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Let's Not Panic and Ruin the World By BRIAN S. WESBURY

You can't move these days without bumping into an economic pessimist. "Recession in America looks increasingly likely," said the Economist magazine on Nov. 17. Two days later, in the International Herald Tribune, Nobel Prize winner Paul A. Samuelson brought up the specter of the Great Depression. And then, on Nov. 26, former U.S. Treasury Secretary Larry Summers wrote in the Financial Times that, "the odds now favor a recession that slows growth significantly on a global basis."

The pressure on policy makers to do something is intense. Not only is there a desire to see the government get even more involved in the housing loan market -- witness the Bush administration's plan to freeze starter rates -- there is also tremendous pressure on the Fed to make another large 50 basis-point rate cut in attempt to alleviate credit-market problems.

This desire for government intervention to fix problems that grown adults have created for themselves is dangerous. Constantly counting on the government to save the economy undermines confidence in free markets, conditions people to believe they don't have to live with bad decisions, and creates a willingness to take imprudent risk. Actions to stabilize the economy in the short term can destabilize it in the longer term, and set the stage for even more intervention to fix the new problems at a later date.

Moreover, all this pessimism makes serious economic problems less likely. If it really happens, a recession in the next year could be

the most anticipated ever. That fact alone makes it improbable. Recessions usually surprise the consensus. When a recession is expected, the odds of rapidly rising inventories, excessive investment, or a surprise drop in new orders are reduced.

In the past, when manufacturing was a larger share of the economy and inventory control was less exact, recessions often began abruptly, sometimes on the heels of very strong growth. Today, with services a larger share of the economy, and technology speeding up information flow, the economy tends to glide more gently into recession. Given this, all the doom and gloom seems unnecessary.



Real GDP in the U.S. grew 4.9% at an annual rate in the third quarter, and has averaged 4.4% in the past two quarters. While real growth in the current quarter will slow (our forecast is 1.5% to 2.0%), this is more of a payback for the past two quarters of strong growth than it is a new direction for the economy. Average annualized growth in real GDP from March to December will be roughly 3.5%.

In addition, nominal GDP, or total spending, has accelerated from a 3.6% annual growth rate in the second half

of 2006 to 6.2% in the past two quarters. This is an excellent signal that Fed policy is still accommodating. When the Fed is tight, the growth rate of nominal GDP, or aggregate demand, does not accelerate.

Despite all of this, many believe that credit-market problems have increased economic risk dramatically. Mr. Summers argues that "levels of the federal-funds rate that were neutral when the financial system was working normally are quite contractionary today." "Speculative markets will not stabilize themselves," wrote Paul Samuelson. For Messrs. Summers and Samuelson, only Fed action can save the world.

But this argument confuses money and credit. It is increases in the money supply that drive total spending (or aggregate demand), not increases in credit. Many people confuse the idea of a "money multiplier" with money creation. They believe banks can create money. This is not true: The Fed is the only entity in the world that creates new dollars.

In a fractional reserve banking system, the money multiplier works as banks lend out part of their deposits and keep some in reserve. Then the next bank, which receives deposits as a result of the first bank's loan, lends out part of the money again. This is repeated over and over so that every dollar of the monetary base is "multiplied" into many more dollars of lending or credit.

Despite problems at many major financial institutions, this process is not breaking down. The Fed is not behind the curve. When the Fed buys bonds to inject new liquidity into the banking system, that money doesn't go into a black hole. Even if a bank has had its capital eroded by large write-downs, it must invest the new cash. Some banks are putting the cash right back into Treasury bonds, which is one reason Treasury yields are so low. Banks need less capital to hold Treasury bonds than they need to hold loans to the private sector.

But, contrary to popular belief, when a bank buys Treasuries, the money mechanism does not stop. For every debit there must be a credit, and this continues endlessly. In fact, it may be that banks are buying those Treasury bonds from foreign holders, say the Abu Dhabi Investment Authority, which just made a huge investment in Citibank. In this case, the money came right back into the U.S. banking system.

There are an infinite number of paths that the monetary transmission mechanism can take. The only time it breaks down is when investors expect deflation, as in the Great Depression. This is when hoarding cash makes sense. But this is not the case today. Consumer prices are up 3.5% versus last year. As a result, as long as the Fed is accommodative, money will find its way into the financial system and the multiplier process will continue.

This does not require massive money center banks such as Citibank. It can happen through any well-capitalized institution. For example, tens of thousands of community and regional banks made few or no subprime loans and have large amounts of excess capital. They are in fantastic shape. However, because the cost of funds for banks does not fall quickly, and adjustable rate loans

reset immediately, a rate cut can hurt these banks' earnings. In addition, with uncertainty about the economy elevated, forcing banks to lend at lower rates doesn't make sense. Widening spreads between Treasury and private-sector bond yields are a signal that the federal-funds rate is too low, not too high. This helps explain why many regional Federal Reserve Bank presidents sound hawkish.

Hedge funds, private equity firms and nonfinancial corporations also have trillions in cash that is already being put to work. Citadel, a hedge fund, bought at-risk loan pools from E*Trade, and increased its investment stake by \$2.5 billion. The French parent of CIFG Services Inc., a major bond insurer, injected \$1.5 billion of new capital to shore up its balance sheet. Bank of America invested in Countrywide and HSBC brought its high-risk loans back onto its balance sheet.

The only real problem is that these "fixes" are not cheap. Citibank is paying 11% to Abu Dhabi. E*Trade reportedly sold its problem loans to Citadel for 27 cents on the dollar, a price many think is well below the true value. Institutions with cash and capital will make huge profits in this environment, while those without these two things will fight to survive. While not everyone is happy about it, the market is healing itself.

Some say that we can't risk a spillover of credit problems into the economy as a whole, but that ignores two things. First, outside of housing-related businesses and financial institutions that invested in subprime securities, the economy is in good shape. Despite many months of fearful forecasts and an erosion in consumer confidence, the economy remains resilient. Early holiday shopping data have been strong, car and truck sales rose in November and manufacturing continues to expand.

Second, more Fed rate cuts risk a weaker dollar, rising inflationary pressures and a new round of lax lending standards. Don't forget that similar arguments were used between 2001 and 2004 to justify a 1% federal-funds rate that was designed to ward off the significant and serious risk of deflation. That policy helped create the subprime lending crisis in the first place.

To top it off, as long as the Fed allows the market to believe more rate cuts are coming, the greater the incentive to put off business activity. An investor who wants to buy distressed property or debt, a potential home buyer, or a hedge fund looking to make a leveraged investment may choose to wait for lower interest rates before taking action. This delays the self-healing process of the marketplace.

All of this argues for a much more laissez-faire approach. Attempting to offset the problems caused by a few (i.e., a bailout), actually creates larger risks for the economy as a whole. The very act of saving the world puts it at greater risk.

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