

Essentials of the Monetary Policy



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FEDERAL RESERVE

The target for the federal funds rate drops to 1%: heading for a quantitative monetary policy

ACCORDING TO THE FEDERAL RESERVE (Fed)

- The Fed has lowered the target for the federal funds rate by 50 basis points to 1%.
- The pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports.
- The intensification of financial market turmoil should put further additional restraint on spending.
- The decline in the prices of energy and other commodities and the weaker prospects for economic activity should bring inflation back to levels that are consistent with price stability.
- Recent policy actions should, over time, help improve credit conditions and promote a return to moderate growth. Nevertheless, downside risks to growth remain.

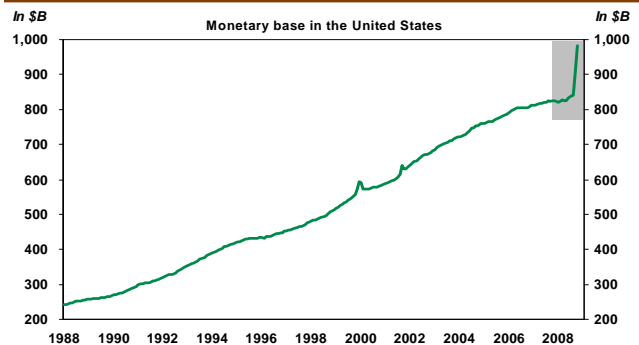
COMMENTS

The Fed continues to take vigorous action, lowering its key rate by 50 basis points for the second time in less than a month. A few days ago, a 25-basis point cut could have seemed sufficient. However, the collapse of consumer confidence and palpably edgy financial markets forced the Fed's hand.

The clear deterioration in the economic outlook and highly fragile financial markets justify this unprecedented response from U.S. authorities to keep the financial system from collapsing and limit the scope of the recession, now inevitable. Without making a clear commitment in this regard, today's statement opens the door to further key rate cuts.

At first glance, the Fed's leeway now appears slight, with the key rate quickly closing in on zero. However, the Fed has already set up the mechanisms it needs to continue taking action even if the key rate instrument were no longer effective.

One sign of quantitative policy: the monetary base has been growing rapidly in the last few weeks



Sources: Datastream and Desjardins, Economic Studies

Like the Bank of Japan in the early part of the decade, the Fed is ready to stimulate the economy by increasing the money supply, without worrying about the impact on key rates. This would be a quantitative monetary policy. The Fed has already started taking this kind of action, injecting huge amounts of liquidity into the banking system and money market, and even buying commercial papers. These actions have made the monetary base jump and seem to be quietly starting to help thaw out the credit market.

Implications: Today's cut was primarily intended to support financial market confidence; further cuts to federal funds are very likely. However, the Fed could increasingly favour direct injections of liquidity to support the economy as the key rate cuts seem to be having less and less of an impact.

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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 FEDERAL RESERVE PRESS RELEASE


“The Federal Open Market Committee decided today to lower its target for the federal funds rate 50 basis points to 1 percent.

The pace of economic activity appears to have slowed markedly, owing importantly to a decline in consumer expenditures. Business equipment spending and industrial production have weakened in recent months, and slowing economic activity in many foreign economies is damping the prospects for U.S. exports. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit.

In light of the declines in the prices of energy and other commodities and the weaker prospects for economic activity, the Committee expects inflation to moderate in coming quarters to levels consistent with price stability.

Recent policy actions, including today’s rate reduction, coordinated interest rate cuts by central banks, extraordinary liquidity measures, and official steps to strengthen financial systems, should help over time to improve credit conditions and promote a return to moderate economic growth. Nevertheless, downside risks to growth remain. The Committee will monitor economic and financial developments carefully and will act as needed to promote sustainable economic growth and price stability. [...]”

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
September 2008			
2	Reserve Bank of Australia	-25 b.p.	7.00
3	Bank of Canada	s.q.	3.00
4	Bank of England	s.q.	5.00
4	European Central Bank	s.q.	4.25
4	Bank of Sweden	+25 b.p.	4.75
12	Reserve Bank of New Zealand	-50 b.p.	7.50
19	Bank of Brazil	+75 b.p.	13.75
16	Bank of Japan	s.q.	0.50
20	Federal Reserve	s.q.	2.00
25	Swiss National Bank	s.q.	2.75
25	Bank of Mexico	s.q.	8.25
24	Bank of Norway	s.q.	5.75
October 2008			
2	European Central Bank	s.q.	4.25
6	Reserve Bank of Australia	-100 b.p.	6.00
6	Bank of Japan	s.q.	0.50
8	European Central Bank	-50 b.p.	3.75
8	Bank of England	-50 b.p.	4.50
8	Bank of Sweden	-50 b.p.	4.25
8	Bank of Canada	-50 b.p.	2.50
8	Swiss National Bank	-25 b.p.	2.50
8	Federal Reserve	-50 b.p.	1.50
15	Bank of Norway	-50 b.p.	5.25
17	Bank of Mexico	s.q.	8.25
21	Bank of Canada	-25 b.p.	2.25
22	Reserve Bank of New Zealand	-100 b.p.	6.50
23	Bank of Sweden	-50 b.p.	3.75
29	Bank of Norway	-50 b.p.	4.75
29	Federal Reserve	-50 b.p.	1.00

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

**Table 2
Coming soon**

Date	Central Bank
October 2008	
29	Bank of Brazil
30	Bank of Japan
November 2008	
3	Reserve Bank of Australia
6	Bank of England
6	European Central Bank
20	Bank of Japan
28	Bank of Mexico
December 2008	
1	Reserve Bank of Australia
3	Reserve Bank of New Zealand
4	Bank of England
4	European Central Bank
9	Bank of Canada
10	Bank of Brazil
11	Swiss National Bank
16	Federal Reserve
17	Bank of Sweden
18	Bank of Japan
January 2009	
8	Bank of England
15	European Central Bank
20	Bank of Canada
21	Bank of Brazil
22	Bank of Japan
28	Federal Reserve
29	Reserve Bank of New Zealand
February 2009	
3	Reserve Bank of Australia

Source: Desjardins, Economic Studies