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ECONOMIC VIEW

What's Free About Free Enterprise?

By PETER L. BERNSTEIN

THERE was a time, in my childhood during the Great Depression, when the streets of Manhattan were filled with unshaven men in threadbare clothes, their coat collars turned up against the cold, their shoes stuffed with newspaper to plug holes in the soles. And there were bank failures.

A huge bailout plan is being hammered out in Washington precisely to avert this kind of economic calamity. The plan is needed, and it needs to be put in place quickly. But at the same time, we need to ask how the financial system came to require a rescue of this magnitude.

This time around, assets are evidently so rotten in so many places that no financial institution wants to risk doing business with any other financial institution without a government backstop.

Such fear recently threw a huge bucket of sand into the wheels of commerce, because business cannot function without credit and banks cannot function without the ability to draw on one another's resources as needed. Some radical, comprehensive step from government was necessary, or else outcomes as bad as — and perhaps even worse than — those of 1931 and 1932 would have been inescapable.

Naturally, a plan of this magnitude has stirred a storm of commentary, but two important potential results deserve more attention than they have received.

The first is the risk of moral hazard within the bailout itself. That is, if government is going to make good so many losses throughout the system, why would anyone set limits on future risk-taking? The situation could turn into a free-for-all that makes the recent disregard of risk look like child's play.

The second problem is more philosophical, involving what the bailout plan reveals about the functioning of the free enterprise system. This raises disturbing questions. Although I agree with President Bush's observation that "the risk of not acting would be far higher," we should

be aware of the secondary effects of what we are getting into.

My position on government bailouts of institutions on the verge of failure has been clear ever since the procedure was formalized in the savings-and-loan crisis in 1989, under the first President Bush. I have favored these steps, even though such rescues reward those who took more risks than they should have and are ultimately paid for by those who were more prudent.

FROM this viewpoint, government bailouts create moral hazard and therefore might seem a mistake. If the government always comes to your rescue when the chips are down, why limit your risks? Why not go for the gold every time? What does it matter if you put the system over the edge, so long as you have a chance to make money and Uncle Sam will take care of everything if you lose? How could any rational individual pass up those kinds of opportunities?

We could avoid this conflict of interests by refusing to bail out the risk-takers and letting the financial miscreants squirm in their own juice. That might provide satisfaction to moralists, but life is not so simple. An epidemic of unpaid bad debts would devastate lenders and ignite a conflagration that could pull down the economic and financial structure, ruining everybody.

We were on the verge of such an outcome in the last few weeks, as banks froze up in fear that every piece of paper was tainted. As a result, they refused to enter into the most routine kinds of transactions with one another. The choice is between two cruel outcomes: the high probability of an irreparably damaged financial system, or an overload of moral hazard. I prefer dealing with moral hazard later; preserving the system — and society — must now have top priority.

My views have developed over the years, from the bailouts of single entities like Long-Term Capital Management or Bear Stearns, or small groups of companies like savings institutions. But these relatively simple transactions have only a distant family resemblance to the Paulson-Bernanke plan for a huge bailout of countless financial institutions, to say nothing of possible help to households that took on mortgages that would work out only if the home price kept rising.

There is an immense difference between a plan for a comprehensive bailout and the far simpler process of bailing out Bear Stearns or even a dozen or so Bear Stearnses. The justification is the same, but the grim consequences in terms of moral hazard are of an incomparably greater order of magnitude.

Once the federal government declares, "Thou shalt not fail," there are no limits to how far future risk-takers will go. Who will see any need to pay attention to the possible consequences

for the government's budget, the market for its bonds, the taxpayers, its creditors and, indeed, the whole economic structure?

Furthermore, there are limits to how freely Washington can dispense largess. We no longer owe the national debt to ourselves, as we did in the 1930s, when deficit financing was first proposed as viable policy to overcome the Depression. Financing the government today depends heavily on foreigners' willingness to buy our bonds, but foreigners accept our obligations only when they see some kind of control over the volume of issuance. They will perceive very little control in plans whose limits are porous and uncertain.

My second issue goes to the foundations of the economic system in which most Americans believe and take for granted. Though we sometimes give it more lip service than respect, it is rooted in individual decision-making in free markets. In theory, at least, the less government intervention, the better; the mantra is that markets know best.

We often hear this refrain, and history confirms its importance in the most profound issues of economic policy. It justifies our revulsion with Communism, our philosophical distance from the current Chinese system, and our distaste when politicians, not markets, try to shape our system.

Faith in free markets made icons of Ronald Reagan and Margaret Thatcher, who made deregulation a policy cornerstone. An echo in our own time was the 1999 repeal of the Glass-Steagall Act, legislated in 1933 to separate investment banking and commercial banks. Its repeal was a key contributor to the calamities now gripping the banking system.

TODAY'S crisis thus emerged from a combination of disasters operating in free markets, but wreaking ruin as they developed. The subprime mortgage mess, the huge leverage throughout the system, the insidious impact of new kinds of derivatives and other financial paper, and, at the roots, the vast underestimation of risk could not have happened in a planned economy. A superjumbo bailout is the inescapable result, but at some point we must confront its more profound implications.

As we move into the future, and as the crisis finally passes into history, how will we deal with this earth-shaking blow to the most basic principle of our economic system? I do not know how to answer that question. But we need to ask it.

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