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Bernanke talks tough

Fed serves notice that interest rates will be going up

SUMMING IT UP

William Rutherford

On May 28 I appeared on CNBC and was asked about the declining U.S. dollar. During the interview I said that a strong dollar was in our interest. It didn't take long for Ben Bernanke, Chairman of the Federal Reserve, to get the message. Last week Mr. Bernanke talked tough to the markets. In an unusual statement, he specifically addressed the weak dollar and put the markets on notice that the next fed interest rate move would be up.

The topic of the dollar's weakness is usually left to Treasury officials to discuss. It is unusual for any central banker, not just the Chairman of the Federal Reserve, to discuss the level of a currency. Perhaps Bernanke was dissatisfied with the executive branch's handling of our dollar policy. Perhaps he was dissatisfied with congressional policies that weaken the dollar. Perhaps he too believed that a stronger dollar would lower the price of oil. No doubt he thought a tougher Fed policy and the stronger dollar would slow inflation and be good for the economy as a whole. In the latter, he was correct.

For a long time the price of oil has been trading inversely to the dollar. As the dollar weakens, inflation becomes a more pressing issue for Americans. It has been long commented in this column about the dilemma the Fed faces in assisting a faltering economy while still containing inflation. If the Fed lowers interest rates to aid the housing and credit markets, the dollar will weaken and more inflationary pressures will result. The Fed must act now to halt inflation, before inflationary expectations become the norm and a self-fulfilling prophecy.

After a slow start, the Fed has done a good job of aiding the housing and credit markets. Not only did it lower interest rates dramatically, but it did heroic work over a weekend to stave off disaster with Bear Stearns. The Fed has been roundly and soundly criticized for its efforts, and yes, it is accepting questionable collateral from financial institutions of all stripes, but did it really have a choice? What was the choice? Failure to act would have led to a disaster of titanic proportions. The Fed did the right thing.

Credit markets, at least at the institutional level, are reportedly loosening up. However, at the retail level, credit standards are tightening, and so, while the government bails out the banks, they are becoming more restrictive in their lending and thereby undermining the Fed.

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Furthermore, banks continue to announce surprising write-offs. You would think that by now they would know the magnitude of their problems. And problems in the commercial loan market are forthcoming.

Locally, we witnessed a significant problem in the commercial lending market when a bank called a loan of a local builder. The result was that 60 subcontractors did not get paid and the builder was subsequently pressured.

Large banks have raised enormous amounts of capital to shore up their balance sheets, which may not leave many capital-raising opportunities for regional and smaller banks. We will likely see bank failures or at least shotgun marriages before long.

The housing market continues to appear bleak. But when compared to disposable income per capita, housing prices appear to be below normal, according to the National Association of Realtors index. Other indexes disagree, but the NAR appears to be more reliable in the current circumstances. At least it appears that the worst is behind us in regard to falling house prices. Future declines should be moderate, and if those fickle banks will lend to buyers, we might even see the beginning of a recovery.

With one in seven homes for sale in foreclosure it is time for banks to become more aggressive in keeping homeowners in their homes. It is a much better and smarter business decision than having empty homes, which have to be managed, running down neighboring property values. Also the government could be much more active in keeping homeowners in their homes. There are plenty of solutions, but a lack of creativity.

That leaves inflation for the Fed to deal with, and today, inflation is really about oil and other commodities. That is why a

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strong Fed policy backing a strong dollar is so important. A strong dollar should lower commodity prices and slow inflation.

The U.S. has spent around $50 billion on oil so far this year. If the dollar were strong, that number would be lower, and consumers would have some more discretionary dollars to spend at retailers and restaurants; the economy would be aided and inflation pressures reduced.

Another thing that would decrease the price of oil would be a reduction in demand. U.S. drivers are driving less, and we are using less oil. Yet politicians propose lowering the price of gasoline at the pump by eliminating gas taxes, a move that would increase demand and reduce the money available for road repair.

While European countries tax gasoline heavily and thereby reduce demand, many Asian countries subsidize the price of gas and thereby encourage use and demand. However, there has been a crack in this policy in Asia, as some countries have announced plans to phase out these subsidies. If only China would stop subsidizing energy consumption, we would soon see a dramatic drop in the price of oil.

Of course, an increase in oil production would help — as well as a switch to collateral fuels such as gas, coal, nuclear, solar and wind.

A drop in the price of oil would help to slow the rise in food prices, but not entirely, since food prices are also driven by a rise in demand. We simply need to produce more food.

The Fed has taken a bold step in its fight against inflation. Let's hope that it is successful and the collateral damage is not too great.

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 four-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.