Some Banks Must Die So the U.S. Economy Can Live: Caroline Baum

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Commentary by Caroline Baum

March 2 (Bloomberg) -- In the government's rush to stabilize the financial system, get the U.S. economy moving again, craft bailouts for institutions and entire sectors of the economy, and re-craft bailouts that aren't doing the trick, the voices of limited government have been all but silenced.

In Washington, the GOP has been shamed into submission. It's not that Republicans don't see a role for the government in the economy, says **Karl Rove**, former adviser to President **George W. Bush**, in his weekly op-ed **column** in the Wall Street Journal. It's just that they don't see the same role as the one envisioned by President **Barack Obama**.

That role, laid out in his first **budget** last week, will be larger than at any time since 1945. **Government spending** is projected to soar to 27.7 percent of gross domestic product in fiscal 2009, which ends in September, according to the White House Office of Management and Budget. That compares with an average of 20.4 percent over the last 30 years.

In an era when we've all become interventionists -- when doing something, anything, is preferable to doing nothing and risking being blamed for any outcome -- it's good to hear a few voices pointing to the danger of government overreach.

Historical evidence suggests that "bad government policies are responsible for causing great depressions," write **Timothy J. Kehoe**, professor of economics at the University of Minnesota, and Gonzalo Fernandez de Cordoba, professor of economics at Universidad de Salamanca in Salamanca, Spain, in "**The Current Financial Crisis**: What Should We Learn from the Great Depressions of the Twentieth Century?"

Future Shock

It turns out the source of the shock, be it internal or external, that triggers a depression "is less important than the reaction to the shock by the economy and, in particular, the government," the economists write.

Before you dismiss Kehoe's views as those of a card- carrying libertarian, consider that he was trained as a Keynesian, is a "lifelong Democrat, voted for Obama," and believes in universal health care, he tells me in a telephone interview.

That said, he's opposed to rewarding people who made bad investments. "The TARP money disappeared; it was scandalous," Kehoe says, referring to the Treasury's Troubled Asset Relief Program. "It went to people who made bad investments to try to pull them out."

The economists' findings in their February 2009 paper are based on a study Kehoe and **Edward Prescott**, recipient of the 2004 Nobel Prize in economics, have been running at the Minneapolis Fed, analyzing depressions in North America and Western Europe in the 1930s, Latin American in the 1980s and isolated examples elsewhere.

Good vs. Bad

They differentiate good outcomes to financial crises (Chile, Finland) from bad outcomes (Mexico, Japan) and find productivity plays an important role.

"All these depressions are associated with bad policies that depress the efficiency of production," Prescott says in a phone interview. "The focus should be on productivity. History provides no support for stimulus."

The current crisis and recession may be different than previous ones in terms of their size and scope, but that does nothing to contradict Kehoe's belief that the financial system needs to be "cleaned out."

In the early 1980s, Chile took control of ailing banks, liquidated the insolvent ones and re-privatized the solvent ones. "The short-term costs of the crisis and the reform in Chile were severe," Kehoe writes.

By 1984, the economy had started to grow. And Chile has been the **fastest-growing** country in Latin America since then.

Pain Therapy

It's worth the cost to sort things out as quickly as possible, he says. "If you postpone short-term pain, you end up with long-term pain," which is what happened in Mexico and Japan.

Fed Chairman **Ben Bernanke** said in congressional testimony last week that the key to stabilizing the economy is stabilizing the financial system.

If that's the case -- and policy makers of all stripes seem to agree that it is -- why a $787 billion **fiscal stimulus** bill filled with political priorities and a budget that increases domestic spending by 8 percent?

As an economist friend of mine says, you can't force-feed someone who's in the middle of coronary thrombosis.

Better to make the treatment fit the disease. Revamping the health-care system won't fix the banks. Raising the price of carbon-based fuels and force feeding the nation alternative sources of energy won't loosen up lending. And higher taxes on the wealthy, and inevitably the not-so-wealthy, won't enhance bank solvency.

Doing so many things at once means a reduced focus on the root of the problem. There's a reason the tortoise beats the hare in **Aesop's fable**.

So what does Kehoe recommend for the current crisis?

"We need to avoid implementing policies that stifle productivity by providing bad incentives to the private sector," he says. "Unproductive firms need to die."

Maybe then the rest of us can start to live.

(**Caroline Baum**, author of "Just What I Said," is a Bloomberg News columnist. The opinions expressed are her own.)

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