According to the U.S. Federal Reserve:

- The target for the federal funds rates remains at 5.25%.
  Votes: For = 10; against = 1 (Jeffrey M. Lacker, Richmond Fed president).
- The Committee members reiterated that the extent and timing of any additional firming that may be needed will depend on the evolution of the outlook for both inflation and economic growth.
- Core inflation remains high and the high level of resource utilization has the potential to sustain inflation pressures.
- Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters.

Commentary:

The U.S. Federal Reserve (the “Fed”) decided to maintain the status quo policy begun in August, holding the benchmark interest rates steady at 5.25%. Dissenting yet again, the Richmond Fed president was the only one to vote for a rate hike. For their part, the other members of the Federal Open Market Committee (FOMC) felt that the current rates were appropriate for the economic situation. In light of the consensus call and futures market implicit probabilities, this decision comes as no surprise.

As expected, the Federal Reserve release hardly differed from the last one except for a few superficial changes. Mr. Bernanke and the Committee members are still concerned about the level of inflation, particularly the core rate, which excludes food and energy. This explains their bias toward tightening. They again called attention to the fact that economic growth has slowed and will continue to do so in the coming quarters. This tone is in line with the most recent statements made by Fed policymakers, including Bernanke himself.

Still, the slowdown, and especially the poor performance of some economic indicators, could cause the Fed to change course sooner than later. In fact, the Committee has already said that the “substantial cooling” of the housing market is a risk factor. Weakness in the manufacturing sector and sluggish consumer spending are also a concern. The deceleration of the economy, combined with easing price pressures stemming from the imbalance in the real estate market, should help bring down core inflation—the main obstacle to rate cuts—in 2007. Thus, the Fed may very well decide to lower interest rates by winter’s end in order to avoid exacerbating the situation.

However, three conditions must exist before this can happen. First, core CPI (excluding food and energy) growth must moderate. Second, some indicators must deteriorate, particularly the ISM index, which recently fell below 50. And third, the Fed must pave the way by clearly signalling its intention to change course. This may happen in its January press release or when it tables its semi-annual report before Congress. If it does, we may well see a rate cut in March, or in May if it decides to adopt a more cautious stance.

It bears mentioning that while there will be new faces on the FOMC in 2007, the balance between hawks and doves will not change. Jeffrey Lacker, the most hawkish member, will be replaced by a like-minded individual: Chicago Fed president Michael Moskow. Among the dovish members, Janet Yellen will be replaced by Thomas M. Hoenig.
The Federal Open Market Committee decided today to keep its target for the federal funds rate at 5-1/4 percent.

Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters.

Readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, 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.

Excerpt from the U.S. Federal Reserve press release
December 12, 2006