THE FINANCIAL CRISIS: THE LIBERAL ANSWER

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Abstract. As a tsunami, we are facing a hype among governments to socialize the losses of banks and (partly) nationalize them. It almost looks as if socialism, at least for the important problems of the world, is working again. In this paper, however, we will look for the liberal (in its European meaning of the word) answer.

In other words, we answer the question why socialism will not work: empirically, economic-theoretically, and ethically.

Empirically, the development in Eastern Germany as compared to that of the Czech Republic after the fall of communism is almost a controlled experiment that shows the differences in the results of socialism versus capitalism.

Economic-theoretically, to solve the financial crisis we do need the use of all the knowledge we do have. We need the knowledge creative bankers do have or do discover if only pressed to use it.

Ethically the more governments decide, the less there is for individuals to decide. Given the self-evident individual right to life, liberty, and property, the policy is immoral.

How would the liberal answer to the crisis have looked like? First, the best rule to regulate banking is the free market. If government guarantees had not backed the loans, many of the homeowners would not have gotten a loan by the financial sector in the first place. Second, many banks would have gone broke. As against the assumption behind the too-big-to-fail doctrine--not all banks would have disappeared in a black whole.

All-in-all the paper makes us cautious to expect results from the present policies to solve the financial crisis.

Key words: Financial crisis, liberalism, socialism, market economy

Introduction

For the liberal, the handling of the financial crisis worsens. At first---with only temporary policies---trust in the banking sector had to be repaired. Presently, however, governments do already speak of creating a new sort of worldwide capitalism. For the world, the credit crisis is no longer an isolated business accident but has become a crisis of the financial system as a whole.

For the liberal, the handling of the authorities of the credit crisis is as wrong as it can be. That counts as well for rescuing individual banks as the proposed worldwide restructuring of the financial system. Not so long ago we all really did think that the
Berlin Wall fell in the direction of the East. Now it appears that state property and detailed regulation are again the highest forms of wisdom.

Is there for the liberal nothing else to do then to remain silent---apparently forever? No. A liberal can say something of importance as regards to the causes of the crisis, the costs of the chosen government solution and offer an even better solution. At least we may remind the public that socialism never has worked and, no matter how the world has changed, it will either at this moment. After all, it are still the same imperfect people who do populate the world.

The causes of the crisis

Our confidence in the banking system is at a low point. Possessions at the debit side of the bank balance do not have the value we thought they had. There are more insolvent debtors then we thought there would be.

How did this situation arise? Through the promoting of home ownership in the US---government policy implemented through the recently by the authorities saved banks Freddy May and Fanny Mac---people got loans. Loans no commercial bank would ever have given them. These loans later on were traded on the market; they were sold to other financial institutions. This in contrast to the old days when those loans mostly remained by the local bank that had accepted them in the first place.

In general, there is nothing wrong with the trading of risks on the market: the modern society cannot do without it. Entrepreneurs know: without risk no profit. However, they also do know that when risks are too high, they need to take precautions. Hence, against risk outside their direct entrepreneurship and expertise, they cover them selves. Nowadays, they have to that. Until the middle of 70s, at the time of the Keynesian politics, risks were socialized. The central authorities tried to regulate fluctuations in the economic climate and exchange rates. That policy finally led to stagflation: stagnation in economic growth combined with inflation. In a---anyway till recently---more liberal world entrepreneurs have to limit the risks themselves. The market furnishes a solution in the form of derivates (Bryan and Rafferty, 2006). Derivates are instruments of which the value depends on the value of the underlying good. In this way, entrepreneurs can insure themselves against price fluctuations without buying the good itself. Entrepreneurs can concentrate on that at which they do best and for the rest they do buy the security they need. In the U.S., financial institution was very creative in developing these kinds of financial products. It is a source of productivity increase for the whole economy; the financial sector included. One of the reasons, cited by Alan Greenspan, people could get loans who in the old days could not get one.

The development of new (knowledge) products goes with ups and downs. Derivatives do contain a risk of themselves. We cannot change that fact; 100% security is not of this world. A recent article in the Wall Street Journal (13.10.08) says, "The 1% Panic." The subtilte is, "Our financial models were only meant to work 99% of the time.” However, that is nothing new. In 1973, Black and Sholes came up with a formula to price options. In 1997, Sholes got the Nobel Prize for his invention. The formula lets us manage more effectively the possible risks of options. Every trader on Wall Street had the formula in his palmtop computer. They could earn money with it; some options or
other financial products were according to the formula priced at a wrong price. In order to profit from his invention, together with others, Sholes founded an investment firm. After initial success, in 1998 it goes awkwardly wrong. Because of the unforeseen crisis in Asia and Russia, the fund goes broke. At least, that should have happened. At the insistence of the Federal Reserve, the financial world rescued the fund (too-big-to-fail?). This though the fund had traded, willingly and in full knowledge of the risks, in the most exotic financial products. Often in products that were outside the direct regulation of the financial authorities.

The costs of the chosen solution

As has been said by Milton Friedman (New York Times, August 13, 1994), “Once again: Why socialism won’t work.” Also, once again, what are the reasons: empirical, economic-theoretically, and ethical that socialism does not work? What does freedom mean for the credit crisis?

Empirical

Empirically there is no doubt that private property and incentives that stimulate self-interest do let production grow. In history, every step of the government in that direction did have positive results for economic growth. China did not solve its poverty problem by giving government aid to industries or getting massive support from abroad. It all started in 1978 and onwards with Deng Xiaoping’s lowering of the marginal tax rates on the products of the farmers. The marginal rate became zero instead of the rate of 100% before. Instead of to produce for the common good, a farmer had, from then on, to produce a certain amount of goods for the common good and the rest he could keep for himself. In the same spirit, more recently to increase the prosperity of the farmers, the Chinese government gave one more aspect of property rights to the farmers: it is possible for the farmers to rent out parts of the land.

In Europe too, as is said by the president of the Czech Republic, Klaus (2008), the situation in his country as compared to that in the former Eastern-Germany is an almost controlled experiment. It demonstrates that government aid does not work. The economic situation in Eastern-Germany, despite solid help from the former West Germany is no better then the situation in the Czech Republic. The only thing a government can do is to promote competition and therewith freedom. The Czech Republic (at that moment united with Slovakia) just did that after the fall of the communism: it opened its borders for foreign products. Domestically there was almost no competition because of the existence of often monolith industries. The authorities, however, did not have the knowledge to split up the industries efficiently or to make them efficient players on the global market. Besides that, the government had to do the whole transformation process in a hurry. If it would take too long, special interests could stifle the whole process.

Theoretical
The goal of freedom is to give the occasion as well as the stimulus to insure the highest possible use of knowledge. It is often said that we do live in a knowledge economy. For the liberal the word “knowledge economy” is a pleonasm. For Hayek (1949) the function of a market economy has always been to spread the information on which the buyers can act. The road to progress is to take raw materials and labor out of products and substitute knowledge for it. Greenspan, when he was president of the Federal Reserve, used to say that the American national income, in real terms, in the last fifty years did grow fivefold. In weight, however, it did not grow (cp. Wriston, 1992. In weight, 2% of world trade is going by air. In value, however, it is 40% of the total value of trade). The West is richer then the rest of the world, not only because it possesses more capital, but also especially because it uses more of the existing knowledge (Hayek, 1960).

The central planners do not have the required knowledge. The government cannot centralize many forms of knowledge. Even if we can make use of the cleverest functionaries, the chance that outside government, there is someone with yet better ideas is much larger. Moreover, even if we can make use of the best knowledge which we possess at this moment—the world would come to a stand still. This is not because there are no possibilities for still future growth, but because all our acting would become congruent with our present knowledge: there is no possibility anymore for new knowledge to arise.

In general, the function of governments is to state the rules of the game: to create freedom and the possibility of the results of freedom. The function of government is not to prescribe the outcomes of the game. The same goes for the financial sector. Besides that, where does all the money of government intervention come from? We do see, as Frederic Bastiat (1975) has said at the beginning of the 19th century, the live giving rain, but we do not see the drought it creates elsewhere.

**Ethical**

Of course, with government intervention there is first the loss of freedom. The more the government decide, the less there is for the individuals to decide. This counts also for what to do with the property of the individual banker and investor. Given the self-evident individual right to life, liberty, and property: the policy is immoral.

The proposed solutions of nationalization and regulation are not a hidden road to socialism but just out right nationalization of property and detailed regulation. Prices, the system of profit and loss, individual property, and freedom of contract are no longer relied on to guide human decision-making. To speak over the rescue of capitalism is a gotspe. It is as Hayek said *The Road to Serfdom* (1944): the administration does create dependent subjects and does not create independent citizens. Social problems, it is thought, arise through the activities of bad and greedy men; everything would be better if only men with good intentions and with power would rule. For Hayek (1960), however, freedom has to be defended not only when it is of obvious use but on principle: the common man without power but with the possibility of voluntary exchange gives the desired result.

Freedom means for the individual, that he or she is free to join society in the manner that he chooses. People do own themselves. However, that means that you can join society only by serving; you only can get rich by serving your fellow men. On the
market place voluntary exchange with mutual advantage does rule. If not voluntarily, by
definition, nothing is bought and sold at the market.

The ethical content of government policies often is no higher than that A sees a
problem by B and finds that C must pay for it. Had A token the money directly of C, we
would have called it theft. Moreover, to think that the authorities do save (by a bailout)
the private sector twists the affairs. It is always the private sector that bails out the
authorities---day in, day out. The authorities can give nothing without taken it before
from the private sector. Though as a rule and that is also the reason no one does protest,
they do not take it from the same sector as they do give it to.

What should have happened

What would have happened if the Central banks had done nothing re the financial crisis?
Then those who are a cause of the present crises, at least partly, do have the possibility,
the chance---and especially also the incentive---to solve the problem. In addition and
most importantly they keep their freedom.

The problem of the credit crisis is that in the knowledge economy in which we
live a knowledge product has fall flat. This is not a situation we should dramatize (cp.
of financial derivatives, with as underlying value the housing prices, has gone down to
almost zero. The underlying value of the houses on the other hand has gone down only
with 10 until 20%. What do you give for a house that is in the direct path of an
approaching hurricane? But that also means that there is the possibility of money to be
earned for the creative mind that can come up with a new knowledge product that gives
the bank balances at this moment the higher value the houses will have after the storm.

To go back to the simple products from the old days, products everyone understands, is
no solution. A derivate as a knowledge product raises productivity as much as the
transition of the type machine---which we all do understand---to today’s personal
computers. As said before, a more efficient banking system did also justify loans to
income groups who formerly could not get a loan.

But would not the whole economy, without government stimulus programs and
the bailing out of the banking sector, have come to a complete standstill? No. Marshall,
who wrote the economic textbook for the first half of the previous century, wrote on the
cover of his *magnum opus* (*Principles of Economics*), "Nature does not go with leaps." It
is always a little bit more or less. Never everything happens at the same time. Of course,
firms would have gone broke. The rest of the economy, however, was in no bad shape.
Many financial institutions too had a very reliable conservative policy. Now those
institutions do have to pay for those that did not have their balances in order. It is as
Mises said, a firm that makes losses should pay taxes (it has after all produced a product
of which the yield is less then it costs) and not the firm that makes a profit.

To sketch the situation, as the authorities did, as an all-or-nothing situation is
necessary for them to justify their unusual policies. In this way, however, it becomes one
of the main causes of the decay of trust in the banking-sector. That the American
government nationalizes banks and for the first time in history directly rescues private
investment banks, is the alarm bell---and they do act correspondingly---for those who
thought the problem is not that serious. Besides, when we panic we are most of the times not thinking straight. Moreover, if we can learn anything from the memoirs of those who do work at the central banks it is that they do not know it either in these special circumstances. An article in *The Wall Street Journal* (18.10.08) says “Bernanke Is Fighting The Last War”. What is meant is that Bernanke’s approach was the right approach for the central banks to fight the crisis in the beginning of the 20e century---but was not practiced by the central banks at that time. The situation, at this moment, however, is completely different. The arbitrary policies re intervention: which banks to help and which not, also points to a great uncertainty in policy objectives. Think of the money of the rescue fund in the U.S. It was originally meant to buy up sub prime loans and then used to save banks themselves or again used for other goals, like saving non-banking firms. When Greenspan presided over the Fed, anecdotic proof often was the only thing they did have (Meyer, 2004; cp. *The Wall Street Journal*, Bear Sterns: The Fed’s Original ‘Systemic Risk’ Sin, March 16, 2009). Presently, it will not be much better.

Why did the authorities intervene? The reason is probably a banal one. Financial institutions and central banks do cooperate a lot: people who do work at those institutions do know each other very well (*The New York Times*, Paulson’s Calls to Goldman Tested Ethics, August 9, 2009). People do switch jobs regularly between governmental agencies and the banking sector. The financial business world did know very well how to sell her special interest as the general interest of the society to the government authorities (cp. *The New York Times*, Geithner as Member and Overseer, Forged Ties to Finance Club, April 27, 2009; *The Wall Street Journal*, Chairman of N.Y. Fed Quits Amid Questions, May 8, 2009). Furthermore, the phenomenon of large concentrated advantages for the financial business world and the scattered costs for the whole society does also explain a lot. For the business world, it pays to come in action, for the ordinary citizen much less.

**What to think of those high bonuses?**

One of the most dangerous side effects of the present situation is that the discussion is pursued with on the background a popular hype against the high rewards for the top of the business world. It is the day of reckoning for bonus payments. As regards the maximum salaries the business world can pay, it is the level or a multiple thereof of the salary of the president or the prime minister in a country that seems to be the highest wisdom.

What is the proper level for a salary? The, and actually only fundamental, truth in our market economy is, that parties, if voluntary, do only make exchanges if both parties do gain. Suppose a top manager makes 5% less mistakes and that saves the firm 50 million. In that situation, to pay, e.g., 5 million as an "excessive" salary should be no problem. Both parties of the exchange do profit; the cake becomes larger. It is not, what managers get paid more the other workers are paid less. Both get more. Voluntary exchange is creative and productive and needs freedom of contract to flourish. The general rule for top incomes is that society mostly gets away with a bargain. If we take the fortune of Bill Gates and compare it with that which he gave society in voluntary exchange, we get away with a gratuity.
Hence, lower wages for top managers are worse the problem they do try to solve. More transparency for those payments is a better solution. At present, there are many obscurities and there is a lot of ignorance over the financial compensation for redundant managers. All kept away in the fine print of the contract. It is a cause of much of the quarrels on shareholders meetings and is the cause of the feelings of deception for employees and public (Gasparino, 2007). Transparency allows for all participants the assessment between expenses and avail. More transparency helps the market process to come up with a reliable performance related pay structure.

Do those high bonuses not give perverse stimuli? Sometimes no doubt, but that is certainly not the rule. It is not the greed of the top managers we must check but the generous givers, the Board of Directors, whose behaviors we must try to understand. Moreover, political stimuli are no better or less perverse. To the voters, politicians do make many promises before the elections. Promises that are impossible to sustain for the government after the election. They often do leave huge debts for the next generation to pay.

To cap salaries, however, is it not at least in part an act of justice? The word justice has two meanings. Today justice is sought in the justice of the results of the market process. It is not looked at as the application of the same market rules to everyone. This last form of justice, the authorities can guard without to look at the persons concerned. Managers who commit frauds can be punished. For the first form of justice, however, the authorities do need a lot of knowledge. How can the authorities judge if a CEO is worth the money, he is paid? Normally, the authorities do not know which part in the reward is for hard work, luck, favoritism, or power. For sure, the height of the salary itself tells us nothing; it is about the dumbest criterion to think of. Reward is the unpredictable result, sometimes very high and sometimes very low, of an impersonal market process. If we do not want endless dickering with financial rewards, we should be so wise to leave it with the direct parties concerned and, more general, with the discovery process of the market of what a correct salary should be.

**Conclusion**

It is not as Greenspan said that we are living in a financial tsunami. We are living in the middle of an almost surreal hype of socialist government policies by politicians. Just as consumers and investors too do have their hypes. Like investors who all do buy internet shares: the internet-bubble. This one, however, is much more dangerous. It is not as the Joker said it in the latest Batman movie: "We need a better kind of criminals." Criminals that do not do it for the money. For the liberal, this world needs just more millionaires (call it bonuses) and bankruptcies. Money is not the best but it is still one of the purest motives for human action. Remember the nine most terrifying words in the English language according to Ronald Reagan: “I’m from the government, and I’m here to help”.

For the liberal the most troublesome characteristic of the present crisis is the speed, almost outside every parliamentary decision-making process, in which the most unusual means are taken: socialization of debts as well as of property. (Not to speak of the coming inflation if we look at how all the stimulus money is created.) At first this happened hesitatingly and was meant to be a temporarily measure. Now the floodgates
are all open and it seems to become a permanent characteristic of our society. If it is, as is said, to be a rescue of capitalism, we have to look at authorities as if they are temporary hedge funds. They are planning to earn money (with the money of taxpayers), though it is still an uncertain result. But they that want-to-do-good, will not give up their power that easily.

The liberal does not see a painless solution either. He sees, however, a solution that has always worked but is, as usual, not trusted. It is even looked at as simplistic and laughably; hence it is not even tried. The tested recipe is to give individuals the freedom to act and to confront them with the consequences of their actions: the ancient principle of profit---and---loss. Losses are part of the progress of society. There has been and will always be periods of depression. This time, collectively we had it wrong concerning the banking sector; a recession corrects that situation. You cannot have the advantages of the market without its disadvantages. We have to make use of all the knowledge there is in society to reform a misallocation of resources; a market economy is the vehicle for that solution.

In short, the market is---for financial products as well as for how to reform the bonus payments for managers---a discovery process (Hayek, 1982). Sometimes, however, things go wrong that cannot be prevented. Government policies must be directed at those who take risk and to confront them with the results of their actions. That is the biggest difference with the possibilities a government servant does face. In the business world, the stimulus is such as to stop if losses become permanent. For the government, however, the stimulus is yet to spend more money on the project. In the private sector the owners are spending there own money, in the public sector this is not the case (Friedman, 1993).

For the liberal, the morality of Gibbons *Decline and Fall of the Roman Empire* is at stake again. The Romans, just as the Greeks, wanted freedom. Only more than freedom they wanted security. They, however, ended up with none of them. In the future, we will know whether what Mark Steyn has said, about the administrations in the thirties of the last century, is still true. "The more policies in the tradition of Roosevelt in a country, the longer the crises in that country did last" (cp. *The Wall Street Journal*, Busting Bank of America, April 27, 2009).

**Literature**


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