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Subprime mess is the ghost of Greenspan past

The former Fed chairman has himself to blame for Wall Street's problems

SUMMING IT UP

William Rutherford

Once upon a time in the reign of Dr. Sir Alan Greenspan (yes, he now uses the honorifics – doctor, an honorary title, was awarded to him for his magazine articles, and sir was bestowed on him by the Queen in 2000, during the market crash, for "his contribution to the global economy"), we had the biggest market decline since the Great Depression. Two and a half million people lost their jobs, and $7.5 trillion in savings was wiped out. (Only recently has the Standard & Poor's 500-stock index rebounded to its 2000 level.)

Sir Alan, then the Federal Reserve's chairman, and his fellow Fed governors began to worry about depression and disinflation, where the values of things begin to fall.

Deflation is a very scary thing, even scarier than inflation, so Sir Alan, who doesn't believe the government should interfere in markets, lowered interest rates to 1 percent in 2003 and kept interest rates unusually low for a long time. The point of this lowering was to get consumers to borrow money and spend it, thereby reflating the economy.

The consumer took the bait. U.S. savings rates turned negative, and American consumers loaded up with debt, especially in the home mortgage market. We saw the remarkable scene of the Federal Reserve chairman publicly asking people to take out variable rate mortgages.

Subprime mortgage lenders made home loans available to buyers who did not otherwise qualify for mortgages. Greenspan, because of his deregulatory philosophy, blocked a proposal to increase scrutiny of subprime lenders during his term, according to a former Fed governor, Edward Gramlich.

Gramlich says he raised the issue directly with Greenspan, but Greenspan rebuffed the suggestion. Greenspan has confirmed his opposition to any oversight. Now, with 13 percent of subprime loans at or near foreclosure, tens of thousands of homeowners are near eviction.

Wall Street, which was all too happy to finance the subprime loans, now finds itself with major problems, and one of the problems is that the Street does not know how big the problem is or will get. Trillions of dollars may be involved, casting a cloud over both debt and equity markets. Private equity transactions may slow.

The subprime problem has already affected at least one Wall Street firm that initially pledged $3.2 billion of its own capital to shore up the funds it sold to finance subprime debt. This is another legacy of Greenspan that has yet to run its course, and it means the current Fed chairman, Ben Bernanke, has yet another Greenspan mess to clean up.

On the one hand, Bernanke has the sub prime problem which could use a dose of lower interest rates, but on the other hand he has inflation, to fight.

Government statistics show the core rate of inflation under control (if you

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leave out those pesky food and oil prices, which have been rising). In May, food prices rose 4.7 percent from a year earlier, a rate of increase is clearly outside the guidelines of the Federal Reserve. Misguided government policies toward ethanol, more political than economic, are pushing up the price of food at all levels. The price of milk, corn, soybeans and wheat approach their highest levels. Henry I. Miller, a fellow at the Hoover Institution, reports that experts speculate milk could cost $5 a gallon by year's end. A gallon of milk already costs more than a gallon of gas in some states. This has caused many restaurants to raise prices and lower profit forecasts. Across the board, food prices are up, as every grocery shopper knows.

In some instances – for example, look at prime beef – shortages are occurring. This inflationary pressure is happening at the same time food shortages are developing

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in other countries. For instance, tuna has become scarce in Japan, as well as pork in China, food staples in both countries. All of this puts food prices on an upward bias.

The implications of rising food costs go far beyond just the prices, as they have political and macroeconomic implications too. Rising food prices in China could lead the government to allow its currency to appreciate. Indeed, China recently has widened the trading band for the yuan.

Could this be a precursor to a floating yuan? If so, this could mean less appetite for U.S. bonds, which could mean rising bond yields, with further negative implications for the financial markets. So, just at a time when the Fed could use a little help, the ghost of Greenspan, in the form of the subprime mess, reappears.

Fact: China is facing a severe water problem. There isn't enough – most of it is concentrated in the south – and it increasingly is unfit to drink. China requires more than 10 times the water required in the United States to produce a dollar of GDP. The use of water by farmers is subsidized heavily by the government, giving farmers little reason to conserve. Removing water subsidies would create higher food prices and might bring food shortages and perhaps social upheaval.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar for its three- and five-year returns. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact Rutherford at 888-755-6546 or on the Web at www.rutherfordinvestment.com.