Economic Commentary

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The Fed is Set to Raise the Fed Funds Rare Tomorrow to 1.75%

The US Federal Reserve Board is holding its regularly-scheduled economic policy meeting tomorrow and is widely expected to raise the US policy overnight rate called the fed funds rate by a quarter of a point to 1.75%. Since June, Alan Greenspan and his fed officials have been saying that the Fed will have to adjust the monetary policy settings back to a more neutral level and that in the months ahead they will be raising interest rates at a "measured pace". Tomorrow's quarter point hike will be the third this year and will raise the fed funds rate to 1.75%, up from a 45-year low of 1.0% on June 30th.

Why the Fed needs to raise rates is fairly obvious at this point. After having lowered them to a generation low to prop up a very weak economy hit by the late 1990s stock market meltdown and the 9/11 terrorist attacks, now that the US economy appears to be on a more or less solid road to recovery, the appropriate response for central monetary authorities is to begin to raise rates back up, away from the highly stimulative level of 1.0% towards a more neutral setting. Most economists estimate that a "neutral" setting for the overnight rate is around 4.0%. Last week in Congressional testimony US Fed Chairman Alan Greenspan said that the US economic "expansion has regained some traction" which suggests that a quarter point hike tomorrow is imminent. Moreover, the price of money cannot stay below the rate of inflation for too long either. Let us remember that at 1.0% US short-term rates are below US consumer inflation which last Thursday was reported to be 2.7% for August (down from 3.0% in July). Even at 1.75%, US monetary policy remains exceedingly stimulative, even with a 1.75% fed funds rate.

How far up can we expect to see rates go in the USA? First of all, the US economy is not experiencing an inflation problem right now, the rise in oil prices notwithstanding. The core PPI and PCE (personal consumption expenditure inflation) which are the Fed's favourite measures of inflation are currently running at 1.5%, which is well below the headline rate of inflation. Secondly, if the Fed is moving to raise rates now, it is more as a preemptive move, to forestall future inflation. Given that the US expansion has regained some traction, the prudent stand is to remove some of the policy stimulus and return monetary policy to a more neutral setting. With two more regularly-scheduled meetings remaining before the end of the year, one on November 10th and the second on December 14th, it appears that the Fed is gearing up to raise rates again once more at either the November or December meetings, so it can round the overnight rate to a more respectable 2.0% level by the end of the year. The funds futures market reflects a similar outlook for market expectations. The October contract reflects a

96% probability for a 25 bp September tightening while the November contract prices a weaker 70% probability for another 25 bp hike at the Nov 10 meeting. The January contract trades at an effective rate of a nice round 2.00% -- pricing in just two 25 bp hikes over the three policy meetings through year-end. My hunch is that the Fed will raise rates in the November 10th meeting and stand pat during the December meeting.

What the above scenario argues for rates on this side of the border, is that the Bank of Canada will hike the Canadian overnight rate again to 2.50% this coming October 19th when its next regularly-scheduled meeting is set. Even though consumer inflation eased last month to 1.9% from 2.3% in July and even though the Bank of Canada's closely watched core inflation eased as well to 1.5%, the central bank will still act on rates in October because growth in Canada is running above the speed limit of 3.0% and the economy is operating near full capacity.

Although tomorrow's rate hike south of the border is propping up the value of the US dollar in the near-term, the medium-term outlook for the US greenback remains weak which puts the odds of a further appreciation in the value of the Canadian loonie at well over 50%.

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