Fed learns lesson on interest rate

>By Alan Rohrbach
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From Mr Alan Rohrbach.

Sir, It seems that along with many other well-informed observers the FT has come to the conclusion that the Fed is "entering the neutral interest rate zone" (editorial, November 28).

What represents a "neutral" interest rate is the subject of endless speculation and central bankers are any way expected to shift base rates around neutral to address economic conditions. Yet there are clear indications that the Fed is prepared to go further than most observers presume by signalling a likely move above the previous expectation of 4 per cent for the top of this cycle.

There is a stepped logic that dictates Ben Bernanke should raise rates at the end of next March. I agree with your assumption of increases in December and January, and the last thing a new Fed chairman can risk is the lack of anti-inflation credibility.

This is especially true in Mr Bernanke's case, as some of his (rightful) perceptions about the need to keep things easy in 2003 raised initial suspicions in that regard. Even if it must be quickly reversed, look for a hike on March 28.

This is exacerbated by the 50-basis point long-yield increase you cite having no significant cooling effect on housing. As monthly payment levels remain very attractive to most buyers, the Fed must rely on the blunt instrument of short-term interest rate effects on personal and business economic sentiment.

Yet these do not operate in a vacuum, which is why there is another dimension to the current stock market rally and reinvigorated consumer sentiment: that the Fed learned a big lesson on the previous cycle. The extended insight to be gleaned from Mr Greenspan's September 27 "history lesson" comes from his comment, "Yet *the significant monetary tightening of 1994 did not prevent* what must by then have been *the beginnings of the bubble* of the 1990s" (my italics).

While the Fed will adamantly deny any attempt to affect the trend of the equity markets, it has also signalled that previous norms of short-term rate influence on corporate and consumer psychology are no longer reliable.

The potential for more demanding labour unions attempting to recover earning power lost to energy inflation is yet another factor that means nobody really knows how high the Fed is prepared to go.

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