Economic Commentary

November 8, 2004

The Fed on Course to Hike Rates on Wednesday by 25 bps to 2.0%

The Federal Reserve is holding its second to last FOMC meeting for the year on Wednesday, November 10th and is unanimously expected to raise the target for the federal funds rate by 25 basis points which will bring it up to 2.0%, the highest level since November 6th, 2001. The Fed will meet again on December 14th, 2004. Although half of market analysts were expecting a pause in rate hikes in the December meeting, the balance of opinion has shifted to the view that the Fed will hike again in its December meeting following last Friday's jobs report, which showed that the economy created 337,000 new jobs in October. Our view is that although the probability for a fifth rate hike since June has certainly risen, the Fed will still opt to pause for six more weeks until its next regularly scheduled meeting sometime in early February, 2005.

Why the Fed has to raise rates is clear by now. The US economy has regained traction with real GDP growing at 3.75% plus rate, job growth, albeit slow to return is back and the specter of deflation in 2001-2002 has now been lifted. The US central monetary policy is no longer justified in holding short-term rates at "emergency" levels. The appropriate thing to do is to return them back to a more neutral setting. Accordingly, the US Federal Reserve has begun from June of this year to remove the monetary policy accommodation and has signaled its intentions to do so in a "measured pace". After having hiked them by 75 basis points in each of the previous three meetings it is now poised to do so again on Wednesday, bringing them to 2.0% from 1.0% in June .

At issue right now is not whether the Fed should or will raise the cost of money, but how quickly does it need to do so and how far does it need to go, i.e. in the present economic global environment what is the appropriate "neutral" level? With Wednesday's rate hike a foregone conclusion, the Fed does not have to raise rates at each meeting, but instead can afford to take some breaks between meetings in order to allow markets more time to adjust to the rise in the cost of funds. With inflation easing right now, the core CPI inflation for September (excluding food and energy) is now running at 2.0% while the Fed's preferred PCE core rate is running at only 1.4%, the Fed is not under pressure to raise rates. Nor are there any strong inflationary expectations being evidenced in bond markets, the 10-year US treasury rate is at a low 4.2%. When we look at capacity constraints the US economy continues to operate substantially below full capacity. The capacity utilization rate has rebounded from a low of 74% early in the year to 77.2% in September, but well below the 82-84% levels of 1998-2001. Finally, although the US Commerce Department shows that real GDP has been expanding at around 3.75%, more recent economic signs are pointing to a slowdown in the country's growth as we move forward. For example, the ISP purchasing managers' index has been slipping since the beginning of the year, consumer confidence has been slipping as well since June while the index of leading indicators has been edging downwards for four months in a row. With oil prices rising higher than expected and staying at $50 plus per barrel, this price insensitive component of consumer expenditure has been a major deflationary force lowering output by as much as half a percentage point on an annual basis. In this context, the Fed can afford to pause in the December meeting and resume its rate-hiking course early next year. We should get further guidance on the Fed's intentions on Wednesday's policy statement following the rate announcement. Currently, the January federal funds futures contract prices in a 76% probability of another quarter point tightening at the December meeting.

How far the Fed should go in raising rates is a more difficult question to answer. Although a further one full point tightening to 3.0% by the middle of 2005 is safe bet, where the Fed will go from there remains uncertain. There are a number of conflicting forces at work here. First of all, one must question the sustainability of the US expansion in light of the record and growing budget and trade deficits. Usually, strong economic growth results in growth in imports faster than exports. If the US continues to grow the US trade deficit will grow larger and at nearly 6% of GDP is already at a record high. In turn, how long can it maintain the trade deficit depends on how long foreigners, especially Pacific-Asian central banks continue to lend it money. Secondly, the Bush administration now that it has secured re-election for four more years has to tackle the budget deficit as well. Cutting the deficit normally requires raising taxes and cutting spending, either of which lessens growth. Third, with the US housing market at lofty levels, higher interest rates will now work in the opposite direction they did when they were falling and this puts the real estate market and the US consumer on main street at an increasing risk.

On the other hand, a great deal will depend on the course of economic growth in China, the world's newest economic engine. China has now displaced Japan as the world's third largest economy. What happens inside China will now have ramifications for global growth, inflation and yes, even interest rates. Following last week's surprise announcement that the Chinese central bank has increased interest rates for the first time in nine years, suggests that this is not an isolated event, but the beginning of a new era where the Chinese central bank will begin using Western-style market tools like interest rates to adjust monetary policy, and soon after that, the exchange rate as well. If the Chinese expansion proves stubborn both inflation and interest rates may move higher than expected next year, which will call for a higher interest rate setting in the US.

On the Canadian side, the Bank of Canada will be holding its last policy meeting for the year on December 7th. With a very strong job report last Friday, which showed that Canada's economy added 34,300 jobs, more than was expected, the odds of another rate hike on this side of the border to 3.0% from 2.75% right now have risen. On the other hand, the jump in the value of the Canadian dollar to 84.0 cents US was also larger than expected. With a higher dollar doing part of the dis-inflationary work of higher interest rates and with core CPI inflation in Canada at 1.5%, one must wonder whether it would be a good idea for the Bank of Canada to pause as well in December.

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