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In this issue

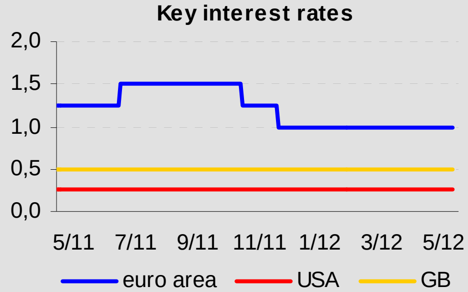
Economic activity in the Euro-Atlantic area remains subdued. Negative sentiment prevails and future developments continue to be surrounded by strong uncertainty associated mainly with Greece's potential exit from the euro area and an escalation of problems in other southern periphery countries, such as Spain, Portugal and Cyprus. The ECB left its key interest rate at 1%. The Swiss National Bank is still maintaining the minimum exchange rate of the franc to the euro at CHF 1.20/EUR. The Norges Bank was the only central bank to lower its monetary policy rate. By contrast, monetary policy tightening was recorded in Poland. The remaining central banks under review left their key interest rates unchanged. Stable rates are expected for all these central banks in the coming quarter as well. In Spotlight *we look at this year's Convergence Reports of the European Central Bank and the European Commission. Our* Selected Speech *summarises the presentation given by José Manuel González-Páramo on the challenges currently faced by the euro area.*

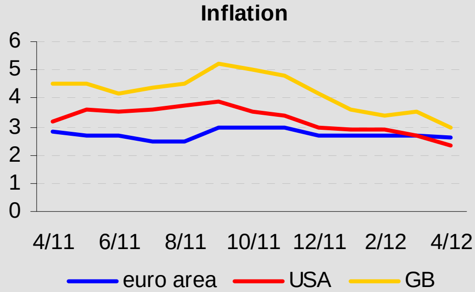
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

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)	4 Apr (0.00) 3 May (0.00) 6 Jun (0.00)	13 Mar (0.00) 24–25 Apr (0.00)	4–5 Apr (0.00) 9–10 May (0.00) 6–7 Jun (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	2.4% (May 2012)[3]	2.3% (Apr 2012)	3.0% (Apr 2012)
Expected MP meetings	5 Jul 2 Aug 6 Sep	19–20 Jun 31 Jul–1 Aug	4–5 Jul 1–2 Aug 5–6 Sep
Other expected events	6 Sep publication of forecast	18 Jul, 29 Aug: publication of Beige Book	8 Aug: 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.





The **ECB** left its key interest rate unchanged and decided to continue conducting three-month liquidity-providing operations (MROs) at a fixed rate and with full allotment. According to the forecast, real GDP growth is expected to be in a range between -0.5% and 0.3% for 2012 and between 0.0% and 2.0% for 2013. The inflation rate will stay above 2% this year. Energy prices and tax increases were identified as short-term upside risks. At the monetary policy horizon, however, the ECB expects the inflation rate to remain in line with its definition of price stability.

The **Fed** left its key interest rate unchanged and plans to keep interest 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. US economic activity expanded moderately amid slowing global economic growth. The labour market situation is improving gradually. The unemployment rate declined to 8.2%. Inflation increased somewhat, primarily reflecting higher prices of crude oil and petrol, although the FOMC assesses this effect as temporary. According to the FOMC members' expectations, inflation should be in a range between 1.9% and 2% in 2012.

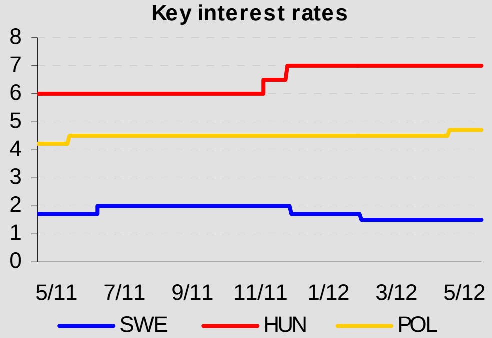
The **BoE** is maintaining its monetary policy rate at 0.50%. Its planned stock of debt securities purchases remained unchanged at GBP 325 billion and the BoE is continuing its purchases to maintain this stock. One MPC member (David Miles) voted to increase the amount by GBP 25 billion at the May monetary policy meeting. Despite falling somewhat, inflation – at 3% – remains above the inflation target. In the medium term, however, it should decrease further as the growth in energy prices and the effects of the January 2011 VAT increase drop out.

Selected central banks of inflation-targeting EU countries

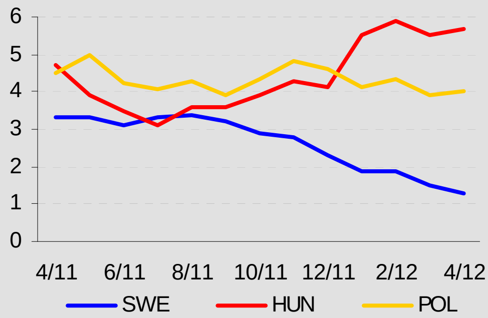
	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	19 Apr (0.00)	27 Mar (0.00) 24 Apr (0.00) 29 May (0.00)	3–4 Apr (0.00) 8–9 May (+0.25) 5–6 Jun (0.00)
Current basic rate	1.50%	7.00%	4.75%
Latest inflation	1.3% (Apr 2012)	5.7% (Apr 2012)	4.0% (Apr 2012)
Expected MP meetings	3 Jul	26 Jun 24 Jul 28 Aug	3–4 Jul 21 Aug 4–5 Sep
Other expected events	4 Jul: publication of Monetary Policy Report	26 Jun: publication of Quarterly Report on Inflation	Mid-Jul: publication of Inflation Report
Expected rate movements[1]	→	→	→

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

Key interest rates



Inflation



The **Riksbank** held its key interest rate unchanged at 1.50%. Annual GDP growth slowed significantly in the fourth quarter of 2011, but the Swedish economy is beginning to show positive signs in the form of rising exports and improving domestic demand. Households and companies are more optimistic about the Swedish economy and their own prospects. At its most recent meeting, the Executive Board of the Riksbank agreed that monetary policy needed to remain expansionary to support the Swedish economy and therefore decided to hold the repo rate at the present level. However, Karolina Ekholm and Lars E.O. Svensson proposed a further lowering of the repo rate (see here for details).

The **MNB** left its key monetary policy interest rate unchanged at 7.00%. Inflation remains above the target. The effect of tax increases is still apparent and is being reinforced by the depreciation of the forint in the second half of 2011 and the rise in oil prices in early 2012. The government's Structural Reform Programme will raise inflation in 2013. The preliminary first-quarter GDP data are indicating weaker-than-expected economic growth. According to the MNB, the sharp deterioration in the external environment has weakened the short-term outlook for Hungarian exports. In addition, the MNB expects domestic demand to fall further in the coming quarters.

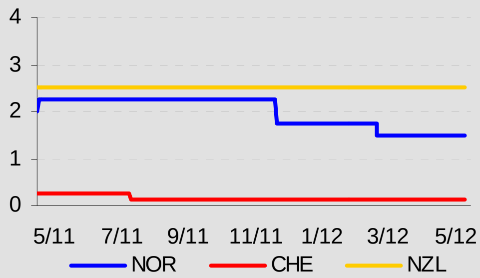
The **NBP** raised its monetary policy interest rate by 0.25 percentage point to 4.75% in May on concerns that the expected economic slowdown will not be sufficient to return inflation to the target in the medium term. The NBP's decision to change its rates also came in response to increased inflation expectations. According to the GDP data for the first quarter of 2012, economic growth showed a modest decline. Investment growth slowed in quarter-on-quarter terms and consumption remained stable. Decreases were also recorded for export and import growths. The inflation rate remained above the target, reaching 4.0% in April.

Other selected inflation-targeting countries

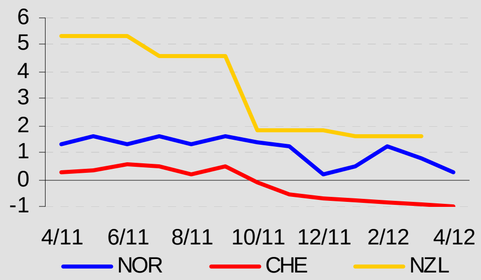
	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[1]
MP meetings (rate changes)	14 Mar (-0.25) 10 May (0.00)	15 Mar (0.00)	26 Apr (0.00)
Current basic rate	1.50%	0–0.25%[2]	2.50%
Latest inflation	0.3% (Apr 2012)	-1.0% (Apr 2012)	1.6% (Apr 2012)
Expected MP meetings	20 Jun 29 Aug	21 Jun	14 Jun
Other expected events	20 Jun: publication of Monetary Policy Report	22 Jun: publication of Monetary Policy Report	14 Jun: 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.

Key interest rates



Inflation



The **Norges Bank (NB)** cut its monetary policy rate by 0.25 percentage point to 1.50% in March. Weak growth prospects in Europe and a strong Norwegian krone are holding down inflation at a low level and restraining growth among Norwegian companies. Money market rates in Norway fell in response to the reduction in the monetary policy rate, but remain markedly higher than the monetary policy rate. In April, Norwegian banks reported in a regular survey that they had increased their margins and tightened lending standards for households and enterprises in the first quarter of 2012.

The **SNB** is maintaining rates within a range of 0–0.25%. At its March meeting, it confirmed its commitment to enforce the minimum exchange rate of CHF 1.20/EUR. It 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 is also continuing to maintain high liquidity on the money market. According to the SNB, there are no inflation risks in Switzerland in the foreseeable future. Its inflation forecast has fallen further compared to December. If developments in the international economy worsen further, or if the Swiss franc does not weaken, downside risks for price stability could re-emerge.

The **RBNZ** left its key rate at 2.50%, commenting that inflation is restrained and is expected to stay near the middle of the target range. The domestic economy is showing signs of recovery. Building activity is rising. The New Zealand dollar has stayed elevated despite recent falls in commodity prices. The RBNZ says that should the exchange rate remain strong without anything else changing, it would need to reassess the outlook for monetary policy settings.

2. NEWS

ECB and EC Convergence Reports published

At the end of May, the European Central Bank and the European Commission published their Convergence Reports for this year. The reports assess the economic and legal convergence of the eight European Union Member States with a derogation from adopting the euro. For the first time they also refer to the recent reforms of economic governance in the EU, in particular the process of prevention and correction of macroeconomic imbalances. The documents conclude that none of the countries examined is currently ready to enter the euro area. The *Spotlight* section of this issue covers the Convergence Reports in more detail.

Hungarian CB sells euros to banks to convert NPLs…

Under a law of December 2011, Hungarian credit institutions are required to convert foreign currency loans delinquent for more than 90 days into forint and forgive 25% of their claims. The MNB will therefore provide euros for institutions up to the total amount outstanding of their foreign currency loans to be converted into forints (including amounts forgiven). The aim is to reduce market demand for foreign currency and prevent potential adverse macroeconomic effects.

…introduces two-year lending facility and extends range of eligible collateral…

In April the MNB introduced a two-year lending facility for banks to support corporate lending. The facility is available once a month at the central bank base rate prevailing during the term of the loan. The MNB also broadened the range of securities it accepts as collateral.

…and raises objections to amendments of MNB Act

The MNB has warned that frequent changes to the institutional and legal framework are reducing the credibility of monetary policy. The increase of the number of members of the Monetary Council jeopardises the central bank's independence. This independence is additionally limited by the regulation of the remuneration of the Governor, which is incompatible with EU legislation. The procedures for the dismissal of the Monetary Council members are also in breach of EU legislation. The ECB raised similar objections in its opinion.

Japanese CB endeavours to support economic growth…

The Bank of Japan decided in March to increase the total amount of loans available through the Growth-Supporting Funding Facility from JPY 3.5 trillion to JPY 5.5 trillion. It established new arrangements for loans of JPY 500 billion for small-lot investments and loans to support economic growth (of up to JPY 10 million) and for US dollar loans of JPY 1 trillion equivalent from its dollar reserves. Furthermore, the deadline for other new loan applications under the Growth-Supporting Funding Facility (introduced in June 2010) was extended to the end of March 2014 and the ceiling for the total amount of loans was increased from JPY 3 trillion to JPY 3.5 trillion. The provision of loans to disaster areas is also continuing.

…and continues to apply monetary easing

In April the Japanese central bank further increased the size of its Asset Purchase Program, from JPY 65 trillion to JPY 70 trillion. It intends to purchase more government bonds.

China slightly enlarges band for daily fluctuations of renminbi in interbank market

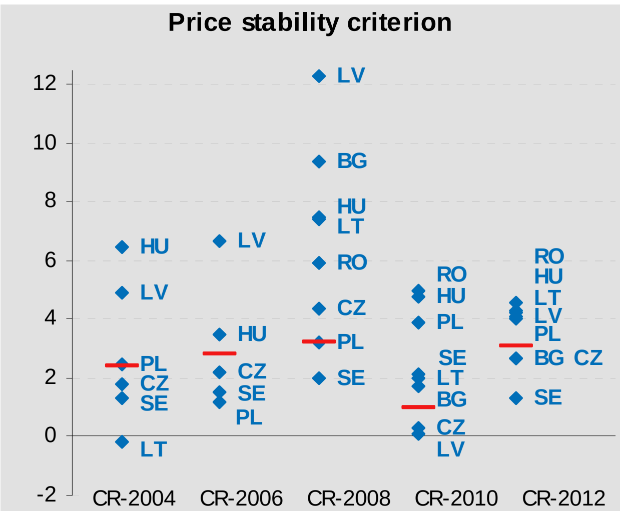
China's central bank announced an enlargement of the floating band of the renminbi's trading prices against the US dollar in the interbank foreign exchange market, from 0.5% to 1%. The fluctuation is calculated from the central parity released on each business day. The spread between the selling and buying prices will not exceed 2% of the central parity.

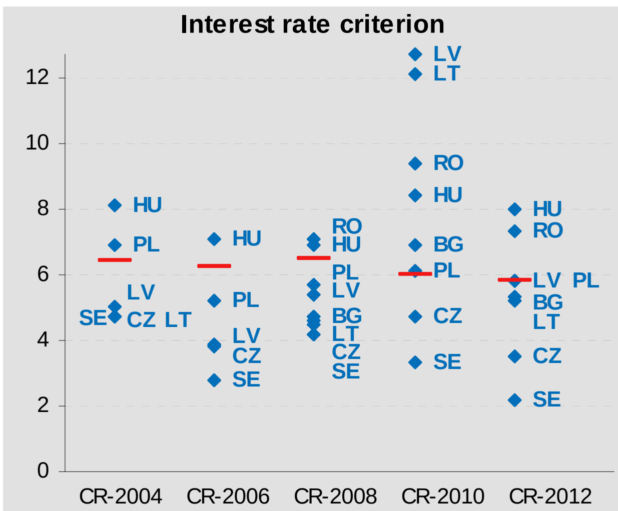
3. SPOTLIGHT: 2012 CONVERGENCE REPORTS

The Convergence Reports of the European Commission and the European Central Bank regularly assess the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union. These countries currently comprise eight Member States of the European Union: Bulgaria (BG), the Czech Republic (CZ), Lithuania (LT), Latvia (LV), Hungary (HU), Poland (PL), Romania (RO) and Sweden (SE). None of the countries examined currently fulfils all the conditions for joining the euro area. The latest results reflect the recent very gradual recovery in economic activity. Inflation has increased slightly. The fiscal criteria values reflect efforts to consolidate public finances. Sovereign risk premiums, which reached extreme levels two years ago, have now declined significantly. In addition to the usual focus on the Maastricht convergence criteria and related additional factors, this year's assessment covers reforms of economic governance and, in the case of the ECB report, also examines the quality of the institutional environment. The May Convergence Reports also include the usual assessment of legal compatibility.

Once every two years, the Commission and the ECB Convergence Reports assess convergence in EU countries which have not yet adopted the euro (except the United Kingdom and Denmark, which have an opt-out clause). The building blocks of the assessment of economic convergence are five quantitative (Maastricht) criteria, which are complemented by other monitored indicators. Emphasis is placed on examining the durability and sustainability of convergence. The developments in 2011 reflected a gradual recovery in economic activity. In the second half of the year, however, economic and financial conditions deteriorated because of adverse spillovers from the euro area.

The reference value for the **price stability criterion**, calculated by adding 1.5 percentage points to the average of the rate of inflation in the three best-performing countries in terms of price stability, was 3.1% in the reference period (i.e. from April 2011 to March 2012). The figures for Sweden (with a rate of inflation of 1.3%), Ireland (1.4%) and Slovenia (2.1%) were used in the calculation. Bulgaria, the Czech Republic and Sweden are currently below the reference value (although according to the Commission's interpretation the Czech Republic is not compliant with this criterion given the projection for 2012). The rates of inflation in the other countries examined are between 4.0% and 4.6%. Inflation has recently been affected by a slight recovery in economic growth. Changes in VAT, administered prices and excise duties have had a major effect on inflation in several countries. In small, open economies, external effects (changes in energy and food prices in particular) are adding to the volatility.

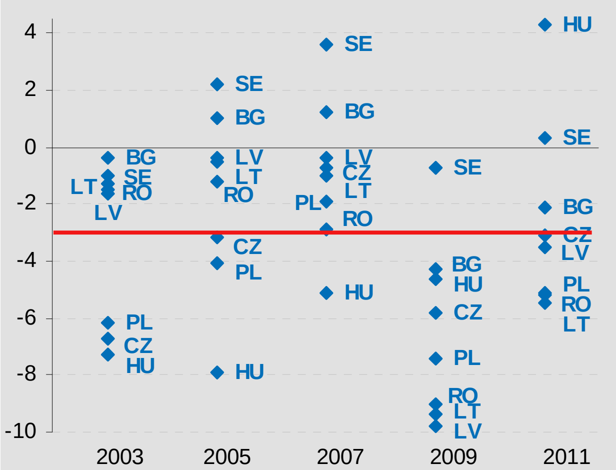




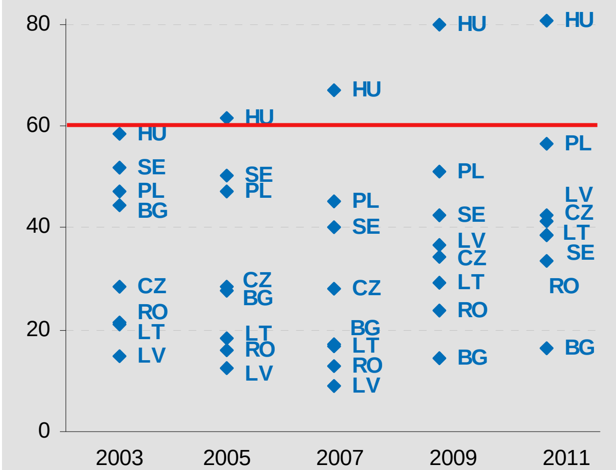
The **interest rate criterion** is regarded as an indicator of long-term convergence. It is calculated by adding 2 percentage points to the average of harmonised ten-year government bond yields in, at most, the three best-performing countries in terms of price stability. However, the extremely high level of rates in Ireland (9.1%) is not considered an appropriate measure of economic convergence and has therefore been excluded from the calculation. The reference value is thus based on the figures for Sweden and Slovenia (2.2% and 5.4% respectively) and is 5.8%. Six countries were compliant with this limit in the reference period, while Romania and Hungary exceeded it. In Romania, economic problems played a role, while Hungary was also affected by reduced investor confidence in government policies.

Fulfilment of the **fiscal criterion** consists in the country not being subject to the excessive deficit procedure. This procedure is initiated upon violation of one of two rules: (1) a government deficit of less than 3% of GDP (the "budget criterion"), and (2) government debt of less than 60% of GDP (the "debt criterion"). Moreover, as the ECB's Convergence Report emphasises, the Fiscal Compact has been approved which sets even stricter requirements for budgetary discipline (although the Czech Republic has not signed the relevant treaty).

Govt budget criterion



Govt debt criterion

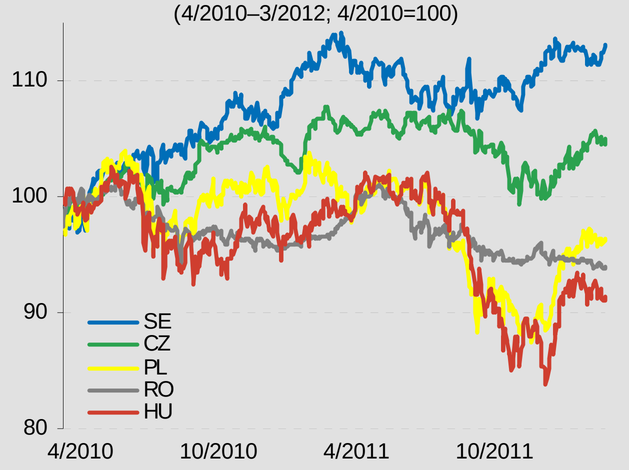


Although the budgetary situation of most of the countries under review has improved compared to the previous year, all them except Sweden are subject to the excessive deficit procedure. Besides Sweden (the only country recording a government surplus), Bulgaria currently fulfils the budgetary criterion (with a deficit of 2.1% of GDP). The Commission expects the other countries to fulfil the condition next year, the only exception being Lithuania, which is projected to post a deficit of 3.2% of GDP. Hungary recorded a general government surplus of 4.3% of GDP in 2011 on account of one-off revenues amounting to about 10% of GDP, primarily related to the transfer of assets from private pension schemes to the state pillar. The deficits in Hungary have regularly been very high in the past decade and Hungary has been subject to the excessive deficit procedure since joining the European Union in 2004. The deadline for correction has been extended twice, and the 2011 result was not recognised as fulfilment of the criterion since it was not based on a structural and sustainable correction. As a consequence, part (0.5% of GDP) of the 2013 cohesion fund commitments for Hungary, was suspended. Hungary's public budgets are reflected in its total debt, which since 2002 has increased by 24.7 percentage points to 80.6% of GDP in 2011. In the other countries examined, total debt is below the reference value. In recent years, however, it has increased in all the countries, with the exception of budget-disciplined Sweden.

The exchange rate criterion, which requires participation in ERM II without devaluation of the central rate, is met by only two countries – Lithuania and Latvia. All the other currencies except the fixed Bulgarian lev fluctuated widely against the euro. For illustration, the reports compare the exchange rates with their levels in April 2010. The Czech and Swedish currencies appreciated against the euro from mid-2010 to early 2011. All the currencies except the Swedish krona depreciated in the second half of 2011 amid renewed concerns about the debt crisis. In this period, the Polish central bank started to intervene against the weak zloty. At the start of 2012, all the currencies except the Romanian leu appreciated.

Exchange rate indices

(4/2010–3/2012; 4/2010=100)



Other factors are examined in addition to the five main quantitative criteria. These include the situation and development of the balance of payments and the development of labour costs and house prices. The Convergence Reports now also point out the need for appropriate structural policies and a stable institutional environment. Both documents also refer for the first time to recently adopted legislation reforming economic governance in the EU and defining a procedure for the prevention and correction of macroeconomic imbalances. To this end, the Alert Mechanism Report has been published containing a scoreboard with ten indicators relating to external imbalances (current account balance, net international investment position, real effective exchange rate, export market shares, nominal unit labour costs) and internal imbalances (house prices, private sector credit flow and debt, government debt, unemployment rate). According to the ECB, the imposition of the excessive imbalance procedure cannot be regarded as the achievement of a high degree of sustainable convergence. Since the new procedure is still in its first year, it has not yet been imposed on any country. However, Bulgaria, Hungary and Sweden will undergo an in-depth review this year. Romania, which is currently under a precautionary EU-IMF programme, was not examined in the Alert Mechanism Report.

Fulfilment of economic convergence criteria – summary

	HICP < 3.1% (4/11–3/12)	deficit < 3% of GDP (2011)	government debt < 60% of GDP (2011)	exchange rate – ERM II	interest rates < 5.8% (4/11–3/12)
Bulgaria	✓	✓	✓	✘	✓
Czech Republic	✓	✘	✓	✘	✓
Latvia	✘	✘	✓	✓	✓
Lithuania	✘	✘	✓	✓	✓
Hungary	✘	-	✘	✘	✘
Poland	✘	✘	✓	✘	✓
Romania	✘	✘	✓	✘	✘
Sweden	✓	✓	✓	✘	✓

Besides economic convergence, the usual room was left for an assessment of the compatibility of national legislation with European treaties. This assessment mainly covers central bank independence, the prohibition of monetary financing and privileged access of the public sector to financial institutions, and the legal integration of national central banks into the Eurosystem.

4. SELECTED SPEECH: COMPLETING THE EURO PROJECT: THE DAY AFTER TOMORROW

In a speech given shortly before his term of office ended, José Manuel González-Páramo, Member of the Executive Board of the ECB, discussed the institutional weaknesses of the single European currency and presented proposals to rectify them.

In his speech, Mr González-Páramo identifies the main challenges to the future of the euro area, in particular institutional shortcomings in the functioning of the monetary union, which are also a source of its current vulnerability. He distinguishes four key pillars for the euro's long-term stability: economic governance, crisis management and resolution, financial regulation and supervision, and monetary policy.

In the area of *economic governance*, he highlights the Fiscal Compact, which should help increase national governments' responsibility for sustainable public finances, with stricter sanctions for non-compliance. He also considers the macroeconomic imbalance procedure to be a significant improvement, providing early warnings against the build-up of potential risks such as excessive credit growth and loss of competitiveness, which became crucial for some Member States in the years before the current crisis.

A functional single *crisis management mechanism* is needed in the case when the increasing imbalances transform into a crisis. This role will be played by the European Stability Mechanism (ESM) supported by new "two-pack" legislation allowing the ESM and other European institutions to place countries experiencing severe financial pressure under enhanced surveillance. The new measures give European institutions greater powers over Member States than the US federal government has over US states.

Functional *regulation and supervision of the integrated financial market* should be the third pillar of stability of the euro. Banking supervision remains fragmented along national borders, leading in some cases to the emergence of protectionist policies. The European Systemic Risk Board (ESRB), created in 2011, should help harmonise the regulatory approach to systemically important banks. In Mr González-Páramo's view, the steps that must be taken include further integration of banking supervision, a strengthening of the role of the European Banking Authority, and the possibility of recapitalising banks through the ESM.

In the field of *monetary policy*, Mr González-Páramo focuses on the ECB's policy successes, mentioning its high credibility stemming from the stable price level and the quick deployment of unconventional measures to repair the monetary policy transmission mechanism and maintain confidence during the period of financial market turbulences.

According to Mr González-Páramo, the main challenges for the future lie in the area of joint governance: a group of representatives of 17 countries with potentially different preferences, and rights of veto and no unified communication strategy is not the optimal institutional set-up for the governance of a monetary union. Financial markets need clearly communicated, credible solutions, not a range of different opinions. Mr González-Páramo therefore views the creation of effective governance principles within a political union as the main medium-term task. This should be aided by the abolition of individual countries' right of veto in decisions on the monetary union. In his opinion, pooling decision-making powers at the monetary union level does not mean losing sovereignty. Rather, it means *sharing* sovereignty while preserving democratic principles. Only after these institutional changes become a reality and show that they can work will it make sense to debate other topics such as the federalisation of banking supervision and deposit insurance or the federalisation of fiscal policy.

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