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THE ORDINARY ECONOMICS OF AN EXTRAORDINARY CRISIS

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Introduction

It is amazing how the economics profession succumbs to mass hysteria in times of adjustment. Why do we even talk of “depression economics”? Do the lessons of economic science drastically change in times of recession? Would it make sense to talk of “depression physics” or “depression biology”? If economics is indeed a hard science, its claims—like those in physics and biology—must be universal.

Admitting that institutions matter does not transform the principles of economics. Those principles transcend time and place, but the manifestation of those principles in action are context dependent. The basic teachings of economics do not go out the window when governments engage in fiscally irresponsible behavior, pursue expansionary monetary policy, and regulate (or even nationalize) industries. In fact, it is the teachings of economics in that context that allows us to predict the results of such a policy path. Extraordinary times call for ordinary economics.

A History of Ideas

That most modern economists cannot articulate ordinary economics should come as no surprise. Ordinary economics has been out of fashion for some time. While not lost entirely, it has taken a backseat in recent years to model jockeying and equilibrium theorizing. This was not always the case. And, with some luck, the economics discipline might turn once again to a more process-oriented approach. Until then, we must rely on the classics and a handful of scholars who have kept the tradition of ordinary economics alive.

The body of theory developed by Smith, Hume, Ricardo, and Say traced out tendencies and directions of change. Except in the simplest of cases—and only then to illustrate the underlying process—classical economists rarely bothered with point prediction of exchange ratios. The price system was depicted as a dynamic process, adjusting to accommodate tastes and technology. In sharp contrast to the omniscient actors assumed to exist in modern equilibrium models, the classical economists assumed merely that self-interested producers and consumers would weed out persistent error. They assumed market participants would draft plans and modify behaviors until all mutual gains were exhausted. Relying on entrepreneurial alertness and action, the classical theory of the market economy was one of economic activity, not a state of affairs.

In the late 19th century, the scientific demands on economic theory shifted from a theory of price formation to price determination. With the analytical focus centered on settled equilibrium states, the idea of economic activity was nearly lost. This is not to say that classical economics was not in need of repair—it certainly was. Prevailing theories of value and cost could not explain several paradoxes that demanded resolution for scientific refinement. It is an unfortunate fact of history that the economists who resolved these paradoxes tended to focus not on the adjustments to changing conditions, but rather on the settled state of affairs that results when all change has ceased. Consequently, the classical view of the market system as an active process was slowly and subtly replaced by equilibrium analysis while the key components of the market economy's self-regulating nature—property, prices, and “profit and loss”—were taken for granted.

With the underlying process removed from economic analysis, the focus shifted further to aggregate variables. The ideas of the past were deemed unsatisfactory in explaining what was perceived to be excessive unemployment. Rejecting Say's Law, Keynes postulated that a general glut—where aggregate supply exceeds aggregate demand—was responsible. This was all remediable, according to Keynes, with sufficient fiscal policy; government spending would overcome market imperfections. Ordinary economics—which emphasized individual actors engaged in the market process—slipped further into the shadows as Keynesian macroeconomics took center stage.

Since the 1940s, economic policy worldwide has been dominated by Keynesian ideas. Even when claiming to break away from this tradition, research in economics was primarily Keynesian. Keynesian ideas led to Keynesian models. Keynesian data was generated to test these models and explore the efficacy of Keynesian policies. All that oscillated was whether one should be “liberal” or “conservative;” but everyone—certainly everyone in power—was fundamentally Keynesian.

The neo-Keynesian consensus entailed a commitment to macroeconomic fine-tuning through fiscal and monetary policy and microeconomic regulation (or nationalization in the UK). The results of this policy consensus were revealed to be disastrous. By the 1970s, economies in the western democracies were failing. Soviet bloc nations were crumbling from within as political corruption coupled with an economic system incapable of aligning incentives for state-owned firms to produce efficiently and meet consumer demands (let alone spur technological innovation!). And we must not forget the third-world crises of the 1970s and 1980s—Mexican debt, Latin American instability, African dictatorship, and Indian brain drain. All of these economic realities were a consequence of neo-Keynesian policies and socialist aspirations.

After the 1987 crash, Reagan was asked whether this meant the rehabilitation of Keynesian economics. He responded by telling the audience that Mr. Keynes didn't even have a degree in economics. Despite Reagan's rhetoric, his diagnosis of the crash was one of aggregate demand failure. His policy response was an attempt to stimulate consumption. Within two minutes of questioning the credibility of Keynes, Reagan endorsed the policy prescriptions of the General Theory, exhorting Americans to “Buy, Buy, Buy!”

The “Washington Consensus,” an era of so-called laissez faire following the Reagan revolution was, in reality, much closer to the policy prescription of John Kenneth Galbraith than Milton Friedman. Sure, Friedman's rhetoric was employed; but Galbraith's policies were pursued. Galbraith argued for activism via a weird mix of

Marx, Veblen, and Keynes. The basic prescription involved government both as referee and active player in the economic game. This, of course, was only nominally different from the same old policies implemented since the 1940s.

Friedman used the logic of economic theory and empirical examination to point out the consequences of government activism. When it came to macroeconomics, however, Friedman was fundamentally a Keynesian. Rather than rejecting the bankrupt methodological and analytical framework of Keynes, Friedman articulated a sort of “conservative” Keynesianism. As such, his intellectual victory did not translate into a fundamental change in the structure of public policy either in the United States or abroad.

Nonetheless, conceptual confusion and historical inaccuracy blames our current problems on an era of small government and laissez-faire policy that never really existed. We have deluded ourselves into believing that politicians who freely adopted the language of the great economists were actually persuaded by their arguments and ready to follow that advice. They were not ready. Instead, they constantly intervened in the economy, either by abandoning principles or in the name of principles. As a result, the language of economics has been corrupted—reduced from science to mere opinion.

Keynes isn't the intellectual solution to our current economic woes. His ideas are one of the primary reasons we are in this mess. He was wrong in 1936. He was wrong in 1956 and 1976. He is still wrong in 2008. Bad economic ideas result in bad economic policy, which, in turn, results in bad economic consequences. That simple linear relationship is true across time and place. While there may be macroeconomic problems, there are only microeconomic solutions. We do not need more of the same old bad economic ideas that have persisted for most of the last century. What we need, instead, is a return to ordinary economics.

Explaining a Crisis with Ordinary Economics

Many claim that economics as a scientific discipline has been rocked by current events. They cite a failure to “predict” the economic downturn and an inability to “fix” it with a consensus on the right public policy as evidence. To be sure, these are dark days for economists. But it is certainly no darker than the 1930s and 40s. Unemployment, reported at 9 percent in March of 2009, hit a record-breaking 24.9 percent in 1933. The so-called crisis of this century pales in comparison to the actual crisis of the last century. But what has been until now a severe recession might result in a crisis if we have not learned from the mistakes of our past.

There are basically three explanations for the Great Depression, two of which place blame on the government. First, we have the Austrian story. From 1922–28, while technological innovation put downward pressure on prices, the general price level was kept more or less stable as a newly established and inexperienced Fed drastically expanded the money supply in fear of deflation. This generated a boom-bust cycle, which began to swing south by the end of the decade. Second, we have the Monetarist claim that the Fed acted incorrectly in the 1930s, contracting the money supply when expansionary policy would have remedied the situation. And, finally, we have the Keynesian explanation, which points to aggregate demand failure.

Austrian and Monetarist explanations need not be at odds with one another. For one, the Austrians address the cause of the depression while the monetarists deal with how it could have been prevented. They pertain to two different time periods. Both pinpoint government as the source of the problem. Most importantly, though, both are far enough removed from the claim of aggregate demand failure to avoid being implicated by the shortcomings of fiscal policy. The lesson to be learned from the 1930s is that the depth and length of the Great Depression cannot be attributed to monetary distortions (either credit expansion or monetary contraction). A host of policy missteps prevented markets from adjusting to changing circumstances.

After the stock market crashed in 1929, market corrections were immediately set in motion. Prices adjusted to the new realities and resources were reallocated accordingly. By June of 1930, the Dow had largely recovered. Then the economy was hit with a massive policy shift on tariffs. The Smoot-Hawley Tariff Act effectively raised the prices of 20,000 imported goods by up to 50 percent. As a consequence, trade was destroyed. The natural process of market correction, which works through the vehicle of trade, came to a screeching halt. In other words, policy shocks transformed the pain of correction into the pain of a crisis.

In hindsight, the Great Depression should come as no shock. Credit expansion followed by monetary contraction created a business cycle and magnified its downturn. Then, just when things were looking up, poor fiscal policy and trade restrictions made reallocating resources exceedingly difficult. Government actions promoted malinvestment and resource mismanagement. Government actions prevented the market from engaging in the natural process of correction. Government actions resulted in the Great Depression. Unfortunately, it seems as though we have not learned from the mistakes of our past. As a result, history might very well repeat itself.

In many ways, the current economic situation is a perfect storm of policy mishaps. In addition to the breakdown of fiscal restraint, which started nearly a century ago, credit expansion under Greenspan following the dot-com bubble bursting in 2000 and the stock market downturn of 2002 encouraged individuals to own homes they could not otherwise afford. In the absence of cheap credit, these ventures would have been unprofitable and, thus, foregone. Expansionary policy gave lenders an incentive to lower standards, extending loans to those who would be less likely to repay. Below-market-level interest rates—initiated and perpetuated by the Fed—generated malinvestment in the housing market.

To make matters worse, the Fed's efforts to increase home ownership were magnified by government meddling. Under the Clinton Administration, government-sponsored entities, including the Federal National Mortgage Association (Fannie Mae) and the Federal

Home Loan Mortgage Corporation (Freddie Mac), were directed to increase the number of mortgage loans extended to low-income families. In 1996, Fannie Mae and Freddie Mac were told that “42 percent of their mortgage financing had to go to borrowers with incomes below the median income in their area” and “12 percent of all mortgage purchases by Fannie and Freddie had to be “special affordable” loans, typically to borrowers with incomes less than 60 percent of their area’s median income.” Under the Bush administration, these programs were continued, even extended. The target for “special affordable” loans increased to 20 percent in 2000; by 2005, it was 22 percent. Although shares in Freddie Mac and Fannie Mae were owned privately since 1968, “their congressional charters suggested that if they got into trouble, Congress would bail them out (as it did, in fact, in September 2008).” As such, they followed the directives of politicians. And politicians on both sides of the aisle were in agreement: Every American ought to own a home.

While their intentions may have been pure, government officials failed to realize why these individuals were unable to get low rate mortgages in the first place. The mere act of extending loans did not change the fact that these individuals were poor candidates for receiving loans. Instead, good intentions bred poor policies and resulted in an even worse state of affairs. Had they been more familiar with the teachings of ordinary economics, they would have known that ought cannot presuppose can.

Lenders, pressured to lower standards, attempted to hedge this additional risk by adopting new, untested means of securitization. Technological development is always a risky venture. However, the risk is usually spread out among many firms employing multiple strategies, and each firm is held accountable for the amount of risk they take on. In this particular case, though, institutional structures developed to rate credit risk had been eroded by government regulation, effectively granting firms a free pass to act irresponsibly. As such, financial institutions leveraged to the hilt at the below-market interest rate. And rather than waiting for a tried and true method to emerge, they invested heavily in mortgage-backed securities. The nature of these securities meant that firms would only be able to repay their loans if the housing market continued to trend upward.

While the portfolios of lenders were becoming less and less stable, borrowers continued to take out loans. And as the interest rate fell, the credentials of those borrowers offered loans sunk as well. These new borrowers were often first-time homeowners with little or no assets to put up as collateral and a limited understanding of adjustable-rate mortgages. Most importantly, these individuals had been shielded from the market's natural tendency to discipline participants. The 1990s was a high-growth decade fueled, at least in part, by expansionary monetary policy. Expecting the upward trend to continue, individuals got comfortable living beyond their means. Even at the exceptionally low interest rates, many of these new borrowers were barely able to service their loans. When rates began to ratchet back up to the market level, they were unable to repay.

The financial fiasco that has followed the bursting of the housing bubble is not a consequence of market instability, but the inability of government to engage in apt intervention. Politicians presume they have the necessary knowledge to effectively tackle the problems that, ironically, they brought about. In reality, they do not possess this knowledge. They cannot possess this knowledge. This knowledge is dispersed throughout society, with each market participant holding information of a particular time and place that is often unknown to others and, in some respects, impossible to articulate. Even if politicians were capable of collecting the necessary knowledge—and, to reiterate, they are not—that knowledge would be outdated before it could be used. We live in a dynamic world where things are constantly in flux. And, to the dismay of politicians, the instantaneous collection of knowledge by one entity—which would be required for apt intervention—is beyond the realm of possibility. Breaking down the institutional structures of an economy to engage in apt intervention when it is impossible to aptly accomplish what is intended ends predictably in catastrophe.

What we are witnessing at present is the endogenous creation of a crisis. Policy failures are compounding the problem. Similar to how in the post-Katrina debacle the folly of man worsened the fury of nature, the policy path taken in response to the bursting housing bubble and subsequent financial system shake-up has turned a market correction

of government-induced distortions into a potential system wide collapse. Make no mistake: Market correction is a painful process. Businesses fail and unemployment rises. Some families must uproot and relocate in order to find new jobs. Others have to retrain, as the skills they possess are no longer deemed valuable by the market. Parents must explain to their children why fewer presents will be under the Christmas tree; why the annual vacation must be postponed; why they are unable to help with those college expenses this year. The process of market correction is not enjoyable, but it is necessary.

It is natural to think in the midst of a recession that times are much worse than they should be. In actuality, it is that times were so much better in the preceding period than they should have been. The boom experienced was artificial, a period of wasteful malinvestment that led to insolvency. And the time for correcting this malinvestment has come. Credit-induced booms are unsustainable—they will come to an end. The only question is when this adjustment will take place. Implementing policy that softens the pain of correction merely prolongs the process of adjustment.

Unfortunately, the Fed and the Treasury have acted as if the only lesson to be learned from the Great Depression is that lack of liquidity can cause a crisis. This is not the relevant lesson for today. Inflation is damaging; deflation is damaging. As Mises once put it, trying to cure the problems created by one by following up with the other is analogous to backing up over a man to undo the damage of driving your car over him in the first place. Expansionary monetary policy and government intervention that prevents market correction when malinvestment is revealed does not get you out of trouble. Instead, it merely masks the problem for another day. The truth is, we have been pushing off the adjustment period for decades. Bailouts, stimulus packages, and easy credit cannot be sustained indefinitely. Postponing the adjustment another round will only make us less equipped to deal with the underlying problem in the future.

Distortions to market signals caused by government manipulation are real. The perverse incentives created by bailouts will be with us for years and the costs of rent-seeking are accumulating. \$700 billion becomes \$850 billion. Rather than investing in productive

ventures, entrepreneurs form special-interest groups to swarm DC for their share of the funds. Just as the policies pursued during the Great Depression extended the period of correction, the decisions politicians make today will certainly have an impact on the length and depth of the adjustment that lies ahead.

Moving Forward

Ordinary economics emphasizes the reality of scarcity: There is no such thing as a free lunch. This applies to those acting in the name of government just as much as anyone else. With this in mind, it is foolish to talk about government spending without also discussing how those expenditures are to be financed. Government can raise revenue in one of three ways: tax, borrow, or inflate. To be clear, the second of these is only a temporary means of raising revenue. Eventually, borrowed funds must be repaid through taxation, inflation, or a combination of the two.

The natural proclivity of democratic governments is to pursue those public policies that concentrate benefits on the well-organized and well-informed and disperse costs on the unorganized and ill-informed. Additionally, there are strong reasons to believe policy making will be biased toward shortsightedness—pay out the benefits now, worry about the costs down the road. Thus, the natural tendency for elected officials is to borrow (rather than tax) and then inflate (rather than tax). In other words, politicians prefer to spend in the short run to meet electoral promises. Then, when the bill comes due, they print more money in order to pay back in cheaper currency. Hence, current deficits are financed by massive amounts of public debt; and this debt is repaid, at least to some extent, by monetization.

Milton Friedman taught us that inflation is everywhere and always a monetary phenomenon. Wage-pull or cost-push inflation stories do not make sense. The oil shocks of the 1970s, for example, would explain a relative price change, but not a change in the general price level. The general price level is determined by the supply and demand for money. While Friedman's dictum is correct, Tom Sargent's work on hyperinflation

suggests it could benefit from modification: Hyperinflation is everywhere and always preceded by fiscal imbalance. Or, put simply, the natural proclivity of government has consequences.

In the 1970s, the Irish government attempted to boost aggregate demand by implementing expansionary fiscal policies. Public infrastructure projects were taken on; government agencies expanded to offset unemployment; and transfer payments increased. Predictably, fiscal expansion was financed with deficit spending. By 1977, public sector borrowing rose from 10 to 17 percent of GNP . In the end, however, these Keynesian-style macroeconomic policies were not effective at stimulating the economy. Ireland's average annual growth rate was a meager 2.2 percent from 1973–1992 . To make matters worse, efforts to stimulate the economy left the Irish government with a fiscal crisis.

Fortunately, Ireland was a member of the European Monetary System (EMS), which effectively prevented the government from monetizing its debt via inflation. Since previous tax increases had failed to raise sufficient revenue, the only remaining option was to cut spending. By 1987, the current operating budget was cut by 3 percent. With government spending under control, Irish policymakers were able to create a more competitive tax system. Although these reforms were adopted to deal with a fiscal crisis, they helped pave the way for Ireland's economic take-off.

Unfortunately, the United States is not restrained as Ireland was. What is more frightening is the near-universal belief that we can spend our way out of trouble. Government spending would likely be deficit financed and the monetization of this debt will cause even more inflation, distorting market signals further. Likewise, it makes no sense to encourage private spending with easy credit, as this very policy created the problem we are dealing with and would only exacerbate it further. The only solution is to allow the market to correct.

Successful politicians at present claim we must move past the dead ideologies of the past and the “do nothing” arguments that have failed time and time again. The reality, of

course, is that those arguments have not been actively pursued since Grover Cleveland. Hoover, and then Roosevelt, was actively involved with the economy. Both attempted to manipulate the market. Both were guilty of the fatal conceit. Both failed miserably. The problems we are currently facing are not the result of dead ideologies, but instead a live political pragmatism. Wealth creation results from realizing the gains from trade and the gains from innovation, not government investment. Citizens and statesmen alike have forgotten the basic ideology that made possible the great growth of the wealth of nations. The foundation of Western civilization—a system of property, contract, and consent—has allowed for freedom of trade and social cooperation under an international division of labor. Without this foundation, Western civilization would cease to exist. For this reason, government, rather than being unleashed, must be constrained. It must be constrained in such a binding way that it is not possible for elected officials to pursue the natural proclivities to provide privileges to political favorites by concentrating benefits and dispersing costs. It must be prevented from monetizing its debt. It must be minimized. How do we get out of the present mess? Not by curtailing market adjustment, that is for sure. Instead, we must allow the market to weed out unproductive investments promoted by the credit-induced boom. If bankrupt businesses are not bailed out, they will fail. The stock market will go down and unemployment will rise. But resources will not go into a black hole. They will be reallocated to more productive uses. Malinvestment, generated and perpetuated by government meddling, will be cleared away.

The political and legal infrastructure that has made the U.S. economy an attractive economic environment and a land of entrepreneurial opportunity throughout its history must be reinforced. When the gains from trade and the gains from innovation are continually realized, long-term economic growth wipes out the consequences of financial miscues relatively quickly. As Robert Lucas noted, “Once one starts to think about [economic growth], it is hard to think about anything else.” This assumes, of course, that the policy regime in place does not completely distort the fundamental structure that makes economic growth possible. If we were to fundamentally change the political and legal structures that have, however imperfectly, secured property rights, ensured the

consensual transference of property and upheld the contracts of individuals, the trend of long-term growth would be reversed.

To date, the absorptive power of the U.S. economy in dealing with government stupidity has been amazing. Remember that the 20th century encompassed WWI, WWII, the Korean War, the Vietnam War, the Cold War, and turmoil in the Middle East. It was the century of the panic of 1907, the Great Depression, stagflation in the 1970s, the 1987 crash, and the 1997 Asian contagion. It was a century full of regulations, mismanaged money, and irresponsible fiscal policy. It was a century of protectionist legislation and pork-barrel politics. Yet it was also a century of amazing technological innovations. The century started with horse and buggies and ended not only with automobiles, but also the ability to fly around the world and rocket a man to the moon. During the 20th century, the cost of domestic trade fell swiftly as trains, trucks, and planes enabled coast-to-coast transactions. International trade reached from the United States to the remotest corners of the world. More so than any other time in human history, Schumpeterian gains from innovation and Smithian gains from trade have swamped the stupidity of government action. This would not have been possible without a political and legal structure that accommodates property, prices, and “profit and loss.”

Conclusion

Hayek argued in the early 1930s that the fate of the economist was to be called upon to address questions of pressing political concern, only to have his advice discounted as soon as it was uttered. Why? Because economics, as a science, puts parameters on the utopias of man. It gives us primarily “negative” knowledge. Economics tells us that we live in a world of scarcity, that there is no such thing as a free lunch. It reminds us that we cannot assume what it is that we hope to prove. It requires us to face reality: Ought cannot presuppose can and can does not always imply ought. As Hayek wrote, “The curious task of economics is to demonstrate to men how little they know about what they imagine they can design.” To this degree, we have failed as a discipline.

Most individuals have no idea what economic science is. In their minds, economics is merely concerned with practical business, or worse, a tool to espouse political ideology. They know nothing of the laws of economics, despite living by them every day. We economists have permitted this. We have allowed politicians and the public to demand of our discipline results that cannot be produced. Shamefully, we have pretended to produce those results in order to obtain power and prestige.

Fortunately, all is not lost. There is still time to realize the power of markets to utilize self-interest, coordinate dispersed information, and spur entrepreneurial discoveries. It is not too late to point out government inefficiency, crowding out of wealth-creating investment, systemic errors produced by knowledge problems, vested interests seeking privileges, and a precarious inclination toward deficits, debts, and debasement. As a discipline, we must learn to recognize once again the importance of a dynamic market process. Even in times of extraordinary crisis—indeed, especially in such times—we must rely on the lessons of ordinary economics.