Imitate FDR’s Treasury Secretary: Bankruptcy not Bailouts

(an open letter to the incoming Secretary of the Treasury)

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[Published in *U.S. Exchequer*, Fall 2008, pps. 45-46]

Dear Mr. Secretary-designate:

There’s been a lot of talk these days about the need for the next President to act with the courage and boldness of FDR. I certainly hope that you choose to follow the example of FDR’s first Treasury Secretary, William Woodin. He did something that our current Treasury Secretary is fully unwilling to do: He embraced creative destruction in the financial sector.

Secretary Woodin: A model to follow

People now remember FDR’s banking holiday, enacted within days of his inauguration. In the weeks just before he took office, banks had been shutting down by the hundreds. This was the greatest banking panic of the Depression.

Upon taking office, FDR decided to take action: He shut down essentially all U.S. banks for four days, from Friday through Monday. On the intervening Sunday, President Roosevelt gave his first Fireside Chat on the radio. In the American memory, it’s the Fireside Chat itself that calmed the nation’s citizens, with the reassuring voice of the President assuring Americans “that it is safer to keep your money in a reopened bank than it is to keep it under the mattress.” When banks reopened on Tuesday, Americans by the millions poured their money back into the remaining banks, and the panic ended, never to be repeated.

Are markets *that* dependent on the psychology of the masses? Can the gentle, persuasive talk of a charismatic leader steer the economy onto the right course?

Surely, calm, careful discussion can certainly play an important role in public policy, and the text of the Chat itself is a model of plainspoken, accurate economics. But Secretary Woodin–the architect of FDR’s Banking Holiday–knew that the nation needed more than just sweet talk. He knew that the way to heal the financial sector was to shut down insolvent banks. So while FDR gave his historic Fireside Chat, Woodin directed the

federal government to discern which banks were solvent and which banks were bankrupt. And on Tuesday, when the banks reopened, one-third of them did not.

That's right: FDR and Woodin's solution to the banking crisis involved closing down over 5,000 of the nation's 18,000 commercial banks. About 3,000 of those banks eventually reopened over the next few years, but the remaining 2,000 banks were "suspended, liquidated or merged" in the words of Milton Friedman and Anna Schwartz's famous *Monetary History of the United States.* Many depositors lost money.

So the solution to the banking crisis involved the kind of tough love that is entirely absent from today's Bailout Nation. FDR and Woodin saved the best and closed the rest. Today, instead, we are told that the Federal Government will buy preferred stock in investment banks and commercial banks and make massive loans to automakers, all with little regard to past performance: There's little stomach for herd-thinning in Washington today. Mass layoffs, we are told, will hurt confidence. Bankruptcy, we are told, will hurt confidence. But FDR and Woodin didn't see things that way, and in the assessment of Friedman and Schwartz, the FDR-Woodin method worked:

"The emergency revival of the banking system contributed to recovery by restoring confidence in the monetary and economic system…." (p. 433)

Shutting down one-third of U.S. banks: ***That*** contributed to confidence. Suspending, liquidating, merging bankrupt firms: *That* contributed to confidence. Allowing Schumpeterian creative destruction to take its course–prodded along, to be sure, by the executive branch rather than the bankruptcy judge–*That* contributed to confidence.

Secretary Paulson: A model to avoid

I hope you follow a different path from the current Treasury Secretary, who appears to have lost his appetite for creative destruction. A meme is quickly spreading: "The Lehmann bankruptcy is to blame for our troubles." The implied solution is obvious: Never again. Never again will we let a major Wall Street house fail: never again will we allow the "destruction" side of Schumpeter's "creative destruction" to see the light of day. The whisperings are everywhere: "Remember the last time we let a big firm fail..."

There's a major problem with this meme: The stock market was fairly stable for a solid week after the collapse of Lehmann of September 15. Actually, it closed up for the week. Given the recent turmoil, it's easy to forget that between the takeover of Fannie and Freddie on 9/7 and the moments before the House's initial rejection of the Paulson bailout on 9/29, the S&P 500 fell less than 4%. Ah, those were the days.

We were told that if we didn't pass the bailout, we would get a massive collapse in the stock market and the commercial paper market would freeze up: We passed the bailout and got both. Thus, it's hard to find evidence that financial markets take comfort from bailouts. At the same time, the big collapses in commodity prices and retail sales have occurred after the bailouts: Again, it's hard to find evidence that consumers take comfort from bailouts.

The reason why is obvious: American firms are going on welfare. The average American knows what happens when an individual person goes on welfare–especially the no-string-attached style of welfare that existed before 1996: You stop looking for work, you stop trying to get education, you spend your time either watching TV or heading over to the government office, lobbying to make sure those checks keep coming.

Now, we're putting entire corporations on welfare: The checks will keep on coming from Washington, and all they have to do to keep the checks coming is keep their executive pay low, don't have too many layoffs, and pay attention to whatever their case worker–or is it committee chairman?—tells them to do. Since the entire point of the welfare payment is to prevent creative destruction of firms, of employment relationships, of relationships with borrowers/suppliers/dealers, welfare-receiving firms will preserve their relationships. Productivity will fall, wages will fall, profits will fall.

How can we be confident that this will happen? Because it happened in Japan in the 1990's. They had a real estate bubble that collapsed just like ours. The collapse destroyed the balance sheets of many banks, and the Japanese government decided it didn't want banks to fail.

Unlike FDR and Woodin, the Japanese government thought failure was bad for confidence, so they found ways to turn leading Japanese banks and businesses into what economists call "zombies." Researchers like Anil Kashyap of the University of Chicago and Takeo Hoshi of the University of California, San Diego spent much of the 90's documenting the well-intentioned creation of Japanese zombies: The low productivity, the high levels of employment, the stagnating wages and profits. That's the model the current Administration has apparently decided to follow–all, of course, with the best of intentions. And all, of course, in complete contradiction to Secretary Woodin's model of creative destruction.

There's an easier solution, quite similar to Secretary Woodin's solution. It's a purely private-sector way to recapitalize weak firms: Bankruptcy. Luigi Zingales of the University of Chicago and Oliver Hart of Harvard University have already explained how to run such a "speed bankruptcy." At the risk of oversimplification: Just let a bankruptcy judge convert debt into equity, and let the new owners take a stab at running the least solvent Wall Street firms, the least solvent automakers, the least solvent commercial banks. Lots of equity means lots of trust, so short-term credit markets will reliquify–and long-term investors will know that the U.S. government won't put bankrupt firms on welfare.

Mr. Secretary-designate, I hope the nation won't look back on Lehmann Brothers as America's last major bankruptcy. I encourage you to learn more about how Secretary Woodin embraced bankruptcy as part of the process of saving the American financial sector. The path to prosperity runs right through Schumpeter's land of creative destruction.