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We're Not Headed for a Depression

No, this isn't the crisis that kills global capitalism.

By GARY S. BECKER

In order to promote a much smoother functioning of the financial system, it is paramount to distinguish between the immediate steps needed to cope with the present crisis and the long-run reforms needed to reduce the likelihood of future crises. Let's start with the short-run fixes.

First of all, the magnitude of this financial disturbance should be placed in perspective. Although it is the most severe financial crisis since the Great Depression of the 1930s, it is a far smaller crisis, especially in terms of the effects on output and employment. The United States had about 25% unemployment during most of the decade from 1931 until 1941, and sharp falls in GDP. Other countries experienced economic difficulties of a similar magnitude. So far, American GDP has not yet fallen, and unemployment has reached only a little over 6%. Both figures are likely to get quite a bit worse, but they will nowhere approach those of the 1930s.

The Treasury's announced insurance of all money-market funds, and the full insurance of bank deposits, carry considerable moral hazard risks, but they have not aroused much controversy. The main thrust of the new banking law allows the Treasury secretary to purchase bank assets up to $700 billion in order to increase the liquidity of the banking system. These assets are of uncertain worth since there is essentially no market for many of them, and hence they have no market price. The government hopes to create this market partly through using auctions, where banks would offer their assets at particular prices, and the government would decide whether to buy them. I would have preferred starting with a smaller dollar value of purchases, and up the amount if the situation deteriorates further.

Partly because many consumers are repelled by the intention to bail out companies and their executives who made decisions that got the companies into trouble, the new law includes income and severance pay limits for executives whose firms seek government help. Even though one cannot think much of executives who led their banks into such a mess, that is a bad precedent since it involves too much micromanagement of bank operations. Moreover, such salary controls can be evaded by very generous fringe benefits.

The moral-hazard consequences for banks receiving a bailout now is worrisome since they may expect to get rescued again by the government if their future investments turn sour. Yet while I find helping these banks highly distasteful, moral-hazard concerns should be temporarily relaxed when the whole short-term credit system is close to collapse. Still, the bank bill with its huge bailout does suggest that the $29 billion bailout of the bondholders of Bear Stearns in March was a mistake. It seemed to have a moral-hazard effect by encouraging Lehman Brothers and other investment banks to delay in raising more capital because they too might have expected the government to come to their rescue if times got much worse. Although the government was apparently concerned that foreign central banks were major holders of the bonds, it was unwise to give them and other bondholders such full protection.

One troubling provision is that the government can take an equity stake in banks it helps. Some economists have proposed a similar role for government equity in these banks. I believe it is unwise to give governments equity in private companies, even if the government does not have voting rights in company policies. Many examples in recent history, such as the current Alitalia fiasco, show that political interests outweigh economic ones when governments have some ownership of private companies. This is likely to happen in this bailout if some banks that are helped decide to sharply cut employment in the districts of some congressmen, or to transfer many jobs overseas.

Taxpayers may be stuck with hundreds of billions of dollars of losses from the various government insurance provisions and government purchases of assets. Although the media has made much of this possibility through headlines like "$700 Billion Bailout," such large losses are highly unlikely except in the low probability event that the economy falls into a sustained major depression. Indeed, with efficient auctions, the government may well make money on its actions, just as the Resolution Trust Corporation that took over many savings-and-loan banks during the 1980s crisis did not lose much, if any, money. By buying assets when they are depressed and waiting out the crisis, the government may have a profit on these assets when they are finally sold back to the private sector. Making money does not mean the government involvement is wise, but the likely losses to taxpayers are being greatly exaggerated.

The temporary banning of short sales is an example of a perennial approach to difficulties in financial markets and elsewhere; namely, "shoot the messenger." Short sales did not cause the crisis, but reflect beliefs about how long the slide will continue. Trying to prevent these beliefs from being expressed suppresses useful information, and also creates serious problems for many hedge funds that use short sales to hedge other risks. Their ban can also cause greater panic in other markets.

The main problem with the modern financial system based on widespread use of derivatives and securitization is that while financial specialists understand how individual assets function, even they have limited understanding of the aggregate risks created by the system. That is, insufficient appreciation of how the whole incredibly complex financial system operates when exposed to various types of

stress. In light of such limitations, it is difficult to propose long-term reforms. Still, a few reforms seem reasonably likely to reduce the probability of future financial crises.

- *Increase capital requirements.* The capital requirements of banks relative to assets should be increased after the crisis is over in order to prevent the highly leveraged ratios of assets to capital in financial institutions during the past several years. Possibly a minimum ratio of capital to assets should be imposed by the Fed on investment banks and money funds. As much as possible, the measure of capital should not be its book value but its market value, such as the market value of publicly traded shares of banks. Book value measures, for example, apparently badly missed the plight of Japanese banks during their decade-long banking crisis of the 1990s.

- *Sell Freddie and Fannie.* The government should as quickly as possible sell Freddie Mac and Fannie Mae to fully private companies that receive no government insurance or other help. These two giants did not cause the housing mess, but in recent years they surely greatly contributed to it, partly through congressional pressure on them to increase their purchases of subprime loans. They have owned or guaranteed almost half of the $12 trillion in outstanding mortgages while having a small capital base. The housing market already has excessive amounts of government subsidies, such as from the tax exemption of interest on mortgages, and should not have government sponsored enterprises that insure mortgage-backed securities.

- *No more bailouts.* The "too big to fail" approach to banks and other companies should be abandoned as new long-term financial policies are developed. Such an approach is inconsistent with a free-market economy. It also has caused dubious company bailouts in the past, such as the large government loan years ago to Chrysler, a company that remained weak and should have been allowed to go into bankruptcy. All the American auto companies have asked for and received handouts too since they cannot compete against Japanese, Korean and German car makers, partly because these American companies have been incredibly badly managed. A "too many institutions in trouble to fail principle," as in the present financial crisis, may still be necessary on rare occasions, but failure of badly run large financial and other companies is healthy and indeed necessary for the survival of a robust free-enterprise competitive system.

Is this a final "Crisis of Global Capitalism" -- to borrow the title of a book by George Soros written shortly after the Asian financial crisis of 1997-98? The crisis that kills capitalism has been said to happen during every major recession and financial crisis ever since Karl Marx prophesized the collapse of capitalism in the middle of the 19th century. Although I admit to having greatly underestimated the severity of the current crisis, I am confident that sizable world economic growth will resume before very long under a mainly capitalist world economy.

Consider, for example, that in the decade after various predictions of the collapse of global capitalism following the Asian crisis, both world GDP and world trade

experienced unprecedented growth thanks to the power of market competition on a global scale. The South Korean economy, for example, was pummeled during that crisis, but has had significant economic growth since. World economic growth will recover once we are over the present severe financial difficulties.

Mr. Becker, the 1992 Nobel economics laureate, is professor of economics at the University of Chicago and senior fellow at the Hoover Institution. Portions of this article first appeared on his Web site.

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