CENTRAL BANK MONITORING – DECEMBER

2009

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CNB CZECH NATIONAL BANK

In this issue

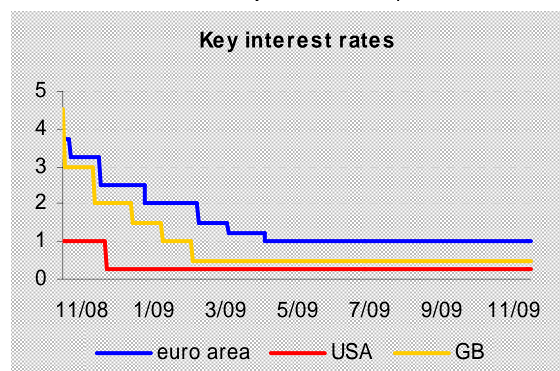
Most of the central banks under review are keeping their key rates low while continuing to pursue unconventional monetary policy. Economic activity remains weak, but there are signs of a pick-up and a gradual recovery is expected at the end of 2009 and in 2010. Inflation is also ceasing to decline. In Spotlight, *we focus on a country that we usually do not monitor but that offers interesting experiences with foreign exchange interventions as an unconventional monetary policy instrument – Israel. Our selected speech is Stefan Ingves's address on the important role of confidence in combating the crisis.*

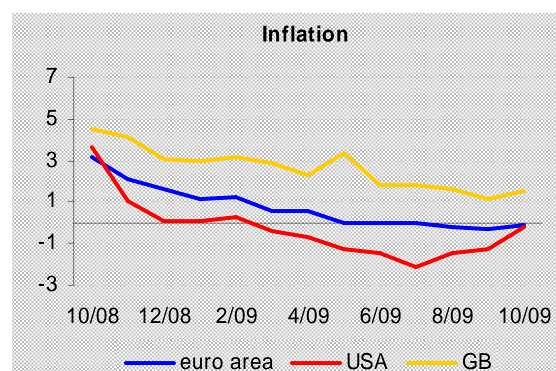
1. Latest monetary policy developments at selected central banks

Key central banks of Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	n.a.	2%
MP meetings (rate changes)	8 Oct (0.00) 5 Nov (0.00) 3 Dec (0.00)	22–23 Sep (0.00) 3–4 Nov (0.00)	9–10 Sep (0.00) 7–8 Oct (0.00) 4–5 Nov (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	0.6% (Nov 2009) [2]	-0.2% (Oct 2009)	1.5% (Oct 2009)
Expected MP meetings	14 Jan 4 Feb 4 Mar	15–16 Dec 26–27 Jan	9–10 Dec 6–7 Jan 9–10 Feb
Other expected events	4 Mar: publication of forecast	23 Feb: publication of report for Congress	16 Feb: publication of IR[4]
Expected rate movements[3]	→	→	→

[1] ECB definition of price stability; [2] preliminary estimate; [3] direction of expected change in rates in coming quarter taken from Consensus Forecast survey; [4] Inflation Report.



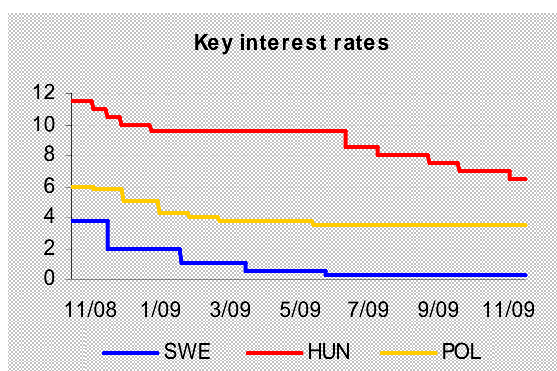


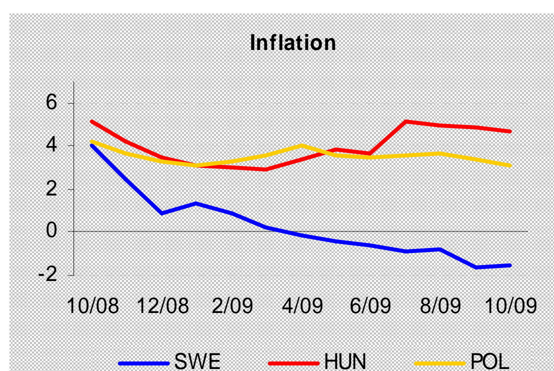
The Fed, ECB and BoE are still supporting their economies using unconventional monetary policy instruments and low interest rates. Central banks seem to be merely outlining possible exit strategies without giving specific details on timing and phasing. The **ECB** is forecasting positive quarter-on-quarter GDP growth for 2009 H2 due to a partial export recovery, the inventory cycle and macroeconomic (fiscal and monetary) stimuli. Inflation expectations are anchored close to or just below 2% in both the medium and long term. Upward pressures on prices and costs will stay contained thanks to weak domestic demand and external developments. The **Fed** is continuing to pursue its unconventional monetary policy. Purchases of debt instruments are likely to be completed in 2010 Q1. Economic activity remains weak. Household consumption has improved but is being hobbled by a weak labour market, stagnating income and tight credit conditions. The corporate sector is continuing to cut back on investment and jobs. In this regard, inflation does not currently seem threatened by significant cost pressures. The **BoE** left its key rate unchanged and continued to purchase securities, increasing the planned amount of its Asset Purchase Facility by £25 billion to £200 billion.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3.0%	2.5%
MP meetings (rate changes)	21Oct (0.00)	28 Sep (-0.50) 19 Oct (-0.50) 23 Nov (-0.50)	29–30 Sep (0.00) 27–28 Oct (0.00) 24–25 Nov (0.00)
Current basic rate	0.25%	6.50%	3.50%
Latest inflation	-1.5% (Oct 2009)	4.7% (Oct 2009)	3.1% (Oct 2009)
Expected MP meetings	15 Dec 10 Feb	21 Dec 25 Jan 22 Feb	22–23 Dec 25–26 Jan 23–24 Feb
Other expected events	10 Feb: publication of Monetary Policy Report	24 Feb: publication of IR[4]	24 Feb: publication of IR[4]
Expected rate movements[3]	→	→	→

[4] Inflation Report





The **Riksbank** left its key interest rate at 0.25% in the previous quarter and repeated that it intends to keep this rate low until Autumn 2010. The deposit rate remains at -0.25%. Economic activity is recording signs of a recovery and the financial markets are gradually stabilising, with interest rate spreads decreasing on the crisis-hit markets. The main uncertainty in the Riksbank's forecast seems to be the speed of recovery of other economies, which could be faster (owing to earlier restoration of confidence in the markets) or slower (owing to the withdrawal of fiscal stimuli from the economy) than in the baseline scenario.

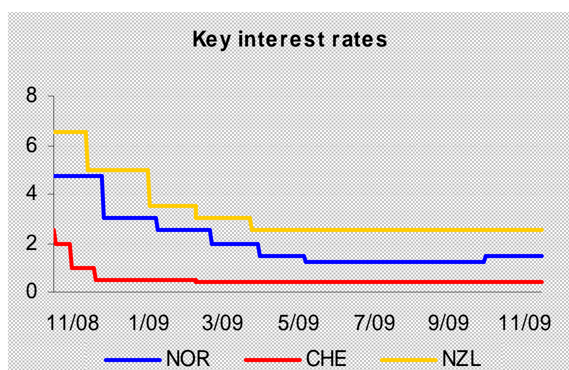
The **MNB** continued to ease monetary policy, lowering interest rates by 0.50 p.p. in each month of the previous quarter to 6.50% because of an improved outlook for inflation and a continuing recession. Owing to an increase in indirect taxes, inflation will (according to the MNB's forecast) be temporarily above the inflation target at the end of 2009 and in 2010, and will fall below the inflation target in 2011. The strong contraction of the Hungarian economy (GDP estimate: -6.4% in 2009) was due to a decline in domestic demand brought about by a significant decrease in fixed investment and corporate inventories. The MNB also expects the Hungarian economy to recover only gradually, since the foreign recovery will cause merely a slower decline in GDP. This means negative GDP growth (-0.6%) is still expected in 2010. Subsequently, the MNB expects GDP growth of 3.4% in 2011.

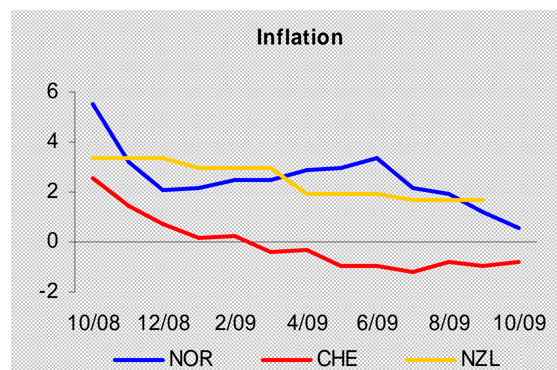
The **NBP** left its key rates unchanged. Economic activity, industrial production and indicators of economic sentiment showed a gradual improvement and positive signals in 2009 Q3. Inflation dropped from 3.4% in September to 3.1% in October. The decline in inflation was fostered by falling food and energy prices. Nevertheless, inflation is still above the inflation target, mainly because of changes to indirect taxes and depreciation of the zloty.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[6]
MP meetings (rate changes)	23 Sep (0.00) 28 Oct (+0.25)	17 Sep (0.00)	10 Sep (0.00) 2 Oct (0.00)
Current basic rate	1.50%	0–0.75%[5]	2.50%
Latest inflation	0.6% (Oct 2009)	-0.8% (Oct 2009)	1.7% (Oct 2009)
Expected MP meetings	16 Dec 3 Feb	10 Dec	28 Jan 11 Mar
Other expected events	24 Mar: publication of Monetary policy report	23 Dec: publication of Monetary policy report	11 Mar: Monetary policy statement
Expected rate movements[3]	↑	→	→

[5] Chart displays centre of band; [6] centre of 1–3% target band





The **Norges Bank (NB)** was the first of the central banks under review to increase its monetary policy interest rate, doing so at its October meeting, when the rate was raised by 0.25 p.p. to 1.5%. The decision was made in the context of faster-than-expected growth in economic activity, rapidly rising property prices, low unemployment and a forecasted rise in inflation to just above the inflation target. A possible rise in the key rate – which thus subsequently materialised – had been hinted at by Governor Svein Gjedrem at the August meeting. The Executive Board of the Norges Bank announced a projection (slide 23) for the key rate in the interval of 1.25–2.25% valid until the publication of the next *Monetary Policy Report* (24 March 2010), assuming that the Norwegian economy is not exposed to new significant shocks.

Despite favourable news regarding the Swiss economy, the **SNB** left the interval for its key interest rate (LIBOR on Swiss franc-denominated deposits) unchanged. The SNB continued to pursue an expansive monetary policy using unconventional instruments, i.e. supplying liquidity and remaining ready to buy CHF-denominated private bonds where necessary. It also probably continued to be active in the foreign exchange market. According to the September forecast, the outlook for inflation for 2009 remains almost unchanged, with negative inflation of -0.5% expected. Compared to the June forecast, however, faster inflation is expected in 2010 and 2011 (i.e. 0.6% in 2010 and 0.9% in 2011).

The **RBNZ** left its key interest rates unchanged at 2.50%. The outlook for economic activity indicates signs of recovery, and the medium-term outlook for inflation will be within the band around the inflation target. Governor Bollard expects the key rate to stay at the current level until 2010 H2.

2. News

Fed changes conditions of some programmes

In light of the gradual improvement in US financial market conditions, the Fed changed the conditions of some of its programmes. On 17 November 2009, it decided to reduce the maturity of primary credit loans from 90 days to 28 days. Primary credit loans for depository institutions (under the Discount Window programme) had originally been provided only overnight, but during the financial crisis the maturity was gradually lengthened to 90 days. The latest change thus means a reduction in maturity, but not a return to the pre-crisis level.

The Fed also tightened the conditions for eligible asset-backed securities under the TALF – a programme designed to support the asset-backed securities (ABS) market, in particular by financing market participants and supporting issuing activity on these markets. Under the new conditions, the assessment of ABSs will be stricter with regard to risk, credit quality, transparency and structure. The assessment will be conducted at the Federal Reserve Bank of New York, which is traditionally responsible for financial product transactions.

ECB amends rating requirements for asset-backed securities in its credit operations

The Eurosystem requires at least two ratings for all ABSs issued as of 1 March 2010 offered to it by selected institutions as collateral in credit programmes. In determining the eligibility of these assets, the Eurosystem will apply the "second-best" rule, i.e. meaning that not only the best, but also the second-best available rating must comply with the Eurosystem's ABS quality requirement. As of 1 March 2011, this rule will be applied to all ABSs, regardless of their date of issue. This measure was introduced to ensure that high credit standards for eligible collateral are met.

… and announces details of refinancing operations for period ahead

The ECB is to continue conducting its main refinancing operations at a fixed rate and with unlimited allotment at least until April 2010. It has also decided that the rate in the last 12-month longer-term refinancing operation will be fixed at the average minimum bid rate of the MROs over the life of this operation. This means only one interest payment will be made – on the maturity date of the 12-month refinancing operation (i.e. 23 December 2010).

BoE increases size of Asset Purchase Facility again…

In November, the BoE decided to increase the size of its Asset Purchase Facility (APF) by £25 billion to £200 billion. The previous increase of £50 billion took place in August.

…**and discusses reducing rate of remuneration on commercial bank reserves** held with the central bank (see the Minutes, item 24). After discussing the issue at its monetary policy meeting on 4–5 November 2009, the Monetary Policy Committee decided not to make use of this tool at the present time, but to keep it available for potential use in the future.

Norges Bank unwinds extraordinary measures supporting liquidity in financial system

In addition to raising its monetary policy rate in October, the Norges Bank has decided not to use liquidity-supplying instruments any more. It has stopped supplying NOK through FX swaps and has also stopped providing liquidity at long maturities. The reasons for this step are the improved conditions on the money market and the stabilising situation of the banking sector in the liquidity area. Collateral requirements will also return to the original (pre-crisis) standards and the number of counterparties in operations with the Norges Bank will be reduced.

Riksbank cancels auction of loans in USD…

The Executive Board of the Riksbank has decided to cancel an auction of loans in US dollars because of low interest. As the situation on the financial markets stabilises, the need for this extraordinary instrument is disappearing. However, Riksbank representatives have declared their readiness to renew access to USD auctions at any time.

…offers new fixed-rate loan with maturity of around 11 months…

On 22 October 2009, the Riksbank decided to introduce auctions for funds of up to SEK 100 billion for banks at a fixed rate (the repo rate + 0.15 p.p.) and with a maturity of 336 days (approximately 11 months). According to the Riksbank, this supplementary instrument will support the effectiveness of monetary policy by contributing to continued low interest rates on loans to companies and households.

…and continues to offer variable-interest loans

The Riksbank will continue to offer variable-rate loans with a maturity of three, six and twelve months. However, the interest rate paid by banks on these loans is being raised as the situation in the financial markets improves. The Riksbank wants to reduce commercial banks' dependence on Riksbank loans by gradually raising the interest rate on these loans through a higher supplement on top of the average repo rate. The extraordinary loan facility will thus be phased out relatively naturally. The supplement on top of the average repo rate will be set at 0.25 p.p. for loans with three-month and six-month maturities and at 0.30 p.p. for loans with twelve-month maturities.

RBNZ announces removal of emergency liquidity facilities

On 14 October 2009, the RBNZ announced the removal of emergency liquidity facilities put in place during the financial crisis, as their usage had been very low in the last six months. They include:

- the Term Auction Facility (TAF), where banks borrowed funds for three, six and twelve months using eligible collateral;
- a shortening of the Term Reverse Repo Facility from one month to an overnight basis;
- the withdrawal of the regular weekly Reserve Bank bill tender (bills issued by the RBNZ). These bills will now be offered as required in the daily OMO.

Nonetheless, the RBNZ is ready to reintroduce the facilities at any time if necessary.

MNB restores corridor around key interest rate to usual ±100 b.p. …

With effect from 24 November, the Hungarian central bank returned the corridor around its key interest rate to the former ±100 basis points. The corridor had been narrowed to ±50 basis points at the end of 2008 in response to the ongoing financial crisis and the liquidity problems of commercial banks. With the tight conditions on the interbank market gradual easing, short-term interest rates have now been lowered. This has provided scope to restore the width of the corridor and to leave more room for commercial banks to manage their liquidity.

…and proposes to regulate foreign currency lending

The regulation is aimed at setting limits on foreign currency borrowing to prevent Hungarian households and firms from being exposed to excessively strong debt-servicing pressures in the event of a sharp weakening of the forint. This step is motivated by the large foreign currency debts of Hungarian households and firms. Such debt presents a risk to financial stability in the event of a sharp depreciation of the Hungarian forint. This is Hungary's painful experience of the financial crisis, during which the forint depreciated markedly.

NBP introduced new instruments to support lending

The NBP introduced on 10th September 2009 new instruments to support lending. The new instruments include: (i) extension of repo transaction maturity to 12 months; (ii) the NBP's purchase of bank-issued bonds in open market operations (iii) discount credit – the enterprise will issue a promissory note to the bank, which in turn may discount this note with the NBP. Discount credit will be used to refinance new loans.

India purchases gold worth $7 billion from IMF

The Indian central bank has purchased 200 tonnes of gold worth roughly $7 billion from the International Monetary Fund, under the IMF's limited gold sales programme. This was done as part of a planned sale of 403 tonnes of gold in order to increase the IMF's lending resources.

3. Spotlight: The Bank of Israel's experience with using foreign exchange interventions as an unconventional monetary policy instrument

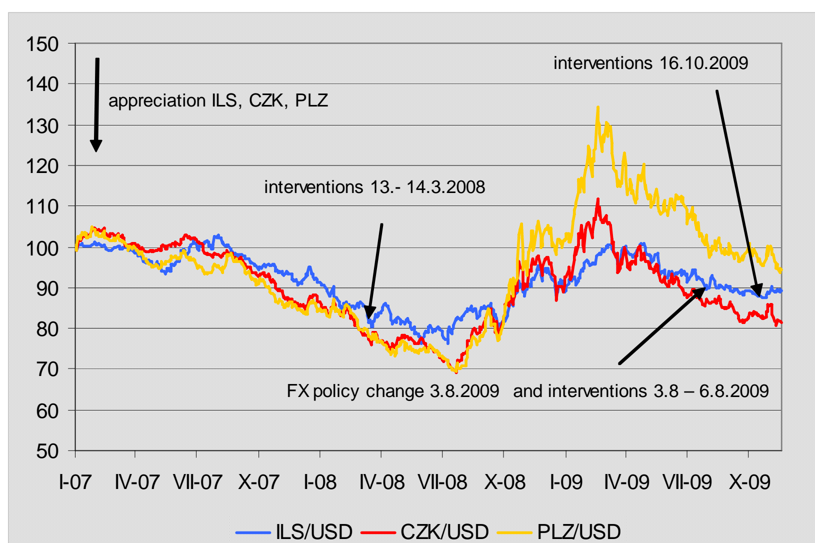
In previous issues of Central Bank Monitoring, we have examined unconventional monetary policy instruments and related exit strategies. So far we have focused on the countries or central banks we usually monitor. In this issue, we break with tradition by looking at the situation in a country we do not normally monitor – Israel. There are several reasons for this. First, the characteristics of the Israeli economy are not dissimilar to those in the Czech Republic. Israel, like the Czech Republic, is a small, open economy with an inflation-targeting regime and appreciation tendencies in the exchange rate of its national currency. It is also interesting that the Bank of Israel did not wait until it was in a situation of almost zero monetary policy interest rates before applying unconventional monetary policy instruments (including foreign exchange interventions), but resorted to them before the rates bottomed out. Finally, the BoI is relatively transparent in providing information on its foreign exchange interventions

The main features of the Israeli economy are outlined in the introduction above. Israel's monetary policy regime is inflation targeting with a defined inflation target of 1%–3% and with a freely floating exchange rate of the shekel. Foreign trade plays an important role in terms of GDP structure. For this reason, the Israeli economy was hit very hard by the fall in external demand and the subsequent recession in the major world economies. The appreciation of the local currency (the shekel) prior to the collapse of Lehman Brothers then exacerbated the fall in exports. As a result, Israel's GDP shrank for two consecutive quarters at the turn of 2009 and the economy entered a recession. The above-mentioned fall in foreign trade went hand in hand with a substantial decline in household consumption and corporate investment. Companies responded to the adverse developments in the domestic and external economy by cutting wages, which, together with rising unemployment, weakened domestic demand even further. The Israeli economy was thus hit by the global financial and economic crisis mainly through the channel of weak external demand, although the transmission through the financial markets channel was not entirely negligible, either.

The Bank of Israel (BoI) responded to the adverse effects of the crisis on the real economy and financial markets not only by lowering monetary policy interest rates, but also by applying unconventional monetary policy instruments, including foreign exchange interventions. The following paragraphs chronologically map the BoI's steps in the areas of monetary policy and foreign exchange intervention policy in the past almost two years.

Before that, the BoI had last intervened in the foreign exchange markets in 1997. It relaunched this instrument on 13 and 14 March 2008, when it **conducted a foreign exchange intervention** by purchasing US dollars totalling $375 million (see Chart 1). This intervention came after the exchange rate of the shekel (ILS) against the dollar had appreciated by around 28% since July 2007. However, the intervention was connected more with the foreign exchange market turmoil after the fall of Bear Stearns and was communicated as being a response to the "non-functionality of the market".

Chart 1: ILS/USD, CZK/USD and PLZ/USD exchange rate



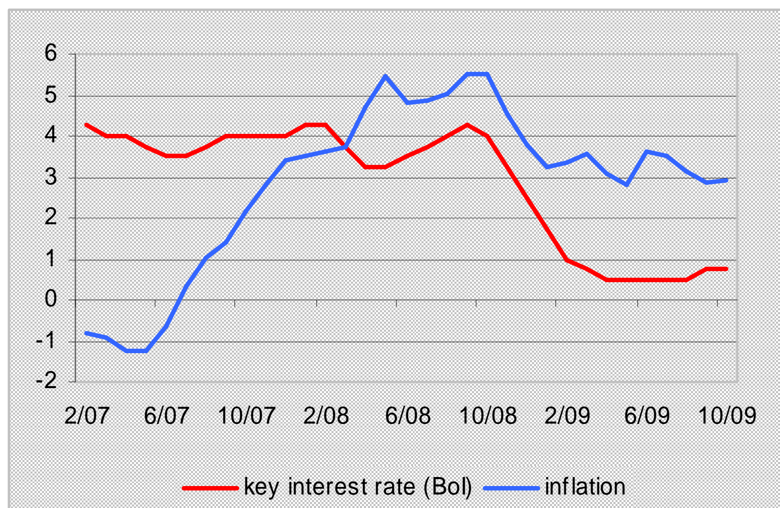
Sources: Thomson Datastream, Bank of Israel official website, Reuters, Bloomberg, own calculations
Note: 1 January 2007 = 100 (basic index), nominal exchange rates

Subsequently, beginning 24 March 2008, the BoI started buying about $25 million a day. According to the BoI's official statements, these daily purchases were aimed at increasing the BoI's reserves as, in its view, the previous level of reserves was inappropriate to the needs of the Israeli economy (the declared target level being $35–40 billion). Later, on 10 July 2008, the average daily rate of purchases was increased to $100 million. This was done not only because of the above-mentioned increase in reserves, but mainly in response to the global financial crisis – in the BoI's own words due to the current market conditions and the cumulative and rapid change in the exchange rate of the shekel. The foreign exchange interventions were by their nature sterilised, i.e. the foreign currency purchases did not ultimately increase the monetary base since they were conducted broadly in parallel with operations resulting in a decrease in the monetary base, e.g. through the sale of domestic financial assets. The overall effect on the monetary base was thus neutral. An interesting moment occurred in mid-2008, when inflation surged above 5%, monetary policy rates were raised twice and foreign currency purchases went on uninterrupted.

In October 2008, the BoI started gradually lowering its monetary policy rates from 4.25% to 0.50% in March 2009 (see Chart 2). During this cycle of rate cuts, two big changes were made to monetary policy. First, between 25 March and 5 August 2009 the BoI **purchased government bonds in the secondary market** to support its expansive monetary policy. The target level was ILS 15–20 billion. In its official announcements, the BoI stated that it did not intend to sell the bonds in the near future and that all the purchases would be sterilised. This suggests that it was intending to intervene at the long end of the yield curve. Second, on 3 August 2009 the BoI **changed its foreign exchange intervention policy**. It abandoned unidirectional interventions (foreign currency purchases) and introduced the possibility of bidirectional intervention, i.e. of buying and selling shekel at any time in the event of large movements in its exchange rate. Under the new policy, which does not have a time limit, the BoI can intervene not only in the case of market failure in the foreign exchange markets, but also in situations where changes in the exchange rate of the shekel are inconsistent with economic conditions. By taking this step, the BoI discontinued its regular daily foreign currency purchases, since in its opinion the required reserve level had been reached and it was now continuing with ad hoc purchases. By abandoning clear rules, the BoI's foreign exchange intervention policy has become more discretionary and the bank has introduced more uncertainty into the forex market as regards its intervention plans. This simultaneously reduces the scope for speculative transactions ensuing from unidirectional interventions. Almost immediately after announcing the changes the BoI again intervened strongly, purchasing US dollars for four consecutive days (in a sterilised manner according to the available information). This change in intervention policy could, however, be viewed also as an

exit strategy from the previous regular interventions. It did not rule out further, now discretionary, interventions, which did indeed follow and were explained by the market situation.

Chart 2: Key interest rate and inflation rate (inflation target 1–3%)



Source: Thomson Datastream.

The change made to foreign exchange interventions in August 2009 was followed by a monetary policy interest rate increase of 0.25 p.p. to 0.75% on 25 August 2009, which surprised many analysts. Immediately after the BoI's monetary policy meeting this was seen as being the start of a cycle of monetary policy tightening. However, the following monetary policy meeting did not bring any further rate increase. Moreover, the BoI again intervened in the foreign exchange market, making foreign currency purchases of approximately $250 million on 16 October 2009 and $30–40 million on 26 October 2009. The purpose of the whole cycle of foreign exchange interventions is not entirely clear, as the required threshold for the level of foreign exchange reserves has been greatly exceeded (the reserves totalled $58.4 billion in September) and the BoI is continuing to intervene. Confirmation of the start of a phase of monetary policy tightening can probably be found in an increase of the key interest rate of 0.25 p.p. to 1% made on 21 November 2009.

If we wish to rate the success of the foreign exchange interventions, we should look out the bilateral nominal exchange rate of the shekel against the dollar, since the interventions were conducted most frequently in this currency pair (see Chart 1). If the purpose was to reverse the shekel's appreciation tendency, any successes were very short term. If the intention was to purchase foreign currency chiefly to boost Israel's foreign exchange reserves, this aim was more than fulfilled, as the planned level was reached (the reserves stood at $59.65 billion in October).

4. Selected speech: On the important role of confidence in combating the crisis

Stefan Ingves, Governor of the Sveriges Riksbank, gave a speech entitled "A Cure for Crises: Confidence, Confidence and Trust" at the EuroFi Forum in Göteburg on 29 September 2009.

Stefan Ingves has many years of experience with the resolution of financial crises in various countries around the world, but the current crisis is extraordinary because of its magnitude and global reach. His cure for crises is made up of two ingredients: (1) regain confidence to resolve a crisis; and (2) preserve confidence to prevent a crisis from repeating itself. Given the international dimension of the present crisis, the cure also involves a third component – (3) trust between political authorities to enhance cross-border crisis management.

Mr Ingves mentioned George Akerlof's theory of asymmetric information, which originally referred to the second-hand car market. According to Akerlof, sellers know the quality of a car they are selling, but potential buyers do not. The risk of purchasing a poor-quality car (a "lemon") lowers the price buyers are willing to pay, but owners of high-quality cars will not sell at this price. A similar situation arose on the asset market. When it became apparent that some assets were lemons, confidence in the banking sector as a whole was eroded, given the uncertainty over the extent of the problem and the fear of bank-to-bank contagion. The situation was made worse by the opacity of some financial products and the increased interconnectedness of the financial system. The lack of confidence between the banks resulted in the breakdown of interbank markets and banks found it costly, or even impossible, to obtain liquidity by selling assets.

In such a situation, Ingves prescribes the **first ingredient** of the cure: restore the public's and the markets' confidence in the banks. This should be done by acknowledging the losses and dealing with the bad assets. To restart a market, it is crucial that investors become confident that the bottom has been reached. This can only be achieved by the realistic and transparent valuation of assets; overvaluing them will only postpone the recovery. Ingves believes that transparent and internationally harmonised accounting rules are another important aspect of building confidence, and stress testing of banks is another effective tool.

To prevent the crisis from repeating itself, the **second ingredient** should be applied – preserving and building confidence in the long run via reforms of liquidity and capital regulation. A key lesson from the crisis is that a liquid market can very quickly become illiquid and so liquidity must be regulated more firmly. Too strict regulation would stifle competition, make financial services more expensive and, in the long run, hamper economic growth. Thus, the extent of financial regulation is – at least partly – a question of society's risk tolerance.

A major aim of regulatory reform should be to ensure that trust in banks does not dissipate again. To do this, it is necessary to increase capital requirements – in terms of both the quality and the amount of capital. This will increase the resilience of banks and the whole system. The important part of capital should be loss-absorbing common equity. Regulators should also discuss the possibilities of creating debt instruments which automatically convert to equity in the event of high losses.

The **third ingredient** of Ingves's cure is building trust between states to enhance cross-border crisis management. This is difficult given the globalised nature of the financial system. Cross-border banks as a rule centralise the management of foreign branches and subsidiaries. Thus, the home supervisor has the overall picture, while the host country is responsible for the financial stability of the economy.

Mr Ingves mentioned the European MoU aimed at improving cross-border cooperation. However, as he adds, it is not easy to live up to its spirit in bad times. Reaching a joint assessment leading to efficient decisions requires open discussions and sharing of information. Mr Ingves appealed for trust-building between countries, citing the example of the Governors of the Nordic Central Banks, who hold regular meetings, as a source of inspiration.

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