

# **Economic Commentary**

August 13, 2002

## **Fed to Leave Rates Unchanged for Now but will Stand Prepared to Lower Them Later in the Year if it Needs to**

The Federal Reserve is meeting this morning to decide on what to do about short-term interest rates.

Despite the market's expectations last week of an up-coming rate cut, the Fed today is unlikely to cut rates below the generational low of 1.75% for Three good reasons: 1) there has not been sufficient evidence that the US economy is heading back to recession yet; 2) if it cuts rates it will be seen as Playing to the needs of the stock market and this is not its mandate anyway, this will undermine its credibility; 3) if it cuts rate it is tantamount to admitting that the US economy is in real trouble and this might do more psychological damage than it will help.

Rather, the Fed is likely to leave rates where they are but suggest that if real economic activity takes a sudden turn for the worst, it stands prepared to cut rates further later on in the year. This way it sends a message that although the recovery is weak it is still not in danger of aborting, while the Fed still retains some more ammunition to deal with problems should the need arise.

As far as the Bank of Canada is concerned, the likelihood of continued rate increases has lessened considerably. However, I think that at least one more rate hike (to 3.0%) is in the cards, probably on September 4th when it holds it's next scheduled meeting.

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