

Of Mises and Min(sky):
Libertarian and Liberal Responses to Financial Crises
Past and Present

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PROLOGUE

In 1933, Adolf A. Berle, Jr., gave a speech to the New York State Bankers Association.¹ Berle captured well some of the main problems we face in regulating banks, and financial systems more generally. Several of his points sound themes that are crucial to this Article. One is the huge difficulties created by the inevitable need to predict a highly uncertain future:

The part of a prophet is always a difficult and dangerous one, but the difference between banking, law, politics and pure academics is that in all but the latter you have to be a prophet. Not only do you have to prophesy, but you have to bet on the result. When you make a loan, when you take a deposit, when you go through any one of the normal banking operations, you have estimated what the future both of that particular operation and of the general condition which surrounded it will probably be.²

Berle also pointed to the vulnerability of banks to contagious panics:

In the last analysis, when there is mass movement in progress, the system becomes one in the public mind whether you choose it or not. It ceases to be a question of the safety of this bank as against that bank. It becomes a question of the safety of any bank at all. And as that mass movement finally developed, it became perfectly obvious that collective action was required.³

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1. Adolf A. Berle, Jr., Address at the Fortieth Annual Convention of the New York State Bankers Association: The Future of American Banking (June 26, 1933).

2. *Id.* at 3.

3. *Id.* at 7.

This is a major problem because banks are central to the whole economy:

You are also familiar with the very simple economic fact that the level of prices, the level of economic activity, which in turn means employment, and much of what we call prosperity, has a very close relation to the aggregate volume of currency and credit. . . . The banks, therefore, form a private group which without any correlation among its members, really dominates a large part of the economic life of the country.⁴

This all creates a massive collective action problem:

Think broadly and not personally, because the individual interest today must be subordinated to the overwhelming national interest. Our first concern must be that the country shall not commit suicide.⁵

I. INTRODUCTION

In case we needed reminding (and many of us did), the recent financial crisis has demonstrated that capitalist financial systems are prone to cycles of heady booms and dismaying busts, and those busts can cast the entire economy into recession or worse.⁶ The last and greatest reminder of this within the United States was the Great Depression. In the 1930s, contentious debate broke out as to what the government can and should do to moderate the boom–bust cycle. Could monetary policy determined by a central bank improve stability, or was it the main culprit behind the Depression? Could fiscal policy in the form of large government deficits help end contractions early? Do we need regulation to control financial markets, and if so, how extensive should it be and what form should it take? In the 1930s, FDR and the New Deal made great changes in American monetary, fiscal, and regulatory policy. In the latest crisis, those questions have become contentious again with new reforms debated and deployed, although the reforms have been far more incremental than those of the New Deal.

Great scholars, public intellectuals, and policymakers debated the pros and cons of governmental intervention in the wake of the Great Depression. The ideas developed then have helped shape debate ever since, although they have been transformed in the course of that ongoing debate. At the heart of that debate are two theoretical approaches to the

4. *Id.* at 9.

5. *Id.* at 15.

6. *See generally* CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, PANICS, MANIAS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (5th ed. 2005); CARMEN REINHART & KENNETH ROGOFF, THIS TIME IT'S DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY (2009).

economics of business cycles: Austrian⁷ and Keynesian⁸ business cycle theory. The two are deeply opposed in their basic policy commitments, with the Austrians advocating a strongly anti-interventionist approach while Keynesians support active governmental intervention. And yet, the underlying economic theories of these two antagonists have much in common. Both focus on the role of financial institutions and markets in driving business cycles, and both have understandings of the role of expectations and uncertainty that are much more realistic than the rational expectations approach which has dominated mainstream macroeconomics for the last few decades.⁹

I find the emphasis on expectations in the face of deep uncertainty a highly useful element of both theoretical approaches. That emphasis contrasts nicely with a focus on incentives and greed that characterizes much modern thinking about economics and politics. Both ignorance and greed matter in understanding how the economy works, but too often we tend to slight the importance of ignorance and uncertainty. That tendency leads to a certain arrogance and moralism in much thought on how best to regulate the economy. A needed humility should come from putting front and center the fact that none of us, neither governmental regulators, private market actors, nor scholarly commentators, really understands in any remotely adequate way what is going on in our economy. How can and should we regulate our economic affairs in light of that ignorance?

In a companion piece, I ponder that question.¹⁰ I use the libertarianism of Friedrich Hayek,¹¹ the conservatism of Michael Oakeshott,¹² and

7. The originator of this approach was Ludwig von Mises. *See generally* LUDWIG VON MISES, *THE THEORY OF MONEY AND CREDIT* (1912); LUDWIG VON MISES, *HUMAN ACTION* (1949). The most important and influential developer of Austrian business cycle theory was Friedrich von Hayek. *See generally* FRIEDRICH VON HAYEK, *PRICES AND PRODUCTION* (1931); FRIEDRICH VON HAYEK, *PROFITS, INTEREST, AND INVESTMENT* (1939); FRIEDRICH VON HAYEK, *THE PURE THEORY OF CAPITAL* (1941); FRIEDRICH VON HAYEK, *MONEY, CAPITAL, AND FLUCTUATIONS* (1984) (essays from 1925–1936).

8. The originator of this approach was, of course, John Maynard Keynes. *See generally* JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY* (1936). But the variant on which I focus was best developed by Hyman Minsky. *See generally* HYMAN MINSKY, JOHN MAYNARD KEYNES (1975); HYMAN MINSKY, *STABILIZING AN UNSTABLE ECONOMY* (1986).

9. The original rational expectations article was John F. Muth, *Rational Expectations and the Theory of Price Movements*, 29 *ECONOMETRICA* 315 (1961). For overviews, see generally STEVEN M. SHEFFRIN, *RATIONAL EXPECTATIONS* (2d ed. 1996); Thomas J. Sargent, *Rational Expectations*, in *CONCISE ENCYCLOPEDIA OF ECONOMICS* (2d ed. 2007).

10. Brett H. McDonnell, *Don't Panic! Defending Cowardly Interventions During and After a Financial Crisis*, PENN. STATE L. REV. (forthcoming), available at <http://www.ssrn.com/abstract=1753760>.

11. *See generally* HAYEK, sources cited *supra* note 7; *see also* FRIEDRICH VON HAYEK, *THE ROAD TO SERFDOM* (1944); FRIEDRICH VON HAYEK, *THE CONSTITUTION OF LIBERTY* (1960).

12. *See generally* MICHAEL OAKESHOTT, *RATIONALISM IN POLITICS AND OTHER ESSAYS* (1962).

the liberalism¹³ of John Maynard Keynes¹⁴ as guides to formulating a general approach to financial regulation in the face of deep uncertainty. I choose those three thinkers both because of their contrasting normative positions and also because each was among the leading thinkers to really put uncertainty at the heart of their thinking about politics and the economy. I suggest an approach I call “cowardly interventions”¹⁵ as a triangulation of the three positions. Following Keynes, I recognize that uncertainty leads to deep instability in financial economics, so that some governmental intervention is needed to create greater stability. But following Hayek and Oakeshott, I recognize the limits of governmental intervention, and stress that such intervention should as much as possible draw on past experience, work with rather than against markets, and be moderate and subject to regular evaluation and reconsideration. I apply this framework to the Dodd-Frank Act,¹⁶ the revision of financial regulation following the recent financial crisis, and argue that on balance the Act is an exemplary exercise in cowardly interventions.

Here, I approach the problem from a slightly different but very closely related perspective. I focus more on the economics of financial markets and regulation rather than the broader philosophical inquiry of the other article, and I narrow the competing positions to libertarianism and liberalism.¹⁷ I take more of an historical approach, following the development of Austrian and Keynesian theories of the business cycle from their origins in the 1930s to today. I consider the details of recent financial regulation less than in the companion article, but I consider financial regulation in tandem with monetary and fiscal policy more than in that article. Considering financial regulation along with monetary and fiscal policy is a worthwhile move. Each of these three types of interventions can help both to dampen inflationary booms and also to shorten and ease recessionary busts. Thus, to some extent, the three types of policies are substitutes. The optimal level for each depends in part upon what is happening with the other two.

This Article proceeds as follows. Part II categorizes approaches to governmental interventions to stabilize the markets into four types. The

13. I use “liberal” in the modern American sense. Liberals in the classical nineteenth-century sense I call “libertarians.”

14. See generally KEYNES, *supra* note 8; JOHN MAYNARD KEYNES, *ESSAYS IN PERSUASION* (1932).

15. The term is deliberately deflating to emphasize the inherent imperfection of any approach given our limited understanding.

16. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

17. I do not think that Burkean (or Oakeshottian) conservatism offers a distinct program within economics.

categorization is based on two distinctions. One distinction is between libertarians, who greatly distrust government and advocate at most very limited interventions, and liberals, who distrust the volatility of financial markets and advocate more extensive interventions. The other distinction focuses on the source of distrust of markets or governments. Distrust may emphasize problems of greed or of ignorance. As noted above, a distinctive and welcome characteristic of the Austrian and Keynesian theories is that they focus more on ignorance than on greed.

Part III begins the analysis of Austrian and Keynesian theories of the business cycle, describing some important similarities as well as differences. Each focuses on the importance of investor expectations in making investment decisions in the face of deep uncertainty. Both see investors regularly becoming involved in speculative booms in which optimistic expectations of future profits lead to overly high levels of capital investment. But the theories differ in their analysis of the source of these expectations. Austrians blame central bank monetary policy, while Keynesians see them as the result of high animal spirits following a period of relative calm and prosperity. Both theories agree that after a while such booms become unsustainable. Eventually expectations shift, and a contraction begins. The contraction can be long and painful, especially as banks, businesses, and households must unwind the large amounts of debt incurred during the boom. The two theories characteristically differ, though, as to the wisdom of governmental intervention to try to lessen the severity and length of the contraction.

Part IV considers developments in the Austrian approach. Contained within the heart of the theory is a recognition of the potential instability of financial markets, which creates serious tension with the strongly libertarian commitments of the approach. I identify four strains of responses within the approach: Panglossian, antifractional reserve banking, pessimistic, and cowardly interventionist. The first downplays the seriousness of market instability, not very plausibly. The second recognizes the seriousness of market instability, but prescribes a ban on fractional reserve banking—a highly implausible policy. The third also recognizes the seriousness of market instability, but is so pessimistic about the likely effects of governmental intervention that it recommends living even with very severe periodic depressions rather than trying to stabilize markets. The fourth is more pragmatic, and allows that a moderate amount of intervention in the form of monetary, fiscal, and financial regulatory policy is appropriate. This fourth response fits within what I call cowardly interventionism, though it tends to the more cowardly side of the spectrum.

Part V considers developments in the Keynesian and related liberal approaches. That theory highlights deeper problems within financial markets than the Austrian theory typically recognizes and, hence, favors greater governmental intervention. Yet further reflection upon both the cognitive limits of governmental actors and also the political pressures they are likely to face, in light of historical experience during the postwar years, suggests deep problems for governmental interventions. In response, some liberals rather naively call for politicians and bureaucrats to do a better, more intelligent and honest, job. Others call for quite extensive financial rules to try to limit the influence of the financial sector. But another response takes the limits on governmental action very seriously, and, as a result, advocates more limited intervention than other liberals would like. This response fits within what I call cowardly interventionism, though it tends to the more interventionist side of the spectrum.

Part VI provides more description of what cowardly interventions within monetary policy, fiscal policy, and financial regulation look like. This includes discussion of tensions that still exist within each policy area between those who approach cowardly interventions from the libertarian end and those who approach from the liberal end. On balance, the actions taken during the crisis and the regulation imposed after the worst of the crisis look like sensible cowardly interventions, although certainly plenty of mistakes were made. Part VII concludes.

II. FOUR APPROACHES TO GOVERNMENT AND MARKETS

Our topic is the appropriate mix of markets and government intervention in markets in trying to reduce financial instability. We can identify two central tendencies among advocates: libertarian and liberal. Libertarians tend to advocate fewer and weaker interventions with markets, while liberals tend to advocate more and stronger interventions. The tendencies can be explained and justified by differing degrees of trust and distrust for the two types of institutions—financial markets and government. Libertarians distrust government more, while liberals distrust financial markets more.

Of course, that states it rather baldly. A given person may well distrust both financial markets and government. Indeed, a key thesis of this Article is that quite strong distrust of both is the healthiest position. Thinkers will vary both in their absolute levels of distrust and in the comparative strength of their distrust of the two institutions. But what characterizes libertarians is their relatively greater distrust of government than markets, with the extremism of their libertarianism tending to increase with an increase in relative distrust of the government. Similarly, what characterizes liberals (as I use the term here) is their relatively

greater distrust of financial markets than of government, with the extremism of their liberalism tending to increase with an increase in relative distrust of the markets.

Theorists can also be distinguished along a different axis. This distinction focuses upon their reasons for distrusting a particular institution, be it markets or government. Put simply, distrust can flow from a belief in either the greed of participants in one of the institutions, or a belief in their ignorance. Of course, both greed and ignorance are ever-present elements of all human institutions. But theorists differ in their accounts both of the strength and importance of these factors, and also in their accounts of how frequently these human weaknesses lead to bad outcomes. Thus, pro-market libertarians certainly accept that greed is widespread among market actors, but they believe that markets tend to work so that social good results from behavior motivated by private greed.¹⁸

Once again, individual theorists may account for both greed and ignorance, and another key thesis of this Article is that both provide important reasons for distrust, although I will particularly emphasize ignorance, in part because I think its importance is generally under-acknowledged. But here too, different theorists tend to concentrate more upon one or the other, with the degree of relative emphasis differing for different thinkers.

Combining these two categorizations of theories leads to four approaches to governmental intervention, as seen in Table 1. Of the two varieties of libertarian approaches, one focuses on greed or incentive problems to explain its distrust of governmental intervention. I refer to this as the public choice approach. A host of scholars have developed this general approach, including Stigler,¹⁹ Buchanan, Tullock,²⁰ Olson,²¹ and Niskanen.²² Public choice theory emphasizes various pathologies likely to afflict governmental policymaking. Industry capture and bureaucratic aggrandizement are the leading concerns. Financial regulation is ripe for industry capture. Consumers and members of the general public each individually have a small stake in this regulation and lack the expertise to evaluate a very complex regulatory regime. Financial industry companies and insiders, by contrast, have much at stake and plenty of

18. An argument, of course, associated with the “invisible hand” metaphor of Adam Smith. *See generally* ADAM SMITH, *THE WEALTH OF NATIONS* 160 (1776).

19. *See generally* George Stigler, *The Theory of Economic Regulation*, 3 *BELL J. ECON. & MGMT. SCI.* 3 (1971).

20. *See generally* JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1958).

21. *See generally* MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965).

22. *See generally* WILLIAM NISKANEN, *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* (1971).

expertise. The latter are much more likely to engage in effective lobbying to advance their interests.²³ Bureaucratic aggrandizement occurs as regulators are guided by their own self-interest. Agencies with extensive rules and large budgets are likely to be more prestigious and offer higher salaries. Bureaucrats may thus be motivated to enact multiple complex rules as a way of maximizing their own power.²⁴ Fiscal policy is even more ripe for interest group manipulation, as fiscal policy is the net result of all governmental spending and taxing, and thus subject to all interest group lobbying over the budget. Monetary policy is probably somewhat easier to partially shield from interest group lobbying, though here too we shall see there are concerns.

		Why Institution Is Distrusted	
		Greed	Ignorance
Institution Most Distrusted	Government	Public Choice –Buchanan –Stigler	Austrian –Mises –Hayek
	Market	Progressive –Brandeis –Stiglitz	Keynesian –Keynes –Minsky

The Austrian approach to financial markets is also libertarian in tendency, but it characteristically focuses on problems of ignorance rather than greed in justifying its distrust of government intervention. The Austrian tradition began with von Mises and Hayek, and more recent advocates include Murray Rothbard²⁵ and, to a certain extent, Tyler Cowen.²⁶ This tradition emphasizes the serious uncertainty that entrepreneurs and banks face in making decisions about future investment. This uncertainty helps create a tendency towards instability within the financial system. Central banks exacerbate this tendency. Loose monetary policy sends false signals into the price system. Although perfectly administered monetary policy could potentially help stabilize markets, central bankers lack the omniscience required to administer such a policy.

23. This sort of situation is ripe for exploitation by the interested group. *See generally* OLSON, *supra* note 21.

24. *See generally* NISKANEN, *supra* note 22.

25. *See generally* MURRAY ROTHBARD, AMERICA'S GREAT DEPRESSION (1963); MURRAY ROTHBARD, WHAT HAS GOVERNMENT DONE TO OUR MONEY? (1963).

26. *See generally* TYLER COWEN, RISK AND BUSINESS CYCLES: NEW AND OLD AUSTRIAN PERSPECTIVES (1997).

Liberals likewise can be split into two categories based on different reasons for distrusting financial markets. One group focuses on greed; I will call these the Progressives. A key early Progressive was Louis Brandeis;²⁷ Joseph Stiglitz is a contemporary exemplar.²⁸ These scholars emphasize various informational imperfections and externalities that afflict Smith's invisible hand with a violent tremor. At their worst, financial markets can feature rampant fraud and abuse. Even well short of that, speculation and high indebtedness can make financial markets vulnerable to causing great harm to a large number of people.

Finally, what I will call the Keynesian school present a rather different set of arguments for the liberal, relatively interventionist position. Keynes himself is, of course, the key figure, with a variety of post-Keynesian economists, above all Hyman Minsky, as important followers and developers of the ideas.²⁹ The Keynesians emphasize ignorance rather than greed as the Achilles' heel of financial markets. Business people must make decisions now based on predicted consequences years in the future. Markets can be subject to alternating waves of optimism and pessimism. This ignorance and uncertainty can lead to great instability, creating a possibility for financial regulation, along with monetary and fiscal policy, to help stabilize the economy.

In this Article, I will focus especially on the two approaches that emphasize ignorance, the Austrians and Keynesians. In part, that is because I think that economists and lawyers tend to dwell too much on incentive issues and ignore the crucial importance of ignorance and uncertainty. Not only does this lead to analysts ignoring important problems, but it also creates a pernicious attitude on the part of scholars studying these matters. A focus on incentives and greed leads to a smug, moralizing view of either market actors or bureaucrats and politicians or both. The disengaged, morally pure scholar is then well-placed to confidently pronounce on the best approach to financial stabilization. In contrast, those who focus on uncertainty and ignorance should be more prone to humility. And humility is the proper attitude to bring towards the highly complex and difficult task of analyzing financial stabilization.

In future sections we shall consider how the Austrians, with admixtures of public choice, and the Keynesians, with admixtures of Progressivism, responded to the Great Depression, how their theories developed

27. *See generally* LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914).

28. *See generally* JOSEPH STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY (2010).

29. *See generally supra* note 8. Another notable post-Keynesian is Paul Davidson. *See generally* PAUL DAVIDSON, THE KEYNES SOLUTION: THE PATH TO GLOBAL ECONOMIC PROSPERITY (2009).

over time, and how their descendants have addressed our latest financial crisis. We shall see the various schools mutating in interesting ways. At least the more sane members of differing schools often come to realize that there are good reasons to distrust their own preferred institution, be it the government or markets. The differing approaches thus evolve in ways that bring them closer together as observers realize that greed and ignorance plague both government and markets.³⁰

III. COMMONALITIES OF THE AUSTRIAN AND KEYNESIAN UNDERSTANDING OF FINANCIAL MARKETS AND BUSINESS CYCLES

Though frequently seen as opposite ends of the political spectrum, the Austrian and Keynesian business cycle theories share important elements. Much more than the dominant macroeconomic models of recent decades,³¹ these theories emphasize the role of financial institutions and markets. They also both feature a major role for the expectations of entrepreneurs and investors, and their understandings of those expectations is less rationalistic than the dominant models in contemporary economics. In short, markets and economies are wilder and less tamed in Austrian and Keynesian theories than in the mathematical models that modern economists love.

Both theories see a boom–bust cycle driven by expectations and the credit market. A critical element of modern capitalist economies is that entrepreneurs and investors must make decisions about large-scale capital investments, which will take years to come to fruition. These decisions are necessarily based upon current expectations of future conditions. But those current expectations are fragile and changeable, and sometimes the expectations will turn out to have been too optimistic. As investors then retrench, problems emerge.

Start with the boom period of a credit cycle. Expectations of future profits from current long-term capital projects go up for some reason. The characteristic reasons in the two theories differ significantly. For Austrian theory, the characteristic reason is lowered interest rates driven by expansive monetary policy.³² For Keynesian theory as developed by

30. My intellectual history here is brazenly Whiggish. I have my own perspective, which mixes elements of all four approaches and features severe distrust of both government and markets based on both ignorance and greed (with an emphasis on ignorance). I am, hence, attracted to elements in the history of all approaches that converge to my own preferred perspective.

31. For rational expectations, see generally *supra* note 9; for real business cycle theory, see generally Robert E. Lucas, Jr., *Understanding Business Cycles*, 5 CARNEGIE–ROCHESTER CONF. SERIES ON PUB. POL'Y 7 (1977); Charles I. Plosser, *Understanding Real Business Cycles*, 3 J. ECON. PERSP. 51 (1989); dynamic stochastic general equilibrium theory, Camilo Tovar, *DSGE Models and Central Banks* (Bank for Int'l Settlements, Working Paper No. 258, 2008).

32. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 9.

Minsky, the characteristic reason is high confidence and greater appetite for risk brought on by a period of calm and prosperity.³³ In either case, the expectation of future profits leads to increased investment in capital-intensive industries. It also leads to increased debt to support much of that investment. As long as the optimistic expectations of future profits are met, the investments will be profitable and the debt can be paid off.

But eventually the boom becomes unsustainable. Profits are not as high as expected, and some of the investments from the good times become unprofitable. Some of the debt becomes increasingly hard to repay. Investors must retrench and find ways to save money to repay their debts. They cut back on new investments and labor costs. Some of the industries that had grown quickly during the boom now shrink. The contractionary phase can be long and painful, as investors turn cautious until their financial standing solidifies, and resources move out of unprofitable areas.³⁴

The Austrian and Keynesian theories differ, though, in their understanding of the role of government in the booms and the busts. As for the booms, Austrians blame the government, and, in particular, central banks' conduct of monetary policy, for leading to overinvestment in areas that will turn out to be unprofitable.³⁵ The Keynesians, by contrast, blame financial market participants for becoming too optimistic and see properly conducted monetary policy as a way of holding down the booms.³⁶ As we shall see, though, each theory can concede a good deal of ground to the other in their understanding of the boom phase. Austrian theory, in its best versions, understands that even without mistaken monetary policy, markets on their own can be unstable and generate booms that eventually lead to busts.³⁷ Keynesian theory, again in its best versions, in turn understands that bad monetary policy can be procyclical rather than countercyclical and, hence, can make matters worse.³⁸ But still, the emphases differ.

As for the busts, the two approaches differ more strongly. The Austrians typically believe that government can do almost nothing useful to stop a slide once it starts. Bad investments have occurred, these must be unwound, and that necessarily involves a good deal of pain for a long time. Attempts to ease the pain will merely prolong it and delay the shifts

33. MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 8, at 233–38.

34. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 13–14; MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 8, at 245.

35. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 9.

36. MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 8, at 324–26.

37. *See infra* notes 67–86 and accompanying text.

38. *See infra* notes 106–118 and accompanying text.

in resources that need to occur.³⁹ By contrast, Keynesians think that in the bust, investors in all sectors will pull back as expectations turn bleak, leading to a general unwillingness to invest or spend and a resulting lack of aggregate demand. At this point, stimulative monetary and fiscal policy can reduce the intensity and shorten the length of the bust.⁴⁰ Here too, each theory can concede some ground to the other, but the concessions are more grudging. Austrians sometimes see some role for limited aid to the unemployed to help tide them over. They also grant that very precise monetary policy may help prevent an overcorrection, but they highly doubt the ability of central banks to get that policy right.⁴¹ In turn, some Keynesians grant that stimuli and bailouts may stop some useful adjustments from occurring and may help bolster inflation.⁴² But still, a (perhaps the) defining difference between the two schools remains that Keynesians, even of the most skeptical sort, are far more willing to advocate monetary and fiscal stimulus policy during a recession than are Austrians, even of the most moderate sort.

IV. LIBERTARIANS

During the Great Depression, a number of economists clung to a belief that markets, left to their own devices, would function well, and that government intervention would do more harm than good. One of the most prominent and brilliant of these was Friedrich Hayek.⁴³ A problem for most economists of this ilk was that traditional economic theory could not really explain how the Great Depression could have occurred in the first place. The challenge was to devise a theory that gave a plausible, realistic account of markets while still concluding that state intervention was unwarranted.⁴⁴ That challenge remains today—the *laissez-faire*-inclined new classical macroeconomics of recent decades resembles the traditional pre-Depression theory in being unable to adequately explain how such a contraction could ever occur.⁴⁵ Over the course of the Great Depression, Hayek elaborated a theory of the business cycle that meets this challenge better than any competitor. That business cycle

39. ROTHBARD, *AMERICA'S GREAT DEPRESSION*, *supra* note 25, at 19.

40. MINSKY, *STABILIZING AN UNSTABLE ECONOMY*, *supra* note 8, at 324–26.

41. HAYEK, *PRICES AND PRODUCTION*, *supra* note 7, at 97–98.

42. MINSKY, *STABILIZING AN UNSTABLE ECONOMY*, *supra* note 8, at 315–16.

43. On Hayek and libertarian scholars during the 1930s and 1940s, see Angus Burgin, *The Return of Laissez-Faire* (Aug. 2009) (unpublished Ph.D. dissertation, Harvard University) (on file with Harvard University Archives Depository).

44. Although, as Burgin emphasizes, the libertarian scholars in the 1930s often stressed that they did not advocate a complete *laissez-faire* policy. *See id.*

45. *See generally* STIGLITZ, *supra* note 28; JOHN QUIGGIN, *ZOMBIE ECONOMICS: HOW DEAD IDEAS STILL WALK AMONG US* (2010).

theory began with Ludwig von Mises, and is known as Austrian business cycle theory. Subsequent economists in the tradition have elaborated on the theory,⁴⁶ but Hayek remains the most influential exponent.

In looking more closely at Austrian business cycle theory, we need to consider in greater detail both the claim that government monetary policy is responsible for creating recessions and the claim that government intervention once a recession has begun will only make matters worse. Although these claims are not that different from policy ineffectiveness claims in more mainstream libertarian economic theory, they are more poignant in the Austrian theory because markets are more fragile according to the Austrian theory, and, hence, the alleged governmental failure is more painful. Austrian theorists do not generally trumpet this market fragility, but it is there in the theory. In this Part, we will ask whether the Austrian claim of governmental ineffectiveness, and worse, holds up once one takes that market fragility seriously.

The Austrian business cycle theory has roots in the capital theory of Eugen von Böhm-Bawerk⁴⁷ and Knut Wicksell.⁴⁸ The first brief statement of the theory was by Ludwig von Mises.⁴⁹ Friedrich Hayek made the main formulation of the theory in the 1930s and used the theory to oppose active intervention in response to the Great Depression.⁵⁰ The main post-World War II elaboration came from Murray Rothbard.⁵¹ A more recent neo-Austrian theory of the business cycle on which I shall draw quite a bit was developed by Tyler Cowen.⁵²

As we have seen,⁵³ the Austrian theory blames expansive monetary policy for igniting the boom phase of a business cycle. Injection of money into the economy through the banking system lowers interest rates and encourages investors in the more capital-intensive parts of the economy to increase their investments. These investments increase overall economic activity. But some portion of the investments will turn out to be malinvestments, which will lead to the bust phase.

But before turning to the bust phase, we must ask two questions about the boom. First, why do money growth and low interest rates cause investors to overinvest in long-term projects?⁵⁴ Second, might other

46. *See generally* ROTHBARD, sources cited *supra* note 25.

47. *See generally* EUGEN VON BÖHM-BAWERK, CAPITAL AND INTEREST (William A. Smart trans., 1890) (1884).

48. *See generally* KNUT WICKSELL, INTEREST AND PRICES (1898).

49. *See generally* MISES, sources cited *supra* note 7.

50. *See generally* HAYEK, sources cited *supra* note 7.

51. *See generally* ROTHBARD, sources cited *supra* note 25.

52. *See generally* COWEN, *supra* note 26.

53. *See supra* notes 27–30 and accompanying text.

54. COWEN, *supra* note 26, at 83–84.

causes lead to similar overinvestment? As to the first question, a more modern rational expectations approach considers the Austrian school suspect, since it requires investors to be systematically fooled by government policy into believing interest rates will remain low long enough for their long-term investments to turn a profit. One can counter this criticism by replying that rational expectations are not a good assumption to make about long-term investments and financial markets—indeed, a more realistic understanding of expectations is one of the main attractions of Austrian theory.⁵⁵ Yet Tyler Cowen has argued rather persuasively that even without the rational expectations assumptions, traditional Austrian theory implies that investors react to money-induced lowered interest rates in quite implausible ways.⁵⁶ Contemporary Austrian theorists have tried to rebut this criticism,⁵⁷ while Cowen has reformulated and generalized the theory in a way that avoids his various specific criticisms, including this one.⁵⁸

For my purposes here, I do not need to resolve this debate—the Austrian theory has challenges, as do all macroeconomic theories, but on at least some versions it still has some real attractions. The bigger question for me is the second one posed above: Once we admit that financial markets can be destabilized by monetary policy, aren't there other causes not tied to governmental intervention that could have the same effect of launching a doomed boom? If markets can be fooled by monetary policy in the way the Austrian theory describes, can't other factors fool them as well? The basic source of the boom is widespread expectations about future returns that turn out to be mistaken and lead to miscoordination in the form of too much investment in long-term capital.⁵⁹ Does the core theory justify the assumption that expansive monetary policy is the only important potential source of such expectations? Even worse for the theory, if there are such other sources, then might there be a role for countercyclical monetary policy to cut off speculative booms before they go too far?

Before looking at how economists in the Austrian tradition have answered those questions, let us first consider similar questions that arise for the analysis of the bust phase of the business cycle. The bust begins once it becomes clear that the malinvestments went too far, leading to unprofitable new projects. Those industries must then cut back, reducing

55. William Barnett II & Walter Block, *Tyler Cowen on Austrian Business Cycle Theory: A Critique*, 2 *NEW PERSP. ON POL. ECON.* 26, 31–32 (2006).

56. COWEN, *supra* note 26, at 80.

57. *See generally* Barnett & Block, *supra* note 55.

58. COWEN, *supra* note 26.

59. *Id.* at 11.

production and jobs. Employees and capital must shift to other areas, and this shift can take a long time and cause painful dislocations in the process. The Austrian theory sees little room for governmental intervention to ease the pain—the disinvesting needs to happen, and trying to ease it will simply delay the pain and lead to more pain in the end. They do leave open a theoretical possibility that intervention might help prevent overshooting or reduce some reductions in demand outside of the affected industries that might occur. But they believe that it is highly unlikely that governments will be able to find the right policies.⁶⁰

Given the severe and prolonged pain that the busts can cause, though, we should not too lightly accept the argument that there is nothing that government can do to help. In particular, Keynesian theory raises the threat that industries throughout the economy will contract as everyone becomes worried and cautious.⁶¹ That leads to a widespread waste of resources well beyond the disinvesting from overly expanded industries that the Austrian theory says is needed. At least some versions of Austrian theory do allow for this possibility.⁶² Are they right that the possibility is of limited importance and does not justify actual intervention to ease a recession? Thus, in the Austrian theory of both the boom and the bust, we find an acknowledgment of serious instability that can occur in part through the operation of financial markets. That instability arises because of the difficulty market participants have in predicting the future—it is an ignorance-based source of possible distrust of the market, in our ignorance v. greed categorization. And this source of distrust of markets is quite close to the distrust that arises from Keynesian theory.

How do the key Austrian theorists react to this possible time bomb lurking within their story? Deep distrust of governmental intervention in markets is a core commitment for them, and yet their theory suggests serious dysfunction within a crucial set of markets. I distinguish four strands of responses: Panglossian, anti-banking, pessimistic, and cowardly interventionist.

The Panglossian response is that the potential for instability within markets in the absence of active governmental intervention is quite limited and, hence, not a big worry. In a libertarian utopia of private currencies and a night-watchman state, there might be mild booms and busts, but they would not do too much harm. There are elements of this response in Mises⁶³ and Rothbard,⁶⁴ for instance. The story behind this is

60. HAYEK, PRICES AND PRODUCTION, *supra* note 7, at 97–98.

61. *See infra* notes 97–98 and accompanying text.

62. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 14–16.

63. *See generally* MISES, HUMAN ACTION, *supra* note 7, at 429–45.

64. *See generally* ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 24–25.

that other than central banks, no other actor is systematically able to create the kind of distorted expectations that lead to the boom. Absent inflationary monetary policy, investor expectations will usually more or less cancel out on the optimistic and pessimistic side,⁶⁵ and the false booms will be relatively rare and mild. The private banking system could, on its own, through heightened lending, inflate the money supply. But the Panglossian view maintains that without central bank facilitation, the banks could not go too far, as depositor and creditor monitoring of bank debt levels would limit excessive bank leverage.⁶⁶ This theory, at least in its more extreme forms, advocates in monetary policy the elimination of central banks combined with a return to the gold standard or private banking and private currencies,⁶⁷ in fiscal policy a very small state⁶⁸ and, hence, very little fiscal policy at all, and in financial regulation only minimal rules.

But the story underlying this version of the theory looks lazy and unjustified. There is serious incoherence in the Panglossian version's treatment of investor expectations. Government monetary intervention is assumed to seriously mislead investors, and yet when it comes to possible private sources of a boom–bust cycle, the theory assumes that expectations will not go very wrong. Keynesian theory, and especially Minsky's version of Keynes, provides a compelling story about how volatile expectations can coordinate in an optimistic crescendo for a long time.⁶⁹ Real business cycle theory also suggests that real changes in the economy may change expectations, but that investors may sometimes not correctly understand the effect of those changes at first. In his generalization of Austrian theory, Cowen has monetary policy as just one of five types of causes for expectations leading to a boom.⁷⁰ Hayek and his followers, for the most part, seem to have been unwilling to follow the logic of their theory as far as it goes when that logic leads to too much distrust of financial markets.⁷¹

A second Austrian response to the possibility of fragility within the private financial system is a denunciation of fractional reserve banking.⁷² This response is particularly associated with Murray Rothbard. Although Rothbard primarily blames central banks for the boom–bust cycle and

65. *Id.* at 8.

66. *Id.* at 24–25.

67. See generally FRIEDRICH HAYEK, DENATIONALISATION OF MONEY (1976).

68. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 22.

69. See *infra* notes 95–96 and accompanying text.

70. COWEN, *supra* note 26, at 25.

71. QUIGGIN, *supra* note 45, at 21.

72. In fractional reserve banking, banks lend out more than they take in from deposits. They can do so because it is unlikely that all depositors will ask for all of their money at the same time.

advocates the same sort of extremes in laissez-faire monetary, fiscal, and regulatory policy, he also argues that fractional reserve banking exacerbates the problem. Through fractional reserve banking, private banks in effect increase the money supply, and by increasing leverage or decreasing reserves, they can inflate the economy. Moreover, fractional reserve banking creates the possibility of bank runs, which make busts more sudden and severe.⁷³

Rothbard's response is to advocate prohibiting fractional reserve banking.⁷⁴ This is an odd position for someone who is generally fiercely libertarian. Rothbard attempts to justify this major state intervention by arguing that fractional reserve banking is fraud, as it requires committing the same property to multiple persons.⁷⁵

As a policy prescription, this is hard to take seriously, for reasons that should have been obvious to a libertarian economist like Rothbard. The fraud argument should be immediately dubious to any first-year law student—a necessary element of fraud is deception, and banks do not hide the basic nature of what they do. Moreover, the political odds of Rothbard's proposal succeeding are indistinguishable from zero—banks would fight it with everything they have. Worst of all, anyone familiar with one of Hayek's best arguments against intrusive regulation⁷⁶ would see that although banning fractional reserve banking is simple to state as an idea, it would be horrendously hard to actually translate into an enforceable law. As we see from the current shadow banking system, there are many ways to behave economically like a bank without calling oneself a bank.⁷⁷ There are huge profits to be had from doing what fractional reserve banks do, and firms would find all sorts of creative ways to get around the law. Any attempt to ban fractional reserve banking would indeed lead down the road to serfdom.

While not possible to take seriously as a practical policy proposal, Rothbard's case against the banks is a telling moment in Austrian business cycle theory. Its very implausibility, almost silliness, and its deep inconsistency with the libertarian thrust of most of that theory, is revealing. An intelligent and usually rigorously consistent theorist like Rothbard is likely to fall into such a trap only when there is a deep hole within that theory, a tension between competing principles that the theory finds impossible to resolve convincingly. Although Rothbard in many places

73. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 26–27.

74. *Id.*

75. *Id.* Note that by invoking fraud, Rothbard introduces some greed-based distrust of market actors to complement the ignorance-based trust of government, which is the theory's leading thrust.

76. See generally FRIEDRICH VON HAYEK, THE ROAD TO SERFDOM (1944).

77. See generally McDonnell, *supra* note 10, at 4–12.

follows the Panglossian response, when he attacks private banks he is recognizing a deep fragility within the market system. As much as possible he tries to blame that fragility on central banks and regulation, but here he more honestly confronts the dilemma of a libertarian approach to business cycles and the financial markets. But his intellectual honesty falters in his lack of serious scrutiny of his proposed solution.

The third possible Austrian response to the threat of instability within the financial system is pessimistic. It recognizes the possibility, indeed likelihood, of truly deep and long-lasting busts in an unregulated system, but insists government intervention would just make things even worse. The policy prescriptions, at least in strong versions, remain as fiercely libertarian (without the odd ban on fractional reserve banking) as the first two responses. One sees elements of this pessimistic response in Hayek and Rothbard. One important step in this direction is Rothbard's recognition of "secondary" features of the bust phase. Although he insists that the unwinding of malinvestments remains the primary feature, he notes that as financial difficulties and bankruptcies increase, over-leveraged banks and businesses may choose to behave very cautiously. Customers and creditors may become worried about banks, leading to possibly contagious bank runs. Given all these risks, people prefer to hold more money and fewer risky assets.⁷⁸

These are the main features of a Keynesian story about the bust phase, particularly as developed in Minsky (as we shall see in the next Part).⁷⁹ It is unclear what Rothbard intends by labeling them "secondary" features. Perhaps this is a matter of logic—the theory points to the unwinding of malinvestments as the key point. But even if secondary in that sense, that does not prevent such secondary features from becoming extremely important in practice. If Rothbard means to deny such practical importance, he gives no good arguments or evidence for accepting that denial.

A pessimistic version of the Austrian theory would grant the great importance of these features and, hence, would grant that busts may be much more painful than the Panglossian version of the theory suggests. But it would insist that we must just live through the pain. This fits with a certain form of moralistic austerity rhetoric that one can find both in Hayek in the 1930s⁸⁰ and also in many observers today.⁸¹ But given the recognition of how badly unregulated markets may fare, this pessimism

78. ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25, at 14–15.

79. *See infra* notes 97–99 and accompanying text.

80. *See e.g.*, HAYEK, PRICES AND PRODUCTION, *supra* note 7, at 98–99.

81. Indeed, a move to austerity has been the key policy direction of the Tory–Liberal Democrat coalition government in the U.K.

requires a stronger theory of why governmental intervention is likely to do more harm than good.

If financial markets on their own may lead to serious inflationary bubbles, is there not then a role for monetary policy, fiscal policy, or regulation to contain those bubbles? The pessimistic theory has both ignorance-based and greed-based arguments against such intervention. As to the former, one can seriously question whether bureaucrats are likely to be able to recognize asset bubbles before the market does. And even if they can identify a bubble, they may not be able to stop it without causing the very recession they want to avert. This was the leading argument that the libertarian Alan Greenspan used to resist suggestions that he should try to prick the housing bubble that led to the latest crisis.⁸² Bureaucrats are likely to be at least as subject to imperfect knowledge as are sophisticated financial markets.

The greed-based case against intervention is developed through public choice theory. Even if bureaucrats and politicians have the wisdom to recognize the economy is in the midst of an inflationary boom, they will face great political pressure to let it continue. Contractionary monetary and fiscal policy lead to immediate felt pain for many, and that pain has to be justified with the assertion that things would have been even worse had the boom been allowed to continue.⁸³ Such counterfactuals are rarely politically compelling, even when true. Almost everyone—financiers, consumers, workers—benefits during the boom phase. Fighting almost everyone is not easy, and even well-designed governing institutions may be unable to do so regularly.

How about intervention during the bust phase? Clearly this can help ease some of the pain. But it does so at great costs, the pessimists claim. These costs include both putting off needed liquidation of failed companies and investments and also the moral hazard created by financial markets being aware that government will bail them out when things go wrong.⁸⁴ Interventions may also generate policy uncertainty, which can delay recovery.⁸⁵ Also, once intervention is allowed, government may well intervene even in many instances where there is little risk of systemic collapse.

For all these reasons, a pessimistic version of the Austrian theory grants that financial markets left to their own devices will cause serious

82. Chairman Alan Greenspan, Remarks at Symposium sponsored by the Fed. Reserve Bank of Kansas City (Aug. 30, 2002), *available at* <http://www.federalreserve.gov/boarddocs/speeches/2002/20020830/>.

83. FRIEDRICH VON HAYEK, CONSTITUTION OF LIBERTY, *supra* note 11, at 330.

84. McDonnell, *supra* note 10, at 8.

85. Robert Higgs, *Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Returned After the War*, 1 INDEP. REV. 561, 563–64 (1997).

problems but maintains that the cure of governmental intervention is worse than the disease. It advocates building barriers to such intervention. Here, though, it faces a difficulty—the very public choice arguments which suggest that intervention is likely to be unhelpful also suggest that it is likely to be unavoidable, particularly now that we have created institutions with the power to do so. Undoing those institutions may very well be politically completely infeasible, not only because there are strong entrenched interests that benefit from those institutions, but also because the benefits from a pure *laissez-faire* approach are highly uncertain, and on this version of the theory we know the costs are high.⁸⁶ So, the pessimistic version of the theory is very likely doomed to a lonely Cassandra position, and knows itself to be so.

Unlike the first two responses to financial market fragility, I find the pessimistic approach quite plausible, although ultimately I do not follow it for reasons developed below. It very much deserves to be a major part of the conversation as to how to respond to the role of finance in boom–bust cycles.

The final possible Austrian approach to addressing the fragility of financial markets fits within what I elsewhere call advocacy of cowardly interventions.⁸⁷ This response moves considerably towards the Keynesian position and is less rigorously libertarian than the other three responses. Like the anti-banking and pessimistic responses, it recognizes the deep fragility of *laissez-faire* financial markets. Unlike the anti-banking response, though, it does not go down the rather goofy path of trying to eliminate fractional reserve banking. Unlike the pessimistic response, it does grudgingly grant the wisdom for some government interventions, in monetary, fiscal, and regulatory policy. It does so because it recognizes the threat that financial markets pose if left alone and that doing nothing in the face of depressions is politically unpalatable.

This more pragmatic approach may be divided into two variants. One agrees with the pessimists that on-balance governmental intervention is likely to make matters worse, but because it also sees some intervention as inevitable, it enters the fray to try to keep that intervention as unobjectionable as possible. The other variant is concerned enough with the instability of markets that it believes that on balance it is possible for governmental interventions to do more good than harm. Both variants agree that there should be strong limits on the extent of interventions.

We can find elements of this pragmatic approach occasionally in Hayek's writings. A good example is his qualified support for central

86. McDonnell, *supra* note 10, at 31.

87. *See generally* McDonnell, *supra* note 10.

banks following discretionary monetary policy.⁸⁸ Tyler Cowen's neo-Austrian approach is rather more consistently pragmatic. In the recent crisis, he supported at least elements of the Dodd-Frank financial reform and the bank bailouts.⁸⁹ He also had some sympathy for a fiscal policy operating through automatic stabilizers,⁹⁰ although much less so for discretionary fiscal policy.⁹¹ In Part VI, I will lay out in more detail what cowardly interventionist monetary, fiscal, and regulatory policies might look like, and how Austrian and Keynesian versions of such an approach will differ. In general, we will see that even the most pragmatic of Austrians (like Cowen) will differ from even the most pragmatic of Keynesians in emphasizing that governmental interventions should remain quite limited.

V. LIBERALS

The Roosevelt administration set the pattern for active governmental interventions in response to the boom–bust cycle. Through jobs and welfare programs it created a modest fiscal stimulus, though spending did not reach the level suggested by economists like Keynes until the ramp-up to World War II. It introduced a whole new system of financial institution and market regulation in a variety of pieces of legislation, above all the Banking Act of 1933, the Securities Act of 1933, and the Securities and Exchange Act of 1934. It moved the United States away from the gold standard, creating the basis for a new form of monetary policy.⁹²

Roosevelt himself was a pragmatic improviser. His policies did not necessarily flow from a consistent philosophy of public policy. Yet here I shall explore some of the leading intellectual justifications for Roosevelt's liberal approach, both justifications made during the Great Depression and also subsequent developments within this tradition. I distinguish two strands within this tradition. One focuses on problems created in financial markets by ignorance and uncertainty, while the other focuses on

88. HAYEK, *CONSTITUTION OF LIBERTY*, *supra* note 11, at 327.

89. Tyler Cowen, *The Inequality That Matters*, AM. INTEREST, Jan.–Feb. 2011, <http://www.the-american-interest.com/contents.cfm?Mid=37>.

90. Tyler Cowen, *Measuring Fiscal Policy and Evaluating Its Results*, MARGINAL REVOLUTION (July 26, 2010, 7:25 AM), <http://www.marginalrevolution.com/marginalrevolution/2010/07/measuring-fiscal-stimulus-and-its-results.html>.

91. Tyler Cowen, *Understanding German Fiscal Policy*, MARGINAL REVOLUTION (June 22, 2010, 2:34 AM), <http://www.marginalrevolution.com/marginalrevolution/2010/06/explaining-german-fiscal-policy.html>.

92. *See generally* ELLEN D. RUSSELL, *NEW DEAL BANKING REFORMS AND KEYNESIAN WELFARE STATE CAPITALISM* (2008).

problems created by greed and corruption. For reasons discussed in the Introduction,⁹³ I focus on the former.

The towering achievement in the liberal tradition from the Great Depression is Keynes's General Theory.⁹⁴ Published in 1936, it postdates the main New Deal legislation and programs. But Keynes circulated his ideas in preliminary form before the book came out, and other economists advocated similar policies. A leading justification for such policies and a related explanation for business cycles was Irving Fisher's debt deflation theory, published in 1933.⁹⁵ Keynes's theory focused on the role of uncertainty in destabilizing financial markets. In response, he advocated countercyclical monetary and fiscal policy to slow down booms before they turned into busts, and to reduce the depth and length of busts when they did occur. Keynes's position on financial regulation is less clear, although the work of successors like Minsky makes clearer the role for regulation in stabilizing financial markets.⁹⁶

Keynesian theory does not work well to justify all elements of the New Deal response. In particular, the focus of the new securities laws on transparency and avoiding fraud does not seem to flow particularly well from a Keynesian analysis of the problems markets face. Rather, that part of the New Deal seems to spring from another liberal tradition that emphasizes the role of greed and deception within financial markets. A leading articulation of this view is Louis Brandeis's *Other People's Money*.⁹⁷ I will discuss more below some roles this plays in the development of the liberal approach to financial regulation, but first I shall focus on the Keynesian tradition.

After the war, Keynesian theory developed in a variety of directions. A mainstream set of economists, led by Paul Samuelson among others, crafted a tamed version that was easier to reconcile with traditional economics.⁹⁸ More interesting for my purposes are the post-Keynesians, who emphasized the role of uncertainty and expectations. Of these, the most important is Hyman Minsky.⁹⁹ Whereas Keynes focused mainly on the bust phase of the business cycle, Minsky focused at least as much on the boom phase.

93. See *supra* paragraph before note 10.

94. See generally KEYNES, *THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY*, *supra* note 8.

95. See generally Irving Fisher, *The Debt-Deflation Theory of Great Depressions*, 1 *ECONOMETRICA* 337 (1933).

96. MINSKY, *STABILIZING AN UNSTABLE ECONOMY*, *supra* note 8, at 354-58.

97. See generally BRANDEIS, *supra* note 27.

98. See generally PAUL A. SAMUELSON, *ECONOMICS: AN INTRODUCTORY ANALYSIS* (1948).

99. See generally MINSKY, sources cited *supra* note 8.

As developed by Minsky, the post-Keynesian theory resembles Austrian business cycle theory in important ways. In the boom phase, overly optimistic investor expectations lead to a high level of capital investments. This appears both in rising stock market prices and, even more seriously, in rising levels of debt. Both banks and operating companies become more and more leveraged, and increasing numbers of actors take on levels of debt that can be repaid only on optimistic assumptions about future profits.¹⁰⁰ A crucial difference from the Austrian theory, though, is that inflationary monetary policy from the central bank is far from the only way that such an inflationary boom can start. Indeed, in Minsky's theory, even without inflationary monetary policy, the nature of investor expectations is likely to lead to a boom eventually, as periods of calmness and prosperity lead investors to forget the threat of bad times and become willing to take on more risk (or rather, to become less aware of the risk they are creating with their ever-more-leveraged investments).¹⁰¹

The resulting boom is unsustainable. Eventually, bad news of some sort will cause investors to start to question their rosy scenarios. It becomes hard to maintain interest payments on all of those leveraged investments, as profits prove less high than expected. Expectations quickly turn negative. Businesses start to cut back as they try to handle their debts. Banks come under increasing pressure, and (in the absence of governmental intervention) bank runs start to occur. These can become contagious: Businesses cutting back leads to increased unemployment and lowered incomes, which causes consumers to cut back, which further reduces profits, which leads to a vicious downward cycle.¹⁰² These are both the primary and the secondary effects identified in Rothbard's analysis of the bust phase.¹⁰³ The collapse of business and demand is deeper and potentially longer-lasting than in the core Austrian theory; although we have seen that in various places the Austrians recognize the elements that can lead to this broader collapse.

Because it sees this bust phase as more severe and the boom phase as more endogenous to financial markets themselves, the post-Keynesian theory is more inclined to advocate governmental intervention than the Austrian theory. During good times, monetary, fiscal, and regulatory policy can help dampen the inflationary boom. During bad times, policies can help reduce the severity and length of the contraction.¹⁰⁴ The more

100. MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 8, at 233–38.

101. *Id.*

102. *Id.* at 239, 324–25.

103. See *supra* note 73 and accompanying text.

104. MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 8, at 324–25.

seriously one sees markets as failing, the more likely one is to see a positive role for governmental interventions to address those failures, *ceteris paribus*.

This theory goes further than the Austrian theory in rejecting the rationality of investor preferences. As we have seen, the Austrian theory takes a rather uncomfortable, inconsistent position between standard theories assuming strong rationality and a position which forthrightly rejects that assumption. The post-Keynesian approach abjures this middle ground and rejects the rationality assumption, which has dominated most macroeconomics in recent decades. Recent developments in economic theory support the post-Keynesian approach. Behavioral theories of economics and finance consider extensive psychological evidence on human decision-making and try to construct more realistic models of behavior based on that evidence.¹⁰⁵ A recent book by Akerlof and Shiller explicitly ties these developments to Keynesian theory.¹⁰⁶

But a thorough application of behavioralism starts raising embarrassing questions for the post-Keynesian approach once one starts applying behavioral ideas to governmental actors, i.e., legislators and bureaucrats. Will they not be subject to the same sorts of misplaced enthusiasms that distort markets? The Keynesian theory calls for the central bank and financial regulators to pull back during an incipient boom—to take away the punch just as the party gets going, to use the memorable metaphor of a former Federal Reserve chief.¹⁰⁷ But if the central bank and regulators are subject to the same optimism based on forgetting past hard times, why should we expect them to play that role? Indeed, won't they give in to the same enthusiasm and add oil to the fire, loosening monetary policy and financial regulators precisely when they should tighten? If so, then doesn't government run a serious risk of exacerbating rather than dampening the business cycle?¹⁰⁸

The greed-based variant of liberalism also saw significant theoretical developments in recent decades. The development of theories of asymmetric information identified many significant market failures. Eventually theorists started applying these ideas to macroeconomic prob-

105. See generally Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124 (1974); ANDREI SHLEIFER, *INEFFICIENT MARKETS* (2000).

106. See generally GEORGE A. AKERLOF & ROBERT J. SHILLER, *ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM* (2009).

107. *Business: The Martin Era*, TIME, Feb. 2, 1970, <http://www.time.com/time/magazine/article/0,9171,878186,00.html>.

108. See generally Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549 (2002); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003).

lems, providing new arguments to defend elements of Keynesian theory. Joseph Stiglitz was a central figure in developing both the microeconomic and the macroeconomic theory.¹⁰⁹ Fraud and poor corporate governance can lead to financial markets that perform quite inefficiently and may break down. Exponents of this brand of Keynesian indeed argued that one could support Keynesian business cycle theory and policy prescriptions without recourse to the kind of rationality assumptions that post-Keynesian theory used.¹¹⁰

But here too, the Keynesian approach faces embarrassment when one starts to apply these ideas to government policymaking itself. Will regulators have access to the information needed to correct market imperfections? Even if they do, will private actors who benefit from private information stand by and allow the government to reduce their power? Straightforward economic thinking, developed within public choice theory, suggests these parties will lobby legislators and regulators to shape rules in ways that help them. During the boom period, financial market interests will lobby to limit or eliminate rules meant to rein them in. When busts hit, they will lobby government to rescue them from their folly. These rescues are a part of the Keynesian prescription anyway, but political pressure will prevent the government from disciplining those who created the crisis. The prospect and past reality of these bailouts create a severe moral hazard problem. Minsky himself was highly conscious that market actors will tend to find ways around attempts to regulate them,¹¹¹ and that governmental rescues reduced market discipline.¹¹²

Postwar history provides much evidence to reinforce these doubts that arise within the Keynesian approach. The Keynesian golden age ended in the 1970s as inflation became a severe problem. Governmental efforts to prevent busts reduced market discipline and prevented needed disinvestments from occurring. As the Great Depression became a distant memory and postwar depressions were short and mild, market participants argued that restrictive old rules were no longer necessary. Deregulation proceeded from the 1970s on. Government debt increased through much (though not all) of the period, as politicians found it easy to follow the Keynesian prescription favoring deficit spending during the bust phase but much harder to follow its prescription of surpluses during the boom. As for monetary policy, although it did manage to break the back

109. See generally Bruce Greenwald & Joseph Stiglitz, *New and Old Keynesians*, 7 J. ECON. PERSP. 23 (1993).

110. See generally Joseph Stiglitz, *The Non-Existent Hand*, 32 LONDON REV. BOOKS 17 (2010).

111. MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 8, at 370.

112. *Id.* at 326.

of inflation during the hard Volcker recession of the early 1980s, under Alan Greenspan markets came to believe in the “Greenspan put”—if financial markets began to flag, he would lower interest rates to avoid a serious recession.¹¹³ The Greenspan put probably helped fuel the asset bubbles first in Internet stock and then in housing. The latter led directly to the recent financial crisis.

How can and should Keynesians respond to the ability of the government to properly intervene to reduce the volatility of business cycles? Within advocates of that position, one can identify several kinds of responses. One sort of response is rather naive. It points to a variety of policy mistakes that regulators have made and asserts they would not have made such mistakes if they had just followed the right theory or had in place someone smart enough to make the right decisions—someone as smart, presumably, as the writer himself. This sort of response is also quite aware of the public choice issues and decries the influence of financial market firms over regulators and policymakers. If only officials were more pure in their dedication to the public good (again, like the writer himself), the proper Keynesian policy would prevail. Joseph Stiglitz’s popular writings often exhibit the characteristics of this kind of response,¹¹⁴ as do the writings of Paul Krugman.¹¹⁵

A more hardline liberal response calls for quite heavy financial regulation, in part to prevent bubbles, but even more to reduce the political power of financial institutions. The recent book *Thirteen Bankers* by Simon Johnson and James Kwak is a good example of this genre.¹¹⁶ Johnson and Kwak focus on the great political power of large Wall Street firms, like Goldman Sachs, and blame them for the deregulation that led to the crisis and then for the bailouts, which treated the banks far too gently. They argue that law should prevent firms from becoming too big to fail and set hard limits on the size of financial businesses. Some liberals go even further and argue for resurrecting the strict price and entry limits that characterized finance in the 1950s and 1960s.

These kind of heavy regulations raise a serious question as to whether they go too far in limiting financial innovation.¹¹⁷ Worse still, contemporary analysis in this genre tends not to have much in the way of

113. *Greenspan Put*, INVESTOPEDIA.COM, <http://www.investopedia.com/terms/g/greenspanput.asp> (last visited Apr. 18, 2011).

114. See generally STIGLITZ, *supra* note 28.

115. See generally Paul Krugman & Robin Wells, *The Slump Goes On: Why?*, N.Y. REV. BOOKS, Sept. 30, 2010, <http://www.nybooks.com/articles/archives/2010/sep/30/slump-goes-why/>.

116. See generally SIMON JOHNSON & JAMES KWAK, *THIRTEEN BANKERS* (2010).

117. See generally Robert Litan, *In Defense of Much, But Not All, Financial Innovation*, BROOKINGS INST., Feb. 17, 2010, http://www.brookings.edu/papers/2010/0217_financial_innovation_litan.aspx.

a convincing story as to how we are supposed to get there. It seems to hope that populist outrage in the wake of a crisis will lead to support for breaking up the banks. But it tends not to do a detailed, realistic political analysis that identifies forces that can plausibly support a sustained assault on the powerful financial sector. Indeed, one can often detect a cynicism and despair that suggests a realization of how unlikely such regulation is. The very concentrated political power that gives rise to a need for such regulation also makes it extremely unlikely.¹¹⁸ Insofar as they recognize their weakness in the face of existing forces, these sorts of liberals rather closely resemble the pessimistic Austrians.¹¹⁹

A more pragmatic response puts some Keynesians within the realm of what I call cowardly interventionism, thereby joining the most pragmatic of the Austrian theorists. Such Keynesians look for ways to loosen the bounds on the rationality of policymakers,¹²⁰ but they recognize that bounded rationality for all is here to stay. They therefore call for less active governmental intervention of various kinds. The political limits on responsible intervention also lead such Keynesians to expect less from the government and explore ways in which policymakers can, to a degree, be shielded from undue political influence.¹²¹

Keynesians of this sort may in their policy advocacy look more like the most pragmatic Austrians than like the more hardline Keynesians. Current economists within this strain include figures like Brad DeLong¹²² and Larry Summers.¹²³ Still, even within the confines of a pragmatic, cowardly interventionist spectrum, one will still see differences between the Austrians and the Keynesians. The Keynesians are still animated by great distrust of the effect of financial markets on the business cycle and are inclined to push governmental intervention further than the Austrians with their ancestral distrust of government.

Thus, in the last two Parts we have seen some theorists within two very different traditions come together. Family resemblances in their theories of the business cycle helped create some possibility of a joint vision. Beyond that, the experience of history has taught painful lessons to both sides. The libertarians started with a great distrust of the government and believed that markets worked well enough that they should be

118. See generally JOHNSON & KWAK, *supra* note 116.

119. *Supra* notes 73–81 and accompanying text.

120. See generally Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, U.N.C. L. REV. (forthcoming 2011).

121. *Id.*

122. Brad DeLong's *Short Biography*, BRAD DELONG'S GRASPING REALITY WITH TWO HANDS, <http://www.delong.typepad.com> (last visited Apr. 25, 2011).

123. *Profile of Lawrence Summers*, HARVARD KENNEDY SCH., <http://www.hks.harvard.edu/about/faculty-staff-directory/lawrence-summers> (last visited Apr. 25, 2011).

left largely alone. But experience revealed deep enough problems with markets that some libertarians came to reluctantly recognize a need for fairly serious intervention to stabilize markets. The liberals started with a great distrust of financial markets and believed that government could do a lot to stabilize those markets and prevent macroeconomic instability. But experience revealed deep enough problems with governments that some liberals came to reluctantly recognize that we should be very skeptical about how much government can do to stabilize the economy. Still, although some within the two sides have moved towards the middle, echoes from their starting points remain, leaving much source of division even where there is significant common ground.

VI. COWARDLY INTERVENTIONS

In the previous two Parts, I have shown how good reasons for distrusting both markets and governments can lead to convergence from very different starting points on a program of what I call cowardly interventions. In this Part, I sketch what such a program looks like. I consider monetary policy, fiscal policy, and financial regulation. In a companion Article,¹²⁴ I have looked in much more detail than I can consider here at financial regulation and, in particular, the Dodd-Frank Act. Here, I will do more than I do in that piece to consider monetary and fiscal policy along with financial regulation.

There tends to be a division of labor in academic treatment of these topics, with economists addressing monetary and fiscal policy and legal scholars addressing financial regulation. That division makes a good deal of sense, but it can be taken too far. The three sets of policies are inter-related. Each can be used to help dampen inflationary booms. The policies can act as substitutes. Hence, they should not be considered each in isolation but together. Economists are well aware that is so for monetary and fiscal policy, but financial regulation tends to be treated separately from the other two. Here, I treat all three together.

A. Monetary Policy

While the more extreme within the Austrian camp condemn central banks altogether,¹²⁵ and some of them call for a return to the gold standard or for competing private currencies,¹²⁶ over the last few decades there has been a convergence within mainstream economics on the basic features of sound monetary policy. The cowardly interventionist ap-

124. McDonnell, *supra* note 10.

125. See generally ROTHBARD, AMERICA'S GREAT DEPRESSION, *supra* note 25.

126. See generally HAYEK, *supra* note 67.

proach fits within that mainstream. But the financial crisis has raised some hard questions.

One constantly recurring struggle over monetary policy concerns the relative weight to be given to curbing inflation and promoting economic growth as often conflicting goals. Given the inflationary bias of policy driven by more politically accountable organs of government, it makes sense for the central bank to be particularly concerned with inflation.¹²⁷ One would expect those coming from an Austrian starting point to have greater concern about inflation than those coming from a Keynesian starting point. Some argue that inflation should be the sole concern of the central bank in setting monetary policy.¹²⁸ But the financial crisis suggests that is not such a good idea. Since our economy is obviously still subject to the possibility of severe contractions, we should not forget the importance of avoiding such contractions. But the more that fiscal and regulatory policy do to help guard against such contractions, the less we need to use monetary policy for that purpose—an instance of the importance of considering these three areas of policy together.

A particular problem in the inflation–growth tradeoff revealed over the past decade concerns the role of asset bubbles. First, during the dot-com bubble and then during the housing bubble, the Federal Reserve faced a question that generated much debate. Inflation as usually measured was low, suggesting little need for a tight monetary policy. But many were concerned that an expansive policy was fueling the asset bubbles and, hence, that policy should be made less expansive in order to prick those bubbles. Alan Greenspan as Chair of the Fed seems to have been torn by this question but ultimately decided that the Fed should not use monetary policy to try to stop asset bubbles.¹²⁹ Two main arguments appear to have swayed him and others. First, it is hard to recognize bubbles while one is in them. Even if, like the Austrians and Keynesians we have considered here, one does not accept strong theories of market efficiency,¹³⁰ someone like Greenspan with a libertarian bent is going to be reluctant to think he can systematically and successfully second-guess market valuations of assets. Second, Greenspan argued that it made most sense to let the bubbles run their course and deal with the effects of their bursting afterward.¹³¹

127. HAYEK, CONSTITUTION OF LIBERTY, *supra* note 11, at 330.

128. Charles Wallace, *Should the Fed Worry About Unemployment?*, DAILY FINANCE, Nov. 20, 2010, <http://www.dailyfinance.com/2010/11/20/should-the-fed-worry-about-unemployment>.

129. Greenspan, *supra* note 82.

130. See generally Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575 (1991).

131. Greenspan, *supra* note 82.

The financial crisis has called those arguments into question. Even if central bankers cannot be sure that their judgment is better than the market's on the existence of a bubble, there are indicators that fairly reliably suggest that a bubble may exist.¹³² Many warned about the housing bubble several years before it popped.¹³³ It is now quite obvious that waiting until a bubble bursts to deal with the consequences is a dangerous strategy. Thus, it may well be that central banks should consider potential asset bubbles and be willing to use monetary policy to prick them when there is good reason to believe that a bubble exists and poses a serious threat to the economy. On the other hand, Greenspan's reasons for not using monetary policy to address asset bubbles do still have real force. Perhaps countercyclical financial regulation provides a more focused and effective way to address asset bubbles. If so, then it may be there is little or no need to use monetary policy to address bubbles, or perhaps one should do so only in the case of the biggest of bubbles. Interestingly, it may well be that a Keynesian is more willing to use monetary policy to address asset bubbles than someone from the Austrian tradition, despite the latter's usual greater concern with inflation. If central banks start using monetary policy to deflate asset bubbles, they will have greater discretion and become more involved in second-guessing market valuations, both of which are suspect from an Austrian perspective. And yet that perspective also focuses on the dangers of asset bubbles. This is a hard question for both groups within our pragmatic middle way.

The other great dilemma of monetary policy raised by the financial crisis concerns its role in the midst of the crisis. The Federal Reserve took quite aggressive action to keep the economy from collapsing, including large purchases and guarantees of assets well beyond the short-term government bonds that constitute its asset portfolio in ordinary times. The wisdom and effectiveness of those actions will continue to be debated for many years. They may have helped save the economy from a Second Great Depression, but they also exposed the Federal Reserve and the U.S. Treasury to potentially huge liabilities¹³⁴ and created severe moral hazard problems as financial industry participants were spared the full pain of their mistakes.¹³⁵ Here, there is an interaction with fiscal policy—one will see less need for aggressive monetary policy in a crisis the more that one believes that fiscal policy is likely to be effective. Presum-

132. See generally ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2d ed. 2005); REINHART & ROGOFF, *supra* note 6; KINDLEBERGER & ALIBER, *supra* note 6.

133. See generally SHILLER, *supra* note 132; NOURIEL ROUBINI & STEPHEN MIHM, *CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE* 1–2 (2010).

134. Although, in the end, few of those liabilities materialized.

135. See generally ROUBINI & MIHM, *supra* note 133, at 165.

ably, almost all would agree that these tools should only be used in extreme circumstances. The experience of the crisis does also suggest, though, that in such extreme circumstances, the tools may be useful.

B. Fiscal Policy

Keynes himself put the greatest stress on fiscal policy during serious economic contractions. But in recent decades, most economists have become rather skeptical, at least of discretionary fiscal policy. There are two concerns, familiar from our discussion already, about a policy that is controlled by elected politicians.¹³⁶ First, those politicians may well not recognize when fiscal stimulus is needed, especially given the lag time in such policy's operation. Second, politicians will be tempted to use deficits during contractions, but not to follow Keynes and institute surpluses during expansions.¹³⁷ The long-term result is structural deficits that fuel inflation and may eventually lead to budgetary crises.¹³⁸

Because of these concerns, most economists favor automatic stabilizers over discretionary fiscal policy.¹³⁹ Automatic stabilizers work, as the name suggests, automatically, and depend less upon the discretion and judgment of legislators. As the economy contracts, benefit programs like unemployment insurance lead to increased expenditures, while government income contracts as tax revenues decrease.

What is the appropriate level of automatic stabilizers? The current level in the United States is below that of most other advanced economies, in part because the general level of spending is lower in the United States and in part because its tax and spending are less redistributive. The question of the right level is hard not only because of differences between libertarians and liberals over the degree of appropriate activism in macroeconomic policy, but even more because many other sorts of policy debates enter into the creation of the government's budget. The questions obviously go well beyond those at issue in this Article. Liberals and libertarians tend to disagree strongly on those questions as well, with

136. As fiscal policy, unlike monetary policy, must necessarily be because fiscal policy emerges from the overall level of spending and taxing in the government's budget, and that budget involves political decisions of all sorts that go well beyond technical macroeconomic policy.

137. See *supra* notes 106–108 and accompanying text.

138. Sovereign debt crises are the most common form of financial crisis. REINHART & ROGOFF, *supra* note 6. In the latest crisis, we have seen a serious sovereign debt crisis right in the European Union. Crises for U.S. states may be next.

139. See generally Cowen, *supra* note 90; J. Bradford DeLong, *Macroeconomics: The Academic Agenda*, BRAD DELONG'S GRASPING REALITY WITH A PREHENSILE TAIL (Mar. 4, 2010, 8:22 AM), <http://delong.typepad.com/sdj/2010/03/macroeconomics-the-academic-agenda.html>.

liberals tending to advocate higher spending in many areas (though not all, defense spending being a major exception to the general trend).¹⁴⁰

The higher the level of automatic stabilizers, the less need there will be for discretionary fiscal policy to address even severe contractions. This can be seen in comparing the U.S. and German reactions to the recent crisis. The United States under Barack Obama had a much larger discretionary stimulus response, but the total level of deficit spending (as a percentage of GNP) in response to the crisis was about the same, due to the larger automatic stabilizers in Germany.¹⁴¹ This creates something of a dilemma for a moderate libertarian within the cowardly interventionist fold. On the one hand, as a libertarian, one will tend to advocate low general levels of government spending, with resulting low automatic stabilizers. On the other hand, when a crisis hits, one will also strongly prefer automatic stabilizers to discretionary stimulus.¹⁴² That may lead to support for somewhat more government spending than one would otherwise want or to supporting more active monetary policy than one would otherwise want.

Is there any room for discretionary fiscal stimulus during a crisis? That became a point of heated debate in the early weeks of the Obama Administration. Here, even Austrians and Keynesians who fall within the cowardly interventionist fold are likely to disagree, with the Austrians quite skeptical of discretionary stimulus and the Keynesians likely to support a fair degree of stimulus.¹⁴³ In between is an intermediate level of stimulus likely to make few people really happy—this is precisely what was enacted in those early weeks of the Obama Administration.

C. Financial Regulation

Financial regulation can also help stabilize the financial sector and, hence, the economy. During boom periods, it can restrain lending, dampening the sort of speculation that both Austrians and Keynesians see as the cause of the eventual bust. During bust periods, central banks or other government agencies can act as lenders of last resort, bailing out or helping to shut down in an orderly way failing financial institutions and, thereby, preventing runs and panics. Yet the growing complexity of finance makes appropriate regulation ever harder to create and enforce, and the politics of regulatory capture create ongoing doubts about the likelihood that agencies will be adequately vigilant.

140. See Cowen, *supra* note 90; J. Bradford DeLong, *supra* note 139.

141. Cowen, *supra* note 90.

142. *Id.*

143. See generally *supra* note 139.

Extreme Austrians advocate very light to no financial regulation, while extreme Keynesians advocate much stronger limits than we currently see, along the lines that prevailed in the early postwar decades. Here, though, I shall briefly lay out an intermediate position. I have analyzed this in much greater detail in my Article on cowardly interventions.¹⁴⁴

Bailing out failing financial institutions is the most direct and obvious way to stop panics, and has been a feature of central banking for centuries.¹⁴⁵ The lender of last resort guarantee can be explicit or implicit, limited or expansive, and the government may charge an advance fee to build up a bailout fund or not. One can see elements of both in the U.S. financial system. For banks covered by the FDIC, the guarantee is explicit, limited to deposits under a certain size (although there may be some indeterminate implicit guarantee for amounts above that level as well), and backed by a fund into which banks pay premia. This system creates a great deal of certainty, and to the extent the FDIC can make premia risk based with an effective measurement of risk, it helps force banks to internalize the risk they take.¹⁴⁶ For other financial institutions, the guarantee is implicit and, hence, uncertain—but the recent crisis reveals that the Federal Reserve and U.S. Treasury are ready to go quite far in honoring their implicit guarantee. The Dodd-Frank Act extended resolution authority so that now the government can orderly resolve a wider range of financial institutions. Due to Republican opposition, no new guarantee fund was created. The concern was that such a fund would increase the chances of an inappropriate bailout, but as a consequence the government can't charge risk-based premia that could have helped to internalize risk.¹⁴⁷

There is plenty of room to debate the proper approach to rescues of financial institutions, and how far the United States is from such an approach as revealed by the recent crisis. Few people can be fully satisfied with how the bailouts worked in the crisis. Our reflections on the perils surrounding governmental intervention suggest that future crises will continue to reveal plentiful problems in governmental responses. But some bailouts are virtually inevitable. There is also a fair amount to

144. McDonnell, *supra* note 10.

145. *See generally* REINHART & ROGOFF, *supra* note 6; KINDLEBERGER & ALIBER, *supra* note 6.

146. *See generally* VIRAL A. ACHARYA ET AL., *REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE*, at ch. 5 (2010).

147. *Id.*

praise in the reaction to the latest crisis,¹⁴⁸ and, as we shall see next, the new resolution authority in Dodd-Frank probably gives improved tools for handling the next crisis. Those operating within a cowardly interventionist approach have plenty of room for debate about major details in how we approach rescues, but they can agree on the basic need for them.

Although sometimes needed, the prospect of rescues creates moral hazard that can increase the amount of risk that financial institutions undertake. Thoughtful intervention needs to find ways to alleviate the problem that intervention creates.¹⁴⁹ The New Deal banking legislation faced this problem when it created FDIC insurance and responded with two main mitigation strategies. Resolution authority allows the FDIC to impose some discipline when it does intervene, and bank capital requirements and supervision regulates *ex ante* the amount of risk that banks can undertake. The Dodd-Frank Act contains both elements as well, although it remains to be seen whether it will work as well as the New Deal legislation.¹⁵⁰

With an effective resolution authority, bank regulators can recreate much of the discipline of unregulated markets. When a bank fails, they can try to make sure that bank shareholders and top officers lose out, so fear of that punishment motivates future bank shareholders and officers. Bank creditors need more protection in order to prevent panics, but perhaps unsecured creditors can and should receive reduced payments in some circumstances to give them incentive to better monitor banks in the future. The FDIC's resolution authority has performed these functions well since the New Deal. But as the financial sector has grown more complicated, more and more institutions and markets are not covered by the FDIC. Shadow banking institutions functionally closely resemble banks but are not regulated as banks.¹⁵¹ These institutions need intervention along lines similar to the New Deal banking legislation. The new resolution authority in Dodd-Frank¹⁵² extends resolution authority to systemically important nonbank financial institutions. The law dictates that shareholders and officers should be punished in the process and leaves for further study and discretion the treatment of unsecured creditors, all as it should. A critical question that will be determined by future regulation and bailouts is whether the Act goes far enough in covering the main

148. Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39 (2009).

149. ACHARYA ET AL., *supra* note 146 at 2.

150. McDonnell, *supra* note 10.

151. *Id.* at Part III.

152. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. II, 124 Stat. 1376 (July 21, 2010).

participants in the shadow banking world. Unfortunately, there is good reason to believe that the legislation covers too limited a realm, focusing on too-big-to-fail companies, but creative regulation could extend the authority further.¹⁵³ There is also a good argument to be made that a modified version of Chapter 11 bankruptcy rather than a new resolution authority would have been a better response—Chapter 11 has stronger rule of law versions that libertarians should cherish.¹⁵⁴

The other main element of the New Deal banking legislation was prudential banking regulation and supervision. This responds to two needs. First, as we have just seen, the possibility of bailouts creates moral hazard, encouraging banks to take on too much risk. Prudential regulation attempts to limit the risk banks take on. Second, we have focused much attention on market failures in the boom phase of the credit cycle. Even without bailouts, we have seen that banks and others are likely to take on too much debt to make too many risky capital investments during the boom phase. Prudential regulation provides a direct way to reduce such leverage and risky investment. As we have seen, the better we expect prudential regulation to succeed in this task, the less we need to use monetary policy to deflate asset bubbles.

The New Deal prudential regulation contributed to decades without a serious financial crisis. But eventually the model became increasingly creaky, as deregulation and financial innovation led to the growth of shadow banking with a growing number of financial products, institutions, and markets not covered under the banking rules. An important need is to extend at least basic limits on capital and leverage to institutions in the shadow banking world. Does Dodd-Frank do that effectively? That is a crucial open question, but the early evidence is not encouraging.¹⁵⁵ The Act does extend prudential regulation to systemically important institutions.¹⁵⁶ But that again (like the new resolution authority) seems to focus only on too-big-to-fail companies. It does not account for the fact that markets of individually modest but collectively important companies behaving in similar ways may pose the same kind of threat to stability. Perhaps the Act can be creatively interpreted to extend further down into the shadow banking world than its text seems to contemplate, but that does not currently appear likely.¹⁵⁷

These are the main general tasks and current open questions for financial regulation. But the recent crisis revealed a variety of more specif-

153. McDonnell, *supra* note 10.

154. For further discussion, see *id.*

155. *Id.*

156. Dodd-Frank Wall Street Reform and Consumer Protection Act, tit. I.

157. McDonnell, *supra* note 10.

ic problems, such as opaque derivative markets, morally hazardous securitization business models, and problematic credit rating agency treatments of mortgage-backed securities. The Dodd-Frank Act attempts to deal with the major problems revealed. I believe it does so quite plausibly, although one can certainly argue that it goes either too far or not far enough.¹⁵⁸ Beyond this, as financial institutions and markets rapidly evolve, new potential problems will arise, which are hard to anticipate now. Financial regulators need to constantly question their current regulatory scheme, asking if new rules are needed for new problems or old rules have become obsolete. I have argued elsewhere that the Dodd-Frank Act builds in mechanisms for asking such questions in a large variety of ways.¹⁵⁹

The area of financial regulation remains very much in flux as the new Act requires hundreds of new regulations for its implementation. These new regulations and the way in which they are enforced will crucially affect the success or failure of the Act. Even this brief overview has suggested many points where persons broadly united within a cowardly interventionist approach may well disagree over important elements of the new rules. Still, at a high level of abstraction, the Dodd-Frank Act seems to be trying to do what a cowardly intervenor thinks financial regulation should try to do.

VII. CONCLUSION

In terms of the two characteristics used to categorize approaches to governmental interventions in finance, the Austrian and Keynesian theories share common ground in their emphasis on ignorance rather than greed as the core reason to distrust an institution. This focus on uncertainty in finance helps lead to economic models of business cycles that resemble each other in important ways. It also tends to lead to greater humility in analysis and policymaking, a welcome feature as we confront the complexities of modern finance and economies. The two theories differ in what institution they most distrust, with the Austrians most distrusting government while the Keynesians are most distrusting of financial markets. This leads to wildly differing policy prescriptions in monetary policy, fiscal policy, and financial regulation when one looks at the core early writings in the two camps.

But we have seen that as the theories developed and were exposed to the exigencies of history, some of the differences have narrowed among some adherents. Each side has been exposed to the reasons for

158. *Id.*

159. *Id.*; McDonnell & Schwarcz, *supra* note 120.

distrust of the institution that it prefers (markets for the Austrians, government for the Keynesians), and each has been hard-pressed to offer good arguments in defense of its preferred institution.

The result among the most pragmatic, moderate adherents of each approach is great distrust of both financial markets and government. Financial markets on their own are deeply unstable, building up large debts during speculative booms that turn into stomach-turning busts. But politicians and bureaucrats cannot easily be trusted to either dampen the booms or ease the busts, both because appropriate policy is extremely hard to judge and because political pressures often work against the best policies.

I have proposed an approach called cowardly interventions as a middle ground that recognizes these reasons for distrust of both government and markets. One should use modest, historically tested interventions in monetary policy, fiscal policy, and financial regulation to try to prevent booms from going too far and to ease the hurt from busts when they occur, while structuring those interventions in ways that do not interfere too far with markets and try to mitigate the unintended consequences that do result. I have laid out in broad outlines what the results look like for each of the three policy areas.

Viewed from this lens, the responses to the great financial crisis of 2007 actually do not look too bad, although policy leading up to the crisis looks much worse. As to before 2007: Overly low interest rates in the years before the crisis probably helped fuel the housing and securitization boom. Fiscal policy was rather responsible during the 1990s, actually achieving a surplus, but after that tax cuts, Medicare drug benefits, and two wars without corresponding spending cuts helped increase the national debt, leaving the federal government more vulnerable when the crisis created a much larger deficit. Financial deregulation led to a loosely regulated shadow banking system and irresponsible levels of debt. All of these mistakes illustrate how hard it is for the government to follow liberal interventionist prescriptions properly during prosperous times.

Once the crisis hit, the governmental response was much better from a cowardly interventionist perspective, though still far from perfect (but then, us cowardly interventionists know not to expect anything resembling perfection). The Federal Reserve proved quite creative in devising aggressive ways to loosen monetary policy when conventional policies were too weak. Rescues of failing financial institutions helped ward off a Second Great Depression, although often they did not do enough to punish those who got the institutions in trouble, thereby worsening moral hazard problems for the future. Automatic stabilizers worked as they were supposed to, and Congress and the President sup-

plemented them with a discretionary stimulus that was probably not large enough but still pretty good-sized and structured fairly reasonably, though too much took the form of tax cuts for my own druthers.¹⁶⁰ The Dodd-Frank Act looks like a mostly reasonable attempt to reregulate the financial industry, although it probably does not do enough to regulate the world of shadow banking.

Of course, we do not know yet if we are really beyond the most recent crisis. Plenty of paths to a renewed plunge still present themselves. Even if we have moved beyond this crisis, we have no idea how well the new rules will do in delaying and dampening the next crisis. Even once the next crisis has come and gone, economists and historians will undoubtedly still debate the effects of the actions taken over the past few years. That is another consequence of our widespread ignorance: not only do we have severe trouble predicting the future, we cannot even clearly and definitively interpret the past. And yet, we (both policymakers and scholars) must persevere in both tasks.

160. Too large a fraction of tax cuts gets saved, as compared with expenditures, especially expenditures that go to those in distress, like unemployment benefits.