

The neutral rate is variable too



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by Frank Uhlenbruch
Investment strategist at Perennial Investment Partners

Few were surprised when the US Federal Reserve raised the US cash rate for an 11th consecutive time in September, when it lifted the rate to 3.75% from 3.5%. Analysts have long expected the central bank to boost the rate until it's at its "neutral" level - one where the economy can grow without fanning inflation.

It's just that this "neutral" level may be higher than analysts previously thought.

The US tightening cycle, which began in June last year when the cash rate was at a 40-year low of 1%, has been unique until now in that the lack of inflation generated by the recovering US economy allowed the Federal Reserve to raise rates at a "measured pace", as it is fond of saying.

However, the old-age problem of faster growth raising concerns about inflation has reappeared.

In the US, the job market is relatively tight and labour costs are rising. The Federal Reserve believes the economy is running close to full capacity - the speed it can expand before excessive demand fuels inflation. Add in the recent surges in energy and input costs and conditions are ripe for a cyclical jump in inflation.

Perhaps, most worrying of all for the Federal Reserve is a leap in consumer inflationary expectations to a four-year high, as measured by the University of Michigan.

These factors challenge current market pricing which points to the Federal Reserve raising the US cash rate to 4.25% to 4.5% by mid-2006 and then keeping rates steady thereafter.

It's unlikely that the US economy will be in balance if the cash rate is at these levels by then.

It's more likely that at this time US economic growth will still be robust with inflation pressures persistent. The rebuilding to repair the hurricane damage in the US will only add to economic growth and inflationary pressures at this time.

Perhaps a US cash rate above 5% (more in line with its long-term average) will soon be seen as a more "neutral" rate. Such a shift in thinking could see short and long US bond yields at much higher levels than they are today.

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