

■ Bernanke's Dilemma



By Clark Winter
Chief Global Investment Strategist
Citigroup Global Wealth Management

Since the end of World War II, the US has been the origin of many global changes and an exporter of consequences. But it is beginning to appear that the US is increasingly becoming an observer of events and an importer of consequences.

This shift is more noticeable in the political arena than in the economic one, where it may be worthy of more attention. With regard to the US Federal Reserve's handling of short-term interest rates, it is becoming increasingly apparent that Fed Chairman Ben Bernanke would like to use inflation targeting to help him determine whether to change rates. This would be fine if manipulating interest rates could solve all the inflation problems for the US. But a growing portion of US inflation is now imported, either in the form of higher energy prices—Americans now import a staggering 13 million barrels of petroleum products a day, at an average cost of nearly \$1 billion a day—or in the form of imported merchandise. The trade deficit is now running at an annualized rate of more than \$776 billion, or 6.2% of US gross domestic product of \$12.5 trillion. The trade deficit, hardly an insignificant amount, can be expected to increase: Even though energy prices have eased lately, US energy demand is insatiable. Also, goods that use huge amounts of energy—such as plasma TV screens and home-entertainment systems—tend to be imported.

Price pressures. Americans since the late 1980s have become accustomed to cheap energy and addicted to the benefits of declining prices, thanks to technological improvements and the vast pools of cheap labor in places like China. Cheap labor, however, is no longer a given. Wages in China are climbing at a rapid clip, especially in urban areas. So while China currently is importing deflation as commodity prices ease, it is now exporting inflation in the cost of finished products. Even if there were complete political stability in the world, there would be a high probability that the Fed would find inflation—with all of

its global force—more challenging to fight than when inflation was predominantly of the domestic variety.

The problem with interest rates. In addition to import-induced inflation, there is also the problem of speculation-induced inflation. While the daily consumption of crude oil around the planet has increased 22% over the past 16 years, the price of oil has increased nearly sevenfold. Gasoline demand has risen at twice the rate of oil consumption, but the price has risen threefold while the market in oil-based derivatives has grown more than 500%. In such an environment, does it make sense for monetary policy and interest-rate manipulation to be the primary mechanism for controlling the economy? Everyone suffers the consequences of higher interest rates; one example is the rising credit-card interest on the \$11.8 trillion in non-mortgage household debt held by US consumers. Higher interest rates also damage consumer spending and weigh on confidence in the housing market.

The dilemma of how to fight inflation. Other central banks have used different inflation-fighting tools at other moments, with no apparent harm and possibly some good. The European Central Bank, for example, largely abjured from raising interest rates between 2003 and late 2005, and Europe's economy worked out matters for itself. The Europeans chose to impose budgetary targets instead. The US Congress could rein in spending if it chose to and could move toward a balanced budget, which the US enjoyed eight years ago. Indeed, fighting inflation with higher rates may not work as well today as it did in the past, since rising rates now expose the increasing weakness of the dollar. Higher rates are usually the Fed's compensation to holders of its debt; however, most holders of this debt are foreigners, mainly Asians, who collectively own \$2.1 trillion of US paper, or more than 52% of the total. They are holding on to their dollars for the moment to keep American consumers in a buying mood. But if higher rates drive American consumers from the marketplace and foreign consumers don't pick up enough of the slack, central banks may be forced to greatly reduce their dollar holdings.

This is Bernanke's dilemma. In the process of attempting to stop the US from running off the path of price stability, he may cause a greater global pileup. ■