The Economic Crisis, *Ex-Post*
An Interview with Amity Shlaes

The extent to which government should intervene in the market is much more than an academic question. By altering incentives, redistributing wealth, and providig safety nets, the government influences living standards and economic expectations of both businesses and individuals. Since the Great Depression, the precise role that the government should play in regulating the economy and furthering the welfare state has been an issue of contentious debate and intense convictions precisely because it strikes at the heart of what a society's priorities are and how they should be organized. The current financial crisis has revitalized this debate, recasting it onto a globalized world where different characteristics require a perspective that judiciously incorporates lessons learned from the past with a thorough understanding of the unique features of the present.

In this interview, Amity Shlaes achieves this balance, and in so doing, helps us to understand the magnitude of what has happened. Noted author of The Forgotten Man, A New History of the Great Depression, Ms. Shlaes has also written numerous articles and regularly appears on noted programs. In this interview, she stresses that it is the private sector, and, more specifically, individual initiative that is ultimately responsible for producing the current high level of American living standards, and that to place emphasis and hope in the prospect that government can successfully extract the economy from this crisis is misguided. By bringing an intellect that is well-versed in the lessons of history but sharp enough to recogize its limitations in explaining the present and future, Amity Shlaes showcases a viewpoint in this interview that is as informative as it is throught-provoking.

The Journal: In *The Forgotten Man*, you mentioned that in 1936 Roosevelt systematized interest group politics to include a broader range of constituencies, creating the 'modern entitlement challenge' that bedevils both Republicans and Democrats. What exactly is the modern entitlement challenge and how is it shaping our government's response to the current economic crisis?

Shlaes: Entitlements are all those things that are owed to people by the government—Social Security, Medicare, Medicaid. Even before we had the crisis these entitlements, which were created either in the New Deal or the 1960's Great Society, were curtailing our budget options in the US. Every year that you look at a chart of the US budget you'll see the entitlements growing and the discretionary spending of the government narrowing what lawmakers can do. President Bush pushed education

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Amity Shlaes is a syndicated columnist for Bloomberg and a senior fellow at the Council of Foreign Relations. She is an expert on the US economy and the Great Depression and has served as a columnist for the *Financial Times* as well as a member of the editorial board of the *Wall Street Journal.*

more toward being an entitlement with *No Child Left Behind*. The problem with the creeping expansion of entitlements is when a budgetary crisis comes. You need more money than you thought you did and you don't have any left because of the entitlements. But, even if the economy were in good health, entitlements are a problem.

The Journal: So, do you think this shift is creating expectations in the American population that are unsustainable in the long-run?

Shlaes: Well, when one entitlement wins, another loses. For the sake of argument, let us say we have another entitlement which we might also call a right, which is the right to have economic opportunity, the right to see economic growth. We feel that it's our right to try to succeed and to see our children succeed. That right, if you want to use that language, is curtailed because we will see lower growth if we have too many other entitlements, or too big a government. A related way to talk about this is to talk negative and positive rights. Too many positive rights hurt negative rights.

The Journal: As the current economic crisis continues to unfold, what should our priorities be in the near-term and the long-term? Furthermore, can these priorities be effectively handled simultaneously?

Shlaes: I would argue that our crises can be handled simultaneously. The standard format that we're following is first fix the financial crisis and then boost the general economy. It is possible that boosting, or freeing the general economy in the right way will also fix the financial crisis. What are the components of an immediate fix that would make the US crisis pass as fast as, say, the Mexican crisis did in the mid-90s? We would set the country up for instant growth by making a more competitive tax regime with lower capital gains rates, lower corporate taxes. We would not let tax rates go up as the administration intends to do, but instead, make a sign that says 'the US is open for business.' Maybe even a stronger more clearly defined Securities and Exchange Commission (SEC) with a precise mandate, and rules standardized with other international securities regulators would help too.

This question of the Securities and Exchange Commission (SEC) is especially important. There has been a certain disingenuousness, to Republican positions, especially when it came to derivatives. So, we pretended that if derivatives fell between jurisdictions—if a derivative security for example, fell between the jurisdiction of the Commodities Futures Trade Commission (CFTC), the old commodities regulator and the SEC, the stock regulator, or some third regulation—then it was okay because the market was flourishing and maybe less regulation meant more growth. Clearly, the price for that attitude is too high. Even the greatest defenders of markets have to acknowledge that now. We need some clarity on regulation and to say we are going to be regulating these things. Maybe one institution, the SEC, should do it, and maybe it should have teeth.

People like me are concerned that if the SEC prosecutes too much, has too many disciplinary actions, or too many arbitrary investigations, that it will tamp down growth just as Sarbanes-Oxley did subsequent to Enron. But now we have a new context and we know what the other costs are and a super-SEC seems less frightening, or like a lesser evil. I think that would also reassure foreign investors. Another component beyond the tax and the regulation of the securities would be closure on lawsuits, which is very hard to get. But Congress does have some power to pass national legislation on lawsuits. In fact Chairman Cox, who's just leaving the SEC, did have a shareholder lawsuit curtailment in class action suits in the 90s. Nobody wants to invest in the US if they're going to be sued. It's as simple as that.

The Journal: What about the Fed, you mentioned that we should rethink the Fed law?

Shlaes: The aspect of the Fed law that is challenging is that, since the post-war period, the Fed has had at least two mandates. One is to stabilize money; the other is to employ people or watch the general economy. We call that the Humphrey-Hawkins tradition, after one of the earlier laws on the topic, and it is a flawed mandate. The very title of the 1978 Fed law for example tells it all: The Full Employment and Balanced Growth Act. The job of the Fed should be to monitor the money, full stop. When you put it in charge of the general economy—and clearly the Fed thinks it's in charge of the general economy now—you have a mission creep and the Fed is not always the most efficient vehicle for recovery.

The Journal: Today interest rates are virtually at zero and President Obama just passed a $787 billion stimulus. Meanwhile, Geithner is revamping TARP and that's going to cost another estimated $1.5 trillion. It's evident the government is taking extreme measures. They're doing whatever is necessary to fix this crisis. Do you think that is true? What are the limitations of the current economic strategy?

Shlaes: We've almost reached them. Spending alone is not the answer. The idea that spending is the only answer is particularly pernicious. If you remember, a few years ago when we talked about spending $100 billion for example, to remove the alternative minimum tax, we felt that was too much money. So, the country's in a kind of "illions" moment. In *The Forgotten Man* I talk about the "illions" moment. When we moved from millions to billions, people were very shocked that there were so many talking with the b-word. Now we're moving similarly from billions to trillions, and that is legally disconcerting and probably wrong.

The Journal: Is the government failing to inform the public about their strategy?

Shlaes: There's lip service paid to the idea that the private sector pulls the load; that the private sector is the locomotive of the US economy. You heard President Obama say that in his inaugural address. But the policy that is now being outlined and promulgated with the passage of the stimulus act isn't really about stimulus because there's not enough emphasis on that which is being stimulated. Our national emphasis is on the process itself, that is, the public sector taking action. To be obvious, the private sector is the only source for the kind of growth to which the US is accustomed.

You can get growth from government spending but not long term, and when it goes away there's a jolt, there's a double dip experience. The market comes back then goes down again, a "W" on a Graph. It is a very familiar pattern for other countries. Usually, before an election you spend like crazy, you win; and then you draw your breath in, and have a financial crisis. It's timed perfectly for the new mandate for the new administration. It ruins the civic quality of our society to jolt consumers like that, to jerk them around and change expectations.

Not enough fair playing ground has been left for the private sector to play in, notwithstanding certain components in the stimulus bill. That is, if you want to start a business today in the United States, you don't know what's going to happen to the dollar. First there's going to be deflation, probably, then inflation. You don't know what laws are going to affect what banks. Whether the shareholders in banks will lose, or whether some of the bondholders or some of the depositors will lose, not in terms of losing their deposits, but through inflation. There is a lot of uncertainty and, therefore, a young person will not start a business. He will opt to go to business school or he will withhold his talent from the marketplace for a certain period of time and then we will forgo growth.

The Journal: So given all this government intervention, do you feel that we are facing a temporary shift towards more government control or is this a continuation of a long-term trend with more government involvement and this time, more so in our capital markets?

Shlaes: I think it's more than temporary, but I also do not believe that we're on the road to serfdom. If you go back and look at the famous Hayek book titled, *The Road to Serfdom*, he said we were headed straight to socialism, and we weren't. We were headed to state capitalism—sometimes more market-oriented, sometimes more state-oriented.

You can have some faith that the US perhaps won't even become like Europe because of migration. So many people come here with expectations of hope that America belongs to the immigrant because they're the ones who drive it, to a greater extent than most people born here will acknowledge, and they want that opportunity. They're a self-selected opportunity-oriented group. I have faith that the US will see very quickly that when we're not relatively competitive our standard of living is curtailed and will, therefore, also adjust.

The Journal: Is it fair, though, to be concerned with the fact that the government encroaches too much, or grows too much? Or does it create its own impetus that it cannot stop?

Shlaes: There is such a thing as re-privatizing banks. They've done it in a lot of crises. So, even if the banks are nationalized this spring, they've been re-privatized in history, in other countries especially.

Look at federal spending as a share of GDP, for example. Right now a lot of us are talking about how much Roosevelt spent and what a big spending it was and what an event it was, and it wasn't. Look at where government spending as a share of the economy was, it was like nine percent, Roosevelt got up to ten percent maybe. Comparatively, even at rest, Reagan and Bush, were at eighteen, nineteen, and twenty percent. We all assume that the size of the federal government is basically going to stay at eighteen, nineteen, and twenty percent. Well, I think that's going to be adjusted this year. Especially with the denominator in the equation being smaller than expected, that being GDP. The government spending will look bigger as a share of the economy because the economy's going to be smaller than we thought it would be.

The Journal: Last October, at the initial outset of the financial crisis, economist Anders Aslund noted, in response to widespread comparisons of the present crisis to that of the Great Depression, that times are much different. First, he pointed out that the financial system is deeper and more sophisticated than it ever was before. Second, never before has the world witnessed a truly global bubble. Third, the 1920s had neither television nor the internet. Today information is disseminated in seconds, which can damage nerves and harm the quality of decisions. Acknowledging these crucial differences, to what extent can we look to history for the answers to our present crisis?

Shlaes: Dr. Aslund is surely wise on all those points. History doesn't always repeat itself, but as they say, sometimes it rhymes. We don't have to look just to US history and the hyperbole of the Great Depression as an analogy. A softer analogy and more precise analogy is Japan in the 90s.

The most important takeaway from the Great Depression is not that spending is underproductive. The administration did not even spend much by postwar standards. The most important lesson from the Great Depression is that macroeconomics has its limits. One thing about macroeconomics whether monetarist economics or Keynesian economics is that it is run from the top by men, or ladies sometimes, somewhere who are adjusting data on a page and not really always aware of the consequences at the bottom. They're not thinking micro from the point of view of the firm; they're thinking macro from the point of view of aggregates and the government. Macroeconomics responds well to experimentation because it likes to experiment. Let's fiddle with this and see if we can get it just right. Fiddle with dials; that is the image. That is really what the 30s were about, running the economy—or trying to learn to run the economy—from the top.

Macroeconomics ignores the cost of uncertainty because macroeconomists like to fiddle and they think; "If I just get it right it's going to be optimal money supplied, fiscal stimulus, then the machine will hum fine."

Microeconomics says the firm is experiencing all this with imperfect information. It doesn't know what the future brings, what the government is going to do, and it doesn't like uncertainty. So in the New Deal we learned of Roosevelt's famous phrase—he sought bold, persistent experimentation. The economy is not going to recover on its own; somebody has to do something now.

Therefore we need to find our way, and if we are going to experiment and not get it right the first time, well, that's US pragmatism. Maybe we'll get it right the second time. Again, it is this sort of faith in the fiddling process, like an engineer who is trying to calibrate. From lower levels it was horrible because businesses never knew what to expect. One minute the government would say bigger government, the next minute it would be cutting the budget; that's what FDR liked to do. He had a very strong budget hawk component of his personality. Some years he really wanted to spend and others he didn't; he wasn't really sure about the economics and his way of dealing with that was retreating to pragmaticism as a justification for inconsistency.

What we see now in this crisis is the treasury saying "Give us license and we'll experiment." I don't think President Obama repeated the FDR phrase—bold, persistent experimentation—but he did offer similar phrases, like swift action and he is always giving himself license to do something else. From his point of view, that makes sense because no one really knows how to fix this mess; we all have our ideas, so he wants to reserve that license. But from the point of view of a business it is annihilating to hear Washington uncertain, and that itself retards recovery because you really don't know what to expect. The phrase that FDR used when he was angry at business for doing this was capital strike, and you see the beginnings of a capital strike now.

A recalcitrant consumer doesn't want to spend. The consumer is evaluating the situation differently. Oh, worse things can happen than I thought; therefore I'll save another increment. You saw that under Gerald Ford too. He wanted the market to cooperate with him and he had a program: Whip inflation now. He thought if you wore buttons to fight inflation somehow consumers would go along. The consumer and the producer do best when they have their own head, when they're not told what to do. That is a big similarity and one that is always overlooked. You won't hear from the new administration that we are afraid of making the market too uncertain, at least not sufficiently.

The Journal: At this point, what is the Obama Administration missing with regards to restoring confidence in the market?

Shlaes: I wouldn't say they're missing. I wouldn't criticize them. It's the beginning, no one knows. But there are different kinds of confidence. There is consumer confidence to want to spend which is what the Keynesian school emphasizes. But there is confidence to want to invest which is much more important and sometimes doesn't come from spending programs. Nowadays some of us are looking for a meter for that. I recommend the University of Chicago Booth School/ Northwestern Kellogg Financial Trust Index. It talks to Households, but not as shoppers, it talks to them as producers.

What is the true patter of people's behavior? Here the University of Chicago is valuable as well. Milton Friedman taught that when you, a citizen, hear of a spending program, you think of the high interest rates that will follow it and therefore maybe you don't want to invest, or you won't invest. That kind of confidence is of concern as well. Again, the confidence that you are operating in a relatively certain environment even if you don't approve of it is being insufficiently regarded in the current political culture.

The Journal: In terms of the bailout, what type of long-term message are we sending to the American people and to the world? How serious is the potential for a moral hazard or is it already here?

Shlaes: Oh, it's already here. Moral hazard is a weird expression. It just means your providing incentive for counterproductive behavior. It says you're disassociating someone's action from his responsibility.

Moral hazard was created with Fannie and Freddie by saying they were supposed to be private companies responsible for themselves but actually they had government backup. To the Chinese bond buyer, clearly the government backup was real because they priced US Fannie bonds or stocks very close to what they priced federal treasuries or other securities. They didn't price them like some riskier commercial bonds because they knew the government was standing in the background. So that was the original moral hazard that triggered this crisis. Now there's more moral hazard because we are teaching people that ownership of a home is an entitlement, and it isn't. You hope everyone can own a home, but they're not entitled to be bailed out if they can't meet their mortgage.

Rick Santelli, a CNBC correspondent for the commodities floor in Chicago, pointed out that those who paid their mortgages are now going to pay higher taxes in order to subsidize those who didn't pay their mortgages. And then we all feel bad that people didn't pay the mortgages, nonetheless some of us forewent outlays in order to meet our mortgages, or the salaries of our staffs if we had business. We didn't do stuff we wanted to do and now we will pay higher taxes and therefore, be able to employ fewer people, as households and as individuals, in order to pay for people who took risks that were inappropriate, thereby encouraging their behavior and discouraging thrift at a time when we should be encouraging it. The limits or inefficiencies of the banks went unacknowledged because nobody wanted to admit how little the banks were actually worth and how illogical their structures were, and how big their principal-agent problems were, and therefore their downturn was much longer.

The Journal: So are we all Keynesians now?

Shlaes: No. At least not forever. Even Keynes was not always a Keynesian. Keynes himself was a great man of many ideas. As we know, he criticized Roosevelt. He told Roosevelt it was wrong, for example, to think that businessmen were any worse than government officials. He told Roosevelt that it was wrong to persecute certain industries for political purposes of the industries and utilities. Keynesianism, as practiced, has some good aspects. It is an interesting and important philosophy that has influenced us a lot, but it is also just window dressing for pork. It legitimizes government spending. In that sense it's not productive. As Anders Aslund said: "We're very different people now than we were in the 30s." We watch the internet; we read books; we see movies.

Keynesians are dominating the politics right now because Keynesianism is convenient for politics. It suits the mood and it suits the temper of the crisis. But in the economic culture, Keynesianism is being challenged as it hasn't been in other decades either by neoclassical economists or by a very important school of thought called public choice economists. Public choice theory says government and the private sector are locked in a power struggle. The leading public choicers are at George Mason University and that econ department is moving up the ranks fast. Their explanation of the current situation would be the government wants to grow so it's using the occasion of the crisis to grow. That fits in very well as an explanation for Rahm Emanuel's statement to the effect that a crisis is a terrible thing to waste. Emanuel gave the public choicers teaching material enough for years with that statement.