Don Brash: Lack of regulation not the problem

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Don Brash
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Bryan Gould argues that the world must learn many lessons from the current international economic crisis ("Global crisis shows need for revision of economics"). Alas, most of the "lessons" he proposes we learn are absolutely the wrong lessons.

Let's first concede that many mistakes were made by many people in the years preceding the current crisis. Irrational exuberance extended well beyond the dot.com stocks in the 90s into the residential property market and the financial sector in this decade.

In retrospect, both monetary policy and fiscal policy were too loose, in the United States at least. And of course, in some cases there was criminal fraud (Bernard Madoff being the best-known example).

But Gould implies that the crisis was caused by "free" and unregulated markets, especially in the financial sector. This is quite simply nonsense. Banks may be relatively lightly regulated in New Zealand (where there is no banking crisis), but they have been highly regulated in the United States and Europe for many years.

Government agencies have stipulated minimum capital levels that banks must maintain, and have enforced a wide range of rules and restrictions, including limits on concentration of credit risk, limits on net foreign exchange positions and much more. They have monitored those rules by regular on-site inspections.

In many ways, this intensive supervision by official agencies made matters worse by leading bank customers to assume that banks were effectively "guaranteed" by Government, thereby enabling banks to operate with levels of capital well below those regarded as prudent in earlier decades. Perhaps even more serious, intensive supervision led some bank directors to suspend their own judgment, and believe that they were behaving prudently provided they were observing all the rules.

Gould seems not to have noticed that the crisis emerged not in the essentially unregulated hedge fund industry, or even among private equity funds, but in the most highly regulated part of the financial sector, namely banking.

Gould argues that "Government involvement in the management of the economy is essential", implying that that has not been the case in recent decades. Again, that could hardly be further from the truth.

Government taxation and spending make up some 40 per cent of total economic activity in most developed countries, and in all developed countries regulations of one kind or another tightly control what businesses can do.

Even in monetary policy - where Gould seems to imagine that central banks are a law unto themselves, operated by bankers primarily for the benefit of other banks - Governments ultimately hold the whip handle.

In the United States, the Federal Reserve Board operates under a statute dating back to early last century, and the chairman of the Fed gives a regular account of his activities to a congressional committee.

The current chairman of the Fed has never been a banker.

In New Zealand, the Reserve Bank has to aim monetary policy at an inflation band agreed with the government of the day, must publish the way it sees monetary policy operating in the immediate future at three-monthly intervals, appears before the finance and expenditure committee of Parliament to be cross-examined every three months, and is subject to a potential "override" of its decisions by the Minister of Finance. The current Governor has never been a banker.

Britain adopted a very similar structure for the Bank of England in 1997, immediately after a new Government was formed by the Labour Party of which Gould had been a senior member for many years. The current Governor has never been a banker.

Gould in any case asserts that fiscal policy is more important than monetary policy. I would not want to get into a debate about which is more important - both are important. At its most basic, monetary policy is essentially about preserving the purchasing power of money.

Unless that is achieved within some tolerable limits, money can't fulfil its important roles as a unit of account, a basis for transactions, and a store of value - just ask the Zimbabweans!

With the benefit of hindsight, monetary policy was probably too loose in recent years, in some countries at least.

We also know that, in the nineties, the United States Government started putting pressure on American banks to lend to borrowers of quite marginal creditworthiness to prove that they were not discriminating on the basis of race.

And driving the housing bubble in many markets, in the English-speaking world at least, were the highly restrictive zoning policies of local governments – policies which sharply increased the price of residential land and led both borrowers and lenders to assume that the price of housing would increase forever.

They were clearly wrong, but they were hardly operating in the "free and unregulated" markets which Gould imagines.

Don Brash is a former Governor of the Reserve Bank of New Zealand.