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Financial Turmoil: Market Failure or Government Failure?

Scholars today widely agree that the Great Depression of the 1930s was largely 'made by government' – via excessively tight monetary policy by the US Federal Reserve, 'beggar thy neighbour' protectionist trade policies and other errors.

It was not a 'crisis of capitalism' as many assumed, but this mistaken belief greatly enhanced the allure of socialism and government intervention more generally.

Similarly, many saw the East Asian crises of 1997-98 as a disastrous consequence of open capital markets, and predicted a retreat from globalisation.

Instead they were quickly recognised as largely due to governments maintaining fixed and over-valued exchange rates and controls on capital flows.

Now in response to the turmoil in financial markets we are again seeing claims about the failure of capitalism and globalisation. Recent *Herald* columns by Tapu Misa, Bryan Gould and Garth George are examples.

How should we understand the current events, which are still unfolding and have a long way to run?

Books will be written on the subject, but plainly the present crisis has a strong 'made by government' element to it again.

Recall that it began with the bursting of the US housing bubble and the high default rates on 'subprime' mortgages (risky loans to unqualified borrowers).

What caused this bubble? A prime source was easy money – the Federal Reserve cut interest rates in response to the dotcom cash earlier

this decade and kept them low despite inflation pressures and the surge in the prices of housing and other assets.

Moreover, the Fed's 1998 rescue of Long Term Capital Management and its response to the dotcom crash led many to believe in the so-called 'Greenspan put' – the expectation that the Fed would bail out troubled financial firms, especially large ones. This arguably resulted in imprudent borrowing and lending (any charges of 'greed' should factor this in, and be levelled at both sides of the market).

Another very important contributor was the implicit government support of Fannie Mae and Freddie Mac, the two huge corporations that back nearly half of the \$12 trillion mortgages outstanding in the United States.

This was a train wreck waiting to happen. The government backing undercut private lenders and encouraged risky practices. Efforts to rectify this situation were defeated by the Democrats in Congress.

Another factor was political pressure on banks to lend in the name of 'affordable housing' (sound familiar?). As a Brookings economist put it, banks "had to show they were making a conscious effort to make loans to subprime borrowers."

Other ill-conceived government regulation has played a part. This includes the requirements for banks in the United States (and internationally) to hold specified levels of capital. Critics have argued that they encouraged banks into off-balance sheet securitisation of mortgages and other assets which has been a prime source of the problems.

Further dubious regulations include mark-to-market accounting requirements (which helped bring down AIG) and those relating to the oligopoly status of the credit rating agencies.

Wider government interventions are also relevant. An example is land supply restrictions that helped drive up house prices in states like California. The fall-out has been milder in less-regulated jurisdictions like Texas.

Another is the plethora of regulations restricting mergers and takeovers of under-performing firms in the United States.

None of this is to argue that there were not serious failures by boards and managements of banks and other institutions. Many of them have been rightly punished through shareholder losses and management firings.

Questions will be asked about corporate governance and executive pay. This is as it should be: as Kipling wrote:

“Let us admit it freely, as a business people should – we have had no end of a lesson: it will do us no end of good.”

When the dust eventually settles some things will stand out.

First, market-based economic systems will not be abandoned: their wealth-generating capabilities relative to alternatives are unsurpassed and recognised worldwide.

Second, many of the pathologies are US-centred: Australian and New Zealand banks have been far less affected (although excessively loose monetary policy earlier this decade and land supply restrictions have unduly inflated the New Zealand housing market).

Third, we have learned yet again that government regulation often does more harm than good. As the *Wall Street Journal* observed, the great irony is that the banks that made some of the worst mortgage investments were the most highly regulated. Bank regulators cannot possibly spot all weaknesses. More emphasis must go on caveat emptor – investors and depositors beware.

The *Journal* also noted that “Adam Smith, that great market disciplinarian, is punishing excess and remaking American finance long before Congress can get into the act.” Nevertheless, there is a big risk that hasty political reactions will produce more bad regulation.

Finally, this won't be the last government-induced boom and bust. Lehman Brothers was gearing up (like Enron) for carbon trading. Will the carbon market be the next fiasco in a few years' time?

Roger Kerr (rkerr@nzbr.org.nz) is the executive director of the New Zealand Business Roundtable.