CENTRE FOR CIVIL SOCIETY

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PRESS RELEASE

Government Intervention Counterproductive: Economic Crisis Calls For New Thinking On Managing Risk, Stimulating Economies – New Report

On the eve of a meeting of government officials from the G20 group of leading economies, a new report from a global group of think-tanks argues that the attempts by governments to intervene in the financial crisis have been counterproductive and it calls for clearer thinking on how to manage the risks inherent in the financial system.

How Not To Solve A Crisis, written by Bill Stacey and Julian Morris, notes that the financial crisis was created in part by well-meaning market interventions intended to enable low-income US households to own homes, and in part by discriminatory regulations against certain classes of asset that resulted in 'regulatory arbitrage,' whereby financial institutions created off-balance-sheet structures in order to generate synthetic credit.

These factors drove lending to impecunious borrowers in the US, fuelling a housing boom. The subsequent bust has led to the collapse in value of the off-balance-sheet structures. Because those structures had been used to underpin loans, their collapse has caused banks to stop lending to one another.

Sequential attempts by governments around the world to intervene in the markets and bolster lending have been largely counterproductive – they have pre-empted private market solutions and in many cases generated further moral hazard, contributing to further erosion of trust and weakening of incentives to lend. As a result, what started as a financial crisis is turning into a full-scale economic catastrophe.

There is currently talk of creating stronger and more global regulatory structures. This would be a disaster on several counts. First, as the report notes, several smaller countries have suffered less in the crisis – seemingly because of different regulatory regimes. If there had been only one global rule and it had been the wrong one, everybody would have suffered equally and we would have less knowledge as to why – and what - to do. When governments compete with one another, they have stronger incentives to identify solutions rather than placate vested interests.

Second, stronger regulation is almost certainly the opposite of what is needed. The danger of creating further incentives for counterproductive regulatory arbitrage is large. The report concludes that from a regulatory perspective, the better solution would be to create governance structures based on simple, clear rules that do not discriminate in favour of or against any particular class of asset.

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The report cautions against any direct intervention by government. It notes that: "Governments are terrible at allocating resources and their attempts to boost our economies will almost certainly backfire. Economic growth is the result of entrepreneurs identifying and filling niches by developing better products and production processes, thereby boosting production and productivity. In contrast, when governments throw money at the economy, they divert resources away from their most efficient and effective uses, undermining innovation and growth."

Finally, the report concludes that: "The best way to stimulate the economies of the world would be to reduce the number of overbearing taxes and regulations that currently inhibit the development and delivery of all manner of products and services."

FULL REPORT: How Not to Solve a Crisis, published by Lion Rock Institute and International Policy Network, in association with other think-tanks and civil society groups around the world:

http://www.policynetwork.net/uploaded/pdf/HowNottoSolveaCrisis.pdf

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