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How Bad Economies Recover Fast When Governments Get Out Of The Way

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It can take years or decades for a bad economy to recover if government throws enough obstacles in the way, like high taxes, costly regulations and class warfare against "millionaires and billionaires." But a turnaround can begin within hours when government gets out of the way.

That's what happened in West Germany. The Nazis had established a regime with totalitarian control of the economy, and for four years after World War II the Allied occupation authorities continued to enforce Nazi economic regulations. "When I got out of the airport bus in Frankfurt," recalled the American journalist William Henry Chamberlin, "A crowd of barefooted boys clamored for a chance to carry my bags to the hotel, where they expected compensation not in paper marks, virtually worthless at the time, but in the universal substitute currency – cigarettes. Such scenes suggested some poverty-stricken Asiatic country, not Western Europe."

Ludwig Erhard, an economist who had participated in the anti-Nazi underground, repeatedly urged the Allies to phase out the controls, and eventually he prevailed. The Allied Occupation authorities appointed him director of economic policy. On Sunday evening, June 20, 1948, Erhard went on the radio and announced that the almost worthless Reichsmark would be replaced by a new currency, the Deutschmark. People would receive one Deutschmark for every 20 Reichsmarks they handed in. Exchange controls would be abolished, since these aimed to maintain currency at above-market exchange rates, discouraging foreigners from accepting it as payment and thereby making lawful trade impossible.

A new currency, however, wouldn't buy anything as long as chronic shortages persisted, so Erhard announced that price controls and rationing regulations would be abolished. Price controls simultaneously (1) discourage suppliers from providing more goods and (2) encourage consumers to line up for whatever might be available, which is why such controls cause shortages. U.S. commander Gen. Lucius Clay reportedly warned Erhard, "My advisers tell me you're making a terrible mistake." Erhard said, "Don't listen to them, General. My advisers tell me the same thing."

Within hours after Erhard's announcement, goods that had been reserved for black market deals began to reappear on long-empty store shelves. During the 1950s, West Germany's industrial production soared 225 percent. West Germany became a leading exporter. Overall, West Germany turned in the best economic performance of any developed country during this period. West Germany charged through the 1970s without the stagflation that afflicted the United States and other countries.

Although it's well-known that a devastated economy like Germany's could grow at above-average rates, the fact is nobody predicted the German economic miracle. It didn't encounter serious trouble until West Germany absorbed backward, bankrupt communist East Germany after 1989. "The turnaround in Germany in 1948 was nothing short of a miracle," MIT economist Rudiger Dornbusch observed. "From one day to the next, productive forces were unleashed to let recovery and growth proceed at breakneck speed."

Japan also had an amazing recovery.   In 1977, historian Edwin O. Reischauer wrote that Japan emerged from World War II "a defeated pariah among nations – its cities destroyed, its industry at a standstill, its people exhausted, confused and demoralized. Yet in only one generation the country has risen like the proverbial phoenix to become, next to the colossi of the United States and the Soviet Union, the greatest economic power in the world." Historian Patricia Hagan Kuwayama added, "If there is one common theme running through the story of postwar Japan's economy, it is rapid, unceasing change."

American Occupation authorities broke up government-enforced cartels and implemented the 1948 Dodge Plan. This limited the Japanese government's economic power and made it easier for new entrepreneurs to emerge. "For the first time," reported economist Katsuro Sakoh, "practically any Japanese, regardless of age, class, or family background, could venture into business and succeed if the elements of hard work, imagination, willingness to take risks, and luck were present. Not only did established businesses prosper under fresher and younger management, but thousands of entirely new enterprises, such as Honda, Yamaha, Sony and Suzuki, to name but a few, were born in this new climate."

Many people have claimed that Japan succeeded because of a government-driven "industrial policy," but nothing could be further from the truth. Taxes were a smaller percentage of Japan's GDP than was the case for England, France, West Germany or the United States. Japan had relatively small, balanced budgets – the opposite of what fashionable Keynesian economists recommended. The private sector dominated Japanese capital markets, providing a reported 90 percent of outstanding loans and 75 percent of total capital. Government paid for a lower percentage of R&D funding in Japan than in West Germany, England or the United States. The principal Japanese government-owned manufacturer produced cigarettes, whereas in Europe government-owned businesses manufactured iron, steel, cars, airplanes and other products.


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It's true that the Japanese government "targeted" certain industries for development, but the top target was agriculture, because after World War II farmers made up about half the Japanese population.   There was government assistance for forestry and fishing as well as rural areas such as Kyushu, Shikoku and Hokkaido. Infrastructure – roads and bridges – was another high priority. Losses from the government-owned Japanese National Railway consumed almost 20 percent of the national government budget. The fabled Ministry of International Trade and Industry (MITI) mainly targeted heavy industries like shipbuilding, coal mining, hydroelectric power plants, nuclear power plants, petrochemical plants and oil refineries.

In other words, the Japanese government didn't do many favors for popular exports like consumer electronics and cars. Indeed, MITI tried to obstruct some of Japan's greatest entrepreneurs.

For example, in 1946 Masaru Ibuka and Akio Morita started what became Sony Corporation. They wanted to license Bell Labs' transistor technology, but MITI blocked Sony's $25,000 payment for the license fee — scarce U.S. dollars shouldn't be spent on something with unknown potential, MITI said. Eventually MITI relented, and in 1955 Sony began producing small transistor radios.

MITI tried to force seven Japanese automakers to merge, but four including Honda refused. Soichiro Honda fumed, "If you want to control us, you will have to be a shareholder. Only our shareholders have the right to dictate to the management of this organization. Then we will listen to you!" MITI had less power than many people realized. It was thanks to resourceful entrepreneurs that starting in 1950, Japan's annual economic growth averaged 9.4 percent for the next 22 years – an extraordinarily long-lived boom.

There have been many other cases of troubled economies that recovered fast when government got out of the way. For example:

* **Chile.** September 1970 was the first time a Marxist was elected president of Chile, South America's longest-running democracy. Salvador Allende seized businesses. He seized some 1,400 farms, and agricultural production collapsed. He seized banks, then went on a money-printing binge. Inflation hit 1,000 percent. Allende decreed price controls that caused severe shortages.

By 1972, investigative journalist David Meissner reported: "People line up for sugar. Beef can be bought only on Friday and Saturday. Toilet paper is the subject of a run on stores." There were daily protests against Allende. On September 11, 1973, General Augusto Pinochet Ugarte led a coup, and Allende was killed.

The economic crisis continued until 1975 when Pinochet decided to cut spending, cut taxes, liberalize trade, privatize money-losing nationalized enterprises and convert the troubled, government-run retirement program into a system with individually-owned retirement accounts. Chileans became the most prosperous people in South America, and by 1988 there was a transition to free elections.

* **United States.** During the late 1970s, Americans were angry about gasoline shortages, seemingly endless gas station lines and double-digit inflation. After Ronald Reagan was sworn in as president, his first official act was to sign an executive order abolishing price controls. The resulting surge in gas prices sent a powerful signal that profits could be made by supplying more gasoline. Prices came down as gasoline became abundant, and gas station lines vanished.

In addition, Federal Reserve Board Chairman Paul Volcker was determined to squeeze inflation out of the economy, but he needed political support, something that Reagan's predecessor Jimmy Carter was unable to provide. That's because the pain (higher unemployment) comes before the gain (lower inflation, then lower unemployment). Affected interest groups complained bitterly about Volcker, as did some of Reagan's closest advisors who worried that Republicans would suffer a setback in congressional elections. Reagan remained steadfast with Volcker, double-digit inflation was vanquished, and a remarkable era of low-inflation prosperity began.

* **Bolivia.** Bolivia had Latin America's worst-ever inflation, because the left political party in power was a coalition that wanted the government to spend more money on social welfare programs and hire more unionized government employees.   But spending exceeded tax revenue, and there were no buyers for Bolivia's risky government bonds. In August 1985, inflation hit an annualized rate of 60,000 percent.

Then Victor Paz Estenssoro, a center-right politician, was elected president. He seemed to understand that fighting inflation would be hard on many people, so it made sense to get through the process as fast as possible. To cut spending, the government let go of 27,000 employees at the government-run oil and tin companies (Bolivia's population at the time was 6 million). The Bolivian peso was pegged to the U.S. dollar, thereby getting control of the Bolivian money supply out of the hands of Bolivian politicians. Price controls, wage controls, exchange controls and interest-rate controls were abolished. Taxes were somewhat simplified. The runaway inflation was stopped in 10 days.

* **Hong Kong.** As a British colony (until 1997), Hong Kong endured shocks from Japanese invaders, communist revolutionaries who claimed Hong Kong for China and Chinese Nationalist agitators who claimed Hong Kong for Taiwan. Hong Kong was overwhelmed with some 3 million refugees, and the total population quadrupled in a few years. Ultimately China, which had cut itself off from the outside world, seems to have decided against an invasion because half their foreign income was earned in Hong Kong.

Meanwhile, Hong Kong offered more freedom than just about anyplace else on earth, thanks to colonial administrators like Financial Secretary John Cowperthwaite. He perfected a laissez-faire paradise that focused on protecting people from force and fraud, supporting free trade and stable money, maintaining low taxes and few regulations, with no special favors or bailouts. Hong Kong became a world-class manufacturing, trade and financial center. When China finally absorbed Hong Kong – and promised to leave it intact – its per capita GDP ($22,990) was 37 times larger than mainland China ($620.)

* **China.** The economic outlook for China began to improve after the eagerly-awaited death of Mao Zedong in 1976. His worst disaster was an insane Soviet-style five-year plan known as the Great Leap Forward that promoted heavy industry and sacrificed agriculture where China had comparative advantages, causing a famine estimated to have killed some 45 million people.

Deng Xiaopeng emerged as the new Chinese leader, and he insisted that the top priority must be reviving the economy. Although he never repudiated the deadly dogmas of Marx, Lenin and Mao, and the Communist Party continued to monopolize political power, Deng stimulated agriculture by dismantling communes that suffocated the initiative of peasants. The government encouraged foreign investment. Money-losing government enterprises continued, but private individuals were permitted to work for themselves and establish businesses, which had been unheard of under Mao. Deng declared, "to get rich is glorious." A substantial private sector began to develop, and China has reported high growth rates for the last three decades.

* **Brazil.** For perhaps a half-century, the Brazilian government directed development, expropriated private property, inflated the money supply and maintained high tariffs to prevent Brazilian customers from shopping for the world's best deals. Result: financial crises, soaring debt, runaway inflation, political turmoil and sometimes military coups.

But by 1990, there was a growing consensus in Brazil to curb inflation, privatize moribund government enterprises and liberalize trade. In 1995, annual inflation – that had peaked around 2,900 percent – was brought down to single digits. In 2002, former labor union official Lula da Silva won the presidential election. Widely expected to pursue an anti-business agenda, Lula turned out to be a very practical man. He affirmed that high inflation must not come back and that Brazilians would be smart to embrace global markets. Brazil became safe for investors and entrepreneurs, helping to usher in today's remarkable economic boom.

So, there really isn't any secret about what needs to be done. There is, however, a huge political challenge about how to do it.

Jim Powell, a Senior Fellow at the Cato Institute, is the author of FDR's Folly, Bully Boy, Wilson's War, Greatest Emancipations, Gnomes of Tokyo, The Triumph of Liberty *and other books.*