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POUR DISCUSSION…

2010DT-01 > Novembre 2010

The Wall Street reform and consumer protection act: A long lasting solution to the financial crisis or an obstacle to future recovery?

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Partenaire financier

Développement économique, Innovation et Exportation
Québec

ISSN 1914-0053 (Imprimé) / ISSN 1914-0061 (En ligne)

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For discussion...

Two years after the financial crisis broke out, the US Congress has voted the Dodd-Frank "Wall Street Reform and Consumer Protection Act" with the stated aim to create a sound economic foundation, to grow jobs, protect consumers, rein in Wall Street, end too big to fail and prevent another financial crisis.

This imposing piece of legislation[1] is important. It will reshape the financial landscape in the US and thus influence markets and regulators for years to come.

Also, its impact on the world largest market will affect the final outcome of the crisis and the future course of the global economy.

In order to assess the effectiveness of this new legislation we have first to compare the voted measures to the ones we proposed in previous papers[2] in our analysis of the causes of the 2008 financial crisis.

[1] This paper is based on the brief summary of the Dodd-Frank Wall Street reform and consumer protection act published by the banking committee of the US Congress.

[2] A banker's perspective on the financial crisis: http://www.cirano.qc.ca/pdf/publication/2009RB-02.pdf

FIRST PART

The possible outcomes of the crisis and the proposed measures to a long lasting solution

The analysis of the main causes of the financial crisis presented in our original paper led to three possible scenarios that could follow the crisis.

The first one considered a quick and painless rebound that has evidently not occurred.

The second scenario explored the possibility of a deepening recession and market weakness.

Only the third scenario suggested a path towards a long lasting recovery. It required a balanced approach and sustained cooperation between the main participants, each putting in place the appropriate measures falling within its sphere of competence and responsibility.

As such we proposed that:

- Governments present a composed attitude to reassure the public and avoid interfering in areas outside their competence. Equally important is their capacity to resist the temptation to scatter borrowed funds for political purposes. It is important that governments preserve their limited financial firepower and apply it to critical bail outs and support of the economy to stimulate future growth, innovation and entrepreneurship.
- Central banks improve their capacity to identify financial bubbles and act early to restrain them.

- Regulators fulfill their pivotal responsibilities by:
    - reviewing the current failed risk models that relied too much on the past and introducing a dose of behavioural factors as well as more stringent stress tests.
    - curbing excessive short term based remuneration and promoting reliance on traditional and experienced risk departments.
    - extending their reach to establish adequate ethical rules for key service providers such as rating agencies and auditing firms who played a role in the crisis. The extent of their intervention will be delicate as regulators should avoid a heavy handed approach that would directly interfere with the risk appetite of financial institutions.
- Financial institutions address the risk management shortcomings that were highlighted by the crisis, for example, by reconsidering their risk measurement models and reconstituting proper credit risk evaluation departments, relying less on rating agencies and more on experienced risk managers, separating their approach to selling financial products and managing *inter alia* the credit, liquidity and interest rate risks.

  The Banks should rein in the short term culture promoted all across their organizations through immediate bonuses and stock options at management level, while preserving their capacity to attract innovative talent.
- Finally, members of Bank boards of directors need to improve their understanding of new, sophisticated financial products, an appreciation that does not come necessarily with experience, but rather requires appropriate training.

SECOND PART

Does the financial reform bill hit the target?

Before looking into the highlights of the legislation, three preliminary remarks seem appropriate:

- The indispensable collaboration of the main partakers in the crisis in shaping the new bill does not seem to have taken place. As a result, this legislation appears almost entirely to be the one sided product of the political process.
- As stated in its title, this is a Wall Street reform bill. It is centered on banks and private financial institutions. Its main goal is not to reform government agencies, regulators and central banks even though they all played a crucial role in the built up of the crisis and if some changes to these official entities are proposed, they are presumably incidental to the main objective.

As a result, the bill does not seem to seek to establish a comprehensive solution to the crisis.

- \- Finally, the bill covers only entities doing business in or from the US. In a global financial system, it can only have a partial impact and even distort competition unless the same rules are applied to the main financial centers around the world.

This surprising limitation is to be expected since the US Congress is essentially a domestic body in contrast with regulators who have long ago

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established a set of relationships with their counterparts in other financial markets and agreed to common rules that allowed for consistent controls over the global financial network. The bill leaves some leeway to regulators to integrate international agreements such as Basel III. However, it does introduce restrictions that might not been agreed upon by other countries and could weaken the position of US financial institutions.

THIRD PART

Analysis of the bill

We shall analyze the measures in the order Congress has presented them.

1. Consumer protections with authority and independence

In creating a consumer financial protection bureau, the US legislator consolidates the responsibilities of various government agencies into one bureau accountable for consumer protections. The new bureau has sufficient powers to supervise consumer lenders, propose new regulation, and act fast when identifying new products that are bad deals for consumers. Congress does not define strictly the type of problems that the new entity should look into.

Despite its duty to educate through the creation of a new office of financial literacy, it is not clear whether such a bureau would have stopped mortgage borrowers from overextending themselves in an overheated housing market.

Beyond the political benefit the legislator might derive from supporting such a reform measure, there may be a real need for such a protection watchdog in the US. But the relevance to the 2008 financial crisis or to the next financial crisis seems remote, apart from the fact that the bill provides the government with a regulatory body that will be clearly responsible when the next problem that affects the consumer comes along.

The cost to the consumer financial services industry is difficult to measure, as better defined oversight provided by the new regulatory body might compensate for some of the added cost burden of a new agency. So, unless the new agency regulates prices and tariffs (in which case there could be a substantial bearing on banks profits), the impact of establishing the new regulatory body on the financial sector itself should be minimal.

2. The financial stability oversight council

Made up of ten federal financial regulators, an independent member and five non-voting members (all from the regulatory world), the council will be charged with identifying and responding to emerging risks throughout the financial system.

In our previous papers we highlighted the need to detect emerging financial bubbles and providing the central banks with clear guidelines and powers to react to it (mostly through interest rate and monetary policies) in order to stabilize a speculative situation before it got out of control.

It can easily be argued that even in the last stages of the crisis (from 2004 on) a rise in interest rates would have gone a long way towards cooling down the real estate market, thus mitigating if not eliminating the dramatic outcome of 2008. Also, once the bubble was detected, it would have been easy for regulators to identify organizations at risk and prompt them to adopt more conservative lending practices.

Therefore this provision seems, at first glance, to respond our earlier recommendation. Indeed, one of its stated goals is to make risks transparent by identifying emerging risks in the economy.

However, this measure falls short in many ways:

- The council is composed of an overwhelming majority of government official and regulators. Clearly, bankers, hedge funds managers and professionals from rating agencies, who are on the cutting edge of market trends, would be needed to provide the committee with vital market insight. Instead, the council will now suffer from a serious lack of hands-on expertise. The creation of a new office of financial research staffed with economists, accountants, lawyers and former supervisors to advise the council cannot really alleviate this shortfall of competence.

- More significantly, the measure creates an observation body but does not target financial bubbles or specifically require a proactive policy on the part of the Federal Reserve to counteract this type of market excess.
- An important objective of the council is to avoid the rise in and complexity of financial organizations and if necessary, empower the Federal Reserve to act to break up financial institutions that have grown to be a potential threat to the system. This applies to banks, but can also be extended to other financial companies. It is easy to see how this measure protects the legislator from bearing the brunt of criticism in the case of another Bear Sterns type bail out. It is more difficult to understand why such drastic limitations should be imposed on US banks, as these restrictions, inevitably entail in the long term a loss of international competitiveness and lack of innovation for US banks operating in a global market where foreign banks are not facing the same restrictions.

This provision shows that politicians have understood the need for a macroeconomic approach to detect unfavourable trends in the financial markets that pose a risk of future systemic difficulties. However, the measures voted to respond to the consequences of the 2008 crisis, are framed by politicians suspicious of large financial entities that trade instruments they do not understand. In doing so, they missed the opportunity to take the appropriate measures and address one of the main weaknesses brought to light by the events of 2008: the incapacity to identify and prevent financial bubbles in a timely manner.

Moreover, the recommendations by congress to the federal reserve for the application of increasingly strict rules as a financial institution expands and the provision for regulators to break up the institutions deemed to

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represent the greatest systemic risk will inevitably rein in growth for US financial institutions, most likely by influencing boards and CEO's into avoiding growth and innovative financial products

3. Ending too big to fail bail outs

This provision aims to protect tax payers from being on the hook to save a troubled financial institution or to cover the cost of its liquidation.

Under this heading, several provisions have been voted. Three of them could have a profound impact on the banking system.

- Funeral plans: Large complex financial companies will be required to periodically submit plans for their rapid and orderly shutdown should the company go under. Other rules limit the amounts that the FDIC can insure to what it expects to be repaid from the company, when it is liquidated, by making sure that the cost is borne by the financial firms not the taxpayer.

  This set of regulations might work in case of isolated problems and therefore can give the illusion that a proper tax payer protection plan is in place. But would it work in times of widespread systemic crisis?

  The reality is that 2008 type of breakdown requires immediate help to failing institutions in order to avoid a domino effect. There is certainly no time for consultation between treasury, Federal Reserve and FDIC as requested by the bill.

  Moreover, experience shows that asset prices fall precipitously in such times and the FDIC will be at a loss to estimate the liquidation value of the institution which in turn establishes the maximum amount it can lend. Under these new rules, the FDIC would practically be paralysed.

  Finally, any hesitation or limitation in the rescue process by the regulatory bodies will be quickly noticed by the market and could worsen the crisis.

  - Volker rule: this rule proposed by the former chairman of the Federal Reserve and adopted by Congress requires the implementation of regulations to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds. It is clear that neither hedge funds nor private equity funds caused or were involved in the unfolding of the financial meltdown and so their relationship with banks was peripheral to the main events.

It is therefore difficult to understand the purpose of this rule other than being a nostalgic attempt to refocus the attention of banks on their lending business by limiting the benefits of 40 years of innovation from their activities. As mentioned in our previous papers, the crisis highlighted the need for banks to review their over reliance on models and rating-based assessment of credit risks. Instead of addressing this point positively by proposing relevant regulatory guidelines, the rule is a negative approach that does not correct the credit risk flaws in the banking system. What it does though is weigh on the profitability of banks and eliminate banking-originated competition for independent hedge funds and private equity funds.

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- Under the heading of Federal Reserve emergency lending and limits on debt guarantees, the legislator first prohibits the Federal Reserve bailing out individual companies. Lending programs are allowed but they must be broad based and carry sufficient collateral to protect tax payers.

  As well, it allows the FDIC to guarantee debt of solvent insured banks but only after meeting serious requirements such as Treasury secretary approval and expedited congressional approval.

  Again such measures would only restrict decisive action in times of extreme disruption. As an example, what would have been the definition of a solvent bank in the fall of 2008 when the interbank market was practically paralyzed? In a panic of such proportions, all financial institutions are vulnerable until the financial markets return to normal.

In short, this chapter of the bill might protect the taxpayer in the short term but could worsen significantly a future financial meltdown with considerable adverse consequences to the economy and ultimately the average taxpayer.

4. Reforming the Federal Reserve

The main purpose of this section of the bill is to restrain the Federal Reserve in cases of emergency lending and debt guarantees. It also imposes several supervisory procedures on this institution.

Congress has missed a chance to extend the mandate of the SEC to the prevention of financial bubbles.

First, the GAO is asked to conduct on a one time basis an audit of the Federal Reserve as well as a study on the current system for appointing Federal Reserve directors. On a more permanent basis, the GAO will have authority to audit discount window lending and open market transactions.

Finally, a set of transparency disclosures on operations and internal rules (including the creation of a vice chairman for supervision position) complete the new framework.

In 2008, at the height of the crisis, the Federal Reserve provided or pledged extremely large amounts and it is understandable that Congress would worry about such unchecked power and try to rein it in.

It is also true that it was the swift coordinated and decisive action of the central banks worldwide that avoided a complete collapse of the banking system. Such response will not be possible in the future on the part of the Federal Reserve alone and the process will be delayed considerably.

In its restrictive approach, Congress has missed a chance to extend the mandate of the SEC to the prevention of financial bubbles. Furthermore, it has taken away some of its emergency intervention powers leaving the whole US financial system in a much more vulnerable position.

5. Creating transparency and accountability for derivatives

Some derivatives such as CDS (credit default swaps) did play a role in the financial meltdown by giving investors the false impression that their positions were hedged and allowing, through loopholes in accounting standards, reduced capital requirements. As explained in our previous papers, the problem did not arise from the use of complicated instruments or the way the markets were structured but rather from models that required a uniform assessment of credit risks (provided by the rating agencies). This over centralisation in the hands of unseasoned analysts replaced a much safer and broadly based appreciation of risk by departments staffed with experienced professionals in each and every bank.

This fundamental flaw is not corrected or even taken into consideration by the new rules.

Instead, the intention is to regulate derivatives as widely as possible. In particular, it directs the SEC and the CFTC towards regulation of over the counter derivatives; requires central clearing and exchange trading with a role for regulators and clearing houses to determine which contracts should be cleared; puts in place data collection and publication systems to ensure market transparency; provide regulators with sufficient authority to impose sufficient capital and margin requirements; finally it establishes a code of conduct *vis a vis* their counterparties for all registered swap dealers.

One thing is clear: the clampdown on the lucrative OTC derivatives will reduce large banks profits.

This new set of requirements is generally sensible and should not interfere with a growing derivative market. Will this new tool and the information it provides be sufficient to allow regulators to detect any emerging financial bubble (which inevitably will have a derivative component) and allow them to respond in a timely fashion? This capacity will depend on the attitude of regulators more than on the bill itself.

One thing is clear: the clampdown on the lucrative OTC derivatives will reduce large banks profits.

6. Mortgage reform

The most important obligation under this heading is that lenders ensure a borrower's ability to repay. It establishes a federal standard in that respect.

The other measures listed under this heading are meant to enforce this important requirement.

It is obvious that had this rule been in force in the past years, the subprime crisis would not have occurred. In that sense it is a good initiative that will protect the consumer in the future. Even though banks have, for the time being, learned their lesson and, as witnessed by a sluggish private real estate market, tightened their lending criteria this rule enacts prudence in the housing market finance.

In all likelihood, this provision will not affect future speculative situations because financial speculation is recurrent but rarely if ever repeats itself.

The mortgage reform can therefore be considered as a good measure to protect the public and improve the quality of lending to the housing market. In terms of avoiding future financial speculation, its usefulness is arguably low.

7. Hedge funds

In the blame game that followed the crisis, hedge funds were one of the favourite targets of politicians. Their secretive attitude, the speculative nature of their trades and the huge amounts they managed, turned them into the perfect suspects.

The reality is that they were neither at the root of the real estate speculation that turned into the subprime situation nor instrumental in aggravating the last phases of the crisis.

Nevertheless, government have long been uncomfortable with the fast growing and financially powerful industry while at the same time careful in preserving the potential advantage of keeping in the US a key but geographically very mobile component of modern finance.

The outcome is a rather mild regulation that requires hedge funds to register with the SEC and more importantly to provide information about their trading activities, necessary for regulators to assess systemic risk.

It is difficult to forecast whether such rules could trigger the departure of these highly secretive organizations to more inviting countries. It probably will depend on how the administration will apply the new rules.

For the time being, this part of the bill does not address any cause of the 2008 meltdown. It might in the future give some warning of a growing bubble through a better insight into hedge funds trades, but only on a partial basis because of the global nature of this industry.

8. Credit rating agencies

The widespread use of credit ratings in financial evaluation models put credit rating agencies at the heart of the crisis.

The overwhelming responsibility these agencies carry in the conduct of modern finance and their oligopolistic situation require a strict oversight.

This need has been well recognized by the US Congress. The new requirements include methodology disclosure and use of independent information. More importantly, it allows investors to bring private rights of action against them. Conflicts of interest are also tackled but do not go as far as shifting the payments of fees from paper issuers to investors. Also it perpetuates a centralized system of credit risk measurement that amplifies any incorrect assessment.

Here the bill comes closer to fixing one of the main causes of the crisis.

9. Executive compensation and corporate governance

The rise of shorterm-ism is at the root of the 2008 financial breakdown. It affected individuals, regulators, politicians and of course banks. The escalating amounts and the structure of executive compensation accelerated the process. Stock options in particular aligned banks' management time horizon to stock market short term vision.

The issue had to be addressed but the proposed measures fall short of an adequate solution.

Shareholders will now have the right to vote on executive pay but only in a non binding manner which of course undermines the intent.

Compensation committees will include only independent directors. The principle is sound but it might create an incentive for management to increase the proportion of friendly and less challenging directors.

Such constraints go in the right direction. They seem too mild to seriously deter banks in the context of a securitized-fuelled speculative bubble.

10. Securitization

The new rules require that companies that sell securitized products retain at least 5% of the credit risk, unless the underlying loan meets standard that reduces riskiness. A better disclosure requirement on the quality of the underlying asset also improves transparency.

Although 5% could be insufficient to deter reckless sale of risky paper, this provision will clearly have banks think twice before they enter into a loan with the exclusive intention to securitize it.

Such constraints go in the right direction. They seem too mild to seriously deter banks in the context of a securitized-fuelled speculative bubble.

What it will do in the future however is curtail even further the availability of legitimate securitized debt in view of the progressive burden it creates on banks` balance sheets.

11. Other measures

Various other measures are included in the bill that are loosely related to the past crisis.

Some of them such as improvements to bank and thrift regulations tighten the implementation of provisions already discussed. Tackling the effect of the mortgage crisis deals with emergency mortgage relief or neighbourhood stabilization program.

Others aim at regulating insurance, municipal securities industry and brokerage industry to protect further the investor.

A few like interchanges fees, credit score protections or transparency for extraction industry including Congo conflict minerals are more a reflection of the political process in the US Congress rather than a solution to future financial problems.

Finally, the creation of a consumer financial watchdog with consolidated, well defined powers and the capacity to act fast is good news for bank clients. On the other hand, it could affect some lucrative bank business such as credit cards.

Finally, the bill leaves reasonable room for regulators to adjust to market conditions and the competitive international financial landscape. Its final impact will then depend on the way it will be applied. However the legislator stated aims are clear and unequivocal to the point where certain consequences become already predictable.

FOURTH PART

Does the Dodd-Frank reach its stated aims?

Let us recall that the US Congress has voted the bill in order to "create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street, end too big to fail and prevent another financial crisis."

1. Rein in Wall Street, end too big to fail

Most regulations under this heading are aimed at restraining banks.

Several provisions will reduce banks net results. The important contribution of OTC derivatives and perhaps credit cards to bank profits are bound to decline. Also the new conditions imposed on extending mortgages will restrict the volume of these lucrative loans.

The too big to fail requirements, as discussed above, might not be helpful in times of systemic crisis. Moreover it could have other undesirable effects.

By putting a lid on bank size, the Volcker rule caps the expansion potential of large banks. This will have an adverse effect on their share price which will lose the growth premium enjoyed previously.

The psychological effect of the yearly liquidation plan - the so called funeral plans - on management is difficult to measure but will certainly point toward a more conservative approach to business on their part.

Finally, US banks will be required under Basel III to raise more capital by international regulators at a time when their market related profits are under pressure, their share price reflects their reduced potential for growth and while they face a less restrained competition in global markets.

Under such conditions and considering that sophisticated high margin new financial products will be under close scrutiny, the main way out for banks will be to squeeze as much profit as they can from their main lending business. This means that they will try first to contain bad debts by applying even more stringent lending criterias thus reducing the amount of credit they extend while at the same time exacting larger spreads on loans and increasing the cost of borrowing throughout the whole economy.

As for reining in Wall Street, the objective is only partially reached as other actors such as hedge funds face much lighter requirements and will retain the capacity to move markets significantly.

2. Protect consumers

Consumer protection is well covered by the bill.

The new directives on extending mortgage loans and improving transparency on bank loans will probably be quite efficient.

The new supervision of the insurance industry as well as the authority of the SEC to impose fiduciary duties on brokers will also in time improve consumer and small investor protection.

The creation of a consumer watchdog completes the process and should bring a real improvement in consumer protection.

It might also inhibit a new sub prime type crisis in the future but the probability of further excesses in that area is very low in any case.

3. Prevent another financial crisis

The recommendations made under scenario three to rectify the shortcomings that lead to the 2008 crisis and to build a path toward a long lasting recovery, are only matched in the case of rating agencies oversight. Some other suggestions are partially met but nevertheless, it is clear that, within the logic of our original paper that the new bill will not prevent another financial crisis.

The new restrictions introduced by the Dodd Frank bill will delay fast and decisive action from the Federal Reserve needed in case of acute financial meltdown.

Indeed, the recent sovereign debt scare in the European Union, a clear consequence of our scenario two, has shown that governments were unprepared for a financial meltdown induced by their own excesses. It is also easy to see that none of the measures of this bill could significantly prevent such occurrence.

Furthermore, the new restrictions introduced by the Dodd Frank bill will delay fast and decisive action from the Federal Reserve needed in case of acute financial meltdown. Accordingly, the window of opportunity to quell an imminent systemic downward spiral could be missed. It is even possible to argue that such window of opportunity might not exist anymore as banks will have now by law to be put into liquidation under the funeral plan at a early stage, triggering more difficulties for other banks and quickly creating a chain reaction of financial institutions going into bankruptcy.

4. Create a sound economic foundation to grow jobs

Faced with a new legislation that will at the same time deplete their profits, weigh on their share price and require additional capital, the logical response of banks as a business will be to apply stringent risk criteria to avoid bad debts, curtail their lending to preserve capital and increase their interest spread to enhance profitability. In view of the pivotal role of banks in the economy, all these actions can only slow down any potential recovery.

In that sense it is difficult to see how the Dodd-Frank bill could grow jobs.

What is more likely is that faced with low growth economy and high unemployment the federal government and the Federal Reserve will continue their policy of high deficits through government spending and artificially low interest rates. Such policy which, so far, has not produced any positive result will increase tensions in the economy rather than create jobs.7

Conclusion

By introducing consumer protection legislation and hitting hard on banks, the Dodd-Frank bill has been designed for political success.

However, it does not address most of the original causes of the crisis in part because it is not the result of an essential collaboration between the main actors of the 2008 unprecedented events. The US politicians have thus largely missed a unique opportunity to moderate future excesses and reduce the chances to set the economy and the markets on a smoother path along the lines of scenario 3 presented in my previous papers.

In fact our analysis shows that they might have increased significantly the risk of future volatility.

The contraction and increased cost of bank lending that is the logical consequence of the bill will in the long term hinder economic growth. Then the Federal government through various stimulus plans and support to states will feel compelled to boost its spending increasing then the risks of a sovereign debt crisis. These factors increase the chances of a scenario 2 type downward spiral.

At the same time, the very low interest rate policy will have to be maintained much longer than anticipated prompting investors to take undue risks in search of better returns. Also the huge liquidity in the system created by an uncontrolled rise in public debt is able to fuel new speculative bubbles. This works in favour of a scenario 1 type of speculative bubble.

Our conclusion is therefore that in the current tug of war between scenario one and two, this bill, as it starts to be applied, will further

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increase the tension between the two possible outcomes. In other words, the equilibrium that has prevailed since end of 2009[1] will become even more unstable and when it breaks down, the chances of a more severe outcome one way or another will have risen. Only that this time around, the treasury and the Federal Reserve will not be allowed to take the quick emergency measures that saved the world economy from a full depression in 2008.

[1] The financial crisis one year later: http://www.cirano.qc.ca/crisis/?l=en

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Novembre 2010