Economic Commentary

December 9, 2003

The Fed Meets Today: No Change in Rates Expected

The Federal Reserve's Open Market Committee (FOMC) is meeting this morning in its last of this year's rate setting meetings. The unanimous consensus amongst economic and market analysts is that it will leave its key benchmark fed funds rate unchanged at the 45-year low 1.0%.

In the meantime, the US dollar has made new lows earlier this morning in European markets touching above 1.2238 (euros per dollar) while the price of gold, a key indicator of confidence in the US greenback made a new high touching $410 per troy ounce. Also startling the markets are data indicating that both China and oil producing countries, members of OPEC are liquidating their US dollar holdings and repatriating capital to their home currencies. As long as interest rates in the US remain below those of other leading economies, the US will find it increasingly difficult to finance its huge current account deficit. At some point, sooner or later, US interest rates will have to rise to restore equilibrium in international capital markets and restore confidence in the US dollar.

Although the US Federal Reserve has repeatedly stated that it is prepared to hold short-term interest rates low until the US economy fully recovers, which most analysts interpret to mean until at least June, 2004, there is increasing doubt as to whether the Fed will be able to do so in the face of rising outflows out of US-denominated assets. The low US inflation rate currently at 1.3% makes it possible for the Fed to hold rates low at current levels. On the other hand, if the US dollar continues to retreat, which it will, and if in response to this global investor confidence in the US dollar continues to slip, the Fed's hand might be forced to raise rates a lot sooner than most analysts expect at this time. Look for signs of this in the US bond market, which I think is becoming increasingly vulnerable to a correction early next year. I expect that the Fed will at some point, maybe even today, adjust the wording of its statement so as to start distancing itself from its current pronouncement that rates will remain low for the foreseeable future.

In the meantime, look for the Canadian dollar to maintain its advance against the greenback.

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