

Essentials of the Monetary Policy



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BANK OF ENGLAND



EUROPEAN CENTRAL BANK

Monetary easing and new quantitative measures

BANK OF ENGLAND (BoE)

As expected, the BoE has lowered its key rate by 50 basis points, bringing it to just 0.5%. At the same time, it announced that it would be buying up assets valued at £75B in the next few months.

The purchases will target private assets, which should help to ensure that the credit market works smoothly, as well as medium- and long-term British government bonds. The purchases will be financed by creating reserves at the central bank, which amounts to printing new money. The BoE has thus undertaken true quantitative policy “with the aim of boosting the supply of money and credit and thus raising the rate of growth of nominal spending to a level consistent with meeting the inflation target in the medium term.”

The outlook for the British economy remains very grim, justifying aggressive action. The BoE is painting a realistic picture of the situation; real GDP fell by an annualized 6% in the fourth quarter of 2008 and the BoE expects it to post a similar contraction in the first part of 2009. To date, inflation’s pullback has been limited by the pound’s depreciation, but annual price growth should go below the 2% target in the second half of the year. Even after lowering the key rate to 0.5%, there is still a significant risk that inflation will be below the target over the medium term.

Implication: The United Kingdom had been expected to resort to increasingly daring quantitative policy but, once again, the strength of the BoE’s action and clarity of its message have impressed. The markets reacted very well, taking corporate and British government bond rates sharply down. Further similar measures could be announced in the next few months. The key rate could stay just above zero for technical reasons.

EUROPEAN CENTRAL BANK (ECB)

To no one’s surprise, the ECB once again reduced its key rate by 50 basis points this morning, putting it at 1.50%. At the press conference that followed the decision, President Jean-Claude Trichet presented a new economic scenario that reflects the deterioration in the euro zone’s outlook.

According to the ECB, the latest economic statistics confirm that demand will be very soft in the euro zone and around the world. ECB employees’ new projections call for Euroland’s real GDP growth to be between -3.2% and -2.2%, followed by a change of -0.7% to +0.7% in 2010.

The inflation rate has plummeted in the last few months, going to 1.2% in February, according to the flash estimate.

Inflation’s past decline is primarily a reflection of the tumble by commodity prices, but the ECB also notes that “signs of a more broad-based reduction in inflationary risks are also increasingly emerging.” As a result, the ECB has slashed its inflation forecast. It is now expecting inflation to be between 0.1% and 0.7% in 2009, and between 0.6% and 1.4% in 2010. This is well below the ECB target, below, but close to, 2%.

Implication: The latest economic statistics and the ECB’s new scenario clearly show a need to continue with monetary easing in the euro zone. President Trichet acknowledged that the key rate could be lowered further and that new, non-traditional measures to stimulate the economy are currently under examination. In our opinion, another 50 basis points key rate cut in April is very likely.

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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 BANK OF ENGLAND PRESS RELEASE


“ [...] and to undertake a programme of asset purchases of £75 billion financed by the issuance of central bank reserves.

World activity continued to weaken, reflecting both depressed confidence and the persistent problems in international credit markets. In the United Kingdom, output dropped sharply in the fourth quarter of 2008 [...]

[...] February *Inflation Report* had implied a substantial risk of undershooting the 2% CPI inflation target in the medium term and that a further easing in monetary policy was likely to be needed [...] But the Committee also noted that a very low level of Bank Rate could have counter-productive effects on the operation of some financial markets and on the lending capacity of the banking system [...]

The Committee judged that this reduction in Bank Rate would by itself still leave a substantial risk of undershooting the 2% CPI inflation target in the medium term [...] with the aim of boosting the supply of money and credit and thus raising the rate of growth of nominal spending to a level consistent with meeting the inflation target in the medium term.

[...] The Committee recognised that it might take up to three months to carry out this programme of purchases [...] intended to improve the functioning of corporate credit markets. But in order to meet the Committee’s objective of total purchases of £75 billion, the Bank would also buy medium- and long-maturity conventional gilts in the secondary market [...]

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
December 2008			
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
17	Bank of Norway	-175 b.p.	3.00
18	Bank of Japan	-20 b.p.	0.10
January 2009			
8	Bank of England	-50 b.p.	1.50
15	European Central Bank	-50 b.p.	2.00
16	Bank of Mexico	-50 b.p.	7.75
20	Bank of Canada	-50 b.p.	1.00
21	Bank of Brazil	-100 b.p.	12.75
21	Bank of Japan	s.q.	0.10
28	Reserve Bank of New Zealand	-150 b.p.	3.50
28	Federal Reserve	s.q.	0.00 / 0.25
February 2008			
3	Reserve Bank of Australia	-100 b.p.	3.25
4	Bank of Norway	-50 b.p.	2.50
5	Bank of England	-50 b.p.	1.00
5	European Central Bank	s.q.	2.00
11	Bank of Sweden	-100 b.p.	1.00
18	Bank of Japan	s.q.	0.10
20	Bank of Mexico	-25 b.p.	7.50
March 2008			
2	Reserve Bank of Australia	s.q.	3.25
3	Bank of Canada	-50 b.p.	0.50
5	Bank of England	-50 b.p.	0.50
5	European Central Bank	-50 b.p.	1.50

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

**Table 2
Coming soon**

Date	Central Bank
March 2009	
11	Bank of Brazil
12	Reserve Bank of New Zealand
12	Swiss National Bank
17	Bank of Japan
17	Federal Reserve
20	Bank of Mexico
25	Bank of Norway
April 2009	
2	European Central Bank
7	Reserve Bank of Australia
7	Bank of Japan
9	Bank of England
17	Bank of Mexico
20	Bank of Sweden
21	Bank of Canada
28	Bank of Japan
29	Bank of Brazil
29	Federal Reserve
30	Reserve Bank of New Zealand
May 2009	
5	Reserve Bank of Australia
6	Bank of Norway
7	Bank of England
7	European Central Bank
15	Bank of Mexico
22	Bank of Japan
June 2009	
2	Reserve Bank of Australia
4	Bank of England

Source: Desjardins, Economic Studies