The U.S. Federal Reserve stays the course and leaves interest rates unchanged

According to the U.S. Federal Reserve:

- The target interest rate for federal funds is staying at 5.25% (votes: for = 10; against = 0).
- Economic growth was moderate during the first half of the year, as the housing market continued its adjustment. Growth should be modest in future quarters.
- Core inflation is showing signs of improvement, but signs of sustained moderation in inflationary pressures are not yet convincing.
- The predominant risk is that inflation will not moderate as expected.

Commentary:

For the eighth time since its June 2006 meeting, the U.S. Federal Reserve (Fed) has left its key interest rates unchanged. The target interest rate for federal funds is therefore staying at 5.25%. The financial markets, and all of the 113 analysts consulted by the Bloomberg firm, were anticipating this status quo.

Since the Fed’s previous meeting at the beginning of May, there have been many ups and downs in financial markets. However, it is felt that the mixed quality of economic indicators argues in favour of future stability in key interest rates. Undermined by good economic news at the end of May and beginning of June, the bond market exhibited a considerable rise in interest rates and a new flattening of the curve after a period of inversion. However, the worries that are still troubling the housing market and less convincing indicators have tempered investors’ enthusiasm since then. Stock markets also seem to be experiencing something of a lull.

It should be noted that the main source of concern for the Fed’s directors, inflation, is showing signs of deceleration. The core consumer price index, which excludes food and energy, has been slowing down steadily for several months now. We expect this trend to continue in the next few quarters, while the recent trend of the U.S. economy and weakening pressures from housing costs will drive annual core inflation down further. The same phenomenon can be observed in the core personal consumption expenditures deflator (which excludes food and energy) which is expected to fall below 2% in terms of annual variation when the May figure is released on Friday. That level is already below the range expected by the Fed for the end of the year.

Given the current weakness of inflationary pressures, along with certain economic indicators that have recently shown signs of improvement, the Fed can afford to be patient and keep its key interest rates at current levels for a long time to come. However, it is still concerned about pressures coming from resources utilization, saying it is not convinced of sustained moderation of inflationary pressures. We still believe that the stability in unemployment rates, the risks in the housing market, the rise in longer term interest rates and the tightening of credit standards by financial institutions should allay some of those fears. In these circumstances, and based on our own economic forecasts, the key interest rates should stay at their current level throughout 2007 and well into 2008. The main risk in this scenario is that the U.S. economy may go off the rails again, leading the Fed to reduce the cost of money. Finally, remember that in July, Mr. Bernanke will present the Fed’s semi-annual report to the U.S. Congress. It was during last year’s address that he announced a halt to the cycle of rate increases.

Core inflation will continue to decelerate

Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

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The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5-1/4 percent.

Economic growth appears to have been moderate during the first half of this year, despite the ongoing adjustment in the housing sector. The economy seems likely to continue to expand at a moderate pace over coming quarters.

Readings on core inflation have improved modestly in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.

In these circumstances, the Committee’s predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

Excerpt from the U.S. Federal Reserve press release
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