NINE Economic Policy Disasters and What We Can Learn From Them

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For Ruth, with love

Du, meine Freundin, mein Zuhaus,
Mein Weg zurück, mein Blick voraus,
Mein Jetzt, mein Damals, mein Inzwischen.
Mein Aufbruch, meine Wiederkehr,
Du, mein Wohin und mein Woher…

Reinhard Mey

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The problem with any ideology is it gives the answer before you look at the evidence. So you have to mold the evidence to get the answer that you've already decided that you've got to have. It doesn't work that way.

BILL CLINTON, *September 20, 2012*

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PREFACE

This book is about failure. Specifically, it is about economic policy mistakes which, combined with bad luck, led to some pretty awful outcomes: a lost decade that humbled an economic superpower; an economic depression that was the worst the industrialized world has ever seen; and a devastating famine that led to emigration, misery, and death. Not exactly a tour through history's lighter moments.

Given the depressing subject matter, a reader might conclude that the author is obsessed with bad choices and bad luck—in short, failure. Nothing could be further from the truth. While writing this book, colleagues, friends, and family have served as a constant reminder of the very good fortune that I enjoy every day. I am grateful to Jorge Arroyo, Teo Dagi, Barry Eichengreen, Jeff Frieden, Ruth Grossman, Tim Guinnane, Masami Imai, and several anonymous referees for their helpful comments on the manuscript. They bear no responsibility for the mistakes that no doubt remain.

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I am grateful to my agent, Peter Bernstein, for his wise counsel on many aspects of this book. I thank my editors at Oxford University Press, Terry Vaughn and Scott Parris, for their enthusiasm and patience, and their editorial assistant, Cathryn Vaulman, for insuring that *WRONG* turned out right. I am grateful to copy editor Ginny Faber and production editor Kendra Millis for the care they took with the manuscript, and to Maria Coughlin for creating the index.

Our children Dina, Joshua, Yonatan, and Yael are truly the four best pieces of good fortune in our lives. They are kind, loving, and curious. Being able to watch them grow is life's greatest privilege.

If there is the opposite of a mistake in my life, my wife Ruth is it. Her love and support mean everything: ואת עלית על כלנה

Newton Centre, Massachusetts
April 2013

PROLOGUE

[T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

JOHN MAYNARD KEYNES
The General Theory

In the early hours of September 15, 2008, Lehman Brothers filed for bankruptcy. The 158-year-old company was one of Wall Street's oldest and most distinguished firms—and one of its most important. At the time that it failed, Lehman had more than 25,000 employees around the world and was the fourth-largest investment bank in the United States. With some $600 billion in assets and more than $1 trillion in liabilities, it was America's largest bankruptcy ever.

The failure of Lehman Brothers was a turning point in the subprime crisis. Following Lehman's collapse, virtually every aspect of America's already existing financial and housing market troubles intensified. Stock prices tumbled: the Dow Jones Industrial Average fell by 4.4 percent on the day Lehman filed for bankruptcy; within

six months, stocks had fallen by 40 percent. The failure accelerated the ongoing downturn in the housing market. Mortgage defaults and delinquencies increased dramatically and the value of mortgage-backed securities plummeted in the weeks following the failure. The day after Lehman's bankruptcy, the Federal Reserve opened an $85 billion credit on behalf of insurance giant American International Group (AIG), which had insured a large amount of these mortgage-backed securities, allowing AIG to avoid Lehman's fate. Less than three weeks later, President George W. Bush signed legislation establishing the Troubled Asset Relief Program (TARP), which authorized the Treasury to buy or insure up to $700 billion of these now-toxic mortgage-backed securities in hopes of preventing a full-scale meltdown of the financial system.

The effect on the broader economy was similarly severe. The unemployment rate, which had been just above 6 percent before the Lehman failure, rose continuously during the subsequent months, reaching 10 percent in October 2009. Bank failures and bankruptcy filings continued their upward march. And, six weeks after the Lehman failure, the National Bureau of Economic Research confirmed what everyone already knew by declaring that the US economy was in recession. The disastrous state of the economy in the months following the Lehman collapse led policy makers, journalists, and academics alike to label the crisis "the worst since the Great Depression."

One year and 5000 miles removed from the Lehman disaster, another financial crisis was brewing. Shortly following the country's October 2009 election, Greece's new finance minister announced that the previous government's estimate of the budget deficit—at 6.7 percent of gross domestic product (GDP), already quite large by developed-country standards—had been severely understated. The new estimate was a staggering 12.7 percent of GDP. Some portion of the deficit can be blamed on the economic slowdown that followed the American subprime meltdown; however, a much larger share was due to irresponsible fiscal management. The previous

government had increased spending and reduced tax collections to curry favor with voters in the run-up to elections for the European and then the national parliament, while tax evasion—always popular in Greece—had become even more rampant than usual.

When the magnitude of the country's fiscal problems became widely known, creditors began to doubt Greece's ability to make payments on its dangerously large public debt. Because of these fears, Greece's credit rating was downgraded to the lowest level of any eurozone country. Further, the Greek government found it necessary to pay investors who *were* prepared to buy their debt increasingly high interest rates to compensate them for the now all-too-real possibility that Greece would default. The yield on Greek 10-year bonds, which had been in the 4 percent to 6 percent range throughout 2009, exceeded 10 percent at the end of October 2010, 20 percent in the autumn of 2011, and was briefly above 35 percent in March 2012. By contrast, the yield on 10-year bonds issued by the more fiscally responsible German government rarely topped 3.5 percent, and was frequently much lower, during 2009–2012.

With bankruptcy looming, the Greek government approached other European Union (EU) governments and the International Monetary Fund (IMF) in search of loans to pay off their maturing debt. Because Greece had adopted the euro a decade earlier—which had made it easier for them to borrow from foreigners who might have been nervous about being repaid in Greek drachma—the government did not have the option of printing more money to pay off the debt. The Greeks needed more than 100 million euros—and soon—to stave off default. The EU and the IMF agreed to lend Greece the money, but the loans came with strings. Greece would have to cut government spending dramatically, laying off public sector employees, cutting subsidies, and privatizing state-owned companies. The combined effect of these cuts was an intensification of the economic downturn already underway and an overall contraction of the Greek economy. The unemployment rate exceeded 25 percent by the summer of 2012. The political situation was no more stable.

Parliamentary elections held in May 2012 left no party capable of forming a government, making a second set of elections necessary six weeks later. A consequence of Greece's economic and political instability was that in both elections candidates from a neo-Nazi party—never before successful in a Greek election—found themselves seated in parliament.

Suspicion soon fell upon other highly indebted European countries, notably Ireland, Italy, Portugal, and Spain, later to be joined by Cyprus. As in Greece, the adoption of the euro had made borrowing abroad easier for these countries: prospective lenders had been emboldened to lend since they would be repaid in what was expected would be a relatively stable euro, rather than the shakier Irish pound, Italian lira, Portuguese escudo, or Spanish peseta. Like the United States, Ireland and Spain experienced property booms following 2000. As real estate prices rose, financial institutions extended ever-increasing amounts of credit to finance purchases. When the property booms collapsed, many borrowers found themselves owners of real estate worth only a fraction of what they had paid—and borrowed to pay—for it. Portugal and Italy grew slowly during the decade, but spent money and piled up private and government debt so rapidly that serious doubts emerged about their ability to repay. With no signs of high consumption slowing in Portugal or of Italy reforming its hopelessly inefficient government institutions, investors became nervous about the sustainability of Portuguese and Italian debts and, more importantly, the prospects for repayment.

As the debt problem grew, European leaders and the IMF struggled to find both a consensus and adequate rescue funds. Bailouts were patched together in a series of all-night summit meetings. The global economic slowdown, however, combined with the fiscal austerity prescribed in an effort to cut debt burdens, reduced governments' ability to attack the recession with expansionary fiscal policy. And although membership in the euro had allowed countries easier access to foreign lending, it also prevented them from pursuing

expansionary monetary policy and devaluation as an avenue toward recovery. As of the time of this writing, there is no easy solution to Europe's woes on the horizon, nor any expectation that the continent is likely to return to robust economic growth anytime soon.

The subprime and European sovereign debt crises described above are two of the most difficult economic challenges faced by the industrialized world during the past hundred years. These episodes have several elements in common. They both came about when overindebted economies became unable to service their obligations in the face of declining economic growth. Both crises took off following landmark events—the Lehman failure and revelations about Greek finances—that shook the confidence of the markets. And both crises were due, in large part, to irresponsible actions by governments and the private sector.

Most importantly, both crises were the result of bad economic policy. And not just minor errors in implementing sound economic strategies during the weeks and months leading up to the crises, but seriously deficient economic policies that had been pursued for years. Furthermore, these policy mistakes had a crucial element in common: they were based on ideology rather than sound economic analysis.

What does it mean to say that policy is based on ideology? Ideologically based policy comes about when decision makers grab hold of a key idea and use it as their one and only guide to economic policy. The idea might, in fact, be a good one but perhaps not appropriate under all circumstances. Consider the free market. The second half of the twentieth century provides ample evidence that the free market economies of the West did a far better job of providing consumer goods and services to their publics than the centrally planned economies of the old Soviet bloc. Believing in the superiority of the free market, however, does not mean that the state should never intervene in the market. If there is only one producer of a particular good or service—a monopoly—public

welfare can be improved by government intervention. If consumers do not have access to accurate information about the products they buy, government-mandated labeling can improve economic efficiency. And in highly complex markets with trillions of dollars at stake—such as the derivatives markets that were at the heart of the subprime crisis—a commitment to completely free markets is madness. Thus, a slavish devotion to the idea of "free markets," can take a sensible idea and turn it into a policy nightmare.

It is also possible that the key idea at the center of an ideologically driven policy may have been reasonable at some point in the past, but has outlived its usefulness. For example, price controls and rationing might make sense in time of war to ensure that resources are available for war-related production and that during a period of national emergency wartime stringencies are shared by all sectors of society. During peacetime, however, such restrictive measures will retard economic development. The gold standard, to mention another example, worked well during the late nineteenth and early twentieth centuries but was an unmitigated disaster during the years between the two world wars. Not knowing when to abandon a familiar—even comfortable—conventional wisdom after it has become an outdated policy idea can buy a one-way ticket to economic disaster.

Finally, policy makers' key idea it might be something that isn't sensible at all but makes a good election slogan. The best example of this in recent years is the long line of American politicians who have pledged not to raise taxes. Under any circumstances. Not now. Or ever. Politicians—and economists—certainly can differ over their preferred level of taxation. Some might favor higher taxes so that the government can spend more to provide things like infrastructure and education; others might argue that lower taxes do a better job of encouraging private savings and investment. Both of these are legitimate points of view. However, any politician who signs a pledge—as all but a handful of the Republican members of the 112th Congress did—to oppose tax increases under any and all

circumstances is no longer a serious policy maker, but an ideologue. And ideologues, as we will see throughout this book, are hazardous to our economic health.

Although the fallout from the subprime crisis was unusually severe, its origins were far from unique. In fact, the subprime crisis followed a boom-bust pattern that has been a common feature of financial crises for more than 200 years. Boom-bust crises occur when business cycles—the periodic, normally moderate swings in economic activity—become exaggerated, leading to an excessive economic expansion followed by a dramatic collapse. During the boom phase of the cycle, profit opportunities rise, giving firms and individuals incentives to borrow money to pour into new ventures. After all, if you can invest $100 of your own savings and earn a profit of $50, why shouldn't you borrow $1000 to invest and earn $500? Following a period of heightened investment activity, returns will begin to fall, and firms and individuals may find themselves with debts that exceed the returns from the previously profitable investments. This lands them—and those who loaned them money—in trouble, exacerbating the downturn. This is the bust phase of the cycle.

The economic boom that preceded the subprime crisis was fueled by wrongheaded economic policy, in particular fiscal and monetary expansion. Fiscal expansion came in the form of three tax cuts enacted during the first three years of the administration of President George W Bush. Accepting the nomination for president at the Republican's 2000 convention in Philadelphia, Bush made it clear that the budget surplus built up during the Clinton years should be returned to the people as a matter of principle, saying to enormous applause: "The surplus is not the government's money; the surplus is the people's money." The federal government had run deficits for 30 consecutive years before it achieved a balanced budget in the late 1990s; nonetheless, the notion of maintaining a small government surplus in case of emergency was taboo in Bush's ideology. The fiscal stimulus was further strengthened by increased

government spending on overseas wars in Afghanistan and Iraq. On principle—or, was it for the sake of ideology?—the Administration gave no consideration to repealing any part of the previous tax cuts to pay for these wars.

The second major impetus for the boom came from expansionary monetary policy adopted by Alan Greenspan and his colleagues at the Federal Reserve from 2001 through 2004. Greenspan, an avowedly pro-free-market Republican who had chaired Gerald Ford's Council of Economic Advisors in the 1970s, had encouraged austerity under Democrat Bill Clinton but was an early supporter of Bush's call for tax reduction. Despite standard rule-of-thumb policy models that prescribed monetary tightening, Greenspan maintained expansionary monetary policy for a longer period than was advisable. It is unclear whether this expansionary monetary stance was an attempt to bring down unemployment or to offer a political boost to President Bush in the months before his reelection campaign; nonetheless, monetary policy remained looser than purely economic reasoning would have mandated.

The European sovereign debt crisis was similarly the result of a poorly conceived economic policy choice made for a distinctly ideological reason: the adoption of the euro. The euro came into existence as an accounting unit in 1999 and as currency notes and coins in 2002; however, the drive to establish a single European currency as a way of cementing European unity was much older. Given Europe's long history of warfare, particularly the two world wars, increasing the economic interdependence of European countries was—and is—an appealing prospect. Nonetheless, hardheaded economic analysis indicated that establishing a single currency for countries as diverse as Greece and Germany, Spain and Finland, and Portugal and the Netherlands could pose insurmountable problems. It is difficult to imagine a situation in which identical monetary policies, the only option under a monetary union, would be appropriate for all these countries. Further, in the absence of a single currency, an uncompetitive, highly indebted country such as Greece could have

printed more money and devalued the drachma in order to increase exports and repay its debt with cheaper currency. Because of the overriding ideological goal of European unity, the more pragmatic problems of the single currency were swept under the rug.

This book considers nine of the worst economic policy mistakes of the past 200 years. The results of these mistakes have ranged from appalling to tragic. America's fear of centralized monetary authority caused it to reject two central banks, condemning the United States to three-quarters of a century punctuated by frequent financial crises. Britain's commitment to free markets, rather than to assisting the starving in Ireland, led to one of the nineteenth century's worst humanitarian tragedies, the Irish famine. Britain's re-establishment of the gold standard after World War I, fueled by a desire to recapture its prewar economic and military preeminence, helped to turn what would otherwise have been an ordinary recession into the Great Depression, the most severe economic crisis the industrial world has ever known. And a variety of ideologically based policies resulted in the American subprime crisis and European sovereign debt crisis.

These policy mistakes led to some of the worst economic disasters on record. It would be an oversimplification to say that each and every crisis discussed in the following pages had just one cause, and in each and every case that cause was an ideologically based economic policy. Many factors contributed to the poor policy choices and bad economic outcomes including, on some occasions, bad luck. Nonetheless, in the cases considered in the chapters that follow, the main culprits were policy makers who were guided by ideology rather than economics.

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Chapter 1

Introduction

This is the excellent foppery of the world, that when we are sick in fortune—often the surfeit of our own behavior—we make guilty of our disasters the sun, the moon, and the stars, as if we were villains on necessity, fools by heavenly compulsion, knaves, thieves, and treachers by spherical pre-dominance; drunkards, liars, and adulterers by an enforc'd obedience of planetary influence; and all that we are evil in, by a divine thrusting on.

KING LEAR (I, ii)

This book is about economic policy. Bad economic policy. Really bad economic policy. More than two centuries of it. Specifically, it examines nine of the worst economic policy mistakes made during the last 200 years.

Why write about *bad* economic policy? Surely *good* policy makes more enlightening, not to mention more uplifting, reading. As someone who has made a career out of writing about contemporary and historical financial crises, I am periodically accused by my colleagues of being the economist's answer to an ambulance chaser: a ghoulish soul who profits from the misfortunes of others. I prefer to think of the study of panics, crises, and other economic disasters in therapeutic terms. Hospitals large and small routinely conduct morbidity and mortality conferences in order to understand bad medical and surgical outcomes and to learn from their mistakes. This is something that students of public policy *should* do; however, a survey of the curricula of a half dozen leading American public policy schools suggests that they do not. Another good medical analogy is

pathology, where the profession's motto is variously given as "the living learn from the dead" or "the dead teach the living." Until our policy makers start to carry malpractice insurance that will compensate *us* for *their* mistakes, we need to understand historical policy blunders to avoid repeating them.

A second reason for focusing on policy mistakes is that they may be easier to spot than policy successes. During the past two centuries, the developed countries—the focus of this book—have grown consistently more prosperous: real gross domestic product (the total value of goods and services produced) per capita in these countries—a rough gauge of the average standard of living—has risen in 70 percent to 80 percent of the years for which data are available. Although countries may grow wealthy in the absence of good policy or less wealthy without the detrimental effects of bad policy, given the long-term upward trend in prosperity, the negative effects of bad policy are more likely to stand out than the positive effects of good policy.

Third, bad policy presents an opportunity to examine economic policy making under a microscope. Is bad policy the result of a flawed policy-making process? Does it occur because the political system, including the electorate, fails to weed out poor policy makers and promote good ones? Does it arise from a commitment to an outdated or somehow mistaken economic ideology? Or does it occur when individuals or groups are somehow able steer the policy-making process toward their private interests, which may come at the expense of the public good?

Finally, and here I might admit to being guilty of the ambulance-chaser charge, bad policy is fascinating. Some people slow down to watch accidents on the highway. Other people like to watch fires consume buildings. I immerse myself in the details of past episodes of failed economic policy. Perhaps this is a character flaw. Like someone having a bad dream, as I see the policy unfold I want to intervene: to shout something about lowering tariffs when they are being mistakenly raised; to urge the adoption

of more sensible monetary, fiscal, or regulatory policies when the policy makers are headed in the wrong direction. Of course, just like in a bad dream, I can't affect the outcome because the episodes discussed here have already taken place. But perhaps this morbid fascination with rehashing old policy mistakes will come in handy when we find ourselves in similar situations in the future.

As long as the book focuses on bad policy, why include historical examples of poor economic policy? Surely the modern world provides enough examples of botched economic policy. Consider the recent subprime crisis, skyrocketing costs of education and health care, absence of a coherent energy strategy, and lack of effective environmental policies, just to name a few. Further, since government influence over the economy has become markedly larger in the years since World War II, modern economic policy mistakes must be even more costly—and therefore more worthy of study—than those of earlier eras.

Although several of the chapters that follow *do* focus on more recent episodes of bad policy, this book has an unabashedly historical outlook. There are two reasons for this. First, history provides a valuable perspective. Given enough chronological distance we can make educated judgments about the long-term consequences of a particular mistake in ways we cannot for more recent episodes. For example, it is much harder to discern the long-term consequences of the subprime crisis, which are still unfolding, than those of the financial crisis of 1907. This is not to say that the 1907 crisis is an open book to modern scholars: even today there are aspects of this episode that are not completely understood. Nonetheless, despite the relatively poor quality of the economic data from the early twentieth century, many of the long-term consequences of the crisis—for example, the establishment of the Federal Reserve System—are clear with the benefit of hindsight. At the time of this writing, the long-term consequences of the subprime crisis are still shrouded in mystery and are likely to remain so for some time.

Second, having spent the past 20 years writing and teaching about the economic history of the developed world, I am firmly convinced that there are few economic phenomena—either good or bad—that are wholly new. Take financial crises. The subprime crisis that marked the end of the first decade of the twenty-first century was in many ways a replica of the boom-bust crises that have plagued the developed world for the past two centuries. This pattern was already more than a half-century old over 150 years ago, when the British financial journalist D. Morier Evans observed:

> Within the last sixty years, at comparatively short intervals, the commercial world has been disturbed by a succession of those terrible convulsions that are now but too familiar to every ear by the expressive name "panic." Each separate panic has its own distinctive features, but all have resembled each other in occurring immediately after a period of apparent prosperity, the hollowness of which it has exposed. So uniform is this sequence, that whenever we find ourselves under circumstances that enable the acquisition of rapid fortunes, otherwise than by the road of plodding industry, we may almost be justified in arguing that the time for panic is at hand.

Certainly, the subprime crisis introduced some new elements and terminology, including collateralized debt obligations, credit default swaps, and a whole alphabet soup of derivative securities. These new—and ultimately dangerous—financial instruments had their antecedents in earlier crises as investors were similarly carried away on waves of enthusiasm over assets as diverse as real estate, railroad stocks, agricultural commodities, shares of limited liability companies, and Latin American debt securities. Fundamentally, however, the combination of an overindebted economy with a boom-bust economic cycle was as surely responsible for the subprime crisis as it was for countless others financial crises during the nineteenth and twentieth centuries.

None of the above is meant to suggest that our present—not to mention future—economic ups and down are merely reruns of the past over which policy makers have no control. Although current economic developments frequently resemble those of earlier eras, the predictive power of history is dubious at best. Nobel laureate Paul Samuelson famously derided the usefulness of stock prices as a tool for economic forecasting by saying that they have "correctly predicted nine out of the last five recessions." Each generation of policy makers confronts its own problems and has an opportunity to make policy anew. There are no forces—sinister or otherwise—that force us to repeat the same mistakes. Nonetheless, policy makers are often faced with dilemmas similar to those of their predecessors: weighing the benefits of international economic cooperation against domestic demands for more isolationist policies; balancing the benefits of tighter regulation to protect consumers with those of a looser regulatory stance that might benefit business and promote economic growth. And the incentives guiding the choices faced by policy makers today are frequently similar to those that faced their predecessors. Mark Twain's observation "History doesn't repeat itself, but it does rhyme" is particularly apt in this context.

The central conclusion of this book is that economic policy should be based on cold, hard economic analysis, rather than a commitment to a particular ideology. Ideologies become entrenched among policy makers for a variety of reasons. Sometimes it is the result of long-established practice combined with old-fashioned laziness. If it has "always been done this way," policy makers may be disinclined to go out on a limb to challenge conventional wisdom. Even if a particular ideology has served the public well, changing circumstances may render the old ways of doing business obsolete. Other times, ideologically based policy is implemented because policy makers—and perhaps the public that directly or indirectly chooses them—are true believers with an unwavering devotion to a particular idea. The episodes discussed here demonstrate that economic policy should never be subservient to ideology.