Economic Commentary

December 11, 2002

Fed Leaves Rates Unchanged at 1.25%, ECB Cuts Rates by 1/2 % to 2.75%

The Federal Reserve voted unanimously to leave the benchmark overnight bank lending rate unchanged at 1.25%, following the November 6th decision to slash rates by 50 basis points. At 1.25%, the fed funds rate is the lowest it has been since July, 1961. Moreover, the real fed funds rate right now - the fed funds rate minus the inflation rate- stands below zero, in negative territory, at -0.55%, something the Fed has done before previous recoveries. What the Fed is trying to do is to ensure that the ailing recovery, which has been slow and uneven until now does not falter at this late stage.

The Fed needs to keep borrowing costs as low as possible in order to support consumer and business investment spending and nurse the economy back to a new cycle of economic expansion. The Fed also maintained the outlook it described in November, stating that the risks of higher inflation and weaker economic growth are now balanced. Some analysts expect that rates will be kept at this low level until the 3rd quarter of 2003.

Incidentally, last Thursday the European Central Bank (ECB) voted to slash the key overnight financing rate by 50 basis points to 2.75%, following the Fed's move in November. This move is long time overdue and will certainly assist the world's second largest economy toward recovery, but it is still not enough to trigger a strong "made-in-Europe" recovery because real interest rates in the euro zone are still positive.

The implication for Canada is that rates here may not increase as fast or as much as have been expected based on the Bank of Canada's policy pronouncements so far this year.

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