# CENTRAL BANK MONITORING – MARCH

2008

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CNB CZECH NATIONAL BANK

## In this issue:

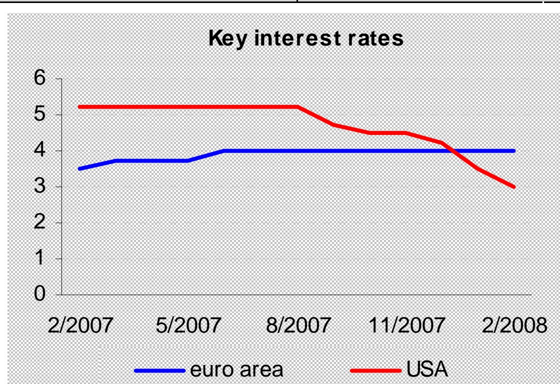
***The past three months have seen growing uncertainty regarding the impacts of the financial crisis on the real economy. The hot topics are depth of the likely recession in the USA, the Fed's sharp cuts in key rates, and the global inflation shock in the shape of rising prices of food and oil. In* Spotlight *we refer back to the September issue of* Monitoring *and take a look at the liquidity problems and the coordinated actions taken by central banks. Our selected speech is Donald L. Kohn's address on developments in Fed monetary policy transparency and communications.***

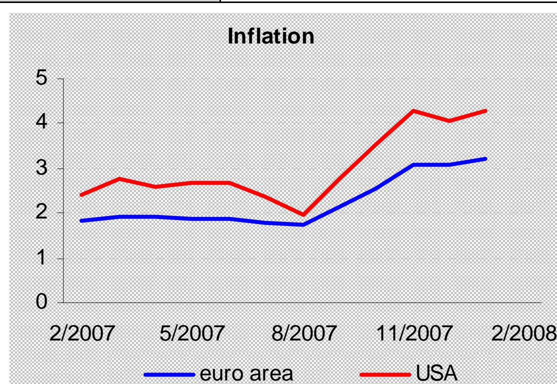
# 1. Latest monetary policy developments at selected central banks

## ECB and Fed

| | Euro area (ECB) | USA (Fed) |
|---|---|---|
| *Inflation target* | < 2%[1] | n.a. |
| *MP meetings (rate changes)* | 10 Jan (0.00)<br>7 Feb (0.00)<br>6 Mar (0.00) | 11 Dec (-0.25)<br>22 Jan (-0.75)<br>30 Jan (-0.50) |
| *Current basic rate* | 4.00% | 3.00% |
| *Latest inflation* | 3.2% (Feb 2008)[2] | 4.3% (Jan 2008) |
| *Expected MP meetings* | 10 Apr<br>8 May<br>5 June | 18 Mar<br>29–30 Apr |
| *Other expected events* | 6 Jun: publication of forecast | 16 Apr: publication of Beige Book |
| *Expected rate movements*[3] | ↓ | ↓ |

- The ECB continued to bide its time and left its rates unchanged at 4%.
- The Fed lowered its key interest rate three times in the past three months (by 1.50 p.p. in total). The Fed's firm stance is evidenced by the 0.75 p.p. rate cut made at an extraordinary FOMC meeting on 22 January.

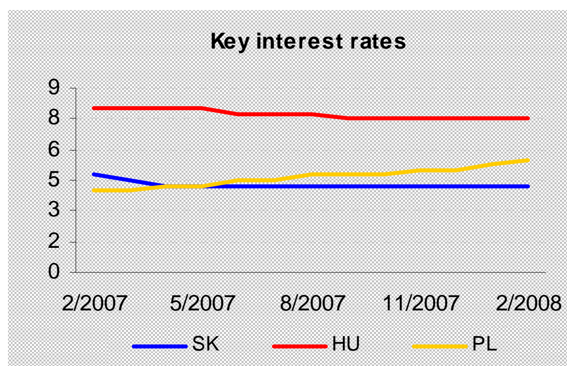


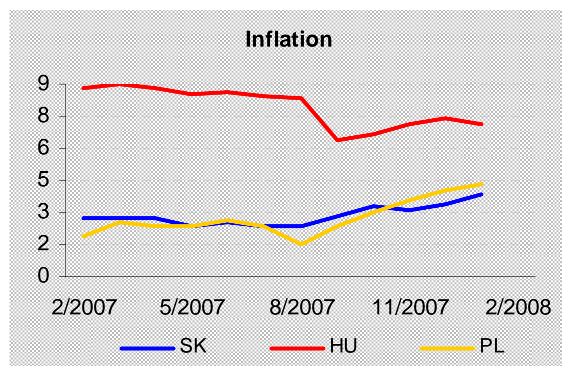




[1] ECB definition of price stability; [2] preliminary estimate; [3] The direction of the expected change in rates in the coming quarter is taken from the Consensus Forecasts survey and from the RBNZ's survey.

## Central European economies

| | Slovakia (NBS) | Hungary (MNB) | Poland (NBP) |
|---|---|---|---|
| *Inflation target* | <2% | 3.0% | 2.5% |
| *MP meetings (rate changes)* | 18 Dec (0.00)[4]<br>29 Jan (0.00)<br>26 Feb (0.00) | 17 Dec (0.00)<br>21 Jan (0.00)<br>25 Feb (0.00) | 18–19 Dec (0.00)<br>29–30 Jan (+0.25)<br>26–27 Feb (+0.25) |
| *Current basic rate* | 4.25% | 7.50% | 5.50% |
| *Latest inflation* | 3.8% (Jan 2008) | 7.1% (Jan 2008) | 4.3% (Jan 2008) |
| *Expected MP meetings* | 25 Mar<br>29 Apr<br>27 May | 31 Mar<br>28 Apr<br>26 May | 25–26 Mar<br>29–30 Apr<br>27–28 May |
| *Other expected events* | 20 May: Report on Monetary Developments 2007 | 19 May: publication of IR[5] | 20 May: publication of IR[5] |
| *Expected rate movements*[3] | → | → | → |



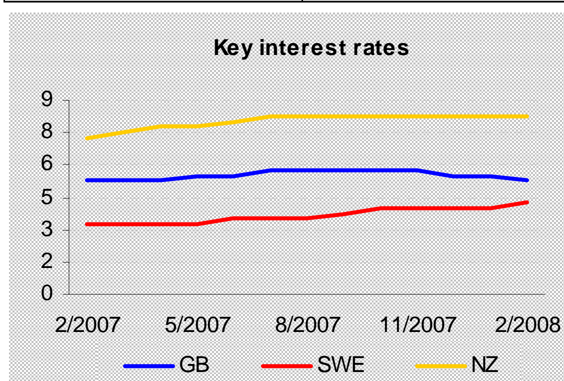



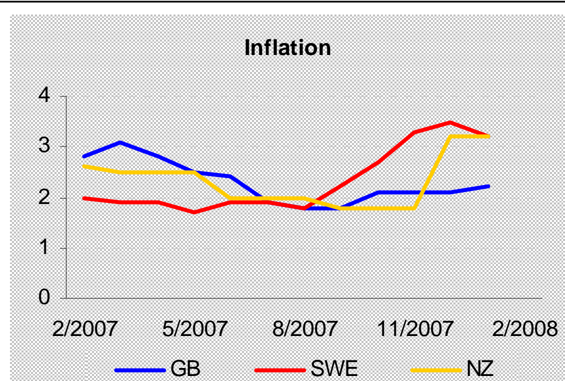

[4] The NBS decides on rates once a week; the dates given correspond to the expected dates of discussion of the Situation Report; [5] Inflation Report

Basic rates in the Central European region (Slovakia, Hungary and Poland) were calmer, with only Narodowy Bank Polski (NBP) raising its key rate. It did so twice in a row by 0.25 p.p. to 5.50% in response to a rising inflation rate amid wage-cost pressures and fears of second-round effects.

## Other selected inflation-targeting countries

| | United Kingdom (BoE) | Sweden (Riksbank) | New Zealand (RNBZ) |
|---|---|---|---|
| *Inflation target* | 2% | 2% | 2% |
| *MP meetings (rate changes)* | 9–10 Jan (0.00)<br>6–7 Feb (-0.25)<br>5–6 Mar (0.00) | 18 Dec (0.00)<br>12 Feb (+0.25) | 24 Jan (0.00)<br>6 Mar (0.00) |
| *Current basic rate* | 5.25% | 4.25% | 8.25% |
| *Latest inflation* | 2.2% (Jan 2008) | 3.2% (Jan 2008) | 3.2% (2007 Q4) |
| *Expected MP meetings* | 9–10 Apr<br>7–8 May<br>4–5 Jun | 22–23 Apr | 24 Apr<br>5 Jun |
| *Other expected events* | 14 May: publication of IR[5] | | |
| *Expected rate movements*[3] | ↓ | → | → |




The BoE lowered its key rate by 0.25 p.p. in response to the financial crisis and the situation in the USA, whereas the Riksbank went in the opposite direction and tightened its monetary policy. The RNBZ left its rates unchanged; its key rate has been 8.25% since July 2007.

## 2. News

### Malta and Cyprus adopt euro

On 1 January 2008, Malta and Cyprus introduced the euro and the number of countries using the single European currency rose to 15. Both countries' central banks thus became members of the Eurosystem. The conversion rates are 1 EUR per 0.429300 MTL and 1 EUR per 0.585274 CYP. January saw an initial period of dual circulation of the national currencies together with the euro. The euro subsequently became the sole legal tender in both countries with effect from 1 February 2008. It is estimated that around 80% of the national banknotes had been withdrawn from circulation in both economies by 4 February. Commercial banks will exchange currency free of charge until 31 March 2008 in the case of Malta and until 30 June 2008 in the case of Cyprus. Both countries have set a time limit of 10 years from the end of the dual circulation period for exchanging currency at the central bank. According to both central banks, the changeover to the euro has been completed successfully and the response of the public has been positive.

### Hungarian forint abandons flexible peg

The Hungarian government and central bank (the MNB) agreed to abandon the flexible exchange rate peg with a fluctuation band of ±15% around the central rate (282.36 forints to the euro) and to adopt a floating exchange rate with effect from 26 February 2008. The flexible peg had been introduced in 2001 after the abandonment of the crawling peg. The MNB says that the floating forint will provide it with better conditions to achieve its inflation target, to meet the nominal convergence criteria and finally to enter ERM II.

### British mortgage bank Northern Rock nationalised…

The UK government decided to take temporary control of mortgage bank Northern Rock owing to massive financial losses caused by the problems in the loan market and by the mortgage crisis in the USA. The Bank of England had tried to support the fifth-largest mortgage bank in the country back in Autumn 2007 by providing financial assistance (direct funding through the discount window at a penalty interest rate), thus taking on the role of lender of last resort. But instead of calming the situation, the arrangement between the BoE and Northern Rock had triggered panic among clients, leaving Northern Rock facing the first run on a bank in the UK since 1866. However, Northern Rock remains open for business as usual, as it was prior to the UK government's decision.

### ...and Mervyn King to be reappointed Bank of England governor

On 30 January 2008, Queen Elizabeth II approved the reappointment of Mervyn King as governor of the Bank of England for a second five-year term. Mr King's first term expires on 30 June.

### Candidates for vice president of Narodowy Bank Polski

The Polish president accepted two candidates for the office of vice president of Narodowy Bank Polski. The first candidate is Mr Piotr Wiesiołek, who, among other things, is regarded as a specialist in foreign exchange reserve management. The second is Professor Witold Koziński, who previously held the position of vice president in 1992–1998 and thus offers a balance of academic and practical experience.

### Hyperinflation in Zimbabwe

The annual rate of inflation in Zimbabwe reached one hundred thousand per cent (100,580.2%) in January. The preceding month it had hit 66,000 per cent. The dramatic surge in inflation is due to food and fuel shortages. A new $10 million banknote was issued in January. Zimbabwe has been mired in economic crisis for the last seven years and has the highest rate of inflation in the world.

## 3. Spotlight: The liquidity problems and the coordinated actions taken by several central banks

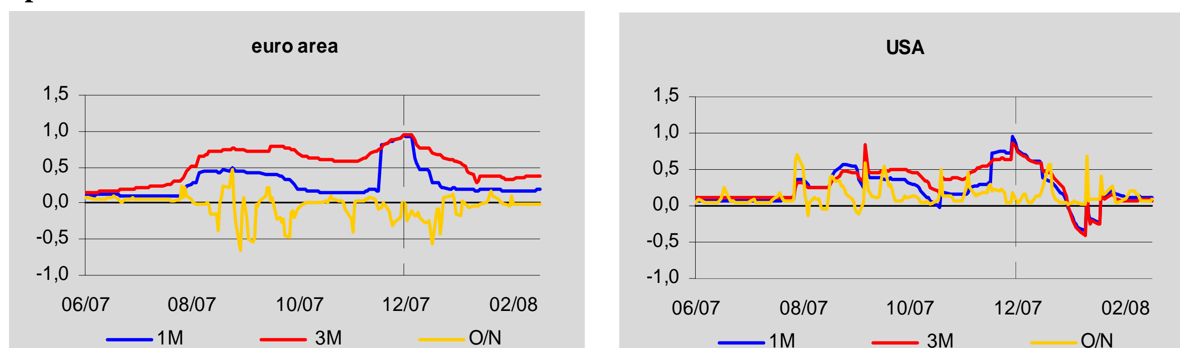
*This March issue of* Monitoring *refers back to last September's* Spotlight*, which examined the financial market crisis in full swing at the time. We now return to this issue, this time from a rather different angle, taking a look at the joint and coordinated provision of liquidity to the money market by several central banks in the latter stages of the crisis.*

**Central banks' actions prior to 12 December 2007 (before the coordinated approach was announced)**

As mentioned in the September issue of *Monitoring*, the ECB and the Fed started to supply the markets with large volumes of liquidity soon after the crisis erupted, doing so in an attempt to bring short-term interest rates down close to the monetary policy rates and to calm the situation. The efforts by these two central banks to reduce interbank rates back to their "pre-crisis" levels continued until early December. The Fed provided the markets with extraordinary liquidity and, with its reduced discount rate, encouraged banks to make more use of the lending facility. However, despite commercial banks' liquidity access problems and a rapidly widening interest rate spread, this facility was little used.[1] The reduction of the Fed's basic rate by 0.25 p.p. on 11 December 2007 was viewed by the markets as too small. Amid the increased uncertainty, banks' unwillingness to actively enter the interbank market continued to show up at longer maturities.

The ECB, which, like the Fed, supplied the market with additional liquidity, succeeded in lowering the overnight rate to the level of its basic rate, but failed to reduce the longer-term 1M and 3M rates to the desired level. This was mainly due to persisting uncertainty concerning individual banks' loan exposures and to the unwillingness of financial institutions to lend to each other. A number of other central banks (the BoE, the BoC and the SNB)[2] were faced with a similar situation. Interbank rates then decreased (and spreads between 1M/3M rates and the basic rate narrowed – see the chart) on the money markets on both sides of the Atlantic until the turn of 2008, thanks above all to the coordinated central bank intervention.

**Spreads between interbank rates and central bank basic rates**




Source: Thomson DataStream. Note: Vertical line denotes 12 December 2007.

**The players and their coordinated approach**

On 12 December 2007, seven central banks took official action to address the elevated pressures in short-term liquidity markets and thus stabilise those markets. Five banks (the Fed, the ECB, the BoE, the BoC and the SNB) took an active stand. The remaining two (the Riksbank and the Bank of Japan) voiced an interest in the joint action, but did not actively provide the market with liquidity. However, they did promise to get involved if the need arose. It is not unusual for a central bank to supply liquidity to the market, although the volumes offered at the auctions in this case were exceptionally high. However, it is rare to see several central banks take joint, coordinated action.

[1] The possible reasons included the following: (a) the rate at which the Fed lent to other banks was not determined by auction (the interaction of supply and demand), but was a penalty rate fixed by the Fed, which evidently deterred banks from bidding; (b) any bank that used the discount window was dogged by the stigma of insolvency.

[2] BoE – Bank of England, BoC – Bank of Canada, SNB – Swiss National Bank.

**How did the coordinated supply of liquidity proceed?**
There were two basic types of operation – collateralised lending to financial institutions at 1M–12M maturities, and currency swap lines. The Fed offered the ECB and the SNB $24 billion through foreign exchange swap lines[3] in order to boost the supply of U.S. dollars in Europe. The Fed also offered large volumes of dollars to financial institutions between 17 December 2007 and 25 February 2008 in six Term Auction Facility[4] (TAF) tenders. These funds were provided at the market rate, mostly with 28-day maturity and with relaxed collateral quality requirements. Demand from financial institutions was three times higher than supply in the tenders in December, and the demand in subsequent auctions was far from met despite an increase in volumes. At the beginning of March Fed decided to increase the amounts outstanding in the TAF and will continue to conduct them for at least the next six months. Moreover, Fed will initiate a series of term repurchase transactions that are expected to cumulate to $100 billion.

Unlike the Fed and the BoE, the ECB provided the market with extraordinary liquidity as soon as the problems emerged[5] (i.e. from the end of August), doing so in the form of extraordinary longer-term refinancing operations (LTROs) in euros with 3M maturity. It carried out further supplementary LTROs on 12 December 2007 and 21 February 2008 and announced one more for 13 March. By contrast, until the coordinated measures started the Fed and the BoE used direct financing through the lending facility. Another difference from the pre-12 December actions is that the operations took place by agreement between the central banks. On the same days on which the Fed conducted its tenders, the ECB announced four dollar term tenders at fixed rates derived from the Fed's tender rates. The dollars used in the ECB and SNB tenders come from the swap lines opened by the Fed.

The BoE offered liquidity on 18 December 2007 and 15 January 2008 in the form of variable-rate long-term repo operations at 3M, 6M, 9M and 12M maturities against eligible collateral denominated in GBP, USD, CAD, SWK, CHF and JPN (the collateral quality requirements were relaxed for 3M operations, and it was the 3M maturity that subsequently accounted for almost the entire allotted auction volume). The final two central banks directly involved (the SNB and the BoC) also supplied liquidity, but in relatively small volumes. The SNB announced two auctions in the form of repo tenders with 1M maturity. The BoC also announced two auctions for 1M.

**Liquidity supply history between 12 December 2007 and 7 March 2008**

| *CB* | *reduction in basic rates (current rate)* | *transaction type* | *auction volume* | *currency* | *rate spread (%)* | *period when operations were conducted*[1] |
|---|---|---|---|---|---|---|
| **ECB** | stability (4%) | TAF<br>LTRO[2] | 4 x 10 bn<br>2 x 60 bn | USD<br>EUR | 4.65–3.12[3]<br>4.88–4.26[4] | 17 Dec–28 Jan<br>12 Dec–21 Feb[5] |
| **Fed** | -1.25 p.p. (3%) | TAF | 2 x 20 bn<br>4 x 30 bn[10] | USD | 4.65–3.08 | 17 Dec–25 Feb |
| **BoE** | -0.25 p.p. (5.25%) | Long-term repo | 1 x 11.4 bn<br>1 x 11.3 bn | GBP | 5.95–5.28[6] | 18 Dec–15 Jan |
| **BoC** | -0.75 p.p. (3.50%) | Term PRA[7] | 2 x 2 bn | USD | 4.30–4.32[8] | 13 Dec–18 Dec |
| **SNB** | stability (2.25–3.25%)[9] | Repo | 2 x 4 bn | USD | 4.79–3.91[6] | 17 Dec–14 Jan |

Source: Central banks' official announcements and websites. Note: [1]time period between first and last tender; [2]Longer-Term Refinancing Operations; [3]fixed rate taken from Fed tender, spread between first and last tender rates; [4]average weighted rate on allotted volumes; [5]along with the LTRO on 21 February, one more operation has been announced for 13 March, but the results are not known; [6]spread between weighted average of first and last tender rates; [7]Term Purchase and Resale Agreements; [8]spread between average first and last tender rates; [9]the SNB regards the 3M Libor in the given spread as the basic interest rate; [10] Fed announced (7 March) increasing of the amounts outstanding in the TAF auctions to 100 bn USD (2 x 50 bn) and operating next auctions during March (10 March and 24 March).

[3] A swap line is a temporary reciprocal currency arrangement between institutions. In this case it involved pairing agreements between the Fed and the ECB (for the provision of up to $20 billion for a period of up to six months) and between the Fed and the SNB (up to $4 billion for up to six months).

**Assessment of the success of the central banks' coordinated approach**

The primary objective of the central banks' coordinated approach was to stabilise the money market and get it functioning again. The key aim from this perspective was to bring interbank 1M and 3M rates back down to the basic monetary policy rates and to restore banks' faith in the money market. This was essentially achieved, with the central banks working together to extend the maturity of funds provided, relaxing their collateral quality requirements and shifting their activities from direct funding to auction determination of rates. The central banks in the overall stabilisation process significantly helped to get the interbank market working again. They realised that they had a greater chance of succeeding in the globalised market if they acted jointly, and so they coordinated their actions.

[4] This Fed instrument was re-introduced on 12 December 2007. Each TAF auction is for a fixed amount ($20 billion and $30 billion) with the rate determined by the auction process. The minimum bid rate is derived from the overnight indexed swap (OIS) rate, which reflects the average overnight interbank rate. The funds are usually provided for 28 days and must be collateralised by securities defined by the Fed.

[5] €40 billion and €75 billion on 23 August 2007 and 12 September 2007 respectively, subsequently renewed at maturity to the tune of €60 billion.

## 4. Selected speech: Donald L. Kohn on developments in Fed monetary policy transparency and communications

*In this part we summarise the speech entitled "Recent and Prospective Developments in Monetary Policy Transparency and Communications: A Global Perspective" given by Donald L. Kohn, Vice Chairman of the Board of Governors of the Federal Reserve System, at the Annual Meeting of the National Association for Business Economics in New Orleans on 5 January 2008.*

Donald L. Kohn focused on the issue of Fed monetary policy transparency and communications in the context of the changes brought in by the Fed in November 2007. Besides increasing the frequency of economic projections from twice to four times a year, the Fed added total inflation to the set of forecasted variables and extended the projection horizon from two to three years (we examined these changes in *Spotlight* in the December 2007 issue of *Central Bank Monitoring*).

In the first part of his speech, Mr Kohn dealt on a general level with the importance of communication policy in central banking. Good communication, he believes, strengthens the effectiveness of monetary policy and shapes the expectations of businesses and households. Expectations are important to the choices that households and businesses make about consumption, investment and saving, and about prices (including asset prices) and wages. Mr Kohn emphasised that good communication is a complement to good monetary policy, not a substitute for it. Nonetheless, central banks are judged on how well they meet their objectives, not on how well they communicate. Markets and the public should understand the central bank's reasoning, strategy and objectives, even if market participants don't agree with the central bank's outlook. According to Mr Kohn, communication must deal with the diversity of views among the central bank's representatives and must also take into account uncertainty. However, the challenge for the central bank is how to best provide the markets and the public with a consistent explanation of monetary policy decisions.

In the second part of his speech, Mr Kohn discussed individual aspects of the Fed's enhanced economic projections, which he regards as a substantial step forward in increasing public understanding of monetary policy decisions. The three-year projection horizon means that FOMC members will put more emphasis on interpreting the equilibrium levels of key variables. The lengthening of the forecast horizon is consistent with the Fed's objectives of maximum employment and price stability. In this context, Mr Kohn also feels it is useful to include total inflation in the set of forecasted variables along with the previously published core inflation projection.

Mr Kohn then referred to the appropriateness of increasing the projection frequency from semi-annual to quarterly. Besides giving more frequent access to relevant projections, this will allow FOMC members to react more flexibly to changing economic circumstances and to take them into account in the Fed's communication policy. The Fed's enhanced projections will be accompanied by a narrative of the story behind the forecast and by extended minutes giving the views of individual FOMC members and a discussion of the risks around the economic outlook. Mr Kohn feels that this explanation, as much as the forecasts themselves, is most useful to the public in interpreting current developments and their implications for monetary policy.

At the end of his speech, Mr Kohn discussed the FOMC's recent communication. This had been driven largely by the necessity to announce and explain the unusual actions taken in connection with the liquidity crisis. The Fed had tried to provide more information than usual (including a discussion of the balance of risks) to reduce uncertainty in the markets and clarify its intentions. In conclusion, Mr Kohn therefore stressed that the diversity of views on the FOMC is one of its strengths and vital to arriving at sound decisions. The public should understand that the FOMC members do not coordinate their messages and that their views are likely to be especially diverse when circumstances are changing quickly and the FOMC members are subject to many different analyses.

This document is produced by the Monetary and Statistics Department of the Czech National Bank and is freely distributable. Closing date: 7 March 2008. 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