THE FEDERAL RESERVE HIKES ITS RATES AGAIN
Katrina's fallout will be short lived but inflation pressures could potentially heat up

According to the Fed:

- The target for the federal funds rate increases to 3.75%: for = 9; against = 1.
- The U.S. economy was growing at a good pace before Katrina hit: the hurricane’s impact on the U.S. economy and prices should be short lived.
- High energy prices may exacerbate inflationary pressures: core inflation remains moderate.
- With the appropriate monetary policy, the risks should remain balanced between price stability and economic growth.

Commentary:

Despite the havoc wreaked by Katrina in the southern U.S., Federal Reserve (Fed) authorities decided (all except one) to hike the target for the federal funds rate for the 11th consecutive time. The markets expected the key rate to rise from 3.50% to 3.75%, although a few observers were banking on the status quo.

In fact, the Fed doesn’t seem to believe the damage caused by Katrina and its consequences on energy prices will last long. Of course, the Fed’s monetary policy committee recognizes the increased uncertainty on the economic scene.

It appears that Fed authorities are more worried about how the hurricane will affect prices than economic activity. In fact, the recent run-up of gas and oil prices has been nothing short of spectacular. At US$1.80 at the beginning of the year, the price of gas climbed to US$2.50 in August, before Katrina. Days after the hurricane, it was more than US$3.05. Fortunately, the price has since come down, but as a result, we can expect the U.S. CPI to go up more than 1% in September, which means that annual inflation will rise from 3.6% in August to close to 4.5%.

This inflationary situation seems to be a cause of increasing concern for the Fed, although the fact that core inflation (excluding food and energy) remains moderate is easing some of its worries. Greenspan and his colleagues therefore continue to believe that the accommodating nature of their monetary policy can be reduced at a measured pace and, as such, it doesn’t seem that the Fed is ready to suspend rate hikes in the short term. In fact, to stop the Fed from trying to bring key rates to neutral levels (estimated at between 4.50% and 5.00%), the post-Katrina economy would have to slow substantially over and above the expected erratic fluctuations. Otherwise, we could see the federal funds rate reach 4.25% at the end of the year.

United States: Monthly change in consumer prices

United States: Inflation should continue to rise in September

Sources: Bureau of Labor Statistics, Energy Information Administration and Desjardins, Economic Studies

Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Gilles Soucy
Vice-president and Chief Economist
Phone: 514-281-2336 or 1 866 866-7000, ext. 2336

François Dupuis
Deputy Chief Economist and Strategist

Francis Généreux
Economist

E-mail: desjardins.economics@desjardins.com
Excerpts from the Fed Press Release:

Output appeared poised to continue growing at a good pace before the tragic toll of Hurricane Katrina. The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. In addition to elevating premiums for some energy products, the disruption to the production and refining infrastructure may add to energy price volatility.

While these unfortunate developments have increased uncertainty about near-term economic performance, it is the Committee’s view that they do not pose a more persistent threat. Rather, monetary policy accommodation, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity. Higher energy and other costs have the potential to add to inflation pressures. However, core inflation has been relatively low in recent months and longer-term inflation expectations remain contained.

The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

September 20, 2005