

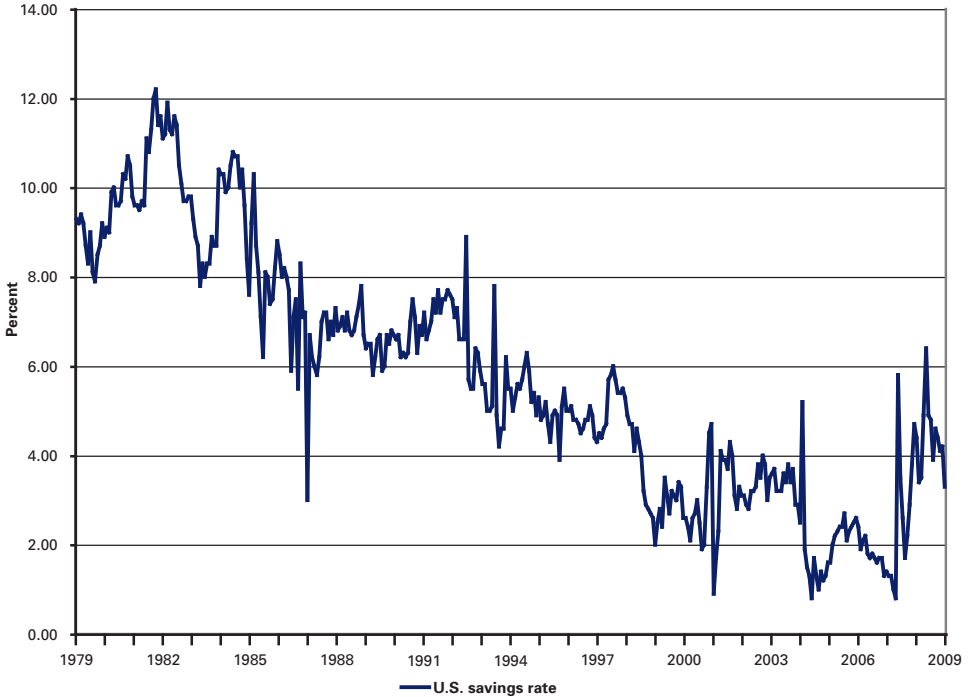
The Great Panic

*Who caused the
great economic collapse?*

ONE OF THE MOST overlooked features of the economic collapse that began in mid-September 2008 is that literally no one forecast it even weeks before the collapse. Not corporate CEOs, not macroeconomic forecasters, not the Federal Reserve, not the Obama campaign team, not the U.S. Treasury. This suggests that it was not simply a fundamental economic collapse, but rather the result of a lack of leadership by government officials. A full week passed after the Lehman Brothers failure before the economic collapse began in earnest. Before that, what had been a typical recession was combined with a severe capital markets squeeze associated primarily with excess housing

PETER LINNEMAN

Figure 1: Savings rate increased because of government-induced panic



Source: Bureau of Economic Analysis

finance. And then, on a Friday afternoon, government officials panicked and announced that the world was coming to an end unless they—the government—saved us. This violated the number one rule of effective leadership: never panic. And as government officials panicked, so too did Main Street. Consumers, panicked by ever-changing government pronouncements and actions, stopped shopping; businesses stopped replacing workers; and lenders ceased to lend. Businesses and consumers rushed into cash, and liquid holdings rose by \$1.4 trillion (10.4 percent) in

four months (Figure 1). This was not a newfound desire to save, but rather a profound wish to protect life savings. In short, government officials said that the world was coming to an end; people believed them and acted accordingly.

Government officials have repeatedly claimed that their actions in 2008 saved the economy from a meltdown. No doubt that when government officials made their pronouncement about the world coming to an end, they did not foresee across-the-board asset price declines of 30 percent to 70 percent. Nor

did they foresee the loss of more than seven million jobs in a year, a 4 percent annual decline in real GDP, and the complete disappearance of all lending activity. In fact, the meltdown they anticipated was surely far milder than that which occurred as a result of their disastrous interventions.

In mid-January 2009, the Obama economic team, which had access to full data and information, proclaimed that without a stimulus program, unemployment would peak at 8.7 percent, but if the stimulus program were adopted unemployment would rise to only 8.0 percent. Yet, unemployment reached 10.2 percent in October 2009, below the high of 10.8 percent experienced during the 1980-82 recession. This underscores the fact that not only did the repeated interventions into the workings of the U.S. economy not save the situation but, according to the projections of the Obama team, they have made things much worse.

Some 2.6 million jobs were destroyed by government actions if we use the Obama projections as our benchmark, and I believe that closer to 6.2 million jobs (8.4 million total lost, less 1.8 million lost during a "normal" recession) were destroyed since December 2007 by flawed government interventions. It is important to note that these interventions were (generally) not ill-intended, but were legitimate attempts to deal with very difficult prob-

lems. But the simple truth is that panic never makes anything better, and always makes things worse.

In spite of the fact that the capital market excesses were the result of disastrous, though well-intended, Federal Reserve monetary policy from 2002 to 2005, the administration and Congress are considering giving the Fed more regulatory power. There is no reason to believe the Fed will use new powers any more effectively than it did the old. Likewise, even though the federal government created the economic meltdown by its serial interventions, Congress and the administration are taking on ever more power. And many of the rule changes that have occurred, such as Term Asset-Backed Securities Loan Facility (TALF), rely on discredited rating agencies to establish acceptable risk levels. People seem to have forgotten that inadequate regulatory care and inattention to enforcing existing laws were the primary causes of the financial market failure. That is, it was the failure to enforce existing regulations, rather than private market greed, that was the root cause of market excesses.

Greed is a condition of human existence. It is at least as prevalent in Congress as on Wall Street. Everyone is greedy; some are greedy for power, others are greedy for money. Most are greedy for both. Most of us believe we ourselves are not greedy, even as we deride the greediness of others. The point is not that

“greed is good,” but rather that “greed is inherent.” It is part of what makes us human. The beauty of a diverse economy, with many small decision-makers rather than a few large decision-makers such as big corporations and government, is that the adverse impact of decisions made by those with excessive greed is limited.

As the atmosphere of panic recedes, a relatively robust recovery of the U.S. economy is likely. This will be true, even though the government plays an ever larger role in our economy, and Congressional decisions are terrible at best. But the United States economy survived and prospered following 1975 in spite of an equally inept Congress. The slowing job losses reveal that employers are beginning to replace the employees who died, retired, or left the labor force. As this continues, jobs will be added to the economy and consumer demand will rise, bolstering consumer confidence. In addition, the bottoming of asset prices will make lenders more willing to lend, and investors more willing to take risk.

Things are very difficult today, perhaps more difficult than any time since the Great Depression. But following similarly dark economic experiences in the 1970s and early 1980s we bounced back from the abyss. And I expect the same to occur over the next two to three years. One metric suggests that things have

been this bad before: a survey of small businesses reveals it was more difficult to receive a loan in 1980-1982 and 1973-1975 than it is today.

WORDS OF ADVICE

What should President Obama and his administration do? First, they should “do less,” but do it with greater clarity and consistency; the economy does best when everyone knows the rules of the game. Second, enforcement of “safety and soundness” requirements for insured depositories should be absolute and transparent. Anything that the regulators cannot figure out is clearly incapable of being characterized as safe and sound. Third, the administration should be honest about the futility of counting on the elimination of waste-fraud-abuse as a method of closing budgetary gaps—an old political ruse. Fourth, cut taxes on those actually paying taxes, namely the upper half of the income distribution, which would place more funds in the hands of consumers and would encourage them to spend and invest. Finally, act now to reform Social Security and Medicare by imposing means tests, and indexing benefits to the consumer price index (rather than to income), which would largely close the long-term budget gap that threatens the United States.

The head of the U.K.'s central bank, Mervyn King, has correctly noted that if governments want to avoid dealing with financial institutions that are "too big to fail," governments must not allow them to become too big. The U.S. government has resisted this approach, and refuses to consider shrinking large banks. Instead, Congress believes that it can concoct a regulatory regime that avoids future financial crises resulting from systemic financial risk posed by companies viewed as "too big to fail." This is a dangerous delusion.

I believe that no firm is too big to fail. In fact, the failure of firms is an essential part of an efficient economy. Failure of those who take excessive risks and are operationally inefficient is a critical part of the dynamics of capitalism. The underpinning of capitalism is that out of the failure of some comes the birth of many. Without failure there can be no long-term success. However, if this view does not prevail and financial institutions are deemed "too big to fail," steps must also be taken to assure that no firm is too large or too politically insulated to fail. There must be a separation between their deposit-taking activities and their risky activities. This return to a Glass-Steagall world will forfeit the efficiencies associated with combining these activities, but it will mean that deposits will not be de facto put at risk by losses on trading and investment activities.

The Obama administration and Congress have displayed troubling signs of paranoia in the past quarter. Most notable in this regard are the rantings coming from the White House concerning Fox News, and the repeated suggestions that anyone opposing their proposed healthcare reforms is against "reform." The Fox News claims are both unseemly and beneath the dignity of the office, all too reminiscent of the paranoia that debilitated the Nixon White House. We hope that the Obama administration does not further escalate its paranoia about "opponents" into a Nixonesque revenge campaign. As for healthcare reform, opposing proposed reforms is not the same as opposing reform in general.

One of our great hopes for the Obama administration was that it would reduce the level of hateful discourse that has colored our political environment over the past sixteen years. In many ways, it was the main reason to vote for Mr. Obama. Unfortunately, we have been sadly disappointed, as the rhetoric of Congress is as hateful and unproductive as any that has characterized American politics for the last two.