

Economic Commentary

January 30, 2006

Fed to Raise Fed Funds Rate to 4.5% Tomorrow, Alan Greenspan's Last Meeting at the Fed

The Federal Reserve Board's Open Market Committee is meeting tomorrow and is widely expected to raise interest rates for the 14th time over a 19-month period to 4.5%, up from 1.0% since June, 2004. Tomorrow's meeting is going to be the last one chaired by Alan Greenspan. Also tomorrow, the White House economic adviser Ben Bernanke will receive Senate approval to become the 14th chairman of the U.S. Federal Reserve Board.

I don't think that it would be an exaggeration to say that the Chairman of the U.S. Federal Reserve is the most powerful position in the world because the decisions it makes on money and interest rates have the biggest impact on peoples' lives and since the Fed also happens to be the *de facto* central bank of the world, it affects global economic conditions. Over the past 18 years that Mr. Greenspan has served as chairman of the Fed he has proven himself repeatedly and he has established an enviable reputation as the best Chairman in the Fed's history. Under his stewardship the United States and by extension the world economy have been very fortunate to have him.

On Wednesday, February 1st, a new Chairman, Ben Bernanke takes over the reigns of the Fed. Although widely considered one of the best economists in the United States and the best candidate for the job, no one is in a position to fill Greenspan's shoes. Mr. Bernanke will still be new and untested, and it will take some time before he proves his credentials and starts to build the credibility that Mr. Greenspan enjoys and earn the confidence of US and global financial markets. The period ahead will most certainly be a delicate one for financial markets, for the US dollar and for the US economy for this reason alone.

But this is not the only concern facing financial markets. He is taking over in a period of crucial choices for monetary policy and heightened economic uncertainty. This uncertainty grew Friday with a government report that showed that U.S. economic growth slowed sharply in last year's fourth quarter to a 1.1-per-cent annual rate, the slowest pace in three years and well below analysts' expectations. Although the US economy grew at a healthy rate of 3.5% for the year as a whole, it raises the question will the economy slow down in 2006 or was this a temporary bump on the road? As I have stressed in previous Commentaries, the position of the US economy is the most precarious it has ever been. With unsustainably large budget and trade deficits, it is dependent on a continual flow of savings from foreign, primarily - Asian central banks. Economic growth over the past four years has been driven by cheap interest rates which

have created a real estate bubble and has turned the average home into an ATM machine for the US consumer to use at will. With interest rates now back to more normal levels, with the real estate market at a peak, and with the US government without fiscal reserves to defend the economy, how much more can this expansion continue to run? What is the outlook for the US economy right now? Should the new Chairman continue to tighten, should he take a breather, or should he consider lowering rates?

Economists are becoming increasingly divided on this issue themselves. One camp believes that last quarter's drop in the growth rate was temporary and that growth has already resumed this quarter and that the economy has momentum, is resilient and will continue to grow albeit at a more moderate rate. That despite the moderation in growth, will still need higher rates to subdue inflation and inflationary expectations. The other camp believes that rising rates are undermining the drivers that kept this expansion going over the past four years and might precipitate a retrenchment in consumer spending and a drop in housing prices.

The new Fed Chairman will be appearing before Congress on February 15th to make his first report. That is when we will get the first chance to hear what he thinks and what he might have in mind. My personal view based on what I have read and seen about Mr Bernanke is that he will make a very good chairman and steward of the US money supply.

In the meantime, lets salute Mr. Greenspan and thank him for his excellent services to the global economy over the past eighteen years and wish him well on his retirement. Lets also take this opportunity to wish Mr. Bernanke good luck in his new position. Sometimes, no wonder how good we are, we also need good luck on our side. Given the challenges that the US economy faces, there is more of a reason to wish him luck this time.

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