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Now Is No Time to Give Up on Markets

By MARY ANASTASIA O'GRADY

"What can we do that would be beneficial? [One thing] is lower corporate taxes and businesses taxes and maybe taxes in general. Particularly, you want to lower the tax on capital so you raise the after-tax return to investing and get more investing going on."

Gary Becker, the winner of the 1992 Nobel Prize in Economic Sciences, is in New York to speak to a special meeting of the Mont Pelerin Society on the global meltdown. He has agreed to sit down to chat with me on the subject of his lecture.

Slumped in a soft chair in a noisy hotel coffee lounge, the 78-year-old University of Chicago professor is relaxed and remarkably humble for a guy who has achieved so much. As I pepper him with the economic and financial riddles of our time, I am impressed by how many times his answers, delivered in a pronounced Brooklyn accent, include an "I think" and sometimes even an "I don't know the answer to that." It is a reminder of why he is so highly valued. In contrast to a number of other big-name practitioners of the dismal science, he is a solid empiricist genuinely in search of answers -- not the job as the next chairman of the Federal Reserve. What he sees is what you get.

What Mr. Becker has seen over a career spanning more than five decades is that free markets are good for human progress. And at a time when increasing government intervention in the economy is all the rage, he insists that economic liberals must not withdraw from the debate simply because their cause, for now, appears quixotic.

As a young academic in 1956, Mr. Becker wrote an important paper against conscription. He was discouraged from publishing it because, at the time, the popular view was that the military draft could never be abolished. Of course it was, and looking back, he says, "that taught me a lesson." Today as Washington appears unstoppable in its quest for more power and lovers of liberty are accused of tilting at windmills, he says it is no time to concede.

Mr. Becker sees the finger prints of big government all over today's economic woes. When I ask him about the sources of the mania in housing prices, the first culprit he names is the Fed. Low interest rates, he says, were "partly, maybe mainly, due to the Fed's policy of keeping [its] interest rates very low during 2002-2004." A second reason rates were low was the "high savings rates primarily from Asia and also from the rest of the world."

"People debate the relative importance of the two and I don't think we know exactly," Mr. Becker admits. But what is clear is that "when you have low interest rates, any long-lived assets tend to go up in price because they are based upon returns accruing over many years. When interest rates are low you don't discount these returns very much and you get high asset prices."

On top of that, Mr. Becker says, there were government policies aimed at "extending the scope of homeownership in the United States to low-credit, low-income families." This was done through "the Community Reinvestment Act in the '70s and then Fannie Mae and Freddie Mac later on" and it put many unqualified borrowers into the mix.

The third effect, Mr. Becker says, was the "bubble mentality." By this "I mean that much of the additional lending and borrowing was based on expectations that prices would continue to rise at rates we now recognize, and should have recognized then, were unsustainable."

Could this behavior be considered rational? "There is a lot of debate in economics about whether we can understand bubbles within a rational framework. There are models where you can do it, but it's not easy," he says. What he does seem sure about is that "the lending would not have continued unless there was this expectation that prices would continue to rise and therefore one could refinance these assets through the higher prices." That mentality was at least partly related to Fed action, he says, because the low interest rates "generated an increase in prices and I think that helped generate some of this excess of optimism."

Mr. Becker says that the market-clearing process, so important to recovery, is well underway. "Construction in new residential housing is way down and prices are way down. Maybe 25% down. Lower prices stimulate demand, reduced construction reduces supply."

That's the good news. But he complains about "counterproductive" government policies "designed to lower mortgage rates to stimulate demand." He says he was against the Bush Treasury's idea of capping mortgage rates (which was only floated) and he has "opposed the mortgage plan of President Obama." "It goes against both these adjustments . . . it would hold up prices and increase construction. I think that's a bad idea at this time."

Yet the professor is no laissez-faire ideologue. He says we have to think about what the government can do to "moderate the hit to the real economy," and he says it should start with "the first law of medicine: Do no harm." Instead it has done harmful things, and chief among them has been the "inconsistent policies with the large institutions . . . We let some big banks fail, like Lehman Brothers. We let less-good banks, big [ones] like Bear Stearns, sort of get bailed out and now we bailed out AIG, an insurance company."

Mr. Becker says that he opposed the "implicit protection" that the government gave to Bear Stearns bondholders to the tune of "$30 billion or so." So I wonder if letting Lehman Brothers go belly up was a good idea. "I'm not sure it was a bad idea, aside from the inconsistency." He points out that "the good assets were bought by Nomura and a number of other banks," and he refers to a paper by Stanford economics professor John Taylor showing that the market initially digested the Lehman failure with calm. It was only days later, Mr. Taylor maintains, that the market panicked when it saw more uncertainty from the Treasury. Mr. Becker says Mr. Taylor's work is "not 100% persuasive but it sort of suggest[s] that maybe the Lehman collapse wasn't the cause of the eventual collapse" of the credit markets.

He returns to the perniciousness of Treasury's inconsistency. "I do believe that in a risky environment which is what we are in now, with the market pricing risk very high, to add additional risk is a big problem, and I think this is what we are doing when we don't have consistent policies. We add to the risk."

On the subject of recovery, Mr. Becker repeats his call for lower taxes, applauds the Fed's action to "raise reserves," (meaning money creation, though he said this before the Fed's action a few days ago), and he says "I do believe one has to try to do something more directly to help with the toxic assets of the banks."

How about getting rid of the mark-to-market pricing of bank assets [that is, pricing assets at the current market price] that some say has destroyed bank capital? Mr. Becker says he prefers mark-to-market over "pricing by cost because costs are often completely out of whack with what the real prices are." Then he adds this qualifier: "But when you have a very thin market, you have to be very careful about what it means to mark-to-market. . . . It's a big problem if you literally take mark-to-market in terms of prices continuously based on transactions when there are very few transactions in that market. I am a mark-to-market person but I think you have to do it in a sensible way."

However that issue is resolved in the short run, there will remain the problem of institutions growing so big that a collapse risks taking down the whole system. To deal with the "too big to fail" problem in the long run, Mr. Becker suggests increasing capital requirements for financial institutions, as the size of the institution increases, "so they can't have [so] much leverage." This, he says, "will discourage banks from getting so big" and "that's fine. That's what we want to do."

Mr. Becker is underwhelmed by the stimulus package: "Much of it doesn't have any short-term stimulus. If you raise research and development, I don't see how it's going to short-run stimulate the economy. You don't have excess unemployed labor in the scientific community, in the research community, or in the wind power creation community, or in the health sector. So I don't see that this will stimulate the economy, but it will raise the debt and lead to inefficient spending and a lot of problems."

There is also the more fundamental question of whether one dollar of government spending can produce one and a half dollars of economic output, as the administration claims. Mr. Becker is more than skeptical. "Keynesianism was out of fashion for so long that we stopped investigating variables the Keynesians would look at such as the multiplier, and there is almost no evidence on what the multiplier would be." He thinks that the paper by Christina Romer, chairman of the Council of Economic Advisors, "saying that the multiplier is about one and a half [is] based on very weak, even nonexistent evidence." His guess? "I think it is a lot less than one. It gets higher in recessions and depressions so it's above zero now but significantly below one. I don't have a number, I haven't estimated it, but I think it would be well below one, let me put it that way."

As the interview winds down, I'm thinking more about how people can make pretty crazy decisions with the right incentives from government. Does this explain what seems to be a decreasing amount of personal responsibility in our culture? "When you get a larger government, when you have the government taking over Social Security, government taking over health care and with further proposals now for the government to take over more activities, more entitlements, the rational response is to have less responsibility. You don't have to worry about things and plan on your own as much."

That suggests that there is a risk to the U.S. system with more people relying on entitlements. "Well, they become an interest group," Mr. Becker says. "The more you have dependence on the government, the stronger the interest group of people who want to maintain it. That's one reason why it is so hard to get any major reform in reducing government spending in Scandinavia and it is increasingly so in the United States. The government is spending -- at the federal, state and local level -- a third of GDP, and that share will go up now. The higher it is the more people who are directly or indirectly dependent on the government. I am worried about that. The basic theory of interest-group politics says that they will have more influence and their influence will be to try to maintain this, and it will be hard to go back."

Still, there remain many good reasons to continue the struggle against the current trend, Mr. Becker says. "When the market economy is compared to alternatives, nothing is better at raising productivity, reducing poverty, improving health and integrating the people of the world."

Ms. O'Grady writes the Journal's Americas column.

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