Monitoring centrálních bank - září 2012

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2012

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CENTRAL BANK MONITORING – SEPTEMBER

2012

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CNB CZECH NATIONAL BANK

In this issue

Economic activity in advanced economies remains subdued and uncertainty regarding future developments in the euro area persists. In Switzerland and Norway, activity on the mortgage market is rising significantly and household indebtedness is increasing in parallel. The ECB lowered its key interest rate by 0.25 pp to 0.75% in July. The Hungarian and Swedish central banks eased monetary policy too. The Swiss National Bank is still maintaining the minimum exchange rate of the franc to the euro at CHF 1.20/EUR. The remaining central banks under review left their key interest rates unchanged, and stable rates are expected in the coming quarter for all the monitored central banks except the Hungarian central bank, which is expected to lower its rates. The latest Spotlight *looks at financial stability issues from the monetary policy perspective. The final section summarises a speech given by New Zealand central bankers on debt and its implications for monetary policy and financial stability.*

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)	5 Jul (-0.25) 2 Aug (0.00) 6 Sep (0.00)	19–20 Jun (0.00) 31 Jul–1 Aug (0.00)	4 Jul–5 Aug (0.00) 1–2 Aug (0.00) 5–6 Sep (0.00)
Current basic rate	0.75%	0–0.25%	0.50%
Latest inflation	2.6% (Aug 2012)[3]	1.4% (Jul 2012)	2.6% (Jul 2012)
Expected MP meetings	4 Oct 8 Nov 6 Dec	12–13 Sep 23–24 Oct	3–4 Oct 7–8 Nov 5–6 Dec
Other expected events	6 Dec: publication of forecast	10 Oct, 28 Nov: publication of Beige Book	14 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.

Key interest rates

2.0 1.5 1.0 0.5 0.0

8/11 10/11 12/11 2/12 4/12 6/12 8/12

euro area USA GB

Inflation

6 5 4 3 2 1 0

7/11 9/11 11/11 1/12 3/12 5/12 7/12

euro area USA GB

The **ECB** lowered its key rate by 0.25 pp to 0.75% in July but did not reduce it any further at the following meetings. Given the high energy prices and increases in indirect taxes in some euro area countries, inflation rate is expected to remain above 2% throughout 2012 but is likely to drop below this level in the course of next year. Inflation expectations continue to be firmly anchored. The ECB expects economic growth in the euro area to remain weak in 2013, with ongoing tensions in financial markets and heightened uncertainty. At the meeting in September, the ECB decided on the modalities for undertaking Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area (see *News*).

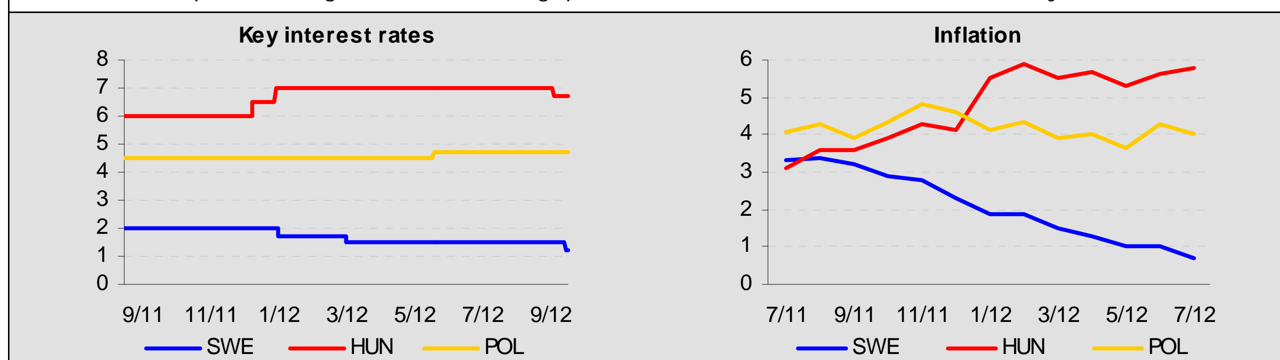
The **Fed** left its key interest rate unchanged and plans to keep rates at the present level until late 2014. It also decided to continue its programme to extend the average maturity of its government bond portfolio. Economic activity in the USA slowed in 2012 H1. Employment growth has been slow in recent months and the unemployment rate remains elevated. Household spending has been rising at a slower pace than in the first half of this year. Despite some further signs of improvement, the housing sector remains depressed. Inflation has declined since earlier this year, mainly reflecting lower prices of crude oil and petrol, and longer-term inflation expectations have remained stable.

The **BoE** maintained its key interest rate at 0.50% and made no changes to its Asset Purchase Programme. Economic activity in the UK is weak and the BoE does not expect it to improve in the near future. The inflation rate fell sharply (from 3.5% in March to 2.4% in June) and the Monetary Policy Committee expects it to decline further in the course of 2013, to below the 2% target. Growth in private sector employment is puzzlingly robust for the BoE given the fall in output.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	3 Jul (0.00) 5 Sep (-0.25)	26 Jun (0.00) 24 Jul (0.00) 28 Aug (-0.25)	3–4 Jul (0.00) 21 Aug (0.00) 4–5 Sep (0.00)
Current basic rate	1.25%	6.75%	4.75%
Latest inflation	0.7% (Jul 2012)	5.8% (Jul 2012)	4.0% (Jul 2012)
Expected MP meetings	25 Oct 18 Dec	25 Sep 30 Oct 27 Nov	2–3 Oct 6–7 Nov 4–5 Dec
Other expected events	20 Oct: publication of Monetary Policy Report	27 Sep: publication of Quarterly Report on Inflation	mid-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 monetary policy rate by 0.25 pp to 1.25% in September. It expects the repo rate to remain at this level until the middle of 2013. Swedish GDP growth was unexpectedly strong in the first half of this year, but the Riksbank expects a slowdown in the quarters ahead. In recent months, the krona has appreciated faster than expected in July. As a result, the current forecast for cost pressures and the inflation rate has been lowered. However, according to the Riksbank, economic activity will gradually recover and inflationary pressures will increase in 2013.

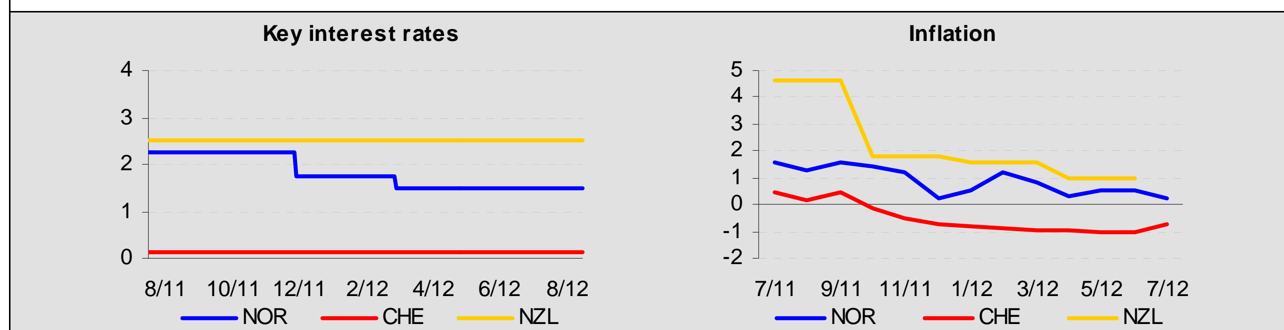
The **MNB** cut its monetary policy rate by 0.25 pp to 6.75% in August. Inflation remains above the target, still reflecting the effects of higher taxes and commodity price increases. The impacts of the Structural Reform Programme will foster higher inflation in 2013. Activity is already weakening in the Hungarian economy; GDP has been declining for two consecutive quarters (according to preliminary estimates, GDP declined by 1.2% quarter on quarter in Q2). According to the MNB, the sharp slowdown in external demand is pulling down on the outlook for Hungarian exports. In addition, the MNB expects domestic demand to fall further in the coming quarters.

The **NBP** decided to keep the monetary policy interest rate unchanged at 4.75%. GDP growth slowed significantly more in 2012 Q2 than expected by the NBP. Growth of consumption and investment expenditure decreased. Change in inventories made the biggest negative contribution to GDP growth, while net exports were a positive contributor. Lending to households and corporations also slowed. Inflation remained above the target, despite falling to 4.0% in July. At the same time, inflation expectations remain elevated.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[1]
MP meetings (rate changes)	20 Jun (0.00) 29 Aug (0.00)	14 Jun (0.00)	14 Jun (0.00)
Current basic rate	1.50%	0–0.25%[2]	2.50%
Latest inflation	0.2% (Jul 2012)	-0.7% (Jul 2012)	1.0% (2012 Q2)
Expected MP meetings	31 Oct 19 Dec	16 Sep 16 Dec	13 Sep
Other expected events	31 Oct: publication of Monetary Policy Report	20 Dec: publication of Monetary Policy Report	13 Sep: publication of Monetary Policy Statement
Expected rate movements[3]	→	→	→

[1] Centre of 1–3% target band; [2] chart displays centre of band; [3] direction of expected change in rates in coming quarter taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey.



Norges Bank (NB) kept its key monetary policy rate unchanged at 1.50%. The external situation and the strong Norwegian krone are fostering low inflation. The Norwegian economy is growing at a solid pace. Both employment and the labour supply are growing, while unemployment remains low. However, household debt and house prices are rising faster than household income.

The **SNB** is maintaining rates within a range of 0–0.25%. At its June meeting, it confirmed its commitment to enforce the minimum exchange rate of CHF 1.20/EUR and is prepared to buy foreign currency in unlimited quantities if this limit is exceeded. However, it considers the Swiss franc to be very strong even at the current rate. It expects an inflation rate of -0.5% in 2012 and 0.3% in 2013. According to the SNB, there is no risk of inflation in Switzerland in the foreseeable future. The imbalances in the Swiss mortgage and property markets are increasing. In response to these growing imbalances, the SNB even considered introducing a countercyclical capital buffer.

The **RBNZ** left its key rate unchanged at 2.50%, commenting that inflation is restrained and is expected to stay near the middle of the target range. The RBNZ slightly lowered its forecast for economic growth, mainly because of uncertainty surrounding the situation in the euro area and a weaker trading partner outlook. According to the RBNZ's assessment, the sources of growth are shifting from foreign activity towards domestic demand. Positive developments are visible in construction, partly due to earthquake damage repairs. However, fiscal consolidation is acting in the opposite direction on domestic demand.

2. NEWS

ECB specifies conditions for transactions in secondary bond markets

The European Central Bank has announced new programme of the Eurosystem's outright transactions in secondary sovereign bond markets, known as Outright Monetary Transactions (OMTs), that aim at safeguarding an appropriate monetary policy transmission. The OMTs will be conducted in bonds of countries that make use of EFSF/ESM financial assistance and the purchases will be strictly conditional on adherence to an appropriate macroeconomic adjustment programme. They will be focused on sovereign bonds with a maturity of between one and three years. No ex ante quantitative limits are set. In case of debt restructuring, the Eurosystem will accept the same treatment as private or other creditors. Publication of the average duration of OMT holdings and the breakdown by country will take place regularly. The ECB simultaneously terminated the Securities Markets Programme (SMP).

ECB further relaxes eligibility criteria for collateral in Eurosystem credit operations

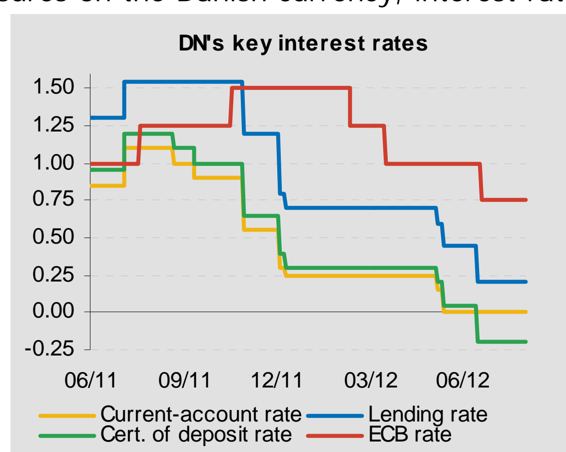
The ECB reduced the rating threshold for certain asset-backed securities (ABSs) in June with the aim of increasing collateral availability. It also expanded the list of eligible ABSs. The newly eligible securities must satisfy additional requirements, and higher valuation haircuts are applicable. ECB took further steps to relax the conditions in September, when it suspended the application of the minimum credit rating threshold for the debt instruments of countries under an EU-IMF programme in general.

Fed and US Treasury agree reduction in credit protection for TALF

The credit protection provided by the US Treasury for the Term Asset-Backed Securities Loan Facility (TALF) was reduced from USD 4.3 billion to USD 1.4 billion in June. TALF was introduced in March 2009 to increase credit availability to American households and businesses. It was originally authorised to lend up to USD 200 billion, with the Treasury's Troubled Asset Relief Program (TARP) providing USD 20 billion in credit protection. Most TALF loans have been repaid. TALF loans outstanding currently total around USD 5 billion. According to the Fed, the programme has experienced no losses to date.

Danish monetary policy deposit rate negative as from July

Danmarks Nationalbank (DN) lowered its monetary policy rates in early July. The seven-day deposit rate was reduced to a negative value of -0.20%. Danish monetary policy, which is based on a fixed exchange rate against the euro with an official fluctuation band of ±2.25%, uses interest rates as the main instrument, with interventions employed to stabilise the currency in the short term. When there are no pressures on the Danish currency, interest rate setting reacts to the ECB's rate adjustments, as was the case in July. Besides the seven-day rate (the rate of interest on certificates of deposit) DN uses an overnight rate (the current-account rate), which stayed at 0.0%. In its most recent step the Danish central bank also increased the limit for current account deposits (from DKK 23 billion to DKK 70 billion). Funds above this threshold will automatically be subject to the seven-day rate. As of 7 September, commercial banks had DKK 69 billion on current accounts and DKK 154 billion on certificates of deposits. Negative rates on newly issued Danish government bonds also indicate investor willingness to pay for safe investments.



MNB governor and ECB raise objections to proposal to tax MNB operations

Hungarian lawmakers have submitted another controversial plan. In a proposed amendment of the original bill on financial transaction tax they have terminated the exemption of the Magyar Nemzeti Bank. The MNB's deposit transactions would be subject to the tax. As pointed out by both the MNB and the ECB, the proposed measure would impair the central bank's financial and institutional independence. Moreover, the payment of tax to the public sector by the central bank is de facto monetary financing.

MNB to publish detailed statement by Monetary Council quarterly

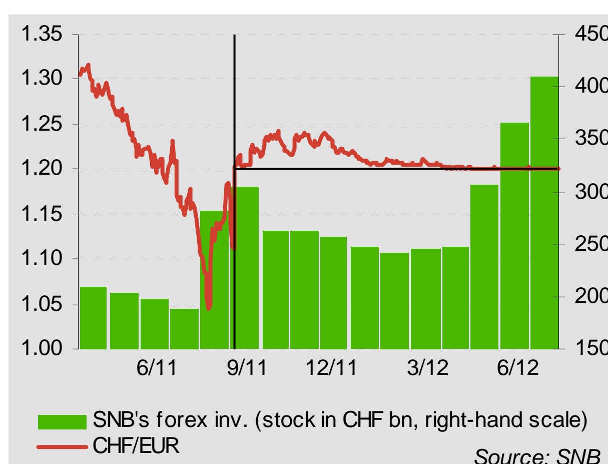
As of September and in the months when its inflation report is published, Magyar Nemzeti Bank will publish a detailed statement instead of a regular press release explaining its policy decision. The Monetary Council's statement will replace the summary of the report.

Select Committee report finds no misconduct by BoE in LIBOR incident

The Treasury Select Committee appointed by the House of Commons published its LIBOR report in August following its inquiry into the Financial Services Authority's (FSA) Final Notice with respect to Barclays. The report presents the Committee's recent findings on the manipulation of the London interbank rate. The Committee concluded, among other things, that although the BoE did not have any regulatory responsibilities for the LIBOR, it had been inactive in a situation where it was aware of the incentive for banks to behave dishonestly. The Committee noted that the BoE should have had adequate procedures in place for the making of a file note of conversations between its senior executives and stated that a much stronger governance framework was needed. The Committee called for action to be taken by the FSA, the government and the Wheatley review, which is examining the LIBOR setting process and the use of the LIBOR and is looking for ways to improve the current system and for alternatives to the interbank rate (the Wheatley review discussion paper was also published in August). The Bank of England confirmed that it is to take over responsibility for prudential supervision of financial firms through its Prudential Regulation Authority and that it already has procedures for recording conversations between senior officials and others outside the Bank. In addition, an internal audit will be carried out.

SNB continues massive interventions against Swiss franc

The Swiss National Bank is continuing to work to maintain the exchange rate above the specified minimum of 1.20 CHF/EUR, but is facing strong pressures. The SNB's foreign investments exceeded CHF 400 billion at the end of July. Owing to the interventions the SNB has become a major participant in the foreign exchange markets and there is speculation about its influence on other currencies, which it is buying up in an effort to maintain its required foreign currency reserve structure. In spite of this, the proportion of euro investments increased from 51% in Q1 to 60% in Q2. A total of 85% of the SNB's foreign investment is held in government bonds. The SNB declared a minimum exchange rate of franc against the euro on 6 September 2011. Since then SNB has strongly confirmed its commitment, saying that it will buy foreign currencies in unlimited quantities to maintain the required minimum exchange rate.



3. SPOTLIGHT: FINANCIAL STABILITY FROM THE MONETARY POLICY PERSPECTIVE

Since the outbreak of the global financial and economic crisis, increased attention has been focused on preventing similar situations in the future in addition to finding the fastest possible and least painful ways of overcoming it. The crisis has given rise to many questions: How can financial stability be maintained in a deeply integrated world with constant innovation? Who should be responsible for such stability? What is the role of monetary policy in this regard? In the search for answers, new challenges are emerging for macroprudential policy, which is supposed (at least partially) to fill the gap that neither financial market regulation and supervision nor monetary policy can reach. Despite the establishment of new institutions and instruments, however, financial stability issues are still highly relevant to monetary policy. It is vital to keep in mind the link between the objectives of price and financial stability and to assess and take into account the mutual effects of the instruments used. A transparent approach is also crucial.

At present, most economists are still focusing their thoughts on the global economic and financial crisis and the subsequent crisis in the euro area. Besides searching for who is to blame and for possible solutions to the current economic problems, increased attention is being paid to finding appropriate preventive measures. Alongside monetary policy and supervision of financial institutions, there is therefore room for macroprudential policy, which is supposed to focus on identifying and preventing systemic risks to financial stability (while supervisory institutions oversee the functioning of individual institutions, macroprudential policy monitors whether the financial system is stable as a whole).

There are many arguments for adding macroprudential policy tasks to the competences of central banks. Price and financial stability objectives can overlap and the policy mix can therefore create synergistic effects. Moreover, financial stability objectives can require funds from lenders of last resort, and this function is in the hands of central banks. Another important factor is cooperation with supervisory authorities, which can be a valuable source of information for identifying systemic risks and whose work is also incorporated into central bank structures in some countries.

However, the objectives of price and financial stability can sometimes conflict. For example, if very high inflation is expected, monetary policy should be tightened. This, however, can seem unfavourable when there are concerns about the solvency of financial intermediaries, whose situation could be aggravated by such a step. Another disadvantage of integrating the two functions in the central bank is asymmetric reputational risk. A problem-free and stable financial environment does not tend to attract the attention of the media, but any disruption is watched very carefully. A reputational loss arising from the financial stability area could therefore negatively affect the ability to conduct monetary policy. So, should these policies be strictly separated in line with the idea that each goal should have its own instrument (the Tinbergen principle), or should we seek concurrent optimisation of the solution?

New Zealand is an example of a country where the monetary and financial stability functions are integrated into the central bank (supervision at both the micro- and macro-level is in the competence of the relevant departments). Similarly, these activities are integrated in Japan, where the central bank is also responsible for financial market supervision. However, many countries have established boards or committees to monitor systemic financial risks, bringing together representatives of central banks, regulatory and supervisory agencies and finance ministries and other invited experts. Such boards have been established, for example, in the USA, the UK and Sweden. In the euro area, the European Systemic Risk Board has been set up (see the table below for more details). In general, the new institutions have been vested with relatively few powers so far, but they can be expected to gain in strength and develop their own instruments. Macroprudential policy tends to be integrated into the central bank in cases where these institutions are responsible for financial market supervision in addition to

monetary policy. By contrast, inter-agency cooperation is a more natural solution in countries with independent supervisory authorities.

Despite the assignation of macroprudential policy competencies to new institutions, it still holds true that monetary policy cannot ignore aspects of financial stability. Monetary policy affects economic activity, the loan default rate (and therefore financial sector losses) and asset prices. On the other hand, macroprudential policy affects the monetary policy transmission mechanism via the functioning of financial markets. Through its instruments it influences the financial conditions, which in turn affect economic activity and ultimately also inflation. This means that macroprudential policy should be taken into account in monetary policy-making, given the interdependence of the two functions.

USA Financial Stability Oversight Council (FSOC)	Nine members representing the following institutions: the Treasury, the Fed, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Federal Housing Finance Agency, the National Credit Union Administration Board and the Consumer Financial Protection Bureau. The tenth member is an independent expert. The Council's meetings are also attended by five non-voting members: the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a selected state insurance commissioner, a chosen state banking supervisor, and a designated state securities commissioner.	The Council was established as part of a major financial reform (the Dodd-Frank Act). It determines which institutions are "systemically important" and are thus subject to stricter rules. It also initiates coordination among individual US regulators and thereby helps to identify risks.
Euro area European Systemic Risk Board (ESRB)	Consists of EU central bank governors, representatives of supervisory authorities of EU countries, representatives of the ECB, the European Commission and the European supervisory authorities (EBA, ESMA and EIOPA) and the Chairman of the Economic and Financial Committee (made up of deputy finance ministers and central bank deputy governors). It has 65 members, of which 37 are voting members. The meetings are chaired by the President of the ECB.	Monitors and assesses risks and issues warnings and recommendations to the EU, EU member states, the ESAs (EBA, ESMA and EIOPA), national supervisory authorities and the European Commission. The Board has created a list of principles for the operation of frameworks in individual EU countries and is preparing a proposal for instruments that national authorities should have at their disposal.
United Kingdom Financial Policy Committee (FPC)	The Committee members will be representatives of the Bank of England and the Financial Services Authority (FSA) and four external experts. Representatives of the Treasury and the chair of the proposed Financial Conduct Authority (FCA) will attend meetings in a non-voting capacity.	The Committee will be charged with identifying, monitoring and taking action to remove systemic risks with a view to protecting and enhancing the resilience of the financial system. Its role is currently being undertaken by an interim committee, which is preparing a list of potential instruments. The establishment of the Committee is part of a wider reform of the regulatory framework. The reform envisages the creation of a Prudential Regulation Authority (PRA) within the BoE and then of an independent Financial Conduct Authority (FCA).
Sweden Council for Cooperation on Macroprudential Policy	Three representatives of the Riksbank and three representatives of the financial supervisory authority (Finansinspektionen).	The Council assesses risks to the financial system twice a year. It also focuses on creating appropriate risk prevention instruments. Riksbank and Finansinspektionen delegates also meet with representatives of the Finance Ministry and National Debt Office to discuss crisis management issues.

Low, stable and predictable inflation helps to create a favourable economic environment, which is a basis for financial stability. By hitting its target, monetary policy can contribute to stability and to the confidence of economic agents in the smooth functioning of the economy. However, sustained low inflation and inflation expectations can paradoxically foster over-optimism, leading to excessive borrowing and asset price growth. Macroeconomic policies then have to adjust to such market behaviour. Clear communication of risks is appropriate in such cases.

Asset price imbalances are frequent topic of debate among central bankers (for details, see, for example, the September 2008 issue of CBM). Besides the fact that it is usually very difficult (if not impossible) to identify an emerging bubble on an asset market (e.g. the property market) in time, it is also hard to affect asset prices with monetary policy. This requires a very big change in the interest rate, which can, however, damage the economy and cause a marked deviation from the primary objective of monetary policy – price stability. On the other hand, fast growth in lending can be dampened by just a minor change in the interest rate, which has a significant effect on firms' borrowing decisions, especially as regards short-term funds.

A properly functioning transmission mechanism is also vital for monetary policy decisions to have the right effects. It can be affected by regulation (macroprudential instruments and how they are implemented) and by financial innovations, some of which react to the new rules. Higher capital and liquidity requirements can increase financial institutions' costs and thus also interest rates on loans offered to firms and households. This can cause economic activity to slow and inflation to decline. However, the effects of regulation on the transmission mechanism are very difficult to estimate in advance. In addition, subsequent innovations can change those effects over time. Some central banks have opted to provide liquidity in reaction to the crisis. This, too, will affect the monetary policy transmission mechanism. The instruments applied by various policies thus should not conflict with each other. It is therefore appropriate either to coordinate such decisions or find a way of achieving joint optimisation. Reducing procyclicality in the behaviour of the financial intermediation sector will help as well.

The ECB says that it takes financial stability considerations into account in its monetary policy in the form of the second pillar and that its monetary policy thus includes elements of "leaning against the wind" (i.e. reacting to an emerging bubble by cumulatively raising the rate). In its monetary policy decisions, the ECB assigns an important role to analyses of the monetary, lending and liquidity conditions, which are directly linked to asset prices. This provides a framework for monitoring long-term risks to financial stability.

Many inflation-targeting central banks – such as the Reserve Bank of New Zealand, the Bank of England, the Swedish Riksbank and the Bank of Canada – argue that their monetary policy regimes also provide room for financial stability considerations. Their protagonists point out that they do not focus strictly and unthinkingly on inflation (i.e. they are not "inflation nutters", as described by Mervyn King from the BoE), but that they perform flexible inflation targeting taking into account stabilisation of the real economy. In this respect it seems appropriate for monetary policy to consider risks to financial stability which, if they were to materialise, might have an adverse effect on price stability in the long run. Flexible inflation targeting can also resolve the problem of the various different time horizons of financial and monetary policy. However, it does have its limits. If flexibility is applied too often and too much, it can endanger the credibility, clarity and effectiveness of the monetary policy regime.

If a central bank does decide to consider financial stability issues in its monetary policy-making, it can try to integrate the financial sector directly into its modelling system. Another option is to take these considerations into account only in its decisions on the interest rate itself. According to some, monetary policy should only be used for financial stability purposes in extreme cases, when no other instruments are available or will suffice. In any event, it is appropriate to further study and analyse the links between financial stability and the real economy as well as the role of financial factors in the transmission mechanism. Given our imperfect knowledge and lack of experience, it is a good idea to examine the effect of monetary policy on financial stability and the impacts of macroprudential measures on the financial sector, the real economy and monetary policy. At the same time, the position of financial stability issues in monetary policy-making should be clear and transparent so as to ensure that it is well understood by financial markets and the public and that monetary policy remains credible and effective.

4. SELECTED SPEECH: DEALING WITH DEBT

Alan Bollard, Governor of the Reserve Bank of New Zealand, and economic adviser Michael Reddell gave a speech in Auckland about debt and its implications for monetary policy and financial stability.

Alan Bollard and Michael Reddell start by saying that although debt is not new, it has some new features – the scale of the debt, the scale of cross-border debt and the central role of highly-leveraged financial institutions and financial markets in making that debt possible. They add that debt is not a bad thing and explain how important loans are for individuals and for the economy as a whole. However, as the speakers point out, the phrase "all things in moderation" might well have been invented for debt. Although there is no consensus among researchers on what is "too much" debt, the speakers consider large increases in debt for several years in succession to be a much better indicator to watch out for. When credit is growing rapidly during an economic boom, the process tends to be self-reinforcing, lulling people into complacency about downside risks and causing them to become over-optimistic about how long the good times will last. But as booms go on, pressures build up.

New Zealand has seen big swings in public and private debt. Central government gross debt was over 100% of GDP for 70 years from the 1870s and in excess of 200% of GDP at peak. In 1972 net government debt was as low as 6% of GDP, but was back to 50% by 1992. Private debt and the net international investment position have gone through similarly wide fluctuations. Over the last couple of decades, private debt has increased substantially while the public debt has been falling. During the last three years of the boom, private sector credit rose by around 14% each year, when nominal GDP was rising at about 6%. Bollard and Reddell admit that they probably put less weight on this gap then they should have.

If they had been asked a decade ago about how New Zealand might have coped in the aftermath of a rapid build-up in debt and asset prices, the speakers might have been sanguine. Their optimistic scenario at the time would have been based on the experience of New Zealand in the early 1990s, Sweden in the 1980s and 1990s, and Korea in the 1990s. All these crises, triggered by debt excesses, were followed by strong recoveries and rapid returns to the trend level of output. But this time it looks as if the accumulated debt is acting as quite a sustained drag. In contrast to many other advanced economies, New Zealand house prices have not come down very much and the country has avoided a systemic financial crisis. Moreover, the government's debt is still much lower than in many other advanced countries. Why then, the speakers ask, is New Zealand (and some other countries) experiencing such a tepid recovery? The factors, they say, include the current idiosyncratic pressures in Europe and the global nature of the crisis, exacerbated by a situation in which many central banks cannot cut rates further. New Zealand's terms of trade also appear to have complicated the adjustment.

The speakers then outline the implications for monetary policy. In 2008/09 the monetary policy rate was cut by nearly six percentage points. But the RBNZ has been surprised at the way policy rates have needed to remain so low for so long. It looks to the authors as though something big is going on in the economy, but it is still too early to know the nature and scale of the change and how enduring it might be.

From the financial stability perspective, New Zealand banks' heavy reliance on foreign funding is an Achilles heel. Furthermore, although the banks are sound, the loans provided abundantly during the good times now pose a risk. Bollard and Reddell believe that the debt stock will probably be sustainable if commodity prices stay strong. They also consider house prices to be still somewhat overvalued. The RBNZ has therefore taken steps to require banks to hold more capital than they were doing previously.

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