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From the Baltimore Sun

Fed chief watchful

Mcclatchy-tribune

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WASHINGTON -- Unless you planned a vacation to New Zealand, you probably don't care much that its central bank raised its lending rate to a record high this month.

But U.S. Federal Reserve Chairman Ben S. Bernanke cares, and his concern is likely to arise when the Fed's policymaking body begins a two-day meeting today.

New Zealand raised its rate to 8 percent because the global economy, enjoying the longest streak of above-average growth in more than three decades, is so hot that it's sparking inflation, or rising general prices.

Higher interest rates douse inflation, but slow an economy. If the Fed is forced to raise rates here this year just as New Zealand has, that also would slow the U.S. economy.

Bernanke and the Fed are watching New Zealand's central bank because global inflation can pass through to the U.S. economy through import prices. Already, the European Central Bank has raised its benchmark lending rate to a six-year high. And Chinese banking authorities are warning that they might raise rates to cool China's overheated stock market. That would raise the cost of making Chinese goods and thus the cost of importing them.

"Pass-through Now Key Question," said a June 22 research report by global banking giant Goldman Sachs & Co. Its researchers concluded that, for now, lower prices of European imports are offsetting higher prices in China.

But the uncertain global inflationary backdrop will bring focus to the Fed's decisions the next two days. Fed members have telegraphed that their benchmark short-term interest rate - the federal funds rate for overnight bank loans - will stay where it's been since last June, at 5.25 percent.

While there's little drama now about this week's Fed's rate target, there could be soon, for storm clouds are gathering over the economic horizon.

Data released Monday by the National Association of Realtors showed sales of existing homes fell in May to the lowest level in four years. Median home prices, measured year over year, have fallen for 10 consecutive months. Yesterday, the Commerce Department reported new-home sales in May were off 15.8 percent from May 2006.

To reverse a slumping housing market, the Fed historically has cut lending rates to spark the economy. But pass-through risks from global inflation now limit the Fed's ability to act. Core inflation, which excludes the volatile energy and food sectors, is already at the upper limits of the Fed's tolerance zone, running at a 2.1 percent annual rate for the 12 months ending in May.

Economists believe global inflation has boxed the Fed into holding rates where they are for the rest of the year, and it

might force it to raise rates later in the year - putting more pressure on home sales and the economy broadly.

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