Essentials of the Monetary Policy

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April 29, 2009

FEDERAL RESERVE

Quantitative policy does not expand

ACCORDING TO THE FEDERAL RESERVE (Fed)

- The Federal Reserve is maintaining the target range for the federal funds rate at 0.00% to 0.25%.
- The economy continues to contract, but the pace of contraction appears to be slowing. The economic outlook has improved slightly since the March meeting.
- Consumption is showing signs of stabilizing, but is still restrained by job losses, the drop in home values and problems in obtaining credit.
- Inflation remains subdued. There is a risk that inflation will remain too low to ensure the long-term stability of the economy and prices.
- The Fed will employ all available tools to promote economic recovery and to preserve price stability.
- Key rates will remain exceptionally low for an extended period.
- In its quantitative policy, the Fed is retaining its target of purchasing US$1,250B of Freddie Mac and Fannie Mae mortgage-backed securities, US$200B of these agencies' bonds, and US$300B in U.S. Treasury securities.

COMMENTS

Today's statement, including the decision to keep the target range for the federal funds rate where it is, does not contain any surprises. Those who anticipated that the target would be taken toward 0% or that the amounts dedicated to the quantitative policy of buying securities would increase are disappointed, of course. Yet it seemed clear that, given the recent economic and financial conditions, no change from the announcements already made was in the cards.

As the Fed states, the economic situation is now showing fewer signs of rapid deterioration. The economy is still contracting, as shown by the 6.1% real GDP contraction in the first quarter and the 2,055,000 jobs lost since the year began. However, a number of indicators already seemed to have troughed or are posting less severe contractions. We should see further quarterly contractions by real GDP until the fall, but the situation should not be as bad as it has been in the last six months. The financial markets have also shown some fairly clear signs of improvement; the stock market has gained more than 12% since the last FOMC meeting.

However, the game is not over and the underuse of production capacity is fanning the still dominant deflation risk. This is especially true in that, in March, the year-over-year change in the consumer price index posted its first negative result since 1955. Prices should drop even more markedly in the next few months, fuelled by the contrast between today's energy prices and last year's.

The Fed has far from exhausted its quantitative policy tools. It is purchasing government bonds at a gradual pace, having only bought US$54B of its target US$300B. It has only acquired US$362B in mortgage-backed securities, compared with the US$1,250B target, and only US$45B of agency debt securities, out of a potential US$200B. Keeping the targets announced in March still gives the Fed the potential to take a lot of action in the markets. Moreover, the program designed to facilitate consumer and business credit, TALF (Term Asset-Backed Securities Loan Facility), is just getting off the ground, with barely US$6.4B outstanding. The federal government's financial rescue plan indicates that this program could run up to US$1,000B.

Implications: Despite today's lack of news, Fed leaders still clearly have some work to do and existing programs have the potential to further support the markets and the economy. If the outlook of lessened contraction materializes, we can expect little policy change over the next few Fed meetings.

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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.

EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE

Information received since the Federal Open Market Committee met in March indicates that the economy has continued to contract, though the pace of contraction appears to be somewhat slower. Household spending has shown signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit. Weak sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories, fixed investment, and staffing. Although the economic outlook has improved modestly since the March meeting, partly reflecting some easing of financial market conditions, economic activity is likely to remain weak for a time. Nonetheless, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability. [...] 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. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt by the end of the year. In addition, the Federal Reserve will buy up to $300 billion of Treasury securities by autumn. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is facilitating the extension of credit to households and businesses and supporting the functioning of financial markets through a range of liquidity programs. The Committee will continue to carefully monitor the size and composition of the Federal Reserve's balance sheet in light of financial and economic developments.

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
29	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
April 2009	
29	Reserve Bank of New Zealand
29	Bank of Brazil
29	Bank of Japan
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
17	Bank of Mexico

Source: Desjardins, Economic Studies