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In this issue

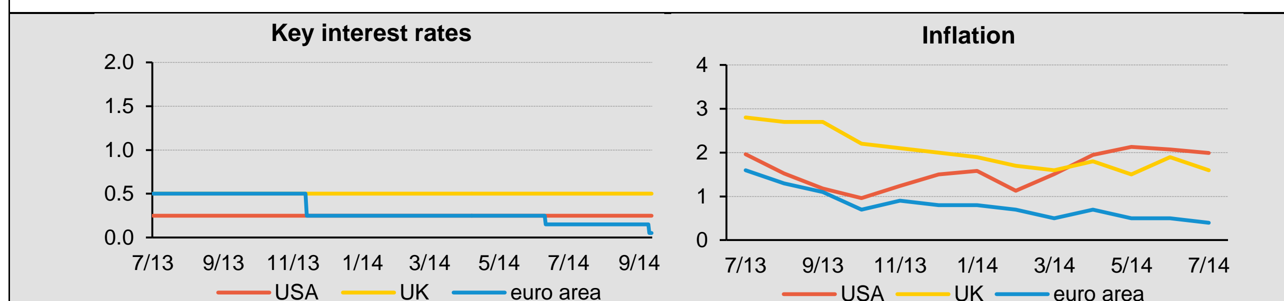
GDP growth in the USA rebounded in 2014 Q2. In July and August, the Federal Reserve further reduced the pace of its monthly asset purchases. If the US economy progresses as the FOMC expects, the purchases will be ended at the October meeting. The European Central Bank lowered its interest rate to technical zero and announced the launch of massive outright purchases of securities in primary and secondary markets as from October 2014. In this way it hopes to boost the fragile growth and steer inflation expectations towards the 2% target. The Bank of England left its interest rate unchanged and maintained the size of its asset purchase programme, reporting sustainable GDP growth above the pre-crisis level. The Riksbank lowered its policy rate in July after being surprised by unexpectedly low observed inflation and subdued domestic inflationary pressures. The Hungarian central bank continued with its series of policy rate cuts, but is expecting the rate to be stable in the period ahead. The Polish central bank left its rate unchanged, even though inflation turned negative for the first time in July. By contrast, the central bank of New Zealand continued to raise its key interest rate. With the prospect of sustainable GDP growth, the RBNZ is returning rates to a more neutral level. The current Spotlight *deals with the exit from unconventional monetary policy instruments. Our* Selected Speech *is by Fed Chair Janet L. Yellen, who presented her observations on US labour market dynamics at the prestigious annual Jackson Hole symposium.*

1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	< 2%[2]	2%
MP meetings (rate changes)	3 Jul (0.00) 7 Aug (0.00) 4 Sep (-0.10)	17–18 Jun (0.00) 29–30 Jul (0.00)	9–10 Jul (0.00) 6–7 Aug (0.00) 3–4 Sep (0.00)
Current basic rate	0.05%	0–0.25%	0.50%
Latest inflation	0.3% (Aug 2014)[3]	2.0% (Jul 2014)	1.6% (Jul 2014)
Expected MP meetings	2 Oct 6 Nov 4 Dec	16–17 Sep 28–29 Oct	8–9 Oct 5–6 Nov 3–4 Dec
Other expected events	4 Dec: publication of forecast	15 Oct: publication of Beige Book	13 Nov: publication of Inflation Report
Expected rate movements[4]	→	→	↑

[1] ECB definition of price stability; [2] January 2012 definition of inflation target; [3] flash estimate; [4] direction of expected change in rates in coming quarter taken from Consensus Forecast survey.



At its September meeting, the **ECB** cut its rates by 0.10 pp, the repo rate to technical zero (0.05%) and the deposit rate to -0.20%. It confirmed it would not lower rates further. It also decided to start purchasing ABSs and will again buy covered bonds issued by MFIs. It will launch the two programmes in October. The details will be announced after the October meeting. This decision was approved by a comfortable majority, but not unanimously. There is, however, unanimous agreement that the ECB should use other unconventional measures as needed. The decision was motivated by new data suggesting that the fragile recovery in GDP growth, which was flat in Q2, i.e. below the ECB forecast, is stalling. The inflation forecast was reduced to 0.6% for 2014 and remains at 1.1% and 1.4% for the next two years.

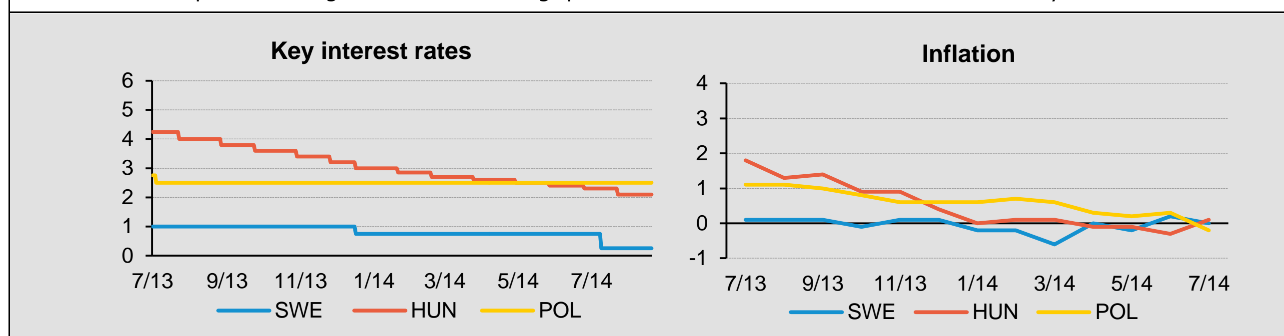
The **Fed** assessed the domestic economic situation as relatively favourable. GDP growth rebounded in 2014 Q2. Household consumption and business investment both rose moderately. Labour market conditions also improved, with the unemployment rate declining further. There remains significant underutilisation of labour resources, but the Fed assesses the favourable trends as sustainable. At both meetings, it announced further reductions in the pace of its bond purchases, from USD 45 billion to USD 35 billion per month as from July and to USD 25 billion per month as from August. If the economy progresses as the FOMC expects, the purchases will be ended at the October meeting. The Fed expects to maintain very low interest rates for a considerable time after the asset purchase programme ends, provided that inflation expectations remain well anchored.

The **BoE** left its interest rate at 0.50% and maintained the size of its asset purchase programme. In August, however, two MPC members voted for a rate increase. Robust economic growth took GDP above the pre-crisis level while the unemployment rate fell sharply. The data suggest a sustainable recovery in productivity and growth in real household incomes. Inflation is close to the BoE’s target and should stay there in the period ahead.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	2 Jul (-0.50) 3 Sep (0.00)	24 Jun (-0.10) 22 Jul (-0.20) 26 Aug (0.00)	1–2 Jul (0.00) 19 Aug (0.00) 2–3 Sep (0.00)
Current basic rate	0.25%	2.10%	2.50%
Latest inflation	0.0% (Jul 2014)	0.1% (Jul 2014)	-0.2% (Jul 2014)
Expected MP meetings	27 Oct 15 Dec	23 Sep 28 Oct 25 Nov	7–8 Oct 4–5 Nov 2–3 Dec
Other expected events	28 Oct: publication of Monetary Policy Report	24 Sep: publication of Quarterly Report on Inflation	1/2 Nov: publication of Inflation Report
Expected rate movements[1]	→	→	→

[1] Direction of expected change in rates in coming quarter taken from Consensus Forecast survey.



The **Riksbank** lowered its policy rate by 0.5 pp to 0.25% in July and held it at this level in September. The Swedish economy is strengthening, but the GDP growth outlook for 2014 and 2015 was revised downwards. Inflation, which is now fluctuating around zero, will also be lower than forecasted in April. The bank was also surprised by subdued inflationary pressures in the domestic economy. The forecast was also affected by lower foreign inflation and interest rate outlooks. Rates are not expected to increase before the end of 2015. The bank again pointed to the rising level of household indebtedness and related risks and called for relevant measures in this area.

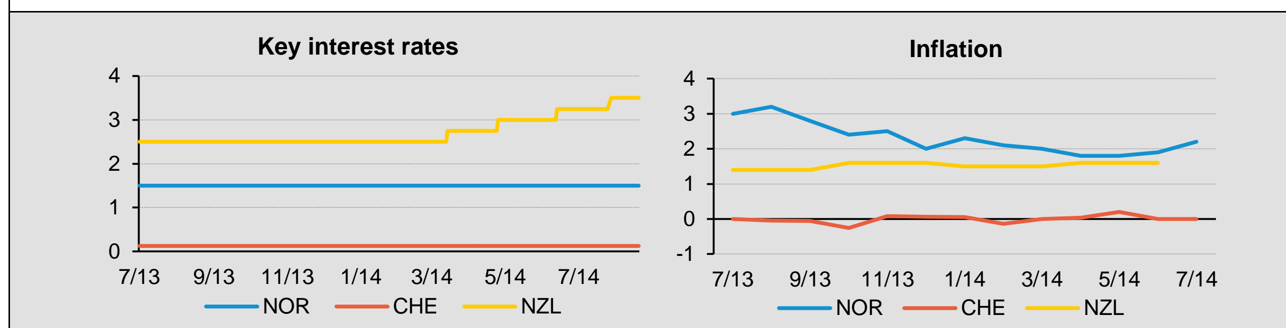
The **MNB** lowered its monetary policy rate at two of the three meetings in the last quarter: by 0.10 pp in June and 0.20 pp in July, i.e. by a total of 0.30 pp to 2.10%. The return of GDP to its potential will be slow, as capacity is not fully utilised. Domestic demand is rising, but exports are recovering only gradually. Unemployment is still falling, but remains above the natural rate. Inflation returned above zero (0.1%) in July after being slightly negative for three months. The MNB expects it to return to 3% at the end of the forecast horizon provided that the monetary conditions remain easy. The MNB also stated in July that – after a significant cumulative reduction of 490 bp over the last two years – it now expects the base rate to be stable at the current level. The MNB's August decision confirmed this statement.

The **NBP** left its monetary policy rate unchanged at 2.50%. After having fallen gradually to zero in previous months, inflation turned negative for the first time in July (to -0.2%), owing mainly to a decline in food prices and lower core inflation. The virtually zero inflationary pressures are accompanied by very low inflation expectations of businesses and households. GDP growth slowed slightly in Q2. Increased uncertainty about future economic developments in Poland was thus the main motivation for leaving rates unchanged. The NBP does not rule out a further rate reduction if the incoming data confirm a further weakening of economic activity, which would keep inflation well below the target in the medium term.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	0–2%	2%
MP meetings (rate changes)	19 Jun (0.00)	19 Jun (0.00)	12 Jun (+0.25) 24 Jul (+0.25)
Current basic rate	1.50%	0.00–0.25%[1]	3.50%
Latest inflation	2.2% (Jul 2014)	0.0% (Jul 2014)	1.6% (2014 Q2)
Expected MP meetings	18 Sep	18 Sep	11 Sep 30 Oct
Other expected events	18 Sep: publication of Monetary Policy Report	24 Sep: publication of Monetary Policy Report	11 Sep: publication of Monetary Policy Statement
Expected rate movements[2]	→	→	↑

[1] Chart displays centre of band; [2] direction of expected change in rates in coming quarter taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey.



NB left its key policy rate unchanged at 1.50%. The arguments for lowering the rate – a modest fall in the domestic GDP growth forecast and below-target inflation – were outweighed by the risk of a build-up of financial imbalances generated by a lower rate. The uncertainty surrounding the current situation and the functioning of the Norwegian economy were also arguments for keeping the rate unchanged. It is uncertain whether house prices will stop rising at the level recorded before the decline in autumn 2013 or whether they will show longer-term growth. Two banks were newly identified as systemically important. This automatically increased their capital requirements.

The **SNB** left rates in the lower part of the 0–0.25% target range and is sticking to its commitment to maintain a minimum exchange rate of CHF 1.20 to the euro. In its statement, it confirmed that the exchange rate commitment is the right tool to avoid an undesirable tightening of monetary conditions. The inflation outlook was revised only slightly. According to the new SNB forecast, inflation will be 0.1% in 2014, 0.3% in 2015 and 0.9% in 2016. The SNB expects GDP growth of 2% for 2014 as a whole. It is continuing to monitor the risks of imbalances in the mortgage and property markets. At the end of June it increased the countercyclical capital buffer required of banks.

The increases in the **RBNZ**'s key interest rate, which started at the second monetary policy meeting in 2014, continued. The bank raised the rate by 0.25 pp at each of the last four meetings, i.e. so far by a total of 1 pp to 3.5%. With the prospect of sustainable GDP growth and rising inflationary pressures in construction and other nontradable sectors, the RBNZ is returning rates to a more neutral level. Inflation is still below the target, but strong GDP growth of 3.3% in 2014 Q1 has been gradually increasing the use of production capacity. GDP growth in 2014 is estimated at 3.7%. The New Zealand dollar seems overvalued at present and is expected to fall.

2. NEWS

Jackson Hole symposium focuses on labour markets

This year's conference of central bankers and academics in Wyoming focused on labour markets. The symposium opened with a speech by Fed chief Janet L. Yellen (see *Selected speech*). The other speakers included Mario Draghi from the ECB, Ben Broadbent from the BoE, Haruhiko Kuroda from the BoJ and Alexandre Antonio Tombini, governor of Banco do Brasil.

Central banks decide to extend US dollar liquidity-providing operations

The central banks of the euro area, the United Kingdom, Japan and Switzerland decided to continue to offer US dollar liquidity-providing operations. The operations, previously planned to be conducted until 31 July 2014, will be provided until further notice. The need for US dollar liquidity-providing operations will be assessed on a regular basis. The ECB also published an article describing its recent experience with foreign currency swap lines.

SNB and People's Bank of China enter into swap agreement

The central banks of Switzerland and China signed a bilateral swap agreement, up to a limit of 150 billion renminbi, or CHF 21 billion. The SNB was granted an investment quota for the Chinese interbank bond market in the amount of 15 billion renminbi, or just over CHF 2 billion. The SNB's foreign exchange reserves can thereby be diversified further.

MNB assesses two-year easing cycle

The Magyar Nemzeti Bank published a document assessing the effects of the unprecedented dynamism in the conduct of Hungarian monetary policy. During the two-year easing period, the MNB cut its policy rate by a total of 490 bp, from 7.00% to 2.10%. The private sector's debt burden was reduced by several hundred billion forints, and Hungary's interest expenses on its forint-denominated government debt declined by more than HUF 300 billion. In addition, the easing cycle contributes to a reduction in the external debt ratio by stimulating economic growth by a total of 1.1 pp in the two years. Both the gradual downward shift in the forint yield curve and the move towards forint-denominated financing made government debt financing cheaper and more secure, while resulting in an improvement in the MNB's profit/loss. The MNB estimates that the interest rate reductions raised the average annual inflation rate by a total of 1.1 pp in two years. If interest rates had not been reduced, inflation this year would have fallen sharply into negative territory – to around -1%.

3. SPOTLIGHT: EXIT FROM UNCONVENTIONAL INSTRUMENTS, BACK TO NORMAL?

Unconventional monetary-policy instruments are being phased out as economic conditions improve, especially in the UK and the USA. The Bank of England is no longer purchasing securities, while the Federal Reserve is tapering its purchases and is expected to discontinue them at its October meeting. Both central banks are then planning to return to a standard monetary policy instrument – the interest rate, or increases thereof. However, this is not likely to occur for some time. Sales of the purchased securities will then be launched after interest rates move sufficiently far from zero, and will take place gradually with due regard to financial market developments. On the other hand, the Swiss National Bank cannot be expected to exit from its minimum exchange rate in the near future and the ECB will launch an unconventional instrument in the form of purchases of asset-backed securities only in October.

Central banks have started using various non-standard monetary policy instruments in recent years as monetary-policy interest rates have hit their lower bound. In addition to further easing the monetary conditions, there has been a need to support confidence in financial markets, lending in the economy and the functioning of the transmission mechanism. However, some banks have been gradually exiting from their unconventional instruments. Detailed procedures for returning to a standard regime are being prepared, based mainly on the level of monetary policy interest rates. The exit from unconventional measures takes various forms depending on the specific instruments used.

The exit from **liquidity-providing and lending-support programmes** is fairly obvious and straightforward – such programmes usually just expire or loans are repaid. In the event of any earlier unexpected inflation pressures, the central bank can withdraw liquidity from the economy in a different way or motivate counterparties to terminate the relevant operations earlier. In the USA these programmes started to be tapered in 2009 and 2010, but the UK's Funding for Lending Scheme is still in full flow, and in the euro area targeted long-term operations (TLTROs) will be added to the special three-year operations this year. Moreover, the ECB continues to provide fixed-rate full allotment for all standard operations.

Forward guidance has become a frequently used instrument at near-zero rates. Many central banks have started to indicate that low interest rates will be maintained for some time, with more or less specific time limits or conditional on selected indicators. With such communication, however, there is a risk of time inconsistency, with central banks promising specific actions in the future but subsequent economic conditions requiring different (tighter) monetary policy settings. Moreover, overly complex messages may confuse the markets and result in excessive speculation.

Fed's forward guidance on extending the period of low interest rates	
1/2009	"for some time"
3/2009 – 6/2011	"for an extended period"
8/2011 – 12/2011	"at least through mid-2013"
1/2012 – 8/2012	"at least through late 2014"
9/2012 – 10/2012	"at least through mid-2015"
12/2012 – 1/2014	"at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored"
3/2014 – 7/2014	"assessment will take into account a wide range of information" "for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored"

BoE's forward guidance on low interest rates	
7/2013	"MPC intends not to raise Bank Rate from its current level at least until the unemployment rate has fallen to a threshold of 7%, subject to the conditions below"
2/2014	"Despite the sharp fall in unemployment, there remains scope to absorb spare capacity further before raising Bank Rate."

Communication of the future actions of the Fed and the BoE became more complicated after both central banks were surprised by a very sharp decline in the unemployment rate (monitored as a condition for considering further steps). Neither of them considers the labour market conditions to be satisfactory. Communication can be a great help in exiting from unconventional forms of monetary policy, but strong vigilance is required as careless or misunderstood communication can give rise to shocks in markets and damage a central bank's credibility.

As regards **asset purchase programmes**, the question is how to define their termination. Do they end with the discontinuation of purchases or with the sale of all the securities purchased?

Both the Fed and the BoE, which have purchased unprecedented amounts of assets in the markets (USD 4.16 trillion and GBP 350 billion respectively), are now announcing plans of action. The BoE is currently maintaining a constant volume of purchased securities. The Fed is still making new purchases, albeit at a falling pace, and will probably end them completely at the end of this year (according to the minutes of the FOMC meeting in June, purchases will be ended in October if the economy progresses as expected).

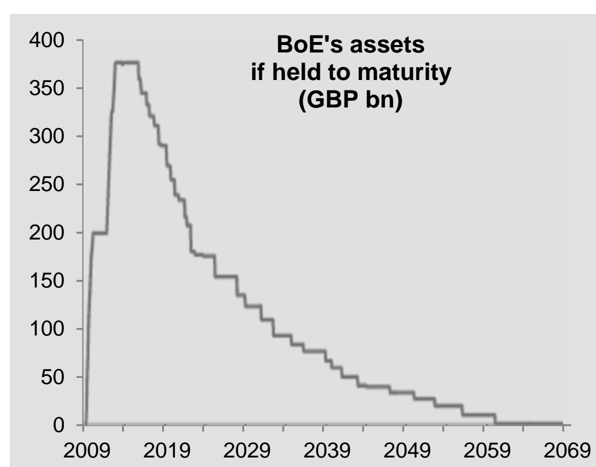
Both the Fed and the BoE are intimating that the interest rate will not increase immediately after the purchases end, but some time later. Moreover, the BoE has announced that the rate increase will be very gradual and limited and the rate will remain below the historical average for some time. Influencing market interest rates from below, mostly via liquidity-absorbing central bank operations, will play a key role in both economies for a while.

Only when the interest rate is sufficiently far from zero, it will be possible to sell off the purchased securities. The sales will probably be gradual and will have to take into account the current economic conditions and the response of the financial markets so as not to cause excessive volatility. However, as expected by the BoE, the upward pressure on yields from the sale of assets will be smaller than the decrease in yields caused by the purchase of the assets, since the markets will be functioning normally at the time of the sale. The BoE currently holds around 40% of total standard government bonds. The sale of those bonds is likely to give rise to a corresponding decrease in other types of assets held by private investors. It will therefore be necessary to sell in a manner that will not disturb the stability of the government bond market and crowd out private sector bonds.

The interest rate will remain the key instrument even after the sell-off begins. The balance sheet will be set on automatic pilot, as FOMC member William C. Dudley puts it. The assets purchased by the Fed and the BoE have a wide range of maturities. If the BoE decided to hold the purchased securities to maturity, they would remain in its balance sheet for several decades, as the average weighted maturity is more than 12 years. A large proportion of the assets held by the Fed also have long maturities.

The principles of the exit strategy outlined by the Fed in June 2011 have meanwhile changed. The expected first step had been to stop reinvestments of principal payments. With the passage of time, and probably also given the markets' often oversensitive response to information disclosures, the FOMC members have concluded that such a decision might complicate communication and indicate a tightening of the conditions without the FOMC meaning to do so. Moreover, as it is desirable to move from zero rates in order to gain monetary policy flexibility, an increase in rates should be the first step. The 2011 strategy had also assumed the sale of agency mortgage-backed securities, but in June 2013 the Fed issued

a statement that this step would probably not occur. However, some of those securities might be sold in the longer term.

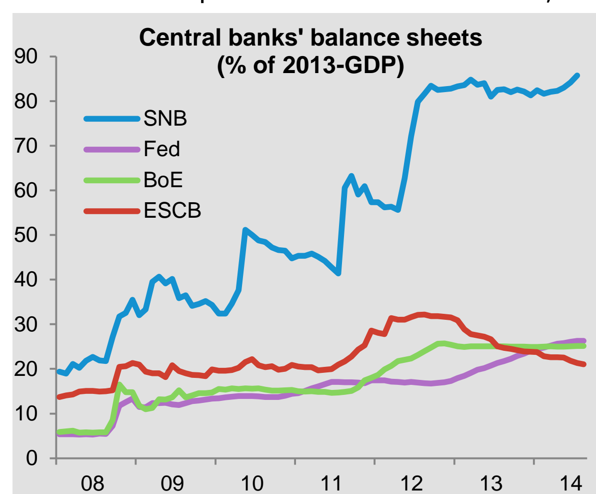


At the FOMC meeting in July 2014, most participants agreed that the rate of interest on excess reserves (IOER) should play the main role during the return of monetary policy to normal, that an overnight reverse repo facility (ON RRP) could play a supporting role by helping to firm the floor under market interest rates, and that the spread between those rates should be near or above the current level of 20 bp. A few participants suggested that the FOMC should also be prepared to use term deposits and term reverse repurchase agreements. Most participants agreed that the federal funds rate, or its target range, should remain a communication instrument. There was a preference for not ending reinvestments of maturing securities until rates are increased; a number of FOMC members prefer a gradual and smooth decline in the Fed's balance sheet. Participants expressed a preference for a simple and clear approach that would facilitate communication to the public and enhance the credibility of monetary policy. It was deemed useful to develop a plan and present it to the public later this year.

Fed's assets
maturity distribution (USD bn, August 2014)

	< 1 y	1–5 y	5–10 y	> 10 y
U.S. Treasury securities	3	1 022	756	655
Federal agency debt securities	6	33	0	2
Mortgage-backed securities	0	0	4	1 674

The least informative central bank as regards the termination of unconventional monetary policy is the Swiss National Bank (SNB), which in September 2011 introduced an **exchange rate commitment**: the Swiss franc must not appreciate below CHF 1.20 against the euro. The easiest way out for the SNB would be to allow a market depreciation of the franc further from this level. Since the SNB has repeatedly called this exchange rate level too strong, it is possible that if the franc does not depreciate further from the commitment level on its own, this instrument will become part of Swiss monetary policy on a long-term basis. Since the commitment level has not changed throughout its existence despite deflation and strong anti-inflationary pressures, it seems that the reasons for changing the level would have to be very strong. Communication remains very strict and uniform. At a press conference in June, the Chairman of the Governing Board of the SNB Thomas Jordan stated in an answer to a question that a reduction in interest rates to negative levels was another possible instrument. When asked about the duration of the exchange rate commitment, Jordan said that this could not be predicted at the moment and would depend on current economic conditions and that the minimum exchange rate was the right instrument for the foreseeable future. Asked about a possible increase in the minimum exchange rate level, he repeated that the current level was appropriate for now.



The Swiss variant gave rise to the largest balance sheet increase, as the SNB had to

purchase large amounts of foreign currencies when it introduced the foreign exchange commitment and again in the first half of 2012 due to the euro area debt crisis. While the Fed and BoE balance sheets have grown to "only" around a quarter of annual GDP, the SNB balance sheet is nearing Switzerland's total annual economic activity. The franc has been at slightly weaker levels since the start of 2013. The average exchange rate this year (as of August) is CHF 1.23 to the euro, deviating by 2.15% on average from the commitment level. However, it is currently difficult to imagine a return to the pre-crisis balance sheet size.

A return to normal, standard monetary policy is also mentioned in connection with the exit from unconventional instruments. However, it can be assumed that the post-crisis economic situation will be very different and monetary policy will not be the same as before. Voices from the BoE and the Fed agree that equilibrium rates will be lower than in the pre-crisis period. The recession has affected households' and firms' perceptions, so higher saving and lower investment will be observed for some time. Moreover, public and private deleveraging will continue. The labour force will grow more slowly due to population ageing, and this, together with low productivity growth, will imply lower potential GDP growth, which is usually positively correlated with real equilibrium interest rates in large closed economies. Global interest rates may also be squeezed by high savings in China. The question, then, is whether the future of monetary policy can be considered a return to "normal" or a new reality.

4. SELECTED SPEECH: LABOUR MARKET DYNAMICS AND MONETARY POLICY

At the Jackson Hole symposium in August, Fed Chair Janet L. Yellen gave a speech on labour market dynamics and their implications for monetary policy.

In the last five years, the US economy has made considerable progress in recovering from the large loss of employment induced by the Great Recession. The unemployment rate has fallen considerably and at a surprisingly rapid pace over the past year. However, as Yellen notes, the labour market has yet to fully recover. With maximum employment being one of the Fed's two monetary policy objectives, assessing how far the economy stands from this goal is of key importance. However, such judgments are complicated by ongoing shifts in the structure of the labour market and have been especially challenging recently, as the severe recession might have caused persistent changes in the labour market's functioning. According to Yellen, the assessment of labour market slack must be based on a wide range of variables and will require difficult judgments about the cyclical and structural influences in the labour market.

Yellen presents some important issues related to the assessment of the current labour market slack. For example, part of the decline in the participation rate clearly relates to the ageing of the baby boom generation. The drop can be attributed to increases in retirement, disability, school enrolment and other reasons, including worker discouragement. Moreover, the number of people who are employed part-time but want full-time jobs is elevated. This may be linked with the shift in employment towards services or to the continuing decline of middle-skill jobs. Additional indications of the strength of the labour market are provided by the quits and hiring rates. To summarise the information on labour market conveniently, Fed staff have developed a labour market conditions index based on 19 different labour market indicators.

In Yellen's view, for much of the past five years there has been obvious slack in the labour market and significant risks of below-target inflation, so the need for extraordinary accommodation has been unambiguous. The FOMC's emphasis is now naturally shifting to the degree of remaining slack, how quickly that slack is likely to be taken up, and thereby to the question of under what conditions the Fed should begin dialling back its extraordinary accommodation. Yellen also recalls the role of unemployment in the Fed's forward guidance, including the introduction of a 6.5% threshold for the unemployment rate. With the unemployment rate quickly declining and nearing the threshold, the FOMC recast its forward guidance, stating that a wide range of information on the labour market will be considered.

Some have argued that, given the uncertainties associated with estimating labour market slack, policymakers should focus mainly on inflation developments. To take an extreme case, if labour market slack was the dominant and predictable driver of inflation, labour market indicators could be largely ignored and the behaviour of inflation should be looked at. In present circumstances, with inflation still running below the FOMC's 2% objective, such an approach would suggest that policy accommodation could be maintained.

According to Yellen, however, historically, slack has accounted for only a small portion of the fluctuations in inflation. Besides, unusual aspects of the current recovery may have shifted the relationship between a tightening labour market and rising inflation pressures. For example, if downward nominal wage rigidities created a stock of pent-up wage deflation during the downturn, observed wage and price pressures might be unusually low for a time. Conversely, profound dislocations in the labour market in recent years may cause inflation pressures to arise earlier, before the slack in the labour market declines. In this case, tightening monetary policy as inflation moves back towards the target might stop labour markets recovering fully. As Yellen concludes, these complexities are issues that the FOMC will need to grapple with.

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