THE FEDERAL RESERVE HALTS ITS MONETARY TIGHTENING
The economic slowdown wins out over inflation fears

According to the U.S. Federal Reserve:

- The target rate for Federal Funds remains unchanged at 5.25%.
- Votes: for = 9; against = 1 (Jeffrey Lacker, President of the Richmond Fed).
- Economic growth has moderated partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices.
- Readings on core inflation have been elevated in recent months; however, inflation pressures seem likely to moderate over time.
- The FOMC judges that some inflation risks remain.

Commentary:

Although today’s decision does not really come as a surprise (over 70% of the analysts surveyed by Bloomberg were expecting it), it is still a major change of heading within the U.S. Federal Reserve. After having raised key interest rates seventeen times in a row, FOMC members finally opted for the status quo (at 9 to 1, the decision was not unanimous, a very rare occurrence). The target for the overnight rate has thus gone from 1.00% in June 2004 to 5.25% last June.

It seems that the increasingly clear signs of slowing economic expansion carried a little more weight than fears of an increase by inflationary pressures. Note, for example, smaller than expected growth by real GDP in the second quarter, which was up by only an annualized 2.5%, and weak job creation in recent months.

On the other hand, this does not mean that inflation concerns have been completely set aside. We also learned this morning that the productivity of American workers only grew by 1.1% in the second quarter, simultaneously generating a 4.2% increase in unit labour costs. The weaker advance by the productivity of U.S. workers could eventually have a bigger impact on wages as well as price indexes.

The members of the FOMC are thus clearly indicating that further rate hikes could be ordered in the coming months if the inflation situation deteriorates. Nonetheless, we are of the opinion that today’s status quo marks a step toward a period of stability for U.S. monetary policy.
U.S. Federal Reserve Press Release:

[...] Economic growth has moderated from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices.

Readings on core inflation have been elevated in recent months, and the high levels of resource utilization and of the prices of energy and other commodities have the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand.

Nonetheless, the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.

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