

A Slippery Slope Called Interventionism

By Frank K. Martin¹

U.S. Treasury Secretary Henry Paulson defended the government moves, saying it was important to ensure the orderly function of financial markets. As for the longer-term consequences of his actions, he evaded responsibility: “I’m not going to speculate on hypotheticals about intervention.”

Federal Reserve Chairman Ben Bernanke uttered a similar refrain, saying the Fed was concerned that “because the financial system is so interconnected, the sudden failure could have shaken already fragile investor confidence and further undermined the economy. Given the current exceptional pressures on the global economy and financial system, the damage caused by a default ... could have been severe and extremely difficult to contain. Moreover, the adverse effects would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.”

Thus reasoned the Treasury secretary and the Fed chairman *almost six months ago* when rationalizing the state-sponsored and partially guaranteed “rescue” of Bear Stearns Companies, Inc.

Fast-forward to Sunday, September 7, 2008, after months of forgone opportunities to “speculate on the hypotheticals about intervention.” Paulson remained ever the plug-the-levee pragmatist and Bernanke the conscientious but nervous reactionary, backpedaling like an unseasoned hiker upon encountering a voracious grizzly on the trail. Apparently reluctant to venture into the deep philosophical forests lurking with the myriad beasts of interventionism, Paulson nonetheless didn’t walk away empty-handed from the “Bear” debacle. “Moral hazard,” which he then defined as the “concept that investors might take greater risks on the belief that government policy would protect them from suffering losses,” was summarily turned upside down. The “nationalization hazard,” as it might become known, abruptly alters the definition of whose ox will be gored if corporate imprudence poses a systemic risk. What Paulson’s actions did say is likely echoing through the halls of corporate America. Overnight the “too big to fail” doctrine has been displaced by the “too big to save *as a private enterprise*” imperative.

In the nationalization of the government-sponsored enterprises (GSEs) Paulson proposed that, on behalf of the taxpayer, the government serve in two capacities: as controlling equity investor and as debt guarantor of the remains of Fannie Mae and Freddie Mac. Presumably as a consideration for the almost

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certainly underestimated risks assumed, Mr. Paulson acknowledged that the radical proposal does give ... the U.S. government a “large stake in the future value of these entities” [79.9% of shareholders equity if warrants are exercised, to be precise]. “In the end,” continued Paulson, “the ultimate cost to the taxpayer will depend on the business results of the GSEs going forward. To that end, the steps we have taken ... will together improve the housing market, the U.S. economy, and the GSEs’ business outlook.” Paulson, conveniently, will be long gone by the time his upbeat prognostications for housing, the economy, and the GSEs are proven either sound or myopic.

With the benefit of six months of hindsight, and as one whose vantage point is far enough removed to be well above the forest and the trees and whose bent is philosophical, I would postulate that Bear Stearns was merely a speed bump on the slippery slope of interventionism. What, I wonder, will be the verdict years hence on Paulson’s decision to nationalize Freddie and Fannie? To be sure, it is not inevitable that interventionism inextricably leads to socialism. Nonetheless, in the words of F.A. Hayek (1899–1992), Nobel laureate economist and political philosopher (as the words might apply to September 7’s actions), “The danger is the greater because we may choose the wrong way, not by deliberation and concerted decision, but because we seem to be blundering into it.”

To paraphrase Adam Smith regarding the conveyance of near dictatorial powers on Henry Paulson and his *de facto* agent, James B. Lockhart III, director of the newly-created Federal Housing Finance Agency, (Congress, what were you thinking?), a person who attempts to direct the employment of capital (at Fannie and Freddie) will not only bring much unwanted attention upon himself but will also unwittingly or otherwise assume authority that should be trusted to no political entity, however mighty, and which “would nowhere be so dangerous as in the hands of a man who had the folly and presumption enough to fancy himself fit to exercise it” (Adam Smith, ... *Wealth of Nations*). Returning to Hayek, “Once this stage is reached, the only alternative to a return to competition is the control of the monopolies by the state, a control which, if it is to be made effective, must become progressively more complete and more detailed.” Lest we forget, efficient planning works best when an individual or board can easily survey all the relevant facts. When the complexity rises to the point where it’s impossible to gain a synoptic perspective—most certainly in the case of the multidimensional morass that is otherwise known by the pathetically inappropriate nicknames of “Fannie” and “Freddie”—then decentralized decision-making becomes the only rational option (the antithesis of the course Paulson chose). If history is any guide, Paulson’s attempt at “market socialism” or central planning, in this instance, may make the Iraq conflict look like enlightened strategy by contrast.

The words of Winston Churchill (after the Allied victory in the Second Battle of El Alamein in 1942) are *apropos* in 2008: “This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.”