

Obama Worse than Bush

(translated from Polish by Irena Czernichowska)

Is it a lack of government control over the economy that caused the catastrophe? No, it is government interventions that caused, prolonged, and deepened this crisis. Marcin Bosacki speaks with John B. Taylor, the economist, an adviser to U.S. presidents Ford, Bush senior, and junior.

John Taylor is an adviser to California Governor Arnold Schwarzenegger, and his new book is entitled *Getting off Track*. What has gotten off track? The rules of free market, which consequently resulted in the still ongoing crisis. Anna Schwartz, a co-author of books by the economist Milton Friedman, wrote that “if a similar book had been published in 1930, the Great Depression would not have happened.”

The latest crisis has renewed the debate in the United States: how much state intervention in the economy should there be?

Who is right? Those who say—roughly—that the state should leave the markets to themselves? Or perhaps those who claim—also simplifying—that capitalism leads to disaster if not guarded, or even led by the state?

The war between these two views has been lasting in the U.S. for decades. Supporters of free markets, my interviewee among them, refer to the views of Friedrich von Hayek and Milton Friedman. Supporters of intervention regard John Keynes as their master for his concept of an active state, adopted by Franklin D. Roosevelt during the crisis in the 1930s.

From the time of Ronald Reagan, American politics and science have been dominated by the supporters of free markets. Taylor himself was an adviser to presidents Gerald Ford and George Bush senior. During the first term of George Bush junior (2001–2005), he was even Undersecretary (Deputy Minister) of the Treasury for International Affairs.

After the outbreak of the crisis, Keynesians set off with the attack. The cover of the weekly magazine *Newsweek* proclaimed “We are all socialists.” University of California professor Christina Romer wrote in her analysis that the lack of market regulations was a cause of the crisis. Today she is the head of the Council of Economic Advisers to President Barack Obama. Paul Krugman, last year’s Nobel economic laureate, quickly wrote a book called *The Return of Depression Economics and the Crisis of 2008*.

In the last month, however, free market supporters set off with a counterattack. Back in January, the analysis by Krugman was at the top of the Amazon.com list, but last week two new books hit the top. The first one is *Meltdown: A Free-Market Look at Why the Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse* by Thomas Woods. The second book is the work of my interlocutor. Its

full title is *Getting off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*.

Free market supporters attacked Krugman for using his Nobel as a political attack on George Bush. Now the left accuses Woods and Taylor of defending politically discredited ideas that inspired the former president.

But in the book and in my interview with its author, Taylor defends not just Bush but the free market principles themselves. Is he successful? Please judge for yourself.

High Objectives and Inflated Bubble

Marcin Bosacki: A general impression is that the world's crisis was caused by greedy and stupid capitalists and the lack of supervision by the state. You have a different opinion. Why?

John B. Taylor: We should take the matter calmly and scientifically. I did so in my book and I am convinced that this crisis is caused, deepened, and now extended by the state's bad, chaotic, and ill-thought actions.

You mean the U.S. government?

-Not only, also governments of other countries, including in Europe.

Factors such as human greed and a desire to profit quickly with minimal expense are permanent in human and world nature. They always existed. So how is the present situation different? By state intervention.

So what exactly caused the current crisis?

-The bubble of mortgage loans—that is now well known. But where did it come from? Well, because the state moved from the principles of sound monetary policy, which worked for the previous 20 years.

In 1992, I proposed a rule by which central banks should develop short-term interest rates to maintain stable economic growth [in short: if inflation rises by 1 percent, bank should raise rates by nearly 1.5 percent. If the GDP falls by 1 percent, rates should be reduced by 0.5 percent]. I formulated this policy, based on studies of different historical periods, including the 80s in the U.S., where such policy was carried with success.

The prestigious weekly magazine *The Economist* called it Taylor's rule.

-The basic principles were applied by the U.S. Central Bank and many other banks over the next ten years. But in 2002 it stopped. The Federal Reserve's board continued to lower the rate from an already low level of 1.75. And it should have raised it. Until the years 2003 and 2004 the rate declined to 1 percent. As a result, for four years, until the end of 2005, rates were abnormally low. This of course reduced credit costs much too drastically and caused a boom in the housing market. An artificial boom. And when the

boom is artificially exacerbated, then the fall must be even more severe. Because the proportion of people who are unable to repay loans, over time, becomes dangerously high.

Is this cycle—boom, followed by a crisis—normal in capitalism?

-Only to some degree. You can reduce the waves so that the boom phases don't become abnormally long and the moments of collapse not too severe. As it was from the early 1980s up to the last big boom.

Previously there was, for example, the Internet boom at the end of the 90s.

-But it was not as artificially expanded. The Internet bubble and its effects were limited by a correct interest rates policy. That is why the recession, which occurred afterwards, was moderate and did not last more than a year. There are economists who call those 20 years the Great Moderation. Unfortunately, at that time, both the authorities and ordinary people have forgotten risk, to a certain degree. Today, we are paying a stiff price.

After September 11, 2001, the Fed wanted to prevent the risk of deflation by lowering interest rates. The government supported that, because it wanted as many people as possible to own a house. A high-minded objective, but they went too far. Everyone can now see the outcome.

How the government strengthened the disease

What in your opinion prolonged the crisis?

-Government reactions—both the U.S. government and the central bank. After the crisis' first signs in the first half of 2007 the cause of the problem was badly diagnosed. It was thought that there was too little capital on the market and that financial liquidity was the problem. In December of 2007, the Fed facilitated banks' access to money. Two months later, the Bush administration pushed through Congress its first stimulus package—tax rebates sent to Americans in the form of checks. Well over 100 billion dollars! Those funds were to stimulate the economy. And? And nothing!

Why?

-Because the problem didn't lie in liquidity but in the fact that the financial institutions didn't trust each other. Because there were already too many bad lending assets, infected by unpaid credits. But, unfortunately, government institutions didn't face the problem of infected assets.

In addition, in the fall of 2007, the policy of too low interest rates was implemented again. The cuts were necessary, but not in such panicked fashion [from September 2007 to October 2008 the basic rate fell from 5.25 percent to again 1 percent]. We were still in the stage of a mild recession, so there was no reason for such rapid cuts. But they were made. They caused a sharp decline of the dollar. This, in turn, led to a big increase in oil prices, which in the first half of 2008 by far deepened and accelerated the recession.

In this case the mistake wasn't even a wrongly diagnosed problem. Here, the government's actions strengthened the disease!

We are now in September 2008. Lehman Brothers is falling; markets are on the brink of collapse. But, in your opinion, even then the rescue of banks to the tune of 700 billion dollars shouldn't have taken place?

-Certainly not in this form. It was this rescue's implementation that triggered a panic. The market was right to think that there were no mechanisms of oversight in this package. So no one in fact knew how the government would spend these huge amounts of money. In fact, the government and the Fed's actions had already been chaotic. The collapse in September 2008 wasn't triggered only by the collapse of Lehman Brothers. Those who think so are mistaken.

Why?

-On September 15, after the collapse of Lehman Brothers, the market rates increased only slightly. They increased a lot more when the government and the Fed announced that they would propose a massive rescue package for banks. In particular, on September 23, when the central bank head Ben Bernanke and the secretary of the treasury Henry Paulson introduced it to Congress.

They introduced it in an obscure way; there were inconsistencies. Why, a few months earlier, had Bear Stearns been prevented from collapsing; in September, Lehman Brothers allowed to fail; and, after several days, AIG rescued? What were the rules of government intervention? To the question of what exactly a 700 billion dollars program is worth, even in November 94% of banks responded that they didn't know. Uncertainty as to the principles upon which the government actions were based caused a crisis, years after it had started, to turn into a disaster.

Which mistakes made by Bush does Obama repeat?

Can the current crisis be compared to the Great Depression of the 30s?

-One can draw conclusions from history but one can't be misled by easy analogies. Lots of things are going wrong now, but there are also positive signs: low fuel prices, the rejection of protectionism by the state. Unemployment is rising, but it will not reach 25-30% as it did 70 years ago. No, certainly, it is not that great a crisis.

Will Obama's team lead America out of it?

-The Bush team, in the last weeks of its term, had already introduced some clarity as to the rules for helping banks. It calmed the situation, panic passed.

Unfortunately, the Obama team repeats many of the Bush Administration's mistakes.

How?

-By giving, for example, tax rebates, or by sending money to people, although it is known now that such actions did not help anything.

Obama will even multiply those errors, because he is spending a lot more money. Out of 787 billion dollars in the economic revitalization package, government is allocating barely 21 billion dollars towards the purchase of goods and services this year; even less towards investments.

And when did the break in the stock market in February start? After the first speech by the new Treasury Secretary Timothy Geithner about support for banks. The market reacted fatefully, because again, it was not known what the government intended. It was not certain whether or how the government would face the fundamental problem—how to clean up the financial system of toxic assets. [Geithner finally offered a concrete plan on the subject two days ago.]

Two months of Obama's administration confirm the fact that government's actions only worsen the situation.

So—even though you say that the fault lies on the side of authorities, not the market—in general you agree with the opinion that it was America that infected the world with the crisis?

-Yes and no. Of course it started in the U.S., but the governments and central banks of other countries, mainly in Western Europe, in fact led the same erroneous policy. Interest rates too low, housing boom too big. Those who say today: "All because of America" exaggerate a lot.

Lesser but wiser governing

What about the need for a global response to this crisis?

-Some problems need to be tackled in a coordinated manner across the globe, some don't. Indeed, there is a need to regulate markets on a global scale; there are already many financial institutions that do such work. Similarly, there is a need to coordinate interest rate policies so that we not repeat the same errors of a few years ago.

Still, shouldn't the state have exercised more control over the market, greedy credit agents, and heads of banks?

-Yes, but the banking supervision in the United States had enough tools needed to exercise this supervision. Only it failed to comply with its duties. This was the case with providing and guaranteeing housing loans by the quasi-national giants Fannie Mae and Freddie Mac. Loans were controlled by the government, but it was officials themselves who ordered those companies to invest in high risk securities.

In their defense, Republicans say that it was the Democrats who did not allow for Fannie and Freddie to heal in time.

-I do not want to be partisan here; the errors were made by both American parties. But in this case, it is true that it was the Bush government and some Republican members of Congress, including John McCain, who called for a law requiring a better surveillance of

these institutions. And it is also true that the law did not pass because it was opposed by a majority of Democrats [both U.S. parties had their interests and even their people in Fannie and Freddie].

But in fact, this crisis has shown that there are only a small amount of cases and institutions where greater state oversight is needed. In most cases, where the state indeed could have acted, it did so poorly. Therefore, this crisis is not a proof that the state has more work to do in the economy. Quite the opposite—it must act wisely, carefully, and in many cases, even less.

History doesn't confirm the argument that the current disastrous crisis can be overcome only by new government programs and expenditures.

How much can capitalism stand

How is this crisis going to end? And when?

-The market needs stability. Therefore, when we finally know what Obama's team intends, which banks they are going to save and which they won't, improvement will come quickly. But the problem is that Obama's government policies don't go in the right direction.

There's also another problem—the budget. Obama's forecasts show that our national debt, already huge, is to double within five years. Even in 10 years, we will have millions of dollars of budget deficits! That is not healthy. It's the same with the persistent increases in state expenses and announcements to raise the taxes. Businesses and banks see that and they won't invest.

So, in the short term, I am not optimistic—the U.S. government, to speak mildly, is not helping the economy out of crisis. But capitalism is a durable system, and recovery will finally come.

Will economists, governments, and the whole world learn something from this crisis?

-They will remember and also learn. Mostly the truths, which proved correct for more than 20 years: caution in setting interest rates, following principles like those in the Taylor rule.

The private sector and ordinary people, in turn, must remember the truth about the risk factor. It exists and can be fatal. Consumption can not be based on overly optimistic expectations. One must be reasonable, thinking about tomorrow, not just today and its pleasures. The savings of Americans are already increasing. It's good for the long-term stability of the U.S. and the world.

What would you have said to the average American or Pole? Don't be too optimistic in your economic behavior? Do not see it through rose-colored glasses?

-That's not the point. The optimism is welcome, if it sticks to realities. I would say: be an optimist, but take into account the risk factor in your decisions. Require clear rules, more information from the bank that gives you credit. Check it.

Still, the Poles should feel calmer than Americans. They should be satisfied that they have chosen the direction of a sound, stable growth, without excesses. It works. Poland did not get off track as the U.S., the U.K., and Ireland did.

My allegations against Greenspan and others

During George Bush's first term, you were Undersecretary of the Treasury, responsible for contacts with foreign countries. With your book, don't you simply defend yourself and your colleagues' legacies?

-I know these allegations, but I am not being partisan. I strongly criticize the actions when Alan Greenspan was at the Fed, but I praised him a lot for the earlier actions, and I criticize the government in which I left and my colleagues.

For what?

-For supporting the policy of too low interest rates, for the stimulus package at the beginning of 2008, for the panicky response in September 2008.

I think that what my critics on the left mean is that I remind people of what caused the Great Moderation we had for more than 20 years. That it began in the early 80s thanks to the politics of Ronald Reagan and the head of the Federal Reserve at the time, Paul Volker—a policy of reasonable interest rates, less state intervention in the economy, tax cuts.

My critics say in 2007, that this led to the disaster. No, it's the departure from these principles that did!