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First Trust

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Monday Morning Outlook

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Circling the Wagons

In a recent interview with the *Financial Times*, US Treasury Secretary Hank Paulson blamed the credit crisis on global imbalances. Specifically, he repeated a story-line popularized by Alan Greenspan and Ben Bernanke that a global savings glut (imbalance) pushed interest rates down around the world and drove investors toward riskier assets.

We call this "circling the wagons" because what this argument does is shift the blame. It shifts the blame off of the Fed, who pushed interest rates down too far in 2002-2004. It also lets the Fed off the hook for using the phrase "considerable period," in an era of 1% federal funds rates to basically double-dare hedge funds and investment banks to use massive leverage.

It lets rating agencies, which are sanctioned by the federal government, slide, despite their huge mistakes. It whitewashes Fannie Mae, Freddie Mac and the politicians who supported their ability to hold mortgage rates down artificially. It also ignores rules and regulations, such as the Community Reinvestment Act (which forced banks to make low income loans), and mark-to-market accounting (which artificially pushed up capital ratios at financial institutions in the early 2000s as the Fed cut interest rates and risk spreads narrowed as leverage increased).

Most importantly, it fans fears of global financial markets, free trade and free markets in general. If this argument influences policy debate, it will lead toward protectionism or devaluation.

The argument suggests that China (in particular), as well as other countries, holding massive reserves, created a glut of savings and low interest rates. The way China accumulated these dollars was by running a trade surplus. As a result, the Treasury Secretary is supporting an argument that either the US devalue the dollar or put up barriers to trade in order to keep this problem from ever happening again. Both of these "fixes" would further harm the economy.

Despite the high level of support for the "global imbalances" argument, we remain skeptical. First, the Fed controls short-term interest rates. And, when the Fed says that they will hold rates low for a considerable period (as it did in 2003), this encourages what Mr. Paulson called the "mis-pricing" of risk.

Secondly, if China (or other high trade surplus countries) would have used accumulated dollars to purchase goods and services from the US, those dollars would not disappear, they would still be in circulation. So, the idea that somehow there is a glut of money because one country or another is holding a big stash ignores the fact that no matter what that country did with the money it would still exist. If it were spent it would represent sales, profits, incomes, and savings for some other entity. For every debit, there must be a credit. The money would not disappear; it would be held by someone else and would still exert forces on the market.

While we understand the desire to circle the wagons and shift blame, the idea that a global savings glut destroyed the economy is seriously wanting. Hopefully, this is not the only line of thinking that determines the future course of policy reaction to the 2008 financial crisis.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-5 / 9:00 am	Construction Spending - Nov	-1.4%	**-1.6%**	-0.6%	-1.2%
sometime	Domestic Auto Sales - Dec	3.5 Mil	**3.3 Mil**		3.6 Mil
during the day	Domestic Truck Sales - Dec	4.0 Mil	**4.3 Mil**		4.0 Mil
1-6 / 9:00 am	Factory Orders - Dec	-2.3%	**-1.3%**		-5.8%
9:00 am	ISM Non-Man. - Dec	36.5	**37.7**		37.3
1-8 / 7:30 am	Initial Claims - Jan 3	545K	**519K**		492K
2:00 pm	Consumer Credit - Nov	+$0.0 Bil	**-$1.5 Bil**		-$3.5 Bil
1-9 / 7:30 am	Non-Farm Payrolls - Dec	-500K	**-505K**		-533K
7:30 am	Unemployment Rate - Dec	7.0%	**6.9%**		6.7%
7:30 am	Average Hourly Earnings - Dec	+0.2%	**+0.3%**		+0.4%
7:30 am	Manufacturing Payrolls - Dec	-103K	**-120K**		-85K
7:30 am	Average Weekly Hours - Dec	33.5	**33.5**		33.5