Economic Commentary

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The Fed on Course to Raise the Overnight Rate to 2.25%

The FOMC, the monetary policy arm of the U.S. Federal Reserve is holding its last fixed-date policy meeting for the year tomorrow and is expected to announce a quarter point hike in the fed funds rate to 2.25%, the interest rate banks charge each other for overnight loans.

Why is the Fed expected to raise rates tomorrow? First of all, there is an overriding need to return monetary policy settings away from the "emergency" levels they had fallen in response to the fallout from the bursting of the stock market bubble in the 2000-2003 period, the economic recession of 2001, the 9-11 terrorist attacks and the deflationary scare of 2002. Now that these challenges have been overcome, the sound course of monetary policy direction dictates that rates must be returned to a more neutral setting, estimated between 3.5-4.0 percent by economists. The Fed will meet again on February 2nd and March 22nd, 2005. The pricing of the federal funds futures contracts on December 10th, price in a 100% quarter point hike at each of the December and February meetings with only a 50% probability of a rate hike at the March meeting.

Second, the rate of price change has rebounded and it is at an early stage of raising concerns about inflation. Headline y-o-y CPI inflation has now returned to 3.2%. The more significant core CPI rate of inflation -which strips out food and energy items from the total index- has rebounded from 1.1% this time last year to 2.0% in October. More revealing is the course of the goods component (as opposed to services) of the CPI. Goods inflation has followed a downward trend from late 1991 until January, 2004, breaching the 0% mark and turning to deflation in the Fall of 2001. After bottoming at a y-o-y rate of –2.5% in January of 2004 it has since climbed back to the 0% watermark level. Continuation of this trend suggests that the core rate will continue to advance well above the 2.0% level and this risks re-igniting inflationary expectations. With ten-year treasury yields at 4.13% inflation expectations are well contained at the moment. Unless the Fed adjusts rates upwards on a timely basis it risks falling behind the curve of inflation expectations. Thus, it is also essential that the Fed raise rates in order to assure markets that it is ahead of the curve when it comes to inflationary pressures.

A third, though less pressing concern, is the willingness of foreign investors to buy USD-denominated assets, especially US treasuries to finance the US budget deficit. Based on the headline rate of inflation (3.2%) the real overnight rate of interest in the USA is still **negative** at –1.2% (2.0% - 3.2%), whereas the comparable real rates for Canada, the eurozone and Japan are +0.2% (2.5% - 2.3%); –0.4% (2.0% - 2.4%) and zero (0% - 0%) respectively.

Only China and many of the South-East Asian bloc countries continue to have negative rates of interest greater than those of the USA, which explains in part their continued willingness to fund the US deficit. As central banks around the world move to tighten rates and as the Chinese monetary authorities move to reform and modernize their exchange rate and monetary policy implementation mechanisms, the US needs to ensure that US rates remain competitive vis-à-vis those of the rest of the world to assure the hegemony of the US dollar. Alan Greenspan's remarks at the G-20 meeting in Berlin in mid-November have echoed these concerns.

What are the implications for the course of interest rates in Canada? Now that the Bank of Canada decided to keep rates on hold at its December 7th meeting at 2.5%, the nominal short-term yield spread between Canada and the USA will narrow to 0% by the beginning of February, assuming that the Bank of Canada decides to stay on the sidelines at its January 25th policy meeting which most market analysts expect it to do. If the Fed keeps raising rates past the February 2nd meeting –which we think they will- we are looking at the prospect that short-term spreads will turn negative.

Currently, market expectations in Canada have changed to the view that the Bank of Canada will stay on the sidelines until at least the middle of 2005, and then nudge rates higher late in 2005 and 2006. This expectation has certainly taken pressure off the Canadian dollar at least for a while and is now trading near the 0.81 cent level, but it remains highly doubtful that the Bank of Canada will be able to keep rates on hold for as long as the markets expect. Monetary policy needs to return to more neutral levels in Canada as well, while inflationary pressures will inevitably spill over into Canada anyway. Although we continue to see rates gradually moving higher during the course of 2005, both the pace and the extent of the rise will remain modest as we forecast in our 2005-07 Economic Outlook.

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