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Monday Morning Outlook

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Government Failure, Or Market Failure?

Every time the US has an economic problem that causes pain or fear (a recession, high energy prices, bank failures, or a market crash) there is always a frantic look for scapegoats. And most often it is greedy corporations or otherwise nefarious private-sector-types that get the blame.

For example, many believe that energy companies are manipulating oil prices. Politicians are always investigating them, and threatening legislation or special taxes. The Great Depression, many believe, was caused by excessive greed. Others think that Savings & Loans went belly-up because they defrauded people and made bad loans. And today, there is a clear belief that subprime loans are all about greed and fraud.

Some of this is true. Found in the rubble of each of these economic upheavals are people who either made very bad decisions or committed fraud. But, a thorough look at these economic problems shows how government policy mistakes played the key causal role in each of them.

The Great Depression was caused by excessively tight monetary policy that began in the late 1920s. This created deflation, and put upward pressure on the dollar, which in turn encouraged protectionism – the Smoot-Hawley Tariff Act was the result. Then Herbert Hoover raised tax rates in 1932, and Franklin Roosevelt ramped up regulation and government spending. The economy never stood a chance.

Richard Nixon closed the gold window, and devalued the dollar in the early 1970s. The Federal Reserve made huge mistakes, boosting inflation and undermining the dollar. This drove up oil prices. Windfall profits taxes and energy price controls made the problems worse.

In the late 1970s and early 1980s, Chicago's Harris Bank would not make oil loans if the oil in the ground was valued at more than $20 per barrel. Penn Square Bank in Oklahoma thought oil would stay high indefinitely and made billions of oil loans. It failed in 1982. The 8th largest US bank, Chicago's Continental Bank, failed in 1984 partly because it had purchased $1 billion in oil and gas participations from Penn Square. In other words, the unexpected decline in oil prices during the early 1980s, when Paul Volcker successfully killed off inflation, helped cause large bank failures. Harris was fine.

It wasn't the bank failures that caused the recessions of the early 1980s, it was Volcker's unexpectedly tight money. This tight money also undermined S&L's. Double-digit short-term rates when many of the mortgages on their books had single-digit interest rates turned them upside down. The losses eventually came to roughly $250 billion.

Today, just like in the past, the US is paying a hefty price for monetary policy mistakes. They began back in 1999 and 2000 when the Fed tightened policy too much. This caused deflationary pressures which the Fed reacted to by cutting interest rates to 1% in 2003. These 1% interest rates, and the belief that they would stay low for a long time, led to excesses in housing, just like the excesses of oil lending were caused by commodity inflation. And with mark-to-market accounting in place today the problems compound even more quickly.

Some argue that since individual people made all these decisions, it's not really the Fed's fault. But this is like telling someone after it's been raining for 2 ½ years straight that they should not have sold their nice red convertible or wasted money on an umbrella now that it has stopped raining. Government failure is more responsible for our current economic problem than is generally realized. Arguing otherwise, and regulating the economy even more, risks compounding the government's already large mistakes. It's government failure that investors should worry about, not market failure.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-24 / 9:00 am	Existing Home Sales - Feb	4.850 Mil	**4.880 Mil**		4.890 Mil
3-26 / 7:30 am	Durable Goods - Feb	0.8%	**0.8%**		-5.1%
7:30 am	Durable Goods (Ex-Trans) - Feb	-0.3%	**-0.5%**		1.5%
9:00 am	New Home Sales - Feb	0.579 Mil	**0.570 Mil**		0.588 Mil
3-27 / 7:30 am	Q4 GDP Final	0.6%	**0.8%**		0.6%
7:30 am	Q4 GDP Chain Price Index	2.7%	**2.7%**		2.7%
7:30 am	Initial Claims - Mar 22	370K	**370K**		378K
3-28 / 7:30 am	Personal Income - Feb	0.3%	**+0.4%**		+0.3%
7:30 am	Personal Spending - Feb	0.1%	**+0.2%**		+0.4%
8:45 am	U. Mich. Consumer Sentiment	70.2	**71.0**		70.5