Close to neutral
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It is not the end, but it is the beginning of the end. The latest minutes show that the Federal Reserve has entered what it expects to be the final phase of the interest rate tightening cycle that began in June 2004. By an extraordinary coincidence, it looks as if that cycle may well end at almost the exact moment that Alan Greenspan hands over the chairmanship of the Fed to his successor-in-waiting, Ben Bernanke.

For a market that has grown used to the certain expectation of a quarter-point rise at each Fed meeting, the minutes came as a shock. They should not have done. With rates at 4 per cent, the Fed is on the threshold of a neutral zone, in which monetary policy is not obviously stimulative. Beyond this, rate rises become less automatic. At some point, they will stop.

The likelihood that this will come sooner rather than later is increased by the fact that the Fed has finally gained traction on long-term interest rates. The yield on 10-year treasuries has risen from 4.02 per cent at the end of August to 4.51 per cent, raising the cost of corporate and housing finance.

However, the Fed is not done yet. The open market committee which sets interest rates thinks that, at 4 per cent, rates remain accommodative and that "a continued measured pace of policy firming remained likely". Those members who raised the danger of going too far did not suggest that risk was imminent. Indeed, the Fed could go a bit beyond neutral, to lock down inflation expectations. While core personal consumption inflation is steady at about 2 per cent, headline inflation is high, and core could edge higher.

The problem the Fed faces is one of its own making. Key elements of the policy statement are little changed from June 2004, when interest rates were at 1 per cent. This is absurd, and the Fed knows it. The once useful guidance that "policy accommodation can be removed at a pace that is likely to be measured" has to go.

The question is what to put in its place. One option would be a more quantitative measure, possibly the precursor to an inflation target. Yet that ought not to be rushed. At this stage in the cycle less is more: there is no need for detailed guidance and the Fed would be misleading the market if it suggested it could provide it.

Most analysts expect another two or three rate hikes from the Fed. Assuming one in December and one in January, with no Fed meeting in February, it will be Mr Bernanke who will have to take the decision whether to goon to 4.75 per cent - calling a halt at4.5 per cent - in his first meeting as Fed chairman in March.

It will be a challenging debut. Given the giant US current account deficit and related domestic savings imbalances, it is hard to know where neutral lies. Even if Mr Bernanke sees cause to go higher, he will have to be prepared to cut quickly if inflation remains benign and economic growth falters.
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