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First Trust

Jul 14, 2008

Monday Morning Outlook

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Don't Forget Government Failure

Confidence in the economy is very low. Oil prices are very high. Stock prices are falling. Financial companies are losing money…some are failing. The government is busy bailing out Fannie Mae and Freddie Mac, creating "stimulus," establishing new lending facilities, and cutting interest rates. With all of this happening at the same time, it's not surprising that some people are questioning the basic underpinnings of capitalism. Trust in free markets seems to be falling and the idea of "market failure' is gaining ground.

For example, United Airlines just sent an open letter to all its customers asking them to join in a protest against "market speculation," which it says is driving up oil prices. At the same time, politicians are demanding more regulation of financial institutions.

A running theme is that if only the government had been more active in the first place, these problems could have been avoided. But in our view, instead of focusing on the mistakes businesses make, much more attention needs to be focused on the government failures that were the primary cause of our current problems.

As everyone who reads this page already knows, we believe the Federal Reserve cut interest rates too low, held rates there too long, and raised rates too slowly, all of which precipitated a sharp increase in inflationary pressures (including oil) and a housing feeding frenzy. Add to this the effects of the Community Reinvestment Act ("CRA"), which forced many lenders to finance homeowners who had a tenuous ability to repay, and we have a recipe for excess risk-taking in housing and painful increases in commodity prices.

The problems at Fannie Mae and Freddie Mac are also clear signs of what happens when government gets too involved in markets. Because investors have treated, correctly as is now clear, Fannie/Freddie as having an implicit government guarantee, they were able to grow much more rapidly than a free market would have allowed.

One of the reasons Fannie/Freddie are too big to fail (at least right now) is that their access to government credit has "crowded out" what could otherwise have been a flourishing competitive market in mortgage securitization, with no one firm dominant enough to necessitate federal help. In addition, because Fannie/Freddie were able to dominate the market using subsidized credit, they pushed private firms toward the fringes of the securitization process and into territory which included subprime and Alt-A loans. Clearly, Fannie/Freddie led to a world with greater securitization of mortgage debt than would otherwise be the case.

Unfortunately, in the headlong rush to fix problems that many assume were caused by the market, there is too little discussion of, or belief in, "government failure." And this can lead to even more mistakes in the future. For example, by cutting interest rates aggressively in the past ten months, the Fed has caused another leg up in oil prices. And blaming speculation undermines trust in markets. The good news is that the US has lived through similar problems in the past and thrived.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-15 / 7:30 am	Retail Sales - Jun	+0.4%	**+0.1%**		+1.0%
7:30 am	"Core" Retail Sales - Jun	+0.9%	**+0.9%**		+1.2%
7:30 am	PPI - Jun	+1.3%	**+1.8%**		+1.4%
7:30 am	"Core" PPI - Jun	+0.3%	**+0.3%**		+0.2%
7:30 am	Empire State Mfg Index - Jul	-7.8	**-5.0**		-8.7
7:30 am	Business Inventories - May	+0.5%	**+0.6%**		+0.5%
7-16 / 7:30 am	CPI - Jun	+0.7%	**+0.8%**		+0.6%
7:30 am	"Core" CPI - Jun	+0.2%	**+0.2%**		+0.2%
8:15 am	Industrial Production - Jun	0.1%	**+0.0%**		-0.2%
8:15 am	Capacity Utilization - Jun	79.4%	**79.2%**		79.4%
7-17 / 7:30 am	Housing Starts - Jun	0.960 Mil	**0.960 Mil**		0.975 Mil
7:30 am	Initial Claims - Jul 12	380K	**365K**		346K
9:00 am	Philly Fed Survey - Jul	-15.0	**-15.6**		-17.1