The Cincinnatian Doctrine Revisited

↳ By Alex J. Pollock

Ten years ago, in September, 2006, just before the Great Housing Bubble's disastrous collapse, the World Congress of the International Union for Housing Finance, meeting in Vancouver, Canada, devoted its opening plenary session to the topic of "Housing Bubbles and Bubble Markets." That was certainly timely!

Naturally, knowing what would come next is easier for us in retrospect than it was for those of us then present in prospect. One keynote speaker, Robert Shiller, famous for studies of irrational financial expectations and later a winner of a Nobel Prize in economics, hedged his position about any predictions of what would come next in housing finance. Six months later, the U.S. housing collapse was under way. The second keynote speaker argued, with many graphs and charts, that the Irish housing boom was solid. Of course, it soon turned into a colossal bust. As the saying goes, "Predicting is hard, especially the future."

Some IUHF members, in the ensuing discussion, expressed the correct view that something very bad was going to result from the excess leverage and risky financial behavior of the time. None of us, however, foresaw how very severe the crisis in both the U.S. and Europe would turn out to be, and the huge extent of the interventions by numerous governments it would involve.

Later in the program, also very timely as it turned out, was a session on the "Role of Government" in housing finance. On that panel, I proposed what I called "The Cincinnatian Doctrine." Looking back a decade later, it seems to me that that this idea proved sound and is highly relevant to our situation now. I am therefore reviewing the argument with observations on the accompanying "Cincinnatian Dilemma" as 2016 draws to a close.

The two dominant theories of the proper role for government in the financial system, including housing finance, are respectively derived from two of the greatest political economists, Adam Smith and John Maynard Keynes.

Smith's classic work, *The Wealth of Nations*, published in the famous year 1776, set the enduring intellectual framework for understanding the amazing productive power of competitive private markets, which have since then utterly transformed human life. In this view, government intervention into markets is particularly prone to creating monopolies and special privileges for politically favored groups, which constrains competition, generates monopoly profits or economic rents, reduces productivity and growth, and transfers money from consumers to the recipients of government favors. It thus results in less wealth being created for the society and ordinary people are made worse off.

Keynes, writing amidst the world economic collapse of the 1930s, came to the opposite view: that government intervention was both necessary and beneficial to address problems which private markets could not solve on their own. When the behavior underlying financial markets becomes dominated by fear and panic, when uncertainty is extreme, then only the compact power of the state, with its sovereign authority to compel and tax, and its sovereign credit to borrow against, is available to stabilize the situation and move things back to going forward.

Which of these two is right? Considering this ongoing debate between fundamental ideas and prescriptions for political economy, the eminent financial historian, Charles Kindleberger, asked, "So should we follow Smith or Keynes?" He concluded that the only possible rational answer is: *"Both, depending on the circumstances."* In other words, the answer is different at different times.

Kindleberger was the author (among many other works) of *Manias, Panics and Crashes*, a wide-ranging history of the financial busts which follow enthusiastic booms. First published in 1978, the book was prescient about the financial crises which would follow in subsequent decades, and has become a modern financial classic. A sixth edition of this book, updated by Robert Z. Aliber in 2011, brought the history up through the 21st century's international housing bubbles, the shrivels of these bubbles which inevitably followed, and the crisis bailouts performed by the involved governments. Throughout all the history Kindleberger and Aliber recount, the same fundamental patterns continue to recur.

Surveying several centuries of financial history, Kindleberger concluded that financial crises and their accompanying scandals occur, on average, about once every ten years. In the same vein, former Federal Reserve Chairman Paul Volcker wittily remarked, "About every ten years, we have the biggest crisis in 50 years." This matches my own experience in banking, which began with the "credit crunch" of 1969 and has featured many memorable busts since, not less than one a decade. Unfortunately, financial group memory is short, and it seems to take financial actors less than a decade to lose track of the lessons previously so painfully (it was thought) learned.

Note that with the peak of the last crisis being in 2008, on the historical average, another crisis might be due in 2018 or so. About how severe it might be we have no more insight than those of us present at the 2006 World Congress did.

The historical pattern gives rise to my proposal for balancing Smith and Keynes, building on Kindleberger's great insight of "Both, depending on the circumstances." I quantify how much we should have of each. Since crises occur about 10% of the time, the right mix is:

- Adam Smith, 90%, for normal times
- J.M. Keynes, 10%, for times of crisis.

In normal times, we want the economic efficiency, innovation, risk-taking, productivity and the resulting economic well-being of ordinary people that only competitive private markets can create. But when the financial system hits its periodic crisis and panic, we want the intervention and coordination of the government. The intervention should, however, be temporary. This is an essential point. If prolonged, it will tend to monopoly, more bureaucracy, less innovation, less risk-taking, and less growth, and less economic well-being. In the extreme, it will become socialist stagnation.

To get the 90% Smith, 10% Keynes mix, the state interventions and bailouts must be withdrawn after the crisis is over.

This is the *Cincinnatian Doctrine*, named after the Roman hero Cincinnatus, who flourished in the 5th century B.C. Cincinnatus became the Dictator of Rome, being "called from the plough to save the state." In the old Roman republic, the dictatorship was a temporary office, from which the holder had to resign after the crisis was over. Cincinnatus did—and went back to his farm.

Cincinnatus was a model for the American founding fathers, and for George Washington in particular. Washington became the "modern Cincinnatus" for saving his country twice, once a General and once as President, and returning to his farm each time.

But those who attain political, economic and bureaucratic power do not often have the virtue of Cincinnatus or Washington. When the crisis is over, they want to hang around and keep wielding the power which has come to them in the crisis. The Cincinnatian Dilemma is how to get the government interventions withdrawn once the crisis is past. In other words, how to bring the Keynesian 10% crisis period to end, and the normal Smith 90% to resume its natural creation of growth and wealth.

The financial panic ended in the U.S. in 2009 and in Europe in 2012. But the interventions have not been withdrawn. The central banks of the U.S. and Europe are still running hugely distorting negative real interest rate experiments years after the respective crises ended. Fannie Mae and Freddie Mac, effectively nationalized in the midst of the crisis in 2008, have not been reformed and are still operating as arms of the U.S. Treasury. The Dodd-Frank extreme regulatory overreaction, obviously a child of the heat of its political moment, has not yet been reformed.

The Cincinnatian Doctrine cannot work to its optimum unless we can figure out how to solve the Cincinnatian Dilemma.