A Stalled Counterrevolution

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> There is no shortage of books attempting to sort out the dynamics of the great financial collapse that began in the summer of 2007. Since we are still in an early phase of the crisis and don't yet know whether it will rival the Great Depression in its depth and duration, all verdicts remain provisional. But rather in the spirit of the 1952 presidential campaign's arguments over who lost China, the battle is already on to define who lost the economy and what to do next.

It’s clear that deregulation of finance played a leading role. However, the right is already marketing a counter-story that the crash is actually the fault of government regulation. You can read this narrative daily in the editorial pages of The Wall Street Journal. Surprisingly, one of the nation’s leading conservative intellectuals is not buying the story. Judge Richard Posner is among the most prolific (and irritating) of the University of Chicago law-and-economics scholars who helped entrench the markets-über-alles paradigm in American academic thought. But Posner has managed to write a compelling book on the crash, A Failure of Capitalism, indicting the major role played by financial deregulation -- though without ever acknowledging that he was one of its intellectual fathers.

“A largely unregulated banking industry,” he writes, “converged, fatally as it has turned out, with falling interest rates in the early 2000s.” The unregulated issuers of credit-default swaps, unlike regulated insurance companies, “were not required to have reserves” to pay claims. The financial industry is rife with conflicts of interest and likewise, credit-rating agencies. “Libertarian economists,” he declares, “failed to grasp the dangers of deregulating the financial markets and underestimated the risk and depth of the financial crisis.” And rather startlingly, he concludes: “The aggregate self-interested decisions of these institutions produce the economic crisis by a kind of domino effect that only government can prevent -- which it failed to do.” None of this is exactly breaking news. But coming from Posner, it is a notable rejection of free-market economics; Adam Smith’s core teaching is precisely that individual self-interest aggregates to a general good and that government should keep hands off.

But how did all this deregulation come to pass? Or, as a good Chicagoan might ask, what is your theory of agency? Mostly, Posner isn’t saying. The book has numerous worthwhile insights, including a surprisingly Keynesian analysis of the dynamics of depressions. But its major weakness, so characteristic of the Chicago school, is to leave out political power. He warns against “an orgy of recrimination against Wall Street,” though the political influence of financial elites goes a long way to explaining the collapse of regulation. To read Posner, you would think that an autonomous actor called government made regulatory decisions in a hermetic realm beyond the vectors of power that operate upon it.

Michael Kinsley is fond of observing that the right welcomes converts while the left is suspicious of heretics. Kinsley has a point, but conversions would be a little easier to take if the convert had the decency to concede that his earlier mistaken theories had collided with reality. Posner, however, doesn’t look back. The author of a leading textbook on law and economics, he was appointed to the federal appellate bench by Ronald Reagan in 1981. In the intervening 28 years, he has found time to write 53 books as well as to continue to teach part-time at the University of Chicago. This superhuman pace leads to a certain glibness, but one should welcome Posner's book even if it is a reversal without a recantation.

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For a more straightforward primer on the crash, the reader cannot do better than Dean Baker's short volume, Plunder and Blunder. Baker anchors the gross financial and regulatory abuses of recent years in the fundamental shifts in the political economy that occurred in the 1970s. During that period, median wage growth adjusted for hours worked largely ceased, and many of the instruments that created the more balanced and managed economy of the postwar boom were either undercut by events (inflation, the oil shock, technology) or deliberately assaulted by shifts in political power (the attack on unions, the weakening of economic regulation, and the creation of a trade regime designed to serve business and undermine labor).

The stagnation of the incomes of most Americans, combined with the globalization of production and finance, Baker explains, set the stage: "More and more, the U.S. economy depended on something far less virtuous than productivity gains and broad prosperity. In pursuit of short-term growth, key institutions relied on risky bets and unsustainable policies. In short, we got hooked on bubbles."

To understand the dynamics of the crash that finally hit in the fall of 2008, it helps to comprehend the back story. Baker sorts out how much of the improved economic growth of the 1990s was the result of a more productive economy (some in the early years) and how much was the illusory gain of a financial bubble (most of it by the late 1990s.) He demolishes the Robert Rubin story that budget balance led to low interest rates, which in turn led to increased investment and growth. Rather, he explains, the low interest rates in a global economy had little to do with domestic fiscal policy but instead were Federal Reserve Chair Alan Greenspan's way of cleaning up after earlier bubbles and stimulating new ones.

Baker is a particularly good guide to the logic of the housing bubble. He disentangles the roles of the several culprits, including President George W. Bush, whose "ownership society" goals led the White House to induce Fannie Mae and Freddie Mac to begin large-scale purchases of badly underwritten loans. It was this policy shift coupled with serial regulatory lapses by Greenspan and others, and not the Community Reinvestment Act demonized by the right, that caused sub-prime mortgages to spin out of control. Baker has also been an astute critic of efforts by former Treasury Secretary Henry Paulson and his successor Timothy Geithner to prop up, rather than clean out, toxic securities, and he includes a useful summary of the kind of regulation that we need going forward.

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The crash of the stock market in 2008 was also the crash of a reigning political ideology and its economic paradigm. While a leftist economist such as Baker never accepted the dominant view, the revisionism of a Posner attests to the breadth of that intellectual collapse. Also instructive is the new thinking of more mainstream academic economists.

For the subtitle of their new book, Animal Spirits, George Akerlof and Robert Shiller use the line: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism. "Animal spirits" is a famous phrase of John Maynard Keynes' to characterize the impulsivity of much economic behavior. Though the new discipline of behavioral economics has added fascinating details about how this irrationality operates, thanks to the ingenious experimental work at the boundary of economics and psychology by such scholars as Daniel Kahneman, Amos Tversky, and Richard Thaler, it turns out that a lot of the fundamentals are right there in Keynes.

As the financial collapse has demonstrated yet again, markets are not self-correcting. If they were, Wall Street would not be lined up for trillions of dollars in government handouts. In saluting Keynes' quip, Akerlof and Schiller argue that much of the story is in the unreliability and incompleteness of supposedly rational behavior -- the micro-foundation of the free-market model. They contend that modern economics, even self-described Keynesian economics, has given short shrift to this core behavioral insight. They embellish the idea by exploring the importance of "norms" of fairness in setting wages and prices, and the key role of confidence in sustaining both normal economic price setting and also periodic euphoria. Episodes of systemic corruption, they suggest, are just another reflection of human fickleness. "The business cycle," they write, "is connected to fluctuations in personal commitment to principles of good behavior." And people's failure to fully calibrate the costs of inflation -- "money illusion" as Keynes called it -- is yet another dimension of nonrationality.

Yet, almost in spite of their effort to hang a whole new macroeconomics on the idea of nonrational micro-behavior, their book also follows Keynes' other insights about the instability of a purely free market economy. For Keynes, even if everyone were perfectly rational, there could be failures of the economy to reach its production potential at equilibrium, and there could be politically generated failures to pursue sensible financial regulation. My one quibble is that Akerlof and Shiller overstate the connection between less-than-perfect rationality and systemic instability.

Their best chapter is on the limited capacity of central banks to prevent or cure calamities. As they note, the Fed cannot push short-term interest rates below zero. Shadow banks are outside the Fed's purview. And, in an observation that has been frighteningly overtaken by events, they write that "the Fed usually trades only in safe, short-term bonds." No longer. Lately, as a desperate response to a crisis partly of the Fed's own making, the Fed has been buying all manner of junk assets. As Dean Baker points out, the Fed itself can be part of the problem when it combines low interest rates with feeble regulation. This is less a matter of animal spirits than the political capture of what is supposed to be a public-spirited entity. And who rescues the system when the Fed's own balance sheet starts coming apart?

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The failure of central bankers is the subject of one of the most compelling works of economic and political history to appear in many years, Liaquat Ahamed's Lords of Finance. His subtitle says it all: The Bankers Who Broke the World. Ahamed, an investment manager and financial historian, writes about the fateful three decades between August 1914 and World War II. He combines biography of the four most influential central bankers of the era with riveting narrative history and lucid economic analysis. This is a story whose broad outlines most educated people vaguely know, but Ahamed magnificently fills in the details and extracts the larger significance. As a mirror of our own times, the history is chilling.

In World War I, the great nations of Europe spent about half of their total national output slaughtering each other. To finance this bloody orgy, they borrowed. In the aftermath, they drowned in war debts. All owed massive sums to the United States, which entered the war late, profited handsomely, and emerged with its productive powers enhanced. France and Britain had the insane idea that they could find the money to pay off the war debts by squeezing Germany "until the pips squeak," as the contemporary phrase had it. They were not bothered by the fact that this was plainly impossible. Lord Cunliffe, a former head of the Bank of England and a leader of the British delegation to the Paris Peace Conference, recommended that Germany pay $100 billion in reparations. "It was an astounding figure," Ahamed writes. "Germany's annual GDP before the war had been around $12 billion."

The central bankers of the war's victors, Montagu Norman of the Bank of England, Benjamin Strong of the New York Federal Reserve, and Émile Moreau of the Banque de France, had one overarching goal -- to restore the prewar gold standard. Their German counterpart, Hjalmar Schacht of the Reichsbank, appointed in the aftermath of Germany's ruinous hyperinflation, had a different goal -- to lift the crushing burden of war reparations that was sandbagging the German economy and by extension the economies of the rest of Europe.

Had these central bankers not been so utterly orthodox in their thinking, they might have grasped that their historic role was not to restore the gold standard but to relieve Europe of the downdraft of war debts so that normal production and commerce might resume. In the end, they managed neither to restore the gold standard nor to get commerce flowing. And when the Great Depression struck, partly as the logical consequence of their folly, the central bankers failed yet again, bound by the orthodoxy of fiscal and monetary restraint.

In 1931, the final collapse of the debt-ravaged German economy ensued. That spring, the central bankers made one last effort to resolve the debt crisis. They failed, despite pleas and threats from Schacht, who had stepped down as head of the Reichsbank. By early 1932, German production had fallen 40 percent and a third of the work force was idle. Hjalmar Schacht went over to the Nazis, subsequently becoming Hitler's minister of the economy, directing public works and rearmament.

Once again, a familiar figure makes a fleeting appearance in this story -- John Maynard Keynes. It was Keynes, as a young adviser to the British Treasury at the Paris Peace Conference, who warned about the catastrophic consequences of the policy of extracting crushing war reparations. Subsequently, in one of the most prescient tracts of the era, "The Economic Consequences of the Peace," Keynes explained that if Germany were to pay reparations at all, its economy had to recover. "If Germany is to be milked," Keynes wrote, "she must not first of all be ruined." Despite a brief flirtation with Keynes by Prime Minister David Lloyd George, his warnings were ignored.

Keynes would get his chance, 25 years later, when as the leader of the British delegation at Bretton Woods, he helped construct a postwar financial and monetary system that used public institutions to restore credit and economic growth, rejecting the deflationary tendencies of private finance. As always, his enemies were the barons of banking, backed by their allies in government, who wanted to rely entirely on private financial flows and a system biased toward the interests of creditors.

"There is no greater testament of his legacy," Ahamed writes, than the fact that the world avoided a repeat of the Great Depression for six decades. But the Keynesian moment at Bretton Woods was very much the exception to a century-old pattern. Ordinarily, the forces of orthodoxy rule—as they do today, notwithstanding Wall Street's disgrace. It takes extraordinary circumstances for the top financial officials of leading governments to be as radical as Keynes.

The malfeasance of today's central bankers has different particulars but a common element -- orthodoxy. However, orthodoxy has a different meaning today, one that seems almost opposite to the rigor of the keepers of the gold standard but in its own way, just as unreal and dangerous. The parallels between the 1920s and the 2000s begin with a common element. Alan Greenspan and Ben Strong both pumped up a stock market bubble with cheap money and feeble regulation. The relative economic weakness of Europe allowed Strong to reconcile his penchant for a gold standard globally with support for cheap money at home. When Strong died in 1928 and the stock bubble seemed increasingly dangerous, his successors excessively tightened credit.

Today, however, orthodoxy has come to mean doing whatever it takes to revive the Wall Street casino. The plan recently announced by Treasury Secretary Geithner and Fed Chair Ben Bernanke is intended not to drive the money changers from the temple but to lend them public funds so that they can double down on their bets. The Fed's own balance sheet will quadruple. The one common thread that links the failed central bankers of Ahamed's tale with the folly of Geithner and Bernanke is that all were working hand in glove with private financial elites.

The economic ideology of laissez-faire has been shattered, but the political power of Wall Street is oddly intact. Keynes may be honored again in unlikely places, but as far as public policy is concerned, he is honored in the breach.

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