ČNB ČESKÁ NÁRODNÍ BANKA
Monetary and Statistics Department
Monetary Policy and Strategy Division

Central Bank Monitoring

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Most of the central banks we monitor continued to tighten monetary policy during the past three months. The BoE and RBNZ increased their rates by 0.25 percentage point and the Riksbank and NBP raised theirs by 0.50 percentage point. Rates in the euro area, Slovakia and the USA were unchanged. The only bank to lower rates was the MNB, doing so by 0.25 percentage point. In* Spotlight *we take a look at the causes and consequences of the crisis in the subprime mortgage market. Our selected speech is Lorenzo Bini Smaghi's address on the preparedness of euro area countries to face the current challenges of globalisation.

1. Developments since the last issue of Monitoring (June 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%	1.8% (Aug 2007)[4]	4.00%	5 Jul/0.00 6 Sep/0.00 ↗	4 Oct 8 Nov 6 Dec ↗	6 Dec: publication of forecast
Sweden (Sveriges Riksbank, SR)	2.0%	1.9% (Jul 2007)	3.75%	19 Jun/+0.25 6 Sep/+0.25 ↗	29 Oct ↗	30 Oct: publication of Monetary Policy Report
United Kingdom (Bank of England, BoE)	2.0%	1.9% (Jul 2007)	5.75%	4–5 Jul/+0.25 1–2 Aug/0.00 5–6 Sep/0.00 →	3–4 Oct 7–8 Nov 5–6 Dec →	14 Nov: publication of IR[5]
Hungary (Magyar Nemzeti Bank, MNB)	3.0%	8.4% (Jul 2007)	7.75%	25 Jun/-0.25 23 Jul/0.00 27 Aug/0.00 ↘	24 Sep 29 Oct 26 Nov ↘	27 Nov: publication of IR[5]
Poland (Narodowy Bank Polski, NBP)	2.5%	2.3% (Jul 2007)	4.75%	26–27 Jun/+0.25 24–25 Jul/0.00 28–29 Aug/+0.25 →	25–26 Sep 30–31 Oct 27–28 Nov ↗	1 Nov: publication of IR[5]
Slovakia (Národná banka Slovenska, NBS)	< 2.0%	1.2% (Jul 2007)	4.25%	26 Jun/0.00 31 Jul/0.00 28 Aug/0.00 →	25 Sep[6] 30 Oct 27 Nov →	Monetary survey issued on given MP meeting dates
USA (Federal Reserve System, Fed)	n/a	2.4% (Jul 2007)	5.25%	27–28 Jun/0.00 7 Aug/0.00 →	18 Sep 30–31 Oct →	17 Oct and 28 Nov: publication of Beige Book
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	2.0% (2007 Q2)	8.25%	26 Jul/+0.25 →	1 Sep 25 Oct 6 Dec →	13 Sep and 6 Dec: publication of Monetary Policy Statement

[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

Cyprus and Malta to join euro area
The Ecofin Council formally decided in mid-July to allow Cyprus and Malta to adopt the euro on 1 January 2008, in line with the positive assessments of the two countries' preparedness for the euro contained in their May convergence reports. The two countries' currencies will be fixed against the euro at their existing central rates.

ECB reviews international role of euro…
In its sixth annual review of the international role of the euro, the ECB focused on developments between July 2005 and December 2006. The use of the euro as a currency of denomination for issuing international bonds and in international loan, deposit and foreign exchange markets had decreased in this period. The euro's role as a reserve currency had increased slightly, and the use of euro banknotes in third countries had also been rising gradually.

…and together with Fed moves to calm markets
Owing to developments in the U.S. mortgage market, the ECB in August supplied the money market with almost EUR 100 billion in the form of overnight credit to banks. This kept the overnight interest rate down at levels close to the ECB's key rate of 4%. The Fed, too, provided the market with extraordinary liquidity, thereby reducing the overnight interbank rate below its own key rate of 5.25%. In addition, the Fed decreased its discount rate by 50 basis points and invited banks to use this facility. The recent developments in the financial markets and the reactions of the ECB and the Fed are described in detail in *Spotlight*.

Sveriges Riksbank describes its new model…
The June issue of the Riksbank's journal Economic Review includes an article by Malin Adolfson, Stefan Laséen, Jesper Lindé and Mattias Villani describing RAMSES (the Riksbank's Aggregated Macro model for Studies of the Economy in Sweden), which the Riksbank has been using for more than a year now. RAMSES is a general equilibrium model capturing the behaviour of households, firms and the central bank.

…and how Riksbank Executive Board members are appointed
In the Swedish central bank's staff magazine Johan Gernandt, Chairman of the General Council, has explained the procedure for appointing new members to the Executive Board. Among other things, the candidate must have long experience and have won respect in one or more of the Riksbank's fields, be a good communicator and be able to work in a group.

Slovakia gears up for euro adoption
As part of its preparations for introducing the euro in Slovakia, the Working Committee for the Introduction of the Euro in Slovakia and the Government's Authorised Representative for the Introduction of the Euro organised a series of lectures during the summer in which invited guests described in detail the euro changeover process in fields such as trade, tourism, local government, consumer protection, legislation, accounting, IT and communication. The NBS also signed a Memorandum of Understanding between the Slovak Republic, the euro area Member States and the European Commission on the start of mass production of euro coins and on preparatory tasks prior to the start of mass production of euro coins. This Memorandum allows the NBS to launch preparations for the minting of euro coins before the derogation in Article 122 of the Treaty establishing the European Community is lifted.

RBNZ intervenes against appreciating domestic currency…

In June, for the first time since the introduction of the floating currency in 1985, the RBNZ intervened in the foreign exchange market to sell New Zealand dollars. Reserve Bank Governor Alan Bollard said that this action was a response to the exceptionally strong level of the exchange rate, which was unjustified in terms of the economic fundamentals. He stated at the same time that the interventions were consistent with the Policy Targets Agreement, which requires that the RBNZ take such measures to avoid unnecessary instability in the exchange rate. In this context, the RBNZ has changed the management of its foreign currency reserves. In the future it will be able to hold some portion of the foreign reserves on an unhedged basis – an “open FX” position.

…and will webcast its news conference live

Starting in September, the RBNZ will webcast its Monetary Policy Statement news conference live on the Bank’s website. Up to now the Governor’s speech, which lasts approximately 30 minutes, has only been broadcast on Sky TV.

3. Spotlight: The crisis in the financial markets

Owing to developments in the U.S. mortgage market, the ECB in August supplied the money market with almost EUR 100 billion in the form of overnight credit to banks. This kept the overnight interest rate down at levels close to the ECB's key rate of 4%. The Fed, too, provided the market with extraordinary liquidity, thereby reducing the overnight interbank rate below its own key rate of 5.25%. In addition, the Fed decreased its discount rate by 50 basis points and invited banks to use this facility.

July and August tend to be a quiet time in the financial markets, with trading volumes usually low at this time of year. Summer 2007, however, looks set to be remembered in the history of the financial markets as a "subprime crisis", i.e. a crisis in the subprime mortgage market.

The roots of this crisis can be traced back to 2001, when the Fed slashed interest rates in an effort to mitigate the effects of the bursting of the stock market bubble (compounded among other things by the terrorist attacks on 11 September 2001). The key federal funds rate was lowered from 6.50% to 1.75% during 2001, reached 1% in mid-2003 and remained at this level until mid-2004. In real terms, short-term rates in the United States remained negative until mid-2005. Such low interest rates for such a long time fuelled a bubble in the property market. Property price growth peaked at 15% in 2005, compared to an average of 6% over the last 20 years.

The surge in property prices had two main effects. First, the total volume of mortgages soared and households increasingly used money borrowed against the rising value of their homes to fund current consumption. Second, the credit standards of the banks providing mortgages slipped as the value of collateral rose. This trend was bolstered by the fact that the mortgages were not left in the banks' balance sheets but were immediately sold on to investors as "mortgage-backed securities" (MBSs). In 2001–2003 subprime mortgages accounted for just 10% of total mortgages. By 2006 their share had leapt to 33%.

At the start of this year it started to become apparent that the credit cycle is entering a new phase. The Fed's key interest rate has now stood at 5.25% since mid-2006, and the higher interest has been gradually taking its toll in the form of a decline in property prices (of more than 2% since the start of this year) and an increasing proportion of unpaid mortgages. Aside from the unusually high ratio of subprime mortgages itself, the marketing strategies of banks providing mortgages have contributed to this situation. These banks had increasingly been offering long-term (10–30 year) mortgages at interest rates that were far below market rates (even zero in extreme cases) at the beginning of the repayment schedule (in the first 6–24 months) and much higher over the remaining life of the loan. Many debtors have since found themselves no longer able to repay after the jump in their monthly repayments. It is estimated that as many as 75% of the subprime mortgages provided in 2006 were such adjustable rate mortgages.

This gets us to the heart of the matter. The market knows that the proportion of unpaid mortgages is now at its highest level in almost 20 years. It also knows that a large volume of mortgages still face a jump in monthly repayments. This will inevitably lead to more defaults. And finally, market participants also know that the price of real estate, which serves as collateral for these mortgages, is falling. No wonder, then, that the prices of MBSs and the securities derived from them – in particular "collateralised debt obligations" (CDOs) – are falling.

However, the market does not know the owners, volumes and composition of these securities. In June, the market was shocked by the announcement that two large hedge funds owned by investment bank Bear Stearns had incurred serious losses on investments in subprime MBSs and were unable to return funds to their investors. In July, such reports became quite commonplace. Press agencies regularly issued reports on the owners of subprime MBSs and CDOs. At the end of July this uncertainty culminated in panic in the corporate bond market. The market saw a rush into government bonds, which offer much craved assurance that the issuer will not go bankrupt.

Following a short-lived calming of the storm at the beginning of August, the situation escalated again on 9 August, when French bank BNP Paribas announced that it had suspended cash withdrawals from some of its money market funds. This type of fund is widely considered to be the safest and most liquid form of collective investment. So the news that even this class of funds may – through a chain of investment instruments – have some exposure to the segment of illiquid and subprime MBSs and CDOs greatly increased the uncertainty in the markets. This generated a surge in interbank interest rates at the shortest maturities. The overnight dollar Libor jumped from 5.35% to 5.86% overnight.

Thus a problem which had started as the inability of some US subprime debtors to repay their mortgages transformed during the summer – through the securitisation of such mortgages and their sale in the form of (often illiquid and, for some market participants, non-transparent) MBSs and CDOs to various institutional investors all over the world – into a problem threatening the very core of the global financial system: the interbank money market.

The strongest response to this situation came from the European and US central banks. The ECB immediately (on 9 August) supplied the market with almost EUR 100 billion in the form of overnight credit. This kept the overnight interest rate down at levels close to the ECB's key rate of 4%. These operations were then repeated several times. On 21 August, the ECB lent an extraordinary EUR 40 billion to the banking sector for three months in an effort to decrease money market rates with longer maturities as well. The ECB's extraordinary refinancing operations, in which it lends money to the banking sector against collateral (a wide range of securities), immediately reduced overnight rates, as banks are forced to deposit their excess funds somewhere at the end of the day. On the other hand, these operations were ineffective as regards bringing down longer, three-month, interbank rates, since uncertainty regarding the credit exposures of individual banks persisted on the market.

The Fed took the same action as the ECB, repeatedly providing the market with extraordinary liquidity and thereby reducing the overnight interbank rate below its own key rate of 5.25%. On 17 August, the Fed lowered its discount rate from 6.25% to 5.75% and called on banks not to hesitate to use this facility. The problem is that borrowing liquidity from the Fed at the discount rate has in the past sometimes carried with it the threat of stigma, with the market viewing it as a sign that the bank is at risk of insolvency. As in Europe, however, the three-month dollar Libor remained around 5.50%, although the market generally expected that the Fed would lower its key rate to 4.50% before the end of the year.

Although the two central banks did not achieve all they had expected from these extraordinary operations, the market viewed their efforts positively. Above all, the central banks sent out a signal to the market that they are aware of the seriousness of the situation and are closely monitoring daily developments. Equally important is the fact that they enabled the banking sector to finance its problem collateral, at least at the shortest maturities.

4. Selected speech: Lorenzo Bini Smaghi on the preparedness of euro area countries to face the current challenges of globalisation

In this part we summarise the speech entitled "Is the euro making countries fitter for globalisation?" given by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, at the European University Institute in Fiesole on 22 June 2007.

In his speech, Lorenzo Bini Smaghi examined whether EMU helps or hinders countries' efforts to adapt to the challenges of globalisation. There are two different views on this. The first emphasises that it is best for a country to be as flexible as possible, both in the functioning of its markets and in its policies, that is, to stay out of the euro area. The alternative view is that globalisation is better dealt with by joining a large currency union such as the euro area.

Mr Bini Smaghi noted that not all countries are reaping benefits from globalisation. He based his argument on the new trade theories, predicting that liberalisations of trade and FDI induce not only trade creation but also, and more importantly, a general reallocation of resources across firms, countries and regions. The most recent literature examines four types of reallocation: (i) the self-selection reallocation effect, in which resources are reallocated from the least to the most productive firms, not only across industries but also, and more importantly, within industries; (ii) the market size effect, which induces shifts in resources from smaller to larger countries, firms being attracted by the associated greater market potential; (iii) the increased sourcing from low-cost countries; and (iv) the reallocation effects derived from preferring trade agreements made with members of a currency union.

Against this theoretical background, Mr Bini Smaghi formulated four general features that contribute to making a country fitter for globalisation: (i) a high degree of accessibility to the country's domestic market; (ii) a sufficiently large domestic market; (iii) technologically advanced products; and (iv) a resilient institutional and political framework.

Mr Bini Smaghi then went back to his initial question of whether EMU is making euro area countries fitter for globalisation. According to Mr Bini Smaghi, the euro is helping in five different ways: (i) it has increased the accessibility and centrality of the participating countries; this is more relevant for small economies at the periphery of the euro area; (ii) it is creating a larger market out of a collection of smaller national economies; (iii) in some respects it is acting as a catalyst for common research and innovation programmes and improving the conditions for further technological gains in euro area countries; (iv) it has helped to increase incentives for structural reforms within participating countries; (v) the institutional framework of a monetary union is conducive to greater macroeconomic stability, which is very important in enabling a country to cope successfully with globalisation. Mr Bini Smaghi also drew attention to several counter-arguments. First, by embracing the single monetary policy framework, a country can no longer tailor its monetary policy to national stabilisation needs and must thus have sufficient flexibility to adapt to external shocks. Second, if several aspects of economic policy are put under joint European control there is a risk of a loss of flexibility in the ability to implement reforms in euro area countries. Third, there is preliminary evidence that the impact of EMU on intra-euro area trade and business cycle harmonisation across countries has been limited.

Mr Bini Smaghi then discussed whether an autonomous exchange rate is an absorber or a source of shocks. The available empirical evidence gives no clear answer to this question, so it is not obvious that abandoning an independent monetary policy and the possibility of country-specific nominal exchange rate fluctuations is necessarily conducive to greater flexibility and macroeconomic stability.

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