Fed rate action commentary from Swiss Re US chief economist

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After today's 25 basis point Federal Reserve increase in the target fed funds rate to 3.5 percent, Swiss Re's US chief economist Kurt Karl commented, "Growth remains solid and inflationary pressures are rising, so we expect the Open Market Committee to continue raising rates in 25 basis point increments at its September and November meetings and possibly in December also. By the middle of next year, the fed funds rate should reach 4.5 percent.

"The unemployment rate has fallen to 5.0 percent, stimulating growth in wages and salaries. Capacity utilization has climbed to 78.4 percent in manufacturing in July, from 72.5 percent at its trough in November 2001, increasing inflationary pressures. Meanwhile, despite oil prices above $60 a barrel, growth has recently accelerated," Karl said. "The Fed needs to cool off the economy in a pre-emptive strike against a potential inflationary spiral. Currently, 4.5 percent is the magical "neutral" fed funds rate that is assumed to halt the decline in the unemployment rate. However, if oil prices do not slow the economy soon, the fed funds rate may need to rise further than 4.5 percent next year.

"In the United Kingdom, sluggish growth and the lack of inflationary concerns recently induced the Bank of England (BoE) to cut rates by 25 basis points. The BoE may make further cuts, though currently none are expected. In Euroland, the European Central Bank (ECB) continues to resist pressure to cut rates, despite weak growth. Instead, assuming the economy gathers strength as expected, the ECB's next move will be to raise rates early next year. In Japan, growth prospects are also improving, so some marginal tightening of monetary policy is possible next year. Canada, on the other hand, will probably raise rates next month based on healthy growth and a declining unemployment rate," added Karl.

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ZURICH: +41 43 285 7171
NEW YORK: +1 914 828 6511
SINGAPORE: +65 6232 3459

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