

In the 'Closed' World Economy, There Are No Imbalances

By John Tamny

"There will not be a 'surplus' of capital until the most backward country is as well equipped technologically as the most advanced." – Henry Hazlitt, *Economics In One Lesson*, p. 188

As the world economy begins to recover from the financial crisis of 2008, myriad post-mortems have sprung up from individuals seeking to explain its causes. Increasingly popular is the notion of "global imbalances" having driven faulty investment in the countries that imported a great deal of capital earlier in the decade.

In a recent piece for the *New York Times*, columnist David Brooks observed that our "economic crisis was caused by a complex web of factors, including global imbalances caused by the rise of China."^[i] In a speech at the University of Exeter, Bank of England Governor Mervyn King stated his belief that "'If countries do not work together to reduce the 'too high to last' imbalances, a crisis of one sort or another in financial markets is only too likely."^[ii] Last fall, at a San Francisco Fed conference in Santa Barbara, Fed Chairman Ben Bernanke warned that governments must "avoid ever-increasing and unsustainable imbalances in trade and capital flows."^[iii]

All three subscribe to the belief that country economies can overflow with an excess of capital. The supposition here is that a country in possession of too much money will suffer poor investment decisions that result essentially from too much money chasing too few investment opportunities.

Much the same, if countries practice export strategies to the exclusion of imports, they'll similarly return capital to the countries exported too with overinvestment once again the result. Unless countries get together to address these trade and capital imbalances, overinvestment in the countries which import excess capital will supposedly drive yet another investment-led collapse.

The problem with all of this theorizing is that countries don't trade or invest, rather it is individuals who do both. As for the notion of "too much capital," the very concept is a logical impossibility owing to the certainty that we as humans have unlimited wants that entrepreneurs are constantly seeking to fulfill through the accession of what is always limited capital. Put simply, the world's economy is the only closed economy, and since the world economy is merely the sum total of individual economic effort worldwide, there's no such thing as a global imbalance.

Countries Don't Trade, but People Do

In a typical financial publication today, the concept of trade frequently centers on exchange between countries. The variations are constant, but we often read of "Japan" exporting the goods it produces to the "United States", and the "United States" exporting its wares to

“Canada.” And if Japan exports more to the US than the US exports to Japan, it is said that the two countries aren’t in balance.

On its face this description is a misnomer. In truth, only individuals trade. As singular economic entities all, we can only demand after we’ve produced first, at which point it should be said that trade between two countries is nothing more than the exchange of myriad goods between consenting individuals.

Conventional economists often reference trade “imbalances” between countries, but broken down to the individual, we can see once again that no such imbalance exists. Considering the average person who goes to work each day, this individual usually runs numerous small trade deficits that are paid for by one large trade surplus.

Specifically, the typical working adult has trade deficits with his landlord, drycleaner, restaurants frequented and a local car dealer, but to fund those supposed deficits, this same individual carries a trade surplus with his employer. Looked at from the perspective of the individual, all trade balances because demand always matches production.

Of course it’s often said through a foggy macroeconomic lens that certain countries pursue “export strategies” whereby their imports don’t match what they export. China is frequently fingered as the main miscreant here given the high rates of saving among its citizens.

Happily, this supposed imbalance is also easy to explain, and the explanation is easy precisely because there’s no imbalance to speak of. Indeed, assuming the highly fanciful notion that the Chinese are producing solely for our benefit and banking all of their savings, the aforementioned savings – unless stashed under a mattress – are a form of demand even if the Chinese themselves aren’t spending at all.

That’s the case due to the economic tautology which tells us no act of saving ever detracts from demand. Instead, savers merely shift their consumption to other individuals, or better yet, their savings are lent to businesses eager to grow. As evidenced by exports with a Chinese origin, its citizens are by definition importing goods of equal value; that or lending excess funds to others with near-term designs on imports.

Imbalances In the United States?

To develop a better sense of why economic imbalances cannot be, it’s useful to look within the United States. With there existing fifty different states in the union, are there capital imbalances to speak of?

Not in the way that economists might assume. Indeed, what’s so fascinating about the very discussion of supposed global imbalances is that if real, they would logically show up on a country by country basis within the states in each country. Importantly, the situation stateside offers insights into an economic concept that is overdone, misunderstood, or both.

In the US we don't so much have imbalances of capital as we have talent imbalances and innovation imbalances that attract or repel capital. Notably, it's a rare economist who will decry capital or trade imbalances between Arkansas or Tennessee, or California and Arizona.

Instead, it is through financial flows in the US that poor stewards of capital are starved of it, while good managers receive it in abundance. And far from a driver of economic crisis, these capital flows or "imbalances" are an essential agent of growth by virtue of the fact that best economic practices are rewarded.

In that sense, the rise of Ford Motor Company served as a capital magnet back in the early part of the 20th century as Ford's success led to copycats in and around Detroit that similarly were able to attract financing. Back then, talent and capital often found its way to the industrial Midwest.

In the 1970s, oil's spike amid the dollar's decline wreaked havoc on the Big Three automakers in Michigan, after which a great deal of talent and capital was redirected to states like Texas and Louisiana where oil was plentiful. In the '80s and '90s we witnessed the rise of software and technology firms such that California's Silicon Valley, Boston's Route 128 and Austin, TX were the recipients of human and financial inflows.

Far from an economic retardant, the change in investor preference merely spoke to market forces once again reorienting capital to its highest use. In the future, depending on where talent and innovation in the U.S. are most prevalent, capital will follow.

And far from an economic negative for the parts of the country that investment migrates from, reduced investment flows will serve as a market signal to individuals in depressed locales to either relocate, change their business strategies, or demand that local and state governments moderate tax and regulatory policies that are luring what economist Reuven Brenner refers to as the "vital few" away.

If Not States, What About Country Imbalances?

To answer the above question, it seems a basic thought experiment is in order. What if Mexico and Canada became our 51st and 52nd states?

If they did join the union, it's a fair bet that soon enough all the worrying over jobs lost to our southern neighbor would disappear. And as Canadian oil interests are the largest provider of "foreign oil" to US refiners, it seems that the misbegotten fear over job losses and oil imports would disappear.

We once again don't concern ourselves over the trade balance between Texas and Tennessee, but when foreign countries are introduced to the mix, what doesn't matter within our borders suddenly becomes a pressing issue.

But if it's remembered that the only closed economy is the world economy, it becomes apparent that capital and trade flows between countries are no different than they are between our fifty states. Once again, capital flows are merely a function of where people are most productive.

Importantly, inter-country capital flows have long been with us, and those financial flows have helped formerly undeveloped countries achieve first-world status. As economists David Backus and Thomas Cooley recently observed in the *Wall Street Journal*, "England financed canals in this country and railroads in Australia and India."^[iv]

More modernly Backus and Cooley note that the US, Australia, Spain and the UK have been importers of capital, while "Germany, Japan, China and Switzerland have been significant exporters of capital."^[v] Rather than a driver of economy destabilizing imbalances, these capital flows have simply been an acknowledgement on the part of profit interested investors that within certain countries the combination of ideas, talent and property laws are most welcoming to investment.

Is There Such Thing as Too Much Capital?

Answering a question similar to the one above, the great economist Henry Hazlitt once responded that "It is incredible that such a view could prevail even among the ignorant."^[vi] Hazlitt understood well an earlier made point that with human wants unlimited and forever unmet, there will never be enough capital to fix all that needs fixing.

Economics at its core is about entrepreneurs easing our myriad needs, so until we reach a point at which everyone is sated, and every productivity-enhancing innovation has reached all sources of production, there will always be a need for new capital. Indeed, while the word "capital" conjures up "money" in the minds of most, the word capital is really about access to mechanical and human inputs in order to utilize them both in more productive ways.

Free capital is what enabled Ford to produce cars that replaced the horse-drawn carriage, allowed the ATM to replace the traditional bank teller, and which turned tortoise-like land-line Internet access into a high-speed service that increasingly serves as our source of communication, news and television. To assume that there ever might be a time of too much capital is to suggest that someday society will be so intellectually bankrupt that ideas will disappear altogether.

A more absurd notion would be hard to comprehend. An overflow of capital due to global imbalances was far from the driver of the 2008 financial crisis despite the protests of some of the world's best known writers and economists.

If Not Global Imbalances, Then What?

What happened this decade instead was something driven by what economists term a "money illusion." The weak dollar drove a recessionary rush to unproductive, hard assets

and this is what created a global recession. And then, once governments intervened to fix a mistake of their own making, the global crisis was born.

The decade's "global imbalances" were no such thing. Instead the world suffered a currency imbalance driven by a weak dollar. Indeed, had the dollar been stable this decade, there's no way we're presently discussing global imbalances.

That is so because the dollar is the single most important price in the world. And to prove this isn't just my American pride talking, I'll quote Otmar Emminger, president of Germany's Bundesbank in the 1980s, who similarly said the dollar is "the most important price in the world economy."

Now why is this the case?

It is because with so many goods and worldwide transactions either priced in dollars or priced in currencies with explicit or vague definitions in terms of the dollar, when the unit of account changes in value, market prices and investments worldwide are distorted. At present the dollar factors into 90 percent of all trades in what is a \$3.2 trillion currency market. It's also the case that nearly two-thirds of the world's central bank reserves are held in dollars. Furthermore, when we consider cross-border transactions between two foreign countries with thinly traded currencies, the dollar remains the go-between currency for the majority of those exchanges. Put simply, if we were in a stable dollar environment this past decade, today's historic market and economic problems would not be with us.

Now, to exhibit what I think is the dollar's substantial power, I want to digress a bit and talk about U.S. equity returns going back to the 1950s. About equities, for the longest time I thought their biggest driver was the level of taxation – if taxes were going down, equities performed better than if taxes were going up.

Generally I still believe this because when we think about taxes, it can't be stressed enough that they're a price. And when the price of work is increased, there's less economy-enhancing production than if the price is decreased. Still, it didn't take me long to figure out that my basic assumption about taxes and equity returns was wanting.

Indeed, in the 1950s the top rate of taxation in the U.S. was 91%, but the S&P 500 rose 253% that decade. My explanation for why is that the dollar had a strict definition of 1/35th of an ounce of gold. Markets love currency certainty, and stocks soared.

In the 1960s we actually reduced the top tax rate to 70%, and stocks did very well, the S&P hitting an all-time-high in 1966. But what's interesting here is that the S&P never rose above its 1966 high for good until 1982. In my mind, the explanation why is fairly simple: by the mid-'60s it became apparent to investors that our commitment to a stable dollar was waning. This showed up most noticeably in the private markets for gold, which revealed a much higher price than the \$35 fix. Markets hate inflation, and the S&P only rose 54% in the '60s.

The '70s are even easier to explain. In 1971 President Nixon took us off the gold standard, and in doing so he removed the world from a dollar/gold standard. In that sense it's no surprise that commodities across the board skyrocketed in the 1970s. The commodity spike wasn't the result of rising demand; rather it was a function of commodities becoming expensive because currencies were cheap. Stocks hate hyperinflation, and the S&P only rose 17% in the '70s.

In the '80s we saw a grand improvement in policy. Ronald Reagan was elected on a platform of reduced taxes and regulation, and most notably, he was a strong-dollar president. The price of gold collapsed on his watch as the dollar strengthened, and no surprise the S&P rose 121% during his presidency.

I'll skip the first President Bush now, and move to President Clinton. I thought he got taxes wrong with increases in 1993, but it should also be said that dollar policy on his watch – with the exception of the end of his presidency when the dollar became too strong – was the best of any modern President. With the dollar strong and stable throughout the vast majority of his two terms, equities rallied and rose 208% during his presidency.

All of which brings us to George W. Bush. I think he got tax cuts right in 2003, but it should also be said that dollar policy under him was nothing short of horrific. The dollar was in freefall (as evidenced by gold's spike) throughout much of his two terms, and no surprise the S&P 500 fell 34% during his presidency.

So the rest of the world should blanch at US dollar policy because when the dollar gyrates in value, it causes shockwaves around the world. Indeed, Japan's lost two decades of deflation would have never occurred had protectionist politicians in the U.S. not forced a much higher yen value on the BOJ, and if we hadn't let the dollar spiral upward in value in the late '90s, it's fair to say that the economies of Thailand, Malaysia, South Korea, Russia and Argentina's would not have collapsed.

And the dollar's collapse this decade I think neatly explains the property boom worldwide, along with the subsequent bust. Once again the global recession was *caused* by the rush to the housing as people chased rising home prices, not by housing's eventual moderation.

The above in mind, some say the solution to our economic problems now is for governments to pursue policies that would enhance the housing market, but I say they get their sequencing backwards. Indeed, housing anywhere in the world does not make us more efficient or productive, it does not open up new markets, nor does a thriving housing market stimulate the very entrepreneurs who drive most any economy.

Worst of all, housing ties us to certain regions, states, cities or countries, which means we can't follow opportunities based on capital flows. Housing is anti-growth.

Put simply, the worldwide rush to housing this decade is what created our general economic malaise whereby limited capital flowed into hard, unproductive assets, so to

stimulate as governments are now trying is to harm the world economy while missing what drives economic growth. Conversely, when we put money in the bank or into a brokerage account, we provide capital to entrepreneurs.

The rush to housing was a rush away from growth opportunities.

Now for background on what caused the housing boom, many of you are likely familiar with the conventional commentary in the States and around the world about what caused the alleged housing “bubble.”

To many, including Martin Wolf of the *Financial Times*, along with the *Wall Street Journal's* editorial page, former Fed Chairman Alan Greenspan's policies in the area of nominal interest rates early in this decade were the cause of the rush to housing. What's apparent is that both Greenspan *and* his critics have misread what drove the nominal gains in home prices in recent years.

Greenspan's critics conclude to varying degrees that his decision to reduce the Fed funds target to 1 percent, in 2003, where it remained for a year, was the cause of the property boom and that the reversal of this policy was the cause of subsequent house price declines.

For his critics to be correct there would presumably have to exist historical evidence showing that low nominal rates of interest have correlated with vibrant housing markets. Very little evidence supporting such a claim can be found.

Take, for example, the aftermath of President Nixon's decision to sever the dollar's link to gold, when the cash rate targeted by the Fed began to rise. Sitting at 5.5 percent in August of 1971, it reached a high of 10 percent by the end of 1973. Despite this substantial increase in the rate target, according to economic historian Allen Matusow's book *Nixon's Economy*, “Housing emerged as the most dynamic sector” in the early 70s.

Moving to Jimmy Carter's presidency, from a low of 5 percent in 1976, the Fed funds rate rose all the way to 13 percent by the end of the decade. But housing hardly faltered, as George Gilder found in his 1981 book, *Wealth and Poverty*. Describing the late '70s property boom that occurred amidst skyrocketing interest rates, Gilder wrote, “What happened was that citizens speculated on their homes...Not only did their houses tend to rise in value about 20 percent faster than the price index, but with their small equity exposure they could gain higher percentage returns than all but the most phenomenally lucky shareholders.” Shades of this decade?

To show how this seemingly contrarian rate phenomenon is not unique to the U.S., we can first look to Great Britain in the 70s. Although the Bank of England moved the bank rate from 5 to 9 percent in 1972, David Smith noted in *The Rise and Fall of Monetarism* that the sector which investors “chose above all others was property development.” Reflecting on the pound crisis years later, the June 1978 Bank of England *Quarterly Bulletin* explained that “There was no other general area of economic activity which seemed to offer as good a

prospective rate of return to an entrepreneur as property development.” That was the case owing to the belief “that property was the inflation hedge *par excellence*.”

Going back even further in time, we can look at what happened in Germany in the aftermath of the Great War. As economist Benjamin Anderson noted in *Economics and the Public Welfare*, “with the mark declining rapidly the wise thing to do was to go heavily into debt, purchase any kind of real values – real estate, commodities, foreign exchange – hold them for a time, then sell a small part of the purchases and pay off the debt.

The great Austrian economist Ludwig Von Mises referred to what I’ve described as a “flight to the real”, and indeed, that’s what individuals have been doing the world over ever since currencies came into existence. When they’re losing value, the only consistent moneymaking concept involves borrowing heavily in order to speculate on hard, commoditized assets that tend to rise when currencies fall. That, in my mind, describes this past decade well.

Notably, empirical evidence produced by H.C. *Wainwright Economics* supports the conclusion that rising rates of interest don’t drive down housing prices in the way that intuition perhaps suggests they might. Indeed, nominal home prices since 1976 have increased the most when interest rates have risen over 200 basis points, and they’ve declined the most when those same rates have fallen more than 200 basis points.

The weak dollar was the driver of the global real estate boom, and now I’ll explain why. In the U.S., while the Federal Reserve issues dollars, it’s rare for a Fed official to comment on the dollar’s value. That’s with good reason because the dollar’s value is the preserve of the U.S. Treasury, and as a result, Treasury secretaries have historically been able to move the dollar’s value on world markets with simple comments about the greenback, pro or con.

Looking at this from the perspective of Treasury actions in this decade, Secretaries Paul O’Neill and John Snow mocked or questioned the importance of a strong dollar, while Secretary Henry Paulson frequently attempted to use his outsized reputation in China to force a revaluation of the yuan against the dollar. The actions of all three secretaries were an implicit communication to the markets that a weaker dollar was the Bush administration’s true policy, and those policies, combined with 9/11 and the imposition of tariffs on steel, lumber and shrimp amid George W. Bush’s presidency led to a falling dollar that powerfully drove up nominal home prices.

Put simply, when the unit of account weakens, there’s as mentioned previously a flight to the real. Not only is housing an asset that is least vulnerable to a falling currency, it’s an asset that in fact thrives in nominal terms in times of currency weakness. So while low rates and unfortunate housing subsidies of the Fannie Mae and Freddie Mac variety certainly contributed to the property boom and subsequent moderation, the major factor has been dollar debasement that in my Wainwright colleague David Ranson’s words led capital “into assets that are invulnerable” to that same debasement.

In short, for Greenspan's critics to be correct, there would have to be an historical correlation between low nominal rates of interest and currency weakness. That's there's very little speaks to criticism of the former Fed Chair that's either misdirected, or unclear.

I should stress that this talk is in no way meant to defend Alan Greenspan. Indeed, I could talk for hours about the various mistakes made on his watch, but I don't feel the evidence supports the popular claim that his interest rate policies brought us to where we are. Now, what's odd is that Mr. Greenspan's recent responses to his critics have rightly failed when it came to repairing any reputation lost. More surprisingly, he's embraced the very supposition about low rates and housing vitality used by his critics.

In Greenspan's case, he's pointed to falling rates as the driver of "remarkably similar housing bubbles that emerged in more than two dozen countries between 2001 and 2006." To his way of thinking, a glut of savings worldwide pushed rates downward such that housing was the sure beneficiary.

Greenspan has concluded that "the evidence that monetary policy added to the bubble is statistically very fragile." By his lights, if there was such thing as a property bubble, it was a world event rather than something endemic to the United States.

In defending himself incorrectly, Greenspan missed the chance to prove his critics wrong. Contrary to his suggestions otherwise, monetary policy *was* at the heart of this decade's real-estate boom, but not in the way Greenspan's critics assume.

Mentioned earlier was the falling dollar since 2001, and the combination of geopolitical and policy factors that led to its weakness. Though the nominal level of rates (in particular, low rates) is a not very predictive indicator when it comes to the value of the dollar, exogenous and endogenous factors have historically affected the dollar negatively, and did so in this decade. So in talking about monetary policy, we should say the absence of policy, particularly any policy from the U.S. Treasury meant to define the greenback's price, made the dollar's value vulnerable such that it weakened and fed the property boom.

And when we consider Greenspan's argument that real estate rallied around the world, it has to be remembered that when the dollar weakens, foreign central banks frequently feel the need to devalue their currencies alongside ours. Indeed, lost in all the modern commentary about the dollar's weakness versus all manner of foreign currencies is the certain truth that a falling dollar begets world inflation.

Simply put, comparing the dollar against other kinds of money in a floating currency world involves comparing one piece of paper lacking definition to another. When we bring an objective benchmark such as gold into the equation, an entirely different story emerges.

This story is a basic one, and it shows that the oft-chronicled foreign currency strength through last year was a mirage; one that obscured the broad currency weakness that the dollar's even greater weakness helped to obscure. From mid-2001 to April of 2008, and I use April of 2008 as the point in time when housing really started to moderate alongside

the collapse of Bear Stearns, the price of gold in terms of the British pound, euro and Aussie dollar respectively increased 151, 101, and 94 percent, while our neighbors in Canada saw the price of gold in terms of their own dollar rise 122 percent.

Some in the audience might question my use of gold as the benchmark, but it's realistically the most objective measure of value that we have. And gold's rise in various non-dollar currencies reveals a broad run on paper currencies worldwide.

The "why" in this equation is that seeking to maintain some level of parity with the dollar with trade in mind, foreign central banks throughout much of this decade added to U.S. monetary mistakes by allowing their own currencies to depreciate relative to gold. And with real estate most correlative with commodities, dollar policy stateside led to a worldwide commodity boom in nominal terms that drove capital into appreciating real assets including housing. A lot has been said about the recent moderation of home prices, but the real correction will occur if and when U.S. monetary authorities seek to rein in dollar weakness; dollar strength certain to lead to stronger currencies worldwide.

In short, there are varying views as to the Fed's ability to control the dollar's value with its interest-rate mechanism. But for one to tie this decade's property boom to the level of rates is to defy history suggesting otherwise.

So how did the worldwide rush to housing get us to where we are?

In inflationary periods, banks chase returns too, and housing was correctly seen as a safe haven. The problem here is that the money illusion can only last so long. That's the case because inflation is and always has been an economic retardant. When all manner of capital is flowing into the proverbial ground, that means there's a great deal less flowing into the entrepreneurial, or wage economy.

Looked at from a practical standpoint, individuals around the world, but most noticeably in the U.S., saw housing prices moving powerfully higher. Witnessing this, they borrowed from eager banks in order to buy more house than they could afford on the assumption that if their mortgages ever became too hard to service, there would be a willing buyer ready to snap up the house for a higher price than the original purchase.

What the average person perhaps didn't foresee is that inflation is death by a thousand cuts. Not only does it erode the value of our existing wages (consider how gasoline prices spiked this decade), but since it creates massive incentives for people to invest in hard objects, there's less capital available for investment in the productive economy. Simplified, real wages were reduced alongside rising mortgage payments that could not be serviced. All of this led to the defaults that eroded bank balance sheets, and those same balance sheets were made worse by government intervention stateside that made it impossible for intrepid investors to price the assets.

Importantly, all of the above should have led to a brief correction. All manner of businesses make mistakes all the time, and historically, particularly in the United States, we've allowed

businesses failures to have their assets swallowed by others. This is the price of prosperity, but it's a good price in that it shows that capitalism is working.

Sadly, this time around, there was a collective blink on both sides of the U.S. political aisle in April of 2008, and I believe it explains what ultimately got us here. Horrific dollar policy led to the very malinvestment that would have given us a slowdown, but our bailout/stimulus culture truly tanked the economy.

To a high degree the capitalist consensus held until last spring. It was then that Bear Stearns, a fairly minor bulge bracket investment bank, ran into trouble. With its share price in freefall heading into the weekend, officials at Treasury and the Federal Reserve effectively blinked, and a forced marriage ensued in which J.P. Morgan purchased Bear for next to nothing in return for the Fed taking on the fallen investment bank's "toxic assets."

Even though Bear Stearns wasn't a bank in the traditional sense, government involvement was defended by some as necessary to avert a collapse of the financial system. Myriad other financial institutions had exposure ("counterparty risk") to trades entered into by Bear, and absent the infusion of government capital, our system of credit would supposedly have cascaded downward, Depression the certain result.

About the notion of bank "contagion" or a "banking domino effect", it should be noted that the only scholarly work ever done on the subject was written by none other than our present Fed Chairman, Ben Bernanke, back in the early '80s. But Bernanke's fears of a domino effect with regard to banks were then, and remain pure conjecture. And assuming the domino effect is real, when we consider how whole countries have bounced back from total economic and human destruction as a result of war, it seems a reach to assume that the world economy would fail to bounce back from the demise of one or many banks.

That is so because when businesses fail, they in no way disappear. Instead, an opportunity arises for competitors to quickly snap up market share, not to mention that capital previously misused by the failed business in question is quickly redirected to those with a stated objective to deploy it more wisely.

Had Bear simply been allowed to go under, there doubtless would have been turbulent markets, but it would be hard to presume any more turbulent than they've been since Bear's collapse. More important, had the Fed and Treasury simply stood aside, Bear's failure would have been a certain signal to other teetering banks to either find new capital, or quickly find a buyer.

More important, and as we've seen very clearly since the bailouts began, government aid meant to avoid "systemic risk" creates risks far worse for the banking system. Indeed, the acceptance of government aid, rather than a bank savior, is a death sentence for the weak and healthy alike.

Those that accept government money are no longer in business for profit, and worse, their existence is a cancer on the healthy firms in the banking system who must compete with

financial institutions no longer serving profit-driven shareholders. Systemic risk was the excuse for shedding free-market principles, but the far more treacherous risk of government ownership was seemingly never considered by many.

Many people point to the subsequent collapse of Lehman Brothers as the true beginning of the financial crisis, but what's often forgotten is that a week after Lehman's bankruptcy, the S&P 500 was higher than it was before the announcement.

Indeed, in considering the causes of the crisis, free markets have historically cheered markets, while government intervention has most often driven investors to the sidelines. Looking back on the "global financial crisis", in concert with Lehman's collapse regulators banned the short-selling of financial stocks which in truth was a ban on buying stocks (short-sellers are by definition tomorrow's buyers), not to mention that investors had to price in a financial future that almost certainly would be characterized by much more muscular government intervention worldwide. And we wonder why stocks tanked?

Conclusion

As opposed to a world economy undone by "global imbalances", it seems a better answer would be that the world economy suffered currency fluctuations driven most notably by a weak, unstable dollar. Indeed, as past Wainwright publications have made plain, when the dollar declines in value, this is frequently a worldwide event as central banks mimic US Treasury policy to varying degrees under the mistaken belief that exported goods will become too pricy absent similar currency debasement.

Looking back on this decade, the dollar began its long descent versus gold in 2001, and as David Ranson and Penny Russell observed in 2007 in the *Wall Street Journal*, the dollar's decade-long decline against nearly every major foreign currency "obscured the fact that the world economy" had "embarked on another classic 'run' on paper currencies."^[vii] And with hard assets like housing frequently the nominal beneficiaries of currency weakness, capital around the world flowed into assets traditionally least vulnerable to that same weakness.

Austrian School economist Ludwig Von Mises noted in *The Theory of Money and Credit* that "monetary depreciation falsifies capital accounting."^[viii] Looked at in light of what happened this decade, Austrian malinvestment drove all manner of investment mistakes that obscured the true health of bank balance sheets ahead of looming economic weakness driven by a migration of capital to hard, unproductive assets.

In that certain sense, the "global imbalances" referenced by leading economic lights were nothing of the sort. Instead, it should be said that inflation is always and everywhere an economic retardant. Thanks to a decline among currencies of all shapes and sizes from 2001-2008, there was an "investment imbalance" that resulted from currency fluctuations which at least for a time, camouflaged how poorly capital was being deployed.

The modern approach to economics has largely been "macro" in nature, by which country economies have been viewed as living, breathing entities unto themselves, as opposed to a

collection of singular economic actors pursuing individual self-interest. As a result of this macro approach, a great deal of commentary has sprung up concerning country trade and capital flows on the mistaken assumption that countries trade and invest with each other, as opposed to individuals investing and trading with other individuals without regard to country border.

As self-interested producers our trade flows by definition balance because we can only buy insofar as we sell first, consumption and production merely two identical sides of the same coin. In light of that truth, trade imbalances of any kind can't be precisely because no individual can over or under-consume.

When global investment imbalances are considered in the context of a closed economy of individual producers, the very notion collapses under its own illogic. Indeed, since no individual can ever prosper or innovate too much, it's plainly impossible that one city, state or country can ever be the recipient of too much investment. Instead, investment is only limited by our singular power to invent.

Looking back on the financial crisis of not long ago, it was decidedly not a function of mythical global imbalances. Instead, the money prices of investments around the world were distorted by currency fluctuations that ensured the kind of investment mistakes that invariably lead to economic downturns.

^[i] David Brooks, "The Populist Addiction", *New York Times*, January 25, 2010

^[ii] Ashley Seager, "Beware global economic imbalances, Mervyn King warns", *The Guardian (UK)*, January 20, 2010

^[iii] John Tamny, "Ben Bernanke Is a Walking Economic Fallacy", *Forbes*, November 2, 2009

^[iv] David Backus and Thomas Cooley, "Global 'Imbalances' and the Crisis", *Wall Street Journal*, January 11, 2010

^[v] *ibid*

^[vi] Henry Hazlitt, "*Economics In One Lesson*", Three Rivers Press, 1979, p. 188

^[vii] David Ranson and Penny Russell, "Money Meltdown", *Wall Street Journal*, July 5, 2007

^[viii] Ludwig Von Mises, "*The Theory of Money and Credit*", Liberty Fund Books, 1980, p. 236