

Why the Current “Policy Bubble” Will Burst

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In the late 1990s, stock markets went through the “dot.com” bubble. Investors bought with “irrational exuberance” the new-era story that the world economy had changed so much that high-flying price-earnings ratios for internet stocks could be justified by the untold profits that virtually any firm establishing a low cost “storefront” in cyberspace could earn into the distant future. The bubble burst in March 2000 when investors finally realized that the low-cost of entry would ensure that profits of the vast majority of dot.com firms would be readily competed away.

Through the first five years of this century, a housing price bubble emerged, founded on the new-era story that housing would become ever scarcer and that all Americans, no matter their incomes and credit scores, deserved home ownership. Besides, the housing price bubble itself fortified the belief that the credit unworthy could and would handle mortgages with little to zero down payments and low “teaser” (subprime) interest rates, with the government subsidizing many mortgages in a variety of ways. The mortgage meltdown ensued when unworthy homeowners’ monthly payments suddenly jumped upward and they began walking away from their mortgages in droves.

In these two bubbles, few disputed the too-good-to-be-true storyline, much less dared to sound the alarm that the underlying logic was flawed – until after each of the bubbles had burst.

Now, we are in the midst of another bubble – a “policy bubble” – with many policy makers and commentators accepting with, again, “irrational exuberance” the new era storyline that the economy is on the precipice of a Second Great Depression and that the only acceptable policy course is for the federal government to orchestrate a two-prong fiscal attack on the country’s economic troubles: 1) bailout financial institutions and other politically selected deserving firms who are “too large to fail” and 2) stimulate the economy with a massive, if not unchecked, expansion of federal deficit spending. Otherwise, the economy will sink ever deeper into the economic abyss for a decade or more.

Few are willing to counter the growing shrillness of the “do something, do anything” policy drumbeat. As a consequence, the proposed bailout and stimulus packages have grown ever larger during the past six months, with the proponents expressing unflinching confidence that they really *know* what will work and what is good for the country.

By this time next year, this new bubble also will have burst under the cold experience of the policy failures that will ensue during the coming months and from reflection that, as in the cases of the dot.com and housing bubbles, too many like-minded people were listening to each other to the exclusion of the few who dared to question the logic of the bailout and stimulus packages. Nevertheless, it is a good bet that by this time next year many people will recognize that the policy proponents really didn’t *know* what

they were doing and that all the bailouts and stimulus expenditures have been largely for naught – at best.

If there is a remaining debate over the effects of the massive increase in government expenditures, it will concern how counterproductive the bailout and stimulus dollars have been. This eventual outcome of the current policy advocacy is likely for several reasons: Advocates of the bailout/stimulus packages have touted only the positive effects of more federal dollars being injected into the system. They have sidestepped any mention of the negative effects of the resulting federal deficits, which now will likely exceed \$2 trillion (and maybe \$3 trillion) over the next twelve months. And the massive increase in deficit spending will require the federal government to pull out of credit markets as many dollars through bond sales as it injects through expenditures. The greater government debt will likely cause people to expect higher tax rates in the future, which will dampen people's enthusiasm for working harder and smarter and saving and investing more.

The federal dollars spent for bailouts of people and firms for their bad decisions also will encourage more of the same bad economic decisions, a realization people will begin to see by this time next year. The bailouts and stimulus packages have been touted for their ability to really “stimulate” the current sagging economy. The country will learn that many of the federal dollars will not be spent for years to come. Many other dollars handed out in bailouts of banks and homeowners will not be spent; the dollars will go to paying off debt from past expenditures.

In addition, during the next twelve months,

- The country will stand witness to how badly politics can operate when \$1 trillion or \$2 trillion dollars are at stake.
- Reports will abound this time next year on how political machinations have filled the troughs of the politically well-connected and how the speed with which the bailout and stimulus packages have been crafted has given rise to virtually unchecked graft and mountains of waste in government.

Government agencies simply cannot be expected to spend as much money as will be at stake over the following year without making huge mistakes and without being misguided by political interests unconcern with larger societal values.

- The country will come to understand how the federal dollars have lined the pockets of lobbyists and elevated the already exorbitant pay of CEOs who pleaded for federal dollars with the interest of only the “common man” at heart.
- The country will observe how the federal government is bound to throw more bailout and stimulus dollars after bad ones (as it has already done) because policy makers and politicians will not easily give up their recommended policy course as intellectually bankrupt in its conception. The advocates will not concede that their recommended policy course was, from the start, a policy train wreck in the making. Besides the mounting deficits will be the country’s not the proponents’.
- There will be howls coming from all quarters of the country over how many advocates of expanded government have used the country’s current financial

troubles as a smokescreen for their larger objective, which has been to enlarge the dominance of the public sector over the private sector. This time next year, free-market economics will experience a revival not because it has proven to be flawless, but rather because the alternative more-government ideology guiding policy for the previous year will have proven to be even more wanting.

- The country will come to understand a lesson learned from the venturesome federal policy upheavals of the 1930s and 1970s, that ever-changing and unstable federal fiscal policy can itself be debilitating to the national economy because it will be hard for people to know what is going to come next from the ebbs and flows of Washington politics.

By this time next year, the case made for the bailout and stimulus packages will be seen for what it has been, a most egregious form of false advertising, founded, as the case has been, on the claim that a lot of economic recovery can be had for nothing, or can be magically willed into existence through some fleeting “multiplier effect” of federal dollars scattered recklessly through government bureaus. Now, free markets are seen as being the heart of the country’s problems. A year from now, many will come to see government intrusion as the problem, a check on what could have been an otherwise even more prospering private economy.