THE ELEPHANT IN THE LIVING ROOM

Since the fall of 2008, as the stock market plummeted, companies folded, and economic fear and uncertainty began to spread, Americans have been bombarded with a predictable and relentless refrain: the free-market economy has failed.

The remedy? According to Barack Obama, the late Bush Administration, Republicans and Democrats in Congress, and the mainstream media, it's more regulation, more government intervention, more spending, more money creation, and more debt.

To add insult to injury, the very people who devised the policies that produced the mess are now posing as the wise public servants who will show us the way out. Following a familiar pattern, government failure has been blamed on anyone and everyone but the government itself. And of course, that same government failure is being used to justify further increases in government power.

The talking heads have been about their usual business of giving the wrong answers to every important question, but this time most of them haven't even been asking the right questions. Where did all the excess risk, leverage, and debt, not to mention the housing bubble itself, come from? When questions like this are raised, the answers are, to say the least, unhelpful. "Excessive risk-taking" simply begs the question. As several economists have noted, blaming the crisis on "greed" is like blaming plane crashes on gravity.

We've been looking in the wrong place. The current crisis was caused not by the free market but by the government's intervention in the market. This is not special pleading on behalf of the market, but the clear verdict of both theory and experience. Fannie Mae and Freddie Mac, government-sponsored enterprises (GSEs) that enjoy various government privileges alongside their special tax and regulatory breaks, were able to draw far more resources into the housing sector than would have been possible on the free market. For years, congressional Democrats pretended all was well at Fannie and Freddie, and that all the warnings were coming from mean people who didn't want the poor to have a chance to own their own homes. (Numerous Democrats really did say that, believe it or not.) Republicans have since used the Democrats' sorry record as a bludgeon against them, but their own record on spending, debt, and government intervention is nothing to be proud of. Republicans by and large have also supported the endless march of government bailouts, which aren't exactly examples of the free market in action.

But even many of those who describe themselves as supporters of the free market have failed to grasp the heart of the problem. To be sure, they have pinpointed legislation like the Community Reinvestment Act that certainly didn't help matters. In pointing fingers at specific programs, however, Republicans have diverted attention to the patient's runny nose and away from his cancer.

Almost nobody in Washington, and precious few elsewhere, has been willing to question the greatest single government intervention in the economy, and the institution whose fingerprints are all over our current

mess: America's central bank, the Federal Reserve System. The Fed is hardly ever mentioned in connection with the crisis, except perhaps as our savior. Major newspapers, magazines, and websites purport to dissect the crisis and identify its causes without mentioning the Fed at all. That's nothing new: there has been no serious discussion of the Federal Reserve in public life for the nearly one hundred years since its creation. The Fed is a wonderful thing, and that's that.

When President George W. Bush addressed the nation on September 24, 2008, with the proposed bailout plan for the financial sector meeting stiff resistance from the American public, he devoted some time to addressing what were purportedly the downturn's "root causes." Apart from a fleeting and ambiguous reference to Fannie Mae and Freddie Mac, none of these implicated the government or its central bank. One of the rules of American political life is that inflationary monetary policy by the Fed is never to be mentioned as the source of any of the country's problems, much less the cause of the boom-bust business cycle. The president stuck to the script: not a single word about the central bank.

Several weeks later, the President announced his intention to hold an international summit in Washington on the financial crisis. (As investment advisor Mike Shedlock put it, "In response to the credit crisis President Bush is gathering up all the people who did not see what was coming, denied what was happening, and then failed to see the implications of what was indeed happening."[1]) He spoke of the need to "preserve the foundations of democratic capitalism," the usual boilerplate whenever the federal government intends another round of burdens on the free market. Various presidents and prime ministers were invited.

The response was predictably inane. Upon hearing of the proposed summit, the French president and the European Commission president indicated their desire to see offshore tax havens targeted, the International Monetary Fund further empowered, and limitations imposed on executive pay, among other irrelevant suggestions. As usual, the possibility that artificially low interest rates of 1 percent might have set the world's economies on unsustainable paths was not mentioned then or at

the November 15 summit itself, which wound up being a relatively toothless exchange of platitudes.[2]

In October 2008 the editor in chief of the Slate Group, which publishes *Slate*, the popular website, proclaimed that the financial crisis was surely the end of libertarianism, since it supposedly proved what a mess "unregulated markets" could cause. Not once were central banking or the Federal Reserve mentioned, even though these are not creations of the free market and their destructive behavior is not the market's fault.

To be sure, a few important exceptions to this general rule can be found, such as investment mavens Jim Rogers, Peter Schiff, and James Grant. Rogers, when asked on CNBC what two courses of action he would take if he were appointed Fed chairman, replied that he would abolish the Fed and then resign. Not by coincidence, these men were also among the very few who predicted the current crisis. So-called mainstream commentators, whose credibility should have completely evaporated by now, laughed at their pessimistic predictions and their criticisms of Fed policy. Thanks to YouTube, you can watch a parade of blockheads actually laughing at Peter Schiff in 2006 for predicting exactly what has happened since. As predictably as night follows day, the dopes who didn't see the crisis coming and said everything was fine are the ones George W. Bush and Barack Obama alike have looked to for advice on how to reverse it.

We are in trouble.

More bailouts, more regulation, more government

The government's course of action in the face of the sinking economy has been just as predictable. First, government officials misdiagnosed the problem, exonerating themselves of any blame and pinpointing various bogeymen instead. For guidance, they turned to studying the causes and cures of the Great Depression—which they of course got all wrong. Then they drew an analogy between (their misinterpretation of) the current situation and (their misinterpretation of) the Great Depression.

Next, Americans were told that in order to prevent another Great Depression, the government had no choice but to implement the same policies that failed to lift the country out of the actual Great Depression. Finally, it was time for our wise rulers to set about making things worse, beginning with (but not confining themselves to) a massive and unprecedented string of bailouts. Depressed economic conditions will thereby persist longer than they would have if the market had been allowed to function.

When in September 2008 the House of Representatives entertained a $700 billion bailout package—soon to be renamed the "rescue plan" by the Bush administration and its media accomplices—for the financial sector, the public response was swift and clear. Democratic senator Barbara Boxer of California reported receiving nearly 17,000 e-mail messages on the subject, nearly all of them negative. Of more than 2,000 calls to her California office (on a single day), only 40 callers supported it—that's 2 percent. Out of 918 calls to her Washington office, exactly one was in favor. Other members of Congress reported similar reactions. Ohio senator Sherrod Brown reported that 95 percent of constituent communications on the subject were from bailout opponents.[3]

What could make a representative disregard so intense an expression of outrage on the part of his constituents? Take a wild guess. The securities and investment industry, according to the Center for Responsive Politics, contributed $53 million to congressional and presidential candidates in the 2008 cycle, placing them second behind lawyers. Congressmen who voted in favor of the bailout when it appeared before the House on September 29 had received 54 percent more money in campaign contributions from banks and securities firms than had those who voted against it.[4]

Surprisingly, the House voted it down at first. That could not be allowed to stand. Instead of concluding that the population did not want the bailout, legislators got to work to figure out how the bill could still be rammed through. The Senate version included billions of dollars' worth of the usual targeted enticements, and the bill was promptly

passed and signed into law. Sure, looting the American population to the tune of $700 billion in order to bail out the most reckless actors on Wall Street seemed like a bad idea, but now that we've added a $6 million tax break for makers of children's wooden arrows, well, that's another story.

After the bailout passed, Treasury secretary Henry Paulson did not exactly comport himself like a man in command of events. First we were told that the bailout money would buy up bad assets from banks (like nonperforming mortgages and "toxic" mortgage-backed securities), and thus revive interbank lending, which had dropped off because of the banks' uncertainty surrounding other banks' exposure to these assets. The administration, congressional leaders, and the media all hammered away against doubters and dissenters that this was the right plan, and it was needed now.

But after the bill passed they changed their minds. The strategy of buying up bad assets was first postponed in favor of handing government money to the banks in exchange for shares of bank stock, even if the banks weren't willing to sell. Then bad-asset purchases were finally abandoned, expressly, by Secretary Paulson. The strategy that we had all been told was critical to the economy, and that we would suffer a collapse of historic proportions without, was simply and promptly forgotten. Paulson even admitted later on that he had known from the beginning that such a strategy—on the basis of which the bailout package was sold to the public—was the wrong solution.[5]

Now it was consumer credit that needed propping up. According to Paulson, "millions of Americans" were facing rising credit card rates or reduced access to credit, thus "making it more expensive for families to finance everyday purchases." That made even less sense than the usual Paulson rationalization. Think about it: is it sustainable in the long run for families to make everyday purchases on credit? How can that go on? Yet we are being asked to prop up an obviously unsustainable system based on borrowing and consumption, instead of encouraging people to live within their means as the market is now trying to do. One doesn't normally look to government officials for economic understanding, but

German chancellor Angela Merkel correctly warned in November 2008 that if Washington's policy was to create more money and encourage more borrowing, it would simply sow "the seeds of a similar crisis in five years' time."[6]

The two major-party candidates for president in 2008 agreed on the congressional bailout package, of course—Americans can't be permitted a real choice on a matter as important as that. Thanks to bailout mania, by the end of 2008 Washington had put itself (meaning the American population) on the hook for some $7.7 trillion. And all indications are that they're just getting started.

"Change you can believe in"

A first glance at Barack Obama's economic team confirms that all the talk of "change" really meant more of the same—more bailouts, more government intervention, more addressing symptoms rather than causes—along with huge deficits and massive increases in government spending, which our leaders superstitiously believe can restore economic health. As with any superstition, no amount of logical argument or historical evidence seems able to dislodge it. This one is particularly difficult to overturn, since it gives intellectual cover to additional spending, something government likes to engage in anyway.

All of these imagined masters of the universe—Henry Paulson, Ben Bernanke, Barack Obama, congressional chairmen like Barney Frank and Chris Dodd—should leave well enough alone. There is nothing the government or the Federal Reserve can do to improve the situation, and a great deal they can do to prolong it. As I suggest in this book, they already have.

We cannot expect the situation to improve until we understand how we got here.

No novel theories are necessary. In these pages I provide a layman's overview of where the economy is and what should be done next, and call attention to a range of important ideas that have been ignored for far too long. A free-market perspective—specifically, the ideas of Ludwig

von Mises and F. A. Hayek—sheds important light on the crisis we currently face, a crisis even many economists and financial analysts do not fully understand, and which is accounted for adequately by none of the usual theories. The ideas in this book are, for the most part, old ones. They've simply been neglected.

The Fed

Interviewed by the *New York Times* in early November 2008, economist James K. Galbraith claimed that perhaps 10 or 12 of the country's 15,000 professional economists saw the economic crisis coming.[7] Well, few of the economists Galbraith associates with may have seen it coming, but hundreds of economists who belong to Mises' Austrian School of economic thought sure saw it. The Austrian School is a small but growing school of free-market economics whose distinguished lineage includes Mises (1881–1973) and Nobel Laureate Hayek (1899–1992). By and large the Austrians warned of the housing bubble before anyone else, and they predicted the crash the economy is enduring now. And the primary culprit, from their point of view, is the Federal Reserve.

Pretense aside, the Federal Reserve System is for all intents and purposes an arm of the federal government. Created by an act of Congress, its chairman chosen by government appointment, and endowed with monopoly privileges, the Fed rests on principles diametrically opposed to those of the free market. It is dedicated to central economic planning, the great discredited idea of the twentieth century. Except instead of planning the production of steel and concrete, as in the old Soviet Union, it plans money and interest rates, with consequences that necessarily reverberate throughout the economy.

The Fed's policy of intervening in the economy to push interest rates lower than the market would have set them was the single greatest contributor to the crisis that continues to unfold before us. Making cheap credit available for the asking does encourage excessive leverage, speculation, and indebtedness. Manipulating interest rates and thereby misleading investors about real economic conditions does in fact misdirect

capital into unsustainable lines of production and discombobulate the market. Imagine that.

As we'll see, the Fed's intervention into the economy can give rise to the boom-bust cycle, making us feel prosperous until we suffer the inevitable crash. The free market is inevitably blamed for that crash. No one even thinks to point the finger at Washington and the Fed. And that is part of what makes it so insidious. These artificial booms, wrote economist Henry Hazlitt decades ago, must end "in a crisis and a slump, and . . . worse than the slump itself may be the public delusion that the slump has been caused, not by the previous inflation, but by the inherent defects of 'capitalism.'"[8]

The Fed is the elephant in the living room that everyone pretends not to notice. Even many of those who blame government for the current mess leave the Fed out of the picture altogether. The free market, meanwhile, takes the blame for the destructive consequences of what it does. This charade has gone on long enough. It's time to consider the possibility that maybe the elephant, and not little Johnny, is the one breaking all the furniture.