Monetary and Statistics Department
Monetary Policy and Strategy Division

Central Bank Monitoring

December 2005

Central banks faced growing inflation risks over the past three months due to the record high oil prices. This, along with mounting demand pressures, compelled the ECB to increase rates. The Fed also continued gradually increasing rates. The RBNZ likewise decided to raise its rates to 7%. Other banks left theirs unchanged. In **Spotlight** ***we take a look at Slovakia's surprisingly early ERM II entry. Our selected speech presents Ben S. Bernanke's views on future monetary policy, which suggest that even greater transparency can be expected after he takes the helm at the Fed.***

1. Developments since the last issue of Monitoring (September 2005) and expected future information

	Inflation target[1]	**Latest inflation**	**Current basic rate**	**MP meeting date/rate change/ expectation**[2]	**Next MP meeting/ expectation**[3]	**Other expected events**
Euro area (European Central Bank, ECB)	<2.0%	2.4% (Nov 2005)[4]	2.25%	6 Oct/0.00 3 Nov/0.00 1 Dec/+0.25 →	12 Jan 2 Feb 2 Mar →	2 Mar: publication of new forecast
Sweden (Sveriges Riksbank)	2.0%	0.5% (Oct 2005)	1.50%	19 Oct/0.00 1 Dec/0.00 →	19 Jan 22 Feb ↗	23 Feb: publication of IR[5]
United Kingdom (Bank of England, BoE)	2.0%	2.3% (Oct 2005)	4.50%	5–6 Oct/0.00 9–10 Nov/0.00 7–8 Dec/0.00 →	11–12 Jan 8–9 Feb 8–9 Mar ↘	15 Feb: publication of IR[5], including new forecast
Hungary (Magyar Nemzeti Bank, MNB)	4.0%	3.2% (Oct 2005)	6.00%	19 Sep/-0.25 24 Oct/0.00 28 Nov/0.00 ↘	19 Dec 23 Jan 27 Feb ↘	27 Feb: publication of IR[5], including new forecast
Poland (Narodowy Bank Polski, NBP)	2.5%	1.6% (Oct 2005)	4.50%	27–28 Sep/0.00 25–26 Oct/0.00 29–30 Nov/0.00 ↘	20–21 Dec 30–31 Jan 21–22 Feb →	22 Feb: publication of new IR[5]
Slovakia (Národná banka Slovenska, NBS)	3.5%	3.5% (Oct 2005)	3.00%	30 Sep/0.00 25 Oct/0.00 29 Nov/0.00 ↘	20 Dec[6] 31 Jan[6] 28 Feb[6] →	Monetary survey issued on given board meeting days
United States (Federal Reserve System, Fed)	n/a	4.3% (Oct 2005)	4.00%	20 Sep/+0.25 1Nov/+0.25 ↗	13 Dec 31 Jan ↗	
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	3.4% (3Q2005)	7.00%	27 Oct/+0.25 →	26 Jan ↗	9 Mar: publication of Monetary Policy Statement

[1] Inflation target valid for the current period (or, in the cases of Hungary and Slovakia, the year-end target)
[2] The direction of the expected change in rates in the past quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)
[3] Provisional meeting dates. The direction of the expected change in rates in the coming quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)
[4] Preliminary estimate
[5] Inflation Report
[6] The NBS Bank Board decides on rates once a week; the given dates correspond to the discussion of the Situation Report. Estimated dates – the meeting calendar for next year has not been published yet.

2. News

Riksbank starts using forecast based on market interest rates ...

Starting from the October Inflation Report, the main scenario of the Swedish central bank's interest rate forecast is based on the assumption that the repo rate evolves in line with market expectations. The Riksbank has published such a forecast only irregularly in the past. A forecast based on constant rates is still compiled, but is described as an alternative scenario. According to Deputy Governor Irma Rosenberg, this shift is intended to increase the transparency of the Riksbank and make it easier to evaluate the accuracy of the forecasts. She also stressed that implied forward rates do not constitute a promise from the Riksbank to change rates in line with the yield curve. A baseline forecast scenario based on market expectations has been applied by the Bank of England since 2004 and was used by the Bank of Norway until June 2005.

... and has new Governor

Lars Heikensten is to step down prematurely from his position as Governor in the new year, due to his nomination as the Swedish member of the European Court of Auditors. He will be succeeded by Stefan Ingves, who joins the Riksbank from a top position at the International Monetary Fund and who has a wealth of monetary policy experience from his time as Riksbank Deputy Governor in 1994–1999.

MNB starts publishing nominal voting

In October, Magyar Nemzeti Bank started publishing the nominal voting of Monetary Council members in the minutes of its Monetary Council meetings. The MNB started publishing minutes in December 2004, but up until October 2005 these only gave the ratio of the votes cast. The MNB made no comment on this change in communication. However, given the large number of Council members (13 since spring 2005), this step can be viewed as an effort to increase the individual responsibility of the Council members.

Slovakia joins ERM II ...

The Slovak koruna joined ERM II at the end of November, with a central rate equal to the market exchange rate on the day the step was announced (EUR 1 = SKK 38.4550). Upon entry into ERM II, Slovakia undertook to pursue sound fiscal policies and promote wage growth that remains in line with productivity growth. ERM II participation is a necessary condition for satisfying the Maastricht exchange rate criterion, which, in turn, is a prerequisite for the country's accession to the euro area. Slovakia plans to adopt the single European currency on 1 January 2009. See *Spotlight* for more details of the Slovakia's entry to ERM II.

... the NBS Bank Board is to expand to 11 members ...

An amendment to the Act on the NBS adopted in October increases the number of members of the NBS Bank Board from eight to eleven. The Governor and two Deputy Governors will continue to be elected by parliament, while the remaining eight board members will be appointed by the government on the proposal of the NBS Governor. The amendment will also integrate supervision of various financial market institutions under the central bank. The amendment to the Act will come into effect on 15 December 2005.

... and the NBS is already preparing the design of Slovak euro coins

In November, the NBS announced a public poll on the designs of the national face of the future Slovak euro coins. The public could vote via the Internet, by text message or by phone. The winning design was a double cross on three mountains. The final design of the euro coins will be decided by the NBS Bank Board at its December meeting.

Bernanke to succeed Greenspan at the Fed

U.S. President George W. Bush nominated Ben S. Bernanke for Chairman of the Board of Governors of the Federal Reserve System (the Fed). Bernanke previously served on the Fed's Board of Governors for six years and is currently Chairman of the Council of Economic Advisers. Bernanke will take office on 1 February 2006. The last part of this publication presents selected points of the nomination speech given by Ben Bernanke before the Senate Committee on Banking, Housing and Urban Affairs.

Bank of Norway alters its forecasting process

In its November Inflation Report, the Bank of Norway abandoned the assumption of interest rates evolving in line with market expectations in its baseline scenario and started publishing an interest rate path based on an assessment by the Executive Board. The assessment takes into account the development of the Norwegian economy as well as the balance between the various objectives of monetary policy. This path is published in fan chart form.

Turkey to explicitly adopt inflation targeting

The Turkish central bank announced at the start of December that it would move to formal inflation targeting by the beginning of next year. The target for 2006 has been set at 5% ± 2 percentage points, while the target for both 2007 and 2008 is 4%. At the same time, Sureyya Serdengecti, central bank governor, said he would hand over responsibility for setting interest rates to a monetary policy committee. In the past, Turkey conducted monetary policy in the regime of "implicit inflation targeting". Although it published its inflation targets, the forecast and/or reasons underlying its monetary policy decisions were not disclosed. 2005 was a transitional year, when the Turkish central bank started publishing such information and generally enhanced its openness to the public.

3. Spotlight: Slovakia enters ERM II

The Slovak koruna joined ERM II at the end of November, with a central rate equal to the market exchange rate on the day this step was announced (EUR 1 = SKK 38.4550). Upon entry into ERM II, Slovakia undertook to pursue sound fiscal policies and promote wage growth that remains in line with productivity growth. ERM II participation is a necessary condition for satisfying the Maastricht exchange rate criterion, which, in turn, is a prerequisite for the country's accession to the euro area. Slovakia plans to adopt the single European currency on 1 January 2009.

Earlier than expected entry

The NBS's decision to enter ERM II this year came as a surprise, as it had been generally expected that Slovakia would join in the first half of next year. The NBS Monetary Programme until 2008, a document approved in December 2004 in which the NBS adopted "inflation targeting in the conditions of ERM II", had also assumed a later date. Minister of Finance Ivan Mikloš explained that Slovakia decided to join ERM II earlier so that the country would have more time to prepare for euro adoption. He also referred to the need to isolate the koruna from exchange rate movements in the Central European region.

Central rate equal to most recent exchange rate

Like most of its predecessors in ERM II, Slovakia decided to set its central rate equal to the market exchange rate on the day of its ERM II entry. On Friday 25 November, the Slovak koruna closed at 38.455 SKK/EUR. The NBS did not explicitly state whether it views this central rate as corresponding to the equilibrium rate, but proclaimed that "the membership of Slovakia in the ERM II and the central rate will contribute to the stabilisation of the exchange rate development of the Slovak koruna and its nominal convergence. At the same time they will support a stable development of the Slovak economy". This differs significantly from the current position of the Czech National Bank and the National Bank of Poland, which do not regard ERM II as a stabilising factor.

Koruna reacts strongly

The Slovak koruna responded to the unexpected step by appreciating strongly (see Chart 1) by more than 2 per cent, followed by a slight correction. This was probably due to the somewhat asymmetric nature of the Maastricht exchange rate criterion, which allows a marked appreciation, but not a depreciation. Expectations of a future strengthening of the Slovak koruna were also supported by the notion that an appreciation would suit the NBS with regard to the fulfilment of its inflation targets (also defined asymmetrically). Since then, the exchange rate has fluctuated within a relatively narrow band of 20 hellers (see Chart 2).

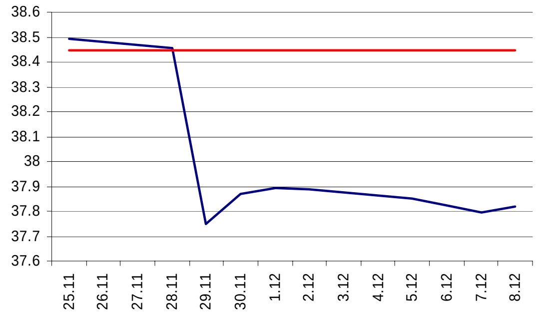
The NBS Governor noted that the NBS would intervene in the foreign exchange market – even within the band – to keep the exchange rate at levels corresponding to the development of the economy. The NBS has considerable experience with interventions. It last intervened in October, with EUR 220 million against the koruna's depreciation. It also intervened in the same direction in April this year, whereas in the first quarter it intervened against the koruna.

Potential conflict between exchange rate criterion and other criteria

In the event of unexpected shocks, the largely fixed relationship of the Slovak currency to the euro could pose a threat to the fulfilment of the other criteria, most notably the criterion on price stability. In Slovakia's case, however, the danger of failing to meet the exchange rate and inflation criteria is low for the following reasons. First of all, Slovakia has a highly open economy with close links to the euro area nations, in which the fixing of the koruna's exchange rate could significantly lower import price variability and consequently foster stability of domestic prices. Second, the equilibrium real exchange rate of the Slovak koruna will appreciate over the coming years, which reduces the probability of a significant nominal exchange rate depreciation. Third, Slovakia is maintaining and will probably continue to maintain during ERM II membership a positive interest rate differential against the euro (currently at 0.75%), which makes the Slovak currency attractive, and is also tightening its domestic monetary conditions, thereby supporting the fulfilment of the NBS's inflation targets.

Chart 1: The SKK/EUR exchange rate on 28 November 2005

Chart 2: The SKK/EUR exchange rate between 25 November and 8 December 2005



Sources: NBS, Bloomberg.

4. Selected speech: Testimony of Ben S. Bernanke before the U.S. Senate

In this section we take a look at the speech given by Ben S. Bernanke, Chairman of the U.S. President's Council of Economic Advisers, who was nominated by George W. Bush as Member and Chairman of the Board of Governors of the Federal Reserve System. The speech was delivered in the U.S. Senate before the Committee on Banking, Housing and Urban Affairs on 15 November 2005.

Ben S. Bernanke opened his testimony by assuring the Senators present that if confirmed he would strictly promote the Fed's independent and nonpartisan status, guided by the mandate from Congress and by the public interest. He affirmed that his priority with respect to monetary policy would be continuity with the policies and policy strategies pursued under Alan Greenspan, current Chairman of the Fed's Board of Governors. He took special note of several aspects of monetary policy and strategy that had evolved under Chairman Greenspan and Chairman Volcker before him. In this context, Bernanke said that, if confirmed, he and his colleagues on the Federal Open Market Committee (FOMC) would promote the following: (i) a focus on long-term price stability as monetary policy's greatest contribution to general economic prosperity and maximum employment; (ii) the application of careful judgment regarding possible risks to the economy, as well as the flexibility to respond to new information or unexpected developments, as monetary policy is effective when it is coherent, consistent and predictable; and (iii) the increasing transparency of monetary policy to the public and the financial markets, continuing the trend pursued by the Fed under Alan Greenspan.

Bernanke went on to outline one possible step towards greater monetary policy transparency, namely to state an explicit numerical inflation target or target band consistent with long-term price stability. He has previously supported this measure in his academic writings and monetary policy speeches. In this context Bernanke stressed that he would take no precipitate steps in the direction of quantifying the definition of long-run price stability, as the matter requires further study at the Fed as well as extensive discussion and consultation. An explicit inflation target could only be adopted if a consensus could be developed that taking such a step would further enhance the ability of the FOMC to satisfy its dual mandate of achieving both stable prices and maximum sustainable employment.

Towards the end of his speech, Bernanke noted that the stability of the nation's financial system is a precondition for the stability of the whole economy. In that regard, he emphasized the role of the Fed and other regulators in ensuring the safety and soundness of the U.S. banking system, while observing the principles of privacy protection, access to understandable information and elimination of discriminatory or abusive lending practices. He also pointed out that the Fed enhances consumer welfare through programmes to promote financial literacy and community economic development.

This document is produced by the Monetary and Statistics Department of the Czech National Bank and is freely distributable. Closing date: 8 December 2005. Current and past issues can be downloaded free from the *Monetary Policy* section of the CNB website. Contact: http://www.cnb.cz or info@cnb.cz.