CUMULATING POLICY CONSEQUENCES, FRIGHTENED OVERREACTIONS, AND THE CURRENT SURGE OF GOVERNMENT'S SIZE, SCOPE, AND POWER

ROBERT HIGGS*

INTRODUCTION

The financial and economic crisis that came to a head in the late summer of 2008 has brought forth a huge government response, many elements of which are without precedent. The crisis, however, did not come from nowhere. In important regards, its roots lie, first, in government policies to promote more widespread homeownership than would occur in a free market and, second, in the Federal Reserve System's mismanagement of interest rates and the money stock. The crisis is far from over, yet it already appears that the surge of extraordinary government actions and the new policies that the crisis has provoked will give rise to important, permanent increases in the government's size, scope, and power. In this way, it mimics the national emergencies of the past century.

I. DIMENSIONS OF THE CRISIS AND THE GOVERNMENT'S RESPONSES

Although the National Bureau of Economic Research places the recent peak of economic activity in the fourth quarter of 2007,[1] real gross domestic product (GDP) did not reach its peak until the second quarter of 2008.[2] By the second quarter of 2009, real GDP had fallen by four percent.[3] Likewise, financial strin-

---

* Senior Fellow in Political Economy, The Independent Institute; Editor of *The Independent Review: A Journal of Political Economy*; rhiggs@independent.org.

1. NAT'L BUREAU OF ECON. RESEARCH, BUSINESS CYCLE DATING COMMITTEE: DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY 2 (2008).

2. BUREAU OF ECON. ANALYSIS, U.S. DEP'T OF COMMERCE, REAL GROSS DOMESTIC PRODUCT, http://research.stlouisfed.org/fred2/data/GDPC1.txt (last visited Feb. 23, 2010).

3. *Id.*

gencies in certain credit markets began to appear in 2007, though they did not become widely noticed until late September 2008, when a full-fledged financial panic developed, and commentary in the news media and the statements of public officials took on a frightened tone. The civilian unemployment rate began to rise after March 2007, when it stood at 4.4%, and by October 2009, it had reached 10.2%.[4]

In response to the growing economic troubles, especially the perceived "credit crunch" of September 2008, policymakers in the Bush Administration (most notably, Treasury Secretary Henry Paulson), in Congress, and at the Federal Reserve System (the Fed) responded by initiating a series of unprecedented actions to rescue tottering banks and other financial institutions and to inject credit into the financial system.[5] In September, the Fed took control of the insurance giant American International Group (AIG),[6] and the Federal Housing Finance Authority took over the huge government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, secondary lending institutions that held or insured more than half of the total value of U.S. residential mortgages.[7] On October 3, Congress passed and the President signed the Emergency Economic Stabilization Act of 2008.[8] Title 1 of this statute authorizes the Secretary of the Treasury to create the Troubled Assets Relief Program (TARP) and authorizes as much as $700 billion for the purchase of so-called troubled assets, primarily mortgage-related securities, held by banks and

---

4. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, CIVILIAN UNEMPLOYMENT RATE, http://research.stlouisfed.org/fred2/data/UNRATE.txt (last visited Feb. 23, 2010).

5. For a useful annotated compilation of the series of events making up the crisis and the government's responses to it, see *Credit Crisis–The Essentials*, N.Y. TIMES, Jan. 12, 2010, http://topics.nytimes.com/top/reference/timestopics/subjects/c/credit_crisis/index.html.

6. In addition to other aid, the Fed agreed to lend AIG up to $85 billion and acquired control of nearly eighty percent of the company. Press Release, Fed. Reserve Bd. (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/20080916a.htm.

7. The government did not nationalize Fannie Mae and Freddie Mac outright, but placed them into conservatorship, taking an ownership interest in the form of senior preferred shares and receiving warrants that would permit the government to acquire 79.9% of the common shares of each company. *See* David Ellis, *U.S. seizes Fannie and Freddie*, CNNMONEY.COM, Sept. 7, 2008, http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/index.htm. Authority for these actions came from the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 117, 122 Stat. 2654, 2683–85.

8. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

other financial institutions.[9] Unable to implement the planned acquisition of troubled assets, the Treasury instead used TARP mainly to inject funds into the banks by purchasing preferred shares and warrants to purchase common stock from them.

By the end of 2008, the Fed had made large, unprecedented types of loans and had given other forms of assistance, including loan guarantees, asset swaps, and lines of credit, to securities dealers, commercial-paper sellers, money-market mutual funds, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, buyers of certain asset-backed securities based on consumer and small-business loans, Citigroup (related to losses resulting from a federal government guarantee of a specified pool of assets), and fourteen foreign central banks.[10] The Treasury and the Federal Deposit Insurance Corporation also took a variety of other large-scale actions to prop up credit and housing markets during the final quarter of 2008.[11]

After Barack Obama became President, his administration and Democratic leaders in Congress concentrated on gaining passage of a new "economic stimulus" bill. These efforts ultimately resulted in the American Recovery and Reinvestment Act of 2009, which the President signed into law on February 17.[12] This statute authorizes a great variety of spending increases, as well as some tax reductions, over the period from 2009 to 2019. According to Congressional Budget Office (CBO) estimates, the combined amount of these spending increases and tax cuts comes to $787 billion over these ten years.[13]

The Obama Administration also proceeded, at the end of April, with two complex "restructuring" arrangements that essentially amounted to government takeovers of General Motors and Chrysler, both of which were teetering on the brink of bankruptcy. Carl Horowitz called this action "one of the most radical moves in the history of American industry," noting that it came not long after the federal government had made huge emergency loans to the

---

9. *Id.* at 3767–800.

10. Brief descriptions of these Fed programs and the amounts of money or other assistance involved in each of them appear in CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2009 TO 2019, at 35–38 (2009).

11. For brief descriptions, see *id.* at 39–41.

12. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

13. *Getting to $787 Billion*, WALL ST. J. ONLINE, Feb. 17, 2009, http://online.wsj.com/public/resources/documents/STIMULUS_FINAL_0217.html.

companies.[14] The government had also forced the resignations of the chief executive officers of the two companies, Rick Wagoner of GM and Robert Nardelli of Chrysler.[15] By the end of July 2009, total government aid to the two firms reached $65 billion.[16]

On June 15, 2009, the *Wall Street Journal* summarized the extraordinary surge of government actions as follows:

> Since the onset of the financial crisis nine months ago, the government has become the nation's biggest mortgage lender, guaranteed nearly $3 trillion in money-market mutual-fund assets, commandeered and restructured two car companies, taken equity stakes in nearly 600 banks, lent more than $300 billion to blue-chip companies, supported the life-insurance industry and become a credit source for buyers of cars, tractors and even weapons for hunting.[17]

Although this statement falls far short of a comprehensive account of the government's responses to the crisis, it suffices to justify the conclusion that within less than a year, the perceived emergency had provoked a huge surge in the federal government's size, scope, and power.

This surge also entailed major fiscal eruptions, including tremendous increases in federal expenditures and an even greater percentage run-up of federal debt. According to the August 2009 CBO update, federal outlays for fiscal year 2009 would total $3.69 trillion, an increase of 24% over the total for the previous year. This increase, which is wholly without peacetime precedent in U.S. history, would raise federal outlays from 21% of GDP to 26.1%. Moreover, because federal receipts were forecasted to contract by almost 17% in 2009, the annual federal budget deficit was expected to increase from $459 billion in 2008 to $1.59 trillion in 2009, an increase of 246%. The CBO forecasted that the 2009 deficit would be equal to 11.2% of GDP, up from 3.2% in the previous year. The borrowing required to finance this gargantuan deficit in the federal budget was forecasted to increase the U.S.

---

14. Carl Horowitz, *Obama Arranges Takeover of GM and Chrysler; Auto Workers Union Gets Huge Stake*, NAT'L LEGAL & POL'Y CTR., May 1, 2009, http://www.nlpc.org/stories/2009/05/01/obama-administration-arranges-takeover-gm-and-chrysler-auto-workers-union-gets-hu.

15. *Id.*

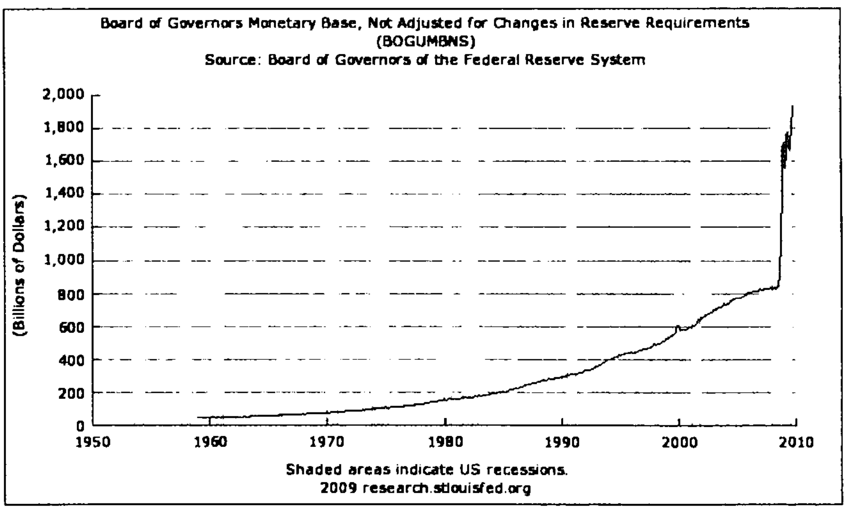
16. *US Govt to Sell GM and Chrysler Stock*, BNET, July 28, 2009, http://www.bnet.com/2407-13071_23-325401.html.

17. Bob Davis & Jon Hilsenrath, *Federal Intervention Pits 'Gets' vs. 'Get-Nots,'* WALL ST. J., June 15, 2009, at A1.

debt held by the public from $5.80 trillion at the end of fiscal year 2008 to $7.61 trillion at the end of 2009, an increase of $1.81 trillion, or 31% in a single year.[18]

Although these U.S. Treasury figures are mind-boggling for an economist or financial historian, the Fed's recent actions have been even more astonishing. Figure 1 shows the most important of these actions, the abrupt increase in the monetary base, which must be seen to be believed.[19] As the figure shows, the monetary base—currency in circulation plus commercial bank reserves—historically has increased smoothly at a fairly modest rate of growth. Between August 2008 and January 2009, however, the Fed's actions caused the country's monetary base to double in only five months. After January 2009, the monetary base remained in this extraordinarily elevated range. In September and October 2009, it increased even further, reaching all-time highs.

Figure 1



18. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: AN UPDATE, at x tbl.1 (2009). The CBO's estimates of spending and the deficit turned out to err on the high side. After the end of the fiscal year, the actual spending total was $3.52 trillion (equal to about 25% of GDP) and the deficit was $1.42 trillion (equal to about 10% of GDP). *See US deficit surges to all-time record,* DAILY FIN., Oct. 16, 2009, http://www.dailyfinance.com/2009/10/16/us-deficit-surges-to-all-time-record.

19. The graph and the underlying data are from the publicly accessible database maintained by the Federal Reserve Bank of St. Louis, *available at* http://research.stlouisfed.org/fred2/series/BOGUMBNS?cid=124.

The Fed's recent monetary policy places the purchasing power of the U.S. dollar in grave jeopardy because the monetary base, as its name indicates, is the foundation on which the U.S. money stock rests. Other things being equal, more than doubling the monetary base will ultimately result in more than doubling the money stock. Hence, the dollar's purchasing power will be tremendously reduced, with a variety of negative effects on the economy. As of November 2009, the banks as a whole have simply absorbed the additional reserves, rather than using them to increase the volume of their loans and investments, which would begin to increase the money stock through the commercial banks' creation of new checking account balances. Between August 2008 and January 2009, legally excess commercial-bank reserves at the Fed increased from less than $2 billion to nearly $800 billion. In October 2009, they amounted to $995 billion, an all-time high.[20] Should the banks begin to employ these excess reserves to make new loans and investments, however, the Fed will face a dilemma: either do nothing to mop up the excess reserves, allowing them to become the fuel for rapid price inflation; or mop them up, most likely either by traditional open-market operations or by offering the banks a much higher rate of interest on their reserve balances at the Fed. Both choices entail increasing the rate of interest, and the Fed will face political pressure opposing such an action, especially if the recession has not ended and the rate of unemployment remains high. Fed Chairman Ben Bernanke has stated that the Fed possesses "the tools" to deal with this problem,[21] but I remain skeptical that he will do so successfully. In any event, the Fed's emergency actions since August 2008 have created serious economic risks that make private planning much more difficult and thereby impede the market economy's successful functioning.

20. Bd. of Governors of the Fed. Reserve Sys., Excess Reserves of Depository Institutions, http://research.stlouisfed.org/fred2/data/EXCRESNS.txt (last visited Feb. 23, 2010).

21. *See, e.g.*, Jeannine Aversa, *Bernanke's Tough Task: Withdrawing Emergency Aid*, ABC NEWS, Aug. 21, 2009, http://abcnews.go.com/Business/WireStory?id=8379185&page=1; *Bernanke's Exit Dilemma*, ECONOMIST ONLINE, Aug. 4, 2009, http://economistonline.blogspot.com/2009/08/bernankes-exit-dilemma.html.

In such circumstances, much "smart money" simply sits idle or goes into safe, low-yield investments, such as Treasury bills.[22]

II. CUMULATING POLICY CONSEQUENCES

The current crisis, like every major economic emergency, occurs in the context of predisposing conditions, institutions, and policies that took shape over a long period. Although many people are inclined, on each such occasion, to conclude that "capitalism has failed," a pure market system does not just spontaneously break down. Such a system automatically produces feedback that guides and motivates producers, investors, and consumers to make constant adjustments to changing conditions. Profits and losses, with the corresponding growth, decline, and disappearance of firms that they bring forth, give market participants reliable indications of whose plans have succeeded and whose plans have failed in meeting consumer demands at prices that cover costs. No one knows the future, and therefore entrepreneurs in a pure market system may make mistakes in appraising the profitability of the various alternatives they perceive as open to them. But sustained, large-scale mistakes are unlikely to occur. The constant flow of price and profit information, combined with the knowledge that one's own wealth is at stake, gives market participants the necessary information and the personal incentive to make appropriate forward-looking adjustments long before overall economic conditions become severely distorted on a wide scale.

When governments intervene, however, the effect is to "falsify" the market's signals. Subsidies permit firms that would go bankrupt to continue in business, even though they are failing to cover their full costs in the market and therefore are effectively generating economic waste by transforming valuable inputs into less valuable outputs. Government price fixing (including the Fed's manipulation of interest rates) distorts the pattern of resource allocation and misleads investors into making commitments ill-suited to future economic conditions. Government regulations and taxes penalize firms that are satisfying consumer demands successfully, diminishing their net returns and causing them to produce less or become insolvent,

22. Tom McGinty & Cari Tuna, *Jittery Companies Stash Cash*, WALL ST. J., Nov. 2, 2009, at A23.

notwithstanding their actual contribution to overall economic efficiency. When market participants are subject to a welter of such government interventions, they may allocate resources in a way that allows distortions and imbalances to cumulate until the burdens these mistakes entail can no longer be sustained, and a sudden crash reveals the unsoundness of the overall economic structure.

The current crisis has arisen in large part from government intervention in the housing and housing finance markets since the 1930s. During the early 1930s, the contraction of economic activity and unevenly falling prices brought about severe distress in housing and financial markets. As businesses failed, incomes fell, and unemployment rose, many homeowners could not make their scheduled mortgage or tax payments and therefore lost their homes to foreclosure or tax sale.

The Roosevelt Administration responded to this dire situation by, among other things, obtaining congressional approval for the Home Owners' Loan Corporation (HOLC) in 1933.[23] The HOLC was terminated in 1951.[24] This government institution restructured approximately one million mortgages on nonfarm, owner-occupied homes, changing the obligations from short-term (usually three to five years), interest-only loans with balloon repayments of the entire principal into long-term (initially fifteen years, later extended by up to ten more years), fully amortized loans. The HOLC thereby prevented many foreclosures.[25] Of course, these arrangements also amounted to a bailout for the banks and other lending institutions that held the refinanced mortgages, and therefore the Roosevelt policy foreshadowed similar bailouts the government has undertaken in 2008 and 2009.

In 1934, the National Housing Act created the Federal Housing Administration (FHA) to insure private lenders against default on conventional, long-term, amortized mortgage loans and the Federal Savings and Loan Insurance Corporation to insure deposits in savings institutions that specialized in recy-

---

23. C. LOWELL HARRISS, NAT'L BUREAU OF ECON. RESEARCH, HISTORY AND POLICIES OF THE HOME OWNERS' LOAN CORPORATION 1 (1951).

24. *Id.* at 6.

25. *Id.* at 1–6.

cling their deposits into mortgage loans.[26] These actions caused more money to flow into mortgage loans than would have without government intervention. The government, in effect, undertook to divert funds into housing purchases and hence to divert labor and capital into house construction and related activities.

A more portentous New Deal action occurred in 1938, when the FHA Administrator exercised his statutory authority to charter the Federal National Mortgage Association (Fannie Mae).[27] "The primary purpose of Fannie Mae was to purchase, hold, or sell FHA-insured mortgage loans that had been originated by private lenders. After World War II, Fannie Mae's authority was expanded to include VA-guaranteed home mortgages."[28] At this time, Fannie Mae was simply part of the U.S. government. In 1968, the institution was split into two parts: the Government National Mortgage Association (Ginnie Mae) and a reconstituted, privatized Fannie Mae.[29]

Ginnie Mae was initially and remains today a wholly government-owned corporation that guarantees the payment of interest and principal on mortgage-backed securities. This guarantee is an explicit U.S. government commitment. Ginnie Mae debt therefore has the same credit rating as U.S. Treasury debt. The institution's website explains: "[T]he Ginnie Mae guaranty allows mortgage lenders to obtain a better price for their mortgage loans in the secondary market. The lenders can then use the proceeds to make new mortgage loans available."[30] Like all of the other government institutions engaged in this sector, from the HOLC to the presently existing ones, Ginnie Mae seeks to make homeownership less costly and therefore more widespread than it would be in a freely functioning, private-property market without government intervention.

Between 1968 and 1970, the reconfigured Fannie Mae became a private GSE, purchasing residential mortgages in the secondary market. An anomalous institution, Fannie Mae was sub-

26. National Housing Act, Pub. L. No. 73-479, §§ 1–203, 402–403, 48 Stat. 1246, 1246–48, 1256–57 (1934).

27. Fannie Mae, About Fannie Mae, http://www.fanniemae.com/aboutfm/charter.jhtml (last visited Feb. 23, 2010).

28. *Id.*

29. *Id.*

30. Ginnie Mae, About Ginnie Mae, http://www.ginniemae.gov/about/about.asp?Section=About (last visited Feb. 11, 2010).

ject to regulatory oversight by the Department of Housing and Urban Development, exempt from oversight by the Securities and Exchange Commission, not required to hold as much capital as competing private financial institutions, freed from the obligation to pay state and local income taxes, and provided with a $2.25 billion line of credit from the U.S. Treasury. Five of the eighteen members of the board of directors can be named by the President of the United States.[31] Although the institution's debt no longer enjoyed an explicit Treasury guarantee, many market participants believed that the government would provide backing if need be, and therefore Fannie Mae was able to borrow at interest rates only slightly above those on U.S. government debt.[32] The general understanding was that the institution would be considered "too big to fail," as indeed it was.

Ostensibly to provide a competitor for Fannie Mae, the government created in 1970 the Federal Home Loan Mortgage Corporation (Freddie Mac) and authorized it to purchase mortgages in the same fashion as Fannie Mae. Freddie Mac was seemingly a private, shareholder-owned corporation, yet it enjoyed the same statutory advantages as Fannie Mae in the secondary mortgage market and the same widespread perception of an implicit government guarantee of its own debt, as shown by the low interest rate it paid when selling its own securities.[33] Freddie Mac's website proclaims: "[W]e reduce the costs of housing finance and expand housing opportunities for all families, including low-income and minority families. It is a unique mortgage finance system that makes homeownership a reality for more of America's families."[34] To be sure, this GSE, like its giant competitor, did make homeownership more widespread than it would have been in a pure, free-market system. Eventually, however, many observers came to acknowledge that

---

31. Lawrence J. White, *Fannie Mae, Freddie Mac, and Housing: Good Intentions Gone Awry, in* HOUSING AMERICA: BUILDING OUT OF A CRISIS 263, 265–68 (Randall G. Holcombe & Benjamin Powell eds., 2009) [hereinafter HOUSING AMERICA].

32. *Id.* at 266–67; Alan Reynolds, *Fannie Mae and Freddie Mac Should Be Cut Down and Cut Loose,* U.S. NEWS & WORLD REP., July 21, 2008, http://usnews.com/opinion/articles/2008/07/21/fannie-mae-and-freddie-mac-should-be-cut-down-and-cut-loose.html.

33. Fannie Mae, Our Charter, http://www.fanniemae.com/aboutfm/charter.jhtml (last visited Feb. 23, 2010); *see also* Freddie Mac, Our Mission, http://www.freddiemac.comcorporate/company_profile/our_mission/ (last visited Feb. 11, 2010).

34. Freddie Mac, Company Profile, http://www.freddiemac.com/corporate/company_profile/ (last visited Feb. 11, 2010).

homeownership was made too easy and too widespread for the good of the country at large.[35] Too many homeowners holding title to "too much home," but possessing little or no equity in it, contributed to the creation of a fragile, excessively leveraged economic structure.

By 2008, Fannie Mae and Freddie Mac owned or guaranteed approximately half of the $12 trillion in residential mortgage loans outstanding in the United States.[36] According to a Staff Report of the House Committee on Oversight and Government Reform:

> Fannie Mae and Freddie Mac were in fact leaders in risky mortgage lending. According to an analysis presented to the Committee, between 2002 and 2007, Fannie and Freddie purchased $1.9 trillion of mortgages made to borrowers with credit scores below 660, one of the definitions of "subprime" used by federal banking regulators. This represents over 54% of all such mortgages purchased during those years. If one factors in Alt-A and adjustable-rate mortgages, this analysis found that, at the end of 2008, Fannie and Freddie were still exposed to $1.6 trillion of risky default-prone loans. Thus, at year-end 2008, Fannie Mae and Freddie Mac were responsible for 34 percent of all outstanding subprime mortgages and 60 percent of all outstanding Alt-A mortgages in the United States.
>
> .... [N]onprime loans, which accounted for only 34% of the GSEs' risk exposure at the end of 2008, were suffering a 6% delinquency rate, accounting for 90% of the GSEs' losses....
>
> The continuing losses caused by Fannie and Freddie's binge on junk mortgages have already cost the taxpayers dearly.... The sum of these federal aid packages brings the total current taxpayer exposure to GSE liabilities to over $700 billion.[37]

This report also adduces substantial evidence that these GSEs did not simply make bad decisions about lending standards on their own. For decades, especially during the past decade, they sustained strong political pressure from members

35. *See, e.g.*, White, *supra* note 31, at 272–73, 278–79.

36. Charles Duhigg, *A Trickle That Turned Into a Torrent*, N.Y. TIMES, July 11, 2008, at C1.

37. STAFF OF H. COMM. ON OVERSIGHT & GOV'T REFORM, 111TH CONG., THE ROLE OF GOVERNMENT AFFORDABLE HOUSING POLICY IN CREATING THE GLOBAL FINANCIAL CRISIS OF 2008, at 24–25 (2009).

of Congress beholden to an "affordable housing" coalition of special interest groups who sought greater and greater relaxation of conventional underwriting standards for mortgage loans, even though many loans eventually were made to borrowers with low credit ratings and no documentation of their income or assets.[38] Noting that "Fannie and Freddie used high leverage to borrow money and gamble on low-down payment affordable and speculative mortgages," the report concludes that "[u]nlike Wall Street, however, the GSEs did this with the mandate and the blessing of Congress and successive Administrations, which encouraged them to use their government-granted competitive advantages to engage in a race to the bottom, boosting the national homeownership rate for political gain."[39] Most important, "[t]he consequences of these policies have also brought the entire global financial system to the brink of collapse, destroying trillions in equity and untold numbers of lives."[40]

To sum up the GSEs' role in establishing important preconditions for the financial crisis, one can scarcely do better than to quote the conclusions of the House staff report:

> The housing bubble that burst in 2007 and led to a financial crisis can be traced back to federal government intervention in the U.S. housing market intended to help provide homeownership opportunities for more Americans. This intervention began with two government-backed corporations, Fannie Mae and Freddie Mac, which privatized their profits but socialized their risks, creating powerful incentives for them to act recklessly and exposing taxpayers to tremendous losses. Government intervention also created "affordable" but dangerous lending policies which encouraged lower down payments, looser underwriting standards and higher leverage. Finally, government intervention created a nexus of vested interests—politicians, lenders and lobbyists—who profited from the "affordable" housing market and acted to kill reforms. . . . While government intervention was not the sole cause of the financial crisis, its role was significant and has received too little attention.[41]

38. *Id.* at 5–8, 12–17, 20–23.
39. *Id.* at 25.
40. *Id.* at 26.
41. *Id.* at 2.

In a careful, independent analysis, Stan J. Liebowitz concurs, documenting that "mortgage underwriting standards had been under attack by virtually every branch of the government [including the Fed] since the early 1990s."[42]

Another factor that has not received due attention, although it may have been the most critical element of the financial crisis, is the Fed's policy from 2001 to 2005. During these years, the Fed attempted to reverse the 2001 recession and to restore economic growth by pushing the interest rates it controls to extraordinarily low levels. The effective Federal Funds rate, which is the Fed's principal target rate in its efforts to control the overall credit markets, was quickly pushed from 6.5% in 2000 to a low of 1% by mid-2003 and kept there for the next year. Although the Fed began to increase the effective Federal Funds rate in mid-2004, this rate did not exceed 2% until December 2004, and it reached 3% only in May 2005.[43] Thus, given that the contemporary rate of inflation was roughly 2 to 3% per year, the Fed was holding the effective real Federal Funds rate in the negative range for about three years.

Small wonder, then, that related interest rates also remained unusually low during this period. Perhaps most important, the interest rate on conventional thirty-year home mortgages fell from 8.5% in May 2000 to less than 6% by January 2003, and afterward it rarely exceeded 6%, rising above that level consistently only after October 2005 and even then never exceeding 6.8% as a monthly average.[44] Figure 2 illustrates this trend. Thus, allowing for price inflation of two to three percent per year, the real rate on conventional, long-term mortgage loans remained at roughly three to four percent for several years after 2002. During that period, the Fed made bank credit, including loans for house purchases, very cheap. By doing so, the Fed fueled the housing bubble. After all, no matter how easy the terms may be in a mortgage-loan market backed by reckless GSEs, transactions still require that

---

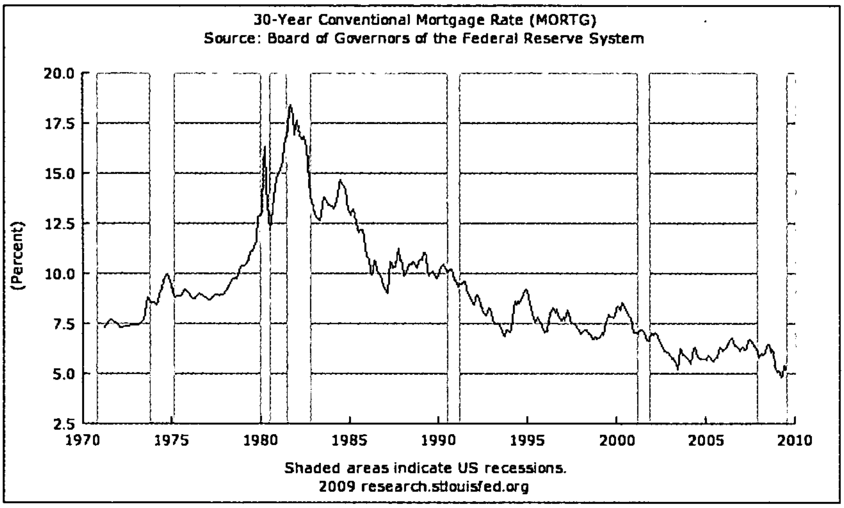
42. Stan J. Liebowitz, *Anatomy of a Train Wreck: Causes of the Mortgage Meltdown*, *in* HOUSING AMERICA, *supra* note 31, at 287, 288.

43. *See* Bd. of Governors of the Fed. Reserve Sys., Effective Federal Funds Rate, http://research.stlouisfed.org/fred2/data/FEDFUNDS.txt (last visited Feb. 23, 2010).

44. *See* Bd. of Governors of the Fed. Reserve Sys., 30-Year Conventional Mortgage Rate, http://research.stlouisfed.org/fred2/series/MORTG?cid=114 (last visited Feb. 23, 2010).

funds be available to the financial institutions that originate the loans. Absent this ample supply of monetary fuel, the development of the housing bubble would have been much less likely, if not impossible.

Figure 2[45]



The brisk rate of growth of the money stock provides further evidence of the excesses of Fed action. Between December 2000 and December 2006, the money stock, as measured by the M2 monetary aggregate, increased from $4.95 trillion to $7.06 trillion, or by 42.7%, in just six years (an average annual rate of growth of 6.1%).[46] To put this monetary growth into perspective, one may consider that from the fourth quarter of 2000 to the fourth quarter of 2006, real GDP increased by only 15.2% (an average annual rate of growth of 2.4%).[47] Thus, in this period, the money stock was growing at roughly 2.5 times the rate at which real output was growing.

Stanford University economist John B. Taylor argues that the Fed is primarily responsibile for fueling the housing boom, and hence for causing the many unfortunate consequences that ensued when this boom ultimately went bust:

45. *Id.*

46. *See* Bd. of Governors of the Fed. Reserve Sys., M2 Money Stock, http:// research.stlouisfed.org/fred2/data/M2NS.txt (last visited Feb. 23, 2010).

47. *See* BUREAU OF ECON. ANALYSIS, *supra* note 2.

> Monetary excesses were the main cause of the boom. The Fed held its target interest rate, especially in 2003–2005, well below known monetary guidelines that say what good policy should be based on historical experience. Keeping interest rates on the track that worked well in the past two decades, rather than keeping rates so low, would have prevented the boom and the bust. Researchers at the Organization for Economic Cooperation and Development have provided corroborating evidence from other countries: The greater the degree of monetary excess in a country, the larger was the housing boom.[48]

III. FRIGHTENED OVERREACTIONS

Since the onset of the current economic troubles, U.S. policymakers have acted as if they are frightened or are seeking to frighten others—insisting that the impending dangers are so ominous that unless extraordinary measures are taken immediately, a catastrophe may occur. Policymakers have also acted as if they do not know what they are doing—devising one new measure after another, in ad hoc responses to a sequence of perceived problems, especially in the various credit markets, and frequently reversing course, even abandoning major initiatives altogether and replacing them with a new bailout du jour.

Moreover, while constantly proclaiming that they seek to remedy economy-wide or even worldwide problems, they have undertaken an unprecedented degree of tailoring in deciding which institutions to help and which to forsake. In this regard, they have given the distinct impression that rather than implementing broad-gauge monetary or fiscal policy, they are engaging in financial and economic "industrial policy," picking winners with little or no apparent economic logic to support their decisions. Bear Stearns must be saved; Lehman Brothers may sink. Citigroup must be saved; CIT Group may fall into bankruptcy. General Motors and Chrysler must be saved; countless smaller firms scattered across the economy may go down. In

48. John B. Taylor, Op-Ed., *How Government Created the Financial Crisis*, WALL ST. J., Feb. 9, 2009, at A19. For other economists who have reached the same conclusion about the fundamental cause of the housing boom, see Mark Thornton, *The Economics of Housing Bubbles*, *in* HOUSING AMERICA, *supra* note 31, at 237, 242–45; Gerald P. O'Driscoll, Jr., *The Financial Crisis: Origins and Consequences*, INTERCOLLEGIATE REV. 44, Fall 2009, at 4, 4.

these circumstances, a firm's survival might well turn on having friends at the Treasury, at the Fed, or in Congress.

Small wonder that the pace of lobbying has quickened perceptibly.[49] The *Wall Street Journal* reports: "Government spending as a share of the economy has climbed to levels not seen since World War II. The geyser of money has turned Washington into an essential destination for more and more businesses. Spending on lobbying is up, as are luxury hotel bookings in the capital."[50] Thus, the existing policies amount to a recipe for political (that is, economically irrational) allocation of resources, which is scarcely reassuring for those seeking to divine the economy's future.

In mid-November 2008, Edmund L. Andrews observed: "White House and Treasury officials have been devising policy on the fly for months now, as what began as a panic over losses on subprime mortgages broadened into a crisis that wreaked havoc on Wall Street, at major commercial banks and in the broader economy itself."[51] In a December 18, 2009 speech at the American Enterprise Institute, President Bush explained rather defensively why he had approved the big financial bailout bill enacted on October 3:

> I was in the Roosevelt Room and Chairman Bernanke and Secretary Paulson, after a month of every weekend where they're calling, saying, we got to do this for AIG, or this for Fannie and Freddie, came in and said, the financial markets are completely frozen and if we don't do something about it, it is conceivable we will see a depression greater than the Great Depression. So I analyzed that and decided I didn't want to be the President during a depression greater than the Great Depression, or the beginning of a depression greater than the Great Depression. So we moved, and moved hard.[52]

---

49. David Cho, Steven Mufson & Tomoeh Murakami Tse, *In Shift, Wall Street Goes to Washington*, WASH. POST, Sept. 13, 2009, at A1; Mark Landler, *Lobbyists Swarming the Treasury for a Helping of the Bailout Pie*, N.Y. TIMES, Nov. 12, 2008, at A22.

50. Davis & Hilsenrath, *supra* note 17.

51. Edmund L. Andrews, *Bailout Effort Shifting Focus To Consumers*, N.Y. TIMES, Nov. 13, 2008, at A1.

52. Posting of Karen Tumulty to Swampland: A blog about politics, *President Bush Uses the D-Word*, http://swampland.blogs.time.com/2008/12/18/president-bush-uses-the-d-word/ (Dec. 18, 2008, 17:37 EST).

John B. Taylor notes that "[t]he realization by the public that the government's [TARP] intervention plan had not been fully thought through, and the official story that the economy was tanking, likely led to the panic seen in the next few weeks."[53] Moreover, "this was likely amplified by the ad hoc decisions to support some financial institutions and not others and unclear, seemingly fear-based explanations of programs to address the crisis."[54]

Further evidence that policymakers were flying by the seat of their pants comes from the sheer number and variety of significant policy actions taken in the brief period from early September to mid-November 2008 and, somewhat less frantically, in the months afterward. Over this time, the government took the following actions:

> Sept. 7: The Treasury takes over mortgage giants Fannie Mae and Freddie Mac, putting them into a conservatorship and pledging up to $200 billion to back their assets.
>
> Sept. 16: The Fed injects $85 billion into the failing American International Group, one of the world's largest insurance companies.
>
> Sept. 16: The Fed pumps $70 billion more into the nation's financial system to help ease credit stresses.
>
> Sept. 19: The Treasury temporarily guarantees money market funds against losses up to $50 billion.
>
> Oct. 3: President Bush signs the $700 billion economic bailout package. . . .
>
> Oct. 6: The Fed increases a short-term loan program, saying it is boosting short-term lending to banks to $150 billion.
>
> Oct. 7: The Fed says it will start buying unsecured short-term debt from companies, and says that up to $1.3 trillion of the debt may qualify for the program.
>
> Oct. 8: The Fed agrees to lend AIG $37.8 billion more, bringing total to about $123 billion.

53. Taylor, *supra* note 48.
54. *Id.*

> Oct. 14: The Treasury says it will use $250 billion of the $700 billion bailout to inject capital into the banks, with $125 billion provided to nine of the largest.
>
> Oct. 14: The FDIC says it will temporarily guarantee up to a total of $1.4 trillion in loans between banks.
>
> Oct. 21: The Fed says it will provide up to $540 billion in financing to provide liquidity for money market mutual funds.
>
> Nov. 10: The Treasury and Fed replace the two loans provided to AIG with a $150 billion aid package that includes an infusion of $40 billion from the government's bailout fund.[55]

Not since the explosion of government intervention into economic affairs at the outset of the New Deal has the government enacted such a rapid-fire succession of significant measures so quickly. Policymakers ordinarily might have studied, debated, and refined any one of these measures for months before its implementation. This time, however, scarcely any of them received more than perfunctory consideration, and many measures were adopted so hastily that it is difficult to believe that they received more than a few hours of serious thought by more than a handful of people. Never before in U.S. history did so many measures of such great importance come forth from so few decision makers in so little time.

Even when Congress voted as a whole, as it did on the bailout bill enacted on October 3, 2008, few members had a genuine grasp on the legislation. Most congressmen were stampeded into going along with the bill by the exhortations of frightened leaders in the executive and legislative branches and by Fed Chairman Ben Bernanke. Four days after Congress approved and the President signed the Emergency Economic Stabilization Act of 2008, Congressman Ron Paul wrote:

> The rallying cry heard all over the Hill the past two weeks was that Congress must act. Our economy is facing a meltdown. Would this bill fix it? Nobody could really explain how it would. In fact, few demonstrated any real understanding of credit markets, of derivatives, of credit default swaps or mortgage-backed securities. If they did, they

55. Kathleen Pender, *Government Bailout Hits $8.5 Trillion*, S.F. CHRON., Nov. 26, 2008, at A1.

> would have known better than to vote for this bill. All they knew was that this administration was saying some frightening things, and asking for a lot of money.[56]

It is possible to survey all of the extraordinary actions the government took in the late summer and autumn of 2008 and conclude that, given the conditions at that time, the authorities had little choice and acted only as the situation clearly required to avoid catastrophe. "There is no playbook for responding to turmoil we have never faced," Secretary Paulson declared in mid-November.[57] "We have done what was *necessary* as facts and conditions in the market and economy have changed, adjusting our strategy to most effectively address the crisis."[58] Although this account is conceivable, it is highly implausible. Much more plausible is the interpretation that if indeed the government's objective were simply to avert catastrophe, then it clearly overreacted. It perceived a serious potential for disaster where the actual potential was much smaller or, in many specific areas, virtually nonexistent. It consistently failed to consider how, if the government did nothing, private parties might meet the existing challenges by means of their own devising because they have such a great incentive to do so. In short, the government overreacted because the handful of government decision makers who wielded the greatest power at the time assumed that central government action ought to be the *first resort* in a perceived crisis.

Consider the crisis atmosphere that the government and the news media created in late September and early October 2008 and, to a somewhat lesser extent, in the four or five subsequent months. As Brian Gilmore, executive vice president of a Massachusetts trade association, stated in November 2008: "The whole psychology is that the sky is falling, even though it's not."[59] The media and government story line, repeated again and again, as if mere repetition made it true, was that the credit markets were "locked up," "clogged," "melted down,"

---

56. Ron Paul, *The Do-Something Congress*, LEWROCKWELL.COM, Oct. 7, 2008, http://www.lewrockwell.com/paul/paul483.html.

57. Henry M. Paulson, Jr., Op-Ed., *Fighting the Financial Crisis, One Challenge at a Time*, N.Y. TIMES, Nov. 18, 2008, at A27.

58. *Id.* (emphasis added).

59. Ross Kerber, *Small-business loans still flowing; Many in Mass. find no barrier*, BOSTON GLOBE, Nov. 21, 2008, at A1.

"frozen," or, in other metaphors, effectively inoperative. One financial dealer after another told news reporters that "nobody is lending," or used words to the same effect.

Yet the Fed's comprehensive data for the volume of lending in various credit markets at the time showed nothing to warrant these hysterical views.[60] Finally, in January 2009, *Global Finance* reported that "[a] chorus of dissenting voices has emerged that is challenging the widely held belief that interbank lending markets have dried up, commercial lending is being curtailed, and non-financial commercial paper markets have virtually ground to a halt."[61] The article cites the analysis of researchers at the Federal Reserve Bank of Minneapolis and a report by Octavio Marenzi, head of the research firm Celent, who stated:

> While there is no denying that we are mired in a very serious financial crisis, this does not yet appear to have transformed into a general credit crisis. . . . In aggregate, credit and lending markets appear to be functioning well and in many cases are actually operating at historically high levels.[62]

Marenzi concluded that unless policymakers had undisclosed data to support their actions, it appeared that they were "making generalizations based on the situation of a particular set of businesses or banks."[63]

Throughout the recent crisis, policymakers operated on the basis of two unspoken assumptions: The volume of outstanding credit should never decline, and if the volume of outstanding credit does decline, the government should act to reverse that decline. Neither assumption makes good economic sense. Past increases in the volume of credit may have been excessive; indeed, in the mortgage-lending market, one would be hard pressed to deny such excesses now that so many subprime and Alt-A loans have become delinquent.[64] One

---

60. *See* Posting of Robert Higgs to The Beacon, *Credit Is Flowing, Sky Is Not Falling, Don't Panic*, http://www.independent.org/blog/?p=201 (Sept. 23, 2008); Posting of Robert Higgs to The Beacon, *The Data Don't Justify Financial-Market Panic*, http://www.independent.org/blog/?p=255 (Oct. 8, 2008); Posting of Robert Higgs to The Beacon, *My Credit Is Not Frozen (Nor Are Most Others')*, http://www.independent.org/blog/ (Oct. 11, 2008).

61. Anita Hawser, *Credit Crunch May Be A Myth*, GLOBAL FIN., Jan. 2009, at 4, 4.

62. *Id.*

63. *Id.*

64. Paul Jackson, *Alt-A Mortgage Loan Delinquencies Nearly As Bad As Subprime*, NUWIRE INVESTOR, May 1, 2009, http://www.nuwireinvestor.com/articles/

cannot easily justify the idea that past foolhardy loans, now being wiped off the accounts in foreclosure proceedings, ought to be propped up or quickly replaced by loans that, under present conditions, can scarcely be any less foolhardy. Yet many of the government's emergency policies seem designed to achieve precisely this nonsensical objective.[65] If credit retrenchment is occurring for good reasons, then the government's actions to offset it are unnecessary, and will most likely be mischievous, as well. Government loans or loan guarantees will prop up borrowers who ought never to have received the loans in the first place. Such measures diminish the economy's overall efficiency and lay the foundation for a recurrence of similar troubles.

Many of the government's crisis actions seem aimed not at doing what makes economic sense, but at saving select incumbent firms that got into trouble by making bad bets. Apart from anything that might be said about taking money from responsible parties and giving it to irresponsible parties, such policies in effect maintain an economic condition in which profits remain private, but losses are socialized. The moral hazard these policies promote may be the worst consequence of the government's crisis response in the long run. Federal Reserve Bank of Philadelphia President Charles I. Plosser noted this danger:

> This crisis, whether it's because of the Fed or the Treasury or Congress, has created a lot of new moral hazards. . . . Once you have done this once, even though it was in a severe crisis, the temptation will be for people to figure that in the next crisis you'll do it again.[66]

What major firm's managers in the future will fear having to bear the full consequences of imprudent actions? Will not all such actors appreciate that the government stands ready to bail out their firms on the grounds that they are "too big to fail" or that permitting them to fail poses too great a "systemic risk"?

---

alt-a-mortgage-loan-delinquencies-nearly-as-bad-as-subprime-52903.aspx; *Subprime, Alt-A mortgage delinquencies rising: S&P*, REUTERS, May 22, 2008, http://www.reuters.com/article/gc03/idUSN2249493920080522.

65. *See* Patrice Hill, *Feds help feed new market for easy mortgages; High-risk loans guaranteed*, WASH. TIMES, Oct. 19, 2009, at A1.

66. Edmund L. Andrews & David E. Sanger, *U.S. Is Finding Its Role in Business Hard to Unwind*, N.Y. TIMES, Sept. 14, 2009, at A10.

Officials at the Treasury and the Fed repeatedly advanced the latter claim when explaining their action. Thus, on October 14, 2008, Secretary Paulson issued a statement that declared: "[O]ur actions are extensive, powerful and transformative. They demonstrate that the government will do what is necessary to restore the flow of funds on which our economy depends and *will act to avoid, where possible, the failure of any systemically important institution.*"[67] Systemic risk denotes the potential for an institution's failure to set in motion a train of other failures, ultimately bringing down the entire economic system or at least a large part of it. It is a frightening prospect, and members of Congress generally defer to Fed or Treasury officials who explain that the powers they possess or seek will be used to avert it.[68] Despite the centrality of systemic risk in the rhetoric employed by policymakers, it has not been well established as a serious threat. In a recent substantial econometric study, the investigators concluded that "chances of systemic failure appear low even during major financial crises."[69] Regardless of its actual likelihood of wreaking major harm, however, systemic risk is an idea that lends itself splendidly to fear-mongering.

IV. THE RATCHET EFFECT

During the past century, whenever the government abruptly expanded its size, scope, and power during a national emergency, it never returned completely to its pre-crisis dimensions or even to the dimensions that it would have attained had pre-crisis trends continued. I call this phenomenon the "ratchet effect."[70] In view of the political logic of this

---

67. Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Actions to Protect the U.S. Economy (Oct. 14, 2008) (emphasis added), *available at* http://www.treas.gov/press/releases/hp1205.htm; *see also Systemic Risk And The Financial Markets: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 7 (2008) (statement of Henry M. Paulson, Jr., Sec'y, U.S. Dep't of the Treasury).

68. Deference is not always forthcoming, however. At a hearing on July 15, 2008, Senator Jim Bunning told Federal Reserve Chairman Ben Bernanke: "Now the Fed wants to be the systemic risk regulator. But the Fed is a systemic risk." Posting of John Carney to Dealbreaker, http://dealbreaker.com/ (July 15, 2008, 11:48 EDT).

69. Söhnke M. Bartram, Gregory W. Brown & John E. Hund, *Estimating systemic risk in the international financial system*, 86 J. FINANCIAL ECON. 835, 839 (2007).

70. *See* ROBERT HIGGS, AGAINST LEVIATHAN: GOVERNMENT POWER AND A FREE SOCIETY 214 (2004); ROBERT HIGGS, CRISIS AND LEVIATHAN: CRITICAL EPISODES IN THE

phenomenon and the particular facts of the current crisis and the government's responses to it, it is likely that we shall see the same pattern of events in the present case.

The government's size, as measured by its fiscal dimensions, almost certainly will remain at a greater level for many years after the current emergency has passed. According to the CBO baseline-projection update in August 2009, federal outlays will jump from 21% of GDP in fiscal year 2008 to 26.1% in 2009, and then fall back to lower ratios in subsequent years. However, the retrenchment is currently forecasted to return the outlay percentage only to 22.6% in fiscal year 2013, after which it will increase slowly until 2019, when it will be 23.4%, or 2.4 percentage points greater than it was in 2008.[71] One would be a fool to take such projections seriously for more than the very short term. Long before the ten-year projection period has run its course, unanticipated changes in economic conditions and government fiscal activities almost certainly will have occurred, displacing the government's spending ratio from its currently projected path. Nevertheless, the current projections do indicate that unless the government's future spending and taxing levels are altered from those implied by currently existing laws or unless the economy performs substantially better than the forecast predicts, the upshot of the present surge in outlays will be a permanently higher level of federal outlays relative to GDP—a fiscal ratchet effect.

The CBO's projections also show that federal taxes as a percentage of GDP will recover from their relatively low levels of 2009 and 2010, and after 2012 they will lodge in the relatively high range (by the standard of the past forty years) of nineteen to twenty percent. Federal debt held by the public is projected to rise every year, ascending from $5.80 trillion (or 40.8% of GDP) at the end of fiscal year 2008 to $14.32 trillion (or 67.8% of GDP) at the end of fiscal year 2019.[72] The CBO report concludes:

> Over the long term (beyond the 10-year baseline projection period), the budget remains on an unsustainable path. Unless changes are made to current policies, the nation will

GROWTH OF AMERICAN GOVERNMENT 30–33 (1987); ROBERT HIGGS, NEITHER LIBERTY NOR SAFETY: FEAR, IDEOLOGY, AND THE GROWTH OF GOVERNMENT 82 (2007).

71. CONG. BUDGET OFFICE, THE BUDGET & ECONOMIC OUTLOOK: AN UPDATE, 1-2 tbl.1-1 (2009).

72. *Id.*

> face a growing demand for budgetary resources caused by rising health care costs and the aging of the population. Continued large deficits and the resulting increases in federal debt over time would reduce long-term economic growth by lowering national saving and investment relative to what would otherwise occur, causing productivity and wage growth to gradually slow.[73]

It also seems likely that the government's responses to the crisis of 2008–2009 will permanently enlarge the scope of its intervention in the economy. The government has acquired major ownership stakes in hundreds of commercial banks and in AIG, General Motors, and Chrysler. It may retain a portion of this ownership and control for a long time. Fannie Mae and Freddie Mac are now effectively government-owned and operated enterprises, and they, along with the recently bloated FHA,[74] remain the overwhelmingly dominant players in the secondary mortgage market, exerting a huge effect on mortgage financing and hence on the markets for residential housing and all the goods and services associated with it—altogether a substantial part of the economy and a sector that plays an especially important role in generating macroeconomic booms and busts.

In addition, the Fed has vastly expanded the scope of its lending and other operations, and it now effectively implements a financial industrial policy through its decisions to aid only selected firms and industries. If the Fed is not "picking winners," it is certainly deciding who will be spared a market-determined fate as a loser.[75] How the Fed will exercise these new powers in the long run remains unclear. Fed officials insist that they intend to withdraw from many of the new areas they have recently entered once the crisis has passed, but it would be surprising if none of the recent "emergency" policies remained in the Fed's arsenal to bulk up its powers. Executives on Wall Street say that "the legacy could be enduring."[76] Officials in the Obama Administration "bristle at even the hint that their rescue measures have ushered in a new era of 'big government.' But supporters

73. *Id.* at xii–xiii.

74. *See* Hill, *supra* note 65.

75. *See* Randall G. Holcombe, *Transforming America: The Bush-Obama Stimulus Programs*, FREEMAN, Sept. 2009, at 34, 34–35.

76. Cho, Mufson & Tse, *supra* note 49.

and critics alike worry that it will be difficult to shrink the government to anything like its former role."[77] Many of the recently created vested interests in these new interventionist measures are sure to press for their perpetuation.

Moreover, if the Fed succeeds in getting the authority it has been seeking to act as a super-regulator of all firms (nonbanks as well as banks) the failure of which might pose a systemic risk to the economy,[78] then the current crisis will have produced another highly significant ratchet effect on the scope of government. Indeed, even if another government agency or a council of several agencies undertakes this role, the action will amount to a major increase in the government's regulatory power.

Unfortunately, the government's engagement as a systemic-risk regulator serves as a perfect example of what F.A. Hayek called the pretense of knowledge.[79] After all, this arrangement would be tantamount to hiring the same fox that has been devouring the chickens as the security guard for the henhouse. Moreover, it is difficult to envision how the government can conceivably attempt to regulate the firms it takes to pose a systemic risk without wreaking major economic mischief. In a passage that remains as apt today as it was in 1776, Adam Smith warned:

> The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.[80]

---

77. Andrews & Sanger, *supra* note 66.

78. *See generally* Alison Vekshin, *Obama's Fed Risk Regulator Plan Fades as Lawmakers Back Council*, BLOOMBERG, July 23, 2009, http://www.bloomberg.com/apps/news?pid=20601070&sod=a_H7XBO4IEB8.

79. *See* Alan S. Blinder, *An Early-Warning System, Run by the Fed*, N.Y. TIMES, July 25, 2009, at BU5; Friedrich August von Hayek, Nobel Prize Lecture, The Pretence of Knowledge (Dec. 11, 1974), *available at* http://nobelprize.org/nobel_prizes/economics/laureates/1974/hayek-lecture.html; *see also* Doug French, *Ben Bernanke's Pretense of Knowledge*, LUDWIG VON MISES INST., Dec. 6, 2008, http://mises.org/story/3247 (applying Hayek's concept to Bernanke's actions in 2008).

80. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 423 (Modern Library 1937) (1776).

Smith was warning against what he had earlier called the presumptuous "man of system," who "is apt to be very wise in his own conceit."[81] Today, that general class may include the presumptuous "man of systemic risk regulation." In view of the seemingly limitless scope of this species of regulation and the likelihood of its being exercised in a very harmful manner, it poses an especially great risk to the economy's successful functioning.

---

81. ADAM SMITH, THE THEORY OF MORAL SENTIMENTS 233 (D.D. Raphael & A.L. Macfie eds., Liberty Fund 1982) (1759).