

March 18, 2009

## FEDERAL RESERVE

### The Fed goes all out: the monetization of debt begins

#### ACCORDING TO THE FEDERAL RESERVE (Fed)

- The Fed is keeping the target interest rate for federal funds within a range of 0.00% to 0.25%.
- The economy has worsened since the meeting held in January.
- Inflation will remain moderate. There is a risk that inflation may stay too low to foster price stability in the long term.
- The Fed wants to use all the tools available to it to promote economic recovery and preserve price stability.
- Key interest rates will remain exceptionally low for an extended period, and the Fed will expand its balance sheet to a considerable degree, in particular by purchasing U.S. Treasury securities.

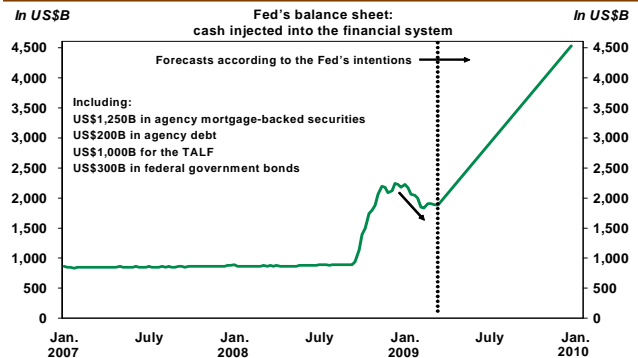
#### COMMENTS

Concern about the economy is evident in the press release issued by the directors of the Fed. They mention numerous factors that are causing the economy to contract: job losses, stock market declines, drops in house prices, tight credit conditions, reduced investment by businesses and a slump in exports. Faced with all these headwinds, the Fed, which has already pushed its key rates to the floor, is playing for high stakes by increasing the size of its balance sheet further.

It should be noted that the Fed had more or less reduced its activities in recent months. The value of assets held by the Fed reached a peak of US\$2,200B in December 2008, while last week they totalled US\$1,900B. The information released by Mr. Bernanke and his colleagues seemed to indicate that the Fed was putting a lot of hope in the TALF (Term Asset-backed Securities Loan Facility) which is starting operations this week. This facility should produce some improvement in credit conditions for households and small businesses. Today's press release implies that the Fed feels that the economic situation has deteriorated to the point where other actions are now required.

The press release announces an increase in the value of debt securities that the Fed can potentially purchase, whether mortgage-backed securities issued by the agencies

**If the measures that have been announced all materialize, the Fed's balance sheet could explode later this year**



Sources: Federal Reserve Board and Desjardins, Economic Studies

Freddie Mac and Fannie Mae, or bonds issued directly by those agencies. But what is noteworthy is the announcement that the Fed will purchase US\$300B in long-term securities from the federal government. This monetization of debt represents a change in strategy. The Fed is attempting to promote a reduction in all interest rates instead of attacking specific markets, which initiatives like the TALF and commercial paper transactions attempted to do. We would point out that the Bank of England adopted this type of quantitative monetary policy in recent weeks, and this has resulted in a marked reduction in interest rates.

**Implications:** The Fed is playing a master stroke today, which should help ease conditions in the credit market. It remains to be seen whether this policy will have the desired effect on economic growth, and whether it will stave off the very real risk of deflation. The markets have already reacted strongly to this news, which is a positive sign. However, the longer-term risks for inflation or the value of the U.S. dollar are becoming more worrisome.

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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**

“ Information received since the Federal Open Market Committee met in January indicates that the economy continues to contract. Job losses, declining equity and housing wealth, and tight credit conditions have weighed on consumer sentiment and spending. Weaker sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories and fixed investment. U.S. exports have slumped as a number of major trading partners have also fallen into recession. Although the near-term economic outlook is weak, the Committee anticipates that policy actions to stabilize financial markets and institutions, together with fiscal and monetary stimulus, will contribute to a gradual resumption of sustainable economic growth [...] In light of increasing economic slack here and abroad, the Committee expects that inflation will remain subdued. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide greater support to mortgage lending and housing markets, the Committee decided today to increase the size of the Federal Reserve’s balance sheet further by purchasing up to an additional \$750 billion of agency mortgage-backed securities, bringing its total purchases of these securities to up to \$1.25 trillion this year, and to increase its purchases of agency debt this year by up to \$100 billion to a total of up to \$200 billion. Moreover, to help improve conditions in private credit markets, the Committee decided to purchase up to \$300 billion of longer-term Treasury securities over the next six months. The Federal Reserve has launched the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses and anticipates that the range of eligible collateral for this facility is likely to be expanded to include other financial assets. The Committee will continue to carefully monitor the size and composition of the Federal Reserve’s balance sheet in light of evolving financial and economic developments.”

**Table 1  
Schedule and key rates**

Date	Central Bank	Decision	Rate
<b>December 2008</b>			
17	Bank of Norway	-175 b.p.	3.00
18	Bank of Japan	-20 b.p.	0.10
<b>January 2009</b>			
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
<b>February 2008</b>			
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
<b>March 2008</b>			
3	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
11	Reserve Bank of New Zealand	-75 b.p.	2.75
11	Bank of Brazil	-150 b.p.	11.25
12	Swiss National Bank	-25 b.p.	0.25
17	Bank of Japan	s.q.	0.10
18	Federal Reserve	s.q.	0.00 / 0.25

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

**Table 2  
Coming soon**

Date	Central Bank
<b>March 2009</b>	
20	Bank of Mexico
25	Bank of Norway
<b>April 2009</b>	
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
<b>May 2009</b>	
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
<b>June 2009</b>	
2	Reserve Bank of Australia
4	Bank of England
4	European Central Bank
4	Bank of Canada
10	Bank of Brazil
11	Reserve Bank of New Zealand
16	Bank of Japan

Source: Desjardins, Economic Studies