

The Tonge Telegraph

June 2006

Goldilocks

Which bowl of economic porridge will the Fed test next? Will it be the one that says the economy is too hot? Will it be the one that says economy is too cold? Then again, you've got a whole group of people testing so some board governors will surely think it's too hot while others disagree.

It is interesting time to be a Federal Reserve Board Governor. In addition to having a new chairman who was still finding his footing there is an economy in need of delicate tinkering. Do they raise the rate another quarter-point in June to further stave off inflation or do they sit tight and see if they've done enough already?

I do not, by any means wish to intimate that there is any problem or dissension at the Fed. That is not the case. It's just that they have a couple of delicate situations to juggle at the same time. In addition, the right answer to the question about raising rates may not be known for months or even years. These are the times when that crystal ball would really come in handy!

I know I've said this before in these newsletters but it is worth repeating. A decision of the Federal Reserve to raise or lower interest rates is a double-edged sword. They raise rates only when the economy is strong and inflation is a concern. They lower rates when the economy is weakening. I'll take the strong economy and concerns about inflation any day over a weakening economy.

The question in the economic community at this point is whether or not the Fed overshot the mark and got too far ahead of the inflation problem or is economy indeed so strong that it is in need of further restraint. The economic discussion is complicated or muddled by the price of oil and the housing market. Historically, an increase in the price of oil was rapidly translated into a decline in economic growth. Similarly, a decline in housing starts or a decline in the price of existing homes was a sure sign that the economy was weakening. Currently we've seen the price of oil more than double while the economy steams ahead. Real estate prices have fallen in many places but they are still building unbelievably huge houses, which are selling at unheard of prices.

The bottom-line is that the Fed has its work cut out for it. Their decision on a rate increase is being watched very carefully by an increasingly jittery group of analysts. The decision is a tough one in part because we are very close to the theoretical limit on interest rates and further increases may start creating other problems, real or imagined.

As usual, stay tuned for further developments, call me if you have any questions and by all means, get out and enjoy the summer.