Written by **Steven J. DuBord** on October 29, 2008

The Panic of 2008

On Monday, October 13, the first business day following an eight-day market swoon that saw the Dow Jones Industrial Average lose more than 2,000 points, the Bush administration announced new steps to "rescue" a global economy that seemingly had gone into free fall. "The United States government is acting; we will continue to act to resolve this crisis and restore stability to our markets," proclaimed the president at an early-morning press conference. "We are a prosperous nation with immense resources and a wide range of tools at our disposal. We're using these tools aggressively."

At a separate conference, Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke clarified what some of those "tools" are to be: the Fed, in just the latest of a long series of moves to take control of the money markets, will purchase large amounts of commercial paper — intercompany debt — while the Treasury will use $250 billion dollars to purchase preferred shares in America's nine largest banks. Ostensibly to avoid any appearances of bias, both healthy and ailing banks are being compelled to submit to what amounts to a partial nationalization of their assets. "Government owning a stake in any private U.S. company is objectionable to most Americans — me included," Paulson said, adding that "[the] alternative of leaving businesses and consumers without access to financing is totally unacceptable."

Americans have not seen such radical federal government intrusions on business and financial activities since the Great Depression. Then as now, the federal government assumed what amounted to dictatorial powers over what had once been private enterprise. Led by the statist zealotry of FDR, the federal government nationalized industry, confiscated privately held precious metals, shut down banking in what was euphemistically called a "bank holiday," and fastened a welter of new controls on financial and commercial activity. The New Deal, carried out in the name of stability, was the genesis of modern Big Government. Now, with possible worldwide depression looming, the federal government is again pulling out all the stops. "Our actions are extensive, powerful and transformative," the Treasury Department admitted in a press release. "They demonstrate that the government will do what is necessary to restore the flow of funds on which our economy depends."

But what exactly *is* necessary to confront the growing financial crisis? What posterity may yet come to know as the Panic of 2008 has roots in actions taken by Big Government (not the oft-maligned free market) years and even decades ago. It will be exacerbated, not alleviated, by government interference, as investors in the United States and worldwide are starting to grasp. The Dow Jones, let it be noted, soared over 900 points on the day of Paulson's bank stock purchase pronunciamento, yet two days later, the markets swooned again, giving up almost all of their short-lived gains.

Unfortunately, the United States and governments worldwide continue to insist on the necessity of "taking action" of some kind. Only government, it is alleged, has the resources to save us from ourselves. The free market and human greed are to blame for this mess, we are told, and only the benign oversight of legislators, regulators, and central bankers can possibly right the foundering economic ship.

The crisis began with the implosion of the subprime mortgage markets more than a year ago, in the midst of the most dizzying running of the bulls Wall Street had ever seen. Even as the Dow Jones surged to new record highs above 14,000 last fall, realization began to dawn on the financial sector, if not yet the public at large, that the party could not last. Securities backed by subprime mortgages — those exotic investment vehicles encouraged by absurd incentives arising from the Community Reinvestment Act (CRA), which required banks to offer mortgages to individuals who would not normally be considered credit-worthy — had become hefty portions of the asset portfolios of many large banks and investment firms. They were pledged as collateral, divided up, resold, repackaged, and otherwise dispersed among financial institutions across the world. All the big players trafficked in mortgage-backed securities, but no one really knew who owned what.

One ploy to induce those with lower incomes and questionable credit to take out mortgages was to offer adjustable interest rates. Mortgages were sold with no money down and low or nonexistent interest — at first. After a certain lapse, however, the terms of payment were to be adjusted upward, with the understanding that the customer would somehow acquire the means to meet the more stringent terms in the meantime.

And then the sky fell. By late 2007, it became clear that mortgage defaults, particularly among subprime borrowers, were rising sharply. Housing prices, which had ballooned over several years, were collapsing across the country, and millions of homeowners suddenly found themselves trying to make payments on houses whose market value was substantially less than what they owed. When their mortgages adjusted upward, homeowners walked away, leaving banks with houses worth substantially less than their balance sheets assumed. Banks and other financial institutions faced massive writedowns, and some of them — Indymac, Bear Stearns, Washington Mutual, and Lehman Brothers among them — failed. By early summer of 2008, investors, seeking a safe haven for funds that no longer appeared safe in stocks or real estate, poured money into commodities, driving the prices of grains and crude oil into the ionosphere. Prices at the supermarket and gas pump skyrocketed in the United States, and portions of the developing world began to experience severe food shortages.

By late summer, the stock markets were feeling the pinch. Months of unending bad news, including high-profile bankruptcies and buyouts across the financial sector, had forced upon investors worldwide the gravity of the crisis. Contrary to upbeat predictions at the beginning of this year to the effect that the subprime crisis would have worked its way through the system by the second quarter, it was clear that no end was in sight. Banks, fearful of exposure to more bad credit, became fearful of lending to one another and to businesses. Stock values began to decline as investors fretted that the fallout from what was now being called the "credit crunch" would reach far beyond the financial sector.

By early October, traditionally a bad time for stocks — the Panic of 1907, the market crash of 1929, and the crash of 1987 were all October events — stocks were declining sharply worldwide. Congress, at the behest of Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke, allowed itself to be stampeded into passing a $700 billion so-called "bailout bill" to rescue ailing banks.

The result, so far, has been chaos. In one extraordinary week, stocks fell nearly 20 percent, before rebounding in one of the steepest one-day gains ever. It is being called the greatest financial crisis since the Great Depression, and will certainly take its place among America’s significant economic contractions.

But is the ongoing turmoil truly the apocalyptic, epoch-ending event many of the more sensationalist commentators are calling it? What is the outcome likely to be and, more importantly, how will it be affected by the actions and reactions of politicians, politically connected financiers, and central bankers?

We’ve Been Here Before

First of all, some historical perspective. While the financial crisis that has turned the world on its ear since last fall is certainly an extraordinary event, it is not — so far — the Mother of All Crises that the media and political classes are making it out to be. It is, at its essence, a severe financial and economic correction brought about by years — indeed, decades — of financial mismanagement on the part of central banks and their toadies in legislatures and statehouses across the developed world, predominantly in the United States. It is the last phase of the latest and greatest business cycle the world has yet seen, a consequence of inflationary policies that have distorted credit markets and encouraged malinvestment, including reckless borrowing, on an enormous scale.

As corrections go, it is severe but not entirely unprecedented. The Panic of 1907, by way of comparison, was the final episode in an economic correction that began with steep declines in stocks in 1906. By October of ’07, when the panic itself hit, the Dow Jones had lost 50 percent of its value. Bankruptcies swept through the financial sector, claiming large and venerable institutions, like the Knickerbocker Trust, that had been part of the financial landscape for generations. Two years after the panic subsided, however, stocks regained all their losses.

Something similar happened in the great Black Monday crash on October 19, 1987, in which the Dow Jones Industrial Average lost more value — 22.6 percent — in a single day than the current crisis has produced in eight straight days of numerically spectacular but percentage-wise less exceptional losses. That remains the largest one-day percentage decline ever for the Dow, putting the lie to claims that the week of October 5 to October 10, 2008 was the "worst week ever" for the stock markets. As in the aftermath of the Panic of ’07, stocks took roughly two years to recover from the ’87 crash, and went on to new heights.

Also relatively recent history was the great bear market of 1974-1975, part of a global downturn manifested by sharp rises in oil prices, among other things. That period saw stocks lose roughly half their value, and was followed by another half-decade of economic malaise, including significant inflation. But by the early eighties, the markets turned upward, producing the greatest increase of wealth, over nearly 20 years of almost uninterrupted expansion, that the world has ever seen. This author is old enough to remember the gloom and doom of the seventies — a lost decade if there ever was one. Yet life went on, and in due course, the economy took a turn for the better.

Few events, save possibly war, are as susceptible to political manipulation and fear-mongering as economic crises. Terms like "panic" and "depression" are accurate indicators of the mood that tends to prevail in times of economic downturn, times that will always beset us periodically as long as the underlying causes of the business cycle — fractional-reserve banking and fiat money — are with us. Since exceptional corrections tend to occur at generational intervals — every few decades or so — each one brings with it a sense of unprecedented calamity, especially for those who live in the now or who are not old enough to remember the last time such an event took place.

But economic downturns, unpleasant and even frightening though they are, always run their course sooner or later. Because they are always the result of tampering with the money supply for political reasons, it must be borne in mind that they are at root political, not economic events, engineered by special interests at variance with the workings of the free market. And — like wars — they are often harnessed to serve political ends.

The current crisis is a case in point. Several decades of artificially depressed interest rates, beginning with the Volcker-run Federal Reserve back in the early eighties, encouraged, instead of thrift and savings, a national addiction to credit and spending. Under such conditions, Americans have become accustomed to "buying" houses with little or no down payment, financing college educations at subsidized interest rates to the tune of tens of thousands of dollars, and purchasing on credit luxury items that once were the exclusive province of the truly wealthy, like boats and high-end cars. Meanwhile stocks, real estate and other assets have appreciated at rates far beyond previously recognized limits, prompting talk — now woefully discredited — of a "New Economy."

Mirroring the expansion of private wealth has been the astounding growth in the size and cost of government, especially since the early eighties. Thanks to the magic of inflation, government programs can be created and paid for by printing money instead of by direct taxation. The resultant ballooning debt and budget deficits have seemingly exacted no economic price; year after year, as the money supply grew by leaps and bounds, government indebtedness soared higher and higher — but prosperity abounded.

Of course, there never was a "New Economy." As with the Roaring Twenties, another artificial boom brought about by irresponsible credit expansion, monetary legerdemain encouraged a general misunderstanding, or as the Austrian economists like to call it, a "cluster of errors" that is the hallmark of an inflationary business cycle. Economics, lest we forget, is the science of how humans behave under unavoidable conditions of scarcity; yet during boom times, scarcity is nowhere to be found. Everyone everywhere can have his cake and eat it too, or so it appears.

Reality, when it finally hits, is a terrible teacher. At long last, the markets discover how distorted valuations have become, and prices seek natural levels. Assets whose book value has inflated manyfold drop to more reasonable levels as demand for overpriced assets disappears. Outraged citizens, seeing their retirement portfolios melt away like the morning dew, demand that someone, anyone, be made to pay for what has been lost. Confidence is replaced by fear. Over time, sane economic behavior returns, but unless the root causes of the inflationary illusion are dealt with, the cycle soon begins anew.

America has weathered many financial and economic storms, of which this latest may or may not turn out to be one of the worst. What she cannot weather for very much longer is the radical transformation of her laws and the abandonment of constitutional restraints that often accompany economic downturns. Booms and busts, after all, are temporary, but the misguided and even pernicious political reforms that often accompany a faltering economy tend to stay around forever, further increasing the overburden of government power. The economic calamities of the Great Depression are remembered now only by a few of the very aged, but the political revolution that the Roosevelt government carried out at the same time is alive and well. We still have farm subsidies, Social Security, federal make-work programs of every description, stifling regulations on bank and financial activities, and paper currency unbacked by any precious metal. But now, decades later, all of these programs, and many more akin to them in spirit, are much larger, more intrusive, and far costlier than when they were created.

Where We’re Headed

History appears to be repeating itself as once again the federal government uses a major economic contraction as a pretext for a major power seizure. Since last December, the Federal Reserve has aggressively transformed itself from a mere central bank into a lender of last resort for every niche in the financial sector, expanding an already hypertrophied money supply by hundreds of billions of new dollars. Meanwhile, the Treasury secretary, thanks to the Emergency Economic Stabilization Act of 2008, is poised to become a permanent financial czar, with emergency powers that will likely remain on the books long after the current crisis has passed.

In a word, we are witnessing a bloodless coup, in which all remaining constitutional limits on the financial powers of the federal government are being discarded in the name of national emergency. Lying ahead, if events continue on their present trajectory, we will likely see wage and price controls, nationalization of other "key" industries like airlines and automobile manufacturers, and possibly, if the monetary crisis becomes acute enough, the confiscation once again of privately held precious metals. All of this, and possibly much more, will be sold as indispensable to our national survival.

But the obliteration of America’s free markets is not the only or even the greatest danger we face as the world sinks into recession. In recent weeks, the possibility of financial reforms on an international level has been floated, with talk of a global shutdown of financial activity to make way for a "second Bretton Woods" that would transform and truly globalize international finance. When Italian Prime Minister Silvio Berlusconi raised just such a possibility at a recent international meeting in New York, he was quickly shushed by the Bush administration, but there can be little doubt how the partisans of global governance, at the UN, the IMF, and elsewhere, intend to exploit the crisis. In fact, on October 22 the Bush administration announced that a global financial summit (the first in a series) will be held in Washington, D.C., on November 15.

The first attempt at creating a managed global financial system took place in 1944 at the Mount Washington Hotel in Bretton Woods, New Hampshire. The idea behind the conference, which was guided by the likes of Harry Dexter White, an assistant to Treasury Secretary Henry Morgenthau, Jr., and famed British economist John Maynard Keynes, was to craft a system of international financial governance to complement the United Nations international political system about to be implemented. Keynes wanted a single world currency, which he proposed calling the bancor, and the American delegation countered with a global currency proposal of their own, the unitas. Also prominent on the agenda at Bretton Woods were the creation of an international bank and a global authority to set international rules on trade.

What the negotiators at the Bretton Woods conference ended up with was far less than ardent internationalists like Keynes and White expected, but still amounted to a first iteration of a global financial and economic order. The International Monetary Fund (IMF) and International Bank for Reconstruction and Development, or IBRD (the precursor to today’s UN-affiliated World Bank Group), two organizations created at Bretton Woods, were not true global banking authorities; they could not issue their own currency nor exercise any authority over central banks like the Federal Reserve. But all signatories to the Bretton Woods Agreement were required to subscribe to the IMF, and would reckon their contributions in terms of SDRs (Special Drawing Rights), a sort of proto-international currency. The IBRD, like today’s World Bank, was primarily concerned with aiding developing nations, not with managing international banking and finance.

The international trade pact agreed upon, the General Agreement on Tariffs and Trade (GATT), fell far short of what many Bretton Woods conferees hoped for. Instead of a truly transnational trade authority, they got a watered-down agreement, whereof the signatories pledged to work towards something stronger and more permanent in the future. As for a global currency, neither the bancor nor the unitas gained any traction, the conferees opting instead to make the U.S. dollar, redeemable in gold, the fallback international currency into which all other currencies would be convertible.

One major plank of Bretton Woods was accomplished decades after the fact with the replacement of GATT by the World Trade Organization (WTO) in 1995. Unlike its predecessor, the WTO is a full-fledged instrument of international government, a global trade ministry, as it were, to which national trade laws, including those of the United States, are now subordinate.

A global currency issued by a global central bank is not yet a reality, although the creation of the first truly international currency, the euro, along with the first transnational central bank, European Central Bank, are troubling precedents.

Regardless of what form a new global financial regime may take, proposals that may find their way to a "second Bretton Woods" are already being bruited about in Washington, London, and elsewhere. British Prime Minister Gordon Brown and Chancellor of the Exchequer Alistair Darling have already been in the United States promoting what the British newspaper *The Guardian* called "a stronger international regulatory system, based around an early-warning system run by the IMF." In the meantime, they hope to "create an international consensus for a tougher global system of regulation" — whatever that might entail.

On October 17, an editorial by Gordon Brown pleading for a new financial world order, entitled "Out of the Ashes," appeared in the *Washington Post*. This "greatest of global challenges," Brown asserted, "demands of us the boldest of global cooperation." The piece went on, in part:

> This week, European leaders came together to propose the guiding principles that we believe should underpin this new Bretton Woods: transparency, sound banking, responsibility, integrity and global governance [Emphasis added.]…. To do this, we need cross-border supervision of financial institutions; shared global standards for accounting and regulation; a more responsible approach to executive remuneration that rewards hard work, effort and enterprise but not irresponsible risk-taking; and the renewal of our international institutions to make them effective early-warning systems for the world economy…. There are no Britain-only or Europe-only or America-only solutions to today's problems. We are all in this together, and we can only resolve this crisis together…. If we do this, 2008 will be remembered not just as a year of financial crisis but as the year we started to build the world anew.

As Prime Minister Brown's piece makes unambiguously clear, the great financial and economic crisis of our time is being harnessed to effect a revolution of laws both national and international. Like the global upheavals that set the stage for the New Deal and Bretton Woods, the Panic of 2008 is allowing our political leaders to take us where we would not be willing to go in less extraordinary times. A crisis created by government is now being exploited by government. Unless America opens her eyes, she will soon see every last remnant of economic freedom lost, and her citizens reduced to financial serfdom.