

Essentials of the Monetary Policy

November 4, 2009



FEDERAL RESERVE

While noting an uptick in the economy, the Fed stays the course

ACCORDING TO THE FEDERAL RESERVE (Fed)

- The Federal Reserve keeps the target range for the federal funds rate at 0.00% to 0.25%.
- The economy continued to pick up since the September meeting. Activity in the housing sector increased. Consumption appears to be expanding, but remains constrained due to job losses, soft income growth, the drop in home values and difficulties getting credit. Business investment continues to contract, but at a slower pace.
- While the level of economic activity will remain weak, measures aimed at stabilizing financial institutions and the markets, as well as monetary and fiscal stimuli will help strengthen economic growth.
- The underutilization of production capacity and stable inflation expectations are such that inflation will remain moderate.
- Key interest rates will stay at exceptionally low levels for an extended period.
- As part of its quantitative policy, the Fed is maintaining its target for the purchase of mortgage securities (US\$1,250B). It is however, reducing the target for bonds issued directly by mortgage agencies, from US\$200B to US\$175B. As announced in September 2009, these purchases will continue until the end of the first quarter 2010.

COMMENTS

While several statistics are sending a fairly clear signal that the recession is over in the United States, the Fed's statement contained few changes on its view of the economic situation compared to the press release issued on September 23. Among the rare changes, the Fed mentioned that household spending seems to be expanding rather than simply stabilizing. Overall, it is quite clear that the members of the monetary policy committee are relieved to see signs of improvement in the economy, but the situation is still quite fragile.

The same tone is found in the statement section that justifies keeping the range for key rates at exceptionally low levels for an extended period. The argument in favour of low rates rests on a weak use of resources, inflation that is trending

moderately and stable inflation expectations. Real GDP may have jumped by 0.9% (non-annualized) in the third quarter (3.5% annualized), but GDP fell by a total of 3.8% throughout the recession. The shortfall thus remains huge. If we add mounting job losses and the recent weakness of some economic indicators (drop in household confidence indexes, housing starts levelling off, credit contraction), the Fed must remain cautious, especially since many of the positive factors seen in this recovery stem directly from measures introduced by the Fed or the government's stimulus plan. The frail recovery and expected weak inflation argue in favour of extreme caution, meaning that key rates will be staying at their current levels.

Furthermore, the Fed continues to modify its balance sheet. As such, the temporary boost measures it put forth during the financial crisis are now much smaller in scope (the value of these assets went from just under US\$2,000B to just over US\$500B). The Fed is still buying up securities even though the target of US\$300B for government securities has already been reached. The quantitative policy will therefore mainly focus on purchasing mortgage securities (where only US\$776B out of the US\$1,250B was spent) and, to a lesser extent, on buying agency-issued securities (where only US\$141B out of the US\$175B available was used). The drop in the target for agency-issued securities should not be seen as a change in policy, but rather as a reflection of the limited availability of these securities.

Implications: The Fed is still in waiting mode. Since there is no guarantee this recovery will be both sustainable and lasting, the Fed will keep its key rates at their current levels for quite some time. Key rates are not expected to climb anytime before the second half of 2010.

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EXCERPT FROM THE FEDERAL RESERVE PRESS RELEASE


« Information received since the Federal Open Market Committee met in September suggests that economic activity has continued to pick up. Conditions in financial markets were roughly unchanged, on balance, over the intermeeting period. Activity in the housing sector has increased over recent months. Household spending appears to be expanding but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing, though at a slower pace; they continue to make progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will support a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.

With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time.

In these circumstances, the Federal Reserve will continue to employ a wide range of 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 continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. [...] »

**Table 1
Schedule and key rates**

Date	Central Bank	Decision	Rate
September 2008			
1	Reserve Bank of Australia	s.q.	3.00
2	Bank of Brazil	s.q.	8.75
3	European Central Bank	s.q.	1.00
3	Bank of Sweden	s.q.	0.25
9	Reserve Bank of New Zealand	s.q.	2.50
10	Bank of England	s.q.	0.50
10	Bank of Canada	s.q.	0.25
16	Bank of Japan	s.q.	0.10
17	Swiss National Bank	s.q.	0.25
18	Bank of Mexico	s.q.	4.50
23	Bank of Norway	s.q.	1.25
23	Federal Reserve	s.q.	0.00 / 0.25
October 2008			
5	Reserve Bank of Australia	+25 b.p.	3.25
8	European Central Bank	s.q.	1.00
8	Bank of England	s.q.	0.50
13	Bank of Japan	s.q.	0.10
16	Bank of Mexico	s.q.	4.50
20	Bank of Canada	s.q.	0.25
21	Bank of Brazil	s.q.	8.75
22	Bank of Sweden	s.q.	0.25
28	Bank of Norway	+25 b.p.	1.50
28	Reserve Bank of New Zealand	s.q.	2.50
29	Bank of Japan	s.q.	0.10
November 2008			
2	Reserve Bank of Australia	+25 b.p.	3.50
4	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
November 2009	
5	European Central Bank
5	Bank of England
19	Bank of Japan
27	Bank of Mexico
30	Reserve Bank of Australia
December 2009	
3	European Central Bank
8	Bank of Canada
9	Reserve Bank of New Zealand
9	Bank of Brazil
10	Bank of England
10	Swiss National Bank
16	Bank of Norway
16	Bank of Sweden
16	Federal Reserve
17	Bank of Japan
January 2010	
7	Bank of England
14	European Central Bank
19	Bank of Canada
25	Bank of Japan
27	Reserve Bank of New Zealand
27	Bank of Brazil
27	Federal Reserve
February 2010	
2	Reserve Bank of Australia
3	Bank of Norway
4	European Central Bank
4	Bank of England

Source: Desjardins, Economic Studies