Central Bank Monitoring

December 2007

Monetary and Statistics Department
Monetary Policy and Strategy Division

The past three months have seen uncertainty regarding the impacts of the global financial market crisis and persisting investor nervousness. In this situation, the Fed twice lowered its key interest rates (by 0.75 percentage point in total) on concerns that the adverse effects might spill over into the real economy. The BoE and MNB also lowered their rates. The ECB bided its time and left its rates unchanged, as did the RBNZ. In Spotlight we take a look at the changes in Fed monetary policy communication. Our selected speech is Jürgen Stark's address on the monetary policy challenges faced by the new EU member states.

1. Developments since the last issue of Monitoring (September 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%	3.0% (Nov 2007)[6]	4.00%	4 Oct/0.00 8 Nov/0.00 6 Dec/0.00 ↗	10 Jan 7 Feb 6 Mar ↘	6 Mar: publication of forecast
Sweden (Sveriges Riksbank, SR)	2.0%	2.7% (Oct 2007)	4.00%	29 Oct/+0.25 ↗	18 Dec 12 Feb →	13 Feb: publication of Monetary Policy Report
United Kingdom (Bank of England, BoE)	2.0%	2.1% (Oct 2007)	5.50%	3–4 Oct/0.00 7–8 Nov/0.00 5–6 Dec/-0.25 →	9–10 Jan 6–7 Feb 5–6 Mar ↘	13 Feb: publication of IR[4]
Hungary (Magyar Nemzeti Bank, MNB)	3.0%	6.7% (Oct 2007)	7.50%	24 Sep/-0.25 29 Oct/0.00 26 Nov/0.00 ↘	17 Dec 28 Jan 25 Feb ↘	25 Feb: publication of IR
Poland (Narodowy Bank Polski, NBP)	2.5%	3.1% (Oct 2007)	5.00%	25–26 Sep/0.00 30–31 Oct/0.00 27–28 Nov/+0.25 ↗	18–19 Dec 29–30 Jan 26–27 Feb ↗	31 Jan: publication of IR
Slovakia (Národná banka Slovenska, NBS)	< 2.0%	2.4% (Oct 2007)	4.25%	25 Sep[5]0.00 30 Oct/0.00 27 Nov/ 0.00 →	18 Dec 29 Jan 26 Feb →	Monetary survey issued on given MP meeting dates
USA (Federal Reserve System, Fed)	n/a	3.5% (Oct 2007)	4.50%	18 Sep/-0.50 30–31 Oct/-0.25 →	11 Dec 29–30 Jan →	
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	1.8% (2007 Q3)	8.25%	13 Sep/0.00 25 Oct/0.00 6 Dec/0.00 →	24 Jan 6 Mar →	6 Mar: publication of Monetary Policy statement

[1] Inflation target valid for the current period (or, in the case of Slovakia, the end-2008 target).
[2] The direction of the expected change in rates in the past quarter is taken from the Consensus Forecasts (CF) 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 CF survey (or, in the case of New Zealand, from the RBNZ's own survey).
[4] Inflation Report.
[5] The NBS decides on rates once a week; the given dates correspond to the discussion of the Situation Report.
[6] Preliminary estimate.

2. News

Riksbank renames inflation rate…

The measure of underlying inflation in Sweden, UND1X, has been renamed the CPIX by agreement between the Riksbank and Statistics Sweden. The name change does not affect the way in which the measure is calculated. The new name took effect on 12 November 2007 simultaneously with the publication of the regular inflation figures. The change is intended to shorten and simplify the name of the inflation measure, thus making it easier to use.

… and updates forecast for each monetary policy meeting

The Riksbank has decided to update its forecasts for the repo rate and a number of other key variables before each of its six monetary policy meetings. The step was introduced due to the contradictory reactions of analysts and markets to the communication of the published paths for endogenous interest rates in the February and June forecasts. The revision of the forecast between monetary policy meetings is intended, along with the recent decision to publish the arguments of the individual board members by name ("attributed minutes"), to foster a greater understanding of Riksbank monetary policy by the markets.

Slovakia completes second year in ERM II

Two years have passed since Slovakia entered ERM II (28 November 2005). The country has therefore completed its minimum required stay in the mechanism (two years). During this time the koruna has been revalued once, from a central parity of 38.4550 EUR/SKK to 35.4424 EUR/SKK. The next step on Slovakia's path to the euro area will be the preparation of the Convergence Reports of the European Commission and the ECB next spring. These reports will then form the basis for an assessment of Slovakia's preparedness to join the euro area, which will take place between May and June 2008.

Fed moves towards greater monetary policy openness

In mid-November, the Federal Open Market Committee (FOMC) took a further step towards improving the transparency of the Fed's monetary policy making. The FOMC decided not only to increase the frequency of its economic projections, but also to begin publishing projections for overall inflation and to extend the projection horizon – see *Spotlight* for more details.

RNBZ issues Financial Stability Report…

The central bank of New Zealand in November issued a Financial Stability Report, in which it commented on the continuing crisis in the financial markets. The report highlights the importance of liquidity for institutions and the financial system as a whole. In an accompanying speech, RNBZ Governor Alan Bollard said that New Zealand was heavily reliant on foreign capital markets, given its large external debt. Recent events had shown that in the event of increased uncertainty and problems with risk assessment, it is difficult to secure necessary funding in credit markets. These events had commanded increased attention by the RBNZ and had led to work being commenced on a specific liquidity policy for banks, planned for publication in 2008.

…and will webcast its Monetary Policy Statements

The RNBZ is to webcast its Monetary Policy Statement news conferences on its website. Following a webcast trial in September 2007, the Bank conducted a survey with external audiences to assess the success of the webcast. The resounding positive response led the RNBZ to approve webcasting as a means of ensuring its messages on monetary policy decisions and financial stability are accessible to wider domestic and international audiences.

3. Spotlight: The Fed takes a further step towards greater openness

In mid-November, the Federal Open Market Committee (FOMC) took a further step towards improving the transparency of Fed monetary policy making. The FOMC decided not only to increase the frequency of its economic projections, but also to start publishing projections for headline inflation and to extend the projection horizon.

Projection frequency

The FOMC's projections had previously been compiled and published semiannually in the Monetary Policy Report submitted to the Congress in February and July. The expanded economic projections will be released four times each year (in February and July and then at the start of the second and fourth quarter, for 2008 in April and October) together with the minutes published around 20 days after each FOMC meeting. The first quarterly economic projection was the one from the FOMC meeting of 30–31 October 2007, released on 20 November 2007.

Overall inflation projection, longer horizon

In addition to the increased projection frequency, overall inflation will be added to the set of projected variables. The projection thus contains the expected future paths of overall inflation, core inflation (i.e. inflation excluding volatile items of the consumer basket, specifically prices of food and energy), real GDP growth and the unemployment rate. The projection horizon has been extended to three years, from two. The minutes also newly contain a fuller discussion of policymakers' individual views and of the risks to the economic outlook. The FOMC believes that these steps will make it better understood by households and firms and make its monetary policy making easier to predict.

"Summary of Economic Projections" – 19 projections

This Summary contains the projections of the 19 members (12 Reserve Bank presidents and 7 Fed governors) who actively participate in FOMC meetings. These members draw up projections independently of each other in accordance with the Fed's dual mandate (see below). In other words, the FOMC's economic projections are not the outcome of a "typical forecasting process" conducted by a team of Fed forecasters, but instead reflect the personal, independent outlook of each of the FOMC members separately. Given the potential diversity of the members' outlooks, the projections are published in the form of a range and a central tendency. The range for each variable is the interval between the lowest and highest projections. The central tendency is narrower, as it excludes the three lowest and three highest projections. Graphically, the outlooks are published as histograms clearly displaying the frequencies and values of the participants' individual views for each variable. The document also gives a comparison of current and past projections.

The Fed and its attitude to price stability

The Fed has a dual mandate to promote price stability and maximum employment. It is meant to attach equal weight to both these objectives. Inflation targeting is not compatible with the equality of status of these two objectives, so the Fed does not apply it and does not define an inflation target. Analysts and the general public can only speculate about what inflation rate the FOMC regards as "desirable" in terms of price stability. However, the present extension of the projection horizon, along with the start of publication of projections for overall inflation, may offer some clue as to the "desirable" inflation rate, since the economic projections are compiled under the condition of an "appropriate monetary policy stance". Under this assumption, the inflation projection at longer horizons reflects the members' views regarding the desirable rate of inflation. The October projection implies that this desirable inflation rate ranges between 1.5% and 2.0%. The extension of the projection horizon and the start of publication of projections for overall inflation will thus help to anchor the inflation expectations of economic agents and thereby benefit the overall functioning of the economy.

The CPI versus the PCE

The inflation rate is measured not by the consumer price index (CPI), as it is by most statistics offices, but by the Personal Consumption Expenditures (PCE) index. The principal differences between these two prices indices are as follows: (i) the PCE reflects a wider basket of consumption expenditures than the CPI; for example, medical care expenditures are strongly represented, accounting for around 20% of all expenditures; (ii) the CPI has a relatively constant consumer basket (changed in the USA approximately once every two years), whereas the expenditure composition of the PCE changes quarterly. The PCE has the advantage that it better reflects relative changes in the prices of goods and services consumed, as the “basket” changes flexibly according to changes in households’ behaviour. The indices also differ in terms of their construction, i.e. (iii) the weights in the CPI are derived from household surveys, whereas the weights in the PCE are derived from corporate surveys; (iv) the PCE is a Fisher chain index (the geometric mean of the current and preceding period), whereas the CPI is derived using the Laspeyres formula (with a fixed base period).

Another possible comparison of the PCE and the CPI states that the PCE contains around three-quarters of the CPI, the remaining one-quarter being represented by other price indices such as the producer price index (PPI). The share of housing expenditures in the CPI is around 42%, whereas in the PCE it is substantially smaller at 23%. Bear in mind that the *relative* comparison of PCE items versus CPI items varies, owing to the variable composition of the PCE basket. It is impossible to say simply which price index is the “better”, but a knowledge of their differences is vital for possible comparisons with other economies.

Greenspan versus Bernanke

Alan Greenspan – the predecessor of the current FOMC Chairman Ben Bernanke – was regarded as having a strong personal influence and an ability to affect the financial markets with his utterances, and also as a critic of inflation targeting. The increase in the projection frequency, the number of projected variables and the horizon of the economic projections is particularly significant because it transforms the Fed’s monetary policy into a more “open hand” one. The start of publication of projections for overall inflation signals a turnaround towards more transparent Fed monetary policy, i.e. towards the way in which monetary policy is implemented in inflation-targeting banks.

If Mr Bernanke plans to talk in the future about the outlook for the US economy from the position of FOMC chairman, this will no longer be the view of just one man, but the view of the entire FOMC. This step towards more open monetary policy is the first of its kind under Bernanke’s leadership, but it is unlikely to be the last.

4. Selected speech: Jürgen Stark on the monetary policy challenges faced by the new EU member states

In this part we summarise the speech entitled "Fast, but sustainable? Challenges and policy options for the catching-up process of central and eastern European countries" given by Jürgen Stark, Member of the Executive Board of the ECB, in Frankfurt am Main on 1 October 2007.

Jürgen Stark focused his speech on the issue of achieving strong and sustainable economic convergence of the new EU member states towards the euro area countries, an issue he described as "one main policy challenge". In the first part of his speech, Mr Stark looked at the catching-up experience of the former accession ("cohesion") countries (Greece, Ireland, Portugal and Spain) and compared this with the process in the new EU member states. The main similarity, he said, was the relatively low GDP-per-capita level at the time of EU accession. The cohesion countries also underwent a strong catching-up process in the 1990s, which resulted in high growth and inflation differentials with the founding countries of the EU. Moreover, the former cohesion countries also experienced strong credit growth and large current account imbalances. One important difference is that (i) all the cohesion countries were able to make use of their monetary and exchange rate policy to adjust, i.e. to cushion the inflationary impact of real convergence by allowing the nominal exchange rate to appreciate, (ii) their catch-up process was longer, which might explain why their convergence process appears to have been smoother than in the new EU member states.

The second part of the speech focused on the current macroeconomic and financial challenges faced by the new EU member states. Mr Stark noted that on average in the past two years the countries applying hard pegs (Bulgaria, Estonia, Latvia and Lithuania) had recorded economic growth almost twice as fast as the countries with more flexible exchange rates (the Czech Republic, Hungary, Poland, Romania and Slovakia), albeit with an inflation rate almost one and a half times higher. According to Mr Stark, these developments are neither in line with economic theory, nor do they reflect the empirical observations in other catching-up economies, including the cohesion countries. Economic performance should not depend in principle on the exchange rate regime applied. Moreover, the impact of the exchange rate regime on inflation suggests that countries with hard pegs usually display a better inflation performance compared with countries with floating exchange rates. In Mr Stark's view, the euro-candidates with hard peg exchange regimes are therefore currently faced with three main challenges: (i) sharply increasing inflation, mainly driven by labour market development; (ii) strong credit growth, supported by very favourable financing conditions, including negative real interest rates; and (iii) substantial external imbalances, stemming from robust private consumption growth. Mr Stark says the key challenges faced by countries with more flexible exchange rates lie in: (a) very loose fiscal policy, with fairly limited corrective efforts in the past, and (b) the inflationary pressures stemming from real convergence, which are likely to increase.

In the third part of his speech, Mr Stark formulated four areas for possible policy intervention to address these challenges: fiscal policy, structural policy, financial stability policy and, last but not least, monetary and exchange rate policy. The ultimate question, according to Mr Stark, is which monetary policy and exchange rate regime is best suited to ensuring a fast and stable convergence process and for a country to cope with the country-specific economic policy challenges.

In conclusion, Mr Stark stressed that it would be wrong to assume that the new member states' current problems can be easily solved by joining the euro area. On the contrary, he believes the new member states should not adopt the euro before a fully sustainable level of convergence has been achieved.

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