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Lessons from Crises Past

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STANFORD – The unprecedented shutdown of much of the US economy that has been ordered by federal, state, and local governments is understandable given the need to slow the coronavirus's spread. Too often, however, well-intentioned and often long-lasting government interventions prevent markets from working properly and thus do more harm than good. Even in times of crisis, markets solve problems well, because they provide the right incentives to use resources effectively.
Policymakers dealing with the COVID-19 pandemic should therefore do everything possible to keep markets functioning and private incentives strong. And history can serve as a useful guide in this regard.

For starters, government should impose minimal restrictions on firms and employees when harnessing the private sector for temporary emergency purposes – whether producing tanks in World War II or ventilators now. Extraneous or overly aggressive government policies often hinder both recovery and the economy's long-run health. Indeed, in most cases (with some sensible exceptions), less regulation is a good prescription for economic success. Today, for example, why not relax occupational licensing requirements for retired doctors and nurses to help relieve pressure on overwhelmed hospitals?

Preserving individual responsibility is also crucial. Frequent government interventions in major labor disputes during the administrations of Presidents John F. Kennedy and Lyndon B. Johnson always ended up with a settlement in the White House. That destroyed private bargaining, because executives and unions didn't make their best offers until they got to Washington. But when President Richard Nixon was faced with a longshoremen's strike in 1969, he let the parties know that they had to take responsibility and settle the matter themselves; once that message registered, they did.

Next, policymakers should not intervene in pricing. Having inherited inflationary pressures throughout the economy, the Nixon administration eventually introduced mandatory wage and price controls in 1971, with broad bipartisan support. Although these measures initially seemed to work, they wound up harming the economy. By contrast, President Ronald Reagan went back to tried-and-true macroeconomic policies, lifted the regulatory burden,

and swiftly reduced tax rates – all of which worked where earlier government intervention hadn't.

Another guiding principle is to let markets adjust. In the summer of 1971, US deficit spending and domestic inflation caused the dollar to become overvalued, triggering a run on Fort Knox as European countries began redeeming their currencies at the fixed rate for gold. Nixon then closed the gold window and began a move toward a global system of flexible exchange rates.
After an initial fight to defend this new regime, it ended up working well. As Milton Friedman later explained: "Suppose we had continued with the system of fixed exchange rates […] When the [1973] Arab-Israeli war broke out, and when the oil embargo came on, there would have been a major international financial crisis […] None of that happened. Why not? Because there was a free price system operating."

Similarly, policymakers should not let public magnanimity displace private markets. Shortly after the Berlin Wall fell, the Soviet Union's leader, Mikhail Gorbachev, was in political trouble because his country's economy was imploding. In order not to "lose Russia," world leaders urged the United States to lead a huge bailout, including the delivery of a large quantity of US government surplus wheat. But that would have destroyed Soviet agriculture, which had been partly freed from planners' controls. Instead, President George H.W. Bush's administration minimized its assistance, and the crisis was solved by markets.

More governments need to appreciate that open markets improve economic outcomes. When Iraqi President Saddam Hussein invaded Kuwait in 1990, oil prices spiked to the equivalent of about $200 per barrel today. The two deepest US recessions since World War II had followed similar dramatic oil-price increases, caused by the Arab oil embargo and Iran's Islamic Revolution. Indeed, one proposal was to shut down the oil futures market. But after intense debate, cooler heads prevailed, and markets remained open.

Today's market interventions will need to be unwound. Sometimes, a government must act to prevent previous desirable government actions from being abused and threatening the functioning of a vital market.

Such was the case when the US government resolved the Savings and Loan (S&L) debacle in the early 1990s. The combination of federal deposit insurance and pension pass-through to it had enabled many insolvent S&L institutions to stay open, taking greater investment risks while paying ever higher interest rates on deposits to keep the money flowing in. That was threatening solvent financial institutions' lifeblood, so rapidly taking over many insolvent S&Ls, while unpopular, limited the ultimate damage.

Governments must take care to intervene properly. In the aftermath of the September 11, 2001, terrorist attacks, President George W. Bush's administration worked to keep markets

open. The immediate task was to cut off al-Qaeda's financing without disrupting global financial flows needed for economic growth. The strategy proved successful: The economy did not tank, and the 9/11 Commission later awarded the administration's economic-policy response its only "A" grade.

Finally, policymakers must focus on economic impact. During the 2008 global financial crisis, Congress passed a temporary "stimulus" package of tax rebates, while a bailout mentality had started earlier that year with the rescue of Bear Stearns. But people largely saved the rebates, and the economy continued to sink. During the COVID-19 pandemic, therefore, US taxpayers must be encouraged to spend their temporary cash payments from the federal government – including in parts of the economy that are still operating and may grow in the future, such as online sales and remote work.

Looking beyond today's public-health imperatives, the US must develop an economic strategy that does not override markets. Effective implementation of such policies will require continuous interaction between government and private-sector actors, lest bureaucratic inertia and needless red tape slow things down. That has been the main lesson of many crises over time: Keep markets open and private incentives strong.

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