by Steve Hanke

President of China, shakes hands with Nicolas Sarkozy (R), President of France

GETTY IMAGES

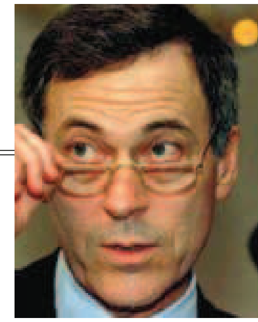
Hu versus Sarkozy

There is no more reliable rule than the 95% rule: 95% of what you read about economics and finance is either wrong or irrelevant. Just reflect for a moment on the most frequently repeated lessons drawn from the Great Depression (1929-33). According to most accounts, the stock market crash of October 1929 was the spark that sent the economy spiraling downward.

How could this be? After all, by November 1929, the stock market had started to recover, and by mid-April 1930, it had reached its pre-crash level. Contrary to the received wisdom, massive government failure – not the stock market crash – pushed the United States into the Great Depression. It was the Federal Reserve that ushered in that terrible nightmare. During the course of the Great Depression, the money supply contracted by 25%. This sent the economy into a deflationary death spiral, with the price level falling 25%.

The Federal Reserve was not the only culprit. In the name of saving jobs, the Smoot-Hawley trade bill became law in June 1930. That intervention increased U.S. tariffs by over 50%. It was quickly followed by the imposition of retaliatory tariffs in 60 other countries. In consequence, world trade collapsed and the unemployment rate in the U.S. surged from 7.8% in June 1930 to 24.7% in 1933.

In addition to the Smoot-Hawley tariff wedge, the Hoover administration and the Democratic Congress imposed the largest tax increase in U.S. history, with the top tax rate on income jumping from 25% to 63% in 1932. If these government policies weren't destructive enough, the Roosevelt administration's New Deal created



Free Market Metrics and GDP Per Capita

Regional Rank	World Bank Doing Business	Cato Economic Freedom of the World	Transparency International CPI	IMF WEO per capita GDP (US$)
1	Singapore	Hong Kong	New Zealand	Australia
2	New Zealand	Singapore	Singapore	Singapore
3	Hong Kong	New Zealand	Australia	Hong Kong
4	Australia	Australia	Hong Kong	New Zealand
5	Thailand	South Korea	South Korea	South Korea
6	South Korea	Thailand	Malaysia	Malaysia
7	Malaysia	Malaysia	China	Thailand
8	China	Philippines	Thailand	China
9	Indonesia	China	Indonesia	Indonesia
10	Philippines	Indonesia	Philippines	Philippines
Correlation with GDP per capita	0.879	0.867	0.903	

Sources: World Bank, Doing Business 2010; Cato Institute, Economic Freedom of the World, 2009 Annual Report; Transparency International, Corruption Perceptions Index 2008; International Monetary Fund, World Economic Outlook October 2009; and Author's Calculations.

regime uncertainty because major policies were being changed so rapidly. As a result, investors were afraid to commit funds to new projects and private investment collapsed.

Far from saving the patient, government intervention came close to killing it. But you wouldn't know it from listening to the current discourse about the Panic of 2008-09. Indeed, politicians and pundits throughout the world have unfortunately dialed back to the Great Depression and drawn on the false lessons of history for policy guidance and justifications for their mega-interventions.

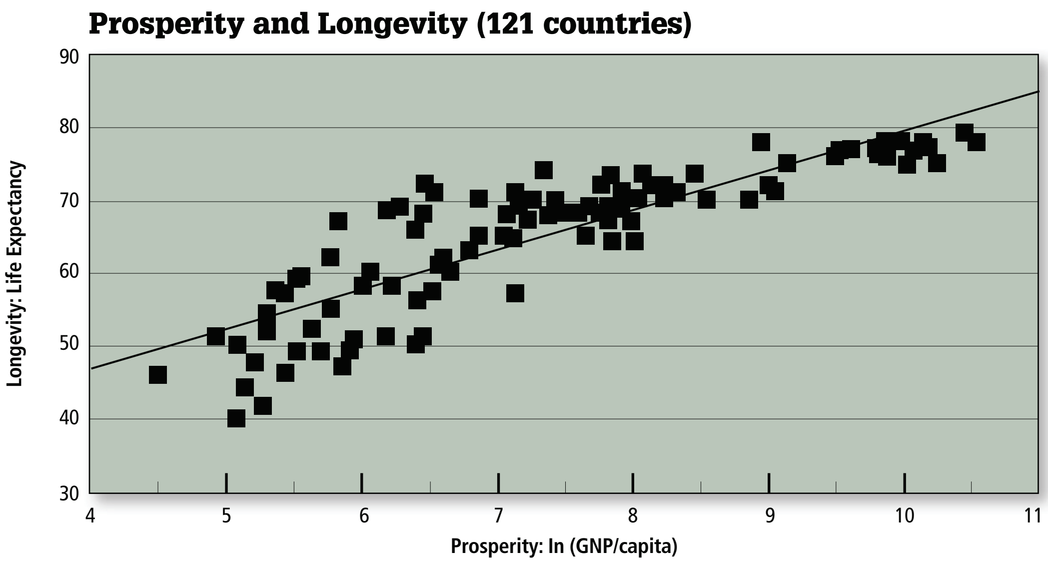
In consequence, the key enabler of both the Great Depression and the Panic of 2008-09–namely the Federal Reserve–is scheduled to become America's systemic risk regulator. This is the world upside down. The Federal Reserve is the systemic risk.

The true lesson to be drawn from business cycle history is that, if left to run their natural course, severe downturns are followed by rapid snapbacks. For example, during the 1921 recession, wholesale prices, industrial production, and manufacturing employment fell by 30% or more, reaching their low in mid-1921. But, absent government intervention, the economy recovered naturally, and by early 1922, it had fully recovered, from its mid-1921 low.

Never mind. The crisis has energized the interventionists. One of the most hyper-active is French President Nicolas Sarkozy. In addition to leading the charge to impose wage controls on top bankers, he has grand visions. He wants to move away from the "fetichism of GDP". The Sarkozy conjecture is that GDP metrics don't measure "happiness".

To correct that alleged flaw, President Sarkozy appointed a "Commission on the Measurement of Economic Performance and Social Progress". It is led by two Nobel laureates: Columbia University's Joseph Stiglitz and Harvard's Amartya Sen. The Commission's report, which was issued in September 2009, presents the known shortcomings associated with national income accounting, including the GDP metrics. That said, the Commission failed to produce any new, reliable measures that account for overall economic health. The commission will, no doubt, go down as a typical Sarkozy fireworks display, with no measured "happiness" at the end of the performance.

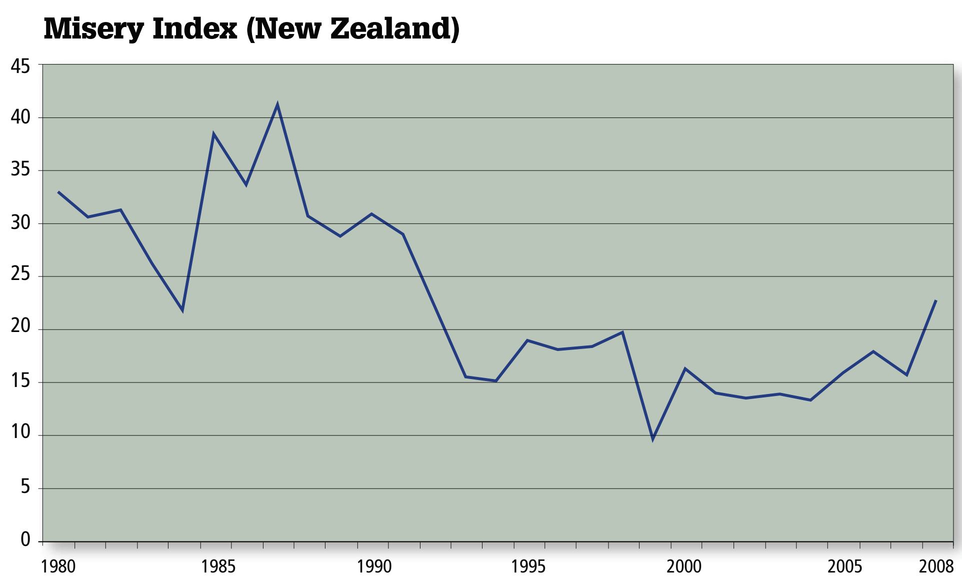
For the foreseeable future, GDP metrics, as well as other standard economic measures, will remain center stage for economists and policy makers. President Hu of China made this clear in a speech on climate change before the U.N. General Assembly in September 2009. While bowing to "greenery", China's President



Sources: Steve H. Hanke and S. J. K. Walters, "Economic Freedom, Prosperity, and Equality: A Survey", The Cato Journal, Vol. 17, No. 2, Fall 1997.

Hu stressed that developing countries should "go for growth".

This was a cold shower for President Sarkozy and other interventionists. After all, GDP growth and levels of GDP per capita are closely, and positively, associated with metrics that measure the vitality of free markets and the ease of doing business (see the accompanying table). And that's not all. Economic growth is, quite literally, a matter of life and death. As the accompanying chart indicates, prosperity (measured by standard metrics) affects life expectancy (health) in a positive way.



Sources: International Monetary Fund, International Financial Statistics; International Monetary Fund, World Economic Outlook October 2009; The World Bank Group, World Development Indicators; and Author's Calculations.

A reliable picture of an economic state of affairs can be obtained by constructing a misery index using standard measures: the sum of the inflation rate, plus the lending (interest) rate, plus the unemployment rate, minus the annual percentage change in GDP per capita.

As an example, the misery index for New Zealand is presented in the accompanying chart for the period 1980-2008.

By the early 1980s, New Zealand's economy was suffering from interventionism and its misery index was at record levels. Then Roger Douglas took over the reins at the Ministry of Finance and pushed through dramatic free-market reforms.

These set the stage for a significant initial fall in New Zealand's misery index. The second stage of the decline in the index occurred during Ruth Richardson's tenure as Minister of Finance in 1991-93, when she pushed through a number of additional liberal economic reforms. In late 1999, the Labour Party, with Helen Clarke at the helm, took power in New Zealand, where it stayed entrenched until November 2008. During that long stretch, the dramatic economic reforms of the late-1980s and early-1990s were eroded away and New Zealand's misery index more than doubled.

President Hu took note of the main lesson of economic history: "go for free markets" and prosperity and longevity will follow. GA

Steve H. Hanke is a Professor of Applied Economics at The Johns Hopkins University in Baltimore and a Senior Fellow at the Cato Institute in Washington, D.C.