

Essentials of the Monetary Policy

June 25, 2008



FEDERAL RESERVE

The monetary policy is now on hold

ACCORDING TO THE FEDERAL RESERVE (Fed)

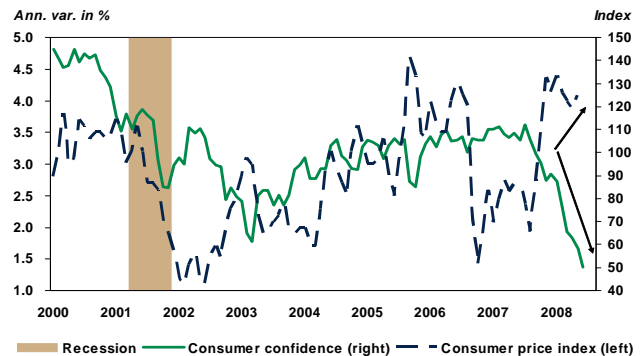
- The Fed announced that it would be keeping the target for the federal funds rate at 2.00%.
- Nine of the monetary policy committee's members voted for the status quo. Only the Dallas Fed's Richard W. Fisher was in favour of a key rate increase.
- The risks to economic growth seem to have diminished somewhat, while inflation risks have increased. The Fed will continue to monitor economic and financial developments and act as needed.
- The financial markets are still under considerable stress and the labour market has slowed. Tightening credit conditions, the housing market contraction and rising energy prices should curb economic growth over the quarters to come.
- The Fed expects inflation to moderate later this year and next year. Uncertainty about the inflation outlook remains high due to the continued increase in energy prices and the elevated state of some indicators of inflation expectations.

COMMENTS

The Fed had done a thorough job of preparing the markets for a monetary policy status quo. The latest comments from Fed leaders did not leave much room for doubt. The decision had been 88.4% priced in by the futures market and forecast by all 102 analysts and economists in Bloomberg's consensus. However, the tone of the statement is a little more hawkish, with inflation risks taking precedence over the economy's deterioration.

Does the tougher tone suggest that key interest rate increases are on the way shortly? In our opinion, no. Unless energy prices continue to rise at this pace, it is hard to picture monetary firming being initiated in 2008. The impacts of the 325 basis points of key rate cuts ordered since September of 2007 have not yet been entirely felt. Moreover, they are largely being offset by tightened credit conditions. For example, the interest rates on one-year mortgages are still higher than they were in June of 2007!

It is difficult for the Fed to balance the threat of inflation and the risks of economic contraction



Sources: Conference Board, Bureau of Labor Statistics and Desjardins, Economic Studies

Despite this, the Fed will be worrying about inflation risks for some time to come. The Fed is focusing on the increase in gas prices (which will keep total inflation over 4% until the fall) and unhinging of inflation expectations. However, the economic impacts of the increase in gas prices, drop in consumer confidence, precarious housing market, downturn in the labour market, financial market instability and increase in excess production capacity mean that the situation is not ripe for an increase in the cost of money in the near future.

Implications: It is hard for the Fed to keep a balance between the threat of inflation and the precarious economy. In the short term, however, it would be inappropriate for key rates to move up. The Fed will instead try to calm the situation down using rhetoric with bite. They are more likely to use words than deeds. Key rates should therefore be steady for the rest of the year. We will be getting more information in mid-July, when the minutes for this meeting are released, and the Fed publishes its semi-annual report.

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**EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE
JUNE 25, 2008**


The Federal Open Market Committee decided today to keep its target for the federal funds rate at 2 percent.

Recent information indicates that overall economic activity continues to expand, partly reflecting some firming in household spending. However, labor markets have softened further and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and the rise in energy prices are likely to weigh on economic growth over the next few quarters.

The Committee expects inflation to moderate later this year and next year. However, in light of the continued increases in the prices of energy and some other commodities and the elevated state of some indicators of inflation expectations, uncertainty about the inflation outlook remains high.

The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time. Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased. The Committee will continue to monitor economic and financial developments and will act as needed to promote sustainable economic growth and price stability.

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
April 2008			
10	Bank of England	-25 b.p.	5.00
10	European Central Bank	s.q.	4.00
16	Bank of Brazil	+50 b.p.	11.75
18	Bank of Mexico	s.q.	7.50
22	Bank of Canada	-50 b.p.	3.00
23	Bank of Norway	+25 b.p.	5.50
23	Reserve Bank of New Zealand	s.q.	8.25
23	Bank of Sweden	s.q.	4.25
29	Bank of Japan	s.q.	0.50
30	Federal Reserve	-25 b.p.	2.00
May 2008			
6	Reserve Bank of Australia	s.q.	7.25
8	Bank of England	s.q.	5.00
8	European Central Bank	s.q.	4.00
16	Bank of Mexico	s.q.	7.50
19	Bank of Japan	s.q.	0.50
28	Bank of Norway	s.q.	5.50
June 2008			
3	Reserve Bank of Australia	s.q.	7.25
4	Reserve Bank of New Zealand	s.q.	8.25
4	Bank of Brazil	+50 b.p.	12.25
5	Bank of England	s.q.	5.00
5	European Central Bank	s.q.	4.00
10	Bank of Canada	s.q.	3.00
12	Bank of Japan	s.q.	0.50
19	Swiss National Bank	s.q.	2.75
20	Bank of Mexico	+25 b.p.	7.75
25	Bank of Norway	+25 b.p.	5.75
25	Federal Reserve	s.q.	2.00

**Table 2
Coming soon**

Date	Central Bank
July 2008	
1	Reserve Bank of Australia
3	European Central Bank
3	Bank of Sweden
10	Bank of England
14	Bank of Japan
15	Bank of Canada
18	Bank of Mexico
23	Reserve Bank of New Zealand
23	Bank of Brazil
August 2008	
5	Reserve Bank of Australia
5	Federal Reserve
7	Bank of England
13	Bank of Norway
15	Bank of Mexico
18	Bank of Japan
September 2008	
2	Reserve Bank of Australia
3	Bank of Canada
4	Bank of England
4	European Central Bank
10	Reserve Bank of New Zealand
10	Bank of Brazil
16	Bank of Japan
16	Federal Reserve
18	Swiss National Bank
19	Bank of Mexico
24	Bank of Norway

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

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