

# **Responding to the Economic Crisis: A Question of Law, Policy or Politics**

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## I. INTRODUCTION

I have been asked to consider the role of the law in the fallout from the financial and economic crisis that by the end of 2007 had become the problem but turned into a crisis by the end of 2008. Governments were called on to rescue financial institutions and to try and to contain the flow on to the real economy. With government intervention the question arose whether regulation of the markets was a necessary or desirable course of action. The debate around the question seemed somewhat unreal in the face of the reality that much of the neo-liberal policy frameworks with their no or regulation 'lite' regimes were responsible at least in part for the crisis the world faced. In this address I argue that the question is not whether to regulate or not to regulate, it is the type and nature of the regulation that is the issue.

## II. THE ECONOMIC CRISIS IN NEW ZEALAND: CAUSES AND RESPONSES

The financial crisis that hit the world late in 2008 has quickly turned into an economic crisis with effects even on New Zealand, though compared with the reaction of governments in other countries New Zealand's response has been rather laid back. Certainly New Zealand through the Australian owned banks has avoided the worst excesses of the sub prime debacle, but it is the knock on effects of the availability of credit that has affected the New Zealand economy that is so dependent on trade. So far the government response to the crisis has been to address the short term effects but as yet no long term response to the statutory framework that regulate our financial system has been made. The assumption appears to be that once this blip has passed there will be a return to normal business and no rethinking or policy change is required. This approach is consistent with the general non-intervention approach of the government to public policy issues. This approach is indicative of the neo liberal policy framework.

Such observations are coloured by the three months that I spent in the United Kingdom in the early part of 2009, as a Visiting Fellow at Cambridge University Faculty of Law, along with an attempt to keep up with the various

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overseas analyses. During my time in the United Kingdom I was rather surprised at the New Zealand assessment of the crisis that implied if we all just think positively it would not be so bad or all go away. While the power of positive thinking has its place, this assessment was somewhat fanciful and displayed ignorance about what is a serious global situation from which New Zealand will not be immune.

While there is much that can be said about the current economic crisis, I agree with Stephen Green, Group Manager of HSBC Holdings plc, who wrote there are four key realities that will have to be taken into account in any new world order. The first is that there is no alternative to capitalism; the second is that we cannot turn the clock back; third government oversight, regulation and at times intervention are essential; and fourth the global balance of power is shifting from west to east and that the framework of international institutions needs to be redrawn to reflect the new realities of globalisation.<sup>1</sup>

While the current crisis has been a fruitful source for analysis there is one core question that keeps arising and will need to be addressed both domestically and globally: that is whether there is a need for more regulation of the financial sector. The debate whether a successful economy is achieved through regulation or market is central to the ideology surrounding neo-liberalism that has dominated the policy settings not only in New Zealand but the United States, United Kingdom and to a lesser extent Europe and Asia over the past 30 years.

New Zealand became a casebook example during the 1980s and 1990s of the policy of deregulation of the economy. The underlying rationale for this policy was that economic prosperity was best achieved through market mechanisms being able to operate freely without the constraints of statutory regulation. The market policy paradigm was also applied to social as well as economic policy. State intervention was seen by the policy makers as a constraint on individual freedom. Individuals were best able the theory argues to determine their own self interest. Notions of community and society were no longer drivers of public policy.

While governments were able to implement neo-liberalism the legislative process and the courts were not so easy to control. Allegations of judicial activism were raised however and became most obvious in the attacks on the Employment Court in 1990s. The arguments were usually framed in terms of the superiority of the common law over legislation. Judges, or at least some judges, were considered better determiners of public policy than the Parliament

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1 S Green, 'Seeking Salvation', *New Statesmen*, 6 July 2009, 34-35; S Green, *Good Value: Reflections on Money, Morality and an Uncertain World*, Allen Lane, 2009.

because they determined matters on a case-by-case basis, which avoided any significant change to public policy. This environment was considered to be better for business because it provided greater certainty and stability.

This analysis ignored the fact that social and economic change was part of the democratic process and when the courts failed to deliver pressure was exerted through the political process for such change. Arguably, it is not the role of the courts to deliver economic or social justice but to determine individual disputes on the basis of the law, as it is known. By and large this is what the courts have done in New Zealand. They are not agents of economic or social change. That has traditionally been the role of the Parliament. Unfortunately the relationship between the courts and Parliament in the New Zealand context has not been subjected to much evidenced-based research with the consequence that ideology has tended to prevail in the public debate.

The afore-mentioned issues are too broad and complex to be considered in any great detail in this paper, the focus of which is the current economic crisis. With regards to the question of the role of the law in the economic crisis, it is my opinion that the polarisation of the issue into market versus regulation is not helpful. Whatever the ideological rhetoric there has always been regulation. It is the nature and type of regulation that has been the focus of debate. It is true that the neo-liberal policy paradigm has produced a 'regulation lite' regime. Since 1984 statutory frameworks have been constructed around the delivery of public and private services that permit the greater operation of market forces to determine outcomes. Any attempt to depart from that framework has been greeted with considerable criticism from lobbyists and the media.

It is also true the Labour governments of the past nine years attempted to introduce a more centre position with a better balance between market forces and state support. Arguably, however, a neo-liberal policy framework is still common in the delivery of policy advice. Notions of a small state with minimal state intervention to correct the inequities in the contracting model, wherein privatisation is reinvented as public/private partnerships are still dominant in public policy. In this respect New Zealand is again standing out from the crowd. Other countries, United Kingdom and the United States, are beginning to reassess the balance between state and market instruments of regulation. This reassessment has come with the recognition that without the state to bail out the financial sector, states would be in a worst position than they are currently in.

Whatever ideological position is taken in the market versus regulation debate, the stark reality facing the world today is that a 'regulation lite' statutory framework has contributed to the collapse of the financial system. It has led to the need for unprecedented state intervention to rescue that system through

the use of taxpayers' money, most of whom never benefited from the rampant market forces that have produced this state of affairs. 'Regulation lite' is not the only cause, of course. The tendency to human greed and the assumption that the banks' own self-interest, itself a tenet of the free market, would provide a corrective against disaster have also contributed.<sup>2</sup> In such circumstances it is not surprising answers are being sought as to who is responsible for this mess and what actions should be taken to ensure it never happens again.

My time in the United Kingdom provided me, fortunately, with easy access to much informed commentary on the current situation. There was much soul searching as to how this situation had been allowed to occur, why people were not warned, and who was to blame. Top bankers appeared before select committees to apologise. In my opinion, the ritualistic nature of such appearances rendered that latter rather unreal and the spin doctors had prepared the bankers well for the onslaught of criticism. Bankers were followed by journalists as inquiries were made into the latter's role and whether had they made a bad situation worse. They defended themselves with the normal justifications of we only report the events, but also pointed out some of them had been warning those who would listen that all was not well in the financial sector. It is true also that prophet academics and commentators had raised concerns, as had employees of financial institutions. Unfortunately nobody was interested in listening because often what was done was 'within the law' and there was an assumption 'they' must know what they are doing.

Such hearings and musing may have had therapeutic value but they are not necessarily helpful in finding a way forward in the framing of a new statutory framework. It is essential that a proper analysis of the causes of the collapse is undertaken to ensure any new framework addresses the causes and not the ideology of the crisis. The most favourable approach is one that recognises there is a role for the market and a role for the state to regulate. An approach which must also be favoured is one that acknowledges the reality of the technology that enables the transfers of capital between and amongst countries quicker than most of us can open our computers. In other words this is a global issue, not just a domestic issue. Given the size of New Zealand and the recent manner in which it has retreated somewhat from internationalism, it is a reasonably safe assumption that we will have little influence over whatever regime emerges from current talks, in Europe and the United States and the G 20 whose objective is to redress what is seen as a global crisis.

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2 D Tuckett, 'Addressing the Psychology of Financial Markets', Institute of Public Policy and Research (IPPR), *Tomorrow's Capitalism*, May 2009.

### III. A WAY FORWARD: A PRINCIPLES-BASED APPROACH

While citizens in New Zealand expect the law to protect them against wrongdoing, including financial wrongdoing, the truth is it is very difficult to find rules based framework that will do this. The complexity of issues makes it difficult for a rules based system to cover every situation. Also the costs of enforcement are prohibitive for most people. The institution that is meant to protect the consumer by ensuring there is competition is the marketplace, the Commerce Commission, is under attack by market players who know they have many more resources than the Commission.

A rules based system also requires equality of information by the contesting parties. It is interesting to observe that much of the cost of litigation in this area is caused by the costs of discovery as the parties seek to find relevant information to help their case. The problem of a lack of transparency in the affairs of some companies has been highlighted by the plight of investors in finance companies that collapsed in 2008. For perfect markets to work there must be perfect information. It is obvious a lack of relevant information has been detrimental to many New Zealand investors, particularly those who lost their lifetime savings and saw their pensions disappear in high profile collapses of finance companies.

Good decision-making also requires no conflict of interest or for such conflicts to be declared. While conflicts of interest are a normal part of life in a small country like New Zealand, we have not found the best way to ensure transparency or avoidance of these conflicts. A small cadre of people runs New Zealand business so the appointment of a wider range of people to boards may be something that could at least be tried. In this regard, there is abundant research that highlights the financial benefit to companies with women on their boards and how few women are considered competent or capable enough to serve on private sector boards.

Therefore, when it comes to looking for appropriate regulatory regimes in this area are principles, as opposed to rules, based, approach is preferable. This approach may make interpretation or enforcement more difficult and there will be cries of uncertainty. The current system can hardly be argued as an example of great certainty, however. It has collapsed and this seems to have come as a surprise to most banks and the institutions that supported them.

One starting point for a new approach is to acknowledge that it is unrealistic to assume that the market can, or should be banned. It is equally unrealistic to argue for an unconstrained market. A democratic society requires that individuals be free to exchange goods and services and have their value

determined by the market. Citizens, however, expect their market relationships to be conducted in an ethical manner. This does not mean risk is not taken but the nature of the risk is what is in dispute when it comes to policy. It also means all participants in the new framework must take responsibility for the good management of the system.

Consideration should be given to the principles approach for a regulatory framework put forward from come from Davis, Lukomnik, Pitt-Watson,<sup>3</sup> and research undertaken by the Institute for Public Policy Research.<sup>4</sup> They studied the causes of the financial crisis in detail in an attempt to find a more enduring future for capitalism. They argue an effective economy is like a political system that works effectively: it has checks and balances, accountabilities and responsibilities, information flows and cultures. The bipolar thinking of regulation versus market does not provide the way forward. The principles which, they argue, should be incorporated in a regulatory framework are:

- entities must be responsible for their actions;
- to have responsibility the entities must be accountable:
- to be accountable there must be relevant reliable information;
- that information must be independently prepared (not by rating companies paid by those they rate);
- and there must be vigilant oversight by all the market participants.<sup>5</sup>

Although these principles may seem like commonsense they would require a fundamental rethinking of our current financial system. A holistic view of the inter-connection between various actors and processes is required not only domestically but globally. Whether New Zealand undertakes a reform of its system will depend both on the perception of whether reform is required, and whether there is sufficient political pressure from those adversely affected by deficiencies in the financial sectors for such reform. This is largely a matter within our own control. Regulatory changes on a global level however are

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3 Stephen Davis, Jon Lukomnik, David Pitt-Watson, 'The New Capitalists: How Citizen Investors Are Reshaping the Corporate Agenda', *Harvard Business Press*: Harvard, 2006.

4 Stephen Davis, Jon Lukomnik and David Pitt-Watson, *Towards an Accountable Capitalism*, Institute for Public Policy Research: London, March 2009, available at <[www.ippr.org.uk/members/download.asp?f=%2Fecomm%2Ffiles%2Faccountable\\_capitalism.pdf](http://www.ippr.org.uk/members/download.asp?f=%2Fecomm%2Ffiles%2Faccountable_capitalism.pdf)> as viewed 5 January 2010.

5 *Ibid*, p 3.

largely outside our control. The construction of global regulatory framework is task of considerable challenge for all parties, but is actively being discussed.

#### IV. CONCLUSION

There is a role for the law to regulate the market. That is not the issue. The issue is what is the nature and form of that regulation. Arguably, what would be helpful is if ideology was placed to one side while an evidenced based study of a new regulatory framework was undertaken. If this does not happen we are destined to a boom and bust mentality and to query why our economy continues to perform so badly. The basis of any effective political or economic system is the maintenance of a sufficient level of trust in those to whom we entrust to make decisions. A lack of trust may well be at the heart the issue. As trust has little financial value at the moment, it may take some time to affect a full recovery.