

Lex

15 Aug 2006 02:01 PM

by FT.com FT Administrator 

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Interest rate 'comfort zone' Catch 22

02 Apr 2007 07:44 PM

by Alan Rohrbach

Additional reasons to your rightful obvious ones it will be hard for the Fed to now move the ostensible core PCE 'comfort zone' fully up to a consistent 2.00 per cent are inherent in another part of your observations: the margin of error.

While it may or may not have immediate implications for the debt markets, intermediate term implications for an already weak US dollar are fairly bad. The purchasing power parity calculus is especially compelling. If 2.00% is the floor for inflation, the US dollar loses more than 30% of its purchasing power over a 20 year horizon. If that is indeed the floor, any margin of error will make it easy to hypothesize 2.50% on average: a loss of close to 40% across the same time frame.

The attendant potential weakness of the greenback is part of the (historically) very recent lesson in how attempting to monetize the high cost basis for energy and excessive consumer debt eventually seeps back into being a major inflation factor. While the central banks don't want the opprobrium for foisting a recession onto already burdened consumers while energy prices are high, historically that is the only way to make the point to the oil producers through lower demand.

This is a classic Catch-22, especially as Mr. Mishkin's 'Inflation Dynamics' speech may have illustrated a critical point. The forbearance which allows higher core inflation as being both more 'comfortable' and unable to be countered without extensive economic weakness was last seen in the Carter era G. William Miller Fed. As in that era's early acceptance of higher inflation as unavoidable, appropriate action may have been possible earlier in the cycle (i.e. before the recent economic excesses, as well as inflation expectations becoming so ingrained at present levels.) Yet it is now much tougher to address due to the extreme over-extension of US housing sector euphoria (a direct result of the Fed allowing credit and equity market exuberance), and its subsequent fragility.

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