

Essentials of the Monetary Policy



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BANK OF CANADA

The key rate will stay at 0.25% until mid-2010

Has the Bank instituted a quantitative easing policy?

ACCORDING TO THE BANK OF CANADA (BoC)

- The target for the overnight rate is lowered 25 basis points to 0.25%. It will stay at that level until the second quarter of 2010, in order to reach the inflation target.
- The rate paid on deposits held by financial institutions at the BoC is left unchanged at 0.25% and provides the floor for the overnight rate.
- The recession in Canada will be deeper than anticipated, with the economy projected to contract by 3.0% in 2009. The Bank now expects the recovery to be delayed until the fourth quarter and to be more gradual. The economy is projected to grow by 2.5% in 2010 and 4.7% in 2011, and to reach its production capacity in the third quarter of 2011.
- Core inflation will decline throughout 2009, gradually returning to the 2% target in the third quarter of 2011, as aggregate supply and demand return to balance. Total consumer price index (CPI) inflation is expected to trough at -0.8% in the third quarter of 2009 and return to target in the third quarter of 2011.

COMMENTS

This morning, the BoC decided to relax its monetary policy by one final notch, lowering the key rate by 25 basis points to a historic low of 0.25%. More than half of private-sector forecasters had expected rates to remain unchanged.

Note that the impact of an additional interest rate cut appears to be marginal and could do more harm than good, in that financial institutions' deposit rates are already close to 0% and, as a result, any decrease in lending rates would sap their financial soundness.

By committing to keeping the rate at 0.25% until the second quarter of 2010, the Bank is striving to ensure that long-term rates remain low, a key condition for jump starting the economy.

However, although the BoC has substantially downgraded its growth and inflation outlooks, it seems that monetary

easing will have to continue over the months to come. Here, the BoC announced that it would increase the terms of its purchase and resale agreements to 12 months, but the risks are still tilted to the downside and argue in favour of even meatier action.

Our growth estimates for the Canadian economy (in line with the BoC for 2009, but more negative for 2010) are compatible with a substantial increase in the output gap, which could go to almost 6% at the end of 2009 and will be hard to close in the coming years. The surplus capacity will keep downside pressure on prices and, although we are not anticipating any ex-energy deflation, there is a substantive risk that the inflation target may not be met over the medium range.

Under these circumstances, the change in the BoC's operating framework, with the deposit rate steady at 0.25%, must be read as openness to quantitative measures designed to increase bank reserves. Initially, the Bank will strive to aim for a reserve level of \$3B to bring the overnight rate to reach the lower bound of the range. Financial institutions with surplus liquidity could thus be encouraged to grant consumer and business credit.

Implications: As traditional monetary policy has reached a floor, the door is now open for quantitative easing. The BoC seems to be trying to gain time, but the risks that inflation will be well under the 2% target in the next few months mean that the BoC's work is not over. Thursday's *Monetary Policy Report* may provide us with more details.

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EXCERPT FROM THE BANK OF CANADA PRESS RELEASE


“[...] The Bank of Canada today announced that it is lowering its target for the overnight rate by one-quarter of a percentage point to 1/4 per cent, which the Bank judges to be the effective lower bound for that rate [...] The Bank now expects the recovery to be delayed until the fourth quarter and to be more gradual. The economy is projected to grow by 2.5 per cent in 2010 and 4.7 per cent in 2011, and to reach its production capacity in the third quarter of 2011. Given significant restructuring in a number of sectors, potential growth has been revised down [...] The Bank expects core inflation to diminish through 2009, gradually returning to the 2 per cent target in the third quarter of 2011 as aggregate supply and demand return to balance [...] the overall risks to its inflation projection are tilted slightly to the downside [...] With monetary policy now operating at the effective lower bound for the overnight policy rate, it is appropriate to provide more explicit guidance than is usual regarding its future path so as to influence rates at longer maturities. Conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target. The Bank will continue to provide such guidance in its scheduled interest rate announcements as long as the overnight rate is at the effective lower bound [...] The Bank retains considerable flexibility in the conduct of monetary policy at low interest rates, consistent with the framework to be outlined in the Bank’s *Monetary Policy Report* on 23 April.

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
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
11	Reserve Bank of New Zealand	-50 b.p.	3.00
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
20	Bank of Mexico	-75 b.p.	6.75
25	Bank of Norway	-50 b.p.	2.00
April 2008			
2	European Central Bank	-25 b.p.	1.25
6	Bank of Japan	s.q.	0.10
7	Reserve Bank of Australia	-25 b.p.	3.00
9	Bank of England	s.q.	0.50
17	Bank of Mexico	-75 b.p.	6.00
21	Bank of Sweden	-50 b.p.	0.50
21	Bank of Canada	-25 b.p.	0.25

**Table 2
Coming soon**

Date	Central Bank
April 2009	
29	Reserve Bank of New Zealand
29	Bank of Brazil
29	Bank of Japan
29	Federal Reserve
May 2009	
5	Reserve Bank of Australia
6	Bank of Norway
7	Bank of England
7	European Central Bank
15	Bank of Mexico
21	Bank of Japan
June 2009	
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
15	Bank of Japan
17	Bank of Norway
18	Swiss National Bank
19	Bank of Mexico
24	Federal Reserve
July 2009	
2	European Central Bank
2	Bank of Sweden
7	Reserve Bank of Australia
9	Bank of England
14	Bank of Japan

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

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