Economic Commentary

December 13, 2005

Fed is Approaching End of Tightening Cycle, But Some More Tightening Left in the Pipeline

As expected the Federal Reserve hiked the fed funds rate to 4.25%, the 13th rate hike in a row and brought its key policy rate to its highest level since May, 2001.

Newsworthy in the Fed's statement today was that it dropped the reference to ``accommodation'' in its policy, a sign that members consider rates to be close to neutral levels and therefore no longer a stimulant to economic growth. The Fed also dropped its pledge to raise its key policy rate at a ``measured'' pace, a phrase that has been in every interest-rate statement for the past 18 months. But it also stated that economic expansion is solid and that potential increases in capacity utilization and elevated energy prices have the potential to add to inflation. Although the core rate of inflation remains moderate and inflation expectations contained, it still judges that some further measured policy firming will be needed over the next few months to balance the risks between inflation and recession.

With this crucial change in the wording of the statement, the Fed has removed itself from the rate tightening "straight jacket" it had placed itself over the past 18 months and is giving itself and more importantly the new Fed Chief Ben Bernanke more latitude to decide the magnitude and timing of future rate increases. As explained in previous commentaries, I expect that the rate will be hiked again to 4.5% on January 31st, the last meeting with Alan Greenspan as its head, and that the newly appointed Chief will probably carry out another hike or two at each of the March 28th and May 10th meetings, thus bringing the rate to between 4.75% and 5.0% by end of Spring. Where rates will go from there will depend on the pace of economic growth in the United States during the 4th quarter of 2005 and first quarter of 2006. If the growth rate moderates and if inflationary pressures begin to subside there will be no need for further tightening. If they don't, we will see some more hikes though the summer.

The U.S. economy grew 3.7 percent in the third quarter from a year earlier, more than twice as fast as any of its European counterparts in the Group of Seven industrial nations. Growth was 2.8 percent in Canada and 2.9 percent in Japan on the same basis. With today's action, the Fed's rate is 2 percentage points above the European Central Bank's refinancing rate, 1 percentage point higher than the Bank of Canada's overnight rate, and a quarter point below the Bank of England's base lending rate.

Attached, here is the statement of today's Fed announcement:

For immediate release

The Federal Open Market Committee decided today to raise its target for the federal funds rate by 25 basis points to 4-1/4 percent.

Despite elevated energy prices and hurricane-related disruptions, the expansion in economic activity appears solid. Core inflation has stayed relatively low in recent months and longer-term inflation expectations remain contained. Nevertheless, possible increases in resource utilization as well as elevated energy prices have the potential to add to inflation pressures.

The Committee judges that some further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives.

Voting for the FOMC monetary policy action were: Alan Greenspan, Chairman; Timothy F. Geithner, Vice Chairman; Susan S. Bies; Roger W. Ferguson, Jr.; Richard W. Fisher; Donald L. Kohn; Michael H. Moskow; Mark W. Olson; Anthony M. Santomero; and Gary H. Stern.

In a related action, the Board of Governors unanimously approved a 25-basis point increase in the discount rate to 5-1/4 percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco.

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