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Bailouts, Debt Magnify Risk of Future Economic Troubles

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The talk now is about "green shoots" and a "light at the end of the tunnel." Markets have rallied, housing prices have stopped falling, banks are profitable again, and it seems like we have been able to save several industrial giants that were on the ropes, like General Motors.

But we must never forget that the light at the end of the tunnel can be an approaching train.

All of these presumably positive signs could also be interpreted as problems. They might contribute to a slower rebound than expected, and possibly to a new crisis further down the road.

It is counterintuitive, but the fundamental economic problem was not the "bust"-- it was the "boom," under which too much wealth was put to inefficient use.

The recession is the period when we wind down investments and put capital and labor to use in more competitive and sustainable businesses. If this redeployment of resources is not allowed to proceed because of bailouts and stimulus programs, old mistakes will survive and drag us down in the future as well.

A famous Austrian economist, Joseph Schumpeter, warned that recovery is sound only if it comes of itself. A government stimulus "adds, to an undigested remnant of maladjustment, new maladjustment of its own which has to be liquidated in turn, thus threatening business with another crisis ahead."

That is where we are right now. The financial crisis is the result of too much cheap credit, too much indebtedness and too many bad investments. So it is ironic that governments are trying to meet the crisis with . . . even cheaper credit, even more indebtedness, and attempts to subsidize and protect bad investments and overproduction -- in the housing sector, the car industry, and everything in between.

The zero percent interest rate, new liquidity facilities, and bailout loans were supposed to unblock the credit market. But they also can result in new investment mistakes, as companies and households base their behavior on interest rates that are unsustainable.

The more investment depends on today's rates, the more reluctant central banks will be to increase them, and even more misguided investments will be made. We have been here before.

Governments have worsened the situation by bailing out some of the most insolvent and uncompetitive

businesses.

By saving car companies, we are guaranteeing a continued overproduction of cars. The very idea of the massive stimulus is to subsidize projects that would not survive the market's cost-benefit analyses.

It seems like politicians want to keep failed investments on artificial life support until economic growth makes it possible for them to survive on their own. But since that means resources are locked into the least productive sectors, this strategy will result in a delayed return to healthy economic growth.

The bailouts also distort future incentives. Goldman Sachs' record second-quarter profits took attention away from the fact that its value-at-risk was at an all-time high.

So just half a year after the U.S. government saved insurer AIG because its collapse would have destroyed Goldman Sachs -- and after the investment bank had been injected with $10 billion of taxpayer money (later repaid) -- the bank has taken on enormous risk.

It seems like a paradox, but in another way it is perfectly logical. Banks have ample evidence that the government has provided them with a multidimensional safety net, so why not take risks for short-term gains if you can send potential losses to the taxpayers?

The problem with all of these policies is not only what they buy, but also what they cost. The debts that are now building will burden countries for a very long time, especially since we already have growing unfunded liabilities in our social security systems to worry about.

The risk is growing that governments will further inflate those debts with monetary policy, which, according to Schumpeter's prophecy, "would, in the end, lead to a collapse worse than the one it was called in to remedy."

It is somewhat understandable why the risk of a 1930s-style depression has led some to call for unprecedented action. One central policymaker has even said the economy has to be saved in the short-term by a monetary stimulus, even if we thereby "foster a bubble, an inflationary boom of some sort, which we would subsequently have to address."

But let's keep in mind that argument came from then-Fed Chairman Alan Greenspan when he introduced 1 percent interest rates in 2003. That "inflationary boom" ended up in real estate; we are now in the "subsequently," and we have to address it.

As Mark Twain pointed out, history does not repeat itself, but sometimes it rhymes.

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