Economic Commentary

January 29, 2004

The Fed Leaves Interest Rates Unchanged, But Gives Itself More Latitude to Move in the Future

As expected, the U.S. Federal Reserve left interest rates unchanged yesterday at 1.0%, a 45-year low. However, in its statement accompanying its decision, it also made a crucial change in the wording of its view on the future direction of monetary policy. It dropped language that it has used since August, 2003 pledging to hold the overnight bank lending rate low for a “considerable period” of time, saying instead that it can “be patient” before raising the rate from its current 1.0% level. It also indicated that the risks of inflation and deflation remain balanced, signaling no chance of an imminent rise in rates.

Yet, the market’s reaction to this subtle change in its working was huge. The Dow Jones Industrial Average fell 142 points, or 1.3%, the biggest percentage drop since October 22, while the S&P fell 16 points, or 1.4%. The benchmark two-year Treasury maturing in 2005 had its biggest drop in three months, falling 5/16 in value. The 10-year note dropped more than ¾, pushing its yield up 12 basis points to 4.19%. The yield on July fed funds futures contracts rose as high as 1.2% yesterday (up from 1.11% the day before), suggesting that traders see an 80% chance that the Fed will raise its key rate by the end of June, up from a 44% chance the day before. The change in language also helped lift the US dollar up by a cent against the euro and up against most currencies in the world including the Canadian dollar. Investors interpreted the omission of "considerable period" as a signal that the Fed is closer to raising interest rates than many thought.

In my view, the announcement does not suggest that an interest-rate increase is imminent. Rather, it appears that the central bank wants to give itself the freedom to raise rates if the economy continues to improve, without worrying about violating a perceived commitment to keep them down. This was a tactical move in my opinion, and a warranted move as well because markets need to be reminded that that the current low interest rates will not stay on hold forever. The rest of the statement suggested the Fed's economic outlook hasn't changed significantly since it last met in early December. "Output is expanding briskly," it said. While "new hiring remains subdued, other indicators suggest an improvement in the labor market."

I believe that markets will recover by the end of the week from this announcement but it will certainly increase the uncertainty and the volatility in the markets and make the descent of the US dollar more orderly. In the meantime, yesterday's action by the Fed coupled with last week's action by the Bank of Canada to lower its overnight rate by ¼% and adjust its forecast on Canadian growth downwards by half a percentage point to 2.5% from 3.0% in November, will certainly have the effect of dampening the ascent of the Canadian dollar, welcome news to Canada's export sector.

However, the medium term trend in the decline of the US dollar and the appreciation of the Canadian Dollar remains, in my view, intact. Therefore, any weakness in the Canadian dollar should be viewed as a buying opportunity. I fully expect to see the Canadian dollar rise above the 80-cent level some time this year. The underlying structural problems in the US economy which are responsible for the greenback's decline will only get bigger while commodity prices will continue to rise helping the loonie gain new ground against the greenback.

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