

Essentials of the Monetary Policy

December 16, 2008



FEDERAL RESERVE

Unprecedented key rate levels and measures announced!

ACCORDING TO THE FEDERAL RESERVE (Fed)

- The Fed announced that it is cutting the target for the federal funds interest rate by at least 75 points. The new target is in a 0.00% to 0.25% range. All members of the monetary policy committee voted for the cut.
- Economic conditions (employment, consumption, investment and industrial production) have deteriorated further. The situation in the financial markets remains difficult and credit conditions have tightened further.
- Inflationary pressure has ebbed substantially. Inflation should moderate more still.
- The Fed will use every tool at its disposal to return the economy to growth and maintain price stability. The key rates should stay at exceptionally low levels for some time.

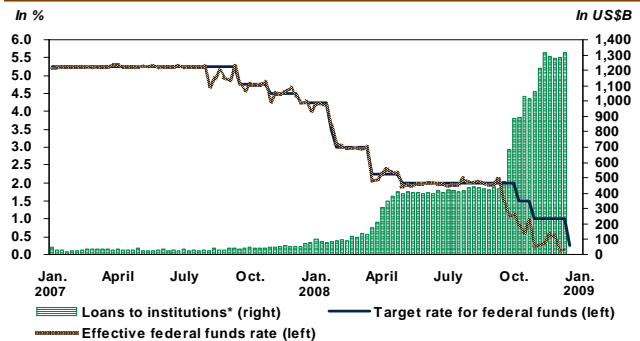
COMMENTS

The Fed's leaders have turned a page in U.S. monetary policy history. By setting the target within a range of 0.00% to 0.25%, they have taken key rates to their lowest level since this type of policy was first established. The new floor attests to the Fed's drive to combat the current problems in the credit market and economy. Note that there are currently no signs that would give us some of hope of rapid improvement in the American economic situation.

Clearly, combating inflation is no longer a concern. The annual change in the consumer price index is very low (it has gone from 5.6% in July to 1.1% in November), eliminating this risk. The continuing recession and drop in energy prices will rein inflation in still further, and we could even see the annual change in the price index go into negative territory temporarily. Fed leaders are therefore now concerned about the risks of potential deflation.

The Fed has now run out of manoeuvring room in terms of its policy for managing key rates. As it said in its statement, it has additional tools at its disposal and it has already greatly broadened its policies to stabilize the credit markets (new credit facilities and loans to financial institutions). Use of these measures has gone from US\$40B a year ago to US\$1,300B. The Fed could very well continue to increase

The Fed is already using other means to act beyond monetary policy alone



* Including repos, loans at the discount rate, Term Auction Facility (TAF), Term Securities Lending Facility (TSLF), etc.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies

the amounts available for this kind of measure. For instance, it is already promising to do so by buying more securities backed by mortgage assets or consumer loans.

Implications: Key rates have now bottomed out. The Fed will therefore now turn solely to quantitative measures to get the financial system and economic activity back on track. However, the Fed will eventually have to look at the challenge involved in getting out of all such operations once the economic and financial situation begins to get back to normal. In the short term, the risks are still tilted towards deterioration in the situation, which is the main concern of Ben Bernanke and his colleagues. The Fed will give us more surprises in terms of using its balance sheet to combat this crisis. More to come...

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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


“[...] Since the Committee’s last meeting, labor market conditions have deteriorated, and the available data indicate that consumer spending, business investment, and industrial production have declined. Financial markets remain quite strained and credit conditions tight. Overall, the outlook for economic activity has weakened further [...] Meanwhile, inflationary pressures have diminished appreciably. 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 further in coming quarters [...] The Federal Reserve will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time [...] The focus of the Committee’s policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve’s balance sheet at a high level. As previously announced, over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity [...]”

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
October 2008			
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	Bank of Brazil	s.q.	13.75
29	Federal Reserve	-50 b.p.	1.00
30	Bank of Japan	-20 b.p.	0.30
November 2008			
3	Reserve Bank of Australia	-75 b.p.	5.25
6	Bank of England	-150 b.p.	3.00
6	European Central Bank	-50 b.p.	3.25
6	Swiss National Bank	-50 b.p.	2.00
20	Bank of Japan	s.q.	0.30
20	Swiss National Bank	-100 b.p.	1.00
28	Bank of Mexico	s.q.	8.25
December 2008			
1	Reserve Bank of Australia	-100 b.p.	4.25
3	Reserve Bank of New Zealand	-150 b.p.	5.00
4	Bank of England	-100 b.p.	2.00
4	European Central Bank	-75 b.p.	2.50
4	Bank of Sweden	-175 b.p.	2.00
9	Bank of Canada	-75 b.p.	1.50
10	Bank of Brazil	s.q.	13.75
11	Swiss National Bank	-50 b.p.	0.50
16	Federal Reserve	-100 b.p. / -75 b.p.	0.00 / 0.25

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

**Table 2
Coming soon**

Date	Central Bank
December 2008	
17	Bank of Norway
18	Bank of Japan
January 2009	
8	Bank of England
15	European Central Bank
16	Bank of Mexico
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
4	Bank of Norway
5	Bank of England
5	European Central Bank
10	Bank of Sweden
19	Bank of Japan
12	Bank of Mexico
March 2009	
3	Reserve Bank of Australia
3	Bank of Canada
5	Bank of England
5	European Central Bank
11	Bank of Brazil
12	Reserve Bank of New Zealand
12	Swiss National Bank
17	Bank of Japan
17	Federal Reserve

Source: Desjardins, Economic Studies