

Economic Commentary

June 23, 2003

THE FED POISED TO CUT THE INTEREST RATE ON WEDNESDAY BY AS MUCH AS HALF A PERCENTAGE POINT

The Federal Reserve's policy setting committee the FOMC is to meet tomorrow and Wednesday and are widely expected to cut the fed funds rate by a 1/4 to probably 1/2 of a percentage point, to 0.75%, the lowest rate since the end of World War II. The rate announcement will come at 2:15 PM Wednesday, following our board meeting.

The futures money market on Friday was pricing a 52% chance of a 50 basis point cut. The Fed, in its previous meeting changed the Fed bias toward deflation with implications for a rate cut at this meeting. Furthermore, Fed Chief Greenspan has also hinted in speeches recently, that he is more concerned about deflation, even if the risk seems small and is prepared to take pre-emptive action to forestall it.

My view, voiced at the last ALCO meeting, is that the Fed will cut rates by 50 basis points at this June meeting. Even though the US economy is showing increasing signals that it is beginning to grow at a more normal rate and therefore might not need another rate cut, what the Fed is trying to do is to take some dramatic rate cutting action in order to hammer in the final nail for an economic expansion. Although the additional benefit of a further rate reduction following 12 previous rate cuts over the past two and a half years is marginal on the economy, its psychological effect is still big. Combined with a lower dollar, an expansive fiscal policy and the recent Bush tax reductions, it may prove to be the effective jolt the economy needs to spur growth in the US and global economy and put an end to the post-stock-bubble blues.

The implications of such a decision for Canada are that it will send the Canadian dollar flying high again, - the Canada-USA interest differential will jump to 275 basis points, 3.5% for Canada vs. 0.75% for the US. But it will also put pressure on the Bank of Canada to reverse course and start cutting rates here in Canada, maybe as early as its next policy setting meeting on July 15th! With two back-to-back months of job losses in Canada, with falling exports and falling inflation, the need to maintain its course has lessened since earlier this year. Thus it is looking increasingly probable that short-term rates might start coming down here in Canada in the second half of this year.

The implication of lower rates for our Bank's NIM -net interest margin- is negative at this point. Based on the March Asset/Liability gap figures, a 1 percentage point gradual decline in rates will lower net interest income by as

much as \$450,000 over the year. A modest increase in our fixed-income exposure at this point might be appropriate given that the Canadian bond market has yet to fully price in these latest developments.

The quandary being faced by decision makers right now is that the bond market is pricing in deflation while the equity market is pricing in inflation, and both markets cannot be simultaneously right. They cannot go on moving in the same direction for too long. Which view is right is hard to tell at this moment. If I have to bet, I would place my bet in favour of the equity market, simply because the policy mix in the world's most powerful economy is solidly expansionary, and based on more than 60 years of history it has always proved effective.

Another way to re-conciliate the two views is that the economy will take off as the equity market expects, but the growth will not prove strong enough to create inflationary worries over the medium-term, which would support the fixed income market's view. In other words, the markets may be predicting non-inflationary growth in output. Time will tell.

A final thought. We are in the third year of President Bush's term in office and heading for the fourth, which is the re-election year. Past history has shown that the US economy and equity markets rise in the final two years of a President's term, so if the political trade cycle is right we should see expansion and a rise in equity prices. Greenspan, in cutting rates on Wednesday, might be trying to avoid being blamed by Bush Jr. as he was by Bush Sr. of not doing enough to secure his re-election. Politics, of course is still a factor.

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