After the Deluge

A specter is haunting the financial markets of the world. A crisis of enormous proportions, which developed slowly from mid-2007 and achieved dizzying momentum after Lehman Brothers collapsed on September 14, 2008, is currently becoming a global economic catastrophe the likes of which have not been seen since the Great Depression. No one dares to accuse the doomsayers of being hysterical and melodramatic now. On the contrary, pessimism has become the order of the day.

As anyone who has been following the news over the past few months knows all too well, this calamity originated in the false prosperity of the American housing market during the years 2001-2006. As a result of low interest rates set by the Federal Reserve and other factors, this market underwent a dramatic expansion without any real supervision or oversight. Lenders approved billions of dollars' worth of mortgages to people with limited financial resources—classified as "sub-prime borrowers"—who understandably jumped at the chance to own their own homes, often for the first time in their lives. As housing prices steadily increased, lenders were confident that borrowers would be able to make good on their loans. This in turn fueled a frenzy of speculation on Wall Street. Large and small investment houses began to repackage mortgage-backed securities in a decidedly creative way that only the sharpest mathematical minds could understand. These securities were then bought and sold around the world by financiers who largely ignored the huge risks involved in such transactions.

Alas, this financial bacchanalia did not last long. In 2006, housing prices began to drop. The beneficiaries of the sub-prime mortgage bubble suddenly started taking considerable losses that became more and more severe as time passed. From Wall Street to Tokyo, stocks went into a nose-dive. Worst of all, the chaos created a worldwide credit crunch. In short, the bubble burst, and major financial institutions once thought invulnerable burst with it.

In order to limit the scope of the disaster, governments and central banks around the world rushed to take emergency measures. Trillions of dollars were earmarked to prop up shaky financial institutions, protect bank deposits and savings, and reinvigorate paralyzed economies. However, countries such as Iceland had already suffered a crippling blow. Indeed, even the world's largest and most powerful economies now appear unable to protect themselves from severe recession.

Among informed and uninformed observers alike, the sheer dimensions of this crisis have created an atmosphere of apocalyptic panic. Some commentators, especially journalists with a sensationalist streak, have not been satisfied with broadcasting gloomy forecasts of an approaching recession, but have rushed to announce—in tones either dismal or elated, depending on their ideology—the imminent demise of capitalism itself. Indeed, even more restrained analysts have declared that the market economy will have to undergo dramatic changes. Everyone seems to agree that the Anglo-American version of capitalism, so-called "neo-liberalism," has suffered a major setback after three decades of economic dominance.

Yet if the reports of capitalism's demise are likely exaggerated, rumors of the return of the New Deal are certainly well founded. Major political and economic leaders are pushing for extensive government spending in order to revive sclerotic economies and provide jobs for the huge numbers of people who are or will soon be unemployed. Barack Obama, the new president of the United States, announced before his election—and again shortly afterward—his intention to initiate a series of large-scale public-works projects in a manner reminiscent of the programs enacted by Franklin Delano Roosevelt in order to salvage his country from the horrors of the Great Depression. The affinity between the two leaders—one of whom became a legend during his term in office, and the other even before he entered the White House—has already been translated into visual images by the American media. The November 13, 2008, cover of *Time* magazine, for instance, displayed a Photoshopped picture of Obama resplendent in Roosevelt's iconic fedora, pince-nez, cigarette holder, and toothy grin. In the accompanying article, entitled "The New Liberal Order," journalist Peter Beinart articulated the expectations of many voters when he urged the president-elect to "do what FDR did… [take] aggressive action to stimulate the economy, regulate the financial industry, and shore up the American welfare state."

There is no doubt that desperate times call for desperate measures. Even the Bush administration, which no one would accuse of secretly aspiring to bigger government, understood this and has swiftly come to the aid of financial institutions nearing collapse. In order to cope with the challenges of this crisis, however, policymakers must demonstrate not only aggressive action, but also judgment. They must be able and willing to distinguish between what is right for times of crisis, and what is right in general. This distinction is crucial. If political and economic leaders choose to ignore it, they may inadvertently transform a temporary emergency into a permanent economic malaise.

Today, the term "state of emergency" is usually linked to the war on terror. Since 9/11, several Western countries, led by the United States and Britain, have enacted a series of exceptional measures to protect themselves from the threat posed by radical Islamic terrorism. In some cases, these policies entailed the suspension of basic constitutional rights in accordance with urgent security needs. The United States, for example, has imprisoned hundreds of suspected terrorists in the Guantánamo Bay Detention Camp in Cuba, as well as in secret CIA facilities around the world, where they have not been granted due process according to American law. This state of affairs has been publicly opposed by liberal-minded members of the legal community and by human rights activists. One reason for this reaction is the fear that the exception will become the rule. An ongoing, indefinite state of emergency, the critics warn, will lead to the demise of enlightened legal standards, and thus the destruction of Western democracy. (A discussion of various aspects of this issue can be found in my essay, "The State of Freedom and the State of Emergency," Azure 28, Spring 2007; and in Benjamin Kerstein's review "Batman's War on Terror," Azure 34, Autumn 2008.)

The current financial crisis has forced many countries to transpose the state-of-emergency paradigm onto the economic sphere. There are, of course, substantial differences between the two situations: Granting huge loans to banks and nationalizing insurance companies are not the same as detention without trial or invasion of privacy. Moreover, an economic crisis does not stem from the subversive actions of hostile forces, and does not require the state to expose and neutralize a known or unknown enemy. Most importantly, the emergency economic measures that have been implemented thus far do not entail limitations on freedom or basic rights. However, there is a common denominator between the interventionist policies that the United States and various European governments are now promoting and the steps they have taken as part of the war on terror: In both cases, the state and the institutions acting on its behalf have expanded the reach of their authority beyond its normal limits, and they have done so in order to secure public order and prevent social chaos. As a result, market forces and institutions that were once relatively autonomous have come under government control. The economic sea, in which a wide variety of fish once swam, belongs once again to Leviathan.

Opponents of neo-liberalism are making the most of this opportunity to sneer at adherents of *laissez-faire* economics. "You see?" they are saying. "The market isn't so nice anymore. Now everyone is rushing into the arms of government." For the most part, however, theirs is a straw-man argument. Even the most outspoken advocates of the "invisible hand" have been aware of its potential cruelty. One of them was the renowned economist Milton Friedman, who led the charge against government intervention in the economy during the 1970s and 1980s. Despite his staunch free market stance, he was of the opinion that certain policies of the New Deal were indeed the right thing to do at the height of the Great Depression. In an interview with PBS, the American public broadcasting network, in 2000, he explained his position, saying that "it was a very exceptional circumstance. We'd gotten into an extraordinarily difficult situation, unprecedented in the nation's history. You had millions of people out of work. Something had to be done; it was intolerable. And it was a case in which, unlike most cases, the short run deserved to dominate."

There are, of course, those who think otherwise. Some historians deny that the New Deal was effective even as a temporary solution to a national emergency. In her recent study, *The Forgotten Man: A New History of the Great Depression*, which provoked fierce controversy when it was published in 2007, the journalist Amity Shlaes presents a serious indictment of Roosevelt's economic policy. Shlaes attempts to debunk the widespread myth that the New Deal saved America from the quagmire into which it began to sink in 1929. In reality, she claims, the opposite is true. "From 1929 to 1940," she writes, "from Hoover to Roosevelt, governmental intervention helped make the Depression Great." Shlaes maintains that swelling public expenses, incessant economic experimentation, a higher tax burden placed on the wealthy and the middle class, and a systematic abuse of the private sector all contributed to prolonging the Depression until World War II. In 1938, she writes, the unemployment rate in the United States was still frighteningly high: One out of every six Americans was jobless, and many others had no job security whatsoever. Ironically, this economic failure only increased Roosevelt's political power. He had the backing of major interest groups as well as broad support from the masses, who believed the New Dealers' populist rhetoric that blamed "big business" for the gloomy situation.

Shlaes's book is convincing enough to give the "new-New Deal" enthusiasts pause. At least it should. Experience demonstrates that, in the long run, a massive expansion of the public sector does not help the economy. It creates an inflated and ineffective bureaucracy, increases the deficit, squeezes taxpayers, and suffocates free enterprise. Given our current circumstances, however, it is hard to justify a sweeping objection to emergency measures. Abandoning the global economy to the invisible hand is simply unacceptable. In a crisis like this, swift and decisive government intervention is inevitable. It prevents, or at least restrains, the kind of mass panic that could lead to further deterioration, and gives the economy—trapped in a worsening credit crunch—room to breathe. It is also, unfortunately, hugely expensive. But at the moment, such actions are all that stand between billions of people and a life of poverty and despair. No government can avoid intervening in such a situation with all the power at its disposal. We can only hope that it will also know when the time has come to withdraw.

"In the long run," John Maynard Keynes once said, "we are all dead." This may be true, but that is no excuse for shortsighted thinking. Indeed, it is precisely *because* today's politicians and economists are being forced to consider extreme measures that they must also contemplate what will happen after the crisis is over. They must remember that a policy suitable for times of crisis may not—and perhaps should not—be suitable in times of normalcy. After all, a drug that cures a critically ill patient may be poisonous to a healthy person.

So what will the global economy look like when the storm has passed? It is clear that the American financial sector, and probably those in other countries as well, will be placed under stricter public supervision. Investment banks, insurance companies, and credit-rating agencies, all of which bear the lion's share of the blame for this catastrophe, will be much more heavily regulated by the government. In all likelihood, the most important lesson these regulators will take from the experience of the past two years is the need to change incentive structures. In an article published in *Harpers* in November, Nobel Prize for Economics laureate Joseph Stiglitz warned that:

> Too many bankers and other lenders have been focused on trying to beat the system by getting around accounting and banking regulations (through what is called accounting and regulatory arbitrage). Indeed, with bonuses based on short-term profits, they had every incentive to gamble and connive. And now that there's a bust, no one is being asked to pay back the hefty bonuses earned during the boom. On the contrary, even as they are dismissed, those who helped send their firms and the American economy into a tailspin are rewarded with generous severance packages. They are enriched regardless of what happens to investors, homeowners, and others who lost so much. Unless we reform incentives, the financial sector will only try to circumvent whatever new regulations are put in place. We simply have a short respite before the next crisis.

It seems, therefore, that there is no way of avoiding a certain degree of regulation in the short run, and perhaps even in the long run as well. Yet it is best to minimize this regulation and not set our hopes too high. After all, *bad* regulation is no less responsible for the current downturn than *lack* of regulation. Indeed, decisions made by senior government bureaucrats turned out to be just as ruinous as the shenanigans of financial moguls. The United States Securities and Exchange Commission's 2004 decision to allow investment houses to use their reserves as investment capital proved disastrous. Likewise, the fact that Freddie Mac and Fannie Mae are sponsored by the American government did not prevent them from acting in an extremely reckless manner, accumulating such enormous losses that they had to be nationalized in September 2008.

In the final analysis, this crisis, however severe and unprecedented, does not change one basic truth: The state is not the most qualified or rational actor in the economy. Its conduct tends to be inefficient and often simply unintelligent. In most cases, it is best to permit the mechanisms of the free market to operate without hindrance. Their ability to repair themselves is vastly more efficient than bureaucratic attempts at central planning. Accordingly, governments that currently control larger and larger segments of the financial market would be wise to transfer some of this power back to private hands as soon as possible. The most troubling question that remains, however, is when that "soon as possible" will be, and what we must do until then in order to weather the storm.

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