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Cool Heads Needed in Economic Turmoil

The current international financial crisis is the worst in most people's lifetimes. A global recession is in prospect. New Zealand cannot escape the consequences. The duty of policy makers is not to make them worse and to respond with policies to assist the country to emerge in better shape.

Some things are clear about the current crisis.

First, it will pass. Defensive actions by governments and market adjustments will pave the way for recovery, probably within a year or two. A repeat of the 1930s Great Depression is highly unlikely.

Second, market-based economic systems will not be abandoned. They involve risk and can be volatile, but their wealth-creating abilities are unsurpassed.

Third, just as in the 1930s depression, the stagflation of the 1970s and the Asian economic crises of the 1990s, many of the current problems are government-made. Governments and businesses need to learn from their mistakes.

The catalogue of follies that precipitated the sub-prime mortgage meltdown in the United States is long, and more emerge by the week.

Prime exhibits include the easy money policies of the Federal Reserve after the dotcom crash, which helped fuel the house price boom; the government sponsorship of Freddie Mac and Fannie Mac, the giant mortgage underwriters that failed; the legislation and political pressure that encouraged banks to lend to unqualified borrowers in the name of 'affordable housing'; land supply restrictions; mark-to-market accounting rules; non-recourse lending regulations; and more.

There will be lengthy deliberations on all these issues. Everyone is saying there is a need for better regulation, but this is vacuous in itself. The

general case for less intervention and more reliance on investor prudence seems overwhelming. Lightly regulated hedge funds and private equity firms have fared better than highly regulated banks.

Once the default avalanche was triggered, authorities in the United States, Europe and elsewhere had little option other than to act to protect their financial systems, although the merits of the various rescue operations will be long debated. A huge issue going forward will be the escalation of moral hazard – the expectation of government bailouts if imprudent lenders get into difficulty.

Thanks to earlier reforms, New Zealand avoided many of these mistakes, although the Reserve Bank's 'go for growth' bias from 2003 with excessively loose monetary policy, encouraged by finance minister Michael Cullen's unwise changes to the Policy Targets Agreement, contributed to the house price bubble which is painfully deflating, and to high ongoing current account deficits.

There are, nevertheless, clear and present dangers.

Some years ago the government rejected an Australian offer to extend to New Zealand depositors the same level of protection afforded its depositors in exchange for not imposing on bank subsidiaries in New Zealand the huge costs of separation of New Zealand and Australian operations. This now appears to be a doubtful call.

Given that decision and last week's move by Australia to introduce a deposit guarantee scheme, there was probably little option for New Zealand other than to follow suit, even though the Reserve Bank and Treasury had long advised against such measures.

However, the scheme being implemented looks clumsy and distorting: wide coverage of retail institutions rather than a focus on protecting the core financial system; costs on major banks amounting to tens of millions of dollars; preferential treatment of smaller institutions; the problematic issue of the absence of a guarantee on wholesale foreign borrowing; massive taxpayer exposures; and moral hazard risks for the future.

Even more threatening is the possibility of an Iceland scenario: the problem of refinancing very large amounts of external debt as loans fall due. Dr Cullen rightly used to worry about excessive balance of payments deficits, but they have continued on his watch.

A major error has been to misdiagnose them as an insufficiency of domestic savings. Even if all countries had the same savings rate, there would still be current account deficits and surpluses between them because rates of investment would differ.

Instead, besides loose monetary policy, the main causes of the ongoing deficits have been years of excessive government spending and cost-increasing regulations that have depressed productivity growth, damaged New Zealand's international competitiveness and squeezed export and import-competing industries.

If external credit dries up, or only comes at a high cost, New Zealand would have to adjust by exporting more and importing less. This would require a shift of resources from the non-traded to the traded goods sector. The nominal exchange rate and real wages would fall. Anything that impedes this adjustment, such as more government spending and public sector wage increases, would make it more painful.

Equally, proposals to defer provisional tax payments, re-arrange the SOE portfolio and pump up infrastructure spending are irrelevant to the underlying problem and could worsen it.

The economy was already in recession before the crisis hit, and is in no shape to absorb the shock of more wrecking balls. Reckless political reactions such as we are seeing daily could do great damage if cooler heads don't prevail.

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