Policy Uncertainty in 1937 and 2008

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In an article published in 1997 titled "Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed After the War," I advanced the idea of *regime uncertainty* in an attempt to advance our understanding of the Great Depression's extraordinary duration and of the highly successful postwar transition to a genuinely prosperous market-oriented economy. The idea is more definite than the hoary but vague idea of "business confidence," though related to it, and different also from the idea of regime uncertainty that some econometricians have used in their macroeconomic studies, though, again, not wholly unrelated.

In my conception, *regime uncertainty* pertains above all to a pervasive uncertainty about the property-rights regime — about what private owners can reliably expect the government to do in its actions that affect private owners' ability to control the use of their property, to reap the income it yields, and to transfer it to others on voluntarily acceptable terms. Will the government simply take over private property? Will it leave titles in private hands, but strip the owners of real control and profitable use of their properties? These questions fall under the rubric of regime uncertainty.

Between 1935 and 1940, this matter attained prime importance. So many businessmen and investors lost confidence in their ability to forecast the future property-rights regime that few were willing to venture their money in long-term investments. They constantly sought clarification of the government's designs, but President Roosevelt merely continued to rage against "economic royalists" and to blame a "strike of capital" for the economy's ongoing troubles, including the depression of 1937-38, which played havoc with the general public's confidence in the New Deal. Treasury Secretary Henry Morgenthau tried repeatedly to persuade the president to make a public statement that would reassure investors, and as the president continued to reject his entreaty, Morgenthau became so frustrated that in a 1937 cabinet meeting, he blurted out to his boss: "What business wants to know is: are we headed toward Socialism or are we going to continue on a capitalist basis?" (qtd. in Higgs, Neither Liberty Nor Safety, p. 114). Astonishingly, Jim Farley and even Henry Wallace backed up Morgenthau's insistence that the president spell out what sort of economic system the administration sought to foster.

In his question, Morgenthau encapsulated the wide ranging uncertainty Lammont du Pont expressed in the same year, when he said:

Uncertainty rules the tax situation, the labor situation, the monetary situation, and practically every legal condition under which industry must operate. Are taxes to go higher, lower or stay where they are? We don't know. Is labor to be union or non-union? . . . Are we to have inflation or deflation, more government spending or less? . . . Are new restrictions to be placed on capital, new limits on profits? . . . It is impossible to even guess at the answers. (qtd. in Higgs, Depression, War, and Cold War, p. 16)

I do not know that the regime uncertainty that an increasing number of commentators and others have perceived recently is comparable to that of the latter 1930s — by now there's not much real capitalism left for the government to destroy, in any event. However, it is clear that the government's frantic actions of the past several months have created a situation in which investors have little confidence about the character of future property rights in the United States. The takeovers of Fannie, Freddie, and AIG, the massive interventions into finanancial markets, the huge bailouts of banks and other financial institutions, mixed with letting Lehman Brothers go down and resisting a bailout for the Big Three auto manufacturers (so far, at least) — all these actions, and others, imply that a rational investor would do well to attach a huge risk premium to any money he puts into investments even for the intermediate term, not to mention the long term.

One of the clearest expressions of this outlook that I have seen so far was made recently by Lou Jiwei, the chairman and chief executive of the China Investment Corporation, who expressed a lack of confidence in Western financial institutions and said that his giant fund would make no new investments in them in the foreseeable future. As the New York Times reported:

"Right now we do not have the courage to invest in financial institutions because we do not know what problems they may have," Mr. Lou said as part of a panel discussion on the second and final day of the Clinton Global Initiative conference [in Hong Kong]. . . . Mr. Lou said that the sheer pace of new initiatives and new rules issued by Western regulatory agencies was disconcerting and made it even harder for him to choose worthwhile investments. "If it is changing every week, how can you expect me to have confidence?" he asked.

How, indeed?

HT to Steve Hanke for calling Lou Jiwei's statement to my attention.