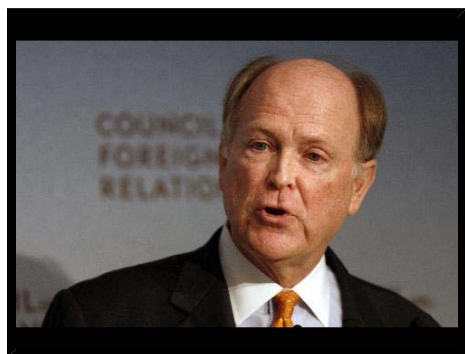


Fed's Plosser Says Inflation to Increase, Warns of Complacency

By Vivien Lou Chen and Scott Lanman



May 22 (Bloomberg) -- Federal Reserve Bank of Philadelphia President **Charles Plosser** said prices may rise 2.5 percent in 2011, a rate well above central bankers' preferred range, and cautioned against complacency on inflation.

"The economy may be at greater risk of inflation than the conventional wisdom indicates," Plosser said in a speech yesterday in New York. "While inflation expectations appear to remain anchored, we should not become sanguine about our credibility. It can be easily lost."

The bank president's inflation forecast for 2011 exceeds central bank officials' long-run preferred range of 1.7 percent to 2 percent, and contrasts with the concerns of some officials and economists that the economic slump may provoke a broad decline in prices.

Fed officials will need to raise the U.S. benchmark interest rate and reduce the central bank's balance sheet when financial and housing markets improve, Plosser said. The Federal Open Market Committee is committed to price stability and will act in a "prompt way" to ensure it, he said.

"The economy is probably not strong enough and not ready for increasing" the main rate, Plosser said after his speech.

Minutes of policy makers' April 28-29 meeting in Washington suggest they're not convinced that recent signs of economic stabilization will remain in place. Plosser echoed that uncertainty yesterday, saying the U.S. may grow below potential "for some time" as unemployment rises and the shock to financial markets persists.

'Bumps and Setbacks'

"To sum up, I am optimistic that the economy and the financial system will recover," Plosser, 60, said during the speech to the New York University Money Marketeters Club. "That does not mean the path to recovery will be smooth. There are plenty of opportunities for bumps and setbacks along the way."

"Both our district and the nation are beginning to see some signs that the severity of the recession is beginning to wane," said the regional bank chief, who joined the Fed in 2006 and doesn't vote on monetary policy this year. Still, "the economy's potential output may be lower than previously estimated for some time," and the effects of the credit crisis are "likely to persist for a while."

Policy makers left open the possibility of increasing the amount of assets they'll purchase to revive the economy, beyond the \$1.75 trillion already committed, according to the minutes released on May 20.

Deeper Contraction

They are also forecasting a deeper U.S. contraction than they expected three months earlier, with a 9 percent or higher unemployment rate through the end of 2010, according to the minutes. The economy

should shrink this year between 1.3 percent and 2 percent, based on officials' central tendency, the minutes said.

Plosser's near-term economic forecasts are generally more sanguine than his colleagues. He said he expects unemployment to peak at more than 9 percent early next year, before "falling gradually." Growth should return in 2010 at a rate of 3 percent, the upper end of Fed officials' central tendency, and at 2.7 percent in 2011, the Philadelphia Fed president said.

"While I see somewhat more economic growth over the next 12 to 18 months than some private-sector forecasters, I also see less deflationary pressure in the near term," Plosser said. "And I see greater risk of higher inflation over the intermediate to longer term."

Inflation Target

Reiterating his call for an inflation target, the regional bank chief also said the Fed has potentially put its independence at risk with its responses to the crisis, by directly lending to non-financial institutions and buying asset-backed securities.

"We need to draw a bright line once again between monetary policy and fiscal policy," Plosser said. "The recent crisis has muddied that separation considerably and we must restore it. The Fed must not be seen by the public or the Congress as a piggy bank that can substitute for difficult fiscal policy decisions."

The central bank's minutes indicate policy makers may be ready to build on their plan in March to buy \$300 billion of Treasuries should the economy or financial markets not improve. Some officials said an increase "might well be warranted at some point to spur a more rapid pace of recovery" from the worst recession in five decades, the minutes said.

The Fed has held the benchmark U.S. interest rate near zero since December.

Boston Fed President **Eric Rosengren** told a Worcester, Massachusetts, audience in a speech yesterday that "a rather slow recovery is likely," an outlook implying a continued weak labor market and an unemployment rate rising through this year.

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