

April 22, 2008 – Volcker, Inflation, the Greenback & the Fed

A few days ago, the former Federal Reserve Chairmen, Paul Volcker gave a speech to the New York Economic Club. Mr. Volcker is generally regarded as the “Tiger Woods” of Fed Chairmen with an almost mythical reputation. He presided over the Fed during the Ronald Reagan presidency and helped stop the runaway inflation from the 1970’s. He did it by raising interest rates to an unprecedented 21%! Some of you may remember 20+% mortgage rates...and we think 6% is high.

Mr. Volcker raised rates to stop runaway inflation and support the dollar. He believed then and now that runaway inflation and a weak dollar are devastating to an economy. He knew his high interest rate policy would throw the US economy into recession but he believed it was the lesser of two evils and our economy would be better off in the long run even though the recession at the time was severe. In hindsight it is tough to argue with the results as the 80’s & 90’s turned out to be the best bull market for stocks in history.

Some believe the current Federal Reserve Chairmen’s low interest rate policy - to save the US economy from recession - will create the runaway inflation Mr. Volcker was forced to deal with in 1980. It is felt, IF Bernanke’s policies do save us from recession today, he is just pushing the problems out to a later date as inflation is rising and the dollar is in free-fall and both will need to be dealt with in the future.

Volcker giving a speech was an unusual event. Very little has been heard from our former Fed Chairmen since his retirement. It is customary for a former Fed Chief to be quiet in retirement as what they say can have an effect on world markets. So out of courtesy, they do not speak as they could make the current Fed Chief’s job more difficult.

But on April 8th Mr. Volcker could sit by no longer. He told the New York Economic Club the current Fed is not doing its job. He went further saying not only is the Fed not doing its job but it is doing the wrong job in attempting to save the economy and the stock market instead of defending the dollar. Mr. Volcker went on to say, this will make the real job of defending the dollar much more difficult in the future...causing even greater economic suffering.

He stated today’s economic conditions of rising commodity prices and a weakening dollar are similar to the 1970’s. Prices today for food and energy (oil is \$117/bbl) and inflation that includes food and energy is showing a 10% yr-over-yr increase. The dollar is at an all-time low...even lower than 1980..

Mr. Volcker was implying the current Fed’s policy is incorrect and its actions are dangerous. In his speech he said, the recession we are in is not the problem of the Fed...it’s the government’s. The #1 mandate of the Fed is to defend the dollar and fight inflation – exactly the opposite of what the current Fed is doing. The solution, Mr. Volcker seemed to be saying, raise interest rates no matter what the consequences, because if we don’t, we will have to raise them more in the future with even more dire consequences.

By speaking out after 20 year of silence, Mr. Volcker was going against the code of silence of former Fed Chairmen he has respected since he stepped down in 1987, to warn us of the weaker dollar and higher inflation ahead and the danger this brings to our great country.

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