators of Regulatory Management Systems (2009)

Progress in Implementing Regulatory Reform: Korea (2007)

Achieving Results for Sustained Growth: Sweden (2007)

Progress in Implementing Regulatory Reform: Japan (2004)

Progress in Implementing Regulatory Reform: Mexico (2004)

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