Letter: Republican Opposition to Debt Reduction in Financial Crises—The Great Depression and Today

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Dear Editors:

In "Why Paulson is Wrong," Luigi Zingales correctly points to the positive outcome for the economy when the Roosevelt administration reduced industrial debt in 1933 by cancelling the gold clauses in industrial bond contracts. Republicans had strongly opposed this policy. When the House voted, the Republicans voted 64–14 (counting pairs as well as actual votes) on a motion that would have eviscerated the policy by making it non-applicable to previously concluded contracts. They voted 48–28 against passage. In the Senate, the relative Republican opposition was even stronger. Senate Republicans voted 19–4 and 18–2 for two amendments to eliminate the cancellation being retroactive and 18–4 against passage.

Depression era governments also massively intervened in mortgage markets. The economic historian Lee Alston has documented that about half the states legislated moratoria on farm mortgages. At the federal level, the Roosevelt administration intervened in the residential mortgage market, creating public sector institutions. The privatization of some of these institutions in the 1960s is arguably a basic element of the current crisis.

The interventions in the Depression era were very controversial at the time. Both the cancellation of the gold clauses and the farm mortgage moratoria would appear to violate the contracts clause of the Constitution.

The Supreme Court upheld both policies, but by narrow 5–4 majorities.

Today, we see similar opposition to government intervention from Republicans. For one example, John McCain initially opposed the AIG bailout. For another, Senator Jim Bunning (R-KY) opposed the takeover of Fannie Mae and Freddie Mac. As I write, there is Republican opposition to the Paulson plan. The opposition might be ascribed to a genuine desire to perfect the government response to the crisis, much in the direction pointed to by Prof. Zingales.

On the other hand, much of the Republican reaction is likely to be gut ideological conservatism, as indicated in McCain's initial opposition to the AIG bailout. The leaders of the Republican House revolt, identified by the *New York Times* as representatives Hensarling (TX), Cantor (VA), and Ryan (WI) were, respectively, the 6th, 43rd, and 48th most conservative of the 201 Republicans in the 110th House. (DW-NOMINATE scores accessible at http://voteview.ucsd.edu.) The ideology would appear to involve, first, a belief that unregulated free markets will always do better than government, second, a belief that government spending per se is bad, and third, a belief that government intervention today will create moral hazard problems in the future. With respect to this latter point, Patrick Bolton and I have made a formal argument ("Political Intervention in Debt Contracts," *Journal of Political Economy*, 2002) that intervention can be beneficial, even if credit markets anticipate intervention ex ante. The key to avoiding the moral hazard problem is to restrict intervention to truly exceptional circumstances. Actions in the Depression did not result in the permanent collapse of credit markets. Nor will intervention today.

Prof. Zingales ends his excellent piece by declaring his affection for free markets but wanting "to save capitalism from the capitalists." But beyond an intelligent response to the current crisis, long-term regulatory correctives are needed to save "capitalism from the *crony* capitalists" and their allies, Democrat as well as Republican, in Congress. To get there, one must cast aside simplistic ideologies that were

proved wrong in the 1930s and will be proved wrong again in this century.

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REFERENCES AND FURTHER READING

Zingales, Luigi (2008) "Why Paulson is Wrong," Economists' Voice, 5(5): Art. 2. Available at http://www.bepress.com/ev/vol5/iss5/art2.

Bolton, Patrick and Howard Rosenthal (2002) "Political Intervention in Debt Contracts," Journal of Political Economy, 110(5): 1103–1134.