

Commentary

On

Chris Hunt “Banking crises in New Zealand – an historical overview”

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Chris Hunt has given us a useful review of New Zealand experience. I want to comment on each of the three events on which he has focused, the nineteenth century experience, the 1980s and the Great Depression. My overall intent is to endorse the view that both he and Michael Bordo have expressed, that banking crises have some common features and some peculiarities, and to raise questions about the importance of learning and the relationship between the financial sector and the real economy.

I do so very conscious of a recent comment by John Hanson II. In the course of a book review,¹ he identified,

the air of wisdom gained from a lifetime of study of certain historical events and episodes in international economic integration. The question is whether such a treatment of various unconnected topics falling under the general rubric of international integration adds much to our understanding of today or of the past. Another question is whether this work belongs to the “lessons from history” genre of historical writing or the “historical roots of the present world” genre. The author seems to want membership in both. Either way, I learned something, but not much which sheds light on the present, either as guide to policy or roots of the current situation.

Hanson found an “arbitrary (but not uninteresting) collection of episodes about international economic contact in the past” and that “the ‘lessons learned’ seem unique to the event which produced the ‘lessons.’” I hope to do at least as well.

1. The 1880s

Chris acknowledges² that the GDP data for the nineteenth century is no more than indicative. However, his graph shows positive growth for the period 1880-96³ which sits oddly beside the terminology of “Long Depression” and the notion that the financial problems of those years had origins in recession. I have argued elsewhere that the data do not permit us to be sure of an annual path but that the period should generally be seen as a plateau, a period of low or no growth following a period of growth and before a boom based on refrigeration. Within the period, there were certainly difficulties for particular industries and for specific regions, especially for employment levels in an economy where more or less casual employment remained significant – so that contemporary comment about unemployment related more to insufficiency of work for day labourers than to long term unemployment for an identifiable group such as it came to mean in the interwar years.⁴

¹ J.R. Hanson II review for EH.NET June 2009 of *Dennis M.P. McCarthy International Economic Integration in Historical Perspective* (New York: Routledge, 2006)

² p. 33 n. 29.

³ Fig 15, p. 37.

⁴ Some will see nuances of annual hiring in agricultural occupations in nineteenth century England; others may prefer to think of “seagulling” on wharves as remained common until at least the 1960s.

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The terminology of “Long Depression” was created by later historians rather than by contemporaries. I would draw attention to the way in which language can be misleading when it is assumed that words like depression and unemployment meant the same in the 1880s as they came to mean in the 1930s. In the nineteenth century, “depression” referred to prices rather than to incomes.

The point on which I would differ most from Chris Hunt’s account of the 1880s is that I would give much more emphasis to the trend of prices. From the mid-1870s to the mid-1890s, the trend of prices was generally downwards – by something like a quarter over 20-25 years on average. Individual prices varied and the task for financial institutions and individuals was to manage portfolios with varying relative prices within a general downward trend.

In particular, many interest rates tended to fall less than goods prices. The net effect was for deflation to transfer income from borrowers to lenders.

Within that general international experience, New Zealand experience had another broad characteristic. New Zealand was part of a process by which new resources were brought into the international economy. The specific characteristics of a long grass-growing season, combined with human capabilities in animal husbandry and in transportation, and marketing, meant that New Zealand could supply wool competitively to North Atlantic markets. Sheepfarming required space but land resources were relatively unimportant. New Zealand soils were not especially fertile, and nor were native grasses. To take advantage of the important natural resources – space and grass growing capacity – there needed to be a lot of investment in land clearing and land improvement.

The New Zealand experience was essentially the working out of a disequilibrium whereby growth potential attracted investment from abroad so that within an international environment of falling prices, New Zealand interest rates fell so as eventually equate to international levels (in the 1890s). The Advances to Settlers scheme was a legislative mechanism to improve the security for international lending within New Zealand when there was no longer the attraction of a major interest incentive.

The financial system which managed this process was led by a subset of what became known as an imperial banking network.⁵ Banks centred on the London money markets provided trade finance and investment facilitation for parts of the international economy like New Zealand. The network included banks which originated in the UK, and those which were founded in the constituent economies as a check on any market power by overseas institutions. (This use of competition as a check on overseas domination will play a role in my comparison of the 1930s and other episodes.) The New Zealand story is a little more complex in that banks were first established in Australia – such as the Bank of NSW, the Commercial Bank of Australia – in response to “Anglo” banks – Union Bank of Australia, Bank of Australasia – and these were all known as ‘Australian’ banks in New Zealand with the Bank of New Zealand and Colonial Bank of New Zealand as local banks which could monitor their New Zealand operations. The National Bank of New Zealand was an Anglo which arrived in New Zealand without any Australian mediation. There were other Anglos in Australia which did not operate in New

⁵ The wording reflects my caution about attributing importance to political status. The imperial network included banks operating in Latin American countries which were never part of the British empire. On the other hand, Canadian banks tended to look to New York rather than to London as the centre of their international operations.

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Zealand – English Scottish and Australian bank for example – and other Australian responses which had no direct New Zealand presence. The Oriental Bank was an Anglo which operated in both Australia and New Zealand and then withdrew from both to concentrate on other areas of operation like Mauritius.

This was the banking system which along with other financial institutions such as the stock and station agents mentioned by Chris Hunt (which also had Anglo and local components), insurance companies, and building societies had to manage the disequilibrium process of the late nineteenth century. The financial crisis which Chris Hunt identifies was the result of inadequate responses to a major challenge.

The key was that failure to forecast accurately the downtrend of output prices relative to input prices, especially the stickiness of interest rates, resulted in some purchasers of land finding it impossible to finance their commitments. Those who engaged in expensive land improvement were even more likely to find themselves in financial difficulties. The difficulties spread from individuals and companies to stock and station agencies and to banks. Hence the early response of the National Bank of New Zealand in writing off capital in the 1880s and early 1890s, the legislative rescue of the Bank of New Zealand and Colonial Bank of New Zealand in the 1890s, and the absorption into wider Australian adjustments of the New Zealand assets of the Bank of NSW, Union Bank, and Bank of Australasia. (The Commercial Bank of Australia began operations in New Zealand only in the early twentieth century.)

There were contemporaneous developments in the real economy. In particular, from the 1880s, refrigeration enabled New Zealand (and other economies) to supply additional products to international markets. Frozen meat in the 1880s, and dairy products, mostly from the 1890s onwards, contributed to an income boom in the period until the First World War. The institutional response was a growth of intensive owner-operated fat-lambing and dairy farms rather than a direct rescue of the estates being built by land improvement schemes in the 1880s, but no doubt the better prospects for farming facilitated a recovery of liquidity by embarrassed developers (and helped the instruments used for the “bad bank” aspect of the Bank of New Zealand into which the Colonial Bank had been merged.⁶) The international trend towards rising prices from the mid-1890s also changed the pattern of transfers of value from borrowers to lenders.

Changes in the real economy, both the direct links between New Zealand production and international markets, and the general trend of world prices were the main mechanisms for recovery from the financial difficulties of the 1880s and early 1890s. Legislative intervention was significant, but a decentralized financial system survived.

As is always the case, economic difficulties engendered puritanical rhetoric about profligacy, just desserts and so on. Condliffe who did so much to establish the broad outlines of New Zealand economic history gave some credence to contemporary comment, especially in the form of land speculation, and added to it by suggesting that departure from free trade gave rise to inefficiency. There is no need for any such mechanism to explain what happened in New Zealand in the late nineteenth century.⁷

⁶ Chris Hunt is right about the Treasury being able to recover the funds provided to the Assets Realization Board, but the accounting of the time did not make adequate allowance for interest or indeed for the management costs of the Assets Realization Board.

⁷ H.D. Bedford, who Chris Hunt cites, wrote good historical and economic analysis, especially his thesis on the history of banking, but he was also a lay Methodist preacher, and his moralizing nowed

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Thus, while essentially endorsing the analysis provided by Chris Hunt, I would invite particular attention to what we can learn from New Zealand experience in the 1880s about

- the importance of understanding the implications of relative price trends within a general deflation; and
- the importance of a sound appreciation of international capital flows - what might now be termed “global imbalances”.

2. The 1930s

The question which arises from Chris Hunt’s treatment of the Great Depression is “why was there no financial crisis in the 1930s?” My first superficial answer would be “because New Zealand was not part of the USA.”

The answer is clearly superficial since there were bank failures outside the US. The collapse of the Kreditanstalt is often taken as significant in the spread of the Great Depression to Europe and in the eventual collapse of the Gold Standard. But it has the enormous merit of reminding us that the US can be far from typical. Bank failures are unusually prominent in US experience.

The Federal nature of the US, and accidents of timing gave the US a fractional banking system which was untypical. The new republic at the end of the eighteenth century gave the US not only a system of state regulation of banking, but the eighteenth century suspicion of banks. Whereas the “country banking system” of the late eighteenth century in Britain and the Continent led to branch banking, the US system remained governed by restriction of banks to particular areas or even single locations. Branch banking responded to risk by pooling risks and managing problems within a single corporation – with occasional failures – whereas the US built networks which accommodated frequent bank failures without systemic problems. The national banking system created at the time of the Civil War, and the Federal Reserve, created in 1914 in response to the unusually deep crisis of 1907, brought the US system somewhat closer to the branch system which characterized banking elsewhere but interwar US experienced many bank failures every year and the Great Depression was marked by a very large number indeed.

The imperial banking system described earlier was an adaptation of branch banking to international economic integration. The New Zealand economy of the 1930s was not one where bank failures were a common experience.

The Great Depression was in origin a failure of economies to adapt to changes in expectations about future prospects relative to contemporaneous consumption decisions. But for New Zealand, as for most of the world, it was a set of challenges transmitted from the North Atlantic through changes in the international sector. As Chris Hunt rightly observes, New Zealand experience in the 1930s was not what later became familiar as a balance of payments crisis. We got so used to economic problems originating in the balance of payments that there was a tendency to assume that any problem was a balance of payments crisis so that as a major problem the Great Depression must have been a major balance of payments crisis. But in the 1930s, imports adjusted to declining exporting receipts and the problem was the direct consequences of income declines. In popular mythology this was romanticized into a communal response to overseas predations needing only the rejection of a few local fifth

more to that than to his analysis. His life is outlined in Michael Gill, “Bedford, Harry Dodgshun 1877 - 1918”. *Dictionary of New Zealand Biography*, updated 22 June 2007 URL: <http://www.dnzb.govt.nz/>

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columnists; in fact, the Depression was a major social dislocation precisely because experience varied from those whose real incomes increased since stable money incomes were mixed with declining price levels, those whose real incomes were about constant, money incomes falling in parallel with prices, and those who experienced disadvantage as real incomes fell, either because their output prices fell faster than input prices, or because their money income disappeared as they became unemployed. Farmers were among those who experienced falling real incomes, but the differential experience was great within the rural community. Again interest rates were relatively sticky and indebted young farmers were much more disadvantaged than established farmers with low external debt levels. The social tensions may actually have been most intense for young farmers who inherited farms but also obligations to make payments of a fixed monetary amount to their parents and siblings. All of these tensions were intensified by the uncertainty of whether the future would not bring a move into a more disadvantaged condition – the wage with constant real income who would become unemployed, the farmer whose monetary income would decline still further while debt commitments remained unchanged.

The government response to this was activist, not the “dead hand” of some mythology. It involved devaluation and a number of other positive responses. Not all were well judged. Compulsory mortgage adjustment was not just a matter of assisting borrowers relative to lenders, farmers relative to financiers, but invaded delicate family arrangements whereby retired farmers passed farms to heir. And as Chris Hunt notes, the compromise reassurance to banks at the time of devaluation made interest rates more rigid.

Still, the real puzzle is why the private sector response was weak. The Reserve Bank originated as a government initiative to disentangle New Zealand from Australia, to untie the impact of the mixed banking structure I described earlier when London borrowers were becoming disenchanted with investment in Australia and did not make appropriate distinction for New Zealand.⁸ But after devaluation, the banking system accumulated fixed deposits and supported activity in Australia.⁹ Why?

I think the answer lies in the real economy. New Zealand had become part of the international economy through its exporting of wool and then of wool, frozen meat and dairy produce. But it was a much more complex economy than an outlying farm. It had been integrated in international services – shipping, insurance, etc – and also in finding the cheapest way of bringing inputs into New Zealand whether as intermediate products – inputs to local services and industries – or as bulk consumer goods requiring further local processing before final consumption. This process of adaptation had been especially successful in assimilating to New Zealand conditions the basic nineteenth century steam technology.

The interwar economy, however, depended a great deal on internal combustion engines and electricity. They tended to come as integrated packages. Whereas boilers, fireboxes, pistons, and gears could be imported and combined with local labour and ingenuity to create steam engines, motor vehicles and electrical machinery offered less room for local activity. Eventually, motor vehicle assembly came to be a major domestic activity – and a barrier to efficient use of New Zealand resources – but the problem in the 1920s was to pay for finished imports and expensive transport. It took time for chassis and engines to be imported, and local (wooden) bodies to be built around them but that did not keep pace with aerodynamic knowledge and ckd packs arrived mostly in the later 1930s. The Great Depression for New

⁸ G.R. Hawke *Between Governments and Banks* (Wellington: RBNZ, 1973) Ch 3.

⁹ Hunt, p.38

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Zealand was a crisis of investment opportunities defined by international technology. Not surprisingly, the challenges to the financial sector were relatively simple. Passive investment overseas was not likely to create liquidity problems in the portfolios of financial institutions.¹⁰

There was lot of comment in the 1930s about the inevitable consequences of profligacy, cutting one's coat to suit one's cloth and so on. The National Expenditure Adjustment Commission picked up its tome and made itself an obvious target for satire, "We object so strongly to having our own incomes further reduced by taxation that we think the incomes of pensioners should be reduced instead.." as A.G.B. Fisher wrote.¹¹ The rhetoric of Puritanism added no more to either contemporary or historical understanding than similar moralizing earlier or later. (The better conclusion is that businessmen are often poor guides to economic strategy, just as coalminers are poor guides to trends in energy markets. Learning by doing tends to have a limited focus.)

Thus, in reflecting on the Great Depression as a financial crisis, I would emphasize:

- US experience is sometimes untypical;
- What is important in the relationship between the real and financial sectors requires careful analysis and may not be what is usually emphasized in mythologies; and
- the same need to distinguish mythology from analysis applies to the social effects of a financial or economic crisis.

3. The 1980s

I have much less comment to offer on Chris Hunt's account of the 1980s. One begins to think that every generation has to learn from its own experience rather than from reflection on earlier experience and that periodic crises in which over-enthusiastic lending results in liquidity problems for borrowers and financial institutions. I certainly recall senior bankers saying to me that for a while the lesson would be understood that character is much more important than security in lending decisions. They were however no more inclined to see me as a brilliant lending opportunity than similar figures had been when I tried years earlier to use historical records of similar sentiments as the basis for my borrowing.

We should recall the extent of change with which the financial sector had to cope in the 1980s. As we contrast the near-universal availability of "hole in the wall" facilities for securing cash internationally with the paraphernalia of travellers' cheques and circular letters of credit in earlier years, we will conclude, I think, that technology been the biggest single influence on the sector. Technology undermined official controls and insulation of national economies from the international context. (We might immediately wonder whether Glass-Steagal was not undermined by technical and institutional change so that its repeal recognized recognition of what had occurred rather than constituted a significant change in the role of regulatory oversight.)

It is hard to resist the conclusion that people who borrowed in foreign currency in the 1980s because interest rates were thereby reduced were stupid; surely anybody who could compare two interest rates would also be aware that exchange rates could vary? Perhaps, but for many years, people's lives had been based on the notion that governments managed the value of New Zealand currency relative to other currencies and significant changes occurred rarely and as matters of major political significance. How long and how much effort does learning take? The

¹⁰ For further discussion see G.R. Hawke 'Depression and Recovery in New Zealand' in R.G. Gregory and N.G. Butlin (eds.) *Recovery from the Depression: Australia and the world economy in the 1930s* (Cambridge etc.: Cambridge University Press, 1988), pp.113-34.

¹¹ G.R. Hawke *The Making of New Zealand* (Cambridge: CUP, 1985), p. 153.

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New Zealand currency was definitively distinguished from sterling in 1933 but copper coins were distinguished only in 1940 when it was realized that some travellers such as seamen could take advantage of a 25% arbitrage opportunity even when it involved transporting pennies around the world, and it was only in the mid-1940s that the New Zealand public accounts ceased to treat the exchange cost of international expenditure as other than a temporary aberration. Given the new learning required in the 1980s, even the fate of the DFC and BNZ looks less surprising.

That applies too to more recent developments. We have gained from new financial market mechanisms which depend on valuation of derivatives - and the Black-Scholes formulae changed dramatically the link between risk-management and collective responses. Furthermore, securitization is a desirable means of permitting widespread participation in investment opportunities. Some financial decisions of the 1980s have proved to be wrong. We would now make a different assessment of the balance of advantage between flexibility and transparency in how we organize markets in derivatives. Rating agencies need new ways to assess securitized assets. But a generalized resort to simply more regulation would be absurd. There is no reason to think that more intense or more extensive application of regulation would have had any impact on the crisis – or any impact elsewhere other than to have reduced gains in living standards in the last twenty years.

4. Contemporary Relevance

We are looking now at a global economic and financial situation which requires careful analysis. And we have many more papers and sessions which will assist us to do that. I suggest that we use Chris Hunt's historical overview of New Zealand's experience to proceed with the following thoughts in mind:

- Locate individual economies within an international context. In the 1880s, New Zealand was part of the process by which new resources were brought into the international economy. Most economies are now minor parts of a process by which new resources in central and western China are brought into the international economy.
- Use the relevant analysis. In the 1880s, it is unwise to identify income trends in New Zealand as though words like “depression” and “unemployment” had the meaning they later acquired. In the 1930s, “economic problem” was not the same as “balance of payments crisis”. Risk is no longer an automatic reason for seeking a collective response. We should not assume that national economies have social homogeneity or that governments will always be treated as vehicles of a common purpose.
- Avoid inappropriate pigeon-holing. Economic issues are not a justification for automatic resort to moral judgements. There were some reckless decisions in the 1880s; there was some extravagance leading up to the 1930s; there was greed in the 1980s and recently. But its identification contributes very little. (I find it convenient to simply reproduce the description, “throng of greedy speculators anxious to work the credit system, to the utmost extent, lenders [who were] utter[ly] reckless in making advances... borrowers [possessed by] unparalleled avidity in profiting by the occasion” all leaped at the ‘apparently boundless amount of capital waiting to be borrowed.’” which is from D.M. Evans *History of the Commercial Crisis in 1857-58* p. 257. Unfortunately, much learning is temporary and every generation has to learn by doing as much as by study of previous experiences. The media and public in one of its periodic fits of righteousness is no more attractive now than when Macaulay wrote, “We know no spectacle so ridiculous as the British public in one of its periodical fits of morality”.)
- Target economic analysis precisely. Financial crises occurred in decentralized systems in the 1880s, 1980s and at the end of the 20th century, and not in the Bretton Woods era. But

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study of those incidents, and of the Great Depression or of the balance of payments crises of the 1950s and 1960s, destroys any simple linking of centralization and crises.