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Getting an Education about the Real World

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Most of the U.S. population got an education during the past two years about what exists in the real world. Before then the dominant dogma in the United States included the following:

- Resolving economic problems is best left to the market.
- When government “bureaucrats” intervene in market operations, they frustrate the corrective power of the market. (Ronald Reagan’s sarcastic comment typifies this sentiment: “I’m from the government and I’m here to help you!”)
- The government role is excessive in President Obama’s health care proposals.
- Bankers, based on their training and experience, are prudent.
- Minimizing government regulation in financial markets improves society’s economic well-being.
- A protracted housing bubble is inconceivable because private markets will bring needed corrections.
- Keynesian economics died when inflation and recession occurred simultaneously during the 1970s.
- Deficit spending by government increases inflation without stimulating economic growth.
- The key danger in enacting health care legislation is increased government deficits.

These arguments continue to be made, but it is now clear that they exemplify a narrow ideology that leaves no room for the preventive and corrective roles of government when making economic policy. The key economic policy debates now taking place—such as those about the mix of private/public roles to stimulate the economy, preventing financial breakdowns without stifling positive innovation, and providing health care—are less dogmatic.

The U.S. economic calamity of recent years started in the housing market. Private financial interests argued in favor of deregulation, and the government and Congress, based

on the prevailing dogma that this would foster innovation, consented. Much of the innovation turned out to be disastrous. Financial institutions pushed subprime mortgages, packaged these tainted mortgages in derivative instruments that even they did not fully understand, and earned high profits for as long as the innovative game continued. Investment and mortgage bankers then based their oversized compensation on these high profits, incomprehensibly oblivious to the certainty that they could not continue indefinitely. When the collapse came, millions of people lost their jobs, homes, savings, and retirement pensions. World wealth was diminished by many trillions of dollars. The numbers are too large for the average person to comprehend. It would take a million days (3,739 years) at a daily expenditure of \$1 million to spend \$1 trillion. One lesson of my education is that many bankers are not prudent when given the opportunity to satisfy unlimited greed.

The belief that the workings of the market would correct the housing bubble was deeply ingrained. Alan Greenspan, former long-time chairman of the Federal Reserve Board, last year told a congressional committee that he was shocked that the self-interest of lending institutions did not drive them to protect shareholder equity. This was Greenspan’s way of admitting that he too had advanced his education. The late Kenneth Boulding, president of the American Economic Association in 1968, often referred to what he called Boulding’s first law, namely, that which exists is possible—and the housing bubble fits this “law.”

Remarkably, the Clinton administration accepted the contention that deregulation of financial markets would advance economic growth by giving more leeway to powerful private interests. Bill and Hillary Clinton had to suffer through the trashing of their health care proposal early in his administration, and he should have understood that private companies and institutions defend their interests even when these differ from the national interest. Two current U.S. examples of this are the opposition of the Teamsters Union to allowing Mexican trucks to bring cargo to destinations in the United States, and the opposition on

economic grounds by the U.S. Chamber of Commerce to reducing the danger of global warming by placing what its members apparently believe is too high a cost on reducing and capturing CO₂ emissions. Private companies do nothing inherently reprehensible when they seek to protect their interests, any more than members of Congress do when they seek to protect the interests of their constituents. But they are working on behalf of particular interests even as they try to cloak this in verbiage that implies that their special interests are the same as the national interest. (What is good for General Motors is good for the United States.) The government has a duty to protect and advance the national interest, and important legislation almost always involves a battle between this obligation and the narrower private interest.¹ This is the main contest being played out in the current U.S. health care debate.

The financial meltdown of 1998 and 1999 had many causes—these included the housing bubble, the large reliance of banks on debt financing, the on-the-books and off-the-books accounting of different aspects of bank borrowing and lending activities that obscured the scale of what was happening, the credit crunch that flowed from this, and the incentive to show short-term profits because of their large role in executive compensation—and these causes were created predominantly in the private sector. As private spending (consumption and investment) collapsed, it was the government (including the bureaucrats) that had to come to the rescue with vast sums of money. (“I’m from the private sector; please come and help me!”) This help started in the Bush administration and was amplified in the Obama administration. Neither president was prepared to wait for the market to do the job—each feared that a serious recession would be transformed into a deep depression if the government did nothing. Economists agree overwhelmingly that the government and Fed financial stimuli kept the U.S. economy from getting much worse than it did.

The problems now under discussion are about the best ways for the government and the Fed to prevent future financial meltdowns. The rescue role had to confront the issue of dealing with financial institutions that were too big to fail (tbtff). Now that many troubled financial institutions have disappeared or were absorbed by others that were sounder, the tbtff problem has become even more acute. No one doubts that something must be done to correct the problems that got the United States and the world into the recent economic mess—indeed, as one looks at growing U.S. joblessness, the continuing mess. The debate is about the specific measures to be put in place. (“No one doubts” may

be overstatement; now that their rescue has taken place, many bankers seem to want the government to just go away.)

In addition to differences of opinion about how to deal with the tbtff problem, the preventive measures must deal with whether and how executive compensation techniques can be changed to diminish excessive risk-taking, the size and composition of the capital structures of banks and financial institutions, and the content of reregulation and who should be responsible for their oversight. The executives of large financial institutions will want room for innovation, which is unlikely to take the same form that it took in the recent past. Innovation can be both constructive and destructive. The word “innovation” implies that it will introduce something new—and this means that merely looking at the past is insufficient to prevent future economic breakdowns emanating from financial failures.

Keynesian thinking about macroeconomics has clearly made a comeback in the minds of policymakers. The reviewer of three new books dealing with Keynes’s thinking in *The Economist* of October 3 made two salient points: Keynes contributed more than anyone else to the way the recent financial-economic collapse was handled; and Keynes was convinced that the capitalist system works most effectively when the government and private enterprise collaborate. Richard Nixon commented in 1971 that “we are all Keynesians now.” In the crisis, the corrective government and Fed policies were Keynesian.

Beyond the reminder that bankers are not necessarily prudent, the reinforcement of my education over the past few years includes the following: it sometimes takes decisive government action to rescue the private sector from its follies; the size of fiscal deficits should not be determined simply to favor a balanced budget, but properly depend on the national economic situation; however, large and sustained fiscal deficits, such as those under the Bush administration, are dangerous for the economy and for the market system itself.

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¹ The classic book on this subject is Mancur Olson, *The Logic of Collective Action and the Theory of Groups*, originally published in 1965 (revised edition 1971, Harvard University Press).