The Fed's dilemma

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As if the Federal Reserve did not have enough on its plate. The central bank has already slashed interest rates to head off a housing-led recession. It has ignored lurking inflation concerns in the rush to protect the economy from risks to growth. After all, the thinking goes, weak demand and rising unemployment should keep prices in check.

The trouble is that inflation moves with long lags. So, even as the US economy slows, inflation is serving up some nasty surprises. In January, broad pressures pushed consumer prices up 4.3 per cent compared to a year earlier. Even the core 2.5 per cent rate, excluding food and energy, is way too high for comfort.

So the Fed faces yet another conundrum. It can rein in its rate cuts, in response to elevated inflation readings, and risk further economic weakness. Or it can press ahead and pray that investors buy the line that inflation will moderate over time. The latter option is more likely. But if investors remain unconvinced, and market-based inflation expectations keep rising, the Fed might find its power significantly reduced.

Already, the central bank is fighting two serious forces. Even as it cuts rates, credit spreads on a multitude of debt products have ballooned, limiting the benefit for borrowers. In addition, the banking system is reeling from huge losses and curbing its lending.

If inflation expectations gather pace, investors in longer-dated Treasuries would demand higher yields to hold these assets and the yield curve would steepen further. With many products, such as mortgages, priced off the long end of the curve, that would prevent the price of credit from falling. The Fed's medium-term view on inflation looks correct. But, for monetary policy tools to remain effective, if must maintain investor confidence even as prices tell a different story.