

Essentials of the Monetary Policy

March 18, 2008



U.S. FEDERAL RESERVE

-0.75% today: are the key rate cuts too aggressive?

ACCORDING TO THE U.S. FEDERAL RESERVE (Fed)

- The Fed used its official meeting to announce a 75 basis point cut to its key rates. The target interest rate for federal funds thus goes from 3.00% to 2.25%.
- The discount rate, which was already cut by 25 basis points on Sunday, also comes down 75 basis points to 2.50%.
- Eight members of the monetary policy committee voted for the cut, while two members (the Dallas Fed's Fisher, and Philadelphia Fed's Plosser) wanted less aggressive cuts.
- The financial markets remain under considerable strain. Tightening credit conditions and intensified deterioration by the housing market should curb economic growth over the quarters to come.
- Inflation remains elevated and some indicators for inflation expectations have deteriorated. The Fed expects inflation to moderate in the coming quarters. Uncertainty about the inflation situation has increased.
- Downside risks to economic growth remain. The Fed will continue to watch the situation and act as needed.

COMMENTS

The extreme volatility of the financial markets in the last few weeks demanded substantial action from Ben Bernanke and his colleagues. They responded with a 75 basis point cut to the key rates, in addition to the 125 basis point cuts already made since the year began.

Clearly, the current problems in the U.S. economy and financial markets are sizeable. The recession is knocking at America's door, and the first two quarters of 2008 should record declines by both production and employment. However, is this fast a key rate cut the best solution at this time? On one hand, monetary easing will not quickly resolve the ongoing major imbalance in the housing market. On the other, the stimulus provided by the federal government's tax rebates will be felt starting in May. We must therefore be patient. Lastly, the rate cuts can only be effective if the credit market stabilizes. To date, the monetary easing policy has

been offset by high spreads between market rates and sharp tightening in credit conditions.

The Fed thus needs to increasingly focus its action on measures that will facilitate smoother functioning by the credit market, to help the liquidity crunch come to an end. Measures such as the creation of the TAF and TSLF (see table 3), and bringing the discount rate towards the target for federal funds seem to be good policies that aim at the heart of the problem.

The Fed also needs to retain some leeway. The 200 basis points that have been trimmed from the federal funds rate in the last two months are now limiting the range of possibilities available if the economy and financial markets deteriorate further. If, on the other hand, households and business respond positively to the new incentives, the economy could quickly generate new inflation pressures. Until the economic situation clears up, it would be best for the Fed to opt for prudence by immediately moderating the pace of its monetary easing. The harsher picture of inflation in today's statement may be a signal that the Fed is striving to moderate the markets' expectations as to future rate cuts.

Implications: There is no doubt that key rate cuts will continue, as the bad economic and financial news will keep on mounting. The Fed is going to have to cool its enthusiasm somewhat and opt for less strenuous cuts, however. The markets could still prod it to cut its rates by 50 points at its next meeting but, after that, a 25 point cut should follow. Rates could come down to 1.50% in the summer.

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NOTE TO READERS: The letters **K**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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**EXCERPT FROM THE U.S. FEDERAL RESERVE PRESS RELEASE
MARCH 18, 2008**


[...] The Federal Open Market Committee decided today to lower its target for the federal funds rate 75 basis points to 2 1/4 percent.

Recent information indicates that the outlook for economic activity has weakened further. Growth in consumer spending has slowed and labor markets have softened. Financial markets remain under considerable stress, and the tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters.

Inflation has been elevated, and some indicators of inflation expectations have risen. The Committee expects inflation to moderate in coming quarters, reflecting a projected leveling-out of energy and other commodity prices and an easing of pressures on resource utilization. Still, uncertainty about the inflation outlook has increased. It will be necessary to continue to monitor inflation developments carefully.

Today's policy action, combined with those taken earlier, including measures to foster market liquidity, should help to promote moderate growth over time and to mitigate the risks to economic activity. However, downside risks to growth remain. The Committee will act in a timely manner as needed to promote sustainable economic growth and price stability. [...]

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
January 2008			
10	European Central Bank	s.q.	4.00
10	Bank of England	s.q.	5.50
18	Bank of Mexico	s.q.	7.50
21	Bank of Japan	s.q.	0.50
22	Bank of Canada	-25 b.p.	4.00
22	U.S. Federal Reserve	-75 b.p.	3.50
17	Bank of Norway	s.q.	5.25
24	Reserve Bank of New Zealand	s.q.	8.25
30	Bank of Brazil	s.q.	11.25
30	U.S. Federal Reserve	-50 b.p.	3.00
February 2007			
4	Reserve Bank of Australia	+25 b.p.	7.00
7	European Central Bank	s.q.	4.00
7	Bank of England	-25 b.p.	5.25
13	Bank of Sweden	+25 b.p.	4.25
14	Bank of Japan	s.q.	0.50
15	Bank of Mexico	s.q.	7.50
March 2007			
3	Reserve Bank of Australia	+25 b.p.	7.25
4	Bank of Canada	-50 b.p.	3.50
5	Reserve Bank of New Zealand	s.q.	8.25
5	Bank of Brazil	s.q.	11.25
6	European Central Bank	s.q.	4.00
6	Bank of England	s.q.	5.25
6	Bank of Japan	s.q.	0.50
13	Bank of Norway	s.q.	5.25
13	Swiss National Bank	s.q.	2.75
14	Bank of Mexico	s.q.	7.50
18	U.S. Federal Reserve	-75 b.p.	2.25

s.q.: status quo; b.p. : basis points
Source: Desjardins, Economic Studies

**Table 2
Coming soon**

Date	Central Bank
March 2008	
31	Reserve Bank of Australia
April 2008	
8	Bank of Japan
10	European Central Bank
10	Bank of England
16	Bank of Brazil
18	Bank of Mexico
22	Bank of Canada
23	Bank of Norway
23	Reserve Bank of New Zealand
23	Bank of Sweden
29	Bank of Japan
30	U.S. Federal Reserve
May 2008	
6	Reserve Bank of Australia
8	European Central Bank
8	Bank of England
16	Bank of Mexico
19	Bank of Japan
28	Bank of Norway
June 2008	
3	Reserve Bank of Australia
4	Reserve Bank of New Zealand
4	Bank of Brazil
5	European Central Bank
5	Bank of England
10	Bank of Canada
12	Bank of Japan
19	Swiss National Bank
20	Bank of Mexico

Source: Desjardins, Economic Studies

Table 3
The Fed's actions

<i>Date</i>	
August 10, 2007	Onset of the financial crisis: the Fed injects US\$38B in liquidity into the interbank market.
August 17, 2007	50 basis point cut to the discount rate, bringing it to 5.75%.
August 21, 2007	The New York Fed cuts loan fees on its government securities.
Sept. 18, 2007	50 basis point cut to key rates. The target for federal funds goes to 4.75% and the discount rate goes to 5.25%.
Oct. 31, 2007	25 basis point cut to key rates. The target for federal funds goes to 4.50% and the discount rate goes to 5.00%.
Nov. 15, 2007	The Fed adds US\$47.25B in liquidity to the interbank market.
Nov. 26, 2007	The New York Fed announces that it will inject liquidity to make the year end easier for financial institutions.
Dec. 11, 2007	25 basis point cut to key rates. The target for federal funds goes to 4.25% and the discount rate goes to 4.75%.
Dec. 12, 2007	The Fed announces the creation of the TAF (Term Auction Facility) to provide the interbank market with more liquidity. The first auctions are for US\$20B.
Jan. 4, 2008	The Fed raises the credit available at each auction through the TAF to US\$30B.
Jan. 22, 2008	Surprise 75 basis point cut to key rates. The target for federal funds goes to 3.50% and the discount rate goes to 4.00%.
Jan. 30, 2008	50 basis point cut to key rates. The target for federal funds goes to 3.00% and the discount rate goes to 3.50%.
March 7, 2008	The Fed raises the credit available at each auction through the TAF to US\$50B. It adds a repurchase facility of up to US\$100B.
March 10, 2008	Between its launch date and March 10, 2008, US\$210B have been provided via the TAF.
March 11, 2008	The Fed announces it is setting up the TSLF (Term Securities Lending Facility). The facility will provide up to US\$200B for a period of 28 days. A broader range of securities are accepted by the Fed in exchange for liquidity (including private sector mortgage securities). The number of participants is broadened.
March 16, 2008	25 basis point cut to the discount rate to 3.25%. The Fed introduces a new credit facility making it possible to lend to more institutions at the same terms as primary discount loans. The Fed lends J.P. Morgan Chase up to US\$30B to facilitate its purchase of Bear Stearns.
March 18, 2008	75 basis point cut to key rates. The target for federal funds goes to 2.25% and the discount rate goes to 2.50%.

Sources: Bloomberg and Desjardins, Economic Studies