

Current Events



Crisis Rules

THE FINANCIAL CRISIS IS FRACTURING CONSERVATIVES ALMOST as much as it is the credit markets. It is doctrine to oppose federal bailouts. The Tenth Amendment—“The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people”—gives clear support for limited federal government. Economic theory also supports limits, offering Joseph Schumpeter’s “creative destruction” as a core principle of successful capitalism and a defense of bankruptcies.

Unfortunately, the current environment is so dangerous that it has interrupted these constraints. The path to recovery hinges on the federal government’s expanding its powers well beyond normal limits in order to restart credit markets and guarantee stability of existing financial institutions. And our regulatory apparatus needs to be pointedly revised to break the selling momentum fueled by faulty short-selling rules and the application of mark-to-crisis accounting to regulatory capital and bond ratings.

Reliance on Washington is intensely disturbing for market-oriented conservatives, but a “no pain, no gain” economic stoicism would only worsen the policy disasters of 2008. Each month that the credit freeze persists, low business confidence forces more layoffs and less investment, a spiral that is not self-correcting.

Adding to the ideological angst, government is already in full cover-up mode. Blame is being spread deep, except to the major Washington culprits—the too-low interest rates imposed in 2003, the weak-dollar policy, the disastrous tax code, poor regulatory choices and indifference to equity prices.

Superpowers on Display

Like it or not, Washington probably won’t change its game plan much during the crisis. The current approach is to use the government’s superpowers to unfreeze credit markets. On Jan. 5 the Federal Reserve began its first purchases of government-guaranteed mortgage securities. It started small (by government standards), \$3 billion to \$4 billion per day. The Fed purchases, expected to extend through the first half of the year and to broaden to more assets, will cause sellers to substitute slightly riskier, longer maturity credit instruments. At its January outset the Fed wasn’t moving fast enough to catch up with the economic free fall, but the injection process, especially in coordination with the new Obama Treasury, should accelerate and gradually restart the credit markets.

Meanwhile, the Fed and Treasury are protecting (absorbing) banks by guaranteeing their debts and buying their preferred

equity. This partially offsets the mark-to-market drain on regulatory capital and helps hold the financial system together.

Losses in U.S. wealth and self-confidence have been massive, with job conditions still worsening. But a long downtrend into 2010 isn’t inevitable, even assuming a systematic lurch to bigger government. A starting point for optimism is to realize that the creation of new capital is more important than the loss of old capital. This is hard to absorb emotionally during a crisis. The world’s past wealth creation is outstripped every generation by innovation, human progress and the rapid growth of the above-subsistence population.

Consumption may also prove less important to the recovery than asserted in the warnings of another Great Depression. Consumption crashed after the Lehman Brothers bankruptcy. With consumption equaling 70% of GDP, a downsizing there would decimate GDP if the economy were static. Yet GDP itself means production, not consumption. A lot of U.S. consumption has been idle or is sourced abroad and won’t be missed. The GDP issue is whether the Crash of ’08 will cause people to work fewer years, less hard or less productively. That’s unlikely.

Even for those deeply worried about old capital and weak consumption there are grounds for optimism. So far most of the banking sector losses have been accounting writedowns, not cash losses. Layoffs would slow and consumption resume if the Fed sped its asset purchases and Washington stopped imposing arbitrarily low prices on equity holders and regulatory capital in the blind assumption that crisis markets are accurately priced.

Meanwhile, the crisis has brought cheaper prices on land, houses, autos and a host of other goods and services. This is clearly a consumption incentive for those who have cash, youth, secure jobs, future job prospects or fixed incomes. Millions of Americans will find it more attractive to work hard and save for a home now that prices are down and mortgage rates are below 5%.

As we agonize over consumption and twist free-market principles to restore market confidence, the tragedy is that Washington’s mistakes could be rectified at any time, ending the crisis. A clear presidential commitment to a more efficient tax regime (lower rates, broader base, less uncertainty), a stable dollar, a quick end to the mark-to-market drain on bank regulatory capital and a level regulatory playing field for shareholders would surprise and overpower the crisis. It would send equity markets soaring, turn short-sellers into buyers and transform public fear into hope, the sound goal President Obama laid out in his inaugural address. **F**



David Malpass, global economist, president of Encima Global LLC; Paul Johnson, eminent British historian and author; and Lee Kuan Yew, minister mentor of Singapore, rotate in writing this column. To see past Current Events columns, visit our Web site at www.forbes.com/currentevents.