Trying to be a Rational Banker in an Irrational World

by Gary Judd, QC, Chairman, ASB Bank[1]

Speech prepared for Institute of Directors, Company Chairmen's Workshop, Millbrook, 27 September 2009 (abridged)[2]

The title of my presentation is "Trying to be a rational banker in an irrational world". That gave me wide scope including the ability to adapt what I might want to say to circumstances which seemed likely to change during the period between when I selected the title and today.

I want to talk to you about some of the causes of the current financial and economic crisis.

My thesis is that there has been a failure by policymakers clearly to identify and honestly to state what those causes are. Instead we have been subjected to rhetoric which suits and is aligned with political agendas because it shifts the blame away from the policymakers.

Clearly identifying and honestly stating the causes of the crisis are necessary for the purpose of devising the right responses. C.f, "In order to meet their commitment to fight protectionism, G20 leaders need to come to grips with what causes it": Lowy Institute for International Policy, September 2009 Policy Brief.[3]

When Commonwealth Bank first became involved with ASB, CBA's managing director was Don Sanders. He introduced me to a little book called "The Country Banker", first published in 1885. This was written by George Rae who lived from 1817 to 1902 and was a banker for almost all his adult life. He had this to say "Our bank failures, without exception, have been the result of either a deplorable ignorance, or a culpable disregard of the first principles of everyday banking."

He said that in the Banker's dealings with the public there must be a total absence of bias -- religious, political or social. "Your doors are open to all sorts and conditions of men, except that you draw the line at dishonesty. You will have no dealings with a rogue, if you know it. You will not open even a deposit account with a stranger, unless he be satisfactorily introduced, lest you find that you have been entertaining a rascal unawares.... In banking the scope for the feelings is limited. You discount a bill, or you lend a man money, or you refuse to

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[1] On 2 August, 2011, Gary Judd retired as chairman and a director of ASB after more than 26 years, first as a trustee of the former trustee bank and since 1988 as chairman of directors.

[2] This version of the speech was prepared 21/8/2011. Apart from footnotes, abridgement is only by deletion of material which reflected the Chatham House Rules basis of the original, lacks present relevance because of its then topicality or is peripheral to the thesis.

[3] http://www.lowyinstitute.org/Publication.asp?pid=1115

do either, as the case may be, not as a matter of sentiment or affection, but purely as a matter of pounds shillings and pence."

He concludes this section, which is a chapter describing the function of a bank manager with the words: "It will be the daily study of your business life, therefore, to learn to distinguish at a glance those transactions in banking which are safe and legitimate, from those which are unsafe and pernicious".

Whilst those words were written when conditions were vastly different to what they are today, the essential message remains as valid today as it was then.

Contrast those statements with this one. "The regulatory issues in the 1990s will not be limited to safety and soundness, but will increasingly emphasise fairness: whether or not banks are fulfilling the needs of their communities".

Who said that? Not someone readily recognisable as a trendy lefty liberal but Lawrence B Lindsey, Member of the Board of Governors of the Federal Reserve System in an address to the California Bankers Association on May 11, 1992.

When Mr Lindsey was telling his banking audience that safety and soundness should be relegated in favour of fairness and the needs of banks' communities, he was in effect saying that the political version of the sentiment or affection -- which George Rae counselled should be avoided -- was what should determine bankers' decisions in relation to the granting of credit.

What Mr Lindsey said was quoted with approbation by the Federal Reserve Bank of Boston in a document entitled Closing the Gap:} A Guide to Equal Opportunity Lending[4], which was released in April 1993. This document made recommendations to Boards of Directors, Management and Loan Production Staff in financial institutions. Ostensibly this document's purpose was to make recommendations to avoid discrimination against racial minorities but in reality it was telling financial institutions to subordinate normal credit evaluation processes in favour of providing equal opportunity to persons who for various reasons would normally be regarded as not creditworthy, persons who if one were to apply the precepts referred to by George Rae would never get a loan because to make the loan would be unsafe and pernicious.

The Boston Federal Reserve document is not isolated. For example, I refer to a 1996 publication by the Federal Deposit Insurance Corporation which includes a Compliance Examination Manual[5] (such publications by the FDIC continued

[4] http://www.bos.frb.org/commdev/commaff/closingt.pdf

[5] **Side** by Side: A Guide to Fair Lending, 1996 revision of 1994 document.
http://www.fdic.gov/regulations/resources/side/partthree.html.

subsequently, although it does appear that by around 2005 -- after the horse had bolted -- the FDIC started to promote more sensible policies).

"FDIC COMPLIANCE EXAMINATION MANUAL

Available by Subscription from the FDIC

Fair Housing Section

In the previous section of this guide, A Comparative Analysis of Residential Loan Applications, we stressed the importance of reviewing loan policies and procedures for any disparate impact implications, i.e., where policies and practices may appear neutral on their face but have the net effect of a disparate impact on a protected group. If an adverse effect or impact on a prohibited bases group is shown, it is the responsibility of the institution to justify the particular policy or practice by a "business necessity." Some policies or practices that may raise disparate impact questions include, but are not limited to, the following excerpted from the"FDIC Compliance Examination Manual"

- A requirement that the property securing a mortgage loan must not exceed a particular age, or appraisal practices that establish unrealistically low values for older properties
- Restricting mortgage lending to loans for certain types of properties, such as single family homes, properties having no more than two floors, those with large lots, garages, or with large square footage requirements
- A policy of not making loans on properties in certain locations or appraisal practices that arbitrarily discount the value of a property because of its location
- A policy of making mortgage loans only to applicants who have previously owned a home
- Establishing highly restrictive downpayment or income requirements, e.g., requiring a 25 percent downpayment or setting a very low (such as 20 per-cent) maximum monthly mortgage payment to income ratio
- Setting high minimum mortgage loan amounts that effectively exclude low-income borrowers or low maximum loan amounts that limit the financial institution's participation in the mortgage market
- Arbitrarily excluding FHA or VA mortgage loans

In addition, general and not specific subjective lending criteria may raise effects test or disparate impact questions.

> Examples of subjective lending criteria that may lead to possible unlawful discrimination include:
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> - The property should be in a "stable" or "rising" area, should be "well-maintained" and have an "attractive appearance" or "good curb appeal"
> - The neighborhood should be "desirable"; there should be "homogeneity of residents and structures"; or the neighborhood should reflect "satisfactory pride of ownership"
> - Applicants must not be of "questionable" character; must have an "excellent" credit rating; or must have "adequate" longevity on the job
>
> Such subjective criteria may allow lending personnel to arrive at differing interpretations. Also, they may have the effect of discouraging creditworthy applicants."

Underlying the messages conveyed by such publications is a raft of legislative provisions: Home Mortgage Disclosure Act (Regulation C) 1975, Equal Credit Opportunity Act (Regulation B) 1974, Fair Housing Act 1968, and the Community Reinvestment Act 1977.[6] These provisions remain in force. Whilst some may say it is possible to read this legislation in a manner consistent with sound banking practices, it can be seen from the material to which I have referred that government agencies did not wish promote it in that way. They were using it for social engineering purposes.

There is a chilling message conveyed by the Boston Federal Reserve document which is included in a section devoted to Staff Training. "Did You Know? Failure to comply with the Equal Credit Opportunity Act or Regulation B can subject a financial institution to civil liability for actual and punitive damages in an individual or class actions. Liability for punitive damages can be as much as $10,000 in individual actions and the lesser of $500,000 or 1% of the credit or's net with in class actions."[7]

Furthermore, when financial institutions were seeking to gain regulatory approval for some action they were wishing to undertake (a merger or a takeover, perhaps) they were forced to complete a scorecard to indicate the degree to which they were complying with these sorts of regulatory requirements.

When politicians, particularly those in the United States, talk about the cause of the economic crisis being "Wall Street greed" and the like, they fail to look at their own actions in legislating for policies which promoted bad banking practices in

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[6] A summary of these laws can be found on page 26 of Closing the Gap:} A Guide to Equal Opportunity Lending http://www.bos.frb.org/commdev/commaff/closingt.pdf.
[7] Ibid, page 10.

relation to the United States housing market. These policies meant that mortgage originators were encouraged to make bad loans. Whilst it has been convenient for politicians and policymakers to blame mortgage brokers, lending institutions and others within the private sector for injudicious lending practices, there has been a complete failure by government to acknowledge that government policies were being implemented when the bad loans were originated, and that people involved in the mortgage origination business would have been acting contrary to government policy backed up by legislation had they been observing lending practices consonant with sound banking practice.

I first heard the term "toxic assets" at this workshop towards the end of September last year. Those of you who attended will recall we were addressed by Paul Silk of Medley Advisors. At that time Treasury Secretary Paulson was advocating for the passage of the TARP -- Troubled Assets Relief Program -- and Paul was telling us that avoiding global financial meltdown depended on the passage of that legislation. It was eventually passed -- but it never got implemented in the way it was promoted. It was promoted as providing the government with the ability to buy toxic assets from financial institutions which were in trouble to get the toxic assets off the balance sheets. But it never happened that way. Instead the government used funds made available by the legislation to put capital into banks -- to recapitalise them with government money so that to varying extents a number of US banks became substantially owned by the US government.

What happened to private enterprise in the land of the free, in the land generally regarded as the bastion of capitalism? You may well ask!

I was in New York at the end of September 2008, a few days after last year's workshop, in the thick of what were the most extraordinary of financial events. I spent a lot of time watching the television and obtaining information off the Internet. The focus was of course on the Troubled Assets Relief Program and the attempts to have the legislation passed.

And what struck me most vividly in all the proclaiming and posturing and politicking was that I did not hear one voice articulating the real causes of the crisis. Instead hatred was being whipped up by the vitriolic attacks on members of the financial community. "Wall Street greed" was the prevailing mantra.

It was said that the greedy Wall Street bankers collected the toxic assets, then sliced them, diced them, packaged them and on sold them to other banks and institutions and retail investors all around the world. And of course these packages of toxic assets were given investment-grade ratings by the ratings agencies.

But the extraordinary thing is that amongst all this hype, not one mention was made of the conditions without which it would not have happened. There would have been nothing for the investment bankers to slice, dice and package if the toxic assets had not been created in the first place.

And here we move to the real causes of the economic crisis, causes which were not acknowledged in official circles and are rarely acknowledged in official circles today and are often not acknowledged by people who move on the fringes of official circles, because it is not politically correct for them to do so.

The fundamental cause of the global economic crisis was liquidity in the global financial system -- the credit creation which arose from deliberate actions of the US Federal Reserve and other central banks, including our own, in keeping interest rates low. We now know with the benefit of hindsight that they were kept artificially low. So there was all this money sloshing around in the global financial system and it had to go somewhere. Where it went was primarily into the US residential lending market.

The analogy I have been using for a long time is that of an aortic aneurysm -- "An aortic aneurysm is a general term for any swelling (dilatation or aneurysm) of the aorta, usually representing an underlying weakness in the wall of the aorta at that location. While the stretched vessel may occasionally cause discomfort, a greater concern is the risk of rupture, which causes severe pain; massive internal hemorrhage; and, without prompt treatment, results in a quick death."

The aorta is the global financial system. Within this financial aorta was the high 'blood' pressure of excess supply of credit induced by the low interest rates. These conditions usually result in price inflation but price inflation was kept down by the abundant supply of Asian consumer goods resulting from the production and productivity of that sector. This helped to disguise the price inflationary pressures created by the inflated money supply.

The underlying weakness in the wall of the aorta was the US residential lending market. This weakness existed because of the American love affair with homeownership which had resulted in the host of ill judged government policies to which I have referred -- policies designed to promote lending into the sector.

The excess supply of credit induced by the low interest rates promoted high demand for housing assets and consequential housing asset price inflation -- what is now described as the housing asset bubble. In my analogy, the financial aorta had started to stretch.

In the mid-2000s, the Federal Reserve became concerned about inflationary pressures so it started increasing interest rates. People who had been induced to take out housing loans were suddenly faced with increasing interest rates when their loans came up for renewal. In my analogy, the stretched vessel started to cause discomfort.

When it became impossible for people to renew their loans, foreclosures started to occur. This was not just the actions of financial institutions in undertaking what we in New Zealand refer to as mortgagee sales. In the United States foreclosure means the financial institution taking possession and ownership of the housing asset. More importantly, in many states of the United States, state law prohibits the financial institution from having the benefit of both the security and personal covenant. In New Zealand a borrower remains liable for any deficiency if the security is inadequate to repay the loan. Not so in these states of the United States. The financial institution takes the house. The borrower has no ongoing liability. Borrowers can choose if they do not wish to continue to meet their borrowing obligations to simply hand the keys over to the financial institution.

Last year before attending the APEC meeting in Lima, Peru, I went to Machu Picchu. There I met a retired dentist from Los Angeles. I took the opportunity to ask him about these policies. He told me of a surgeon whom he said used to be his friend, a wealthy man with a very good income. The surgeon had a house which had become worth less than the amount owing on it. He bought another more expensive house having persuaded some institution to lend him the money and he simply handed back the keys of his first house to the lending institution. He was able to walk away without any personal liability in respect of that loan. The dentist told me the surgeon was no longer his friend because he was so disgusted at the surgeon's behaviour.

I return to my aortic aneurysm analogy. Prompted by the rise in interest rates, foreclosures started to occur and there was a general and continuing decline in the value of housing assets, a rapidly escalating downward spiral. The financial aorta had begun to rupture causing severe pain and internal haemorrhaging. The housing loan assets rapidly became worthless because no one wished to acquire them. Effectively this asset class just died.

The American housing market was the weak place in the financial aorta. Had the excess money supply not found its way predominantly into that market it probably would have gone somewhere else. Whether it would have had the same disastrous consequences can only be a matter of speculation. But we must deal with the facts and the facts are that the primary asset bubble was created in that market.

In the United States, bankers and other mortgage originators did what government policy wanted them to do. They lent without paying proper regard to the financial soundness of the borrowers and in circumstances where collateral was impaired because value was artificially inflated and where in many cases they were lending within a financial system which removed all personal responsibility from the borrowers. Buyers into this market would in those cases know that their only risk was to lose their house. But when that means no more

than going back to the position you were in beforehand there is no real risk. You may as well enjoy the pleasures of homeownership.

In doing what government policy wanted them to do, the brokers and other purveyors of housing loans lost all sense of proportion, one might say lost all sense. So we had such crazy things as "pick a payment" mortgages. These were loans where borrowers were invited to decide how much they would pay.

Lending institutions and borrowers alike proceeded on the basis that there was only one way the housing market could go and that was upwards. If borrowers finally found they could not afford the loan, that would be okay because the house could just be sold.

The situation was made worse by the activities of other participants in the housing market.

The "toxic assets" created as a result of these policies were cascaded into financial instruments which got disseminated around the world. Nobody seemed to realise that if you put together a parcel of these toxic assets, it didn't turn them into instruments which were deserving of a high credit rating. Rubbish is rubbish whether it is an individual piece or a part of a large parcel. The large parcel is also rubbish. Yet they got investment-grade ratings from the ratings agencies.

The origination of these financial instruments was made possible largely by two US government supported institutions, Fannie Mae and Freddie Mac, who were the major instrumentalities for securitising the "toxic assets", that is to say packaging them together and selling them to provide more capital to be reinvested in the housing market. As of 2008, Fannie Mae and Freddie Mac owned or guaranteed about half of the U.S.'s $12 trillion mortgage market. See the Wikipedia description[8] which includes the following summary of Fannie Mae's activities.

Fannie Mae buys loans from approved mortgage sellers, either for cash or in exchange for a mortgage-backed security that comprises those loans and that, for a fee, carries Fannie Mae's guarantee of timely payment of interest and principal. The mortgage seller may hold that security or sell it. Fannie Mae may also securitize mortgages from its own loan portfolio and sell the resultant mortgage-backed security to investors in the secondary mortgage market, again with a guarantee that the stated principal and interest payments will be timely passed through to the investor. By purchasing the mortgages, Fannie Mae and Freddie Mac provide banks and other financial institutions with fresh money to make new loans.

President George W Bush tried to restrict the activities of these two institutions. This from an article in the New York Times of September 11, 2003.[9]

"New Agency Proposed to Oversee Freddie Mac and Fannie Mae

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[8] For more information about Fannie Mae (what is said can be applied equally to Freddie Mac), see http://en.wikipedia.org/wiki/Fannie_Mae

[9] http://www.nytimes.com/2003/09/11/business/new-agency-proposed-to-oversee-freddie-mac-and-fannie-mae.html?sec=&spon=&&scp=3&sq=%202003%20fannie%20freddie%20labaton&st=cse

By STEPHEN LABATON

Published: Thursday, September 11, 2003

The Bush administration today recommended the most significant regulatory overhaul in the housing finance industry since the savings and loan crisis a decade ago.

Under the plan, disclosed at a Congressional hearing today, a new agency would be created within the Treasury Department to assume supervision of Fannie Mae and Freddie Mac, the government-sponsored companies that are the two largest players in the mortgage lending industry……

The plan is an acknowledgment by the administration that oversight of Fannie Mae and Freddie Mac -- which together have issued more than $1.5 trillion in outstanding debt -- is broken. A report by outside investigators in July concluded that Freddie Mac manipulated its accounting to mislead investors, and critics have said Fannie Mae does not adequately hedge against rising interest rates.

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[Treasury Secretary John W. Snow] said that Congress should eliminate the power of the president to appoint directors to the companies, a sign that the administration is less concerned about the perks of patronage than it is about the potential political problems associated with any new difficulties arising at the companies.

The administration's proposal, which was endorsed in large part today by Fannie Mae and Freddie Mac, would not repeal the significant government subsidies granted to the two companies. And it does not alter the implicit guarantee that Washington will bail the companies out if they run into financial difficulty; that perception enables them to issue debt at significantly lower rates than their competitors. Nor would it remove the companies' exemptions from taxes and antifraud provisions of federal securities laws."

I highlight from this report that Fannie and Freddie are government sponsored agencies. The president appointed the directors, they received subsidies and had an implicit government guarantee. They were exempt from taxes and antifraud provisions of federal securities laws.

The Bush administration's endeavours to rein in Freddie and Fanny were frustrated by the Democrats in Congress. Fannie and Freddie were able to carry on regardless. This from Wikipedia on Congressman Barney Frank[10], probably the greatest supporter of Fannie and Freddie within the US Congress.

[10] http://en.wikipedia.org/wiki/Barney_Frank

House Financial Services Committee

Fannie Mae and Freddie Mac

In 2003, while the ranking Democrat on the Financial Services Committee, Frank opposed a Bush administration proposal for transferring oversight of Fannie Mae and Freddie Mac from Congress and the Department of Housing and Urban Development to a new agency that would be created within the Treasury Department. The proposal reflected the administration's belief that Congress "neither has the tools, nor the stature" for adequate oversight. Frank stated, "These two entities...are not facing any kind of financial crisis.... The more people exaggerate these problems, the more pressure there is on these companies, the less we will see in terms of affordable housing."[51] …

A greatly watered down version of what the Bush administration had proposed was eventually passed by Congress in 2005.

The facts show that US government policies and procedures and the actions of US governmental institutions were directly and indirectly responsible in the first instance for the creation of the toxic assets which in turn lead to the global financial crisis. They were directly responsible

- by reason of the legislation which was passed to sideline sensible prudential practices, and
- by reason of the actions of government agencies in using this legislation to promote social engineering agendas, which promoted lending for homeownership without due regard to the creditworthiness of the borrowers,
- by reason of legislation in some states eliminating personal responsibility for repayment, and
- by reason of the activities of Fannie and Freddie as government-sponsored institutions.

US government policies and procedures were indirectly responsible because of the climate created by the laws and policies for which they were directly responsible.

This does not mean that many private-sector institutions did not also fail lamentably to maintain proper lending standards. It does not mean that there weren't brokers out in the market, and other mortgage originators, engaging in

bad practices to drum up business and benefiting in the remuneration they received from the loans that they sold. It does not mean that investment banks and other institutions did not fail to observe prudence and proper practices when they dealt with parcels of toxic assets. It does not mean that investment banks and other institutions did not have remuneration practices which encouraged this sort of poor behaviour.

But what I say is that *in the first instance* it was government activity which was responsible. For had the government not been doing what I have described, the scope for these private-sector activities would not have existed.[11]

I concluded the draft of this presentation on Tuesday 15 September, the deadline for submission to the IOD being the next day. Coincidentally, reported in New Zealand that Tuesday morning was a speech by President Obama on the economy.[12] He started his address with these ringing words.

It was one year ago that we experienced … a crisis. As investors and pension-holders watched with dread and dismay, and after a series of emergency meetings often conducted in the dead of the night, several of the world's largest and oldest financial institutions had fallen, either bankrupt, bought, or bailed out: Lehman Brothers, Merrill Lynch, AIG, Washington Mutual, Wachovia. A week before this began, Fannie Mae and Freddie Mac had been taken over by the government. Other large firms teetered on the brink of insolvency. Credit markets froze as banks refused to lend not only to families and businesses but to one another. Five trillion dollars of Americans' household wealth evaporated in the span of just three months.

As he went on, did he mention any of the matters that I have drawn attention to as being causes of the crisis? Of course not. It was all the fault of those greedy institutions and individuals who made reckless loans and enabled poor quality investments. They need to be stopped from doing it again. This is what he said.

Unfortunately, there are some in the financial industry who are misreading this moment. Instead of learning the lessons of Lehman and the crisis from which we are still recovering, they are choosing to ignore them. They do so not just at their own peril, but at our nation's. So I want them to hear my words: We will not go back to the days of reckless behavior and unchecked excess at the heart of this crisis, where

[11] An important further feature of the 2009 environment the full significance of which I did not them appreciate (apart from the specific NZ situation referred to below) but is now painfully evident is the lack of providence of many governments in racking up huge public debt, a process which accelerated in response to the GFC. A cynic such as I may say: in some cases the GFC was a convenient excuse to increase government involvement in the economy which for some is an ideological imperative. In terms of my thesis that identifying and honestly stating the causes of the crisis are necessary for the purpose of devising the right responses, it might be thought that massively increasing public debt to try to solve a problem of catastrophic private sector debt is to ignore one of the causes of the problem. In New Zealand's case we were fortunate that we started the process with the public balance sheet in good shape. But it could have been much better and the economy much better able to respond had the surpluses of earlier years not been squandered by profligate politically opportunistic government spending in pursuit of ideological imperatives (big government is best).

[12] http://enduringamerica.com/2009/09/14/transcript-president-obamas-speech-on-the-economy-14-september/

too many were motivated only by the appetite for quick kills and bloated bonuses. Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall.

That's why we need strong rules of the road to guard against the kind of systemic risks we have seen. And we have a responsibility to write and enforce these rules to protect consumers of financial products, taxpayers, and our economy as a whole. Yes, they must be developed in a way that does not stifle innovation and enterprise. And we want to work with the financial industry to achieve that end. But the old ways that led to this crisis cannot stand. And to the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself.

Instead, we are calling on the financial industry to join us in a constructive effort to update the rules and regulatory structure to meet the challenges of this new century. That is what my administration seeks to do. We have sought ideas and input from industry leaders, policy experts, academics, consumer advocates, and the broader public. And we've worked closely with leaders in the Senate and House, including Senators Chris Dodd and Richard Shelby, and Congressman Barney Frank, who are now working to pass regulatory reform through Congress.

Taken together, we are proposing the most ambitious overhaul of the financial system since the Great Depression. But I want to emphasize that these reforms are rooted in a simple principle: we ought to set clear rules of the road that promote transparency and accountability. That's how we'll make certain that markets foster responsibility, not recklessness, and reward those who compete honestly and vigorously within the system, instead of those who try to game the system.

I shall come back to this again, after I refer to the primary cause of the crisis. But at this point I simply underscore that there is no reference whatsoever to the crucial part which US government policy had played. You will note President Obama's reference to Congressman Barney Frank, and remind you as I have demonstrated above of his involvement in stopping the legislative action to rein in Fannie and Freddie. That legislation is unlikely to have prevented what subsequently occurred but might have ameliorated the consequences of some of the more egregious activities of Fannie and Freddie had they been stopped in 2003.

I have been speaking so far mainly about one of the two major causes of the financial crisis but the primary cause was the excess money supplied to the system.

You can't necessarily blame the Federal Reserve and other central bankers for the misjudgements which resulted in the excess money in the system. The problem is the system which permits men to play God with the money supply. They think they know what's best but they don't. A central banker can get something right only by sheer coincidence. Even if he doesn't make a misjudgement of events current at the time, he cannot be responsive to future changes in the financial environment in such a way as to avoid perverse outcomes, because first of all he has to recognise that the environment is changing and secondly he has to use imprecise instruments to try to deal with the change.

Take our own central bank. Interest rates were kept low in the early 2000's -- which at least one economist called the "go for growth" policy, a policy roundly criticised by that

economist[13]. RBNZ became concerned about inflationary pressures, particularly asset inflation in the housing market and hiked interest rates in 2007. But RBNZ didn't know we were going to have a drought. And it didn't know that oil prices were going to skyrocket during 2008. So what happened? By the time the global economic crisis properly arrived in September 2008, New Zealand had already been in recession since the beginning of the year. As a consequence New Zealand has had to bear greater pain from the global economic crisis than would otherwise have been the case. This is because the global impact was layered on top of the recessionary situation which already existed.

I do not need to dwell on the money supply cause of the crisis because that has been now acknowledged reasonably widely, for example by our own Reserve Bank Governor, Dr. Alan Bollard in a speech he gave to the Hawke's Bay Chamber of Commerce on 14 July 2009.[14]

The world recession in hindsight

The story of the past decade has now been told many times.

Around the world, liquidity and credit grew hugely until the crisis. The expansion was fed by stimulatory monetary policy in the developed world responding to the 2000-01 global downturn, a "glut" of international capital pouring out of emerging markets and oil producers, and a

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[13] Rodney Dickens
22 June 2007.
"**RODNEY'S RAVINGS**
Many will assume this Raving is about the Reserve Bank's recent interventions in the foreign exchange market. It is not. The attempt to push down the NZD by the Reserve Bank (RBNZ) is an exercising in being seen to do something rather than a realistic attempt to help exporters. It was never going to achieve much and could even be counter productive, but it means Governor Bollard, and indirectly Finance Minister Cullen and the government, can't be accused of not caring.
This Raving is about the "go for growth" experiment with monetary policy pursued since Governor Bollard took up the helm in September 2002. It is about exporters not only facing an excruciatingly high exchange rate, but also labour costs that are rising faster than their international competitors, low to negative labour productivity growth, and over the top construction costs. It is about the thousands of gullible investors who will see their dreams go down the tube at the hands of a central bank that experimented with low interest rates and fuelled the speculative bubble in the property market that the investors found irresistible.
Use the link below to access the report. http://www.sra.co.nz/pdf/thecosts.pdf."

4 May 2009. "This Raving provides one perspective on why the RBNZ is repeating the mistake it made in both the early 1990s and early 2000s. But rather than just whinge about inept monetary policy this Raving also looks at who will be some of the winners – or at least temporary winners – from the RBNZ having put its "go for growth" hat back on. The winners will include share market investors and firms exposed to the housing and residential building markets. Exporters will be losers because rather than resulting in a lower exchange rate the RBNZ's "go for growth" approach will help fuel a higher NZD. And ultimately we will all be losers when the RBNZ indulges in extreme interest rate settings. Anyone willing to learn should have learnt that the experiment with excessively low interest rates between 2002 and 2005 played a critical part in fuelling a speculative bubble in the housing market ! that in turn resulted in lots of people losing their shirts and/or hard-earned savings." http://mail.google.com/mail/?hl=en&tab=wm#advanced-search/subset=cat_Rodney's+Ravings&has=%22go+for+growth%22&within=1d/12109efb4b964cb4

[14] http://www.rbnz.govt.nz/speeches/3698349.html

proliferation of new financial firms, instruments and practices seeking to ride the credit wave. Risk managers and regulators alike struggled to keep up with the growing complexity. Credit expansion and asset price inflation reinforced each other, and oil and other commodity price inflation followed.

The boom proved to be unsustainable. Around mid-2007, US house prices began to fall, and impairments on mortgage loans began rising sharply. Soon, the quality of a wide range of securities and derivatives based on bank loans came under question. With growing panic about who was exposed and how badly, financial firms stopped dealing with each other in September 2008. Short-term funding markets shut down. Some very large firms, including Lehman Brothers, AIG, and Fannie Mae and Freddie Mac, failed or were restructured. The implosion of liquidity crippled the equity and term funding markets.

The widespread reduction in credit availability to the economy, massive loss of wealth, and plummeting business and consumer confidence drove economic recession. Developed-country consumers and firms slashed expenditure on big-ticket durable items such as cars and machinery. Reflecting this, exports and production in upstream economies in the global manufacturing supply chain, particularly in East Asia, collapsed (see Figure 1) – but commodity exporters such as Australia and New Zealand were less hard hit.

In the six months to March 2009, global economic activity fell more rapidly than at any time since World War II.

An aspect of that description with which I would cavil is the failure to mention that it was the Federal Reserve's decision to push interest rates up which placed pressure on borrowers' ability to service their borrowings and started the downward spiral which began to occur around mid-2007. Playing God with the money supply did not just create the expansionary conditions which led to the bubble in the housing market, but also it started the downward spiral.

Why is it important to understand these facts, the fact that the underlying cause of the problem was the money supply and the fact that the excess liquidity and credit found its way into the creation of the toxic assets largely because of US government policies? Because if you don't understand and acknowledge causes of a problem, how on earth are you going to be likely to devise appropriate solutions.

The major response of the world's political leaders has been to feed the financial system the same poison which caused the problem in the first place. A drunk might get temporary relief from a hangover by having more of the same but the relief is only temporary and then he'd get worse than he was the previous time. The hangover can be cured only by staying off the booze, drinking plenty of water and taking non-alcoholic hangover cure.

The financial system is no different. There had to be pain. There had to be casualties. The weak had to go and the strong to survive.

But that was politically unpalatable, so the politicians tried to prevent it from happening. Despite the fact that excess money supply caused the problem in the first place, the politicians and central banks are trying to solve the problem by increasing money supply. They have been doing it in two ways. First they have been encouraging credit creation by lowering interest rates. Secondly, in some economies -- in particular the USA and the United Kingdom -- they have been doing it by increasing the supply of primary money.

In the money supply system we have had since the gold standard was abandoned there are two basic sources of money supply. There is the money

which is <u>created</u> by the central banks and there is the credit which is <u>advanced</u> by the commercial banks. The quantity of money in circulation will depend on the quantities of both, but the money which is created by the central banks is far more important because the money supply arising from credit creation is a multiple of the money created by the central banks.

The quantity of credit in circulation will depend on behaviour -- the behaviour of borrowers in being keen or reluctant to borrow and of the banks on being keen or reluctant to lend. This behaviour is primarily influenced by interest rates, but not always. In some cases, even though interest rates are low, risk aversion may deter borrowing -- we see this at present in the business area -- business is cautious, banks are cautious. In other cases, even where interest rates are high, exuberance and inflation expectations may induce borrowing. Human behaviour is intensely frustrating for central bankers -- because human beings don't always do what central bankers think they should or will do.

What is of high concern at present, however, is that central bankers have not just been trying to induce economic activity by lowering interest rates to encourage credit creation -- in addition some central banks have been increasing the base money supply, the money which central banks create. The euphemism is "quantitative easing" -- but what it actually is, is printing money. The only difference between the United Kingdom and the US on the one hand and Zimbabwe on the other is a matter of degree.

If we take the US, for example, the government is running massive deficits. These deficits are financed by the US Treasury issuing bonds -- i.e. by borrowing money from the public. Because the government is borrowing in order to spend, the issuing of bonds by the government doesn't change the money supply -- money goes from the public to the government and then back to the public when the government spends it.

But what happens when the Federal Reserve buys a government bond? The bond is taken out of circulation and replaced by money. Where does the Fed get the money from? It doesn't get it by borrowing from the public, like the government did when it issued the bonds to finance the deficit. That would be self-defeating. For quantitative easing the very object of the exercise is to increase the money supply. No, what the Fed does is to print money, or the equivalent of printing money by crediting the appropriate institution's account with the Fed.

Once this has happened and the money in circulation has been increased it cannot be decreased again unless the Fed can persuade the public to buy bonds from the Fed. When the public buys bonds from the Fed, money is taken out circulation and replaced by bonds -- and the Fed, unlike the government, does not spend the money which it has taken out of circulation.

When the Fed decides at some point in time that it is concerned about inflation, it will want to sell bonds to the public. But the public will be awash with bonds because the government has been issuing them like mad to finance the deficit.

So we have the government wanting to issue bonds, and the Fed now wanting to sell bonds that it has bought for quantitative easing.

The only way the government and the Fed can sell bonds is by reducing the price -- i.e. by increasing the yield, that is to say by paying higher interest rates.

So it is inevitable that there will be upward pressure on interest rates for all durations except possibly very short-term interest rates which are the only ones which can be directly influenced by the overnight or official cash rates.

If there is a return of economic activity which, after all, is what the politicians are trying to induce, there will also be pressures in relation to the credit creation part of the money supply situation. So what happens if they get their wish. There will then, whether we like it or not, be upward pressure on commodity prices and asset prices. Price inflation is likely to occur and with that there is likely to be new asset inflation, i.e. asset bubbles.

If I now come back by way of conclusion to my thesis that there has been a failure by policymakers clearly to identify and honestly to state the causes of the global economic crisis. As I said, we have been subjected to rhetoric which suits and is aligned with political agendas because it shifts the blame away from the policymakers. Also I believe it to be aligned with a fundamental feature of the political condition which is the desire to be able to exercise control, and an enthusiasm to grasp opportunities to exercise such control.

Instead of saying that the fundamental cause of the crisis was the huge growth in liquidity and credit, as Alan Bollard has correctly identified, and asking what policy prescriptions are desirable going forward to ensure that doesn't happen again, the response of the policymakers has actually been to do precisely the same thing, but in spades, and in part in a much more dangerous way by creating primary money and not just by encouraging credit creation. If any consideration has been given to how this cause might be avoided in the future it certainly has not been the subject of public statements.

There has been no mention

- of the desirability of research and discussion to find a way of removing the basic problem which is central bankers playing God when they do not have the omnipotence and omnipresence attributed to God and so will get it wrong more often than not,

- even if policymakers won't do that, of policy prescriptions to prevent excessive liquidity and credit generation by central banks,

- that it was government policies which made it all but certain that the US housing market would be where the excess money supply would go, and consequentially

- of the changes in policy required to ensure that doesn't happen again,

- that the major source of the securitised toxic assets which the investment banks and other institutions packaged up to be sold to investors all around the world were the government sponsored organisations, Fannie Mae and Freddie Mac, and consequentially

- of the steps to be taken to get rid of them.

Instead, the political rhetoric is directed to putting the blame on others. Policymakers and politicians want the public to put the blame on "Wall Street greed". Policymakers and politicians say they want to try to prevent future problems by things such as increasing regulation, imposing restraints on remuneration and generally increasing governmental involvement in the financial affairs of economies.

On the face of it none of this makes sense. It is irrational.

To draw another analogy. It is a bit like engineers deliberately setting off explosive devices to cause landslides into a dam. Landslides which are likely to cause a breach in the dam and to flood the countryside below. Instead of ceasing to generate the landslides the engineers resolve to continue them but to try to build the dam a bit higher.

I don't know how things will turn out. I don't know how history will judge policymakers' response to the economic crisis. It may be that my cynicism is misplaced and that what has been done will prove to be a way out of the crisis.

But of this I am of no doubt: that there would have been a greater likelihood of finding the best response if there had been a clear and honest identification and acknowledgement of the causes of the problem. Instead we have obfuscation, evasion, posturing and politicking.

Even now we would be in a better position going forward if policymakers adopted a rational approach, even if belated.

A rational approach must take account of all causes. Ignoring fundamental causes is a recipe for disaster.