American Enterprise Institute for Public Policy Research

The Lesson From the Crisis: Regulations Are Worthless

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Posted: Wednesday, January 28, 2009

ARTICLES
Wirtschaftswoche (Germany)
Publication Date: January 18, 2009

Is free-market capitalism to blame for today's economic crisis? Despite well-documented empirical evidence of the relationship between economic freedom and growth, many believe unrestrained capitalism is the cause of recent turmoil in the global economy. A more accurate story, however, is that excessive government regulation, not free-market capitalism, is responsible for aggravating the current economic contraction.

In German


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If we gathered together a random sample of the world's citizens a year ago, and asked them to characterize the core principles of a successful society, then "free market capitalism" would surely have received nearly unanimous support. A country should, the consensus was, strive to place its wealth in private hands, and allow private individuals to transact among themselves with as little influence from government as possible. Such an organization would, the story went, provide the maximum welfare to a nation's citizens.

One could hardly blame individuals for responding in that way. Over the past twenty years, capitalism spread to every corner of the globe, even to former communist nations such as China and Russia. With it came prosperity. Moreover, the countries that bet the most on capitalism, like the United States, radically outperformed nations that hedged their bets and erected elaborate government constraints on free markets.

The previous consensus emerged because of the personal experience of billions of citizens that has been widely documented in a large empirical literature. There has been a striking positive relationship between economic freedom and economic growth. A 2000 report by Harvard University economist Robert Barro found that property rights and free markets were the most important institutional elements for promoting economic growth. Similarly, the Fraser Institute's annual *Economic Freedom of the World Report* has documented numerous times that the free-market recipe of competition, entrepreneurship and investment activity is crucial for fostering long-term economic growth.

The case seemed closed. Yet today, if one were to gather the same individuals, their answers would be fundamentally different. The global economy is in free fall, and some of the most "free", like Iceland, have been hit the hardest.

When people trust that the government will protect them and it fails to, disaster strikes. But failure is what government is best at. Protect yourself.

We are at a turning point where the world's citizens are fundamentally reassessing their commitment to capitalism.

When projecting where the debate will end up, it is important to note at the outset that this is not the first time that we have reached this crossroads.

The idea that free market capitalism is the best organizing principle for a civilization is an old one, dating back at least to Adam Smith's *Wealth of Nations*, which was published in 1776. The idea that capitalism has shortcomings is just as old as capitalism itself. Critics from the early Mercantilists to Marx and Keynes have exposed capitalism's weaknesses, and offered alternatives.

No creation of man, even capitalism, is perfect and immune to revision. History fluctuates. When times are good, men take great satisfaction in their creations, perhaps giving themselves too much credit for their good fortune. And when times are bad, there is a tendency to look back to the academy and give new authority to critics that warned that our creations were always bound to fail.

The history of capitalism is one of ebbs and flows. When capitalist economies boom, its critics are quiet, or at least ignored. But when capitalist economies experience collapse, as is sadly the case today, then introspection and criticism can even lead to revolution.

But throughout the trials, capitalism survived because it significantly outperformed any alternative. Revolutions have the most force when a sufficient mass of revolutionaries becomes convinced that some alternative structure is superior. In the current episode, the case for a radical reduction in our commitment to freedom and private action would require evidence that the current crisis was caused by excessive freedom, but also, and more crucially, evidence that something else works better.

It seems enormously unlikely that that such evidence will be found.

In terms of the causes of the crisis, financial market historians will certainly cite the U.S. real estate market as the spark that ignited the conflagration. But the distinguishing characteristic of that market is not wild-eyed freedom, but rather, excessive government intervention.

This is clearly demonstrated by the recent catastrophic failures of Fannie Mae and Freddie Mac, which precipitated the wide-spread instability in the financial markets. In 1992, the government-sponsored enterprises were given the mission of expanding "affordable housing." In order to fulfill strict regulations imposed by the Department of Housing and Urban Development (HUD), Fannie and Freddie purchased and guaranteed large numbers of subprime and other nontraditional loans and eventually became the primary customers of AAA-rated subprime-mortgage pools.

Although the enormous risk created within the financial system did not go unnoticed, there was little political will at the time to eliminate the hazard. Indeed, one of the world's most famous capitalist saw the dangers very early on. In 2005, Alan Greenspan warned that if Fannie and Freddie "continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, they potentially create ever-growing potential systemic risk down the road." Further, Greenspan asserted, "we are placing the total financial system of the future at a substantial risk."

In 2005, legislation was proposed which would have reformed the entities and eliminated their investments in risky assets. The legislation failed, however, because of the obstruction of Democrats such as Christopher Dodd and Barney Frank, who received massive political contributions from Fannie and Freddie.

If markets had been left to themselves, then the dodgy loans that brought down our financial system would never have been made.

This leaves open the question why the toxic assets spread so rapidly to the willing buyers throughout the world. The simplest explanation is that the poison received the U.S. government's seal of approval, and too many trusted that seal.

The next piece of evidence that an opponent of free market capitalism would have to deliver in order to win new adherents is documentation that countries that were more skeptical of capitalism, and fettered it accordingly, were able to avoid the crisis, or at least suffered less than the capitalist swashbucklers.

Recent data on economic performance across countries suggests the opposite. Although no country has escaped recent economic turmoil unscathed, an international comparison of stock market performances over the last year that I recently published in the National Review shows that countries that were economically free (like Canada), while still suffering downturns, have fared much better on average than more regulated economies, (like the Netherlands).

There is no model one can point to that worked. No regulator on earth was ahead of the curve on this crisis.

Indeed, if we have learned anything it is that regulation was worthless. Like the failed communist planners before them, government regulators were fundamentally unable to deliver on their promises. So why should we expect them to do better next time?

Regulators likely failed because, as was long ago argued by University of Chicago economist George Stigler, they become captives of the firms they were supposed to regulate.

Having corrupt police is worse than having no police at all. When people trust that the government will protect them and it fails to, disaster strikes. But failure is what government is best at. Protect yourself.

All of which makes it hard to see how the current crisis could go down in history as providing evidence of the inadequacy of capitalism. A corrupt government body doled out an excessive amount of loans, building a house of cards that eventually collapsed catastrophically. When the collapse came, no amount of regulation provided immunity to the repercussions. Those who put the most faith in government, suffered the worst.

In the end, those with the brightest future will leave this crisis where they began it: committed capitalists.

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