CENTRAL BANK MONITORING – SEPTEMBER

2010

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CNB CZECH NATIONAL BANK

In this issue

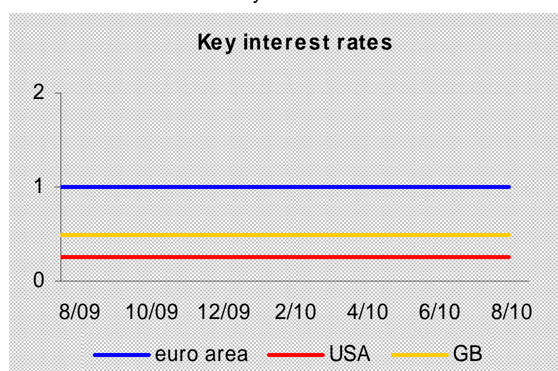
The past quarter saw continued public finance consolidation across Europe and the initial results of an inspection of Greek finances. A question mark still hangs over whether the global economy is clearly recovering. The Riksbank and the RBNZ raised their key rates, while the other central banks under review left theirs unchanged. In Spotlight *we take a look at the "Greek crisis", and not only from the perspective of Greece and the other southern states, but also with regard to the euro area as a whole. Our selected speech is the address given by Barbro Wickman-Parak, Deputy Governor of the Riksbank, on publishing an interest rate path.*

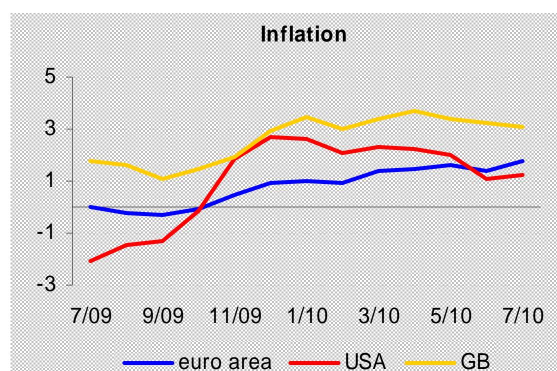
1. Latest monetary policy developments at selected central banks

Key central banks of Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	na	2%
MP meetings (rate changes)	8 Jul (0.00) 5 Aug (0.00) 2 Sep (0.00)	22–23 Jul (0.00) 10 Aug (0.00)	7–8 Jul (0.00) 4–5 Aug (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	1.6% (Aug 2010)[2]	1.2% (Jul 2010)	3.1% (Jul 2010)
Expected MP meetings	7 Oct 4 Nov 2 Dec	21 Sep 2–3 Nov 14 Dec	8–9 Sep 6–7 Oct 3–4 Nov
Other expected events	2 Dec: publication of forecast	20 Oct and 1 Dec: publication of Beige Book	10 Nov: publication of Inflation Report
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.

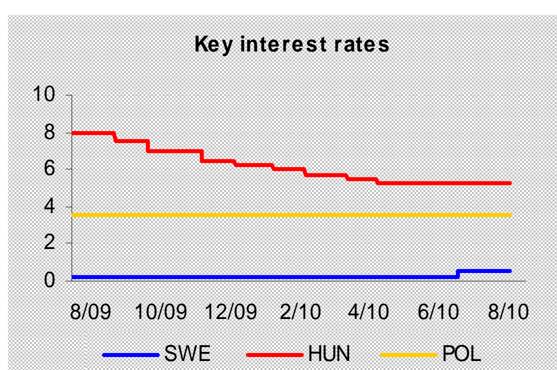


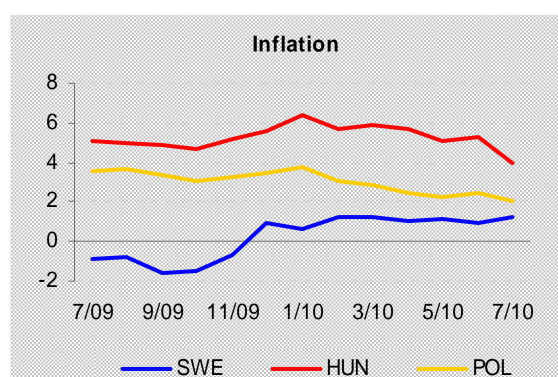


The **ECB** left its interest rates unchanged. On the basis of an economic analysis it expects an only gradual recovery in economic activity. Its monetary analyses, which indicate very slow growth in money and credit, also suggest subdued inflation going forward. The ECB decided to continue its liquidity-supporting measures. Its main refinancing operations will be conducted as fixed rate tender procedures with full allotment for as long as necessary, and at least until 18 January 2011. It will also continue providing 3-month refinancing operations until the end of this year. The **Fed** kept its key rate unchanged and decided to reinvest principal payments from agency debt in Treasury bonds in order to maintain high liquidity. The decision came in response to a slowing pace of recovery in output and employment. Household consumption was increasing gradually but remained constrained by high unemployment, modest income growth and tight credit. The **BoE** left its key rate unchanged and maintained its stock of debt security purchases at £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)	1 Jul (+0.25) 1 Sep (+0.25)	21 Jun (0.00) 19 Jul (0.00) 23 Aug (0.00)	29–30 Jun (0.00) 27–28 Jul (0.00) 24–25 Aug (0.00)
Current basic rate	0.50%	5.25%	3.50%
Latest inflation	1.2% (Jul 2010)	4.0% (Jul 2010)	2.0% (Jul 2010)
Expected MP meetings	25 Oct	27 Sep 25 Oct 29 Nov	28–29 Sep 26–27 Oct 23–24 Nov
Other expected events	26 Oct: publication of Monetary Policy Report	23 Nov: publication of Inflation Report	24 Nov: publication of Inflation Report
Expected rate movements[3]	↑	→	→





The **Riksbank** as expected raised its key interest rate at two meetings: by 0.25 p.p. in July and by another 0.25 p.p. at the start of September to 0.75%, also deposit rate from -0.25 p.p. to zero. The Swedish central bank still regards inflationary pressures as being low, but expects them to increase as the economic recovery progresses. The Swedish economy has shown strong growth since the start of the year. The upswing in world trade has contributed to an acceleration in exports and investment. Signs of an improvement can also be seen in the labour market. Household consumption is increasing thanks to rising optimism. However, this positive development is expected to be dampened by the less favourable situation in the United States and by modest activity in the Eurozone due to fiscal consolidation. Another factor in interest rate decision-making is that household indebtedness has increased significantly in recent years.

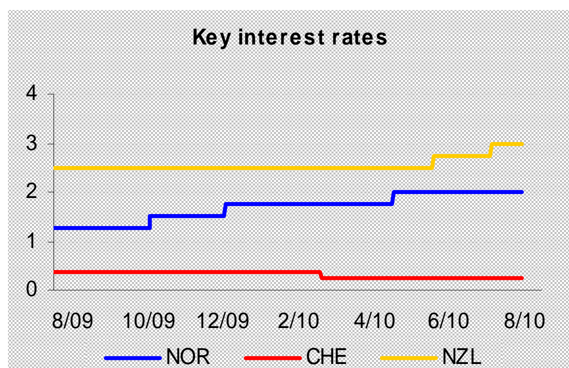
In light of inflation risks stemming from a weakening exchange rate and cost shocks on the one hand, and of output below its potential level on the other, the **MNB** left interest rates unchanged at 5.25%. Household consumption is still being depressed by high unemployment and by high monthly instalments on foreign currency loans due to the depreciation of the forint. Perceptions of the risks associated with Hungarian financial assets have not fallen significantly, unlike in the case of assets of other economies of the CEE region. Domestic demand remains weak, but the economy is being driven by stronger-than-expected external demand. According to the MNB, the pass-through of cost shocks (rises in commodity and food prices) to inflation is a source of uncertainty in assessing the outlook for inflation.

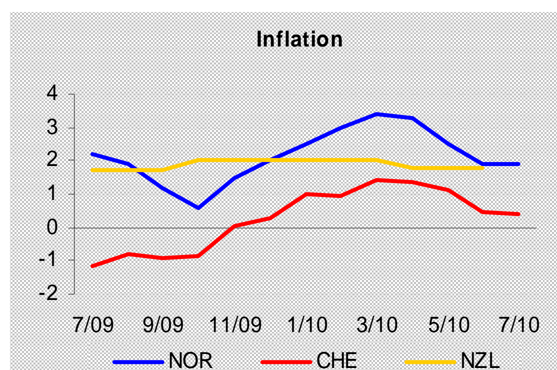
The **NBP** left its key rates unchanged. The Polish economy is continuing to grow. The rising trend in construction was confirmed and industrial output recorded fast growth. The labour market situation is gradually improving, with employment growing and the unemployment rate declining. Inflation decreased again in July (to 2.0%), mainly as a result of base effects connected with a strong rise in the prices of fuels and excise goods one year before. A minor increase in inflation is expected in the first months of 2011 due to a change of VAT rates.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[5]
MP meetings (rate changes)	23 Jun (0.00)	17 Jun (0.00)	29 Jul (+0.25)
Current basic rate	2.00%	0–0.75%[4]	3.00%
Latest inflation	1.9% (Jul 2010)	0.4% (Jul 2010)	1. 8% (2010 Q2)
Expected MP meetings	27 Oct	16 Sep	16 Sep 28 Oct
Other expected events	27 Oct: publication of Monetary Policy Report	16 Sep: publication of Monetary Policy Report	16 Sep: Monetary Policy Statement
Expected rate movements[3]	↑	→	↑

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





The **Norges Bank (NB)** kept its key monetary policy rate at 2.00% in June. According to the NB, the Norwegian economy is developing in line with expectations. Activity is rising moderately. Inflation has slowed and is now just below 2 per cent. Governor Svein Gjedrem says that developments in inflation, output and employment imply that the interest rate should be kept low. The low interest rate is not currently fostering growth in household debt, although house prices are rising significantly. However, the consideration of guarding against the risk of future financial imbalances that may disturb activity and inflation suggests that the interest rate should be gradually brought closer to “a more normal level”.

The **SNB** left the target range for the interest rate (Libor on CHF-denominated deposits) unchanged at 0.00–0.75% and is keeping the Libor in the lower part of the target range at around 0.25%. The Swiss economy is benefiting from recovery of the global economy, and domestic demand is also favourable. For 2010, the SNB is expecting real GDP growth of about 2.0% (around 0.5 p.p. higher than in the previous forecast). The deflationary risk has disappeared, but tensions on the financial markets with regard to public finances have increased the downside risks. Should these risks materialise, the threat of deflation could increase via an appreciation of the Swiss franc. In its forecast the SNB expects inflation of 0.9% in 2010, 1.0% in 2010 and 2.2% in 2012.

The **RBNZ** increased its key interest rate by 0.25 p.p. to 3.00%. At a news conference Reserve Bank Governor Alan Bollard said that while the outlook for economic growth had softened, it was still appropriate to continue to reduce the extraordinary level of support implemented during the 2008/09 recession. As the economy grows, inflationary pressures – which are currently modest (the inflation rate has been near 2% for the past five quarters) – are expected to pick up.

2. News

Fed reinvests principal payments and purchases further Treasury securities

On 10 August 2010, the Fed decided to keep constant its holdings of securities at their current level by reinvesting its principal payments from agency debt and agency mortgage-backed securities in further purchases of Treasury securities. This decision is meant to help support the economic recovery while maintaining price stability.

EC, ECB and IMF on mission to Greece

A team of experts from the European Commission, the ECB and the IMF visited Greece from 26 July to 5 August 2010 for a review of the Greek government's economic programme, which is being supported by loans of €80 billion from the euro area nations and €30 billion from the IMF. The review found that the programme had made a strong start. The end-June quantitative performance criteria had all been met, led by a vigorous implementation of the fiscal programme, and other reforms were ahead of schedule. However, some important challenges and risks remained.

Impressive progress had been made on structural reforms. The Greek Parliament had approved pension reform. Labour market reform was also well underway. Implementation of recent tax reform and budget reform was key for fiscal consolidation. Restoring competitiveness and boosting potential growth remained critical to the programme's success. The challenge facing the government in this regard would be to overcome resistance from vested interests to opening-up of closed professions, deregulation, implementation of the services directive, and elimination of barriers to development of tourism and retail.

In the financial sector, there had been a moderate deterioration in capital adequacy. However, all but one bank had passed the stress tests (covering 90% of Greek banks). This had helped to calm financial market tensions. Greece was still unable to access financial markets except for placement of short-term government bonds.

BoE Governor sends letter to Chancellor

As the inflation rate in July 2010 reached 3.1%, i.e. more than one percentage point above the inflation target, BoE Governor Mervyn King sent a letter to the Chancellor of the Exchequer as he is required to do by law. In his letter the Governor gives the three main short-run factors explaining why the inflation target had been exceeded: first, rising oil prices; second, an increase in VAT from 15% to 17.5%; and third, the continuing effects of the sharp depreciation of sterling in 2007 and 2008, which had led to a rise in consumer prices.

Professor Marek Belka becomes new NBP President

On 10 June 2010, the Polish Sejm approved Professor Marek Belka, an economist, as the head of the National Bank of Poland. Professor Belka previously served as Minister of Finance and Prime Minister of Poland as well as Director of the European Department at the IMF. The new NBP President declared that he would strengthen the independence of the NBP and would cooperate with the government and other authorities in support of the Polish economy, provided this would not put at risk the performance of the NBP's primary objective, which is the price stability.

NBP requests new arrangement under IMF's Flexible Credit Line

Following the expiry of the Flexible Credit Line (FCL) provided to Poland by the IMF, the NBP and the Polish Finance Ministry requested a new FCL arrangement amounting to SDR 13.69 billion (1,000% of quota) covering a period of 12 months.

NB's reputation is strong, although there is room for improvement

A survey conducted by TNS Gallup for Norges Bank polled both the general public and representatives of numerous industries. The results revealed that NB was fulfilling its mandate in a satisfactory way. External communications had improved in recent years, but the respondents would welcome even greater openness and accessibility.

MNB conducts further mortgage bond purchase

On 18 August, the MNB purchased domestically issued forint mortgage bonds totalling HUF 3.4 billion on the secondary market. Counterparties had submitted offers for a total amount of HUF 36.1 billion. The next auction will take place on 15 September 2010. The history of previous purchases can be found here and here. The mortgage bond purchase programme was approved by the MNB Council on 8 February 2010.

3. Spotlight: The euro and the euro area at the time of the "Greek crisis"

The recent tenth anniversary of the euro drew praise from many quarters. This year, however, has been a severe test for the common European currency. The magnitude of the problems facing the euro area and some of its member states has been fully revealed. Many observers were already aware of these problems, but none expected them come to a head so quickly. In the following text we outline the initial conditions of the three seemingly most vulnerable countries of the euro area – Greece, Spain and Portugal. We then examine developments in these countries and in the euro area as a whole when the situation escalated in the wake of the global financial and economic crisis.

Not so long ago we were celebrating the tenth anniversary of the euro, which was seen in a generally positive light. The new currency and the newly established European Central Bank were building credibility, inflation in the monetary union was low and stable, and pre-crisis inflation differentials were tending to fall. The low inflation and low interest rates were having – or at least seemed to be having – a favourable effect on the economy. In addition, there was a belief that the euro guaranteed macroeconomic stability and that the elimination of exchange rate risk boosted trade and foreign direct investment in the euro area. The increasing integration of financial markets was seen as a good thing.

People were aware that the euro area had its weak spots, but few suspected that these problems would lead to such serious complications. Scarcely had Europe begun to recover from the financial and economic crisis when another severe test – a fiscal crisis – hit the monetary union. Problems broke out in Greece, and the other member states, fearing contagion, promised to come to its aid. In response, German Eurosceptics filed a constitutional complaint. There was talk in the media about the possible exit or exclusion of certain countries from the monetary union and about the introduction of a super-euro for the stronger states of the euro area.

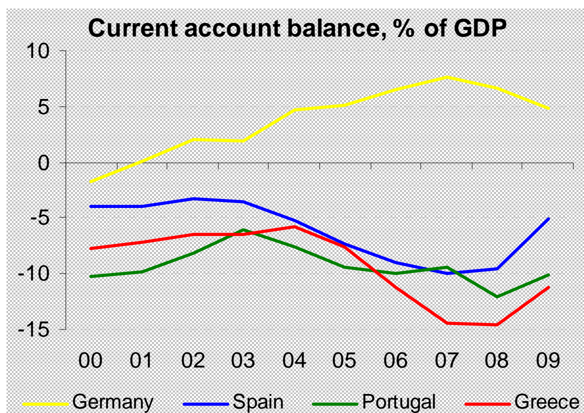
It is therefore relevant to ask whether the euro area really is an "optimal currency area". It is appropriate for countries to adopt a common currency if their economies are economically integrated and simultaneously are sufficiently "alike" (in terms of, for example, economic structure, exchange rate and interest rate movements, and business cycle alignment) and if, therefore, they are less likely to experience asymmetric shocks. Such shocks cannot be eliminated altogether, but when they do occur, individual countries should be able to react by means other than monetary policy or movement of the exchange rate, i.e. they should be sufficiently flexible in the area of prices and wages and on the labour market generally, and they should be capable of using the stabilisation function of public budgets. Economic shocks can also be dampened significantly by a sound and stable financial system. So much for the theory. What was going on in the southern periphery of the euro area in reality?

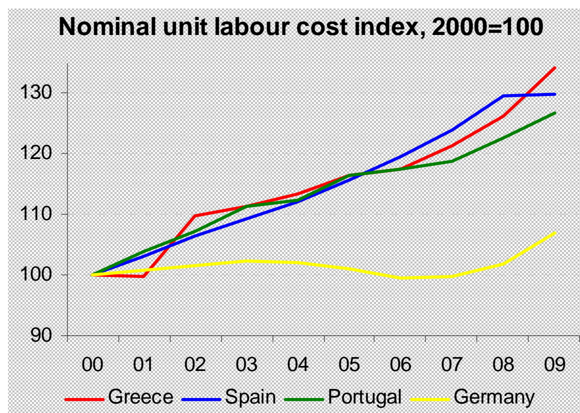
Imbalances in the euro area

The southern nations – Greece, Spain and Portugal – recorded rapid growth in past years, driven mainly by strong domestic demand stimulated by an excessively easy common monetary policy and by expansionary domestic fiscal policy. Excessive growth in nominal unit wage costs – wage growth outpacing productivity growth – reduced these countries' competitiveness in the European and global market. Low external demand led in turn to wide current account deficits. Weakening the currency (e.g. in the form of competitive devaluation) – an adjustment mechanism which these countries had repeatedly used in the past (albeit at the cost of higher inflation) – was no longer an option.

The volume of loans grew in both the government and private sector as credit became cheaper and more widely available (on joining the monetary union these countries had seen a decrease in nominal interest rates, the elimination of exchange rate risk within the euro area and a decline in sovereign risk premia). Higher inflation in the south (due to both cyclical overheating and long-term convergence of their economies) led to an even greater fall in real interest rates, which have been zero or even negative in recent years.

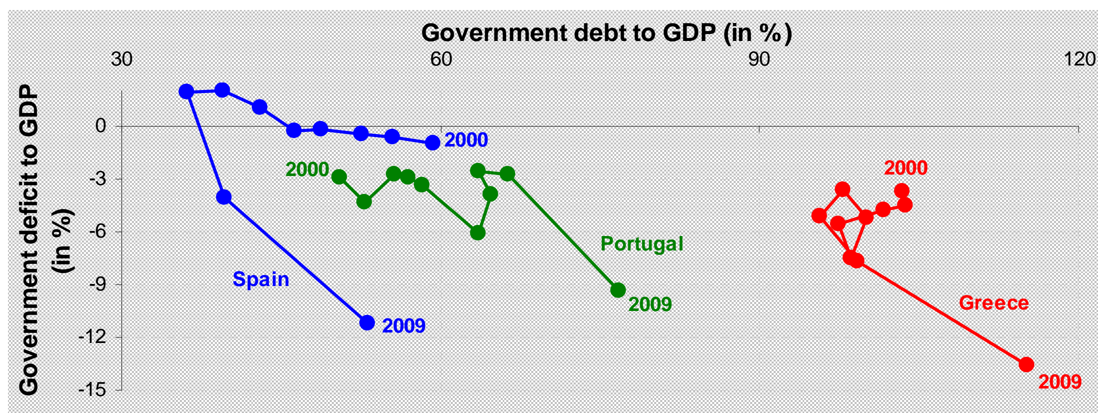
The foreign capital entering these countries was not allocated efficiently. The money was used largely to fund government deficits and mainly stimulated private consumption and (in Spain) excessive





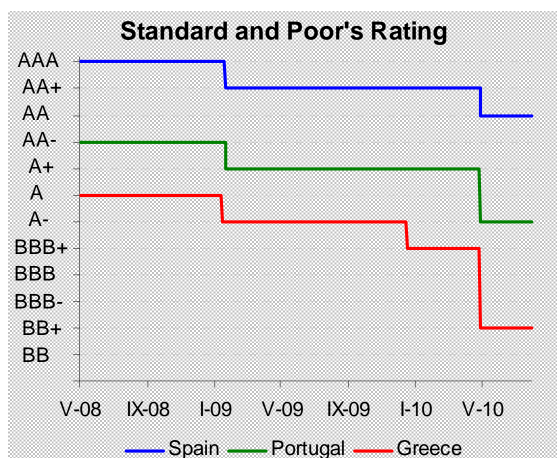
growth in property prices. External debt (public and private) was therefore not founded on productive investment providing income for debt repayment in the future.

The government debt was particularly high. Of the three countries under review, only Spain managed to cut its government debt significantly before the global financial and economic crisis erupted.



The problem of government debt is not confined to the southern states of the euro area, but affects most of the others as well. However, Greece and Italy have a dismal track record. Their public debt exceeds their annual GDP. In the current poor economic situation, with tax revenues crippled and public spending pressures growing, reducing debt is a particularly tough task. An extra complication moving forward is the unfavourable demographic trend in most European countries.

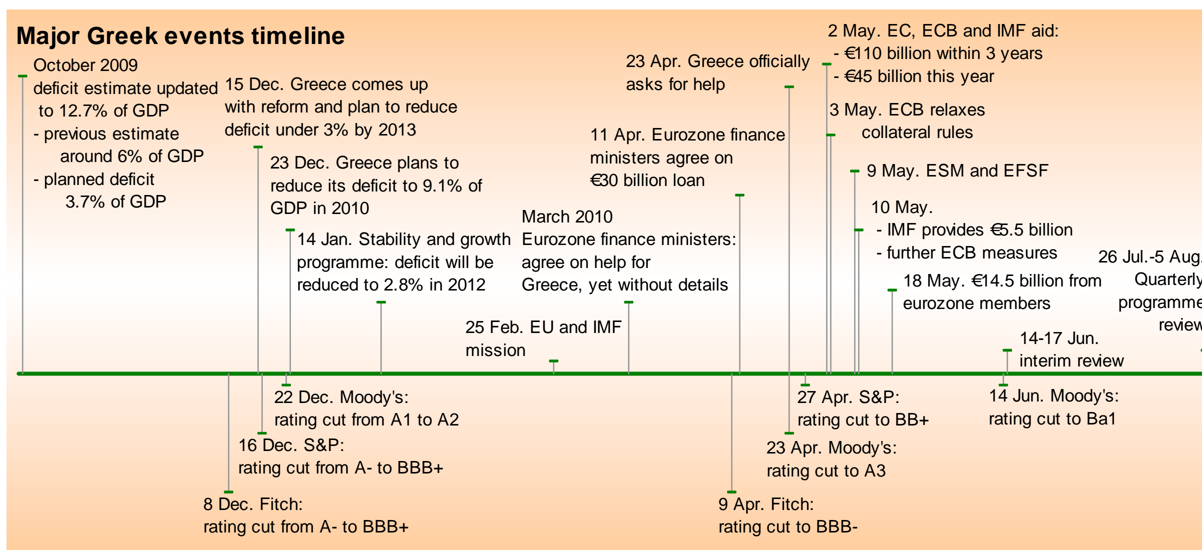
The Greek crisis and the reaction to it



The government debt problem in Greece has escalated this year. Although large public budget deficits are practically a tradition in this country, recent developments have proved to be the last straw for investors. The new government of George Papandreou came to power in October 2009 and that same month revised the estimated or intended government deficit for 2009 from the originally planned 3.7% of GDP and from a later estimate of around 6% of GDP to 12.7% of GDP. A further upward revision of 0.2 p.p. was made in February, and in April the estimate was increased again to 13.6% of GDP. What is more, this was not the first time that serious problems had been uncovered in Greece's statistics[1] and in its budget system. Ratings downgrades added to the pessimism about the

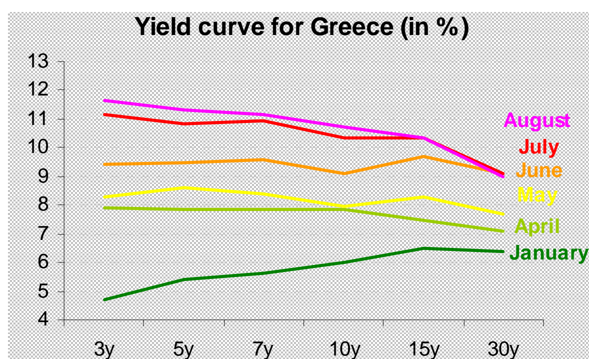
situation in Greece. The response of the markets was fast and uncompromising. In addition to growth in Greek bond yields, the indices of the Athens Stock Exchange and the common currency of the euro area both reacted negatively.

By March, discussions between EU and IMF representatives on assistance for Greece were in full flow. Greece faced the risk of being unable to find buyers for its bonds or of having to issue bonds at unacceptably high interest rates. When Greece officially requested financial aid in April, CDS spreads on Greek government bonds climbed to levels higher than at the time of Lehman Brothers bankruptcy.



The conditions of the joint assistance programme of the IMF, the European Commission and the ECB were published in early May. Over the following three years, Greece was to be granted €110 billion – €30 billion from the IMF and €80 billion from the Commission, the latter combining contributions from the individual euro area nations in proportion to their shares in the ECB's capital. The programme is aimed at quickly restoring confidence in the Greek economy and its financial stability. In the longer term it is vital to improve the economy's competitiveness and restructure economic activity towards a greater growth contribution from investment and exports. Fiscal consolidation needs to be implemented and the balance of payments needs to be balanced. The programme is based primarily on spending cuts. Wage and pension cuts are unavoidable. The revenue side features increases in VAT and excise duties. Reform of the pension system is absolutely essential. Reform of public administration, structural reforms on the labour market and other reforms should follow. Last but not least, the institutions are demanding improvements in the quality of reporting and statistics.

At the same time, the ECB temporarily relaxed its conditions for accepting Greek debt instruments as collateral in liquidity-providing operations for euro area banks by suspending the application of the minimum credit rating threshold for eligible requirements. Another measure followed on 10 May, when, in order to address the tensions in financial markets, the ECB started purchasing public and private debt securities (and announced its intention to sterilise the impact of these purchases on the liquidity of the banking sector), reintroduced its longer-term liquidity-providing refinancing operations, and reactivated its swap lines with the Fed.



The EU also decided to introduce two temporary instruments: the European Stabilisation Mechanism (ESM), under which a country can, where necessary, obtain assistance of up to €60 billion from the EU budget; and the European Financial Stability Facility (EFSF) with a capacity of €440 billion, intended solely for euro area countries and backed by guarantees of the monetary union members according to their

shares in the ECB's capital. Although the foreign assistance provided to Greece addressed the urgent needs of its economy and stopped the Greek crisis spilling over to other countries, ultimate success will depend on Greece alone. Besides major fiscal consolidation measures, Greece has approved a reform of the pension system and is working on labour market reform. Road haulage and energy have been liberalised. According to a recent inspection conducted by the IMF and the EU Greece has made a strong start with the programme and is currently complying with its conditions. A further €9 billion should therefore be released in September.

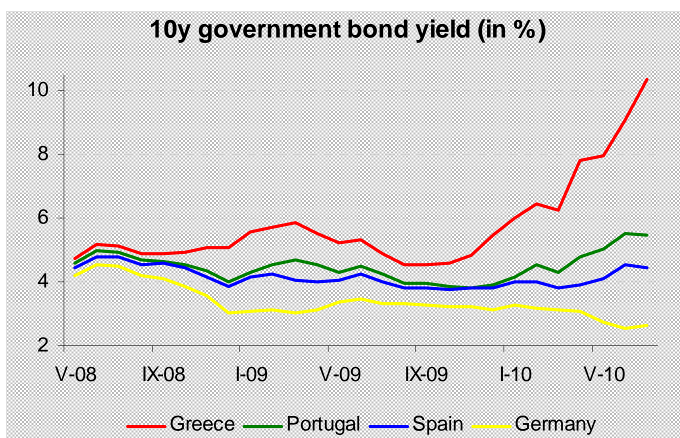
Despite all these measures, however, the markets have yet to be convinced that Greece is on the right track towards resolving the situation, and the Greek bond yield curve is continuing to rise. CDS spreads have come down from their record levels, but remain very high.

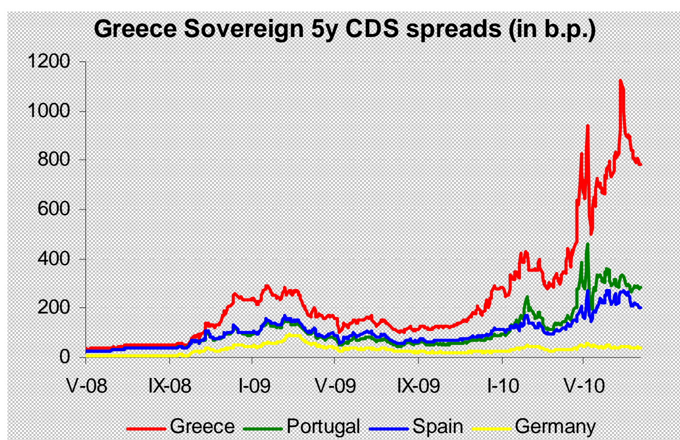
Spain and Portugal

Spain and Portugal are also well aware of the seriousness of the situation. Although they are not beset by scandals about "creative" compilation of government financial statistics, and although they are not as deeply in debt as Greece, the nervous markets have turned their attention to the sustainability of the fiscal situation in these two countries as well. Here too, CDS spreads on government bonds have increased, ratings have been downgraded, and governments are having to pay a premium for credit.

In Spain, moreover, property prices are still sliding and the private sector remains mired in debt. In addition, this country has long been plagued by high unemployment, which exceeded 20% in the first quarter of this year and is therefore putting the budget under extreme pressure.

Both countries have now introduced austerity measures. Spain reduced public sector pay by 5% in June. Next year wages will be frozen at this year's level. Salaries of top government officials are to be cut by 15% and pensions will not be automatically indexed to inflation. Labour market reforms are under preparation. The savings should reduce the deficit by a total of €15 billion in 2010 and 2011, to 9.3% and 6% of GDP respectively.





Portugal is intending to cut social benefits and spending on public sector workers and to sell off state assets. The austerity programme also includes increases in VAT and income tax. The plan is to reduce the country's deficit to 2.8% of GDP by 2013.

Impacts on the euro area

Although Greece is a relatively small economy – its GDP accounts for less than 3% of total euro area output – it turns out that its problems could have far-reaching implications for the entire monetary union. The problems of Greece and the other Southern European states have uncovered the euro area's structural weaknesses – the heterogeneity of its economies, its high debt levels and its unfavourable demographic trends.

Between the start of December and the start of June the euro weakened by around 20% against the dollar. The sharpest depreciation (of 7.6%) occurred during May, when risk premia also started rising owing to a decline in bond market liquidity.[2] The economic sentiment of corporations and households in the euro area deteriorated temporarily.

Nervousness related to the debt crisis is also affecting holders of Greek government debt, whose ranks include many European financial institutions. The largest volumes of such bonds in absolute terms are held in France (around €40 billion), Germany and Italy, while Luxemburg has the largest exposure as a percentage of GDP.

It will be interesting to see how things pan out in the coming months and years. There are still doubts about how Greece will get on in the current situation – whether it will succeed in pushing through difficult reforms and steering the economy in the required direction, whether it will in fact be capable of returning to the financial market in three years' time, and whether its problems will spread to other countries. The current situation has intensified the debate about the need to change the institutional set-up for economic policy coordination in the EU.

4. Selected speech: The repo rate path – experiences three years on

Barbro Wickman-Parak, Deputy Governor of the Riksbank, gave a speech on the three-year experience with publishing the repo rate path at Danske Bank in Stockholm on 17 June 2010.

Mrs Wickman-Parak reviewed the Riksbank's three-year experience of publishing forecasts for its key monetary policy rate, the repo rate. She began by discussing the reasons which led the Riksbank to switch to its own repo rate forecasts. A forecast for growth and inflation requires an assumption about the interest rate. Initially, i.e. in 1995, when inflation targeting was introduced, the Riksbank assumed in its forecasts that the interest rate would be unchanged during the forecast period. This assumption had some advantages, but was unrealistic. The Riksbank therefore moved towards a more realistic assumption. From autumn 2005 it began using market expectations regarding interest rates, as reflected in implied forward rates. However, situations arose where the forward rate path did not agree with what the Riksbank considered to be the "best" forecast for the repo rate. From there, it was only a small step towards creating and publishing its own interest rate forecast. Publishing forecasts for the repo rate made the forecasts themselves more consistent and also introduced greater openness, although as the Riksbank has stressed all along, the repo rate path is a forecast, not a promise.

A large part of the monetary policy effect is through influencing expectations among participants in the economy. Mrs Wickman-Parak's view is that the Riksbank, by publishing its own interest rate forecasts, improves the opportunities to influence interest rates with longer maturities by influencing the general public's expectations of future repo rates. According to the Deputy Governor, this proved very useful during the financial crisis. Publishing the interest rate path also provides the opportunity to describe alternative scenarios for future economic developments and the consequences they would have for monetary policy. Alternative scenarios are published not merely for economic developments, but also for the repo rate path, which shows different monetary policy alternatives.

The introduction of the repo rate path was accompanied by misgivings. There were fears that confidence in the Riksbank might be harmed if the actual repo rate in the future deviated from the earlier forecast. There was concern that the Riksbank might hesitate to change the repo rate forecast for reasons of prestige, even if circumstances indicated this was necessary. However, this fear has come to nought.

What role do the differences between market expectations and the Riksbank's interest rate forecasts play? Owing to increased uncertainty these deviations have become larger since the financial crisis erupted. Since 2007, there has been no systematic deviation in expectations (the average deviation is approximately zero for the three years). Nevertheless, one might ask why market expectations deviate from the Riksbank's forecast. Mrs Wickman-Parak points out that expectation cannot be observed, they can only be estimated. Some of the deviations may thus be due to various market premia. Deviations may also arise if the markets do not share the Riksbank's view of economic developments, i.e. not only of future inflation and growth, but also of future interest rates, due to different views regarding the transmission mechanism and the effects of the repo rate on the economy.

According to Mrs Wickman-Parak, the repo rate path facilitated communication during the financial crisis, since it expressed the Riksbank's monetary policy intentions during an uncertain situation. When the repo rate was cut to 0.25% in July 2009, its path signalled a low repo rate for a long period ahead. Mrs Wickman-Parak believes that publishing the path at the time gave the Riksbank an advantage over many other central banks, who tried to use purely verbal methods to signal that their policy rates would be low for a long time. The existence of the published repo rate path in connection with cutting the repo rate to 0.25% provided credible evidence that a low interest rate over a long period of time was what was needed to keep inflation close to the inflation target and to anchor inflation expectations close to the target, something which is so important for an inflation targeting regime. As Mrs Wickman-Parak put it, the Riksbank put its cards on the table.

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