

How Capitalism Will Save Us

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We are experiencing the devastating consequences of a chain of major economic policy errors, which, to use a current cliché, created the perfect storm. These government blunders temporarily paralyzed the global credit system and are now sending the U.S. and Europe into recession, while sharply cutting back Asia's growth rates.

Left to its own devices, the credit crisis, which began in August 2007, would have crushed economies as severely as did the Great Depression.

Belatedly, but thankfully, governments recognized that the only way to get credit flowing again was for them to make quick and direct massive infusions of new equity into beleaguered banks, as well as commit to other emergency measures hitherto unimaginable.

If sensible rescue efforts continue--and they will--the immediate crisis will quickly pass. Shell-shocked businesses and consumers won't recover rapidly from the trauma of recent months, especially as we now cope with recession. But the downturn shouldn't be prolonged: The economy here and those overseas should start to pick up no later than next spring.

That soon? Despite the crisis, the global economy still retains enormous strengths. Between the early 1980s and 2007 we lived in an economic Golden Age. Never before have so many people advanced so far economically in so short a period of time as they have during the last 25 years. Until the credit crisis, 70 million people a year were joining the middle class. The U.S. kicked off this long boom with the economic reforms of Ronald Reagan, particularly his enormous income tax cuts. We burst from the economic stagnation of the 1970s into a dynamic, innovative, high-tech-oriented economy. Even in recent years the much-maligned U.S. did well. Between year-end 2002 and year-end 2007 U.S. growth exceeded the entire size of China's economy. Obviously China's growth rates were higher, but China was coming off a much smaller base.

The world is flush with cash. It's frozen because of fear, but the cash is there. Productivity gains are burgeoning.

So, will this global boom resume next year, slowly at first and then with increasing momentum? It should. Whether that happens, however, depends on the next, highly dangerous phase: the political aftermath.

Will we and other countries pursue policies that hinder growth and retard or abort a full-blown recovery, e.g., regulations that stifle innovation and taxes that harm the creation and deployment of capital? Washington politicians are asking: If the federal government can bail out banks, why not other battered businesses? Congress recently voted for \$25 billion in loan guarantees aimed at helping Detroit automakers. (This money is to be used not only to aid Detroit but also to prevent another flare-up of the credit crisis. If the Big Three defaulted on their debts, holders of credit default swaps--which in recent years have grown like toxic weeds--would demand payment from those who wrote the insurance on the automakers' bonds. This would create another wave of losses for financial institutions.)

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Some liberal political activists are advocating using Washington's new powers to pursue other agendas, such as forcing tighter emissions curbs or mandating costly health insurance coverage. New attempts to restrict corporate pay, at least in some sectors, is a given--overlooking the unintended side effects of Bill Clinton's attempt to limit CEO pay packages back in 1993. (The deductibility of CEOs' salaries was capped, which led companies to use stock options as never before.) Protectionists are renewing calls for trade restrictions in the name of consumer safety and promoting "better" labor and environmental standards. Politically resurgent labor unions and other activists will push for rules on who sits on corporate boards to "better represent consumers and investors." They want an implicit veto power over the policies of publicly held companies. They're also ready to remove barriers, such as the secret ballot, in order to coerce workers into joining unions.

The financial sector will certainly face new rules and regulations. Will these be sensible, such as rationalizing our myriad, overlapping financial regulatory structures and pushing for the creation of exchanges and clearinghouses for exotic instruments, such as credit default swaps, so we have transparency and standardization? Or will they be punitive and costly like the Sarbanes-Oxley Act? Washington's new powers over banks may make our capital markets more hostile to entrepreneurs--savings bonds won't give you high returns, but they will protect you from political fallout. Or, as happened with **Fannie Mae** (nyse: [FNM](#) - [news](#) - [people](#)) and **Freddie Mac** (nyse: [FRE](#) - [news](#) - [people](#)), will they make banks do things for political not economic reasons?

A chilling result of the crisis will be furthering the deadly process of criminalizing business failures. In the old days when an enterprise failed, the proprietors often ended up in debtors' prison. One of the significant advances of civilization and economic progress was the idea of limited liability, which took hold in the 19th century: Investors would be liable only for the money they actually put into a corporation; their other assets would be safe. If an enterprise failed, they lost only what they had invested. Limited liability thereby set off a positive explosion of risk taking. Our standard of living today would be where it was in the 1850s were it not for the wide use of limited liability.

But in recent years, particularly after the Enron/WorldCom corporate scandals, federal and local prosecutors began actively pursuing evidence of fraud whenever a big business went bust. Yes, there has been corporate wrongdoing, and miscreants have been tried and jailed. But many noncriminal individuals have been pursued.

One notorious case was the IRS' attempt to prosecute KPMG and a number of its partners and employees for alleged tax fraud. The shelters KPMG sold in the 1990s were not illegal. The IRS still determined, however, that they weren't valid. That kind of tax dispute would normally be settled in civil court. Instead, prosecutors threatened KPMG with annihilation: Settle on our terms or we will hit you with an enterprise-killing indictment. Arthur Andersen had recently been destroyed by such an indictment, even though the courts subsequently threw the charges out. The feds even pressured KPMG not to pay the legal bills of the targeted individuals--which would have forced these people to settle, as they couldn't afford the massive legal costs of defending themselves. Thankfully, a courageous federal judge stopped this abuse.

But the itch to indict remains. No sooner had Bear Stearns, **Lehman Brothers** (nyse: [LEH](#) - [news](#) - [people](#)) and **AIG** (nyse: [AIG](#) - [news](#) - [people](#)) gone bust than criminal investigators swarmed in. They will find evidence of "fraud"--why didn't you more aggressively mark down the value of suspect paper even if there wasn't a market for it? Why the expressions of confidence in the soundness of your businesses when the rumors of trouble were surfacing? Lost in all this will be the fact that Lehman and AIG didn't know they were in mortal peril until almost the very end. There will be indictments. The chilling lesson: Unsuccessful risk taking or failing in business can send you to prison.

So what *should* our responses be now? To answer that, we must first understand the crisis' causes.



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