Economic Commentary

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Federal Reserve to Raise Short-term Target Rate Again to 3.5%

The Fed's Policy setting committee, the FOMC is meeting today and is fully expected to raise the overnight target for the federal funds rate to 3.5% and the discount rate to 5.6%, up another quarter point. This will be the tenth straight hike in the short-term policy rate.

The decision is fully anticipated by the markets. The June policy statement along with Alan Greenspan's recent testimony before Congress have clearly argued for continued removal of "policy accommodation" at a "measured pace". What remains to be seen today is if there is going to be a change in the wording or the tone of the press release issued along with the announcement. Given the Fed's stated tone and decidedly stronger economic data coming out of the United States recently, we expect little or no change in the statement. This should maintain the present outlook for continued rate increases for the balance of the year.

Based on the strength of the recent jobs report and today's productivity report which shows that productivity slowed in the second quarter, and given that capacity utilization has reached the 80% mark -which most analysts view as the point where increasing pricing power sets in and sparks higher inflation- it is hard to argue against the maintenance of the present stance. In fact, the market now appears to be looking beyond the "neutral" rate defined roughly as being around 4%. For example, Goldman Sachs has just raised its mid-2006 forecast for the fed funds rate to 5%, from 4.5%.

Complicating the Fed's task of adjusting monetary policy to a neutral setting is the fact that long-term rates have yet to respond to its policy tightening so far and in effect obstruct the Fed's efforts. This implies that the Fed may have to raise short-term rates even higher to achieve its policy objective. Further complicating this attempt is the booming US housing market, which has turned peoples' homes into an ATM machine, increasing liquidity in the market. Last year, homeowners took out $600 billion in equity from their homes, which they have mostly used to finance consumption.

The futures market currently prices a January policy rate of 4.16%, which translates to almost three more rate hikes for the next three Fed meetings remaining for the year. Where and when the Fed will stop will depend on the course of economic developments over the next few months.

In the meantime, oil has made a new high yesterday to just under US $64 a barrel with the prospect that it will rise further before it eases. The Bank of Canada is holding its next policy meeting on September 7th and the odds for an end in the rate-tightening moratorium have increased further.

Kenneth N. Matziorinis, Ph.D.
Canbek Economic Consultants Inc.
canbekeconomics@videotron.ca
www.hellascapital.ca/canbekeconomics