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Fed must remain vigilant on inflation: Plosser

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By Verna Gates

BIRMINGHAM, Alabama (Reuters) - The Federal Reserve must remain vigilant against rising inflation pressure this year even as the U.S. economy slows sharply, Philadelphia Federal Reserve President Charles Plosser said on Wednesday.

In a speech to the Rotary Club of Birmingham, Alabama, Plosser said he expects U.S. growth to be "quite weak" in the first half of 2008 and said the jobless rate will rise to 5.25 percent by year end.

But he added that core inflation, which strips out volatile food and energy costs, will remain above 2 percent, forcing the central bank to keep a close watch on inflation expectations.

"Unfortunately, I expect little progress to be made in reducing core inflation this year or next, and I am skeptical that slower economic growth will help," he said.

Since September, the Fed has cut benchmark interest rates by 2.25 percentage points to 3 percent to help the economy weather a deep housing slump and global credit crunch.

Plosser said the rate cuts have will help the economy return to around trend growth of about 2.7 percent by 2009 but warned it would take a few quarters for them to start having an effect.

Plosser's remarks weighed on U.S. stocks, which dipped following his remarks and dismal sales figures from Macy's Inc (M.N: Quote, Profile, Research, Stock Buzz). In midafternoon trading, the Standard & Poors 500 Index .SPX was down 0.04 percent at 1,336.08.

Plosser said he expects growth in 2008 to top out at around 2 percent and said consumer spending and retail sales are likely to be weaker in the first half of the year than in 2007.

He did not forecast a recession but told reporters after his speech that "if something can tip us into recession, the housing market is the biggest risk."

Plosser said he expected housing to remain a drag on growth in 2008. He also said slower payrolls growth could drive the jobless rate up to 5.25 percent by year end.

In January, the government said the economy shed 17,000 jobs. The unemployment rate stood at 4.9 percent.

KEEPING INFLATION IN CHECK

Going forward, he said rising inflation remains an equally large risk for the U.S. economy and the central bank.

When factoring in the inflation rate, he said real benchmark interest rates are now approaching zero, which he called "clearly an accommodative level."

"In taking aggressive action in supporting the economy's eventual return to its trend growth rate, I continue to believe we must not lose sight of the other part of the Fed's dual mandate, which is price stability," he said. "We cannot be confident that a slow-growing economy in 2008 will by itself reduce inflation."

The Fed holds its next rate-setting meeting on March 18, and markets anticipate another interest rate reduction.

Plosser is a voting member of the rate-setting Federal Open Market Committee this year and voted in favor of a half-percentage-point cut at the last meeting on January 30.

Given recent high oil and food prices, Plosser said, the central bank needs to watch both the core and headline inflation rates to gauge underlying price pressures in the economy.

Signs that inflation expectations are edging higher "may be early warning signs of a weakening of our credibility, and we must be very careful to avoid that," he said.

And while he said rate cuts were justified given slower U.S. growth, he said easier monetary policy would not by itself solve all the economy's problems.

He told reporters that lower rates would not solve the problems of bond insurers who are struggling to hold onto top credit ratings because they have suffered severe losses from backing mortgage securities which have plunged in value over the past year.

He added that the bond insurers' problems "did not directly influence" the Fed's recent rate cuts, which accounted for 1.25 percentage points of the cuts since September.

Bond insurers guarantee over $2.4 trillion of debt.

(Reporting by Verna Gates; Writing by Steven C. Johnson; Editing by Editing by Jonathan Oatis)