Fed rate action commentary from Swiss Re chief US economist

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Following today's announcement that the Federal Reserve Board would raise the target federal funds rate 25 basis points to 2.25 percent, Swiss Re chief economist Kurt Karl said, "Another meeting, another rate hike, expect more of the same in 2005. Though there continues to be concern about the strength of the economic expansion, growth is sufficiently robust for the Fed to continue raising the federal funds rate. The Fed still needs to get this rate to about 4.0 percent or two percent above core inflation. It continues to be our view that the Fed will do this with 25 basis-point hikes at each of the next seven FOMC meetings.

"Growth continues to be close to or above its long-term trend, allowing the Fed to gradually tighten monetary policy," Karl said. "Inflation is under control with core inflation close to 2.0 percent, but short-term interest rates need to rise to prevent an increase in future inflation. If growth decelerates substantially, the Fed will slow its pace of tightening and if it accelerates, the Fed will raise rates by 50 basis points at some meetings. High and volatile oil prices, large and persistent federal deficits and the weakening dollar all pose the risk of higher inflation. As the Fed raises rates next year, growth continues and inflation remains close to 2 percent, the yield on the 10-year Treasury note should rise to 4.9-5.4 percent by end-2005.
"High oil prices and the strong euro are slowing economic activity in Europe, postponing any European Central Bank interest rate increases until the second half of 2005," added Karl. "In Japan, the recovery has also lost some momentum, but inflation has not yet returned, so the Bank of Japan is unlikely to tighten monetary policy until the second half of 2005 at the earliest. In the United Kingdom, one more rate hike to 5.0 percent for its key policy rate is still expected. However, growth weakened and housing inflation moderated in the second half of this year, so this final hike is not assured. The Bank of Canada is expected to raise rates next year although at a slower rate than the Fed, taking their key policy rate to 3.5 percent by year-end."

Notes to editors

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