BANK OF ENGLAND (BoE)

- The BoE keeps its key interest rate at 0.50%.
- The purchase of securities financed by the creation of bank reserves held steady at £200B (US$290B).

This morning, the BoE announced that no changes would be made to its monetary policy. Though it did not explain its decision, comments made by BoE leaders these past few weeks indicate concerns about the recent rise of financial strain in Europe. Access to capital markets by British banks was affected, and trade between the United Kingdom and the euro zone could be limited by weaker growth within the zone and the pound’s appreciation vs. the euro.

For the time being, however, the economic recovery appears to be on track and the BoE only slightly adjusted its growth forecasts in its latest report on inflation. The special budget slated for June 22 will provide some answers as to how the new coalition government intends to act to reduce the huge budget deficit.

Sharp inflation, which surged 3.7% in April, is also a source of concern for the BoE. This inflation run-up stems, however, from three temporary factors: oil prices, the increase in the value-added tax, and the sharp decline by the pound sterling in 2007-2008. Inflation could very well remain high throughout 2010, but the BoE still expects inflation to then retreat to below its target, since surplus production capacity is still substantial.

Implications: The resurgence of financial tensions has put a halt on any precipitated rate increases in the United Kingdom despite inflation’ vigour. The BoE will keep its key rate unchanged for several more months, and remains poised to support its banking sector if the need arises.

EUROPEAN CENTRAL BANK (ECB)

- The ECB’s key rate remains at 1.00%.
- The economy in the euro zone should grow at a moderate pace. Inflationary pressures over the medium term remain contained.

After posting weak growth of 0.2%, (non-annualized) in Q1 2010, the pace of GDP advances in the euro zone seems to have bounced back this spring. The ECB’s growth forecast for 2010 was revised upward slightly, to between 0.7% and 1.3%. Weak domestic demand reduces somewhat the outlook for GDP growth in 2011 however, to between 0.2% and 2.2%. Weak inflation is expected, but has been revised upwards, to somewhere between 1.4% and 1.6% in 2010 and 1.0% and 2.2% in 2011, reflecting the impact of a weaker euro.

Without expanding on the details about the bond purchases made by the ECB over the past few weeks, President Trichet explained that these purchases were necessary to restore order in certain financial markets. The problems seen in European markets at the beginning of May hindered the monetary policy’s transmission mechanisms and even threatened to escalate into a global crisis. Strong demand for the liquidities made available by the ECB shows that the money market is still not operating perfectly.

Implications: Persistent problems in Europe and the uncertainty that continues to cloud economic outlooks should prompt the ECB to maintain the extraordinary measures implemented to support financial markets. No rate hikes are therefore anticipated before June 2011.

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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 EUROPEAN CENTRAL BANK PRESS RELEASE

“[…] Based on its regular economic and monetary analyses, the Governing Council decided to leave the key ECB interest rates unchanged. The current rates remain appropriate. Taking into account all the new information which has become available since our meeting on 6 May 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon. Global inflationary pressures may persist, while domestic price pressures are expected to remain low. The latest information has also confirmed that the economic recovery in the euro area continued in the first half of 2010, but quarterly growth rates are likely to be rather uneven. Looking ahead, we expect the euro area economy to grow at a moderate pace, in an environment of continued tensions in some financial market segments and of unusually high uncertainty. Our monetary analysis confirms that inflationary pressures over the medium term remain contained, as suggested by weak money and credit growth. Overall, we expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations remains of the essence […]”