Essentials of the Monetary Policy
Desjardins Economic Studies
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FEDERAL RESERVE

The Fed stays the course, no rate hikes in sight

ACCORDING TO THE FEDERAL RESERVE (Fed)

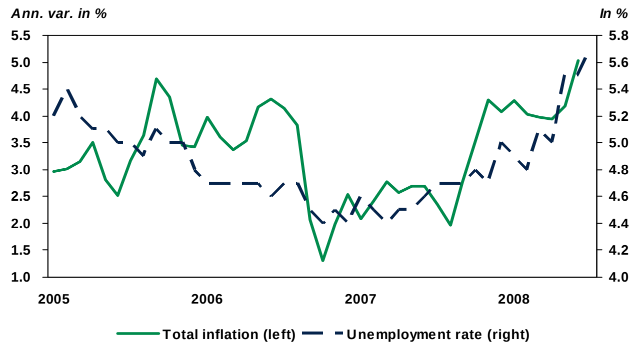
- The Fed decided to keep the target for the federal funds rate at 2%.
- Nine members of the monetary policy committee voted in favour of maintaining the status quo. Richard W. Fisher from the Dallas Fed was the only member in favour of increasing key rates.
- Downside risks to growth remain, the upside risks to inflation are also of significant concern to the Committee, which will continue to monitor the financial and economic situation and act as necessary.
- The economy grew in the second quarter, but the labour market continued to weaken and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and elevated energy prices are likely to weigh on economic growth over the next few quarters.
- Inflation was high due to previous increases in the prices of commodities and the fact that certain inflationary expectation indicators are high. The Fed expects that inflation will moderate later on this year and next, but the scenario on inflation is still rife with uncertainty.

COMMENTS

The Fed's decision took no one by surprise as every analysts surveyed by Bloomberg expected the Committee to maintain the status quo. The Fed's statement contained few changes, except for the balance between the risks weighing on economic growth and inflation. The previous statement put a greater emphasis on inflationary risks. In addition, unlike what many expected, the number of dissidents who would have preferred an immediate rate increase remained the same.

Like several other central banks, the Fed now finds that its hands are tied. On the one hand, the thrust of inflationary pressures argue in favour of rapidly tightening the monetary policy. The annual change in the consumer price index jumped to 5% in June, its highest level since February 1991. On the other hand, the economic and financial situation remains very worrisome in the United States, which would make any rapid rise in key rates premature at best. Even if

Inflation continues to rise, but the labour market is deteriorating



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

the U.S. economy saw almost 2% growth in the last quarter, many signs of weakness still remain: the real estate correction continues, the unemployment rate is rising rapidly and the financial position of banks continues to deteriorate.

While not mentioned in its statement, the corrections we have seen in the past few weeks in the commodity markets, especially oil prices, must have brought a sigh of relief to the Fed. This recent development could very well soften inflationary pressures in the coming quarters.

Implications: Today's statement confirms that the Fed is in "pause" mode and nothing points to an imminent increase in key interest rates. The strength of inflation is forcing the Fed to keep its hawkish tone in order to limit dissension among committee members. That said, the monetary authorities are well aware of the many difficulties the U.S. economy is facing. Unless there's another surge in oil prices, key interest rates should remain unchanged at least until the end of the year.

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EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE AUGUST 5, 2008

The Federal Reserve Board

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

Economic activity expanded in the second quarter, partly reflecting growth in consumer spending and exports. However, labor markets have softened further and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and elevated energy prices are likely to weigh on economic growth over the next few quarters. Over time, the substantial easing of monetary policy, combined with ongoing measures to foster market liquidity, should help to promote moderate economic growth.

Inflation has been high, spurred by the earlier increases in the prices of energy and some other commodities, and some indicators of inflation expectations have been elevated. The Committee expects inflation to moderate later this year and next year, but the inflation outlook remains highly uncertain.

Although downside risks to growth remain, the upside risks to inflation are also of significant concern to the Committee. 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*
May 2008			
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
July 2008			
1	Reserve Bank of Australia	s.q.	7.25
3	European Central Bank	+25 b.p.	4.25
3	Bank of Sweden	+25 b.p.	4.50
10	Bank of England	s.q.	5.00
15	Bank of Canada	s.q.	3.00
15	Bank of Japan	s.q.	0.50
18	Bank of Mexico	+25 b.p.	8.00
23	Reserve Bank of New Zealand	s.q.	8.00
23	Bank of Brazil	+75 b.p.	13.00
August 2008			
5	Reserve Bank of Australia	s.q.	7.25
5	Federal Reserve	s.q.	2.00

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

Table 2
Coming soon

Date	*Central Bank*
August 2008	
7	Bank of England
7	European Central Bank
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
4	Bank of Sweden
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
October 2008	
2	European Central Bank
6	Bank of Japan
7	Reserve Bank of Australia
9	Bank of England
17	Bank of Mexico
21	Bank of Canada
22	Reserve Bank of New Zealand
23	Bank of Sweden
29	Bank of Norway
29	Bank of Brazil
29	Federal Reserve

Source: Desjardins, Economic Studies