



GOVERNMENT FAILURE

Kevin Rudd likes to blame unrestrained capitalism, neo-liberal ideology and the previous Coalition Government for the global financial crisis. The truth is that Australia is one of the few countries in the world where the Government is not to blame for this crisis.

At the heart of this crisis are millions of homeowners across America 'defaulting' on their home loans – when they are no longer able to make repayments to their lenders. Often this occurs when an income earner in the household loses their job, reducing their capacity to service their loan. Other times, it can be because interest rates rise, resulting in higher monthly repayments.

These sorts of events occur all the time in modern economies, as businesses fail or as central banks tighten interest rates to combat inflation. But this is the first time that homeowners defaulting on their loans have caused world-wide economic havoc. So what is different about this financial crisis?

The key difference is the sheer number of homeowners who are defaulting on their loans. In previous cycle downturns, small numbers of property owners found themselves unable to pay their loans. No doubt, these hurt the bottom lines of some banks and other lenders, but they did not result in massive bankruptcies.

Why then, are more homeowners defaulting on their loans this time around? The answer is very simple. Many more people own homes who cannot afford to service the loans on them, and could never have been reasonably expected to do so.

It's here where the critics pile on the free market. Clearly, they say, rapacious bankers on Wall Street and shonky mortgage lenders have cruelly taken advantage of those with no capacity to pay loans on their homes. It's a failure of the free market and the Government needs to step in to correct this awful mess.

Let's take a step back, and look at the reasons why these lenders and bankers chose to make these loans. Most banks and lenders have always had strict criteria to determine the creditworthiness of their applicants – it is in their interests to, because if they make loans to those who cannot pay them back, they won't make any profits. Over the last two decades, however, these standards have become more and more relaxed, and millions of applicants who have no capacity to service loans have been awarded them.

Did bankers wake up one morning, and decide for no apparent reason that it would be a good idea to start lending lots of money to people who could never pay it back? No. They changed lending standards in response to government policy.

The 1977 Community Reinvestment Act (CRA) was a Carter Administration initiative to expand home ownership to the poor, particularly minorities. In 1994 the Clinton Administration ramped up the enforcement of the CRA as part of their National Homeownership Strategy, which aimed to increase homeownership amongst poor and minority groups.

The Clinton administration repeatedly cited the benefits of home ownership, such as lower crime rates and better performance at school.

The Clinton Administration believed that mortgage companies had racist lending practises – whether conscious or not – and applied pressure to banks to lift their lending rates among minority ethnic groups. They forced banks to comply through lawsuits if they were found to be issuing proportionally more loans to white applicants than black ones, unless they could prove that black applicants were rejected according to strict lending criteria.

Fannie Mae and Freddie Mac, government-sponsored mortgage enterprises also played a role in this process. They facilitate loans to homeowners by 'buying' the loans from banks and mortgage lenders, allowing these organisations to go out and make more. Effectively, the taxpayer is facilitating a much larger number of loans in the mortgage market than would take place without government intervention. In 1992 Congress authorised Fannie Mae and Freddie Mac to also assist in extending credit to low-income households, in the hope that it would facilitate greater homeownership.

These measures worked. Between 1994 and 1999 the number of homeowners who were African American and Hispanic increased by 2 million. From the beginning to the end of the Clinton Administration, home ownership leapt from 63% to 68%.

The effect of this government action is clear. Because of government policies, there were far more households already on the edge of defaulting when the recent cyclical downturn hit. Millions quickly found themselves unable to pay their loans, and the banks who simply responded to Government urgings found themselves bankrupt.

We are lucky that the former Coalition Government in Australia did not try to use the banking system to achieve utopian social outcomes. Instead, during its 11 years in office, the Coalition paid back debt, set up a world class financial regulator in APRA and left Australia in a very strong position to deal with any looming crisis.

Unfortunately, the same cannot be said for the Rudd Government. Their decisive interventions into the Australian economy have done more harm than good. Last year we saw the bungled deposit guarantee, which threw the stable and secure financial system in Australia into a panic. The \$52 billion in cash splashes announced so far will plunge our Government deep into debt, and leaves us with nothing in reserve if the plan does not work.

Markets aren't perfect, but it is folly to think that governments don't fail too. More often than not, government intervention into the economy can cause the perverse incentives – such as encouraging those who cannot afford a home to buy one – that are responsible for problems we face today.

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