

Essentials of the Monetary Policy



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BANK OF ENGLAND



EUROPEAN CENTRAL BANK

More monetary easing

BANK OF ENGLAND (BoE)

To no one's surprise, the BoE kept its key rate at 0.50% this morning. BoE leaders have, in recent months, clearly stated that they deem this level to be a floor. The BoE did not sit on its hands, however, announcing that it was expanding its asset purchase program by £50B, taking it to £125B (US\$188B). The BoE expects it to take three months to finalize its purchases.

In the U.K., the expansion of quantitative measures is justified by the fact that the BoE judges the global economy to still be in a severe recession and that the international financial system remains fragile. Following a sharp 7.4% annualized contraction by Britain's GDP in the first quarter of 2009, the BoE is, however, saying that national and international surveys are showing some promising signs that the pace of contraction is beginning to slow.

At 2.9% in March, Britain's inflation rate is still well over the central bank's target. However, the rapid rise in prices primarily seems to be reflecting the pass-through effects of the pound's plunge. The BoE notes, however, that the economy's excess capacity has increased and that wage pressures have dropped off sharply. It still expects inflation to drop below the 2% target later this year, anticipating that excess capacity will keep downside pressures on prices thereafter.

Implication: Despite elevated inflation and some promising signs, the BoE seems to think—justifiably, in our opinion—that Britain's economy and financial system are still in trouble. Over the medium range, the primary risk remains overly low inflation, which justifies continuing with the quantitative policy. Further enhancements to the asset purchase program could be announced in a few months, if the situation does not improve. The next Inflation Report, to be released on May 13, will provide the details on the BoE's economic scenario.

EUROPEAN CENTRAL BANK (ECB)

The ECB lowered its key rate by 25 basis points this morning, taking it to 1.00%. It has also lowered its range, taking the lending rate down to 1.75% and keeping the deposit rate at 0.25%. These key rate movements had been fully priced in. The question was whether the ECB would announce that its key rate is now at a floor, and whether it would institute new, non-traditional measures.

Contrary to what we could have feared, the ECB is not closing the door on further key rate cuts, despite the reticence previously expressed by some Council members. It considers, however, that the 1% rate is appropriate, given all of the information and analysis available.

The ECB has also opted to institute new measures to support credit. In most cases, these involve expanding the programs that are already used to provide the banking system with liquidity. As of the end of June, the ECB will go ahead with one-year refinancing operations. The ECB has also decided to keep accepting an expanded list of eligible assets until the end of 2010.

This morning's surprise came from the fact that the Governing Council agreed to proceed with buying covered bonds. The terms of the purchases will be released in early June, but the amount should be around €60B. The ECB is striving to support this mortgage-backed bond market, which has been especially hard hit by the crisis. The purchases will be sterilized, meaning that what is involved is credit easing, not quantitative easing.

Implication: Despite their deep reluctance to use true quantitative measures, ECB leaders have found a way to continue to support the economy and Europe's financial system. The door is open to another key rate cut, but only if the situation deteriorates further.

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Director and Deputy Chief Economist

Mathieu D'Anjou
Senior Economist

Martin Lefebvre
Senior Economist

Hendrix Vachon
Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

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 EUROPEAN CENTRAL BANK PRESS RELEASE


“[...] On the basis of its regular economic and monetary analyses, the Governing Council decided to reduce the interest rate on the main refinancing operations of the Eurosystem by a further 25 basis points and the rate on the marginal lending facility by 50 basis points, to 1.00% and 1.75% respectively. The interest rate on the deposit facility will remain unchanged at 0.25%. This decision brings the total reduction in the interest rate on the main refinancing operations of the Eurosystem since 8 October 2008 to 325 basis points [...] Current key ECB interest rates are appropriate taking into account all available information and analysis. In addition to the reductions in interest rates, the Governing Council decided today to proceed with its enhanced credit support approach. In continuity and consistency with the operations we have undertaken since October 2008, and in recognition of the central role played by the banking system in financing the euro area economy, we will conduct liquidity-providing longer-term refinancing operations with a maturity of 12 months. The operations will be conducted as fixed rate tender procedures with full allotment. The rate for the first of these operations, to be announced on 23 June 2009, will be the rate on the main refinancing operations at that time. Subsequently, the fixed rate may include a premium to the rate on the main refinancing operations, depending on the circumstances at the time [...] The Governing Council has decided in principle that the Eurosystem will purchase euro-denominated covered bonds issued in the euro area. The detailed modalities will be announced after the Governing Council meeting of 4 June 2009 [...] These decisions have been taken to promote the ongoing decline in money market term rates, to encourage banks to maintain and expand their lending to clients, to help to improve market liquidity in important segments of the private debt security market, and to ease funding conditions for banks and enterprises [...]”

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
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	Reserve Bank of New Zealand	-50 b.p.	2.50
29	Bank of Brazil	-100 b.p.	10.25
29	Bank of Japan	s.q.	0.10
29	Federal Reserve	s.q.	0.00 / 0.25
May 2008			
5	Reserve Bank of Australia	s.q.	3.00
6	Bank of Norway	-50 b.p.	1.50
7	Bank of England	s.q.	0.50
7	European Central Bank	-25 b.p.	1.00

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

**Table 2
Coming soon**

Date	Central Bank
May 2009	
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	Reserve Bank of New Zealand
10	Bank of Brazil
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
21	Bank of Canada
22	Bank of Brazil
29	Reserve Bank of New Zealand
August 2009	
4	Reserve Bank of Australia
6	Bank of England
6	European Central Bank
10	Bank of Japan

Source: Desjardins, Economic Studies