Stock Market Decline Just the Beginning

Despite the parallels with the autumn of 2008, the *Wall Street Journal* views the two crises as stemming from entirely different causes. Wrote the *Journal*'s Franceso Guerrera on Tuesday:

> The [crisis of 2008] spread from the bottom up. It began among over-optimistic home buyers, rose through the Wall Street securitization machine, with more than a little help from credit-rating firms, and ended up infecting the global economy. It was the financial sector's breakdown that caused the recession.

{modulepos inner_text_ad}

> The current predicament, by contrast, is a top-down affair. Governments around the world, unable to stimulate their economies and get their houses in order, have gradually lost the trust of the business and financial communities.

What's more, Guerrera claims, the first crisis came about as a result of easy credit, whereas this time around, there are piles of money sitting around that nobody wants to lend. And, whereas in 2008-2009, governments were able to "solve" the problem and eventually succeeded in "avoiding a global Depression," governments this time around don't have as many options. There's plenty of money out there, so injecting more won't make much of a difference – or so the *Wall Street Journal* believes.

That the most venerated source of financial news in the United States could be so utterly mistaken about the financial crisis, its origins, and its solution, is indicative of just how severe the problem is. First of all, we are not entering a new crisis but experiencing a new phase of the very same crisis that began back in late 2007. Government bailouts and other forms of "shock therapy" did not prevent a global depression, but guaranteed one. The anemic "recovery" touted by the Obama administration and other governments worldwide has been a mere blip akin to the reflexive action of a dying patient on a defibrillator. The economy of the West as we have known it for several generations is dying, and the various economic and financial crises that are becoming drearily routine are all symptoms of its terminal illness. And the illness has a name: Big Government.

To understand the current phase of decline that we are entering with a vengeance, we have to understand what has already taken place. The first big meltdown in fall of 2008 was not caused — despite what many, including the *Wall Street Journal*'s Guerrera, believe — by speculative excesses stemming from a failure of the free market. It is true that the real estate bubble was driven by irrational speculation, with homeowners "flipping" houses and raking in six-figure profits almost overnight. It is also true that the magnitude of the real estate bubble was impossible to gauge because of the practice of selling and re-selling mortgages all over the world and repackaging them in various absurdly complex financial instruments in order to dilute the risk of exposure to mortgage default.

But all of these excesses were driven by profound market distortions, distortions created by government, not by the private sector. The real estate mania was encouraged by unnaturally low interest rates created by the Federal Reserve. The normal risks associated with mortgage contracts were artificially blunted by the federal government's policy of underwriting (i.e., subsidizing) most ordinary mortgages — thereby encouraging lenders to offer mortgages to many who otherwise would not have qualified, and on terms far easier than the free market would ever accommodate. And federal laws (particularly the Community Reinvestment Act) that forced lenders — in the name of non-discrimination — to lend to the otherwise credit-unworthy further skewed the mortgage industry. And because of large masses of high-risk borrowers getting into homes, those who issued the mortgages were motivated to seek ever-more-complex financial innovations to dilute the risk of the mortgages that they held.

In other words, the crisis of 2008-2009 was due every whit to Big Government – the same Big Government that has managed to shift blame from itself and onto the supposedly unreliable free market. Instead of addressing the problem — too much government control and mismanagement of the economy — the government made things many times worse by expanding its control over almost every facet of the financial sector and by spending trillions of dollars to prop up America's ailing banks and other mega-corporations. And in the midst of this crisis, we have also continued to wage expensive wars overseas, despite the election of a President who on the campaign trail professed opposition to the Iraqi and Afghan quagmires. Is it any surprise that, in 2011, we have all the same problems — high unemployment, a moribund housing market, tumbling stock markets, foreign military quagmires, and interest rates near zero – with trillions of dollars' worth of new debt and a web of new controls over banks, finance, insurance, and health care added on?

Europe, meanwhile, is even more heavily burdened with government debt and economic controls than we are, and is consequently in even worse shape. The sovereign debt crisis unfolding across the pond, which will eventually destroy the entire economy of Western Europe, has many contributing causes: huge debts generated by welfare-state policies, a collapsing real estate bubble, contagion from the American collapse, and the lunatic mismanagement of eurozone finances by the European Central Bank. But, as with the United States, the common thread is Big Government and the destruction of the free market — the same free market that drove the unexampled progress enjoyed by the West for the past few centuries.

Even as late as postwar Germany, there were still European leaders enlightened enough to put their trust in the power of economic freedom. Under the guidance of Konrad Adenauer, for example, West Germany literally rose from the ashes of world war to become an economic miracle. But such leadership is nowhere to be found in 21st-Century Europe, with most of the continent opting to join the socialist European Union — a consensual superstate carrying on the programs of Caesar and Napoleon by other means.

The situation is little different in the United States, where many Americans continue to clamor for costly government programs like Social Security, Medicare, and subsidized student loans, that they have no desire to pay for. As a consequence, politicians continue to borrow and spend to keep such programs running and their constituencies happy. And when the debts come due, the Federal Reserve is called upon to print more money to cover the shortfalls. Such is the fatal illusion encouraged by "robbing selected Peter to pay for collective Paul."

Which brings us back to the state of the stock market, which closed down more than four percent today, and seems to be on the cusp of another epic collapse. The only thing that the bailouts and the Federal Reserve's "injections of liquidity" accomplished was to pour trillions into the big banks and financials. They in turn used the new money to bid up stocks and commodities, which explains why the stock market rose in a mini-bull market for a year and a half while the rest of the economy got worse and worse. Now, with interest rates near zero (and promised to stay there until 2013 by Bernanke), the government and the Fed are running out of options. Investors are coming to the realization that the United States is drowning in debt that it does not intend to repay in honest money, and the prospect of huge European banks — not to mention Italy and Spain — going the way of Greece and Lehman Brothers is at last forcing the markets to acknowledge the severity of the crisis.

The problem is Big Government, and the solution, on paper at least, is straightforward enough: trim government down to size and eliminate all of the decades' worth of socialist controls exerted by Big Government on the workings of the marketplace, and then watch, as postwar Germans did, an economic miracle unfold. In the United States, this would entail rolling back the size of the federal government by at least a factor of 50 percent, and probably much more — far more than the trivial "cuts" that Congress and the president were squabbling over for months. Real cuts in the tens of trillions of dollars would be required merely to halt the vertiginous rise in the national debt, let alone begin paying it down.

But the reality is that too many Americans are now addicted to the trappings of the welfare state: subsidies, cheap credit, government-sponsored health care programs, and so forth. The U.S. government is probably not going to do anything significant about its finances until it is forced to — by an inability to borrow more money, by a ruined economy, by hyperinflation, and by the civil unrest that will inevitably follow in their train.

The inconsequential downgrade of our credit rating (the first of many) and the swooning stock markets are only the beginning. Unless our country somehow finds the political will to change course, we will soon enter an age that will soon make the faux prosperity of the last generation seem like a half-remembered dream.