THE FREEMAN
IDEAS ON LIBERTY

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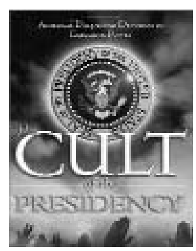

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Cover: Paul Hocksenar

Perspective

News Flash: FDR Didn't Restore Prosperity!

The New Deal did not end the Great Depression. This statement will come as no shock to *Freeman* readers, but it will to the many people who never encountered it before. Now people *are* encountering it—in newspaper columns and news-talk shows.

Why, after years of being taught that Franklin Roosevelt's economic intervention saved the country from disaster, is the general public now being told—by FDR fans, not critics—that this is not the case?

It's the Rooseveltians' way of helping President Obama get over any fear he has of deficit spending. Paul Krugman, the newest Nobel laureate, a Keynesian, and a *New York Times* columnist, is explicit about this. "[H]ow much guidance does the Roosevelt era really offer for today's world?" Krugman asks. "The answer is, a lot. But Barack Obama should learn from F.D.R.'s failures as well as from his achievements: the truth is that the New Deal wasn't as successful in the short run as it was in the long run. And the reason for F.D.R.'s limited short-run success, which almost undid his whole program, was the fact that his economic policies were too cautious."

By "too cautious," Krugman means that FDR's deficits were too small. Roosevelt ran deficits (except for one year), but they were about the same size as those run by his predecessor, Herbert Hoover. Roosevelt's biggest deficit, in 1936, was "only" 4.4 percent of GDP, Jim Powell points out in *FDR's Folly*. Both Hoover and Roosevelt were big spenders—FDR doubled spending by 1940—but they were also big taxers, which kept the deficit from growing. This is confirmed by University of Arizona economist Price Fishback, who wrote, "Once we take into account the taxation during the 1930's, we can see that the budget deficits of the 1930's and one balanced budget were tiny relative to the size of the problem. . . ."

Roosevelt was quite a tax enthusiast. He levied or raised taxes on liquor, tobacco, gasoline, corporate dividends, estates, incomes (top rate 75 percent versus Hoover's 63), "excess" profits, and undistributed profits.

(The last tax was repealed in 1939.) And then there was the payroll tax that came in with Social Security. All in all, the New Deal more than tripled the tax burden from 1933 to 1940 raising it from $1.6 billion to $5.3 billion. Serious deficit-spenders don't raise taxes. But Roosevelt did. Is it any wonder that net investment dropped $3.1 billion during the decade or that unemployment was about as high in 1939 as it was in 1932?

This raises the question of whether big-time deficit spending *would* have ended the Depression. Krugman and others think so. But how could it have done so? Deficits are financed either by borrowing or by creating money out of nothing. When the government borrows money, that's money no one else can borrow and invest. Where's the gain? Moreover, the money is put to purposes selected by politicians, not entrepreneurs trying to please consumers.

When the government creates money, three things happen. First, the new money lowers interest rates below the level justified by society's time preference; that creates perverse incentives to invest in longer-term projects far from the consumer-goods level. Second, the money changes relative prices (rather than raising prices evenly) because particular economic interests get it earlier than everyone else. Third, prices later rise generally, reducing everyone's purchasing power. The result is a distorted structure of production and a boom that is unsustainable because it is based not on real savings but on fiat money. When the inflation stops, the bust follows.

Since the New Deal didn't end the Depression and a New Deal on steroids wouldn't have done so, President Obama should pay no heed to Krugman and his Keynesian economic advisers. The way to wake up the economy is reduce the total government burden on producers and consumers by, among other things, slashing spending, taxes, and borrowing.

* * *

Years ago economist Bruce Yandle identified a phenomenon that accounts for a good deal of government intervention. Tacit alliances form between those who seek a particular intervention for moralistic reasons and those who seek it for financial advantage. Since Yandle first noticed such an alliance in efforts to outlaw Sunday liquor sales, he dubbed this phenomenon "Bootleggers and Baptists." In this issue he applies this principle to the "affordable housing" policies that have pushed the economy into turmoil.

Government deserves the lion's share of blame for this turmoil, but private market actors don't escape all culpability. As Max Borders points out, many cocksure investors let themselves be blindsided by a black swan.

Is it too much of a stretch to call this the Age of the Bailout? You may not think so after reading Lawrence White's catalog of federal largess and its likely consequences.

Of course all these bailouts are necessary because the rescued firms are "too big to fail." Is there a more ridiculous doctrine? Michael Heberling thinks not.

Commentators frantically trying to blame the free market for the economic mess think they have found a culprit: the unregulated market for derivatives. Are they right? Robert Murphy takes up that question.

Most free-market advocates attribute the infamous housing bubble at least in part to Alan Greenspan's easy-credit policies at the Federal Reserve. But not everyone. David Henderson and Jeffrey Rogers Hummel offer a dissenting view.

Here's what our columnists have come up with this issue: Lawrence Reed provides a timely reminder of FEE's credo. Thomas Szasz demonstrates that psychiatry isn't medicine but rather the medicalization of conflict. Stephen Davies counsels against auto bailouts. John Stossel warns against inflation. David Henderson traces the unintended consequences of fuel-efficiency standards. And Gerald O'Driscoll, reading that Alan Greenspan claimed to be shocked by risky lending, replies, "It Just Ain't So!"

Books occupying our reviewers deal with the imperial presidency, free trade, the rich, and energy independence.

—*Sheldon Richman*
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What We Believe

BY LAWRENCE W. REED

The Foundation for Economic Education, publisher of this magazine since 1956, is now in its seventh decade, and I am now in my seventh month as its president. As we expand the outreach of our programs and publications, now is a good time to remind our readers who we are and what we believe in.

FEE's vision—the ideal we are striving to achieve—is a world where people flourish in a free and civil society. In such a world the individual's creative, productive energies are unleashed; private property and the sanctity of contract are upheld; the use of force is confined to protecting the peace; competitive markets allocate scarce resources; and honesty is universally regarded as the best policy in both public and private affairs.

We believe a free society is not only *possible*; it is also *imperative*, because there is no acceptable alternative for a civilized people. Our hope is that through education, men and women will understand the moral, philosophic, and economic principles that undergird a free society; that they will appreciate the direct connection between those principles and their material and spiritual welfare; that they will strive to pass those principles on from one generation to the next.

> Our core values begin with the notion that ideas matter. Indeed, ours is a battle of ideas exclusively, not a battle of personalities. Ideas can and do change the world.

The future we envision is one in which individual expression gives rise to great, even presently unimaginable achievements in culture, medicine, science, and education. Men and women will engage one another peacefully and voluntarily because they will respect one another's uniqueness, rights, property, and aspirations. No one will be so lacking in humility and introspection as to fancy himself better equipped to plan the lives of others than they, individually, are able to plan for themselves, their families, and their businesses.

FEE aims to provide the best available instruction in the principles of a free society to individuals of all ages whose minds are open to freedom's exciting challenge. Our organization seeks to be known as a beacon of a vibrant, growing, international movement to educate for liberty.

Our core values begin with the notion that ideas matter. Indeed, ours is a battle of ideas *exclusively*, not a battle of personalities. Ideas can and do change the world. Investing in them can ultimately reap the highest of returns. Principles, not pragmatism or expediency, define our work.

We are optimistic. Pessimism is a self-fulfilling prophecy. We are waging a battle of ideas to *win*, not to make a living, bide our time, or go down with the ship with a smile on our faces.

Politics is not our bailiwick. Indeed, we seek to *de-politicize* life. We want to enlighten public discussion by emphasizing that there is (and *ought* to be) much more to life in a free and civil society than the political apparatus. We do not advise politicians how to employ the use of force, but rather we make the case against the *initiation* of force, period.

Within a broadly "pro-liberty" framework, FEE is a "big tent" organization, meaning we encourage dialogue among friends of liberty who may differ with one another on such matters as the precise bounds of government or specific policy issues that are beyond FEE's economic and philosophic focus. We seek to build bridges not burn them.

Lawrence Reed (lreed@fee.org) is the president of FEE.

We are not religiously affiliated, but that does not mean we are unfriendly to people of faith. To paraphrase the title of a book by FEE's late scholar Edmund Opitz, faith and a free economy can be "allies, not enemies."

A free economy in the long run is unlikely if not impossible without the widespread practice of sturdy character—including such traits as humility, self-discipline, self-reliance, patience, and respect for others. The economic theories of the Austrian school figure prominently in FEE's approach, but we welcome the contributions of other schools of thought broadly sympathetic to us in their understanding of freedom and a free economy.

In material terms, free people are not equal and equal people are not free. Attempts through the use of government to create equality of income and wealth not only work against our natures as unique individuals, but also lead inevitably to force and conflict.

Private property is a human right first and foremost. Its protection is an indispensable foundation of economic activity in a free society.

Central planning is, as economist Ludwig von Mises stated, "planned chaos." The spontaneous order of free markets, competition, incentive, entrepreneurship, profit and loss, and flexible prices is infinitely superior in both moral and economic terms.

Pioneering inventors, risk-taking wealth creators, and visionary organizers of people and tools are among society's greatest heroes. Those whose business is the forcible redistribution of those heroes' achievements are engaged in immoral, envious, demagogic, or otherwise anti-social behavior.

Government has nothing to give anybody except what it first takes from somebody, and a government that's big enough to give us everything we want is big enough to take away everything we've got.

Taking the Message of Liberty to the World

Nothing about liberty guarantees its future. It is not in any way automatic. It can be lost just as surely and fully by our own choices and votes as it can be taken by a foreign invader. Those who believe in it can take nothing for granted. We must work hard to foster widespread understanding of it or lose it to those who value money and power more.

FEE seeks no resources or special favors from any political authority. We rely entirely on the voluntary support of those who share our perspective and support our mission. We treat the funds our supporters have entrusted to us as if we had earned them ourselves in the first place. We are "entitled" to nothing but the respect and support our work merits in the eyes and hearts of free men and women.

FEE thinks of itself not as a place the world must come to, but as an organization that takes its message to the world. Our seminars are not held in one place but in many. We are forging strategic partnerships with others who love liberty so that we may reach new audiences, especially the young, wherever eager ears desire to hear.

FEE thinks of itself not as a place the world must come to, but as an organization that takes its message to the world.

And in all matters we aim for the highest standards of ethical speech and conduct, sound internal management, continuous quality improvement, and customer service. We will never believe we're so good at something that we can't get better.

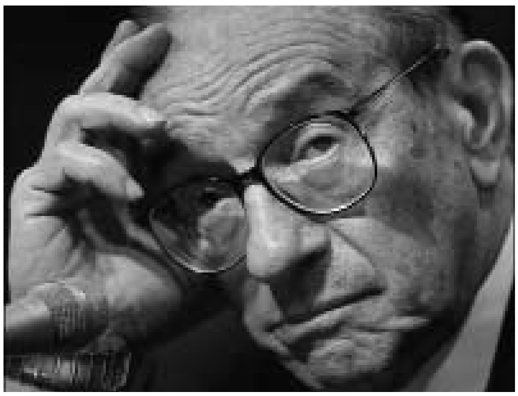
So there you have it. This is what we believe at FEE. I hope you find it inspiring and worth supporting.

Greenspan Should Be Shocked by Risky Lending? It Just Ain't So!

BY GERALD P. O'DRISCOLL, JR.

Toward the end of his tenure as Fed chairman in early 2006, Alan Greenspan was the object of praise edging at times into adulation. It came from some unlikely sources. Milton Friedman penned an encomium for Greenspan in the pages of the *Wall Street Journal* titled, "The Greenspan Story: He Has Set a Standard." After noting that the Fed had done "more harm than good" for most of its history, Friedman described Greenspan's performance as "remarkable."

In little more than two years, Greenspan's legacy has been reevaluated. At hearings of the House Oversight Committee, he tried to save as much of his original reputation as possible. Chairman Henry Waxman set the tone by observing that the entire economy was paying the price for Greenspan's inattention to the risks in the subprime mortgage market.



Greenspan's show trial appealed to a sense of schadenfreude.
Photo courtesy www.trackrecord.es

Greenspan's defense reminded me of a famous scene in the movie *Casablanca*. The flawed but ultimately heroic Captain Renault (played by Claude Rains) announces that Rick's was being shuttered until further notice. Asked why, Captain Renault stated (as he accepted his nightly winnings) that he was "shocked" to discover that gambling was going on. In a similar vein, Greenspan expressed to the House committee his "shocked disbelief" that risky lending had been going on during his tenure

As Fed chairman, Greenspan was the architect—the "maestro"—of a low-interest policy that flooded the economy with cheap credit after the collapse of the dot-com bubble in 2000-01. Real (inflation-adjusted) short-term interest rates were negative for several years. Risk premiums were driven down to historic lows—indeed, they all but disappeared. These elements made for a classic asset bubble. As economic historian Gary Gorton recently noted (in his paper, "The Panic of 2007"), the whole subprime house of cards would have tumbled down if housing prices had simply stopped rising, much less begun falling. They stopped rising and then began falling in 2007 and into 2008.

We're Forever Blowing Bubbles

Economists have been observing and analyzing asset bubbles for centuries. Adam Smith talked about the South Sea company (and its bubble) in *The Wealth of Nations.* The effects of credit policy—first of ease then restriction—were well-analyzed by nineteenth-century economists. In the twentieth century, booms and busts were the central focus of business-cycle theorists. These included such figures as the British economist J.M. Keynes and the Austrian economists Ludwig von Mises and Friedrich A. Hayek. Mises and Hayek in particular linked the development of asset bubbles to easy-credit policies of central banks. Later, entire schools of economics—Keynesian, Monetarist, etc.—wrote on the topic.

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The elements of a classic bubble should not have eluded the Fed chairman. The Fed sets the Fed funds rate, the rate at which banks lend to each other. That rate greatly influences other short-term lending rates. For three years, the Fed funds rate was at or below 2 percent. For one year in that period, the rate was 1 percent. That cheap-money policy fostered the leveraged borrowing and risk-taking that characterized the subprime mortgage market. Elsewhere I have called this "casino capitalism." (See my "Subprime Monetary Policy," *The Freeman*, November 2007, http://tinyurl.com/66tnu5.)

In an October 18 interview with the *Wall Street Journal*, Anna Schwartz, the eminent economic historian (and coauthor with Milton Friedman of *A Monetary History of the United States*), observed that asset bubbles—"manias," as she calls them—always have the same cause. "If you investigate individually the manias that the market has so dubbed over the years, in every case, it was expansive monetary policy that generated the boom in an asset." In the dot-com bubble it was equity shares of high-tech start-up companies. In recent years it has been residential real estate. The asset may change, but not the cause—monetary policy.

Grant Me Fiscal Discipline, but Not Yet

Why do central bankers repeat the same mistakes over and over again? Dr. Schwartz has the answer: "In general, it's easier for a central bank to be accommodative, to be loose, to be promoting conditions that make everybody feel that things are going well." I guess we could call this "feel-good" monetary policy.

How did Greenspan answer the question of why he had been so accommodative, so loose? He told us he was merely following orders, complying with the will of Congress. He had done "what I was supposed to do, not what I'd like to do." This is followership, not leadership. It's also just not so.

Under Article I, Section 8, of the U.S. Constitution, Congress has the power "to coin money, regulate the Value thereof, and of foreign coin, and fix the Standard of Weights and Measures." Though at times controversial, courts have endorsed Congress's power under that clause to create a central bank and delegate to it the conduct of monetary policy. The Fed was designed and structured to have operational independence. While the seven governors are political appointments, the presidents of the 12 reserve banks are not. The Fed has always been self-financing and needed no appropriation from Congress. That design has maintained its operational independence.

The House hearing should have focused not on Greenspan's personal failings but rather on institutional failure. The Fed was created in 1913 to save the country from recurring financial panics. It was a bankers' bank that would provide liquidity to ordinary banks, so that credit squeezes would no longer bring economic activity to a halt. By the 1920s, economists like Irving Fisher were arguing that central banks could manage money and keep its value more stable than did the gold standard. So the promise of central banking was stable prices and the end of panics and credit squeezes.

The Fed got off to a rocky start. After World War I, the economy was hit by the panic of 1920-21. By some measures, it was the sharpest panic in U.S. history. The Great Depression followed, beginning in 1929 (full recovery did not occur until after World War II). Monetary policy was thought to have improved after the war. But then came the inflation of the late 1960s, 1970s, and into the 1980s. Some economists believed they detected a "Great Moderation," first in residential construction in the 1980s and later in real growth (GDP) and inflation. Every time observers thought central bankers had got it right, there was another mania, another panic, another recession.

Today, nearly 100 years after the founding of the Fed, we are in the midst of financial panic, experiencing a credit squeeze, and caught between inflationary and deflationary forces.

At some point even the most ardent supporters of central banks must question whether there is an institutional flaw in them. Some critics think the restoration of the gold standard would be the cure. Some think central banks themselves must be abolished. More of the same is unthinkable. Financial instability is, unjustly, undermining the case for free markets.

Show trials of principals like that of Alan Greenspan appeal to a sense of schadenfreude, but they are no substitute for some serious rethinking of our monetary institutions.

Bootleggers, Baptists, and Bailed-Out Bankers

BY BRUCE YANDLE

For more than a year now, people worldwide have experienced an extraordinary chain of economic events. Led by crushing increases in U.S. mortgage-related bankruptcies, the world financial collapse that followed has been termed the subprime crisis, the financial meltdown, the Wall Street bailout, the beginning of another Great Depression, and even the end of capitalism as we have known it.

How did it happen? How could so many smart people be struck dumb simultaneously? And what does any of this have to do with Bootleggers and Baptists?

My Bootlegger/Baptist theory was born in 1983 when I was working at the Federal Trade Commission and doing my best to understand the political forces that bring us so much federal regulation. I recalled how my kinfolk explained why Georgia and other states closed down the liquor stores on Sunday: The states that went dry on Sunday—meaning they did not allow the legal sale of alcoholic beverages—were those where the local Baptists and bootleggers lobbied for the same end. The good Baptists just wanted the Lord's Day to be relatively alcohol-free. And the bootleggers just loved the idea of having one day without competition from the legitimate sellers.

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The Baptists did the highly visible lobbying and preaching, while the bootleggers paid the politicians, or so the story goes.

"Bootleggers and Baptists" is now part of the body of theory used by economists and political scientists to explain political behavior. Let's see if the B&B theory can help explain the subprime crisis.

Anatomy of the Subprime Crisis

The subprime crisis became part of national consciousness in the early fall of 2007. First described as a real-estate bubble that somehow got pricked, the crisis got its name from a category of mortgages that had been made to unqualified borrowers. Lending activity by banks, savings and loans, and mortgage lenders had been expanded to reach families without the means to scrape together a down payment or even make the monthly payments normally required for fixed-rate mortgages. To accommodate the less-qualified borrowers, lenders creatively offered mortgages with adjustable rates and balloon payments at the end. With billions of dollars of subprime loans being generated, U.S. mortgage lenders packaged the loans and sold them to America's backstop mortgage lenders, Fannie Mae and Freddie Mac, two massive quasi-private firms formed by Congress to help make real the American dream that every family would own a home on its own precious plot of land. From there, the mortgage paper went to the four corners of the earth.

We have just identified the Baptist theme and some of the Baptists. The theme is achieving the American

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dream of home ownership. What could be more noble than this? And the Baptists? The politicians who pride themselves on helping ordinary people and even the helpless to achieve the dream. But it is also possible that these Baptists are really bootleggers in Baptist clothing. Think about it.

This highly condensed story has more than a grain of truth in it. Indeed, the broad outline is gospel truth. But there is something strange about the story so far. Where did the money come from? Why would smart bankers make loans to unqualified borrowers? And how could the lenders find a market for bonds backed by subprime mortgages?

Mr. Bush Enters the Story

There is obviously more to the story.

Government was committed to making homes affordable to all Americans. That commitment took the form of banking regulations that required financial institutions to make loans in high-risk regions of cities. Added to this were special HUD (Housing and Urban Development) programs that favored lower-income families as well as long-standing programs like the FHA-insured mortgages that assisted families in purchasing homes.

The affordable-housing program took a serious turn in December 2003, when a smiling President Bush put his name on the American Dream Downpayment Act.

The affordable-housing program took a serious turn in December 2003, when a smiling President Bush put his name on the American Dream Downpayment Act. The accompanying HUD press release described the legislation this way:

"There is a reason why many American families can't buy their first home—they can't afford the downpayment and other upfront closing costs required to qualify for a mortgage. For as many as 40,000 low-income families, that will change as President Bush today signed *The American Dream Downpayment Act* into law."

Congress authorized $200 million to bring assistance to some 5.5 million families by the end of the decade. On signing the law, President Bush said:

"Today we are taking action to bring many thousands of Americans closer to the great goal of owning a home. These funds will help American families achieve their goals, strengthen our communities, and our entire nation."

HUD Ups the Ante

While $200 million is a lot of money, it didn't go far enough to satisfy the Baptist urge. To extend the reach of the taxpayer money, Congress instructed HUD to expand the affordable-home program. HUD put pressure on Fannie Mae and Freddie Mac to open the money valves.

Reporting on the subprime crisis in 2008, *Washington Post* writer Caroline Leonnig explained the process this way:

"In 2004, as regulators warned that subprime lenders were saddling borrowers with mortgages they could not afford, the U.S. Department of Housing and Urban Development helped fuel more of that risky lending. Eager to put more low-income and minority families into their own homes, the agency required that two government-chartered mortgage finance firms purchase far more 'affordable' loans made to these borrowers. HUD stuck with an outdated policy that allowed Freddie Mac and Fannie Mae to count billions of dollars they invested in subprime loans as a public good that would foster affordable housing."

Leonnig goes on to describe HUD's reaction to those accusations:

"HUD officials dispute allegations that the agency encouraged abusive lending and sloppy underwriting standards that became the hallmark of the subprime industry. Spokesman Brian Sullivan said the agency and Congress wanted to increase homeownership among underserved families and could not have predicted that subprime lending would dominate the market so quickly.

"Congress and HUD policy folks were trying to do a good thing," he said, "and it worked."

Indeed.

Of course, those who have followed the subprime epoch know how this part of the story ended. On September 7, 2008, CBS News described the demise of two secondary mortgage lenders this way:

"For decades, Fannie and Freddie fulfilled the American dream, reports CBS News correspondent Tony Guida. Consumers took out loans from banks, which in turn sell those loans to Fannie or Freddie. Then the mortgage giants repackaged those loans and sold them to investors, guaranteeing the mortgages would be repaid.

"As home ownership grew universal, Fannie and Freddie prospered. Their CEOs, Daniel Mudd and Roger Syron, together earned around $30 million in 2007, reports Guida.

"But as they fattened, critics say they got greedy, underwriting too many home loans that never should have been made.

"Fannie Mae and Freddie Mac lost a combined $3.1 billion between April and June. Half of their credit losses came from these types of risky loans with ballooning monthly payments."

Now we have found two more bootleggers: Mr. Mudd and Mr. Syron, along with countless unnamed Wall Street executives who prospered mightily while designing, packaging, and handling the new mortgage-backed instruments that the world seemed eager to purchase. To these we might add some realtors and developers who supported affordable-housing programs.

At times, interest rates were lower than the inflation rate. At other times, the cost of borrowing was less than the expected price appreciation of the property, or so it appeared. It seemed too good to be true. And sadly, it turned out that way.

How Do You Fool That Many People?

There is yet another important piece to the story. We still need to understand how major financial institutions worldwide simultaneously could be fooled into buying paper that turned out to be trash. What does due diligence mean?

It turns out that by U.S. law, all credit instruments associated with mortgage-backed paper must be rated by one of three rating agencies. These are Moody's, Standard and Poor's, and Fitch. No competing rating agencies are allowed to enter the market. These three widely-respected rating agencies often assigned their highest rating to mortgage-backed products that contained subprime loans. By mixing pieces of subprime with high-quality mortgages, the mortgage packers were able to obtain the highest possible credit rating for instruments that were not 100 percent high-quality paper. When the default avalanche started, international buyers and sellers could no longer rely on the credit rating that had been given to the mixed-bag products. Credit markets fell into a deep sleep.

Of course, there is far more to the story than just this part about subprime mortgages and the American dream. The money for making it all happen had to come from somewhere, and from where else but the Fed along with an inflow of funds from international lenders? A long period of Fed credit easing during 2000–2004 laid a foundation for interest rates so low that people were practically paid to borrow money. That's right: At times, interest rates were lower than the inflation rate. At other times, the cost of borrowing—especially with federal assistance—was less than the expected price appreciation of the property, or so it appeared. It seemed too good to be true. And sadly, it turned out that way.

With easy money and subsidized lending, the great mortgage-making machine had nowhere to go but up—that is, until inflation reared its ugly head and the Fed reversed course.

When the Fed hit the money brakes in 2006, interest rates rose, adjustable-rate mortgages reset monthly payments, and people at the family-budget margin found they couldn't make the payments. The American dream turned into a nightmare. Mortgage defaults followed. Glutted housing markets followed that. Falling prices followed that. And Fannie Mae and Freddie Mac found themselves in a heap of trouble—along with everyone else who had purchased mortgage-backed securities, including Lehman Brothers, Morgan Stanley, UBS, and a host of other international lenders. Obviously, not all banks and lending institutions were caught in the American-dream squeeze play, but enough large ones were caught for "too big to fail" to become the lobbying cry in national capitals.

Bailouts and Lobbying

Fallout from the Bootlegger/Baptist story brought massive cash flow to major banks and delivered mergers that would not likely pass antitrust muster under other circumstances. The acquisition of Countrywide by the nation's largest bank, Bank of America (BOA), is a case in point. This was followed by BOA's acquisition of Merrill Lynch, the nation's largest brokerage firm. Countrywide's merger was arranged by the Federal Home Loan Bank (FHLB) with funds provided by FHLB member banks. The stronger banks that did it right were taxed to assist a competitor who didn't. Ayn Rand must be turning over in her grave.

Along the way, BOA and eight other major banks were tapped by the secretary of treasury to become part of the nationalized U.S. banking system. They were hardly in a position to turn down the invitation. With Washington now the center of the financial universe and the home of the agents of taxpayer equity owners, bankers who previously were not so engaged decided to invest more in lobbying the politicians.

> Once again a crisis has emerged, driven partly by Bootlegger and Baptist interest groups. And once again, a crisis has fed the leviathan, and the leviathan has taken a larger bite from the market economy.

This is hardly the end of capitalism, but it is another case of "Crisis and Leviathan," the model of political behavior told so well by economic historian Robert Higgs. Once again a crisis has emerged, driven partly by Bootlegger and Baptist interest groups. And once again, a crisis has fed the leviathan, and the leviathan has taken a larger bite from the market economy.

Will Robert Higgs's forecast come to pass?

Higgs predicts that once a crisis has passed, the fattened leviathan continues to hold sway. The agencies that emerge to manage the nationalized banks will become a permanent part of the government landscape, and those quasi-private businesses supported by government will continue to be important players in a Bootlegger-and-Baptist saga.

Betting on Higgs would be a safe bet for sure.

Psychiatry: The Shame of Medicine

BY THOMAS SZASZ

The practice of medicine rests on cooperation and the ethical-legal premise that treatment is justified by the patient's consent not his illness. In contrast, the practice of psychiatry rests on coercion and the ethical-legal premise that treatment is justified by the mental illness attributed to the patient and *must be "provided"* regardless of whether the patient consents or not. How do physicians, medical ethicists, and the legal system reconcile the routine use of involuntary psychiatric interventions with the basic moral rule of medicine, *Primum non nocere*, a Latin phrase meaning "First do no harm"?

The answer is: by the medicalization of conflict as disease and coercion as treatment. Carl Wernicke (1848–1905), one of the founders of modern neuropathology, observed, "The medical treatment of [mental] patients began with the infringement of their personal freedom." Today, it is psychiatric heresy to note, much less emphasize, that psychiatry-as-coercion is an arm of the punitive apparatus of the state. Absent the coercive promise and power of mental-health laws, psychiatry as we know it would disappear.

The practice of psychiatry rests on coercion and the ethical-legal premise that treatment is justified by the mental illness attributed to the patient and *must be "provided"* regardless of whether the patient consents or not.

Ever since its beginning approximately 300 years ago, psychiatry's basic function has been the restraint and punishment of troublesome individuals justified as hospitalization and medical care. For two centuries all psychiatry was involuntary psychiatry. A little more than 100 years ago individuals began to seek psychiatric help for their own problems. As a result the psychiatrist became a full-fledged double agent and psychiatry a trap. The film *Changeling*—written by J. Michael Straczynski and directed by Clint Eastwood—is a current example.

The story, set in Los Angeles in 1928, is said to be the "true story" of Christine Collins, whose son Walter is kidnapped. The corrupt police make little effort to find Walter. Months pass. To repair their damaged image, the police decide to stage a reunion between an abandoned youngster pretending to be Walter and his mother, played by Angelina Jolie. Unsurprisingly, she realizes that the fake Walter is not her son. After confronting the police and city authorities she is vilified as an unfit mother, branded delusional, and incarcerated in a "psychopathic ward." There she is subjected to the brutalities of sadistic psychiatrists and nurses and watches fellow victims being punished by electric shock treatment—ten years before its invention. So much for the truth of the story.

Clueless about the true nature of the psychiatric terrorization to which the Jolie character is subjected, film critic Kirk Honeycutt praises Clint Eastwood, who, he says, "again brilliantly portrays the struggle of the outsider against a fraudulent system. . . . *Changeling* brushes away the romantic notion of a more innocent time to reveal a Los Angeles circa 1928 awash in corruption and steeped in a culture that treats women as hysterical and unreliable beings when they challenge male wisdom."

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The Jolie character does not simply challenge "male wisdom." Instead, her actions illustrate the insight of the Hungarian proverb, "It is dangerous to be wrong but fatal to be right." The psychiatrist as brutal agent of the state enters the story *only after the mother proves*—by securing the testimony of her son's teacher and dentist—that "Walter" is an impostor. The psychiatrically incarcerated individual's greatest crime—for which psychiatrists cannot forgive her—is that she is innocent of lawbreaking and objects to being deprived of liberty.

Medicalized Terrorism

Psychiatric coercion is medicalized terrorism. So-called critics of psychiatry—who often fail or refuse to distinguish coerced from contractual psychiatry—are unable or unwilling to acknowledge this disturbing truth. As a result, the more things change in psychiatry, the more they remain the same, as the following conveniently forgotten example illustrates.

> Psychiatric coercion is medicalized terrorism. So-called critics of psychiatry fail to acknowledge this disturbing truth.

On May 21, 1839, Elizabeth Parsons Ware (1816–1897) married the Reverend Theophilus Packard. The couple and their six children resided in Kankakee County, Illinois. After years of marriage, Mrs. Packard began to question her husband's religious and pro-slavery beliefs and express opinions contrary to his. In 1860 Mr. Packard decided that his wife was insane and proceeded to have her committed. She learned of this decision on June 18, 1860, when the county sheriff arrived at the Packard home to take her into custody. The law at the time stated that married women "may be entered or detained in the hospital [the Jacksonville State Insane Asylum] at the request of the husband of the woman or the guardian . . . without the evidence of insanity required in other cases." Mrs. Packard spent the next three years in the Asylum. In 1863, due largely to pressure from her children, who wished her released, the doctors declared her incurable and released her. Mrs. Packard stayed close to her children, retained their support, founded the Anti-Insane Asylum Society, and published several books, including *Marital Power Exemplified, or Three Years Imprisonment for Religious Belief* (1864) and *The Prisoners' Hidden Life, Or Insane Asylums Unveiled* (1868).

The Beginning, Not the End

Little did Mrs. Packard realize that she was living at the beginning, not the end, of the Psychiatric Inquisition. Today, "inquiry" into the minds of unwanted others is a pseudoscientific racket supported by the therapeutic state. Millions of schoolchildren, old people in nursing homes, and prisoners are persecuted with psychiatric diagnoses and punished with psychiatric treatments. Nor is that all. Untold numbers of Americans are now psychiatric parolees, sentenced by judges—playing doctors—to submit to psychiatric treatment as so-called outpatients or face incarceration and forced treatment as inpatients.

The subtext of films such as *Changeling* is always subtle psychiatric propaganda seeking to make people believe they are witnessing past "psychiatric abuses." The truth is that every new psychiatric policy or practice labeled an "advance" is a step toward making psychiatric deception and brutalization more legal and more difficult for the victim to resist.

As I write this column, I learn from an "antipsychiatry" website that a man named Ray Sandford is being subjected to court-ordered outpatient electroshock treatment. "Each and every Wednesday, early in the morning, staff shows up at Ray's sheltered living home called Victory House in Columbia Heights, Minnesota, adjacent to Minneapolis. Staff escorts Ray the 15 miles to Mercy Hospital. There, Ray is given another of his weekly electroconvulsive therapy (ECT) treatments, also known as electroshock. All against his will. On an outpatient basis. And it's been going on for months."

As the forced psychiatric treatment of competent adults living in their own homes becomes the "standard of medical practice," the failure to provide such betrayal and brutality becomes medical malpractice. In a democracy people are said to get the kind of government they deserve. In a pharmacracy they get the kind of psychiatry they deserve.

Black Swans, Butterflies, and the Economy

BY MAX BORDERS

One side blames the market. The other blames government. We get two causal stories going in opposite directions and a lot of animus. But both perhaps are missing something important in this titanic debate about our current financial crisis. It's time we exposed a complicated truth about the economy of the 21st century.

Nassim Nicholas Taleb is famous for introducing us to black swans. Though these rare creatures have long been used among academic philosophers to explain the shortcomings of reasoning by induction ("Every swan I've ever seen has been white, therefore all swans are white."), Taleb uses the black swan as a stark metaphor for the inevitability of highly improbable events. In other words, black swans are rare, but one will swim by eventually.

As far as Wall Street—particularly the people with a large stake in getting things right—is concerned, this financial crisis involved a confluence of events. Some of these black swans were set in motion by government, like flexible lending standards to extend home ownership, Fannie and Freddie, and a mortgage-friendly tax code. Others were set in motion by willfully ignorant bankers, big shot risk-modelers, and people believing they could live beyond their means. It all came together in a fantastic cascade of failure. The trouble is, no one—neither government nor market actors—can predict such a large-scale event. Black swans happen.

Black swans happen
Paul Hocksenar

The other important thing to remember is that the economy is a chaotic system. Most of the time chaotic systems achieve a sweet spot between order and chaos, which is a good thing if an economy is to be robust. Chaotic systems, though, change constantly and involve dynamics that are highly sensitive to initial conditions.

An Ecosystem, Not a Machine

Sadly, we're getting a whole lot of precisely the wrong kind of thinking in response to this crisis. Indeed most of the bad thinking arises from viewing the economy through the lens of a false metaphor: economy as machine. We've heard pundits accuse the government or banks of being "asleep at the switch." But in a complex system, there is no switch. We've heard people ask how to "fix it," "run it," or "regulate it," suggesting if just the right sort of genius controlled the rheostats, we'd get just the right sort of economy.

The economy is not like a machine at all. It is rather more like an ecosystem that no one can run, fix, or regulate. The hubristic sort of person who thinks he or anyone can run an economy is the victim of what Hayek called the "fatal conceit." If given power, the planner will end up making the rest of us the victims of his false metaphor.

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It is ironic that Alan Greenspan—once adored by the press but now pilloried by it—is being blamed not only for wielding a laissez-faire ideology that supposedly *caused* the crisis, but also for failing to predict a black swan. Greenspan was a single, powerful government bureaucrat in charge of gathering enough data to determine the "right" interest rate for a multitrillion-dollar economy. Given the size of that task, he did pretty well for many years. But he was one man. He was housed in a government building. He held an unelected office and made decisions in a bureaucracy that has a monopoly on money and influences the price of credit, at least in the short run. One can hardly call that free-market fundamentalism. Whether Greenspan offered artificially cheap credit or not, interest rates were only one factor among many. To have asked him to predict the best of all possible worlds and adjust interest rates accordingly would have been to ask him to be an oracle channeling the knowledge only God would have. Greenspan is not omniscient. Nor is Bernanke. No one is. But to "run" an economy would require not only omniscience, but omnipotence as well—a power that would bend the actions of millions to its singular will.

Whatever your ideological persuasion, the economy is a complex system that cannot be planned, designed, or have its black swans regulated away. Far from the caricatures sketched in the papers, this is precisely what serious free-market types have been saying for years. That's why it's a little more than silly to blame free-market ideology for the current mess, and a little more than mendacious to claim that government fingerprints won't appear all over the crisis when the postmortem is done.

Hunting Black Swans with Shots in the Dark

The timeless nostra of the politician are to prime the pump (machine metaphor) and to regulate. It seems so simple. But that response is deceptively linear. If you could ask FDR, might he now concede his policies stretched the Depression out for a decade beyond what was necessary? He listened to J.M. Keynes and a coven of interventionists. If we agree that our mixed economy is a complex system, then we also have to agree that the benefits the partly free market confers are an emergent property of that system. If we attempt to regulate away the rare, unforeseen black swan event, the costs of our hubris will be terrible, for we will regulate away untold benefits, too.

In the real world the question may come down to whether we should accept a couple of years of painful market adjustments or decades of recession caused by the blunt instrument of politics. Devastating unintended consequences and unseen effects will follow government attempts to clean up a mess made in great measure by its own hand. Why? Because no one possesses a God's-eye view of the economy. Government intervenes within the system as part of it, not from outside of it. Nor is the economy an instrument to be manipulated to positive effect—at least not over the long term. That is why Keynes got it so terribly wrong and why the economy must heal itself from within in a distributed, holistic way.

People want government, like God, to come down and fix the unfixable, or explain the inexplicable. That's why they're finding it easier to blame greed for our current financial crises. But greed is rather more like gravity: When you fall, you can blame either Newton or the banana peel on the ground.

The profit motive is a good thing when it operates in an environment where bad bets are punished with losses and good investments are rewarded. Only government can distort that healthy profit-and-loss system, giving people incentives to make bad decisions. And it's in this environment that greed is no good to anyone. It turns out, however, that greed—or better, rational self-interest—can help our economy stabilize faster than government ever could. As the lubricant of our economic system, self-interest will cause a million market actors to recalibrate and to direct resources to projects that create value in our society. We the people will temper our irrational urges and mitigate our risks if government restores the rules that let profit and loss bring discipline. But if government continues to change the rules to bias the market in favor of irrational behavior, rent-seeking, and corporatism, the chaotic aspects of the system will continue to wobble out of equilibrium. Black swans will become commonplace.

The Financial Bailouts: "See the Needle and the Damage Done"

BY LAWRENCE H. WHITE

On Wednesday, September 17, 2008, according to the *New York Times*, Fed Chairman Ben Bernanke used "a speaker phone from his ornate office" to tell Treasury Secretary Henry Paulson "that it was time to adopt a comprehensive strategy that Congress would have to approve" for dealing with the financial-market troubles. After a second call on Thursday morning, Paulson agreed. The next day he called publicly for what the *Times* described as "far-reaching emergency powers to buy hundreds of billions of dollars in distressed mortgages despite many unknowns about how the plan would work."

Just one day later, September 20, the Bush administration announced a price tag: It would ask Congress for what the *Times* described as "unfettered authority for the Treasury Department to buy up to $700 billion in distressed mortgage-related assets from the private firms." News reports noted that $700 billion amounts to more than $2,000 for every man, woman, and child in the United States. Secretary Paulson released a three-page draft of the legislation he wanted. It did not specify how the money would be spent, but did say that no court could review the Treasury's decisions about spending the money. Paulson warned of dire consequences should Congress not approve the legislation quickly and as proposed.

In asking for huge sums and unrestrained power for government to intervene in financial markets, Bernanke and Paulson discarded any pretense of adhering to free-market principles. The *Times* reported that an attendee at a strategy meeting quoted Bernanke as justifying the abandonment of principles by declaring that, "There are no atheists in foxholes and no ideologues in financial crises." The aim of avoiding a deeper crisis, in other words, rationalizes whatever seems expedient. We should flee from the threat of a "financial meltdown" even into the arms of a constitutional meltdown. Surprisingly, many "free-market" commentators and economists echoed this sentiment. Some of them pledged to reaffirm free-market principles in the future even while calling for their abandonment for the duration of the financial turmoil. Their questionable judgment seems to have been that more government intervention was needed to offset—and *would* offset rather than compound—the previous interventions that had created financial chaos.

Few in Congress questioned the figure of $700 billion. Some House Republicans proposed a nominally less-interventionist plan that would have had the federal government not purchase—"only" guarantee—home-mortgage assets. Instead of putting an explicit price tag on the taxpayers' burden for the bailout, government guarantees of mortgages and mortgage-backed securities would have obliged taxpayers to pay lenders and bond holders whenever and wherever borrowers or security issuers defaulted, implying off-balance-sheet taxpayer exposure on an unspecified scale. A blank check rather than a $700 billion check—some improvement.

After congressional wrangling for nine days over what to add to the three-page Treasury proposal, a bill of 110 pages emerged. A deal had been struck. The Treasury's authority to purchase had grown beyond mortgage-related assets to include "any other financial instrument that the Secretary, after consultation with

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the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability." In other words, whatever the two wanted.

Shock in the House

On Monday, September 29, the House of Representatives shocked political pundits by voting down the bailout bill 228–205. With constituent email and phone messages to Congress running heavily against the bailout (some estimates said 30–1), the majority that day disregarded dire warnings that Congress had "no time" to put any more careful thought into what it was doing.

Two days later, however, the U.S. Senate approved a further-revised bailout bill 74–25. Although they had not taken time to put a lot of additional thought into it, senators had nonetheless added a lot of text: The bill had now grown to 422 pages. The Emergency Economic Stabilization Act of 2008 now not only provided $700 billion for a Troubled Assets Relief Program, but also included sections and subsections on Renewable Energy Incentives, Carbon Mitigation and Coal Provisions, Transportation and Domestic Fuel Security Provisions, a grab-bag of tax-credit extensions, a subtitle for Mental Health Parity and Addiction Equity, another for Heartland and Hurricane Ike Disaster Relief, an increase in federal deposit insurance, and authority for securities regulators to relax accounting rules that financial firms facing mortgage-related losses were finding inconvenient. The height of special-interest absurdity was reached in Section 503 of the Act which, according to the official Library of Congress summary, "Exempts from the excise tax on bows and arrows certain shafts consisting of all natural wood that, after assembly, measure 5/16 of an inch or less in diameter and that are not suitable for use with bows that would otherwise be subject to such tax (having a peak draw weight of 30 pounds or more)."

Two days after the Senate vote, on Friday, October 3, the once-reluctant House approved the bailout bill 263–171. In the second House vote 33 Democrats and 25 Republicans switched from no to yes. One congresswoman unashamedly explained to National Public Radio that she had switched because the new bill included solar-energy tax credits. President Bush immediately signed the bill. Prices on the New York Stock Exchange, which had closed way down the day the first bill had failed to pass, closed down again on the day the revised bill passed and was signed into law.

"Plan" A

The "plan" for how to spend the $700 billion bailout has always been extremely vague, from its inception in the Bernanke-Paulson phone call, through the case Paulson made before Congress, to the passage of the enabling legislation. Improvisation continued up to the date this account was written in late November. The Treasury originally announced an intention to buy troubled mortgage-related assets, and hence the bill refers to a Troubled Asset Relief Program, or TARP. But on what terms would they buy these assets? More than a month after passage, that had yet to be made clear. American Public Media's *Marketplace* program reported on November 7 that, "A securities industry trade group just came out with a survey, and it found that financial players are so unclear about how TARP would work, they aren't sure they want to participate." The Treasury had to schedule a meeting with banking industry representatives on November 10 to fill them in on the evolving specifics of TARP.

> The "plan" for how to spend the $700 billion bailout has always been extremely vague.

The "troubled" assets to be purchased are mortgage loans, bundles of such loans ("mortgage-backed securities"), and apparently any other financial assets the Treasury wants to include. What makes them "troubled" is basically that financial institutions can't sell them for what they paid for them. The basic reason is that an unexpectedly huge share of mortgages has gone bad: Mortgage-default rates have skyrocketed. Further, the secondary market for mortgage-backed securities has dried up. A firm trying to sell some of its holdings would fetch only fire-sale prices.

There is a basic problem with having the Treasury buy assets that the market won't buy except at fire-sale prices. Either the Treasury outbids the market and overpays for the assets—which benefits financial institutions at taxpayer expense—or the government pays the current market price, which would compel banks to mark other assets down accordingly and book the losses they've been trying to avoid booking.

In arguing for the bailout, Bernanke proposed that an "auction" of troubled assets for taxpayer-provided dollars would enable accurate "price discovery," even though the Treasury would be the only bidder, and thereby would restore an active market. How such an auction would work, how it could be designed to arrive at hoped-for prices—above current market prices but not above what the assets would supposedly be worth in a normal market—was never spelled out. In mid-November "Plan A" appeared to have been more or less officially shelved. Never mind that Paulson had told Congress that hundreds of billions for troubled-asset purchases were urgently and immediately needed to avoid financial Armageddon.

On November 25 the idea of troubled-asset purchases made a dramatic comeback under the auspices of the Federal Reserve, which is discussed below.

"Plan A" appeared to have been shelved. Never mind that Paulson had told Congress that hundreds of billions were urgently and immediately needed to avoid financial Armageddon.

"Plan" B

On October 13 the Treasury announced a new way to spend $250 billion of the $700 billion: It would inject equity capital into banks, buying newly issued preferred shares. It soon thereafter injected $125 billion into nine major banks: Citigroup, Bank of America, Wells Fargo, JPMorgan Chase, Bank of New York Mellon, State Street, Merrill Lynch, Morgan Stanley, and Goldman Sachs. The last-named is the former investment bank, recently converted into a commercial bank, previously headed by Paulson. From the group of nine banks the Treasury took "preferred shares" with fixed 5 percent dividends (increasing to 9 percent if the shares have not been repurchased in five years).

On November 23 the Treasury announced it would inject an additional $20 billion of equity into Citigroup. For this second injection it took preferred shares with an 8 percent dividend. The Treasury together with the FDIC also provided an off-balance-sheet *guarantee* against losses on about $300 billion of Citibank's troubled real estate assets, in exchange for which the Treasury and FDIC took additional preferred shares.

The federal government is now part-owner of the nine banks. The banking system has been partially nationalized. The preferred shares are ownership claims of a type falling between debt obligations (bonds) and common stock shares. They are riskier than bonds because preferred shareholders must stand behind bondholders in the line to get paid in the event that the bank can't pay everyone.

To compensate for its risk the Treasury also took stock warrants—contracts that give it the right to buy shares in the future at a specified price so that it can make a profit should the banks' stock prices someday rise higher than that price. "Recapitalizing" a firm normally leads to lower share prices, however, because it means more shares dividing ownership of the same asset portfolio. The infusion dilutes existing shares. For this reason two of the nine banks reportedly *objected* to participating in the Treasury's capital infusion with attached strings. The Treasury explained that it did not make participation voluntary because it did not want to stigmatize as weak the banks that chose to participate. A financial analyst's report in late November named Bank of America, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley, and Wells Fargo as the weakest institutions.

The other half of the Treasury's $250 billion has been designated for assignment to smaller banks to be named later. Among other things, the Treasury reportedly hopes these capital injections will enable recipient banks to buy up other, weaker banks. An anonymous

Treasury official told reporters: "One purpose of this plan is to drive consolidation." Thus taxpayer money is being allocated to influence the shape of the banking market.

"Plan" C?

What will "Plan" C be? As the Treasury continues to improvise, everything and anything is possible. So says Neel Kashkari, the former Goldman Sachs employee under Paulson who is now the Treasury's chief bailout administrator under Paulson. Asked whether funds might go to insurance companies, other financial firms, and even nonfinancial firms like automakers, one news story reported, "Kashkari indicated that everything was on the table. 'We are looking at everything,' he said. 'We are trying to figure out what will provide the most benefit to the financial system.'"

House Speaker Nancy Pelosi, Senate majority leader Harry Reid, and other congressmen have urged the Treasury to use some of the $700 billion to inject capital into the leading U.S. automakers. These same lawmakers specified no such authority in the bailout bill. Some $1.5 billion of the $700 billion will go to local governments for reasons unrelated to the financial system.

Insurance executives have reportedly lobbied for the bailout to include troubled insurance company assets. There is now a precedent: The Treasury has given $67.5 billion of the bailout to AIG, the failed insurance giant brought down by its imprudently massive guarantees on mortgage-backed securities, in exchange for troubled assets and preferred shares. AIG was already on an $85 billion life-support loan from the Federal Reserve.

Second Bailout

The Treasury's $700 billion bailout is actually the *second* federal bailout program underway. The press has widely reported on the Treasury bailout bill and the post-bill spending improvisations. Columnists and the public have openly debated the dubious wisdom of that program. Congress has held hearings and has voted on the bailout bill, even if it has left it to the Treasury to decide how the $700 billion will be spent. But flying under the radar, attracting much less public attention and almost zero congressional scrutiny, have been the Federal Reserve's ongoing efforts that in mid-November added up to a $1.7 *trillion* shadow bailout program for favored financial institutions, more than double the size of the Treasury's bailout. On November 25 the Fed announced two new lending lines that will add another $800 billion, bringing the total to $2.5 trillion—more than *triple* the size of the Treasury's bailout. (This section draws heavily on my paper for the November 2008 Cato Institute monetary conference, "Federal Reserve Policy and the Housing Bubble.")

The Fed's bailout efforts began back in March 2008 with the Fed putting up $29 billion to sweeten a deal in which the commercial bank JPMorgan Chase would take over the teetering investment bank Bear Stearns. A new Fed-owned subsidiary ("Maiden Lane LLC") was set up to cleanse the Bear Stearns balance sheet by acquiring troubled mortgage-backed securities for the $29 billion. The transformation of the Federal Reserve's balance sheet, which used to hold virtually nothing but safe Treasury securities, had begun. Between March and November, as the Fed improvised new interventions into financial markets, the dollar amounts of the Fed's commitments grew and grew.

The interventions are visible among the assets on the Fed's balance sheet for November 5, where many new entries appear that were absent one year ago. The list begins with "Term Auction Credit" at $301 billion, representing 28-day and 84-day loans to banks. Previously loans to commercial banks were limited to overnight loans for meeting reserve requirements. Banks were expected to attract longer-term funds from depositors or private institutional investors in the money market. Next on the list is "Primary Dealer and other Broker-Dealer Credit" of $72 billion—that is, loans to securities dealers. A year ago the Fed did not lend to securities dealers. Third is the "Asset Backed Commercial Paper Money Market Mutual Fund Liquidity Facility"—loans to banks or bank holding companies to allow them to purchase assets from money-market mutual funds. Previously money-market funds that needed to liquidate commercial paper holdings were expected to sell them in the money market. "Other credit extensions," a catchall fourth new entry, amount to $81 billion.

The fifth new entry is "Net portfolio holdings of Commercial Paper Funding Facility LLC," $243 billion. A memo to the Fed's balance-sheet release explains: "On October 27, 2008, the Federal Reserve Bank of New York began extending loans . . . to Commercial Paper Funding Facility LLC. This LLC is a limited liability company that was formed to purchase three-month U.S. dollar-denominated commercial paper from eligible issuers and thereby foster liquidity in short-term funding markets and increase the availability of credit for businesses and households." That is, the Fed has formed a new subsidiary for directly allocating funds to a particular segment of the financial system, the commercial paper market. Previously the Fed purchased only Treasury securities, and let private banking and financial markets allocate the funds it thus injected to their best uses.

Sixth is "Net portfolio holdings of Maiden Lane LLC," $27 billion, representing the troubled assets acquired from Bear Stearns. Note that the assets have been marked down from their acquisition price of $29 billion: the Fed has suffered a loss of $2 billion. By holding the assets the Fed is speculating that the market for selling them will be better later on. Previously the Fed did not get involved in financial takeovers by absorbing troubled assets to sweeten the deal. The FDIC sometimes did, but only in mergers between two insured commercial banks. Bear Stearns was an investment bank, not an insured commercial bank.

Last September the Federal Reserve began buying federal agency notes—short-term IOUs of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—from securities dealers. As of November 5 the Fed was holding $13 billion of such notes, where it held zero one year ago, though it has held small amounts of agency debt in the past. The Fed's "primary" (overnight) loans to commercial banks are currently at $110 billion, up from only $1.4 billion a year ago. In total the Fed's assets have more than doubled, from $889 billion a year ago to an astounding $2.08 *trillion* in mid-November. Further increases are on the way.

Two items make the Fed's bailout loan program even larger than the $1.2 trillion increase in its total assets. First, the Fed has funded $303 billion of its new loans by selling off Treasury securities from its portfolio. Second, off its balance sheet (but recorded as a "memorandum item"), the Fed also runs a "Term Securities Lending Facility" that has lent $197 billion of its Treasury securities to broker-dealers, giving them something liquid to sell in exchange for IOUs collateralized by less liquid securities like mortgage-backed securities. As of November 5 the Fed's new loans and purchases had extended $1.7 trillion in new credits to financial institutions over the past year.

On November 25 the Federal Reserve announced that in the following week it would begin purchasing up to $600 billion in securities issued or guaranteed by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. It would buy them from its primary securities dealers through "a series of competitive auctions." It also announced the creation of a $200 billion Term Asset-Backed Securities Lending Facility to make new term loans to financial institutions, loans to be collateralized by nonmortgage pools of consumer and small-business loans. In both cases the Fed is engaged in price-setting, trying to drive interest spreads (the differential yields over Treasury bills required to attract purchasers) on riskier securities back into their historical ranges. Thus the Fed is second-guessing the risk premiums set in competitive financial markets. As of Thanksgiving, the new facilities had not yet appeared on the Fed's balance sheet.

Unprecedented Credit Expansion

From $1.2 trillion of added bank reserves, the late-November lending programs (if not somehow offset) will push added bank reserves to $2 trillion. The Fed has no clear exit strategy from its unprecedented credit expansion. It has too few Treasury securities left to sell in order to pull the credits back in, the traditional method for contracting bank reserves. No doubt the Fed hopes that the new loans will be repaid (and not re-extended) as financial market conditions improve. But borrowing firms whose ability to repay depends on the prices of their mortgage-backed securities recovering may be unable to repay any time soon because the effects of overbuilding during the housing bubble will depress the price of real estate and thus of mortgage-backed securities for a long while. Moreover, they may be *unwilling* to repay. Nonbank financial firms that are now enjoying the Fed's below-market lending rates will have no incentive to wean themselves and every reason to lobby for keeping the new bargain lending windows open indefinitely. "Temporary emergency" government subsidies have a way of living on and on. Just ask the recipients of federally subsidized farm loans.

The Fed's new activities deserve to be called a bailout program because they seek to channel credit selectively at below-market interest rates, or purchase assets at above-market prices, in hopes of rescuing, or enhancing profits for, favored sets of financial institutions. The Fed's new lending facilities are not parts of a central bank's traditional "lender of last resort" role. A lender of last resort injects reserves into the commercial banking system to prevent the quantity of money from contracting—and thereby to protect the economy's payment system—when there is an "internal drain" of reserves (bank runs and the hoarding of cash). There has been only one bank run (on IndyMac) and no contraction in the money stock. Investment banks do not issue checking deposits, are therefore not subject to depositor runs, and are not part of the payment system. Neither are securities dealers. Money-market mutual funds play a limited payment role, but because they do not issue demandable debt, they are not subject to runs. The Fed's expansions of its own activities therefore had nothing to do with protecting the payment system or stabilizing the money supply.

The "lender" in "lender of last resort" has long been an anachronism. Central banks in sophisticated financial systems discovered decades ago that they can inject bank reserves without lending by purchasing government securities in the open market. By doing so, the central bank supports the money stock while avoiding the danger of favoritism associated with making loans to specific banks (or nonbanks) on noncompetitive terms. It also avoids the potential favoritism in purchasing other securities. The Fed's new activities, by contrast, extend an array of loans to various financial institutions and purchase securities from nonbank issuers and holders. These activities pose the risk of favoritism—of substituting the Fed's judgment for the market's about what kinds of institutions and what particular firms should survive. They have nothing to do with replenishing the reserves of the banking system or

preventing contraction in the stock of money. The Fed's activities seem rather to aim at protecting financial institutions from the consequences of imprudent portfolio decisions.

The Federal Reserve's new interventions into financial markets over the past year have proceeded at its own initiative and without precedent. They seem to be enjoying the complete freedom from oversight that Secretary Paulson unsuccessfully sought for the Treasury's bailout program. The Fed's program has attracted little attention mostly because it has not required a congressional appropriation. The Fed is "self-financing": It can "print up" any funds it needs to make loans or purchase assets by simply expanding the quantity of unbacked claims on itself. This does not mean that Fed credit expansion provides a free lunch. When the Fed increases the stock of dollars, it levies an implicit tax on holders of existing dollar balances by creating an inflationary depreciation of the dollar.

An Evaluation of the Bailouts

The financial turmoil of 2008 was the result of what may be briefly described as a government-policy-induced cluster of entrepreneurial errors by financial-market participants. Paulson's and Bernanke's bailout programs are disabling the key market mechanisms for correcting entrepreneurial errors: price adjustments and bankruptcies. Delays in the correction of mortgage asset prices, and delays in the necessary resolution of insolvent financial institutions, do not promote but rather hinder a sound economic recovery. As ABC News commentator John Stossel has written: "We do need protection from reckless businessmen. But there is only one way to provide that: market discipline. That means no privileges and no bailouts."

When government does not intervene with taxpayer-financed bailouts, private market participants will recapitalize banks (as Mitsubishi Bank recently did for Morgan Stanley) and buy distressed assets in genuinely price-discovering market transactions, to the extent that those risking their own money think warranted. The resolution (sale or liquidation) of firms that are not worth recapitalizing makes room in the market for better-run institutions to take their place. As the United States discovered in the savings-and-loan fiasco of the 1980s, and as Japan discovered in the 1990s, a government policy of keeping insolvent financial firms open beyond their expiration date makes survival more difficult for healthy firms.

Along these lines, the eminent monetary historian Anna J. Schwartz candidly criticized the bailout programs in an interview with the *Wall Street Journal* on October 18. To promote recovery the Fed and Treasury "should not be recapitalizing firms that should be shut down," Schwartz said. Rather, "firms that made wrong decisions should fail. You shouldn't rescue them. And once that's established as a principle, I think the market recognizes that it makes sense. Everything works much better when wrong decisions are punished and good decisions make you rich."

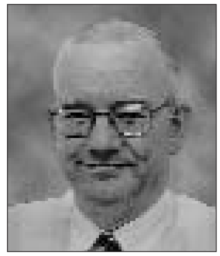
Schwartz observed that "Lending freezes up when lenders are uncertain that would-be borrowers have the resources to repay them." Removing the uncertainty by enforcing the usual rules requiring insolvent firms to exit the market promptly would provide greater clarity to financial markets. The economist Pedro H. Albuquerque has drawn out the implications of this insight: bailout plans make "the information problem worse by keeping unhealthy banks afloat," which "endangers the entire economy through planned obfuscation." A hypothetical used-automobile market in which buyers are reluctant to buy because they fear that sellers are trying to palm off unreliable vehicles is known to economists as a "lemons" market. Albuquerque observes that "The government is artificially creating a lemon market when it does not allow discrimination between healthy and unhealthy banks to occur via bank failures."

Some editorial and op-ed writers have claimed that many financial institutions have been "unregulated" too long and must now become regulated. But financial institutions have never been unregulated. They have been regulated by profit and loss. The failure of Lehman Brothers and the near-failure of Merrill Lynch raised the interest rate at which profit-seeking lenders were willing to lend to highly leveraged investment banks. The market thereby forced Goldman Sachs and Morgan Stanley to change their business models drastically and to convert to commercial banks. If that isn't effective regulation, what is? Protecting firms from failure (Bear Stearns, AIG, Fannie Mae, Freddie Mac, Goldman Sachs, Citibank) and mitigating their losses with bailouts renders this most appropriate form of regulation much less effective.

Financial institutions have never been unregulated. They have been regulated by profit and loss.

The eagerness of Ben Bernanke and Hank Paulson to substitute their own judgment for the dispersed judgments of a freely competitive financial market may reflect simple intellectual error. Or, less innocently in the case of former Goldman Sachs CEO Paulson, it may be error compounded with partiality. In an open letter to Congress on the eve of the bailout bill's passage, John A. Allison, CEO of the large and successful regional bank BB&T, pointed out that "There is no panic on Main Street and in sound financial institutions. The problems are in high-risk financial institutions and on Wall Street." The bailout seemed designed, in his view, to benefit a select group of Wall Street firms: "The primary beneficiaries of the proposed rescue are Goldman Sachs and Morgan Stanley. . . . [T]his is primarily a bailout of poorly run financial institutions." This design, Allison continued, was not an accident but the result of partiality in the designers' interests and perspective: "Treasury is totally dominated by Wall Street investment bankers. They do not have knowledge of the commercial banking industry. Therefore they cannot be relied on to objectively assess all the implications of government policy on all financial intermediaries."

Bailing Out the Big Three Repeats Britain's Mistake



BY STEPHEN DAVIES

A major reason for any kind of historical writing is to provide guidance for the present. As we read an account of the past, we may see similarities to the present and (we may hope) avoid repeating the same kinds of mistakes. In this sense historiography forms part of the collective memory of a society (which is one reason why history can be a very controversial subject). Sadly, many people lack this kind of perspective, while others who know about the past seem incapable of learning from it. Consequently, the same type of error gets repeated, often at great cost. It seems the U.S. political class, as represented by Congress and much of the commentariat, has done just that by trying to "save" the Big Three auto manufacturers. In doing this they will repeat a catastrophic series of mistakes made by British governments 30-40 years ago. It is worth recounting this sorry tale.

At one time British-owned auto manufacturers were world leaders. In 1952 the merger of Austin and Morris to form the British Motor Corporation (BMC) created the world's fourth-largest producer of cars. By the 1960s, however, the British auto industry faced growing problems. The main firms had lost an increasing share of the market to foreign-owned competition both at home and abroad. The profitability of many firms was steadily declining. This reflected a number of problems, such as old-fashioned or low-quality products or those, like the iconic Mini, that were triumphs of design but whose production costs made them unprofitable. Also, the management of many firms was both incompetent and hindered by chaotic organization of sales and production. Most seriously, the industry was plagued by bad labor relations, with frequent strikes and disputes and rigid enforcement of job demarcation.

Prime Minister Edward Heath
Photo courtesy the Sir Edward Heath Charitable Foundation.

Faced with this, British governments intervened to encourage mergers and the takeover of the failing firms by the remaining successful ones. This led ultimately to almost all the remaining British-owned firms being brought into one firm in 1968 with the creation of British Leyland (BL) via a state-sponsored merger of BMC and Leyland Motor Company. The underlying problems were not addressed, however, and the labor relations and chaotic management in particular became even worse. In the early 1970s the Heath administration gave financial assistance despite having opposed aid to failing firms during the 1970 election. By 1975 British Leyland was insolvent and on the verge of going out of business.

To Nationalize or Not to Nationalize

At this point the British government had a choice. It could allow BL to go bankrupt, with many of its 40 plants closing and the remainder being sold off, or it could act to prevent this. The government decided to take the firm into public ownership. The idea was to invest several billion pounds in the firm, and several hundred million pounds were indeed put in. The taxpayers also took on most of the outstanding debt. This did not stop the losses, however. The firm (with various name changes) continued to decline while soaking up a steady stream of government money. Several parts of the business were sold off, and eventually the core (the old BMC) was sold by the government in 1988. It never made money and finally closed in 2005—during a general election. In other words, the British government (or rather the taxpayers) spent 23

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years and a fortune trying to preserve an enterprise that went out of business anyway.

This was a classic case of trying to prevent the inevitable. The parts of the original firm that survived would almost certainly have done so in any event, as they were always profitable and would have found purchasers had BL been allowed to go bankrupt in 1975. Some might argue that at least jobs were preserved—for up to 30 years in some places. This is wrong for two reasons. First, the number of jobs actually preserved for that length of time was quite small because there was a steady loss from 1975 onward as a succession of managements made desperate efforts to keep the ship afloat.

Even more serious were the hidden costs of this bailout. All the money put into BL and its successors was capital that could have been employed profitably, creating work somewhere else. Instead it was simply wasted. The British-owned auto industry was essentially doomed by the mid-1970s. Trying to resist this did nobody any favors in the long run and simply prolonged the agony of re-adjustment to a painful and disruptive change.

The British government (or rather the taxpayers) spent 23 years and a fortune trying to preserve an enterprise that went out of business anyway.

Ominous Parallels

The parallels with the current position of the Big Three are not exact, but they are disturbingly close. The firms in question are also run down by a generation or more of bad management decisions, bad investments, and crippling wage, healthcare, and pension costs. It is not that auto manufacturing in America is unviable. Honda, Toyota, and others manufacture very profitably in the United States, just as Nissan does in the UK. There is nothing to suggest that giving the Big Three the massive amounts of money they want will do anything other than delay their demise and create a slow and lingering death rather than a swift one. In fact, so dire is the position of General Motors and Chrysler that even with assistance they are unlikely to survive as long as parts of British Leyland did. Meanwhile, all the money given to these firms will be money that could have been used to more effect elsewhere in the economy.

The U.S. political class is probably aware of this, even if it does not realize it will simply be repeating on a much larger scale what the British government did 30 years ago. They are motivated by two main concerns. The first is economic nationalism—the fear that if these firms and their suppliers go out of business, the United States will be weakened. The answer to this is straightforward, no matter how unpalatable it may be to nationalists: The aim of production is consumption, not national power and prestige. In the longer term policies that weaken productivity (which any diversion of capital will do) will actually reduce the power of the nation-state (if that is your main concern).

The second concern is for the many who would lose their jobs and the communities that would lose most of their employment. This comes down to an argument about whether concerns of this kind (which are serious and important) should be a matter for government action. Even if you think they should be, however, it does not follow that the right course is for Uncle Sam to support these firms financially. The example of Britain shows that the much more effective policy would be to let the firms be wound up and use the money to try to revitalize the local economy of places like Michigan. As people here in England watched the goings-on in Washington and Detroit, there was an overwhelming urge to shout, "Don't do it!" Sadly, even if the folks in Congress had heard, I doubt they would have followed the advice of history.

Too Big to Fail

BY MICHAEL HEBERLING

"Once you lose your freedom to fail, you also lose your freedom to succeed and you cease to be a free society."

—U.S. Rep. Jeb Hensarling of Texas

In March 2008 the investment banking firm Bear Sterns failed and the federal government quickly stepped in. The public was inundated with the phrase "too big to fail" (TBTF) by the financial news media. You had to go back to 1998 for the last time it was used so often. In that year the troubled hedge fund Long-Term Capital Management had $4.6 billion in losses. The Federal Reserve stepped in to orchestrate a restructuring deal to avoid bankruptcy. With this government intervention, the precedent was established for future calls for help. In 1999 Kevin Dowd, writing for the Cato Institute, stated: "[T]he intervention implies a return to the discredited doctrine that the Fed should prevent the failure of large financial firms, which encourages irresponsible risk taking. . . ."

She probably thought she was too big to fail, too.

An institution is deemed "too big to fail" if its collapse would be expected to create a devastating ripple effect throughout the economy, creating a "systemic risk." When this occurs the government is expected to provide some form of assistance. This can vary from a guaranteed loan, where management and stockholders get off scot-free (as with Chrysler in 1979), to guaranteeing the assets of a failing bank, to facilitating an outside takeover (Bear Stearns). In the event of an outside takeover thousands of employees could be shown the door and stockholders left with pennies on the dollar. Since the public only notices that it is paying the bill, it has a hard time discerning these subtle differences. As a result, the term "bailout" is used broadly to describe any form of government financial intervention to assist a crashing TBTF company or its creditors.

Too Big to be Free-Market

There are no clear guidelines on who is (or what constitutes) TBTF. As a result the "systemic risk" scare is ad hoc and apparently meant to be taken on faith. Any large company can claim it is vital to the health of the economy because its failure would have a domino effect on suppliers. Other firms can pick up the slack and even acquire the assets of the failed firm, but this is usually ignored.

TBTF is problematic because it indirectly influences how companies are managed. If there is a real, or implied, government safety net should things "head south," management might be inclined to take on more risk for greater profit. This illustrates the concept of "moral hazard," an insurance term. If you are insured, you may be less cautious. TBTF is actually a state of mind that afflicts the senior management of our largest corporations. If they *think* they are TBTF, even if they aren't, they still behave as if they are. This is the crux of our current financial problem.

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In an ideal free-market environment, entrepreneurs would be willing to take on risk based on an expected return. Since returns are never guaranteed, the entrepreneur's willingness to take on risk is tempered by the potential downside (a loss), if things don't pan out. While the rewards for extremely risky investments may be great, so too are the penalties. In severe cases the company could go bankrupt. As a result, this risk/reward/loss relationship in the free market would force rational behavior into the business decision-making process.

TBTF companies are no longer on their own to succeed or fail. With TBTF we now have the government in the game—not so much as another player but as a non-neutral referee ready to step in if the game gets too rough. What's more, TBTF companies operate under a different set of rules from merely mortal ones. In 2004 Gregory Mankiw, then chairman of the President's Council of Economic Advisers, said, "Expecting a government bailout if things go wrong creates an incentive for a company to take on risk and enjoy the associated increase in return."

TBTF is problematic because it indirectly influences how companies are managed.

So if you are (or think that you are) TBTF, there is little or no perceived penalty to counterbalance risky behavior. With a guaranteed—or at least an implied—government safety net, the sky is the limit when it comes to risk-taking. The siren song of big returns (with little or no risk) becomes irresistible—and you no longer operate in a free-market environment. According to Thomas Sowell, "The hybrid public-and-private nature of these activities amounts to 'privatizing profit and socializing risk' since taxpayers get stuck with the tab when high-risk finances don't work out." In other words, it is a travesty to say or imply that our current crisis stems from market failure.

Mixed Signals

What makes the TBTF phenomenon so difficult to follow (and understand) is that there is no official list of "too big" companies put out by the Treasury Department. The taxpayer only finds out that a company is on the list after the company fails.

The tab to the taxpayer for bailing out Bear Stearns is $29 billion and counting. What remained of Bear Sterns' assets, along with government guarantees, were transferred to JPMorgan Chase. The next TBTF firm to run into trouble was the investment bank Lehman Brothers Holdings Inc. Although conventional wisdom held that Lehman, with $615 billion in debt, was TBTF, this time the Fed said no.

These mixed signals about what was and what was not TBTF sent the financial markets into a tailspin. Some federal policymakers and many in the financial news media saw this as the beginning of the credit "crunch." (In fact, while credit standards have tightened, money is still being lent for all kinds of loans.) It was no longer prudent to do business with any "troubled" bank. Since no one knew which banks the government would or would not bail out, inhibition set in.

The next TBTF firm to ask for federal help was the world's biggest insurance company, American International Group Inc. (AIG). Not wishing to mishandle another TBTF firm, the Fed quickly agreed to lend $85 billion to AIG in September to avert bankruptcy. The following month AIG came back to the Fed asking for an additional $37.8 billion, citing liquidity problems. The Fed's response: No problem. But are you sure $123 billion will be enough? AIG is intricately involved in America's money-market funds. In November AIG came back and said: "On second thought, could you make that an even $150 billion?" The government response: Fine, but only on one condition, and you may find this to be exceedingly harsh. We absolutely insist that your top 70 executives *not* get any bonuses this year. AIG's response: "You drive a hard bargain, but we have a deal."

As a result of this action, the government now owns 80 percent of the company's assets.

In September the federal government took over two more TBTF firms. The quasi-governmental Fannie Mae and Freddie Mac own or guarantee about 40 percent of the nation's mortgages. This bailout will cost the taxpayer $200 billion. Egged on by influential members of

Congress, Freddie and Fannie blatantly abused their government-sponsored-enterprise (GSE) designations, and no two firms better exemplify the "moral hazard" argument. Since they were chartered by Congress, many believed their mortgage-backed securities were guaranteed by the federal government. Then-Fed chairman Alan Greenspan told Congress in 2004: "The Federal Reserve is concerned that Fannie Mae and Freddie Mac were using this implicit reliance on a government bailout in a crisis to take more risks, in order to multiply the profitability of subsidized debt." When housing prices started to tank we found out that this was exactly what was going on.

Bad Medicine and a Hail Mary

One would think that with all of the government oversight these TBTF events would not keep popping up. Since the government doctor has utterly failed to prevent this disease, why should we think the same government doctor suddenly knows how to cure the disease now that it has metastasized throughout the economy?

The Treasury, with the help of Congress, has thrown a $700 billion "Hail Mary" called the Troubled Asset Relief Program (TARP). Whether or not this bailout "restore[s] confidence in our financial system" (Treasury Secretary Henry Paulson) remains to be seen. Judging by the stock market, the early results are not good. Ironically, the first step of the plan was to identify publicly the banks that are really TBTF by buying their preferred stock. Nine TBTF banks, which account for 50 percent of all U.S. deposits, will get half the $250 billion earmarked for banks and thrifts. These include JPMorgan Chase, Wells Fargo, Citigroup, Bank of America (plus Merrill Lynch, which is being acquired by BoA), Goldman Sachs, New York Mellon, Morgan Stanley, and State Street. The bailout bill also includes a provision for the FDIC to offer an unlimited guarantee on bank deposits in business accounts that do not bear interest. For individual depositors, the FDIC insurance limits will increase from $100,000 to $250,000. How do these actions reduce the "moral hazard" problem? The last time the individual deposit insurance limit was raised—from $40,000 to $100,000 in 1980—we had the S&L crisis, which ended up costing the taxpayer $150 billion.

Being on the official TBTF list has its pros and cons. On the positive side, you can't fail. The government guarantee is no longer implied. It's real. But being on the official TBTF list has a severe downside: additional regulation. The government will be very close at hand to make sure that our biggest banks become and remain stodgy. In other words: We're from the government and we're here to make sure that your risk level remains in the "safe zone." In October New York Senator Charles Schumer, a member of both the finance and banking committees, wrote Paulson demanding that "banks receiving capital eliminate their dividends, restrict executive pay and stick to safe and sustainable, rather than exotic, financial activities." Given the makeup of the new Congress and administration, expect even more intrusive micromanaging of our financial institutions—but that is only to be expected if the Treasury becomes a stockholder. From now on innovation will be discouraged, downplayed, or slow-rolled by the government. As a result of these rescue actions, our entire financial system has effectively become nationalized.

The most troubling aspect of the ever-increasing number of government bailouts is the subtle change overtaking the entire country. The mindset of companies and individuals today is shifting away from self-responsibility.

A Troubling Cultural Shift

The most troubling aspect of the ever-increasing number of government bailouts is the subtle change overtaking the entire country. The mindset of companies and individuals today is shifting away from self-responsibility. We blame everyone else for our mistakes and look to others (the taxpayer) to come to the rescue.

When it comes to handouts and bailouts the government is no longer simply on the slippery slope—it's in free-fall. Every bailout makes it harder to say no when the next TBTF request comes forward. Aren't the Big Three automakers too big to fail as well? In many people's eyes the answer is yes. At the end of September Congress approved a $25 billion low-cost loan package to help the automakers and their suppliers modernize their facilities so as to be "more green." But this wasn't enough. General Motors CEO Rick Wagoner, whose company was hemorrhaging cash, sought another $10 billion in federal assistance the next month to help finance the merger of GM and Chrysler. However, this request was denied. Then in November the Big Three found sympathetic ears from the big two in Congress, House Speaker Nancy Pelosi and Senate Majority Leader Harry Reid, for yet another $25 billion "bridge" loan for the Big Three. The Bush administration ultimately dished out $17.4 billion from the $700 billion TARP fund to assist GM and Chrysler. It also handed the problem of deciding the long-term future of the bailouts to the Obama administration, which had already expressed support for a bailout package. (Notably, the several profitable foreign-owned automakers with facilities in the United States weren't looking for help.)

It shouldn't need pointing out that the "too big to fail" doctrine fundamentally changes the nature of a market economy, which when free is a profit-*and-loss* system. Not only does the doctrine reward error, sloth, and inefficiency, it deprives other, more competent entrepreneurs of the scarce resources they need to serve consumers. Who knows what products and opportunities would arise if the free market, not politicians, determined who had access to capital?

Did Deregulated Derivatives Cause the Financial Crisis?

BY ROBERT P. MURPHY

For a few months in 2008 I naively thought that the disastrous financial "rescue" actions led by Treasury Secretary Henry Paulson would at least be counterbalanced by widespread recognition that our economic turmoil had been government's handiwork.

How wrong I was. By the time of this writing, the mainstream press had delivered the "consensus" judgment that blind faith in the free market fostered the housing bubble. Jacob Weisberg's *Slate* column, "The End of Libertarianism" (http://tinyurl.com/57835b), sums up this official verdict: "We have narrowly avoided a global depression and are mercifully pointed toward merely the worst recession in a long while. This is thanks to a global economic meltdown made possible by libertarian ideas. . . . [A]ny competent forensic work has to put the libertarian theory of self-regulating financial markets at the scene of the crime."

Just to make sure that the free market got the blame for the financial meltdown, Alan Greenspan himself testified to Congress that he had been "shocked" that self-interest (in the absence of paternalistic regulation) did not compel financial institutions to adopt adequate risk controls. Greenspan—viewed by the average pundit as a staunch libertarian—went so far as to say that he "found a flaw in the model that I perceived is the critical functioning structure that defines how the world works."

I will argue that government interventions, not laissez faire, caused the housing bubble and the ensuing financial crisis. In addition to describing some of the general factors involved, we will focus specifically on the blame attributed to the "unregulated" market for credit default swaps.

The mainstream press had delivered the "consensus" judgment that blind faith in the free market fostered the housing bubble.

Despite their confident judgments of guilt, critics such as Jacob Weisberg point to very few *specific* regulatory changes that (allegedly) fostered the housing boom and the related vulnerability of so many financial institutions to the ensuing crash in home prices. The only two concrete examples I have seen are the gradual repeal of Glass-Steagall throughout the 1990s and the Commodity Futures Modernization Act in 2000. To his credit, Weisberg candidly admits that he can't point to a smoking gun: "[N]eglecting to prevent the crash of '08 was a sin of omission—less the result of deregulation per se than of disbelief in financial regulation as a legitimate mechanism."

Generally speaking, Weisberg and others accuse Alan Greenspan, Phil Gramm (former chairman of the Senate Banking Committee), and SEC chairman Christopher Cox of willfully ignoring, for ideological reasons, warnings about the growing market in credit derivatives.

At this point, we note that *even if this were the whole story*, it wouldn't necessarily prove that these men (and other policy makers) were mistaken in their actions. Two exaggerated analogies will illustrate the point: Suppose an environmentalist group had lobbied for the

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government to ban all new house construction starting in 2002, or suppose a Marxist organization had lobbied for the nationalization of all real estate in 2002. Either of these moves, in retrospect, probably would have averted the housing bubble and its related consequences. But surely that doesn't mean government officials back in 2002 would have been wrong to reject these proposals.

By the same token, Greenspan and others had valid reasons for resisting new regulations on the evolving markets in derivatives. As we will explain below, these complex assets can promote efficiency through risk transference. In other words, the world economy grew faster than it otherwise would have because of the proliferation of derivatives. So even if Weisberg and others are right, and the financial crisis is the fault of unregulated derivatives, it is still an empirical question whether avoiding the housing boom and bust would have been worth more than the extra consumption made possible all over the world from the market-driven growth in derivatives.

It is still an empirical question whether avoiding the housing boom and bust would have been worth more than the extra consumption made possible all over the world from the market-driven growth in derivatives.

Government Mistakes: Sins of Commission

In contrast to the vague declaration that "someone should have done something!" offered by the critics of the Invisible Hand, proponents of the free market can point to specific government interventions that fostered the excesses of the housing boom. Most obvious is Greenspan's handling of the Fed funds target rate and the growth of the monetary base following the dot-com crash. Greenspan's easy-money policy coincided with the upswing in the housing boom. When the Fed began raising rates, housing prices tapered off and then began plunging. The connection between Fed policy and the housing bubble is so obvious that even mainstream analysts endorse the theory.

Other possible culprits include the Community Reinvestment Act (CRA), a Carter-era measure that was strengthened in 1995 and used to pressure banks and thrifts that enjoyed deposit insurance into lending in all neighborhoods where they accepted deposits, including low-income, weak-credit areas. Many analysts have also placed at least some blame on the Federal Housing Administration as well as the government-sponsored enterprises Fannie Mae and Freddie Mac. Through explicit or implicit federal backing, these agencies were able to bolster the secondary market for mortgages and allow applicants who otherwise would not have qualified to obtain mortgages.

When cataloging government interventions that may have contributed to the housing boom, we should mention the existence of the Working Group on Financial Markets—also known as the "plunge protection team"—that was established in response to the 1987 stock-market crash, as well as belief in the "Greenspan put," the Fed's perceived promise to provide bank liquidity when needed. As we will see, the financial crisis of 2008 was largely the result of institutions failing to protect themselves from (what seemed to be) improbable but catastrophic scenarios. Even though writers such as Nassim Nicholas Taleb have been famously warning about "fat tails" or "black swan" events, investors could quite rationally have downplayed these warnings. "After all," high-level managers could have reasoned in the midst of the housing boom, "in the event of an absolute meltdown, the federal government will swoop in to save us. They couldn't possibly stand back and let the entire investment banking industry collapse." The bailouts engineered by Paulson and Bernanke have vindicated this belief. In retrospect it is not obvious that firms such as Lehman Brothers and Bear Stearns behaved foolishly. If politicians tell a man playing roulette that he can keep all of his winnings but will only suffer 20 percent of his losses, is it really irrational for him to borrow large sums of money to wager on the game?

Credit Default Swaps

The poster child for the (alleged) failure of the deregulated financial sector is the market for credit default swaps (CDSs). These contracts are traded over the counter, so no one knows exactly how much exposure they contain, but estimates place the worldwide notional value of all CDSs in the neighborhood of $50 trillion at the end of 2007. It was largely because of its issuance of CDSs that the giant insurer AIG needed a government bailout. The AIG episode showed that the financial panic was not limited to firms that foolishly overinvested in mortgage-backed securities but also could spread to those companies that had issued credit default swaps on the bonds of these now at-risk firms.

Although in practice CDSs can be complex, the idea behind them is simple. The seller of a CDS agrees to compensate the buyer in the event of a "credit event," such as GM's defaulting on its bonds. In return, the buyer makes periodic payments to the seller. The obvious analogy is to an insurance contract, but the difference is that people can buy a CDS on GM bonds even if they don't own GM bonds. It is as if someone bought fire insurance on his *neighbor's* house.

> One reason these contracts are structured as "swaps," rather than standard insurance, is to evade the regulations governing traditional insurance products.

One reason these contracts are structured as "swaps," rather than standard insurance, is to evade the regulations governing traditional insurance products. For example, if AIG wanted to sell life insurance to a man in Florida, it would have to set aside reserves according to Florida law in order to make it more likely that AIG could fulfill the policy if the man died a week later. In contrast, if AIG sold a Florida man protection against a bond default by GM, then the government allowed AIG much more discretion in how it handled this new potential liability on its books.

It is easy to see why critics of pure free markets have such disdain for the credit-default-swap market. This seems to be a clear case where short-term greed led to reckless behavior, which would have been prevented by prudent government oversight.

Yet matters are not so simple. After all, the shareholders and creditors of AIG were presumably not complete idiots. Did they care less about protecting their wealth than politicians in D.C. did? Did they understand derivatives less well than government bureaucrats understood them? Looking at the matter from a different angle, why would the buyers of CDSs simply assume that the counterparty would make good on the contracts if government regulations did not enforce the same safeguards applied to traditional insurance?

It turns out the Invisible Hand *did* lead everyone to seek safety. Although all the details are not yet available, as of this writing it appears that AIG's risk models (primarily developed by academic consultant Gary Gorton) were not to blame for sinking the company. Rather, AIG was driven into the arms of the government because its large clients (such as Goldman Sachs) insisted on larger and larger amounts of collateral as the financial crisis continued.

Plagued by Illiquidity

In other words, Gorton's models may still prove to be fairly accurate. AIG was not crippled by a string of unexpected credit events (and consequent payouts). What actually happened is that the holders of CDSs issued by AIG became scared about its ability to honor its contracts, and AIG could not continue to operate while satisfying all of the growing calls to put up more collateral against these outstanding time bombs. In short, AIG was plagued by illiquidity, not necessarily by insolvency. It is true that AIG executives failed to prepare adequately for this contingency, but it nonetheless removes some of the mystery behind its failure when we realize that AIG may very well have correctly assessed the risk of its positions—it just failed to predict correctly how its *customers* would assess this risk, in the midst of a global financial panic and also during a period when there was a "credit crunch" among large institutions.

The case of AIG also reinforces our earlier point about government intervention muting the potency of market incentives. It takes two to tango. The problem of AIG on the eve of its rescue was the fault not just of AIG's managers and shareholders, but also of the counterparties who had bought billions of dollars worth of CDSs from the insurer. In a completely free market, these counterparties would be subject to the hazards of a potential AIG bankruptcy. In reality, however, huge firms such as Goldman Sachs could rely on the U.S. government to rescue them from their reckless exposure to AIG. In fact, the *New York Times* reports that Lloyd Blankfein, the current CEO of Goldman Sachs, was the only investment bank executive in the room when federal officials decided to rescue AIG—and this was mere hours after they had decided to let Lehman Brothers fail. (As for Goldman's demands for more AIG collateral, even "too big to fail" companies exercise some caution—just not enough.)

Bankruptcies do not signal the inefficiency of the market any more than the overthrow of Newtonian physics proved the weakness of the scientific method—let alone that government should take charge of all scientific research.

People Make Mistakes in the Market

In situations such as the present crisis, there is a temptation for libertarian economists to look for specific government interventions that "caused" the problems. This is understandable, and indeed we have listed some of these factors. Yet we should also remember that failure is a normal part of the market process. Investors and entrepreneurs are not omniscient. Bankruptcies do not signal the inefficiency of the market any more than the overthrow of Newtonian physics proved the weakness of the scientific method—let alone that government should take charge of all scientific research.

In addition to the definite contributions of government policies, it is also true—and proponents of the free market should feel no shame in admitting—that many institutions were seduced by fancy mathematical finance models. Part of what happened is that the whiz kids from MIT and other top-flight programs made simplifying assumptions on the underlying probabilities of various events. For example, Moody's might have rated a particular mortgage-backed security as extremely safe, since it was composed of thousands of small bits of mortgages spread all over the country. Before the housing crash, the conventional wisdom held that "real estate is local." It was considered virtually impossible that *all* markets—from San Francisco to Las Vegas to Miami to Chicago—would experience a large spike in mortgage-default rates simultaneously. Nobody had ever seen such a correlated fall, so it seemed like a reasonable assumption. The models, based on this assumption, produced results confirming the safety of mortgage-backed securities.

When confronted with this reality many free-market thinkers want to blame a government policy. In the case of the ratings agencies, we *do* have some contenders. The most obvious example is that the dominant firms (Moody's, Standard and Poor's, Fitch) benefit from government regulations placed on banks and other institutions. If a bank or insurance company wants to invest in bonds the government insists that these bonds meet a certain level of safety. Of course, the bank can't simply hire Joe the Bond Rater to slap "AAA" on them. The regulations insist that a reputable ratings agency meet certain criteria. In practice these rules ossify the ratings market, and partially protect Moody's and the others from the repercussions they would have suffered after their disastrous evaluations of mortgage-backed securities during the housing boom.

But even if the critics were right and the present crisis was largely caused by faulty forecasts made in the private sector, it would not prove a crushing defeat for free markets. After all, there are plenty of examples of horrible business decisions made by private individuals. The Edsel and "New Coke" flops, Decca Records' 1962 rejection of the Beatles because "guitar music is on the way out," and the rejection by a dozen publishers of the initial Harry Potter manuscript are all examples of stupendous entrepreneurial error. Given the advantage of hindsight, it is easy enough for us to laugh at the businesspeople who made such boneheaded calls, and critics of the marketplace could easily enough infer that the free market can't be trusted with the task of innovation.

However, the mere existence of entrepreneurial error is not an indictment of free markets. People can only achieve bold successes when they take risks. The virtue of the market is that it allows individuals the freedom to risk their own money—or that of investors whom they can convince to fund them voluntarily—reaping the rewards if they succeed and bearing the losses if they fail. There is no reason to suppose that government bureaucrats would have designed better models of risk assessment. Indeed, two Fed economists wrote a paper in 2005 claiming that there was no housing bubble (http://tinyurl.com/6jcx3v)!

What is truly ironic is that the government's rescue efforts—supposedly made "necessary" by the "unregulated" market—only ensure that market discipline will be weaker. Not *all* major institutions were taken in by the derivatives hysteria during the housing boom. Warren Buffett famously warned his own investors in 2002 that derivatives were "financial weapons of mass destruction" that would at some point wreak unexpected havoc. The takeovers of AIG, Fannie, and Freddie, as well as the $700 billion bailout, reduce the relative strength of those firms that behaved more sensibly during the boom. If and when the next crisis occurs, it will be in part because the government has just shown that playing it safe and adopting a long-term perspective doesn't pay in U.S. financial markets. It's much more profitable to go for the risky yet lucrative payouts, and then run to the government if things turn sour.

If and when the next crisis occurs, it will be in part because the government has just shown that playing it safe and adopting a long-term perspective doesn't pay in U.S. financial markets.

Amidst the efforts to "control the narrative" and assign blame for the financial crisis, fans of the free market should not lose sight of the real benefits of derivatives. Futures contracts on oil, for example, allow producers and major consumers such as airlines to lock in guaranteed prices and confidently engage in long-term projects that would otherwise be too risky. Even the much-maligned credit default swap allows the transfer of risk in mutually beneficial trades. Especially in an uncertain financial environment, CDS contracts allow certain firms to raise cash more easily—because those lending them money can buy CDSs on their bonds—and the price of a particular CDS contract itself communicates information about the market's view of the firm being insured. These benefits will all be seriously muted if the government stampedes in and imposes top-down regulations.

Despite the claims of their critics—and even of some of their fair-weather friends—unregulated markets are not to blame for the systematic mistakes of the housing boom. Yet even if private errors were the primary cause, it still would not follow that government bureaucrats would make wiser decisions in the future.

Was Money Really Easy Under Greenspan?

BY DAVID R. HENDERSON AND JEFFREY ROGERS HUMMEL

Former Federal Reserve chairman Alan Greenspan has become everyone's favorite scapegoat. His policies allegedly caused, or at least contributed to, the current financial crisis. He is attacked from the left for lax financial regulation, from the right for loose monetary policy, and from the middle for both. Yet two years ago, on leaving office, Greenspan was widely heralded as a financial wizard whose wise, discretionary macromanagement had brought an unprecedented two decades of low inflation, high prosperity, and infrequent and mild recessions. Both viewpoints, in reality, are mistaken.

During the Keynesian dark ages persisting through the mid-1970s, no one—except a few monetary cranks and monetarist economists cloistered in their academic ivory towers—believed that the Federal Reserve's monetary policy even mattered. This was a period when Paul Samuelson, who would go on to win the 1970 Nobel Prize in economics the second time it was awarded, could proclaim in a 1969 *Newsweek* column that "there is no sight in the world more awful than that of an old-time economist, foam-flecked at the mouth and hell-bent to cure inflation by monetary discipline. God willing, we shan't soon see his like again." Today almost everyone—economists, investors, and the general public alike—seems to have swerved to the opposite extreme. The Fed controls not only inflation, they seem to think, but also everything else that happens to the American economy, good or bad. The truth, however, is somewhere in the middle.

Today almost everyone seems to think the Fed controls not only inflation but also everything else that happens to the American economy, whether good or bad.

We are not arguing that Greenspan's policies were perfect. Nor should anything that follows be construed as a defense of central banking or of the Federal Reserve. Particularly alarming is the way the lender-of-last-resort function has been expanding the moral-hazard safety net and mispricing risk—trends to which Greenspan no doubt contributed. Our ideal would combine abolition of the Fed and unregulated free banking.

Nonetheless Alan Greenspan stands out as the most competent—arguably the *only* competent—helmsman of U.S. monetary policy since creation of the Federal Reserve System. As Milton Friedman observed on Greenspan's retirement, "For the first 70 years after it opened in 1914, the Fed did far more harm than good, presiding over inflation in two World Wars, converting a moderate recession into the great

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depression, and then, in the 1970s, producing the most serious peacetime inflation in our nation's history." By contrast, Greenspan's "performance has indeed been remarkable."

Greenspan oversaw relatively low and stable inflation and ushered in a striking decline in the volatility of real gross domestic product. Although defenders of macroeconomic intervention often suggest that government policies after World War II dampened business cycles, the truly significant change should be dated at 1987, the year Greenspan assumed office. The current fuss about a recession that, according to standard indicators, still is no worse than the minor recessions of 1990 and 2001 testifies to how high his legacy has raised the bar. Until a year or so ago many observers had therefore credited Greenspan with being the best at reading the economic tea leaves. But as we will demonstrate, the source of Greenspan's apparent success has little to do with monetary discretion.

Why do people now believe Greenspan was an "inflationist"? For one main reason: They note how low interest rates were from 2002 through 2004.

Freezing Total Reserves

Recently-converted critics are now charging Greenspan with having carried on an excessively expansionary monetary policy, particularly following the recession of 2001 and possibly during the dot-com boom that preceded it. But an objective examination of his record of nearly two decades shows that he did not. Instead, however unintentionally and unwittingly, he came close to freezing the *domestic* monetary base and deregulated the broader monetary aggregates.

Why do people now believe Greenspan was an "inflationist"? For one main reason: They note how low interest rates were from 2002 through 2004. But interest rates have never proved an adequate gauge of what the Fed is doing—not during the Great Depression, when rates were very low despite a collapsing money stock; not during the Great Inflation of the 1970s, when rates were high despite an expanding money stock; and not under Greenspan. A focus on interest rates ignores the simple fact that interest rates can change as a result of real factors involving supply and demand and are not simply "set" by the Fed.

The market ultimately determines interest rates. While central banks are big enough players in the loan market (and the quintessential noise traders to boot) that they can push short-term rates up or down somewhat, that ability is increasingly diminished—even for a major central bank like the Fed—as globalization integrates world financial markets. In defending his actions, Greenspan is correct in attributing the unusually low interest rates early this decade mainly to a massive flow of savings from emerging Asian economies and elsewhere.

A better, although now unfashionable, way to judge monetary policy is to look at the monetary measures: MZM, M2, M1, and the monetary base (see chart, p. 36). From 2001 to 2006 the annual year-to-year growth rate of MZM fell from over 20 percent to nearly 0 percent. During that same time M2 growth fell from over 10 percent to around 2 percent and M1 growth fell from over 10 percent to negative rates. Admittedly the Fed's control over the broader monetary aggregates has become quite attenuated, for reasons elucidated below. But even the year-to-year annual growth rate of the monetary base since 2001 fell from 10 percent to below 5 percent in 2006. When all these measures agree, it suggests that monetary policy was not all that expansionary during 2002 and 2003 under Greenspan despite the low interest rates.

The key to what was really going on is the monetary base, which the Federal Reserve controls directly. The base consists of reserves held by the banks and other depositories, either in their accounts at the Fed or as vault cash, plus currency in circulation among the general public. Between December 1986—eight months before Greenspan became Fed chairman—and December 2005, the monetary base rose by a hefty amount, from \$248 billion to \$802 billion (no figures are seasonally adjusted). True, that doesn't sound like a freeze. But virtually the whole increase was in currency

Money Definitions

M1: currency in circulation, travelers' checks, and transaction deposits (accounts that permit unlimited checking).

M2: M1 plus savings deposits, small time deposits, money-market deposit accounts, and retail money-market mutual fund shares.

M3 (which the Fed ceased reporting in March 2006): M2 plus bank-issued repurchase agreements, Eurodollar deposits held by U.S. residents in foreign branches of U.S. banks, large certificates of deposit (over $100,000), and institutional money-market mutual fund shares.

MZM (Money of Zero Maturity and reported only by the St. Louis Fed): M2 minus small time deposits plus institutional money-market mutual fund shares.

in circulation. (See the graph of the monetary base and its two components on p. 37.) During that same time total bank reserves grew from $65 billion to $73 billion, for an average annual growth rate of a mere 0.65 percent. (These figures are unadjusted for any changes in reserve requirements and—unlike the somewhat misleading reserve totals reported by the Fed's Board of Governors—include all vault cash, clearing balances, and float.) In some years aggregate reserves rose; in others they fell, with the major bump surrounding Y2K, when the accumulation of reserves by banks appears to have induced the Fed to accommodate a 40 percent jump followed by a 30 percent drop. Total reserves are also the one monetary measure whose growth rate shows a slight uptick into 2003, when interest rates were down. But that is thin backing for the extravagant accusations that "easy Al" was conducting an exceptionally expansionary monetary policy.

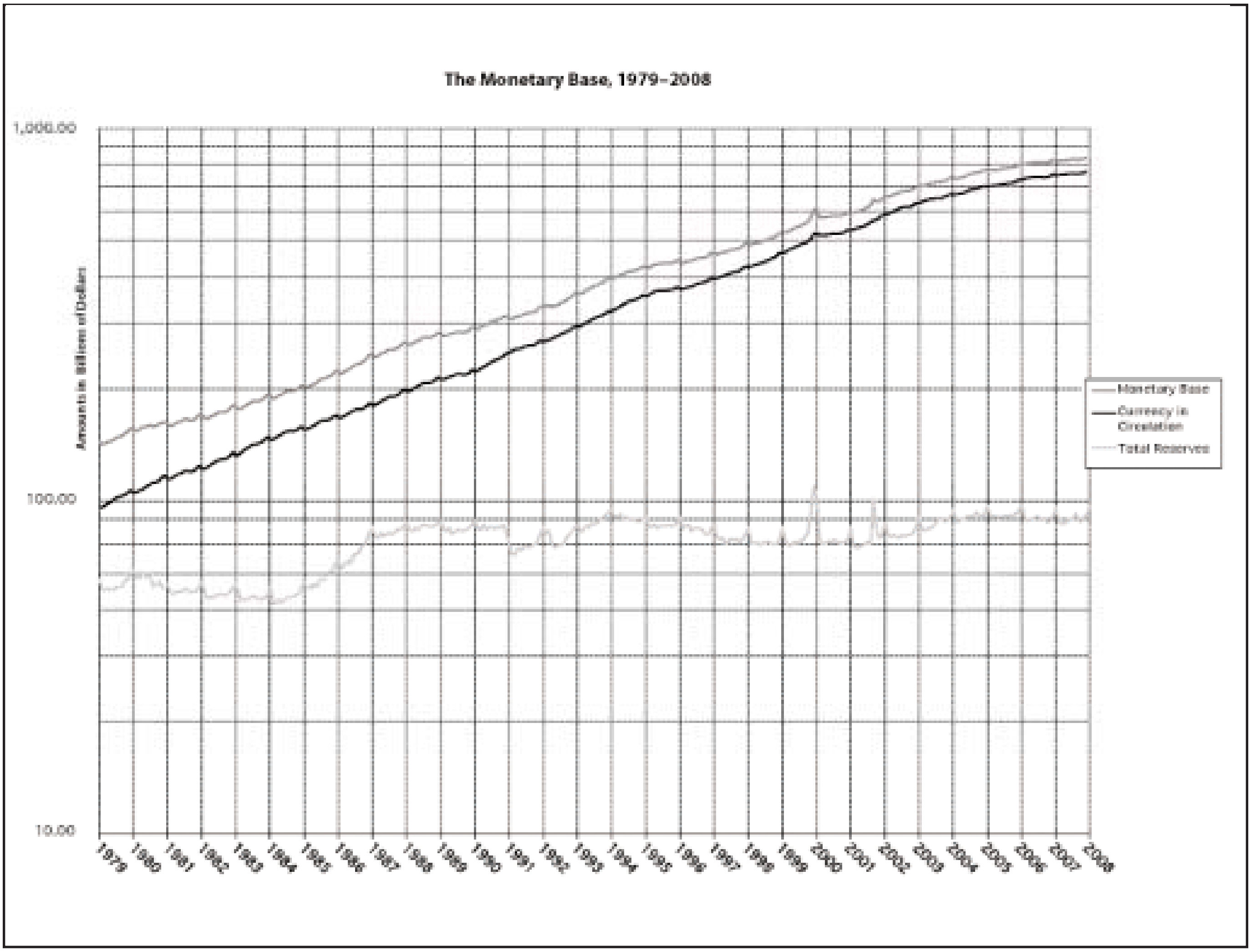
Currency in Circulation

During the same 19 years, currency in circulation exploded faster than the monetary base—at an annual rate of 7.54 percent. Before this explosion currency was less than three-quarters of the total monetary base; by the end of Greenspan's tenure it was over 90 percent. In a period when debit cards and possibly ATMs were reducing currency demand, analysts were aware that all this new cash was not bulging in the wallets and purses of the average American. It was going abroad as a stable dollar evolved into an international currency. These growing foreign holdings of Federal Reserve notes became an additional factor increasing money demand and keeping U.S. inflation in check during the 1990s.

Ideally we should adjust the monetary base and monetary aggregates downward to account for this drain abroad. Richard G. Anderson of the St. Louis Fed estimates that the proportion of U.S. currency held abroad doubled between 1986 and 2005, from 25 to nearly 50 percent. Although his estimates may be too low, the Fed makes no such adjustment. Doing so would reduce the average annual growth rate of the monetary base between December 1986 and December 2005 from 6.4 to 4.9 percent.

Furthermore, in a fully deregulated monetary system, private banks—not the Fed—would be the institutions issuing currency. Currency would become an additional bank liability like deposits and respond to market forces. In our current system, the public still determines how much of the base becomes currency in circulation by their decisions to withdraw and redeposit cash. The Fed controls only the total base whereas currency passively expands to accommodate people's preferences. This suggests that a more meaningful approximation of the base would be simply to subtract all currency in circulation, leaving us with only aggregate reserves as our proxy. Thus the virtual freezing of reserves turns out to be the most salient yet ignored feature of Greenspan's tenure. Interestingly, the late Milton Friedman had recommended in the 1980s something similar to what Greenspan did de facto: freeze the base.

Greenspan also helped deregulate the broader monetary aggregates: M2, MZM, and M3. The Depository



Since the total monetary base and currency in circulation increased in line with one another, total reserves were more or less frozen under Greenspan.

Institutions Deregulation and Monetary Control Act of 1980 had begun phasing out interest-rate ceilings on deposits and modified reserve requirements in complex ways. Combined with later administrative deregulation under Greenspan through January 1994, these changes left all the financial liabilities that M2 adds to M1—savings deposits, small time deposits, money market deposit accounts, and retail money-market mutual fund shares—utterly free of reserve requirements and allowed banks to reclassify many M1 checking accounts as M2 savings deposits. M2 and the broader measures became quasi-deregulated aggregates with no legal link to the size of the monetary base.

A result noted by Milton Friedman in 2003 is that fluctuations in the velocity of M2 were offset by fluctuations in the amount of M2. Interestingly, this is similar to what monetary economists George A. Selgin and Lawrence H. White predicted would happen under free banking—or a market-determined monetary system void of government involvement. They argued that free banking would automatically adjust the quantity of money to changes in velocity. If velocity rose, signaling a fall in money demand, market mechanisms would cause banks to reduce the quantity of money they created. And if velocity fell, signaling a rise in money demand, banks would enlarge the quantity of money. The response of M2 to changes in velocity in the 1990s offers stunning confirmation of this claim. The result was that inflation was held in check.

Thus during the dot-com boom of the 90s the velocity of M2 rose as people shifted into stocks. But this was offset by the declining growth rate of M2, which fell to near zero between 1994 and 1996. Assorted Fed watchers reached opposite conclusions depending on which variable they chose to focus on. Some warned that Greenspan's policies were deflationary. Others looked at the higher growth rates of the base and M1, which remains more closely tied to the base and more distorted by currency going abroad, and predicted higher inflation. Both were wide of the mark, of course, but not because of Greenspan's miraculous central-bank discretion. The result was a product of the market process, and when the collapse of the dot-com boom burst the M2 velocity bubble it induced a new spike in M2 growth.

Some economists warned that Greenspan's policies were deflationary. Others predicted higher inflation. Both were wide of the mark, of course, but not because of Greenspan's miraculous central-bank discretion.

Why Any Inflation?

If Greenspan approximately froze total reserves, why was there any inflation at all during his tenure? Rather than averaging 2.5 percent annually, shouldn't prices have remained constant or actually fallen? Indeed, in a thoughtful critique of an earlier version of this article, Selgin denied that the broader monetary measures were responding to changes in velocity, since productivity growth would have therefore generated just such a gradual deflation. The answer relates to the market's extraordinary capacity for financial innovation. Until the recent, extraordinary changes in Fed operations, bank reserves in the United States paid no interest, giving banks a strong incentive to economize on their use and maximize lending. They figured out ways to do so even under reserve requirements, as amply illustrated by the origins and growth of the Federal funds market, where banks regularly lend each other excess reserves.

Financial deregulation gave the process an additional boost. From December 1986 to December 2005—the same period during which aggregate reserves remained almost constant—the aggregate de facto reserve ratio of the banking system as a whole backing M2 fell by half, from 2.52 percent to 1.23 percent. So the quantity of M2 deposits grew at a secular rate of 4.6 percent, enough to generate mild, sustained inflation. And the quantity of *domestically held* currency grew alongside at an accommodating rate.

This steady, long-term decline of reserve ratios cannot easily be halted and confronts government fiat money with a fatal long-run problem. Re-tightening of reserve requirements would only burden banks with an implicit tax not faced by other financial institutions, encouraging the development of new, highly liquid money substitutes that effectively avoid the requirements. Congress has, moreover, moved in the opposite direction, permitting the Fed to eliminate all remaining reserve requirements in 2011, thereby bringing the United States into line with such countries as Australia, New Zealand, Canada, the United Kingdom, and Sweden, which have already done so. True, the Fed has now started paying interest on bank reserves, which has enormously increased demand for them in the short run. Nonetheless banks will still be able to earn greater interest on loans and securities under normal economic circumstances. Moreover, paying interest on reserves in effect transforms that portion of the monetary base into Treasury securities payable in fiat money, rather than genuine fiat money itself.

In short, the ongoing spread of electronic funds transfers and assorted cashless payments is essentially replacing money with a sophisticated network of computerized barter. The demand for fiat money will thus approach zero asymptotically. So long as the money base is built on a fiat foundation with no other source of demand, the price level will slowly but inexorably head toward infinity. Only a commodity base with a nonmonetary demand—say gold, although it could just as well be silver, some combination of the two, or a more complex basket of commodities or financial assets—will anchor the price level over the long haul. Under free banking, the expansion of monetary substitutes would drive down the demand for gold-as-money, but gold's value can never drop below its commodity value. Gold would continue to provide the unit of account, the common numeraire in nearly all transactions, without ever needing to be used as a medium of exchange.

Greenspan cannot be held responsible for this ultimate unviability of fiat money, although his deregulation accelerated the inflationary bias. A steady, secular contraction of total reserves could in theory have offset the declining reserve ratio, delivering a constant price level or even secular deflation over the last two decades. But the continued fall of base-money demand is itself inevitable as long as developed economies wish to capture the enormous welfare gains of financial innovation and a more efficient allocation of savings.

Greenspan, like the Wizard of Oz,was a lousy wizard—but he was a good deregulator. And that made all the difference.

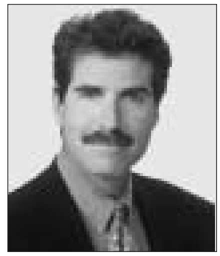
An Ironic Legacy

So what did cause the current financial crisis? That is similar to asking what caused the minor recessions of 1990 and 2001. Unlike the cause of inflation the cause of business cycles is not obvious, which is why economists still vigorously debate the question. Minor blips in total reserves under Greenspan may have played some poorly understood role in any of these three events. Because Greenspan only imperfectly implemented Friedman's rule of freezing the monetary base, without intending to do so, his policy may have ended up slightly *too* discretionary. But that possibility hardly justifies the "asset bubble" hubris of those economic prognosticators who, only well after the fact, declaim with absolute certainty and scant attention to the monetary measures how the Fed could have pricked or prevented such bubbles.

The misunderstanding of Alan Greenspan's management of the U.S. money stock has an ironic coda. Before his appointment the Federal Reserve had proved so palpably inept as to all but discredit discretionary monetary policy. Both monetarist rules and free banking were gaining adherents among economists. But today, despite the recent financial turmoil, most interpret Greenspan's record as showing either that discretionary policy can be done right or that what is needed is some activist pseudo-rule such as that developed by John B. Taylor of Stanford University. Central bankers, after half a century or more of failure, have allegedly learned from their past mistakes. Finally, according to this view, they have the knowledge to plan the money stock properly.

In a review of Greenspan's memoirs Harvard economist Benjamin Friedman claims that Greenspan was a practitioner *par excellence* of monetary discretion (despite paying lip service to laissez faire) and that Greenspan's major failing was that he was not more of a regulator. Friedman is wrong on both counts. Greenspan, like the Wizard of Oz, was a lousy wizard—but he was a good deregulator. And that made all the difference. His success stemmed from weakening Fed discretion with the unintentional approximation of a rigid monetary rule and the very deregulation that Benjamin Friedman deplores. Rather than demonstrating that monetarist rules are obsolete and free banking unnecessary, Greenspan's policies suggest that the more thoroughly either of those two objectives is implemented, the greater the macroeconomic stability our economy will enjoy.

Government Sets Us Up for the Next Bust



BY JOHN STOSSEL

If an athlete injures himself and suffers great pain, we recognize the shortsightedness of giving him painkillers to keep him going. The pain might be masked, but at the risk of greater injury later.

That's a good analogy for the inflationary policies now pursued by Washington. These policies may temporarily "stimulate the economy," but they also disguise and aggravate the underlying problems. We will all pay a serious price.

Policy makers have thrown caution to the wind. Twelve-digit dollar figures are tossed about casually. Late last year, after then-Treasury Secretary Henry Paulson changed course—yet again—and announced that the Federal Reserve would commit $800 billion more in "new loans and debt purchases," the *New York Times* reported, "Fed and Treasury officials made it clear that the sky was the limit."

The total federal commitment as of that date was over $7 trillion.

The Fed had given up trying to make it easier for banks to lend to each other. Now, the *Times* reported, it "is directly subsidizing lower mortgage rates . . . doing so by printing unprecedented amounts of money, which would eventually create inflationary pressures if it were to continue unabated."

How can the economy straighten itself out if it is being systematically skewed by government interference with prices?

No kidding.

When we hear that the U.S. Treasury is doing this or the Federal Reserve is doing that, we should remember that these agencies are run by mere mortals, and as such, they cannot know how to "fix" something as complex as an economy. But they certainly are capable of wrecking one.

That's what their inflationary policies will do.

In a free market, prices do more than tell us what we have to pay for things. They are messages emitted by an intricate communications system that inform us of the relative scarcity of resources, labor and consumer goods, and the relative intensity of consumer demand. Thanks to prices, we can tell producers how we rank our preferences, and they in turn can arrange production according to our priorities. Without prices, economic coordination is impossible, which is why attempts at state planning produce, in Ludwig von Mises' words, "planned chaos."

We associate inflation with a rising price level, but equally important, relative prices change when new money is created. That garbles the messages. As Mises writes, "The additional quantity of money does not find its way at first into the pockets of all individuals; . . . [P]rice changes which are the result of inflation start with some commodities and services only. . . . [T]here is a shift of wealth and income between different social groups."

The Fed gives money to AIG or Citicorp, but not to Lehman Brothers, or you and me. The new bank reserves also push interest rates below what the market would have set, further distorting production by encouraging investment plans to be made on the basis of artificially low rates.

How can the economy straighten itself out if it is being systematically skewed by government interference with prices?

We are in the mess we're in precisely because of earlier government interference. Easy mortgage terms and guarantees contrived a housing boom and irresponsible

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John Stossel is co-anchor of ABC News' "20/20" and the author of Myths, Lies, and Downright Stupidity: Get Out the Shovel—Why Everything You Know is Wrong, *now in paperback. Copyright 2008 by JFS Productions, Inc. Distributed by Creators Syndicate, Inc.*

lending that could not be sustained. The consequences have shaken the foundation of the financial industry. But instead of freeing the market and allowing the errors to be corrected, the government is seducing the economy into a whole new set of errors. That will lead to the next bust.

"But doesn't the government have to act?" people ask. "We can't just let financial companies fail!"

I say, "Why not?"

Jim Rogers, the successful investor and author, puts it well: "Why are we bailing out Citibank? Why are 300 million Americans having to pay for Citibank's mistakes? The way the system is supposed to work [is this]: People fail. And then the competent people take over the assets from the failed people, and then you start again with a new, stronger base. What we're doing this time is . . . taking the assets from the competent people, giving them to the incompetent people, and saying, 'OK, now you can compete with the competent people.' So everybody's weakened: The whole nation is weakened, the whole economy is weakened. That's not the way it's supposed to work."

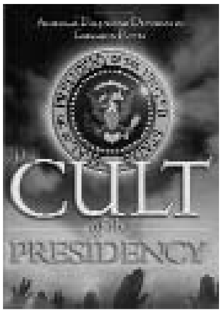
Book Reviews

The Cult of the Presidency: America's Dangerous Devotion to Executive Power

by Gene Healy

Cato Institute • 2008 • 264 pages • $22.95 hardcover; $13.00 e-book

Reviewed by Brian Doherty



Gene Healy relates a sad and disturbing "kids say the darndest things" anecdote in his new book. The story typifies an attitude toward government that Healy, senior editor at the Cato Institute, rightly identifies in his book's title as *The Cult of the Presidency.* A little girl, on hearing that President Kennedy had been murdered in 1963, wondered sadly to her mother "where would we get our food and clothes from?"

That little girl with her bizarre beliefs about the powers and responsibilities of the president is a voting adult now—as are millions whose attitudes about government are at least somewhat like hers. She's probably now wondering if our new president can fill the impossible role Americans expect of their chief executive.

As Healy demonstrates, the perceived responsibilities and powers of the president of the United States have metastasized dangerously since their original conception at the American founding. The president was meant merely to *preside* over the execution of the laws of the United States, not to be an all-powerful superhero unconstrained in an endless quest to right all wrongs, foreign and domestic. When President John Adams craved the title of "His Highness," Congress would have none of it; Pennsylvania Senator William Macley called the notion "base," "silly," and even "idolatrous."

Healy charts the resilience of this constrained vision of presidential power, even after the upheaval and power grabs of the Lincoln era. The accumulation of power and hubris at 1600 Pennsylvania Avenue accelerated with the rise to power and prominence of men such as Theodore Roosevelt (who wanted to legislate changes in the English language from the White House and started foreign military adventures without congressional approval) and Woodrow Wilson (who declared that God ordained him to be president and cheered a "spirit of ruthless brutality [in the] fiber of our national life. . . . [E]very man who refuses to conform will have to pay the penalty.").

From Franklin D. Roosevelt on, all the traditional restrictions on the president's powers crumbled. We find ourselves in a political world where, as in a 1992 presidential debate, candidates are asked to "make a commitment [to] meet [the] needs" of all Americans. Not a single candidate even raised his brow at the extraconstitutional implications of that request.

This book provides a depressing dissection of modern trends in political power—and in Americans' *conception* of that power, which underlies the problem of executive overreach. As Healy notes, that makes any quick fix to the "cult of the presidency" unlikely. But the book also contains touches of delightful nostalgia for an America gone by.

One can't help admiring such derided "do-nothing" presidents as Warren Harding. He gets sneered at by historians and political science professors for lacking the hubris of power, but he pardoned the peaceful protestors his predecessor Woodrow Wilson tossed in jail. Every American should feel a yearning for a past in which a presidential candidate like William Taft could say bluntly that the president "cannot create good times . . . cannot make the rain to fall, the sun to shine, or the crops to grow;" a world where it took five years after the third assassinated president for Congress to grant the holder of the office his own armed janissaries; a time when presidents before Wilson thought that giving their state of the union addresses in person was demagogic.

Healy rightly notes that Congress is complicit in the failure of the Founding Fathers' system whereby jealousy of their respective prerogatives was supposed to keep any one branch of government from overpowering the others. Our craven Congress grants vague powers and then complains about how the executive uses them—both in war-making and domestic policy.

If Congress is to blame for giving way, the White House is to blame for pushing. Healy details the many ways in which the recent Bush administration championed a wildly expansive vision of executive power in the wake of 9/11. The administration's leading scholar of executive omnipotence, John Yoo, formerly of Bush's Office of Legal Counsel, once said in a public debate that the president might well be able to order the extralegal crushing of a child's testicles if he had the proper national-security reason for doing so.

Gene Healy has ably cast down the idols of the cult of the presidency. But it remains a limited devotion in a larger cult: that of government itself. That cult's complications and crises loom even larger than the presidency.

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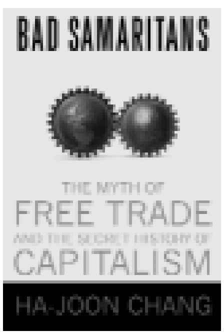
Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism

by Ha-Joon Chang

Bloomsbury Press • 2008 • 288 pages • $26.95 hardcover; $17.00 paperback

Reviewed by Robert Batemarco



Most people seize on the failure to practice what one preaches as proof of the error of the message preached. This is the logical fallacy known as *tu quoque*. It is far more often the case, however, that the message is virtuous but virtue is not what the hypocritical preacher truly seeks. Ha-Joon Chang, author of *Bad Samaritans,* similarly draws a fallacious conclusion when he takes the wealthy nations of the West to task for not adhering to the doctrines of free trade, monetary stability, and fiscal responsibility to which they pay lip service.

But *tu quoque* is the least of the logical errors informing this book's misguided policy conclusions. Once we get beyond the silly comparison of an infant industry with his six-year-old son, we see the real shortcoming of his attack on free trade: his attenuated understanding of entrepreneurship. Entrepreneurs use resources for which they are responsible (either their own or those they have borrowed and must repay) based on their appraisals, in the face of uncertainty, of consumer demand and resource availability in the future. The infant-industry argument central to this book implicitly assumes that the only investments that can contribute to economic growth are those that compete with imports. But of all the import-competing industries in any developing country, which ones should be fostered through protectionism? Also, there's no reason to presume that government leaders making those choices would do so on the basis of objective appraisal of their profitability. Favoritism towards relatives and cronies is far more likely.

Rather than let real entrepreneurs bear the risk and reap the rewards, infant industry protectionism is little more than a socialization of risk. While it may yield more investment, the investment to be protected is likely to be misdirected and thus less conducive to growth than investment that must meet a harsher market test.

The author rails against "neo-liberal" ideologues (the bad Samaritans of his title), blissfully unaware of his own ideological biases—namely, a touching faith in the ability of government leaders to make the right choices more often than private entrepreneurs risking their own capital. Entrepreneurs are not necessary in this view, since the government can do their job at least as well. The government can determine pragmatically which industries to protect, how much inflation will maximize growth, which foreign investments to permit, and which enterprises it should own.

Not only does Chang get the big picture wrong, he commits a lot of smaller errors along the way. He misplaces Jean-Baptiste Colbert's tenure as France's finance minister by 200 years (1865–1883 instead of 1665–1683). He cites the "failure of electricity deregulation in California, which resulted in the infamous blackout in 2001," oblivious to the continued price controls that made "deregulation" a terrible mischaracterization of what really went on. He avers that "[s]trengthening of the welfare state . . . will also help reduce political corruption by making the poor less vulnerable to vote buying,"—as if the welfare state were much more than vote-buying on a wholesale basis. Another howler is his description of the late socialist John Kenneth Galbraith as a non-leftist. I guess he was just another non-ideological pragmatic centrist like Chang himself.

He also sneaks some subtle premises into his work, which helps explain why he supports so many bad policies. His tacit approval of Britain's ban on the migration of skilled workers in the 1700s could only come from someone who believes the state owns its residents. Much of his discussion of less-developed countries' lack of respect for intellectual property rights seems to be based on the premise that if you need something you can't afford you have the right to steal it. Throughout the book he cites the existence of specific policies as prima facie evidence that they are justified. For example, "When they were backwards themselves in terms of knowledge, all of today's rich countries blithely violated other people's patents, trademarks and copyrights."

Even when Chang raises interesting points his statist views put him on the wrong side of the issue. For example, he is critical of what he calls the unholy trinity of the IMF, World Bank, and WTO, but for the wrong reasons—downplaying the high taxes and additional regulations they impose in exchange for the putative "benefits" they provide.

Overall, *Bad Samaritans* gives us a good picture of what we champions of freedom are up against. The author J. Wallace Day once said, "Always keep your friends close, but your enemies keep closer." That is the best rationale I can come up with to recommend that supporters of economic liberty read this book—to know what enemies of free trade are saying today.

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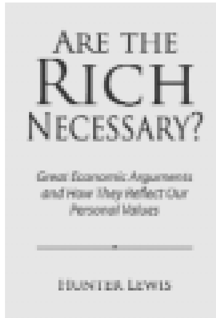
Are the Rich Necessary? Great Economic Arguments and How They Reflect Our Personal Values

by Hunter Lewis

Axios • 2007 • 231 pages • $20.00

Reviewed by George Leef



In my high school days I had a friend who had been thoroughly imbued with the socialist mindset. He was willing to concede there might be some adverse consequences if the government went too far toward equality and economic control, but was adamantly in favor of the "humanity" of socialism. We amiably debated the role of profit, income inequality, just prices, greed, and similar questions.

Reading Hunter Lewis's *Are the Rich Necessary?* made me think back on those discussions, for it delves into the basic economic and philosophical disputes between advocates of socialism and advocates of laissez-faire capitalism. Throughout, Lewis gives readers a dialogue between opposing points of view similar to but much more learned than my debates back then. I regard his presentation of the socialist/egalitarian philosophy as fair (Lewis is not merely pummeling a strawman), but the pro-market side clearly comes out on top. If you were to give the book to a libertarian son or daughter, you need not worry about turning him or her into a Marxist.

At the outset Lewis says he isn't trying "to propagate a particular set of ideas." It is obvious, however, that he knows the free-market arguments very well and is not indifferent between the two camps.

His first chapter digs into the title question: Are the rich necessary? Lewis presents several arguments that they are not: that they are parasites, cause poverty, and exploit the poor. In support of that litany of complaints Lewis quotes Abby Rockefeller (yes, a descendent of oil billionaire John D. Rockefeller), who said, "Many suffer because of the few." Lewis then follows up by making the case that the rich (at least those who earn their money) are beneficial.

In presenting the pro-market side, Lewis quotes extensively from Henry Hazlitt: "No matter whether it is their intention or not, almost anything that the rich can legally do tends to help the poor. The spending of the rich gives employment to the poor. But the saving of the rich and their investment of these savings in the means of production gives as much employment and in addition makes that employment constantly more productive and highly paid."

It's hard not to notice that the argument against income inequality has a bumper-sticker quality to it, while Hazlitt's rejoinder aims at the rational faculties. I don't think Lewis is being unfair here. You could make the anti-capitalist argument longer, but you can't make it any better.

Another topic Lewis addresses is profit. My high-school friend was against profits because in his view they made things more expensive. We find that childish notion in the arguments that profit is unnecessary. Lewis cites historian Howard Zinn, who contends that the profit system "distorts our whole economic and social system . . . leaving important things unproduced."

In the following pro-profit arguments he presents, Lewis adduces facts that show the silliness of Zinn's position. For example, he refers to Mark Kurlansky's book *Cod* to show how the profit motive led people to make the discoveries and investments necessary for large-scale cod fishing to begin, which in turn made it possible for great numbers of Europeans to increase their protein intake substantially. People made the investments in commercializing the cod fishery because they thought they would be profitable. Progress in overcoming hunger hinged on the market's profit motive. Lewis also goes into the alternatives to privately owned, profit-seeking business (government ownership and worker-owned firms) and points out that they entail serious difficulties.

How about economic depressions? Opponents of the free market often point to depressions as proof of the need for pervasive government regulation of the economy or even state ownership. *Freeman* readers will be delighted to read the counterarguments that Lewis gives. They are based on Austrian insights that government manipulation of money and credit causes widespread misallocation of capital to projects that have to be liquidated once the tinkering ends. Lewis deserves a round of applause for making Austrian business cycle theory comprehensible to the average reader.

Are the Rich Necessary? also plows into other key aspects of the intellectual battle between free-market advocates and their opponents, including globalization, central banking, and "just prices."

This highly readable book would be an excellent gift for anyone whose economic thinking is at the same level as my friend's was. I am going to pass my copy along to my sons. Their economic understanding is much better than his was, but the book is certain to sharpen their understanding and give them an arsenal of arguments to use against the anti-capitalist mentality.

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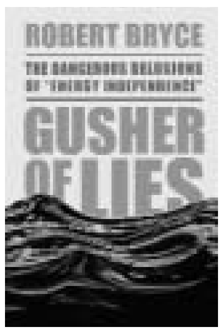
Gusher of Lies: The Dangerous Delusions of "Energy Independence."

by Robert Bryce
Public Affairs • 2008 • 384 pages • $26.95 hardcover; $16.95 paperback

Reviewed by William Anderson



Al Gore recently called for a ten-year plan to phase out *all* electric plants powered by fossil fuels and replace them with windmills and other "renewable" energy sources. While the media fawned over Gore's speech, I decided to read Robert Bryce's *Gusher of Lies* to see if the speech made sense.

It doesn't. Bryce's book has a big dose of something that Gore and his followers ignore: reality. Indeed, a reader of this book is going to receive mega-doses of reality.

Those who believe the political classes in this country have created a colossal mess in the energy industry will find *Gusher of Lies* very helpful. At a time of volatile energy prices, it pays to be informed.

It is important to note that Bryce is not a person of the right. While he is critical of the government's oil price-control policies of the 1970s (unlike most political liberals, who supported them), this book is not an apology for oil companies. He is especially contemptuous of the Bush administration and its neoconservative political allies for the invasion of Iraq. Bryce's political "liberalism" gives the book even more credibility, since he can't be easily dismissed as yet another right-wing shill.

Bryce is an oil expert, and he gladly passes on much of his own knowledge and expertise in his book. He provides a good history of oil production both in the United States and abroad, giving this book a vast scope.

Two crucial points leap out, however. One is the fraud of "alternative" fuels, and especially corn-based ethanol, which Bryce rightly calls a "scam." The other is the larger issue of understanding our economically dependent world.

Most important, Bryce writes that the mantra of "energy independence" is ignorant at best and delusional at worst. "Energy independence," he shows, is just a cheap political slogan to con people into accepting a terribly interventionist stew of policies to subsidize alternatives to oil.

Bryce devotes more than 50 pages to Chapter 12, "The Ethanol Scam," filling it with fact after fact showing clearly that the real scammers have been our elected officials and people tied in with the corn industry. He begins by declaring, "Ethanol isn't motor fuel. It's religion. And America is divided into two camps: the believers and the heretics." Exactly.

Other gems include: "Mixing morality and politics can lead to bad policies. But mixing morality and motor fuel makes for a truly lethal cocktail. And few politicians dare look too closely at the ethanol moonshine." And this: "If America is 'addicted' to oil, then it's equally true that the corn ethanol industry is a world-class junkie when it comes to subsidies."

Besides Congress and the late Bush administration, Bryce points a finger at Archer Daniels Midland (ADM), the self-proclaimed "Supermarket to the World." Bryce goes through the billions of dollars in subsidies ADM has received for producing ethanol—and the millions it has given to politicians, both Republican and Democratic.

Bryce does not stop with the political payoffs. He deals with the economic and scientific issues that make corn-based ethanol a loser. First, the "net energy gain" that comes with producing ethanol is vastly inferior to that of petroleum; second, when one considers the economics of ethanol, one finds that it costs more to make the fuel than it can bring in revenues on a free market. Without subsidies, ethanol would soon die.

In a refreshing change from the political rhetoric of "energy independence," Bryce calls for engagement of the Arab and Muslim world instead of promotion of the climate of fear that American politicians are sowing. He writes, "The continuing use of fear as a political tool —along with the constant drumbeat of terrorism—has become part and parcel of America's demented approach to energy policy."

That engagement includes Iran, the very country the Bush administration has tried to isolate. Furthermore, Bryce points out that China is going to continue growing economically, and that means Americans must pay attention to that country and work with it, not against it.

While *Gusher of Lies* is not an entirely free-market book, it exposes the folly of government central planning in the energy industries and demonstrates that the political class is perpetrating a massive deception. This is cold comfort, given the hardcore statism that dominates our politics, but it is good to know that at least one energy expert has blown the whistle on this scam.

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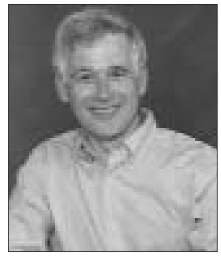
Unintended Consequences in Energy Policy



BY DAVID R. HENDERSON

On the first day of every economics class I teach I start with The Ten Pillars of Economic Wisdom. This is a list I have put together of the ten most important principles in economics. Pillar number six is, "Every action has unintended consequences; you can never do only one thing." U.S. energy policy illustrates this to tragic effect. Costly policies that have reduced economic freedom and had nasty economic consequences riddle the landscape.

Start with the Corporate Average Fuel Economy (CAFE) law, which requires each auto producer in the U.S. market to make fleets that average at least 27.5 miles per gallon for cars and at least 20.7 mpg for trucks. (Former President Bush and Congress increased that to 35 mpg by 2020, with no lower standard for light trucks.) That law had the unintended but totally predictable consequence of making cars less safe. The reason is that one relatively cheap way to raise fuel economy is to make cars lighter, and the lighter they are, other things being equal, the more dangerous they are to their occupants. In 1989 two economists, Robert Crandall of the Brookings Institution and John Graham of Harvard University's John F. Kennedy School, found that, adjusting for the downsizing of cars that would have occurred anyway, the CAFE laws would cause an extra 2,200 to 3,900 deaths over the life of a 1989-model-year car.

But the CAFE law is itself the result of another unintended consequence of government policy, namely price controls on oil and gasoline. President Nixon's economy-wide wage and price controls, imposed in 1971, did not cause much difficulty at first. But when the Organization of Petroleum Exporting Countries (OPEC) raised the world price of oil from about $3 a barrel to about $11 over a few months in late 1973, Nixon's price controllers refused to allow refiners to pass on the whole increase in the price of gasoline. The result was a massive shortage of gasoline, with long lines at the pump. Rather than remove the controls, Nixon had government officials start allocating the gasoline by various arbitrary criteria, a process the Ford and Carter administrations continued.

Government officials in the Ford administration and in Congress noticed that American car buyers were not buying as many high-fuel-economy cars as these officials thought they should. In other words, Americans were responding to the artificially low price of gasoline by acting as if the price of gasoline were low! Gee, what a surprise. Of course, instead of removing the price controls, Congress and Ford decided to regulate the fuel economy of new cars—that's how we got CAFE. Like all regulations, this one bred its own lobby, featuring Ralph Nader and Clarence Ditlow. They had been, until that time, advocates of car safety. But they wanted enforced fuel economy even more.

Americans were responding to the artificially low price of gasoline by acting as if the price of gasoline were low! Gee, what a surprise.

That's not the end. One way the companies could meet their CAFE targets was by importing small, high-fuel-economy cars from their foreign production facil-

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ities. The United Auto Workers union noticed this and lobbied for—and achieved—separate standards. Auto companies then had to hit the standard with their domestic production and, separately, with their imports. That caused the companies to produce more small cars at home rather than import even successful cars from abroad. According to William Niskanen, the chief economist at Ford in the late 1970s, Ford dropped its Fiesta in the late 1970s not despite, but because of, the car's potentially large market: Ford feared that its German-made Fiesta would "steal" sales from its U.S.-made Escort, thus lowering its domestic CAFE average.

Moreover, even the increase in the world price of oil engineered by OPEC in late 1973 was in part the unintended consequence of U.S. energy policy. Why? Because OPEC had been formed in response to President Eisenhower's restrictions on oil imports. As economist Ben Zycher points out, in 1959 the U.S. government established the Mandatory Oil Import Quota Program (MOIP), which restricted the amount of imported crude oil and refined products allowed into the United States. It also gave preferential treatment to oil imports from Canada and Mexico. Two major growing sources of supply at the time were the Middle East and Venezuela. By reducing a major market for Middle Eastern and Venezuelan oil, the import-quota system drove down the demand for that oil, causing its price to fall in February 1959 and again in August 1960.

In September 1960 governments of four Persian Gulf countries—Iran, Iraq, Kuwait, and Saudi Arabia—facing discrimination against their oil, joined with Venezuela to form OPEC. Their goal was to get monopoly power to offset the monopsony power created by the U.S. oil import quota system and thus get higher prices. Although OPEC was at first relatively powerless, by 1973 the governments of eight other countries—Algeria, Ecuador, Gabon, Indonesia, Libya, Nigeria, Qatar, and the United Arab Emirates—had joined. In 1973, OPEC made its move.

Because so many Americans feared the return of gas lines, they were more open than otherwise to a U.S. attack on Iraq.

From the CAFE to the Mess Tent

CAFE laws and other fuel-economy standards are not the only unintended consequences of U.S. price controls on oil and gasoline. One can even speculate reasonably that these price controls led to two major wars initiated by the U.S. government. The reason is that instead of blaming their government for lines at gas stations, Americans have tended to blame foreign governments—especially the government of Saudi Arabia, the leader of the OPEC cartel and its largest producer. In 1979 President Carter formed the Rapid Deployment Force to train for combat mainly in deserts. President Reagan kept this force and renamed it the U.S. Central Command.

Whatever Carter's motives or understanding in forming this force, the hardwiring in Americans' minds led them to associate gas lines with nasty Middle East governments rather than with the nasty U.S. government. That made them more willing than otherwise to support intervention in Middle Eastern affairs to secure the continued flow of oil. Thus when Henry Kissinger claimed in August 1990 that Saddam Hussein's invasion of Kuwait, if left unopposed, "would cause a worldwide economic crisis," many Americans believed him. In a *Wall Street Journal* article that month, I showed that, in fact, the absolute worst harm Hussein could do to the U.S. economy, even if he grabbed Saudi Arabia and the United Arab Emirates, was a loss of less than half of 1 percent of GDP annually. But because so many Americans feared the return of gas lines, they were more open than otherwise to a U.S. attack on Iraq.

Later, in 2003, the U.S. government still had the military capability to invade Iraq. The stated issue this time was Saddam Hussein's alleged weapons of mass destruction. Still, the fact that the U.S. government had the capability to attack Iraq was due in part to Carter's buildup of the Rapid Deployment Force.

As poet Robert Burns might say, "Oh what a tangled—and tragic—web government weaves when first it practices to intervene."