

IN REVIEW

Progress, If Not Utopia

REVIEW BY GEORGE LEEF

A phrase we often hear these days is, “We cannot allow *X* to go unregulated.” That is commonly said with regard to some new good or service, such as cryptocurrencies or vaping, but the notion could apply to anything that isn’t already subject to detailed oversight by some governmental agency. The assumption behind it is that

regulation is essential for the public good and the only real regulation is done by government. If we don’t have some arm of the state in control, we have no control at all.

Wright State University economist Evan Osborne delivers a powerful counter to that assumption in his book *Self-Regulation and Human Progress*. He makes the case that human action is subject to control through voluntary market processes and that such regulation is nearly always more conducive to innovation and harmony than is control dictated by some authority figure or group. He writes:

There is substantial historical reason to believe, as I seek to demonstrate, that as society becomes more complex, the inadequacies of political regulation, and therefore the need for self-regulation, actually grow. But if instead it is political regulation that grows, existing problems fail to be addressed effectively, generating more anger and in turn more political regulation.

Replacing order from above / Peering far back into human history, Osborne finds that people generally looked to their rulers for order. Labor was assigned to people,

for example, rather than having a competitive labor market where individuals could seek the best compensation for their talents. The idea of control from above became ingrained; it was a long time before people began to consider anything other than government regulation of their lives. For that reason, economic progress was dormant for much of human history.

In time, however, some individuals began to think for themselves, contemplating the world and how life might be improved. Those people thought scientifically and wanted to communicate with each other. The scientific method arose spontaneously out of their exchanges, unhindered by governmental dictates. The whole enterprise of science grew through self-regulation and certainly would have suffered if rulers had managed to regulate it.

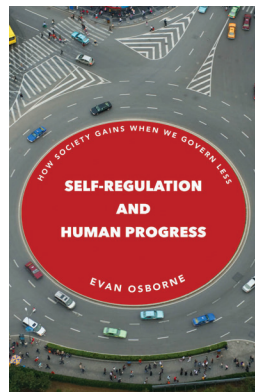
An important contributor to scientific progress was England’s Royal Society of

London for Improving Natural Knowledge (chartered by King Charles II but not under the crown’s control). Scientists of the day (mid-17th century) decided that experiments done privately had to be conducted again in front of an audience of Society members in order for the findings to be accepted. Hence the Society’s motto, *Nullius in Verba* (“Take nobody’s word for it”). Osborne writes, “Under such conditions, experimentation became in the eyes of the scientific community as close to an unbiased feedback system as has so far been imagined.” From England, the scientific method, a marvelously self-regulating system, spread worldwide.

Equally important was the concept that speech did not need, and indeed should not have, government regulation. In 16th and 17th century Europe, the heads of the Church and national monarchs were particularly concerned with what people read once Gutenberg’s press made the production of written material inexpensive. Naturally, they didn’t want tracts or books that were in any way heretical or treasonous in circulation, and punished those who defied their restrictions. It was widely accepted that religious and secular officials were entitled to do this.

The case for the right of free communication appeared first in England with John Milton’s *Aeropagitica*. In it, he argued for an almost complete freedom of press and speech and showed why systems of state licensing of printers were undesirable. Summarizing Milton, Osborne writes, “Speakers who must answer to a possibly critical audience, in true self-regulating style, would always get closer to truth than their censors will.”

Intellectuals in the Netherlands, France, the German states, and other nations took up Milton’s arguments. For example, in Denmark, Johann Struensee, the king’s personal physician, was appointed royal adviser in



Self-Regulation and Human Progress: How Society Gains When We Govern Less

By Evan Osborne
251 pp.; Stanford Economics and Finance, 2018

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1770. A “wild-eyed child of the Enlightenment” as Osborne describes him, Struensee issued a number of decrees to liberalize Danish law, including complete freedom of the press. Arguments for freedom of communication captured the minds of thinkers throughout Europe and North America. The Virginia Declaration of Rights in 1776, for example, included freedom of the press.

John Stuart Mill’s *On Liberty* made such an overwhelming case for freedom of speech that by the closing decades of the 19th century the idea that governments should regulate communications was in such disrepute that it survived in only a few backward domains such as Russia and the Ottoman Empire.

Economic self-regulation / But what about the socio-economic aspects of life? Early in human history, they too were heavily controlled by religious and secular authorities. Eventually, however, the idea developed that we could rely on self-regulation in the socio-economic realm.

Osborne traces the earliest expressions of a free market philosophy to India. He writes, “The idea that rulers can merely improve the commercial environment, but the welfare of the people ultimately is achieved by merchants and farmers on their own, without any particular guidance from those rulers, was found in ancient thought there.”

Most of Europe resisted self-regulatory ideas until the 16th century. At the University of Salamanca in Spain, however, scholars began to question the beliefs that supported top-down regulation of commerce, such as the concept of the “just price.” Those scholars argued the just price should simply be whatever price was agreed to by both seller and buyer.

From Spain, the free market concepts drifted northward into France, the Netherlands, and England. Frenchman Richard Cantillon set forth the fundamental concepts of price equilibrium and the coordination of resources to produce the most desired goods in his *Essai sur la nature du commerce*. The Dutchman Bernard Mandeville, in his *Fable of the Bees: Or, Private Vices, Publick Benefits*, anticipated Adam Smith in arguing

that the pursuit of self-interest is conducive to prosperity for all. And of course, Smith systematically explained why nearly all political interference with production and commerce would be counterproductive from the standpoint of public welfare.

Against social Darwinism / These ideas were developed further by philosophers Herbert Spencer in England and William Graham Sumner in the United States. Both opposed coercive government at home and internationally—that is, imperialism. They maintained that a minimalist state led to economic and moral progress. Osborne

All-powerful governments would tolerate no opposition while attempting to create perfect humans for the perfect state.

defends Spencer and Sumner against the calumny that their philosophy boiled down to saying that the poor deserve their lot in life.

Of course, opponents of the self-regulated economy made its alleged unfairness the central thrust of their case for a large, if not omnipotent, government to regulate the economy, redistribute income, protect consumers, provide for old age, care for medical needs, and so on. The American intellectual Richard Hofstadter, for example, denounced what he saw as the cruelty of the free market. It was he who coined the pejorative term “social Darwinism” to turn people away from the government minimalism of Smith and other liberals.

Osborne devotes two chapters to responding to attacks on the idea that self-regulation is preferable to political regulation. Some critics argued that the self-regulating mechanisms were often inadequate (what we now term “market failures”) and therefore state intervention was needed to ensure a just society. Others said that society had to be entirely transformed, eliminating private property and competition. Osborne notes the irony in the

fact that skepticism about free markets was itself “generated through self-regulating communication—not just reaction to the seeming excesses of the industrial age, but from the incentives public intellectuals have to say something counterintuitive.”

In the 18th century, a number of starry-eyed opponents of free-market societies founded socialist communities, believing that people would flock to their more humane, property-less mode of living. Those communities were perfectly consistent with the self-regulation concept, but their almost universal failure convinced opponents of *laissez-faire* that the social changes they thought

necessary had to be imposed by government. Thus grew political movements for wage and hour regulation, safety legislation, progressive income taxation, and much more.

An outgrowth of this backlash against self-regulating societies, Osborne writes, was nationalism. He observes that while monarchs had occasionally extended the reach of the state into socio-economic concerns,

it takes *national* leaders to ask (and claim to know how to answer) such questions as “How should French schools be run?” or, “How should the German economy be managed?” Chancellors and parliaments ask those questions; kings and queens seldom did.

Using their power to regulate away the supposed horrors of industrial capitalism, leaders sought to create a tribal loyalty to the nation. The worst consequences of that were wars far bloodier than any before.

The other prong of the counter-reaction against the liberal, self-regulating polity was totalitarianism. All-powerful governments would tolerate no opposition while attempting to create perfect humans for the perfect state. Dissent would be taken as a sign of mental illness to be “treated” with re-education camps—or a bullet to the head. Our author wants us to compare that with the free, self-regulating

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society that leaves people alone to make their own choices.

In the end, Osborne impresses upon the reader that there is inevitably a tradeoff between increasing government regulation and decreasing private-sector innovation and problem solving. “Imagine if all the bile spent over the last several decades in arguing over how to alter political provision of health care had instead been spent as

energy improving it from below,” he writes. Thomas Sowell likes to point out that people who have “cosmic visions” usually can’t be bothered to contemplate the world as it actually exists, with marginal gains and losses; Osborne’s book makes that clear to anyone with an open mind. Self-regulation does not result in utopia, but it does far more to promote progress than does reliance on political regulation. R

Milton Friedman Caused the Financial Crisis — and Other Tall Tales

◆ REVIEW BY VERN MCKINLEY

According to the American Economic Association, there are about 1,000 newly minted Ph.D. economists each year. The primary professional options for them once they complete their degree include working in an academic environment, in government, at an international agency, or in the private sector with banks and

investment houses. The most high-profile of them toil in the field of public policy. Whether they hold current positions in government or are former government economists now in the private sector or in academia, they can be viewed in the media each day weighing in on a variety of contemporary subjects.

In *The Economists’ Hour*, *New York Times* writer Binyamin Appelbaum scrutinizes the changes wrought over the last 50 years in the public policy role of economists. He starts his book by explaining the attitude policymakers held, before the golden age of economists, at one of the major employers of Ph.D. economists, the Federal Reserve: “In the early 1950s ... the central bank’s leadership included bankers, lawyers, and an Iowa hog farmer, but not a single economist.” At that time, there were staff economists at the Federal Reserve, but in the words of the Fed’s chairman at the time, William McChesney Martin, “They are all located in the basement of this building, and there is a reason why they are there.... They don’t know their

own limitations, and they have a far greater sense of confidence in their analyses than I have found to be warranted.”

Appelbaum traces how the world of public policy has evolved in its views of economists since that time, at the Federal Reserve and elsewhere. The term “Economists’ hour,” embedded in his book’s title, is his description of the four decades between 1969 and 2008. He demarcates those years as the time frame that economists began to play a leading role in curbing taxation and public spending, deregulating large sectors of the economy, and clearing the way for globalization. He claims that the Economists’ hour ended in 2008 during the Great Recession when “trust-the-market economists” saw their theories disproven.

Appelbaum does not have a Ph.D. in economics. (He holds a bachelor’s in history from the University of Pennsylvania.) He has spent much of the time since the early stages of the financial crisis writing about it and its aftermath. Prior to joining the *Times*, he wrote for the *Charlotte Observer* where he

developed a series on subprime lending that nearly won him a Pulitzer Prize. *The Economists’ Hour* is his first book.

Appelbaum clearly does not see all the developments during the Economists’ hour as having good results:

The embrace of markets lifted billions of people around the world from abject poverty.... But the market revolution went too far. In the United States and in other developed nations, it has come at the expense of economic equality, of the health of liberal democracy, and of future generations.

He compares the U.S. economic growth rate of just over 3% during the 1960s to the just under 1% growth during the 2000s and blames the market revolution:

Political and social constraints on the role of markets were set aside. Governments pulled back from efforts to regulate the marketplace, to invest in future prosperity, or to limit inequality.

Greatest economist of the 20th century? / Without a doubt, the book’s lead character is Milton Friedman. The references to him occupy over half a page in the index; no other individual or topic comes close.

This prominence is because Friedman’s rise in importance largely corresponded with the timing of Appelbaum’s Economists’ hour. Harvard’s Andre Shleifer calls the period from 1980 to 2005 “the Age of Milton Friedman.” This age began just after the breakdown in confidence in Keynesian economic principles during the 1970s.

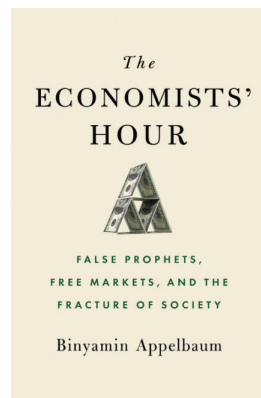
Appelbaum at times shows admiration for Friedman and at other times he is clearly disdainful. Glowing quotes about Friedman are front-loaded in the book’s early chapters: “The most creative social political thinker of our age” (Sen. Daniel Patrick Moynihan); “Around any academic lunch table on any given day, the talk is more likely to be about Milton Friedman than about any other economist” (economist Robert Solow); “He has had more influence on economic policy as it is practiced around the

world today than any other modern figure” (economist Larry Summers). In describing some of Friedman’s early work, Appelbaum seems to approve of his influence on Richard Nixon in eliminating the compulsory draft and replacing it with an all-volunteer military force paid market wages. Appelbaum nicely summarizes Friedman’s philosophy on the historical evidence of government action: “Ambitious interventions ... tended to make matters worse.”

Living through the Economists’

hour / After the initial chapters primarily devoted to Friedman, the subsequent ones fall into a regular cadence. They are narrowly focused on a discrete issue over a 50- or 60-year period of public policy discourse: the turbulent monetary policy environment; the ever-evolving parameters of taxation; corporate antitrust litigation; industry-wide deregulation; benefit–cost analysis; exchange rates; case studies of the Chilean and Taiwanese economies; and the financial industry up to and including the 2007–2009 financial crisis. In most of these chapters, Appelbaum discusses Friedman’s influence on the topics and generally inserts a criticism of his public policy stance or those of other like-minded economists.

There are some not-so-endearing qualities to Appelbaum’s historical compilation. Many of his statements need to be fact-checked. Case in point (in a chapter entitled “Representation Without Taxation”), he describes the aftermath of the Reagan years: “It took most of the next two decades to repair the damage to the government’s finances.” This is what he has to say, notwithstanding the fact that the deficit as a percentage of gross domestic product blew up during the early 1980s because of a recession that Appelbaum admits Reagan inherited, peaking at 6% of GDP. After the deficit peaked, it drifted downward for the



The Economists’ Hour: False Prophets, Free Markets, and the Fracture of Society
By Binyamin Appelbaum
448 pp.; Little, Brown, 2019

remainder of the 1980s to a level of under 3% of GDP.

Economists’ hour, meet the Great Recession

/ Appelbaum pulls together the winding history of the rise and fall of economists in a concluding chapter. He starts off with a rather extraordinary statement about the Great Recession: “Friedman had as large a hand in causing the crisis as any man.” There are no citations to support this statement in his meticulously compiled endnotes that go on for a full 89 pages. I assume that he feels this conclusion is obvious based on the prior 10 chapters he has set forth before the reader, but it is not obvious. The financial bubble that began in the 1990s was brought on by heavy-handed intervention in the housing market, intervention that Friedman was dead-set against. As part of Appelbaum’s post mortem on the financial crisis, he fails to mention Fannie Mae and Freddie Mac, their housing goals, or any of the other social engineering that pushed people into buying homes they could not afford and goosed the homeownership rate to an unsustainable level.

Appelbaum casually describes the federal government’s massive interventions to shore up the financial sector: “The gov-

ernment had tried to support the banks by purchasing bonds in the open market, but the market had collapsed, so the government decided to save the financial system by taking ownership stakes in the largest financial firms.” Yet again, he cites no supporting facts that this particular intervention is what brought the financial system back from the edge.

Many progressives believe that the Federal Reserve was too accommodating to the wishes of financial institutions in providing easy money and massive, opaque bailouts. Appelbaum is not one of them. Instead, he elevates an emerging breed of economists presumably for a new, interventionist era:

Almost the only policy makers willing to persist in efforts to revive growth were the small coterie of former economics professors who ran the Federal Reserve. In November 2010, with the unemployment rate still at 9.8 percent, the Fed ended four decades of single-minded focus on inflation and launched a campaign to stimulate job growth.

He cites this intervention as the death knell for the Economists’ hour:

The Economists’ hour did not survive the Great Recession.... In the depths of the Great Recession, only the most foolhardy purists continued to insist that markets should be left to their own devices.

Conclusion / Appelbaum’s book is engaging and well researched, but it is not for everyone. If readers tend to agree with the limited-government perspective, they will have doubts about—and strong arguments against—his theories of economics. Those who believe that government should strive to reduce income inequality, provide universal health care, bolster the minimum wage, “build a more generous social safety net,” and “extend protection to the less fortunate” will appreciate his conclusion that Friedman has been public enemy number one, as evidenced by the recent history of economic policy. R

Choking Down Socialism

◆ REVIEW BY ART CARDEN

The aphorism is right: the good ideas *do* need to be relearned every generation. Just three short decades after the Berlin Wall fell, we're sitting amidst a revival of enthusiasm for "socialism." Various organizations report that a rising tide of young people view socialism favorably, and it's into this reality that Robert Lawson and Benjamin Powell step to remind readers that *Socialism Sucks*.

I've been friends with the authors for a very long time, and they are accomplished and prolific producers of the kind of dry, academic treatment for which economists are (in)famous. This book, however, is most certainly not what you would get at a university seminar or in a conference room at the annual meeting of a professional scholarly organization. Picking up *Socialism Sucks* is like walking into the middle of the conversation at the hotel bar after a long day at one of those conferences, after everyone has had a few drinks. The language gets a bit salty and some of the jokes are crude and corny, but perhaps you should expect nothing less from a book subtitled *Two Economists Drink Their Way Through the Unfree World*.

The authors' message is fundamentally no different from what one might glean by reading their academic work, albeit by reading it through a pair of strong beer goggles. They warn readers early that this isn't a normal academic book and "if that offends you, you can put this book down and read one of our boring academic journal articles instead. It will make the same points but without the local color." I recommend that you keep reading the book.

Sweden doesn't suck / The book begins with a spicy foreword from libertarian firebrand Tom Woods and an introduction that finds our authors drinking "excellent but highly taxed Belgian beer in Sweden." That this is an introduction and not an actual chapter is important, and that's reflected in its title: "Not Socialism: Swe-

den." It's a clarifying exercise as much as anything. When neo-socialists look at Sweden and say "socialism works," they're not actually talking about *socialism*. Sweden doesn't get its own actual chapter in a book about socialism because Sweden isn't actually socialist. It's a robust free-market economy that has high taxes and a big welfare state. It's not a society in which the state owns and manages the means of production.

Lawson is one of the principal investigators compiling the Fraser Institute's Economic Freedom of the World Index. According to the index, Sweden and its Nordic neighbors are solidly free-market countries. They have high taxes, big welfare states, and heavily regulated labor markets compared to the United States, but they perform very well on other free-market margins like the quality of their legal system and the security of Swedish property rights, access to sound money, freedom to trade internationally, and regulatory burden.

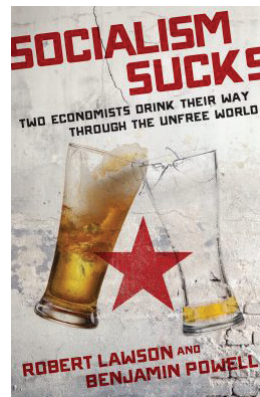
As Lawson and Powell note, Sweden became a rich country by *liberalizing*. As late as 1950, Swedish taxes as a percentage of gross domestic product were 19%, lower than in the United States and elsewhere in Europe. The size of the Swedish government exploded between 1960 and 1980, and it fell from fourth-richest country in the developed world in 1970 to 14th richest in 2000.

Seeing socialism / If you can't find *real* socialism in Sweden, then where is it? Here is where Lawson and Powell begin vigorously and enthusiastically drinking their way through the unfree world, with stops in Venezuela to see "Starving Socialism," Cuba to see "Subsistence Socialism," and North Korea to see "Dark Socialism." (Well, actually, the authors didn't *enter* North Korea, but rather visited the Chinese side of the Korean border to learn about life next door; they had promised their wives they wouldn't be killed or imprisoned on the trip.) They also visited China to see "Fake Socialism," Russia and Ukraine to see "Hungover Socialism," Georgia (the country, not the state) to see "New Capitalism," and finally a socialism conference in Chicago where they wanted to find out why, exactly, self-described American socialists like socialism and what they mean by the term.

Along the way, their boozy adventures show how socialism sucks. Bearded neo-socialist enthusiasts for local craft microbrews might rethink their enthusiasm upon realizing that there are only *two* kinds of beer in Cuba. (On the other hand, Bernie Sanders has said he worries that Americans have too many choices in

deodorant, so maybe two is the right number of beers for socialists.) Georgia, their last stop before heading back to the United States, has a unique regional wine tradition that was almost completely destroyed by communism, but it has experienced a resurgence as economic freedom has increased.

It's easy to get conned by romantic visions of socialist paradise. Socialist reality is different. The authors' trip to Cuba is an excellent illustration. The Cuban government is filled with canny propagandists who are good at putting on a wonderful show for rich tourists, including noting that Havana's Hotel Nacional is "reportedly one of the world's great hotels." But the authors want to get



Socialism Sucks:
Two Economists Drink Their Way Through the Unfree World

By Robert Lawson and Benjamin Powell
224 pp.; Regnery Publishing, 2019

behind the curtain, so to speak, and have a look at the grittier reality of Cuban socialism. What they find is depressing: (again) only two kinds of beer, rotting and decrepit hotel rooms, and bland food even in the legal private restaurants. The reason for that last finding is that the proprietors still have to source their meats, vegetables, and spices through the government. Lawson and Powell highlight the difference between Cuban cuisine in Miami’s Little Havana—which is excellent—and Cuban cuisine in actual Havana—which sucks.

They also address the “whatabouts” common to any defense of socialism, e.g., access to health care, education, etc. For this they use a summary of research by Powell and coauthors Gilbert Bertine and Vincent Geloso in which they take a critical look at Cuba’s vaunted life expectancy and infant mortality numbers. First, communist regimes can and do improve these metrics by sheer brute force: they pour resources into health care, for example. Second, the data are misleading. Abortion rates, for example, are very, very high, and a lot of high-risk pregnancies are terminated (presumably under pressure from health officials) lest they ultimately be carried to term where they can adversely affect the health statistics.

Socialism, American style / The book ends with our authors doing more field research (and drinking) at a conference in Chicago organized by the International Socialist Organization. They noted the thriving black market of unregistered vendors selling t-shirts, knick-knacks, and calendars, as well as the absence of “a clear definition of what constituted socialism.” The apparent incoherence was underscored “when at one point early in the rally, most of the people in the room started a spontaneous, ‘Free abortion on demand. We can do it. Yes, we can,’ chant that lasted a good minute or two.” Lawson and Powell point out that while socialist countries have high abortion rates, “abortion is not exactly a central pillar of a socialist system” and therefore “an odd item to draw such enthusiasm.”

In their conversations with attendees, the authors learn that a lot of the people

there were drawn from environmental and abortion-rights activism and seemed to be united not by socialism per se but by their position to the left of the Democratic Party’s mainstream. Or, as the authors put it, “Many of the conference attendees we asked thought socialism meant simply aspiring toward a world with better conditions for various marginalized groups.” By that definition, Lawson and Powell are socialists. I’m a socialist. The staff of the Cato Institute and the readers of *Regulation* are socialists. It’s a definition devoid of meaning.

It’s here that the authors—and Lawson in particular in his work on the Economic Freedom of the World Index—do an especially valuable service by highlighting the slipperiness of the meaning of “socialism,” which seems to change based on who is in power and which regimes are doing well. The right, obviously, did no one any favors by crying “Socialism!” every time Barack Obama said anything. American intellectuals, academics, and celebrities hailed Venezuela as a socialist success story, a proof-of-concept for the better world that would

follow *la revolución*, and they wrote fawning obituaries for Hugo Chavez after his death in 2013. Then, all of a sudden, Venezuela became “not real socialism” once it started falling apart. The Revolution apparently will not be televised on the basis of things as trivial as clear theory, carefully collected evidence, and on-the-ground observations.

The conviction that socialism can and will work, it appears, is immune to evidence. That problem will only get worse as the horrors of the Soviet gulags and the mass starvation of China’s Great Leap Forward and the Ukrainian *Holodomor* recede into history.

Socialism Sucks may not succeed as an exercise in persuasion. As some reviewers have pointed out, it probably won’t appeal to people who aren’t already on the authors’ “side.” But as George Mason University economist Bryan Caplan has noted, this may not detract from the book’s value. It is a useful reminder for people who are already broadly sympathetic to the libertarian worldview that for all of the ways actually-existing, actually-practiced “capitalism” falls short of perfect, we can thank God it’s not socialism. R

Would Bagehot Be Smiling?

◆ REVIEW BY VERN MCKINLEY

During the 2007–2009 financial crisis, Walter Bagehot’s name (pronounced “Badge-it”) crossed the lips of many central bankers, notwithstanding the fact that he had been dead for some 130 years and he was not a central banker. This relevance came from his belief that the Bank of England needed to act as a lender of

last resort during a financial crisis. Former Federal Reserve chair Ben Bernanke, writing in his 2015 memoir *The Courage to Act*, confidently declared that the string of programs he helped to implement during the 2007–2009 crisis “prevented the financial system from seizing up and helped to keep credit flowing. Walter Bagehot would have been pleased.”

In this new biography of Bagehot, financial writer James Grant considers the role of the Bank of England and Bagehot’s broader footprint on financial policy. Grant is a

prolific writer who primarily focuses on volumes tracing markets and finance from a historical perspective. His last book was *The Forgotten Depression: 1921—The Crash that Cured Itself*. That book explained Grant’s narrative that the deep U.S. recession of the early 1920s was resolved largely through market forces that addressed the malinvestment of that era, in contrast to the heavy-handed government intervention that was applied during the Great Depression of the 1930s and the Great Recession of the Bernanke era.

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In this book, Grant looks at a true renaissance man of the Victorian Era, that period of time in the United Kingdom dominated by the reign of Queen Victoria. The book makes clear the broad array of accomplishments Bagehot claimed during his 51 years of life.

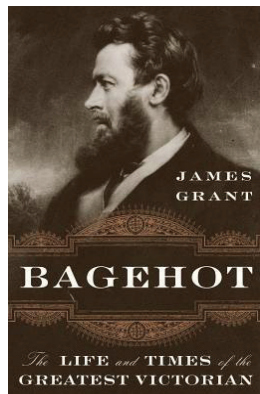
A wonderful (conflicted)

life / Bagehot's most widely known accomplishments include that he was a banker and the author of the book *Lombard Street*, named after London's counterpart to Wall Street. In that book, he set forth his views on the need for the Bank of England to provide emergency lending during a financial panic and hold the nation's bullion reserve (so banks would not have to take on that costly burden). He was also the editor of the periodical *The Economist*, which was founded by his father-in-law, James Wilson.

Bagehot weighed in on many of the major issues in 19th century finance through his writings and in discussions with the technocrats and politicians of the day. What may be known by fewer people is that he also put himself in the running for Parliament on multiple occasions. Grant notes that someone taking on such a broad range of roles in the 21st century would likely be labeled as conflicted:

It was, indeed, in the multifaceted capacity of banker-lobbyist-editor-political aspirant that Bagehot visited the chancellor on March 3, 1864. Today, such an overlay of professional roles might set in motion half a dozen ethics committees, but not then.

In his 30 years of leading *The Economist*, Bagehot felt strongly about many issues beyond financial panics. He carried forth the mantle of Wilson on matters of trade, as Grant illustrates: "Free trade (*The Economist* sometimes reverentially



Bagehot: The Life and Times of the Greatest Victorian

By James Grant
368 pp.; W.W. Norton,
2019

capitalized the initial letters 'F' and 'T')." Bagehot and the pages of *The Economist* railed (at least since the 1850s) against those investors who, in a time of "corruptingly low interest rates," would seek out investments in risky markets: "People who lend to States like Spain and Turkey and Egypt deserve to lose their money, and the clever people who think they will go in for a little time and get out before the crisis comes are among the most likely to lose." In the realm of politics, Grant describes Bagehot as someone "who believed in progress, religious liberty, limited government, clean elections, non-entanglement in foreign wars, free trade, and ... free banking."

A life marked by financial crises / Bagehot was a banker and a close observer of the financial system from his perch at *The Economist*. Grant manages to weave through the events of Bagehot's life, punctuating them with references to the major

Although many modern-day central bankers claim Bagehot as a kindred spirit, Grant makes clear that 19th century finance was vastly different.

banking panics of his era: 1825, 1837, 1847, 1857, and 1866. The last of those panics saw the collapse of the bills, brokers, and money dealers Overend, Gurney & Co., which had a great deal of influence on how Bagehot viewed a central bank's role in a crisis.

He was initially duped about the condition of Overend, commenting in *The Economist* about a restructuring of the institution:

Overend's must have much money left with them.... The house is not weakened

but strengthened by what has occurred. As to the management, there ought to be, and must be, great traditional knowledge and skill in a concern which has been so very profitable so very long.

Grant then writes of Bagehot's optimistic outlook, "He would soon rue it." Overend would unravel in short order:

By the time the Overend Gurney directors met in the first week of May to consider a capital call, the situation was irretrievable. Their only recourse was ... the Bank of England.... The Bank dispatched a three-man team to inspect the supplicant's books. The verdict was negative—the Corner House was insolvent—and the Bank [of England] declined to assist.... Overend Gurney closed its doors. The ensuing panic exhausted the descriptive powers of the financial press.

A life consumed with the Bank of England's role / Bagehot will likely always be most known for his views on central bank lending. His thoughts on the matter were developed in a number of intellectual battles with the likes of Thomson Hankey, a mem-

ber of Parliament and a governor of the Bank of England, and George Norman, a director at the Bank of England for 50 years. Hankey was of the view that "a good banker had no need of a central bank and a bad banker

had no claim on a central bank." As part of a lecture series he released, Hankey gave a brutal assessment:

The Economist newspaper has put forth ... the most mischievous doctrine ever broached in the monetary or banking world in this country; that it is one of the proper functions of the Bank of England to keep money available at all times to supply the demands of bankers who have rendered their own assets unavailable.

Norman made similar principled arguments:

Some solvent businesses might be unable to borrow and that such deprivation could force some into bankruptcy. Well, if so, it was their own fault for sailing too close to the wind. In any case, crises soon passed. The solvent would swim—the insolvent sink—and the public at large would learn a valuable lesson.

These discussions “nudged the editor of *The Economist* in the fruitful direction of *Lombard Street*—that seminal description of the workings of Victorian finance.” Given his role as a banker, Grant calls Bagehot an “interested party” on matters of the role of the Bank of England. Bagehot’s own bank, Stuckey’s Banking Company, was not a likely recipient of lending during a crisis: “Stuckey’s seemed crisis-proof. It sailed regally through the Panic of 1857, the American Civil War and the occasional poor West Country Harvest.” But if the Bank of England did not play the role supporting *Lombard Street*, Stuckey’s “would earn a great deal less if the monetary rules required it to stockpile its share of non-interest bearing cash that the Bank of England now husbanded for the banking community as a whole.”

In his Author’s Note, Grant’s admiration for Bagehot is on full display for the sheer volume of his work: “His output astounded me—5,000 words a week at least, and each word placed just where it should be. Was such a thing possible?” But in the same breath Grant excoriates Bagehot for the weak intellectual support he provides for his notions of central bank lending and reserves:

His embrace of the dubious notion, so corrosive to financial prudence, that the central bank has a special obligation to the citizens who present themselves as borrowers and lenders, investors and speculators. No other class of person enjoys access to the government’s money machinery.

But much of Grant’s harshest scorn is

reserved for today’s central bankers. Does he think the Fed and other central banks have bastardized Bagehot’s dictum in its crisis response? The answer clearly is yes:

Because Bagehot’s words are so easily quoted, they are often misquoted. His prescription that, in a panic, a central bank should lend freely at a high rate of interest against good collateral has virtually become, following 2007, “Lend freely at low rates of interest while materializing immense sums of fiat money with which to raise the prices of financial assets in order to stimulate spending by the people who own the assets.”

Although many modern-day central bankers claim Bagehot as a kindred spirit, Grant makes clear that the world of 19th

century finance was vastly different. Bagehot believed that “money was gold and silver and that alone.... [Bagehot] never changed his publicly expressed view about [the importance of] the gold standard or the abomination of fiat currency.” In so doing, Grant openly questions the intellectual honesty of those modern central bankers who pick and choose the writings of Bagehot that they happen to agree with, rather than taking a more holistic view of his philosophy on all matters finance.

Bagehot is a great read, supported by Grant’s usual painstaking historical research. That said, I would have preferred a volume narrowly focused on Bagehot’s views on the role of central banks. Some questions remain in my mind on that issue. But that is not the book Grant chose to write and I will defer to his judgment. R

Did Germany Contribute to the U.S. Great Depression?

◆ REVIEW BY VERN MCKINLEY

The interwar German economy was truly a “basket case.” Most people know this because of the anecdotes from the Weimar Republic’s bout with hyperinflation during the early 1920s. What student of economics or finance has not seen the photos of German children playing with stacks of worthless German currency?

But a much less known event was the major financial crisis in Germany that followed less than a decade later. This dearth of common knowledge prompted Tobias Straumann to write *1931*. Straumann is an associate professor of economic history at the University of Zurich who specializes in the study of 20th century European finance and economic history. In his preface he explains that the idea for the book came from his conclusion “that the wider public has little knowledge of the 1931 German financial crisis and its key role in Hitler’s sudden electoral success.” My own research had made me aware of a major debt-moratorium that the large New York banks adopted in 1931, the so-called “standstill

agreement” negotiated by Albert H. Wiggin, who was chairman of Chase Bank. That agreement was intended to give the German government breathing room by reducing its immediate repayment obligations. Needless to say, the moratorium made life difficult for the U.S. banks in the midst of the Depression.

Reparations / As Straumann explains, the Treaty of Versailles, which ended World War I, assigned blame for the war to Germany and its allies and imposed general compensation mandates for the damage done. It was left to the diplomats to work through the details of that compensation.

Straumann writes that the reparations

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saga began in earnest in 1921:

The London Ultimatum of May 1921 was supposed to resolve the issue, but only made things more complicated by fixing the final bill at the extremely high level of 132 billion gold marks.... Economically, Germany could have paid the reparations, but politically, such a scenario was simply unenforceable, as most German citizens were convinced that their country had not lost the war. Thus, when the cost of the reparation bill became known in Germany, a sort of tax boycott ensued.

In the end, there was a large shortfall in receipts and the Reichsbank monetized the excess, boosting an already lofty inflation rate and leading to the widely known example of “full-blown hyperinflation.”

After the hyperinflation, rescheduling of debts was addressed in the Dawes Plan (named for Charles Dawes, later Calvin Coolidge’s vice president) and a new German currency was put in place. The German and the global economy improved for a time through most of the 1920s. But as with nearly all such plans, the Dawes Plan also had its flaws, resulting in its replacement with the Young Plan (named for American industrialist Owen Young) of 1930. The struggle with the implementation of the Young Plan is where the story of the 1931 financial crisis really starts.

There are four major overlapping historical lines at work in *1931*: the diplomatic efforts to address reparations; the instability in the banking systems in Austria and Germany; the intervention of the United States, primarily through the efforts of President Herbert Hoover; and the political dynamics in Germany, which ultimately led to the ascension of Adolf Hitler to the position of chancellor.

Diplomatic efforts / The Young Plan was signed in the Hague in January 1930. The diplomatic agreement tried to resolve the previously unresolved: “it redefined the terms of the reparations payments and was thought to be a complete and final settlement” on the subject. The plan reduced

the yearly payments for Germany, reduced foreign financial control, and committed the Allies to withdrawal from the Rhineland. But it also required Germany to make payments for 58 years (into the late 1980s) and that gave the Nazi Party fuel for arguments that the agreement imposed massive burdens on the nation for “three generations.”

The plan also altered the priority of payments for Germany’s foreign debts. Political pressures from each of the stakeholder nations immediately caused tension in the implementation of the Young Plan, solidifying decades-old animosities on all matter of diplomatic, financial, and strategic issues.

Financial instability / By early 1931, German finances began to unravel: “The Reich’s revenues were deteriorating rapidly. Brutal measures will be unavoidable.” The financial systems in Germany and Austria showed signs of instability.

The crisis started with the failure of Credit-Anstalt, the largest financial institution in Austria, in May 1931. Austrian Chancellor Otto Ender announced a bailout plan that involved a capital injection by the government, supplemented by funds from the central bank and the renowned Rothschild family. Notwithstanding the government’s effort to prop up the bank, a run ensued, carrying off a full 30% of deposits.

By early June, the second-largest German bank, Danat, was being hurt on the funding side by withdrawals of foreign deposits and was being dragged down by write-downs on bad debt for one of its biggest clients, textile manufacturer Nordwolle. The bank was headed by Jakob Goldschmidt, who led the bank into a universal banking existence that was a mix of commercial and investment banking with a thin level of capital supporting these risks. By July, Danat was ready to close its doors, which it did temporarily with the

government guaranteeing all deposits and liabilities. A broader run on a number of banks was triggered, leading to a general bank holiday. Three other large German banks that survived into the 21st century, Deutsche Bank, Dresdner Bank, and Commerzbank, held firm with stronger capital positions to support operations, although Dresdner did have its share of troubles.

America gets involved / The popular narrative of the U.S. Great Depression is that Hoover was unwilling to get the government involved to counteract the Great Contraction. History tells a different story: Hoover was quite the activist by 1931. Very late in the game and as Straumann describes it, “out of the blue” Hoover got personally involved in trying to

foster economic recovery in the United States and Europe. At home he proposed the bureaucracy known as the Reconstruction Finance Corporation (RFC) to bolster troubled financial institutions. For Europe, in June 1931 he proposed “a one-year moratorium on all war-related debts” to support Germany, which included inter-governmental debts, reparations, and relief debts. After weeks of multilateral negotiations delayed by France’s initial slow response, a moratorium was agreed to.

Neither of Hoover’s remedies, the RFC nor the moratorium, had much effect. In Germany, capital outflows later in June and the instability of its banking system overwhelmed any benefit that might have come from temporarily easing payment mandates. The final standstill agreement went into effect for six months, but it was later extended into early 1933.

The Nazis and Hitler / Early on in *1931* Straumann cites a clear beneficiary of the turmoil flowing from the Young Plan:

One figure profited enormously from



1931: Debt, Crisis and the Rise of Hitler

By Tobias Straumann
272 pp.; Oxford
University Press, 2019

the campaign against the Young Plan: Adolf Hitler.... Before the vote [on the Young Plan], hardly anybody outside of the radical Right took notice of this hysterical politician with the comedic moustache and the strident voice.

The turmoil from the Young Plan facilitated Hitler's coming to power. The book's jacket emphasizes this by including his image. Less than a year after the Young Plan was signed, the Nazi Party leapt from a 3% share in the Reichstag to 18% in September 1930; by July 1932 it had grown to 37%. "In his very first campaign speech ... Hitler singled out the Young Plan as the symbol of failure of the Weimar elites," Straumann notes. German Chancellor Heinrich Brüning was stunned by the 1930 election results, as he had hoped the vote "would widen his political support."

That election was a key turning point as the economy began to turn and "markets were in a manic-depressive mood." Hitler was politically successful because

he managed to monopolize the widespread criticism of the post-war order established by the Versailles Treaty and the Young Plan. Relentlessly, he had made the link between Germany's debt and the economic crisis.... He sensed that blaming foreign powers for domestic misery was extremely effective and enjoyed broad support across all parties and all classes in society.

The worst of the crisis in 1931 coincided with the further rise of the Nazi Party.

Conclusion / Straumann's book is well-researched and the story well-told, with one exception. He argues that the instability in Germany led to the global and U.S. banking crisis:

Germany's 1931 crisis not only gave the Nazis the opening they needed, but also triggered an international liquidity crisis, throwing banks and financial markets across the globe into chaos..., prompting a wave of devaluations in

such distant places as India and Japan, a run on the dollar, and a banking crisis in the United States.

He presents no evidence for this statement about cross-border contagion, including a contribution to the U.S. economic collapse. The National Bureau of Economic Research puts the beginning of the Great

Contraction that ushered in the Depression at August 1929, well before the instability discussed in this book. A banking crisis was underway in the United States before 1931. Some spillover from the instability in Germany no doubt made the situation here somewhat worse, but it is not at all clear that it triggered the U.S. banking crisis. R

Was There a Housing Bubble Last Decade?

◆ REVIEW BY DAVID R. HENDERSON

In his recent book *Shut Out*, Kevin Erdmann, a finance expert and visiting fellow at the Mercatus Center at George Mason University, has two main messages. The first, which is not controversial among economists, is that restrictions on residential construction in coastal California and the urban Northeast have constrained supply

so much that housing in those areas is virtually unaffordable for people in the lower- and middle-income classes. His other message is more controversial: the financial crisis last decade was not due to a housing bubble but, rather, to bad policy decisions based on the idea that there had been a bubble. Whereas I was already convinced of his first point, I, like the majority of economists, was skeptical of his second. But because of all the data and reasoning he brings to the issue, I now find myself at least 90% convinced.

Probably because his second point is the more controversial, Erdmann spends roughly the first half of the book making that case. At times his narrative gets bogged down and his language is often sloppy. For example, he uses the word "shortage" to refer to a situation where demand increases but supply doesn't. Economists, however, tend to reserve that word for situations where the price fails to clear the market such that quantity demanded exceeds the quantity supplied. The good news is that he often saves the day with pithy, clever quotes that sum up his message. Also, the more than 100 graphs he uses in the book seem like

overkill, but that is better than underkill.

Types of cities / Erdmann makes his case by looking at the diverse characteristics of U.S. cities rather than lumping them all together, and by studying changes in housing prices and rents over time. He focuses on the 20 largest U.S. metropolitan areas and divides them into four categories: Closed Access cities, Contagion cities, Open Access cities, and Uncategorized cities. The five Closed Access cities are New York City, Los Angeles, Boston, San Francisco (including San Jose), and San Diego. In those cities, local and state governments have imposed strong restrictions on construction.

Erdmann seems a little vague about when those restrictions got really tight. His narrative suggests that it was in the 1990s, but there's no index to help one look for a clear answer; he did confirm in an email to me that he dates it to 1995. In those cities, housing starts, even in economic expansions, have been low, incomes have been high, rents have been high (and rising) even relative to incomes, and there were large rates of out-migration of households with low incomes.

The four Contagion cities are Miami,

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Riverside, CA, Phoenix, and Tampa. Why does Erdmann call them Contagion cities? Because the price increases in the Closed Access cities caused a massive number of lower- and middle-income people to move from them to the Contagion cities where they could afford housing, and bid up housing prices there to the point where they are still affordable but less so than before.

The Open Access cities are Dallas–Fort Worth, Houston, and Atlanta. Erdmann explains, “These growing cities are able to build enough new homes to meet demand.” By “able,” he means that builders were allowed to build, not hemmed in by government restrictions as in the Closed Access cities. By “meet demand,” he means that the increase in the quantity supplied at a roughly constant inflation-adjusted price equaled the increase in quantity demanded.

The last group, Uncategorized cities, are Chicago, Philadelphia, Washington, Detroit, Seattle, Minneapolis, St. Louis, and Baltimore. Washington, Seattle, and Chicago, writes Erdmann, “are dealing with the same pressures that the Closed Access cities are.” Housing costs (by which he means prices) have increased but at the metropolitan level, housing starts are much higher than in Closed Access cities, “housing costs as a proportion of income are near national norms,” and domestic migration out of them isn’t as extreme as for Closed Access cities. Even though Erdmann writes in the present tense, presumably he means to use the past tense given that his narrative is about the past. In St. Louis and Detroit, housing permits issued were higher than in the major Closed Access cities.

Why choose just 20 cities total? Erdmann explains in a footnote that these 20 cities “capture the bulk of the aggregate story.” That seems reasonable.

Challenging the standard story / The standard story that most people, including economists, have accepted about last decade is that the rise in home prices was fueled by an expansion of credit and that both borrowers and lenders naively expected the growth in home prices to continue.

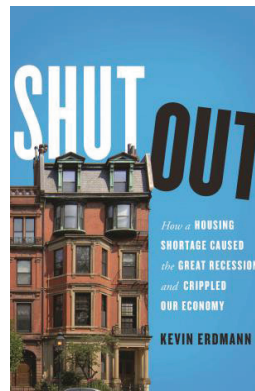
Erdmann rejects this story with a com-

plex analysis that considers many factors. In his introduction to the book, he nicely summarizes his thesis, writing:

These findings suggest that we did not have a housing bubble. We had a housing supply bust—first in the places where people want to live, in places where there is more opportunity. That supply bust caused prices to rise in those cities—most notably in New York City, Los Angeles, Boston, and San Francisco—metropolitan areas I call the Closed Access cities. After the turn of the century, millions of households flooded out of those cities because of the shortage of housing—so many that they overwhelmed cities in the main destinations for those households, such as inland California, Arizona, and Florida. Then we imposed a credit and monetary bust on the entire country in a misplaced attempt to alleviate the problem.

Erdmann has many objections to the standard narrative. One thread of the narrative is that subprime lending was a major contributor to the increase in the U.S. homeownership rate from 64% in 1994 to an all-time high of 69.2% in 2004. Erdmann claims that subprime lending was not an important factor. Why? If it were an important cause of higher homeownership, he argues, there should have been a fairly pronounced correlation between the homeownership rate and housing prices. There wasn’t. He points out that homeownership had risen to 66.5% by late 1998, halfway to its peak, while real home prices were still about the same.

In the standard story, subprime mortgages were granted to relatively low-income families that were unwise to buy houses but were able to do so because of lax lending standards. But, notes Erdmann, between 1995 and 2004, the huge increase in new owners was among people in the top two



Shut Out: How a Housing Shortage Caused the Great Recession and Crippled Our Economy

By Kevin Erdmann

309 pp.; Rowman & Littlefield, 2019

income quintiles. For the top quintile, he notes, over 40% of non-owners became owners versus about a 20% increase for the middle quintile and virtually no change in the bottom two quintiles. That doesn’t fit the standard narrative.

Erdmann cites an August 2017 working paper by Stefania Albanesi, Giacomo De Giorgi, and Jaromir Nosal on the characteristics of individual borrowers. Even in ZIP codes with high levels of subprime lending, they found, borrowers tended to have higher credit scores. Also, the debt growth for borrowers with lower credit scores, writes Erdmann, “tended to

be among young borrowers who subsequently maintained rising incomes and rising credit scores.” The bottom line, he writes, is that “there was no shift to high credit risks during the housing boom.”

Another part of the standard story involves so-called “liar loans”: mortgages requiring little documentation that ostensibly were made by predatory lenders to naive borrowers who did not understand the terms. Erdmann quotes a study by Federal Reserve Bank of Chicago economist Gene Amromin finding that these loans went primarily to high-income households with high credit ratings. The borrowers, according to Amromin, expected both their incomes and their house prices to grow. While he and Erdmann both dismiss the idea that these borrowers were naive, I do think it’s naive to expect house prices always to rise. But Amromin and Erdmann’s point seems to be that they were not so naive as to not understand the terms of the loan. That is probably correct.

Another part of the standard story is that private securitizations of mortgages resulted in ample lending, producing rising homeownership and house prices. Erdmann shows that the timing for this doesn’t fit the narrative. He has a graph showing that most of the boom in private

securitizations, which happened between the second quarter of 2004 and the end of 2006, came *after* the rise in homeownership, which peaked in the second quarter of 2004. For the increase in private securitization of mortgages to be a major cause of the boom in homeownership, most of it would have had to happen just before or at the same time as the increase in ownership.

In a chapter on migration between cities, Erdmann notes that for his story about migration from and to Closed Access cities to make sense, people in those cities who have families would move out and be replaced by people with fewer children. Sure enough, federal tax data show that households moving into Closed Access cities had 0.2 fewer members per household than households moving out. That sounds small, but it's one-third of the drop in the average size of an American family between the 1960s and 2018.

Tight money, tight housing markets / In one of the final chapters, “A Moral Panic and a Financial Crisis,” Erdmann shows that the Federal Reserve responded to the financial crisis not by flooding the market with liquidity, as Alan Greenspan did after the 1987 stock market crash, but by bailing out particular financial institutions and then sopping up the added liquidity by selling bonds. The technical term for what the Fed did is “sterilization.”

Erdmann could have strengthened his case by pointing to the well-developed economics literature on this point. San Jose State University economist Jeffrey Rogers Hummel has laid out the facts on this in detail (see “Ben Bernanke versus Milton Friedman,” *Independent Review*, Spring 2011) and notes that both Rutgers University economics professor Michael Bordo and monetary blogger Scott Sumner have also made this point. Maybe it's all the more impressive that Erdmann, who is not an economist, appears to have come to this conclusion on his own. Moreover, he notes, the Federal Reserve started paying interest on bank reserves, which, of course, caused banks to hold on to reserves that they otherwise would have lent. This started

in October 2008, which has to be one of the worst-timed Fed decisions since the Great Depression. The result of the relatively tight monetary policy was a large increase in mortgage delinquencies.

Erdmann's best chapter is his epilogue. In it, he shows just how dysfunctional housing policy has been in the Closed Access cities. He includes a two-and-a-half-page quote from an April 2016 article in the *San Francisco Chronicle* about the barriers state and local governments have erected to prevent new housing. That passage is heart-breaking and, in my case, anger-inducing.

The epilogue also includes a nice discussion of one of the few cases where the term “trickle-down” makes sense: housing. Erdmann argues that when new housing is supplied to the top end of the market and high-end tenants move into the new luxury

units, the vacated housing is often occupied by people with lower income. I've often made that point with an analogy to cars: you don't generally see lower-income people driving relatively new Cadillacs, but you do see them driving 10-year old Cadillacs. Erdmann supplies his own car analogy, writing, “We don't insist that auto manufacturers only produce new cars that are worse than the existing used cars in order to be equitable.” Moreover, he notes, whatever policy is chosen leads to some form of trickle-down: “When new units don't ‘trickle down’ to households with lower incomes, households with lower incomes have to ‘trickle down’ to Phoenix or Las Vegas.”

Erdmann, quite reasonably, sees the solution in allowing more construction, especially in Closed Access cities. His last line sums up his policy message: “Let it rip.” **R**

A Dangerously Seductive Theory

◆ REVIEW BY PIERRE LEMIEUX

Consider “fake news”—the real sort, based on demonstrably false facts or false narratives. Actual fake news is ubiquitous and spreads like wildfire, thanks in part to the internet.

In his new book *Narrative Economics*, Nobel economics prizewinner Robert Shiller cites research that “found that false stories had six times

the retweeting rate on Twitter as true stories.” Moreover, he notes, “truth is not enough to stop false narratives,” especially when the latter thrive on identity and “us versus them” thinking.

Some people even enjoy stories that they know are false, much like “pro” wrestling. (We know people realize pro wrestling is fake because few people bet on matches.) “Fake news,” Shiller writes, “seems to be part of the normal human condition.” This book aims to show that “contagious” narratives—both false and true—“are responsible for many of the changes we observe in economic activities.”

What are narratives? / A narrative is a story

or other representation that explains or justifies some event or institution and that affects people's behavior. Economic narratives relate to economic events or institutions. For example, the Laffer curve and the story of its originally being drawn on a restaurant napkin went viral around 1980 and may have influenced voters and politicians.

According to Shiller, neuroscience and neurolinguistics suggest that the human brain is organized around analogies, metaphors, and stories—all the stuff of narratives. In short, people love stories.

Paraphrasing psychologist Jerome Bruner, Shiller writes that “we should not assume that human actions are driven

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in response to purely objective facts.” This should remind the reader of Friedrich Hayek’s insistence that the “objective facts” of the social sciences include “the beliefs or opinions held by particular people” and that “so far as human actions are concerned, the things are what the acting people think they are” (*The Counter-Revolution of Science*, 1953). Disappointingly, Shiller fails to cite Hayek in his book.

Shiller is a practitioner of “behavioral economics,” a different school of economic analysis than Hayek’s. Behavioral economists argue that narratives are based on imagined representative situations (“framing”) or emotions. Many random and arbitrary factors are involved in the formation of narratives. Further, individuals are as irrational as the narratives they follow.

Going viral / Shiller argues that economic narratives can affect major economic events when they go viral either online or through other media. But why does a narrative go viral?

The short answer is that we don’t know—but, Shiller emphasizes, we must try to learn more. He theorizes that a constellation or confluence of narratives may be necessary for an idea to catch fire. Other factors, like glamor, may also be required for a narrative to go viral.

Shiller argues that epidemiological models of contagious diseases are useful for understanding the spread of economic narratives. The simple Kermack–McKendrick mathematical model developed in 1927, which measures the strength of an epidemic from its early growth to its peak and eventually its decline, used three equations to show how the infected fraction of the population is equal to the contagion rate minus the recovery rate. This simple and attractive model is said to fit the evolution of internet “memes.”

In a similar pattern, an economic narrative that goes viral starts slowly, increases rapidly, reaches its peak, and eventually dies down—if it does not mutate and get contagious again. For example, the Laffer curve went viral and reached its peak in the early 1980s. Other viral narratives discussed

by Shiller show the same evolution as measured by the frequency of related keywords in books.

Influence of economic narratives / Many sorts of narratives can drive the major economic events that are booms and busts along the business cycle. Consider the following examples.

Stock market bubbles feed on narratives of confidence or panic. A massive and decades-old economic literature debates why bubbles and crashes can happen if financial markets are efficient (the “efficient market hypothesis” or EMH), that is, if they incorporate all available information. Without getting into this debate, it is useful to know that Shiller has been a major critic of the EMH. In *Narrative Economics* he shows that references to the expression “stock market crash” started around 1926 and, reaching epidemic status, may have contributed to the wave of pessimism that crashed the market in 1929.

Narratives that encourage panic may contribute to a recession, while those that favor confidence can boost the economy. From a Keynesian perspective, a recession results from a drop in aggregate demand, leading to declines in production and employment. But it is not as obvious as Shiller believes that an aggregate demand shock is either sufficient or necessary for a recession, yet this notion is very much part of his understanding of the economic cycle.

In this Keynesian perspective, it becomes important to increase consumption during an economic slowdown, at the very time when people have less money to do so. Hence, there is a narrative that frugality prolonged the Great Depression and that conspicuous consumption and pursuit of “the American Dream” after World War II fueled economic growth. Note that the analyst’s theoretical perspective may affect his hypotheses about the

causal effects of different narratives or the direction of causality. Perhaps it is because of the Great Depression that consumption plunged?

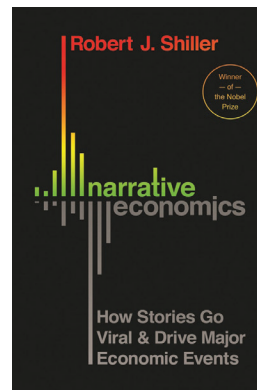
Another narrative that peaked during the Great Depression was that people cannot buy what they produce, meaning that a capitalist economy is marred by general overproduction or underconsumption.

This idea (which had been rejected by French economist Jean-Baptiste Say in the early 19th century) was revived academically by Keynes in his 1936 *General Theory of Employment, Interest and Money*, but it was already in the zeitgeist of the time. It appeared in Aldous Huxley’s 1932 book *Brave New World* in the depth of the Great Depression: Babies are conditioned by an untiring whisper, including the mantra: “We always throw away old clothes. Ending is better than mending. ... The more stitches, the less riches.”

Yet another narrative that may have contributed to the pessimism of the

Great Depression concerns labor-saving machines. The idea that these devices hurt labor was popularized by the early 19th century Luddites and then reappeared during the global depression of the 1870s. Shiller quotes the *Philadelphia Inquirer* of February 3, 1876: “The steam-power of seven tons of coal is sufficient to make 33,000 miles of cotton thread in ten hours, while, without machinery, this would equal the hand labor of 70,000 women.” He also reports that in Germany in 1933, the worst year of the Great Depression, a Nazi Party official promised to ban the replacement of men with machines.

Similar narratives reappeared after World War II as a fear of automation and artificial intelligence. According to Shiller, this fear may have contributed to the 1957–1958 and 1960–61 recessions, as well as those of 1980, 1981–1982, and 2000–2001. A recent narrative on the dangers of machine learn-



Narrative Economics: How Stories Go Viral and Drive Major Economic Events

By Robert Shiller

384 pp.; Princeton University Press, 2019

ing seems to have peaked in 2016, though it did not cause economic damage.

Likewise, a narrative that single-family homes make good speculative investment took off in the second half of the 20th century. This contributed to the housing bubble of 1997–2006 and, Shiller argues, to the Great Recession of 2008–2009.

Narratives of profiteering and evil business can affect the course of economic events. One such narrative became “highly contagious” in 1918: a report that an anonymous woman in a street car had hit a businessman with her umbrella after the latter was overheard boasting about the money he made from the war. Narratives of war profiteering peaked during the 1920–1921 recession. In 1920, Sen. Arthur Capper declared, “Profiteers are more dangerous than Reds,” and called for boycotting high prices. Still, it’s hard to be convinced by the hypothesis that narratives of profiteering can prolong a recession by preventing people from buying; man does not live by narratives alone.

Perceived profiteers in popular narratives can also be labor unions if they obtain wage increases that result in so-called “cost-push inflation.” This narrative, which went viral just after World War II and again in the 1970s, assumes that the government accommodates these cost increases with an increase in the money supply. Without this accommodation, prices would have to decrease somewhere else in the economy (other things equal, everybody cannot consume more simultaneously), with no net inflation as the result.

Even when central bank actively and directly creates inflation by increasing the money supply, rationally ignorant (if not simply ignorant) voters look for other scapegoats than their own government, as happened in the wake of World War II. “The mass of people ... are not very well informed,” Shiller notes, which is one reason why they must base their actions on narratives. During the German hyperinflation of 1917–1923, a contemporary observer, American economist Irving Fisher, noted that the citizens did not blame their own government.

What did we learn? / All these stories are no doubt interesting, but do they really imply that a new “narrative economics” is needed? What do readers learn, exactly, from this book?

Perhaps we learn that viral narratives can have big economic effects, for better or worse. But didn’t we already know that? Prices and resource allocations change if some fad increases the demand for something. The theory of information cascades, where people rationally follow the opinions of people they trust, adds to this explanation. (See “Following the Herd,” Winter 2003.) Aren’t contagious ideas and “memes” just another way to say that individuals, when they make choices,

It’s hard to be convinced that narratives of profiteering can prolong a recession by preventing people from buying; man does not live by narratives alone.

decide on the basis of how they believe the world works?

The book does explain how to formalize the spread of narratives with a simple epidemiological model, but is that really useful? Perhaps yes, but the sort of interdisciplinary approach advocated by Shiller has its dangers too. Hayek warned social scientists about the danger of “scientism”—that is, a “slavish imitation of the method and language of Science.”

Another positive danger (“positive” by opposition to “normative”) is to forget that people have conscious minds and intentions, that they are different from atoms and animals. Shiller acknowledges this danger. Moreover, it seems, you can always find some narrative that fits with the events you want to explain.

The normative danger may be worse. It consists in considering some ideas as contagious diseases, just as the public health movement views preferences and lifestyles it dislikes. (See “The Dangers of ‘Public Health,’” Fall 2015.) Public health experts and activists call “epidemics” the spread of everything they don’t like, such as smoking,

vaping, and guns. Between Shiller’s use of the notion of “thought viruses” and calls for quarantining the bearers of these viruses, the distance may be smaller than the author of *Narrative Economics* probably thinks.

Shiller’s appeal to qualify economists’ basic assumption of actor rationality is not new either. Hayek, for one, already incorporated such qualifications in his theory. Many standard (neoclassical) economists do so in other ways, although not as radically as some behavioral economists.

Shiller does remind us that it is tempting, and sometimes rational, for individuals to follow viral narratives that end up generating bubbles and crashes. Sometimes they act on the basis of purely

emotional narratives and false news. But this typically happens when individuals follow the crowd and have little private incentive to stop and think. When a person privately purchases a

car from which he will get all the benefits and pay all the costs, he has an incentive to make a rational decision. At least in a free society, not everything falls under the overwhelming influence of mobs.

That narratives can contribute to major economic events such as booms and busts seems an intuitive idea, and Shiller provides some evidence for it. However, the frequent if not usual presence of a constellation of narratives, sometimes pointing in different directions, seems to attenuate the explanatory power of any specific narrative. Furthermore, the direction of causality is not always clear: is it a narrative that caused an event or the event that generated or fueled the narrative? Often, causality can go both ways. “Ultimately,” Shiller admits, “we can give no final proof of causality.”

Focusing on narratives can lead to neglecting other factors hidden in plain sight. For example, he downplays the role of the federal government in the Great Recession through its active and (often coercive) encouragement of, and participation in, the supply of mortgages to low-income individuals. The author of *Narrative Econom-*

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ics overlooks the insights of public choice economics.

A subliminal idea / Assume for a moment that individuals are by-and-large irrational, as behavioral economists believe, and that they follow more or less arbitrary narratives, as Shiller claims. Given this, how can one believe that governments—that is, individuals in their political and bureaucratic roles—will be more rational than private actors? Shiller easily falls into the narrative that government is populated

by disinterested politicians who rationally adopt policies proposed by omniscient bureaucrats and consultants. He argues that “policymakers should try to create and disseminate counternarratives that establish more rational and more public-spirited economic behavior.”

This is strange because he previously admitted that government actors are influenced by narratives. Moreover, governments often amplify dangerous narratives and fake news instead of dampening them—not to mention the frequent

use of straight propaganda. The Trump administration is only an extreme version of what we are used to seeing in developed countries.

I suspect that most readers will like the numerous illustrations given in *Narrative Economics*, from charts of viral “epidemics” to fascinating quotes from old newspapers. They may also be tempted by the subliminal idea that the state—the ideal state—should try to control these epidemics in the pursuit of social nirvana. Shiller’s is a seductive theory, but a perilous one. R

Working Papers ⇄ BY PETER VAN DOREN

A SUMMARY OF RECENT PAPERS THAT MAY BE OF INTEREST TO REGULATION’S READERS.

Health Policy

■ “Medicaid and Mortality: New Evidence from Linked Survey and Administrative Data,” by Sarah Miller, Sean Altekruze, Norman Johnson, and Laura R. Wherry. July 2019. NBER #26081.

How should we evaluate health insurance policy initiatives? One obvious metric is whether increases in the population covered by health insurance reduce mortality. A previous Working Papers column (Summer 2019) reviewed a paper that described the statistical difficulties in ascertaining whether publicly subsidized health insurance expansions reduced mortality. Because most people are insured and mortality rates among the non-elderly are low, the detection of an incremental mortality reduction from increased insurance coverage in the entire population would require a sample size of 40 million people. Because such a study is not feasible, the use of general mortality rates to evaluate the effects of policies to expand coverage is also not feasible.

This paper modifies that conclusion in an important way. If the analysis could be confined to a smaller population in which many people were not insured and the existing mortality rate was higher, the sample size required to detect an effect would be much smaller. This paper studies only individuals ages 55–64 who had incomes equal to or lower than 138% of the poverty level or whose educational attainment was less than high school. The annual mortality rate in this sample was 1.4%.

The paper compares mortality rates in those states that expanded Medicaid coverage under the 2009 Affordable Care Act to those states that did not. Prior to Medicaid expansion, the mortality rates among those in the expansion-eligible population were parallel in the two groups of states and not statistically distinguishable.

After Medicaid expansion, the mortality rate in the near-retirement-age low-income population in the expansion states fell to 1.27%. Given an estimate of 3.7 million people in expansion states ages 55–64 whose incomes were less than 138% of the poverty line and thus eligible for Medicaid under expansion, about 4,800 fewer people died annually because of Medicaid expansion.

Mutual Funds and Antitrust

■ “Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry,” by Patrick Dennis, Kristopher Gerardi, and Carola Schenone. July 2019. SSRN #3423505.

Institutional investors that sponsor index funds—Vanguard, BlackRock, Fidelity, etc.—are now among the largest shareholders of most publicly traded companies. They frequently hold significant stakes in all the firms within a market. Critics of this pattern of “common ownership” theorize that such institutional investment could reduce market competition and increase consumer prices. There are empirical papers in the published literature that ostensibly demonstrate such harm is occurring.

A previous article in *Regulation* (“Calm Down about Common Ownership,” Fall 2018) criticized the common ownership thesis on logical grounds. The diversified shareholders of index funds not only own all airline stocks or bank stocks (the industries examined in two empirical articles that concluded that consumers are hurt by common ownership), they also own all other firms, including firms whose profits would be *hurt* by high prices for airline and banking services. So why would shareholders want to hurt themselves by exercising market power in some economic sectors that would reduce profits in (many) other sectors?

Another logical argument in the *Regulation* article noted that

the mutual fund companies that offer index funds also offer managed funds, which differ in their ownership stakes of firms within industries. One Vanguard managed fund, for example, owns similar amounts of American, Delta, and United Airlines but no Southwest, while another Vanguard fund owns Southwest but no American, Delta, or United. Thus, the economic interests of the mutual fund companies regarding intra-industry competition are not obvious.

Finally, the article argued that the measure of common ownership used in the empirical studies (the “modified Herfindahl–Hirschman Index” [MHHI]) was not a pure measure of common ownership, but also of market share. Thus, increased demand could cause both prices and market share—and this measure of common ownership—to increase.

This article explores that statistical problem in detail. The conceptual problem is that the MHHI includes both ownership and control terms as well as airline market shares. This is important because the widespread interpretation of the empirical results in the literature is that increased common ownership by institutional investors increases airline ticket prices. If the results are instead driven by variation in airline market shares, then the policy implications are unclear.

The authors conclude that the positive relationship between the measure of common ownership and airline ticket prices is the result of variation in airline market shares rather than variation in common ownership among institutional investors. The paper demonstrates this result by constructing two alternative “placebo” measures of common ownership: one in which *variation in market shares is muted* by design while variation in common ownership is retained, and a second measure in which *variation in common ownership is muted* by design while variation in market shares is retained. The authors find that the first placebo measure is uncorrelated (or negatively correlated in some specifications) with average prices, while the second measure is positively correlated with prices. Thus, it is variation in market shares, not ownership, that drives the correlation between this measure of common ownership and prices.

Consumer Credit

■ “Does Price Regulation Affect Competition? Evidence from Credit Card Solicitations,” by Yiwei Dou, Geng Li, and Joshua Ronen. March 2019. SSRN #3361050.

■ “The Economic Consequences of Bankruptcy Reform,” by Tal Gross, Raymond Kluender, Feng Liu, et al. September 2019. NBER #26254.

The Credit Card Accountability Responsibility and Disclosure Act (CARD Act) was enacted in 2009 as an ostensible enhancement of consumer protection. A previous Working Papers column (Winter 2014–2015) reviewed a paper that concluded that consumers benefited from the legislation

because fee reductions mandated by the law occurred without any offsetting interest rate increases.

Another provision of the law prohibits interest rate increases on new transactions within the first year of opening an account and on existing balances in the first year (except when the rate on existing balances was explicitly described as a time-limited introductory rate). The first of these papers examines how these provisions affected consumers.

The authors examine credit card mail solicitation offers from 2001 through 2016, comparing offers to consumers, which are regulated, to offers to small businesses, which are not. The authors use the solicitations to examine the responsiveness of offers to those of other companies. Given that the CARD Act regulated only interest rate increases, how did firms respond to interest rate decreases of other firms? The paper concludes that issuers’ offered interest rates to consumers were about 1.3 percentage point higher because of reduced responsiveness to competitors’ interest rate offers in the post-CARD Act period.

Relatedly, the consumer bankruptcy rate rose from 0.3% of households in the early 1980s to 1.5% in the early 2000s. In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act, which made filing for bankruptcy more difficult and expensive. Reform supporters argued that the savings from reduced bankruptcy (the greater amount of loans repaid to banks) would be passed on to consumers in the form of lower interest rates.

The second of these papers finds that reform reduced the bankruptcy rate by 50%, resulting in roughly 1 million fewer bankruptcies in the two years after reform (even after accounting for the dramatic increase in bankruptcy filings just before the reform took effect). The authors conclude that 60–75% of the savings from reduced bankruptcies were passed on to consumers in the form of lower interest rates.

Franchise Laws

■ “Trouble Brewing? Impact of Mandated Vertical Restraints on Craft Brewery Entry and Production,” by Jacob Burgdorf. September 2018. SSRN #3392392.

Manufacturers and distributors need each other, but distributors often believe that manufacturers make money at distributors’ expense through what economists describe as opportunism. In this narrative, distributors engage in costly, irreversible investments that help the sales of their product, only to have their distribution relationship subsequently terminated in an attempt by the manufacturer to expropriate the profits from the distributors. Or manufacturers force distributors to purchase products during sales slumps so that distributors, rather than manufacturers, suffer wealth losses.

In some industries, distributors use the political system to mandate the nature of the relationship between manufactur-

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ers and distributors. The contentious history between auto manufacturers and dealers led dealers to lobby successfully in all 50 states for legislation that prohibits manufacturers from forcing dealers to accept unwanted cars, protects dealers against termination of franchise agreements, and restricts additional franchises in a franchised dealer's relevant market area. The laws also prohibit a manufacturer from selling directly to the public through vertical integration. Tesla has run afoul of this provision in its attempts to sell cars directly to the public, bypassing the existing dealer network. (See "Tesla and the Car Dealers' Lobby," Summer 2014.)

This paper describes an analogous history in the beer industry. Almost all states have beer franchise laws. They were passed in the 1970s as wholesalers became concerned about increased consolidation among national brewers. The laws make renewal of brewer distributor contracts more or less automatic and the termination of such contracts extremely difficult. Twenty states, though, allow brewers to distribute their own beer without restriction. This freedom puts an important check on the role of distributors.

The role analogous to Tesla in the beer story is played by craft brewers. In states with beer franchise laws but with no possibility of self-distribution, craft brewers had to use distributors that

were oriented toward serving the large national brands. Craft brewers often felt ill-served by these mandated distributor relationships.

Bell's Brewery, a highly regarded craft brewer in Kalamazoo, MI, illustrates the defects of mandated franchise restrictions. In 2006, Bell's Chicago wholesaler was owned by National Wine and Spirits (NWS), which planned to sell the rights to distribute Bell's products to another wholesaler. Bell's opposed the sale, worrying that its beers would not be promoted well by the new wholesaler. Rather than engaging in a costly legal battle trying to end the wholesale contract, Bell's pulled distribution of its beer out of the entire state of Illinois, despite the state comprising over 10% of Bell's sales. Exiting the state allowed Bell's to end its contract with NWS. Bell's returned to Illinois nearly two years later, once NWS lost its wholesale license and the right to sue.

This paper examines craft brewer entry from 1984 through 2016. The average was 0.880 breweries per million people per year. But in states that had franchise laws that restrict brewery distribution and require the use of independent wholesalers, net entry decreased by 30-60% (0.320 to 0.518 breweries per million people per year). In the states in which brewers could self-distribute, the decrease was just 0.16 breweries per million people per year. R

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