# Liberty, Limited Government, and the Rule of Law in the Wake of the Global Financial Crisis

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Limited Government and the Rule of Law Often Decline During Crises

- -- Wars
- -- Financial Crises
- -- Natural Disasters

But, the Growth of the State is not an Inevitable Feature of Crises

The Growth of the State is not, however, an Inevitable Consequence of a Crisis

Let’s start with a comparison of the current crisis to the crisis of the 1930s and 1940s

# Is the current crisis like the “Great Depression”?

That will be up to us. It depends on what policies are followed. Compare the Depression of 1920-21 with that of 1929-1946.

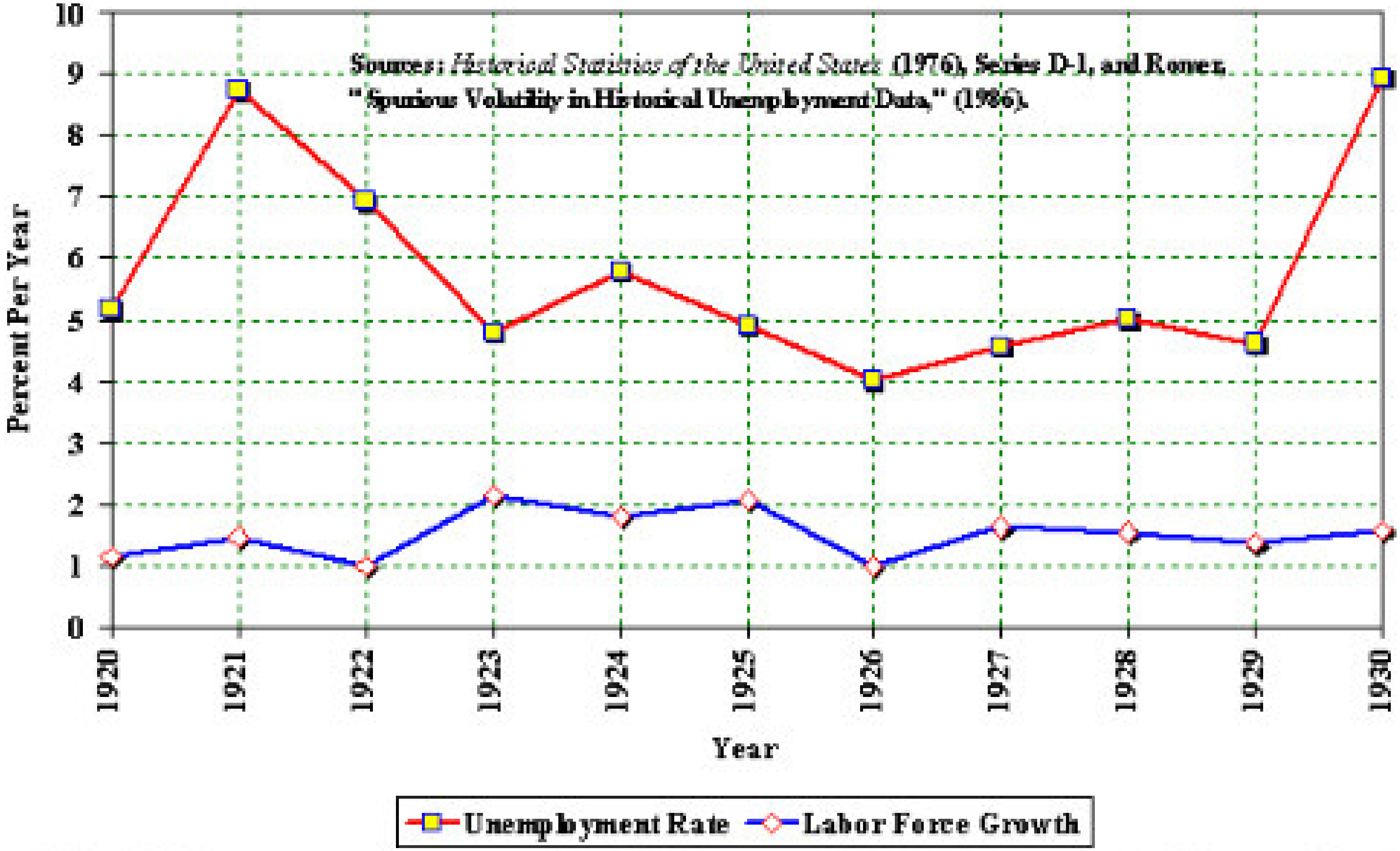
**Economic data for 1920–21 recession**[2][3][4]

| Estimate | Production | Prices | Ratio |
|---|---|---|---|
| 1920-21 (Commerce) | -6.9% | -18% | 2.6 |
| 1920-21 (Balke&Gordon) | -3.5% | -13% | 3.7 |
| 1920-21 (Romer) | -2.4% | -14.8% | 6.3 |
| 1929-30 | -8.6% | -2.5% | 0.3 |
| 1930-31 | -6.5% | -8.8% | 1.4 |
| 1931-32 | -13.1% | -10.3% | 0.8 |

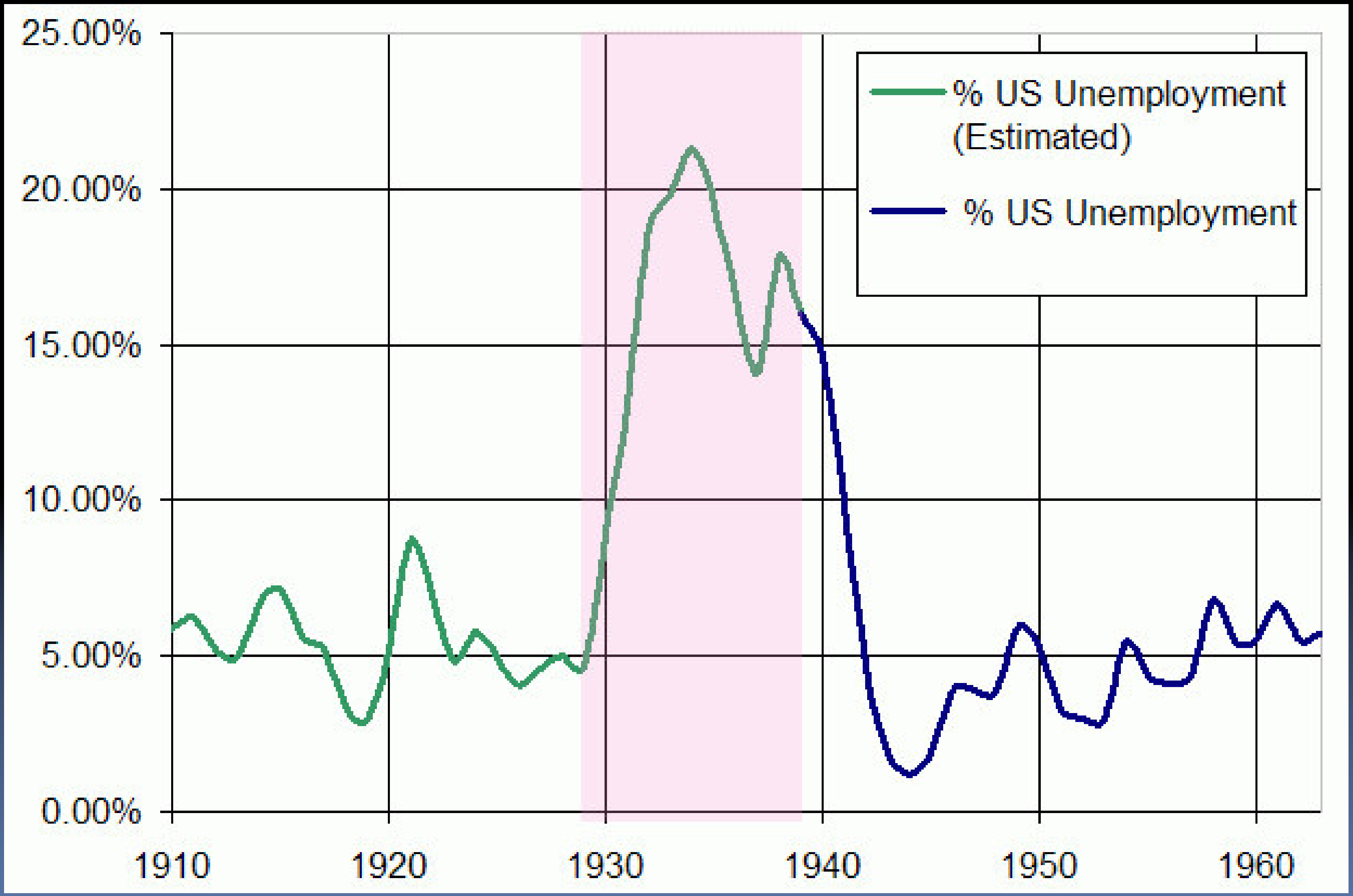
**Unemployment rate**[7]

| Year | Lebergott | Romer |
|---|---|---|
| 1919 | 1.4% | 3.0% |
| 1920 | 5.2% | 5.2% |
| 1921 | 11.7% | 8.7% |
| 1922 | 6.7 | 6.9% |
| 1923 | 2.4 | 4.8% |

Figure 5: Labor Force Growth and Unemployment, 1920 to 1930



# Note the “Depression Within the Depression”



# What do those crises tell us about the present one?

1. Monetary and Financial Policies Matter
2. Trade Policy Matters
3. Choice of Policies Can Prolong or Shorten Economic Contractions

# Let's Take a Look at the Present Crisis

1. Monetary Policy
   1. The Federal Reserve AND Central Banks around the world lowered interest rates and embarked on remarkably expansionist policies in the last decade
   2. Real interest rates were *negative* for several years in the US (esp. 2003-2004)
   3. Enormous Interventions into financial markets, especially mortgage markets, promoted an asset bubble, notably in housing
   4. That collapse of that bubble was far worse than most collapsing bubbles, even of greater magnitudes (e.g., the "Dot-Com" Bubble), and crashed much of the world's financial systems and led to a general downturn in trade.

# Let’s focus for a moment on policies to promote “home ownership” in the US

- Let’s introduce some US Government Agencies and Government-Sponsored Enterprises
  - Federal Housing Administration
  - Fannie Mae (Federal National Mortgage Association)
  - Freddie Mac (Federal Home Loan Mortgage Corporation)

## Each agency was empowered by the state to encourage home ownership: FHA guarantees hom loans, and Fannie Mae and Freddie Mac "securitize" them to free bank capital to make more loans

1. FHA guarantees home loans
   1. Traditional "down payment" requirements for a loan were 20%
   2. FHA pushed them down to 3% in recent years
   3. The FHA down payment option introduced in 2008: 0% down payment
2. Starting in 1992 Congress pushed Fannie Mae and Freddie Mac to focus securitization on lower income borrowers
   1. 1996: 42% of mortgage financing to go to borrowers with below the median income in their area
   2. 2002: 50%
   3. 2005: 52%

1. 1996: 12% of all mortgages purchased by Fannie Mae and Freddie Mac had to be "special affordable mortgages," made to borrowers with incomes less than 60% of the median in their area
2. 2000: 20%
3. 2005: 22%
4. 2008: 28%

The result: A huge asset bubble, fueled by easy credit and channeled into one kind of asset" -- *<u>HOUSING</u>*

# 1. Those mortgages were "securitized" and sold on international markets

1. The securities were sold in "tranches" or "slices" that were then sold with different ratings
2. The ratings were issued by a state-enforced oligopoly of "Rating Agencies" – and those agencies were paid by the issuers of the securities, NOT by the buyers
3. The underlying securities were guaranteed by the US government
4. The Basel Accord(s) encouraged banks to issue mortgages, have them securitized, and then to buy the securities to meet their capital requirements.

**The Result:** A Systemic Mis-Pricing of Risk and Over-Valuation of Assets Worldwide, with Resulting Distortion of Behavior

# What About Policy Responses?

1. A "Crisis of Solvency" was misinterpreted as a "crisis of liquidity," and huge amounts of new money were pumped into economies;
   1. The problem was not liquidity, but the fact that the underlying assets valuations were wrong, and some firms were simply insolvent – the value of the assets was lower than they thought
      1. The likely result of that: inflation and a postponement of adjustments
   2. Policies are being implemented to keep prices up – even housing prices! – and to subsidize insolvent firms
      1. That was one of the primary reasons for the Great Depression; policies were designed to keep wages *and* prices high and to prevent price adjustments

   3. Steps toward ***protectionism***

# The Disastrous Impact of Bailouts

Firms should be allowed to go bankrupt, which allows the firm to be reorganized and old – failed – management to be fired.

The bailout of troubled or failed firms promotes cronyism and corruption.

# The Disastrous Impact of Protectionism

The Smoot-Hawley Tariff : Signed into Law June 17, 1930

Raised tariffs on over 20,000 imported goods

“Retaliation” occurred before it was even passed: In May of 1930, Canada raised tariffs on goods imported from the US; many others followed

Imports to – and exports from – the US collapsed, and much of world trade with it

World trade collapsed by roughly 2/3

# The World is Suffering from Mountains of Debt

State Policies Encouraged Borrowing, Spending, Borrowing, and More Spending

# The Result?
# Financial Collapse

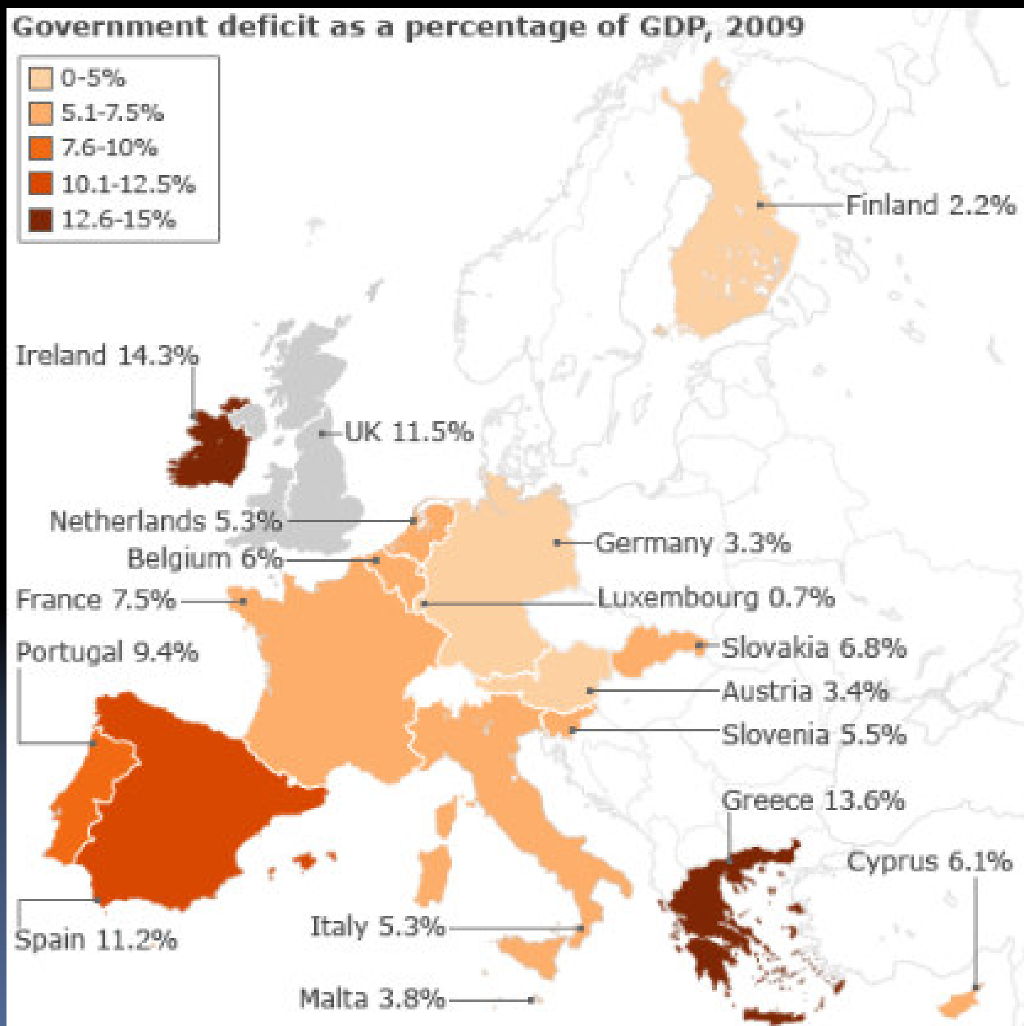
# The Greeks Are Suffering From It Now

# In only 5 years

Government spending went from 42% of Greek GDP to…

51%

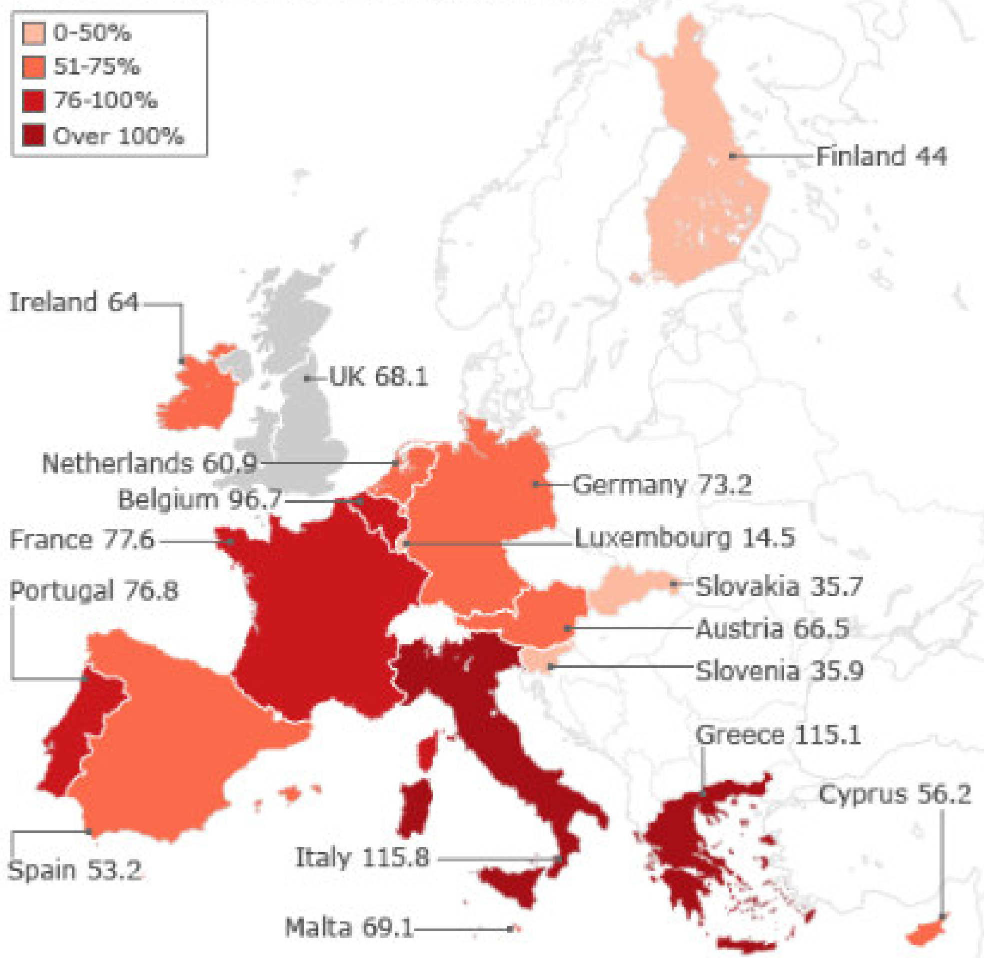
# And it's not just Greece….




| | Total debt (% GDP) | Total debt (€ m) | 2009 deficit (% GDP) |
|---|---|---|---|
| Italy | 115.8 | 1,760,765 | 5.3 |
| Greece | 115.1 | 273,407 | 13.6 |
| Belgium | 96.7 | 326,606 | 6.0 |
| France | 77.6 | 1,489,025 | 7.5 |
| Portugal | 76.8 | 125,910 | 9.4 |
| Germany | 73.2 | 1,762,211 | 3.3 |
| Malta | 69.1 | 3,948 | 3.8 |
| UK | 68.1 | 1,067,819 | 11.5 |
| Austria | 66.5 | 184,105 | 3.4 |
| Ireland | 64 | 104,667 | 14.3 |
| Netherlands | 60.9 | 347,021 | 5.3 |
| Cyprus | 56.2 | 9,527 | 6.1 |
| Spain | 53.2 | 559,650 | 11.2 |
| Finland | 44 | 75,217 | 2.2 |
| Slovenia | 35.9 | 12,519 | 5.5 |
| Slovakia | 35.7 | 22,585 | 6.8 |
| Luxembourg | 14.5 | 5,464 | 0.7 |

SOURCE: Eurostat. All figures for 2009

National debt as a percentage of GDP, 2009

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What Is the Proper Policy Response?

Remember the Contrast between the Crisis of 1920-21 and the Crisis of 1929-1946