Monetary and Statistics Department
Monetary Policy and Strategy Division

Central Bank Monitoring

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Most of the monitored central banks continued to tighten monetary policy during the last quarter. The ECB, BoE and NBP raised their rates by 0.25 percentage point and the RBNZ increased its by 0.50 percentage point. Rates in Sweden, Hungary and the USA were unchanged. The only bank to lower rates was the NBS, doing so by a total of 0.50 percentage point. In Spotlight we take a look at the assessments of Cyprus and Malta in the EC and ECB convergence reports. Our selected speech is Kate Barker's address on whether monetary policy should be activist or gradualist.

1. Developments since the last issue of Monitoring (March 2007) 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%	1.9% (May 2007)[4]	4.00%	12 Apr/0.00 10 May/0.00 6 Jun/+0.25 ↗	5 Jul 6 Sep ↗	6 Sep: publication of forecast
Sweden (Sveriges Riksbank, SR)	2.0%	1.9% (Apr 2007)	3.25%	29 Mar/0.00 3 May/0.00 ↗	19 Jun 6 Sep ↗	20 Jun: publication of Monetary Policy Report
United Kingdom (Bank of England, BoE)	2.0%	2.8% (Apr 2007)	5.50%	4–5 Apr/0.00 9–10 May/+0.25 6–7 Jun/0.00 ↗	4–5 Jul 1–2 Aug 5–6 Sep →	8 Aug: publication of IR[5]
Hungary (Magyar Nemzeti Bank, MNB)	3.0%	8.8% (Apr 2007)	8.00%	26 Mar/0.00 23 Apr/0.00 21 May/0.00 →	25 Jun 23 Jul 27 Aug ↘	27 Aug: publication of IR[5]
Poland (Narodowy Bank Polski, NBP)	2.5%	2.3% (Apr 2007)	4.25%	27–28 Mar/0.00 24–25 Apr/+0.25 29–30 May/0.00 →	26–27 Jun 24–25 Jul 28–29 Aug →	26 Jul: publication of IR[5]
Slovakia (Národná banka Slovenska, NBS)	< 2.0%	2.0% (Apr 2007)	4.25%	27 Mar/-0.25 24 Apr/-0.25 29 May/0.00 →	26 Jun[6] 31 Jul 28 Aug →	Monetary survey issued on given MP meeting dates
USA (Federal Reserve System, Fed)	n/a	2.3% (Apr 2007)	5.25%	20–21 Mar/0.00 9 May/0.00 →	27–28 Jun 7 Aug →	13 Jun, 25 Jul and 5 Sep: publication of Beige Book
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	2.5% (2007 Q1)	8.00%	26 Apr/+0.25 7 Jun/+0.25 →	26 Jul →	

[1] Inflation target valid for the current period (or, in the case of 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 decides on rates once a week; the given dates correspond to the discussion of the Situation Report.

2. News

ECB and EC publish convergence reports for Cyprus and Malta…

In mid-May the ECB and the European Commission published their convergence reports assessing the preparedness of Cyprus and Malta for adopting the euro. According to these reports, Cyprus had fulfilled all the conditions laid down in the Maastricht Treaty and it was subsequently given a positive recommendation by the Commission. In Malta's case, the Commission's report stated that the country had achieved a high degree of sustainable convergence and hence fulfilled one of the main conditions for adopting the euro. The convergence reports are examined in more detail in *Spotlight*.

…and ECB sells more gold

During April and May the ECB sold 37 tons of gold from its reserves. These sales are in conformity with the Central Banks' Gold Agreement signed in 27 September 2004. Together with the gold sales of 23 tons last autumn, the ECB has thus sold 60 tons of gold in the third year of the agreement. The ECB will sell no more gold up to the end of September.

Sveriges Riksbank gets new Executive Board members…

Owing to the expiry of the term of office of Kristina Persson and the resignation of Deputy Governor Eva Srejber, the General Council of the Riksbank appointed two new members to its Executive Board. They are Lars E. O. Svensson, professor at Princeton University, and Barbro Wickman-Parak, chief economist at SBAB (Sveriges Bostadsfinansieringsaktiebolag). The General Council also decided to appoint Irma Rosenberg as First Deputy Governor.

…and becomes more transparent

Following the Riskbank's recent decision to publish its own interest rate forecasts (see the March issue of Monitoring) several more changes are to be made to the Riksbank's communication policy. First, a press conference will be held after each Executive Board meeting, regardless of whether or not interest rates are adjusted. Previously, press conferences have only been held if rates have been changed or when a new forecast has been published. Second, the members of the Executive Board will signal future interest rate developments only at their meetings and not between them. In exceptional cases there may be signalling between meetings if the economic situation changes radically. The final change is a decision to publish the names of members who express opinions at Executive Board meetings in the minutes of the meetings.

BoE writes first letter to finance minister

UK inflation reached 3.1% in March and thus exceeded the Bank of England's 2% target by more than one percentage point for the first time in the ten-year history of the independent BoE. In this situation, the Bank was obliged to send an open letter to the Chancellor of the Exchequer setting out the reasons for the overshooting, the BoE's response and the period within which inflation is expected to return to the target.

NBP sets up euro area integration bureau

The main task of the new Bureau for Integration with the Euro Area is to prepare a report on Poland's full membership in the third stage of the Economic and Monetary Union (the euro area). This report will contain an analysis of the costs and benefits of euro area membership, an assessment of the functioning of the euro area so far, and a definition of the conditions for the adoption of the euro in Poland. The report will be prepared on the basis of consultations with academic and financial institutions, employees' and employers' representatives and other public institutions.

Slovak koruna's central rate devalued

At the request of Slovakia, the finance ministers of the euro area Member States and the countries participating in ERM II decided, by mutual agreement, to revalue the central rate of the Slovak koruna in March. The new central rate was set at 35.4424 SKK/EUR, which represents a revaluation of 8.5%.

According to the NBS, the revaluation of the central rate is in line with the equilibrium movement of economic fundamentals, as the appreciation of the Slovak koruna's nominal exchange rate is due to high productivity growth.

Alan Bollard reappointed as RBNZ Governor

New Zealand's Finance Minister Michael Cullen reappointed Alan Bollard as Governor of the RBNZ for the next five years. The Finance Minister and the Governor also signed a new, unchanged Policy Targets Agreement (PTA). According to both parties, the existing PTA continues to ensure transparency and sufficient accountability in the conduct of monetary policy by the RBNZ.

China widens fluctuation band

In May, the People's Bank of China (PBC) enlarged the daily fluctuation band for the exchange rate of the domestic currency against the dollar to ±0.5%. The limits of the previous band of ±0.3% had been reached only in exceptional cases. According to the PBC, this is a further step in the gradual relaxation of its exchange rate regime and is aimed at strengthening the pricing and risk management capabilities of financial institutions.

3. Spotlight: Convergence reports assess the preparedness of Cyprus and Malta for the euro

In mid-May, the [ECB]() and the [European Commission]() published convergence reports assessing the preparedness of Cyprus and Malta for adopting the euro. According to these reports, Cyprus had fulfilled all the conditions laid down in the Maastricht Treaty and it was subsequently given a positive recommendation by the Commission. In Malta's case, the Commission's report stated that the country had achieved a high degree of sustainable convergence and hence fulfilled one of the main conditions for adopting the euro. By contrast with Cyprus, however, the Commission's recommendation in this case was conditional on the abrogation of the excessive deficit procedure which Malta is subject to according to both reports. Together with the convergence report, the Commission submitted a recommendation to the Council of the EU, in the composition of the ministers of finance of the Member States (Ecofin), to abrogate the excessive deficit procedure for Malta. At its June meeting, Ecofin followed this recommendation and ended the procedure, and so Malta fulfils the criterion regarding the stability of public finances. The final decision on whether or not to accept the countries into the euro area will be taken by Ecofin in July.

Criterion on price stability fulfilled comfortably in both countries

In February, Cyprus and Malta asked the ECB and the Commission to prepare extraordinary convergence reports so that they would be able to adopt the euro at the start of next year. Over the reference period (April 2006 – March 2007), the harmonised inflation rates in Cyprus and Malta were 2.0% and 2.2% respectively, and were thus 1.0 and 0.8 p.p. respectively below the reference value given by the average of the three EU countries with the lowest inflation rates (in this case 3.0%). According to the reports of both the Commission and the ECB, both countries thus comfortably fulfilled the price stability convergence criterion. Inflation in these countries had been relatively stable in previous years as well. Moreover, the Commission states that in both countries inflation is likely to remain below the reference value in the months ahead. In the case of Cyprus, slight upside risks to this outlook are associated primarily with second-round effects of past growth in energy prices and the expected harmonisation of VAT rates. In the case of Malta, a renewed increase in energy prices and a simultaneous rapid rise in credit are the main upside risks going forward.

Fulfilment of criterion on long-term interest rates is likewise no problem

Long-term interest rates in both Cyprus (4.2%) and Malta (4.3%) were well below the 6.4% reference value over the reference period. Rates in both countries were practically the same as those in the three EU countries with the lowest inflation and only slightly above the euro area average.

Successful stays by both countries in ERM II

The exchange rate convergence criterion was similarly satisfied in both countries with no major problems over the reference period (May 2005 – April 2007). Both countries participated in ERM II in this period. The Central Bank of Cyprus maintained the exchange rate in the upper half of the fluctuation band, very close to the central rate. The Maltese central bank maintained the exchange rate directly at the central rate, in line with a commitment made upon ERM II entry. The exchange rates in both countries were therefore stable in this period despite high current account deficits in recent years. Especially for Malta, the net outflow of portfolio investment recorded in the last two years has been more than financed by net inflows of direct and, in particular, other investment.

The fulfilment of all these three convergence criteria is primarily the result of appropriately chosen monetary policy focusing de facto on maintaining a fixed exchange rate. Primarily by means of this fixed rate, the monetary authorities have tried to achieve and maintain low inflation and interest rates. Such a regime is appropriate for countries that have already achieved a relatively high level of real convergence towards the core of the EU and which are therefore recording only a low rate of equilibrium appreciation of their national currencies. In other countries (such as the Baltic States), however, a very similar monetary policy arrangement to that applied in these two relatively advanced economies is leading to high inflation and non-fulfilment of the inflation criterion. In these less advanced economies experiencing equilibrium appreciation, fixed exchange rate regimes are preventing the inflation pressures stemming from catching-up of the advanced countries' price and economic levels from being absorbed through nominal appreciation.

Malta battled to fulfil the fiscal criterion right up to the last moment

Cyprus fulfilled the criterion relating to public finances. The excessive deficit procedure for Cyprus was terminated in July 2006. Its general government deficit stood at 1.5% of GDP in 2006, well below the 3% reference value. A further slight improvement is expected for 2007. Government debt amounted to 65.3% of GDP in 2006 and thus exceeded the 60% reference value. Quite a significant improvement is expected for 2007 and the debt-to-GDP ratio should fall below the 60% level at the turn of 2009. This can be viewed as sufficient to satisfy the criterion. The Commission has numerous suggestions for further improvement and many comments on the government scenario, but it does not doubt the generally improving government debt trend.

Malta, too, is recording improving results compared to when it joined the EU. Its general government deficit reached 2.6% of GDP in 2006 and was thus below the reference value. A further slight decrease is expected for 2007. General government debt stood at 66.5% of GDP in 2006 and thus exceeded the reference value. Only a small decrease in the debt-to-GDP ratio is expected for 2007. The ECB convergence report also notes that part of the improvement in the public finance deficit in 2005 was due to temporary measures. In its report, the ECB expects it to take years for the total debt to fall below 60%. The convergence criteria include a condition that the country must not be subject to an Ecofin decision on the existence of an excessive deficit. The ECB and Commission reports both stated, however, that Malta was the subject of an excessive deficit procedure. By contrast to Cyprus, the Commission's recommendation in this case was conditional on the abrogation of the excessive deficit procedure. Together with the convergence report, the Commission submitted a recommendation to Ecofin, to abrogate the excessive deficit procedure for Malta. At its June meeting, Ecofin followed this recommendation and ended the procedure, and so Malta fulfils the criterion regarding stability of public finances.

Compatibility of national legislation achieved in both countries

The ECB and Commission reports both state that the two countries' national legislation is compatible with the requirements of the EC Treaty and the Statute of the ESCB and ECB. In Malta's case, however, the Commission's report mentions the existence of an incompatibility in the Central Bank of Malta Act as regards the prohibition of monetary financing. The incompatibility concerns the possibility of providing credit to Maltese banks in order to maintain financial stability and in other exceptional cases. According to the Commission, this might be a case of public support which the state should not provide. Nevertheless, this fact had no bearing on the overall assessment of this criterion.

Ecofin will have final say

The final decision on whether or not to accept the countries into the euro area will be taken by Ecofin in July. If its decision is positive, an irrevocable conversion rate between the euro and the national currency will be set for each country. Both countries are expected to introduce the euro on 1 January 2008 under the "Big Bang" scenario, i.e. simultaneous changeover for cash and non-cash transactions.

4. Selected speech: Kate Barker on the frequency of interest rate changes

*In this section we summarise a speech entitled "**Interest rate changes – too many or too few**" given* *by Kate Barker, Member of the BoE's Monetary Policy Committee (MPC), at the Confederation of British Industry's North East Dinner in Newton Aycliffe on 20 March 2007.*

Ms Barker started by summarising the theoretical arguments and practical experience with the timing of monetary policy interest rate changes over the MPC's ten-year life and her own six-year mandate. Since its first meeting in June 1997, the MPC has met 119 times, and rates have been changed at 34 of these meetings. The peak was reached in June 1998 (7.5%) and the low point in July 2003 (3.5%). In this context, Ms Barker first of all rejected the frequent classification of the MPC members as "doves" or "hawks". If monetary policymakers were predisposed to be either "soft" or "hard" with regard to keeping inflation low, they would be failing to do their main job – of achieving price stability expressed in terms of a symmetric inflation target. The differences in voting between the individual MPC members thus tend to reflect different views either about the economic outlook and the risks around it, or about the appropriate monetary strategy.

Ms Barker then discussed two arguments relating to the timing of interest rate changes. The first is *gradualism* (where a required interest rate change is implemented gradually, rather than all at once) and the second is *waiting* (where the interest rate change is put off until later). Waiting is most often motivated by caution about making a change in direction in the path of interest rates, but it can also involve waiting for a particular piece of information or a more sophisticated analysis of new data. One argument in favour of gradualism is the existence of uncertainty about the detailed workings of the economy and about the central bank's ability to affect inflation by changing rates. Another reason for gradualism is uncertainty about recent economic data which might later be revised. One argument against gradualism, by contrast, is that reacting too slowly and cautiously increases the probability of inflation deviating substantially from the target, necessitating a larger correction at a future date. Frequent rate reversals could also be damaging to monetary policy credibility and increase the cost of a mistake. In addition, they would reduce the central bank's ability to affect long-term interest rates. In a monthly monetary policy decision-making system, Ms Barker has therefore always preferred the option of changing rates immediately rather than waiting. The advantage of her approach, she believes, is that it enables future small moves in the same direction if new data suggests this is necessary, and lessens the risk of the need for a sharper change in interest rates at a later date.

Empirical work looking back at the MPC's behaviour compared to the predictions from a simple Taylor rule (in which the interest rate responds to movements in inflation and the output gap) suggests that the MPC appears to have been only slightly more responsive to news than policymakers in the UK over the previous twenty years. An extension of the Taylor rule to allow for variables representing financial conditions or the use of real time data reveals that policy seems to have been substantially less gradual over the ten-year life of the MPC. Estimates of forward-looking Taylor rules also suggest a less gradual approach. The experience of a sample of eight inflation-targeting central banks shows that monetary policymakers: (i) are slow to change interest rates in a new direction (because of concerns about loss of credibility), and (ii) tend to make changes in interest rates more frequently when producing a new macroeconomic forecast.

Ms Barker concluded by noting that the MPC has become less activist over the past ten years, due partly to the changing economic environment. She added that its external members have been more active on average than the internal members in the voting on interest rates. The presence of externals not only widens the range of views, but also prevents any tendency towards complacency.

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